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ITC Limited

Disrupted Q2; FMCG margins scaling up

Consumer Goods	Sharekhan code: ITC	Result Update

3R MATRIX

	+	=	-
Right Sector (RS)		✓	
Right Quality (RQ)	✓		
Right Valuation (RV)	✓		

\+ Positive = Neutral - Negative

Reco/View	Change
Reco: **Buy**	↔
CMP: **Rs. 174**	
Price Target: **Rs. 250**	↔

↑ Upgrade ↔ Maintain ↓ Downgrade

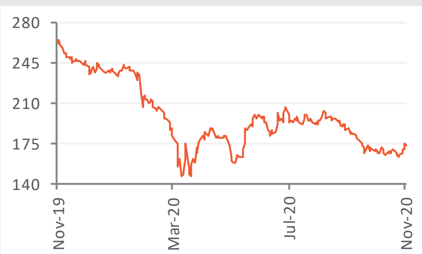
Company details

Market cap:	Rs. 2,14,046 cr
52-week high/low:	Rs. 266/135
NSE volume: (No of shares)	165.7 lakh
BSE code:	500875
NSE code:	ITC
Free float: (No of shares)	1,230.5 cr

Shareholding (%)

Promoters	0.0
FII	13.0
DII	43.6
Others	43.5

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	2.4	-11.0	6.2	-33.4
Relative to Sensex	-3.5	-21.1	-26.0	-36.9

Sharekhan Research, Bloomberg

Summary

- ITC's Q2FY2021 performance was affected by localised lockdowns in July-August resulting in a 12% decline in volume of core-cigarette business (net sales was down by ~14%). Cigarette sales started recovering from September but yet to reach pre-COVID levels.
- Non-cigarette FMCG performed strongly, rising by 18.4% led by staples, operating profit grew 66% y-o-y to Rs. 366 crore (margins rose 300 bps to 9.7%).
- As non-cigarette FMCG business scales up, its OPM is expected to improve further and would remain stable (despite normalisation of sales in some categories in the post-COVID era).
- Stock trades at discounted valuation of 12.3x its FY2023E EPS, consistent improvement in the non-cigarette FMCG margins along with normalisation of cigarette business would be key re-rating trigger for the stock. We maintain Buy with an unchanged price target of Rs. 250.

Q2FY2021 performance was disrupted by localised lockdowns in July-August 2020 having a significant impact on core cigarette business. Overall revenues stood flat at Rs. 11,976.8 crore and operating margins (OPM) decreased by 453 bps to 33.9% leading to 11% decline in PBT. Cigarette business net revenues (excluding excise duty) were down by 14.4%y-o-y due to a 12% decline in volumes. South metros and large towns were affected by localised lockdown affecting cigarette sales. Cigarette business PBT decreased by ~16%. Non-cigarette FMCG business revenues grew by 18% largely driven by 25% growth in essential categories (contribute ~75% of revenues). Discretionary/out-of-home category revenues decreased by 2%. OPM of non-cigarette FMCG business improved by 300 bps y-o-y to 9.7%. Cigarette sales normalised in June but affected by localised lockdowns from mid-July, they were badly hit in August. However, with receding cases and the economy getting slowly unlocked, sales are recovering m-o-m but are yet to reach pre-COVID levels. The non-cigarette FMCG business revenue growth is also boosted by opportunistic scale-up in categories such as sanitiser, Atta, hand wash, ready-to-cook food and disinfectant sprays/surface cleaners. However, some of the category growths would normalise in the post-COVID era. But scale-up in margins of the business will sustain due to robust brand portfolio, higher operating leverage, product innovation and supply chain efficiencies. Further, the company managed to significantly reduce fixed costs and other discretionary costs (other expenses down by 14.1% in H1FY2021). Though some of the fixed cost will rise when businesses such as cigarettes and hotels normalise, structural cost benefits would continue to support profitability. Thus, we expect OPM of the non-cigarette business to consistently improve in the near term.

Key positives

- Non-cigarette business OPM reached close to 10%.
- Rural index stood at 109 while urban index stood 95.
- Agri business revenues grew by ~13% (value-added businesses up by 25%).

Key negatives

- Cigarette business sales volumes decreased by 12%.
- Paperboard, paper and packaging (PPP) revenues and PBIT decreased by 6.8% and 7.2%.

Our Call

View - Retained Buy with unchanged price target of Rs. 250: The cigarette business is expected to regain normalcy by Q4. Non-cigarette FMCG business is expected to deliver strong performance on the back of better reach and strong traction to new launches. The management's enhanced focus and redefined growth strategies have aided scale of the non-cigarette FMCG business margins. The stock is currently trading at 12.3x its FY2023E EPS which factors in near-term headwinds. Any sustained scale-up in margins of the non-cigarettes FMCG business and normalisation in the core cigarette business would be key triggers for a valuation uptick. We maintain our Buy recommendation on the stock with unchanged price target of Rs. 250.

Key risk

Any increase in tax on cigarettes in the upcoming GST meets or sustained slowdown in consumer demand would act as a key risk to our earnings estimates.

Valuation (Consolidated) Rs cr

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Revenues	45,784	46,807	43,182	50,285	57,325
OPM (%)	37.8	38.3	35.0	37.4	38.1
Adjusted PAT	12,387	15,170	12,400	15,157	17,279
Adjusted EPS (Rs.)	10.1	12.4	10.2	12.4	14.2
P/E (x)	17.3	14.0	17.1	14.0	12.3
P/B (x)	3.7	3.3	3.4	3.3	3.1
EV/EBIDTA (x)	10.8	10.3	12.1	9.7	8.4
RoNW (%)	22.5	24.8	19.5	23.8	26.0
RoCE (%)	27.8	25.5	20.1	25.5	28.6

Source: Company; Sharekhan Research

Revenues stood flat; OPM declined significantly: Gross revenue stood flat at Rs. 11,976 crore, due to a 3.8% decline in the core cigarette business (14.4% decline in net revenues) disrupted by localised lockdown in the month of July and August. Non-cigarette FMCG revenues grew by ~18% during the quarter. Hotel business posted sharp decline of 81% in revenue. Gross margins declined significantly to 53.8% from 60.5% in Q2FY2020 largely due to change in revenue mix with cigarette business contribution tapering off. OPM also plunged to 33.9% in Q2FY2021 from 38.4% in Q2FY2020, mainly on account of higher employee costs and lower operating leverage. Operating profit declined by 11% y-o-y to Rs. 4,060.6 crore. Operating profit and PBT decreased by 11% each. Adjusted PAT decreased by ~20% to Rs3232.20crore due to one-time tax gain in the base quarter due to a reduction in corporate tax rates. Excluding the one-time gain in the base quarter, the tax decline was 12%.

Cigarette business volumes fell by 12%, margins declined: Cigarette business sales volume declined by 12% in Q2FY2021 affected by localised lockdown in July-August. South, metros and large town markets relatively more impacted as compared to other regions/towns. Further temporary disruption in certain wholesale market is also affecting the sales. However, the management stated with unlock of economy, the business has started seeing a recovery on m-o-m basis from September. Easing of restrictions aided the company to service markets effectively. Cigarette business EBIT decreased by 15.6% y-o-y. Sales volume has recovered but currently trending below pre-covid levels. We expect full normalisation in the cigarette FMCG by Q4FY2021.

Non-cigarette FMCG business registered good growth; margins expanded: The non-cigarette FMCG business revenues increased by 15.4% y-o-y to Rs. 3,374.6 crore (18% y-o-y on a comparable basis excluding the educational & stationary business) driven by heightened awareness of quality products, focus on health and immunity and rising trend of in-home consumption. Staples, convenience foods and health & hygiene products, representing ~75% of the portfolio, recorded strong growth of 25% whereas discretionary categories fell by 2% (recovered from 25% decline in Q1). Rural index stood at 109x in Unlock 4.0 in September as urban index of 95x. Further traditional trade channels also seen strong uptick, while e-commerce is growing faster and currently constitutes 5% of ITC's domestic revenues. An enhanced scale, product mix enrichment and other strategic cost management initiatives led EBIDTA margins to expand by 300 bps to 9.7%. The segment's PBIT stood at Rs. 252.7 crore in Q2FY021 as against Rs. 90.5 crore in Q2FY2020. Essential consumer goods such as staples, noodles, biscuits, dairy, sanitisers, etc. witnessed robust demand and gained market share. Manufacturing of these categories have scaled up to 100%. Most of these categories are registering robust growth. The company launched 70 new products in H1FY2021 and most of these products are getting strong traction. This along with good traction for hygiene products and new launches would help ITC to achieve good growth in the coming years. Margins of non-cigarette FMCG is expected to increase in the coming years helped by increase in scale of new launches and a better revenue mix.

Agri business performing well: Revenue of the agricultural business grew by 12% y-o-y driven by trading opportunities mainly in oilseeds and rice. PBIT margins fell by 85 bps, mainly lower exports of leaf tobacco in Q2FY2021 and an unfavourable mix. The agri-business remains focused on enhancing its presence in identified high value-added segments such as spices for 'food-safe' markets, processed fruits, frozen marine products, etc. Value-added business ex-aqua grew by 25% during the quarter. The 'ITC Master Chef' range of frozen snacks posted robust growth in retail channel. The range was augmented with the launch of eight new variants and was extended to 70+ cities during the quarter. The business is well-poised to support its branded packaged food business. We expect agri-business to deliver steady performance in FY2021.

Hotel business saw sequential improvement: Revenue declined by 81% y-o-y, driven by severe disruptions in operations with the onset of COVID-19 pandemic. However saw sequential jump with leisure locations witnessing a strong pick-up in demand. The company managed to reduce fixed cost by ~50%. Segmental EBIDTA loss stood at Rs. 117 crore in Q2FY21, lower than Rs175crore in Q1FY021.We expect the hotel business to underperform in FY2021 owing to disruption in tourism and business due to the pandemic. However, if the vaccine is discovered by the end of the year, we can see faster recovery in the travel and tourism sector. The long-term potential of the sector is intact.

Paperboards, Paper & Packaging (PPP) business remained muted: Revenues declined by 7% y-o-y in Q2FY2021. A significant growth in exports partly mitigated subdued domestic demand. The PPP business' PBIT margins stood flat at 22.6%. Structural interventions, in-house pulp production and operating efficiencies mitigated the impact of negative operating leverage. Business provides strong support to cigarette and non-cigarette FMCG business along with providing superior packaging services externally. The business is expected to recover gradually in line with recovery in key businesses.

Results (Standalone) Rs cr

Particulars	Q2FY21	Q2FY20	y-o-y (%)	Q1FY21	q-o-q (%)
Net revenue	11976.8	11871.5	0.9	9501.8	26.0
Total expenditure	7916.1	7309.1	8.3	6855.2	15.5
Operating Profit	4060.63	4562.37	-11.0	2646.58	53.4
Other income	609.8	654.3	-6.8	896.8	-32.0
Interest	13.8	13.3	3.2	16.8	-18.0
Depreciation	382.5	395.7	-3.3	398.2	-3.9
Profit before tax	4274.1	4807.7	-11.1	3128.4	36.6
Tax	1041.9	784.6	32.8	785.7	32.6
Adjusted PAT	3232.2	4023.1	-19.7	2342.8	38.0
Exceptional item	0.0	0.0	-	0.0	-
Reported PAT	3232.2	4023.1	-19.7	2342.8	38.0
EPS (Rs.)	2.6	3.3	-19.9	1.9	38.0
			bps		**Bps**
GPM (%)	53.8	62.2	-843	52.2	157
OPM (%)	33.9	38.4	-453	27.9	605

Source: Company; Sharekhan Research

Segmental revenue Rs cr

Particulars	Q2FY21	Q2FY20	YoY %
FMCG - cigarettes	5121.3	5326.8	-3.9
FMCG - others	3795.0	3288.3	15.4
Hotels	82.0	426.6	-80.8
Agri	2985.3	2647.5	12.8
Paperboard, Paper and Packaging	1458.7	1565.4	-6.8
Total	**13442.1**	**13254.7**	**1.4**
Less: inter segment sales	1550.2	1504.6	3.0
Gross Sales	**11891.9**	**11750.2**	**1.2**

Source: Company; Sharekhan Research

Segmental PBIT Rs cr

Business segments	PBIT (Rs. crore)			Margins (%)		
	Q2FY21	Q2FY20	YoY %	Q2FY21	Q2FY20	Chg in BPS
FMCG - cigarettes	3244.8	3844.5	-15.6	63.4	72.2	-881
FMCG - others	252.7	90.5	179.3	6.7	2.8	391
Hotels	-184.9	17.4	-	-	4.1	-
Agri	256.1	249.4	2.7	8.6	9.4	-84
Paperboard, Paper and Packaging	330.3	355.9	-7.2	22.6	22.7	-9
Total	**3898.9**	**4557.7**	**-14.5**	**29.0**	**34.4**	**-538**

Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector View – Cigarette would remain under regulatory hurdle, FMCG long-term growth prospects intact

A consistent increase in taxes and the regulatory regime along with a sharp increase in illegal trade in recent years, especially at the premium end, continue to pose significant challenges to the legal cigarette industry in the country. Taxes on cigarettes were increased by 13% in February. Further, to increase its revenue kitty and support states in the current pandemic situation, the government might further increase taxes on cigarette in the upcoming months. Thus, an increase in taxes remain a key overhang on the cigarette business as it gives fuel to growth in the sales of illegal cigarettes. On the other hand, outlook for FMCG industry in India is positive as lower per-capita consumption, emergence of new categories and improving demographics provides enough scope for the FCMG companies to achieve sustainable revenue growth in the medium to the long run.

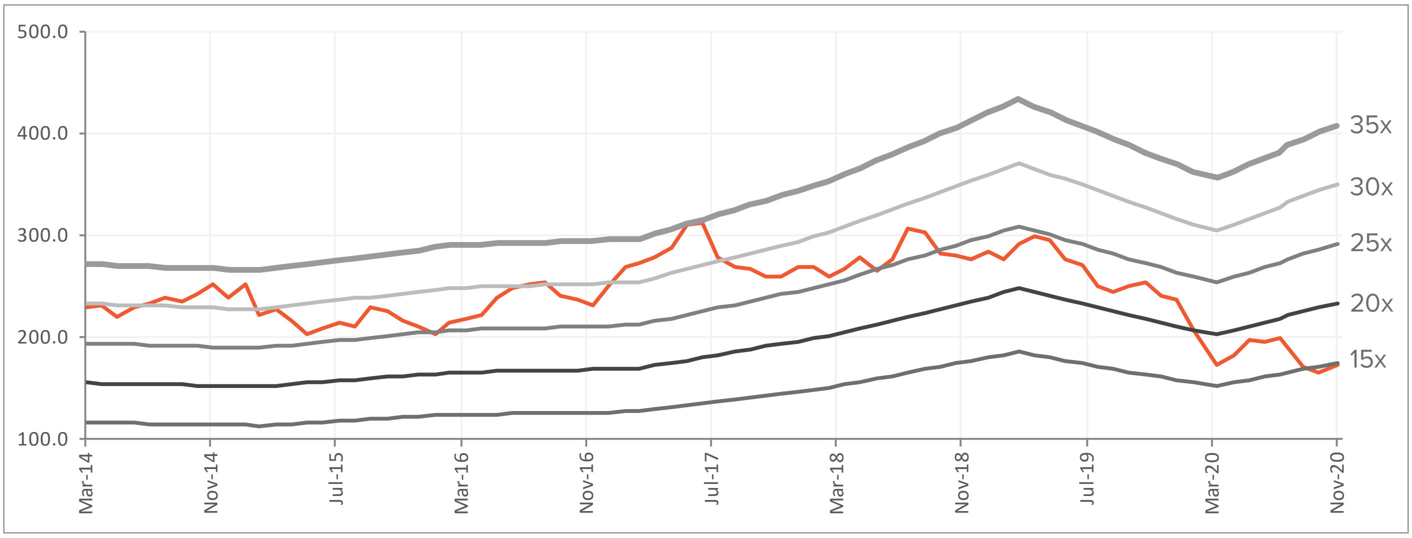
■ Company Outlook – Non-cigarette FMCG to maintain a good run; cigarette business to improve gradually

Cigarette sales normalised in June but were affected by a localised lockdown from mid-July and were badly hit in August. However, with receding COVID-19 cases and the economy getting slowly unlocked, sales are recovering m-o-m from September but yet to reach pre-COVID levels. Non-cigarette FMCG business revenue growth is also boosted by opportunistic scale-up in categories such as sanitiser, Atta, hand wash, ready-to-cook food and disinfectant sprays/surface cleaners. However, growth in some categories would normalise in the post-COVID era. However, the scale-up in margins of business will sustain due to a robust brand portfolio, higher operating leverage, productive innovation and supply chain efficiencies.

■ Valuation – Retained Buy with unchanged price target of Rs. 250

The cigarette business is expected to regain normalcy by Q4. Non-cigarette FMCG business is expected to deliver strong performance on the back of better reach and strong traction to new launches. The management's enhanced focus and redefined growth strategies have aided scale of the non-cigarette FMCG business margins. The stock is currently trading at 12.3x its FY2023E EPS which factors in near-term headwinds. Any sustained scale-up in margins of the non-cigarettes FMCG business and normalisation in the core cigarette business would be key triggers for a valuation uptick. We maintain our Buy recommendation on the stock with unchanged price target of Rs. 250.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer Comparison

Particulars	P/E (x)			EV/EBIDTA (x)			RoCE (%)		
	FY20	FY21E	FY22E	FY20	FY21E	FY22E	FY20	FY21E	FY22E
Hindustan Unilever	64.6	57.4	45.5	45.8	40.3	34.1	105.2	39.1	28.5
ITC	14.0	17.1	14.0	10.3	12.1	9.7	25.5	20.1	25.5

Source: Company, Sharekhan estimates

About company

ITC is one of the largest diversified players in India present in businesses such as cigarettes, FMCG, hotels and paper. The company is the market leader in the domestic cigarette and PPP segments. The company is also the second-largest hotel chain by revenue and profitability, with a strong room inventory. The company has a strong distribution reach of more than 2 million, which it is utilising to scale-up its consumer goods business and de-risk its business model. ITC's revenue and PAT grew by 3.0x and 3.8x over FY2009-FY2020.

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. The company has quickly rebound from the disruption caused by lockdown and key businesses are operating at normal levels. Though FY2021 is expected to be impacted by supply disruption, the strong recovery is anticipated in FY2022. Further scale up in the performance of non-cigarette FMCG business and improvement in the margins would be trigger for the stock going in the medium to long term. Also strong cash flows and cheery dividend payout makes it good bet in the current uncertain environment.

Key Risks

- Significant rise in taxes on cigarettes or government actions to curb tobacco and tobacco consumption would act as a key risk to the cigarette business.
- 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
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	29.4
2	Life Insurance Corp of India	16.3
3	Unit Trust of India	7.9
4	SBI Funds Management Pvt Ltd	2.6
5	HDFC Asset Management Co Ltd	2.3
6	General Insurance Corp of India	1.8
7	ICICI Prudential Asset Management	1.6
8	JPMorgan Chase & Co	1.6
9	New India Assurance Co Ltd	1.5
10	Republic of Singapore	1.2

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

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