Consumer & Retail
Tobacco
Equity – India

ITC

Overweight

Target price (INR)	315.00
Share price (INR)	259.05
Potential total return (%)	23.3

Performance	1M	3M	12M
Absolute (%)	-2.7	4.3	34.5
Relative^ (%)	2.8	-3.0	-5.3

Index^	BOMBAY SE SENSITIVE INDEX
RIC	ITC.BO
Bloomberg	ITC IN
Market cap (USDm)	21,828
Market cap (INRm)	989,099
Enterprise value (INRm)	940040
Free float (%)	70

Note: (V) = volatile (please see disclosure appendix)

10 May 2010

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Issuer of report: HSBC Securities and Capital Markets (India) Private Limited

OW: The mystery of the missing 91 paisa

- **Recent price hikes to more than offset the impact of tax increases; we estimate 18% cigarette division EBIT growth**
- **Consensus yet to build in the benefit of second round of price hikes (INR0.91); our FY11 EPS is above consensus by this same amount**
- **We value ITC on SOTP basis at INR315, and maintain our Overweight rating with 23% potential return**

FY11e EPS may surprise on the upside: In our FMCG preview published 16 Apr 2010, we had highlighted our bullish stance on ITC. In this note we present a detailed analysis as to why in our opinion street EPS estimates are behind the curve. Our conclusion: while the fact that ITC has taken a second round of price increases is well known by now, most analysts are probably not building in the EPS accretion on this account (as shown in chart 4, consensus EPS estimates have remained almost unchanged in the last 2 months). This price increase results in an additional INR0.9 EPS share – which interestingly is also the difference between HSBC and consensus estimates. Our discussion with investors seems to suggest that they too have not changed their estimates to fully account for this, which leads us to believe that an upside surprise on FY11 EPS is in the offing.

18% EBIT growth in cigarettes; 21% overall EPS growth in FY11: Based on ITC's track record, we believe that 1% cigarette volume growth in FY11 is possible on the back of 15% price increases. Net sales for cigarettes should increase by 14% and with operating leverage translate to 18% on the bottom line. We expect a decline in FMCG losses from INR3.7bn to INR3.1bn and 40% EBIT growth in Hotels business for EPS growth of 21%.

Valuation: We value ITC on SOTP basis at INR315 per share. We apply a multiple of 21x for the cigarettes division, which is in line with global peers adjusting for growth and return metrics (for details, please see table 8). June quarter results could be a catalyst for the stock, as it could result in EBIT margin expansion for the cigarettes business.

1. ITC: Snapshot Financials (INRm)

	Sales	y-o-y	EBIT	y-o-y	Net Profit	y-o-y	EPS (INR)	PE	ROE	ROA
FY09	163,323	11.4%	44,914	9.7%	33,246	5.3%	8.81	29.4	25.3%	17.8%
FY10e	184,613	13.0%	55,769	24.2%	40,859	22.9%	10.80	24.0	27.1%	19.3%
FY11e	212,736	15.2%	67,786	21.5%	49,469	21.1%	13.08	19.8	28.5%	20.5%
FY12e	242,064	13.8%	78,085	15.2%	56,860	14.9%	15.04	17.2	28.4%	20.6%

Source: Company, HSBC

HSBC

Financials & valuation

Financial statements

Year to	03/2009a	03/2010e	03/2011e	03/2012e
Profit & loss summary (INRm)				
Revenue	163,323	184,613	212,736	242,064
EBITDA	50,723	62,003	74,915	86,358
Depreciation & amortisation	-5,809	-6,234	-7,129	-8,273
Operating profit/EBIT	44,914	55,769	67,786	78,085
Net interest	-187	-377	-377	-377
PBT	49,909	60,587	72,928	83,824
HSBC PBT	49,848	60,491	72,814	83,694
Taxation	-16,254	-19,357	-23,009	-26,447
Net profit	33,246	40,859	49,469	56,860
HSBC net profit	33,246	40,859	49,469	56,860
Cash flow summary (INRm)				
Cash flow from operations	35,335	44,423	53,203	61,001
Capex	-17,609	-15,605	-20,616	-26,333
Cash flow from investment	-14,054	-20,624	-25,636	-32,357
Dividends	-15,700	-16,339	-20,144	-24,389
Change in net debt	-5,797	-7,652	-7,656	-4,522
FCF equity	14,634	23,995	27,518	29,069
Balance sheet summary (INRm)				
Tangible fixed assets	91,258	100,628	114,115	132,175
Current assets	85,122	98,025	112,309	125,330
Cash & others	13,183	20,815	28,451	32,954
Total assets	201,453	228,747	261,538	298,642
Operating liabilities	32,147	34,594	37,667	41,842
Gross debt	1,867	1,847	1,827	1,807
Net debt	-11,316	-18,969	-26,625	-31,147
Shareholders funds	140,282	160,996	186,077	214,904
Invested capital	131,049	143,243	160,306	182,710

Ratio, growth and per share analysis

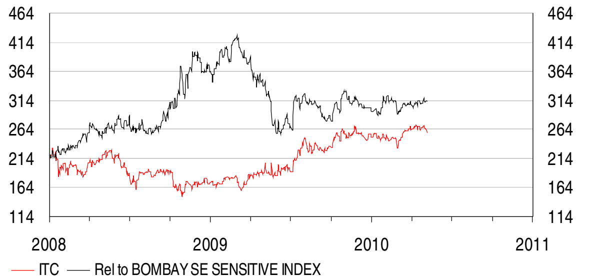
Year to	03/2009a	03/2010e	03/2011e	03/2012e
Y-o-y % change				
Revenue	11.4	13.0	15.2	13.8
EBITDA	11.0	22.2	20.8	15.3
Operating profit	9.7	24.2	21.5	15.2
PBT	6.6	21.4	20.4	14.9
HSBC EPS	5.5	22.6	21.1	14.9
Ratios (%)				
Revenue/IC (x)	1.3	1.3	1.4	1.4
ROIC	23.4	26.6	29.6	30.2
ROE	25.3	27.1	28.5	28.4
ROA	17.8	19.3	20.5	20.6
EBITDA margin	31.1	33.6	35.2	35.7
Operating profit margin	27.5	30.2	31.9	32.3
EBITDA/net interest (x)	271.4	164.4	198.6	228.9
Net debt/equity	-8.0	-11.7	-14.2	-14.4
Net debt/EBITDA (x)	-0.2	-0.3	-0.4	-0.4
CF from operations/net debt				
Per share data (INR)				
EPS reported (fully diluted)	8.81	10.80	13.08	15.04
HSBC EPS (fully diluted)	8.81	10.80	13.08	15.04
DPS	3.70	4.51	5.46	6.28
Book value	37.09	42.57	49.20	56.83

Valuation data

Year to	03/2009a	03/2010e	03/2011e	03/2012e
EV/sales	5.8	5.1	4.4	3.8
EV/EBITDA	18.8	15.2	12.4	10.6
EV/IC	7.3	6.6	5.8	5.0
PE*	29.4	24.0	19.8	17.2
P/Book value	7.0	6.1	5.3	4.6
FCF yield (%)	1.5	2.5	2.9	3.1
Dividend yield (%)	1.4	1.7	2.1	2.4

Note: * = Based on HSBC EPS (fully diluted)

Price relative



Source: HSBC

Note: price at close of 06 May 2010

HSBC

Price increases ahead of tax increases

In our view, ITC has taken cigarette price increases which are much ahead of that needed to offset tax increases

- On 28 February 2010, the Union budget was announced with effective excise duty hikes of c15%. Given that excise duty constitutes 40-45% of the gross selling price of the cigarette, it requires a price hike of c7.5% to maintain net realisation per stick
- Not many states have increased VAT as feared, and we estimate that effective tax rate would have gone up only by c100 bps. We estimate that ITC needs to take up prices by 8.5% to maintain net realisation per stick, after absorbing the excise duty and VAT increase impact.

2. Changes in VAT rates for different states in CY10

States	Old VAT rate %	New VAT rate %
Gujarat	15.0	20.0
Haryana	12.5	21.0
Kashmir	12.5	13.5
Karnataka	12.5	15.0
MP	12.5	13.0
Uttaranchal	12.5	13.5

Source: Company, HSBC

- ITC has however, taken up prices by 15% (as per table below 17.4% but estimated at 15% after accounting for coinage), which will increase the net realisation per stick by 13.1%

3. Price increase taken

	Old MRP	New MRP	Price increase	contribution to cigarettes sales	Weighted average price increase
First round of price increases					
Kings Segment					
Goldflake	4.7	4.8	2.1%	13.0%	0.3%
Classic	4.8	5	4.2%	2.5%	0.1%
Longs Segment					
Navy Cut	3.4	4	17.6%	13.0%	2.3%
Regulars Segment					
Bristol	2.3	2.5	8.7%	8.0%	0.7%
Scissors	2	2.5	25.0%	12.0%	3.0%
Goldflake	3	3.5	16.7%	20.0%	3.3%
Capstan	1.9	2.5	31.6%	7.0%	2.2%
Second round of price increases					
Regulars Segment					
Goldflake premium	2.9	3.5	20.7%	10.0%	2.1%
Flake filter	1.9	2.5	31.6%	10.0%	3.2%
Flake filter premium	2	2.5	25.0%	1.0%	0.3%
Overall			**18.3%**	**96.5%**	**17.4%**

Source: Company, HSBC

- In the first round of price increases, ITC took price increases amounting to 12% - this was immediately after the budget ie around 5th May, and was fairly well known soon
- In the second round of price increases, ITC took further price increases amounting to 3% - this was in the second half of March, but there were no formal announcements and news spread in the market slowly and with a lag as products hit retail shelves.

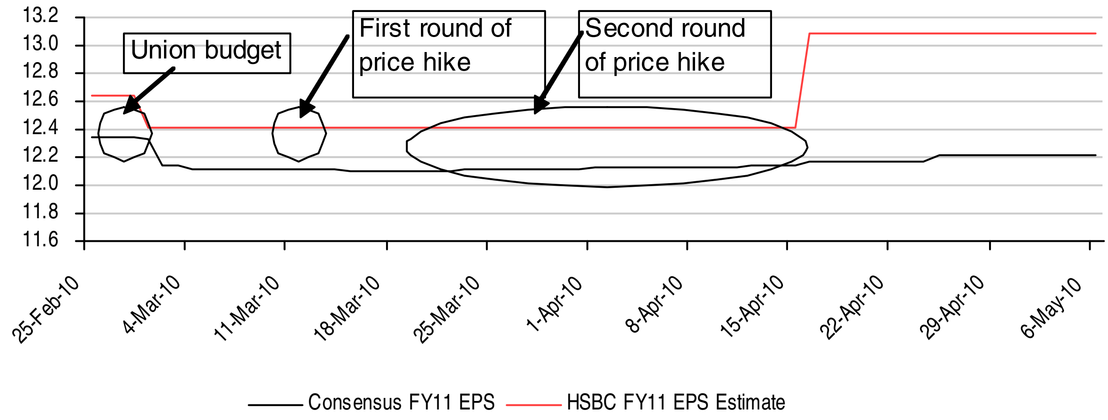
We are 7% higher than consensus and highest on the street

Our numbers are higher than consensus – we believe that most analysts may not have built in the second round of price increases in their models.

As can be seen in the chart below, consensus EPS has shifted down by cINR0.25 after the Union budget and has remained more or less unchanged from that level. We are different from most analysts in the following way

- Most analysts had built in the first round of price increases at c12%, and also some possible increase in VAT rate by the states. Since consensus estimates have not changed, it seems that they have kept it that way.
- In the last two months however, VAT increase has been lesser than expected at just c100 bps, while price increase has been 15% instead of 12%.
- We have revised our estimates to factor in the above impact. Given that consensus estimates have been flat, it seems that most analysts have not done the same.

4. HSBC and consensus FY11 EPS movements



Source: Company, HSBC

Impact works out to 91 paisa per share

The increase of c3% in prices travels directly to the bottom-line after deducting VAT and income tax works out to INR0.91 per share, ie 8% of FY10e EPS estimates and 7% of FY11e estimates.

5. Calculation of impact of 3% price hike on EPS

	INRm
Gross sales value for cigarettes in FY10 (incl VAT)	195,500
3% increase in prices	5,865
VAT at effective rate of 14.5%	743
Price increase post VAT	5,122
Additional material cost / overhead to be incurred	0
Increase in pretax profits	5,122
Increase in post tax profits	3,483
Increase in EPS (INR)	0.91

Source: Company, HSBC

Interestingly, the difference between our EPS estimates and consensus estimates are INR0.86, very close to the EPS increase on account of the second round of price hikes.

Cigarettes business to clock 18% EBIT growth in FY11

We believe cigarettes business will clock a healthy 18% EBIT growth. As mentioned earlier, net realisation per stick is likely to be 13%, and with a 1% volume growth, this is likely to result in a net sales growth of 14%. Combined with operating leverage, we expect cigarettes division EBIT to expand c18% y-o-y.

6. ITC – cigarettes EBIT growth calculation (INR)*

	Base year	Year 1	Assumptions	
Volume	100	101	1%	yoy growth
Average selling price per stick	2.3	2.6	15%	yoy growth
VAT rate	13.5%	14.5%	100	increase in bps
VAT per stick	0.27	0.33		
Total VAT	27	34		
Excise duty per stick	0.96	1.11	15%	yoy growth
Excise duty	96	112		
Net selling price per stick	1.06	1.20		
Net sales	106	121		
RM/PM per stick	0.2	0.22	10%	yoy growth
Total RM/PM	20	22		
Overheads	28	31	9%	yoy growth
EBIT	58	69		
EBIT growth yoy		17.8%		

Source: HSBC, company
* On a hypothetical volume base of 100 sticks

Volume growth estimated at 1%

We believe that ITC can achieve a volume growth of 1% in FY11e. As shown in table below, ITC has managed to maintain volumes almost flat in FY08 when price increases were nearly 22% and in FY09 when the entire non filter category (c20% of volumes) was effectively wiped out the volume decline was only 2.5%. Moreover, gross revenue growth over the last 5 years has averaged 14.4%. Due to the price inelastic nature of demand, we believe that gross sales growth this year will be stretched slightly to 16% (15% price increase and 1% volume increase). While negative volume growth could be expected in Q1 FY11, it should pick up in coming quarters.

7. ITC – relation between gross sales, volume and price

	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10e
Gross revenue growth adjusted for VAT	12.0%	6.0%	8.4%	13.1%	13.1%	21.0%	11%	14.2%
Price hikes	7.5%	2.8%	1.3%	4.3%	5.6%	21.8%	13.3%	5.4%
Volume growth	4.2%	3.1%	7.1%	8.4%	7.1%	-0.7%	-2.5%	7.9%

Source: Company, HSBC

EPS growth aided by reduction in FMCG losses and a good year for hotels

While our cigarette EBIT grows by c18% a year, our EPS for the company grows at c21%

- FMCG losses expected to reduce from INR3.7bn to INR3.1bn due to focus on cost control and operating leverage. (The company has a nascent personal care business whose fixed costs are being defrayed on a small base currently)
- Hotels EBIT to grow by 40%. As the hotels industry comes out a recession, ARRs and occupancies will increase, resulting in a 22% topline growth, and 40% EBIT growth due to operating leverage.

Investment thesis

ITC is the dominant player in the tobacco industry in India with a market share of c80%. India's cigarette market is growing volumes at c5% pa (long-term average) and is likely to maintain this pace for several years due to shifts from other forms of tobacco consumption such as bidis and chewing tobacco. This is in sharp contrast to other parts of the world where volumes are declining. High EBIT margins of 55% and 100%+ ROE for the segment, along with the robust growth outlook, justify a higher PE multiple than global peers, in our view.

ITC has historically been able to manage increases in taxation by increasing prices with beneficial results. In addition to cigarettes, the company has interests in diverse businesses such as foods, personal products, hotels, commodity trading and paperboards. These contribute more than half of net sales but cigarettes contribute 80%+ to company EBIT. Our Overweight rating is backed up by our view of the immense potential for growth in cigarettes (volume, price and margins), along with increasingly improved return profiles of the agri and paper businesses being complemented by narrowing FMCG losses.

Valuation

We value ITC on a SOTP basis at INR315 per share. We value the cigarettes business, which is the major part of the valuation, at 21x PE, in line with global peers, adjusting for higher growth rates and better ROEs.

8. ITC SOTP Valuation

Basis	Business	Multiple	Per Share (Mar'12)	Price
EPS	Cigarettes	21.0x	12.0	252
	Hotels	15.0x	0.7	10
	Agribusiness	6.0x	1.0	6
	Paperboards	5.0x	1.8	9
Sales	FMCG - Others	1.5x	13.5	20
Cash	Cash per share			18
	Target Price			**315**

Source: HSBC

Under our research model, for stocks with a volatility indicator, the Neutral rating band is 5 percentage points above and below the hurdle rate for Indian stocks of 10.5%. This translates into a Neutral band of 5.5% to 15.5% around the current share price. Our target price of INR315 represents a potential return of 23.3% (including dividend yield of 1.7%), which is above the Neutral band. We therefore remain Overweight on the stock.

Downside risks include volume backlash to price increases being higher than estimated; a slowdown in consumer spending that reduces volume growth; increased losses on the FMCG business; and PE multiple contraction in the event of a significant economic downturn.

Disclosure appendix

Analyst Certification

The following analyst(s), economist(s), and/or strategist(s) who is(are) primarily responsible for this report, certifies(y) that the opinion(s) on the subject security(ies) or issuer(s) and/or any other views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Percy Panthaki

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For each stock we set a required rate of return calculated from the risk free rate for that stock's domestic, or as appropriate, regional market and the relevant equity risk premium established by our strategy team. The price target for a stock represents the value the analyst expects the stock to reach over our performance horizon. The performance horizon is 12 months. For a stock to be classified as Overweight, the implied return must exceed the required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile*). For a stock to be classified as Underweight, the stock must be expected to underperform its required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile*). Stocks between these bands are classified as Neutral.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation of coverage, change of volatility status or change in price target). Notwithstanding this, and although ratings are subject to ongoing management review, expected returns will be permitted to move outside the bands as a result of normal share price fluctuations without necessarily triggering a rating change.

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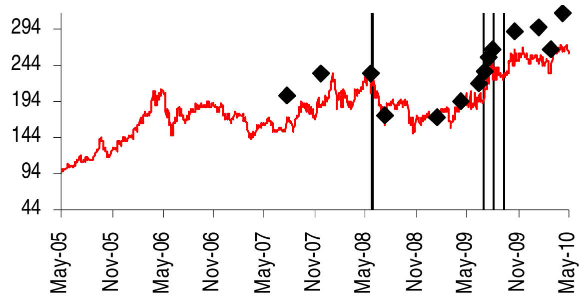
Overweight (Buy)	49%	(12% of these provided with Investment Banking Services)
Neutral (Hold)	37%	(11% of these provided with Investment Banking Services)
Underweight (Sell)	14%	(10% of these provided with Investment Banking Services)

Share price and rating changes for long-term investment opportunities

ITC (ITC.BO) Share Price performance INR Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
Overweight	Neutral	23 May 2008
Neutral	Overweight	06 July 2009
Overweight	Neutral	05 August 2009
Neutral	Overweight	14 September 2009
Target Price	**Value**	**Date**
Price 1	201.00	27 July 2007
Price 2	233.00	26 November 2007
Price 3	231.00	23 May 2008
Price 4	175.00	16 July 2008
Price 5	172.00	20 January 2009
Price 6	193.00	17 April 2009
Price 7	218.00	15 June 2009
Price 8	234.00	06 July 2009
Price 9	254.00	23 July 2009
Price 10	264.00	05 August 2009
Price 11	290.00	23 October 2009
Price 12	295.00	18 January 2010
Price 13	265.00	01 March 2010
Price 14	315.00	16 April 2010

Source: HSBC

HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
ITC	ITC.BO	259.05	06-May-2010	4, 6

Source: HSBC

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