

No news is good news for ITC; some news is bad news for Nestle. The Union Budget 2011-12 left the excise rates on cigarettes unchanged—significant positive surprise for the street. No change in excise duty on cigarettes is a likely precursor to State VAT incidence increasing to 20% from 15%, in our view (recently Gujarat increased it to 25% and Himachal to 16%). Bringing of various food products (noodles, pasta, soups etc.) into tax net with 1% excise duty is a precursor to a potentially higher rate under GST, in our view. Reiterate ADD on ITC and REDUCE on Nestle.

Company data and valuation summary

ITC				Forecasts/Valuations			
Stock data				2011	2012E	2013E	
52-week range (Rs) (high,low)	185-114			EPS (Rs)	6.5	7.8	9.1
Market Cap. (Rs bn)	1,195.8			EPS growth (%)	22.8	19.0	17.4
Shareholding pattern (%)				P/E (X)	24.0	20.2	17.2
Promoters	0.0			Sales (Rs bn)	209.8	248.4	280.5
FIs	14.5			Net profits (Rs bn)	49.9	59.2	69.7
MFs	2.6			EBITDA (Rs bn)	75.0	89.2	104.3
Price performance (%)				EV/EBITDA (X)	15.2	12.6	10.7
Absolute	1M	3M	12M	ROE (%)	32.1	32.4	33.1
Rel. to BSE-30	(3.9)	(9.1)	37.5	Div. Yield (%)	1.8	2.4	2.9
	(1.0)	0.3	27.6				

Company data and valuation summary

Nestle India (a)				Forecasts/Valuations			
Stock data				2011	2012E	2013E	
52-week range (Rs) (high,low)	4,224-2,295			EPS (Rs)	87.0	104.1	126.2
Market Cap. (Rs bn)	341.3			EPS growth (%)	17.0	19.6	21.2
Shareholding pattern (%)				P/E (X)	40.7	34.0	28.1
Promoters	62.8			Sales (Rs bn)	62.5	75.4	89.9
FIs	10.6			Net profits (Rs bn)	8.4	10.0	12.2
MFs	2.2			EBITDA (Rs bn)	12.6	15.5	19.0
Price performance (%)				EV/EBITDA (X)	26.9	22.0	18.0
Absolute	1M	3M	12M	ROE (%)	129.6	124.8	121.2
Rel. to BSE-30	6.4	(2.3)	34.8	Div. Yield (%)	1.7	2.1	2.5
	9.6	7.7	25.1				

Key takeaways from Budget 2011-12

- ▶ Bringing of various food products (pasta, spaghetti, macaroni, noodles, coffee and tea premixes, sauces, ketchups, soups, toothpowder etc.) under the tax net with 1% duty.

This could potentially be a precursor to a higher rate of duty under GST. Negative for Nestle, HUL

- ▶ Bringing of various paper products (notebooks, exercise books) under the tax net with 1% duty.

This could potentially be a precursor to a higher rate of duty under GST. Negative for ITC's stationery business

- ▶ Customs duty on crude palm stearin imported for manufacture of laundry soap is reduced to nil from 20%.

Marginally positive for HUL. Estimated benefit of Rs180 mn for HUL's Sunlight laundry soap (sells predominantly in Kerala and West Bengal) while Jyothy can potentially relaunch the 'Vanamala' brand in Kerala

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- ▶ Introduction of 1% excise duty on articles of jewelry manufactured or sold under a brand name.

Negative: Modest impact on Titan's jewelry business

- ▶ Status quo maintained on excise duty rates at 10%.

Positive: For most consumer companies as they are in a better position now to take price increases to offset commodity cost escalation without impacting volume growth. This is particularly beneficial for Asian Paints, GSK Consumer, Colgate, HUL

Our positive view on ITC and cautious view on Nestle remains

- ▶ ITC (ADD, TP Rs185) is entering a phase of high FCF generation—we forecast Rs156 bn (Rs20/share) over FY2010-13E. The confluence of all businesses performing well and no increase in capex plans is driving this—we expect potential increase in payout ratio from the current 50%. However, ITC needs to watch for potential increases in state VAT in FY2012E. Two recent examples:

- In the budget for FY2012, Gujarat increased the VAT on cigarettes to 25% (from 20%), and
- Himachal Pradesh increased it to 16% (from 13.75%) for cigarettes. It is interesting to note that VAT on bidis was increased to 16% from 5%.

We model 4% volume growth in cigarettes (which has upside risks now) and forecast an EPS of Rs7.8 for FY2012E (+19% growth, 3% higher than consensus).

- ▶ The recent excise proposals potentially impact ~10% of Nestlé's portfolio. While we believe that Nestlé's product portfolio allows price increases and cross-subsidization (for example, price increases in relatively inelastic infant foods to compensate for input cost inflation in other categories), bringing of many food products under excise net is incrementally negative. Stock trades at 34X FY2012E, retain REDUCE and TP Rs3,100.

Gujarat and Himachal Pradesh have hiked VAT on cigarettes in FY2012 budget

State/region	Contribution to ITC cigarette sales		Current VAT on cigarettes		Any change in VAT
	(Value, %)				
Tamilnadu	11		12.5	No	
West Bengal	8		12.5	No	
Haryana	4		20.0	No	
Chattisgarh	3		12.5	No	
Bihar	3		13.5	Yes, increased from 12.5%	
Gujarat	3		25.0	Yes, increased from 20%	
Himachal Pradesh	2		16.0	Yes, increased from 13.75%	
Maharashtra	9		20.0	No	
Delhi	4		20.0	No	
Rajasthan	3		20.0	No	
Uttar Pradesh	4		13.5	No	
Andhra Pradesh	13		12.5	No	
Kerala	12		12.5	No	
Karnataka	9		15.0	No	
Madhya Pradesh	3		12.5	No	

Source: Kotak Institutional Equities estimates

ITC: Profit model, balance sheet, cash flow model 2007-2013E, March fiscal year-ends (Rs mn)

	2007	2008	2009	2010	2011E	2012E	2013E
Profit model (Rs mn)							
Net sales	123,693	140,012	156,119	181,532	209,846	248,439	280,535
EBITDA	39,700	44,703	48,686	60,936	71,911	86,152	101,107
Other income	3,365	6,109	5,349	6,034	7,795	8,234	9,483
Interest	(169)	(173)	(284)	(730)	(543)	(592)	(570)
Depreciation	(3,629)	(4,385)	(5,494)	(6,087)	(6,871)	(7,683)	(8,575)
Pretax profits	39,267	46,255	48,258	60,153	72,291	86,112	101,446
Tax	(12,267)	(14,517)	(15,622)	(19,543)	(22,425)	(26,905)	(31,793)
Net profits	27,000	31,738	32,636	40,610	49,866	59,207	69,653
Earnings per share (Rs)	3.6	4.2	4.3	5.4	6.5	7.8	9.1
Balance sheet (Rs mn)							
Total equity	104,371	120,577	137,351	140,644	169,759	195,463	224,912
Deferred taxation liability	4,729	5,451	8,672	7,850	7,850	7,850	7,850
Total borrowings	2,009	2,144	1,776	1,077	1,077	1,077	1,077
Current liabilities	38,576	44,323	47,036	80,482	64,931	70,100	74,068
Total liabilities and equity	149,684	172,495	194,835	230,053	243,617	274,490	307,908
Cash	9,002	5,703	10,310	11,263	15,977	31,263	47,129
Current assets	53,896	64,490	71,287	70,008	70,738	79,018	87,155
Total fixed assets	56,109	72,956	84,860	91,514	99,633	106,940	116,355
Investments	30,678	29,346	28,378	57,269	57,269	57,269	57,269
Total assets	149,684	172,495	194,834	230,053	243,617	274,490	307,908
Free cash flow (Rs mn)							
Operating cash flow	31,040	37,112	41,493	49,850	57,682	68,353	79,824
Working capital	(8,667)	(6,634)	(4,991)	6,541	6,014	(4,078)	(3,604)
Capital expenditure	(15,702)	(21,239)	(17,407)	(12,751)	(15,000)	(15,000)	(18,000)
Free cash flow	6,672	9,238	19,095	43,640	48,697	49,275	58,220
Key ratios (%)							
Sales growth	26.3	13.2	11.5	16.3	15.6	18.4	12.9
EBITDA margin	32.1	31.9	31.2	33.6	34.3	34.7	36.0
EPS growth	20.1	17.1	2.8	23.8	21.7	18.7	17.6

Source: Company, Kotak Institutional Equities estimates

Nestle: Profit model, balance sheet, 2006-2012E, December calendar year-ends (Rs mn)

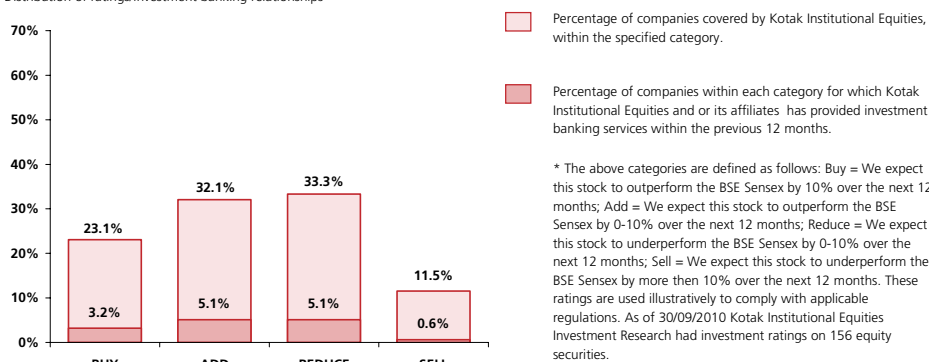
	2006	2007	2008	2009	2010E	2011E	2012E
Profit model (Rs mn)							
Net sales	28,161	35,043	43,242	51,294	62,547	75,373	89,870
EBITDA	5,385	6,962	8,638	10,542	12,507	15,339	18,793
Other income	202	246	322	364	427	255	305
Depreciation	(663)	(747)	(924)	(1,113)	(1,278)	(1,857)	(2,478)
Pretax profits	4,923	6,461	8,036	9,793	11,656	13,738	16,620
Tax	(1,654)	(2,148)	(2,387)	(2,620)	(3,264)	(3,699)	(4,457)
Net profits	3,269	4,313	5,649	7,173	8,392	10,039	12,163
Earnings per share (Rs)	33.9	44.7	58.6	74.4	87.0	104.1	126.2
Balance sheet (Rs mn)							
Total equity	3,889	4,184	4,733	5,813	7,140	8,945	11,131
Total borrowings	163	29	8	6	6	6	6
Current liabilities and provisions	8,726	9,865	12,208	14,538	16,922	19,989	23,845
Total liabilities and equity	12,777	14,078	16,950	20,356	24,069	28,940	34,982
Cash	2,387	1,322	2,286	3,588	3,400	1,952	1,922
Current assets	4,590	6,001	6,043	7,010	7,773	6,949	7,499
Total fixed assets	5,800	6,755	8,622	9,758	12,895	20,039	25,561
Total assets	12,777	14,078	16,950	20,356	24,069	28,940	34,982
Free cash flow (Rs mn)							
Operating cash flow, excl. working capital	3,561	4,363	5,568	7,065	8,487	10,699	13,192
Working capital	561	361	1,149	1,355	1,258	3,542	2,857
Capital expenditure	(1,497)	(1,702)	(2,790)	(2,249)	(4,414)	(9,000)	(8,000)
Free cash flow	2,624	3,022	3,927	6,170	5,330	5,241	8,048
Key assumptions							
Revenue Growth (%)	13.7	24.4	23.4	18.6	21.9	20.5	19.2
EBITDA Margin(%)	19.1	19.9	20.0	20.6	20.0	20.4	20.9
EPS Growth (%)	(0.7)	31.9	31.0	27.0	17.0	19.6	21.2

Source: Company, Kotak Institutional Equities estimates

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As of September 30, 2010

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