

23 February 2010

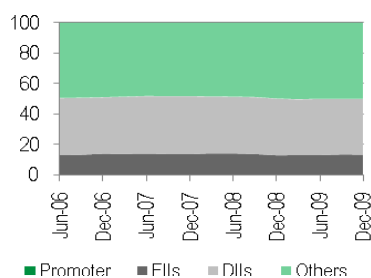
India
Consumer

Price: Rs 247
Target price: N.A.

Stock details

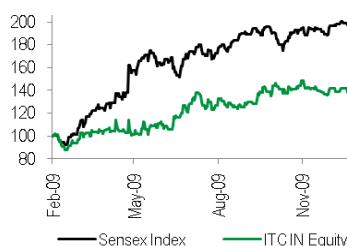
Bloomberg code	ITC IN
Reuters Code	ITC.BO
3m avg traded value (Rs mn)	1,057
52-wk H/L (Rs)	156/271
Sensex	16,272
Mcap (US\$m/Rs bn)	20296/937

Shareholding (%)



Stock performance (%)

	1m	6m	1yr
Absolute	(1.12)	7.60	36.71
BSE Sensex	(3.47)	6.79	84.04



Source: Bloomberg, Capitaline.

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Grey smoke... tread with caution

Pre-budget, consensus seems to believe that excise hike shall be moderate and 59mm shall be introduced at Re1. We differ from the consensus and believe the consensus seems to be more on the optimistic side.

59mm cannot be introduced at Re1

Even we believe that probability of introducing a new excise slab for 59mm is high this year, but we strongly believe that its feasible price point can be only above Rs1.25 per stick.

Risk to pass on price hike will be high if excise hike is steeper

We look at two scenarios of excise hike,

- **With 59mm introduced:** Looking at a scenario where KSFT and MKFT witness excise hike of ~10% and RSFT hike of ~18%.
- **Without 59mm:** 10% excise hike across 3 segments.

We believe it will be difficult to achieve >12.5% EBIT growth under both the scenarios.

Scenario analysis suggests:

- Under scenario 1, 11% cigarettes EBIT growth is the best possibility with 12.8% price hike and 0% volume growth, but with risk of margin erosion.
- Under scenario 2, 11% cigarettes EBIT growth is the best possibility with 10.9% price hike and ~1% volume decline.

VAT hike in various state budgets will make the going tougher

It is widely believed that state budgets may see VAT on cigarettes going up. Currently, a few states have 20% VAT on cigarettes while majority of them are between 12.5% and 15%. **1% increase in VAT rate needs 0.78% additional price hike to maintain the margin. With Haryana imposing 20% VAT on cigarettes, probability of other states increasing VAT goes higher.**

Outlook

Unlike common belief, price hikes will not be easier for ITC this year as it may need price hike across brands, and dependence for price hike may be higher on price sensitive brands. We believe taxation risks will weigh on the stock and may offer opportunities to enter the stock at lower price.

Risk beyond consensus

Consensus talks about 6 - 8% excise hike and introduction of 59mm at Re1 price point. We believe 59mm cannot be introduced at Re1 price point and probability of 10% or higher excise hike is equally high. We look at two scenarios of excise hike:

Scenario 1: Differentiated excise hike with 59mm introduced

Scenario 2: 10% excise hike across segments and 59mm not introduced

We have looked at these 2 scenarios with the following points under consideration:

- Industry's demand of 59mm filters after the 2008 budget which made non filters unfeasible, and increased the entry level cigarette price to Rs1.50
- Objective to reduce fiscal deficit should mean maximizing revenue from cigarettes industry
- With GST to be introduced in the next 6 -12 months, simplification of duty structure

Scenario 1 : Introduction of 59mm

Figures as shown

Segment	Size	Excise duty (Rs / stick)		
		Current	Our expectation	Translated hike
KSFT	84mm	1.81	2.00	10.4%
MKFT	74mm	1.36	1.50	10.2%
RSFT	69mm	0.84	1.00	18.6%
Micro Filter	59mm	-	0.50	N.A.

Source : Industry data, Indiabulls Research

Scenario 2 : Without 59mm

Figures as shown

Segment	Size	Excise duty (Rs / stick)		
		Current	Our expectation	Translated hike
KSFT	84mm	1.81	1.99	10.0%
MKFT	74mm	1.36	1.50	10.0%
RSFT	69mm	0.84	0.93	10.0%

Source : Industry data, Indiabulls Research

Can 59mm filter be introduced at Re1?

Price point feasibility for 59mm – Re1 per stick: no way

Figures in Rs

MRP	Invoice		Product		
	Price	Excise	Cost	GMC	GMC%
1.00	0.77	0.30	0.17	0.30	39.1%
1.00	0.77	0.50	0.17	0.10	12.7%

Source : Industry data, Indiabulls Research

The following table clearly illustrates the difficulty in introducing 59mm at Re1. For it to introduce at Re1, excise slab has to be lower than 30p per stick, which we believe will not be possible. And if 59mm is introduced at 50p, the companies will make gross margin of 6-10% only, which no listed cigarette company will like to live with.

59mm can be introduced only above Rs1.25 per stick

Figures in Rs

MRP	Invoice		Product		
	Price	Excise	Cost	GMC	GMC%
1.25	0.96	0.50	0.17	0.29	30.1%
1.50	1.15	0.50	0.17	0.48	41.8%

Source : Industry data, Indiabulls Research

With boundary condition of minimum 30% gross margin, we believe 59mm can be introduced only between Rs1.25 to Rs1.50.

What it means; good news in the form of introduction of 59mm, while bad news in the way of higher duty on RSFT, which forms 86% of industry and 85% of ITC's volume.

Where's the price hike option for ITC:

Some key price hike for ITC?

Figures in Rupees

Segment	% of ITC's volume	Average price	Next price point	% price hike	Overall price hike impact	Volume impact
KSFT	10%	4.49	5.00	11%	1%	Low
MKFT	5%	3.40	3.80	12%	1%	High
Premium RSFT	34%	2.94	3.40	16%	5%	Low
Popular RSFT	51%	2.00	2.40	20%	10%	High

Source : Industry data, Indiabulls Research

It clearly shows that other RSFT which contributes 51% to ITC's volume would need price hike, if duty hike is more than 6%. Considering these brands are relatively price elastic, negative impact on volume will be higher.

Scenarios of excise hike

Scenario 1: Differentiated excise hike with 59mm introduced

Scenario 1 : Introduction of 59mm

Figures as shown

Segment	Size	Excise duty (Rs / stick)		
		Current	Our expectation	Translated hike
KSFT	84mm	1.81	2.00	10.4%
MKFT	74mm	1.36	1.50	10.2%
RSFT	69mm	0.84	1.00	18.6%
Micro Filter	59mm	-	0.50	N.A.

We believe that 11% cigarettes EBIT growth is the best possibility with 12.8% price increase and 0% volume growth. Under this scenario, we believe 59mm shall be able to garner volume from RSFT segment, and may result in marginal margin erosion.

Scenario 1 : EBIT sensitivity to price volume matrix

%		Volume									
		-7.1%	-5.9%	-4.7%	-3.6%	-2.4%	-1.2%	0.0%	1.2%	2.4%	3.6%
Price Change	6.5%	-24%	-22%	-20%	-18%	-16%	-14%	-11%	-9%	-7%	-5%
	7.0%	-23%	-20%	-18%	-16%	-14%	-12%	-10%	-8%	-5%	-3%
	7.4%	-21%	-19%	-17%	-15%	-12%	-10%	-8%	-6%	-4%	-2%
	7.9%	-19%	-17%	-15%	-13%	-11%	-9%	-6%	-4%	-2%	0%
	8.4%	-18%	-16%	-13%	-11%	-9%	-7%	-5%	-2%	0%	2%
	8.9%	-16%	-14%	-12%	-10%	-7%	-5%	-3%	-1%	1%	4%
	9.4%	-15%	-12%	-10%	-8%	-6%	-3%	-1%	1%	3%	5%
	9.9%	-13%	-11%	-9%	-6%	-4%	-2%	0%	3%	5%	7%
	10.4%	-11%	-9%	-7%	-5%	-2%	0%	2%	4%	7%	9%
	10.9%	-10%	-8%	-5%	-3%	-1%	2%	4%	6%	8%	11%
	11.4%	-8%	-6%	-4%	-1%	1%	3%	6%	8%	10%	12%
	11.9%	-7%	-4%	-2%	0%	3%	5%	7%	10%	12%	14%
	12.3%	-5%	-3%	0%	2%	4%	7%	9%	11%	14%	16%
	12.8%	-4%	-1%	1%	4%	6%	8%	11%	13%	15%	18%
	13.3%	-2%	0%	3%	5%	8%	10%	12%	15%	17%	20%
	13.8%	0%	2%	4%	7%	9%	12%	14%	16%	19%	21%
14.3%	1%	4%	6%	8%	11%	13%	16%	18%	21%	23%	
14.8%	3%	5%	8%	10%	13%	15%	17%	20%	22%	25%	

Source : Industry data, Indiabulls Research

Scenario 2: 10% excise hike across segments and 59mm not introduced

Scenario 2 : Without 59mm

Figures as shown

Segment	Size	Excise duty (Rs / stick)		
		Current	Our expectation	Translated hike
KSFT	84mm	1.81	1.99	10.0%
MKFT	74mm	1.36	1.50	10.0%
RSFT	69mm	0.84	0.93	10.0%

Source : Industry data, Indiabulls Research

We believe that 11% cigarettes EBIT growth is the best possibility with 10.9% price increase and 1.2% volume decline. Under this scenario, we believe popular RSFT shall lose out volume but will be compensated by the premium RSFT, and may result in marginal margin expansion.

Scenario 2 : EBIT sensitivity to price volume matrix

%		Volume									
		-7.1%	-5.9%	-4.7%	-3.6%	-2.4%	-1.2%	0.0%	1.2%	2.4%	3.6%
Price Change	6.5%	-15%	-13%	-10%	-8%	-6%	-4%	-1%	1%	3%	5%
	7.0%	-13%	-11%	-9%	-6%	-4%	-2%	0%	3%	5%	7%
	7.4%	-12%	-9%	-7%	-5%	-3%	0%	2%	4%	7%	9%
	7.9%	-10%	-8%	-6%	-3%	-1%	1%	4%	6%	8%	11%
	8.4%	-9%	-6%	-4%	-2%	1%	3%	5%	8%	10%	12%
	8.9%	-7%	-5%	-2%	0%	2%	5%	7%	9%	12%	14%
	9.4%	-5%	-3%	-1%	2%	4%	6%	9%	11%	13%	16%
	9.9%	-4%	-1%	1%	3%	6%	8%	10%	13%	15%	18%
	10.4%	-2%	0%	3%	5%	7%	10%	12%	15%	17%	19%
	10.9%	-1%	2%	4%	7%	9%	11%	14%	16%	19%	21%
	11.4%	1%	3%	6%	8%	11%	13%	16%	18%	20%	23%
	11.9%	3%	5%	7%	10%	12%	15%	17%	20%	22%	25%
	12.3%	4%	7%	9%	12%	14%	16%	19%	21%	24%	26%
	12.8%	6%	8%	11%	13%	16%	18%	21%	23%	26%	28%
	13.3%	7%	10%	12%	15%	17%	20%	22%	25%	27%	30%
	13.8%	9%	11%	14%	16%	19%	22%	24%	27%	29%	32%
14.3%	10%	13%	16%	18%	21%	23%	26%	28%	31%	33%	
14.8%	12%	15%	17%	20%	22%	25%	27%	30%	33%	35%	

VAT hike may be an additional burden

In our working above, we have assumed average VAT rate to be 13.5% for ITC which is as of now. However, if VAT rate is hiked by some of the states, it will increase pricing pressure and thereby volume may be impacted. Currently, ITC's effective VAT rate works out to ~13.5% and accordingly 1% increase in VAT will warrant 0.78% additional price hike. Haryana has recently announced the hike in VAT on cigarettes to 20%, which increase the probability of other states also increasing the VAT on cigarettes.

Gestalt: Unlike common belief, as shown in the table above, price hikes will not be easier for ITC this year as it may need price hike across brands, and dependence for price hike may be higher on price sensitive brands. We believe with taxation risks on the higher side, the stock will give opportunity to enter at lower price.

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