

ITC Ltd is one of the leading conglomerates with business interests in cigarettes & tobacco, packaging, agri-business, food, hotels, lifestyle retailing, personal care, paper & stationery and branded apparels. In the cigarette segment, the company enjoys more than ~80% market share by value in India. Despite the presence across various business segments, cigarette still draws a major part of profitability as ITC operates with over 2 mn retailers across India managing one of the largest distribution networks in the country.

Investment Rationale

Non-cigarette FMCG business provides strong earning visibility - While contributing ~26% to the total revenues in Q3FY15, the non-cigarette FMCG registered an 11.4% YoY revenue growth in Q3FY15, amidst continuing weakness in discretionary demand, signalling ITC's fast traction in the Indian FMCG market. Hurt by weakness in cigarette business, ITC is betting big on the non-cigarette FMCG space. The company is aiming to achieve a revenue growth of ₹150 bn in the segment through acquisitions in the upcoming two-three years. Though not much details have been disclosed about the upcoming acquisitions, we believe, the non-cigarette FMCG business is going to get a boost going forward, which makes the outlook brighter for the overall revenue-base. The company also plans to set-up 20 factories for its FMCG products as it aims to garner ₹1 lakh crore revenue from that business alone by 2030.

Riding high on fast growing packaged food business - ITC has gained rapid strides in the packaged food business with Sunfeast now the market leader in the highly competitive premium cream biscuits segment with ~27% market share and 'Aashirvaad' atta is the leader in the atta biscuits brand with ~70% market share. While the new launches 'Sunfeat Mom's Magic' range of cookies witnessed good traction in the target market; 'Sunfeast Yumfills Whoopie pie', a premium chocolate-enrobed cake, met with encouraging consumer response. Thus, we believe, the newly launched products along with the existing ones would bring a significant improvement in the company's performance in FY15E and in the following years.

Well diversified revenue stream bodes well for ITC - One of the reasons for ITC's success is its diverse product portfolio which is directly related to the lifestyle and an increase in disposable income of the consumer in India. ITC's major revenue comes through cigarettes, which comprises ~47% of the sales mix. In addition to cigarettes, ITC has a whole host of other revenue streams that are hotels (~3%), agri-business (~18%), paperboards and packaging (~14%), and other FMCG products (~26%). Diversified revenue stream protects the company from the recessionary pressures on any particular segment.

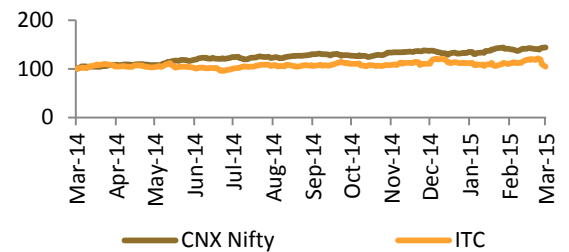
Market Data

Rating	BUY
CMP (₹)	317
Target (₹)	386
Potential Upside	~21.8%
Duration	Long Term
Face Value (₹)	1.0
52 week H/L (₹)	410.0/312.5
Adj. all time High (₹)	626.1
Decline from 52WH (%)	22.6
Rise from 52WL (%)	1.5
Beta	0.8
Mkt. Cap (₹bn)	2,541.7
EV (₹bn)	2,574.4

Fiscal Year Ended

Y/E	FY14A	FY15E	FY16E	FY17E
Revenue (₹bn)	353.2	400.8	451.4	508.2
EBITDA (₹bn)	130.5	149.3	174.6	203.8
Net Profit (₹bn)	88.9	101.5	119.7	140.7
EPS (₹)	11.1	12.7	14.9	17.6
P/E (x)	29.3	25.7	21.8	18.5
P/BV (x)	9.6	8.4	7.4	6.5
EV/EBITDA (x)	19.7	17.2	14.6	12.8
ROCE (%)	34.4	34.9	36.4	37.8
ROE (%)	32.6	32.8	34.0	35.2

One year Price Chart



Shareholding Pattern	Dec'14	Sep'14	Diff.
Promoters	-	-	-
FII	20.8	20.3	0.5
DII	34.8	34.8	-
Others	44.4	44.9	(0.5)

ITC has a diversified presence with business interests in cigarettes & tobacco, packaging, agri-business, food, hotels, lifestyle retailing, personal care, paper & stationery and branded apparels.

In the cigarette segment, the company enjoys more than ~80% market share by value in India.

ITC - a leading FMCG player in India with market leadership in the cigarettes business

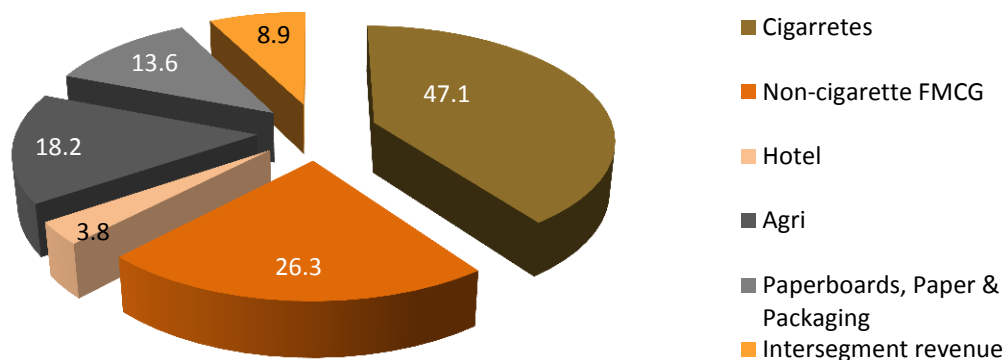
ITC has a diversified presence with business interests in cigarettes & tobacco, packaging, agri-business, food, hotels, lifestyle retailing, personal care, paper & stationery and branded apparels. ITC is India's leading FMCG marketer, the clear market leader in the Indian Paperboard and Packaging industry and the country's foremost Agri business player.

In the cigarette segment, the company enjoys more than ~80% market share by value in India. Despite the presence across various business segments, cigarette still draws a major part of profitability as the company's Cigarettes Business has an extensive FMCG distribution network with direct servicing of 1,00,000 markets and 2 mn retail outlets, managing one of the largest distribution networks in the country. ITC's Agri-Business is one of India's largest exporters of agricultural products and globally the 5th largest leaf tobacco exporter.

The company continues to rapidly scale up its new FMCG businesses leveraging. The new FMCG businesses comprising Branded Packaged Foods, Personal Care Products, Education and Stationery Products, Lifestyle Retailing, Incense Sticks (Agarbattis) and Safety Matches have grown at an impressive pace over the past several years. Within a relatively short span of time, ITC has established vital brands with significant salience among consumers like Aashirvaad, Sunfeast, Bingo!, Yippee!, Candyman, mint-o and Kitchens of India in the Branded Foods space and Essenza Di Wills, Fiama Di Wills, Vivel and Superia in the Personal Care products segment. In FY14, ITC entered into Deodorants category with the launch of its brand Engage.

ITC's hotels have evolved into being India's second largest hotel chain with over 95 properties across 66 locations in the country. Apart from the market leader in FMCG space, the company enjoys the dominant position in the Indian Paperboard and packaging business.

Revenue-mix as in Q3FY15 (%)

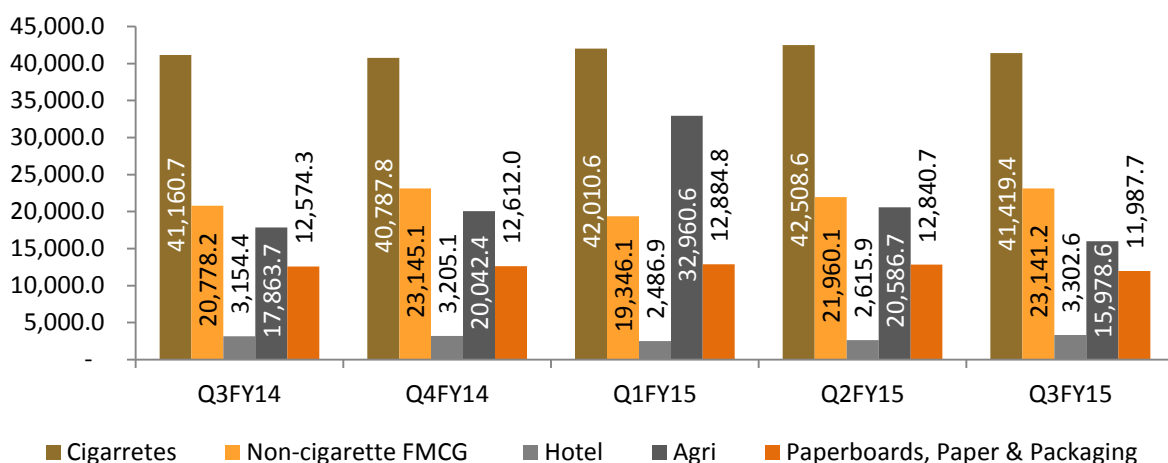


ITC's Q3 performance was deeply impacted by the full impact of steep hike in excise duty on cigarettes announced in the Union Budget 2014-15 coupled with sharp increase in VAT by key states - Tamil Nadu, Kerala and Assam.

Lower cigarette volumes hurt revenue growth in Q3FY15

India's leading cigarette manufacturer, ITC witnessed a subdued performance for the third quarter ended Q3FY15 with a mere 2.5% YoY growth in standalone total revenue at ₹89,425.9 mn hurt by lower volumes of cigarettes sold (down ~12-14%) during the quarter. ITC's Q3 performance was deeply impacted by the full impact of steep hike in excise duty on cigarettes announced in the Union Budget 2014-15 coupled with sharp increase in VAT by key states - Tamil Nadu, Kerala and Assam. Revenue growth from the company's major segment, cigarettes, remained flat with just 0.6% YoY growth at ₹41,419.4 mn, while from its hotel business; ITC was able to fetch a 4.7% revenue growth at ₹3,302.6 mn. De-growth in agri-business by 10.6% YoY to ₹15,978.6 mn in Q3FY15 further capped the top-line growth. The agri business performance was hurt by the lack of trading opportunities in Soya, during the quarter under review.

Segment-wise revenue trend (₹ mn)

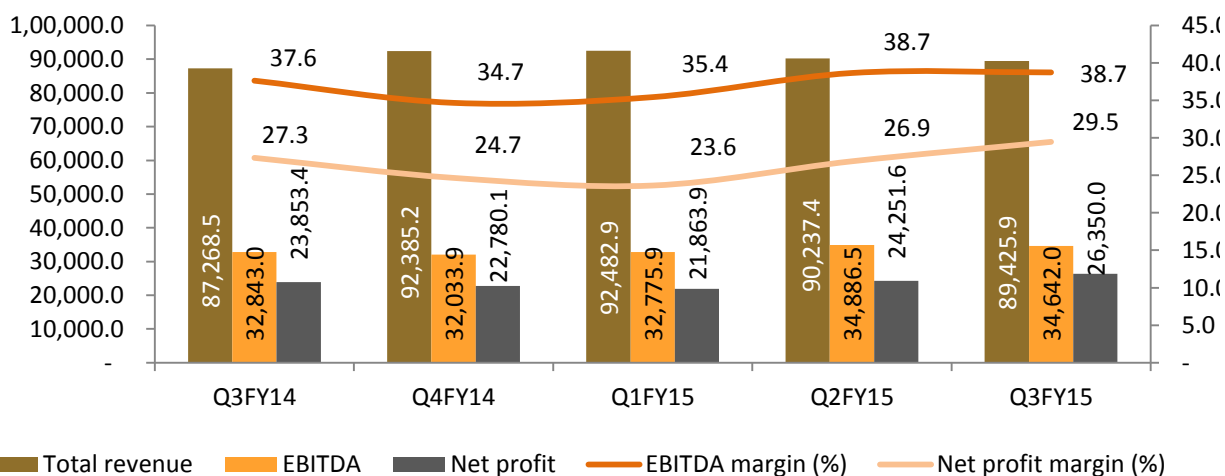


*Excluding inter-segment revenue

Moving forward, the operating profit of the company grew by 5.5% YoY in Q3FY15 as higher inventory cost restricted the growth.

Moving forward, the operating profit of the company grew by 5.5% YoY to ₹34,642.0 mn in Q3FY15 as higher inventory cost restricted the growth. The inventory cost (as a % of total revenue) grew by 142bps YoY to 1.9% in Q3FY15 compared to 0.5% in the corresponding period a year ago. EBITDA margin surged 110bps YoY to 38.7% in Q3FY15 as against 37.6% in Q3FY14 as lower raw material cost and other expenses compensated for higher inventory cost.

Total revenue and profitability trend (₹ mn)



During Q3FY15, the company saw a growth of merely 0.6% YoY in revenue from the cigarette space with a 2.6% sequential decline.

In a bid to compensate for higher excise duty and VAT, ITC move to hike prices of its key brands seems inevitable.

ITC's strategy to hike prices on its key brands would drive revenue growth in the coming quarters.

With an aim to de-risk its flagship cigarette business which has been under pressure with continuous excise duty hikes from the past three years, ITC is planning to scale up its non-cigarette FMCG business.

After accounting for an 8.4% YoY decline in interest cost followed by a 10.4% and 5.2% YoY increase in taxes and depreciation charges, the standalone net profit grew by 10.5% YoY to ₹26,350.0 mn in Q3FY15 as against ₹23,853.4 mn in the same period a year earlier.

Cigarettes: Aggressive price hike strategy to boost revenue growth

ITC has been witnessing continuous decline in volumes due to incessant price-hike undertaken by the company in order to compensate for the steep excise duty hikes by the government in the last two years (~18% hike in Budget 2012-13 and ~20% in 2013-14 Budget). In Union Budget 2014-15, the government announced the duty hike of 72% on cigarettes of length not exceeding 65 mm and to 11-21% for cigarettes of other lengths, hurting ITC's cigarette segment's performance even more.

Impacted by yet another hike in excise duty by 25% in below 65 mm cigarettes category and 15% in above 65 mm category, in Union Budget 2015-16, the company saw ~12-14% decline in cigarette volumes. Moreover, increase in VAT in Q3FY15 by its key states - Kerala, Tamil Nadu and Assam, which accounts for ~30% of the company's total sales volume, is also having an unfavorable impact on the company's performance. During Q3FY15, ITC saw a growth of merely 0.6% YoY in revenue from the cigarette space with a 2.6% sequential decline.

As expected, ITC has passed on the excise duty hike on customers. While raising the price of its most expensive brand, Insignia, by 20%, the company has raised the prices of Gold Flake Kings, Classic and Benson and Hedges by 15% to ₹218 from the current price of ₹190. With a 14% price rise in India Kings to ₹250, the company's hike in prices for all 84mm long cigarettes mentioned above comes in the range of 15%. For 64mm cigarettes, ITC has kept the range of 15-21.3% with the price of one of the ITC's most popular brands, Wills Navy Cut being raised by 13% to ₹78.

We believe, the cigarette volume would continue to see decline in the coming quarter. However, since the addiction factor plays a great role in tobacco products, we expect the company to witness some moderation as the strategy to hike prices on its key brands would drive revenue growth, going forward. Cigarette division is the major contributor to ITC's total revenue and accounted for ~47% of the top-line growth in Q3FY15.

Eyes revenue of ₹150 bn in next 2-3 years from non-cigarette FMCG space

With an aim to de-risk its flagship cigarette business which has been under pressure with continuous excise duty hikes from the past three years, ITC is planning to scale up its non-cigarette FMCG business. Currently, the non-cigarette FMCG segment accounts for ~26% of the total revenue (as in Q3FY15).

ITC is eyeing to increase the turnover to ₹150 bn from the non-cigarette FMCG segment in the coming 2-3 years through the inorganic way as it is eagerly looking for acquisitions in the same segment. ITC has been on an acquisition spree in the FMCG space marking a shift from its initial focus on creating brands from scratch. In 2014, it acquired the B-Natural juice brand and last month it acquired Savlon and Shower to Shower from Johnson & Johnson.

In FY15, ITC plans a turnover of ~₹110-120 bn from its portfolio of 50 FMCG brands across 20 categories. Further, the company plans to extend the brands under its current portfolio, much like how Dettol straddles health and hygiene segments. ITC is also getting ready to enter the dairy segment with ghee and dairy whitener in FY16, and will commission its dairy plant in a month or two. While ITC has been continuously examining opportunities to expand its presence in all e-commerce sites, it is also setting up its own online stores for niche products like Kitchens of India.

ITC's paper & packaging division has ~60% market share in the domestic value-added paperboard market which is expected to grow at a rate of 10-15% over the next 4-5 years.

The agri business provides strategic sourcing support to the company's Cigarettes Business and is the leading exporter of quality Indian tobacco.

During Q3FY15, ITC has unveiled its latest offering in the super-premium segment - ITC Grand Bharat near Gurgaon, which is likely to provide an impetus to sales going forward.

Paper & Packaging segment: optimistic industry outlook augurs well for the segment

The paperboard, paper & packaging segment, which contributed ~13.6% to the total revenues in Q3FY15, witnessed a de-growth by 4.7% YoY to ₹11,987.7 mn, during the quarter, due to slowdown in the FMCG and Cigarette industry. The Paper & packaging segment enjoys the strategic benefits of vertical integration, as it provides ~65% of total tissue for cigarette division in India, raw materials for the notebooks division and packaging solutions to other FMCG division. Any slowdown in the above-mentioned sectors has an adverse impact on the paper & packaging segment of the company.

ITC's paper & packaging division has ~60% market share in the domestic value-added paperboard market which is expected to grow at a rate of 10-15% over the next 4-5 years, thereby increasing the probability of better margins in the segment, going forward. Further, the domestic paperboard industry is likely to grow at ~8% CAGR over the next five years which would provide steady opportunities for the segment.

Agri Business: driving growth from strong procurement & distribution network

ITC trades in agriculture product like tobacco leaves, soya, wheat and coffee; where the company enjoys strong competencies in procurement which has been created by long-term association with farmers through its E-choupal program. The business provides strategic sourcing support to the company's Cigarettes Business and is the leading exporter of quality Indian tobacco. ITC's deep rural linkages and expertise in agri-commodity sourcing is a critical source of competitive advantage for the branded packaged foods business. Despite a 10.6% YoY decline in revenue to ₹15,978.6 mn in Q3FY15, ITC's continuous efforts to increase the overall efficiency of procurement by pursuing cost optimization initiatives and increasing the distribution reach bodes well for the overall revenue growth.

Hotel business: new offering in the super-premium segment to improve performance

The hospitality sector continued to be adversely impacted by the weak economic conditions and high levels of room inventory in key Indian cities leading to a relatively weak pricing scenario, which weighed on ITC's hotel business, leading to a muted revenue growth of 4.7% YoY from the hotel business in Q3FY15 while contributing just 3.8% to the overall revenue-base. ITC operates more than 105 hotels at 90 locations across India. The company manages hotel brands under several segments. ITC Hotel at the luxury end, Welcome Hotel in the 5-star segment, Fortune in the mid-market segment, and Welcome Heritage in the luxury heritage segment comprises ITC's Hotel brand chain. It manages approximately 3,500 rooms in the luxury and premium segment.

Given the weak pricing scenario in the backdrop of excessive room inventory coupled with the adverse economic environment in the global markets which impacted the tourist inflow and additions to the room supplies, the outlook for the hotel division doesn't seem very promising for the near-term. However, ITC's efforts towards increasing the revenue share from this segment augur well for the company. During Q3FY15, ITC has unveiled its latest offering in the super-premium segment - ITC Grand Bharat near Gurgaon, which is likely to provide an impetus to sales going forward.

Balance Sheet (Consolidated)

Y/E (₹mn)	FY14A	FY15E	FY16E	FY17E
Share Capital	7,953.2	7,953.2	7,953.2	7,953.2
Reserve & surplus	264,416.4	301,434.7	343,635.6	391,744.5
Net Worth	272,369.6	309,387.9	351,588.8	399,697.7
MI	2,030.3	2,294.2	2,592.5	2,929.5
Total debt	2,266.4	2,606.4	2,997.3	3,446.9
Provisions	60,882.2	68,188.1	75,006.9	82,507.6
Deferred tax liability	13,069.9	14,115.5	15,244.7	16,464.3
Other non-current liabilities	427.4	448.8	471.2	494.8
Other current liabilities	57,793.5	60,683.2	63,717.3	66,903.2
Capital Employed	408,839.3	457,724.0	511,618.7	572,444.0
Fixed Assets	157,415.3	176,305.1	197,461.8	221,157.2
Goodwill	2,971.4	3,030.8	3,182.4	3,341.5
Investments	72,840.2	87,408.2	104,889.9	125,867.9
Loans & advances	22,451.2	27,839.5	35,077.8	44,198.0
Deferred tax asset	355.2	515.0	746.8	1,082.9
Other non-current assets	12.4	12.4	12.4	12.4
Other current Assets	152,793.6	162,612.9	170,247.7	176,784.2
Capital Deployed	408,839.3	457,724.0	511,618.7	572,444.0

Key Ratios (Consolidated)

Y/E	FY14A	FY15E	FY16E	FY17E
EBITDA Margin (%)	37.0	37.2	38.7	40.1
EBIT Margin (%)	34.2	34.6	36.1	37.6
NPM (%)	25.2	25.3	26.5	27.7
ROCE (%)	34.4	34.9	36.4	37.8
ROE (%)	32.6	32.8	34.0	35.2
EPS (₹)	11.1	12.7	14.9	17.6
P/E (x)	29.3	25.7	21.8	18.5
BVPS(₹)	34.0	38.6	43.9	49.9
P/BVPS (x)	9.6	8.4	7.4	6.5
EV/Operating income (x)	7.3	6.4	5.7	5.1
EV/EBITDA (x)	19.7	17.2	14.6	12.8

Profit & Loss Account (Consolidated)

Y/E (₹mn)	FY14A	FY15E	FY16E	FY17E
Total revenue	353,170.8	400,848.9	451,355.8	508,226.6
Expenses	222,651.9	251,596.6	276,756.3	304,431.9
EBITDA	130,518.9	149,252.2	174,599.5	203,794.7
Other Income	9,709.5	10,680.5	11,748.5	12,923.3
Depreciation	9,649.2	10,614.1	11,675.5	12,843.1
EBIT	130,579.2	149,318.5	174,672.5	203,875.0
Interest	63.7	70.1	77.1	84.8
Profit Before Tax	130,515.5	149,248.5	174,595.4	203,790.2
Tax	40,609.3	46,700.7	53,705.8	61,761.7
MI/Share of profit/loss of asso.	992.4	1,091.6	1,200.8	1,320.9
Net Profit	88,913.8	101,456.1	119,688.8	140,707.6

Valuation and view

Aggressive pricing, strong balance sheet, investments across segments and new businesses, may help ITC to gain further market share in the Indian FMCG business pie. Moreover, above average industry growth in the non-cigarette FMCG business is also likely to power the company's growth, going forward. A rising market share in the packaged food business and strong growth in the personal care segment, may help propel ITC to the top of the pie in the FMCG industry over the coming years. We remain bullish on ITC on higher earnings visibility and improving profitability in the non-cigarette FMCG business that could lead to higher cash flows and payout ratios.

At a current market price (CMP) of ₹317, the stock trades at 21.8x FY16E and 18.5x FY17E, earnings. We recommend 'BUY' with a target price of ₹386.2, which implies potential upside of 21.8% to the CMP from 1 year perspective.

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