25 November 2009 (No. of pages: 8)

ITC (ITC IN)

Food, beverage and tobacco: India

6-mth rating: 1

Target price: Rs306.0 (+16.0%)

Share price: Rs263.8 (24 Nov)

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Profitability of non-cigarette FMCG segment continues to improve

1 (*Buy*) rating maintained and target price raised

- ITC's 2Q FY10 results were above our expectation, due mainly to better-than-expected improvement in the profitability of the non-cigarette FMCG segment and robust tobacco-leaf exports. We maintain our **1** (*Buy*) rating with a revised six-month target price of Rs306 (from Rs257), based on a sum-of-the-parts valuation (Rs267/share [a PER of 23x based on our FY11 EPS forecast] for the cigarette business, Rs32/share for the company's other businesses, and Rs7/share for cash and cash equivalents).

Decline in non-cigarette FMCG segment losses

- Losses in the non-cigarette FMCG segment have been declining continuously over the past few quarters. In our view, this has occurred mainly because of improved product mix, better sourcing of raw materials, and supply-chain efficiencies.

Slowdown in hotel business remains a concern

- Even in 2Q FY10, the hotel division continued to be affected by the global economic slowdown. Declines in occupancies and average room rates (ARRs) continued for the quarter ended September 2009. We expect a pick-up by 2H FY10 (the second half of the year is usually a better period for the hotel business), as we already saw some early signs of recovery at the end of 2Q FY10.

Reuters code		ITC.NS

Market data

SENSEX Index		17,131.08
Market cap	(US$bn)	21.51
EV	(US$bn; 10E)	20.7
3-mth avg daily T/O	(US$m)	27.42
Shares outstanding	(m)	3,784
Free float	(%)	73.7
Major shareholder		Tobacco Manufacturers India Ltd (26.3%)
Exchange rate	Rs/US$	46.394

Performance (%)*	1M	3M	6M
Absolute	1.4	9.9	43.7
Relative	(0.5)	0.3	16.5

Source: Daiwa
Note: *Relative to SENSEX Index

Investment indicators

		2010E	2011E	2012E
PER	(x)	25.1	21.8	19.2
PCFR	(x)	28.0	26.6	23.5
EV/EBITDA	(x)	16.8	14.9	13.1
PBR	(x)	6.2	5.4	4.6
Dividend yield	(%)	1.5	1.7	1.7
ROE	(%)	26.7	26.5	25.8
ROA*	(%)	20.0	20.3	20.1
Net debt equity	(%)	Net cash	Net cash	Net cash

Source: Daiwa forecasts
Note: *Net of deferred liability

Price and relative performance

Source: Bloomberg, Daiwa

Income summary

Year to 31 Mar	Revenue (Rs m)	(%)	EBITDA (Rs m)	(%)	Net profit (Rs m)	(%)	EPS (Rs)	(%)	CFPS (Rs)	DPS (Rs)
2008	139,475	*12.8*	44,165	*11.5*	31,200	*15.6*	8.279	*15.4*	6.727	3.500
2009	153,881	*10.3*	48,402	*9.6*	32,636	*4.6*	8.647	*4.4*	8.460	3.700
2010E	170,521	*10.8*	57,023	*17.8*	39,680	*21.6*	10.513	*21.6*	9.424	4.000
2011E	190,831	*11.9*	64,406	*12.9*	45,732	*15.3*	12.116	*15.3*	9.922	4.500
2012E	211,839	*11.0*	72,913	*13.2*	51,992	*13.7*	13.775	*13.7*	11.246	4.500

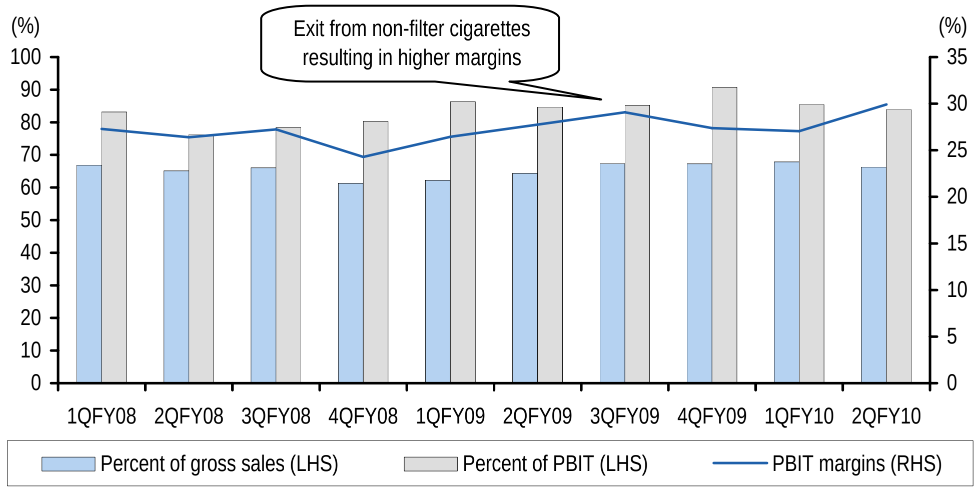
Source: Company, Daiwa forecasts
Note: The investment indicators and income summary on the front page of this report, as well as the back-page financial summary, are all based on the forex assumptions set out in the table at the back of this report, unless stated otherwise.

Cigarettes continue to drive profit

Cigarette revenue continues to rise strongly

The cigarette division contributed 66.3% of 2Q FY10 revenue. The company experienced pressures due to the smoking ban in public places, the imposition of graphic health warnings on tobacco products, an increase in VAT rates on cigarettes to 20% from 12.5% by some states, including Maharashtra, Delhi, Rajasthan, and Pondicherry, and the exit from popular low-priced micros and plain non-filter cigarettes. In spite of these pressures, the cigarette division's net revenue continued its strong growth, expanding 21% YoY in 2Q FY10.

ITC: cigarettes' quarterly contribution to gross sales and PBIT, and PBIT margins



Source: Company, compiled by Daiwa

Reduction in other FMCG losses and improvement in margins

We forecast the losses of the FMCG business to decline to under Rs4bn from FY10 onward

The improved product mix, better sourcing of raw materials, better servicing of markets, better consumer franchise, and supply-chain efficiencies helped ITC sales in this division to increase by 14% YoY in 2Q FY10. The margins were also positively affected by cost-curtailment activities. We expect annual losses for this business to decline to under Rs4bn from FY10 onward, from the current level of around Rs5bn, and for this reduction in losses to come from focusing on higher-end consumer products, rather than on consumer staples.

India's second-largest exporter of agri-products

Continuing as the global leader in the integrated tobacco-leaf business

Agri-business experienced sales growth of 19% YoY in 2Q FY10. The business continues to provide strategic sourcing support to the company's cigarette business by ensuring international-quality supplies. ITC's main customers include the major tobacco companies around the world. The agri-business contributed 16.3% of 2Q FY10 gross revenue. The PBIT margin almost doubled during the same period. In 2Q FY10, company experienced lower throughput of soya, coffee, and spices, affecting the overall agri-product revenue.

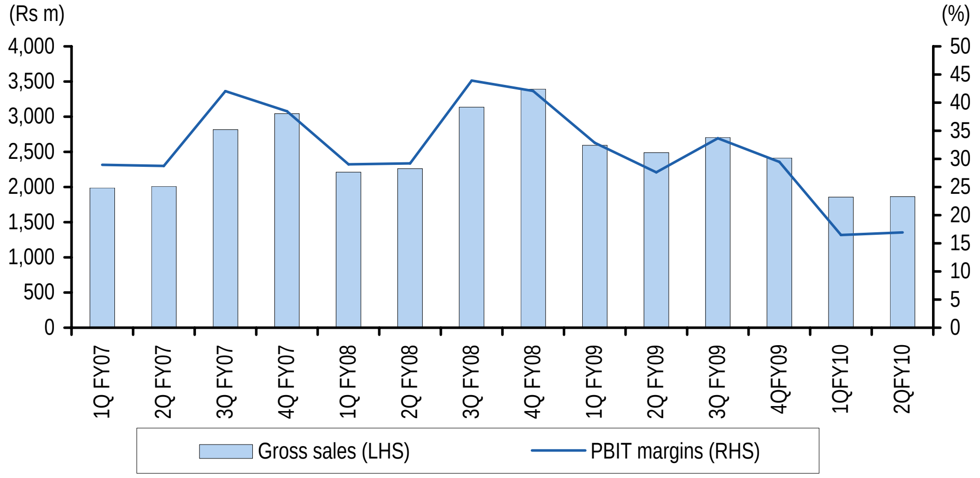
Hotel business continues to experience pressure

We expect a recovery in the hotel business in 2H FY10

Due to the economic slowdown, a drop-off in domestic air travel, and a slowdown in inbound tourism, the hotel business recorded a drop in occupancy rates and average room rates in 2Q FY10. The improvements in occupancies in the last couple of weeks of 2Q FY10 could indicate early signs of recovery in this division. In 2Q FY10, hotels contributed 3% of the company's gross revenue. The *ITC Royal Gardenia* opened in Bangalore in 2Q FY10.

The hotel business is cyclical in nature. Margins are usually higher in the second half of the year, as occupancy and room rates during the peak season are higher than those during the off-season (the second quarter of the year).

ITC: hotel segment: gross sales and PBIT margins



Source: Company

ITC: Daiwa earnings-forecasts revisions (Rs m)

Year to 31 March	2010E	2011E	2012E
Total revenue			
Sales – new	170,521	190,831	211,839
Sales – previous	164,917	181,747	200,892
Change (%)	3.4	5.0	5.4
EPS (Rs)			
EPS – new	10.5	12.1	13.8
EPS – previous	10.0	11.3	12.7
Change (%)	5.1	6.9	8.3
Net profit			
Net profit – new	39,680	45,732	51,992
Net profit – previous	37,751	42,786	48,026
Change (%)	5.1	6.9	8.3

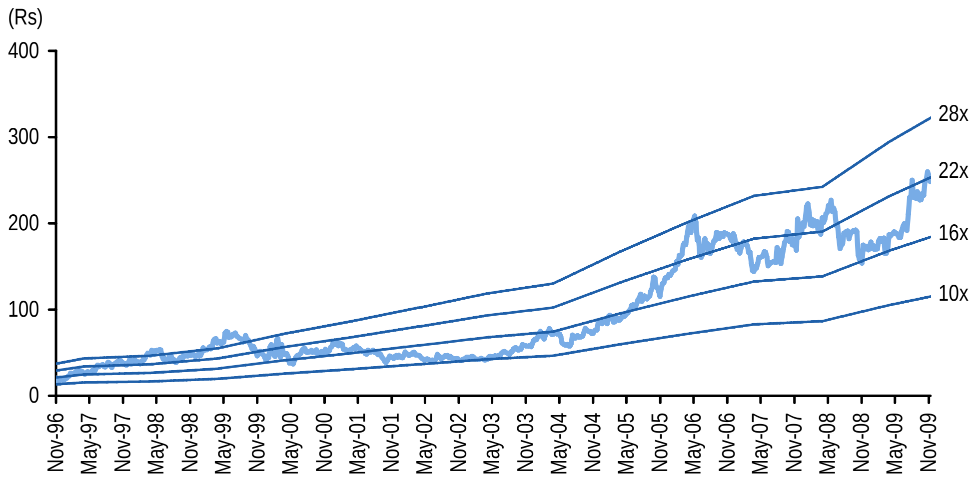
Source: Daiwa forecasts

Valuation and target price

Over the past three years, ITC has traded in a PER range of about 17-25x

The company has traded within a PER range of about 17-25x over the past three years. In our view, the stock's recent fluctuations within this band have more to do with news flow related to the cigarette business. We believe the company deserves to trade at around the 20x PER level.

ITC: one-year forward PER bands



Source: Bloomberg, Company, Daiwa forecasts

We use a SOTP method to arrive at our six-month target price

We use a sum-of-the-parts (SOTP) method to value the different parts of the company's business (see the following table for a breakdown). We maintain our **1** (*Buy*) rating, with a revised six-month target price of Rs306 (from Rs257), based on our SOTP valuation (Rs267/share [a PER of 23x based on our FY11 EPS forecast] for the cigarette business, Rs32/share for the other businesses, and Rs7/share for cash and cash equivalents).

ITC: SOTP valuation

Segment	Rs	Methodology	Multiple (x)	Remarks
Cigarettes	267	PER	23.0	Discount to the historical PER of 25x enjoyed by HUL
FMCG	13	EV/sales	1.5	In line with Nestle India
Hotels	9	EV/EBITDA	10.0	In line with Indian Hotels (IH IN, not rated)
Agri Business	2	EV/EBITDA	5.0	We expect EBITDA growth of over 20%
Paperboards	8	EV/EBITDA	5.0	We expect EBITDA growth of around 15%
Net cash	7			
Total	306			

Source: Daiwa forecasts

Company background

ITC was incorporated in 1910 as Imperial Tobacco Company of India Ltd. as a pure cigarette and tobacco-leaf business. Currently, it has a diversified presence across a number of product ranges under various basic segments including other FMCG, hotels, agri-business, and paper and packaging. Its core competencies lie with its distribution reach and effective supply-chain management. In addition to this, the company has also made initiatives targeting India's rural population through its e-choupal, choupal saagars and choupal fresh outlets.

ITC – financial summary

Profit and loss (Rs m)

Year to 31 March	2008	2009	2010E	2011E	2012E
Cigarettes	138,256	151,151	176,890	194,647	211,664
Other FMCG	25,111	30,140	32,161	33,314	39,927
Hotels	11,002	10,203	8,633	9,924	10,816
Agri-business	38,684	38,460	28,027	30,994	34,622
Paper & packaging	23,643	28,220	29,206	32,214	37,091
Total	236,696	258,173	274,917	301,093	334,119
Less: inter-segment revenue	23,137	26,738	16,858	15,095	16,924
Gross revenue	213,559	231,435	258,059	285,998	317,195
Less: excise	74,084	77,554	87,538	95,167	105,356
Net sales	139,475	153,881	170,521	190,831	211,839
Other operating income	0	0	0	0	0
Total revenue	139,475	153,881	170,521	190,831	211,839
YoY growth (%)	12.8	10.3	10.8	11.9	11.0
Total operating expenses	95,309	105,479	113,499	126,425	138,926
EBITDA	44,165	48,402	57,023	64,406	72,913
Margins (%)	31.7	31.5	33.4	33.8	34.4
YoY growth (%)	11.5	9.6	17.8	12.9	13.2
Depreciation	4,385	5,494	6,478	7,700	8,965
EBIT	39,781	42,908	50,544	56,705	63,948
Other income	6,109	5,349	8,423	11,228	13,260
Interest	173	0	183	183	183
PBT	45,717	48,257	58,785	67,751	77,025
Tax	14,517	15,622	19,105	22,019	25,033
Tax rate (%)	31.8	32.4	32.5	32.5	32.5
Minority interests	0	0	0	0	0
Adjusted PAT	31,200	32,636	39,680	45,732	51,992
Net-profit margin (%)	22.4	21.2	23.3	24.0	24.5
Extraordinary items	0	0	0	0	0
Reported PAT	31,200	32,636	39,680	45,732	51,992

Cash flow (Rs m)

Year to 31 March	2008	2009	2010E	2011E	2012E
PBT	45,717	48,257	58,785	67,751	77,025
Depreciation	4,385	5,494	6,478	7,700	8,965
Net change in working capital	(4,847)	(4,070)	(2,165)	(4,756)	(5,251)
Others	(13,795)	(12,400)	(19,105)	(22,019)	(25,033)
CFO	31,460	37,281	43,992	48,677	55,706
Capex	(21,232)	(17,397)	(18,149)	(18,097)	(18,095)
Net investments made	(102)	(467)	0	0	0
Others investing activities	1,434	1,435	0	0	0
CFI	(19,900)	(16,429)	(18,149)	(18,097)	(18,095)
Change in share capital	6	6	0	0	0
Change in debt	136	(369)	0	0	0
Dividend and dividend tax	(15,432)	(16,299)	(17,663)	(19,871)	(19,871)
Others	431	431	0	0	0
CFF	(14,859)	(16,231)	(17,663)	(19,871)	(19,871)
Total cash generated	(3,299)	4,621	8,180	10,708	17,740
Cash opening balance	9,002	5,702	10,324	18,504	29,212
Cash Closing Balance	5,702	10,324	18,504	29,212	46,952
Cash and Equivalents	26,592	29,778	37,958	48,667	66,406

Balance sheet (Rs m)

As at 31 March	2008	2009	2010E	2011E	2012E
Paid-up capital	3,769	3,774	3,774	3,774	3,774
Reserves & surplus	116,808	133,576	155,593	181,453	213,574
Total equity	120,577	137,351	159,367	185,228	217,348
Minority interests	0	0	0	0	0
Total debt	2,144	1,776	1,776	1,776	1,776
Deferred liabilities	5,451	8,672	8,672	8,672	8,672
Other non-current liabilities	0	0	0	0	0
Capital employed	128,172	147,798	169,814	195,675	227,796
Total cur. lia. & prov.	44,323	47,050	49,157	53,203	57,735
Total liabilities	172,495	194,848	218,971	248,878	285,530
Net fixed assets	72,956	84,860	96,531	106,927	116,057
Investments	8,456	8,923	8,923	8,923	8,923
Inventory	40,505	45,997	49,217	55,123	61,738
Debtors	7,369	6,687	7,410	8,292	9,205
Other current assets	16,616	18,603	18,932	20,946	23,201
Cash and equivalents	26,592	29,778	37,958	48,667	66,406
Total current assets	91,083	101,066	113,517	133,028	160,550
Total assets	172,495	194,848	218,971	248,878	285,530

Ratios

Year to 31 March	2008	2009	2010E	2011E	2012E
Adj. EPS (Rs)	8.3	8.6	10.5	12.1	13.8
YoY change (%)	15.4	4.4	21.6	15.3	13.7
Cash EPS (Rs)	9.4	10.1	12.2	14.2	16.2
EBITDA – core (%)	31.7	31.5	33.4	33.8	34.4
Net-profit margin (%)	22.4	21.2	23.3	24.0	24.5
Net debt to equity (x)	net cash	net cash	net cash	net cash	net cash
PER (x)	31.9	30.5	25.1	21.8	19.2
EV/EBITDA core (x)	22.0	20.0	16.8	14.9	13.1
PBR (x)	8.2	7.2	6.2	5.4	4.6
EV/sales (x)	7.0	6.3	5.6	5.0	4.5
ROCE (%)	27.3	24.9	26.5	26.3	25.7
ROE (%)	27.7	25.3	26.7	26.5	25.8
ROIC (%)	33.0	28.7	29.4	29.3	29.7
BVPS (Rs)	32.0	36.4	42.2	49.1	57.6
DPS* (Rs)	3.5	3.7	4.0	4.5	4.5
Dividend-payout ratio (%)	42.3	42.8	38.0	37.1	32.7
Dividend yield (%)	1.3	1.4	1.5	1.7	1.7
Sales/total assets** (x)	0.9	0.9	0.9	0.8	0.8
Avg. collection days	18	17	15	15	15
Avg. inventory days (on opex.)	142	150	153	151	154

Source: Company, Daiwa forecasts
*Excludes dividend tax
**Net of deferred liability

Daiwa forex assumptions (vs. US$)

Year end	Rmb	HK$	W	S$	NT$	A$	Rs	Rp	RM
2007	7.300	7.800	935.8	1.440	32.432	1.143	39.413	9,400	3.310
2008	6.828	7.750	1,259.6	1.430	32.792	1.423	48.803	11,120	3.460
2009E	6.700	7.800	1,200.0	1.410	32.500	1.250	47.000	9,800	3.480
2010E	6.450	7.800	1,160.0	1.390	32.200	1.120	46.100	9,500	3.440
2011E	6.200	7.800	1,100.0	1.370	32.400	1.160	45.500	9,500	3.420

Source: Daiwa

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