ITC Ltd.

EQUITY REPORT

Indbank Merchant Banking Services Ltd (A Subsidiary of Indian Bank)

February 7, 2014

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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 the company operates with over 2 mn retailers across India managing one of the largest distribution networks in the country.

Investor's Rationale

- ITC continues to hold leadership position in the cigarette business due to the breadth of its powerful cigarette brands and their making it India's largest cigarette company with more than 80% market share by value. This also enables the company to enjoy strong pricing power and maintain steady volume growth. Cigarettes are highly taxed but ITC being the market leader is able to pass on the impact to the customers. The company also keeps on tinkering with the size and packaging to optimise the segment's profitability. Further, with ITC's dominance in the cigarettes segment, we believe its pricing power would continue to aid cigarette margins.

- The company has maintained healthy returns ratios consistently over the years primarily driven by the cigarette segment which would continue to fetch superior returns. Driven by higher return from the cigarette business and improving contribution from FMCG segment, the consolidated RoCE is expected to improve to 36.8% and RoE expected at 33.3% by FY'15E.

- ITC's non-cigarette FMCG business grew by 26% YoY in FY'13, surpassing the industry growth, a sign that ITC is fast gaining market share in the Indian FMCG industry, which is still dominated by HUL, with a 15% market share. In a short span of time, ITC has penetrated successfully in segments like food & confectionery and personal care products. Consequently we expect non-cigarette businesses to add to the earnings in FY'15 in a better way backed by a strong performance in packaged food business and rising benefits of scale that could augment its cash flows and payout ratios.

- One of the reasons for ITC's success is its diverse product portfolio. It 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 58% of the sales mix. In addition to cigarettes (16.8% YoY growth in revenue in FY'13), ITC has a whole host of other revenue streams that are hotels (6.5% YoY), agri-business (26.5% (YoY), FMCG (26.6% YoY) and paperboards and packaging (9.0% YoY). All these businesses (except other FMCG) are profitable at the operating level. Diversified revenue stream protects the company from the recessionary pressures on any particular segment.

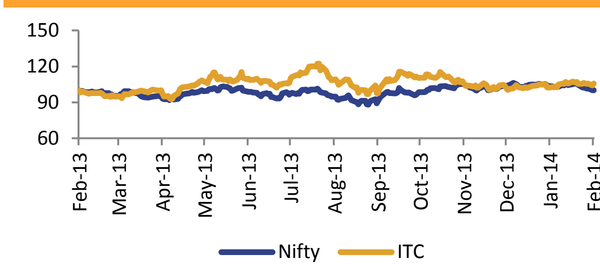
Market Data

Rating	**BUY**
CMP (₹)	323
Target (₹)	**380**
Potential Upside	~17.6%
Duration	Long Term
Face Value (₹)	1.0
52 week H/L (₹)	380/281
Adj. all time High (₹)	380
Decline from 52WH (%)	17.6
Rise from 52WL (%)	14.9
Beta	0.9
Mkt. Cap (₹bn)	2,552.3
Enterprise Value	2,516.7

Fiscal Year Ended

Y/E	FY12A	FY13A	FY14E	FY15E
Revenue (₹bn)	265.3	316.3	368.5	427.4
EBITDA (₹bn)	92.1	111.7	133.2	155.7
Net Profit (₹bn)	62.6	76.1	92.2	108.1
Adj EPS (₹)	8.0	9.6	11.7	13.7
P/E (x)	40.4	33.5	27.7	23.6
P/BV (x)	13.0	11.0	9.1	7.9
EV/EBITDA (x)	27.1	22.5	18.8	16.0
ROCE (%)	33.7	34.4	35.5	36.8
ROE (%)	32.2	32.9	33.1	33.3

One year Price Chart



Shareholding Pattern	Dec'13	Sep'13	Diff.
Promoters	-	-	-
FII	19.26	19.30	(0.04)
DII	34.33	34.32	0.01
Others	46.41	46.38	0.03

ITC - One of the World's most reputable companies

The company enjoys the leadership across the 4 industry verticals – Tobacco, Hotels, Paperboards & Packaging, Agriculture.

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 the country'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 Cigarette 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, crossing ₹70 bn mark during FY'13. 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 FY'14, 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.

Segmental performance over the years

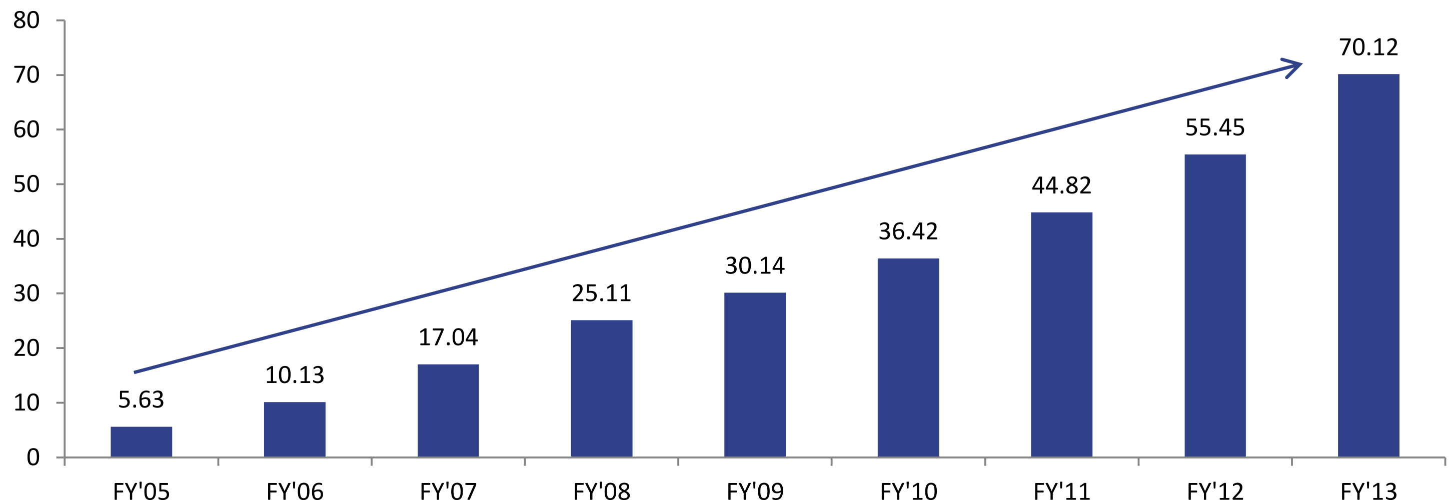
Segment Performance (Consolidated)	FY'10	FY'11	FY'12	FY'13
Sales (₹bn)				
Cigarettes	181.1	207.2	232.3	271.4
FMCG-Others	36.6	45.0	55.6	70.4
Hotels	9.8	11.5	10.7	11.4
Agri business	38.6	47.5	56.9	72.0
Paper & Packaging	32.3	36.7	41.3	45.0
EBIT				
Cigarettes	51.1	60.0	71.9	86.9
FMCG-Others	(3.8)	(3.3)	(2.1)	(0.9)
Hotels	2.3	2.8	2.9	1.5
Agri business	4.5	5.7	6.4	7.3
Paper & Packaging	6.8	8.2	9.4	9.6
EBIT margin (%)				
Cigarettes	28.2	29.0	31.0	32.0
FMCG-Others	(10.4)	(7.3)	(3.8)	(1.3)
Hotels	23.5	24.3	27.1	13.2
Agri business	11.7	12.0	11.2	10.1
Paper & Packaging	21.1	22.3	22.8	21.3

Non cigarette FMCG business to be the major growth driver for ITC in the coming quarters. Buoyed by strong quarterly performance, ITC is aiming to double its turnover from this segment to ₹150 bn by 2017-18.

ITC targets sales of ₹150 bn by 2017-18 from its non-cigarette FMCG business

The new FMCG businesses have grown at an impressive pace over the past several years, with the revenues crossing ₹70 bn mark during FY'13. The company's new FMCG businesses are the fastest growing among the top Indian FMCG companies operating in India and continues to rapidly scale up its new FMCG businesses leveraging on its strong distribution network developed over the years for its cigarette business to boost the revenue base and growth. In a short span of time, ITC has penetrated successfully in segments like food & confectionery and personal care products. ITC is targeting a revenue-base of ₹150 bn by 2017-18 as compared to the revenue base of ₹70 bn in 2012-13. The new FMCG businesses turn profitable in this fiscal and recorded a profit of ₹0.1 bn during Q3FY'14 on the back of enhanced scale and improvement in profitability. Despite a slowdown in consumption, the Q3FY'14 profits in the non-cigarette FMCG business, imbued confidence that the business could turn break-even by FY15E on an annual basis and add to the earnings in a better way.

Rapid Scale up of FMCG businesses, with sales crossing ₹70 bn mark in FY'13

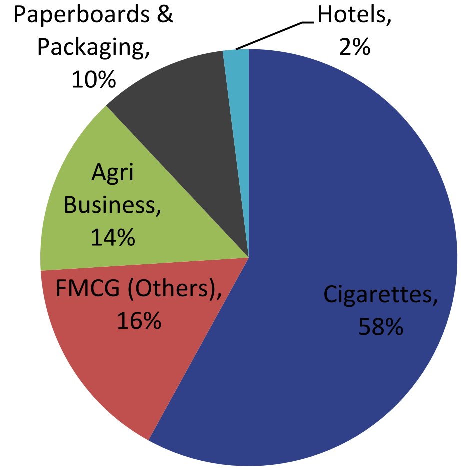


ITC witnessed a 13.1% YoY rise in revenue driven by the new FMCG businesses and the Paperboards, Paper & Packaging segment.

Witnessed impressive performance in Q3FY'14

ITC posted yet another impressive performance during Q3FY'14 with healthy topline growth and high quality earnings notwithstanding a challenging business environment (significant deceleration in consumption expenditure, sustained high inflationary conditions and the steep increase in taxes/duties on Cigarettes). The net revenue registered a robust growth of 13.1% at ₹86,231.1 mn driven by the new FMCG businesses and the Paperboards, Paper & Packaging segment. During the quarter, net profit rose more than 16% YoY to ₹23,853.4 mn led by huge rise in other income. Other income surged ~19% YoY to ₹3,910.6 mn during the quarter. In line with strong sales growth, the EBITDA during the quarter surged ~15% YoY to ₹32,843 mn with the Q3 EBITDA margins increased to 38% as against ~37% YoY.

Revenue contribution in Q3FY'14



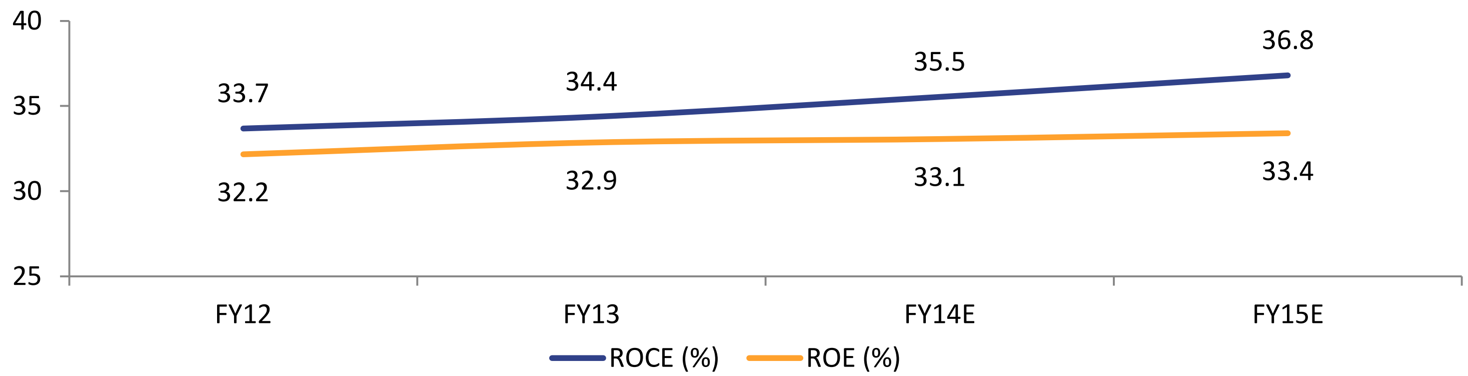
ITC's pricing power remains very strong in cigarettes and has undertaken continuous price hikes in cigarettes in FY'14, which will further boosts its margins and realisation.

Expects improved ROE and ROCE led by higher returns from the cigarette and FMCG segment

The cigarette business continues to remain the mainstay business of the company, which contributes more than 50% to total revenues, reflects ITC's dominance in the cigarettes segment. The company's gross revenue from the cigarettes business grew 12.6% YoY to ₹76,639.8 mn in Q3FY'14 due to higher price realization. ITC continues to enjoy the pricing power in cigarettes and has undertaken continuous price hikes in cigarettes in FY'14, which will further boosts its margins and realisation. However, volumes will remain under pressure in FY'14 as price hikes are visibly hurting demand for cigarettes. However, we expect the cigarette demand will improve over the next few quarters coupled with the pricing power in cigarettes would led the company's strong growth in the cigarettes and overall earnings.

ITC has witnessed improved profitability in the cigarette vertical amid a good pan India response to the 64mm segment. 64mm continued to gain traction with ~8% share in volumes. The price hike (in Wills Navy Cut Kings, Bristol and 64mm Gold flake), coupled with the increasing popularity of the 64mm segment, is expected to boost the company's margins. Moreover, higher return form cigarette segment and improving contribution from other FMCG segment will continue to result in improved Return on equity (ROE) and Return on capital employed (ROCE) in the coming years.

Return ratios to stay elevated



With ITC's dominance in the cigarettes segment, we believe its pricing power would continue to aid cigarette margins.

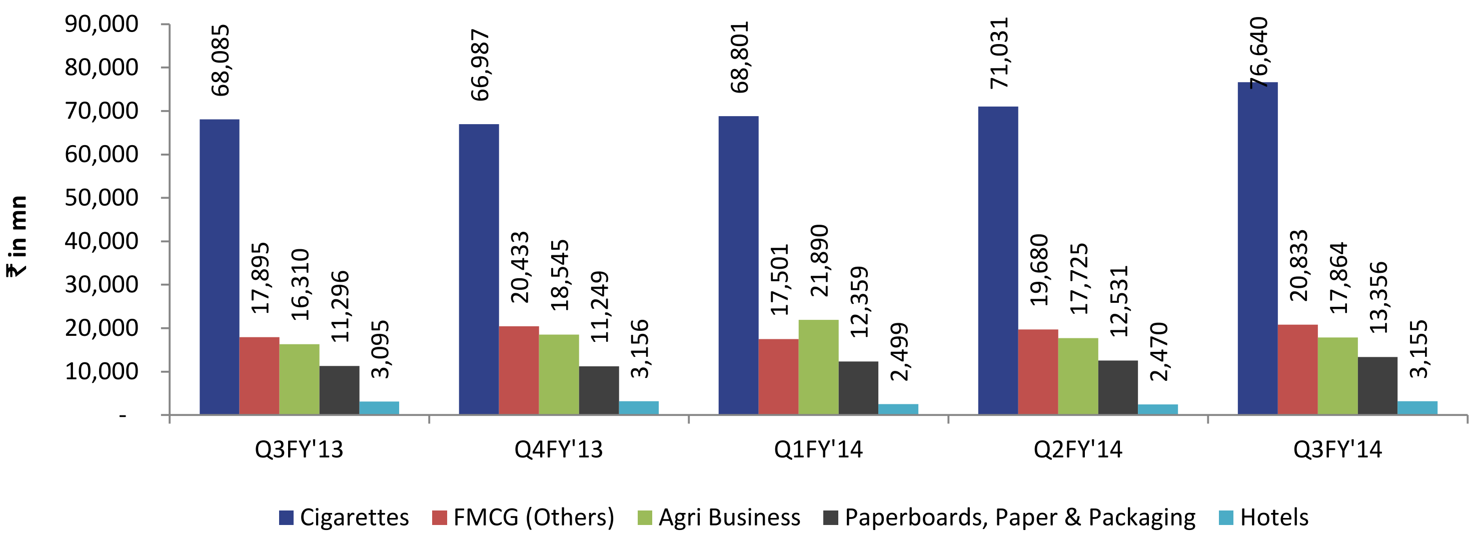
FMCG (non-cigarette) business is gaining traction with the division registering a profit of ₹103.5 mn on the back of enhanced scale and improvement in profitability.

Aggressive price hike measure boosted the cigarette business revenue in Q3FY'14

In the face of an environment of deceleration in consumption expenditure, sustained high inflationary conditions and steep increase in taxes on cigarettes, the gross revenue from ITC's mainstay cigarette business, which contributes more than 50% to total revenues, grew 12.6% YoY to ₹76,639.8 mn. Gross margin expanded 180 bps to 34.6% and net margin jumped 340 bps to 64.4% in the quarter gone by despite the company's move to increase cigarette prices by more than 15% due to higher taxes during the quarter. Further, with ITC's dominance in the cigarettes segment, we believe its pricing power would continue to aid cigarette margins.

Interestingly, its non-cigarette FMCG business made a turnaround during the quarter with the division registering a profit of ₹103.5 mn over a loss of almost ₹239.8 mn in a year-ago period on the back of enhanced scale and improvement in profitability. Gross revenues of the FMCG business, which accounts for ~20% of ITC's revenues, went up 16.4% YoY to ₹20,833.2 mn in the quarter gone by despite a marked slowdown in consumption expenditure. The segment growth was driven by Aashirvaad atta and Sunfeast Yippee! instant noodles as well as newer launches include Sunfeast Delishus gourmet cookies and Candyman confectionery among brands.

Cigarettes continue to dominate ITC's gross revenue; maintaining its contribution at ~60%



New product launches across various segments bolsters revenue outlook. With the inflation showing signs of easing in the recent times, the domestic consumption may get a boost.

Positive outlook for the Indian FMCG industry augers well

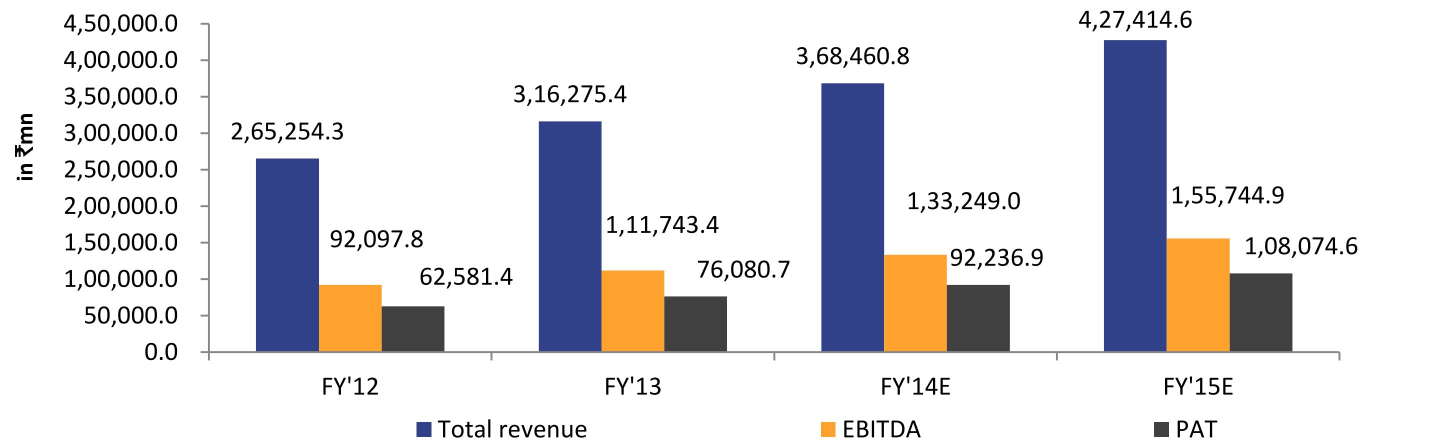
Indian FMCG industry has grown at a CAGR of 17% over the last five years on the back of increasing income levels, increasing urbanisation, strong rural demand and favourable demographic trends. These growth drivers, coupled with the low levels of penetration and per capita usage in India, are expected to result in robust industry growth in excess of 15% per annum over the medium-term. Further, the sector will be riding high on account of good monsoon, which will help to bolster rural incomes and rural consumption, a key target market for Indian FMCG industry players. With the industry players focused towards new product launches and brand extensions in the recent past are likely to boost margins. Despite the slowdown in the Indian economy, the near-term outlook for the Indian FMCG industry looks positive with volumes set for modest growth and margins expected to remain healthy amid muted raw material costs. With the inflation showing signs of easing in the recent times would provide a fillip to the domestic consumption. The record slump in the Indian rupee and high interest rates are unlikely to have any direct impact on the Indian FMCG sector, thus signaling a positive outlook for FMCG companies such as ITC.

Long-term outlook for hotel business remains positive

Hotel business remains a weak link, as it was adversely impacted by slowdown. Any significant improvement in the hotel segment contribution in the overall sales and PBIT is unlikely in the near term.

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 1.9% YoY from the hotel business in Q3FY'14. Segment Results, however grew by 12.1% during Q3FY'14 aided by improved financial performance by ITC Grand Chola. In line with its strategy of expanding presence, ITC has commenced operations at 4 properties (2 in Kerala, 1 each in Dwarka and Chandigarh) during Q3FY'14, resulting in addition of appx. 650 rooms in India during the year through the management contract route. Besides, the company is also in the phase of completing the new properties at Kolkata, Hyderabad, Bengaluru and at the Classic Golf Resort near Gurgaon. The company was the industry leader in terms of operating margins, while the outlook for ITC's hotel business remains positive amid long-term bullish prospects for the Indian Hotel industry. ITC is aiming to increase the capacity from over 95 hotels (more than 8,000 rooms) currently to 150 hotels (13,000 hotels) to consolidate its position in the Indian hotel industry, going forward.

Performance continues to remain impressive

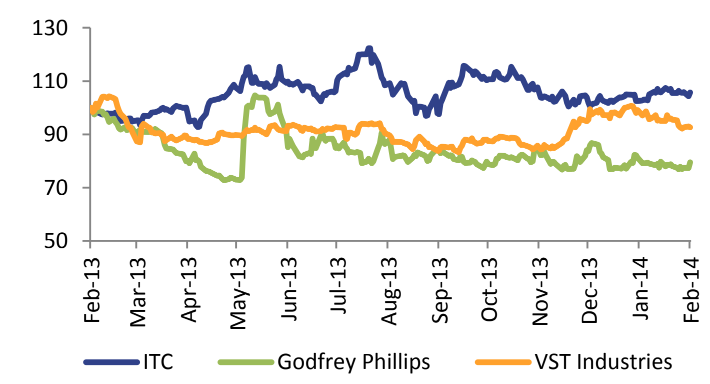


Relative Valuation

	P/E	P/BVPS	Dividend Yield (%)
ITC	33.5	11.0	1.6
Godfrey Phillips	15.5	2.5	1.6
VST Inds.*	19.5	8.1	3.9

** Standalone*

Relative Price Chart



Balance Sheet (Consolidated)

Y/E (₹mn)	FY12A	FY13A	FY14E	FY15E
Share Capital	7,818	7,902	7,902	7,902
Reserve and surplus	186,767	223,677	271,109	316,649
Net Worth	**194,586**	**231,579**	**279,011**	**324,551**
Minority Interest	1,571	1,799	1,979	2,177
Loans	1,073	908	813	723
Provisions	44,787	53,391	56,061	58,864
Net Deferred Tax Liability	8,820	12,136	12,136	12,136
Other long term liabilities	505	405	344	292
Capital Employed	**2,51,342**	**3,00,218**	**3,50,344**	**3,98,743**
Fixed Asset	120,898	138,854	147,185	156,016
Goodwill	3,141	3,165	3,165	3,165
Investment	52,068	59,813	65,794	65,794
Loans & Advances	15,803	17,759	20,956	24,728
Net Current Assets	59,257	80,374	112,990	148,787
Deferred tax assets (Net)	163	241	241	241
Other Assets	12	12	12	12
Capital Deployed	**2,51,342**	**3,00,218**	**3,50,344**	**3,98,743**

Profit & Loss Account (Consolidated)

Y/E (₹mn)	FY12A	FY13A	FY14E	FY15E
Revenue	**265,254**	**316,275**	**368,461**	**427,415**
Operating Expenses	173,157	204,532	235,212	271,670
EBITDA	**92,098**	**111,743**	**133,249**	**155,745**
Depreciation	7,455	8,591	8,763	9,201
EBIT	84,643	103,152	124,486	146,544
Other Income	7,844	8,776	9,654	10,619
Interest	805	872	785	706
PBT	91,682	111,057	133,355	156,457
Tax	28,458	34,121	40,007	46,937
Minority Interest	643	855	1,112	1,445
Net Profit	**62,581**	**76,081**	**92,237**	**108,075**

Key Ratios (Consolidated)

Y/E	FY12A	FY13A	FY14E	FY15E
EBITDA Margin (%)	34.7	35.3	36.2	36.4
EBIT Margin (%)	31.9	32.6	33.8	34.3
NPM (%)	23.6	24.1	25.0	25.3
ROCE (%)	33.7	34.4	35.5	36.8
ROE (%)	32.2	32.9	33.1	33.3
EPS (₹)	8.0	9.6	11.7	13.7
P/E (x)	40.4	33.5	27.7	23.6
BVPS (₹)	24.9	29.3	35.3	41.1
P/BVPS (x)	13.0	11.0	9.1	7.9
EV/Operating Income (x)	9.4	8.0	6.8	5.8
EV/EBITDA (x)	27.1	22.5	18.8	16.0

Valuation and view

Strong pricing power due to dominant market share in the cigarettes alludes to ITC’s robust financial condition. Moreover, above average industry growth in the non-cigarette FMCG business, with the new FMCG business turned profitable in Q3FY’14 is also likely to power 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 Indian 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 ₹323, the stock trades at a P/E of 27.7x FY14E and 23.6x FY15E. We recommend ‘BUY’ with a target price of ₹380, which implies potential upside of ~18% to the CMP from long term (1 year) perspective.

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