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24 June 2013

India

Consumer

Reuters ITC.BO
Bloomberg ITC IB

Priced on 24 June 2013

India Sensex @ 18,540.9

12M hi/lo Rs355.75/244.60

12M price target Rs370.00
±% potential +18%

Shares in issue 7,901.8m
Free float (est.) 69.5%

Market cap US\$41,916m

3M average daily volume
Rs2,064.6m (US\$37.3m)

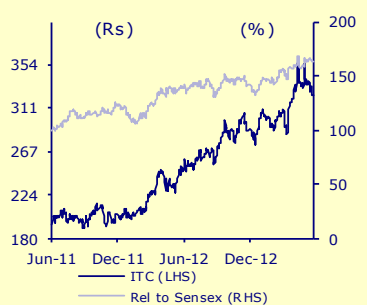
Foreign s'holding 13.6%

Major shareholders

BAT 30.5%
FIIs 19.7%

Stock performance (%)

	1M	3M	12M
Absolute	(4.7)	3.0	25.5
Relative	1.3	4.1	14.9
Abs (US\$)	(10.5)	(5.6)	20.9



Source: Bloomberg

www.clsa.com

Cash machine

ITC's FY13 annual report highlights: a) ROE expanding to an all-time high led by an improvement in new FMCG and agri; b) while increase in working capital moderated OpCF growth, lower capex helped and FCF rose 26%; c) cigarette prices in India today are highest relative to income and illegal cigarettes form ~18% of the market; d) ESOPs granted at ~0.8% of outstanding capital. We continue to rate ITC as O-PF and revise up our SoTP based target price to Rs370/sh.

FY13 return ratios at all-time high, again

ITC's RoE continued to move up and touched an all-time high of 36% in FY13, up ~7ppt in the past three years and 60bps YoY. RoEs are being driven up largely by improving margins and slightly higher asset turns. Interestingly, ITC's cigarette business RoCEs declined along with hotels and paperboards while new FMCG and agri saw an improvement. ITC's working capital also rose five days YoY (+Rs7.8bn) in FY13 due to a reduction in payable days even while receivables/inventory days were flat.

Strong cash generation; FCF: +23% YoY

ITC's FY13 capex declined 13% YoY off a high base to Rs20.8bn – investments continued across businesses with 26% invested in cigarettes and 33% in paperboards (new capacity). While the rise in OpCF was muted at 12% due to higher working capital, FCF rose by a strong 23% YoY. We believe that the capex has peaked in FY12 and expect average capex over FY14-16 should be similar to FY13. On the back of this, FCF should rise at 25% Cagr over FY14-16CL which is ahead of EPS Cagr of ~17.5%.

Indian biri is affordable but cigarettes are most expensive

Few worrying facts presented in the report: a) 17% world population in India compares with just 1.8% cigarette consumption due to prevalence of other formats like 'biri'; b) 60% of cigarette smokers in India consume other tobacco forms; c) comparisons indicate that cigarette prices in India are highest relative to its income while biris are cheaper; d) illegal cigarettes are now at ~18% and India is the fifth largest market.

0.8% ESOPs granted

ITC granted 0.8% of outstanding shares as ESOPs in FY13 cf. 1%+ in the past six years. The annual report also states that if the company had used black-Scholes model for valuing these options, the reported earnings would have been lower by 5%. ITC remains the most prolific issuer of ESOPs in our FMCG coverage universe.

Maintain O-PF

AT 27.5x one year forward earnings, the stock trades at a premium to five year average, which is justified given its increasingly diversified earnings profile, strong cash flow and improvement in new FMCG which should break even in FY14. We note that ITC's dividend pay-out (ex-special) is up from 50% in the past five years to 65%+ now and there exists potential for a further increase in coming years. We revise our SoTP based target price for Jun-14 at Rs370/sh.

Financials

Year to 31 March	12A	13A	14CL	15CL	16CL
Revenue (Rsm)	247,984	296,056	346,624	400,408	463,483
Net profit (Rsm)	61,624	74,184	86,703	102,574	120,279
EPS (Rs)	7.9	9.4	11.0	13.0	15.2
CL/consensus (26) (EPS%)	-	-	99	98	97
EPS growth (% YoY)	21.5	19.7	16.3	18.3	17.3
PE (x)	39.9	33.3	28.7	24.2	20.7
Dividend yield (%)	1.4	1.7	2.0	2.3	2.7
FCF yield (%)	1.5	1.9	2.5	3.1	3.7
PB (x)	13.1	11.1	9.9	8.6	7.5
ROE (%)	35.5	36.1	36.5	38.0	39.0
Net debt/equity (%)	(37.7)	(38.6)	(43.1)	(47.9)	(53.0)

Source: CLSA

High taxes a key concern in case of India

Among the fastest growing FMCG firm in the country

While ITC has been launching new products, personal care is still in gestation period

Key comments by the management

Figure 1

Extracts from annual report

	Remarks
Cigarettes	
Excise/ VAT	<ul style="list-style-type: none"> Discriminatory and punitive taxation coupled with a growing incidence of smuggling and illegal manufacture are the biggest challenges confronted by the domestic cigarette industry These challenges were further compounded during the year by the steep increase of 22% in cigarette Excise Duty rates announced in the Union Budget 2012 and the arbitrary increases in Value Added Tax (VAT) on cigarettes by some States Such increases not only undermine the legal domestic cigarette industry and sub-optimize revenue potential from this sector but also fail to achieve the objective of tobacco control in the country
Consumption	<ul style="list-style-type: none"> ...while 34.6% of all adults in India use tobacco in some form, only 5.7% of the adult population consume cigarettes The fact that cigarette consumption is price elastic, while consumption of tobacco per se is not, is borne out by the fact that the total tobacco consumption in the country increased from 406 million kg in 1981-82 to 475 million kg in 2010-11... ... even as the tobacco consumption in the form of cigarettes declined from 86 million kg to 72 million kg during the same period. Thus, while overall tobacco consumption is increasing in India, the share of cigarettes in overall tobacco consumption has declined from 21% to 15%.
Relative pricing	<ul style="list-style-type: none"> At 2.25% of per capita GDP, cigarette taxes (per 1000 cigarettes in most popular price category) in India are the highest in the world
Illegal cigarettes	<ul style="list-style-type: none"> Illegal segment has grown exponentially from 11 billion sticks in 2004 to 22 billion sticks in 2012... of which, 2 billion sticks have been added in the last one year alone... Illegal cigarettes accounts for 18% of cigarette trade and India is now the fifth largest market in the world
Packaged foods	
Growth	<ul style="list-style-type: none"> New FMCG businesses have been rated to be the fastest growing among top consumer goods companies operating in India as per recent AC Nielson report In terms of annualized consumer spend, Aashirvaad and Sunfeast are today over Rs20bn each...
Brands	<ul style="list-style-type: none"> ... Classmate at around Rs10bn while Bingo!, Candyman and Vivel are more than Rs5bn each Sunfeast Yippee! has been well received by consumers and is the second largest (instant noodle) brand in the market
New launches	<ul style="list-style-type: none"> In the Bakery and Confectionery Foods business, the Biscuits and Confectionery categories gained significant scale and market standing during the year. Launch of several 'first-to-market' variants including 'Dark Fantasy Choco Fills - Coffee', 'Dark Fantasy Choco Meltz', 'Butterscotch Zing', 'Kaju Badam Cookies
Personal care	
Soaps	<ul style="list-style-type: none"> The launch of the 'Couture Spa' range of soaps under the 'Fiama Di Wills' brand was one of the key interventions during the year
New segments	<ul style="list-style-type: none"> The year also marked Company's foray into the high growth Deodorants market with the launch of 'Aqua Pulse Deodorant Spray' under the 'Fiama Di Wills Men' franchise
Skin	<ul style="list-style-type: none"> The Skin Care range was also expanded during the year with the launch of 'Vivel Cell Renew' Body Lotion, Hand Crème / Moisturizer and 'Vivel Perfect Glow' Skin Toner in target markets. 'Vivel' was voted as one of the 'Top 5 Most Exciting Brands' in Personal Care in India by Brand Equity and Nielsen's Annual Survey. The new product launches have received encouraging consumer response
Distribution	<ul style="list-style-type: none"> Company's products being tried by over 70m households during the year (as per IMRB Household Panel survey - January 2013)
Others	
Lifestyle	<ul style="list-style-type: none"> The retail footprint of the brand (Lifestyle) was expanded to 90 Exclusive stores across 40 cities and more than 500 'shop-in-shops' in leading departmental stores and multi-brand outlets John Players' has established a strong pan-India presence with availability in over 350 stores and 1,400 multi-brand outlets and departmental stores
Hotels	<ul style="list-style-type: none"> During the year, your Company unveiled its latest offering in the super premium segment - ITC Grand Chola in Chennai
Paper/ paperboard	<ul style="list-style-type: none"> Company successfully commissioned a paper machine with an installed capacity of over 1 lakh tonnes (100k tons) per annum at the Bhadrachalam plant during. The total capacity of the Bhadrachalam plant now stands at over 5.5 lakh (550k) tonnes per annum

Source: CLSA Asia-Pacific Markets

Cigarette prices in India today are highest relative to income and illegal cigarettes form ~18% of the market

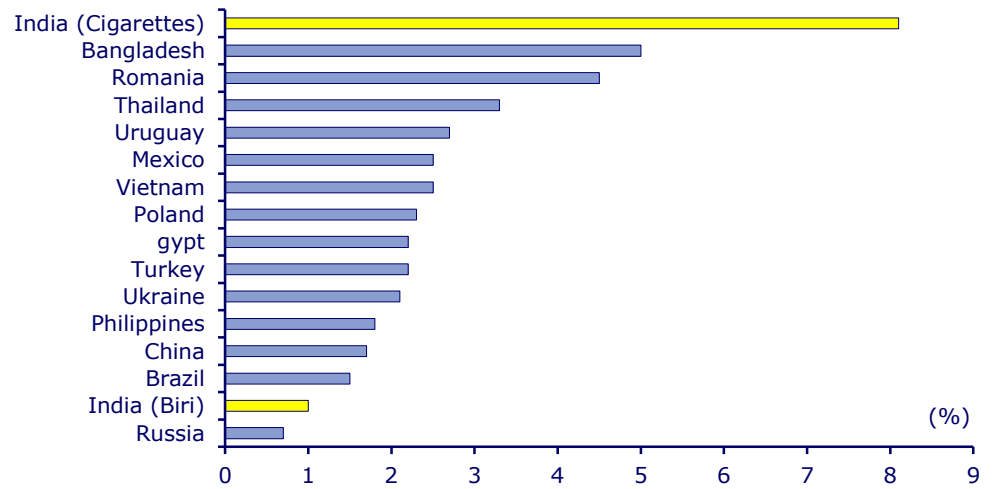
Due to availability of options like 'biri' and other forms of tobacco, cigarette per capita is dismally low in India

Despite low cigarette penetration, ITC is a margin growth story in India due to high taxes which impact the volume growth

Cigarette prices in India are higher than other countries

Figure 2

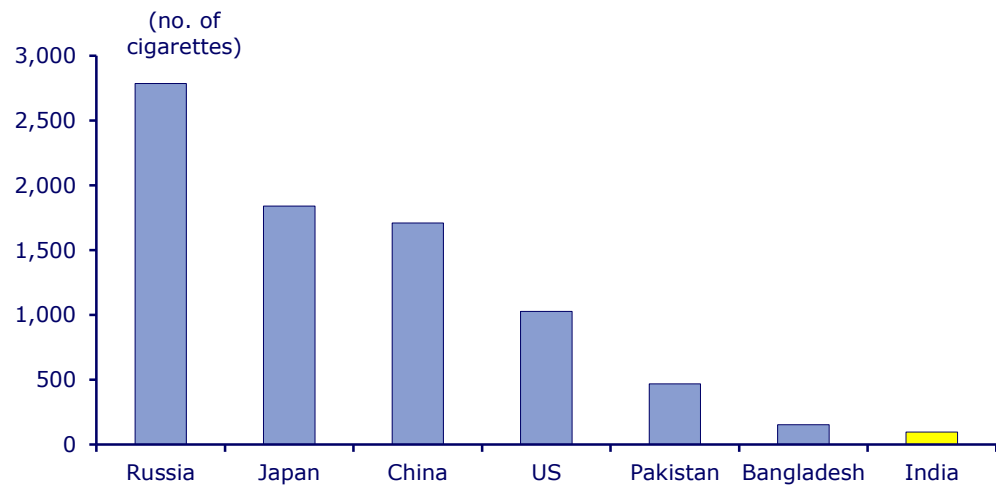
Price of cigarettes relative to income



Source: Company, CLSA

Figure 3

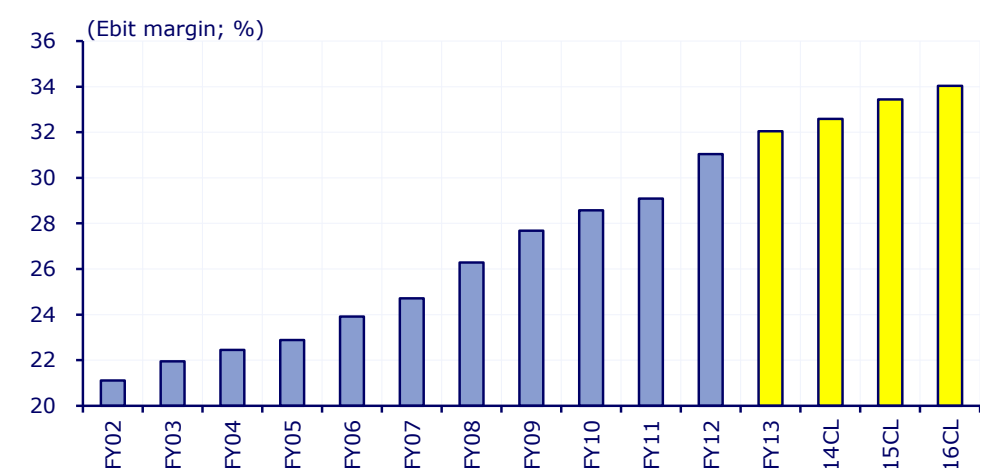
Per-capita cigarette consumption



Source: Company, CLSA

Figure 4

Cigarette Ebit margins for ITC



Source: CLSA

Margin expansion and slightly better asset turns driving 60bps YoY expansion in FY13 RoE

RoE continued to move up and touched an all-time high

RoCE declined in cigarettes, hotels and paperboards...

... but improved in agri (and new FMCG where losses declined)

Return ratios to an all-time high

Figure 5

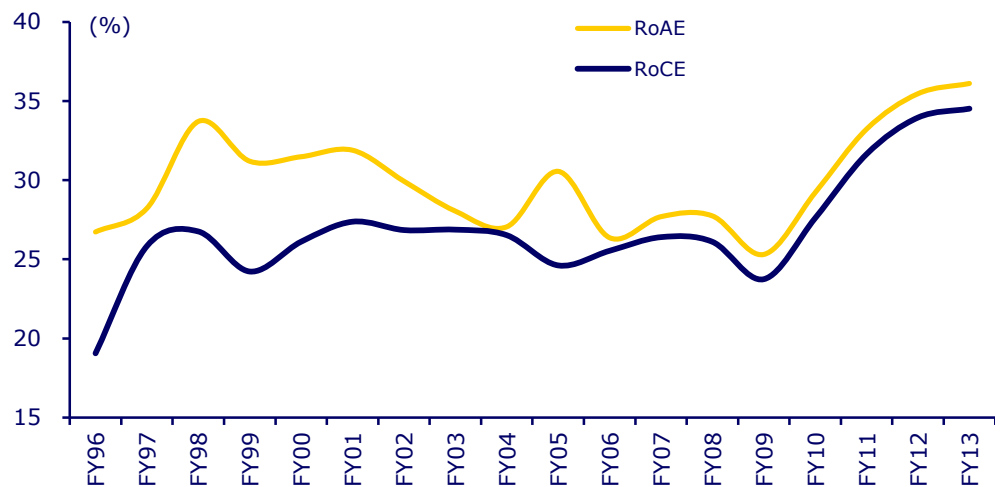
Du pont analysis

	FY09	FY10	FY11	FY12	FY13	14CL	15CL	16CL
Ebit Margin (%)	27.6	30.1	30.5	31.5	32.2	32.9	33.7	34.2
Asset Turnover (x)	1.1	1.2	1.3	1.4	1.4	1.4	1.4	1.4
Financial Leverage (x)	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.0
Interest burden (x)	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Tax Burden (x)	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
RoAE	25.3	29.2	33.2	35.5	36.1	36.5	38.0	38.3

Source: CLSA

Figure 6

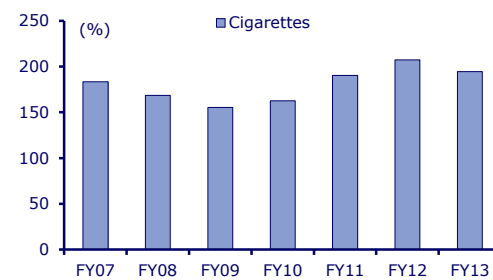
ITC's return ratios over the years



Source: CLSA

Figure 7

Reported RoCE in cigarettes



Source: CLSA

Figure 8

... and paperboards

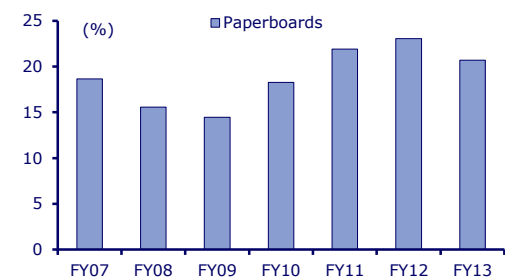
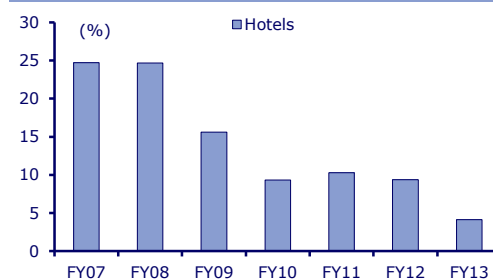


Figure 9

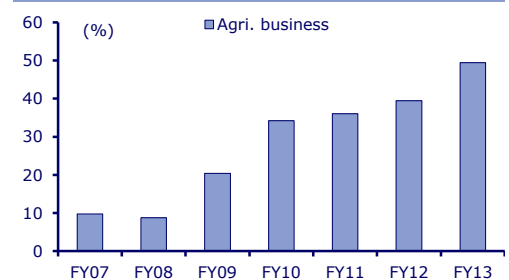
Reported RoCE in hotels...



Source: CLSA

Figure 10

...and agri business



Capex declined from the peak; over the next three years, we believe that FY14-15 capex would annualised at FY13 levels

ITC continues to spend a third of its capex on cigarettes

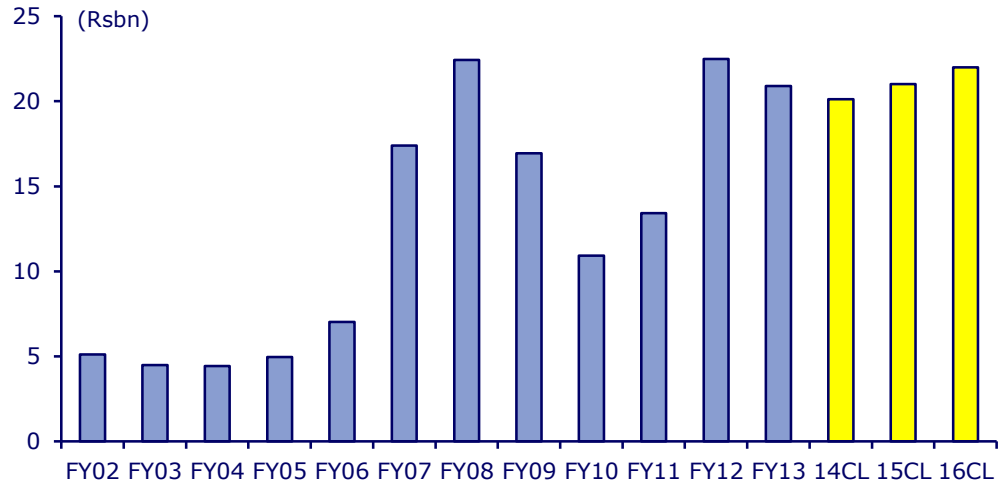
FY12 saw higher capex in hotels while FY13 was on paperboards

Working capital rose five days YoY due to a decline in payable days

Moderation in capex in FY13; rise in working capital

Figure 11

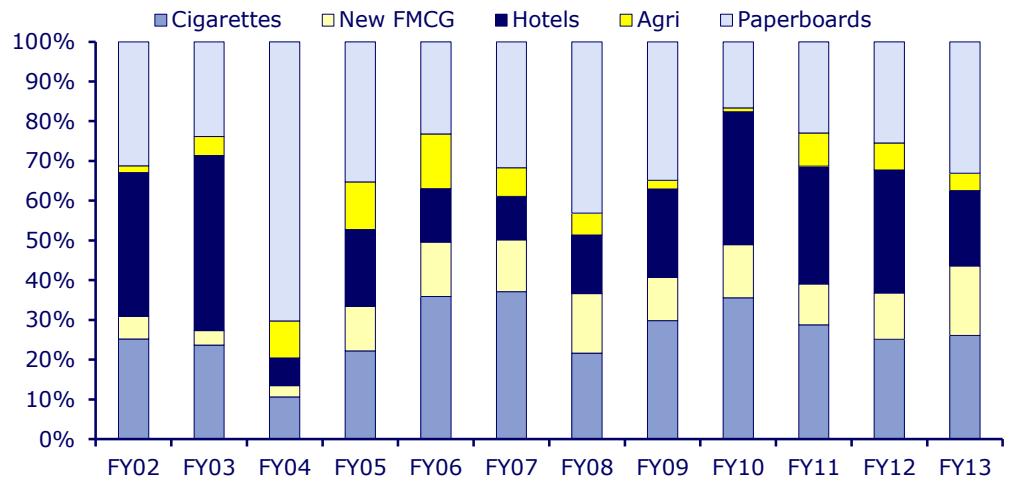
Trend in annual capex



Source: CLSA

Figure 12

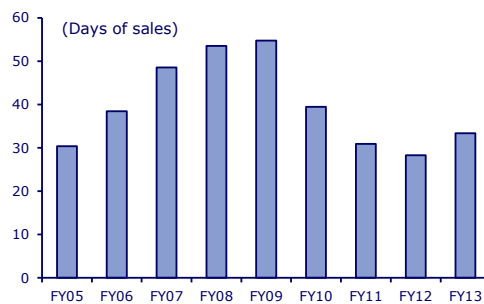
Segment-wise capex



Source: CLSA

Figure 13

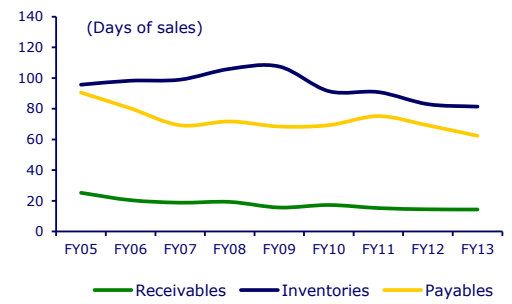
Overall working capital...



Source: CLSA

Figure 14

...trend in components



We believe that the capex has peaked in FY12 and expect annual spent over FY14-16 should be similar to FY13

On the back of this, FCF should rise at 25% Cagr over FY14-16CL which is ahead of EPS Cagr of ~17.5%

We build in flat days in working capital resulting in net outflows over FY14-16

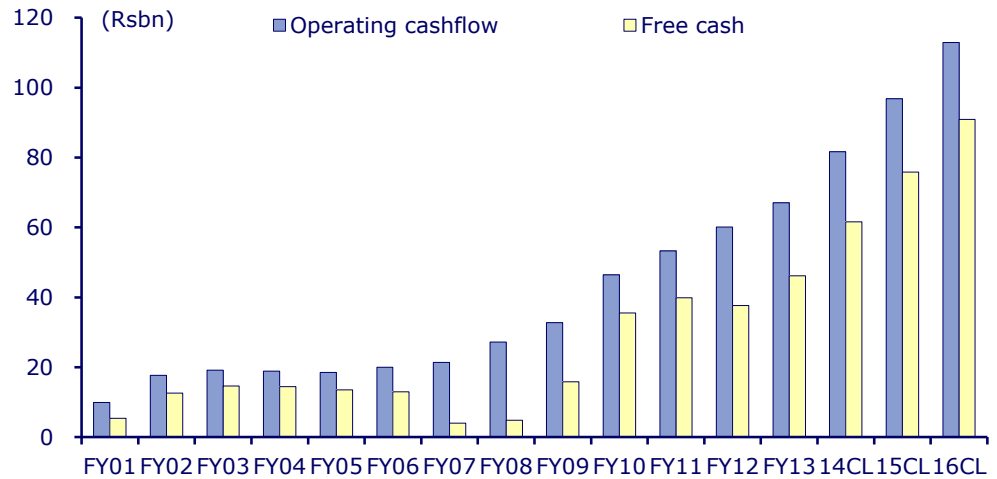
Expect annual capex over FY14-16 to stay at around FY13 levels

ITC to generate rising free cash

25% FCF Cagr over FY14-16CL

Figure 15

Trend in operating and free cash flow



Source: CLSA

Figure 16

Free Cash Flow statement

(Rsm)	FY11	FY12	FY13	14CL	15CL	16CL
Cash from operations	53,327	60,156	67,099	81,691	96,824	112,899
PAT	49,876	61,624	74,184	86,703	102,574	120,279
Tax provisions	848	4,172	3,794	900	1,000	1,000
Interest	684	779	865	900	925	950
Depreciation	6,560	6,985	7,956	9,000	10,000	11,000
Other income	(5,014)	(8,332)	(9,099)	(10,464)	(12,033)	(13,838)
Working capital	1,679	(1,275)	(7,852)	(4,623)	(4,917)	(5,766)
Other current assets	(1,627)	(4,083)	(2,643)	(725)	(725)	(725)
Others	320	287	(107)	-	-	-
Cash from investments	(14,328)	(18,213)	(19,851)	(9,658)	(8,967)	(8,161)
Capex	(13,419)	(22,476)	(20,899)	(20,122)	(21,000)	(22,000)
Investments	(1,435)	(2,527)	740	-	-	-
Other Income	5,014	8,332	9,099	10,464	12,033	13,838
Others	(4,488)	(1,542)	(8,791)	-	-	-
Cash from financing	(35,516)	(32,466)	(32,326)	(49,429)	(58,704)	(67,974)
Equity	9,038	7,650	9,223	-	-	-
Debt	(85)	(101)	(115)	-	-	-
Interest costs	(158)	(779)	(865)	(900)	(925)	(950)
Dividends	(44,517)	(40,015)	(40,884)	(48,529)	(57,779)	(67,024)
Others	206	780	315	-	-	-
Net change in cash	3,483	9,477	14,922	22,604	29,153	36,764
Free Cash Flow	39,908	37,680	46,200	61,569	75,824	90,900

Source: CLSA

ITC steadily raised the dividend pay-out from 30% in FY03 to 50% by FY06 and ~65% in FY12-13

While we build in a similar pay-out over FY14-16CL, there is a potential for a step-up...

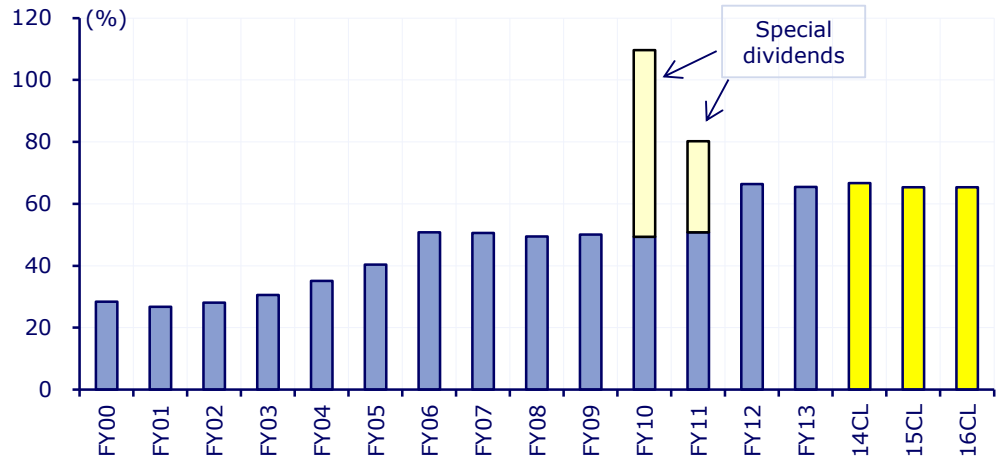
... supported by a strong and net cash balance sheet

Rising cash on the balance sheet

Strong dividend payout; healthy balance sheet

Figure 17

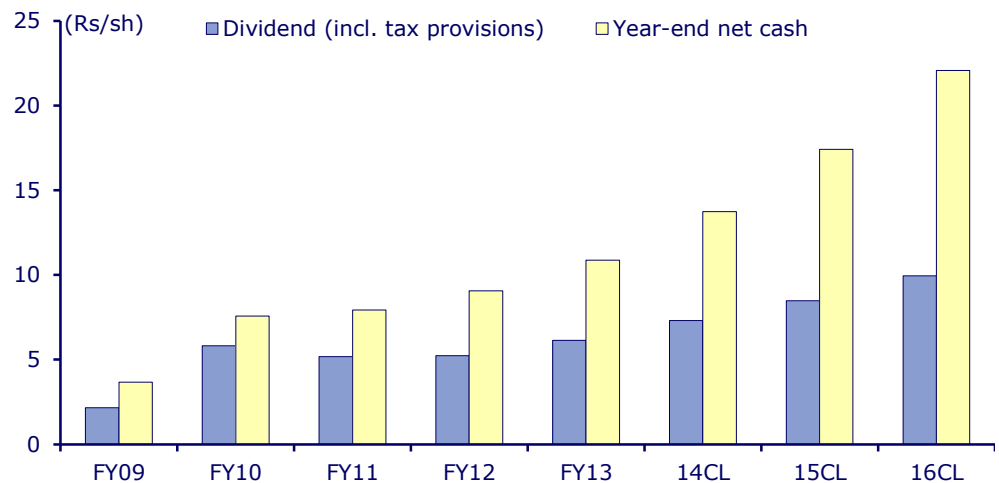
Trend in dividend pay-out



Source: CLSA

Figure 18

Year-end net cash and dividend per share



Source: CLSA

Figure 19

Summary balance sheet

(Rsm)	FY11	FY12	FY13	14CL	15CL	16CL
Equity Capital	7,738	7,818	7,902	7,902	7,902	7,902
Others	151,795	180,101	214,977	243,900	279,450	321,149
Networth	159,533	187,919	222,879	251,802	287,352	321,149
Debt	993	892	777	777	777	777
Deferred tax liability	8,019	8,727	12,037	12,937	13,937	14,937
Total	168,544	197,538	235,693	265,516	302,066	344,765
Net fixed assets	96,785	113,759	126,971	138,093	149,093	160,093
Investments	15,633	19,533	20,009	20,009	20,009	20,009
Net current assets	(6,220)	(7,577)	1,968	(1,934)	(5,537)	(10,602)
Cash & liquid	62,346	71,822	86,744	109,349	138,501	175,265
Total	168,544	197,538	235,693	265,516	302,066	344,765

Source: CLSA

Non-cigarette business are becoming increasingly self-sufficient and in fact, generating cash

While cigarette's contribution to overall revenues has been going down over the years...

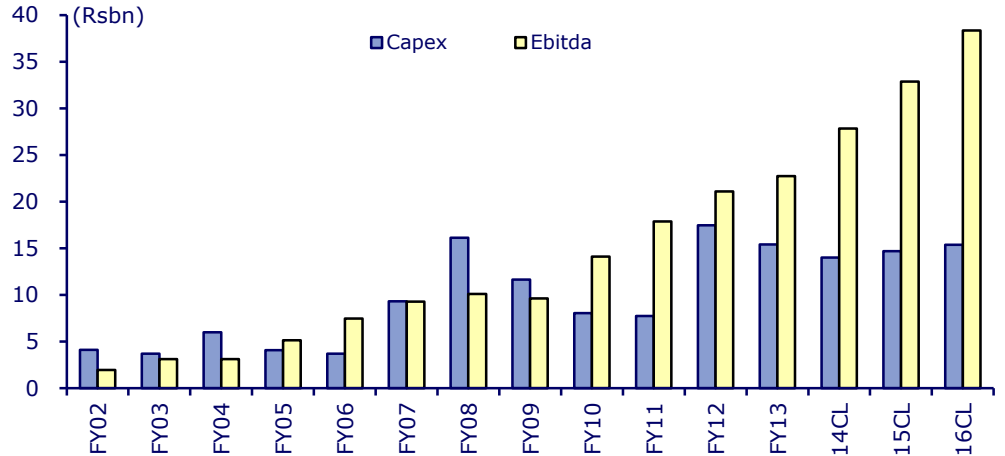
... it still forms bulk of ITC's overall Ebit

The new FMCG business has been steadily showing improvement and we expect a break-even in FY14

Other businesses have been self-sustaining

Figure 20

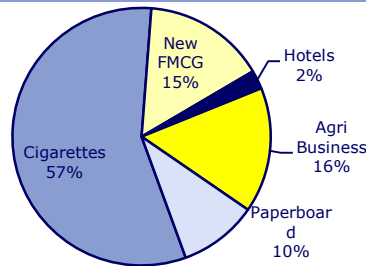
Non-cigarette capex and Ebitda



Source: CLSA

Figure 21

Gross FY13 revenue split



Source: CLSA

Figure 22

Net FY13 revenue split

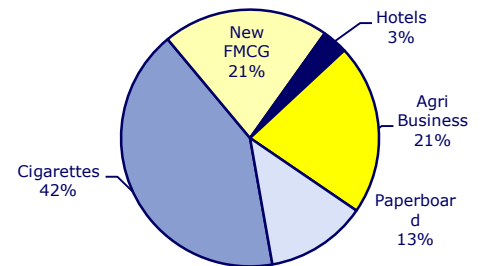
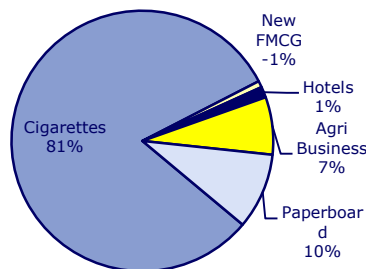


Figure 23

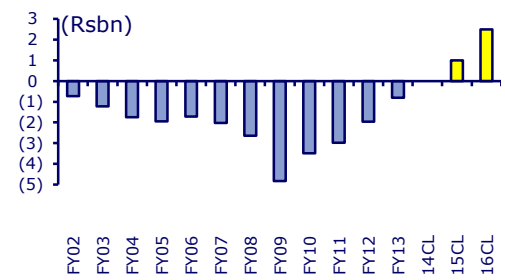
FY13 Ebit break-up



Source: CLSA

Figure 24

Trend in FMCG losses



ITC granted 0.8% of outstanding shares as ESOPs in FY13 cf. 1%+ in the past six years

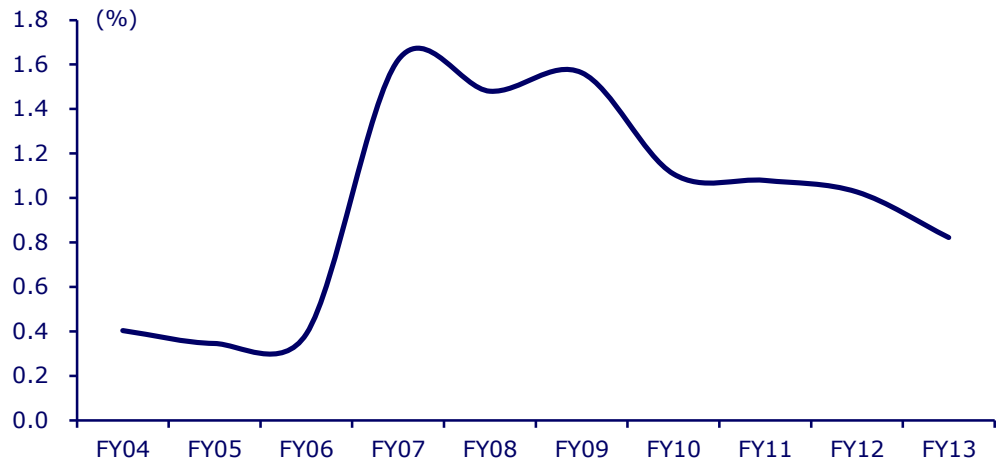
If the company had used black-Scholes model for valuing options, reported earnings would have been lower by 5%

Cigarette forms bulk of ITC's fair value, though, proportion of new FMCG business has been steadily rising

ESOPs diluting EPS by 5%

Figure 25

ESOPs granted as a proportion of shares over the years



Source: CLSA

Figure 26

Impact on FY13 EPS due to ESOPs

	FY13
Net earnings	74,184
Less: Fair value compensation cost based on Black Scholes model	3,610
Adjusted profit	77,794
Adjusted EPS	9.0
Reported EPS	9.5
Change	(5)

Source: CLSA

SoTP based target price of Rs370/sh

Figure 27

SoTP calculation

Segment	Rs/sh	Remarks
Cigarette	286	26x Jun-15 PE
New FMCG	44	3x Jun-15 EV/Sales
Agri-business	10	7.5x jun-15 EV/Ebitda
Paperboards & packaging	15	7.5x Jun-15 EV/Ebitda
Hotels	7	12x Jun-15 EV/Ebitda
Net cash	9	Cash as at Jun-14
Fair value	370	

Source: CLSA

Summary financials

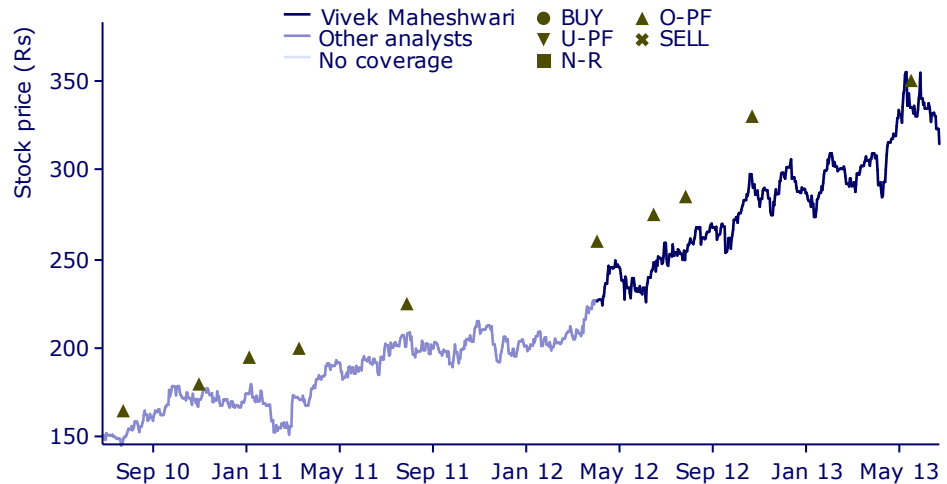
Year to 31 March	2012A	2013A	2014CL	2015CL	2016CL
Summary P&L forecast (Rsm)					
Revenue	247,984	296,056	346,624	400,408	463,483
Op Ebitda	84,996	103,318	122,866	145,039	169,581
Op Ebit	78,011	95,363	113,866	135,039	158,581
Interest income	-	-	-	-	-
Interest expense	(779)	(865)	(900)	(925)	(950)
Other items	11,744	12,344	14,195	16,325	18,774
Profit before tax	88,975	106,842	127,161	150,438	176,404
Taxation	(27,352)	(32,658)	(40,458)	(47,864)	(56,126)
Minorities/Pref divs	0	0	0	0	0
Net profit	61,624	74,184	86,703	102,574	120,279
Summary cashflow forecast (Rsm)					
Operating profit	78,011	95,363	113,866	135,039	158,581
Operating adjustments	-	-	-	-	-
Depreciation/amortisation	6,985	7,956	9,000	10,000	11,000
Working capital changes	(1,275)	(7,852)	(4,623)	(4,917)	(5,766)
Net interest/taxes/other	(23,565)	(28,368)	(36,552)	(43,298)	(50,916)
Net operating cashflow	60,156	67,099	81,691	96,824	112,899
Capital expenditure	(23,959)	(21,168)	(20,122)	(21,000)	(22,000)
Free cashflow	36,197	45,931	61,569	75,824	90,900
Acq/inv/disposals	(3,900)	(476)	-	-	-
Int, invt & associate div	10,965	11,479	13,295	15,400	17,824
Net investing cashflow	(16,895)	(10,164)	(6,827)	(5,600)	(4,176)
Increase in loans	(101)	(115)	-	-	-
Dividends	(40,015)	(40,884)	(48,529)	(57,779)	(67,024)
Net equity raised/other	6,332	(1,014)	(3,732)	(4,292)	(4,935)
Net financing cashflow	(33,784)	(42,013)	(52,261)	(62,071)	(71,959)
Incr/(decr) in net cash	9,477	14,922	22,604	29,153	36,764
Exch rate movements	0	0	0	0	0
Opening cash	62,346	71,822	86,744	109,349	138,501
Closing cash	71,822	86,744	109,349	138,501	175,265
Summary balance sheet forecast (Rsm)					
Cash & equivalents	71,822	86,744	109,349	138,501	175,265
Debtors	9,824	11,633	13,620	15,734	18,212
Inventories	56,378	66,002	77,276	89,266	103,328
Other current assets	0	0	0	0	0
Fixed assets	113,759	126,971	138,093	149,093	160,093
Intangible assets	-	-	-	-	-
Other term assets	38,098	48,823	49,573	50,323	51,073
Total assets	289,882	340,174	387,911	442,918	507,971
Short-term debt	-	-	-	-	-
Creditors	46,989	50,571	59,208	68,395	79,169
Other current liabs	45,356	53,911	63,187	72,456	84,037
Long-term debt/CBs	892	777	777	777	777
Provisions/other LT liabs	8,727	12,037	12,937	13,937	14,937
Minorities/other equity	0	0	0	0	0
Shareholder funds	187,919	222,879	251,802	287,352	329,050
Total liabs & equity	289,882	340,174	387,911	442,918	507,971
Ratio analysis					
Revenue growth (% YoY)	17.2	19.4	17.1	15.5	15.8
Ebitda growth (% YoY)	19.4	21.6	18.9	18.0	16.9
Ebitda margin (%)	34.3	34.9	35.4	36.2	36.6
Net profit margin (%)	24.8	25.1	25.0	25.6	26.0
Dividend payout (%)	57.1	55.6	57.0	55.9	55.8
Effective tax rate (%)	30.7	30.6	31.8	31.8	31.8
Ebitda/net int exp (x)	109.1	119.5	136.5	156.8	178.5
Net debt/equity (%)	(37.7)	(38.6)	(43.1)	(47.9)	(53.0)
ROE (%)	35.5	36.1	36.5	38.0	39.0
ROIC (%)	54.9	56.3	58.6	65.8	73.8
EVA@/IC (%)	43.1	44.4	46.7	54.0	61.9

Source: CLSA

Companies mentioned

ITC (ITC IB - RS314.40 - OUTPERFORM)

Recommendation history of ITC Ltd ITC IB



Date	Rec	Target	Date	Rec	Target
18 May 2013	O-PF	350.00	28 July 2011	O-PF	225.00
22 October 2012	O-PF	330.00	09 March 2011	O-PF	200.00
27 July 2012	O-PF	285.00	03 January 2011	O-PF	195.00
15 June 2012	O-PF	275.00	29 October 2010	O-PF	180.00
02 April 2012	O-PF	260.00	22 July 2010	O-PF	165.00

Source: CLSA



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Note: In the interests of timeliness, this document has not been edited.

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