Company

19 July 2010 | 12 pages

ITC (ITC.BO)

Equity

The Read-Through – FY10 Annual Report Analysis

- **Profitability ratios trend up** — RoE and RoCE at c29% and c41% respectively are marginally above the FY09 values, driven by a stable balance sheet size (a tad under Rs150bn) and accompanied by a c175bps EBITDA margin expansion. RoIC (adjusted for cash surpluses), rose to ~58% (vs. 42-48% levels in FY08/09).
- **Cigarette business' operating leverage robust** — We estimate that fixed costs of cigarette business have risen by 23% over the past 4 years – while net cigarette revenues have risen an estimated 75% (primarily driven by price – volumes have risen only ~11% FY06-10). The growth in cigarette EBITDA over the same period has been 81% - illustrating the high operating leverage and sensitivity to pricing.
- **Cash surpluses register sharp increase** — Cash + liquid investments rose to cRs52bn end FY10, from cRs30bn end FY09, and accounted for ~35% of total funds applied. The sharp increase was driven primarily by a ~Rs12bn increase in PBT, and also ~Rs6.1bn generated through better working capital management.
- **Capex: ITC less profligate than perceived** — Historically, investors have been concerned as ITC's capex spends surged over FY07-10 (~Rs16bn annual average), vs. ~Rs6bn between FY04-06. We note these concerns should abate, as the annual capex spends as % of cigarette EBITDA have declined from 45% in FY07 to 24% in FY10. The cigarette EBITDA has risen ~60% over FY07-10, while capex spends have remained relatively static. Given that capex is expected to remain at ~Rs15bn pa, we expect this ratio to decline further.
- **We maintain Buy** — Over the long term, we believe ITC should continue to be a core holding given its strong market positioning and healthy growth in cash flows of the cigarettes business. Over the immediate term, however, we think share price performance could be muted, given a) the recent spike in share price and b) the specter of declining cigarette volumes in 1HFY11.

Buy/Low Risk	**1L**
Price (19 Jul 10)	Rs290.85
Target price	Rs302.00
Expected share price return	3.8%
Expected dividend yield	1.9%
Expected total return	**5.7%**
Market Cap	Rs1,111,986M
	US$23,799M

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 (%)
2009A	32,636	8.65	4.4	33.6	8.0	25.3	1.3
2010A	40,610	10.64	23.0	27.3	7.9	29.2	3.4
2011E	48,816	12.79	20.2	22.7	6.7	31.9	1.9
2012E	56,100	14.69	14.9	19.8	5.8	31.4	2.2
2013E	61,808	16.19	10.2	18.0	5.0	29.7	2.4

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Fiscal year end 31-Mar	2009	2010	2011E	2012E	2013E
Valuation Ratios					
P/E adjusted (x)	33.6	27.3	22.7	19.8	18.0
EV/EBITDA adjusted (x)	22.4	18.0	15.1	13.1	11.8
P/BV (x)	8.0	7.9	6.7	5.8	5.0
Dividend yield (%)	1.3	3.4	1.9	2.2	2.4
Per Share Data (Rs)					
EPS adjusted	8.65	10.64	12.79	14.69	16.19
EPS reported	8.65	10.64	12.79	14.69	16.19
BVPS	36.39	36.84	43.20	50.52	58.59
DPS	3.70	10.00	5.50	6.32	6.96
Profit & Loss (RsM)					
Net sales	153,881	181,532	202,708	231,445	260,947
Operating expenses	-110,557	-126,879	-137,338	-155,898	-177,760
EBIT	**43,324**	**54,653**	**65,370**	**75,547**	**83,187**
Net interest expense	-183	-534	-245	-360	-360
Non-operating/exceptionals	5,117	6,034	7,195	7,923	8,741
Pre-tax profit	**48,257**	**60,153**	**72,321**	**83,110**	**91,568**
Tax	-15,622	-19,543	-23,504	-27,011	-29,760
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	**32,636**	**40,610**	**48,816**	**56,100**	**61,808**
Adjusted earnings	32,636	40,610	48,816	56,100	61,808
Adjusted EBITDA	48,818	60,740	71,920	82,581	90,821
Growth Rates (%)					
Sales	10.3	18.0	11.7	14.2	12.7
EBIT adjusted	9.1	26.1	19.6	15.6	10.1
EBITDA adjusted	10.7	24.4	18.4	14.8	10.0
EPS adjusted	4.4	23.0	20.2	14.9	10.2
Cash Flow (RsM)					
Operating cash flow	**37,281**	**80,587**	**27,777**	**49,473**	**61,147**
Depreciation/amortization	5,494	6,087	6,550	7,034	7,634
Net working capital	-4,070	34,712	-27,589	-13,660	-8,295
Investing cash flow	**-16,429**	**-41,633**	**-15,000**	**-12,000**	**-12,000**
Capital expenditure	-17,397	-12,741	-15,000	-12,000	-12,000
Acquisitions/disposals	968	-28,891	0	0	0
Financing cash flow	**-16,231**	**-38,015**	**-22,574**	**-28,151**	**-31,016**
Borrowings	-369	-698	1,923	0	0
Dividends paid	-16,299	-44,517	-24,497	-28,151	-31,016
Change in cash	**4,621**	**939**	**-9,797**	**9,322**	**18,131**
Balance Sheet (RsM)					
Total assets	**194,848**	**230,053**	**238,311**	**275,146**	**314,950**
Cash & cash equivalent	10,324	11,263	1,466	10,788	28,919
Accounts receivable	6,687	8,588	11,040	12,501	15,107
Net fixed assets	84,860	91,514	99,964	104,930	109,296
Total liabilities	**57,498**	**89,410**	**73,347**	**82,234**	**91,246**
Accounts payable	29,645	34,983	36,907	42,008	48,008
Total Debt	1,776	1,077	3,000	3,000	3,000
Shareholders' funds	**137,351**	**140,644**	**164,964**	**192,912**	**223,704**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	31.7	33.5	35.5	35.7	34.8
ROE adjusted	25.3	29.2	31.9	31.4	29.7
ROIC adjusted	23.5	27.8	31.1	31.5	30.9
Net debt to equity	-6.2	-7.2	0.9	-4.0	-11.6
Total debt to capital	1.3	0.8	1.8	1.5	1.3

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The Read-Through – FY10 Annual Report Analysis

Segmental Focus: Cigarette Business' Operating Leverage

Based on our estimates, we note that the fixed costs of the cigarette business have risen by 23% over the past 4 years – while net revenues have risen an estimated 75% (primarily driven by price – volumes have risen only ~11% FY06-10. The growth in cigarette EBITDA over the same period has been 81% - illustrating the high operating leverage and sensitivity to pricing.

Gross margins are estimated to have declined to ~77% - on account of soaring tobacco costs – up 93% over FY08-10.

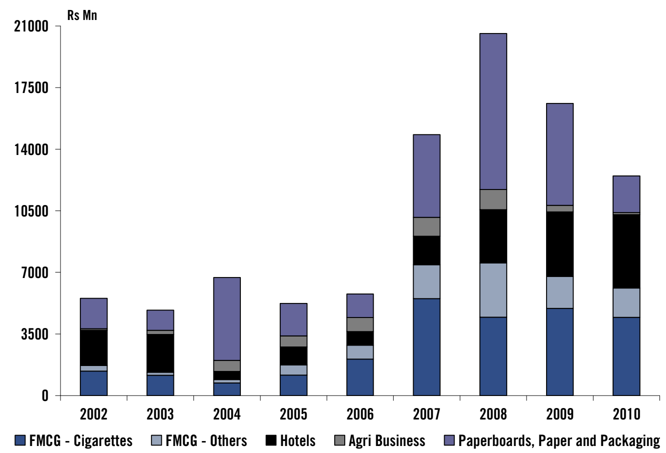
Figure 1. ITC: Cigarette Business (Rs Mn)

Year ended Mar 31	2006	2007	2008	2009	2010
No. of sticks sold	75,894	81,265	80,723	78,370	84,040
Cigarette revenues (gross)	113,297	128,337	138,256	151,151	172,830
less: Excise	(60,171)	(66,671)	(71,484)	(75,582)	(79,619)
Net cigarette revenues	**53,127**	**61,666**	**66,772**	**75,568**	**93,212**
Cigarette related costs	7,818	9,422	9,553	13,786	20,955
Cigarette gross profits	45,309	52,244	57,218	61,782	72,256
GM (%)	85.3%	84.7%	85.7%	81.8%	77.5%
Other expenses	17,187	19,469	19,538	18,368	21,192
EBITDA	**28,122**	**32,775**	**37,680**	**43,414**	**51,064**
EBITDA margin (%)	*52.9%*	*53.1%*	*56.4%*	*57.4%*	*54.8%*

Source: Company Reports and Citi Investment Research and Analysis estimates

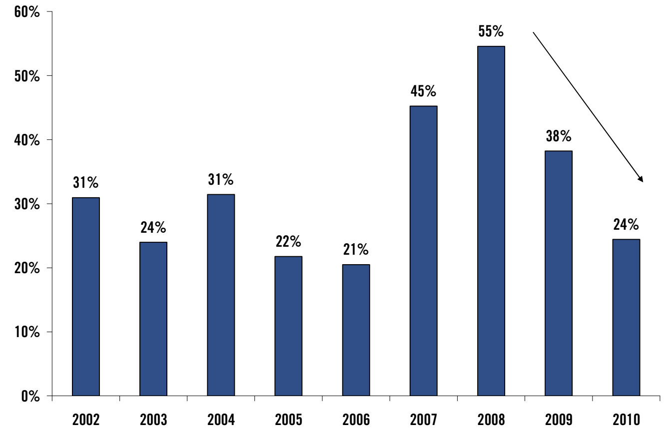
Capex forecast is expected to be ~Rs45-60bn over FY11-13E. Around one-third of this capex is for the hotels business (to add 1,100 rooms over FY12/13 in Chennai and Kolkata) and around 30% in FMCG (including cigarettes). For the cigarettes business, in addition to the new plant, management plans to invest in technology. The paper business (15-20% of budgeted capex) will add another 100,000MT of paperboard capacity by FY12.

Figure 2. Capex Trends



Source: Company Reports

Figure 3. Ratio of Capex / Cigarette EBITDA (%)



Source: Company Reports, CIRA

Annual capex spends as % of cigarette EBITDA have declined from 45% in FY07 to 24% in FY10. Capex is expected to remain at ~Rs15-20bn p.a. over the next 3 years, and cigarette EBITDA is forecast to increase. Thus, we expect this ratio would decline even further.

Balance Sheet Structure –Cash Surpluses Rise Meaningfully

The overall cash and liquid investments rose to cRs52bn end FY10, from cRs30bn end FY09. The sharp increase was driven primarily by a ~Rs12bn increase in PBT, and also ~Rs6.1bn generated through better working capital management. The market value of quoted investments in FY10 was ~Rs13.6bn (Rs912m in FY09); whereas the book value of quoted investments was ~Rs6.8bn. Total value of unquoted investments was Rs52bn as of FY10.

Figure 4. Balance Sheet Structure

	2006	2007	2008	2009	2010
Fixed Assets	46.3%	50.5%	56.9%	57.4%	61.2%
Investments	37.0%	27.6%	22.9%	19.2%	38.3%
Cash	9.0%	8.1%	4.4%	7.0%	7.5%
Net current assets (excluding cash)	7.7%	13.8%	15.7%	16.4%	-7.0%
Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**

Source: Company Reports and CIRA

Working Capital Management Improves: ~Rs6.2bn Cash Flow Generated

The cash flow statement in the FY10 annual report depicts that operating cash flows improved significantly – from Rs32.4bn to Rs46.3bn – driven partly by improvements in working capital.

Figure 5. Working Capital Ratios

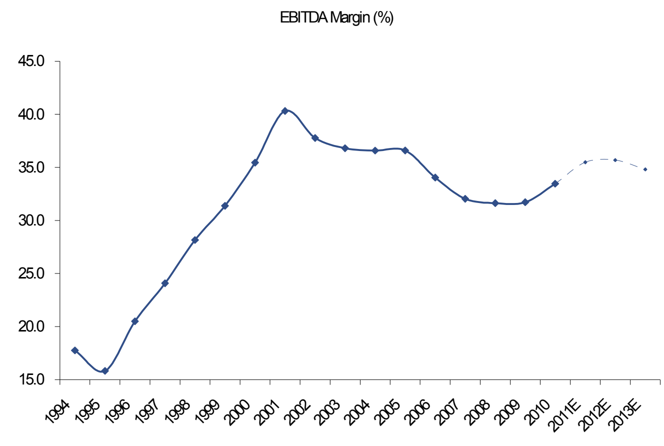
	2006	2007	2008	2009	2010
Inventory turnover (x)	1.72	1.80	1.63	1.49	1.52
Inventory (days)	213	203	225	245	240
Finished goods inventories (days)	18	21	18	26	17
Raw materials (days)	153	138	166	149	160
Collection period (days)	12	12	13	11	12
Payables (days)	124	104	107	103	106
Stores, spares & tools inventory (days)	10.07	8.49	9.45	10.11	9.22
WIP / sales (%)	0.46%	0.46%	0.47%	0.49%	0.44%

Source: Company Reports and CIRA

Vignettes from the Management Discussion and Analysis Section

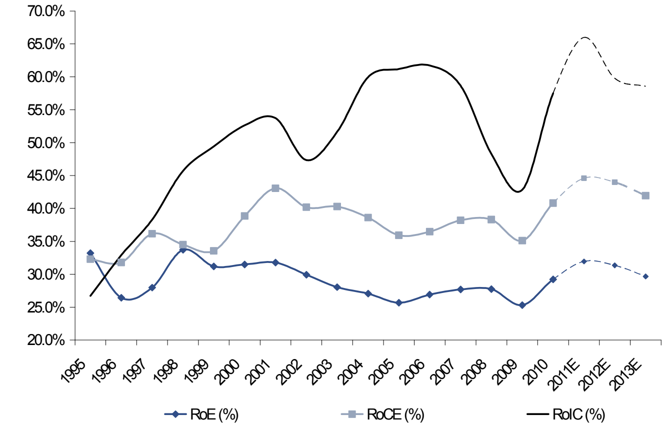
ITC management noted that FY10 was "an impressive performance with a healthy top-line growth and high quality earnings, reflecting the robustness of its corporate strategy of creating multiple drivers of growth". Reflecting the stability of its businesses, ITC's net revenues and PAT have grown at a CAGR of 19% and 17% respectively over FY05-10. RoCE has improved from 36% to 41% during this period.

Figure 6. EBITDA Margin Trends (%)



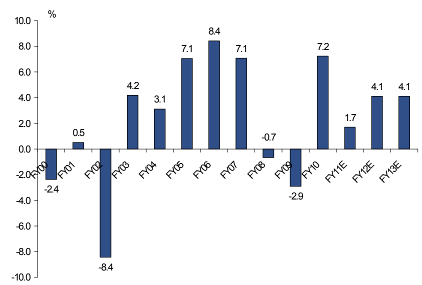
Source: Company Reports and CIRA Estimates

Figure 7. Return Ratio Trends (%)



Source: Company Reports and CIRA Estimates

Figure 8. ITC- Cigarette Volume Trends



Source: Company Reports and CIRA Estimates

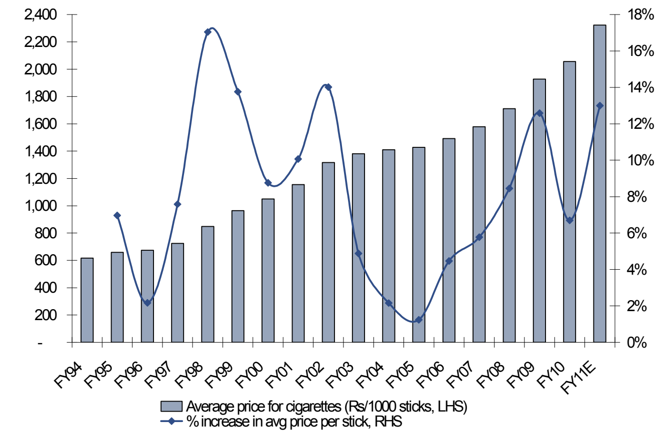
Cigarettes

Management notes that a punitive approach (from a taxation perspective) has resulted in the share of cigarettes in total tobacco consumption in India progressively declining from 23% in 1971/72 to only about 15% currently. Taxes imposed per kg of tobacco consumed in cigarettes are 35 times higher than those from other forms of tobacco products.

Over FY10, ITC launched new variants of 'Gold Flake' and 'Navy Cut Filter Kings' and new brands like 'Flake Excel Filter' and 'Duke Filter'.

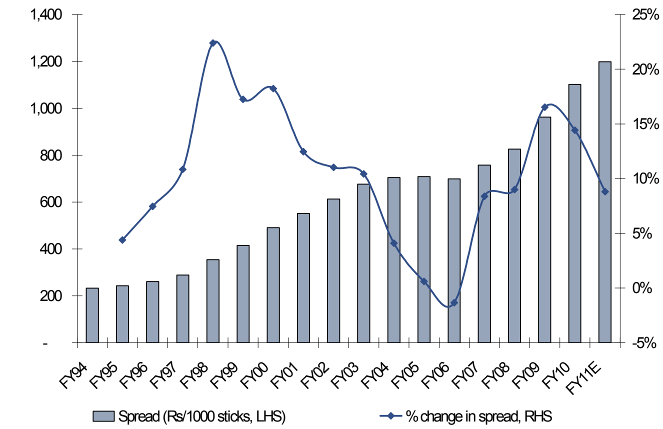
ITC also commissioned a new cigarette plant at Ranjangaon, Pune, which resulted in overall capacity increasing to 134bn cigarettes from 109bn cigarettes.

Figure 9. Average Cigarette Pricing Trends (Rs/1000 sticks, % Change Y/Y)



Source: Company Reports and CIRA Estimates

Figure 10. Difference Between Price hike vs. Excise duty change (Rs/1000 sticks, % Change Y/Y)



Source: Company Reports and CIRA Estimates

Other FMCG

a) Branded packaged foods

The branded packaged foods business revenues rose 19% over the previous year. The focus is on value addition though cost reductions across the supply chain. The biscuit industry witnessed an impressive growth of around 14% during the year. ITC's 'Sunfeast' brand continued to consolidate its position with an All India-Urban market share of 11%. In the salty snacks segment, 'Bingo!' penetrated new markets, and improved brand positioning through word of mouth and differentiated advertisements.

This business continues to invest in manufacturing and distribution infrastructure to support larger scale in the wake of growing volumes.

The outlook for branded packaged goods is expected to improve – growth is forecast at 15%.

b) Lifestyle Retailing

The network is now 56 exclusive stores in 30 cities and 150 'shop–in–shops'. Two 'Wills Lifestyle' boutique stores were opened at ITC's Gardenia (Bangalore) and ITC Mughal (Agra). In the 'youth' segment, 'John Players' has a pan-India presence with over 225 flagship stores and 1,200 multi-brand outlets and departmental stores.

Given the economic environment, the business cut costs, improved working capital management and worked to improve frontline-staff productivity. Better collaboration with vendors enabled the business to introduce premium offerings and improve sourcing efficiencies.

c) Education & Stationery

The education & stationery products business registered strong revenue growth of 40% in FY10 – which was over 60% revenue growth in FY09. The distribution footprint continues to increase – 2,800 markets vs. 2,000 markets in FY08.

d) Personal Care Products

Management commentary has started reflecting market share/brand building initiatives – vs. the commentary in FY09 that focused on manufacturing/R&D. Volume market share in soaps is ~5%, and 3.4% in shampoos. The 'Vivel' and 'Superia' brands are each estimated to be >Rs2bn per annum in consumer spends.

The business added capacity to its plant at Haridwar and commissioned a new plant at Manpura in Himachal Pradesh. Capacity increased almost 4x to ~236,000 MT from ~59,000 MT.

Hotel Business

2HFY10 was better than 1H, driven by growth in the Indian economy and the beginnings of a gradual recovery in USA and Europe. ITC commissioned the ITC Royal Gardenia, a 292-room hotel at Bangalore. Two more hotels are being commissioned at Chennai and Kolkata with 600 and 500 rooms respectively (to be launched in the next 2 years).

Book value of investments in EIH (EIHO.BO; Rs128.65; Not Rated) and Hotel Leelaventure (HTLE.BO; Rs49.60; Not Rated) are ~Rs2.2b and ~Rs1bn respectively.

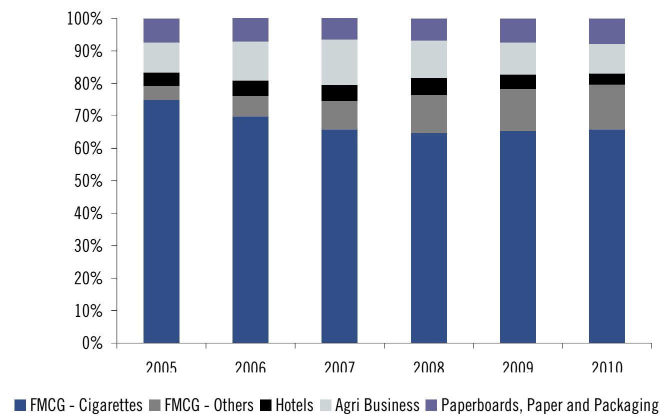
Paperboards, Paper and Packaging

ITC has c26% market share in the paperboards segment. To maintain share, it plans to invest in a new paperboard machine, which will be operational in 2012. Within the cigarette tissue segment ITC has 65% market share, and in the décor segment, it enjoys a 26% market share. Overall segment revenues rose ~19% Y/Y, with value-added paperboards growing at 29%. Export revenues rose 38%.

Agri Business

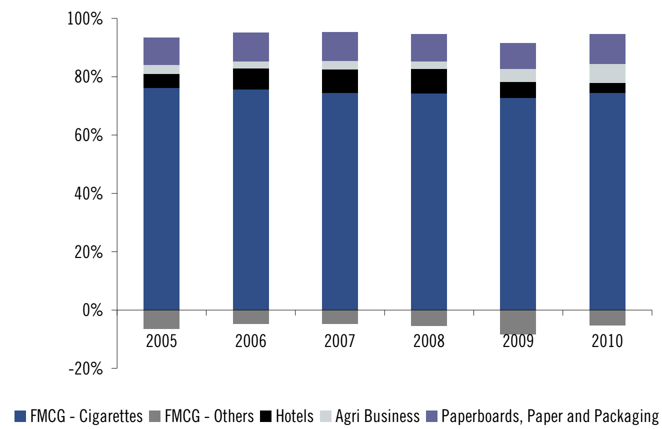
ITC has gradually focused this business on tobacco and other cash crops like soya, coffee, etc. A combination of a) global shortfall in tobacco supply, and b) introduction of Indian tobacco in international blends, has resulted in ITC becoming the 6th largest leaf exporter globally. Rural retailing continues – ITC has 24 Choupal Sagars (same as FY09).

Figure 11. Revenue Mix (%)



Source: Company Reports

Figure 12. EBIT Mix (%)



Source: Company Reports

There is no meaningful variance between parent and consolidated accounts (+5%/3% difference in revenues/ PAT respectively); as most subsidiaries are small and have limited impact to the consolidated earnings.

ITC

Company description

ITC is the leading cigarette manufacturer and marketer in India with about 74% market share by volumes. The group is ~32% owned by BAT (British American Tobacco). 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 a) agri / marine products, b) hotels, c) paper & packaging and d) IT. However, about 65% of its revenues and 88% of its profits are from the cigarette business (in FY09). 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 Rs302. Cigarette business remains strong on the back of a robust pricing environment, good volumes and better mix. ITC has been successful in passing the higher excise duty increases, resulting in strong margins. Positive cigarette volume growth despite aggressive pricing action should enable the stock's recent re-rating to sustain. 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). We forecast a strong 18% EPS growth CAGR over FY10-12E.

Valuation

Our target price of Rs302 is based on 22x SeptFY11E earnings. ITC's stock has experienced a gradual re-rating, as concerns pertaining to cigarette volume decline (post the excise/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. In FY11E also, the company has taken aggressive price increases that should not only make up for the excise increases, but also add to the operating margins. 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. 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 25-26x). From a relative P/E perspective, however, ITC appears relatively cheap - trading at around 1.3x - 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.

Appendix A-1

Analyst Certification

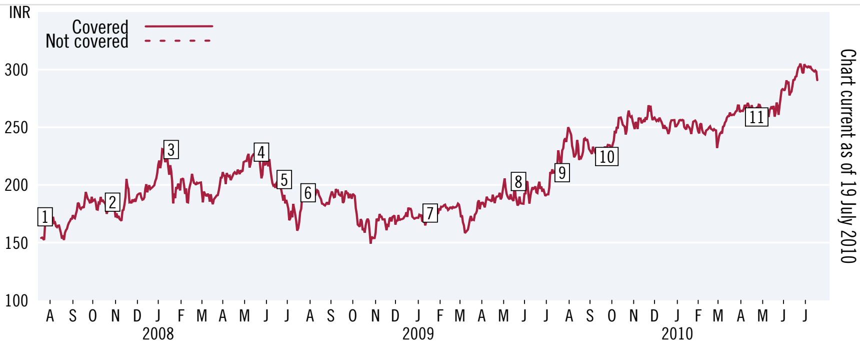
The research analyst(s) primarily responsible for the preparation and content of all or any identified portion of this research report hereby certifies that, with respect to each issuer or security or any identified portion of the report with respect to an issuer or security that the research analyst covers in this research report, all of the views expressed in this research report accurately reflect their personal views about those issuer(s) or securities. The research analyst(s) also certify that no part of their compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this research report.

IMPORTANT DISCLOSURES

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	25-Jul-07	*1L	*195.00	165.85
2	28-Oct-07	1L	*215.00	180.80
3	18-Jan-08	1L	*247.00	212.60
4	25-May-08	1L	*243.00	213.60
5	26-Jun-08	1L	*238.00	191.35
6	30-Jul-08	1L	*222.00	187.80
7	19-Jan-09	1L	*210.00	170.55
8	22-May-09	1L	*225.00	183.25
9	23-Jul-09	1L	*260.00	229.95
10	24-Sep-09	1L	*267.00	232.40
11	23-Apr-10	1L	*302.00	266.85

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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Rohini Malkani has in the past worked with the India government or its divisions in her personal capacity.

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Data current as of 30 Jun 2010	**Buy**	**Hold**	**Sell**
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% of companies in each rating category that are investment banking clients	47%	45%	40%

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