

## Company Focus

19 January 2008 | 12 pages

# ITC (ITC.BO)

 Target price change   
 Results 

## Buy: 3QFY08: Solid Cigarette Profitability, Raise TP to Rs247

- Raising target price** – We are raising our target price for ITC to Rs247, increasing our target multiple from 20x to 23x. We expect recovery in cigarette volumes to continue to drive stock re-rating, as has been the case historically. As such, our 23x target P/E is towards the middle of the stock's valuation band over the last 3 years and is supported by 22.5% EPS CAGR over FY07-FY10E
- Cigarette business showing solid resilience** – ITC's pricing strategy, loading price hikes in favor of mid-end cigarettes and not leaving any 'pricing gaps' across its cigarette portfolio, is paying off. Its cigarette EBIT profits increased 16% in 3QFY08 and 13.7% in 9mFY08 despite declining volumes. Volume trend is also improving, with 3Q volumes declining less than 1%.
- 3QFY08 profits in-line** – 3QFY08 net profit growth of 15.8% yoy were in-line with our estimates. Positive surprise was 16% growth in cigarette EBIT profits, while growth hotels and agri-business have recovered.
- Foods portfolio (ex-Bingo) breaks even** – ITC's foods portfolio (excluding 'Bingo' brand) has broken even in 3Q. EBIT loss margins for new FMCG business continue to decline, despite scaling up of expenses related to the launch of new personal care products under the 'Fiama di Willis' brand in 3Q.
- Hotels, agri-business back on track** – Hotels business growth has picked up after slowing over the last 2 quarters, as the key Delhi property opened after renovation. While agri-business sales declined (due to ban on rice exports), EBIT profit grew 28% due to higher (high margin) leaf tobacco exports.

<b>Buy/Low Risk</b>	<b>1L</b>
Price (18 Jan 08)	Rs212.60
Target price	Rs247.00
	<i>from Rs215.00</i>
Expected share price return	16.2%
Expected dividend yield	1.7%
<b>Expected total return</b>	<b>17.8%</b>
Market Cap	Rs800,617M
	US\$20,440M

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



### Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2006A	22,354	6.00	10.0	35.4	8.7	26.4	1.3
2007A	27,000	7.18	19.5	29.6	7.7	27.7	1.5
2008E	33,176	8.82	22.9	24.1	6.5	29.2	1.7
2009E	40,466	10.76	22.0	19.8	5.5	30.2	2.0
2010E	49,613	13.19	22.6	16.1	4.6	31.1	2.4

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification and important disclosures.

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
<b>Valuation Ratios</b>					
P/E adjusted (x)	35.4	29.6	24.1	19.8	16.1
EV/EBITDA adjusted (x)	22.8	19.2	15.6	12.5	9.9
P/BV (x)	8.7	7.7	6.5	5.5	4.6
Dividend yield (%)	1.3	1.5	1.7	2.0	2.4
<b>Per Share Data (Rs)</b>					
EPS adjusted	6.00	7.18	8.82	10.76	13.19
EPS reported	6.00	7.18	8.82	10.76	13.19
BVPS	24.34	27.74	32.57	38.58	46.13
DPS	2.67	3.10	3.54	4.20	5.00
<b>Profit &amp; Loss (RsM)</b>					
Net sales	97,905	123,693	143,809	168,680	198,073
Operating expenses	-67,955	-87,758	-99,750	-114,208	-130,533
<b>EBIT</b>	<b>29,950</b>	<b>35,935</b>	<b>44,060</b>	<b>54,472</b>	<b>67,539</b>
Net interest expense	-119	-33	-30	-30	-30
Non-operating/exceptionals	2,411	3,365	3,365	3,366	3,366
<b>Pre-tax profit</b>	<b>32,242</b>	<b>39,267</b>	<b>47,395</b>	<b>57,808</b>	<b>70,875</b>
Tax	-9,888	-12,267	-14,218	-17,342	-21,262
Extraord./Min.Int./Pref.div.	0	0	0	0	0
<b>Reported net income</b>	<b>22,354</b>	<b>27,000</b>	<b>33,176</b>	<b>40,466</b>	<b>49,613</b>
Adjusted earnings	22,354	27,000	33,176	40,466	49,613
Adjusted EBITDA	33,274	39,564	48,333	59,334	72,782
<b>Growth Rates (%)</b>					
Sales	30.9	26.3	16.3	17.3	17.4
EBIT adjusted	29.1	20.0	22.6	23.6	24.0
EBITDA adjusted	26.4	18.9	22.2	22.8	22.7
EPS adjusted	10.0	19.5	22.9	22.0	22.6
<b>Cash Flow (RsM)</b>					
<b>Operating cash flow</b>	<b>19,507</b>	<b>22,952</b>	<b>31,908</b>	<b>42,757</b>	<b>52,049</b>
Depreciation/amortization	3,323	3,629	4,274	4,862	5,242
Net working capital	-2,739	-7,677	-5,542	-2,571	-2,806
<b>Investing cash flow</b>	<b>-1,797</b>	<b>-11,178</b>	<b>-16,000</b>	<b>-16,000</b>	<b>-16,000</b>
Capital expenditure	-5,382	-15,299	-7,000	-7,000	-7,000
Acquisitions/disposals	0	0	0	0	0
<b>Financing cash flow</b>	<b>-11,201</b>	<b>-10,950</b>	<b>-17,038</b>	<b>-17,832</b>	<b>-21,228</b>
Borrowings	-1,256	812	-2,009	0	0
Dividends paid	-11,347	-13,645	-15,030	-17,832	-21,228
<b>Change in cash</b>	<b>6,509</b>	<b>824</b>	<b>-1,131</b>	<b>8,925</b>	<b>14,821</b>
<b>Balance Sheet (RsM)</b>					
<b>Total assets</b>	<b>130,840</b>	<b>149,684</b>	<b>172,952</b>	<b>203,116</b>	<b>240,333</b>
Cash & cash equivalent	9,110	9,544	8,413	17,337	32,157
Accounts receivable	5,480	6,367	9,850	11,553	13,567
Net fixed assets	44,051	56,109	58,835	60,973	62,731
<b>Total liabilities</b>	<b>40,226</b>	<b>45,313</b>	<b>50,434</b>	<b>57,965</b>	<b>66,799</b>
Accounts payable	21,890	23,848	27,122	31,069	35,527
Total Debt	1,197	2,009	0	0	0
<b>Shareholders' funds</b>	<b>90,615</b>	<b>104,371</b>	<b>122,517</b>	<b>145,150</b>	<b>173,534</b>
<b>Profitability/Solvency Ratios (%)</b>					
EBITDA margin adjusted	34.0	32.0	33.6	35.2	36.7
ROE adjusted	26.4	27.7	29.2	30.2	31.1
ROIC adjusted	42.5	39.6	40.5	46.3	54.5
Net debt to equity	-8.7	-7.2	-6.9	-11.9	-18.5
Total debt to capital	1.3	1.9	0.0	0.0	0.0

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## Raising Target Price to Rs247

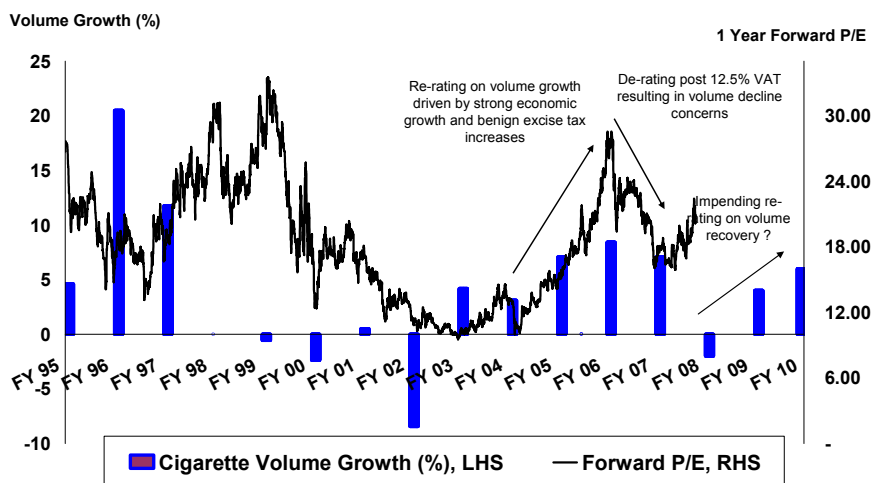
Figure 1. ITC: Returns (%): Abs & Rel to Sensex

(%)	3M	6M	12M
Absolute	21.6	38.1	23.6
Rel. to .BSESN	13.2	15.4	(12.0)

Source: Powered by dataCentral

We are raising the target price for ITC to Rs247 from Rs215 earlier. Our target price is based on 23x FY09E earnings. We are raising our target multiple for ITC from 20x to 23x. We believe that ITC stock is a re-rating candidate, driven by cigarette volume recovery and strong growth of its foods portfolio. The stock witnessed a strong re-rating over FY05-FY07, driven by strong cigarette volume growth in a strong economic growth environment. During this period, the stock traded between 18x-29x forward P/E. However post imposition of a 12.5% VAT from FY08 (which ITC passed on through price hikes), the stock witnessed a sharp de-rating on concerns pertaining to volume declines. Over 9mFY08, volumes have declined by about 2%, but have started improving sequentially over the last 1-quarter. The stock performance has picked up over the last 3 months driven by lower than expected volume decline; with improving volumes going forward, we believe the stock is likely to be re-rated further. We are therefore raising our target P/E multiple to 23x, towards the mid-point of the last 3 years valuation range. If volume growth were to revert back to 7%-8% levels, we believe that the valuation multiples could look up further. We are assuming 4% volume growth in FY09E and 6% growth in FY10E

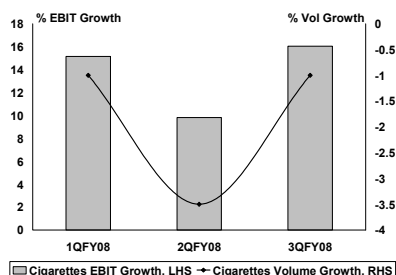
Figure 2. ITC One Year Forward PE v/s Cigarette Volume Growth (%)



Source: Citi Investment Research

## 3QFY08 Results Analysis

Figure 3. ITC: Cigarette EBIT & Volume Growth in FY08



Source: Company Reports

1. **Cigarettes:** 3QFY08 cigarette volumes declined marginally, to less than 1%. ITC's cigarette volumes seem to be improving sequentially and we expect further improvement going forward. However, more than the volumes, we are enthused by the profitability of the cigarette business. Cigarette EBIT increased by 16% yoy, driven by price hikes and improving product mix. ITC had affected average price hike of 20% in April-May 2007 following levy of 12.5% VAT and 6% increase in excise for FY08. ITC's pricing strategy did not leave any price 'gaps' across its cigarette portfolio, and price hikes were heavily loaded in favor of the mid-segment brands (65% of volumes), which has aided cigarette margins. While the blended average price increases across the portfolio is about 20% at the gross level, increase in **net price realizations** (net of excise and VAT) were skewed heavily in favor of the mid segment brands – net price hikes range from 18.5%-72% in the regular filters segment. Overall, even in the event of volume declines, ITC's cigarette margins seem protected. We enumerate below our price hike analysis for ITC:

Figure 4. ITC – Segment Wise Price Hike Analysis

Brand / Segment	Old per stick price (Rs)	New per stick price (Rs)	Inc. in price per stick (Rs)	FY07 per stick excise (Rs)	FY08 per stick excise (Rs)	FY08 VAT per stick (Rs)	FY07 net realization per stick (Rs)	FY08 net realization per stick (Rs)	Change in net realization (Rs)	% Change in net realization
<b>KSFT - 10% of volumes</b>										
555 FT Kings	4.00	4.50	0.50	1.725	1.811	0.45	1.88	1.78	-0.09	-4.8
B. & H. Special	4.00	4.50	0.50	1.725	1.811	0.45	1.88	1.78	-0.09	-4.8
B. & H. Lights	4.00	4.50	0.50	1.725	1.811	0.45	1.88	1.78	-0.09	-4.8
India FT. Kings	4.50	5.00	0.50	1.725	1.811	0.51	2.33	2.18	-0.14	-6.1
India Kings Lights	4.50	5.00	0.50	1.725	1.811	0.51	2.33	2.18	-0.14	-6.1
Classic FT Kings	3.50	4.00	0.50	1.725	1.811	0.40	1.43	1.38	-0.04	-2.8
Classic Mild FT Kings	3.50	4.00	0.50	1.725	1.811	0.40	1.43	1.38	-0.04	-2.8
Classic Menthol FT Kings	3.50	4.00	0.50	1.725	1.811	0.40	1.43	1.38	-0.04	-2.8
Classic Ultra FT Kings	3.50	4.00	0.50	1.725	1.811	0.40	1.43	1.38	-0.04	-2.8
Gold Flake Light Kings	3.30	3.80	0.50	1.725	1.811	0.38	1.25	1.23	-0.02	-1.6
Gold Flake FT Kings	3.40	3.80	0.40	1.725	1.811	0.38	1.34	1.23	-0.11	-8.2
Silk Cut	NA	3.50	NA	1.725	1.811	0.35	NA	0.99	NA	
<b>Longs - 5% of volumes</b>										
Wills FT (Twin)	2.90	3.40	0.50	1.2980	1.363	0.34	1.31	1.35	0.04	3.0
<b>Regulars - 65% of Volumes</b>										
Gold Flake Prm. FT	1.90	2.40	0.50	0.803	0.843	0.24	0.91	1.07	0.17	18.5
Bristol FT	1.45	1.95	0.50	0.803	0.843	0.20	0.50	0.72	0.21	42.4
Bristol FT TT	1.45	1.95	0.50	0.803	0.843	0.20	0.50	0.72	0.21	42.4
Bristol Menthol FT	1.45	1.95	0.50	0.803	0.843	0.20	0.50	0.72	0.21	42.4
Capstan FT	1.40	1.90	0.50	0.803	0.843	0.19	0.46	0.68	0.22	47.7
Wills Flake FT	1.25	1.75	0.50	0.803	0.843	0.18	0.32	0.56	0.23	72.4
Scissors FT	1.45	2.00	0.55	0.803	0.843	0.20	0.50	0.75	0.25	50.4
Scissors Menthol FT	1.45	2.00	0.55	0.803	0.843	0.20	0.50	0.75	0.25	50.4
Silk Cut	NA	2.00	NA	0.803	0.843	0.20	NA	0.75	NA	
<b>Plains - 10% volumes</b>										
Gold Flake	1.50	1.75	0.25	0.535	0.562	0.18	0.82	0.84	0.02	2.6
Scissors NP	1.25	1.50	0.25	0.535	0.562	0.15	0.59	0.64	0.05	7.9
<b>Micros - 10% volumes</b>										
	<b>0.45</b>	<b>0.50</b>	<b>0.05</b>	<b>0.160</b>	<b>0.168</b>	<b>0.05</b>	<b>0.25</b>	<b>0.23</b>	<b>-0.01</b>	<b>-5.5%</b>

Source: Cigarette dealers; Citi Investment Research

- 2. New FMCG business:** New FMCG business sales grew 50% yoy, driven by 60% sales for branded packaged foods. ITC's foods business (excluding Bingo brand) has broken even in 3Q and is expected to return profits going forward. Overall losses for the new businesses continue to decline – EBIT losses as % of sales in 3QFY08 declined to 9.8%, an improvement of 81bps over 2Q last year. Losses would have been much lower, but for marketing expenses related to the launch of shampoos and shower gels under the 'Fiama Di Willis' brand.
- 3. Hotels:** Hotels business revenues started to recover in 3Q and grew 11.4% after slowing over the last 2 quarters. Revenues were curtailed by rupee appreciation, as well as renovation of a block in ITC Maurya (a high end property in Delhi) and Rajputana in Jaipur. ITC has migrated towards complete rupee billing in September to mitigate the impact of rupee appreciation. Its Delhi property has been renovated and was made fully

operational in mid- 3QFY08, while the Jaipur property will be operation in 4Q. This is likely to drive further pick up in growth.

4. **Paperboard and paper:** Paper segment revenues grew 11%, and EBIT margins improved by 42bps. Revenue growth for this division has been adversely impacted on account of cigarette volume slowdown for ITC, though it should pick up as cigarette volumes start to recover. In addition, its new paper mill with 100,000 TPA capacity is likely to be commissioned in 4QFY08.
5. **Agri-business:** Agri-business revenues declined 9.4%, on account of government imposing a ban on non-basmati rice exports. However, EBIT profits increased by 28.1% due to increasing contribution from higher margin leaf tobacco exports, while EBIT margins declined 410bps.

**Figure 5. ITC: 3QFY08 Profit and Loss Summary (Rupees in Millions, Percent)**

	3QFY07	3QFY08	% Change
<b>Gross Sales</b>	<b>49,936.1</b>	<b>54,892.9</b>	<b>9.9</b>
Excise Duty	-18,789.1	-20,313.0	8.1
<i>Excise %</i>	<i>-37.6</i>	<i>-37.0</i>	<i>62bps</i>
<b>Net sales</b>	<b>31,147.0</b>	<b>34,579.9</b>	<b>11.0</b>
Expenditure	-20,319.0	-22,582.7	11.1
<b>Operating profit</b>	<b>10,828.0</b>	<b>11,997.2</b>	<b>10.8</b>
<i>OPM (%)</i>	<i>34.8</i>	<i>34.7</i>	<i>-7bps</i>
Interest	8.7	-18.3	-310.3
Depreciation	-921.0	-1,097.4	19.2
Other income	697.9	1,374.0	96.9
<b>PBT</b>	<b>10,613.6</b>	<b>12,255.5</b>	<b>15.5</b>
Tax	-3,439.6	-3,948.3	14.8
<i>Tax rate (%)</i>	<i>32.4</i>	<i>32.2</i>	<i>-19bps</i>
<b>PAT</b>	<b>7,174.0</b>	<b>8,307.2</b>	<b>15.8</b>
<i>Net Profit Margin</i>	<i>23.0</i>	<i>24.0</i>	<i>99bps</i>
Exceptionals	0.0	0.0	nm
<b>Net Profit post exceptionals</b>	<b>7,174.0</b>	<b>8,307.2</b>	<b>15.8</b>
<b>EPS</b>	<b>1.91</b>	<b>2.21</b>	<b>15.8</b>
<b>Cost Details</b>	<b>3QFY07</b>	<b>3QFY08</b>	<b>% Change</b>
Raw Materials	12,967.3	13,129.5	1.3
<i>% of Sales</i>	<i>41.6</i>	<i>38.0</i>	<i>-366bps</i>
Staff Cost	1,647.1	1,906.4	15.7
<i>% of Sales</i>	<i>5.3</i>	<i>5.5</i>	<i>22bps</i>
Other Expenditure	5,704.6	7,546.8	32.3
<i>% of Sales</i>	<i>18.3</i>	<i>21.8</i>	<i>351bps</i>

Source: Company reports, Citi Investment Research

Figure 6. ITC: 3QFY08 Segmental Details (Rupees in Millions, Percent)

Segmental Revenues (Net)	3QFY07	3QFY08	% Change
<b>FMCG</b>			
Cigarettes Gross	32,787.2	35,294.0	7.6
Cigarettes Net	15,202.0	16,933.4	11.4
Others	4,366.5	6,554.4	50.1
<b>Total FMCG</b>	<b>37,153.7</b>	<b>41,848.4</b>	<b>12.6</b>
Hotels	2,815.9	3,135.9	11.4
Agri business	7,318.9	6,629.4	-9.4
Paperboard, Paper & Packaging	5,432.3	6,039.5	11.2
<b>Total Non-FMCG</b>	<b>15,567.1</b>	<b>15,804.8</b>	<b>1.5</b>
Less : Intersegment Sales	3,482.6	4,134.3	18.7
<b>Total Revenues</b>	<b>49,238.2</b>	<b>53,518.9</b>	<b>8.7</b>
<b>EBIT (INR Mn)</b>	<b>3QFY07</b>	<b>3QFY08</b>	<b>% Change</b>
Cigarettes	8,282.8	9,610.8	16.0
Others	-464.9	-644.7	38.7
<b>Total FMCG</b>	<b>7,817.9</b>	<b>8,966.1</b>	<b>14.7</b>
Hotels	1,184.0	1,377.2	16.3
Agri business	216.6	277.5	28.1
Paperboard, Paper & Packaging	1,041.3	1,182.8	13.6
<b>Total Non-FMCG</b>	<b>2,441.9</b>	<b>2,837.5</b>	<b>16.2</b>
Less: Interest (Net)	-8.7	18.3	-310.3
Less: Net Un-allocable Expenses	-345.1	-470.2	36.3
<b>Total EBIT</b>	<b>10,613.6</b>	<b>12,255.5</b>	<b>15.5</b>
<b>EBIT Margins %</b>	<b>3QFY07</b>	<b>3QFY08</b>	<b>% Change</b>
Cigarettes (EBIT Margins as % of gross sales)	25.3	27.2	197bps
Cigarettes (EBIT Margins as % of net sales)	54.5	56.8	227bps
Other FMCG	-10.6	-9.8	81bps
<b>Total FMCG</b>	<b>21.0</b>	<b>21.4</b>	<b>38bps</b>
Hotels	42.0	43.9	187bps
Agri business	3.0	4.2	123bps
Paperboard, Paper & Packaging	19.2	19.6	42bps
<b>Total Non-FMCG</b>	<b>15.7</b>	<b>18.0</b>	<b>227bps</b>
<b>Total</b>	<b>21.6</b>	<b>22.9</b>	<b>134bps</b>

Source: Company Reports

## ITC

### Company description

ITC is the leading cigarette manufacturer and marketer in India with about 74% share by value. The group is 32% owned by BAT. The company's cigarette portfolio carries 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 in four other business divisions, namely agri / marine products, hotels, paper & packaging and IT. However, more than 75% of its revenue is from the cigarette business. The group has made significant investments in the hotels, paperboard and processed foods (biscuits, ready-to-eat foods, confectioneries) businesses.

## Investment strategy

We rate the stock as Buy/Low Risk (1L) with a target price of Rs247. ITC stock has underperformed the Sensex by 12% over the last 12 months. Post imposition of a 12.5% VAT from FY08 (which ITC passed on through price hikes), the stock witnessed a sharp de-rating on concerns pertaining to volume declines. However, we believe that the worst is now behind us for ITC and that risk-reward is now turning favorable. The stock performance has picked up over the last 3 months driven by lower than expected volume decline; with improving volumes going forward, we believe the stock is likely to be re-rated further. Our analysis also suggests that consumer down trading from high end brands towards mid end brand (regular filters) may not have a negative impact on cigarette margins – on the contrary cigarette operating margins may surprise positively. If this scenario were to play out, then cigarette EBIT would grow higher than our estimates.

## Valuation

Our target price of Rs247 is based on 23x FY09E earnings. We are raising our target multiple for ITC from 20x to 23x. We believe that ITC stock is a re-rating candidate, driven by cigarette volume recovery and strong growth of its foods portfolio. The stock witnessed a strong re-rating over FY05-FY07, driven by strong cigarette volume growth in a strong economic growth environment. During this period, the stock traded between 18x-29x forward P/E, with an average of 24x P/E. However post imposition of a 12.5% VAT from FY08, the stock witnessed a sharp de-rating on concerns pertaining to volume declines. However, volumes have started to improve and we expect them to start growing from FY09E. With rising volumes, the stock is likely to be re-rated. We are therefore raising our target P/E multiple to 23x, towards the mid-point of the last 3 years trading multiple range. If volume growth were to revert back to 7%-8% levels, we believe that the valuations could look up further. We are assuming 4% volume growth in FY09E and 6% growth in FY10E. ITC has a relatively stable earnings stream, so P/E is our primary valuation methodology.

## Risks

We rate ITC as Low Risk because the company operates in branded businesses and its earnings volatility is low. With most of its earnings coming from the tobacco segment, ITC is most at risk from controls and the government's tax policy. Perceived as being a "sin" industry, the stock is prone to negative share price reactions. 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. Upside risks to our target price include continuation of the government's policy of moderating excise taxes and a sharper-than-expected increase in dividend payout. If any of these factors has a greater impact than we expect, the stock could have difficulty achieving our target price.



# Appendix A-1

## Analyst Certification

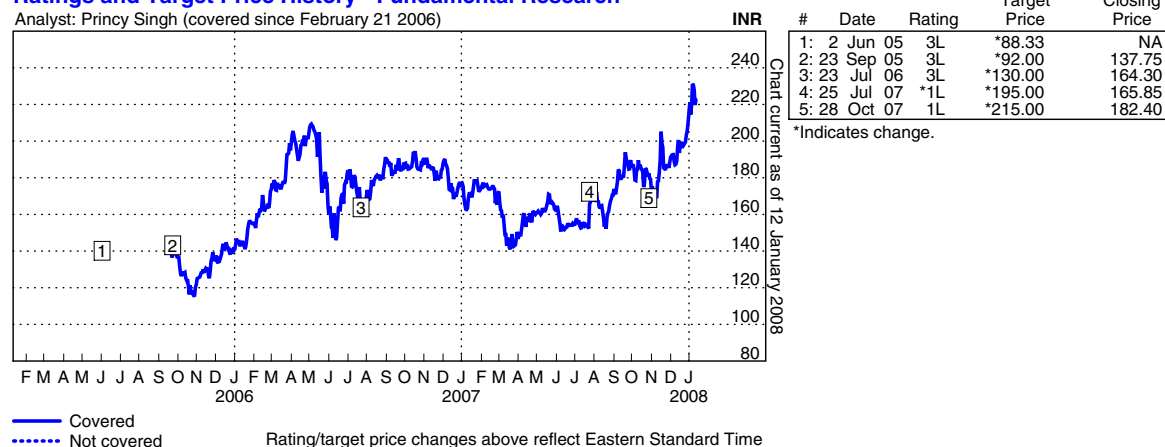
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### ITC (ITC.BO)

#### Ratings and Target Price History - Fundamental Research

Analyst: Princy Singh (covered since February 21 2006)



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