ITC - BUY

ITC IN	Rs183	FMCG	25 May 2009	Quarter results

Improving cigarette business performance

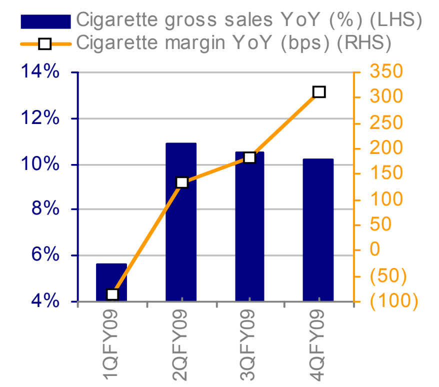
ITC's 4QFY09 net profit growth was in line with our expectation at 10% YoY, as lower other income (down 46% YoY) and a marginal decline in sales was offset by a 590bps expansion in EBITDA margin. The key highlight of the quarter's results was the cigarette business, which registered net sales growth of 16% YoY, on a 6-8% increase in prices and an improvement in sales mix. Cigarette volumes declined 3.5% YoY, which on a strong base, indicates an improved underlying volume trend. Another highlight was the fall in FMCG losses, which after peaking at Rs1.27bn in 3QFY09 declined to Rs1.1bn in 4QFY09. Management projected a 20% drop in FMCG losses in FY10, which in our view bodes well for overall business profitability. On the other hand, there is no let-up in pressure on hotels and agri business. The 590bps improvement in EBITDA margin was on account of higher cigarette EBIT margin and lower sales in the agri business in which margins are typically very low. Incorporating FY09 results and lower estimates for the hotels and agri business, we lower our earnings estimates for FY10-11 by 5-10%. Our new SOTP-based target price is Rs222. We reiterate BUY.

Cigarettes business posts another strong quarter: Cigarette net sales grew 16% YoY. Underlying cigarette volume decline of 3.5% YoY (though in line with a similar decline in 3Q) indicates an improving trend, in our view. Cigarette volume growth in the year-ago quarter was robust at c2% as the company sold out inventory of non-filter cigarettes after the budget announcement of 140-390% increases in excise tax on non-filter cigarettes. Cigarette EBIT margins expanded by 310bps YOY, on an improved product mix and benefits of price hikes.

Other FMCG losses have peaked out, management guides to 20% lower losses in FY10: After peaking in 3Q (at Rs1.27bn), other FMCG losses have come down to 1Q levels, at Rs1.1bn. Management's target is to bring losses down to Rs4bn (from Rs5bn posted in FY09), implying continued focus on profitability.

Poor performance in hotels and agri pull down revenues: Hotel revenues declined 29% YoY and EBIT margin declined by 1,260bps in 4Q, as the economic slowdown and travel advisories issued after the Mumbai terror strikes hit the tourist and business traveller arrivals. Agri revenues declined by 51% YoY as product rationalisation continued, coupled with poor soya exports.

Cigarette performance improving



Source: IIFL Research

Financial summary

Y/e 31 Mar	FY08A	FY09ii	FY10ii	FY11ii	FY12ii
Revenues (Rs m)	139,475	153,881	179,327	206,749	236,344
EBITDA Margins (%)	31.6	31.6	31.1	31.9	32.1
Pre-Exceptional PAT (Rs m)	31,201	32,635	38,083	45,218	52,269
Reported PAT (Rs m)	31,201	32,635	38,083	45,218	52,269
EPS (Rs)	8.3	8.7	10.1	12.0	13.9
Growth (%)	15.6%	4.6%	16.7%	18.7%	15.6%
PER (x)	**22.1**	**21.1**	**18.1**	**15.2**	**13.2**
ROE (%)	25.9	23.8	24.7	25.9	26.4
Debt/Equity (x)	0.0	0.0	0.0	0.0	0.0
EV/EBITDA (x)	**15.5**	**14.0**	**12.1**	**10.2**	**8.8**
Price/Book (x)	5.7	5.0	4.5	3.9	3.5

Price as at close of business on 22 May 2009

12-mth Target price (Rs) 222 (21%)

Market cap (US$ m)	**14,655**
52Wk High/Low (Rs)	231/132
Diluted o/s shares (m)	3762
Daily volume (US$ m)	22.8
Dividend yield FY09ii (%)	2.4
Free float (%)	68.0

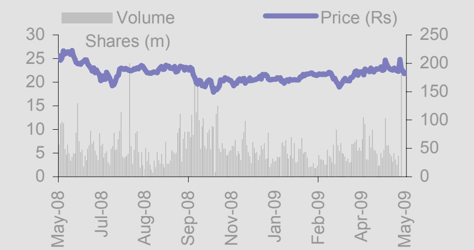
Shareholding pattern (%)

Foreign Corporate	32.0
FIIs	13.9
Domestic MFs/Insurance cos	37.8
Others	16.3

Price performance (%)

	1M	3M	1Y
ITC	-3.6	1.9	-17.8
Rel. to Sensex	-32.0	-55.2	0.0
Godfrey Phillips	38.1	49.2	-21.0
VST	32.7	60.7	0.1
HUL	-3.6	-6.9	-1.2

Stock movement



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In-line results

ITC's 4QFY09 PAT grew by 10% YoY, in line with our estimate of 9.6% YoY growth. However, net sales declined by 1% YoY, as against our expectation of 9.2% growth. The main cause of the variance from our expectation was the 51% decline in the low-margin agri business, where the company rationalised soya exports due to their low-margin profile.

Figure 1: 4QFY09 results- broadly in line with our estimates

Rs m	4QFY08	3QFY09	4QFY09	% YoY	% QoQ
Gross sales	60,097	59,172	59,536	-0.9	0.6
Excise duty	-20,753	-20,838	-20,617	-0.7	-1.1
Excise %	34.5	35.2	34.6	10bps	-59bps
Net sales	39,344	38,333	38,918	-1.1	1.5
Expenditure	-28,898	-24,806	-26,291	-9.0	6.0
EBITDA	10,446	13,527	12,627	20.9	-6.7
EBITDA (%)	26.6	35.3	32.4	590bps	-284bps
Interest	-27	-5	-137	406.7	2940.0
Depreciation	-1,215	-1,442	-1,451	19.4	0.6
Other income	1,638	1,229	879	-46.4	-28.5
PBT	10,842	13,310	11,918	9.9	-10.5
Tax	-3,485	-4,277	-3,828	9.8	-10.5
Tax rate (%)	32.1	32.1	32.1	-3bps	-2bps
PAT	7,356	9,032	8,090	10.0	-10.4
Net profit margin	18.7	23.6	20.8	209bps	-278bps
Exceptionals	0	0	0	NM	NM
Net profit post exceptionals	7,356	9,032	8,090	10.0	-10.4

Source: Company, IIFL Research

Figure 2: Raw-material costs declined largely due to lower agri sales

Cost Details	4QFY08	3QFY09	4QFY09	% YoY	% QoQ
Raw Materials	18,445	15,171	15,777	-14.5%	4.0%
% of Sales	46.9	39.6	40.5	-634bps	96bps
Staff Cost	1,911	2,130	2,222	16.3%	4.3%
% of Sales	4.9	5.6	5.7	85bps	15bps
Other Expenditure	8,542	7,506	8,293	-2.9%	10.5%
% of Sales	21.7	19.6	21.3	-40bps	173bps

Source: Company, IIFL Research

Figure 3: Hotels and agri businesses continue to be under pressure

Segmental revenues (Rs m)	4QFY08	3QFY09	4QFY09	% YoY	% QoQ
Cigarettes - Gross	35,830	39,015	39,493	10.2	1.2
Cigarette - Net	17,302	19,935	20,115	16.3	0.9
Other FMCG	7,384	7,223	8,388	13.6	16.1
Hotels	3,393	2,705	2,413	-28.9	-10.8
Agri business	10,781	6,212	5,259	-51.2	-15.3
Paperboard, Paper & Packaging	6,197	6,699	7,470	20.6	11.5

Source: Company, IIFL Research

Figure 4: Cigarettes profitability improved on price hikes and better product mix

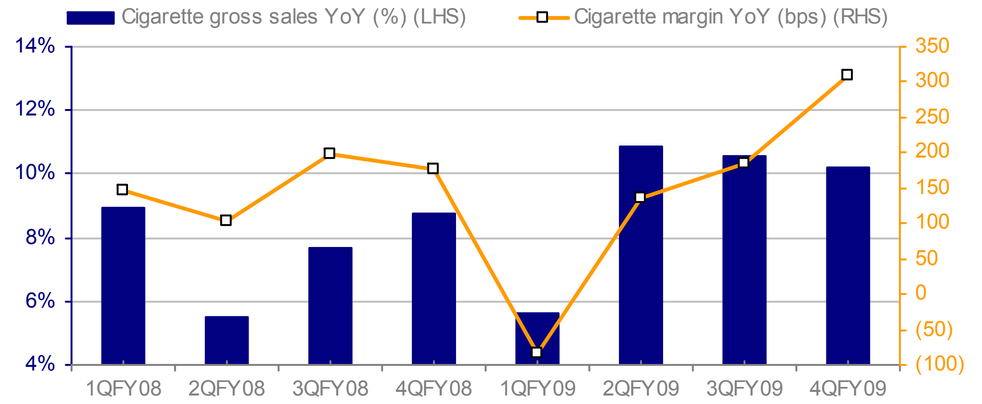
Segmental EBIT margin (%)	4QFY08	3QFY09	4QFY09	YoY	QoQ
Cigarettes	24.3	29.1	27.4	310bps	-169bps
Other FMCG	-16.0	-17.6	-14.0	198bps	360bps
Hotels	42.1	33.7	29.5	-1262bps	-420bps
Agri business	3.4	8.1	10.1	666bps	201bps
Paperboard, Paper & Packaging	19.8	16.6	20.3	53bps	376bps
Total	22.9	21.3	23.0	3bps	168bps

Source: Company, IIFL Research

Cigarettes: Sales and margins continue to look up

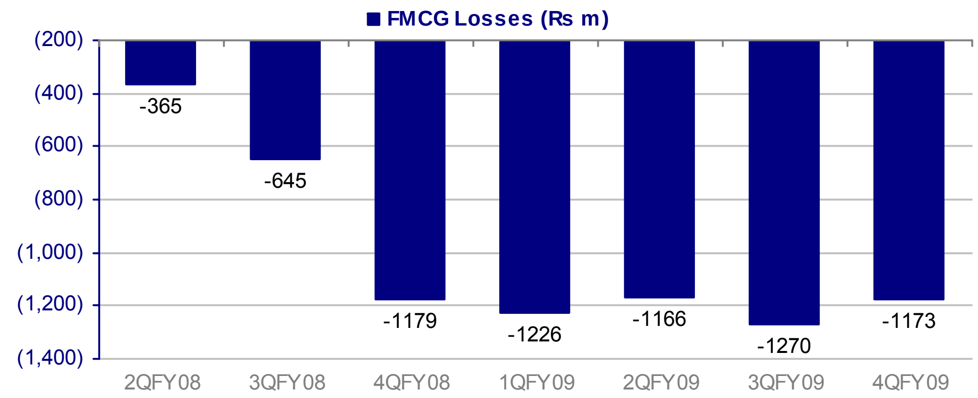
ITC's cigarette business consolidated on its strong recovery post the discontinuation of non-filter cigarettes in 1QFY09. Gross sales grew 10.2% YoY, while net sales grew 16.3%. Underlying cigarette volume decline of 3.5% (though in line with a similar decline in 3Q) implies an improving trend, in our view. Cigarettes volume growth in the year-ago quarter was robust at c2% YoY, as the company pushed out inventory of non-filter cigarettes post the budget announcement of a 140-390% hike in excise tax on non-filter cigarettes. Cigarette EBIT margin expanded 310bps YoY, thanks to price hikes taken over the past year and the improvement in mix as non-filter cigarettes were discontinued this year. The company has taken further price hikes in April in 'Gold Flake Filter Kings' (contributes c5% in volumes and 6-7% in value) by 10%, which will help the company expand cigarette margins over the quarters ahead. FY10 volume growth in cigarettes will depend largely on the excise duty hike that the government eventually imposes in the upcoming budget. We are building in a c5% hike in cigarette excise rate and 4% growth in ITC's volumes in FY10.

Figure 5: Cigarette gross sales and margins are seeing a strengthening trend



Source: Company, IIFL Research

Figure 6: Other FMCG losses seem to have peaked in 3QFY09

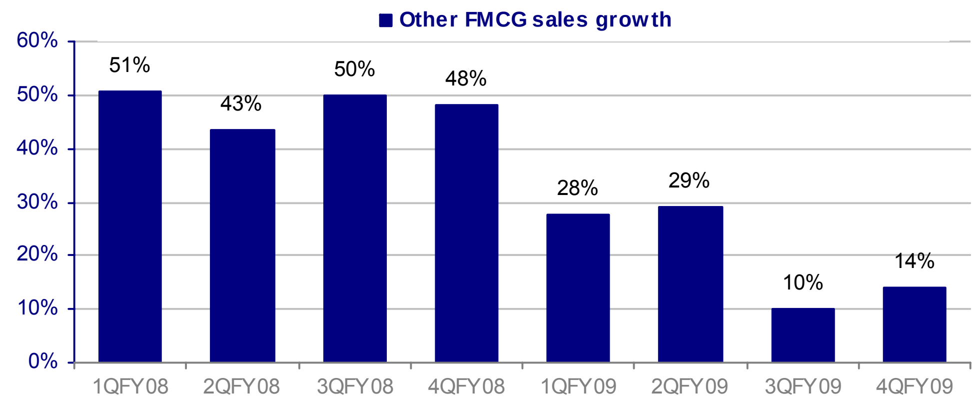


Source: Company, IIFL Research

Other FMCG losses come off, sales growth sluggish

Losses in the other FMCG business appear to have peaked in 3Q at Rs1.27bn; in 4QFY09, the business registered a loss of Rs1.1bn, as the company continued its focus on improving profitability. Management aims to contain losses at Rs4bn—20% lower than the Rs5bn loss posted in FY09. Sales growth, however, has remained sluggish at 14%, much lower than the 40-60% growth seen during FY08, as the company continued its focus on profitability in its core foods business comprising biscuits and branded staples. The slowdown in discretionary apparels has also been hit by the economic slowdown.

Figure 7: Other FMCG sales growth is clearly moderating

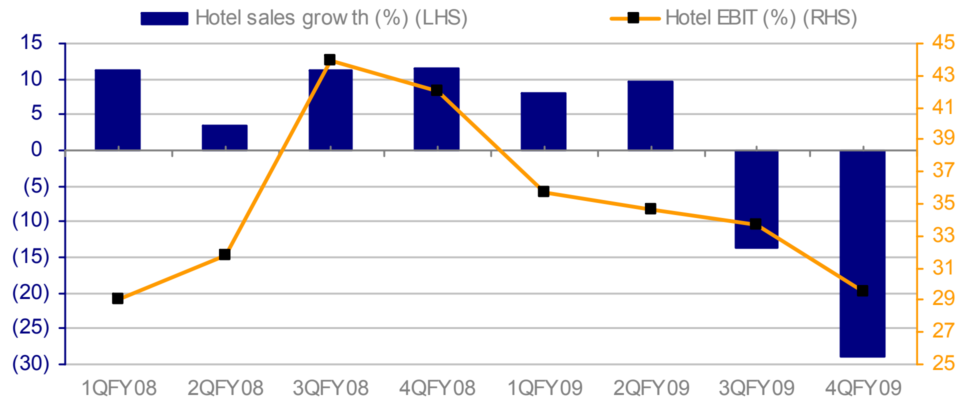


Source: Company, IIFL Research

Hotels business continues to be hurt by the economic slowdown

Hotels revenues declined 29% YoY as ARRs and occupancies remained under pressure due to the impact of the economic slowdown. EBIT margins also continued to decline and were down over 1260bps YoY. The negative travel advisory given by many countries after the Mumbai terror attacks had a major impact in March quarter. The outlook on hotels remains grim, as there is unlikely to be any uptick in tourism and businesses continue to reduce spends on travel. The June quarter is also likely to be a tough one for the company, because of an unfavourable base (1QFY08 had recorded high sales, with ITC being the official host for the Indian Premier League cricket tournament).

Figure 8: Hotels – revenue and profitability growth continue to slide

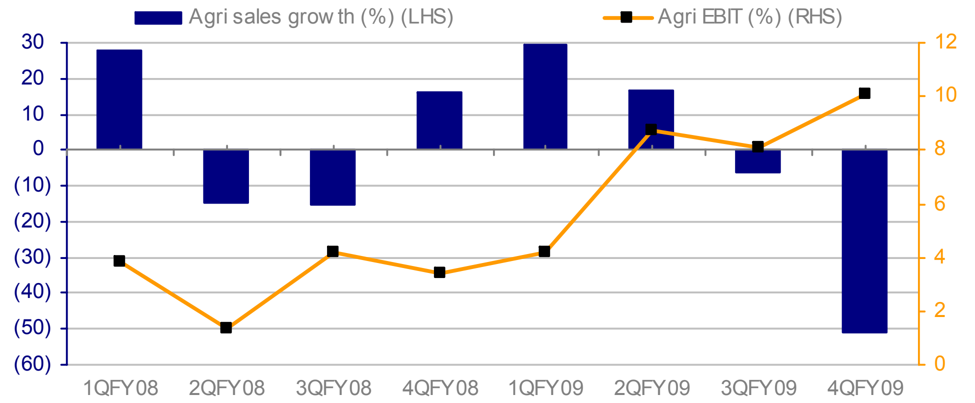


Source: Company, IIFL Research

Agri-sales hit by portfolio rationalisation

Agri sales declined by 51% YoY, as the company rationalised soya and other low-margin agri exports, in view of increasing policy interventions and high volatility in prices. However, EBIT grew by 43% YoY, with margins tripling from 3.4% to 10.1%, reaching the highest level in the last 17 quarters.

Figure 9: Agri sales were down sharply, though margins expanded

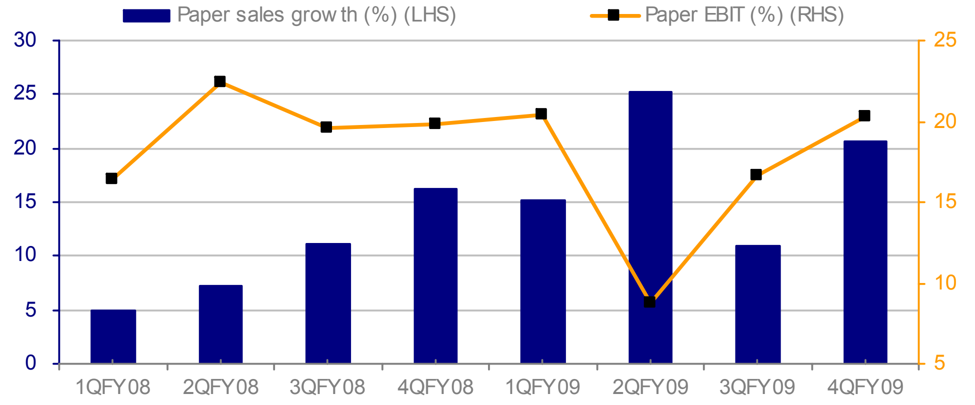


Source: Company, IIFL Research

Paperboards and packaging

Sales saw a pick-up in growth, up 20% YoY. Margins expanded by 53bps YoY and 376bps QoQ, reflecting the production ramp-up at the new pulp and paperboard facilities, which started operations three quarters ago.

Figure 10: Paper growth strong, margins improve on new production ramp up



Source: Company, IIFL Research

We revise earnings estimates, target price

We revise our estimates as we incorporate FY09 details and build in lower estimates for the hotels and agri business. We lower our FY10ii and FY11ii EPS estimates by 5% and 10% respectively. Our new SOTP-based target price is Rs222 and we maintain BUY.

Figure 11: ITC's sum-of-the-parts valuation details

Business	Valuation method	Value / Share (Rs)
Cigarettes	P/E	171
Other FMCG	Mcap/Sales	20
Hotels	P/E	19
Agri	P/E	3
Paper	P/E	9
Total		**222**

Source: IIFL Research

Financial summary

Revenue growth will be driven by the cigarette business, which should see a return to volume growth in FY10ii

Management has earmarked Rs60bn of capex to be equally split between consumer, paper and the hotels business over FY09-11

Income statement summary (Rs m)

Y/e 31 Mar	FY08A	FY09ii	FY10ii	FY11ii	FY12ii
Revenue	139,475	153,881	179,327	206,749	236,344
EBITDA	44,039	48,585	55,725	65,940	75,764
EBIT	**39,655**	**43,091**	**49,208**	**58,333**	**67,068**
Net Interest expense	-46	-183	-54	-54	-54
Other Income	6,109	5,348	6,685	8,022	9,627
Profit before tax	**45,718**	**48,256**	**55,840**	**66,302**	**76,641**
Taxes	-14,517	-15,622	-17,757	-21,084	-24,372
Net profit	**31,201**	**32,635**	**38,083**	**45,218**	**52,269**

Cashflow summary (Rs m)

Y/e 31 Mar	FY08A	FY09ii	FY10ii	FY11ii	FY12ii
Profit before tax	45,718	48,256	55,840	66,302	76,641
Depr. & amortization	4,385	5,494	6,517	7,606	8,696
Tax paid	-13,795	-15,622	-17,757	-21,084	-24,372
Working capital ∆	-5,217	-3,481	-3,158	-3,291	-4,082
Operating cashflow	31,091	34,648	41,442	49,533	56,884
Capital expenditure	-21,232	-19,799	-20,000	-20,000	-6,381
Free cash flow	**9,859**	**14,849**	**21,442**	**29,533**	**50,502**
Equity raised	6	0	0	0	0
Investments	1,332	6,000	3,000	-2,000	-2,000
Debt financing/disposal	136	0	0	0	0
Dividends paid	-15,432	-15,836	-21,058	-25,004	-28,903
Other items	430	0	0	0	0
Net change in cash	**-3,669**	**5,012**	**3,383**	**2,529**	**19,599**

Source: Company data, IIFL Research

Fixed assets increase due to capex in the hotel, paper and consumer business

Balance sheet summary (Rs m)

Y/e 31 Mar	FY08A	FY09ii	FY10ii	FY11ii	FY12ii
Cash & equivalents	7,163	12,176	15,559	18,088	37,687
Sundry debtors	7,369	10,118	11,300	12,462	14,245
Inventories - trade	40,505	43,600	50,809	58,579	66,964
Other current assets	15,155	16,927	19,726	22,742	25,998
Fixed assets	**72,957**	**87,262**	**100,745**	**113,139**	**110,824**
Intangible assets	0	0	0	0	0
Other term assets	29,346	23,346	20,346	22,346	24,346
Total assets	**172,495**	**193,427**	**218,484**	**247,355**	**280,064**
Short-term debt	2,089	2,089	2,089	2,089	2,089
Sundry creditors	27,870	30,761	35,867	41,370	47,309
Other current liabs	16,453	17,696	20,623	23,776	27,180
Long-term debt/CBs	56	56	56	56	56
Other long-term liabs	5,451	5,451	5,451	5,451	5,451
Net worth	**120,577**	**137,375**	**154,400**	**174,614**	**197,980**
Total liabs & equity	**172,495**	**193,427**	**218,484**	**247,355**	**280,064**

We build in a dip in margins in FY10 as hotels margins take a hit

Ratio analysis

Y/e 31 Mar	FY08A	FY09ii	FY10ii	FY11ii	FY12ii
Revenue growth (%)	14.7	10.3	16.5	15.3	14.3
Op Ebitda growth (%)	11.3	10.3	14.7	18.3	14.9
Op Ebit growth (%)	10.4	8.7	14.2	18.5	15.0
Op Ebitda margin (%)	31.6	31.6	31.1	31.9	32.1
Op Ebit margin (%)	28.4	28.0	27.4	28.2	28.4
Net profit margin (%)	22.4	21.2	21.2	21.9	22.1
Dividend payout (%)	49.5	48.5	55.3	55.3	55.3
Tax rate (%)	31.8	32.4	31.8	31.8	31.8
Net debt/equity (%)	-4.2	-7.3	-8.7	-9.1	-18.0
Net debt/op Ebitda (x)	-0.1	-0.2	-0.2	-0.2	-0.5
Return on equity (%)	25.9	23.8	24.7	25.9	26.4

Source: Company data, IIFL Research

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.
SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.
Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.
