

3 June 2010 (No. of pages: 10)

ITC (ITC IN)

Food, beverage & tobacco: India

6-mth rating: **1**

Target price: Rs306.00

Share price: Rs281.30 (2 Jun)

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FMCG and hotels segments provide positive surprises in 4Q FY10

1 (*Buy*) rating maintained

- We forecast ITC's total sales and earnings to increase at CAGRs of 14.9% and 14.7%, respectively, from FY10-13. We maintain our **1 (*Buy*)** rating, with a six-month target price of Rs306 based on our sum-of-the-parts (SOTP) valuation (Rs239/share [a PER of 23x based on our FY11 EPS forecast] for the cigarette business, Rs60/share for the other businesses, and Rs7/share for cash and cash equivalent). ITC remains our top pick in the sector, supported by what we see as its extremely strong cigarette business.
- The stock trades currently at PERs of 23x, 19.9x and 17.5x on our 2011, 2012 and 2013 EPS forecasts, respectively.

Non-cigarette FMCG segment losses narrow

- Losses for non-cigarette FMCG segment have continued to narrow over the past few quarters. In our view, this has been due mainly to improvements in the product mix and the sourcing of raw materials, and increased supply-chain efficiency.

Revival at the hotels business

- After a slowdown in the first three quarters of FY10 for the hotels division, occupancy rates and average room rates (ARRs) picked up in 4Q FY10.

Reuters code ITC.NS

Market data

SENSEX Index		16,741.84
Market cap	(US\$bn)	22.86
EV	(US\$bn: 11E)	22.31
3-mth avg daily T/O	(US\$m)	22.07
Shares outstanding	(m)	3,818
Free float	(%)	73.7
Major shareholder	Tobacco Manufacturers India Ltd (26.3%)	
Exchange rate	Rs/US\$	46.985

Performance (%)*	1M	3M	6M
Absolute	5.8	16.3	9.5
Relative	11.0	16.5	12.3

Source: Daiwa

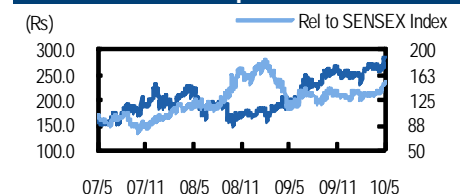
Note: *Relative to SENSEX Index

Investment indicators

		2011E	2012E	2013E
PER	(x)	23.0	19.9	17.5
PCFR	(x)	22.1	18.8	16.5
EV/EBITDA	(x)	14.8	12.6	10.7
PBR	(x)	6.8	5.8	5.0
Dividend yield	(%)	1.8	2.1	2.5
ROE	(%)	32.1	31.5	30.7
ROA	(%)	22.3	22.4	22.3
Net debt equity	(%)	net cash	net cash	net cash

Source: Daiwa forecasts

Price and relative performance



Source: Bloomberg, Daiwa

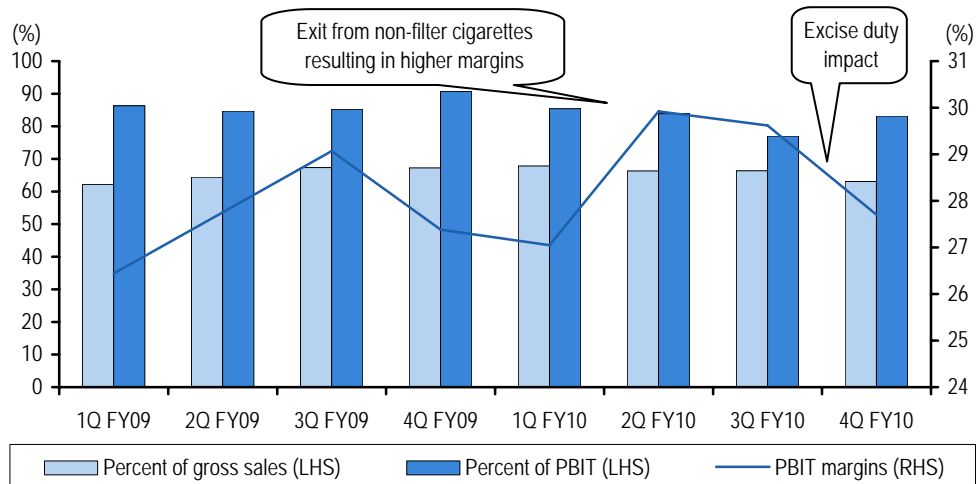
Income summary

Year to 31 Mar	Revenue		EBITDA		Net profit		EPS		CFPS	DPS
	(Rs m)	(%)	(Rs m)	(%)	(Rs m)	(%)	(Rs)	(%)	(Rs)	(Rs)
2009	153,881	10.3	48,402	9.6	32,636	4.6	8.647	4.4	9.877	3.700
2010	181,532	18.0	60,740	25.5	40,610	24.4	10.636	23.0	11.296	10.000
2011E	210,335	15.9	70,679	16.4	46,707	15.0	12.233	15.0	12.749	5.000
2012E	240,820	14.5	82,225	16.3	53,978	15.6	14.137	15.6	14.954	6.000
2013E	275,566	14.4	95,389	16.0	61,360	13.7	16.070	13.7	17.087	7.000

Source: Company, Daiwa forecasts

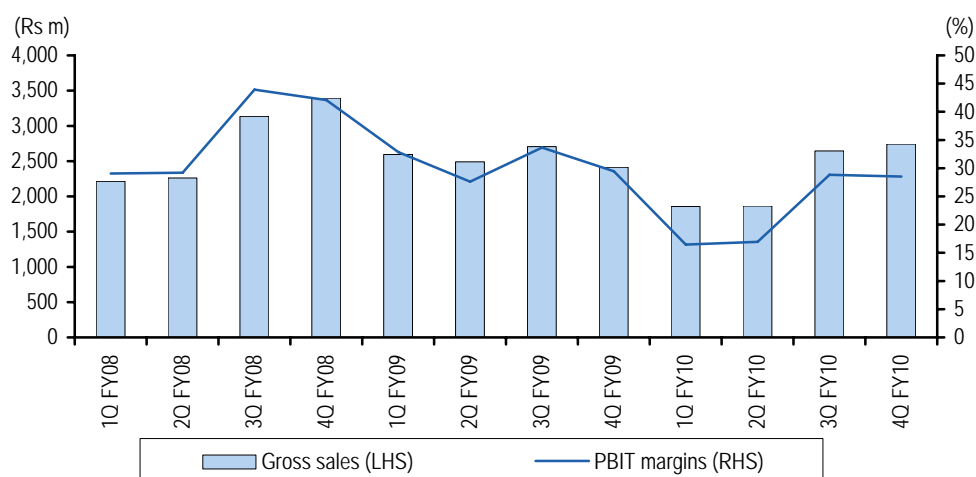
The three most important charts in this report ...

ITC: cigarettes' quarterly contribution to gross sales and PBIT, and PBIT margins



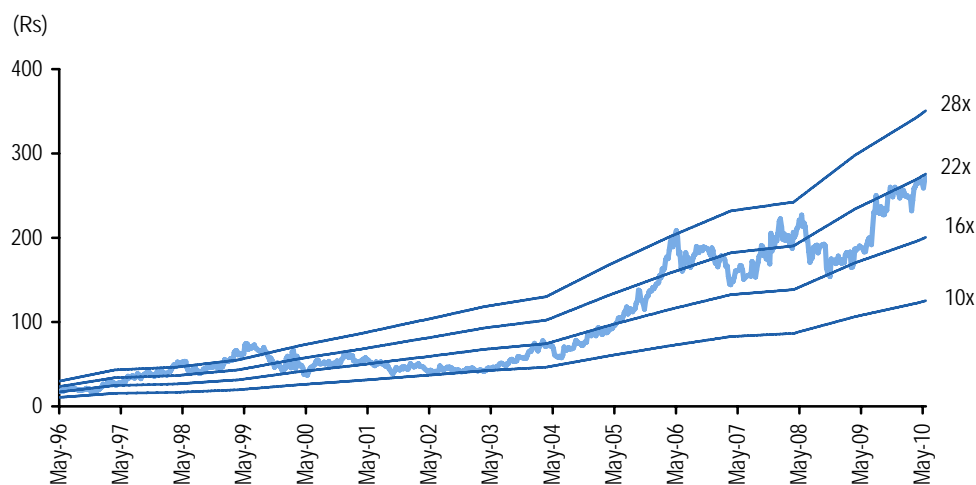
Source: Company, compiled by Daiwa

ITC: hotels segment - gross sales and PBIT margins



Source: Company, compiled by Daiwa

ITC: One-year forward PER bands



Source: Company, Daiwa forecasts

Company background

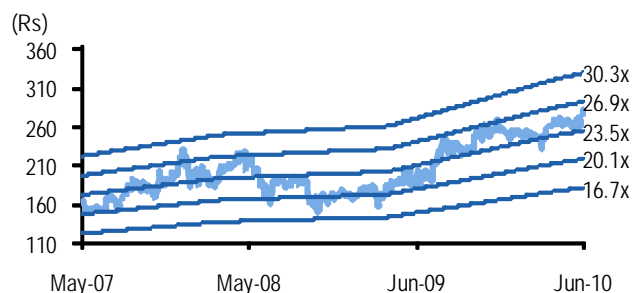
ITC was incorporated in 1910 as Imperial Tobacco Company of India Ltd. as a pure cigarette and tobacco-leaf business. Currently, it has a diversified presence across a number of product ranges under various basic segments including other FMCG, hotels, agri-business, and paper and packaging. Its core competencies lie with its distribution reach and effective supply-chain management.

ITC – financial summary

Profit and loss (Rs m)						Balance sheet (Rs m)					
Year to 31 Mar	2009	2010	2011E	2012E	2013E	As at 31 Mar	2009	2010E	2011E	2012E	2013E
Cigarettes	75,568	93,212	104,854	117,025	130,039	Cash & short-term investment	38,701	19,446	27,693	39,892	55,767
Other FMCG	30,056	36,339	41,872	50,167	60,106	Inventory	45,997	52,151	59,973	67,170	75,231
Others	48,256	51,981	63,609	73,628	85,422	Accounts receivable	6,687	7,888	9,140	10,465	11,974
Total revenue	153,881	181,532	210,335	240,820	275,566	Other current assets	18,603	18,932	20,946	23,201	25,727
Other income	0	0	0	0	0	Total current assets	109,989	98,417	117,752	140,728	168,699
COGS	(66,587)	(76,254)	(88,162)	(100,118)	(113,743)	Fixed assets	84,860	96,531	106,927	116,057	124,033
SG&A	(8,144)	(9,326)	(10,783)	(12,245)	(13,911)	Goodwill & intangibles	0	0	0	0	0
Other op. expenses	(36,242)	(41,299)	(48,411)	(55,197)	(62,643)	Other non-current assets	0	0	0	0	0
EBIT	42,908	54,653	62,978	73,260	85,270	Total assets	194,848	194,948	224,679	256,785	292,732
Net-interest inc./(exp.)	0	(534)	(183)	(183)	(183)	Short-term debt	0	0	0	0	0
Assoc/forex/extraord./others	5,349	6,034	6,400	6,890	7,183	Accounts payable	31,612	35,729	41,088	46,018	51,875
Pre-tax profit	48,257	60,153	69,196	79,967	92,270	Other current liabilities	15,438	15,438	15,438	15,438	15,438
Tax	(15,622)	(19,543)	(22,489)	(25,989)	(30,911)	Total current liabilities	47,050	51,167	56,526	61,457	67,313
Min. int./pref. div./others	0	0	0	0	0	Long-term debt	1,776	1,776	1,776	1,776	1,776
Net profit (reported)	32,636	40,610	46,707	53,978	61,360	Other non-current liabilities	8,672	8,672	8,672	8,672	8,672
Net profit (adj.)	32,636	40,610	46,707	53,978	61,360	Total liabilities	57,498	61,614	66,973	71,904	77,761
EPS (reported) (Rs)	8.647	10.636	12.233	14.137	16.070	Share capital	3,774	3,818	3,818	3,818	3,818
EPS (adj.) (Rs)	8.647	10.636	12.233	14.137	16.070	Reserves/R.E./others	133,576	129,516	153,887	181,063	211,153
DPS (Rs)	3.700	10.000	5.000	6.000	7.000	Shareholders' equity	137,351	133,334	157,706	184,881	214,971
EBIT (adj.)	42,908	54,653	62,978	73,260	85,270	Minority interests	0	0	0	0	0
EBITDA (adj.)	48,402	60,740	70,679	82,225	95,389	Total equity & liabilities	194,848	194,948	224,679	256,785	292,732
						Net debt/(cash)	(36,926)	(17,670)	(25,917)	(38,117)	(53,992)

Cash flow (Rs m)						Key ratios					
Year to 31 Mar	2009	2010E	2011E	2012E	2013E	Year to 31 Mar	2009	2010E	2011E	2012E	2013E
Profit before tax	48,257	60,153	69,196	79,967	92,270	Sales – YoY %	10.3	18.0	15.9	14.5	14.4
Depreciation and amortisation	5,494	6,087	7,700	8,965	10,119	EBITDA (adj.) – YoY %	9.6	25.5	16.4	16.3	16.0
Tax paid	(12,400)	(19,543)	(22,489)	(25,989)	(30,911)	Net profit (adj.) – YoY %	4.6	24.4	15.0	15.6	13.7
Change in working capital	(4,070)	(3,568)	(5,728)	(5,846)	(6,239)	EPS (adj.) – YoY %	4.4	23.0	15.0	15.6	13.7
Other operational CF items	0	0	0	0	0	EBITDA margin % (adj.)	31.5	33.5	33.6	34.1	34.6
Cash flow from operations	37,281	43,130	48,679	57,097	65,240	EBIT margin % (adj.)	27.9	30.1	29.9	30.4	30.9
Capex	(17,397)	(17,758)	(18,097)	(18,095)	(18,095)	Net-profit margin % (adj.)	21.2	22.4	22.2	22.4	22.3
Net (acquisitions)/disposal	0	0	0	0	0	ROAE (%)	25.3	30.0	32.1	31.5	30.7
Other investing CF items	968	0	0	0	0	ROAA (%)	17.8	20.8	22.3	22.4	22.3
Cash flow from investing	(16,429)	(17,758)	(18,097)	(18,095)	(18,095)	ROCE (%)	32.8	39.9	42.8	42.3	42.3
Change in debt	(369)	0	0	0	0	ROIC (%)	28.7	31.6	32.1	33.4	34.9
Net share issues/(repurchases)	6	44	0	0	0	Net debt to equity (%)	net cash	net cash	net cash	net cash	net cash
Dividends paid	(16,299)	(44,671)	(22,335)	(26,802)	(31,270)	Effective tax rate (%)	32.4	32.5	32.5	32.5	33.5
Other financing CF items	431	0	0	0	0	Accounts receivable (days)	16.7	14.7	14.8	14.9	14.9
Cash flow from financing	(16,231)	(44,627)	(22,335)	(26,802)	(31,270)	Payables (days)	72.8	67.7	66.7	66.0	64.8
Forex effect/others	(968)	0	0	0	0	Net interest cover (x)	n.a.	102.4	344.7	401.0	466.7
Change in cash	3,653	(19,256)	8,247	12,199	15,875	Net dividend payout (%)	42.8	94.0	40.9	42.4	43.6

PER bands



Source: Company, Daiwa forecasts

Note: 2010 numbers are unaudited, audited figures are due to be released by 30 June 2010

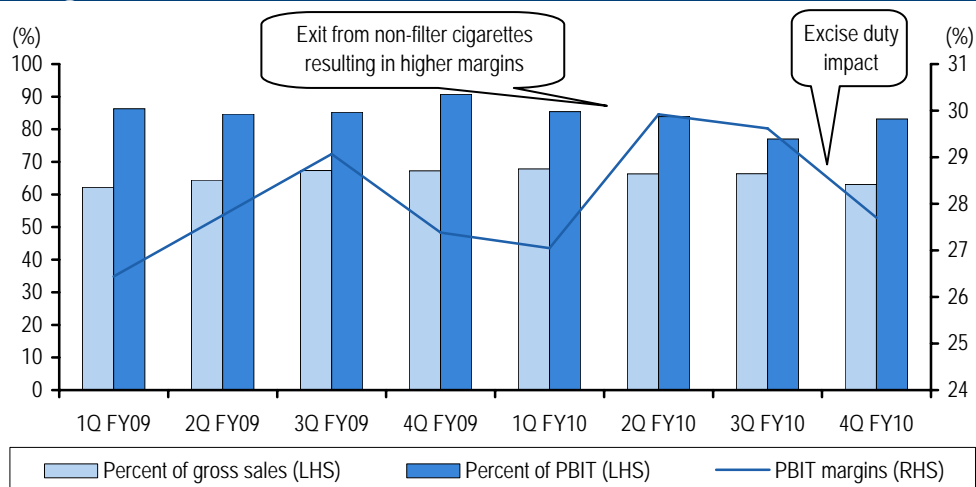
All segments contributed to the solid performance

Cigarettes continue to drive profit

Cigarette revenue continues to rise strongly

The cigarette division contributed 63.1% of 4Q FY10 revenue. ITC retained its leading overall market position and improved its standing within certain segments of the cigarettes market in FY10. However, the company experienced pressure on sales volume and pricing due to the ban on smoking in public places, the requirement that graphic health warnings be placed on tobacco products, an increase in VAT rates on cigarettes, and its exit from popular low-priced micros and plain non-filtered cigarettes segments. Despite this, the cigarette division's net revenue continued to increase strongly, expanding by 14% YoY in 4Q FY10.

ITC: cigarettes' quarterly contribution to gross sales and PBIT, and PBIT margins



Source: Company, compiled by Daiwa

Reduction in other FMCG losses and improvement in margins

Loss for the FMCG business declined to under Rs4bn in FY10

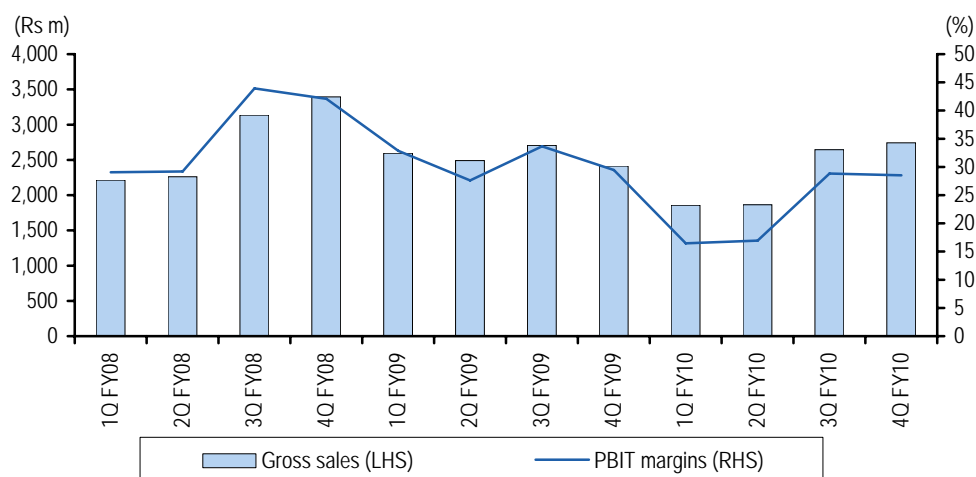
Improvements to the product mix and supply-chain efficiency helped ITC's FMCG sales to increase by 34% YoY in 4Q FY10. We expect annual losses for this business to remain under Rs4bn from FY11 onward, and for this reduction in losses to be supported by the company's continued focus on higher-end consumer products, rather than on consumer staples.

In the 'Staples' category, sales of *Aashirvaad* flour rose by 21% YoY and the brand sustained its leading market share of 56%. In the 'Biscuit' category, the *Sunfeast* brand consolidated its position, with an all-India urban market share of 11% in FY10.

Recovery at the hotels business

Turnaround at the hotels business in 4Q FY10

Due to the economic slowdown, a drop-off in domestic air travel, and a slowdown in inbound tourism, the hotels business saw its occupancy rates and ARR drop in FY10. However, this trend reversed in 4Q FY10. In 4Q FY10, the division accounted for 3.8% of the company's gross revenue (down from 4.1% for 4Q FY09). Construction activity continued at the company's new super-luxury properties in Chennai and Kolkata.

ITC: hotel segment: gross sales and PBIT margins

Source: Company, compiled by Daiwa

***Remains a global leader
in the integrated
tobacco-leaf business***

India's second-largest exporter of agri products

Sales for the agri business were up 88% YoY for 4Q FY10. The business continues to provide strategic sourcing support for the company's cigarette business by ensuring international-quality supplies. ITC's main customers include the major tobacco companies around the world. The agri business contributed 13.8% of 4Q FY10 gross revenue. This performance was attributable mainly to the strong performance of the tobacco-leaf portfolio.

ITC: revisions to Daiwa forecasts (Rs m)

Year to 31 March	2011E	2012E
Total revenue		
Sales – new	210,335	240,820
Sales – previous	190,831	211,893
Change (%)	10.2	13.7
EPS (Rs)		
EPS – new	12.23	14.14
EPS – previous	12.12	13.77
Change (%)	1.0	2.6
Net profit		
Net profit – new	46,707	53,978
Net profit – previous	45,741	51,986
Change (%)	2.1	3.8

Source: Daiwa forecasts

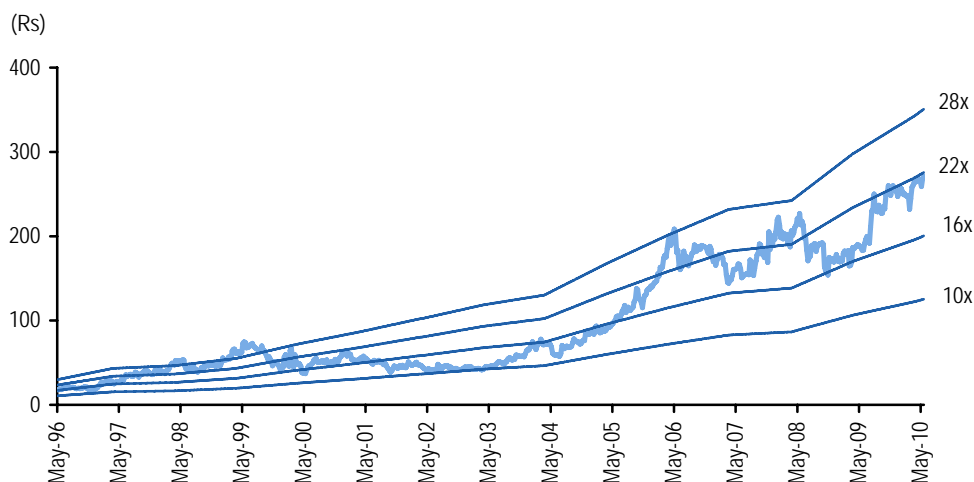
We have revised up our earnings forecasts to factor in our expectation of a pick-up in sales across ITC's business segments.

Valuation and target price

Over the past three years, ITC has traded in a PER range of about 16-25x

The company has traded within a PER range of about 16-25x over the past three years. In our view, the stock's recent fluctuations within this band have more to do with news flow related to the cigarette business. We believe the company deserves to trade at around the 20x PER level.

ITC: one-year forward PER bands



Source: Company, Daiwa forecasts

We use an SOTP method to arrive at our six-month target price

We use an SOTP method to value the different parts of the company's business (see the following table for a breakdown). We maintain our **1 (Buy)** rating, with a six-month target price of Rs306, based on our SOTP valuation (Rs239/share [a PER of 23x based on our FY11 EPS forecast] for the cigarette business, Rs60/share for the other businesses, and Rs7/share for cash and cash equivalents).

ITC: SOTP valuation

Segment	Rs	Methodology	Multiple (x)	Remarks
Cigarettes	239	PER	23.0	A 20% discount to the past two-year PER of 20-25x of Hindustan Unilever (HUVR IN, Rs237.75, 2)
FMCG	22	EV/Sales	2.0	In line with Nestle India
Hotels	8	EV/EBITDA	12.0	In line with Indian Hotels (Not rated)
Agri Business	12	EV/EBITDA	12.0	EBITDA growth of over 20%
Paperboards	18	EV/EBITDA	8.0	EBITDA growth of around 15%
Net cash	7			
Total	306			

Source: Daiwa forecasts

Risk factors

We see the main downside risks to our view as a slower-than-expected narrowing of losses for the FMCG division and potential increases in the various taxes imposed by the government on cigarettes.

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