19 June 2006

Consumer Brands & Retail
India

HSBC
Global Research

# ITC

## Still a strong puff

- **Double-digit cigarette revenue growth in FY07f, combined with non-cigarette businesses breaking even from FY08f, results in an EPS CAGR of 19.8% FY06-08f**
- **Our scenario analysis of VAT imposition shows that it's highly likely that a new standard rate of 12.5% can be passed through in higher prices**
- **We increase our notional price target by 2% to INR197, representing 21% potential upside, and retain our Overweight rating**

## Revenue growth in cigarettes remains strong

ITC's volume growth in cigarettes continues to remain strong in Q1FY07 (ending June 06). The price increases that ITC has pushed through post the 2006-07 budget, on 28th February 2006, have had no negative impact on ITC's volume growth. We continue to forecast FY07f tobacco revenue growth of 11.7%.

## VAT likely to be imposed at 12.5%

Cigarettes have so far been exempt from Value Added Tax (VAT) but we believe they will fall into the VAT net by March 2007.

There are three scenarios for VAT imposition:

*Scenario I. A VAT of 4% is imposed on cigarettes at transaction value.*

This would impact 2% of ITC's gross revenues. This scenario has its genesis in the Finance Bill of 2003, wherein the VAT imposition was based on the abolition of the Additional Excise Duty (that ITC pays under the Goods of Special Importance Act 1957) and a transaction value that was based on the wholesale dealer price, less excise duty. Since the excise duty in cigarettes accounts for c50% of the cigarette prices, this would


**Harrish Zaveri**
Analyst
+91 222268 1240
harrishzaveri@hsbc.co.in

**Matt Marsden**
Analyst
+852 2996 653
mattmarsden@hsbc.com.hk




**Stock data**

| Current price | | Reuters | Bloomberg equity | Bloomberg debt | Valuation range |
|---|---|---|---|---|---|
| INR | 163.20 | ITC.BO | ITC IN | NA | INR187-215 |

Source: HSBC

affect 2% of ITC's revenues, an impact that could be easily passed on to consumers.

*Scenario II. The imposition of a VAT rate of 12.5% on transaction value.*

In this case, the total impact on ITC would be approximately 6.25%. We believe that this hike in duties could also be easily passed on to consumers. We believe that this scenario is the most likely:

- All government VAT imposed so far been at 12.5% (excluding coconut oil and some varieties of tea, which have been at 4%). The authorities are clear that when excise and service taxes are merged together the common expected rate will be 12%-14%
- 68% of current duties collected under Goods of Special Importance Act 1957 are passed onto state governments. It is highly unlikely that the amount of tax collected under just a 4% transaction value rate would make up this shortfall. Thus we expect the rate to be higher at 12.5%

*Scenario III. The imposition of a VAT rate of 12.5% in addition to a hike in the Central Excise of (say) 5-6%.*

This would be negative for ITC and, in this case, the total impact on gross profit would be over 10%. The last time that the government imposed a 15% excise duty (February 2002) ITC's cigarette volumes actually declined. We believe that this scenario is highly unlikely as current tax on cigarettes represents 12% of central government's total excise revenue. It is unlikely that central government will jeopardise this tax revenue with such a severe rate hike, in our opinion.

## Provisions taken for state entry taxes may be written back

ITC also has pending litigation in the Constitutional Bench of the Supreme Court against the imposition of state level entry taxes. ITC's disposition is similar to the earlier litigation (against the state level luxury taxes), i.e. that the state governments cannot tax tobacco under the Good of Special Importance Act, 1957. The company has already made a provision of INR4.25bn (equivalent to incremental EPS of INR 1.1 per share) for this purpose in FY06. This is not in our current valuation but provides additional upside.

## Break-even for non-cigarette FMCG business in 2HFY08

ITC's food business accounts for 70% of its non-cigarette revenues. This implies that over the last four years, ITC has been able to create a brand with annual revenue of INR7bn – *Sunfeast* (its biscuit brand). This is 40% of the size of the country's leading biscuit brand *Britannia*, and is one of the biggest brand creations that has happened over the last five years within the consumer staples sector. ITC also has plans for setting up a biscuit manufacturing plant (planned capex: INR700m) which would imply that ITC visualises a 50% growth in the size of the brand over the next two years. The management has guided to a break-even within the of the non-cigarette FMCG business in H2FY08.

## Risks

### Hotels

ITC is investing in building new hotels in Bangalore, Chennai and Hyderabad. None of these hotels will be up before December 2008. It is possible that, with over 20 hotels being planned, ITC's hotels may open into a more adverse industry environment, with rooms in oversupply. However, we believe that the quality of ITC's properties and the sustainability of its food and beverages business (which accounts for c30% of its hotel revenues) will insulate ITC against the adverse impact of a negative cycle, should this occur.

### Paper

The profitability of the paper business is dependent on pulp prices and the availability of power.

However, ITC has set up a 100,000 tonne pulp mill that would, to some extent, insulate it from the rise in pulp prices and has set up an internal generating capacity that supplies it 94% of its entire power requirements.

### Cigarettes

A hike in Central excise duty along with the imposition of 12.5% VAT would be a risk, as it would have an adverse impact on the momentum of cigarette volume growth; however, as described above, we feel that this is highly unlikely.

## Maintain Overweight with a refreshed target price of INR197

Our valuation range for FY08 (beginning April 2007) of INR187-215 (earlier range: INR176-217) is driven by:

### 1. PE multiple approach

ITC's shares re-rated after the Supreme Court ruled in its favour in a case pertaining to a dispute over the luxury taxes post January 2005. Going forward, we believe that the momentum of the upward re-rating is likely to be slower. ITC currently trades at a PE of 22x on our FY07f earnings estimates.

For our 2007 multiple-based fair value, given our expectation that the earnings growth would be sustained at 19.8% per annum over FY06-FY08f, we are comfortable applying an earnings multiple of 22x to our FY08f (April 2007 to March 2008) fully diluted EPS forecast of INR 8.54. This gives a 2007 fair value of INR188 per share.

### 2. Sum Of The Parts approach

A sum-of-the-parts valuation, which yields a fair value of INR187 per share. We break up the contribution of each of ITC's divisions to EBIT and assign an EBIT multiple based on peer valuations.

- We have assigned a multiple of 16.2x to the cigarettes business, factoring in the fact that cigarette valuations are based on zero litigation environment in India
- Given ITC's size, we assume ITC's paper business would trade at a multiple of 8x, 10% lower than that of Ballarpur Industries Ltd (BILT), ie 9.3x
- Similarly, we assume that the hotel business would trade at an earnings multiple of 15x, a 25% discount to Indian Hotels' PE of 20x
- We have assigned a multiple of 2.5x to ITC non-cigarette revenues in FY08f, based on the fact that the future size of profits could be much higher

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**ITC Sum-of-the-parts valuation**

| | FY08f EBIT (INRm) | Multiple (x) | Mkt cap (INRm) | Comments |
|---|---|---|---|---|
| Cigarettes | 33,998 | 16.2 | 550,766 | Multiple based on three factors: a) ITC's monopoly status within cigarette industry b) Minimal chance of cigarette litigation in India c) Faster growth considering low cigarette penetration. International cigarette players such as **Altria** and **Gallaher** trade at multiples ranging from 12.3-13.3x |
| Paper | 3,164 | 8 | 25,312 | Multiple based on ITC's own competitive advantage within paper with relatively higher composition of value-added paperboard and internal power generation as well pulp generation insulating it to some extent from the vagaries of the pulp cycle. **BILT**, ITC's nearest competitor, trades at 9.3x forward consensus estimates |
| Hotels | 4,000 | 15 | 60,000 | Multiple based on ITC's own competitive advantage within hotels with excellent properties and relatively higher share of 5-star rooms. Oversupply within the industry unlikely to happen until FY09-10. **Indian Hotels**, ITC's nearest competitor and market leader, is tradin at higher valuations on consensus |
| Agri-business | 1,407 | 5 | 7,035 | Multiple based on the fact that it is a trading business |
| | **FY08f revenues (INRm)** | | | |
| Non-cigarettes FMCG | 24,323 | 2.5 | 60,808 | Multiple on revenues based on the fact that the future size of profits could be much higher |
| Total market cap | 66,892 | | 703,921 | |
| Value per share (INR) | | | 187 | |

Source: HSBC estimates

## 3. DCF approach

A DCF analysis (WACC 11.6%, 3-stage DCF ending in the year 2045), which yields a fair value of INR215.

**DCF WACC calculation**

| | |
|---|---|
| Risk free rate | 7.50% |
| Risk premium | 5% |
| India Equity Premium (ERP and Risk Free rate) | 9.28% |
| Beta | 0.71 |
| Cost of equity | 11.6% |
| Cost of debt | 10.00% |
| Proportion of debt | 0.0% |
| Proportion of equity | 100.0% |
| Cost of capital (WACC) | 11.59% |

Source: HSBC

## Target price and rating

We take the average of our three valuation methodologies to arrive at our FY08f (beginning April 2007) target price of INR197 per share. Our target price represents 21% potential upside and we maintain our Overweight rating on the stock.

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# Financials & valuation

**Financial statements**

| Year to | 03/2005a | 03/2006e | 03/2007e | 03/2008e |
|---|---|---|---|---|
| **Profit & loss summary (INRm)** | | | | |
| Revenue | 76,394 | 97,905 | 119,444 | 139,750 |
| EBITDA | 27,925 | 33,274 | 41,667 | 48,989 |
| Depreciation & amortisation | -3,129 | -3,323 | -3,873 | -4,548 |
| Operating profit/EBIT | 24,797 | 29,950 | 37,794 | 44,441 |
| Net interest | -424 | -119 | 0 | 0 |
| PBT | 26,731 | 32,692 | 40,238 | 46,886 |
| Taxation | -8,360 | -9,888 | -12,715 | -14,816 |
| Net profit | 18,371 | 22,803 | 27,523 | 32,070 |
| HSBC net profit | 18,371 | 22,803 | 27,523 | 32,070 |
| **Cash flow summary (INRm)** | | | | |
| Cash flow from operations | 25607 | 29859 | 35565 | 44112 |
| Capex | -8,377 | -8,589 | -10,001 | -13,501 |
| Dividends | -7733 | -9,951 | -10514 | -11,265 |
| Change in net debt | -7178 | -43234 | -5657 | -9,299 |
| FCF | 23610 | 25469 | 28000 | 33238 |
| **Balance sheet summary (INRm)** | | | | |
| Intangible fixed assets | 0 | 0 | 0 | 0 |
| Tangible fixed assets | 41,369 | 46,634 | 52,762 | 61,715 |
| Current assets | 35,393 | 43134 | 56,661 | 72,918 |
| Cash & others | 557 | 426 | 6,083 | 15,382 |
| Total assets | 117,483 | 130,516 | 152,143 | 177,353 |
| Operating liabilities | 19,256 | 24,715 | 30,085 | 35,148 |
| Gross debt | 2,454 | 0 | 0 | 0 |
| Shareholders funds | 78,956 | 90,114 | 105,809 | 125,205 |
| Invested capital | 56,949 | 63,633 | 73,254 | 84,103 |

**Ratio, growth and per share analysis**

| Year to | 03/2005a | 03/2006e | 03/2007e | 03/2008e |
|---|---|---|---|---|
| **Y-o-y % change** | | | | |
| Revenue | 18.1 | 28.2 | 22.0 | 17.0 |
| EBITDA | 18.3 | 19.2 | 25.2 | 17.6 |
| Operating profit | 17.0 | 20.8 | 26.2 | 17.6 |
| PBT | 15.3 | 22.3 | 23.1 | 16.5 |
| HSBC EPS | 15.3 | 24.1 | 20.7 | 16.5 |
| **Ratios (%)** | | | | |
| Revenue/IC (x) | 1.5 | 1.6 | 1.7 | 1.8 |
| ROIC | 34.4 | 34.7 | 37.8 | 38.6 |
| ROE | 25.7 | 27.0 | 28.1 | 27.8 |
| ROA | 16.6 | 18.5 | 19.5 | 19.5 |
| EBITDA margin | 36.6 | 34.0 | 34.9 | 35.1 |
| Operating profit margin | 32.5 | 30.6 | 31.6 | 31.8 |
| EBITDA/net interest (x) | 65.8 | 278.9 | N/A | N/A |
| **Per share data (INR)** | | | | |
| EPS Rep (fully diluted) | 7.36 | 6.07 | 7.33 | 8.54 |
| HSBC EPS | 4.89 | 6.07 | 7.33 | 8.54 |
| DPS | 2.06 | 2.65 | 2.80 | 3.00 |
| NAV | 21.03 | 24.00 | 28.18 | 33.34 |

**Valuation data**

| Year to | 03/2005a | 03/2006e | 03/2007e | 03/2008e |
|---|---|---|---|---|
| EV/sales | 7.5 | 5.8 | 4.7 | 4.0 |
| EV/EBITDA | 20.6 | 17.2 | 13.6 | 11.4 |
| EV/IC | 10.1 | 9.0 | 7.7 | 6.6 |
| PE* | 33.4 | 26.9 | 22.3 | 19.1 |
| P/NAV | 7.8 | 6.8 | 5.8 | 4.9 |
| FCF yield (%) | 0.3 | 2.2 | 2.7 | 3.3 |
| Dividend yield (%) | 1.3 | 1.6 | 1.7 | 1.8 |

Note: * = Based on HSBC EPS

**Issuer information**

| | | | |
|---|---|---|---|
| Share price (INR) | 163.20 | Country | India |
| Reuters (Equity) | ITC.BO | Bloomberg (Equity) | ITC IN |
| | | Bloomberg (Debt) | ITC |
| Market cap (INRm) | 612,565 | Enterprise value (INRm) | 572,372 |
| No of shares (m) | 3,753 | Free float (%) | 65.5 |
| Analyst | Harrish Zaveri | Contact details | 91 22 2268 1240 |

Note: price at close of 16 Jun 2006

# Disclosure appendix

## Stock ratings and basis for financial analysis

HSBC believes that institutional investors utilise various disciplines and investment horizons when making investment decisions, which depend largely on individual circumstances such as the investor's existing holdings, risk tolerance and other considerations. Given these differences, HSBC has two principal aims in its equity research: 1) to identify long-term investment opportunities based on particular themes or ideas that may affect the future earnings or cash flows of companies on a 2-year time horizon; and 2) from time to time to identify short-term investment opportunities that are derived from fundamental, quantitative, technical or event-driven techniques on a 0-3 month time horizon and which may differ from our long-term investment rating. HSBC has assigned ratings for its long-term investment opportunities as described below.

This report addresses only the long-term investment opportunities of the companies referred to in the report. As and when HSBC publishes a short-term trading idea the stocks to which these relate are identified on the website. Details of these short-term investment opportunities can be found under the Reports section of this website.

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## Rating definitions for long-term investment opportunities

**Stock (vs Global sector universe of companies under coverage by sector team)**

- Overweight (Buy)
- Neutral (Hold)
- Underweight (Sell)

HSBC assigns ratings to its stocks in this sector on the following basis:

For companies covered on a sector basis, we apply a ratings structure which ranks the stocks according to their notional target price vs current market price and then categorises (approximately) the top 40% as Overweight, the next 40% as Neutral and the last 20% as Underweight. The performance horizon is 2 years. The notional target price is defined as the mid-point of the analysts' valuation for a stock.

Prior to 15 November 2004, HSBC's ratings system was based upon a two-stage recommendation structure: a combination of the analysts' view on the stock relative to its sector and the sector call relative to the market, together giving a view on the stock relative to the market. The sector call was the responsibility of the strategy team, set in co-operation with the analysts. For other companies, HSBC showed a recommendation relative to the market. The performance horizon was 6-12 months. The target price was the level the stock should have traded at if the market accepted the analysts' view of the stock.

From 15 November 2004 to 7 June 2005, HSBC carried no ratings and concentrated on long-term thematic reports which identified themes and trends in industries, but did not make a conclusion as to the investment action that potential investors should take.

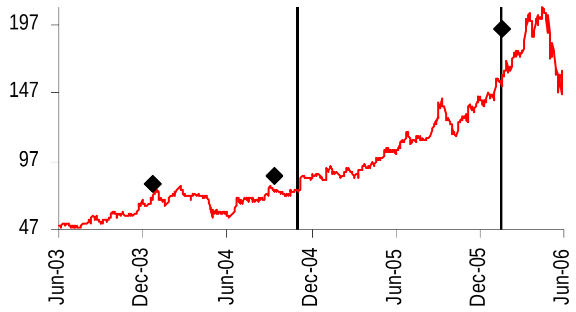
## Rating distribution for long-term investment opportunities

As of Monday, June 19, 2006, the distribution of all ratings published is as follows:

| | | |
|---|---|---|
| **Overweight/Buy** | 43% | (37% of these provided with Investment Banking Services) |
| **Neutral/Hold** | 40% | (37% of these provided with Investment Banking Services) |
| **Underweight/Sell** | 17% | (31% of these provided with Investment Banking Services) |

## Share price and rating changes for long-term investment opportunities

ITC share price performance INR vs HSBC rating history




Source: HSBC

Rating & price target history

| From | To | Date |
|---|---|---|
| Buy | N/R | 15 November 2004 |
| N/R | Overweight | 03 February 2006 |

| Target price | Value | Date |
|---|---|---|
| Price 1 | 80.00 | 07 January 2004 |
| Price 2 | 86.67 | 28 September 2004 |
| Price 3 | N/A | 15 November 2004 |
| Price 4 | 194.00 | 03 February 2006 |

Source: HSBC

## Issuer & Analyst disclosures

Disclosure checklist

| Company | Ticker | Recent price | Disclosure |
|---|---|---|---|
| ITC | ITC.BO | 163.2 | 6, 9 |

Source: HSBC

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Harrish Zaveri has a long position in the shares of ITC Ltd.

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**Issuer of report**
**HSBC Securities and Capital Markets (India) Private Limited**
Registered Office
52/60 Mahatma Gandhi Road
Fort, Mumbai 400 001, India
Telephone: +91 22 2267 4921
Fax: +91 22 2263 1983
Website: www.hsbcnet.com/research

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