Company

23 July 2009 | 12 pages

ITC (ITC.BO)

Equity ☑
Target price change ☑
Estimate change ☑

Buy: Cigarette Volumes Grow, Other FMCG Losses Subside

- **1QFY10 beats expectations** — ITC reported a healthy 17% Y/Y PAT growth to Rs8.8bn, above our (Rs8.6bn) and Street (Rs8.2bn) estimates. EBITDA margins expanded 385bps Y/Y to 32.8%, driven by steady cigarette business profitability, lower losses in non cigarette FMCG and benefits of mix improvement in the agricultural commodities business.
- **Volumes grow in the cigarette business** — Cigarette volumes rose ~5-6% (after 8Qs of decline/modest growth), as pricing remained stable, given no excise hikes. Segment EBIT margins expanded ~60bps, including one-off costs of ~Rs300m– expenses attributed to changes in packaging as pictorial warnings were introduced. Excluding these, margins rose ~130bps Y/Y.
- **Other FMCG: strategic focus on profitability** — Losses declined ~19% Y/Y – positive as it allays investor concerns on future profitability. Mgmt reiterated that loss levels will be reduced to ~Rs4bn in FY10E – an achievable target, given that the focus in all businesses (personal care, biscuits, staples, retailing) has shifted to profitability rather than revenue growth.
- **Raise earnings estimates** — We increase earnings by 3-7% over FY10-11E on the back of improving profitability from FMCG segments (both cigarette and others) and paper business. Cigarette volume estimates increased to 5% for FY10/11E (from 3.2%/4.7%). We have pared revenues by 8-11% (hotels business remains challenged, rationalization of agri portfolio).
- **Reiterate Buy, raising target price to Rs260** — This is based on 22x Sept10E (a slight premium to the last 3-year average P/E of ~21x. We expect the stock to re-rate as cigarette volumes grow and other FMCG losses abate.

Buy/Low Risk	1L
Price (23 Jul 09)	Rs229.95
Target price	Rs260.00
from Rs225.00	
Expected share price return	13.1%
Expected dividend yield	2.0%
Expected total return	**15.1%**
Market Cap	Rs867,923M
	US$17,925M

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

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2008A	31,201	8.28	15.4	27.8	7.2	27.7	1.5
2009A	32,636	8.65	4.4	26.6	6.3	25.3	1.6
2010E	40,676	10.78	24.6	21.3	5.5	27.6	2.0
2011E	48,426	12.83	19.1	17.9	4.8	28.5	2.4
2012E	55,460	14.69	14.5	15.6	4.1	28.3	2.7

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	2008	2009	2010E	2011E	2012E
Valuation Ratios					
P/E adjusted (x)	27.8	26.6	21.3	17.9	15.6
EV/EBITDA adjusted (x)	19.2	17.4	14.0	11.7	10.1
P/BV (x)	7.2	6.3	5.5	4.8	4.1
Dividend yield (%)	1.5	1.6	2.0	2.4	2.7
Per Share Data (Rs)					
EPS adjusted	8.28	8.65	10.78	12.83	14.69
EPS reported	8.28	8.65	10.78	12.83	14.69
BVPS	32.00	36.39	41.79	48.21	55.56
DPS	3.50	3.70	4.61	5.49	6.29
Profit & Loss (RsM)					
Net sales	139,475	153,881	177,101	204,513	235,270
Operating expenses	-99,747	-110,557	-122,976	-139,522	-160,558
EBIT	**39,728**	**43,324**	**54,125**	**64,991**	**74,711**
Net interest expense	-120	-183	-115	-115	-115
Non-operating/exceptionals	6,109	5,117	6,162	6,761	7,446
Pre-tax profit	**45,718**	**48,257**	**60,172**	**71,637**	**82,042**
Tax	-14,517	-15,622	-19,496	-23,210	-26,582
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	**31,201**	**32,636**	**40,676**	**48,426**	**55,460**
Adjusted earnings	31,201	32,636	40,676	48,426	55,460
Adjusted EBITDA	44,113	48,818	60,175	71,587	81,865
Growth Rates (%)					
Sales	12.8	10.3	15.1	15.5	15.0
EBIT adjusted	10.3	9.1	24.9	20.1	15.0
EBITDA adjusted	11.3	10.7	23.3	19.0	14.4
EPS adjusted	15.4	4.4	24.6	19.1	14.5
Cash Flow (RsM)					
Operating cash flow	**31,460**	**37,281**	**46,547**	**53,641**	**58,600**
Depreciation/amortization	4,385	5,494	6,050	6,596	7,154
Net working capital	-4,847	-4,070	-179	-1,381	-4,014
Investing cash flow	**-19,900**	**-16,429**	**-15,000**	**-15,000**	**-15,000**
Capital expenditure	-21,232	-17,397	-15,000	-15,000	-15,000
Acquisitions/disposals	1,332	968	0	0	0
Financing cash flow	**-14,860**	**-16,231**	**-20,312**	**-24,183**	**-27,695**
Borrowings	136	-369	0	0	0
Dividends paid	-15,432	-16,299	-20,312	-24,183	-27,695
Change in cash	**-3,299**	**4,621**	**11,234**	**14,459**	**15,905**
Balance Sheet (RsM)					
Total assets	**172,495**	**194,848**	**222,664**	**255,436**	**292,653**
Cash & cash equivalent	5,703	10,324	21,558	36,017	51,922
Accounts receivable	7,369	6,687	7,803	8,949	10,227
Net fixed assets	72,957	84,860	93,810	102,213	110,059
Total liabilities	**51,918**	**57,498**	**64,950**	**73,478**	**82,930**
Accounts payable	27,870	29,645	32,995	37,510	43,289
Total Debt	2,144	1,776	1,776	1,776	1,776
Shareholders' funds	**120,577**	**137,351**	**157,714**	**181,958**	**209,723**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	31.6	31.7	34.0	35.0	34.8
ROE adjusted	27.7	25.3	27.6	28.5	28.3
ROIC adjusted	25.8	23.5	26.0	28.5	29.8
Net debt to equity	-3.0	-6.2	-12.5	-18.8	-23.9
Total debt to capital	1.7	1.3	1.1	1.0	0.8

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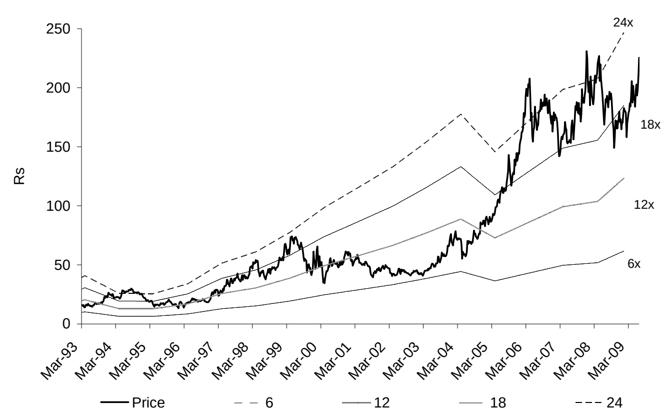
Reiterate Buy, Increasing Target Price to Rs260

We increase our target price to Rs260 (from Rs225) based on 22x Sept10E. The increase in target price is driven by a) 5% increase in effective EPS (average of FY10/11E), and a revision in the multiple to 22x from 20x. We expect the stock to re-rate to 22x – a slight premium to the 21x average it has traded at for the past 3 years, on account of a) resumption in meaningful growth in cigarette volumes after almost 2 years and b) curtailment in loss levels in the non cigarette FMCG business. In future, we expect uncertainty on cigarette volumes to recede as the multiple taxes (VAT, sales tax, etc) coalesce to a uniform GST. We also expect the excise duty regime to remain somewhat benign after 2 years of robust hikes.

We also note that from an absolute P/E perspective, ITC is close to peak valuations (around 24-25x). From a relative P/E perspective, however, ITC appears relatively cheap – trading at around 1.25x – vs. a peak of around 1.7x.

Figure 1. ITC: 1 Year Forward P/E Band Charts



Source: DataStream, Company, Citi Investment Research and Analysis estimates

Figure 2. ITC: Relative P/E to BSE Sensex

Source: DataStream, Company, Citi Investment Research and Analysis estimates

Earnings Revisions- EPS increased by 3-7% over FY10-11E

Figure 3. Earnings Revision Summary

	2010E			2011E		
	Old	New	% Chg	Old	New	% Chg
Cigarette Volume Growth	3.2%	5.2%		4.7%	5.2%	
Sales (Rs Mils.)	191,840	177,101	-8%	230,972	204,513	-11%
EBITDA (Rs Mils.)	57,173	60,175	5%	65,804	71,587	9%
EBITDA Margin (%)	29.8%	34.0%		28.5%	35.0%	
Net Profit (Rs Mils.)	39,503	40,676	3%	45,175	48,426	7%
Diluted EPS (Rs)	10.5	10.8	3%	12.0	12.8	7%
Dividend Per Share (Rs)	4.2	4.6	10%	4.8	5.5	14%

Source: Citi Investment Research and Analysis

1) We reduce our overall FY10-11E revenue assumptions by 8-11% on the back of lacklustre growth in hotels and some rationalization of agri business portfolio.
2) We increase our cigarette volume estimates upward to 5% for FY10/11E (earlier 3.2%, 4.7% for FY10/11 respectively).
3) Profitability of the hotels segment would be affected in FY10E, and we expect some rebound in FY11E (predicated on ~15% revenue growth).
4) We expect loss levels in the non cigarette FMCG to reduce by ~20% - based on mgmt guidance. 1QFY10 is a step in the right direction.
5) Paper business' profitability is forecast to improve as volumes increase and the leverage from the backward integration flows through into profits.
6) We reduce our capex assumptions to the lower end of mgmt guidance band of Rs15-20bn. FY09 capex (Rs15.9bn) was lower than our earlier expectations of Rs18bn.
7) We increase our DPS assumptions by 10-14% in FY10-11E, as we increase earnings and maintain dividend payout at FY08/09 levels of around 40%.

1QFY10 Results Review

Key takeaways:

EBITDA margins positively surprised - expanded 385bps Y/Y and 40bps QoQ to 32.8%; attributed to

a) robust cigarette business performance,

b) ~19% decline in non cigarette FMCG losses,

c) 650bps expansion in the agri business due to mix improvement

PAT growth of 17% was above expectations, driven by 19% growth in EBITDA as benefits of raw material costs accrued

Revenue growth was a muted ~5% Y/Y, despite a 14% growth in overall FMCG segments. Lower growth was due to a decline in the hotels division and a sharp (but planned) decline in agri businesses

Figure 4. 1QFY10 Results Summary (Rupees in Million, %)

	1QFY09	1QFY10	%YOY
Gross Sales	**59,589**	**62,687**	**5.2**
Excise Duty	(20,592)	(21,860)	6.2
Excise %	*34.6*	*34.9*	*32 bps*
Net sales	**38,997**	**40,827**	**4.7**
Expenditure	(27,726)	(27,456)	(1.0)
Operating profit	**11,271**	**13,371**	**18.6**
OPM (%)	*28.9*	*32.8*	*385 bps*
Interest	(14)	(58)	314.2
Depreciation	(1,261)	(1,516)	20.2
Other income	1,144	1,378	20.5
PBT	**11,140**	**13,175**	**18.3**
Tax	(3,653)	(4,388)	20.1
Tax rate (%)	*32.8*	*33.3*	*51 bps*
PAT	**7,487**	**8,787**	**17.4**
Net Profit Margin (%)	*19.2*	*21.5*	*232 bps*
Exceptionals	-	-	nm
Net Profit post exceptionals	**7,487**	**8,787**	**17.4**
EPS	**2.0**	**2.3**	**17.4**
Cost Details			
Raw Materials	18,036	16,219	(10.1)
% of Sales	*46.2*	*39.7*	*-652 bps*
Staff Cost	2,181	2,822	29.4
% of Sales	*5.6*	*6.9*	*132 bps*
Other Expenditure	7,509	8,415	12.1
% of Sales	*19.3*	*20.6*	*136 bps*

Source: Company Reports

Results Analysis

1. Cigarette Volumes Grow: +5-6% Y/Y growth in cigarette volumes led to a robust performance in the segment. We expect ITC's cigarette volumes to improve in future – after a 3% decline in volumes in FY09, growth should rise to 5% in both FY10E and FY11E.

In the quarter, cigarette EBIT rose 17% Y/Y, with EBIT margins increasing ~60bps Y/Y. The extent of margin expansion would be more if we exclude one-off costs (~Rs300m) – these expenses were due to the changes in packaging after pictorial graphic warnings were introduced. Excluding these, margins rose ~130bps Y/Y.

Overall, the smoking ban or pictorial warning on cigarette packs does not seem to have a tangible/substantial impact on volumes. In future, we do not expect pictorial warnings to impact revenues, as cigarettes are typically sold in single sticks, rather than packs.

2. Other FMCG businesses: Overall revenue growth was 9.5% Y/Y; moderated from 10-20% Y/Y levels earlier. EBIT loss at Rs998m declined ~19% Y/Y; which is a positive as it is a step in the right direction, and allays investor concerns related to burgeoning losses in this segment.

We believe that management's guidance of reducing the segment's operating loss for FY10 to ~Rs4bn in FY10E (from Rs4.8bn in FY09) can be met comfortably.

Some key points:

- Personal care portfolio has reached a monthly run rate of Rs300m driven by Vivel/Superia brands. Management indicated that it will continue its investments to grow the Fiama franchise.
- In the biscuits category, the mix of glucose is declining, which augurs well for profitability.
- Within the retail business, the renegotiation of rentals and closure of loss-making stores should reduce losses in this segment too.

3. Hotels: As expected, the disappointing trend continued, with revenues and EBIT declining ~28% Y/Y and 64% Y/Y respectively, below expectations. EBIT margins contracted ~16% Y/Y. It must be noted that 1QFY09 hotels revenues were boosted by IPL. Management also stated that the construction on the Bangalore and Chennai properties was progressing satisfactorily.

4. Paperboard and paper: Paper segment revenues rose ~12% Y/Y and EBIT margins declined ~140bps Y/Y – slightly affected (~Rs100m) by one-off costs on account of packaging for the pictorial warning related issues. In future, we think benefits of an enhanced capacity with the commencement of the new pulp mill will contribute to the profits.

5. Agri-business: Segmental EBIT rose ~31% Y/Y, buoyed by strong growth in leaf tobacco exports – and resulted in a margin increase of 645bps. Revenues, however, declined 48% Y/Y on account of lower soya and wheat output. Mgmt indicated that it is consciously paring revenues of low value addition (and low margin) products.

Figure 5. ITC: Gross Revenue Trends (Rs m)

Revenues	1QFY09	2QFY09	3QFY09	4QFY09	1QFY10	% Change YoY	% Change QoQ
FMCG							
Cigarettes	36,361	36,282	39,015	39,493	41,606	14.4%	5.4%
Others	6,936	7,593	7,223	8,388	7,594	9.5%	-9.5%
Total FMCG	**43,297**	**43,875**	**46,238**	**47,881**	**49,200**	**13.6%**	**2.8%**
Hotels	2,594	2,490	2,705	2,413	1,857	-28.4%	-23.0%
Agri business	18,345	8,641	6,215	5,259	9,406	-48.7%	78.9%
Paperboard, Paper & Packaging	6,517	7,533	6,699	7,470	7,306	12.1%	-2.2%
Total Non-FMCG	**27,457**	**18,663**	**15,620**	**15,143**	**18,569**	**-32.4%**	**22.6%**
Less : Intersegment Sales	12,308	6,198	3,916	4,317	6,460	-47.5%	49.7%
Total	**58,446**	**56,340**	**57,943**	**58,707**	**61,309**	**4.9%**	**4.4%**

Source: Company Reports

Figure 6. EBIT Trends (Rs m)

EBIT	1QFY09	2QFY09	3QFY09	4QFY09	1QFY10	% Change YoY	% Change QoQ
Cigarettes	9,614	10,069	11,341	10,814	11,254	17.1%	4.1%
Others	(1,226)	(1,166)	(1,270)	(1,173)	(998)	-18.6%	-14.9%
Total FMCG	**8,388**	**8,903**	**10,071**	**9,641**	**10,256**	**22.3%**	**6.4%**
Hotels	853	687	911	711	306	-64.1%	-57.0%
Agri business	765	754	502	531	999	30.5%	88.3%
Paperboard, Paper & Packaging	1,234	1,222	1,111	1,519	1,278	3.5%	-15.9%
Total Non-FMCG	**2,852**	**2,664**	**2,523**	**2,761**	**2,583**	**-9.4%**	**-6.4%**
Less: Interest (Net)	14	28	5	137	58	314.2%	-57.3%
Less:Net Unallocable Expenses	87	(342)	(720)	347	(394)	-553.9%	-213.6%
Total	**11,140**	**11,881**	**13,310**	**11,918**	**13,175**	**18.3%**	**10.5%**

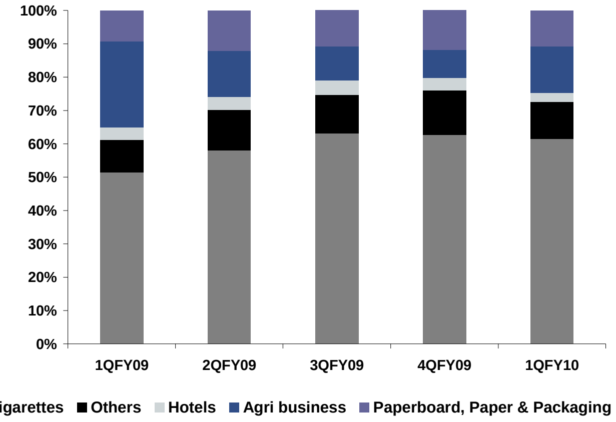
Source: Company Reports

Figure 7. EBIT Margin Trends (%)

EBIT Margins (%)	1QFY09	2QFY09	3QFY09	4QFY09	1QFY10	Change YoY (bps)	Change QoQ (bps)
Cigarettes	26.4	27.8	29.1	27.4	27.0	61	(33)
Others	(17.7)	(15.3)	(17.6)	(14.0)	(13.1)	454	84
Total FMCG	**19.4**	**20.3**	**21.8**	**20.1**	**20.8**	**147**	**71**
Hotels	32.9	27.6	33.7	29.5	16.5	(1,640)	(1,299)
Agri business	4.2	8.7	8.1	10.1	10.6	645	53
Paperboard, Paper & Packaging	18.9	16.2	16.6	20.3	17.5	(144)	(284)
Total Non-FMCG	**10.4**	**14.3**	**16.2**	**18.2**	**13.9**	**352**	**(432)**

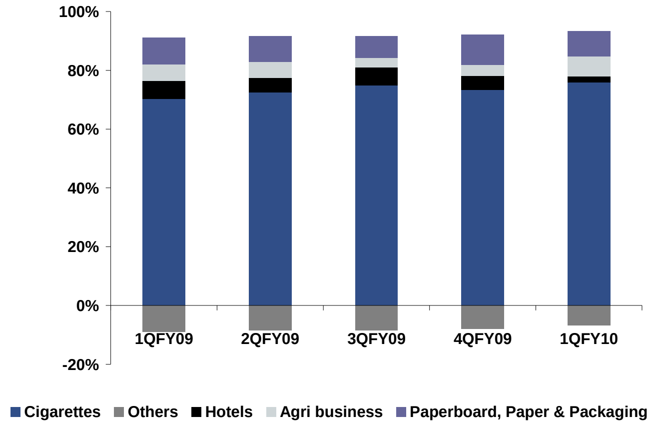
Source: Company Reports

Figure 8. ITC: Revenue Mix (%)



Source: Company Reports

Figure 9. ITC: EBIT Mix (%)



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, about 65% 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 Rs260. After 2 years of a high tax regime (which ITC passed on through price hikes), we believe that in future ITC will face less challenging times and that the risk-reward continues to be favorable. There has been ~70-80% uptrade from the lower-end plains to the mid-end regular filter cigarettes. The resumption of cigarette volume growth should enable the stock's recent re-rating to maintain and improve from current levels. Over the next few years, ITC's overall revenue streams should become far more balanced as the non-tobacco FMCG business attains critical mass (currently 13% of revenues).

Valuation

Our target price of Rs260 is based on 22x Sept-10E earnings. ITC's stock has experienced a gradual re-rating, as concerns pertaining to cigarette volume decline (post the VAT imposition) have been largely unfounded, with overall cigarette volumes declining only c.1-3% in FY08/09, thus underscoring the resilience and defensive attributes of the core cigarette business. Moreover, while PAT and earnings have been somewhat volatile over the past few years, this has been on account of the different growth trajectories and life cycles of

ITC's other businesses, some of which (i.e., the personal care and foods business) are at an extremely nascent stage of operations and have yet to attain sustainable cash generation. Our target P/E multiple of 22x is above the last three-year historical trading average (~21x). We expect uncertainty on cigarette volumes to recede as the multiple taxes (VAT, sales tax, etc) coalesce to a uniform GST. We also expect the excise duty regime to remain somewhat benign after 2 years of robust hikes. This – coupled with lower losses in the non cigarette FMCG business – should enable the stock to re-rate. We also note that from an absolute P/E perspective, ITC is close to peak valuations (around 24-25x). From a relative P/E perspective, however, ITC appears relatively cheap – trading at around 1.25x – vs. a peak of around 1.7x.
ITC has a relatively stable earnings stream, so P/E is our primary valuation methodology.

Risks

We rate ITC shares as Low Risk because the company operates in branded businesses and its earnings volatility is low. Downside risks that could prevent the stock from reaching our target price include: 1) With most of its earnings coming from the tobacco segment, ITC is most at risk from controls and the government's tax policy. 2) Perceived as being a "sin" industry, the stock is prone to negative share price reactions. 3) 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.

Appendix A-1

Analyst Certification

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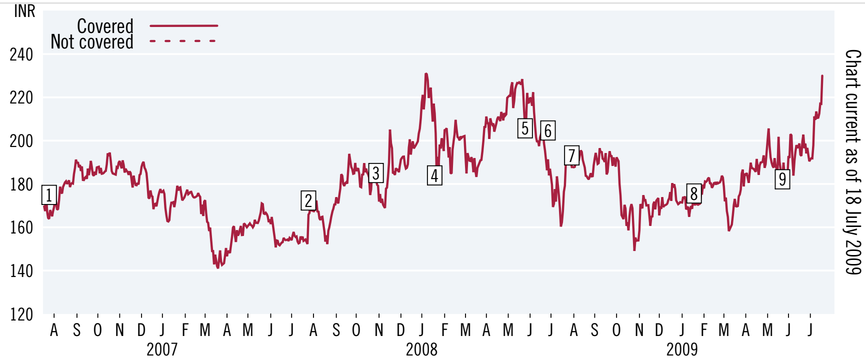
ITC (ITC.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Jamshed Dadabhoy
Covered since May 6 2008



Date	Rating	Target Price	Closing Price
1 24-Jul-06	3L	*130.00	164.30
2 25-Jul-07	*1L	*195.00	165.85
3 28-Oct-07	1L	*215.00	180.80
4 18-Jan-08	1L	*247.00	212.60
5 25-May-08	1L	*243.00	213.60
6 26-Jun-08	1L	*238.00	191.35
7 30-Jul-08	1L	*222.00	187.80
8 19-Jan-09	1L	*210.00	170.55
9 22-May-09	1L	*225.00	183.25

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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