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Stock Update

ITC Ltd

Regaining momentum in Cigarettes; FMCG profitability improving

Consumer Goods	Sharekhan code: ITC	Company Update

Summary

- We retain Buy on ITC with a revised PT of Rs. 280; discounted valuations at 17.4x its FY2023E EPS, improving business outlook and dividend yield of 4.4% make it an attractive bet in the FMCG space.
- With improving mobility, regularisation in store operations, and no hike in tax rate on cigarettes in the recent GST meet will help cigarette volumes to recover at a good pace in the coming quarters (100% recovery by Q2/Q3FY22).
- Non-cigarette FMCG business revenue growth to improve to mid-teens with expected recovery in out-of-home category; market share gains in personal care and biscuits and scale-up in recently acquired businesses in the quarters ahead.
- Non-cigarette FMCG business OPM expanded by 590 bps to 8.9% over the past four years; the company is focusing on scaling in contribution of high-margin products, premiumisation through new launches, and supply and operational efficiencies to improve business margins ahead.

ITC's cigarette business sale volumes are likely to reach 100% of pre-COVID levels by Q2/Q3 of FY2022, led by improved mobility post easing of lockdown norms and normalised store operations. With improvement in sales volume, profitability of the cigarette business is expected to improve sequentially. The company is focusing on achieving sustainable growth in the non-cigarette FMCG business, launching new products in low penetrated categories, value-accretive inorganic opportunities, and building portfolio with purposeful brand. This will also help business margins to further improve from current levels of 8-9%.

- **Cigarette sales volume to recover strongly:** With receding COVID cases and normalisation of store operations, cigarette sales volume started improving from mid-June. Further, with improved mobility and no tax rate hike on cigarettes in the recent GST meet, sale volumes are expected to improve at a good pace (likely to reach 100% of pre-COVID level by Q2/Q3. On low base of FY2021, we expect cigarette sales volume to grow by 12-13% in FY2022 (Net revenue to grow by 7%).
- **Striving for sustainable revenue growth and margin expansion in the FMCG business:** Future-ready portfolio, expanding into low penetrated categories, building portfolio of purposeful brands, multi-channel distribution network and value accretive M&A to achieve sustainable double-digit revenue growth in the medium to long term. Overall, the non-cigarette FMCG business revenue is expected to post a 16% CAGR over FY2021-FY2024. The company is focusing on scaling in contribution of high-margin products, premiumisation through new launches, and supply and operational efficiencies, which would help business margins to further improve from current levels of 8-9%.
- **Strong cash flows invested in key businesses and higher dividend payout:** ITC has strong cash-generation ability because of high cash generated by its core cigarette business. The company has generated cumulative free cash flow (FCF) of ~Rs. 50,000+ in the past five years. The company had invested a large part of these cash flows in improving growth prospects of non-cigarette FMCG and hotel businesses. Further, strong cash flow is utilised in dividend payout, which stood at 102% in FY2021 (dividend yield of 4.4%).

Our Call

View - Retain Buy with a revised PT of Rs. 280: Cigarette business sales volume are expected to improve in the coming quarters with easing of lockdown restrictions in most states. Management's enhanced focus and redefined growth strategies have aided scaling up of the non-cigarette FMCG business margins. The company has sustained ESG rating of AA by MSCI-ECG, the highest among global tobacco companies. The stock is currently trading at 17.4x and 15.6x its FY2023 and FY2024 EPS, respectively, which is at a stark discount to some of the large consumer goods stocks. Strong earnings visibility with improving growth prospects of the core cigarette business and margin expansion in the non-cigarette FMCG business, high cash-generation ability with strong dividend payout, and sustained ESG rating will reduce the valuation gap in the coming years. We maintain our Buy recommendation on the stock with a revised PT of Rs. 280.

Key Risks

Any increase in tax on cigarettes or government implementing policies to curb tobacco products consumption or any disruption in consumer demand due to frequent lockdowns would act as key risk to our earnings estimates.

Valuation (standalone) Rs cr

Particulars	FY21	FY22E	FY23E	FY24E
Revenue	48,525	53,756	59,351	65,763
OPM (%)	32.0	34.5	36.5	37.0
PAT	13,032	14,371	17,052	19,058
EPS (Rs.)	10.7	11.8	14.0	15.6
P/E (x)	22.8	20.6	17.4	15.6
P/B (x)	5.1	5.0	4.8	4.6
EV/EBIDTA (x)	17.6	14.6	12.4	11.0
RoNW (%)	21.2	24.2	28.0	29.9
RoCE (%)	21.5	26.9	31.1	33.6

Source: Company; Sharekhan estimates

3R MATRIX

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

\+ Positive = Neutral - Negative

What has changed in 3R MATRIX

	Old		New
RS		↔	
RQ		↔	
RV		↔	

Reco/View	Change
Reco: **Buy**	↔
CMP: **Rs. 242**	
Price Target: **Rs. 280**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

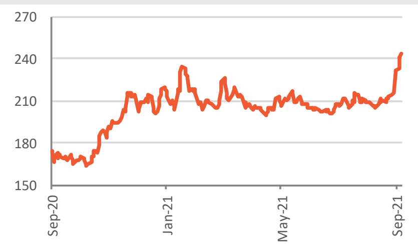
Company details

Market cap:	Rs. 297,874 cr
52-week high/low:	Rs. 246 / 163
NSE volume: (No of shares)	246.1 lakh
BSE code:	500875
NSE code:	ITC
Free float: (No of shares)	1230.9 cr

Shareholding (%)

Promoters	0.0
FII	14.3
DII	42.4
Others	43.4

Price chart



Price performance

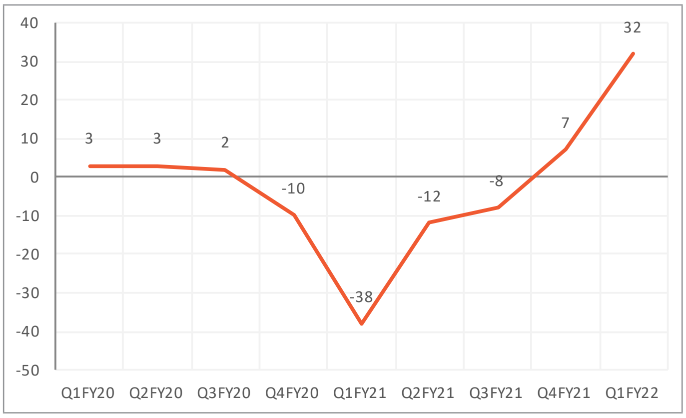
(%)	1m	3m	6m	12m
Absolute	17.3	18.6	8.9	40.2
Relative to Sensex	9.5	4.0	-10.7	-19.9

Sharekhan Research, Bloomberg

Cigarette sales volume to recover strongly in the coming quarters

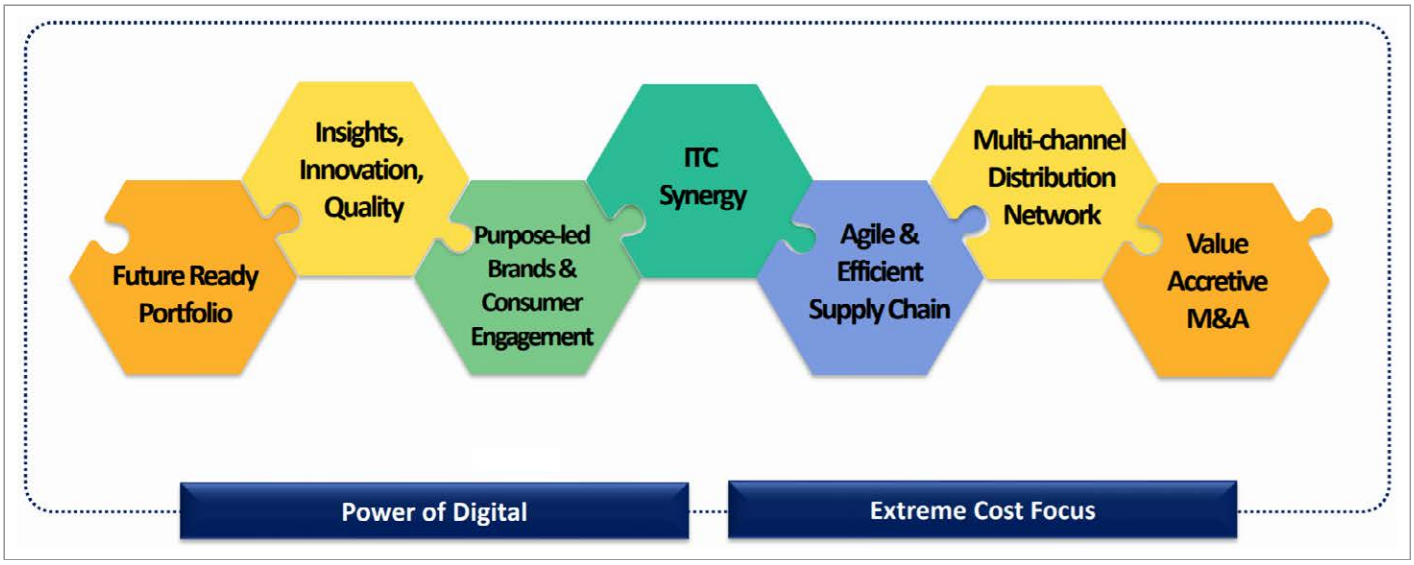
ITC's cigarette revenue stood at 95% of Q1FY2020 revenue (normalised base), affected by the second wave of COVID-19. With receding COVID cases and normalisation of stores operations, cigarette sales volume started improving from mid-June. Further, with improved mobility and no tax rate hike on cigarettes in the recent GST meet, sales volumes are expected to improve at a good pace (likely to reach 100% of pre-COVID level by Q2/Q3. The company has scaled up its reach despite COVID-led market disruption. Rural stockist network has reached 3x and rural servicing infrastructure at 1.2x of base quarter. On low base of FY2021, we expect cigarette sales volume to grow by 12-13% in FY2022 (Net revenue is likely to grow by 7%). Sales volume in the subsequent years is expected to grow in mid-single digit in the absence of any significant increase in tax rate and market share gains in key markets.

Cigarette sales volume seeing significant uptick



Source: Company, Sharekhan Research

Non-cigarette FMCG business strategy

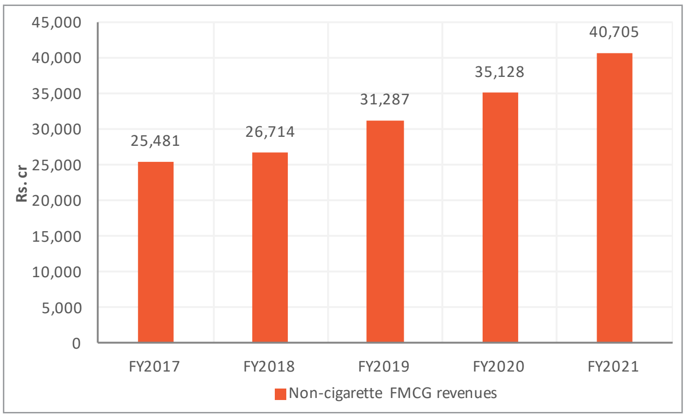


Source: Company presentation

Levers in place for sustainable growth in the non-cigarette FMCG business

ITC's non-cigarette FMCG business revenue posted a 9% CAGR over FY2015-FY2021 (to Rs. 14,728.1 crore in FY2021). The company's current product portfolio comprises of 25 recognised brands and caters to Rs. 22,000 crore of consumer annual spends, providing a number of opportunities to grow in the coming years. Leveraging on robust innovation platforms of life sciences and technology, the company launched 120 new and innovative products in FY2021. The company is focusing on building purpose-led brands based on consumer needs. The company is leveraging on digital platforms and consumer experiences to bring in relevant innovation in the market. Further, focusing on expanding the distribution reach, market

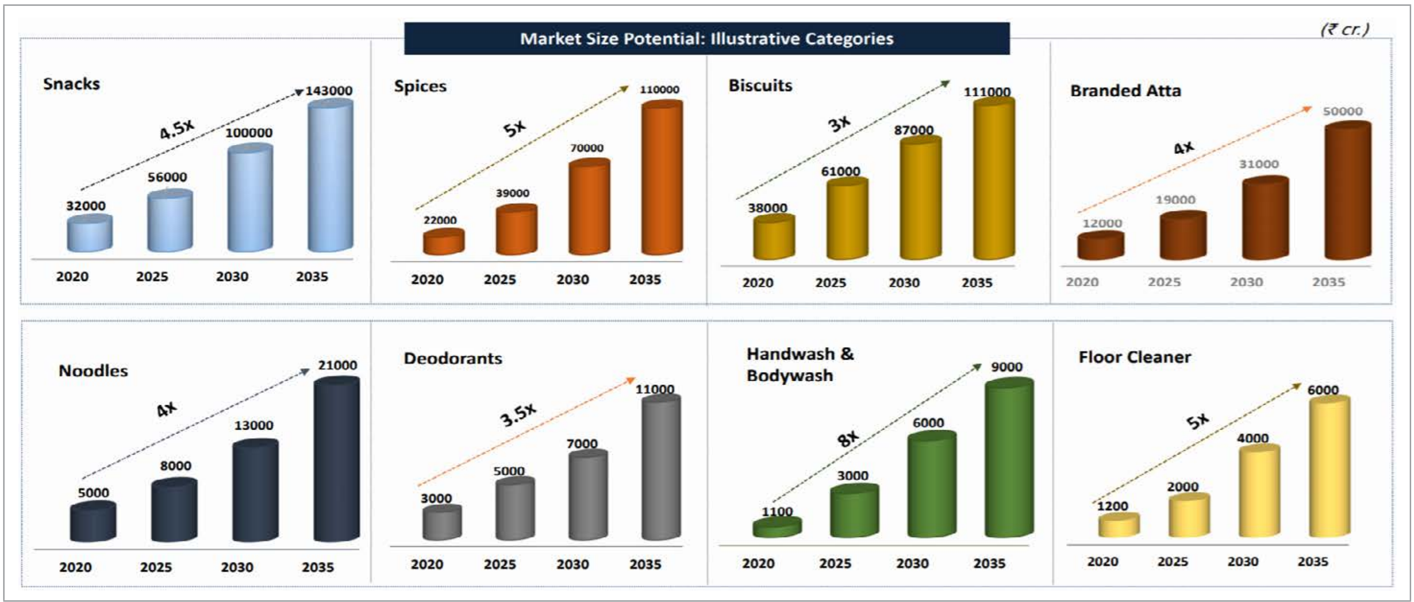
Non-cigarette FMCG revenues growing steadily



Source: Company, Sharekhan Research

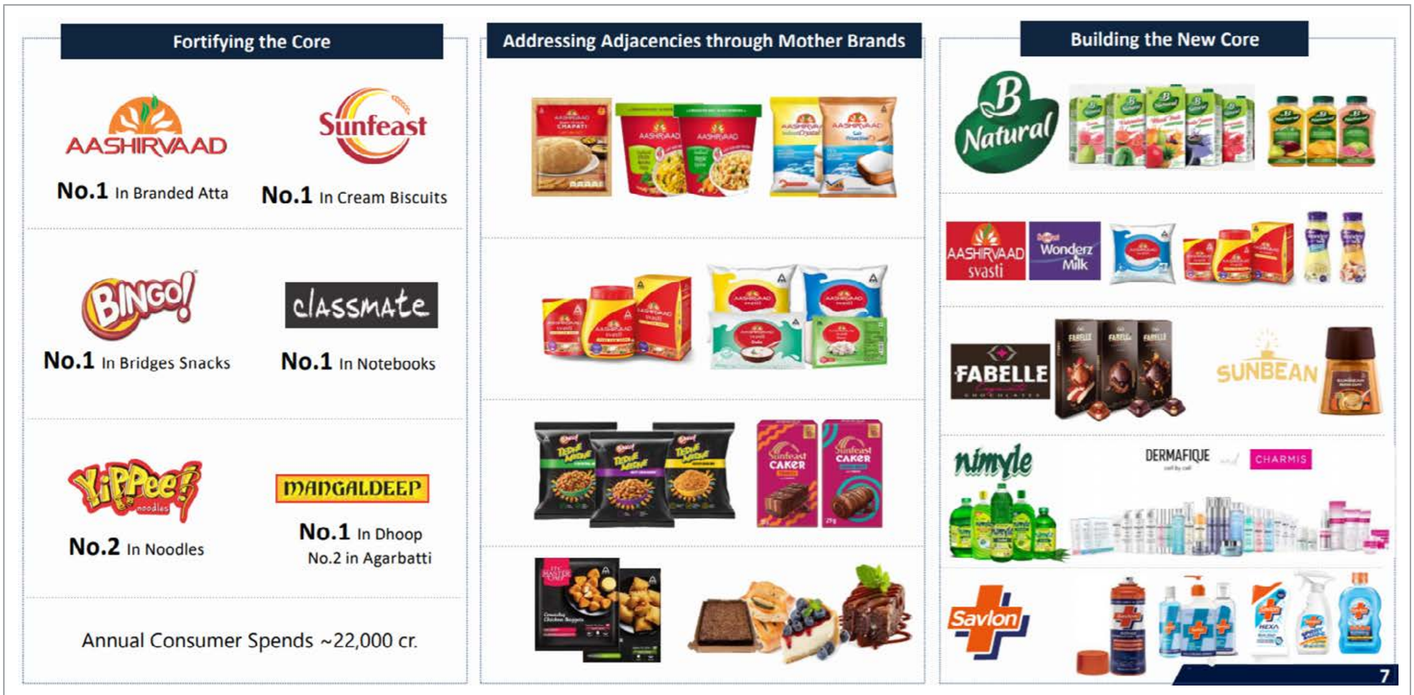
and outlet coverage were expanded to 1.3x and 1.1x, respectively, compared to pre-COVID levels in FY2021. The stockists network nearly doubled to sharp target rural markets to drive growth, mitigate the impact of disruptions in the wholesale channel, and effectively service emergent demand. Future-ready portfolio, expanding into low penetrated categories, building portfolio of purposeful brands, multi-channel distribution network, and value-accretive M&A to achieve sustainable double-digit revenue growth in the medium to long term. Overall, the non-cigarette FMCG business revenue is expected to post a CAGR of 15-16% over FY2021-FY2024.

Potential to grow through expansion in addressable market



Source: Company presentation

Potential to grow by fortifying the core and by addressing adjacencies

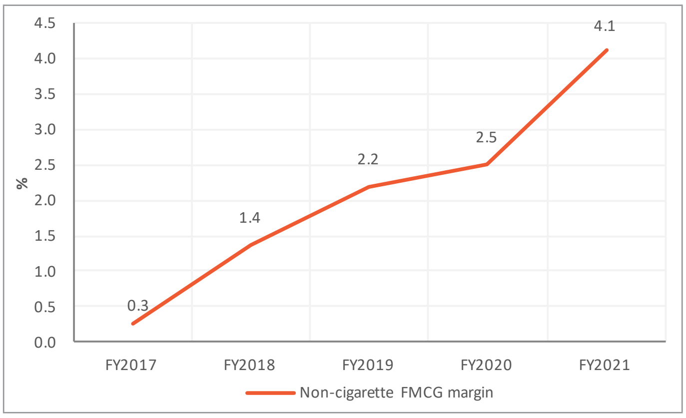


Source: Company presentation

Non-FMCG margins expanded by 590 bps over FY2018-FY2021; Scope for further margin expansion

Non-cigarette FMCG business OPM expanded by 590 bps to 8.9% over the past four years. The company is focusing on scaling in contribution of high-margin products, premiumisation through new launches, and supply and operational efficiencies to improve business margins ahead. Categories such as Bingo, Noodles, and Biscuits have higher margins compared to categories such as Atta in foods. Further, through inorganic initiatives, the company added margin-accretive brands such as Sunrise, B-Naturals, and Savlon in its portfolio, which have strong growth prospects in the medium to long term. Focus would be increasing the presence of these brands in key markets, leveraging on its strong distribution reach. Further, the company is focusing on distribution and supply chain efficiencies such as reducing distance-to-market, direct shipments by eliminating multiple handlings, smart buying through real-time price discovery, and packaging innovations to add-on incrementally to margins in the near to medium term. Thus, we expect FMCG margins to further scale-up by 300-400 bps over the next three to four years. Any significant increase in raw-material prices or slowdown in the high-margin category's growth would act as key risk to margin expansion.

Significant margin expansion of non-cigarette FMCG business



Source: Company, Sharekhan Research

Re-defining strategies for the hotel business

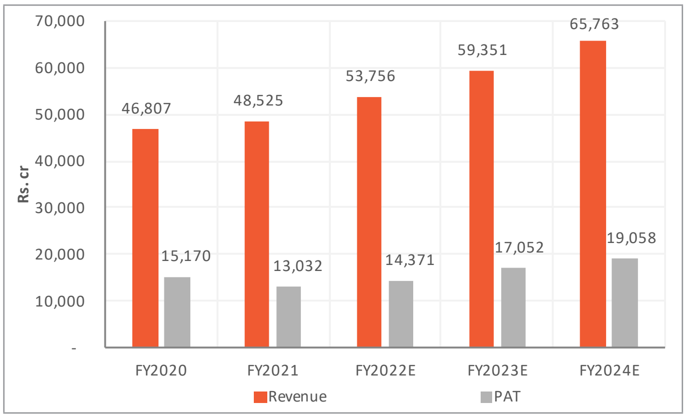
The pandemic had a toll on ITC's hotel business in FY2021, with revenue declining by 66% y-o-y to Rs. 627.5 crore and business making losses at EBIT level. Q1FY2022 performance was disrupted by the second wave of COVID-19. However, reduction in COVID-19 cases, improving mobility, and strong recovery in domestic leisure travel will lead to strong improvement in ITC's hotel business performance in the near to medium term. We expect the hotel business's revenue to recover to 50-55% of pre-COVID level in FY2022. The company would pursue the asset-light strategy for its hotel business and would focus on adding more rooms through management contracts. It will continue to examine an alternative structure for the business to improve its growth prospects in the long run.

Strong cash flow generation would lead to higher investments behind key businesses

ITC has strong cash-generation ability because of high cash generated by its core cigarette business. The company has generated cumulative FCF of ~Rs. 50,000+ in the past five years. ITC generated FCF of Rs. 11,654 crore, while net cash stood at Rs. 4,000 crore in FY2021. The company had invested a large part of these cash flows in improving the growth prospects of non-cigarette FMCG and hotel businesses. Further, strong cash flow is utilised in dividend payout, which stood at 102% in FY2021 (dividend yield of 4.4%).

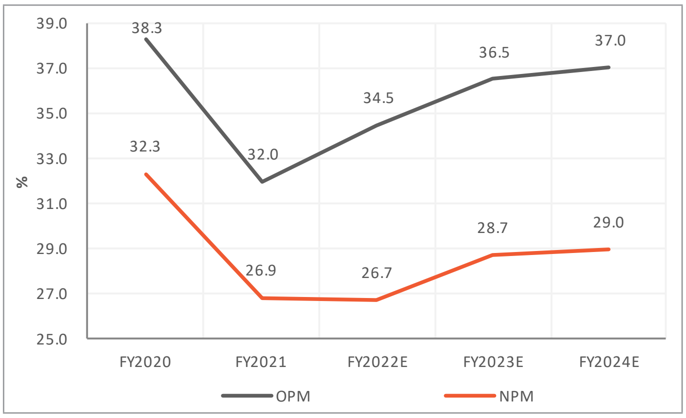
Financials in charts

Revenue and PAT to grow steadily



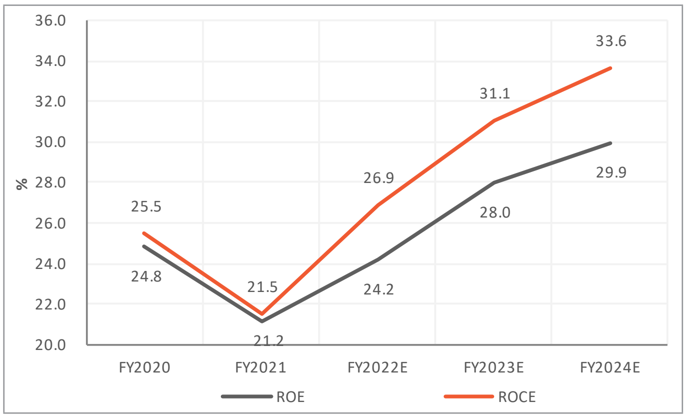
Source: Company, Sharekhan Research

Margins to rise from current level



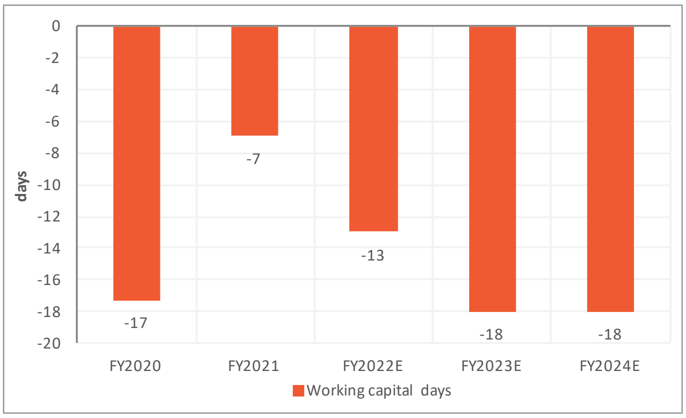
Source: Company, Sharekhan Research

Return ratios to improve significantly



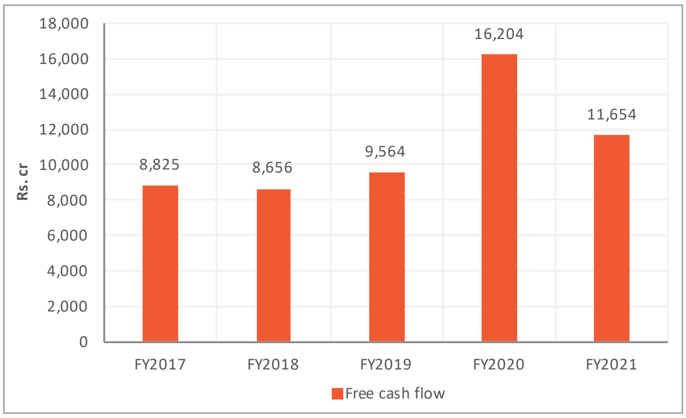
Source: Company, Sharekhan Research

Stable Working capital



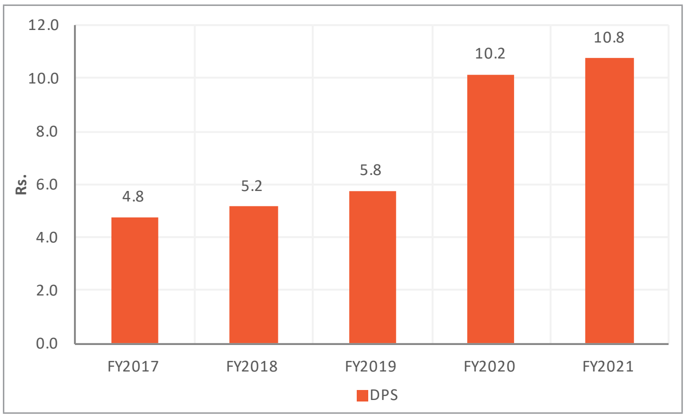
Source: Company, Sharekhan Research

Trend of free cash flow generation



Source: Company, Sharekhan Research

Dividend per share increasing over the years



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector outlook – Demand remains resilient; Margins to improve sequentially

After second wave disruption in April-May 2021, companies witnessed faster recovery in performance in June-July 2021. Rural market is gaining momentum and with the monsoon expected to be normal, rural growth is expected to be stronger than urban growth in the quarters ahead. Further, corporates opening up with full capacity and improving mobility would improve demand for out-of-home categories such as colour cosmetics, beverages and juices, deodorants and hair colour. Thus, we expect consumer goods companies to post better sales volume in the quarters ahead. On the other hand, prices of key raw materials (including palm oil, copra, and raw tea) have started correcting from their high. The substance of same along with calibrated price hikes would enable consumer goods companies to post better OPM sequentially. Profitability is likely to be better off in H2FY2022. Improving revenue mix and better operational efficiencies remain key margin drivers in the medium term.

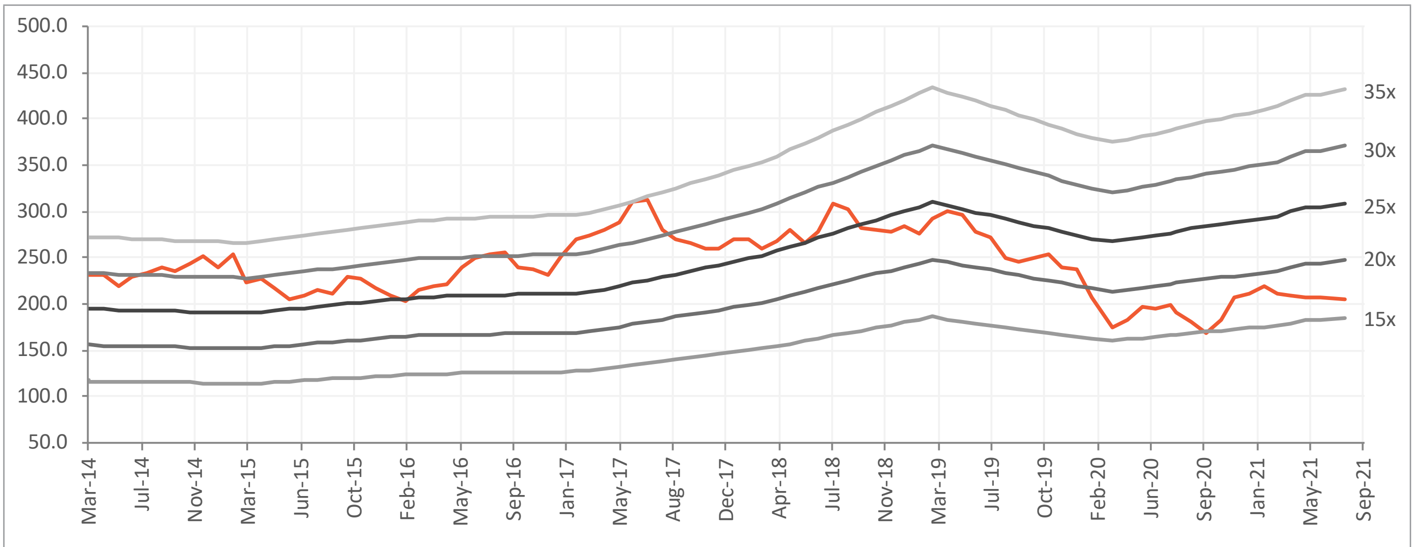
■ Company outlook – Cigarette business to regain normalcy; FMCG margins to scale up

ITC's Q1FY2022 performance was strong because of low base. Cigarette business sales volume improved from mid-week of June 2021 with most regaining normalcy (except for certain markets of Kerala, Odisha, and North East). We expect cigarette sales volume to sequentially improve with easing of restrictions and no price hikes expected in the immediate term due to no hike in tax rate of cigarettes in Union Budget. Resilient demand in the domestic market, scale-up in sales of new product launches, and improved penetration would help non-FMCG business revenue to grow in double digits in the coming quarters. Business margin expansion would sustain, with scale up in revenue of products/categories and better revenue mix.

■ Valuation – Retain Buy with a revised PT of Rs. 280

Cigarette business sales volumes are expected to improve in the coming quarters with easing of lockdown restrictions in most states. Management's enhanced focus and redefined growth strategies have aided scaling up of the non-cigarette FMCG business margins. The company has sustained ESG rating of AA by MSCI-ECG, the highest amongst global tobacco companies. The stock is currently trading at 17.4x and 15.6x its FY2023 and FY2024 EPS, respectively, which is at a stark discount to some of the large consumer goods stocks. Strong earnings visibility with improving growth prospects of the core cigarette business and margin expansion in the non-cigarette FMCG business, high cash-generation ability with strong dividend payout, and sustained ESG rating will reduce the valuation gap in the coming years. We maintain our Buy recommendation on the stock with a revised PT of Rs. 280.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer Comparison

Particulars	P/E (x)			EV/EBIDTA (x)			RoCE (%)		
	FY21	FY22E	FY23E	FY21	FY22E	FY23E	FY21	FY22E	FY23E
Hindustan Unilever	80.3	68.2	56.9	57.3	49.5	41.4	36.5	26.4	31.6
ITC	22.8	20.6	17.4	17.6	14.6	12.4	21.5	26.9	31.1

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, respectively, 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 the past few years) by scaling up the fast-growing consumer goods and hotel businesses. The company has quickly rebound from disruption caused by the lockdown and key businesses are operating at normal levels. Though FY2021/FY2022 is expected to be impacted by supply disruption; strong recovery is anticipated in FY2023. Further, scale up in the performance of the non-cigarette FMCG business and margin improvement would be triggers for the stock in the medium to long term. Moreover, strong cash flows and cheery dividend payout make it a 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	16.2
3	Unit Trust of India	7.9
4	SBI Funds Management Pvt. Ltd.	2.82
5	Capital Group Companies	2.47
6	QIB Insurance Company	2.36
7	ICICI Prudential Asset Management	2.05
8	General Insurance cooperation of India	1.76
9	HDFC Asset Management Company	1.68
10	New India Assurance Co. Ltd	1.49

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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