

Stock Update

Mixed performance; Cigarette volume growth improved to ~7%

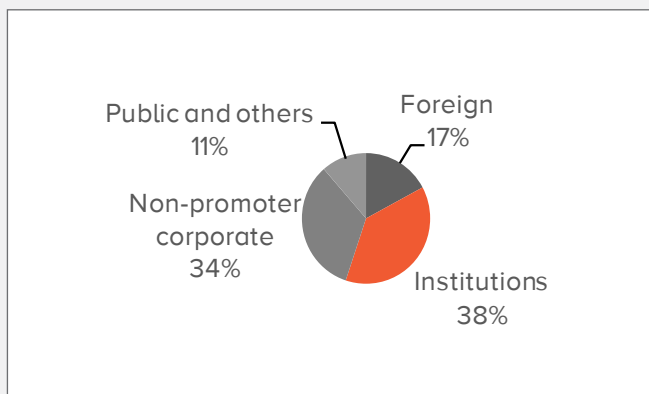
ITC

Reco: Buy | CMP: Rs278

Company details

Price target:	Rs347
Market cap:	Rs340,464 cr
52-week high/low:	Rs323/251
NSE volume: (No of shares)	117.5 lakh
BSE code:	500875
NSE code:	ITC
Sharekhan code:	ITC
Free float: (No of shares)	1224.7 cr

Shareholding pattern



Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	4.7	0.4	5.7	7.9
Relative to Sensex	2.6	-6.2	5.5	4.7

Key points

- ♦ **Revenue grew strongly by ~15% but unfavourable mix affected profitability:** In Q3FY2019, ITC's net revenue grew by 14.9%, driven by strong 25.7% growth in the agri business and 20.5% growth in the paperboard, paper and packaging (PPP) business. Revenue of the core cigarette business grew by 9.6% y-o-y during the quarter, with volume growth of improving to ~7%. Gross margin declined by 145 BPS y-o-y to 60.6%. Operating profit grew by 11.2% y-o-y to Rs. 4,325.8 crore and operating profit margin (OPM) declined by 124 BPS y-o-y to 37.8% mainly on account of lower margins in the cigarette business and agri business. PAT grew by 13.8% y-o-y to Rs. 3,209.1 crore (broadly in line with our expectation of Rs. 3,174 crore). Strong growth in adjusted PAT can be attributed to mid-teens revenue growth and 30% growth in other income during the quarter.
- ♦ **Cigarette sales volume grew by ~7%; Non-cigarette FMCG steady performance; Paperboard, Paper & Packaging business outperforms:** Revenue of the cigarette business grew by 9.6%, with cigarette sales volume growing by ~7% in Q3FY2019. PBIT of the cigarette business grew by 8.8% y-o-y, lower than revenue growth mainly on account of downtrading to low-price cigarettes (largely to 64 mm cigarettes) and higher input cost (mainly due to increase in leaf tobacco prices). Revenue of the non-cigarette FMCG business grew by 11.5%, driven by strong double-digit growth in atta, snacks, cream biscuits and noodles during the quarter. However, the restructuring of lifestyle retailing and unfavourable timing of trade promotion activities in matches and agarbatti category led to lower than expected revenue growth for the quarter. PBIT of the non-cigarette FMCG business grew by 63.1% to Rs. 76.7 crore during the quarter. Revenue of the agri business grew by 25.7% y-o-y, largely on account of rising opportunities in trading of oilseeds, rice, spices and coffee. However, PBIT margin of the business declined by 491 BPS to 10.3% mainly on account of subdued demand for leaf tobacco in international markets and steeper depreciation in currencies of competing markets. Revenue of PPP business grew by ~20%, while PBIT grew by 23.8% y-o-y, driven by product mix enrichment, higher realisation, strategic investments in imported pulp substitution, process innovation leading to improved pulp yield and benefits of a cost-competitive fibre chain. Revenue of the

hotel business grew by just 11.7% in a seasonally strong quarter. PBIT of the hotels business (excluding gestation cost of new properties) grew strongly by 29% during the quarter.

- ♦ **Outlook – Improvement in cigarette sales volume to sustain; Non-cigarette FMCG to grow in double digits:** With no significant price hike undertaken in the recent past, cigarette sales volume is expected to grow in mid-to-high single digits in the coming quarter. However, margins of the cigarette business are expected to be lower due shift from long/king-size cigarettes to small-size cigarettes. The non-cigarette FMCG business is expected to maintain its double-digit revenue growth with the demand environment improving in rural India. The increase in scale of non-cigarette FMCG business will provide support to overall margins in the medium term. With room demand likely to exceed room supply, we expect the company's hotel business to deliver

strong performance in FY2019/FY2020. The PPP business will continue to post better profitability on account of improved revenue mix and benign input cost.

- ♦ **Fine-tuned estimates to factor in lower margins; Maintain Buy with an unchanged PT of Rs. 347:** We have fine-tuned our earnings estimates for FY2019 and FY2020 to factor in lower-than-expected operating margins and higher depreciation charges. We have introduced FY2021 estimates in this note. We expect ITC to post strong double-digit revenue growth and decent earnings performance in the near term. ITC is currently trading at 21.8x its FY2021E earnings, which is at a stark discount to some of the large FMCG stocks. We maintain our Buy recommendation on the stock with an unchanged price target (PT) of Rs. 347. Any significant increase in tax rate in the upcoming GST council meets would act as a key risk to our earnings estimates.

Valuations (standalone)

	Rs cr				
Particulars	FY2017	FY2018	FY2019E	FY2020E	FY2021E
Revenue	40,088.7	40,627.5	45,455.7	51,495.8	58,022.9
Net profit	10,200.9	10,397.5	12,089.3	13,847.2	15,560.6
OPM (%)	36.4	38.3	38.1	38.6	39.0
EPS (Rs.)	8.4	8.5	9.9	11.3	12.8
PE (x)	33.3	32.6	28.1	24.5	21.8
EV/EBITDA (x)	21.9	20.4	18.2	15.7	13.8
RoCE (%)	29.8	28.4	29.0	31.4	32.7
RoNW (%)	23.5	21.5	22.9	24.7	25.4

Results (standalone)

	Rs cr				
Particulars	Q3FY19	Q3FY18	YoY %	Q2FY19	QoQ %
Net Sales	11431.3	9952.2	14.9	11272.5	1.4
Total expenditure	7105.5	6063.1	17.2	7066.5	0.6
Operating Profit	4325.8	3889.1	11.2	4206.0	2.8
Other income	836.4	642.4	30.2	504.1	65.9
Interest	5.6	24.0	-76.6	13.5	-58.4
Depreciation	335.4	290.8	15.3	327.5	2.4
Profit before tax	4821.2	4216.7	14.3	4369.1	10.3
Tax	1612.1	1396.5	15.4	1414.5	14.0
Adjusted PAT	3209.1	2820.2	13.8	2954.7	8.6
Exceptional item	0.0	270.0	-	0.0	-
Reported PAT	3209.1	3090.2	3.8	2954.7	8.6
EPS (Rs.)	2.6	2.3	13.8	2.4	8.6
			BPS		BPS
GPM (%)	60.6	62.1	-145	60.2	37
OPM (%)	37.8	39.1	-124	37.3	53

Segment-wise performance

Cigarette business: Sales volume grew by 4-5%; Lower realisation marred margins

- ♦ Revenue of the cigarette business grew by 9.6%, with cigarette sales volume growing by ~7 in Q3FY2019 (improved from 5-6% achieved in Q2FY2019). Growth in sales volume was on

account of no substantial price increase in the portfolio in the recent past and low base of Q3FY2018.

- ♦ However, the downtrading in cigarette sales to low-price cigarettes (largely to 64 mm cigarettes) resulted in lower realisation growth. This along with higher input prices (including leaf tobacco) and increased salience of capsule

cigarettes in the sales mix led to PBIT of the cigarette business growing by 8.8% y-o-y as against revenue growth of ~10%.

- ◆ With no price hikes in the portfolio in recent times, we expect volume growth to sustain in the range of mid-to-high single digit in the coming quarters, considering the low base of H2FY2018. However, the downtrading to low-price cigarettes would result in lower realisation growth and would keep a check on margins in the coming quarters. Overall, we expect mid-single digit volume growth for FY2019.

Non-cigarette FMCG business - Revenue grows in double digits; Profit saw a huge jump

- ◆ In Q3FY2019, ITC's non-cigarette FMCG business grew by 11.5% y-o-y to Rs. 3,201 crore with most categories performing well. However, the restructuring of lifestyle retailing and unfavourable timing of trade promotion activities in matches and agarbatti category led to lower than expected revenue growth for the quarter.
- ◆ PBIT of the non-cigarette FMCG business grew by 63.1% to Rs. 76.7 crore (improved from Rs. 58.5 crore in Q2FY2019). This was mainly driven by enhanced scale, product mix enrichment and cost-management initiatives, notwithstanding increased input costs, sustained investments in brand building, gestation cost of new categories and start-up costs of new facilities.
- ◆ In the staples, snacks and meals business, *Aashirvaad atta* consolidated its leadership position across markets with continued uptick in sales momentum. Increasing consumer traction for *Bingo! Potato Chips* and *Tedhe Medhe* continued to drive growth in the snacks business. In the instant noodles category, product portfolio was augmented with the launch of *YiPPee! My range noodles*, which has been receiving good response.
- ◆ In the confections business, *Dark Fantasy Choco Fills* witnessed further acceleration in growth momentum, driven by superior product attributes and consumer activation. During the quarter, *Sunfeast Mom's Magic Choco Chip* and two crispy variants of *Sunfeast Snackys* – '*Masala Twist*' and '*Something Else!*' were launched, thus expanding the biscuits portfolio.
- ◆ In the dairy and beverages business, *Sunfeast Wonderz Milk* was launched in three exciting formats (Fruit 'n' Milk, Shakes and NutShakes)

in select markets. The company also expanded its fresh dairy footprint by launching *Aashirvaad Svasti* milk and dahi in Kolkata.

- ◆ The personal care products business enhanced its market standing during the quarter with strong performance of handwash, bodywash and herbal floor cleaners (Nimyle was extended to new markets in south, after recording robust growth in eastern markets). Pocket perfumes continued to show strong growth despite intense competition in recent months. The *Dermafique* range of premium creams, cleansing and toning products launched in the previous quarter was also expanded with the introduction of two new variants of cleansing mousse and body serum. *Charmis* range of skin creams, which was relaunched in the previous quarter, has been well received by discerning consumers.

Agri business – Strong revenue growth of ~26% y-o-y

- ◆ The agri business segment's revenue grew strongly by 25.7% y-o-y to Rs. 1,924.6 crore and posted PBIT of Rs. 198.8.1 crore, down 14.8% y-o-y.
- ◆ The company leveraged trading opportunities in wheat, coffee, oilseeds and aqua, resulting in strong revenue growth for the quarter. However, steeper depreciation in currencies of competing origins, subdued demand for leaf tobacco in international markets and escalation in leaf cost pertaining to Andhra 2017 crop continued to weigh on PBIT margin.
- ◆ The company is scaling up the recently launched range of frozen snacks comprising 10 variants of vegetarian and non-vegetarian snacks under the *ITC Master Chef* brand after receiving encouraging consumer traction in the launch markets. The company is also stepping up initiatives in value-added agriculture, which include packaged prawns, fruit puree, fresh fruits and vegetables and dehydrated onions.

Hotel business – Pick up in revenue with substantial growth in profitability owing to higher room rates

- ◆ ITC's hotels business registered revenue growth of ~12% y-o-y to Rs. 451.9 crore and strong growth of 29% y-o-y in PBIT (excluding gestation cost of new properties) in Q3FY2019, driven by improvement in average room rates. The recently commissioned ITC Kohenur and ITC Grand Goa, Resort and Spa continued to receive excellent response from discerning guests, setting higher standards in service excellence.

- ♦ The business made steady progress during the quarter in the construction of ITC Hotels at Kolkata and Ahmedabad and WelcomHotels in Guntur and Bhubaneswar.

Paperboard, paper and packaging business – Revenue grew by 20.5% owing to strong demand environment

- ♦ ITC's paperboard, paper and packaging (PPP) business revenue grew by 20.5% y-o-y in Q3FY2019 to Rs. 1,542.5 crore on account of strong demand and capacity augmentation in value-added paperboard and décor segments. PBIT grew by healthy 23.8% y-o-y to Rs. 332.1

crore, driven by product mix enrichment, higher realisation, strategic investments in imported pulp substitution and process innovation leading to improved pulp yield and benefits of a cost-competitive fibre chain.

- ♦ In view of the sharp increase in imported pulp prices during the year, operations of the bleached chemical thermo mechanical pulp mill were further scaled up during the quarter to reduce import dependency, which delivered substantial savings to the business. Capacity utilisation of the décor and paperboard machines was scaled up during the quarter.

Segmental revenues

Particulars	Rs cr				
	Q3FY19	Q3FY18	YoY %	Q2FY19	QoQ %
FMCG - Cigarettes	5,073.4	4,629.2	9.6	5,026.1	0.9
FMCG - Others	3,201.0	2,871.8	11.5	3,160.4	1.3
Hotels	451.9	404.4	11.7	362.6	24.6
Agri	1,924.6	1,530.9	25.7	2,219.7	-13.3
Paperboard, Paper and Packaging	1,542.5	1,279.6	20.5	1,424.5	8.3
Total	12,193.3	10,715.9	13.8	12,193.2	0.0
Less: Inter-segment sales	853.2	863.1	-1.2	1,098.3	-22.3
Gross Sales	11,340.2	9,852.7	15.1	11,094.9	2.2

Segment profits

Segment profits						Rs cr
Particulars	PBIT			Margins (%)		Chg in BPS
	Q3FY19	Q3FY18	YoY %	Q3FY19	Q3FY18	
FMCG - Cigarettes	3557.7	3269.3	8.8	70.1%	70.6%	-50
FMCG - Others	76.7	47.0	63.1	2.4%	1.6%	76
Hotels	60.3	54.8	10.1	13.3%	13.5%	-20
Agri	198.8	233.3	-14.8	10.3%	15.2%	-491
Paperboard, Paper and Packaging	332.1	268.3	23.8	21.5%	21.0%	57
Total	4225.6	3872.6	9.1	34.7%	36.1%	-148

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