

July 30, 2014
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Rating	Accumulate
Price	Rs357
Target Price	Rs381
Implied Upside	6.7%
Sensex	25,991
Nifty	7,749

(Prices as on July 28, 2014)
Trading data

Market Cap. (Rs bn)	2,822.5
Shares o/s (m)	7,901.8
3M Avg. Daily value (Rs m)	5794

Major shareholders

Promoters	0.00%
Foreign	19.26%
Domestic Inst.	34.68%
Public & Other	46.06%

Stock Performance

(%)	1M	6M	12M
Absolute	11.7	9.4	(3.0)
Relative	8.2	(16.3)	(34.6)

How we differ from Consensus

EPS (Rs)	PL	Cons.	% Diff.
2015	12.4	12.9	-3.9
2016	14.8	15.2	-2.7

Price Performance (RIC: ITC.BO, BB: ITC IN)

Source: Bloomberg

ITC reported Adj. PAT of Rs21.9bn mainly due to 21.4% EBIT growth in the cigarettes business as non-cigarette EBIT increased by 2% only. Cigarette volumes increased ~3% (~-2.5% in Q4 and -1.5% in Q1FY14) as elections delayed 2014 budget and price increase. Slowdown has been clearly reflected in just 10.9% sales growth in FMCG and flat sales of Hotels business. Paper business has shown improved profitability and new pulp unit will help restore profitability. We expect improved profitability in FMCG due to benign input costs; Hotel recovery will be gradual, given the economic slowdown. We expect cigarette volumes to suffer as we expect ITC to undertake 15% price increase to post 22% increase in excise duty. Although industry shift from 64mm to 69mm should benefit ITC due to its stronghold on the segment, emergence of cigarettes as a revenue generator of last resort for GOI is a structural negative in our view. We roll forward our 12-month target price to June 2016 earnings and arrive at a target price of Rs381, a 7% upside. We maintain 'Accumulate' rating on the stock.

- **Cigarettes EBIT up 21.4% as volumes up by 3%:** Cigarette business reported 21.4% EBIT growth with 140bps EBIT margin expansion as volumes are up by ~3%. Impact of steep 22% weighted average increase in excise duty and its impact on volumes and profit growth will be reflected in the coming quarters. We expect near-term volume pressure and moderation in profit growth.
- **Non-cigarette business' EBIT increases 2%:** Non-cigarette business' EBIT increased by 2% YoY (18.6% in Q4FY14). FMCG sales growth slacked to 10.9%; it has reported a loss of Rs156m even as margins improved by 30bps. Hotels reported an EBIT loss Rs121m (Rs143m impact of depreciation method) sluggish economy, elections and IPL had impact on ARR and occupancy levels. Paperboard sales grew by 10.8%, EBIT increased by 9.3% even as margins declined by 30bps (up 640bps QoQ). Agri business sales increased 50.6%; EBIT increased by 1.6% due to higher proportion of low margin commodity exports.

Key financials (Y/e March)	2013	2014	2015E	2016E
Revenues (Rs m)	299,013	332,386	373,880	434,346
Growth (%)	18.9	11.2	12.5	16.2
EBITDA (Rs m)	106,275	122,969	142,229	168,194
PAT (Rs m)	74,184	86,503	99,620	119,099
EPS (Rs)	9.4	10.9	12.4	14.8
Growth (%)	19.1	15.9	14.3	18.7
Net DPS (Rs)	5.3	6.0	7.0	8.3

Profitability & Valuation	2013	2014	2015E	2016E
EBITDA margin (%)	35.5	37.0	38.0	38.7
RoE (%)	36.1	35.6	35.8	37.5
RoCE (%)	36.3	35.6	35.8	37.5
EV / sales (x)	9.2	8.3	7.3	6.2
EV / EBITDA (x)	25.7	22.3	19.1	16.0
PE (x)	38.0	32.8	28.7	24.2
P / BV (x)	12.7	10.8	9.7	8.5
Net dividend yield (%)	1.5	1.7	2.0	2.3

Source: Company Data; PL Research

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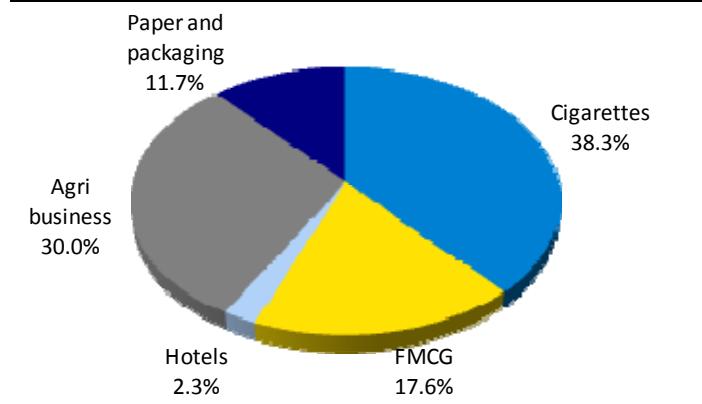
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Exhibit 1: Q1FY15 Result Overview (Rs m); EBITDA grew 17.9% even as margins decline by 230bps; Cigarettes once again acts as a saviour

Y/e March	Q1FY15	Q1FY14	YoY gr. (%)	Q4FY14	FY15E	FY14	YoY gr. (%)
Net Sales	92,483	74,107	24.8	92,385	373,880	332,386	12.5
Gross profit	52,707	45,417	16.1	53,689	227,875	200,823	13.5
<i>Margins (%)</i>	57.0	61.3		58.1	60.9	60.4	
Other Exp	19,931	17,504	13.9	21,655	85,646	77,853	10.0
EBITDA	32,776	27,913	17.4	32,034	142,229	122,969	15.7
<i>Margins (%)</i>	35.4	37.7		34.7	38.0	37.0	
Depreciation	2,313	2,153	7.4	2,378	10,067	8,999	11.9
Interest	152	170	(10.6)	95	377	377	0.0
Other Income	2,346	2,032	15.4	2,667	13,216	11,071	19.4
PBT	32,657	27,622	18.2	32,227	145,002	124,664	16.3
Tax	10,793	8,709	23.9	9,447	45,382	38,161	18.9
<i>Rate (%)</i>	33.0	31.5		29.3	31.3	30.6	
Adj. PAT	21,864	18,913	15.6	22,780	99,620	86,503	15.2
Reported PAT	21,864	18,913	15.6	22,780	99,620	87,852	13.4

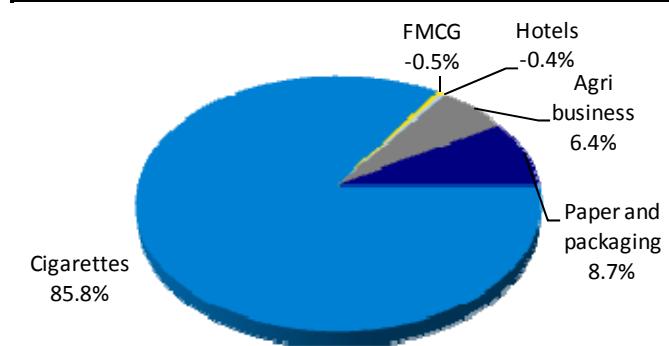
Source: Company Data, PL Research

Exhibit 2: Q1FY15 Sales mix: Share of FMCG slowly inching up



Source: Company Data, PL Research

Exhibit 3: Q1FY15: Cigarettes are 85.8% of EBIT



Source: Company Data, PL Research

Net sales have increased by 24.8% to Rs92.4bn. Gross margins have declined by 430bps due to higher proportion of low margin Agri products in total sales. EBITDA margins decline was arrested to 230bps YoY to 35.4% due to 30bps decline in staff cost and 180bps decline in Other expenditure. EBITDA increased by 17.4% to Rs32.7bn. PBT increased by 18.2% to Rs32.6bn as depreciation increased by 7.4% YoY and Interest cost declined by 10.6% YoY to Rs152m. Adj.PAT increased by 15.6% to Rs21.8bn due to 150bps increase in Tax rate to 33%.

Exhibit 4: Cigarette EBIT up 21.4%; FMCG EBIT loss at Rs156m; Hotels profits only Rs22m (adj), commodity exports impact Agri margins

	2QFY13	3QFY13	4QFY13	1QFY14	2QFY14	3QFY14	4QFY14	1QFY15
Cigarette Volume gr %	0.5	1.5	2.5	-1.5	-3.7	-2.5	-2.5	-2.5
Sales (Rs m)	83,758	84,420	88,868	88,840	88,842	95,531	99,792	109,689
Cigarettes	33,852	36,574	36,232	35,374	37,238	41,161	40,788	42,011
FMCG	16,908	17,827	20,362	17,447	19,622	20,778	23,145	19,346
Hotels	2,170	3,095	3,155	2,499	2,470	3,154	3,205	2,487
Agri business	20,239	16,310	18,545	21,890	17,725	17,864	20,042	32,961
Paper and packaging	10,590	10,615	10,575	11,631	11,787	12,574	12,612	12,885
Sales growth (YoY)								
Cigarettes	14.0	13.1	11.5	7.1	10.0	12.5	12.6	18.8
FMCG	26.1	30.1	26.0	18.4	16.1	16.6	13.7	10.9
Hotels	2.8	11.0	10.4	7.5	13.8	1.9	1.6	(0.5)
Agri business	41.1	43.1	31.1	29.4	(12.4)	9.5	8.1	50.6
Paper and packaging	5.3	8.5	7.9	12.3	11.3	18.5	19.3	10.8
EBIT (INR m)								
Cigarettes	20,802	22,335	21,124	22,417	24,117	26,526	25,519	27,218
FMCG	(303)	(240)	119	(189)	(127)	104	431	(156)
Hotels	153	555	406	89	87	622	599	(121)
Agri business	2,597	1,726	1,275	1,993	2,846	2,054	1,455	2,025
Paper and packaging	2,825	2,286	1,881	2,516	2,208	2,317	1,884	2,749
EBIT growth (YoY)								
Cigarettes	20.3	21.1	20.2	18.0	15.9	18.8	20.8	21.4
FMCG	NA	NA	NA	(51.3)	(58.1)	143.2	263.0	17.6
Hotels	(64.8)	(45.5)	(51.0)	(65.9)	(43.0)	12.1	47.3	(235.2)
Agri business	8.8	21.9	20.8	16.3	9.6	19.0	14.1	1.6
Paper and packaging	(2.5)	1.9	(3.9)	(5.0)	(21.9)	1.4	0.1	9.3
EBIT Margin (%)								
Cigarettes	61.4	61.1	58.3	63.4	64.8	64.4	62.6	64.8
FMCG	(1.8)	(1.3)	0.6	(1.1)	(0.6)	0.5	1.9	(0.8)
Hotels	7.1	17.9	12.9	3.6	3.5	19.7	18.7	(4.9)
Agri business	12.8	10.6	6.9	9.1	16.1	11.5	7.3	6.1
Paper and packaging	26.7	21.5	17.8	21.6	18.7	18.4	14.9	21.3

Source: Company Data, PL Research

Cigarette volumes up by ~3%; EBIT up 21.4%

Cigarette business reported 18.8% increase in net sales and 21.4% increase in EBIT as margins expanded 140bps. Volumes were up by ~3% as realizations increased 15.5%. While Q1 performance has shown improvement in cigarette volumes, recent increase in excise duty by 22% will have its impact in the coming quarters. We believe that a steep 72% increase in excise duty on 64mm segment will have adverse impact on volumes as this segment would require steep price increase, the segment had grown to more than 8% of ITC's sales and more than 10-11% of industry volumes. Although we don't rule out consumer shift happening from 64mm cigarettes to 69mm, volumes are expected to suffer in the near term.

Exhibit 5: Volumes up by 3% after 4 quarters of decline

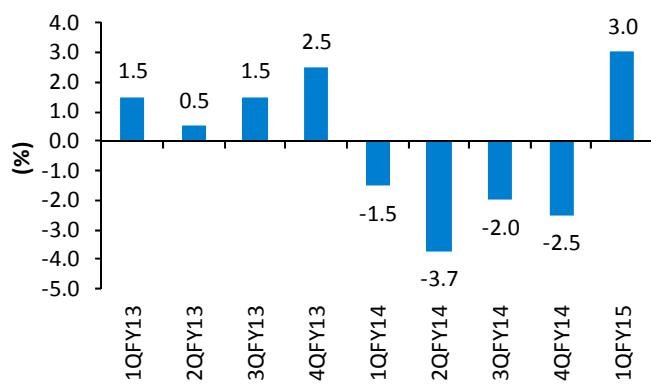
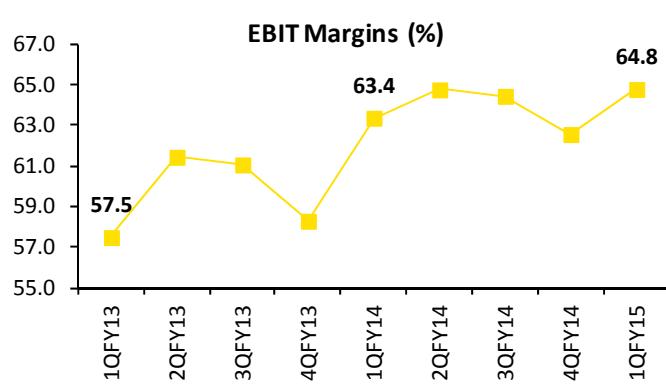


Exhibit 6: Cigarette margins up 140bps



Source: Company Data, PL Research

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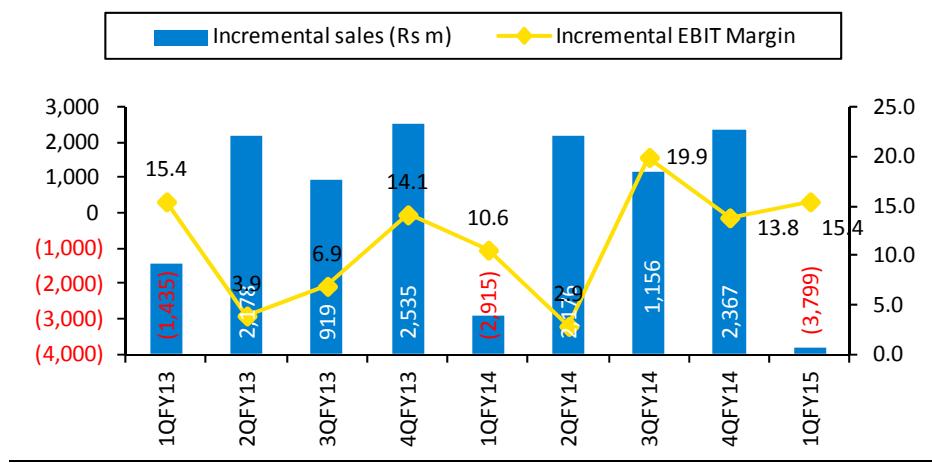
FMCG sales up 10.9%; EBIT margins up by 30bps

FMCG sales grew by 10.9% to Rs19.3bn, while it reported EBIT loss of Rs156m even as margins improved by 30bps. Although demand has been impacted due to slowdown across segments, richer sales mix and economy of scales has improved the profitability. ITC is looking to expand its direct distribution reach by 0.1m which would improve rural sales and growth.

'Aashirvaad' atta consolidated its leadership position. Biscuit segment saw the launch of 'Sunfeast Farmlite' cookies in the health segment which enabled ITC to gain market share. ITC rebranded its offering in the mid price cream biscuit segment under the 'Sunfeast Bounce' to sharpen its position and retain leadership in the 'cream' segment of the market. 'Sunfeast Yippee!' continued to gain share in Noodles segment.

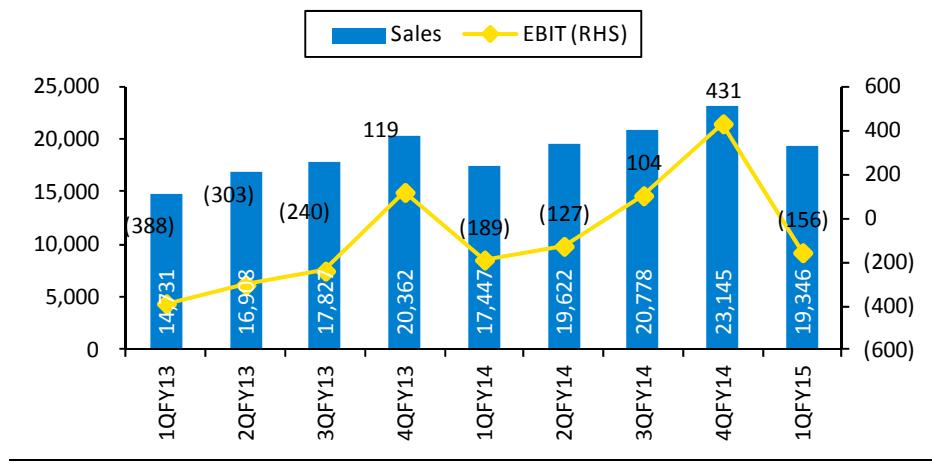
'Classmate' and 'PaperKraft' sustained leadership in 'Education and Stationery' products business and is looking at increasing reach of value brand 'Saathi' to increase its share. Personal products saw introduction of two variants in deodorant category. We believe that the recent move by the GOI to release excess wheat stocks in the open market will be a positive for ITC, given that wheat is one of the major inputs for both 'Aashirvaad' Atta and 'Sunfeast' biscuits.

Exhibit 7: Sharp QoQ decline shows demand pressures, margins continue to expand



Source: Company Data, PL Research

Exhibit 8: FMCG sales up 10.9%; EBIT loss at RS156m

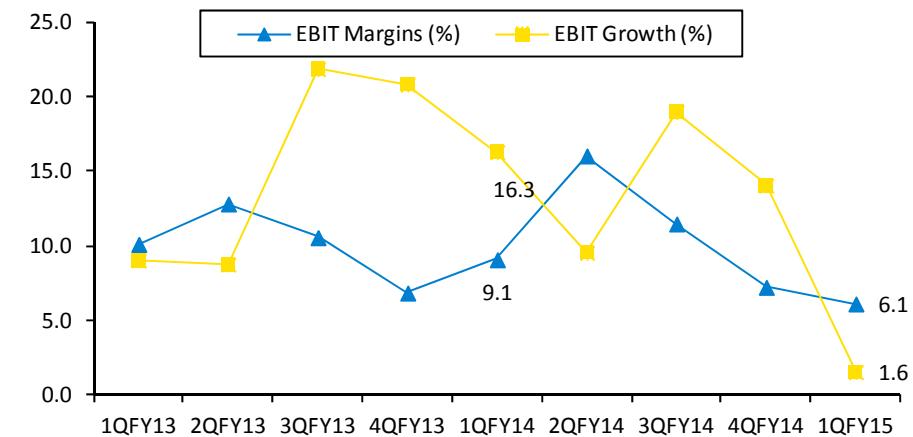


Source: Company Data, PL Research

Agri sales up 50.6%, margins nosedive as sales mix deteriorates

Agri business sales improved 50.6%, EBIT expanded by 1.6% to Rs2.02bn as margins declined by 300bps to 6.1%. Sharp sales growth was due to export opportunity in coffee, soya and wheat. Shift in sales mix towards low margin commodity exports impacted the segmental margins. We expect leaf tobacco business (45% of sales) to sustain its profitability; however, FY15 margins would be lower due to deterioration in sales mix.

Exhibit 9: Agri business EBIT margins and Growth

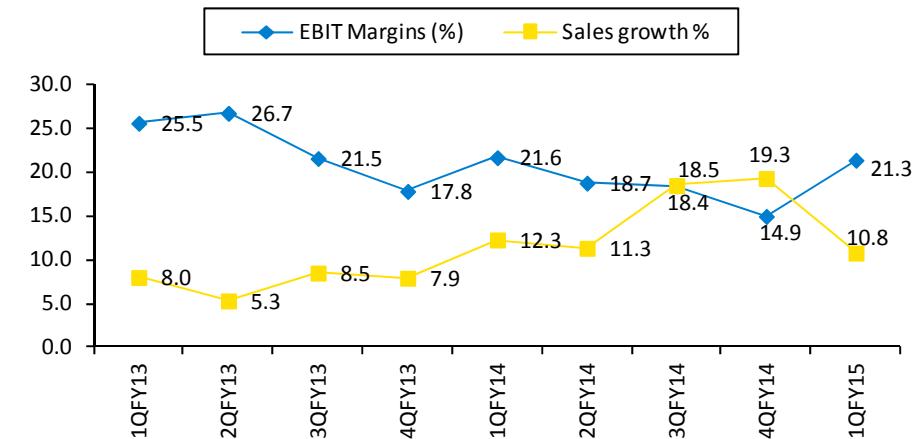


Source: Company Data, PL Research

Paperboard and Paper: Sales up 10.8%, EBIT margins recover smartly

Paper business reported 10.8% increase in sales and 9.3% increase in EBIT as margins declined 30bps. Sales growth was due to combination of 5-6% price increase ramp-up in paperboard unit and improved sales mix. Although ITC has not been able to fully cover the sharp increase in wood, coal and chemical costs, margins have increased by 640bps QoQ, partly due to seasonal impact. Although recovery to sustained margins of 21% will take some time, worst seems over for the profitability of this business. New pulp unit will further improve profitability in the current year.

Exhibit 10: Margins under pressure due to high raw material costs



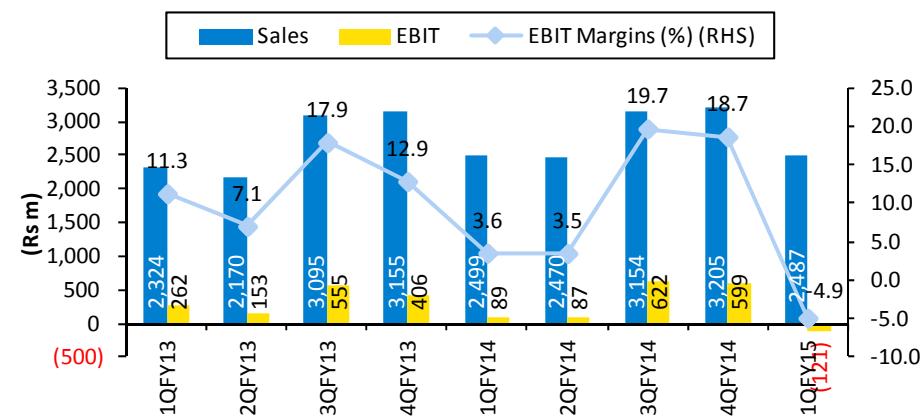
Source: Company Data, PL Research

Hotels: low occupancy and ARR continue to impact profitability

Hotels business has reported flat sales and loss of Rs121m due to change in the useful life of assets for depreciation. Excluding this impact, EBIT would be Rs22m, a decline of 75%. Poor economic growth, elections and shifting of IPL from India impacted the occupancy levels and ARR remained sluggish during the period. Commissioning of Bengaluru property also added to margin pressure.

ITC has commissioned its 115 room “My Fortune Bangalore” property, while *Classic gold resort* near Gurgaon is nearing completion. Construction activity of the new properties at Kolkata and Hyderabad is on schedule.

Exhibit 11: Hotels: Margin expands 580bps as EBIT grows 47.3%



Source: Company Data, PL Research

Hotels business has been facing pressure due to **1)** high room inventory addition **2)** decline in ARR and **3)** rising costs of manpower, electricity and other operational costs. We expect Hotel segment to witness delayed recovery as it is contingent on the recovery in the economy. Recent measure by the GOI to boost trade and industry will act as a catalyst for this segment; however, no short cuts to growth are expected in this segment.

Exhibit 12: Annual segmental data

	FY11	FY12	FY13	FY14	FY15E	FY16E
Net Sales (Rs m)						
Cigarettes	105,737	123,244	139,696	154,561	164,006	186,266
FMCG	44,716	55,256	69,828	80,992	94,458	111,278
Hotels	10,008	10,062	10,742	11,328	12,551	13,627
Agri Business	47,480	56,953	72,007	77,521	94,668	108,204
Paperboards & Paper	35,072	39,234	42,368	48,605	53,772	67,000
EBIT (Rs m)						
Cigarettes	57,668	69,077	83,259	98,580	112,344	130,386
FMCG	(2,976)	(1,955)	(813)	218	661	1,558
Hotels	2,666	2,794	1,377	1,397	1,632	2,044
Agri Business	5,663	6,432	7,313	8,348	9,467	11,361
Paperboards & Paper	8,192	9,368	9,640	8,925	10,217	14,070
EBIT Margin (%)						
Cigarettes	54.5	56.0	59.6	63.8	68.5	70.0
FMCG	(6.7)	(3.5)	(1.2)	0.3	0.7	1.4
Hotels	26.6	27.8	12.8	12.3	13.0	15.0
Agri Business	11.9	11.3	10.2	10.8	10.0	10.5
Paperboards & Paper	23.4	23.9	22.8	18.4	19.0	21.0
EBIT Growth (%)						
Cigarettes	16.8	19.8	20.5	18.4	14.0	16.1
FMCG	(14.9)	(34.3)	(58.4)	(126.9)	203.0	135.6
Hotels	23.0	4.8	(50.7)	1.5	16.8	25.3
Agri Business	26.5	13.6	13.7	14.2	13.4	20.0
Paperboards & Paper	19.7	14.3	2.9	(7.4)	14.5	37.7
Non-Cigarette Businesses						
Net Sales	137,277	161,505	194,945	218,446	255,449	300,109
Growth %	19.8	17.6	20.7	12.1	16.9	17.5
EBIT	13,545	16,638	17,516	18,888	21,977	29,034
EBIT Growth (%)	35.6	22.8	5.3	7.8	16.4	32.1
EBIT Margin (%)	9.9	10.3	9.0	8.6	8.6	9.7

Source: Company Data, PL Research

Income Statement (Rs m)

Y/e March	2013	2014	2015E	2016E
Net Revenue	299,013	332,386	373,880	434,346
Raw Material Expenses	120,658	131,563	146,005	169,367
Gross Profit	178,355	200,823	227,875	264,979
Employee Cost	13,870	16,084	17,576	19,919
Other Expenses	58,210	61,770	68,069	76,866
EBITDA	106,275	122,969	142,229	168,194
Depr. & Amortization	7,956	8,999	10,067	11,103
Net Interest	(8,522)	(10,694)	(12,839)	(16,263)
Other Income	9,387	11,071	13,216	16,640
Profit before Tax	106,842	124,664	145,002	173,354
Total Tax	32,658	38,161	45,382	54,255
Profit after Tax	74,184	86,503	99,620	119,099
Ex-Od items / Min. Int.	—	2,698	—	—
Adj. PAT	74,184	86,503	99,620	119,099
Avg. Shares O/S (m)	7,901.8	7,953.2	8,013.2	8,073.2
EPS (Rs.)	9.4	10.9	12.4	14.8

Balance Sheet Abstract (Rs m)

Y/e March	2013	2014	2015E	2016E
Shareholder's Funds	222,879	262,620	293,709	341,010
Total Debt	777	665	777	777
Other Liabilities	12,037	12,970	13,067	13,211
Total Liabilities	235,692	276,255	307,552	354,998
Net Fixed Assets	126,971	143,085	142,060	150,957
Goodwill	—	—	—	—
Investments	20,009	25,122	25,122	25,122
Net Current Assets	88,713	108,049	140,370	178,919
<i>Cash & Equivalents</i>	<i>86,744</i>	<i>96,006</i>	<i>144,886</i>	<i>187,150</i>
<i>Other Current Assets</i>	<i>106,450</i>	<i>128,081</i>	<i>129,238</i>	<i>147,847</i>
<i>Current Liabilities</i>	<i>104,482</i>	<i>116,039</i>	<i>133,754</i>	<i>156,079</i>
Other Assets	—	—	—	—
Total Assets	235,692	276,255	307,552	354,998

Cash Flow Abstract (Rs m)

Y/e March	2013	2014	2015E	2016E
C/F from Operations	68,587	77,278	111,256	116,154
C/F from Investing	(34,901)	(38,124)	(57,649)	(60,585)
C/F from Financing	(33,205)	(44,704)	(49,906)	(57,734)
Inc. / Dec. in Cash	481	(5,550)	3,702	(2,164)
Opening Cash	1,405	2,012	2,347	2,622
Closing Cash	1,886	(3,538)	6,049	457
FCFF	44,594	69,423	106,246	113,918
FCFE	44,479	69,312	106,357	113,918

Quarterly Financials (Rs m)

Y/e March	Q2FY14	Q3FY14	Q4FY14	Q1FY15E
Net Revenue	78,625	87,269	92,385	92,483
EBITDA	30,179	32,843	32,034	32,776
<i>% of revenue</i>	38.4	37.6	34.7	35.4
Depr. & Amortization	2,209	2,259	2,378	2,313
Net Interest	21	91	95	152
Other Income	2,462	3,911	2,667	2,346
Profit before Tax	30,412	34,403	32,227	32,657
Total Tax	9,428	10,550	9,447	10,793
Profit after Tax	20,984	23,853	22,780	21,864
Adj. PAT	20,984	23,853	22,780	21,864

Key Financial Metrics

Y/e March	2013	2014	2015E	2016E
Growth				
Revenue (%)	18.9	11.2	12.5	16.2
EBITDA (%)	20.1	15.7	15.7	18.3
PAT (%)	20.4	16.6	15.2	19.6
EPS (%)	19.1	15.9	14.3	18.7
Profitability				
EBITDA Margin (%)	35.5	37.0	38.0	38.7
PAT Margin (%)	24.8	26.0	26.6	27.4
RoCE (%)	36.3	35.6	35.8	37.5
RoE (%)	36.1	35.6	35.8	37.5
Balance Sheet				
Net Debt : Equity	(0.4)	(0.4)	(0.5)	(0.5)
Net Wrkng Cap. (days)	61	77	64	64
Valuation				
PER (x)	38.0	32.8	28.7	24.2
P / B (x)	12.7	10.8	9.7	8.5
EV / EBITDA (x)	25.7	22.3	19.1	16.0
EV / Sales (x)	9.2	8.3	7.3	6.2
Earnings Quality				
Eff. Tax Rate	30.6	30.6	31.3	31.3
Other Inc / PBT	8.8	8.9	9.1	9.6
Eff. Depr. Rate (%)	4.7	4.9	4.9	4.9
FCFE / PAT	60.0	80.1	106.8	95.6

Source: Company Data, PL Research.

Key Operating Metrics

Y/e March	2013	2014	2015E	2016E
Cigarette Volume growth %	2.0	(2.5)	(5.0)	3.5
Cigarette EBIT growth %	20.5	20.3	12.2	16.1
FMCG EBIT (rsm)	(812.6)	218.2	661.2	1,557.9

Source: Company Data, PL Research.



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Rating Distribution of Research Coverage



PL's Recommendation Nomenclature

BUY	: Over 15% Outperformance to Sensex over 12-months	Accumulate	: Outperformance to Sensex over 12-months
Reduce	: Underperformance to Sensex over 12-months	Sell	: Over 15% underperformance to Sensex over 12-months
Trading Buy	: Over 10% absolute upside in 1-month	Trading Sell	: Over 10% absolute decline in 1-month
Not Rated (NR)	: No specific call on the stock	Under Review (UR)	: Rating likely to change shortly

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