Flashnote

HSBC Global Research

Consumer & Retail
Tobacco
Equity – India

ITC (ITC)

Upgrade from N to OW: Attractive at current valuation

- **Favourable risk-reward balance after recent stock pullback; concerns on tax, competition, monsoon overdone**
- **Upside risks to EPS, fuelled by potential price increases on certain brands**
- **No change to EPS and SOTP-based TP of INR264; volume-backed EPS growth of 17% at PE of 20x attractive. Upgrade to Overweight from Neutral on valuation**

Attractive at current valuation: ITC's stock price has dropped 10% since 31 July 2009, and has underperformed the Sensex by 13% despite no change in its fundamentals. We believe this makes for an attractive entry point and believe the following concerns are adequately reflected in the stock price: monsoon risk, the Marlboro tie-up with Godfrey Phillips India, and VAT increase in the next budget.

Concerns priced in: (1) Monsoon risk: FMCG stocks have dropped on rainfall concerns; so has ITC, despite no correlation between cigarette sales and monsoon (R-square 0.05). **(2) Marlboro, GPI tie-up:** There is concern that competition will increase for ITC as Marlboro cigarettes, earlier available via imports, will now be produced and distributed locally, by Godfrey Phillips India. We believe the impact on ITC will be minor and stretched over a long period. **(3) VAT increase in the next budget:** If this happens, ITC has the flexibility to offset it with price increases without affecting volumes meaningfully.

Risks to EPS skewed to the upside: The company has already implemented an average price increase of 5% (Bristol and Goldflake Kings prices taken up 10-20%) which is factored into our forecasts. The potential for price increase on other brands (Scissors, Navy Cut, Capstan), which represent a third of sales and which have seen no price hikes for over two years, represents scope for EPS upside of 5% on an annualised basis on our estimates.

Valuation and catalyst: The stock currently trades at 20x 12-month forward PE multiple, in line with its historical average. Given the higher and better quality EPS growth, we believe there is a scope for multiple expansion, and this represents an upside risk to target price. We have valued the cigarettes division on a PE of 21x FY11e, in line with global tobacco peers after adjusting for the difference in growth rates and return metrics. We upgrade our rating from Neutral to Overweight on valuation. **Catalysts:** Good quarterly results and price increase in cigarettes are potential catalysts for the stock.

ITC: Financial snapshot (INRm)

Year to 31 Mar	Sales	y-o-y	EBIT	y-o-y	Net Profit	y-o-y	EPS (INR)	PE	ROE	ROA
FY09	163,323	11.4%	44,914	9.7%	33,246	5.3%	8.81	25.8x	25.3%	17.8%
FY10e	187,371	14.7%	53,901	20.0%	39,471	18.7%	10.44	21.8x	26.3%	18.6%
FY11e	213,744	14.1%	62,727	16.4%	45,811	16.1%	12.11	18.7x	26.6%	19.0%
FY12e	242,458	13.4%	72,050	14.9%	52,526	14.7%	13.89	16.4x	26.7%	19.2%

Source: Company data, HSBC estimates

Overweight

Target price (INR)	**264.00**
Share price (INR)	**227.10**
Potential total return (%)	**18.2**

Performance	1M	3M	12M
Absolute (%)	0.6	14.9	18.5
Relative^ (%)	-6.5	9.2	4.7

Index^	BOMBAY SE IDX
RIC	ITC.BO
Bloomberg	ITC IN
Market cap (USDm)	17,633
Market cap (INRm)	857,595
Enterprise value (INRm)	810979
Free float (%)	70

Note: (V) = volatile (please see disclosure appendix)

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Financials & valuation

Financial statements

Year to	03/2009a	03/2010e	03/2011e	03/2012e
Profit & loss summary (INRm)				
Revenue	163,323	187,371	213,744	242,458
EBITDA	50,723	60,135	69,856	80,323
Depreciation & amortisation	-5,809	-6,234	-7,129	-8,273
Operating profit/EBIT	44,914	53,901	62,727	72,050
Net interest	-187	-189	-189	-189
PBT	49,909	58,526	67,926	77,885
HSBC PBT	49,848	58,425	67,812	77,755
Taxation	-16,254	-18,696	-21,700	-24,882
Net profit	33,246	39,471	45,811	52,526
HSBC net profit	33,246	39,471	45,811	52,526
Cash flow summary (INRm)				
Cash flow from operations	35,335	41,986	49,071	56,521
Capex	-17,609	-15,605	-20,616	-26,333
Cash flow from investment	-14,054	-20,624	-25,636	-32,357
Dividends	-15,700	-16,339	-19,460	-22,585
Change in net debt	-5,797	-5,209	-4,191	-1,826
FCF equity	14,634	21,926	23,483	24,641
Balance sheet summary (INRm)				
Intangible fixed assets	0	0	0	0
Tangible fixed assets	91,258	100,628	114,115	132,175
Current assets	85,122	98,429	110,730	121,439
Cash & others	13,183	18,372	22,543	24,348
Total assets	201,453	229,151	259,959	294,751
Operating liabilities	32,147	36,393	40,474	44,887
Gross debt	1,867	1,847	1,827	1,807
Net debt	-11,316	-16,525	-20,716	-22,542
Shareholders funds	140,282	160,293	183,518	210,148
Invested capital	131,049	144,293	161,829	184,379

Ratio, growth and per share analysis

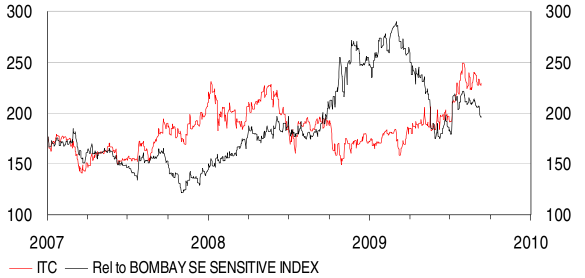
Year to	03/2009a	03/2010e	03/2011e	03/2012e
Y-o-y % change				
Revenue	11.4	14.7	14.1	13.4
EBITDA	11.0	18.6	16.2	15.0
Operating profit	9.7	20.0	16.4	14.9
PBT	6.6	17.3	16.1	14.7
HSBC EPS	5.5	18.5	16.1	14.7
Ratios (%)				
Revenue/IC (x)	1.3	1.4	1.4	1.4
ROIC	23.4	25.6	26.8	27.3
ROE	25.3	26.3	26.6	26.7
ROA	17.8	18.6	19.0	19.2
EBITDA margin	31.1	32.1	32.7	33.1
Operating profit margin	27.5	28.8	29.3	29.7
EBITDA/net interest (x)	271.4	317.7	369.0	424.3
Net debt/equity	-8.0	-10.2	-11.2	-10.6
Net debt/EBITDA (x)	-0.2	-0.3	-0.3	-0.3
Per share data (INR)				
EPS reported (fully diluted)	8.81	10.44	12.11	13.89
HSBC EPS (fully diluted)	8.81	10.44	12.11	13.89
DPS	3.70	4.36	5.06	5.80
Book value	37.09	42.38	48.53	55.57

Valuation data

Year to	03/2009a	03/2010e	03/2011e	03/2012e
EV/sales	5.0	4.3	3.8	3.3
EV/EBITDA	16.2	13.5	11.5	9.9
EV/IC	6.3	5.6	5.0	4.3
PE*	25.8	21.8	18.7	16.4
P/Book value	6.1	5.4	4.7	4.1
FCF yield (%)	1.8	2.6	2.9	3.0
Dividend yield (%)	1.6	1.9	2.2	2.6

Note: * = Based on HSBC EPS (fully diluted)

Price relative



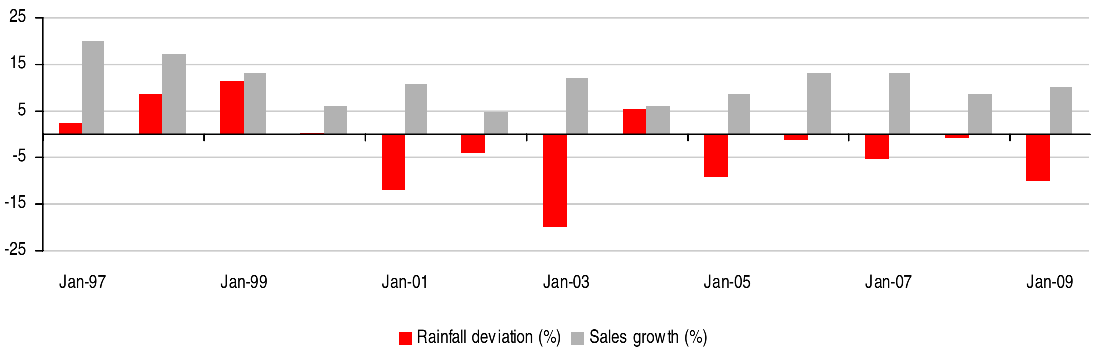
Source: HSBC

Note: price at close of 11 Sep 2009

Monsoon risk for FMCGs does not apply to ITC

FMCG sector stocks are being sold on monsoon concerns, and ITC has fallen, in line with the sector (stock down 10% since end-July). However, we believe that ITC is not affected by rainfall deficiency and has historically shown low correlation between the deviation in rainfall from normal and gross sales growth in cigarettes (R-square comes 0.05 over the last 12 years). In our view, consumers are likely to cut down on other items of expenditure before they do cigarettes, if the monsoon deficiency affects farmers' incomes. We therefore believe there is no major downside risk to our sales estimates from the monsoon.

No correlation between rainfall and cigarette sales (R-square 0.05)



Source: IMD, ITC, HSBC

Marlboro tie-up with Godfrey Phillips India

Philip Morris has tied up with Godfrey Phillips India (GPI) to produce and manufacture Marlboro in India. To date, Marlboro was available in India through import and a local distributor. The agreement with GPI raises concerns that Philip Morris has become more serious about its Marlboro strategy in India and may capture a higher market share. We believe that these fears are overplayed, as:

- Marlboro is already available in India and so any further market share gain will be slow and gradual. We believe Marlboro will find it difficult to capture market share as ITC is the dominant player in the cigarette segment and entry barriers are substantial, given that there are strict controls on advertising.
- The Kings segment, in which Marlboro is present, is a small segment in India, accounting for c10% of total cigarette volumes. Even if Marlboro manages to gain a significant 10 percentage points share in the Kings segment, it would still dent ITC's overall market share only by 1%.
- It is unlikely that Marlboro will enter the Regulars segment (which accounts for c80% of total cigarette volumes) as world-wide, Marlboro is manufactured according to particular standards. It is unlikely that Philip Morris will make an exception for India, which is currently quite small in the global scheme of things.
- The growth in Marlboro will be subject to capacity constraints faced by GPI, as setting up fresh capacity for cigarettes is still subject to government licensing. GPI is unlikely to push Marlboro at the cost of its own brands.
- Goldflake in ITC's Kings segment has a distinctive flavour; its users may not switch to Marlboro.

Potential VAT increase to 20% in the next budget

There is a possibility that VAT could be increased from 12.5% to 20% in the next budget. Already, a few states such as Delhi, Maharashtra and Rajasthan have increased their rates to 20%. The concern is that other states may follow suit in the next budget. This is not factored in our current forecasts (we have built in an excise duty increase of 5% and VAT rate maintained constant). Our sensitivity analysis shows that ITC will have to take price hikes to the tune of 11% (instead of the 6% that we are building in currently) to maintain our EPS estimates if VAT is hiked to 20%. Such a hike should not hit volume (our volume growth estimate: 5%) as historically, we've seen relative immunity to price increases; ITC hiked prices by 22% in FY08, which had only a 1% adverse impact on volume.

Upside risk to earnings

We believe that there is an upside risk to earnings (we are higher than consensus by 2% for FY10e and FY11e) as analysts may be underestimating the growth in profits in the cigarettes division. We have pencilled in a 5% increase in selling price for FY10e. With the recent price increases on Goldflake and Bristol, ITC has already raised prices 5%; it could raise some prices further before March 2010, which we believe could be an upside to consensus earnings estimates. We believe that price increases are possible on Scissors, Capstan and Navy Cut, all three of which have not faced price increases since over two years (most of the other brands have seen price increases over last 12 months).

ITC: Price increases

Brand	Months since last price increase	Brand	Months since last price increase
Kings - Goldflake	5	Regulars-Flake FT	14
Longs - Navy Cut	29	Regulars-Capstan FT	29
Regulars - Goldflake FT	4	Regulars-Berkeley FT	14
Regulars - Bristol FT	1	Regulars-Scissors FT	29

Source: HSBC

Scissors and Capstan have not seen price increases as smokers migrating from the non-filter variants of these brands were effectively paying more already, limiting the scope for a price increase. Navy Cut saw a 26% price increase in April 2007, and it could have taken time for volumes to stabilise. We believe that ITC could increase prices on these three brands. We estimate these brands together account for about a third of ITC's volumes. We estimate that a 5% increase in each brand could raise EPS by 5% on an annualised basis.

On the flip side, there is a possibility that the slowdown in hotels may carry on longer than expected. We have built in an EBIT decline of 5% in FY10e in the hotels business. In a bear case scenario, if the EBIT decline is 20%, the impact on company EPS is just 1%. This can easily be made up through better volumes or price increases in cigarettes. Overall, we believe the risk on consensus EPS is on the upside.

Valuation

ITC: SOTP valuation

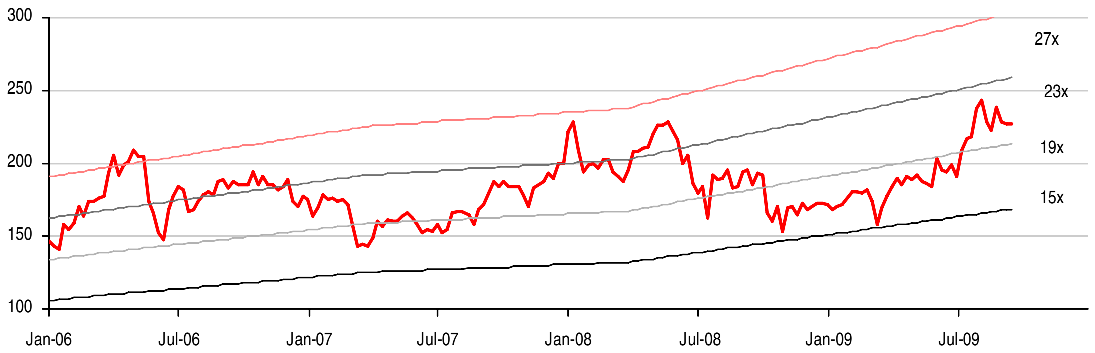
Basis	Business	Multiple	Value per share (INR)	Price (INR)
EPS	Cigarettes	21.0x	10.2	213.74
	Hotels	15.0x	0.6	9.1
	Agribusiness	6.0x	0.6	3.6
	Paperboards	5.0x	1.4	6.8
Sales	FMCG - Others	1.5x	11.5	17.3
Cash	Cash per share			13.9
	Target Price			**264**

Source: HSBC estimates

We value ITC on an SOTP basis at INR264. We value the cigarettes business at 21x PE, in line with global peers, accounting for differences in growth rates and return on equity. The cigarettes business, with an ROE of c150% and EPS growth prospects at c15-17%, deserves to be valued at 21x PE, in our view. We have valued other businesses such a hotels, agri and paperboards in line with multiples of similar companies in India. Since FMCG is loss-making we have valued it at 1.5x sales a 50% discount to other FMCG companies such as Hindustan Unilever. ITC is currently trading in the middle of its PE band (see chart below). We believe that it should go at higher than average multiples given that volume growth has returned after two years of decline and is unlikely to go into negative territory in the foreseeable future. Our SOTP based price target however does not assume any PE multiple expansion, so there is an upside risk to the valuation.

Under our research model, for Indian stocks without a volatility indicator, the Neutral band is 5 percentage points above and below the hurdle rate of 10.5%. This translates into a Neutral rating band of 5.5% to 15.5% around the current share price. Our target price of INR264 for ITC represents a potential total return of 18.2% (including an expected dividend yield of 1.9%), which is above the Neutral band. We therefore upgrade the ITC stock from Neutral to Overweight.

ITC: 12 month forward PE band chart



Source: Datastream, HSBC

Risks

Downside risks to our Overweight call are higher- or faster-than-expected tax hikes, slowdown in consumer spending reducing volume growth, and PE multiple contraction in the event of a significant economic downturn.

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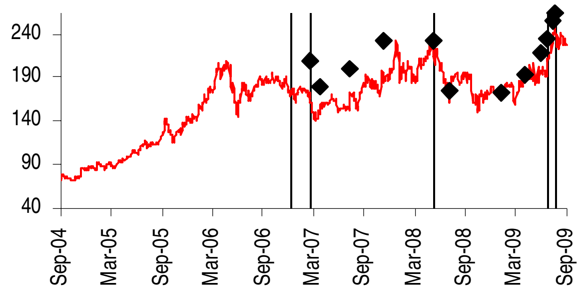
Share price and rating changes for long-term investment opportunities

ITC (ITC.BO) Share Price performance INR Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
Overweight	Neutral	19 December 2006
Neutral	Overweight	01 March 2007
Overweight	Neutral	23 May 2008
Neutral	Overweight	06 July 2009
Overweight	Neutral	05 August 2009
Target Price	**Value**	**Date**
Price 1	210.00	01 March 2007
Price 2	180.00	09 April 2007
Price 3	201.00	27 July 2007
Price 4	233.00	26 November 2007
Price 5	231.00	23 May 2008
Price 6	175.00	16 July 2008
Price 7	172.00	20 January 2009
Price 8	193.00	17 April 2009
Price 9	218.00	15 June 2009
Price 10	234.00	06 July 2009
Price 11	254.00	23 July 2009
Price 12	264.00	05 August 2009

Source: HSBC

HSBC & Analyst disclosures

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Company	Ticker	Recent price	Price Date	Disclosure
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Source: HSBC

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