

## ITC Ltd

### Positive on margins

■ **Revenues decline marginally, but margins surprise**

ITC's 4Q FY09 results indicate the benefits of multiple drivers of growth which the company has built over the years. Gross sales declined by 0.9% to Rs 59,585 million largely due to a decline in the agri business, which was hit owing to product rationalisation and negligible trade in soy products, and hotels, which continued to suffer from the economic slowdown. However, EBITDA margin expanded by 454 bps YoY to 33.1%, with all business segments except hotel reporting margin expansion.

■ **Cigarettes and paperboard businesses drive growth**

Cigarettes revenue grew by 10.2% YoY despite an overall volume decline of ~3%, with about ~18% growth in filters volume. Price hikes on filters without corresponding duty hikes on the segment resulted in PBIT margins expanding 310 bps YoY to 27.4%. Overall cigarettes PBIT grew 24.3% YoY. The paperboard business grew 20.6% YoY, benefiting from the starting of new capacities. PBIT grew by 23.8% YoY and PBIT margin expanded by 53 bps YoY to 20.3%.

■ **Valuation: Maintain Buy**

We expect ITC to post EPS of Rs 10.2 for FY10 and Rs 12.2 for FY11. At Rs 190, the stock trades at 18.7x FY10E EPS. Given the strong resilience of the company's cigarettes business, we believe the stock will see traction building up, further boosted by lower-than-expected FMCG losses. However, concerns on excise duty hike might put pressure on the stock in the near future. We maintain our **Buy** rating on the stock with an SOTP-based target price of Rs 213 (21.0x FY10E earnings), and believe any decline in the share price will be better opportunity to add.

**Figure 1: Key quarterly financials**

Rs million (unless stated otherwise), year-end March

	4Q FY08A	4Q FY09A	4Q FY09E	Variation (actual/est.,%)	4Q FY09 Consensus	1Q FY10E
Sales	40,426	39,274	41,539	(5.5)	44,391	38,609
% growth	19.9	(2.8)	2.8		9.8	(1.0)
EBITDA	11,529	12,983	12,382	4.9	12,259	12,620
Margin (%)	28.5	33.1	29.8		27.6	32.7
Net profit	7,356	8,090	8,378	(3.4)	8,576	8,294
EPS (Rs)	2.0	2.1	2.2	(3.5)	2.3	2.2
% growth	12.9	9.8	13.8		16.6	10.6

Source: Company data, Bloomberg, Reliance Equities estimates. Note: Priced at COB 25 May 2009.

## Buy

**Rs 190**

Target price: Rs 213

### FMCG

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Bloomberg code	ITC IN
Reuters code	ITC.BO
3m avg. traded value (Rs m)	1,084
52-wk H/L (Rs)	224.5/132.1
Sensex	13913.3
Mcap (US\$ m/Rs bn)	15,157/717

### Shareholding (%)

	Mar-09	Dec-08
Promoters	-	-
MFs, Fls, banks	37.7	37.9
FIIIs	13.6	13.9
Others	48.6	48.2

### Stock performance (%)

	1m	6m	1yr
Absolute	-0.2	12.8	-11.1
BSE 30 index	22.8	60.0	-16.4

### Sector rankings (descending order)

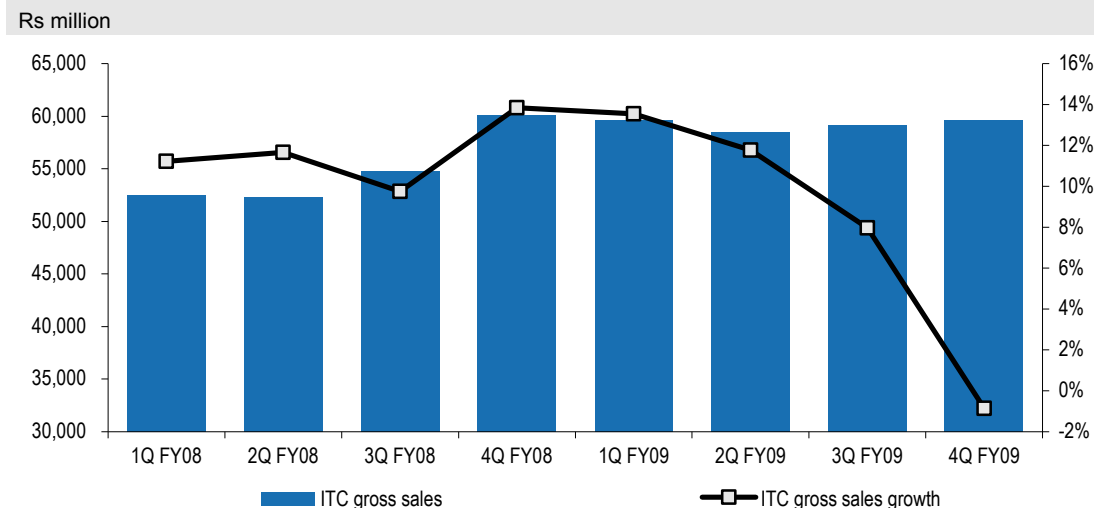
	Reco	TP	Upside (%)
ITC	Buy	213	12.2
Dabur	Buy	122	5.8
Marico	Sell	70	4.2
Colgate	Sell	485	5.6
HUL	Sell	233	0.3

Source: Bloomberg, Capitaline, Reliance Equities estimates.

## Key takeaways

### Overall revenue decline disappointed

**Figure 2: Quarterly gross sales and growth**

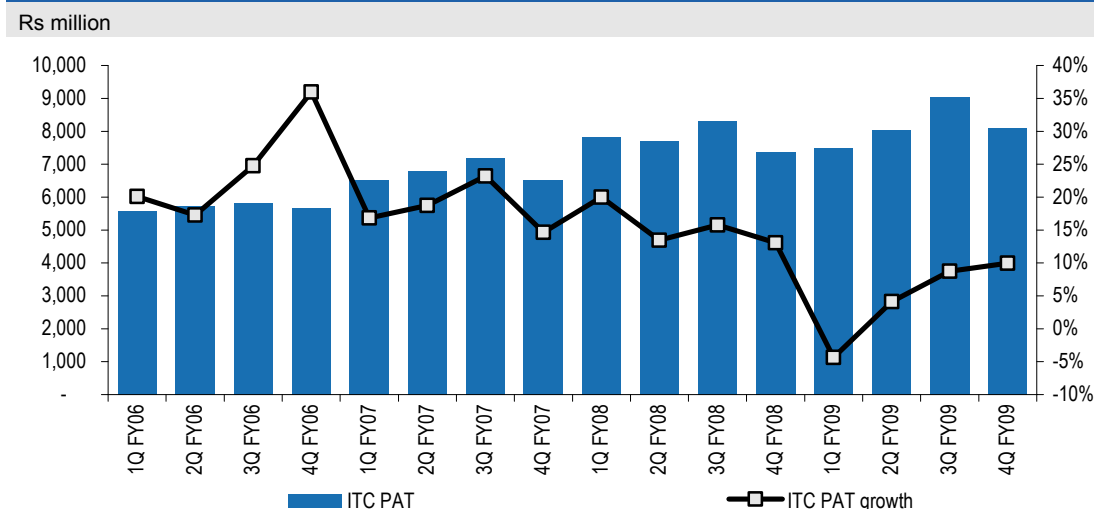


Source: Company data, Reliance Equities research.

In 4Q FY09, ITC's net income (including other operating income) declined by 2.8% to Rs 39,274 million vs. our expectation of Rs 41,539 million. Gross sales declined by 0.9% YoY to Rs 59,585 million. This was largely because of declines of 51.2% YoY in the agri business and 28.9% YoY in the hotel business.

### However, PAT growth maintained its uptrend

**Figure 3: Quarterly PAT and growth**



Source: Company data, Reliance Equities research.

In 4Q FY09, ITC's PAT grew by 10.0% to Rs 8,090 million, maintaining an uptrend. PBIT margins in all segments expect hotels improved.

## Cigarettes drive earnings growth

FY09 marks the phasing out of non-filters in the cigarettes industry. In 4Q FY09, ITC cigarette volumes continued to decline, but showed growth sequentially. Excise hike will become crucial for FY10; we are expecting a 10% excise hike from 1 July 2009 and volume growth of 4% for FY10.

**Figure 4: Cigarettes business performance**

Units as shown	1Q FY09	2Q FY09	3Q FY09	4Q FY09
Volume	-3.3%	-1.8%	-3.8%	-2.8%
Average Price	9.3%	12.9%	15.0%	13.4%
Value	6%	11%	11%	10%
Excise	5%	7%	4%	5%
Product Cost & Overheads	11%	13%	17%	8%
PBIT	2%	17%	18%	24%
PBIT Margins	26.4%	27.8%	29.1%	27.4%

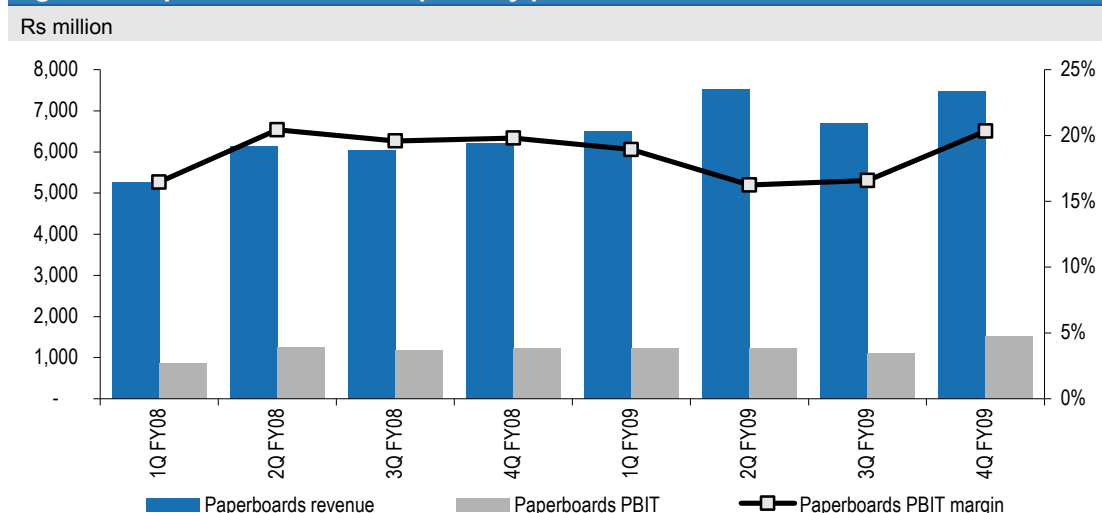
Source: Company data, Reliance Equities research.

In 4Q FY09, we were expecting a cigarette PBIT margin of 26.4%, with YoY expansion of 211 bps YoY. However, we were surprised at a better-than-expected margin of 27.4%, which indicates better management of cost overheads.

## Value-added paperboards drives growth and margins

In 4Q FY09, paperboard revenues grew by 20.6% YoY vs. our expectation of 17.1% YoY. This was mainly driven by value-added paperboards which grew by 13.0% YoY for the full year. PBIT grew by 23.8% YoY with margin improving 53bps YoY to 20.3%. We expect margin to improve further with the new pulp mill stabilising.

**Figure 5: Paperboard business quarterly performance**

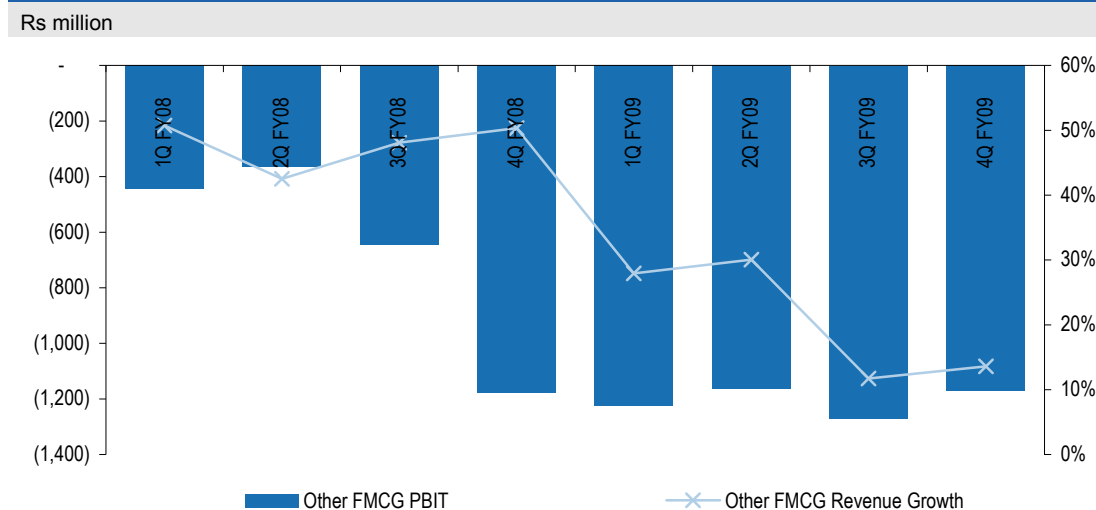


Source: Company data, Reliance Equities research.

## Non-cigarette FMCG revenues continued to see muted growth

The other FMCG businesses grew by 13.6% YoY vs. our expectation of 10.3% YoY growth. As lower raw material prices start factoring in from 1Q FY10, we expect losses to reduce further.

**Figure 6: Non-cigarette FMCG business performance**

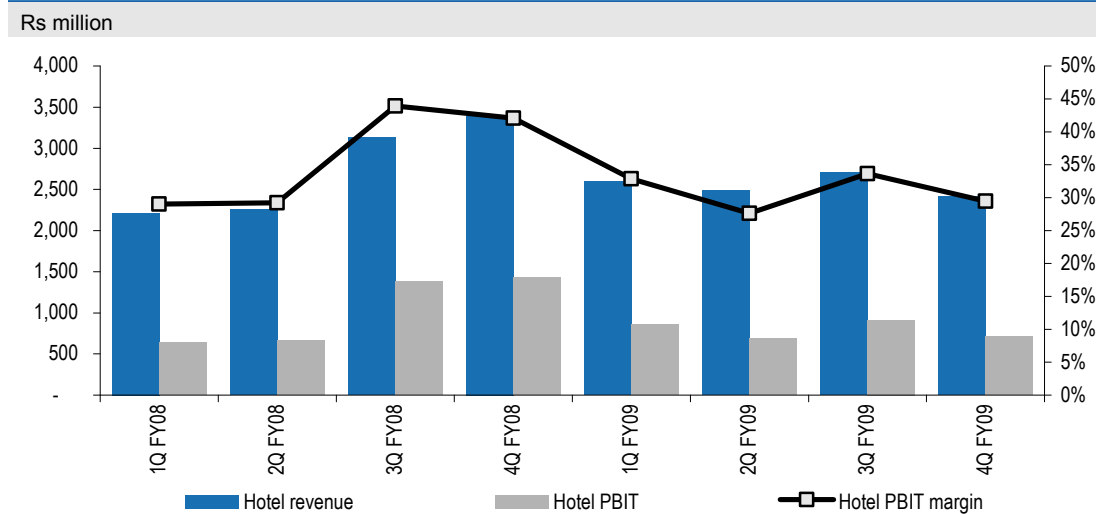


Source: Company data, Reliance Equities research.

## Hotels continue to be hit by the economic slowdown

The decline in hotel revenues was expected by the Street. In 4Q FY09, a double-digit reduction in occupancy levels and average room rates (ARR) led to a 28.9% decline in revenues vs. our expectation of 12.0% YoY decline. PBIT declined by 50.0% YoY to Rs 711 million vs. our estimate of a 33.7% YoY fall. Significant slides in occupancies and average room rates led to the PBIT margin declining 1,262 bps YoY to 29.5%.

**Figure 7: Hotel business performance**

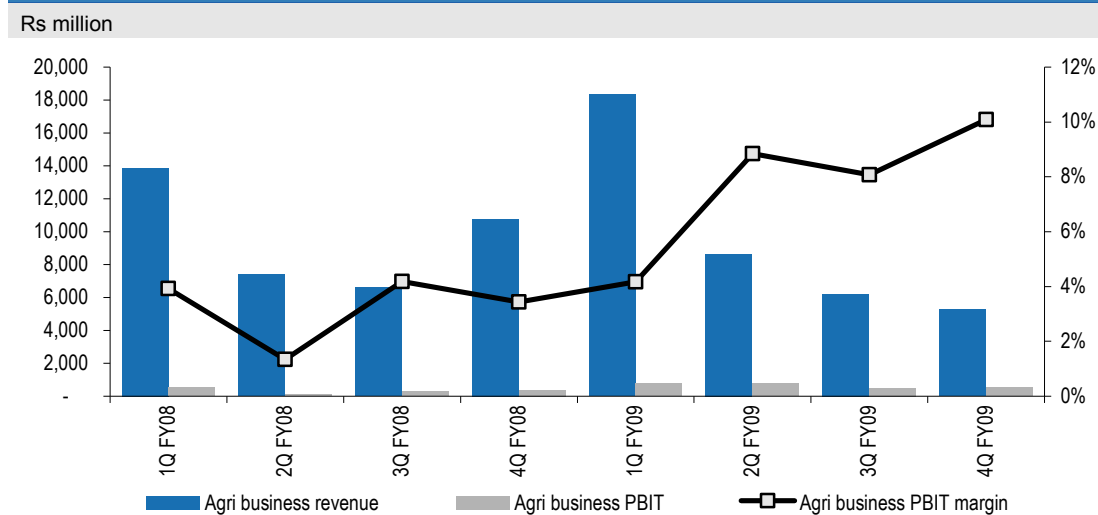


Source: Company data, Reliance Equities research.

## Agri revenues declined but margin improved

In 4Q FY09, agri business revenues declined by 51.2% YoY vs. our expectation of a 45.8% YoY fall. This was due to negligible trade in soy products and rationalisation of the agri portfolio to align it with the company's sourcing needs. However, moving out of non-core and low-margin commodities improved margin 666 bps YoY to 10.1%. PBIT grew at 43.4% YoY.

**Figure 8: Agri business performance**



Source: Company data, Reliance Equities research.

## Valuation

At the current share price of Rs 190, the stock trades at 18.7x FY10E. Concerns on the stock during the year included cigarettes volume decline, higher FMCG losses and then a slowdown in hotels. We believe overall cigarettes volume do show a 3% decline, but underlying filters normal volume growth of ~4.5% supports our argument that cigarettes volume will continue to grow. However, ITC's pricing power in cigarettes remains uncontested, the proof of which lies in the company's ability to expand margins consecutively for at least eight years. The base effect on cigarettes volume should also work in favour of the company from FY10. Further, we believe delivering a reduction in FMCG losses will continue to assuage long-standing concerns on the Street.

We value ITC's cigarettes business at 13x FY10E EV/EBITDA to factor in 19.5% EBITDA growth in the business between FY09 and FY11E. We maintain **Buy** with our target price equal to our sum-of-the-parts-based fair value of Rs 213, which is effectively 21.0x FY10E earnings.

**Figure 9: Sum-of-the-parts valuation**

Segment	EV/EBITDA	Value/sh.	Basis
Cigarettes	13x	173	Premium to international peers with 15% EBITDA CAGR FY09-11E
Other FMCG	1.5x sales	15	Discount to domestic FMCG peers owing to concerns on losses
Hotel	5x	6	Comparable to Indian Hotels
Agri	3x	3	Comparable to Ruchi Soya
Paper	5x	12	15% premium to BILT
<b>Total</b>		<b>208</b>	
Less: Debts		1	
Add cash		6	
<b>Target price</b>		<b>213</b>	

Source: Bloomberg, Reliance Equities estimates.

**Figure 10: International peer valuations**

Units as shown									
	M. cap	CMP	Revenue growth	EBITDA growth	PAT growth	EV/EBITDA	P/E (x)	ROE (%)	
	(US\$ bn)	(US\$)	CAGR (FY08-10E)	CAGR (FY08-10E)	CAGR (FY08-10E)	(x) FY10E	FY10E	FY10E	
Philip Morris International	83.8	43	-3.8%	-4.3%	-7.9%	9.4	14.2	110.9	
British American Tobacco Plc	52.7	26	6.7%	7.5%	8.9%	8.3	11.2	38.7	
Japan Tobacco Inc	29.9	2,987	-5.3%	-9.0%	8.5%	7.0	18.8	8.2	
Reynolds American Inc	11.4	39	-3.0%	-2.8%	-2.7%	5.3	9.3	19.0	
KT&G Corp	7.5	54	4.7%	4.1%	0.5%	7.7	10.1	23.9	
Souza Cruz SA	7.5	25	3.5%	1.9%	3.3%	8.1	11.6	48.2	
British American Tobacco BHD	3.5	12	1.5%	-0.3%	0.1%	10.5	15.0	179.0	
<b>Average</b>	<b>196</b>		<b>-2.6%</b>	<b>-2.0%</b>	<b>-0.4%</b>	<b>8.2</b>	<b>13.2</b>		

Source: Bloomberg estimates, Reliance Equities research.

Based on Bloomberg consensus data, ITC's global peers trade at 8.2x EV/EBITDA FY10E despite an EBITDA decline of 2%, which supports our case for 13x EV/EBITDA FY10E for ITC's cigarettes business.

**Figure 11: Quarterly results**

Rs million (unless indicated otherwise), year-end March

	4Q FY09	4Q FY08	YoY gr.	3Q FY09	FY09	FY08	YoY gr.
<b>Net sales</b>	<b>38,918</b>	<b>39,344</b>	<b>-1.1%</b>	<b>38,333</b>	<b>153,881</b>	<b>139,475</b>	<b>10.3%</b>
Other op. income	356	1,082	-67.1%	253	1,946	2,345	-17.0%
<b>Total op. income</b>	<b>39,274</b>	<b>40,426</b>	<b>-2.8%</b>	<b>38,587</b>	<b>155,827</b>	<b>141,820</b>	<b>9.9%</b>
<b>Expenditure</b>							
Raw materials	15,777	18,445	-14.5%	15,171	64,468	60,167	7.1%
<i>% of total op. inc.</i>	<i>40.2%</i>	<i>45.6%</i>		<i>39.3%</i>	<i>41.4%</i>	<i>42.4%</i>	
Employee cost	2,222	1,911	16.3%	2,130	8,909	7,333	21.5%
<i>% of total op. inc.</i>	<i>5.7%</i>	<i>4.7%</i>		<i>5.5%</i>	<i>5.7%</i>	<i>5.2%</i>	
Other expenditure	8,293	8,542	-2.9%	7,506	31,919	27,936	14.3%
<i>% of total op. inc.</i>	<i>21.1%</i>	<i>21.1%</i>		<i>19.5%</i>	<i>20.5%</i>	<i>19.7%</i>	
Total expenditure	26,291	28,897	-9.0%	24,806	105,296	95,436	10.3%
<b>EBITDA</b>	<b>12,983</b>	<b>11,529</b>	<b>12.6%</b>	<b>13,780</b>	<b>50,532</b>	<b>46,384</b>	<b>8.9%</b>
<i>EBITDA margin</i>	<i>33.1%</i>	<i>28.5%</i>		<i>35.7%</i>	<i>32.4%</i>	<i>32.7%</i>	
Other income	523	555	-5.9%	976	3,403	3,764	-9.6%
PBDIT	13,506	12,084	11.8%	14,756	53,935	50,148	7.6%
Depreciation	1,451	1,215	19.4%	1,442	5,494	4,385	25.3%
PBIT	12,055	10,869	10.9%	13,314	48,441	45,764	5.8%
Interest	137	27		5	183	46	
PBT	11,918	10,842	9.9%	13,310	48,257	45,718	5.6%
Prov for tax	3,828	3,485	9.8%	4,277	15,622	14,517	7.6%
<i>% of PBT</i>	<i>32.1%</i>	<i>32.1%</i>		<i>32.1%</i>	<i>32.4%</i>	<i>31.8%</i>	
<b>PAT</b>	<b>8,090</b>	<b>7,356</b>	<b>10.0%</b>	<b>9,032</b>	<b>32,636</b>	<b>31,201</b>	<b>4.6%</b>

Source: Company data, Reliance Equities research.

**Figure 12: Segmental sales and earnings breakdown**

Rs million (unless indicated otherwise), year-end March

	4Q FY09	4Q FY08	YoY gr.	3Q FY09	FY09	FY08	YoY gr.
FMCG - cigarettes	39,493	35,830	10.2%	39,015	151,151	138,256	9.3%
FMCG - others	8,388	7,384	13.6%	7,223	30,140	25,111	20.0%
Hotels	2,413	3,393	-28.9%	2,705	10,203	11,002	-7.3%
Agri business	5,259	10,781	-51.2%	6,215	39,460	38,684	2.0%
Paperboards, paper & pkging	7,470	6,197	20.6%	6,699	28,220	23,643	19.4%
<b>Total</b>	<b>63,024</b>	<b>63,585</b>	<b>-0.9%</b>	<b>61,858</b>	<b>259,173</b>	<b>236,696</b>	<b>9.5%</b>
<b>Sales mix</b>							
FMCG - cigarettes	62.7%	56.3%	631	63.1%	58.3%	58.4%	(9)
FMCG - others	13.3%	11.6%	170	11.7%	11.6%	10.6%	102
Hotels	3.8%	5.3%	(151)	4.4%	3.9%	4.6%	(71)
Agri business	8.3%	17.0%	(861)	10.0%	15.2%	16.3%	(112)
Paperboards, paper & pkging	11.9%	9.7%	211	10.8%	10.9%	10.0%	90
<b>PBIT</b>							
FMCG - cigarettes	10,814	8,701	24.3%	11,341	41,838	36,340	15.1%
FMCG - others	(1,173)	(1,179)	-0.5%	(1,270)	(4,835)	(2,635)	83.5%
Hotels	711	1,428	-50.2%	911	3,162	4,108	-23.0%
Agri business	531	370	43.4%	502	2,562	1,292	98.3%
Paperboards, paper & pkging	1,519	1,227	23.8%	1,111	5,086	4,531	12.2%
<b>Total</b>	<b>12,401</b>	<b>10,547</b>	<b>17.6%</b>	<b>12,594</b>	<b>47,813</b>	<b>43,636</b>	<b>9.6%</b>
<b>PBIT margins</b>							
FMCG - cigarettes	27.4%	24.3%	310	29.1%	27.7%	26.3%	139
FMCG - others	-14.0%	-16.0%	198	-17.6%	-16.0%	-10.5%	(555)
Hotels	29.5%	42.1%	(1,262)	33.7%	31.0%	37.3%	(635)
Agri business	10.1%	3.4%	666	8.1%	6.5%	3.3%	315
Paperboards, paper & pkging	20.3%	19.8%	53	16.6%	18.0%	19.2%	(114)
<b>Total</b>	<b>19.7%</b>	<b>16.6%</b>	<b>309</b>	<b>20.4%</b>	<b>18.4%</b>	<b>18.4%</b>	<b>1</b>
<b>PBIT mix</b>							
FMCG - cigarettes	87.2%	82.5%	470	90.1%	87.5%	83.3%	422
FMCG - others	-9.5%	-11.2%	172	-10.1%	-10.1%	-6.0%	(407)
Hotels	5.7%	13.5%	(780)	7.2%	6.6%	9.4%	(280)
Agri business	4.3%	3.5%	77	4.0%	5.4%	3.0%	240
Paperboards, paper & pkging	12.2%	11.6%	61	8.8%	10.6%	10.4%	25

Source: Company data, Reliance Equities research.



**Figure 13: Summary financials**

Rs million (unless indicated otherwise), year-end March

Income statement	FY08	FY09	FY10E	FY11E	Cash flow statement	FY08	FY09	FY10E	FY11E
<b>Sales</b>	<b>139,475</b>	<b>153,881</b>	<b>180,263</b>	<b>213,049</b>	PBT	45,718	48,257	58,041	69,532
Raw material	(46,394)	(53,158)	(62,886)	(74,444)	D&A add back	(4,385)	(5,494)	(6,152)	(6,766)
Employee expenses	(7,333)	(8,909)	(10,369)	(12,028)	Taxes paid	(13,795)	(15,622)	(17,821)	(21,316)
SG&A & Mktg exps	-	-	-	-	(Inc)/dec in w. cap	3,273	12,675	15,530	20,792
Other operating expenses	(41,709)	(43,229)	(47,263)	(55,423)	Other op. cash flow	602	(6,168)	(4,634)	(9,952)
Other op. income	-	-	-	-	<b>Cash flow from op. (A)</b>	<b>31,414</b>	<b>33,649</b>	<b>44,963</b>	<b>52,290</b>
<b>EBITDA</b>	<b>44,039</b>	<b>48,585</b>	<b>59,744</b>	<b>71,153</b>	Cap exp. (B)	(21,232)	(16,143)	(14,513)	(14,729)
Depn and amort.	(4,385)	(5,494)	(6,152)	(6,766)	Acquisitions	-	-	-	-
<b>EBIT</b>	<b>39,655</b>	<b>43,091</b>	<b>53,592</b>	<b>64,387</b>	Divestitures	-	-	-	-
Net int. income/exp.	(46)	(183)	(200)	(200)	Others	1,332	4,346	-	-
Inc./loss from assoc.	-	-	-	-	<b>Cash flow from investing</b>	<b>(19,900)</b>	<b>(11,797)</b>	<b>(14,513)</b>	<b>(14,729)</b>
Other non-op inc./exp.	6,109	5,349	4,648	5,345	FCF (A+B)	10,182	17,506	30,450	37,561
PBT	45,718	48,257	58,041	69,532	Divids pd (com. and pref.)	(15,432)	(16,339)	(19,671)	(23,582)
Provision for taxes	(14,517)	(15,622)	(18,749)	(22,428)	Inc. in equity	6	-	-	-
Minority interest	-	-	-	-	Inc./(dec.) in debt	136	209	230	253
Preference dividend	-	-	-	-	Other financing cash flows	476	183	200	200
Reported net profit	31,201	32,636	39,291	47,104	<b>Cash flow from financing</b>	<b>(14,814)</b>	<b>(15,947)</b>	<b>(19,241)</b>	<b>(23,129)</b>
<b>REIPL net income</b>	<b>31,201</b>	<b>32,636</b>	<b>39,291</b>	<b>47,104</b>	<b>Total cash flow</b>	<b>(3,299)</b>	<b>5,905</b>	<b>11,209</b>	<b>14,432</b>
Wtd avg # of shares	3,768.6	3,768.6	3,768.6	3,768.6	<b>Capital management</b>	<b>FY08</b>	<b>FY09</b>	<b>FY10E</b>	<b>FY11E</b>
EPS (basic, rep) (Rs)	8.3	8.7	10.4	12.5	Inventory days	96.9	102.4	98.7	95.4
EPS (dil., rep.) (Rs)	8.3	8.7	10.4	12.5	Receivable days	18.0	18.6	18.0	17.4
<b>EPS (dil., adj.) (Rs)</b>	<b>8.3</b>	<b>8.7</b>	<b>10.4</b>	<b>12.5</b>	<b>Growth and margins (%)</b>	<b>FY08</b>	<b>FY09</b>	<b>FY10E</b>	<b>FY11E</b>
DPS (Rs)	3.5	3.7	4.5	5.3	Sales growth	14.7	10.3	17.1	18.2
Divid payout ratio (%)	42.3	42.8	42.8	42.8	EBITDA growth	11.3	10.3	23.0	19.1
<b>Balance sheet</b>	<b>FY08</b>	<b>FY09</b>	<b>FY10E</b>	<b>FY11E</b>	EPS growth	15.4	4.6	20.4	19.9
Cash and equiv.	5,703	11,608	22,817	37,249	EBITDA margin	31.6	31.6	33.1	33.4
A/c.s receivable	7,369	8,334	9,407	10,853	EBIT margin	28.4	28.0	29.7	30.2
Loans and adv.	15,155	17,139	19,346	22,319	Net margin	22.4	21.2	21.8	22.1
Inventory	40,505	45,808	51,707	59,651	Rev. growth – peers	-	-	-	-
Other current assets	1,461	1,652	1,865	2,151	EBITDA growth – peers	-	-	-	-
<b>Total curr. assets</b>	<b>70,193</b>	<b>84,541</b>	<b>105,142</b>	<b>132,223</b>	EBITDA margin – peers	-	-	-	-
Accounts payable	27,397	29,022	34,017	40,200	EPS growth – peers	-	-	-	-
Short-term debt	2,089	2,297	2,527	2,780	Noplat	27,063	29,142	36,280	43,618
Other curr. liab.	473	522	597	703	Invested capital	115,280	138,603	162,494	191,249
<b>Total curr. liab.</b>	<b>29,958</b>	<b>31,841</b>	<b>37,141</b>	<b>43,683</b>	ROIC (%)	25.7	23.0	24.1	24.7
<b>Net curr. assets</b>	<b>40,234</b>	<b>52,700</b>	<b>68,000</b>	<b>88,540</b>	ROIC/WACC (x)	-	-	-	-
Net fixed assets	72,957	83,605	91,966	99,929	ROIC – peers (%)	-	-	-	-
Net intangibles	-	-	-	-	<b>Valuations</b>	<b>FY08</b>	<b>FY09</b>	<b>FY10E</b>	<b>FY11E</b>
Investments	29,346	25,000	25,000	25,000	P/E (x)	22.9	21.9	18.2	15.2
Other long-term assets	-	-	-	-	P/E (peers) (x)	-	-	-	-
<b>Total assets</b>	<b>142,536</b>	<b>161,305</b>	<b>184,967</b>	<b>213,469</b>	EV/sales (x)	5.1	4.6	3.9	3.2
Total loans	56	56	56	56	EV/sales – peers (x)	-	-	-	-
Other long-term liab.	21,904	24,376	28,416	33,396	EV/EBITDA (x)	16.2	14.5	11.6	9.6
Shareholders' funds	120,577	136,874	156,495	180,017	EV/EBITDA (peer group)	-	-	-	-
Pref. shrs/other equity	-	-	-	-	P/B (x)	5.9	5.2	4.6	4.0
Minority interest	-	-	-	-	P/B peer group (x)	-	-	-	-
<b>Total liab. and equity</b>	<b>142,536</b>	<b>161,305</b>	<b>184,967</b>	<b>213,469</b>	Div yield (%)	1.8	2.0	2.3	2.8
<b>BVPS (Rs)</b>	<b>32.0</b>	<b>36.3</b>	<b>41.5</b>	<b>47.8</b>	Free cash flow yield (%)	1.4	2.4	4.3	5.2
<b>DuPont analysis</b>	<b>FY08</b>	<b>FY09</b>	<b>FY10E</b>	<b>FY11E</b>	<b>Quality of earnings</b>	<b>FY08</b>	<b>FY09</b>	<b>FY10E</b>	<b>FY11E</b>
Margin (%)	22.4	21.2	21.8	22.1	Op. cash flow/net income (x)	1.0	1.0	1.1	1.1
Asset turnover (x)	0.9	0.8	0.9	0.9	Capex/Depn (x)	4.8	2.9	2.4	2.2
Leverage (x)	1.4	1.4	1.4	1.4	Tax charge/pre-tax income (x)	31.8	32.4	32.3	32.3
ROE (%)	27.7	25.4	26.8	28.0	Net debt/equity (%)	(0.0)	(0.1)	(0.1)	(0.2)
					Interest cover (x)	860.2	235.2	268.0	321.9

Source: Company data, Reliance Equities estimates.

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**Key to REIPL recommendations**

**Buy** = Expected return more than +15%

**Sell** = Expected return +15% or less

All returns calculated over a 12-month period.

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