Company

22 July 2010 | 10 pages

Equity

ITC (ITC.BO)

Other Businesses Buttress Cigarette Profitability

- **1QFY11 PAT marginally beat estimates** — PAT growth of ~22% YoY to Rs10.7bn was marginally ahead of our/consensus estimates of Rs10.6/10.4bn respectively. Moderate EBITDA margin expansion of ~110bps YoY to 33.4% was primarily on the back of a healthy performance of the other FMCG businesses and the paper business. Net revenues of Rs48bn (+16% YoY) were in line with estimates.
- **Pricing drives cigarette profits** — ITC's recent pricing, coupled with mix improvements led to ~12% and ~16% YoY growth (90bps margin expansion) in cigarette revenues and profits respectively. We estimate ~4% YoY volume decline in 1Q; expect pick up post the monsoons – forecast 1.7% and 4% underlying cigarette volume growth in FY11/12E respectively.
- **Non-cigarette FMCG losses decline 11% YoY** — Management targets to reduce losses to ~Rs2.6-2.8bn in FY11. Revenue growth of 32% YoY was driven by better realizations/mix benefits in biscuits/staples. Personal care *(Vivel/ Superia)* revenue run rate is now ~Rs4bn p.a. (Rs3.6-3.7 earlier). Soaps / shampoo market share is at 5% / 3.5% - up from ~3.5% / <3% end 1HFY10.
- **Paper business does well, supported by hotels pick up** — a) Better pricing and product mix enrichment drove 14%/48% YoY growth in revenues/EBIT for paper/paperboards business. b) Mgmt mentioned hotels business continued to pick up QoQ. c) Agri business revenues rose 44% YoY given higher soya, leaf tobacco & wheat sales; however segment margins contracted 150bps YoY.
- **Maintain Buy** — We reckon ITC should continue to be a core holding over the long term, given its strong market positioning and healthy growth in cigarette cash flows. The near term share price performance could however be muted, given a) the recent price performance, and b) the specter of declining cigarette volumes in 1HFY11. We would use any weakness as an enhanced buying opportunity.

Buy/Low Risk	**1L**
Price (22 Jul 10)	Rs295.60
Target price	Rs302.00
Expected share price return	2.2%
Expected dividend yield	1.9%
Expected total return	**4.0%**
Market Cap	Rs1,130,609M US$23,971M

Price Performance (RIC: ITC.BO, BB: ITC IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2009A	32,636	8.65	4.4	34.2	8.1	25.3	1.3
2010A	40,610	10.64	23.0	27.8	8.0	29.2	3.4
2011E	48,816	12.79	20.2	23.1	6.8	31.9	1.9
2012E	56,100	14.69	14.9	20.1	5.9	31.4	2.1
2013E	61,808	16.19	10.2	18.3	5.0	29.7	2.4

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Fiscal year end 31-Mar	2009	2010	2011E	2012E	2013E
Valuation Ratios					
P/E adjusted (x)	34.2	27.8	23.1	20.1	18.3
EV/EBITDA adjusted (x)	22.8	18.3	15.4	13.3	12.0
P/BV (x)	8.1	8.0	6.8	5.9	5.0
Dividend yield (%)	1.3	3.4	1.9	2.1	2.4
Per Share Data (Rs)					
EPS adjusted	8.65	10.64	12.79	14.69	16.19
EPS reported	8.65	10.64	12.79	14.69	16.19
BVPS	36.39	36.84	43.20	50.52	58.59
DPS	3.70	10.00	5.50	6.32	6.96
Profit & Loss (RsM)					
Net sales	153,881	181,532	202,708	231,445	260,947
Operating expenses	-110,557	-126,879	-137,338	-155,898	-177,760
EBIT	**43,324**	**54,653**	**65,370**	**75,547**	**83,187**
Net interest expense	-183	-534	-245	-360	-360
Non-operating/exceptionals	5,117	6,034	7,195	7,923	8,741
Pre-tax profit	**48,257**	**60,153**	**72,321**	**83,110**	**91,568**
Tax	-15,622	-19,543	-23,504	-27,011	-29,760
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	**32,636**	**40,610**	**48,816**	**56,100**	**61,808**
Adjusted earnings	32,636	40,610	48,816	56,100	61,808
Adjusted EBITDA	48,818	60,740	71,920	82,581	90,821
Growth Rates (%)					
Sales	10.3	18.0	11.7	14.2	12.7
EBIT adjusted	9.1	26.1	19.6	15.6	10.1
EBITDA adjusted	10.7	24.4	18.4	14.8	10.0
EPS adjusted	4.4	23.0	20.2	14.9	10.2
Cash Flow (RsM)					
Operating cash flow	**37,281**	**80,587**	**27,777**	**49,473**	**61,147**
Depreciation/amortization	5,494	6,087	6,550	7,034	7,634
Net working capital	-4,070	34,712	-27,589	-13,660	-8,295
Investing cash flow	**-16,429**	**-41,633**	**-15,000**	**-12,000**	**-12,000**
Capital expenditure	-17,397	-12,741	-15,000	-12,000	-12,000
Acquisitions/disposals	968	-28,891	0	0	0
Financing cash flow	**-16,231**	**-38,015**	**-22,574**	**-28,151**	**-31,016**
Borrowings	-369	-698	1,923	0	0
Dividends paid	-16,299	-44,517	-24,497	-28,151	-31,016
Change in cash	**4,621**	**939**	**-9,797**	**9,322**	**18,131**
Balance Sheet (RsM)					
Total assets	**194,848**	**230,053**	**238,311**	**275,146**	**314,950**
Cash & cash equivalent	10,324	11,263	1,466	10,788	28,919
Accounts receivable	6,687	8,588	11,040	12,501	15,107
Net fixed assets	84,860	91,514	99,964	104,930	109,296
Total liabilities	**57,498**	**89,410**	**73,347**	**82,234**	**91,246**
Accounts payable	29,645	34,983	36,907	42,008	48,008
Total Debt	1,776	1,077	3,000	3,000	3,000
Shareholders' funds	**137,351**	**140,644**	**164,964**	**192,912**	**223,704**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	31.7	33.5	35.5	35.7	34.8
ROE adjusted	25.3	29.2	31.9	31.4	29.7
ROIC adjusted	23.5	27.8	31.1	31.5	30.9
Net debt to equity	-6.2	-7.2	0.9	-4.0	-11.6
Total debt to capital	1.3	0.8	1.8	1.5	1.3

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1QFY11 Results Summary

PAT growth of 22% to Rs10.7bn was marginally above expectations, driven by 20% growth in EBITDA

EBITDA margins expanded by 110bps YoY to 33.4%; this was above our expectations. Key variance were the non-cigarette businesses, esp. the paper/paperboards segment (EBIT margins +520bps YoY, 250bps QoQ)

Overall net revenue growth of 16% YoY was largely in line with expectations – on the back of +12% YoY cigarette growth and 32% YoY other FMCG growth.

Cigarette business performance was decent, driven by ~16% growth led by pricing/mix improvement.

~11% YoY decline in non cigarette FMCG EBIT losses buttressed margins. However we note that on a sequential basis, the losses increased by 13%.

Figure 1. 1QFY11 Results Summary (Rupees in Million, %)

	1QFY10	1QFY11	%YOY
Gross Sales	62,687	71,722	14.4
Excise Duty	(21,211)	(23,555)	11.1
Excise %	*33.8*	*32.8*	*-99 bps*
Net sales	**41,476**	**48,166**	**16.1**
Expenditure	(28,105)	(32,103)	14.2
Operating profit	**13,371**	**16,064**	**20.1**
OPM (%)	*32.2*	*33.4*	*111 bps*
Interest	(58)	(58)	(0.7)
Depreciation	(1,516)	(1,597)	5.3
Other income	1,378	1,292	(6.3)
PBT	**13,175**	**15,701**	**19.2**
Tax	(4,388)	(4,998)	13.9
Tax rate (%)	*33.3*	*31.8*	*-147 bps*
PAT	**8,787**	**10,703**	**21.8**
Net Profit Margin (%)	*21.2*	*22.2*	*104 bps*
EPS	**2.3**	**2.8**	**21.8**
Cost Details			
Raw Materials	15,213	17,911	17.7
% of Sales	*36.7*	*37.2*	*51 bps*
Staff Cost	2,822	3,419	21.2
% of Sales	*6.8*	*7.1*	*30 bps*
Other Expenditure	10,070	10,772	7.0
% of Sales	*24.3*	*22.4*	*-192 bps*

Source: Company Reports

Results Analysis

1. Cigarettes: Cigarette revenues rose ~12% YoY driven by the price increases taken YTD – weighted avg. price hike across ITC's portfolio was ~15%; which we believe was more than sufficient to offset ~18% excise hike in the FY11 Union Budget and VAT rate increases by some states (wt avg. VAT rate is around 14%).

We estimate ~4% decline in cigarette volumes during the quarter. We expect some pick up in 2HFY11 and estimate ~1.7% volume growth in FY11E.

During the quarter, cigarette EBIT rose 16% YoY, as EBIT margins expanded ~90bps YoY.

Management mentioned that it is currently test marketing some products in new <60mm filter segment. Additionally, it has introduced some new brands/variants during the quarter, namely *Lucky Strike, Classic Menthol Rush,* and *Gold Flake SLK*, which could aid volumes to some extent.

2. Other FMCG businesses: Overall, non-cigarette FMCG revenue growth was 32% YoY to Rs10.1bn. Scale, better realizations, mix benefits and ongoing supply chain initiatives led to ~430bps YoY margin expansion. EBIT loss at Rs893m declined ~10% YoY; however increased on sequential basis (+13% QoQ).

While advertising and brand building continued at an aggressive pace, esp in the personal care space; management has recently guided that the segment's operating losses are likely to reduce further in FY11. This will be driven by foods portfolio (Sunfeast biscuits + Aashirwaad) and a healthy growth in the stationery/education business. Overall, management guided that the non-cigarette FMCG business will break even in FY12E.

ITC's personal care portfolio revenues rose 86% YoY during the 1Q. Vivel/Superia revenues are expected to ~Rs2bn each in FY11, based on the current run rate. The personal care segment will continue to be a drag on profitability – we expect it will break even only in FY13E, once overall market share is ~8-10%, and gross profits offset aggressive brand building initiatives. Market shares in soaps and shampoos were ~5% and 3.5% respectively.

Biscuits, flour, confectioneries and education/stationary business revenues grew 43%, 21%, 25% and 30% YoY respectively during the quarter.

3. Hotels: 1QFY10 hotel business continued to do well during the quarter - revenues and EBIT increasing ~21% YoY and 26% YoY respectively. Management noted some sequential improvement in occupancies and ARRs.

Chennai property (~600 rooms) launch is on track – expected by 2HFY11. Further, Kolkata property (~500 rooms) is on course to be launched in FY12.

4. Paperboard and paper: Paper segment revenues rose ~14% YoY and EBIT growth was 48%YoY. This was above our expectations driven by: a) higher realizations and b) positive mix benefits towards value added paper. Benefits of enhanced capacity with commencement of the new pulp mill will aid margin growth going forward.

We estimate 12-15% revenue growth over the FY11, with some margin expansion, driven strong pricing environment.

5. Agri-business: Segmental revenues rose ~44% YoY– however a change in mix resulted in a margin decline of 150bps YoY.

Over the medium term, margins should remain steady given the focus on higher profitability products.

Figure 2. ITC – Gross Revenue Trends (Rs m)

Revenues	1QFY10	2QFY10	3QFY10	4QFY10	1QFY11	% Change YoY	% Change QoQ
FMCG							
Cigarettes	41,606	41,831	44,225	45,168	46,697	12.2%	3.4%
Others	7,594	8,653	8,918	11,253	10,056	32.4%	-10.6%
Total FMCG	**49,200**	**50,484**	**53,143**	**56,421**	**56,754**	**15.4%**	**0.6%**
Hotels	1,857	1,863	2,645	2,743	2,251	21.2%	-17.9%
Agri business	9,406	10,283	9,052	9,881	13,498	43.5%	36.6%
Paperboard, Paper & Packaging	7,306	8,217	8,453	8,360	8,291	13.5%	-0.8%
Total Non-FMCG	**18,569**	**20,363**	**20,150**	**20,984**	**24,041**	**29.5%**	**14.6%**
Less : Inter segment Sales	6,460	7,761	6,678	5,817	10,365	60.4%	78.2%
Total	**61,309**	**63,086**	**66,614**	**71,587**	**70,430**	**14.9%**	**-1.6%**

Source: Company Reports

Figure 3. ITC – EBIT Trends (Rs m)

EBIT	1QFY10	2QFY10	3QFY10	4QFY10	1QFY11	% Change YoY	% Change QoQ
Cigarettes	11,254	12,517	13,098	12,512	13,050	16.0%	4.3%
Others	(998)	(850)	(860)	(787)	(893)	-10.5%	13.4%
Total FMCG	**10,256**	**11,667**	**12,238**	**11,725**	**12,157**	**18.5%**	**3.7%**
Hotels	306	316	763	782	385	25.9%	-50.7%
Agri business	999	1,741	1,041	583	1,231	23.2%	111.1%
Paperboard, Paper & Packaging	1,278	1,862	2,014	1,688	1,885	47.5%	11.6%
Total Non-FMCG	**2,583**	**3,919**	**3,818**	**3,053**	**3,501**	**35.5%**	**14.7%**
Less: Interest (Net)	58	181	109	185	58	-0.7%	-68.7%
Less: Net Unallocable Expenses	(394)	483	(1,063)	(454)	(101)	-74.4%	-77.8%
Total	**13,175**	**14,920**	**17,010**	**15,048**	**15,701**	**19.2%**	**4.3%**

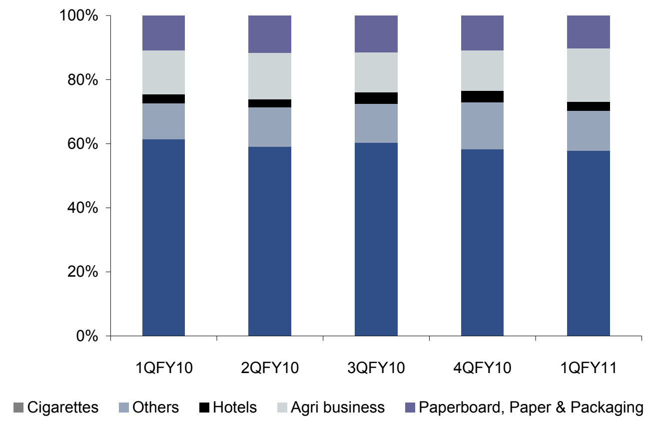
Source: Company Reports

Figure 4. ITC – EBIT Margin Trends (%)

EBIT Margins (%)	1QFY10	2QFY10	3QFY10	4QFY10	1QFY11	Change YoY (bps)	Change QoQ (bps)
Cigarettes	27.0	29.9	29.6	27.7	27.9	90	24
Others	(13.1)	(9.8)	(9.6)	(7.0)	(8.9)	426	(188)
Total FMCG	**20.8**	**23.1**	**23.0**	**20.8**	**21.4**	**58**	**64**
Hotels	16.5	16.9	28.8	28.5	17.1	64	(1,140)
Agri business	10.6	16.9	11.5	5.9	9.1	(150)	322
Paperboard, Paper & Packaging	17.5	22.7	23.8	20.2	22.7	524	254
Total Non-FMCG	**13.9**	**19.2**	**18.9**	**14.6**	**14.6**	**65**	**1**

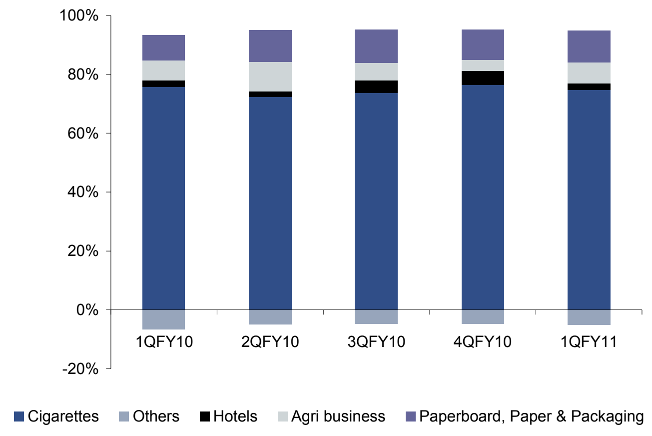
Source: Company Reports

Figure 5. ITC – Revenue Mix (%)



Source: Company Reports

Figure 6. ITC – EBIT Mix (%)



Source: Company Reports

ITC

Company description

ITC is the leading cigarette manufacturer and marketer in India with about 74% market share by volume. The group is ~32% owned by British American Tobacco. Its cigarette portfolio has strong brands such as Wills, Gold Flake, India Kings and Scissors, and two of BAT's global brands, Benson & Hedges and State Express 555. Besides tobacco, ITC operates four other business divisions: a) agri / marine products, b) hotels, c) paper & packaging and d) IT. However, about 65% of revenues and 88% of profits are from the cigarette business (in FY09). The group has made significant investments in hotels, paperboard and processed foods (biscuits, ready-to-eat foods, confectioneries).

Investment strategy

We rate shares Buy/Low Risk (1L) with a Rs302 target price. Cigarette business remains strong on the back of a robust pricing environment, good volumes and better mix. ITC has been successful in passing the higher excise duty increases, resulting in strong margins. Positive cigarette volume growth despite aggressive pricing action should enable the stock's recent re-rating to sustain. Over the next few years, ITC's overall revenue streams should become far more balanced as the non-tobacco FMCG business attains critical mass (currently 13% of revenues). We forecast a strong 18% EPS growth CAGR over FY10-12E.

Valuation

Our Rs302 target price is based on 22x SeptFY11E earnings. ITC's stock has experienced a gradual re-rating, as concerns pertaining to cigarette volume decline (post the excise/VAT imposition) have been largely unfounded, with overall cigarette volumes declining only c.1-3% in FY08/09, thus underscoring the resilience and defensive attributes of the core cigarette business. Moreover, while PAT and earnings have been somewhat volatile over the past few years, this was due to different growth trajectories and life cycles of ITC's other businesses, some of which (i.e. personal care and foods business) are at an extremely nascent stage and have yet to attain sustainable cash generation. In FY11E alsoit has taken aggressive price increases that should make up for the excise increases, and add to the operating margins. Our target P/E multiple of 22x is above the last three-year historical trading average (~21x). We expect uncertainty on cigarette volumes to recede as the multiple taxes (VAT, sales tax, etc) coalesce to a uniform GST. This, coupled with lower losses in the non cigarette FMCG business - should enable the stock to re-rate. We also note that from an absolute P/E perspective, ITC is close to peak valuations (around 25-26x). From a relative P/E perspective, however, ITC appears relatively cheap - trading at around 1.3x - vs. a peak of around 1.7x. ITC has a relatively stable earnings stream, so P/E is our primary valuation methodology.

Risks

We rate ITC shares Low Risk as the company operates in branded businesses with low earnings volatility. Downside risks that could prevent the stock from reaching our target price include: 1) With most of its earnings coming from the tobacco segment, ITC is most at risk from controls and the government's tax policy. 2) Perceived as being a "sin" industry, the stock is prone to negative share price reactions. 3) Other significant risks for the company are dilution in capital efficiency from investments in non-tobacco businesses and the possible acquisitions of capital intensive businesses that fail to enhance value.

Appendix A-1

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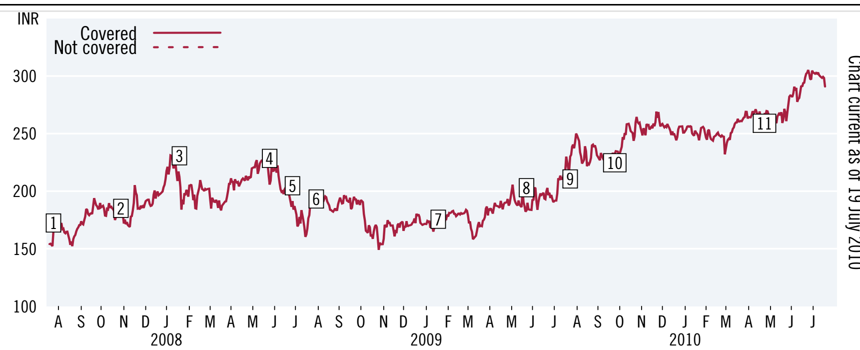
Fundamental Research

Analyst: Jamshed Dadabhoy
Covered since May 6 2008



	Date	Rating	Target Price	Closing Price
1	25-Jul-07	*1L	*195.00	165.85
2	28-Oct-07	1L	*215.00	180.80
3	18-Jan-08	1L	*247.00	212.60
4	25-May-08	1L	*243.00	213.60
5	26-Jun-08	1L	*238.00	191.35
6	30-Jul-08	1L	*222.00	187.80
7	19-Jan-09	1L	*210.00	170.55
8	22-May-09	1L	*225.00	183.25
9	23-Jul-09	1L	*260.00	229.95
10	24-Sep-09	1L	*267.00	232.40
11	23-Apr-10	1L	*302.00	266.85

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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% of companies in each rating category that are investment banking clients	47%	45%	40%

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