Equity Research | India

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MF Global Company Update

ITC Limited

Classic ITC story gets flakey

FMCG

ITC IN: Downgrade to SELL

RS 268

We downgrade ITC to Sell based on changing business strategy in favour of volumes, rising regulatory and macroeconomic risks and stretched valuations. Our key arguments are:

Margins in cigarettes segment seem to have peaked: ITC has recently introduced 64mm products in some markets to upgrade consumers from bidis and contraband products and drive volume growth. We note that the differences between 69mm and 64mm may not be perceptible which could result in consumers down-trading from 69mm to 64mm. Down-trading will lead to decline in cigarette segment EBIT margins. We also find that the 84 mm premium products have lower/similar margins than some of the 69mm products. Thus decline in 69mm consumption could result in sluggish operating profit growth and uninspiring margin performance.

Rising State VAT reducing pricing efficacy: Pricing power in the cigarettes business is the hallmark of the category which sustains valuations and provides long-term earnings visibility. We note that pricing power in the cigarettes business is declining on account of rising State VAT. Absolute State VAT paid has increased by 25% CAGR during FY08 – 13E for ITC and will continue to rise over the medium term. We believe further increases in State VAT will significantly reduce pricing power which will impact valuations negatively over the medium to long-term.

Framework Convention for Tobacco Control (FCTC) regulations-Much more than plain packaging: While introduction of plain packaging will be a serious threat, we find that the FCTC guidelines purview stretch far beyond packaging norms and include norms for taxation to environmental concerns. India has been at the forefront of implementation of FCTC norms and the continuance of which poses serious risks to the cigarettes sector in India.

FMCG business- Value creation will not be inspiring: ITC's FMCG business is largely a low margin business and value accretion from this business over the medium to long-term will not be significant. We estimate long-term operating margins for the segment at ~8% with value contribution of only 8%.

Stretched valuations- Downgrade to Sell: ITC's cigarette business currently trades at PER of 29x on FY14E earnings, inline with consumer staples sector which is not sustainable in the long run. We value the company at Rs 245 based on SOTP methodology in-line with our DCF valuation. We downgrade the stock to Sell.

TARGET RS 245 (-9%)

STOCK RATING

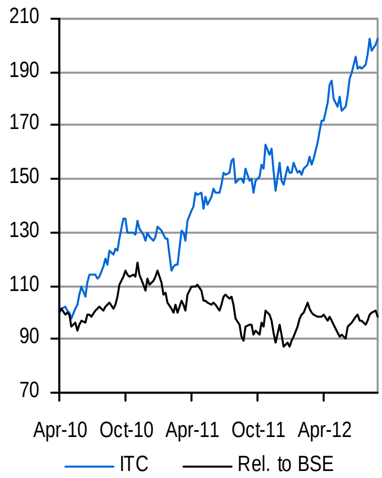
BUY	NEUTRAL	SELL
> 15%	-15% TO +15%	< -15%

COMPANY DATA	
O/S SHARES :	7847MN
MARKET CAP (RS) :	2104BN
MARKET CAP (USD) :	38.7BN
52 - WK HI/LO (RS) :	273 / 185
AVG. DAILY VOL. (3MTH) :	24.3MN
FACE VALUE (RS) :	1

SHARE HOLDING PATTERN, %	
FII / NRI :	49.4
FI / MF :	34.1
NON-PROMOTER CORP. HOLDINGS :	5.7
PUBLIC & OTHERS :	10.7

PRICE PERFORMANCE, %	1MTH	3MTH	1YR
ABS	0.1	9.7	34.7
REL TO BSE	-4.0	-1.0	24.2

PRICE VS. SENSEX



Source: Bloomberg, MF Global India Research

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Margins in the cigarettes segment have peaked: 64mm–A masterstroke or a forced innovation

The cigarettes business has consistently witnessed improvement in operating margins primarily driven by price hikes. While price hikes have helped the companies register robust operating profit growth, volume growth continues to remain sluggish. We also note that volume growth sluggishness has intensified in the last 5 years on account of sharp increase in prices and proliferation of tobacco products like Gutkha. The per capita consumption of cigarettes has reduced over the last 30 years while Bidis and other forms of tobacco consumption have increased.

The Indian FMCG market has consistently witnessed uptrading in most categories on account of rising incomes and changing demographics but cigarettes consumption trends have largely been contrarian on account of pricing and new products. Thus, while category volume growth has been sluggish operating profit growth has been largely price led. We have witnessed consistent margin improvements in the category and we believe margins have a reached an inflexion point and further margin improvements on account of pricing are unlikely to be value accretive.

We see ITC's intervention in the 64mm category to be an important milestone having the potential to significantly change the landscape of the category on one hand while potentially being margin dilutive on the other hand.

ECONOMICS OF VARIOUS BRANDS (ESTIMATED MARGINS)

	GOLDFLAKE			CAPSTAN		BRISTOL	SCISSORS	BENSON & HEDGES	CLASSIC	WILLS
CIGARETTE SIZE IN MM	84	69	64	69	64	69	69	84	84	74
(RS/STICK)										
GROSS MRP	5.8	4.50	2.5	3	2	3.7	3.5	6	6	4.9
EXCISE DUTY	2.3	1.20	0.7	1.2	0.67	1.2	1.2	2.3	2.3	1.72
VAT	1.2	0.92	0.5	0.6	0.4	0.8	0.7	1.2	1.2	1.0
DEALER MARGINS	0.6	0.50	0.3	0.4	0.3	0.4	0.4	0.7	0.7	0.5
NET MRP	1.8	1.89	1.0	0.8	0.7	1.3	1.2	1.8	1.8	1.7
RM	0.4	0.34	0.3	0.2	0.2	0.3	0.3	0.4	0.4	0.36
MANUFACTURING AND FREIGHT	0.3	0.30	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
EBIT PER STICK	1.0	1.25	0.4	0.3	0.2	0.8	0.6	1.1	1.1	1.0
EBIT MARGIN %	59.6	66.2	41.2	34.2	23.0	56.8	53.2	61.3	61.3	60.3

Source: MF Global India Research Estimates

The 64mm products have significantly lower margins than 69mm and 84mm products. More importantly the per stick profitability of 64mm Goldflake is 1/3rd of 69mm for Goldflake brand. Pan-India introduction of 64mm products could significantly dent the operating margins.

It is important to note here that GoldFlake 69mm is the most profitable product for the company both on margin and per stick profitability. Premium cigarettes while enjoying high margins do not have significantly different margins from the 69mm products like Bristol. Thus 69mm cigarettes not only generate high volumes but are also significantly value accretive for the company.

RS PER STICK	GOLD FLAKE REGULAR PRICE PER STICK	GOLD FLAKE KINGS PRICE PER STICK	PRICE PREMIUM OF 84MM VS 69 MM (%)	EXCISE DUTY PER STICK 69 MM	EXCISE DUTY PER STICK 84 MM	TAX PER STICK PREMIUM OF 84MM VS 69 MM (%)
FY2005	1.7	2.8	65	0.67	1.45	116
FY2006	1.9	3.0	55	0.74	1.60	116
FY2007	2.00	3.3	65	0.78	1.68	115
FY2008	2.5	3.8	52	0.82	1.76	115
FY2009	2.8	4.0	43	0.82	1.76	115
FY2010	3	4.4	47	0.82	1.76	115
FY2011	3.5	4.8	37	0.97	1.96	102
FY2012	3.575	5.1	43	0.97	1.96	102
FY2013	4.5	5.8	29	1.19	2.31	93

Source: MF Global India Research

The company has taken steepest price hikes in the 69mm brands in the last 3 years. The premium of 84mm vs 69mm has declined from 65% in FY2005 to 29% in FY13. This is encouraging consumers to uptrade from 69mm to 84mm brands as 84mm products are perceived to premium with better quality of filter and tobacco. Thus, on one hand the company is encouraging consumers to up-trade to 84mm products from 69mm products the company also intends to up-trade consumers of bidis and contraband products with the introduction of 64mm products. We note that the strategy is seemingly sound but we also believe that the company over the medium to long-term could see decline in the 69mm category as consumers of 69mm up-trade to 84mm and down trade to 64mm categories.

EBIT MARGIN ANALYSIS ACROSS CIGARETTE SIZES FOR ITC BRANDS (ESTIMATES)

	69MM (GOLD FLAKE REGULAR)		74 MM (WILLS NAVY CUT)		84 MM (GOLD FLAKE KINGS)	
	FY12	FY13	FY12	FY13	FY12	FY13
(RS/STICK)						
GROSS MRP	3.90	4.50	4.40	4.90	5.50	5.80
EXCISE DUTY	0.97	1.20	1.47	1.72	1.96	2.30
VAT	0.68	0.90	0.77	0.98	0.96	1.16
DEALER MARGINS	0.43	0.50	0.44	0.49	0.55	0.58
NET MRP	1.82	1.91	1.72	1.71	2.03	1.76
RM	0.32	0.34	0.34	0.36	0.39	0.41
MANUFACTURING AND FREIGHT	0.30	0.30	0.30	0.30	0.28	0.30
EBIT PER STICK	1.20	1.27	1.08	1.05	1.36	1.05
EBIT MARGIN %	66.16	66.54	62.69	61.38	66.88	59.56

Source: MFGlobal India Research

We also note that in FY13, margins for 69mm GoldFlake are likely remain stable or marginally improve on account of sharp price hikes but in the 84mm premium GoldFlake brand operating margins are likely to decline.

69mm Vs. 64mm – Not much to set them apart

GOLDFLAKE 84 VS 69 VS 64

Source: MF Global India Research

A closer look at the 84mm, 69mm and 64mm products reveals that there are significant differences between the 69mm and 84mm products in terms of amount of tobacco, length of filter and aspirational values but the differences between 69mm and 64mm are not significant. While we acknowledge that there is a marginal difference in the length and quality of filter of 64mm but the difference may not be very perceptible.

We also note that the retail channel has higher profitability (if sold loose) and better return on investment in the 64mm compared to the 69mm products. The company also has other brands like Flake (69mm) in the similar price range of 64mm.

Key benefits of 64mm launch

Is it a masterstroke?

We asses that the 64mm is an important milestone for ITC as it helps the company in introducing products at price points which will help the company in uptrading consumers from contraband and bidis. While the benefits of the product introduction are relevant we believe the execution of the product will be one of the most critical factors.

MARKET SHARE (%)	CY2005	CY2006	CY2007	CY2008	CY2009	CY2010
ITC BRANDS	67.5	67.8	67.9	71.8	73.5	74.1
GOLD FLAKE	29.6	29.7	29.6	30.4	31.7	32
CLASSIC	7.2	7.5	7.8	9.6	10.9	11.7
WILLS	9.1	8.8	8.3	8.8	8.6	8.9
SCISSORS	7.1	7.3	7.6	7.9	7.7	7.3
CAPSTAN	7.2	7	7	7.5	7.2	6.9
BRISTOL	6.3	6.8	6.9	6.9	6.7	6.5
OTHERS	1	0.7	0.7	0.7	0.7	0.8
GODFREY PHILLIPS BRANDS	11.1	11.6	11.9	12.9	13.5	13.6
FOUR SQUARE	5.3	5.7	6.3	6.9	7.8	7.9
CAVENDERS	2.9	2.9	2.6	2.7	2.4	2.3
RED & WHITE	2.4	2.5	2.6	2.8	2.9	2.9
TIPPER	0.4	0.4	0.4	0.4	0.3	0.3
OTHERS	0.1	0.1	0	0.1	0.1	0.2
VST INDUSTRIES BRANDS	8.7	8.4	8.5	8.5	8.4	8.4
CHARMINAR	5.8	5.5	5.1	4.1	3.8	3.6
CHARMS	2.4	2.2	2.4	2.7	2.9	3
OTHERS	0.5	0.7	1	1.7	1.7	1.8

Source: Euromonitor, MF Global India Research

The cigarettes market is largely driven by the 69mm products. One of the biggest competitors for ITC in the 69mm is Godfrey Phillips with its brand Four Square.

ITC has launched the 64mm mostly in the northern states where GPI has strong competitive positioning. Successful launch of the 64mm could potentially reduce consumption of 69mm products and result in significant market share gains for ITC at the cost of GPI.

This could be a masterstroke for ITC as it will gain market share in an already concentrated market and also ensure long-term volume growth in a sluggish environment.

Or a forced innovation?

We acknowledge that 64 mm product is a key innovation from ITC's stable which can possibly provide long-term volume growth visibility if execution plays out according to the company's expectations but our concerns are primarily on account of lower profitability of the product and long-term margin dilution on account of cannibalization.

EXCISE DUTY STRUCTURE

FILTER CIGARETTE (RS PER 1000 STICKS)	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013
75MM-85MM	1675	1759	1759	1759	1959	1959	2309
70MM-75MM	1260	1323	1323	1323	1473	1473	1718
65MM - 70MM	780	819	819	819	969	969	1194
<65 MM	-	-	-	-	-	-	669

Source: MF Global India Research

The current excise duty structure encourages introduction of smaller sized cigarettes as excise duty in this category is significantly lower than the other products. The introduction of 64mm cigarettes is intended to upgrade consumers from contraband and bidis but we believe upgrade process will be a considerable challenge for companies. A closer look at contraband market throws certain keen insights.

A BAND APART

Source: MF Global India Research

We believe the products depicted above belong to the contraband category. The contraband products with printed MRP of Rs 16-18 for 10 sticks generally retail at price points of Re1 in the loose format and also as low as Rs 5 for 10 sticks. The category is extremely profitable for the retailers considering the margins and return on investment. Thus compared to the 69mm contraband products, 64mm at more than double the price point does not offer a significantly better value proposition.

Thus, we believe 64mm is more likely to lead to down trading by consumers from 69mm as the perceptible differences are not significant. This is more likely to result in decline in EBIT margins. Thus considering the significantly higher risks and phased introduction of 64mm products we note that the 64mm products are largely forced innovation to resuscitate volume growth in the sluggish category.

Margins near peak levels

ITC has one of the highest margins in the world on account of its relatively high market of 74%. ITC's margins are significantly higher than the global top 4 namely Philip Morris, British American Tobacco, Imperial Tobacco Company and Japan Tobacco. These companies have lower margins on account of diversified geographic reach and lower margins in the emerging and developing countries.

MARGIN (%)	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012
BRITISH AMERICAN TOBACCO	32.7	33.2	32.8	34.9	39.3	41.0
PHILIP MORRIS INTERNATIONAL	42.0	43.0	43.5	43.6	44.8	46.4
JAPAN TOBACCO	28.5	29.1	28.8	26.6	25.2	28.4
ITC CIGARETTES	55.2	54.8	53.6	53.0	54.5	56.1
ALTRIA GROUP	38.0	38.5	32.2	37.1	38.7	39.4

Source: Bloomberg, MF Global India Research

We have also looked at margins of Imperial Tobacco Company in developed markets. We note that Imperial Tobacco Company's margins in the UK are very high at 66%. Thus margins of more than 60% are possible in developed countries where companies have significant market leadership and realisations are significantly higher than the emerging countries.

IMPERIAL TOBACCO COMPANY OPERATING MARGINS

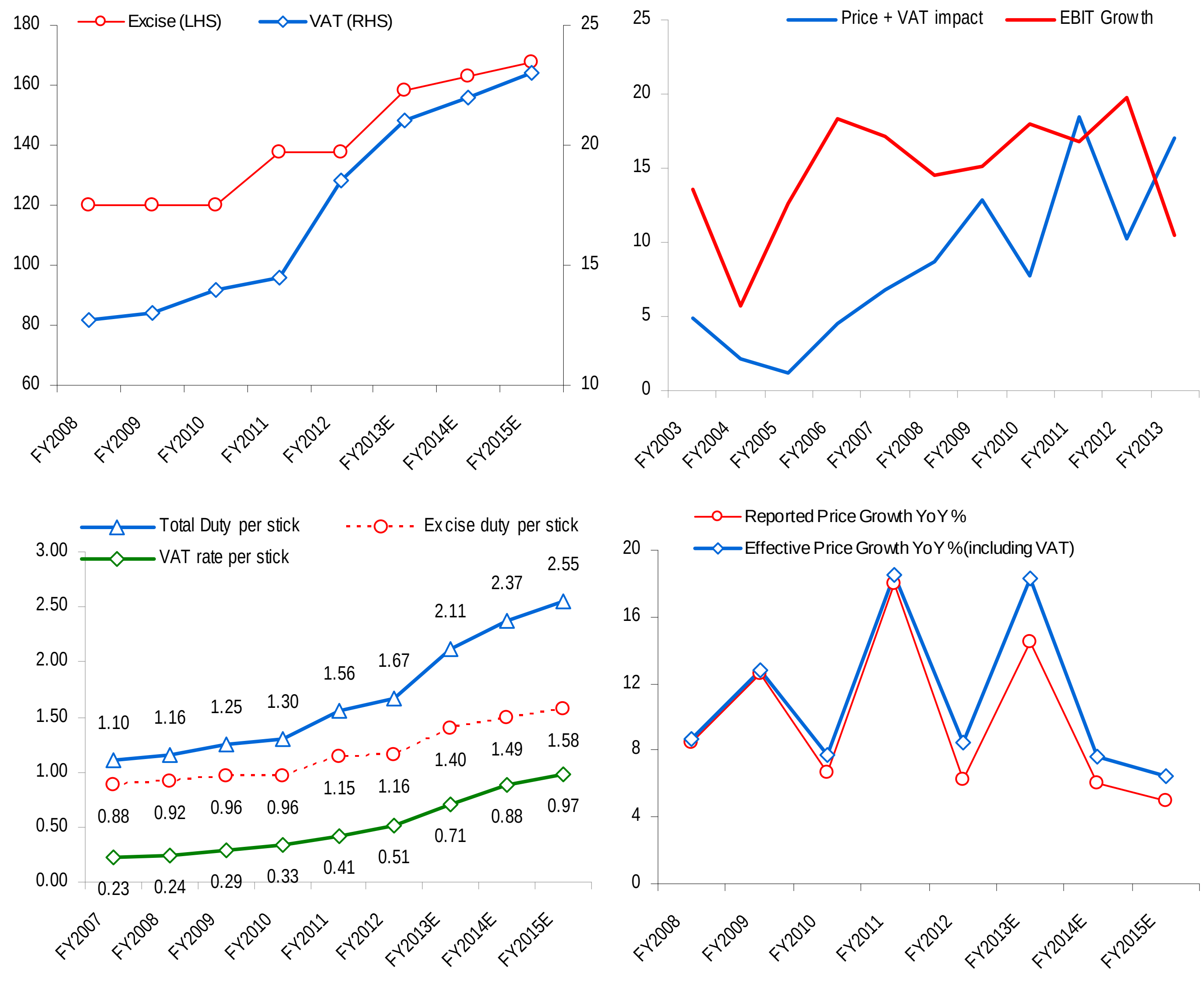
	FY2008	FY2009	FY2010	FY2011	FY2012
- UK	63.4%	67.2%	67.3%	68.7%	66.4%
- GERMANY	44.3%	46.5%	48.8%	50.8%	52.4%
- SPAIN	NA	36.5%	45.1%	45.3%	40.2%
- REST OF EU	50.2%	39.5%	38.0%	41.9%	41.3%
- USA	29.9%	30.6%	33.4%	33.6%	32.0%
- REST OF WORLD	22.6%	26.9%	28.9%	31.4%	33.9%

Source: Bloomberg, MF Global India Research

While we acknowledge that the case for margin ascendance is strong for ITC, we also note that margins for cigarettes business for ITC over the last 5 years post the introduction of State VAT have generally hovered in the 53%-56% range. Thus on a holistic basis considering the increasing tax rates, slowing volume growth, company's strategy for lower margin products and rising regulatory risks we believe margins are unlikely to see significant improvement from the current levels in the medium term.

Rising State VAT reducing pricing efficacy – An underestimated risk

ANALYSIS OF VAT IMPACT



Source: MF Global India Research Estimates

Over the last 10 years ITC has managed stable EBIT growth in the cigarettes business driven by pricing. A closer look at the data reveals that the period, post the introduction of State VAT in 2007, the company had to resort to incrementally higher price hikes to manage similar EBIT growth. Thus we find that efficacy of pricing is declining which is the hallmark of the inelastic cigarette category which will have long-term consequences on valuations for the company.

Regulatory risks for the cigarettes industry have continued to rise with the introduction of State Value Added in the year 2007. Generally the regulatory risks associated with ITC have been focused on central excise duty and stock performance is impacted by the quantum of increase in the central excise duty. While the central excise duty is still the major component of levies on the cigarettes category state VAT has increased at a much faster pace.

Also it is very important to note that while the Central excise duty is based on per 1000 sticks the state excise duty is based on a % of MRP which has continued to rise. Thus, as price growth continues for the cigarettes industry state VAT will continue to increase at least in-line with the price growth.

ITC'S TAX (EXICSE + VAT) PAID ON CIGARETTES

RS MN	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013E	FY2014E	FY2015E
TOTAL DUTIES PAID	64,339	89,691	93,835	97,902	109,199	127,229	144,702	180,849	215,096	242,946
EXCISE DUTY	64,339	71,358	74,084	75,316	81,064	93,603	100,734	120,068	135,576	150,100
GROWTH (%)	12.7	10.9	3.8	1.7	7.6	15.5	7.6	19.2	12.9	10.7
VAT		18,334	19,751	22,586	28,135	33,626	43,968	60,782	79,520	92,846
GROWTH (%)			7.7	14.4	24.6	19.5	30.8	38.2	30.8	16.8
CONTRIBUTION %										
EXCISE DUTY	100.0	79.6	79.0	76.9	74.2	73.6	69.6	66.4	63.0	61.8
VAT	0.0	20.4	21.0	23.1	25.8	26.4	30.4	33.6	37.0	38.2

Source: MF Global India Research Estimates

We have also observed that the quantum of increase in state excise duty is now in-line with the central excise duty which will further burden the consumers and put pressure on price growth. We believe further increases in state VAT are a serious deterrent to the cigarettes industry. We believe state VAT will continue to rise in the current situation of state finances and recent trends.

The contribution of State Vat to the total levies on cigarettes has risen very sharply in the last 3 since its introduction in FY2007.

STATES	ESTIMATED REVENUE CONTRIBUTION %	FY2010 (%)	FY2011 (%)	FY2012 (%)	FY2013 (%)
TAMIL NADU	12.5	12.5	12.5	20	20
KERALA	9	12.5	12.5	12.5	15
KARNATAKA	9	13.5	13.5	15	17
ANDHRA PRADESH	9	14.5	14.5	20	20
MAHARASHTRA	9	20	20	20	20
WEST BENGAL	10	12.5	13.5	20	20
UTTAR PRADESH	4	12.5	12.5	13.5	50
RAJASTHAN	3	20	20	40	50
GUJARAT	3	12.5	20	25	25
OTHERS	32	12.80	13.27	16.08	17.05
TOTAL VAT RATE		13.73	14.32	18.41	20.44

Source: MF Global India Research

Currently Rajasthan and Uttar Pradesh have VAT rate of 50% but the retail cigarette prices in these two states compared to the other states are not significantly different. Thus the UP and Rajasthan's burden of VAT is shared by the other states. We believe that over the medium to long term other states will also increase VAT rates in-line with UP and Rajasthan.

Thus in a typical but probable scenario of VAT rate of 50% the price hikes needed to offset the increase in taxes will be 77% and with a significant reduction in long-term pricing power and volume growth.

VAT rates have increased substantially in FY12 and further increases in FY13 cannot be ruled out as states have the liberty to increase VAT rates anytime during the year.

PRICE HIKE REQUIRED TO MAINTAIN OPERATING MARGINS AT 50% STATE VAT

IMPLIED PRICE HIKE OF 77%	STATE VAT AT 20%	STATE VAT AT 50%
GROSS MRP	4.9	8.7
EXCISE DUTY	1.72	1.72
VAT	1.0	4.3
DEALER MARGINS	0.5	1.0
NET MRP	1.7	1.7
RM	0.36	0.36
MANUFACTURING AND FREIGHT	0.3	0.3
EBIT PER STICK	1.0	1.0
EBIT MARGIN %	60.3	60.2

Source: MF Global India Research

We have assumed a typical case for Wills Navy Cut for the State VAT scenario at 50%. The implied price hike to maintain absolute EBIT and EBIT margins works out to 77% assuming the company is able to maintain its economies of scale. Managing volume at such high prices will be an arduous task for the cigarette companies.

Thus, we expect State VAT will continue to rise faster than the category price hikes as other states might be encouraged by Rajasthan and UP’s precedence. We believe the risks associated from State VAT are grossly underestimated which could have long-term repercussions on both pricing and volume growth.

FY13E impact of VAT on pricing power

In FY11, although ITC's cigarette volume degrowth was at ~3% YoY, sharp price growth of 18% YoY enabled EBIT growth of 16% YoY. In FY13E, however although the on the ground price growth is similar to FY11 at 17% YoY, the effective price growth is lower at 14% YoY, on account of State VAT rate increase by 3% YoY. ITC's weighted average VAT rate has increased from 17.5% in FY12 to 20.5% in FY13. Hence the efficacy of pricing to generate strong EBIT growth in FY13E is being restricted by impact of State VAT. Below we have depicted the impact of VAT rate on a quarter - wise basis on the pricing growth for ITC.

Q1FY13 VOLUME GROWTH YOY %	1.00
Q1FY13 PRICE GROWTH BREAK UP	14.0
VAT IMPACT	3.0
PRICE HIKES	17.0
- CLASSIC	0.8
- WILLS NAVY CUT	1.3
- BENSON AND HEDGES	0.4
- CAPSTAN	0.7
- GOLD FLAKE	3.4
- POST BUDGET (WEIGHTED AVERAGE)	10.6
Q2FY13 VOLUME GROWTH YOY %	-3.00
Q2FY13 PRICE GROWTH BREAK UP	13.4
VAT IMPACT	4.2
PRICE HIKES	17.6
- CLASSIC	0.3
- WILLS NAVY CUT	0.9
- BENSON AND HEDGES	0.4
- CAPSTAN	0.7
- GOLD FLAKE	3.4
- POST BUDGET (WEIGHTED AVERAGE)	12.0
Q3FY13 VOLUME GROWTH YOY %	-2.25
Q3FY13 PRICE GROWTH BREAK UP	16.4
VAT IMPACT	2.5
PRICE HIKES	18.8
- BENSON AND HEDGES	0.1
- CAPSTAN	0.3
- GOLD FLAKE	3.4
- POST BUDGET (WEIGHTED AVERAGE)	12.0
- ADDITIONAL PRICE HIKES	3.0
Q4FY13 VOLUME GROWTH YOY %	-0.75
Q4FY13 PRICE GROWTH BREAK UP	12.55
VAT IMPACT	2.45
PRICE HIKES	15.0
- POST BUDGET (WEIGHTED AVERAGE)	12.0
- ADDITIONAL PRICE HIKES	3.0
SUMMATION OF FY13 PRICE GROWTH	14.1
MFG ANNUAL ESTIMATE FOR FY13	14.1

Q1FY13 VAT rate break up: 2.35% weighted VAT impact of H2FY12 comprising of VAT rate hikes in West Bengal, Tamil Nadu and Andhra Pradesh. 0.65% weighted VAT impact of Q1FY13 in states of Kerala, Karnataka, Bihar.

Q2FY13 VAT rate break up: 2% weighted VAT impact of H2FY12 comprising of VAT rate hikes in West Bengal, Andhra Pradesh with marginal impact of Tamil Nadu . 2.4% weighted VAT impact of H2FY13 addition impact of VAT rate hike in UP of 1.45%.

Q3FY13 VAT rate break up: 0.1% weighted VAT impact of H2FY12. 2.4% weighted VAT impact of H2FY13.

Q4FY13 VAT rate break up: 2.4% weighted VAT impact of H2FY13.

Source: MF Global India Research

FY13 Cigarettes EBIT Growth could surprise negatively – Q2FY13 and Q4FY13 are likely to be weaker

We significantly differ from consensus on expectations for ITC's Cigarette business in the forthcoming quarters of FY13E. Against the consensus estimates of 15%+YoY EBIT growth we are estimating EBIT growth to decelerate to 10% YoY for FY13E. On volume growth while consensus estimate is marginally positive we expect Volume degrowth of 1.5% YoY in FY13E. We believe that State VAT rates are reducing efficacy of pricing growth in driving Cigarette EBIT growth.

(RS MN)	Q1FY11	Q2FY11	Q3FY11	Q4FY11	Q1FY12	Q2FY12	Q3FY12	Q4FY12	Q1FY13	Q2FY13	Q3FY13	Q4FY13
CIGARETTE VOLUME GROWTH %	*-4.0*	*0.0*	*2.5*	*-2.5*	*7.5*	*7.0*	*4.5*	*5.0*	*1.0*	*-3.0*	*-2.3*	*-0.8*
CIGARETTE PRICE GROWTH YOY %	*16.7*	*15.5*	*16.9*	*16.2*	*7.5*	*8.4*	*10.1*	*9.2*	*17.0*	*17.6*	*18.8*	*15.0*
CIGARETTE PRICE GROWTH YOY % EXCLUDING VAT IMPACT	*16.2*	*15.0*	*16.4*	*15.7*	*5.5*	*7.0*	*6.5*	*6.0*	*14.0*	*13.4*	*16.4*	*12.6*
NET SALES	48,236	50,612	54,244	58,363	57,675	59,742	61,954	68,611	66,522	66,234	70,312	75,062
GROWTH, %	16.3	16.3	17.9	15.5	19.6	18.0	14.2	17.6	15.3	10.9	13.5	9.4
EBITDA	16,071	17,889	19,694	17,934	18,729	21,080	23,000	21,700	23,075	22,902	25,969	24,117
GROWTH, %	20.2	16.4	18.7	16.4	16.5	17.8	16.8	21.0	23.2	8.6	12.9	11.1
EBITDA MARGIN, %	33.3	35.3	36.3	30.7	32.5	35.3	37.1	31.6	34.7	34.6	36.9	32.1
MF NET PROFIT	10,703	12,467	13,892	12,811	13,327	15,143	17,010	16,143	16,022	16,412	19,107	17,544
GROWTH, %	21.8	23.5	21.4	24.6	24.5	21.5	22.4	26.0	20.2	8.4	12.3	8.7
PAT MARGIN, %	22.2	24.6	25.6	22.0	23.1	25.3	27.5	23.5	24.1	24.8	27.2	23.4
ADJ FULLY DILUTED EPS, RS	1.38	1.61	1.80	1.66	1.72	1.96	2.19	2.09	2.05	2.10	2.44	2.24
SEGMENT WISE NET SALES	58,454	59,835	60,713	63,790	69,685	69,599	70,001	75,461	77,372	77,648	80,379	84,212
CIGARETTES	24,836	25,501	27,726	27,673	28,736	29,681	32,328	32,496	33,042	30,650	35,479	34,220
OTHER FMCG	10,014	10,556	11,021	13,125	11,978	13,407	13,707	16,165	14,731	16,075	16,706	19,556
AGRI BUSINESS	13,568	12,496	10,376	10,818	17,071	14,345	11,394	14,142	16,914	16,712	13,388	15,556
HOTELS	2,099	2,089	2,816	3,003	2,305	2,111	2,787	2,858	2,324	2,449	3,325	3,123
PAPER	7,937	9,192	8,773	9,170	9,596	10,054	9,784	9,799	10,361	11,762	11,481	11,757
INTERSEGMENT REVENUE	10,365	9,400	6,818	5,595	12,197	9,857	8,245	7,044	11,135	11,414	10,066	9,150
NET SALES	48,089	50,435	53,895	58,195	57,488	59,742	61,756	68,418	66,237	66,234	70,312	75,062
REVENUE GROWTH YOY %												
CIGARETTES	12.37	12.88	15.58	12.82	15.70	16.39	16.60	17.43	14.99	3.26	9.74	5.30
OTHER FMCG	32.19	22.27	23.83	16.91	19.61	27.00	24.37	23.16	22.98	19.91	21.87	20.98
AGRI BUSINESS	44.24	21.53	14.64	9.49	25.82	14.80	9.81	30.72	-0.92	16.50	17.50	10.00
HOTELS	21.47	20.05	13.72	17.22	9.78	1.05	-1.03	-4.82	0.82	15.97	19.29	9.27
PAPER	12.96	16.30	8.07	14.19	20.90	9.38	11.52	6.87	7.98	16.98	17.35	19.97
SEGMENT EBIT												
CIGARETTES	13,050	14,582	15,330	14,706	15,767	17,289	18,442	17,579	18,998	17,762	21,037	18,705
OTHER FMCG	-892.5	-669	-736	-678.4	-762.8	-558	-468	-166.8	-388.4	-188.4	11.6	311.6
EBIT GROWTH YOY %												
CIGARETTES	15.96	16.50	17.03	17.53	20.82	18.56	20.30	19.53	20.49	2.74	14.07	6.41
EBIT MARGINS %												
CIGARETTES	52.54	57.18	55.29	53.14	54.87	58.25	57.05	54.09	57.50	57.95	59.29	54.66

Source: MF Global India Research Estimates

- **Pricing growth in FY13 similar to FY11 but increasing VAT rate reduces the effective price growth:** We estimate on the ground Cigarette price growth for ITC at 17% YoY, similar to FY11. However the main differential between these 2 years is the impact of rising VAT rates on FY13E. On account of sharp increase in weighted average VAT rates by 3% YoY in FY13E, we expect the effective price growth to be lower at 14% YoY.

- **Estimate negative average Volume growth of 2% YoY over the remaining quarters of FY13E against consensus view of positive volume growth. Analysis of volume growth trends in FY09 and FY11 supports our estimations:**
    - We analyse volume growth in FY09 and FY11 wherein ITC had undertaken double digit price growth. We observe that Cigarettes witnessed volume degrowth of ~3% YoY. Hence in FY13E, price growth at 17% YoY being similar we estimate Volume growth to come under pressure.
    - Also the cigarette price growth base effect preceding to FY13 have been sharp at 18% YoY in FY11 and ~9% YoY (adjusted higher for VAT impact) in FY12, which we estimate to have a bearing on cigarette volumes in FY13E.
    - Rising macroeconomic concerns are also expected to negatively impact consumer sentiment.
    - Hence although ITC has effectively managed volume growth in Q1FY13 at 1% YoY, we expect average Volume degrowth of 2% YoY over the remaining quarters of FY13E.

- **Opportunity for additional price hikes is limited in H2FY13E:** We believe that rising volume growth pressure will limit the extent of pricing growth that ITC can undertake in H2FY13E. We notice that ITC has yet to take price hikes to mitigate the impact of sharp VAT rate hikes in UP. Also macroeconomic risks limit the ability to effectively pass on price hikes to consumers. We estimate a marginal weighted average price hike of 3% YoY in H2FY13E.

- **Net Sales growth in Cigarettes expected to decelerate sharply:** On account of volume degrowth, lower effective impact of pricing growth and limited scope for price hikes in H2FY13, we estimate Cigarette net sales growth to decelerate to 5 – 10% YoY over Q2 – Q4FY13E.

- **Pricing growth of 17% YoY may not be able to provide sustenance of the strong EBIT growth trend. We estimate Cigarette EBIT growth of 10% YoY against consensus view of 15%-18% YoY for FY13E**:
    - Analysis of EBIT growth in FY11 indicates that ITC had to undertake price hikes of 5%+ over the required 12% YoY so as to mitigate the impact of 17% YoY increase in excise duties. Hence a 18% YoY price growth generated EBIT growth of 16% YoY in FY11.
    - Coming to FY13, the excise duty hike is sharper at 21% YoY, requiring price growth of 14 – 15% YoY to set off the impact. Secondly VAT rate hike by 3% YoY, requires similar quantum of price growth to mitigate the impact. Hence the cumulative price growth to neutralize taxation impact is 17% YoY.
    - A sustained EBIT growth of 15% YoY over the forthcoming quarters necessitates a price growth to 23% YoY (including VAT) for FY13E (23% YoY price growth will be the severest in ITC's history). Implying that ITC will have to take weighted average price hikes of 6% YoY in H2FY13E to meet consensus estimates of 15% YoY EBIT growth.

As we believe that room to take higher price hikes in H2FY12 is limited, we estimate Cigarette EBIT to decelerate to 10% YoY in FY13E. In Q2FY13 we expect EBIT growth at 3% YoY, due to sharp volume degrowth to 3% YoY, lack of price hikes to set off UP VAT impact is expected to reduce pricing efficacy and full impact of excise duty hike of 21% YoY to be reflected.

Framework Convention for Tobacco Control (FCTC) Guidelines – Much more than Plain Packaging

In this section we highlight the guidelines laid down by Framework Convention for Tobacco Control (FCTC) which stretch much beyond the highly publicized packaging norms. While we acknowledge that risks associated with plain packaging norms for the tobacco industry are likely to be beyond the investment horizons of most financial institutions, we find that adherence to the FCTC guidelines present serious discernible risks to the tobacco sector over the medium to long-term. India has been a signatory of FCTC since its inception in 2005 and has made significant progress in the implementation of the guidelines.

A closer study of FCTC guidelines indicate that FCTC guidelines have far reaching consequences for the tobacco industry with packaging norms being just one of the measures to reduce demand for tobacco products. The FCTC guidelines have framed stringent norms covering critical issues from taxation to environmental norms to reduce demand and supply of tobacco products.

Being a signatory, India has been at the forefront of implementing the FCTC guidelines. However there is a long way to go to achieve complete adherence to the guided recommendations. In our analysis we present the key guidelines and the implementation of which will seriously impact the cigarettes industry over the medium to long-term.

We believe that implementation of FCTC guidelines will deter tobacco consumption over the medium to long-term. This poses serious risks to the valuations of cigarette companies and ITC cannot be insulated from the long-term de-rating risks. We present the key FCTC guidelines and status of the implementation in India and Globally.

WHO Framework convention on tobacco control

The Framework Convention on Tobacco Control (FCTC) is the first treaty to be negotiated under the World Health Organisation (WHO). It has been effective from February 2005 with 172 countries as signatories as of April 2011.

Objective: The objective is to comprehensively control the spread of the global tobacco epidemic. The treaty comprises of certain legally binding provisions for the signatories by way of tobacco demand reduction provisions (Artcile 6 – 14) and tobacco supply reduction provisions (Article 15 – 18).

WHO FCTC Demand reduction measures

Article 6 - Raising taxes on all tobacco products to reduce the consumption
Article 7 - Non-price measures to reduce the demand for tobacco
Article 8 - Protection from exposure to second hand tobacco smoke.
Article 9 and 10 - Tobacco content and product regulation
Article 11 - Packaging and labeling of tobacco products.
Article 12 - Education, Communication, training and awareness
Article 13 - Prohibition on tobacco advertisement, promotion and sponsorship
Article 14 - Promoting tobacco cessation and providing treatment for tobacco dependence

WHO FCTC Supply reduction measures

Article 15 - Regulation of illicit trade in tobacco products.
Article 16 - Prohibition on sales of tobacco products to and by minors.
Article 17 - Provision of support for economically viable alternative activities (livelihood and cropping) for tobacco farmers and workers.
Article 18 - Protection of the environment and health of persons in relation to the environment in respect of tobacco cultivation and manufacture.

Implementation of the FCTC: The Conference of the Parties (COP) is the governing body of FCTC and comprises all the signatories of the Convention. The COP reviews the implementation of the FCTC and undertakes decisions that are imperative in the effective implementation of the FCTC.

Progress of the FCTC:

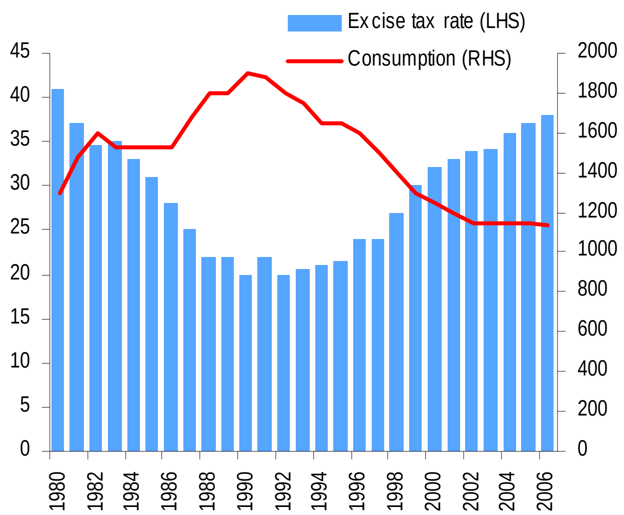
- The COP convenes regularly to discuss the implementation of the FCTC.
- Guidelines on numerous (10+) demand and supply reduction measures have been developed while the remainder are in advanced stages of development.
- Signatories have been periodically submitting their country's progress report highlighting the substantial progress being made in meeting their obligations as defined in the FCTC.

Below we present our brief analysis on specific FCTC guidelines which we believe to have a negative material impact on the tobacco industry in India in the medium to long term. We have analysed India's current status in these guidelines and highlight the probable tobacco control norms that could emerge in India in the future.

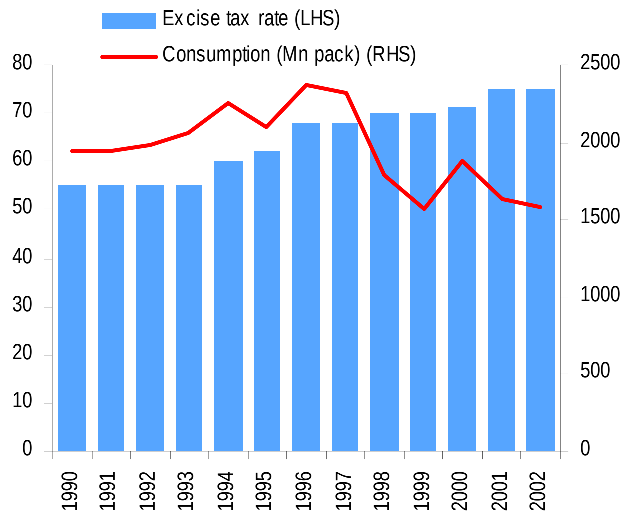
Raising taxes on all tobacco products to reduce the consumption – WHO recommends taxation at 67%-80% of MRP, India currently stands at ~58% of MRP

Increase in taxes most effective way to reduce tobacco demand: FCTC recognizes that increase in taxes is the most effective way to reduce the consumption of tobacco globally. It also specifies that sharp hike in tobacco retail prices on account of increase in taxes is a crucial deterrent for economically disadvantaged and young tobacco users. It is to be noted that these users comprise majority of the new target consumers for the tobacco companies as is being witnessed in India. Below we present the successful impact of increase in taxes on decreasing tobacco consumption for emerging economies South Africa and Thailand

SOUTH AFRICA



THAILAND



Source: WHO

High revenue generation ability for the government on account of low price elasticity of cigarettes: FCTC discusses the ability for the governments to generate higher tax revenues on account of prevailing low price elasticity of cigarettes. High income countries i.e Europe and North America are estimated to have a price elasticity of -0.4 implying for every 10% increase in tax, cigarette consumption decreases by 4%.

Price elasticity in India: According to WHO the reported price elasticity in India for Cigarette is lower at -0.18 to -0.34, implying a marginal decrease in cigarette consumption by ~2 to 3% for every 10% increase in taxes. For Bidis the price elasticity is high at -0.86 to -0.92, ie ~9% decrease in Bidi consumption for every 10% increase in taxes. Similarly for Chewing tobacco it is estimated at -.92

PRICE ELASTICITY OF DEMAND	CIGARETTES	BIDIS
HIGH INCOME COUNTRIES	-0.4	
LOW AND MIDDLE INCOME COUNTRIES	-0.8	
CHINA	-.5 TO -.64	
INDIA	-.18 TO -.34	-.86 TO -.92

Source: FCTC Guidelines

Hence any increase in taxation in Bidis and Chewing tobacco does not generate any higher revenues for the government on account of the high price elasticity. Hence we observe that the tax regime in Bidis and smokeless tobacco continues to be marginal in relative comparison to Cigarettes while Cigarette has observed sharp excise and State VAT duty hikes in the past 5 years. We estimate that the Indian Government will continue to leverage on Cigarettes as higher tax revenue generating opportunity.

FCTC Guideline Recommendation for Article 6 related to taxation

FCTC is currently in advanced stages of developing guidelines for Article 6 with the latest status being the filing of the working paper in November 2012. However there are certain conclusions that the working committee has highlighted:

*(1) **Reduce the affordability of the product:** When governments set taxes, it is important that they are set so as to reduce the affordability of tobacco products to such an extent that there are significant reductions in tobacco use and its consequences, particularly among the youth and economically disadvantaged people.*

*(2) **Taxation rate should effectively prevent product substitution:** A tax structure that raises the prices of all tobacco products and minimizes the gap between the prices of low- and high-priced brands of a given type of tobacco product, reduces opportunities for tobacco users to switch to cheaper brands/products in response to tax increases.*

WHO Guidelines

WHO has defined several recommendations that countries should incorporate in their tobacco taxation policies. Below we highlight the recommendations and India's current status on the same:

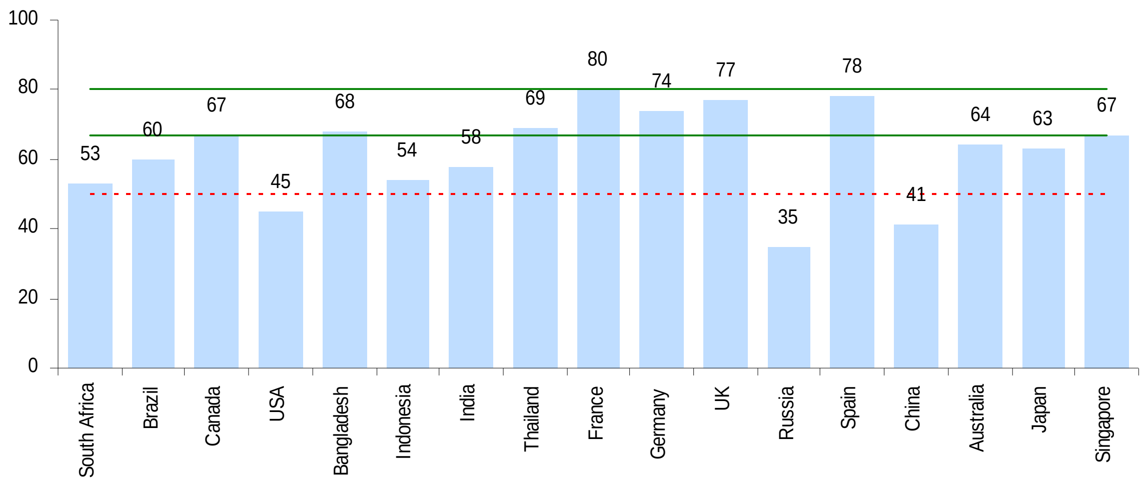
SR. NO	WHO RECOMMENDATIONS ON TAXATION	INDIA'S STATUS	COMMENTS
1	SET THE TAX AT BETWEEN TWO THIRDS (67%) AND FOUR FIFTHS (80%) OF THE RETAIL PRICE OF ALL TOBACCO PRODUCTS	✘	PREVAILING TAX RATE AT 58%
2	TAX ALL TOBACCO PRODUCTS AT COMPARABLE RATES TO PREVENT PRODUCT SUBSTITUTION.	✘	MULTI TIER TAX STRUCTURE
3	TIE THE TOBACCO TAX TO THE RATE OF INFLATION AND CONSUMER PURCHASING POWER.	✘	
4	ALLOCATE TOBACCO TAX REVENUES, OR A PORTION OF THEM, TO TOBACCO CONTROL OR HEALTH PROMOTION PROGRAMMES.	✘	
5	BAN THE 'DUTY FREE' SALE OF TOBACCO PRODUCTS.	✘	

Source: WHO Tobacco Epidemic Report 2011, FCTC, India FCTC Progress Report, MF Global India Research

Reduce the affordability of the product

- **Taxation rate at two thirds or four fifths of the retail price as per WHO standards:** WHO has specified that the taxation rate for tobacco products should be maintained at 67 – 80% of the retail price. Below we have presented the relative comparison of the prevailing tax rate in several geographies. India's taxation rate at 58% (including VAT) is above the current world average of 50%, however it continues to be significantly lower than the set benchmark of 67 – 80%.

RELATIVE COMPARISON OF EFFECTIVE CIGARETTE TAXATION RATES



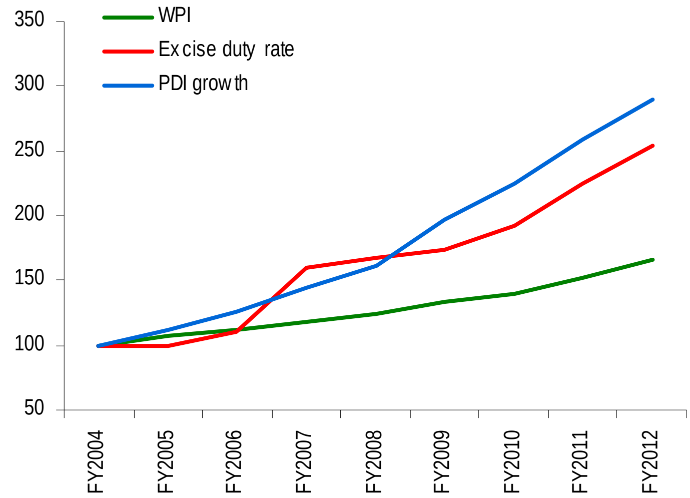
Source: WHO Tobacco Epidemic Report 2011, MF Global India Research

- **Tie taxation rate to inflation and consumer purchasing power:** It has been reported that thought tobacco taxation rates have increased the taxation rates have not been in line with the inflation rates and the income growth rate specifically in developing economies like India. Hence the affordability of tobacco products has improved inspite of higher tobacco product prices on account of higher taxes. Countries like Australia and New Zealand have benchmarked their tobacco taxation rates to inflation to prevent increase in usage due to higher purchasing power.

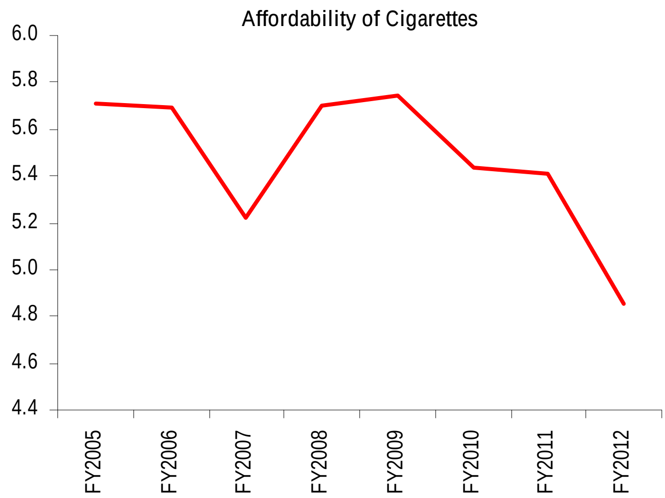
India analysis

- **Excise and VAT rate exceeds inflation but lags income growth:** We have analysed the increase in excise duty rate for filter cigarettes, inflation and personal disposable income growth in India for the period FY05 – 12 indexed to FY2004. We observe that the excise and VAT tax rates exceed inflation particularly from 2007 since the introduction of VAT rates at 12.5%. However the combined tax rate lags income growth. Hence India presents a case for benchmarking tobacco taxation rate to income growth.
- **Affordability of cigarettes has increased – A downward curve implies improvement in affordability:** In accordance with tobacco industry experts we have evaluated the affordability of cigarettes in India by measuring the ratio of purchase amount of 100 packs of the most sold brand (Gold Flake Regular 69mm) to the per capita GDP for the period FY05 -12. In line with expectations, we observe that the affordability of cigarettes has improved during the period.

INDEXED ANALYSIS OF INFLATION, INCOME GROWTH AND EXCISE DUTY INCREASE



AFFORDABILITY OF CIGARETTES



Source: MF Global India Research

Bloomberg Initiatives and Gates foundation funded report on recommendation of tobacco taxation in India

Bloomberg Initiatives has conducted comprehensive analysis of tobacco taxation recommendations for several countries including India. These recommendations take cognizance of the guidelines recommended by WHO. The 2010 report on India puts forward certain staggering recommendations on both forms of Smoking tobacco ie – Cigarettes and Bidis. We have discussed the same below:

- **Increase bidi taxes to Rs. 98 per 1000 sticks:** The report recommends a sharp increase in bidi taxes by 7x to Rs. 98 per 1000 sticks from the Rs. 14 per 1000 sticks, stating that the government can continue to generate higher tax revenues to the point of tax rate at 40% of the retail price of bidis. This will increase tax revenues by Rs. 37 bn for the government.
- **Increase cigarette taxes to Rs. 3691 per 1000 sticks:** The report recommends an increase in cigarette taxes to Rs. 3691 per 1000 stick (assumed realization of Rs. 1.72 per stick), implying that taxation rate upto 78% of the retail price will generate increase in tax revenues for the government to the tune of Rs. 146 bn. The current taxation rate on cigarettes including VAT in India is 58%.

- **Abolish system of taxing cigarettes based on length to simplify and strengthen tobacco taxation:** The report recommends that in order to simplify the tax administration, the practice of taxing cigarettes based on length should be abolished. Eliminate differential taxes on smoked tobacco products and thereon administer higher tax rates adjusted for inflation. This will enable to increase tax revenue collection (decrease tax evasion).

Implications of FCTC and WHO tobacco taxation recommendations for India

- **Taxation rates to remain on the uptrend, of which we are cautious of probability of sharp increase in the State VAT rate:** It is clearly evident that the Indian government has stepped up control of the tobacco use in the past few years namely by way of increase in incidence of taxation. With two rounds of sharp excise duty increase of 17% YoY in FY11 and 21% YoY in FY13 and increase in VAT rates by 7% during FY12 – FY13, India's present effective taxation rate for Cigarettes is 58%, which is above the world average of 50%. However since India continues to be below the 67 – 80% recommendation of WHO we estimate taxation rates (excise + State VAT) to be on the uptrend in the medium to long term. Of the taxation rates we are highly cautious of State VAT rates. The average State VAT for ITC is currently 20 – 21%, of which certain states like Rajasthan and Uttar Pradesh are at 50%. Hence on account of the wide gap we estimate sharp movement in VAT rates to hold in the medium to long term.
- **Cigarette industry largely to bear burden of high taxation rates on account of low price elasticity:** Considering the inability to generate higher tax revenues from Bidis and Smokeless tobacco on account of their high price elasticity of -0.9, we estimate that the taxation burden of the tobacco industry will continue to be borne by the Cigarette industry. Cigarette industry's low price elasticity of -0.2 to -0.3, will continue to present lucrative tax revenue generating prospects for the government.

Tobacco content and product regulation – ITC might have to withdraw the premium variants in Classic and GoldFlake if the regulations are fully implemented

Article 9 and 10 aims to develop effective tobacco control regulation for contents and emission to reduce tobacco attributable diseases and premature deaths by reducing the attractiveness of tobacco products, addictiveness and reducing the overall toxicity.

Attractiveness – no flavoured agents: Article 9 and 10 suggests that tobacco producers are undertaking efforts to reduce the harshness of tobacco products by introducing flavouring substances. Some tobacco products contain sweetners which have proven to increase their palatability to users. Flavouring substances include benzaldehyde, maltol, menthol and vanillin. Spice and herbs like cinnamon, ginger and mint can also be used to improve the attractiveness of the product.

FCTC Guideline Recommendation

The guidelines recommend that parties should prohibit or restrict ingredients that are being used to increase the palatability in tobacco products.

ITC's position on Article 9 and 10

- **ITC products in violation of Article 9 and 10:** Below we present a list of ITC's brands that are in violation of the Article 9 and 10 of the FCTC.

Source: MF Global India Research

- **Variants aiding premiumisation:** These variants have been developed to largely aid premiumisation and attract new consumers particularly in the age group of 18 – 24 years.
- **Investments largely made in developing flavoured variants than new brands in the last decade:** We observe that ITC has not invested behind developing new brands in the last decade but has primarily focused on introducing new variants. Below is the list of the same.

FY2002	- NEW AND INNOVATIVE FLAVOUR OPTIONS IN 2 LEADING BRANDS
FY2003	- GOLD FLAKE KINGS COOL MIST LAUNCHED
FY2007	- LIMITED EDITION OFFERINGS IN DIFFERENT FLAVOURS
FY2008	- LIMITED EDITION PACKS AND FLAVOURED VARIANTS IN CLASSIC
FY2011	- CLASSIC MENTHOL RUSH LAUNCHED
FY2011	- GOLD FLAKE ARCTIC MENTHOL LAUNCHED

Source: MF Global India Research

Conclusion

- **Withdrawal of variants if guideline implemented:** In course of implementation of the Article 9 & 10 of the FCTC policy in India there is a probability that ITC may have to withdraw these variants in the medium to long term.
- **Branding ability to be restricted:** These variants provide ITC the opportunity to facilitate branding of the Classic (c. 16%) and Gold Flake (c. 43%) brands. Any withdrawal will restrict ITC's branding exercise.
- **Setback to strategy to drive premiumisation and thereby margins:** These variants are typically priced at a premium in relative comparison to the regular brand. Hence any withdrawal will marginally impact ITC's cigarette EBIT margins. Also the current rapid pace of premiumisation among ITC's Cigarette brands will get impacted on account of lack of product choice for consumers.

Packaging and labelling of tobacco products – Possibility of harsh pictorial warnings for Indian tobacco products in the medium term

Article 11 proposes measures that Parties can use to increase the effectiveness of their packaging and labeling measures. Well designed health warnings and messages on tobacco product packages have been shown to be a cost-effective means to increase public awareness of the health effects of tobacco use and to be effective in reducing tobacco consumption.

FCTC Guideline Recommendation under Article 11

Stated below are recommendations of Article 11. We have analysed India's status on the same.

SR NO.	ARTICLE 11 RECOMMENDATIONS	INDIA'S STATUS	COMMENTS
1	APPROVED BY THE COMPETENT NATIONAL AUTHORITY	✓	
2	WARNING LABELS SHOULD USE PICTURES	✓	
3	LABELS SHOULD INCLUDE FULL COLOUR PICTURES	✓	
4	LABEL SHOULD OCCUPY 50% OR MORE OF THE DISPLAY	✘	OCCUPIES 40% OF THE FRONT DISPLAY SIZE
5	LABEL SHOULD OCCUPY NOT LESS THAN 30% OF THE DISPLAY	✓	
6	LABEL SHOULD APPEAR BOTH FRONT AND BACK OF THE PACKAGE	✘	APPEARS ONLY ON THE FRONT OF THE PACK
7	ENSURE THAT HEALTH WARNINGS ARE ROTATED	✓	12 - 36 MONTHS ROTATION
8	CARRY HEALTH WARNINGS THAT DESCRIBE HARMFUL EFFECTS OF TOBACCO USE	✓	
9	ENSURE THAT THE WARNINGS ARE CLEAR, VISIBLE AND LEGIBLE	✓	
10	WARNINGS IN PRINCIPAL LANGUAGES OF THE COUNTRY	✓	
11	PRODUCTS CONTAIN INFLORMATION ON RELEVANT CONSTITUENTS AND EMISSIONS OF TOBACCO PRODUCTS	✓	
12	NOT USE MIS LEADING TERMS LIKE MILD, LIGHTS, EXTRA AND ULTRA	✘	

Source: FCTC Guidelines, COPTA, India FCTC Progress Report, MF Global India Research

India's health warning size on tobacco products smaller on a relative basis and below FCTC norms of 50%+

Below we present a relative comparison of the size of India's health warnings on tobacco products against other developed and developing economies that have similar or higher adult tobacco usage. We find that clearly the size of health warnings in India significantly lags against the countries analysed.

RELATIVE COMPARISON OF HEALTH WARNING SIZE ON CIGARETTE PACKS

	AVERAGE OF FRONT AND BACK (%)	FRONT (%)	BACK (%)
SOUTH AFRICA	20	15	25
BRAZIL	50	0	100
CANADA	50	50	50
USA	50	50	50
BANGLADESH	30	30	30
INDIA	20	40	0
THAILAND	55	55	55
FRANCE	35	30	40
GERMANY	35	30	40
UK	35	30	40
RUSSIA	40	30	50
SPAIN	35	30	40
CHINA	30	30	30
AUSTRALIA	60	30	90
JAPAN	20	-	-
SINGAPORE	50	50	50
PAKISTAN	40	40	40
REPUBLIC OF KOREA	30	30	30

Source: WHO Tobacco Epidemic Report 2011

Ban on usage of misleading terms like milds, lights

- **Article 11**: Effective measures should be adopted to ensure that product labeling and packaging do not promote a tobacco product by any means that are false, misleading, deceptive or likely to create an erroneous impression about the product's characteristics, health effects, hazards or emissions. These may include terms such as "low tar", "light", "ultra-light" or "mild"
- **FCTC Recommendation:** Parties should prohibit the usage of the terms mentioned above and terms such as "extra" and "ultra"
- **Probable withdrawal of variants will impact ITC's premiumisation of present cigarette product brands:** ITC's product portfolio comprises brand like Classic Milds and Gold Flake Lights which are premium variants of the regular brands. Any probable withdrawal of such variants will adversely impact the benefits of premiumisation which have accrued to ITC in the past few years by way of margin expansion. Hence such action will exert marginal margin pressure on ITC's cigarette business.

India's packaging and labeling norms progression in implementation of FCTC guidelines

India initiated health warnings for tobacco products with textual messages. However stricter norms have been introduced in the past 3 years with the introduction of pictorial warnings.

Introduction of pictorial warnings in 2009

The health ministry had notified coloured graphic warnings in 2006 and in 2007, however in the final recommendation in 2009 the final warnings were significantly benign relative to the intention of stringent packaging norms.

NOTIFIED IN 2006	NOTIFIED IN 2007	INTRODUCED IN MAY 2009
		

Source: COPTA

Size of the warning set at 40% in 2009

The final recommendation of the size of the health warnings was set at 40% of the front display. However this was below the notification of 50% set in 2007.

Stricter Health warning norms issued in 2011

In Dec 2011, the government introduced coloured health warning norms as recommended by FCTC. However we notice that issued norms for smokeless tobacco is explicit than that for smoking tobacco.

INTRODUCED IN DEC 2011 FOR SMOKING TOBACCO	INTRODUCED IN 2011 FOR SMOKELESS TOBACCO
	

Source: COPTA

Way forward for health warnings in India to replicate stringent warnings in other countries

We estimate that as India increases the extent of implementation of FCTC recommendations for packaging, the pictorial warnings in India are expected to be harsh in the future. We also expect an increase in the size of the warnings and expect regular periodic rotation of the warnings in the future. Below we present certain norms exercised in Brazil and Australia. These warnings focus on both the pictorial warning and the message which is crucial for educating the user on the ill effects of tobacco consumption

BRAZIL

AUSTRALIA

Source: International Tobacco Control Project

Harsh warnings to have a definite impact on tobacco use in India

While it is difficult to ascertain the extent of the impact on tobacco use, studies indicate that harsh tobacco warning norms have a definitive impact on tobacco use by way of 1/ reducing the incidence of tobacco consumption 2/ enabling consumers to take the decision to quit the habit 3/ restricting new consumers particularly the youth from starting consumption. Hence any measure in packaging norms in the future is estimated to negatively impact the tobacco industry.

Impact on Cigarettes category to be higher than other tobacco products: The present packaging norms are not being effectively implemented in bidis and smokeless tobacco as these categories are largely unorganized in nature with higher consumption habit prevalent in rural areas. Conversely, the cigarette industry largely constitutes of organized players that follow tobacco regulations strictly. Hence any introduction of new packaging norms will have a higher impact on the Cigarette industry due to higher sensitivity to packaging norms.

Prohibition on tobacco advertisement, promotion and sponsorship – Brand sharing of Wills and point of sale advertising could come under scanner

Article 13 aims to enforce a comprehensive ban (domestic and international) on tobacco advertising, promotion and sponsorship to all forms of commercial communication and all forms of contribution to event, activity or individual with the aim, effect or likely effect to promote the use of tobacco product directly or indirectly

SR NO.	ARTICLE 13 RECOMMENDATIONS	INDIA'S STATUS	COMMENTS
1	APPLYING RESTRICTIONS ON ALL TOBACCO ADVERTISING, PROMOTION AND SPONSORSHIP	✓	EFFECTIVE FROM 2003
2	REQUIRE THAT HEALTH MESSAGES ACCOMPANY ALL TOBACCO ADVERTISING, PROMOTION AND SPONSORSHIP	✓	
3	REQUIRE DISCLOSURE TO GOVERNMENT AUTHORITIES BY THE TOBACCO INDUSTRY OF EXPENDITURES ON ADVERTISING, PROMOTION AND SPONSORSHIP NOT YET PROHIBITED	✘	
4	RESTRICTION OF ADVERTISING AT POINT OF SALE	✘	
5	RESTRICTION ON BRAND SHARING AND STRETCHING AS MEANS OF TOBACCO ADVERTISING AND PROMOTION	✘	WILLS NAVY CUT CIGARETTE BRAND NAME EXTENDED BY ITC TO FIAMA DI WILLS, ESSENZA DI WILLS AND WILLS LIFESTYLE IN THE FMCG SEGMENT

Source: FCTC Guidelines, India FCTC Progress Report

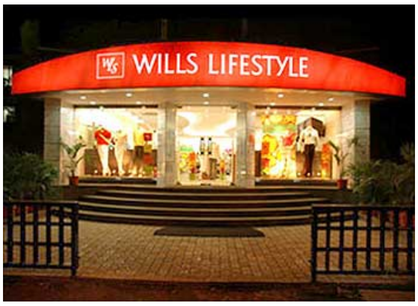
Retail sale and display

- **Article 13**: Display of products at point of sale constitutes advertising and promotion. Display is said to stimulate the purchase decision of the consumer, giving the impression that tobacco use is socially acceptable and more importantly make it harder for the user to quit. Young users are said to be the most susceptible to promotional display of tobacco products.
- **FCTC Recommendation:** Parties should introduce a total ban on any display and on the visibility of tobacco products at points of sale, including fixed retail outlets and street vendors. Only the textual listing of products and their prices, without any promotional elements, would be allowed.

Source: MF Global India Research

Brand Sharing and Stretching

- **Article 13:** Brand "stretching" and Brand "sharing" occurs when a tobacco brand name, emblem, trademark, logo or trade insignia or any other distinctive feature (including distinctive colour combinations) is connected with a non-tobacco product or service in such a way that the tobacco product and the non-tobacco product or service are likely to be associated.
- **FCTC Recommendation**: Parties should ban brand sharing and stretching as they are means of tobacco advertising and promotion.



Source: MF Global India Research

Article13 implications for ITC

- **Retail Sale and Display:** ITC has the most comprehensive network of retail outlets for the Cigarette business on a pan India basis. ITC has been investing in point of sale display promotion to generate consumer interest.
- **Brand Sharing and Stretching:** ITC has extended the Wills cigarette brand to the FMCG business with brands – 1/ Wills Lifestyle - clothing apparel brand 2/ Fiama Di Wills – soap, shampoo, body was brand.
- **Restriction on point of sale promotion will entirely withdraw any branding opportunity for ITC:** Point of sale display enables in attracting new consumers and also influences the purchase decision of users that want to convert from other tobacco products to Cigarettes. Hence repeal of point of sale promotion withdraws the branding opportunity available to ITC. This can also present a level playing field opportunity to other competitors, thereby increasing competitive intensity in the organized cigarette category.
- **Will impact the brand saliency that ITC has generated in the FMCG segment:** ITC has made significant investments in developing Fiama Di Wills brand in the Personal Products category. ITC also operates 153 Wills Lifestyle stores with sharp increase in store additions on a YoY basis. Hence any regulatory change in "brand sharing" guidelines will have a negative impact on <10% of ITC's FMCG revenues.

Plain packaging – A real long-term risk

The FCTC guidelines recognize the effectiveness of plain packaging in controlling tobacco use. Article 11 and 13 of the guidelines discuss plain packaging with recommendations that are similar to the recent plain packaging policy being adopted by Australia.

Article 11 - Packaging and labeling of tobacco products

Parties should consider adopting measures to restrict or prohibit the use of logos, colours, brand images or promotional information on packaging other than brand names and product names displayed in a standard colour and font style (plain packaging). This may increase the notice ability and effectiveness of health warnings and messages, prevent the package from detracting attention from them, and address industry package design techniques that may suggest that some products are less harmful than others.

Article 13 Prohibition on tobacco advertisement, promotion and sponsorship

The effect of advertising or promotion on packaging can be eliminated by requiring

- *plain packaging: black and white or two other contrasting colours, as prescribed by national authorities;*
- *nothing other than a brand name, a product name and/or manufacturer's name, contact details and the quantity of product in the packaging,*
- *without any logos or other features apart from health warnings,*
- *tax stamps and other government-mandated information or markings;*
- *prescribed font style and size; and standardized shape, size and materials.*

Plain packaging from India's standpoint

- **Several form of tobacco products:** Indian tobacco consumption habit consists of both smokeless (chewing tobacco, gutka) and smoking tobacco (bidi, cigarettes) products. Hence any plain packaging guideline will have to be standardized across the numerous products.
- **Large unorganized tobacco industry:** The Indian tobacco industry continues to be largely unorganized with absence of practice of current packaging norms in products like bidis in the rural markets.
- **Effective implementation estimated to be complex, hence remote in the medium term:** Lack of effective packaging norms in rural areas (constitute majority of the tobacco users in India) and large unorganized market in bidis, chewing tobacco (main forms of tobacco usage in India) is estimated to make implementation of plain packaging a complex policy in India. Hence the introduction of plain packaging norms is expected to be remote in the medium term.
- **Prior to plain packaging, stringent health warnings on tobacco products is foreseeable:** With India lagging in the implementation of certain recommendations of Article 11 of FCTC on packaging and labeling, we estimate that stringent norms in terms of harsh picture warnings, larger size of warnings, frequent rotation of warnings are the expected effective measures on packaging of tobacco products in India in the future.

Source: Department of Health, Australia

India's progress report on implementation of FCTC guidelines since 2006

In our study of the FCTC guidelines we have analysed India's progress in the implementation of the recommendations since CY2005 from when on India became a signatory of this global tobacco control policy. We have studied India's recently submitted 5 year progress report on Tobacco control to FCTC and have highlighted below the critical measures undertaken. These initiatives have been all pervasive in their implementation of the demand and supply measures as recommended by FCTC.

		YEAR	INITIATIVES	COMMENTS
ARTICLE 6	RAISE TAXES ON ALL TOBACCO PRODUCTS	2007	STATE VAT	STATE VAT OF 12.5% INTRODUCED ON TOBACCO PRODUCTS
		2009	NON - FILTER CIGARETTES	INCREASE IN TAX RATE ON NON FILTER CIGARETTES BY 1.4X - 4X RENDERING THE SEGMENT UNVIABLE
		2006 - 2012	EXCISE TAX RATE = INFLATION	INCREASE IN EXCISE DUTY ON FILTER CIGARETTES AT 7% CAGR DURING FY06 - 13 IN LINE WITH AVERAGE WPI INFLATION FOR THE SAME PERIOD
ARTICLE 8	PROTECTION FROM EXPOSURE TO SECOND HAND SMOKE	2008	BAN ON SMOKING IN PUBLIC PLACES	THE PROHIBITION OF SMOKING IN PUBLIC PLACES RULES, 2008 CAME IN FORCE IN OCT 2008 APPLICABLE IN ALL PUBLIC PLACES
ARTICLE 9 & 10	TOBACCO CONTENT AND PRODUCT REGULATION			PROPOSAL TO CREATE NATIONAL TOBACCO REGULATORY AUTHORITY INVOLVING SET UP OF TOBACCO TESTING LABS
ARTICLE 11	PACKAGING AND LABELING OF TOBACCO PRODUCTS	2009	PICTORAL WARNINGS	INTRODUCTION OF BLACK AND WHITE PICTORAL WARNINGS
		2011	ROTATION OF WARNINGS	INTRODUCED HARSHER COLOURED PICTORIAL WARNINNGS
ARTICLE 12	EDUCATION, COMMUNICATION, TRAINING AND AWARENESS	2009	ANTI TOBACCO MASS CAMPAIGNS	NATIONAL TOBACCO CONTROL PROGRAMME (NTCP) EARMARKS $5 MN FOR UNDERTAKING ANTI TOBACCO MASS CAMPAIGNS
		DEC-09	FIRST PHASE OF CAMPAIGNS	AIRED TELEVISED AND RADIO CAMPAIGNS IN 11 LANGUAGES
		MAR-11	SECOND PHASE OF CAMPAIGNS	AIRED TELEVISED AND RADIO CAMPAIGNS IN 16 LANGUAGES
ARTICLE 14	PROMOTING TOBACCO CESSATION	2011	EXPAND TOBACCO CESSATION CENTRES	LOOKING TO EXPAND CURRENT NETWORK OF CENTRES FROM 19 TO 42
		2011	SUBSIDISE NICOTINE CHEWING GUMS	LOOKING TO SUBSIDISE NICOTINE CHEWING GUMS TO PROVIDE BOOST TO NICOTINE REPLACEMENT THERAPY IN INDIA
ARTICLE 17	PROVISION OF SUPPORT FOR ECONOMICALLY VIABLE ALTERNATIVE ACTIVITIES FOR TOBACCO FARMERS AND WORKERS.	2008	SKILL BASED TRAINING FOR BIDI ROLLERS	MINISTRY OF LABOUR LAUNCHED PILOT PROGRAM IN 17 TOWNS
		2009	ALTERNATIVE CROPPING SYSTEM TO BIDI AND CHEWING TOBACCO.	PILOT PROJECT OF 3 YEARS UNDERTAKEN IN AREAS OF AP, TN, GUJARAT, WB AND KARNATAKA. RS. 33 MN EARMARKED FOR THE PROJECT
OTHERS	RESEARCH, SURVEILLANCE AND EXCHANGE OF INFORMATION	2010		GLOBAL ADULT TOBACCO SURVEY INTRODUCED WITH COMPREHENSIVE INFORMATION OF TOBACCO CONSUMPTION IN INDIA
	LEGISLATION, REGULATION AND POLICIES	2007		NATIONAL TOBACCO CONTROL PROGRAMME LAUNCHED IN THE 11TH FIVE YEAR PLAN 2007 - 2011. STATE LEVEL AND DISTRICT LEVEL TOBACCO CONTROL CELLS LAUNCHED TO MONITOR IMPLEMENTATION

Source: India FCTC Progress Report, MF Global India Research

Serious intention of tobacco control to increase regulatory risk for the tobacco industry: We believe that the Indian government's intention to effectively control tobacco use is clearly visible particularly in terms of taxation. With taxation and packaging norms being the most effective in restricting tobacco demand, we estimate that the regulatory risks in these 2 factors to be on the increase in the future.

Cigarette industry the most impacted by FCTC measures: The taxation risk has been the highest for the Cigarette industry in the past 5 years with sustained increase in excise duty, steep hikes in the non filter cigarette segment, introduction of State VAT and steep hikes in State VAT during CY11 - 12. Cigarette industry's sensitivity to packaging norms is higher than other tobacco products as detailed in discussion on Article 11. We estimate that Cigarette industry will continue to remain under regulatory pressure in the future with increase in taxation and packaging norms being the critical risk factors. Hence ITC's Cigarette business will remain vulnerable to tobacco regulation in the medium to long term.

FMCG others – Strong revenue growth but value added will not be inspiring

The FMCG others segment has seen inspiring revenue growth in the last 5 years. ITC has consistently gained market shares in most of the key categories that the company operates. We believe that the segment will continue to register robust revenue growth and market share gains over the medium term but we do not expect significant economic value addition over the long-term as a large part of the FMCG others portfolio consists of products with low margins and the company may not be able to achieve market leadership position in perceptible time horizon. We believe the FMCG others category over the long-term will see normalized margins of 7-8% which is relatively lower than other FMCG companies like Hindustan Unilever, Nestle, Dabur and others.

SEGMENTS SNAPSHOT

				FY2015E			
(ESTIMATES)	REVENUES FY2012E (RS MN)	REVENUE CONTRIBUTION (%)	SALES GROWTH 3 YR CAGR (%)	REVENUES (RS MN)	REVENUE CONTRIBUTION (%)	NORMALISED EBIT MARGINS (%) (N)	EBIT (N) (RS MN)
BRANDED FOODS	36,274	65.42	20	62,183	66.35	6.2	3,831
- BRANDED ATTA	12,666	22.84	20	21,886	23.35	4	875
- SNACKS	4,006	7.22	15	6,092	6.50	8	487
- BISCUITS	15,499	27.95	20	26,783	28.58	7	1,875
- NOODLES	1,300	2.34	25	2,539	2.71	8	203
- READY TO EAT MEALS	169	0.31	25	330	0.35	8	26
- CONFECTIONARY	2,635	4.75	20	4,553	4.86	8	364
PERSONAL CARE & OTHERS	19,171	34.58	18	31,534	33.65	6	1,877
- SOAPS	3,918	7.07	15	5,958	6.36	6	358
- SHAMPOO	1,228	2.22	20	2,123	2.27	10	212
- SKIN CARE	400	0.72	50	1,350	1.44	15	203
- OTHERS	13,625	24.57	17.5	22,103	23.58	5	1,105
FMCG SEGMENT	55,446		19	93,717		8.1	7,586

Source: Euromonitor, MF Global India Research Estimates

Branded Foods

Branded Atta: The FMCG others business is largely a low margin business with robust growth rate. The company has strong market position in branded Atta and branded foods segments. The company has market leadership position in branded Atta segment with the brand Ashirwad. We believe branded atta currently contributes 23% of the FMCG portfolio. We expect branded atta contribution to remain stable over the long term. Branded atta is a low margin business and we believe normalized margins in this business will be ~4% in the long-term as value addition in the category is not very significant.

Biscuits: In biscuits the competitive activity continues to remain high with Britannia and Parle being the key competitors. The company has managed to scale up the biscuits portfolio with an impressive range of premium biscuits but considering the company’s lower market share and competitive intensity we believe the long-term operating margins are likely to be ~7-8% in the category.

Snacks: The company has made decent progress in the snacks category. The snacks category is an attractive category with relatively better margins in the foods segment but success rate in the category is not particularly inspiring. ITC has experimented with a number of products in the category and has been successful with a handful of products. We expect that over the long term the category will have relatively better margins than the biscuits segment at ~10%.

Personal care

Soaps: ITC has gained market share in the soaps segment but margins in the soaps segment are not very inspiring in the long-term. We also see that competitive intensity in the soaps category is very intense with major global majors like Unilever, Reckitt and Indian players like Godrej. We do not expect significant value accretion from the soaps segment over the long-term for ITC.

Other personal care categories: In the other personal care categories of Shampoos and Skin the company's success rate has been limited. These categories have relatively higher margins in the FMCG business. We do not expect the company to be profitable in these categories over the medium term but in the long term the company could achieve margins of ~10-15% in an optimistic scenario.

Valuation of FMCG – others segment

FMCG BUSINESS VALUATION BASED ON FY15E

KEY PARAMETERS	RS MN
REVENUE	93,717
EBIT	7,586
EBIT MARGIN (%)	8
PAT	5,310
PER	30
EV	159,311
VALUE/SHARE	20
IMPLIED EV/SALES ON FY13E	2.4

Source: MF Global India Research Estimates

We value the FMCG business on FY15E based on certain optimistic assumptions on margins and multiples. Based on FY15E we assume normalized margins of 8% and arrive at an EV of Rs 160bn based on 30x FY15E earnings. At such sky valuation multiples the per share value of FMCG business translates to only 7.5% of the company value.

Thus we note that FMCG business is not a significant value driver for ITC over the medium to long-term. We continue to believe that value accretion for the company will continue to depend on the cigarettes business.

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Stretched valuations – Downgrade to Sell

ITC trades at a significant premium to global tobacco companies on account of higher growth rate and margin profile. We believe the current valuations are stretched and are unlikely to sustain in the medium to long term on account of rising risks and possible earnings disappointments.

GLOBAL PEER VALUATION SUMMARY

	PER (X)			EV/SALES (X)			EV/EBITDA (X)		
	FY12	FY13E	FY14E	FY12	FY13E	FY14E	FY12	FY13E	FY14E
ITC	33.6	28.8	24.5	7.8	6.8	5.9	22.1	18.9	16.1
BRITISH AMERICAN TOBACCO	19.3	15.0	13.7	4.6	4.6	4.4	11.3	11.3	10.6
IMPERIAL TOBACCO	13.4	11.3	10.5	2.1	4.1	4.0	9.9	9.6	9.2
PHILIP MORRIS	17.1	16.7	15.1	5.2	5.2	4.9	11.2	11.1	10.4
ALTRIA GROUP	15.6	15.1	14.0	4.6	4.6	4.6	11.0	10.6	10.2
JAPAN TOBACCO	12.6	11.9	10.9		2.1	2.0		7.0	6.7

Source: Bloomberg, MF Global India Research Estimates

ITC V/S DOMESTIC CONSUMER STAPLES

	P/E (X)		ROE (%)		EV/EBITDA (X)		P/B (X)		EV/SALES (X)		EBITDA MARGIN %		2 YR EBITDA GROWTH CAGR	2 YR EPS GROWTH CAGR
	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E		
ITC	30.6	26.3	34.3	34.7	20.4	17.3	9.8	8.5	7.3	6.3	36.0	36.5	14.7	13.4
HUL	36.4	31.8	73.4	62.0	25.8	22.0	22.2	17.7	4.5	3.9	14.1	14.4	19.4	19.3
DABUR	29.1	23.3	39.9	38.9	21.2	16.7	10.2	8.2	3.6	3.0	16.9	17.8	21.2	21.1
MARICO	30.7	25.0	26.6	22.9	20.8	16.8	6.4	5.2	3.1	2.6	13.7	14.1	30.4	28.8
GCPL	28.2	23.2	25.5	26.4	19.9	16.3	6.7	5.6	3.6	2.9	18.0	17.7	28.6	24.3
NESTLE	40.3	33.1	70.6	61.8	23.5	19.2	24.2	17.6	5.2	4.3	22.0	22.3	20.5	17.4
COLGATE	34.5	30.7	107.3	104.9	25.1	21.5	35.1	29.7	5.4	4.6	21.3	21.3	28.2	28.9
GSKCONS	27.8	24.7	36.8	34.7	22.9	19.2	9.4	7.9	3.8	3.2	16.5	16.7	19.0	21.2
CONSUMER STAPLES	34.3	29.2												

Source: MF Global India Research Estimates

Globally tobacco companies trade at a reasonable discount to consumer staples. At current market prices ITC trades inline with consumer staples sector. The cigarettes business trades at 29x FY14E earnings and it is largely inline with the consumer staples sector in India.

IMPLIED VALUATION AT CURRENT MARKET PRICES

BUSINESS	VALUATION METRIC	IMPLIED MULTIPLE	VALUE (RS MN)	VALUE/ SHARE
CIGARETTES	PER	29	1,653,440	217
OTHER FMCG	EV/ SALES	2	152,578	20
PAPER AND PAPERBOARD	EV/ EBITDA	7	103,470	14
AGRI AND AGRI PRODUCTS	EV/SALES	1.5	65,019	9
HOTELS	EV/ EBITDA	10	41,975	6
TOTAL ENTERPRISE VALUE			2,016,482	
ADD: CASH			127,487	17
MARKET CAPITALIZATION			2,143,968	274

Source: MF Global India Research Estimates

We believe the fair multiple (although stretched on absolute basis) is 25x for the cigarettes implying a 15% discount to the consumer staples sector which is trading at 29x FY14E earnings.

SUM OF PARTS VALUATION, ITC, RS MN

BUSINESS	VALUATION METRIC	FAIR MULTIPLE	VALUE (RS MN)	VALUE/ SHARE
CIGARETTES	PER	25	1,425,379	187
OTHER FMCG	EV/ SALES	2	152,578	20
PAPER AND PAPERBOARD	EV/ EBITDA	7	103,470	14
AGRI AND AGRI PRODUCTS	EV/SALES	1.5	65,019	9
HOTELS	EV/ EBITDA	10	41,975	6
TOTAL ENTERPRISE VALUE			1,788,421	
ADD: CASH			127,487	17
FAIR MARKET CAPITALIZATION			1,915,907	245

Source: MF Global India Research Estimates

We find the current valuations for the FMCG industry in general to be stretched and ITC trading in-line with consumer staples may not be sustainable in the long-term. Our estimates for ITC are conservative but we find ITC is unlikely to sustain earnings growth higher than the consumer sector.

Thus, considering the rising regulatory and macroeconomic risks and possible negative earnings surprises, we believe the premium valuations are not sustainable in the long-run. Hence, we downgrade the stock to Sell.

Fair Value Calculation based on DCF methodology

We have valued ITC on a DCF based method at Rs 248 per share. We estimate 8 year Consolidated revenue CAGR at ~13% YoY with Cigarette business growth at 10% CAGR and Other FMCG business growth estimated to maintain traction at ~18% CAGR. We estimate normalized (long-term) consolidated EBIT margins of ~32%.

MEDIUM-TERM FORECASTS

RS MN	SALES FY2012	CAGR (8 YEARS)	SALES 2020 E	EBIT MARGIN (%)	EBIT (N)	EBIT %
CIGARETTES	123,218	10.1	265,904	56.0	148,906	71.6
OTHER FMCG	55,211	17.9	206,106	8.0	16,489	7.9
AGRIBUSINESS	35,079	11.9	86,541	16.0	13,847	6.7
HOTELS	9,963	13.5	27,428	30.0	8,228	4.0
PAPERBOARDS	23,733	15.4	74,596	27.5	20,514	9.9
GROUP	247,203	13.1	660,576	31.5	207,984	100

Source: Company, MF Global India Research Estimates

Our exit multiple for Cigarettes business is 20x implying an earnings yield of 5% (terminal growth rate of 6%). Our exit multiple for FMCG others business is similar to the Cigarettes business. Our exit multiples for Hotels and Agribusiness are conservative.

DERIVATION OF ENTERPRISE VALUE 2017 (EXCLUDING INTERMEDIATE FCF)

RS MN	EBIT (N)	YIELD REQ (%)	P/E (X)	EV/EBIT (X)	EV (2020)
CIGARETTES	148,906	5.0	20	14.0	2,084,687
OTHER FMCG	16,489	5.0	20	14.0	230,839
AGRIBUSINESS	13,847	20.0	5	3.5	48,463
HOTELS	8,228	10.0	10	7.0	57,599
PAPERBOARDS	20,514	7.0	14	10.0	205,140
GROUP	207,984	5.5	18	12.6	2,626,728

Source: Company, MF Global India Research Estimates

We have discounted the cash flows at 11%, considering a risk free rate of 8% and market risk premium of 6%, implying a beta of 0.5

MEDIUM-TERM CASH FLOW GENERATION

RS MN	2012	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2020E
EBIT	85,998	96,803	113,385	130,226	148,883	169,294	192,366	217,829	246,153
NOPLAT	61,621	68,824	80,010	90,839	103,341	117,391	133,216	150,626	169,954
DEPRECIATION	6,988	8,030	8,701	9,563	10,479	11,341	12,244	13,189	14,176
CAPEX	23,216	17,500	15,000	13,500	14,000	14,500	15,000	15,500	16,000
FCF	45,393	59,355	73,711	86,903	99,820	114,232	130,460	148,315	168,130
% CONVERSION	53	61.3	65.0	66.7	67.0	67.5	67.8	68.1	68.3
DISCOUNT FACTOR	1.0	0.9	0.8	0.7	0.7	0.6	0.5	0.5	0.4
PV	45,393	53,473	59,826	63,543	65,755	67,791	69,749	71,437	72,956
NPV	45,393	98,866	158,692	222,234	287,989	355,780	425,529	496,966	569,923

Source: Company, MF Global India Research Estimates

On the basis of our DCF valuation, the fair value of the company is computed at Rs 249 and is largely in line with our SOTP valuation of Rs. 245 indicating a downside of 10% from the current levels.

DERIVATION OF FUNDAMENTAL VALUE

RS MN/ RS PER SHARE	VALUE
ENTERPRISE VALUE-2020	2,626,728
NPV INTERMEDIATE FCF	569,923
NET CASH- END OF FY2012	26,190
RETURN REQUIREMENT	11%
EV FUTURE VALUE END OF FY2012	1,709,730
TARGET VALUE END OF FY2012	1,735,919
TARGET VALUE PER SHARE (END MAR 2012)	224
TARGET VALUE PER SHARE (END OF MAR 2013)	249
IMPLIED FY13 MULTIPLE (P/E)	28
IMPLIED 2 -YEAR FORWARD MULTIPLE (P/E)	24
CMP	269
CMP AT 1-YEAR FORWARD MULTIPLE (P/E)	31
% UPSIDE	-7

Source: Company, MF Global India Research

FINANCIALS

INCOME STATEMENT

Y/E MAR, RS MN	FY2010	FY2011	FY2012	FY2013E	FY2014E
NET SALES	181,532	211,676	247,984	278,013	319,072
GROWTH, %	16.3	16.6	17.2	12.1	14.8
TOTAL INCOME	181,532	214,590	251,738	282,424	324,144
OPERATING EXPENSES	-120,832	-140,464	-163,252	-182,265	-207,693
EBITDA	60,700	74,126	88,486	100,158	116,451
GROWTH, %	24.9	22.1	19.4	13.2	16.3
MARGIN, %	33.4%	35.0%	35.7%	36.0%	36.5%
DEPRECIATION	-6,087	-6,559	-6,988	-8,030	-8,701
EBIT	54,613	67,567	81,499	92,128	107,750
GROWTH, %	24.9	22.1	19.4	13.2	16.3
MARGIN, %	33.4	35.0	35.7	36.0	36.5
INTEREST RECEIVED/(PAID)	-648	-684	-779	-740	-796
OTHER INCOME	6,147	5,798	8,253	9,086	10,708
PRE-TAX PROFIT	60,113	72,682	88,973	100,474	117,662
TAX PROVIDED	-19,543	-22,806	-27,352	-31,649	-37,652
PROFIT AFTER TAX	40,570	49,876	61,621	68,824	80,010
MINORITIES	0	0	0	0	0
MF NET PROFIT	40,570	49,876	61,621	68,824	80,010
GROWTH	24.3	22.9	23.5	11.7	16.3
EXTRAORDINARY ITEMS: GAINS/(LOSSES)	0	0	0	0	0
UNADJ. SHARES (M)	7,636	7,713	7,738	7,818	7,818
WTD AVG SHARES (M)	7,541	7,541	7,541	7,818	7,818

CASH FLOW

Y/E MAR, RS MN	FY2010	FY2011	FY2012	FY2013E	FY2014E
PRE-TAX PROFIT	60,113	72,682	88,973	100,474	117,662
DEPRECIATION	6,087	6,559	6,988	8,030	8,701
CHG IN WORKING CAPITAL	34,027	-4,336	1,324	-3,223	-3,242
TOTAL TAX PAID	-20,365	-22,637	-26,643	-40,376	-37,652
CASH FLOW FROM OPERATING ACTIVITIES	79,862	52,268	70,642	64,904	85,469
CAPITAL EXPENDITURE	-12,741	-11,834	-24,029	-9,037	-16,575
CHG IN INVESTMENTS	-28,891	1,724	-7,621	19,533	0
CASH FLOW FROM INVESTING ACTIVITIES	-41,632	-10,110	-31,650	10,496	-16,575
FREE CASH FLOW	38,229	42,158	38,991	75,401	0
EQUITY RAISED/(REPAID)	44	3,920	80	0	0
DIVIDEND (INCL. TAX)	-44,517	-40,015	-40,890	-43,172	-45,444
CASH FLOW FROM FINANCING ACTIVITIES	-44,474	-36,095	-40,810	-43,172	-45,444
NET CHG IN CASH	-6,245	6,063	-1,819	32,228	23,450

BALANCE SHEET

AS AT 31ST MAR, RS MN	FY2010	FY2011	FY2012	FY2013E	FY2014E
CASH & BANK	11,263	22,432	28,189	60,406	83,856
DEBTORS	8,581	8,851	9,860	10,854	12,457
INVENTORY	45,491	52,692	56,378	61,910	68,085
LOANS & ADVANCES	15,945	18,032	18,311	20,135	22,906
OTHER CURRENT ASSETS	0	0	0	0	0
TOTAL CURRENT ASSETS	81,279	102,007	112,739	153,304	187,304
INVESTMENTS	57,269	55,545	63,166	43,633	43,633
GROSS FIXED ASSETS	119,679	127,770	141,519	159,019	174,019
LESS: DEPRECIATION	38,255	44,208	50,452	60,880	69,581
ADD: CAPITAL WIP	10,090	13,226	22,763	16,697	18,272
NET FIXED ASSETS	91,514	96,789	113,830	114,837	122,711
NON-CURRENT ASSETS	3,362	4,083	4,243	0	0
TOTAL ASSETS	233,424	258,424	293,978	313,261	355,135
CURRENT LIABILITIES AND PROVISIONS	34,991	44,735	48,087	51,981	56,461
TOTAL CURRENT LIABILITIES	34,991	44,735	48,087	51,981	56,461
NON-CURRENT LIABILITIES	12,290	13,094	13,861	891	891
TOTAL LIABILITIES	92,780	98,892	106,059	99,702	107,010
PAID-UP CAPITAL	3,818	7,738	7,818	7,818	7,818
RESERVES & SURPLUS	136,826	151,794	180,100	205,741	240,306
SHAREHOLDERS' EQUITY	140,644	159,532	187,918	213,559	248,125
TOTAL EQUITY & LIABILITIES	233,424	258,424	293,978	313,261	355,135

PER-SHARE DATA

	FY2010	FY2011	FY2012	FY2013E	FY2014E
MF EPS (INR)	5.3	6.5	7.96	8.80	10.2
GROWTH, %	22.7	21.7	23.1	10.5	16.3
BOOK NAV/SHARE (INR)	18.7	21.2	24.9	27.3	31.7
FDEPS (INR)	5.4	6.6	8.2	8.8	10.2
CEPS (INR)	6.2	7.5	9.1	9.8	11.3
CFPS (INR)	9.8	6.2	8.3	7.3	9.6
DPS (INR)	5.1	4.6	4.7	4.8	5.0

FINANCIAL STRUCTURE

	FY2010	FY2011	FY2012	FY2013E	FY2014E
TOTAL DEBT/EQUITY (%)	0.0	0.0	0.0	0.0	0.0
NET DEBT/EQUITY (%)	-8.0	-14.1	-15.0	-28.3	-33.8

PROFITABILITY, PRODUCTIVITY, LIQUIDITY AND VALUATION RATIOS

	FY2010	FY2011	FY2012	FY2013E	FY2014E
RETURN ON ASSETS (%)	19.0	20.5	22.5	22.8	24.1
RETURN ON EQUITY (%)	29.2	33.2	35.5	34.3	34.7
RETURN ON INVESTED CAPITAL (%)	32.8	39.7	43.8	45.1	48.9
ROIC/COST OF CAPITAL (X)	4.1	5.0	5.5	5.7	6.2
ROIC - COST OF CAPITAL (%)	24.9	31.8	35.9	37.2	41.0
RETURN ON CAPITAL EMPLOYED (%)	22.4	24.4	27.0	27.3	28.8
COST OF CAPITAL (%)	7.9	7.9	7.9	7.9	7.9
ROCE - COST OF CAPITAL (%)	12.9	14.5	16.5	19.1	19.4
ASSET TURNOVER (X)	1.5	1.7	1.8	1.8	2.0
SALES/TOTAL ASSETS (X)	0.8	0.9	0.9	0.9	1.0
SALES/NET FA (X)	2.1	2.2	2.4	2.4	2.7
WORKING CAPITAL/SALES (X)	0.2	0.2	0.1	0.1	0.1
FIXED CAPITAL/SALES (X)	0.0	0.0	0.0	0.0	0.0
RECEIVABLE DAYS	17	15	15	14	14
INVENTORY DAYS	91	91	83	81	78
PAYABLE DAYS	106	116	107	104	99
CURRENT RATIO (X)	2.3	2.3	2.3	2.9	3.3
QUICK RATIO (X)	1.0	1.1	1.2	1.8	2.1
INTEREST COVER (X)	84.3	98.8	104.6	124.5	135.4
DIVIDEND COVER (X)	1.1	1.4	1.8	1.9	2.0
PER (X)	50.4	41.4	33.7	30.4	26.2
PEG (X) - Y-O-Y GROWTH	2.0	1.8	1.4	3.9	1.6
PRICE/BOOK (X)	14.4	12.7	10.8	9.8	8.4
YIELD (%)	1.9	1.7	1.7	1.8	1.9
EV/NET SALES (X)	11.2	9.7	8.2	7.3	6.3
EV/EBITDA (X)	33.5	27.6	23.1	20.3	17.3
EV/EBIT (X)	33.5	27.6	23.1	20.3	17.3
EV/NOPLAT (X)	49.7	40.2	33.4	29.7	25.4
EV/CE	10.3	9.6	8.3	7.8	6.7
EV/IC (X)	16.3	16.0	14.6	13.4	12.4

Source: Company, MF Global India Research Estimates

RECOMMENDATION HISTORY

RECOMMENDATION	TARGET, RS	CMP, RS	DATE
DOWNGRADE TO SELL	245	268	17 SEP 2012
NEUTRAL	250	249	27 JUY 2012
NEUTRAL	250	232	28 MAY 2012
NEUTRAL	230	216	19 MAR 2012
BUY	245	207	25 OCT 2011
BUY	225	206	29 JULY 2011
BUY	190	164	6 SEPT 2010

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