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In Focus

ITC

BUY	Rs 194	October 17, 2006

Visit Note – Buoyant consumer demand and hikes in cigarette prices warrant an earnings revision

We met the ITC management recently for an update about developments and plans of action

Following are the key takeaways

Cigarettes division

Rising income levels, changing lifestyles increase tobacco consumption

With income levels rising and a moderate tax policy, growth in cigarettes during the year has been strong. Growth in the duality of tobacco consumption has led the growth momentum in cigarettes during the year. Thus increasing number of tobacco consumers are smoking cigarettes in addition to chewing tobacco and smoking bidis. This indicates a change in lifestyle, which stems from rising income levels and has led to the higher growth in cigarettes.

Continued growth momentum aids price hikes, to improve profitability

Pricing power has never been an issue with the cigarettes sector due to the addictive nature of cigarettes and strong brand loyalties. Thus, with the continuing strong growth, ITC has been able to hike prices of its leading brands (Gold Flake and Scissors). The Gold Flake hike has come on Gold Flake Kings, which figures in the premium filter segment. However, price hikes in the value-for-money brand Scissors, estimated to be ITC's third-largest brand (about 14% of cigarette sales) enthuses us. According to our analysis, the price hike on Gold Flake Kings is around 3% while that on Scissors is about 15-20% across three variants.

According to our interaction with the management, the price hikes have been led by the excise duty hikes in the last budget. ITC, like other FMCG players in the country, has been raising prices in steps. However we believe that the second round of price hikes would contribute to the company's profitability. The earlier price hike is estimated to have contributed about 3% to the total 11% growth in cigarettes in Q1 FY07, which in turn is estimated to meet the 5% rise in excise duty in the last budget. In the first quarter, the cigarettes division is estimated to have recorded about a 6.5% growth in volumes and about a 4.5% growth in realizations.

We further believe that in addition to increasing realizations during the year, the second round of price hikes during Sep.'06 is estimated to have led to a strong growth in volumes during Q2 FY07. This is due to the inventory pile-up with distributors and dealers, which happens just when a price hike is announced and new packs with the revised MRP are yet to come into the market.

In our current earnings estimates, we have not factored in the higher profitability from the recent price hikes and would revise our figures, post-Q2 FY07 results.

(Stock price as on October 16, 2006)

Probability of 4% VAT high

There is a high probability that VAT (at 4%) may be levied on cigarettes, as the value addition in the supply chain is lower than in other FMCG products. The estimated trade margin involved in cigarettes is a low 8-9%, against 25-30% for other FMCG products. The Kelkar Committee's recommendation on taxation, too, has not included VAT on cigarettes. This could primarily be due to the low value addition.

Further, according to the Finance Act, 2003, states could levy up to 4% VAT on the assessable value (net of excise duty). Thus VAT could be expected to be levied at 4% on the assessable value.

Increase in tobacco prices not a concern for ITC in FY07

In the last few months, prices of tobacco have been rising. However, this is not expected to hit ITC's margins, as the company carries a tobacco inventory of about 12-18 months. Thus, during FY07, the company is not expected to feel the impact of rising tobacco prices. In future, the impact could be minimized by its strong relationships with the tobacco farming community, and its strong and wide procurement network.

Non-cigarette FMCG

In non-cigarette FMCG, Foods, Lifestyle retailing and Stationery would be key growth drivers.

To focus on greater profitability in foods, through a better product mix, and cost and tax savings

The company plans to grow its biscuits business through gains in market share by focusing on premium product categories, like Cookies, carrying higher margins. It thus plans to expand its profitability in biscuits through a better product mix and cost savings in processes, logistics and taxes. This would be achieved through higher sales of high-margin products, strategically located as well as through backward-area manufacturing units and state-of-the-art technology in manufacturing. Working on these lines, ITC is setting up a state-of-the-art biscuit-manufacturing plant in the backward region of Haridwar. This would be operational by Apr.'07. Further, it has commenced setting up a biscuit-manufacturing plant in Bangalore, strategically located to manufacture and distribute biscuits.

ITC continues with its guidance of breaking even in the non-cigarette FMCG business by end-FY08. However, in the context of the much-speculated launch of personal products by the company, we expect a delay in this division breaking even.

Lifestyle retailing and stationery businesses to grow through a wider range of products and through expansions

Lifestyle retailing, operated through the brands Wills Lifestyle and John Players, is growing through a wider range of products and extended distribution network. However, the key driver behind the lifestyle retailing business is the John Players range of garments targeted at the mid-segment. John Players has been growing strongly, aided by a wide range and brand promotions. Besides lifestyle retailing, the stationery business, addressing a Rs 20bn market, is driving growth in the non-cigarette FMCG business. The company plans to expand this business segment and is setting up a 90,000-ton plant to manufacture high-end uncoated writing and printing paper.

Agri-trading business

Wheat, Soya spurring growth in agri-trading

Agri-trading during Q1 FY07 continued to grow robustly, primarily through more trading of wheat and soya due to higher crops. As the monsoon is expected to have been favourable during the year, we believe that wheat and soya crops would continue to be high and contribute to the growth in agri-trading.

Consolidating operations in *e-choupal*, to set up 80 *Choupal Sagars* in three-four years

ITC is consolidating operations under the *choupal* network (now about 6,500 installations) and is focusing on increasing the throughput per installation. Against its earlier strategy of increasing its e-*choupal* network by about 1,000 installations a year, it is reducing the annual expansion to about 100-500 installations. In turn, it has improved the technology in the e-*choupal* network by connecting the installations through VSAT. This has raised the investment per e-choupal to Rs 225,000 (against Rs 125,000 previously). ITC has also slowed down its expansion of the *choupal sagar* network and is focusing on increasing the throughput per *choupal sagar*. It has brought down to 20 its earlier guidance of setting up 30 *choupal sagars* by end-FY07. During Q1 FY07, it launched three more *choupal sagars,* taking the total number to ten in the states of Madhya Pradesh and Uttar Pradesh. It has nine *choupal sagars* in an advanced stage of completion. Over a three- to four-year period, it plans to set up about 80 *choupal sagars*. It is breaking even at the store level in some cases and plans to get higher benefits from the larger scale of operations in future.

Paper and paperboard to be driven by capacity additions

The Paper and Paperboard business would be mainly driven by capacity additions. The company now has three capacity expansions underway, comprising uncoated writing and printing paper, uncoated paperboard, and pulp.

Schedule of capacity expansions

	Capacity *(tons)*	Months remaining for completion
Uncoated Writing and Printing Paper	90,000	30
Uncoated PaperBoard	90,000	30
Pulp	100,000	12-15

The expansion into pulp manufacturing is a backward integration to support the expansion initiatives in uncoated writing and printing paper, and uncoated paperboard. Further, the expansion in writing and printing paper would primarily cater to the stationery business.

Hotels may achieve a 30% growth, led by ARR growth

As seen in Q1 FY07, the hotels division recorded consistent growth in FY07 over the previous fiscal's high base. In view of the continuing buoyancy in the hotels sector and based on our interaction with the company management, the hotels division could achieve a 30% yoy growth during FY07 (against last year's 35%), primarily led by growth in ARRs across properties. We currently estimate a 26.3% growth for the hotels division for FY07 and are planning to revise it, post-Q2 FY07 results in view of the buoyant ARR growth in the sector.

Bangalore property to be operational by December 2008

ITC is setting up a property at Bangalore, which would be operational by Dec.'08. Its Chennai hotel property is in the conceptualization stage and construction has yet to begin.

Capital expenditure of Rs 7bn-8bn a year

The company has given guidance of about Rs 25bn in capex over the next three to four years. Thus, we continue to factor in a capex of about Rs 8bn a year for the next two years. However, this capex limit of Rs 8bn may shoot up if the company is able to finalise a strategically located property with the required forest land and water-supply arrangement to set up its 200,000-ton writing and printing paper manufacturing plant.

Outlook and Valuation

The second round of price hikes in cigarettes and the better-than-expected growth seen in hotels warrant an earnings revision for ITC. However, we would wait for the Q2 FY07 results and then revise our earnings estimates. At the CMP of Rs 194, the stock trades at 26.2x FY07E earnings and at 22.4x FY08E earnings. In view of the strengthening of our belief that the continuing rise in income levels and the moderate tax policy would drive ITC's cigarettes growth and earnings momentum, we continue to recommend a **BUY** on the stock at the current levels.

Key Figures

Y/e March	FY05	FY06	FY07E	FY08E
Net Sales (Rs m)	76,395	97,905	122,361	143,599
EBITDA (Rs m)	27,926	33,274	39,354	46,175
PAT (Rs m)	18,371	22,804	26,797	31,329
PAT Growth (%)	*15.3*	*24.1*	*17.5*	*16.9*
EPS (Rs)	4.9	6.1	7.1	8.3
PER (x)	38.2	30.8	26.2	22.4
EV / EBITDA (x)	17.4	21.7	18.0	15.1
EV / Sales (x)	3.6	4.4	3.6	3.1
RoE (%)	*25.7*	*26.9*	*27.4*	*27.5*
RoCE (%)	*24.7*	*25.4*	*26.3*	*26.8*