

## Company Focus

28 October 2007 | 12 pages

# ITC (ITC.BO)

 Target price change   
 Estimate change 

## Buy: 2QFY08 – Cigarette Business Showing Resilience

- Cigarette volumes surprise positively** — ITC's cigarette volumes seem to be more resilient to sharp price increases than they have been historically. Volumes in 2QFY08, which we believe is possibly the worst quarter for volumes following 20% price hike, declined only 3.5% against our expectation of 6%-7% decline. ITC management expects the volume trend to improve.
- Raising estimates, price target** — Raising FY08E-FY10E EPS estimates by 8.9%-11.9%, building in lower cigarette volume decline in FY08E, from 5% to 2%. Increasing price target to Rs215, still based on 20x FY09E P/E.
- 2Q profits in-line** — 2QFY08 net profit growth of 13.4% yoy was in-line with our estimates. Positive surprise was 10% growth in cigarette EBIT profits, while agri-business and hotels profit growth were below our expectations.
- Losses in FMCG business abating** — EBIT losses (as % of sales) in new FMCG business are now down to 6% of sales, while the business is scaling up rapidly. New FMCG sales grew 43.3% yoy. ITC is test marketing its personal care products currently, and a national rollout seems imminent.
- Hotels, agri business disappoint** — Hotels and agri-business EBIT growth was below estimates. Hotels suffered due to rupee appreciation and renovation of some properties, while agri-business was hit by a ban on pulses exports and weak domestic prices. ITC has addressed these issues; all hotel room rents will be rupee denominated and e-choupal network is not building new positions.

<b>Buy/Low Risk</b>	<b>1L</b>
Price (26 Oct 07)	Rs180.80
Target price	Rs215.00
	<i>from Rs195.00</i>
Expected share price return	18.9%
Expected dividend yield	2.0%
<b>Expected total return</b>	<b>20.9%</b>
Market Cap	Rs680,639M
	US\$17,293M

### 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	30.1	7.4	26.4	1.5
2007A	27,000	7.18	19.5	25.2	6.5	27.7	1.7
2008E	33,176	8.82	22.9	20.5	5.6	29.2	2.0
2009E	40,466	10.76	22.0	16.8	4.7	30.2	2.3
2010E	49,613	13.19	22.6	13.7	3.9	31.1	2.8

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)	30.1	25.2	20.5	16.8	13.7
EV/EBITDA adjusted (x)	19.2	16.1	13.2	10.5	8.3
P/BV (x)	7.4	6.5	5.6	4.7	3.9
Dividend yield (%)	1.5	1.7	2.0	2.3	2.8
<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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## Cigarette Business Showing Resilience

ITC's 2QFY08E cigarette EBIT profits increased 10% yoy, despite a 3.5% decline in volumes. We had expected ITC's cigarette volumes to decline by 6%-7% in 2QFY08, given that the impact of price hikes as well as the UP state trade tax were actually fully felt only in 2Q. However, the volumes seem to have been much more resilient and have surprised us positively, and compared to similar situations in the past. According to ITC management, consumers have been able to absorb the price hikes much better than has been the case historically owing to:

1. A much improved GDP and income growth environment over the last 3 years, compared to earlier years
2. A benign excise environment (5%-6%) excise hikes over the last 3-year, that has allowed ITC to keep its price hikes over the last 3 years (except in FY08) contained to near or sub-inflation levels
3. An expanded brand portfolio that covers all price points on a per stick basis – Rs0.5 to Rs4.5 per stick. Almost 70% of cigarettes in India are sold loose at the retail end

ITC management expects volumes to start recovering. We also believe that 2QFY08 was probably the worst from a cigarette volume perspective and expect volume trend to be better. We are now revising our volume decline estimate for FY08E from a 5% decline to a 2% decline. Given that overall volumes have fared better in 1HFY08, compared to our FY08 estimates, we believe that there is a strong chance of positive surprises on volumes ahead.

**Figure 1. FY08E Earnings Sensitivity to Cigarette Volume Growth**

Cigarette Volume Growth (%)	PAT (Rsm)	% Change from Base Case
-4.0	31,363.8	-5.5
-3.0	32,270.0	-2.7
<b>Base Case -2.0</b>	<b>33,176.2</b>	<b>0.0</b>
-1.0	34,082.0	2.7
0.0	34,988.5	5.5
1.0	35,894.6	8.2
2.0	36,800.8	10.9
3.0	37,706.9	13.7
4.0	38,613.1	16.4

Source: Citi Investment Research estimates

## Raising EPS estimates, target price

Following better than estimated 1HFY08 cigarette volumes and earnings, we are revising up our FY08E-FY10E EPS estimates by 8.9%-11.9%. The key change in our model driving our new estimates is our change in cigarette volume assumptions, which we now expect to decline by 2% in FY08E against a 5% decline assumption that we were building in earlier. Our target price increases to Rs215, still based on 20x FY09E P/E.

Our earnings revision summary is enumerated below:

**Figure 3. ITC Stock Price Performance**

(%)	3M	6M	12M
Absolute	10.3	13.0	(1.1)
Rel. to .BSESN	(7.8)	(14.4)	(33.5)

Source: DataStream

**Figure 2. Earnings Revision Summary**

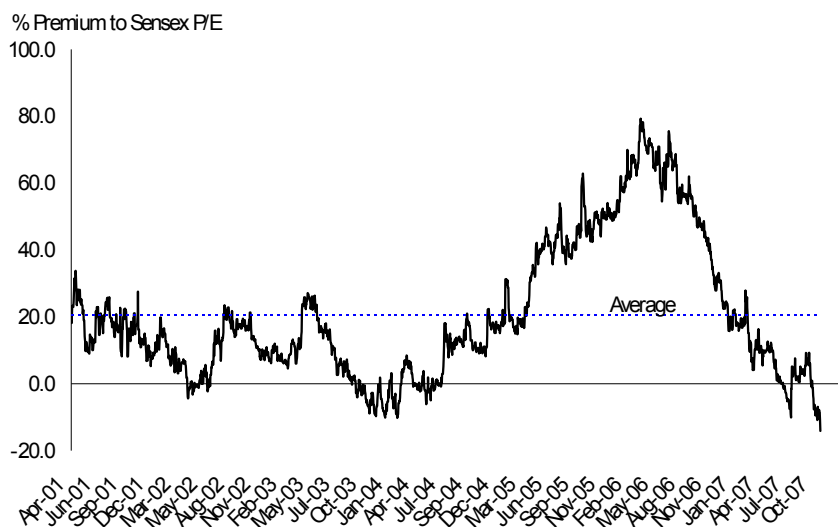
	EPS (Rs)			Net Profit (Rs Mills)			DPS (Rs)		
	Old	New	% Change	Old	New	% Change	Old	New	% Change
2008E	8.1	8.8	8.9	30,458	33,176	8.9	3.5	3.5	0.0
2009E	9.7	10.8	10.5	36,591	40,466	10.6	4.2	4.2	0.0
2010E	11.8	13.2	11.9	44,319	49,613	11.9	5.0	5.0	0.0

Source: Company Reports and Citi Investment Research Estimates

## Valuations seem attractive

ITC stock has underperformed the Sensex by 33.5% over the last 12 months and currently trades at about a 15% discount to the Sensex P/E, at its historical low. Historically, the stock has traded at an average premium of 20% and had only on two occasions before traded at a discount to Sensex P/E. The stock currently trades at a 17x FY09E P/E against FY07-FY10E EPS CAGR of 22.4%. Over the last 3 years, ITC has traded in the range of 15x-28x 1-year forward P/E. With recovery in cigarette volumes, we expect the stock to start trading towards the upper end of its recent valuation band.

**Figure 4. ITC P/E Relative to Sensex P/E**



Source: Company Reports; Citi Investment Research Estimates; DataStream

## 2QFY08 Results Analysis

1. **Cigarettes:** ITC had affected average price hike of 20% following levy of 12.5% VAT and 6% increase in excise for FY08. However, ITC's pricing

strategy that did not leave any price ‘gaps’ across its cigarette portfolio and price hike that were heavily loaded in favor of the mid-segment brands (65% of volumes) have aided. While the blended average price increases work to 20%, increase in net price realizations (net of excise and VAT) work out to be 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 5. 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 43.3% yoy, driven by 54% sales for branded packaged foods. Losses for the new businesses continue to decline – EBIT losses as % of sales are now down to 6%, an improvement of 574bps over 2Q last year. ITC has recently forayed into the shampoo and soaps segments, which are currently in the test marketing

stage. We believe that the company is on track to achieve break even for this business by FY09E.

3. **Hotels:** Hotels business revenues growth slowed to 13.2% yoy, curtailed by rupee appreciation, as well as renovation of a block in ITC Maurya (a high end property in Delhi) at Rajputana in Jaipur. ITC has migrated toward complete rupee billing in September to mitigate the impact of rupee appreciation. Its properties that are under renovation will also be operational in 3QFY08. Management has indicated that hotel segment growth will pick up over the next few quarters.
4. **Paperboard and Paper:** Paper segment revenues grew 13.3%, but EBIT margins contracted by 87bps, mainly due to lower sales contribution from the high margin captive paper division that supplies paper for ITC cigarettes. 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.
5. **Agri-Business:** Agri-business revenues declined 12.5%, while EBIT margins declined 410bps. Agri-business was adversely impacted on account of rupee appreciation, which hurt imports; as well as a depressed domestic market on account of ban on exports and reduction in import duties of certain agri-commodities. ITC is renegotiating its export contracts to take into account the rupee appreciation and expects growth for Agri-business to recover next year.

**Figure 6. ITC 2QFY08 Profit and Loss Summary (Rupees in Millions, Percent)**

	2QFY07	2QFY08	% Change
Gross Sales	46,826.0	52,315.7	11.7
Excise Duty	-18,167.2	-19,581.9	7.8
Excise %	-37.6	-37.4	13bps
<b>Net sales</b>	<b>28,658.8</b>	<b>32,733.8</b>	<b>14.2</b>
Expenditure	-19,149.1	-22,413.9	17.0
<b>Operating profit</b>	<b>9,726.9</b>	<b>10,319.9</b>	<b>6.1</b>
OPM (%)	33.7	31.5	-216bps
Interest	-34.8	-9.1	-73.9
Depreciation	-909.7	-1,062.0	16.7
Other income	794.8	2,082.5	162.0
<b>PBT</b>	<b>9,577.2</b>	<b>11,331.3</b>	<b>18.3</b>
Tax	-2,781.6	-3,622.6	30.2
Tax rate (%)	29.0	32.0	293bps
<b>PAT</b>	<b>6,795.6</b>	<b>7,708.7</b>	<b>13.4</b>
Net Profit Margin (%)	23.5	23.5	2bps
Exceptionals	0.0	0.0	nm
<b>Net Profit post exceptionals</b>	<b>6,795.6</b>	<b>7,708.7</b>	<b>13.4</b>
<b>EPS</b>	<b>1.8</b>	<b>2.0</b>	<b>13.4</b>
<b>Cost Details</b>	<b>2QFY07</b>	<b>2QFY08</b>	<b>% Change</b>
Raw Materials	12,310.9	14,562.7	18.3
% of Sales	42.6	44.5	185bps
Staff Cost	1,496.7	1,750.6	17.0
% of Sales	5.2	5.3	16bps
Other Expenditure	5,341.5	6,100.6	14.2
% of Sales	18.5	18.6	14bps

Source: Company Reports

Figure 7. ITC 2QFY08 Segmental Details (Rupees in Millions, Percent)

Segmental Revenues (Net)	2QFY07	2QFY08	% Change
Cigarettes	14,097.1	15,737.3	11.6
Others	4,096.0	5,870.0	43.3
<b>Total FMCG</b>	<b>18,193.1</b>	<b>21,607.3</b>	<b>18.8</b>
Hotels	1,838.6	2,080.6	13.2
Agri business	8,470.0	7,407.3	-12.5
Paperboard, Paper & Packaging	4,756.5	5,595.8	17.6
<b>Total Non-FMCG</b>	<b>15,065.1</b>	<b>15,083.7</b>	<b>0.1</b>
Less : Inter-segment Sales	4,599.6	3,957.2	-14.0
<b>Total</b>	<b>28,658.6</b>	<b>32,733.8</b>	<b>14.2</b>
EBIT	2QFY07	2QFY08	% Change
Cigarettes	7,866.3	8,638.0	9.8
Others	-489.8	-365.2	-25.4
<b>Total FMCG</b>	<b>7,376.5</b>	<b>8,272.8</b>	<b>12.2</b>
Hotels	577.8	660.3	14.3
Agri business	460.9	99.5	-78.4
Paperboard, Paper & Packaging	1,108.6	1,255.6	13.3
<b>Total Non-FMCG</b>	<b>2,147.3</b>	<b>2,015.4</b>	<b>-6.1</b>
Less: Interest (Net)	34.8	9.1	-73.9
Less: Net Unallocable Expenses	-88.6	-1,052.2	1,087.6
<b>Total</b>	<b>9,577.6</b>	<b>11,331.3</b>	<b>18.3</b>
EBIT Margin (%)	2QFY07	2QFY08	% Change
Cigarettes	55.8	54.9	-91bps
Others	-12.0	-6.2	574bps
<b>Total FMCG</b>	<b>40.5</b>	<b>38.3</b>	<b>-226bps</b>
Hotels	31.4	31.7	31bps
Agri business	5.4	1.3	-410bps
Paperboard, Paper & Packaging	23.3	22.4	-87bps
<b>Total Non-FMCG</b>	<b>14.3</b>	<b>13.4</b>	<b>-89bps</b>
<b>Total</b>	<b>33.4</b>	<b>34.6</b>	<b>120bps</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 Rs215. ITC stock has underperformed the Sensex by 34% over the last 12 months and by 8%

over the last 3 months. The stock de-rating has been triggered by a higher than expected 12.5% VAT on cigarettes, which is likely to pare cigarette volume growth. However, we believe that the worst is now behind us for ITC and that risk-reward is now turning favorable. While recent stock underperformance is already building in a cigarette volume decline in FY08E, we believe that margins could throw up positive surprises. 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 Rs215 is based on 20x FY09E earnings. Historically ITC has traded at an average premium of about 20% to Sensex valuations. Our target price is based on ITC's historical average premium to Sensex P/E. Over the last two years, ITC has traded in a valuation range of 15x-25x. With the overhang of VAT behind us, and with increasing optimism on the core cigarette business, we expect the stock valuations to be re-rated towards the higher end of its recent trading band, which justifies our 20x target multiple. 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

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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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