ITC Limited

Cigarette volumes on the recovery path

24 January 2011

Current Reco	**: BUY**
Previous Reco	**: BUY**
CMP	**: INR169**
Target Price	**: INR189**
Potential Upside	**: 12%**

Results highlights

ITC's overall performance improved during the quarter with continued recovery in cigarette volumes and lower losses in other FMCG. However, profitability was impacted by drop in paper margins due to the uncertainty over "Graphical Warnings". Additionally, no meaningful improvement was noticed in the hotels division with lower than expected turnout at the commonwealth games.

During 3QFY11, ITC's net sales grew by 20% to INR54.5bn, while EBITDA and PAT improved by 19% and 21% to INR19.7bn and INR13.9bn, respectively. Other income increased by 22% to INR2.1bn on account of ~253m arising from dividend income and higher treasury income.

Cigarette volumes grew 2%

Cigarette volumes witnessed a 2% growth leading to an 18% improvement in sales to INR52.4bn. Going ahead, we believe that the division would see continued improvement in volumes, and hence, maintain our volume growth estimates for FY11e at 1.2%.

Paper profitability impacted by packaging inventory depletion

The division posted a slower growth of 8% in sales at INR9.2bn and a 5% drop in PBIT to INR1.9bn leading to decline in PBIT margins of about 294bps to 20.9%. This was on account of packaging inventory depletion caused by the uncertainty around the change in graphic statutory warnings on cigarette packaging.

Valuation and outlook

In view of the lower than expected growth in profits during the quarter, we are reducing our EPS estimates for FY11e marginally by 1% to INR6.5 and for FY12e by 2% to INR7.8. At the CMP of INR169, the stock is trading at a PE of 26.2x FY11e and at 21.6x FY12e. Our SOTP-based target stands revised to INR189 which provides 12% upside at current levels. We continue to be positive on ITC in view of its pricing strength and ability to outperform in an inflationary scenario and therefore we maintain a BUY on the stock.

Quarterly financials

INRm	3QFY11	3QFY10	Chg (%)	9mFY11	9mFY10	Chg (%)
Revenues	54,535	45,319	20	153,313	129,071	19
EBITDA	19,690	16,593	19	53,643	45,339	18
EBITDA margin (%)	36.1	36.6	(51)	35.0	35.1	(14)
Other income	2,533	2,074	22	5,930	4,664	27
Depreciation	1,681	1,549	9	4,918	4,549	8
Interest expenses	229.6	108.7	111	341.2	348.5	(2)
Tax	6,422	5,569	15	17,253	14,777	17
PAT	13,891	11,442	21	37,061	30,328	22
PAT margin (%)	25.5	25.2	22	24.2	23.5	68
Reported PAT	13,891	11,442	21	37,061	30,328	22

Source: Company, Antique

Market data

Sector	:	FMCG
Market Cap (INRbn)	:	1,301.5
Market Cap (USDbn)	:	28.5
O/S Shares	:	7,705.9
Free Float (m)	:	4,565.2
52-wk HI/LO (INR)	:	185/112
Avg Daily Vol ('000)	:	8,651.9
Bloomberg	:	ITC IN
Reuters	:	ITC.BO

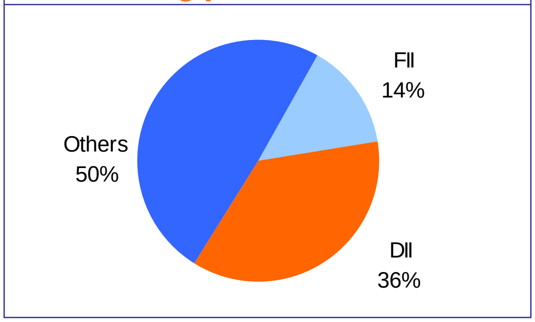
Source: Bloomberg

Returns (%)

	1m	3m	6m	12m
Absolute	1.0	(3.1)	15.5	41.1
Relative	6.6	3.3	9.3	26.6

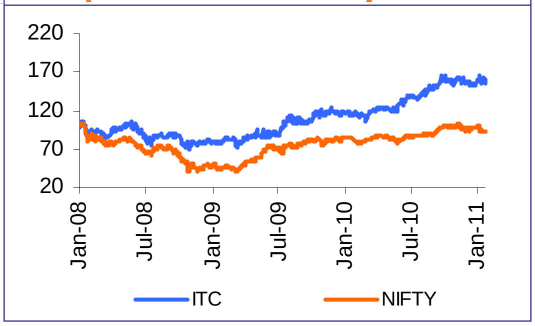
Source: Bloomberg

Shareholding pattern



Source: BSE

Price performance *vs* Nifty



Source: Bloomberg

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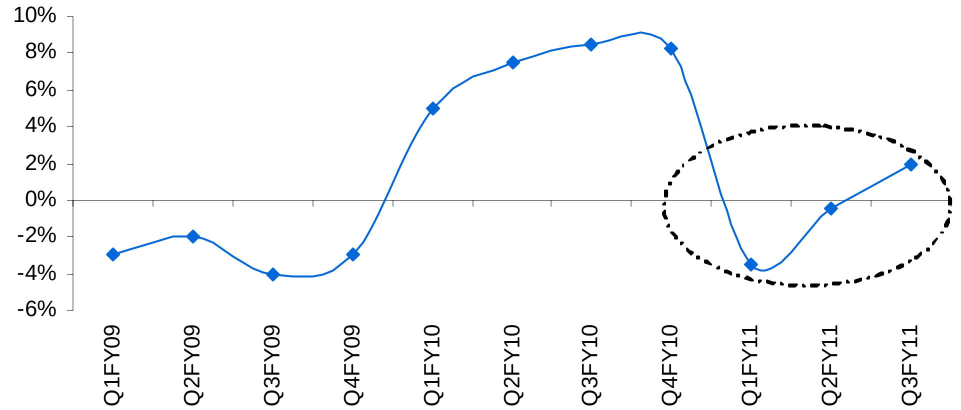
Cigarette volumes grew 2%

Cigarette volumes during the quarter witnessed a 2% growth, leading to an 18% increase in sales to INR52.4bn. The increase in cigarette volumes was led by the king size segment. Going ahead, we believe that the division would witness continued improvement in volumes, and thereby, we maintain our volume growth estimates for FY11e at 1.2%. Additionally, during 4QFY11, the division is expected to register higher realisation growth led by price increase in Bristol filter and Wills Excel filter by 12% and 20%, respectively. We estimate the weighted average price increase to be nearly 1.2% based on ITC's cigarette portfolio.

ITC cigarette volume growth



Source: Company, Antique

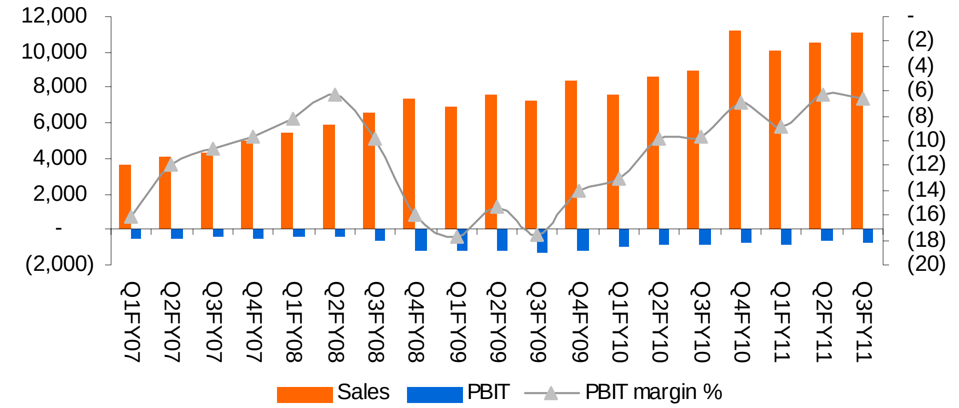
Paper performance impacted by uncertainty over graphical warnings

ITC's paper division overall witnessed a slowdown during the quarter due to the uncertainty over graphical warnings, impacting its packaging sales. The division posted a lackluster 8% growth in sales at INR9.2bn and a 5% decline in PBIT to INR1.91bn leading to a drop in PBIT margins of nearly 294bps to 20.9%. The lower growth in sales and the decline in profits were due to the uncertainty over the graphical warnings in cigarettes which had led to the shutdown of production in ITC's cigarette unit for about 10 days. In view of the new graphical warnings scheduled to be implemented during December 2010, ITC had built a strong inventory of cigarettes during October and November 2010; which in turn had already resulted in strong built of packaging paper for its cigarette division. This internal sales of packaging paper was partially factored in the higher sales of the previous quarter. Further, during December 2010, due to no clarity over the implementation of graphical warnings, the company largely continued to utilise its existing inventory of packaging paper without any new production which took the inventory below the normal levels. Lower production levels and consequently lower utilisation levels of the packaging paper unit led to a degrowth in profitability of the unit during the quarter.

Other FMCG continues to witness lower losses

Other FMCG segment has witnessed a 24% growth in sales to INR11.0bn aided largely by rise of 28% in Sunfeast' biscuits and 48% in Bingo range of potato chips. The growth in biscuits was driven by product mix improvement led by increase in sales of value-added variants of cookies and creams. In the Staples category, 'Aashirvaad' atta grew by 29% during the quarter driven by improved realisation and higher volumes. The division continued to witness lower losses at INR736m as against INR860m in the previous corresponding period backed by improvement in profitability through a combination of product mix enrichment, higher net realisation, smart commodity sourcing and active cost management across the supply chain.

Improving performance across FMCG division

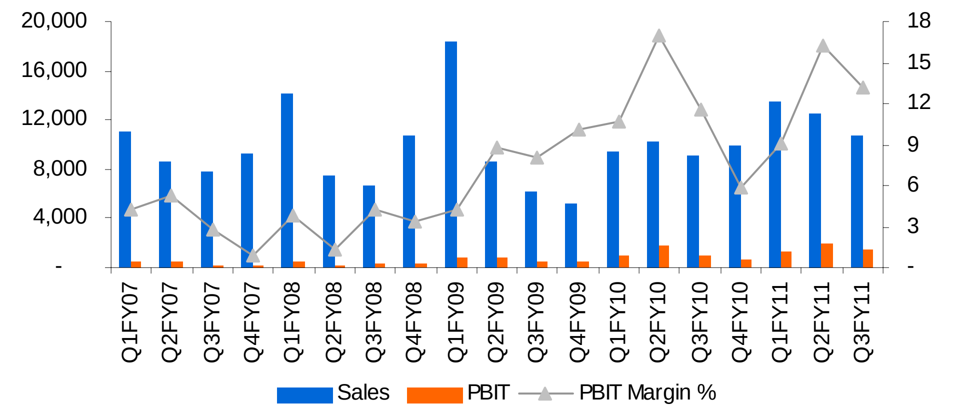


Source: Company, Antique

Agri performance remains consistent

Agri revenues grew 18% to INR10.7bn and PBIT improved 36% to INR1.41bn primarily due to higher sales of soya and coffee during the quarter and improved profitability in leaf tobacco. Global prices of leaf tobacco remained firm while domestic prices dropped leading to higher margins in leaf tobacco exports during the quarter.

Agri division's profitability on the uptick

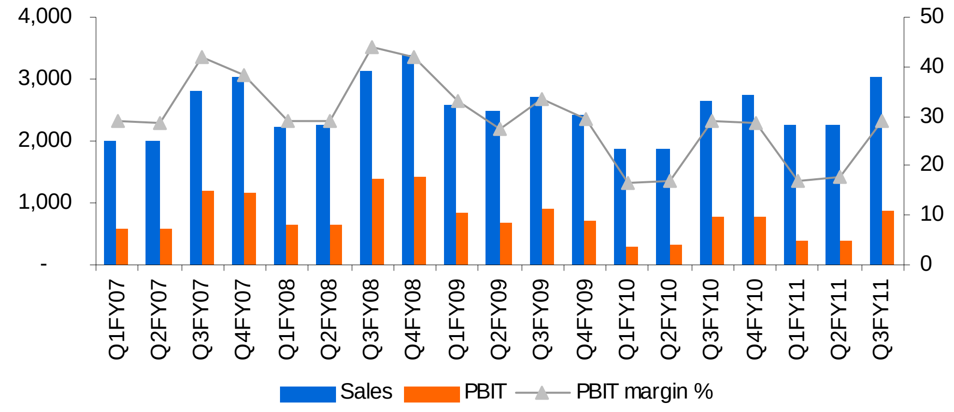


Source: Company, Antique

Hotel division yet to witness a recovery

Hotel division registered 15% and 16% growth in revenues (at INR3.0bn) and PBIT (at INR886m), respectively. The division according to our understanding has witnessed a 10-12% growth in ARRs while the occupancy rates grew at about 2-3% during the quarter. The below than expected turnout at the common wealth games partially had an impact on the occupancy rates and the division's performance. Going ahead, during 4Q, which has traditionally been one of the best quarters for the hotels division, the occupancy rates are on an upward trend. However, the division is expected to see gradual recovery only.

Hotel's lackluster performance during last 9 quarters



Source: Company, Antique

Valuation and outlook

In view of the lower than expected growth in profits during the quarter, we are reducing our EPS estimates for FY11e marginally by 1% to INR6.5 and for FY12e by 2% to INR7.8. At the CMP of INR169, the stock is trading at a PE of 26.2x FY11e and at 21.6x FY12e. In view of the reduction in earnings estimates, our SOTP-based target price stands reduced by 2% to INR189.

We continue to be positive on the company in view of its pricing strength and ability to outperform in an inflationary scenario. We maintain our BUY recommendation on the stock at the current levels.

Financials

Profit and loss account (INRm)

Year ended 31st Mar	2008	2009	2010	2011e	2012e
Revenues	139,475	153,881	179,609	212,932	249,921
Expenses	95,511	105,296	118,869	141,356	164,335
EBITDA	**43,964**	**48,585**	**60,740**	**71,576**	**85,586**
Depreciation & amortisation	4,385	5,494	6,087	6,600	7,200
EBIT	**39,579**	**43,091**	**54,653**	**64,976**	**78,386**
Interest expense	46	183	534	600	620
Other income	6,109	4,750	6,034	7,800	9,500
Profit before tax	**45,642**	**47,658**	**60,153**	**72,176**	**87,266**
Taxes incl deferred taxation	14,517	15,622	19,543	22,833	27,637
Profit after tax	31,126	32,036	40,610	49,344	59,629
Adjusted profit after tax	**31,126**	**32,036**	**40,610**	**49,344**	**59,629**
Recurring EPS (INR)	**4.1**	**4.2**	**5.3**	**6.5**	**7.8**

Balance sheet (INRm)

Year ended 31st Mar	2008	2009	2010	2011e	2012e
Share Capital	3,769	3,774	3,818	7,636	7,636
Reserves & Surplus	116,808	133,576	136,826	157,264	186,575
Networth	**120,577**	**137,351**	**140,644**	**164,900**	**194,212**
Debt	2,144	1,776	1,077	1,077	1,077
Capital Employed	**122,721**	**139,126**	**141,721**	**165,977**	**195,289**
Gross Fixed Assets	89,597	105,587	119,679	127,679	147,679
Accumulated Depreciation	(27,909)	(32,867)	(38,255)	(44,855)	(52,055)
Net Assets	**61,688**	**72,719**	**81,424**	**82,824**	**95,624**
Capital work in progress	11,268	12,141	10,090	10,090	10,090
Investments	29,346	28,378	57,269	57,269	57,269
Current Assets, Loans & Advances					
Inventory	40,505	45,997	45,491	59,638	68,788
Debtors	7,369	6,687	8,588	11,928	13,758
Cash & Bank balance	5,703	10,324	11,263	10,625	39,469
Loans & advances and others	16,616	18,603	15,929	19,334	19,334
Current Liabilities & Provisions					
Creditors	27,870	29,645	34,983	44,537	56,279
Other liabilities & provisions	16,453	17,405	45,499	28,752	34,772
Net Current Assets	**25,870**	**34,561**	**788**	**28,235**	**50,297**
Deferred tax assets/(liabilities)	(5,451)	(8,672)	(7,850)	(12,441)	(17,991)
Application of Funds	**122,721**	**139,126**	**141,721**	**165,977**	**195,289**

Per share data

Year ended 31st Mar	2008	2009	2010	2011e	2012e
No. of shares (m)	7,537	7,549	7,636	7,636	7,636
BVPS (INR)	16.0	18.2	18.4	21.6	25.4
CEPS (INR)	3.5	3.5	4.5	5.6	6.9
DPS (INR)	3.5	3.7	10.0	5.6	6.8

Margins (%)

Year ended 31st Mar	2008	2009	2010	2011e	2012e
EBITDA	31.5	31.6	33.8	33.6	34.2
EBIT	28.4	28.0	30.4	30.5	31.4
PAT	22.3	20.8	22.6	23.2	23.9

Source: Company, Antique

Cash flow statement (INRm)

Year ended 31st Mar	2008	2009	2010	2011e	2012e
EBIT	**39,579**	**43,091**	**54,653**	**64,976**	**78,386**
Depreciation & amortisation	4,385	5,494	6,087	6,600	7,200
Interest expense	(46)	(183)	(534)	(600)	(620)
(Inc)/Dec in working capital	(4,848)	(4,070)	34,712	(28,084)	6,782
Tax paid	(13,983)	(12,551)	(19,543)	(18,242)	(22,087)
CF from operating activities	**25,088**	**31,782**	**75,375**	**24,650**	**69,661**
Capital expenditure	(20,861)	(16,862)	(12,041)	(8,000)	(20,000)
Inc/(Dec) in investments	1,332	968	(28,891)	-	-
Income from investments	6,109	4,750	6,034	7,800	9,500
CF from investing activities	**(13,420)**	**(11,144)**	**(34,899)**	**(200)**	**(10,500)**
Inc/(Dec) in share capital	6	6	44	3,818	-
Inc/(Dec) in debt	136	(369)	(699)	-	-
Dividends paid	(15,568)	(16,412)	(44,533)	(25,088)	(30,317)
Others	460	759	5,650	(3,818)	-
CF from financing activities	**(14,966)**	**(16,016)**	**(39,538)**	**(25,088)**	**(30,317)**
Net cash flow	**(3,298)**	**4,621**	**939**	**(637)**	**28,844**
Opening balance	9002	5703	10324	11263	10625
Closing balance	**5,703**	**10,324**	**11,262**	**10,625**	**39,469**

Growth indicators (%)

Year ended 31st Mar	2008	2009	2010	2011e	2012e
Revenue	15	10	17	19	17
EBITDA	11	11	25	18	20
PAT	15	3	27	22	21
EPS	(42)	3	25	22	21

Valuation (x)

Year ended 31st Mar	2008	2009	2010	2011e	2012e
PE	40.9	39.8	31.8	26.2	21.6
P/BV	10.6	9.3	9.2	7.8	6.6
EV/EBITDA	28.9	26.1	20.9	17.7	14.8
EV/Sales	9.1	8.3	7.1	6.0	5.1
Dividend Yield (%)	2.1	2.2	5.9	3.3	4.0

Financial ratios

Year ended 31st Mar	2008	2009	2010	2011e	2012e
RoE (%)	26	23	29	30	31
RoCE (%)	32	31	39	39	40
Debt/Equity (x)	0.0	0.0	0.0	0.0	0.0
EBIT/Interest (x)	(858.6)	(235.2)	(102.4)	(108.3)	(126.4)

Source: Company Antique

Important Disclaimer:

Analyst ownership in stock	No

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