Sharekhan
by BNP PARIBAS

ITC

Steady performance

Sector: Consumer Goods
Result Update

	Change
Reco: **Buy**	↔
CMP: **Rs. 249**	
Price Target: **Rs. 297**	↔

↑ Upgrade ↔ No change ↓ Downgrade

Company details

Market cap:	Rs. 305,934 cr
52-week high/low:	Rs. 310/234
NSE volume: (No of shares)	133.6 lakh
BSE code:	500875
NSE code:	ITC
Sharekhan code:	ITC
Free float: (No of shares)	1228.6 cr

Shareholding (%)

Promoters	0.0
FII	16.4
DII	42.4
Others	41.2

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	-1.5	-7.2	-15.7	-10.5
Relative to Sensex	-1.5	-10.1	-17.5	-23.5

Sharekhan Research, Bloomberg

ITC posted steady numbers in Q2FY2020 with revenue growing by 5.3% and operating profit growing by 8.5% (OPM increased 112 bps to 38.4%). Higher other income led to a 10% y-o-y growth in profit before tax. A lower tax incidence drove up profit after tax (PAT) by 36%. Core cigarette business volumes grew by 3% largely driven by higher growth in premium cigarettes while regular and small-size cigarettes registered muted performance due to higher salience of sales in rural markets. The non-cigarette FMCG business continues to clock strong improvement in the profitability despite a tough demand environment. The company continues to focus on de-risking its business model by increasing the scale of the non-cigarette FMCG businesses. A discounted valuation at 18.1x its FY2021E earnings makes it a good buy in the FMCG space.

Key Positives

- Cigarette volume grew by 3%; in line with a 3% volume growth achieved in Q1.
- Despite a lean quarter, hotel revenue grew by 17.7%
- The paperboard, paper & packaging (PPP) business' revenue grew by ~10% and PBIT margins improved by 91 bps to 22.7%.
- Overall OPM expanded by 112 bps, largely driven by an improvement in profitability of the core cigarette business and the non-cigarette FMCG business that grew by 55% y-o-y.

Key Negatives

- Non-cigarette FMCG business grew 6.5% on comparable basis due to slowdown in rural market.
- Agri-business PBIT margins declined by 121 bps to 9.4%.

Our Call

Valuation: We have broadly maintained our earnings estimates for FY2020 and FY2021. Though revenue is expected to grow in single digits, the expansion in OPM, higher other income and reduction in the corporate tax would result in strong double digit earning growth in FY2020. ITC continues to trade at a discounted valuation of 18.1x its FY2021E earnings, lower than some large-cap FMCG companies. We maintain our Buy recommendation on the stock with an unchanged price target (PT) of Rs. 297.

Key risks: Any increase in competition in the core cigarette business from other brands or illegal cigarettes along with a possibility of a tax rate hike on cigarettes remains a key risk to earnings estimates in the near to medium term.

Valuation (Standalone) Rs cr

Particulars	FY17	FY18	FY19	FY20E	FY21E
Revenue	40,089	40,628	45,784	49,886	55,618
OPM (%)	36.4	38.3	37.8	38.5	38.8
Adjusted PAT	10,201	10,810	12,387	15,158	16,818
Adjusted EPS (Rs.)	8.3	8.5	10.1	12.4	13.8
P/E (x)	29.9	29.4	24.7	20.0	18.1
P/B (x)	6.7	5.9	5.3	4.8	4.3
EV/EBIDTA (x)	19.5	18.1	16.2	14.5	12.9
RoNW (%)	23.5	21.5	22.5	25.0	25.1
RoCE (%)	29.8	28.4	27.8	27.7	28.4

Source: Company; Sharekhan estimates

Revenue grew by ~5.3%; OPM expanded by 112 bps y-o-y

Net revenue grew by 5.3% y-o-y to Rs. 11,871 crore, driven by a 6% rise in core cigarette business and a 4% reported growth (~6.5% comparable growth) in the non-cigarette FMCG business. Gross margins expanded by 202 bps to 62.2% mainly aided by a better revenue mix. OPM improved by 112 bps to 38.4% mainly on account of higher margins in the cigarette business and the non-cigarette FMCG business. Other income grew by ~30% y-o-y to Rs. 654.3 crore. Despite higher operating margins and other income, a ~21% rise in depreciation costs led to 10% growth in profit before tax. A lower tax expense due to reduction in the corporate tax rate resulted in a ~36.2% rise in reported PAT to Rs. 4,023.1 crore.

Cigarette business volume growth stood at 3; margins expanded due to better mix

Cigarette business revenue grew by 6% y-o-y to Rs. 5,326.8 crore, with sales volumes and realisations, each growing by 3%. Premium cigarette sales growth was better that of regular and small-size cigarettes (which saw a dip in sales). Regular and small size cigarettes have higher salience of sales coming from the rural market which was affected by a slowdown in the demand environment. This led to cigarette business PBIT rising by 7.4% y-o-y, as against a revenue growth of 6% (PBIT margins improved by 96 bps y-o-y). We expect cigarette sales volumes to be at 4-5% in the near term and margins to be higher due to a better mix.

Non-cigarette FMCG business growth moderated to 6.5%; profitability improves

The non-cigarette FMCG business revenue grew by 6.5% y-o-y on comparable basis (excluding the discontinued retail business) impacted by categories with higher rural salience. Revenue growth was lower than some of the earlier quarters mainly on account of sluggish demand. Urban centric categories such as Aashirwaad Atta, Bingo snacks, Sunfeast premium biscuits and liquids (handwash and bodywash) in personal care products continued to do well and clocked higher growth than the base business. EBITDA grew by 39% y-o-y to Rs. 221 crore despite a step-up in investments in brand building, gestation and start-up costs of new categories/new facilities. The company continued to mitigate the effect of a slowdown by enhancing direct reach, introducing offers, investing in modern trade/e-commerce channels and extending credit to certain trade partners. We expect H2FY2020 to be better than H1 due to better monsoons and an improving liquidity environment especially in rural areas.

Other businesses performed well

Hotel business revenue grew by 18% y-o-y driven by recently-commissioned hotels – ITC Kohenur, Hyderabad, ITC Grand Goa and ITC Royal Bengal. The performance of existing hotels was relatively subdued due to a sluggish demand environment. Hotel business EBIDTA grew by 37%, but higher depreciation towards new properties led to a relatively lower EBIT. We expect H2FY2020 to be much better for the hotel business owing to stable occupancy rates and a higher contribution from new properties. Agri-business revenue grew by 19.3% y-o-y, yet PBIT margins fell by 121 bps, mainly due to subdued demand for leaf tobacco in international markets, weaker competing currencies and an unfavourable revenue mix. The PPP business registered revenue growth 10% driven by strong growth in the value-added Paperboards segment and a richer product mix, which was partially offset by weak demand in FMCG and liquor industry. The PPP segment's PBIT margins improved by 91 bps to 22.7%.

Results (Standalone) Rs cr

Particulars	Q2FY20	Q2FY19	YoY %	Q1FY20	QoQ %
Net revenue	11871.5	11272.5	5.3	11502.8	3.2
Total expenditure	7309.1	7066.5	3.4	6937.1	5.4
Operating Profit	4562.4	4206.0	8.5	4565.7	-0.1
Other income	654.3	504.1	29.8	620.2	5.5
Interest	13.3	13.5	-1.3	15.2	-12.4
Depreciation	395.7	327.5	20.8	358.9	10.2
Profit before tax	4807.7	4369.1	10.0	4811.7	-0.1
Tax	784.6	1414.5	-44.5	1637.8	-52.1
Reported PAT	4023.1	2954.7	36.2	3173.9	26.8
EPS (Rs.)	3.3	2.4	36.2	2.6	26.8
			BPS		**BPS**
GPM (%)	62.2	60.2	202	64.0	-176
OPM (%)	38.4	37.3	112	39.7	-126

Source: Company; Sharekhan Research

Segmental revenue (Standalone) Rs cr

Particulars	Q2FY20	Q2FY19	YoY %	Q1FY20	QoQ %
FMCG - cigarettes	5326.8	5026.1	6.0	5433.4	-2.0
FMCG - others	3288.3	3160.4	4.0	3060.1	7.5
Hotels	426.6	362.6	17.7	392.6	8.7
Agri	2647.5	2219.7	19.3	3611.2	-26.7
Paperboard, Paper and Packaging	1565.4	1424.5	9.9	1527.5	2.5
Total	**13254.7**	**12193.2**	**8.7**	**14024.8**	**-5.5**
Less: inter segment sales	1504.6	1098.3	37.0	2663.5	-43.5
Gross Sales	**11750.2**	**11094.9**	**5.9**	**11361.4**	**3.4**

Source: Company; Sharekhan Research

Segmental PBIT (standalone) Rs cr

Particulars	PBIT (Rs crore)			Margins (%)		
	Q2FY20	Q2FY19	YoY %	Q2FY20	Q2FY19	Change in bps
FMCG - cigarettes	3844.5	3579.1	7.4	72.2	71.2	96
FMCG - others	90.5	58.5	54.8	2.8	1.8	90
Hotels	17.4	15.6	12.0	4.1	4.3	-21
Agri	249.4	236.1	5.7	9.4	10.6	-121
Paperboard, Paper and Packaging	355.9	310.9	14.5	22.7	21.8	91
Total	**4557.7**	**4200.1**	**8.5**	**34.4**	**34.4**	**-6**

Source: Company; Sharekhan Research

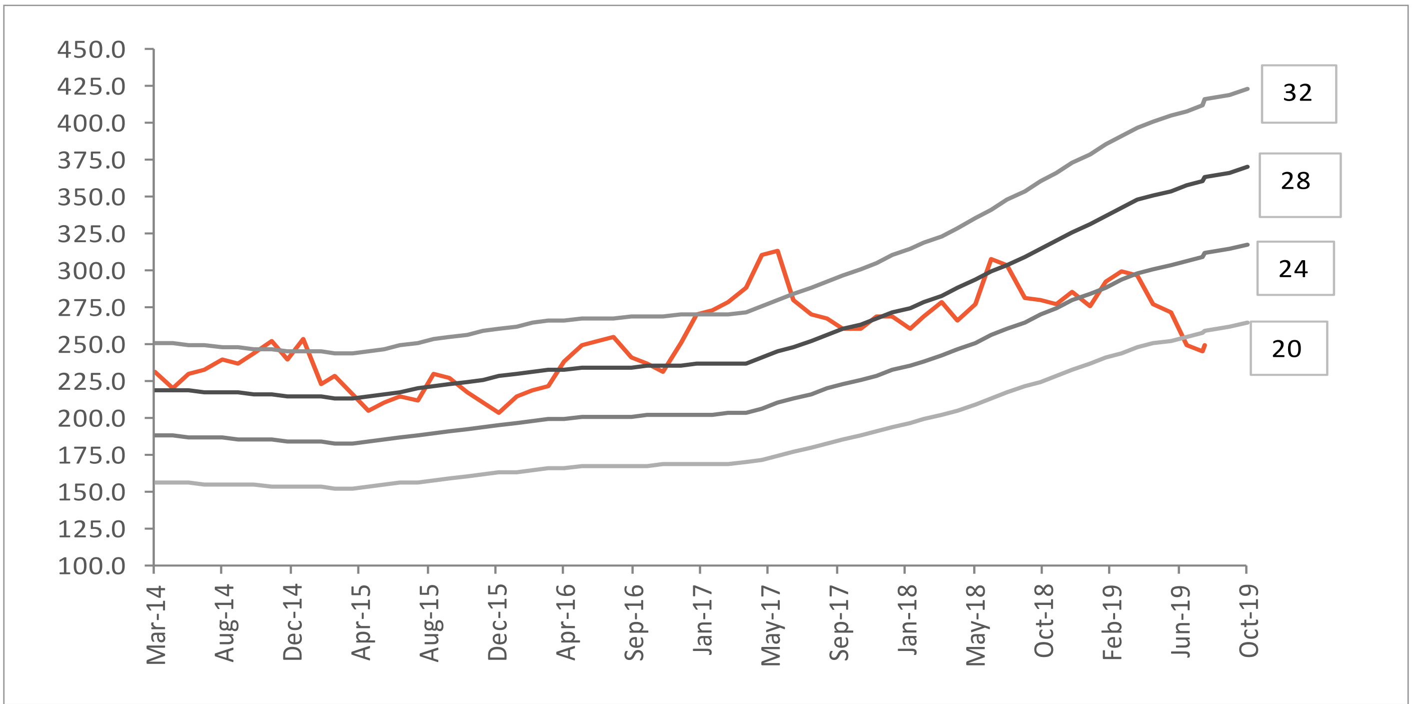
Outlook

High single digit revenue growth; margin expansion and tax cut to drive earnings in FY2020: Revenue grew by 5.5% and operating profit grew by ~9% in H1FY2020. We expect cigarette business volume growth to sustain at 4-5% in the coming quarters in the backdrop possibly no-material change in tax rates. Cigarette business margins are expected to remain high due to a better mix. With strong monsoons and improving liquidity in the rural markets, demand for consumer goods is expected to improve gradually. This would result mid-to-high single digit revenue growth for non-cigarette FMCG business. However higher operating efficiencies and increase in scale of business of certain key sub-categories would continue to boost margins of non-cigarette FMCG products in the near to medium term. H2 will be better for hotel business as it will cash in seasonal benefits. Overall we expect ITC's revenue to grow by 8-9% in FY2020. The increase in OPM and a lower corporate tax rate would help achieve a growth of 22% in PAT in FY2020.

Valuation

We have broadly maintained our earnings estimates for FY2020 and FY2021. Though revenue is expected to grow in single digits, the expansion in operating margins, higher other income and reduction in the corporate tax would result in strong double digit earning growth in FY2020. ITC continues to trade at a discounted valuation of 18.1x its FY2021E earnings, lower than some large-cap FMCG companies. We maintain our Buy recommendation on the stock with an unchanged price target (PT) of Rs. 297.

One year forward P/E band



Source: Sharekhan Research

Peer Comparison

Particulars	P/E (x)			EV/EBIDTA (x)			RoCE (%)		
	FY19	FY20E	FY21E	FY19	FY20E	FY21E	FY19	FY20E	FY21E
Hindustan Unilever	74.4	60.6	51.0	52.7	43.7	37.8	113.2	108.7	95.9
ITC	24.7	20.0	18.1	16.2	14.5	12.9	27.8	27.7	28.4

Source: Company, Sharekhan estimates

About company

ITC is one of the largest diversified players in India with a presence in businesses such as cigarettes, FMCG, hotels and paper. It is the market leader in the domestic cigarette and paper, paperboard & packaging segments. With a strong room inventory, it is the second-largest hotel chain in terms of revenue and profitability. The company has a strong distribution reach of more than two million, which it is utilising to scale-up its consumer goods business and de-risk its business model. Revenue and PAT grew by 3.0x and 3.8x over FY2009-19.

Investment theme

ITC is focusing on de-risking its business model by reducing dependence on its core cigarette business (affected by regulatory and tax hurdles for past few years) by scaling up the fast-growing consumer goods and hotel businesses. For the last 2-3 years the company has added new products in the consumer goods portfolio and entered into various new categories. The increase in scale of these categories would help ITC post better profitability in the medium to long term. The cash cow cigarette business is expected to post decent performance in the absence of any increase in tax rates on cigarettes. Discounted valuations makes ITC one of the better picks in the FMCG space.

Key Risks

- A significant rise in taxes on cigarettes or government actions to curb tobacco production and consumption would act as a key risk to the cigarette business.
- A sustained consumption slowdown would affect the growth rate of categories such as consumer goods and hotels in the near term.

Additional Data

Key management personnel

Sanjiv Puri	Chairman and Managing Director
Rajiv Tandon	Executive Director and Chief Financial Officer
Nakul Anand	Executive Director
Sandeep Kaul	Divisional Chief Executive
Rajendra Kumar Singhi	Company Secretary

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	British American Tobacco PLC	29.5
2	Life Insurance Corp of India	16.3
3	Unit Trust of India	7.9
4	ICICI Prudential Asset Management	2.0
5	SBI Funds Management Pvt Ltd	1.9
6	General Insurance Corp of India	1.7
7	HDFC Asset Management Co Ltd	1.6
8	Republic of Singapore	1.6
9	New India Assurance Co Ltd	1.5
10	ICICI Prudential Life Insurance Company	1.3

Source: Bloomberg

Sharekhan

by BNP PARIBAS

Know more about our products and services

For Private Circulation only

Compliance Officer: Mr. Joby John Meledan; Tel: 022-61150000; email id: compliance@sharekhan.com;

For any queries or grievances kindly email igc@sharekhan.com or contact: myaccount@sharekhan.com

Registered Office: Sharekhan Limited, 10th Floor, Beta Building, Lodha iThink Techno Campus, Off. JVLR, Opp. Kanjurmarg Railway Station, Kanjurmarg (East), Mumbai – 400042, Maharashtra. Tel: 022 - 61150000. Sharekhan Ltd.: SEBI Regn. Nos.: BSE / NSE / MSEI (CASH / F&O / CD) / MCX - Commodity: INZ000171337; DP: NSDL/CDSL-IN-DP-365-2018; PMS: INP000005786; Mutual Fund: ARN 20669; Research Analyst: INH000006183;