Company Focus

24 October 2008 | 10 pages

ITC (ITC.BO)

Results

Buy: 2QFY09 – Results Above Expectations

- **PAT growth +4% Y/Y** — ITC's 2Q results were ~6% above our (subdued) estimates, marginally 2% below consensus estimates. Key variance was attributed to 190bps EBITDA margin compression (at 29.7%, 130bps below estimates) as ad spends on the FMCG business rose substantially.
- **Cigarette segmental EBIT +17% Y/Y** — This was driven by revenue growth of c11% and c130bps margin expansion (both Y/Y and Q/Q). Overall segmental performance was slightly ahead of expectations. 2Q cigarette volumes were –c3% Y/Y.
- **Investments in FMCG impact "other FMCG" profits** — EBIT loss of ~Rs1.16bn was driven by aggressive investments in brand building / ad spends. Management indicated that FY09 losses would be capped in the range of ~Rs4-4.2bn. Mgmt guided to improvement in margins from 4Q, as commodity costs (wheat, oils, etc.) decline.
- **Good quarter for the agri business; hotels lackluster; paper disappoints** — Agri business surprised positively as EBIT margins rose 7% Y/Y, driven by exports of tobacco leaf and soya. Hotel business EBIT was +4%, impacted by lower occupancy levels. FY09 EBIT guidance was maintained at c15%, implying 2H will be seasonally weaker. Paper EBIT was -3% Y/Y as mill commissioning resulted in heightened depreciation levels.
- **Reiterate Buy (1L)** — Defensive appeal persists in this uncertain environment. Cigarette business continues to demonstrate resilience. Near term concerns on FMCG losses should abate as loss levels remain under control.

Buy/Low Risk	1L
Price (24 Oct 08)	Rs159.20
Target price	Rs222.00
Expected share price return	39.4%
Expected dividend yield	2.3%
Expected total return	**41.8%**
Market Cap	Rs600,210M
	US$12,082M

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 (%)
2007A	27,000	7.18	18.2	22.2	5.7	27.7	1.9
2008A	31,201	8.29	15.6	19.2	5.0	27.7	2.2
2009E	34,575	9.19	10.8	17.3	4.3	26.6	2.3
2010E	41,225	10.96	19.2	14.5	3.7	27.5	2.8
2011E	48,284	12.83	17.1	12.4	3.2	27.8	3.2

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	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	22.2	19.2	17.3	14.5	12.4
EV/EBITDA adjusted (x)	14.5	13.2	11.8	9.9	8.4
P/BV (x)	5.7	5.0	4.3	3.7	3.2
Dividend yield (%)	1.9	2.2	2.3	2.8	3.2
Per Share Data (Rs)					
EPS adjusted	7.18	8.29	9.19	10.96	12.83
EPS reported	7.18	8.29	9.19	10.96	12.83
BVPS	27.74	32.05	36.94	42.77	49.60
DPS	3.10	3.51	3.68	4.38	5.13
Profit & Loss (RsM)					
Net sales	123,693	139,475	161,697	195,075	234,496
Operating expenses	-87,684	-99,747	-117,555	-141,596	-171,114
EBIT	**36,009**	**39,728**	**44,141**	**53,478**	**63,383**
Net interest expense	-107	-120	-139	-139	-139
Non-operating/exceptionals	3,365	6,109	6,695	7,108	7,555
Pre-tax profit	**39,267**	**45,718**	**50,697**	**60,447**	**70,798**
Tax	-12,267	-14,517	-16,122	-19,222	-22,514
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	**27,000**	**31,201**	**34,575**	**41,225**	**48,284**
Adjusted earnings	27,000	31,201	34,575	41,225	48,284
Adjusted EBITDA	39,638	44,113	49,420	59,697	70,363
Growth Rates (%)					
Sales	26.3	12.8	15.9	20.6	20.2
EBIT adjusted	20.0	10.3	11.1	21.2	18.5
EBITDA adjusted	18.9	11.3	12.0	20.8	17.9
EPS adjusted	18.2	15.6	10.8	19.2	17.1
Cash Flow (RsM)					
Operating cash flow	**24,070**	**31,460**	**33,388**	**40,658**	**45,076**
Depreciation/amortization	3,629	4,385	5,279	6,219	6,980
Net working capital	-8,040	-4,848	-6,466	-6,786	-10,188
Investing cash flow	**-11,195**	**-19,900**	**-20,000**	**-20,000**	**-20,000**
Capital expenditure	-15,687	-21,232	-20,000	-20,000	-20,000
Acquisitions/disposals	4,492	1,332	0	0	0
Financing cash flow	**-12,432**	**-14,860**	**-16,181**	**-19,293**	**-22,597**
Borrowings	812	136	0	0	0
Dividends paid	-13,645	-15,432	-16,181	-19,293	-22,597
Change in cash	**443**	**-3,299**	**-2,793**	**1,365**	**2,479**
Balance Sheet (RsM)					
Total assets	**149,684**	**172,495**	**197,728**	**228,016**	**263,185**
Cash & cash equivalent	9,002	5,703	2,909	4,274	6,753
Accounts receivable	6,367	7,369	10,001	11,656	13,661
Net fixed assets	56,109	72,957	87,678	101,459	114,479
Total liabilities	**45,313**	**51,918**	**58,757**	**67,114**	**76,595**
Accounts payable	23,848	27,870	33,837	38,944	44,968
Total Debt	2,009	2,144	2,144	2,144	2,144
Shareholders' funds	**104,371**	**120,577**	**138,971**	**160,902**	**186,589**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	32.0	31.6	30.6	30.6	30.0
ROE adjusted	27.7	27.7	26.6	27.5	27.8
ROIC adjusted	31.4	25.8	23.2	23.9	24.2
Net debt to equity	-6.7	-3.0	-0.6	-1.3	-2.5
Total debt to capital	1.9	1.7	1.5	1.3	1.1

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2QFY09 Results Review

Key takeaways:

Results were above our expectations, (though slightly below consensus); revenues surprised positively

EBITDA margins declined 185 bps to 29.7%, attributed to the continued investments in FMCG – the 41% rise in other expenses may be attributed to the ad expenses

Cigarette margins expanded 135bps Y/Y & 130bps Q/Q. Cigarette volumes were marginally negative.

Figure 1. ITC: 2QFY09 – Profit and Loss Statement (Rupees in Million, Percent)

	2QFY08	2QFY09	%YOY
Gross Sales	**52,283**	**58,439**	**11.8**
Excise Duty	(19,582)	(20,806)	6.2
Excise %	*37.5*	*35.6*	*-185 bps*
Net sales	**32,701**	**37,633**	**15.1**
Expenditure	(22,382)	(26,473)	18.3
Operating profit	**10,320**	**11,160**	**8.1**
OPM (%)	*31.6*	*29.7*	*-190 bps*
Interest	(9)	(28)	205.5
Depreciation	(1,062)	(1,340)	26.2
Other income	2,083	2,098	0.8
PBT	**11,331**	**11,891**	**4.9**
Tax	(3,623)	(3,864)	6.6
Tax rate (%)	*32.0*	*32.5*	*52 bps*
PAT	**7,709**	**8,027**	**4.1**
Net Profit Margin (%)	*23.6*	*21.3*	*-224 bps*
Exceptionals	-	-	nm
Net Profit post exceptionals	**7,709**	**8,027**	**4.1**
EPS	**2.0**	**2.1**	**4.1**
Cost Details			
Raw Materials	14,563	15,484	6.3
% of Sales	*44.5*	*41.1*	*-339 bps*
Staff Cost	1,751	2,377	35.8
% of Sales	*5.4*	*6.3*	*96 bps*
Other Expenditure	6,068	8,612	41.9
% of Sales	*18.6*	*22.9*	*433 bps*

Source: Company Reports

2QFY09 Results Analysis

1. Cigarettes deliver on expectations: Cigarette revenues, +11% Y/Y, was driven by price hikes on key brands (Gold Flake Premium: +12.5% and Gold Flake: +16.7%) + uptrade. As expected, cigarette volumes were marginally negative this Q (down ~3% Y/Y).

Over the Q, cigarette EBIT rose a healthy 17% Y/Y, with EBIT margins expanding 135bps Y/Y, driven by a combination of uptrade + price hikes.

2. Other FMCG – loss levels don't surprise: Overall revenue growth, +30% YoY, was in line with management's trends. EBIT losses at cRs1.16bn were slightly better than our expectations – we reckon overall losses could be contained closer to the cR4-4.2bn range, indicated by management. We estimate advertisement expenses and brand building exceeded Rs1bn this Q, reflected in the sharp 42% rise in 'other expenditure'.

3. Hotels: Hotels revenues rose a sedate 10% Y/Y (marginally higher occupancy levels Y/Y + ~10-12% Y/Y growth in ARRs). EBIT margins contracted by 160bps, given creeping cost pressures. Overall EBIT guidance was maintained at 15% for the fiscal, implying that 2H margins will remain challenged.

4. Paperboard and paper: Segmental revenues rose 22% Y/Y though EBIT margins declined 420bps (impacted by higher depreciation, post the commissioning of both the pulp mill and the paper machine). Management indicated the pulp business' margins should improve going forward with the backward integration provided by the pulp mill. We forecast 17% CAGR in revenues over FY08-10E in this segment, and whilst input costs remain an area of concern, we reckon our current forecasts reflect this.

5. Agri-business: Agri-business revenues rose 17% Y/Y on account of a sharp growth in tobacco leaf exports. This, coupled with a benign base of the previous year, enabled a 7% EBIT margin expansion to 8.7%.

Figure 2. ITC: Gross Revenue Trends (Rs m)

Revenues	2QFY08	3QFY08	4QFY08	1QFY09	2QFY09	% Change YoY	% Change QoQ
FMCG							
Cigarettes	32,717	35,294	35,830	36,361	36,282	10.9%	-0.2%
Others	5,838	6,554	7,384	6,936	7,593	30.1%	9.5%
Total FMCG	**38,555**	**41,848**	**43,214**	**43,297**	**43,875**	**13.8%**	**1.3%**
Hotels	2,261	3,136	3,393	2,594	2,490	10.1%	-4.0%
Agri business	7,407	6,629	10,781	18,345	8,641	16.7%	-52.9%
Paperboard, Paper & Packaging	6,145	6,040	6,197	6,517	7,533	22.6%	15.6%
Total Non-FMCG	**15,814**	**15,805**	**20,371**	**27,457**	**18,663**	**18.0%**	**-32.0%**
Less : Inter segment Sales	4,168	4,134	5,124	12,308	6,198	48.7%	-49.6%
Total	**50,201**	**53,519**	**58,461**	**58,446**	**56,340**	**12.2%**	**-3.6%**

Source: Company Reports

Figure 3. EBIT Trends (Rs m)

EBIT	2QFY08	3QFY08	4QFY08	1QFY09	2QFY09	% Change YoY	% Change QoQ
Cigarettes	8,638	9,611	8,701	9,614	10,069	16.6%	4.7%
Others	(365)	(645)	(1,179)	(1,226)	(1,166)	219.1%	-4.9%
Total FMCG	**8,273**	**8,966**	**7,522**	**8,388**	**8,903**	**7.6%**	**6.1%**
Hotels	660	1,377	1,428	853	687	4.1%	-19.4%
Agri business	100	278	370	765	754	657.8%	-1.5%
Paperboard, Paper & Packaging	1,256	1,183	1,227	1,234	1,222	-2.6%	-1.0%
Total Non-FMCG	**2,015**	**2,838**	**3,025**	**2,852**	**2,664**	**32.2%**	**-6.6%**
Less: Interest (Net)	9	18	27	14	28	205.5%	97.2%
Less:Net Unallocable Expenses	(1,052)	(470)	(322)	87	(342)	-67.5%	-493.4%
Total	**11,331**	**12,256**	**10,842**	**11,140**	**11,881**	**4.8%**	**6.7%**

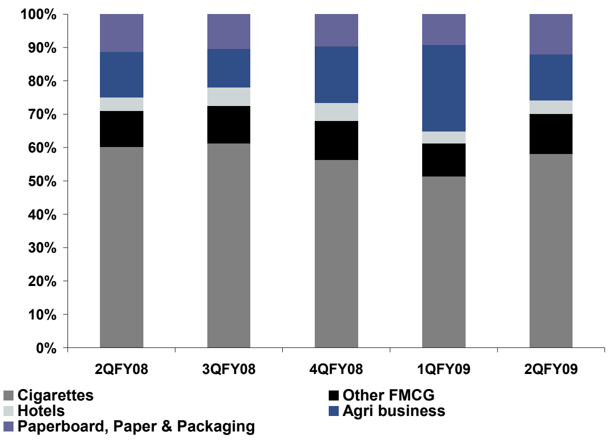
Source: Company Reports

Figure 4. EBIT Margin Trends (%)

EBIT Margins (%)	2QFY08	3QFY08	4QFY08	1QFY09	2QFY09	Change YoY (bps)	Change QoQ (bps)
Cigarettes	26.4	27.2	24.3	26.4	27.8	135	131
Others	(6.3)	(9.8)	(16.0)	(17.7)	(15.3)	(909)	233
Total FMCG	**21.5**	**21.4**	**17.4**	**19.4**	**20.3**	**(117)**	**92**
Hotels	29.2	43.9	42.1	32.9	27.6	(159)	(526)
Agri business	1.3	4.2	3.4	4.2	8.7	738	455
Paperboard, Paper & Packaging	20.4	19.6	19.8	18.9	16.2	(420)	(271)
Total Non-FMCG	**12.7**	**18.0**	**14.8**	**10.4**	**14.3**	**153**	**388**

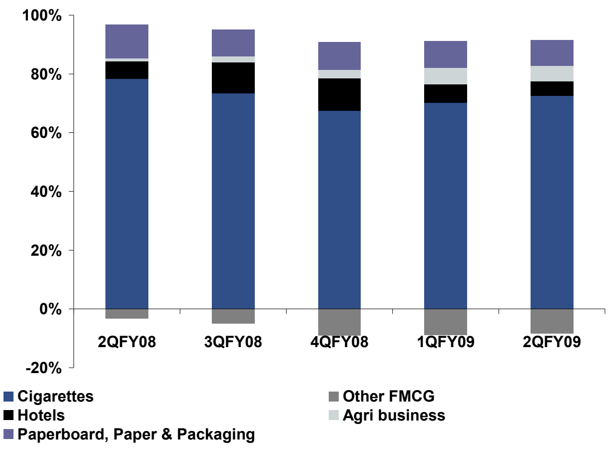
Source: Company Reports

Figure 5. ITC: Revenue Mix (%)



Source: Company Reports

Figure 6. 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 Rs222. ITC stock has outperformed the Sensex by 23% 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. We believe that going forward, ITC will face less challenging times and that the risk-reward continues to be favorable. We expect consumers to trade up from the lower end plains to the mid end regular filter cigarettes. Despite the drop in volumes, we expect overall revenue and margin mix to improve - and cigarette EBIT margins might even surprise positively on account of this uptrade. 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 12% of revenues).

Valuation

Our target price of Rs222 is based on 22x Sept09E 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 c1% in FY08, thus underscoring the resilience and defensive attributes of the core cigarette business. Moreover, whilst 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 at the mid-point of the last three years' trading multiple range. If cigarette volume growth were to revert back to 7%-8% levels, we believe that the stock multiples might re-rate further. We are assuming a c2% decline in volume growth in FY09E, followed by a 3% growth in FY10E. 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

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ITC (ITC.BO)

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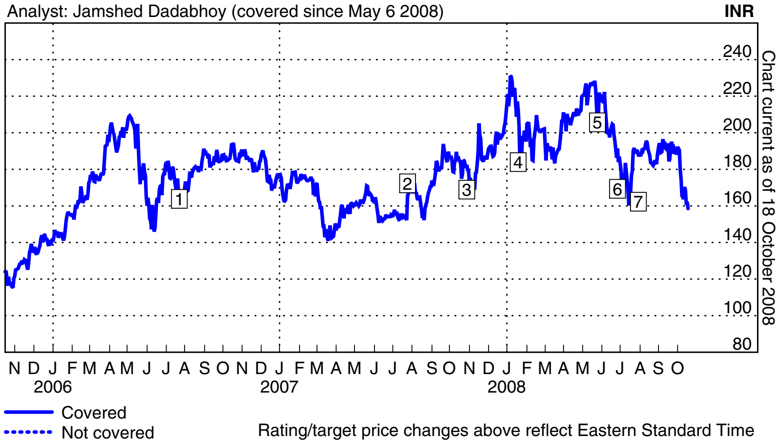
Analyst: Jamshed Dadabhoy (covered since May 6 2008)



#	Date	Rating	Target Price	Closing Price
1:	23 Jul 06	3L	*130.00	164.30
2:	25 Jul 07	*1L	*195.00	165.85
3:	28 Oct 07	1L	*215.00	182.40
4:	18 Jan 08	1L	*247.00	212.60
5:	25 May 08	1L	*243.00	205.70
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*Indicates change.

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