MANGAL KESHAV

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March 15, 2010

ITC Limited

See higher volume decline risk

HOLD

Consumer Sector | Company Update

Price: Rs258 | Revised Target Price: Rs271

Shishir Manuj | Tel : +91-22-67103043 | shishir.manuj@mangalkeshav.com

Stock Details

Reuters / Bloomberg	ITC.BO / ITC IN
Equity Capital (mn Shares)	3774
Face Value (Rs)	1
52 Week H/L (Rs)	271/162
Market Cap (Rsbn)	975
Daily Avg. Volume (mn shares)	4.5
Daily Avg. Turnover (US$ Mn)	23.5
BSE Sensex / Nifty	17,166 / 5,137

Source : Capitaline

Shareholding Pattern

(as on 31st December '09)	(%)
Promoters	31.8
FIs/FIIs	50.6
Others	17.6

Source : Capitaline

Consensus Versus MKSL Estimates

	MKSL	Cons	Diff (%)
FY10E			
Sales (Rs bn)	189	180	*5.0*
EPS (Rs)	11.2	10.7	*4.6*
FY11E			
Sales (Rs bn)	205	204	*0.6*
EPS (Rs)	12.4	12.3	*0.6*
FY12E			
Sales (Rs bn)	230	230	*(0.1)*
EPS (Rs)	14.5	14.3	*0.9*

ource : Bloomberg, Mangal Keshav Research Estimates

Price changes since July'09

Brands	MRP*	Chg (%)	Actual SP*	Chg (%)
Gold Flake Kings	4.8	*9.1*	5.0	*11.1*
Wills Classic Navy Cut	4.0	*17.6*	4.0	*14.3*
Gold Flake Filter	3.5	*20.7*	3.5	*16.7*
Bristol	2.5	*8.7*	2.5	*0.0*
Scissors	2.5	*25.0*	2.5	*25.0*
Wills Flake Filter	2.0	*14.3*	2.0	*0.0*
Gold Flake Kings	4.8	*9.1*	5.0	*11.1*

*Source: Mangal Keshav Research, *Retailer price/stick*

Price Performance

(%)	1M	3M	12M	YTD
Absolute	4.6	2.4	60.2	3.0
Rel. to Sensex	(1.7)	2.1	(45.5)	4.7

Source : Capitaline

Investment Arguments

- We revise our cigarette volume estimates to 2.6% decline in FY11E, followed by 5.4% growth in FY12E. Our volume estimates are more pessimistic than the Street, as we find the cigarette price inelasticity argument exaggerated. Cigarette volumes have mostly fallen when gross realisations have changed by more than Rs0.10/stick. We see gross realisations (including VAT) jumping 13.5% to Rs2.63/stick in FY11E. However, net realisation would only see an increase of Rs0.07/stick. We expect Q4FY10 to benefit from stocking up.
- We now become more concerned than ever of likely downtrading in cigarettes in India, as price hikes in cigarette in the last few years have been significant. The absence of low-priced filter and non-filter options would also slowdown the recruitment of new smokers, thereby slowing down the longer-term growth.
- We find price manoeuvrability squeezed for ITC after this round of price hikes, as price hikes in the last few months now cover a significant portion of its portfolio. With RSFT pack MRPs at round figures, additional retailer margin due to coinage issues will disappear.
- State VATs and GST rates are the next bout of headwind that we see. We see state VATs being raised to a weighted average of 18% from the current 15%. Time-weighted, we see average VAT rate of 16% in FY11E. We do not see any benefits to cigarettes from likely lower GST rates than VAT.
- Cigarette segment margins will dip in FY11E, and EBIT contribution will decline. We see NCFMCG mostly filling up the shortfall, as we expect it to report full year profits in FY12E. We expect to see improvement in Hotels segment also over the quarters. We have cut agri-segment margins to single-digit for FY11E and ahead, while raising it for paperboards.
- Our estimates remain almost unchanged and are in line with the street estimates after the recent round of cuts by the Street. At 20.9x 1-year rolling forward PER, the stock looks fairly valued. We have revised our target price to Rs271 (from Rs261). The target price is based on equally-weighted average of SOTP and DCF. We maintain our **HOLD** rating.

Key Consolidated Financials

(YE March) (Rs mn)	FY08	FY09	FY10E	FY11E	FY12E
Total Income	149,071	165,501	188,668	205,108	230,115
Operating Profit	48,383	53,106	67,267	74,470	86,497
Net Profit	31,578	33,277	42,293	46,876	54,624
yoy change (%)	*14.6*	*5.4*	*27.1*	*10.8*	*16.5*
EPS (Rs)	8.4	8.8	11.2	12.4	14.5
OPM (%)	32.5	32.1	35.7	36.3	37.6
RoE (%)	28.0	25.7	28.4	27.3	27.7
RoCE (%)	26.4	24.1	26.8	26.1	26.6
P/E (x)	30.9	29.3	23.1	20.8	17.9
EV/EBITDA (x)	19.6	17.8	13.8	12.5	10.6

Source: Company, Mangal Keshav Research Estimates

Revise volume estimates to 2.6% decline in FY11E

Volume growth estimate Change

(bn sticks)	FY10E	FY11E	FY12E
Cigarettes vol. (New)	84.2	82.0	86.4
Cigarettes vol. (Old)	83.4	88.0	92.4
New Growth (%)	*7.5*	*(2.6)*	*5.4*
Old Growth (%)	*6.4*	*5.5*	*5.0*

Source: Mangal Keshav Research Estimates

After the recent steeper-than-expected price hikes in several key brands, we are revising downwards our assumptions for volume growth for FY11E and FY12E. Due to stocking up, we will likely see a spurt in Q4FY10 before the volumes start to go down.

Pictorial warning also to be made more dissuasive: We are going to see a change in the pictorial warning which is likely to be made more repulsive. The earlier pictures were considered too ineffective to dissuade consumers. Field tests are believed to be showing better result on smokers of the new pictorial warning compared to the old one. We believe that tighter implementation of the existing regulations on distribution, marketing and packaging will continue to weaken new recruits to smoking over a longer period of time.

Our volume estimates are more pessimistic than the Street: Currently, the street is building in volume changes ranging between +/- 2% for FY11E, which is more optimistic than our assumptions. We are building a 2.6% decline in cigarette volumes in FY11E. We expect that to improve to 5.4% growth in FY12E.

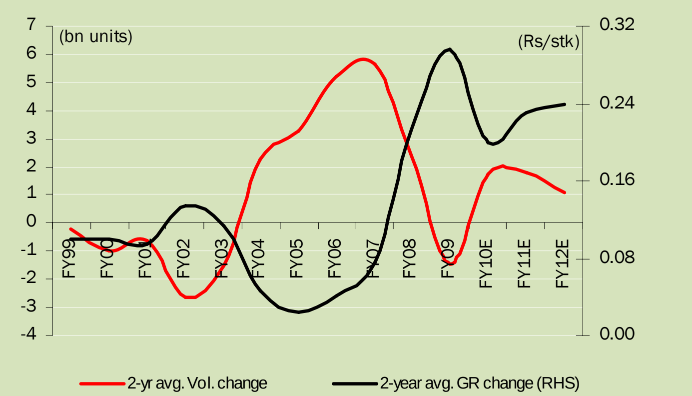
Cigarette price inelasticity claims exaggerated

Cig. volumes have not grown in any year with Gross Realisation, proxy for MRP, hike above Rs0.10/stick in 11 years until FY09 (except FY01).

We find claims of price inelasticity of cigarette demand exaggerated. We have observed strong negative correlation between 2-year average cigarette volume change and average price change. In the last 12 years of data that we have analysed, 2-year volume changes have been negative six times. In all these years of declines 2-year average GR change has been more than Rs0.10/stick, except in FY08. **On a year-on-year basis, volumes have declined five out of last 11 years. Volumes have not grown in any year until FY09 (except FY01) with GR change above Rs0.10/stick.** We believe this critical level of Rs0.10/stick has got taken off in FY10E. We believe the new level for the medium-term could be Rs0.15-0.20/stick, but volume growth would be slower.

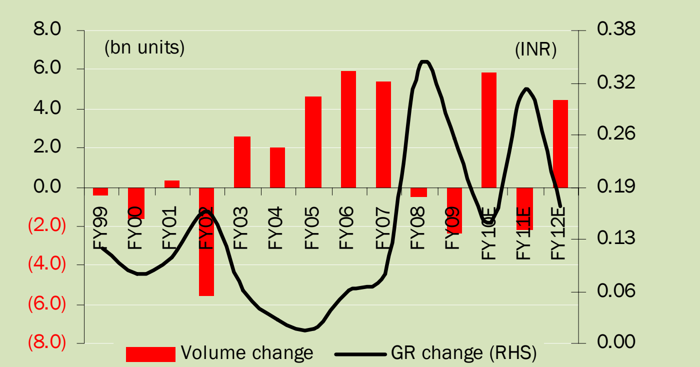
Downtrading a rising risk: We believe the impact on volumes would also be complemented by downtrading risk. While we are not necessarily talking about cigarette smokers downtrading to beedis, downtrading to cheaper brands is a real possibility. Besides, the Indian smoking market is characterised by “dual smoking” where almost 60% of smokers smoke both cigarette and beedis. If cigarette inflation continues to remain steep, we believe this trend could further catch on, or at least delay migration towards cigarette. We also have been commenting on the adverse impact of absence of non-filter and higher inflation on longer-term acquisition of new smokers. **We believe that is the real risk to longer-term volume growth of cigarettes in India.**

Avg*. Volumes have dipped 6times in 11 years, but..



*Source: Company, Mangal Keshav Research Estimates; * 2-year average*

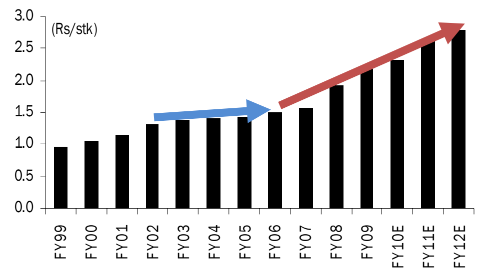
FY10E vol. increasing despite sharper hike



Source: Company, Mangal Keshav Research Estimates

Price hikes higher than tax changes: In the last couple of years, we have seen significantly higher cigarette price hike driven largely by taxation increase. Beginning FY08, we saw the introduction of VAT, regular increase in excise duties as well as sharp increase in non-filter cigarette excise. However, cigarette price hikes have been ahead of that required by such tax hikes and cost inflation, resulting in higher segment margins.

Cigarette GR*- Spurt in recent times



*Source: Mangal Keshav Research, *per stick*

Per stick analysis shows price hikes ahead of excise hikes

(Per stick)	FY09	FY10E	FY11E	FY12E
No. of sticks sold (bn)	78.4	84.2	82.0	86.4
Gross Realisation (Rs)	2.17	2.32	2.63	2.80
Change in GR (Rs)	0.25	0.15	0.31	0.17
Effective duties (Rs)	1.21	1.24	1.48	1.59
Change in duties (Rs)	0.11	0.03	0.24	0.11
Net Realisation (Rs)	0.96	1.08	1.15	1.21
Change in NR (Rs)	0.14	0.12	0.07	0.06
EBIT (Rs)	0.53	0.60	0.65	0.69

Source: Company, Mangal Keshav Securities Estimates

Ability to take any further price hike constrained

While the price hikes in most brands have been steep and ahead of tax hikes, we are concerned by the reduced maneuverability ITC has now in the RSFT brands. The recent round of price hikes and those in the past few months have covered most key brands, including the highly price-sensitive lower-priced RSFT brands- *Scissors* and *Bristol*. Prices/pack (10 sticks) has been taken up by 25% and 9% for highly price-sensitive *Bristol* and *Scissors*. The price points were earlier quite close to the round digits (ending in 0 or 5) leaving additional margins for the retailer selling on stick basis rather than packs. However, the round prices now will not leave them any benefits from coinage issues.

Key states and VAT rates on cigarettes

States	New	Old
Maharashtra	20.0%	12.5%
Rajasthan	20.0%	12.5%
Delhi	20.0%	12.5%
Gujarat	20.0%	12.5%
A.P	14.5%	12.5%
Haryana	20.0%	12.5%
Orissa	12.5%	12.5%
Chhattisgarh	14.5%	12.5%
Puducherry	15.0%	12.5%

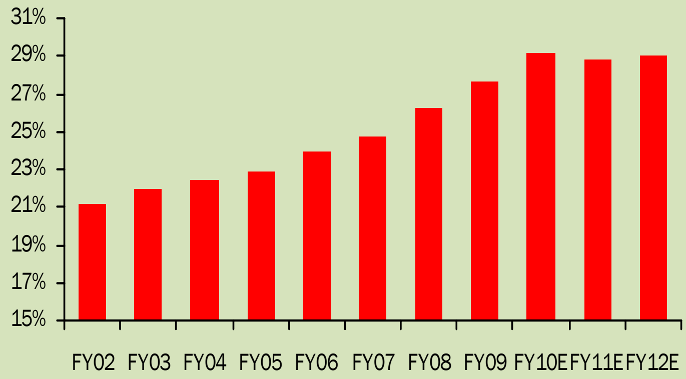
Source: Mangal Keshav Research

State VAT rates likely to be increased to 20%, no rollback likely even if GST rates are lower: We believe ITC's steep price hikes are also due to the hikes in VAT rates by some states. Many states have already moved above the 12.5% to anywhere between 14% and 20%. We believe that most states would slowly move towards the 20% rate. For now, we have built in 16% effective VAT rate for FY11E and 17.5% for FY12E. However, with the likelihood of the combines GST rates likely in the region of 16%, the current state VAT rates on cigarettes might prove to be excess. **We still believe states would be disinclined to lower their VAT rates on cigarette to any lower GST rates.**

Cigarette margins to decline marginally; first time since reporting started: We believe the price hikes taken will offset the impact of sharp increase in excise duties announced in the recent Budget. We are therefore not expecting any meaningful impact on segment margins, although we are now building in 50bps yoy decline in FY11E largely due to lower benefits from operating leverage. This would be the first dip in cigarette EBIT margins since the company started reporting segment margins in FY02.

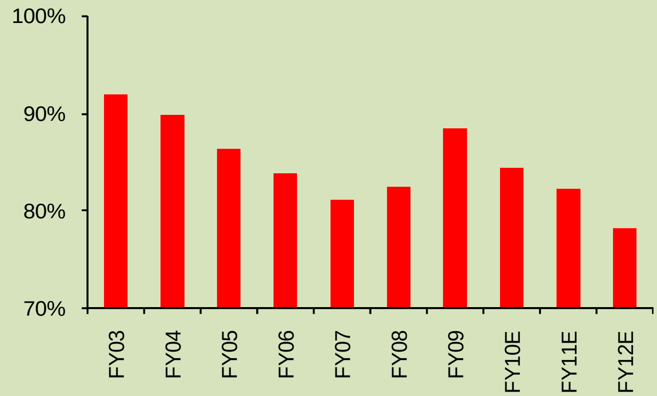
Cigarette contribution to EBIT to decline to 78%: We will see higher contribution from non-cigarette business over the next two years, as cigarette EBIT contribution will likely decline to 78% of total (from a peak of 88.5% in FY09). We like the fact that the cash flow sources will get more diversified, thereby lowering the risk from a tighter control on tobacco consumption ahead.

Cigarette segment margin- Some dilution ahead



Source: Company, Mangal Keshav Research Estimates

Cigarette EBIT contribution to decline ahead



Source: Company, Mangal Keshav Research Estimates

NCFMCG- Breakeven in FY12E to reduce impact on overall profitability. Revenue growth to slowdown.

NCFMCG- Profitability to be the focus ahead: Most of the EBIT contribution loss from cigarettes would be picked up by NCFMCG, which we expect to turn around on a full year basis in FY12E. Revenue growth could, however, be softer than what we have seen in the recent years, as high food inflation is hurting total demand. Raw material pressure is also leading to price hikes or grammage reduction. We have seen some action in the biscuits segment already. ITC has been depending a lot on promotional efforts to drive volume market share. Most of these categories are past critical size and we are likely to see lower promotions, as it turns towards profitability of these categories. We would especially like to see apparel business margins improving, as the segment enjoys much higher margins than the rest of the NCFMCG business, particularly in the higher-end lifestyle apparel business that *Wills Lifestyle* is in. **We believe investors would be happier if the tradeoff involved lower revenue growth for higher profits now in FMCG and apparels.**

Hotels- OR and ARR improvement seen, expect continued economic recovery to help demand. New Bangalore property will be available for full year

Hotels: Sustained signs of growth ahead: We are seeing sustained signs of improvement in the Indian hotel industry. Most players are seeing recovery in ARR, although they still remain lower than 2008 levels. Occupancy rates are also expected to improve from around 65% to 75% over the next few quarters. ITC has reported lower declines in revenue as well as margins over the last few quarters. We are likely to see a flattish quarter in Q4FY10. The Bangalore property is fully open now. The Chennai property is on line to be commissioned sometime towards the end of FY11E. There are few more properties in line including those in Kolkata and Hyderabad. We believe volumes will also come from the managed properties of Fortune Hotel, where ITC has big plans.

Paperboards- Margins could yield some gains back: After a strong margin expansion in FY10E, we expect operating margins to taper off a bit in FY11E. We believe margin improvements through operating efficiencies have been essentially captured. We expect improved paper demand in both domestic as well as international markets to help realisation. However, we are seeing significant capacity addition by both domestic as well as other Asian players, which should cap gains.

Agri-business: The best is behind us: We believe that the best of both growth and margins in agri-business is behind us. Agri-business has been re-structured and ITC is focusing only on higher margin produce. However, we see segment margins slipping back into high single-digits, as last year was unexceptionally helped by the high international tobacco prices. Besides, we are seeing significantly higher challenges from the policy front, as food inflation in India has touched high-teens making it a socio-economic problem for the government to manage.

Target Upgraded to Rs271; Maintain HOLD

Estimates nudged only a bit: Our estimates have been marginally revised on account of these changes. The street estimates are now in line with our estimates.

Valuations fair: ITC is trading at 20.9x EPS and 12.5x EV/EBITDA on a 1-year forward basis. The multiples are marginally ahead of the long-term averages the company has enjoyed. We are upgrading our target price to Rs271 (from Rs261) based on some revision in earnings. We have based our target price on equally-weighted DCF (Rs278) and SOTP (Rs264) based fair targets. We reiterate our **Hold** rating.

Trading at Historical averages

Average	PER (x)	EV/EBIDTA (x)	Prem. To Sensex (%)	PEG (x)
Since 2001	16.8	10.1	20.0	1.2
5yr	19.9	12.2	27.4	1.5
3yr	19.6	11.8	18.2	1.6
1yr	18.8	11.2	25.8	1.4
Current	20.9	12.5	28.4	1.7

Source: Company, Mangal Keshav Research Estimates

SOTP- Raising target

Segment	Basis(FY11E)	Value (Rsbn)	Target Multiple	Value (Rsbn)	Value / Share (Rs)
Cigarettes	PER	43	20.0	863	229
FMCG*	P/Sales	42	2.0	69	18
Hotels	EV/EBITDA	6	16.0	87	23
Agri Business	PER	3	4.0	11	3
Paper & Packaging	PER	7	5.0	33	9
Others	PER	2	2.0	4	1
Sub-Total		103		1067	283
Cash				56	15
Total				1,122	297
Discounted SOTP Target					264

*Source: Mangal Keshav Research Estimates * Accumulated losses for the segment have been subtracted from the overall value*

Risks

- Cigarette demand remaining robust due to improving income and other behavioural changes could put our estimates to risk.
- We see any faster improvement in hotels and quicker turnaround in FMCG as risks to our thesis. Both these segments are currently seeing improvement in their margins.

Research Team			
Amit Khurana, CFA	Head - Research	91-22 6710 4032	amit.khurana@mangalkeshav.com
Shishir Manuj	FMCG, Retail, Media	91-22 6710 3043	shishir.manuj@mangalkeshav.com
Mehul Mehta	Capital Goods	91-22 6710 3044	mehul.mehta@mangalkeshav.com
Piyush Parag	Automobiles, Shipping	91-22 6710 3041	piyush.parag@mangalkeshav.com
Nitin Bagde	Technical Analyst	91-22 6710 3053	nitin.bagde@mangalkeshav.com
Rajesh Satpute	Technical Analyst	91-22 6710 3054	rajesh.satpute@mangalkeshav.com
Pranav Mer	Commodities	91-22 6710 3048	pranav.mer@mangalkeshav.com
Viral Shah	Research Associate	91-22 6710 3049	viralshah@mangalkeshav.com
Jay Thakker	Research Associate	91-22 6710 3046	jaythakker@mangalkeshav.com
Swati Saboo	Research Associate	91-22 6710 3052	swati.saboo@mangalkeshav.com
Divyata Dalal	Research Associate	91-22 6710 3050	divyata.dalal@mangalkeshav.com
Amar More	Production	91-22 6710 3055	amar.more@mangalkeshav.com
Institutional Sales / Trading Desk			
Roshan Shah	Sr. Vice President, Institutional Sales	91-22 6710 3040	roshan.shah@mangalkeshav.com
Venkat Ramesh Babu	Sr. Vice President, Institutional Sales	91-22 6710 3039	venkat.ramesh@mangalkeshav.com
Jatin Shah	Sales Trader	91-22 6710 3037/38	jatin.shah@mangalkeshav.com
Madhukar Muravne	Dealer	91-22 6710 3034/35	madhukar@mangalkeshav.com
Ashish Parekh	Dealer	91-22 6710 3036	ashishparekh@mangalkeshav.com

Regd. Office :	501, Heritage Plaza, J. P. Road, Opp. Indian Oil Colony, Andheri - (W), Mumbai - 400 053.	
	Tel : (91-022) 3068 8000	Fax : (91-022) 6679 0535
Institutional Team :	301A-304A, Kotia Nirman, Opp. Laxmi Industrial Estate, New Link Road, Andheri (W), Mumbai - 400 053.	
	Tel : (91-022) 6710 4030	Fax : (91-022) 6725 9861