Stock Update

Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

ITC Ltd

Good Q2; Cigarette sales volume reached close to pre-COVID levels

Consumer Goods	Sharekhan code: ITC

Reco/View	Reco: **Buy**	↔	CMP: **Rs. 238**	Price Target: **Rs. 280**	↔

↑ Upgrade ↔ Maintain ↓ Downgrade

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	+	↔	+

ESG Disclosure Score NEW

ESG RISK RATING Updated Oct 08, 2021				27.30
Medium Risk				
NEGL	LOW	**MED**	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

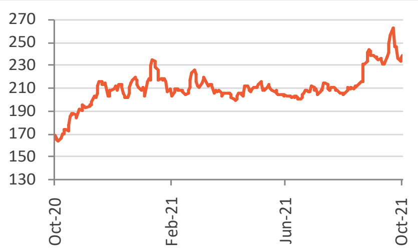
Company details

Market cap:	Rs. 293,717 cr
52-week high/low:	Rs. 265 / 163
NSE volume: (No of shares)	252.2 lakh
BSE code:	500875
NSE code:	ITC
Free float: (No of shares)	1232.0 cr

Shareholding (%)

Promoters	0.0
FII	11.8
DII	43.7
Others	44.6

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-0.1	15.7	16.0	42.6
Relative to Sensex	-1.9	-0.4	-6.9	-8.3

Sharekhan Research, Bloomberg

Summary

- ITC's Q2FY2022 cigarette sales volume growth stood at 10% (net revenue grew by 11%); Cigarette EBIT margin stood flat on a y-o-y basis. Sales volume recovered to pre-COVID levels.
- Non-cigarette FMCG business revenue grew by 3% in Q2FY2022 on a high base of last year (two-year CAGR stood at 23%). EBIDTA margin sustained at 10% despite raw-material inflation.
- With improving mobility and regularisation in store operations, cigarette sales volume is expected to improve in the coming quarters. Any significant increase in tax rate on cigarette would be risk to cigarette sales volume.
- The stock is currently trading at 17.1x/15.3x its FY2023/FY2024E EPS, which trades at a discount to consumer basket. Dividend yield of 4.6%. We maintain our Buy recommendation on the stock with a PT of Rs. 280.

ITC's Q2FY2022 performance was in-line with street expectation with revenue growing by 13.3% y-o-y to Rs. 13,553.5 crore and PAT growing by 14.4% y-o-y to Rs. 3,697.2 crore. Overall, operating profit margin (OPM) stood flat at 36.3% (improved by 357 bps q-o-q basis). Core cigarette business revenue grew by 10% (net revenue grew by 11.4%), driven by sales volume growth of 10%. Non-cigarette FMCG business revenue grew by 2.9% y-o-y on high base of 15% growth in Q2FY21 (grew by 23% on two-year CAGR basis). EBIDTA margin of the non-cigarette FMCG business sustained at 10% despite raw-material inflation. Hotel business registered strong recovery with 3x improvement in hotel occupancy, while paperboard, paper, and packaging (PPP) revenue grew by 25% y-o-y during the quarter.

Key positives

- Cigarette business volumes grew by 10%, in-line with our expectation.
- Hotel business revenue grew by 3.6x to Rs. 295 crore, led by 3x improvement in occupancies.
- Agri business PBIT margin improved by 209 bps to 10.7% due to better mix.
- PPP business revenue grew by 25% y-o-y because of higher sales volume.

Key negatives

- Gross margin decreased by 42 bps due to unfavourable mix.
- Non-cigarette FMCG business grew by 2.9% on high base; agri business revenue decreased by 7%.

Management Commentary

- Scale-up of stockiest network by 2x, market coverage by 1.4x, strong traction to new product launches, and increased e-commerce salience will help the non-cigarette FMCG business revenue to consistently improve in the coming quarters.
- Cigarette sales volume recovered to pre-COVID level sales. Broad-based recovery across key markets. Stockiest network and rural infrastructure scaled up to 2.1x y-o-y and 1.1x y-o-y, respectively.
- Hotel business to recover strongly in H2 with sustained strong demand from domestic leisure travel and gradual improvement in corporate travel.

Revision in estimates – We have broadly maintained our earnings estimates for FY2022/FY2023/FY2024 with cigarette sales volume growth coming in-line with expectation..

Our Call

View – Retain Buy with an unchanged 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 stock is currently trading at 17.1x and 15.3x its FY2023 and FY2024 EPS, respectively, which is at a stark discount to some of the large consumer goods stock. Strong earnings visibility with improving growth prospects of the core cigarette business, margin expansion in the non-cigarette FMCG business, and high cash-generation ability with strong dividend payout will reduce the valuation gap in the coming years. We maintain our Buy recommendation on the stock with an unchanged 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
Revenues	48,525	53,756	59,351	65,763
OPM (%)	32.0	34.5	36.5	37.0
Adjusted PAT	13,032	14,371	17,052	19,058
Adjusted EPS (Rs.)	10.7	11.8	14.0	15.6
P/E (x)	22.3	20.2	17.1	15.3
P/B (x)	5.0	4.9	4.7	4.5
EV/EBIDTA (x)	17.3	14.3	12.2	10.8
RoNW (%)	21.2	24.2	28.0	29.9
RoCE (%)	21.5	26.9	31.1	33.6

Source: Company; Sharekhan estimates

Good quarter – Revenue up by 13.2%, OPM remained flat

ITC's standalone revenue grew by 13.2% y-o-y to Rs. 13,553.5 crore, beating our as well as street expectation of Rs. 13,213.7 crore and Rs. 13,177 crore, respectively. Revenue rose by 4.6% q-o-q. Gross revenue of the core cigarette business grew by 10.2% y-o-y to Rs. 5,641.7 crore. Non-cigarette FMCG revenue grew by 6.4% y-o-y to Rs. 4,036.4 crore. Hotel business recovered with revenue significantly higher at Rs. 294.7 crore, up from Rs. 82 crore in Q2FY2021. PPP business revenue grew by 25.4% y-o-y to Rs. 1,829.7 crore, while agri business revenue declined by 7% y-o-y to Rs. 2,776.1 crore. OPM remained flat at 36.3%, slightly better than our expectation of 35.4% and street expectation of 35.8%. Operating profit grew by 13.7% y-o-y to Rs. 4,615 crore. Reported PAT growth was higher than operating profit growth at 14.4% y-o-y to Rs. 3,697.2 crore due to lower interest expenses (decreased by 24.1% y-o-y) and higher other income (increased by 11% y-o-y). PAT was ahead of our expectation of Rs. 3,490.3 crore and was marginally higher than street expectation of Rs. 3,695 crore.

Cigarette business volume grew by 10%; Margins stood almost flat

Cigarette business gross sales grew by 10% y-o-y to Rs. 5,641.7 crore (up by 10% q-o-q). Net revenue excluding excise duty grew by ~11%. Cigarette sales volume grew by 10% on low base of 12% volume decline. The same has almost recovered to pre-COVID level sales. Gross sales stood at 5% higher than Q2FY2020 (normal base quarter). Cigarette sales volume recovered to pre-COVID level sales. There was broad-based recovery across key markets. Stockiest network and rural infrastructure scaled up to 2.1x y-o-y and 1.1x y-o-y, respectively. Markets such as Kerala and east have remained relatively subdued. Cigarette business EBIT grew by 10% y-o-y. EBIT margin as a percentage of net sales stood flat at 74.4%. We expect cigarette business sales volume to improve on a sequential basis with most markets (including South India and Northeast India) expected to come back to normalcy coupled with no price increases in the portfolio expected in the immediate term. However, any significant increase in the excise duty on cigarette in the coming quarters will act as a key risk to cigarettes sales volume.

Non-cigarette FMCG business registered 6.4% revenue growth y-o-y on high base; Segmental EBIDTA margin remained flat at 6.7%:

ITC's non-cigarette FMCG business reported revenue of Rs. 4,036.4 crore, up 6.4% y-o-y on a high base (Q2FY2021 up by 19%). On a sequential basis, revenue grew by 8.3%, led by strong recovery post the second wave of COVID-19. Snacks, confectionery, and beverages performed well as 'Discretionary/'Out-of-Home' categories recorded strong growth on a sequential and y-o-y basis. Staples and convenience foods witnessed moderation on a high base of Q2FY2021, while it was well-above pre-Covid period; performed well on a sequential basis for the second consecutive quarter. Hygiene products witnessed marked demand volatility and moderated sequentially in line with lower intensity of the pandemic; remained significantly above pre-pandemic levels. Segment EBITDA margins remained flat at 6.7% despite unprecedented commodity inflation; sharp escalation in input costs offset largely through focused cost management actions, premiumisation, judicious pricing actions, fiscal incentives, and favourable business mix. Segment wise, EBIT was up by 7.6% y-o-y to Rs. 271.9 crore. Modern trade sales grew strongly both y-o-y (favourable base) and sequentially on account of improved mobility and store footfalls. E-commerce channel posted robust growth due to account-specific strategies, new product introductions including e-commerce first brands, and customised supply chain solutions. Channel salience stood at 7% in H1 – 3x H1FY2020 levels. Availability in rural markets enhanced through scale-up of stockist network (2x Q2FY2021 levels). Market coverage and direct outlet servicing stood at 1.4x and 1.1x of Q2FY2021 levels, respectively.

Agri business declined by 7% y-o-y due to supply-side constraints:

ITC's agri business reported a decline in revenue by 7% y-o-y to Rs. 2,776.1 crore due to shortage in the availability of containers/port congestions and inclement weather towards the end of the quarter delayed customer call-off. External businesses reported robust growth, led by wheat, rice, leaf tobacco, aqua, and spices exports. The business leveraged the e-Choupal network to provide strategic sourcing support to the branded packaged foods businesses with sharply aligned procurement strategies in line with category-relevant market dynamics. EBIT grew by 15.7% y-o-y to Rs. 296.1 crore and EBIT margin expanded by 209 bps y-o-y to 10.7%. Margin expansion was driven by favourable business and customer mix.

Strong recovery in the hotel business the post second wave of COVID-19:

With easing of travel restrictions imposed during the second wave, the domestic leisure segment and staycations witnessed an uptick during the quarter; Business travel continued to gather momentum. The business reported revenue of Rs. 294.7 crore during the quarter as against Rs. 82 crore in Q2FY2021 and Rs. 127.2 crore in Q1FY2022. Revenue growth can be attributed to sharply targeted packages catering to emerging trends and consumer needs along with focused communication campaigns. Strong recovery was witnessed in occupancy levels. ARRs improved on a sequential and y-o-y basis but remained below pre-Covid levels. Continuing with the pursuit of its 'asset-right' strategy, ITC launched two new brands – 'Storii' and 'Mementos' – to expand its footprint across the country through management contracts. ITC launched Welcomhotel Katra in August 2021 and Welcomhotel Bhubaneswar in October 2021. Structural cost management actions undertaken in the past year aided in reduction of controllable cash fixed costs by 31% over Q2FY2020. ITC continues to leverage digital investments towards facilitating guest acquisition, enhancing guest experience, augmenting revenue generation, and driving operational efficiency.

PPP business reported robust revenue growth (+25.4% y-o-y)

The PPP business reported revenue of Rs. 1,829.7 crore, up 25.4% y-o-y, primarily driven by recovery in demand due to opening up of the economy. Paperboards and specialty papers business witnessed revival of demand across most end-user segments other than publications, quick service restaurants (QSR), and wedding card segments, which remained relatively subdued. The VAP segment registered robust growth. Exports delivered a strong performance on a high base and notwithstanding logistical challenges. Packaging and printing business performed well, driven primarily by the cartons segment. EBIT of the business grew by 23.8% y-o-y to Rs. 409 crore, while margins remained marginally flat at 22.4%. Higher realisations, investments in pulp import substitution, cost-competitive fibre chain, sharper focus on operational efficiency leveraging data analytics, and industry 4.0 enabled margins to remain stable despite escalation in key input prices.

Results (Standalone) Rs cr

Particulars	Q2FY22	Q2FY21	y-o-y (%)	Q1FY22	q-o-q (%)
Gross revenue	**13,553.5**	**11,976.8**	**13.2**	**12,959.2**	**4.6**
Excise duty	822.6	793.7	3.6	742.0	10.9
Net revenue	**12,731.0**	**11,183.1**	**13.8**	**12,217.1**	**4.2**
Raw Material Consumed	5,446.2	4,737.0	15.0	5,786.1	-5.9
Employee Expenses	753.2	661.0	13.9	734.1	2.6
Other Expenses	1,916.6	1,724.5	11.1	1,704.8	12.4
Total expenditure	8,115.9	7,122.5	13.9	8,225.0	-1.3
Operating Profit	**4,615.0**	**4,060.6**	**13.7**	**3,992.2**	**15.6**
Other income	677.0	609.8	11.0	429.0	57.8
Interest	10.5	13.8	-24.1	10.3	1.3
Depreciation	401.5	382.5	5.0	395.5	1.5
Profit before tax	**4,880.1**	**4,274.1**	**14.2**	**4,015.4**	**21.5**
Tax	1,182.9	1,041.9	13.5	1,001.9	18.1
Reported PAT	**3,697.2**	**3,232.2**	**14.4**	**3,013.5**	**22.7**
EPS (Rs.)	3.0	2.6	14.4	2.5	22.7
			bps		**bps**
GPM (%)	57.2	57.6	-42.1	52.6	458.2
OPM (%)	36.3	36.3	-6.0	32.7	357.4
NPM (%)	29.0	28.9	13.8	24.7	437.5
Tax rate (%)	24.2	24.4		25.0	

Source: Company; Sharekhan Research

Segmental revenue performance Rs cr

Particulars	Q2FY22	Q2FY21	y-o-y (%)	Q1FY22	q-o-q (%)
FMCG - cigarettes	5,641.7	5,121.3	10.2	5,122.2	10.1
FMCG - others	4,036.4	3,795.0	6.4	3,725.6	8.3
Hotels	294.7	82.0	259.6	127.2	131.6
Agri	2,776.1	2,985.3	-7.0	4,091.3	-32.1
Paperboard, Paper and Packaging	1,829.7	1,458.7	25.4	1,582.7	15.6
Total	**14,578.7**	**13,442.1**	**8.5**	**14,648.9**	**-0.5**
Less: Inter segment sales	1,222.5	1,550.2	-21.1	1,764.5	-30.7
Gross Sales	**13,356.2**	**11,891.9**	**12.3**	**12,884.5**	**3.7**

Source: Company; Sharekhan Research

Segmental PBIT and margins

Business (Rs cr)	PBIT (Rs crore)			Margins (%)		
	Q2FY22	Q2FY21	YoY %	Q2FY22	Q2FY21	Chg in BPS
FMCG - cigarettes	3,583.2	3,244.8	10.4	63.5	63.4	15.3
FMCG - others	271.9	252.7	7.6	6.7	6.7	7.8
Hotels	-48.0	-184.9	-74.1	-16.3	-225.6	-
Agri	296.1	256.1	15.7	10.7	8.6	209.0
Paperboard, Paper and Packaging	409.0	330.3	23.8	22.4	22.6	-28.7
Total	**4,512.3**	**3,898.9**	**15.7**	**31.0**	**29.0**	**194.6**

Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector view - Cigarette remains a regulatory risk, FMCG long's-term growth prospects intact

The domestic cigarette industry is affected by sustained increase in taxes and regulatory regime along with a sharp increase in illegal trade in recent years, especially at the premium end, which continue to pose significant challenges to the legal cigarette industry in the country. Though cigarette was skipped from increased taxes in Union Budget, there is sustained risk of regulatory hurdles implemented to curb tobacco products consumption. On the other hand, outlook for the FMCG industry in India is positive as lower capita consumption, emergence of new categories, and improving demographics provide enough scope for FCMG companies to achieve sustainable revenue growth in the medium to long run.

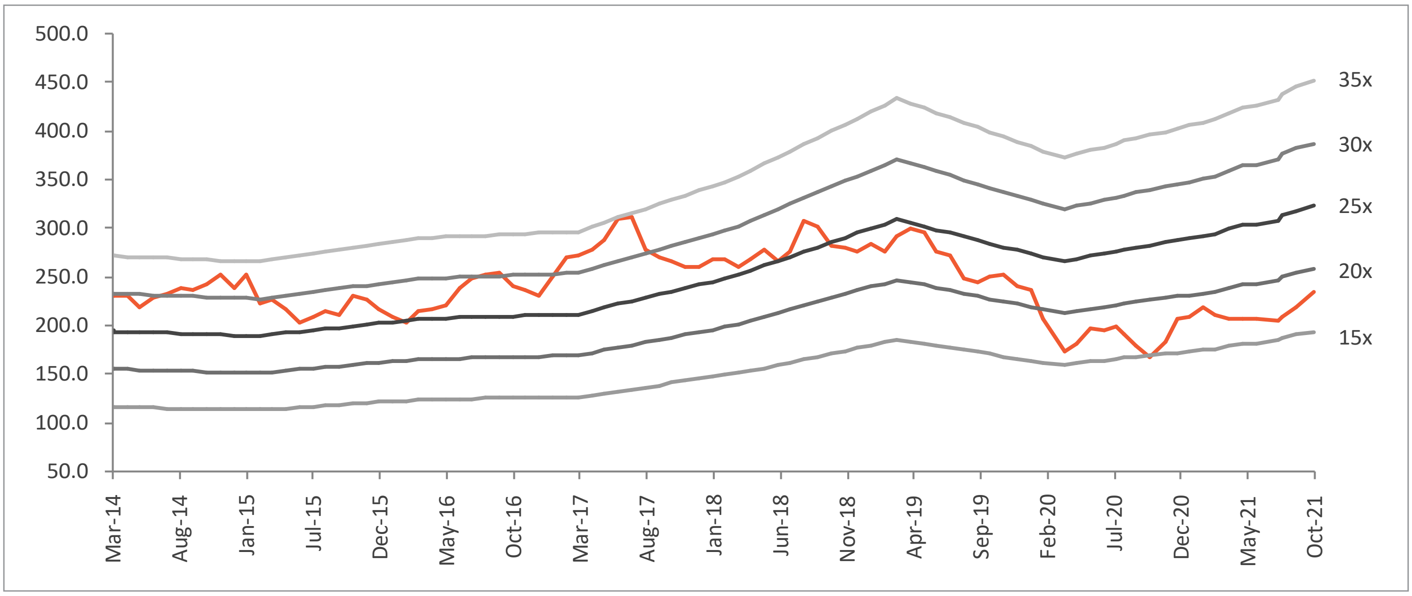
■ Company outlook - Cigarette business to regain normalcy; FMCG margins to scale up

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 an unchanged 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 stock is currently trading at 17.1x and 15.3x 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 and high cash-generation ability with strong dividend payout will reduce the valuation gap in the coming years. We maintain our Buy recommendation on the stock with an unchanged PT of Rs. 280.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer Comparison

Companies	P/E (x)			EV/EBIDTA (x)			RoCE (%)		
	FY21	FY22E	FY23E	FY21	FY22E	FY23E	FY21	FY22E	FY23E
Hindustan Unilever	69.2	61.4	49.9	49.3	43.4	36.0	36.5	25.2	31.1
ITC	22.3	20.2	17.1	17.3	14.3	12.2	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

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 Corp. of India	1.76
9	HDFC Asset Management Co. Ltd.	1.68
10	New India Assurance Co. Ltd.	1.49

Source: Bloomberg

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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

Sharekhan

by BNP PARIBAS

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