23 November 2021

Company Update | Sector: Consumer

ITC

BSE SENSEX	S&P CNX
58,664	13,393

CMP: INR232 **TP: INR240 (+4%)** **Neutral**

Muted Cigarette volumes; Other FMCG margin pressures weigh on ITC

ITC Limited

Stock Info

Bloomberg	ITC IN
Equity Shares (m)	12,259
M.Cap.(INRb)/(USDb)	2853.9 / 38.3
52-Week Range (INR)	265 / 189
1, 6, 12 Rel. Per (%)	1/-5/-12
12M Avg Val (INR M)	6876
Free float (%)	100.0

Financials & Valuations (INR b)

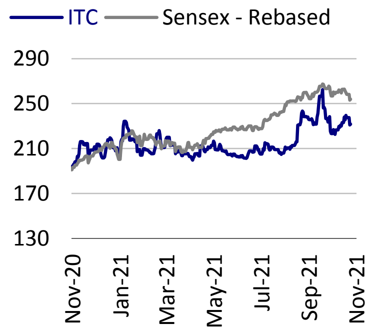
Y/E March	2021	2022E	2023E
Sales	454.9	522.6	569.1
Sales Gr. (%)	-0.3	14.9	8.9
EBITDA	155.3	190.8	224.8
EBITDA Mrg. (%)	34.2	36.5	39.5
Adj. PAT	130.3	153.9	180.6
Adj. EPS (INR)	10.6	12.5	14.7
EPS Gr. (%)	-14.8	18.1	17.3
BV/Sh.(INR)	47.9	49.3	51.7
Ratios			
RoE (%)	21.2	25.7	29.1
RoCE (%)	20.6	25.0	28.3
Payout (%)	101.5	100.0	90.0
Valuations			
P/E (x)	21.8	18.5	15.7
P/BV (x)	4.8	4.7	4.5
EV/EBITDA (x)	16.3	13.3	11.2
Div. Yield (%)	4.7	5.4	5.7

Shareholding pattern (%)

As On	Sep-21	Jun-21	Sep-20
Promoter	0.0	0.0	0.0
DII	43.7	42.4	43.5
FII	10.9	11.9	13.1
Others	45.4	45.8	43.5

FII Includes depository receipts

Stock performance (one-year)



- **Tapering in-home consumption and sharp commodity cost inflation could affect strong EBIT growth in the Other FMCG segment, preventing the contribution of Cigarettes in overall EBIT to decline much (likely to reduce to ~80% in FY23E which is still within its ten-year range of 80-86%).**
- **Cigarette volumes for ITC and even other players globally have been on a declining trend, given the increased health consciousness among consumers over the last decade. With the government having recently (Oct'21) set up an expert panel tasked with preparing a comprehensive tax policy proposal for all forms of tobacco from a public health perspective, the overhang of a policy change that may affect cigarette volumes remains on the stock.**
- **The rumored demerger of ITC Infotech, even at INR200-250b, is only 6-8% of ITC's current market capitalization and is partly factored in the price already. In our opinion, it does not portend demerger of other FMCG or the Hotels business in the near term, nor does it reduce the dependence on its Cigarette EBIT.**
- **While ITC's efforts on the overall ESG (environmental, social, and corporate governance) front are truly commendable, the concern over its Cigarettes business from an ESG perspective remains in play, as more funds turn ESG-compliant globally, affecting the valuations of global Cigarette companies, including ITC.**
- **The earnings growth in the latter half of the last decade considerably weakened v/s the first half. We don't see any significant pickup in the earnings trajectory going forward (7.7% PBT CAGR over FY20-23E). RoE saw a sharp decline in the latter half of the decade, despite the corporate tax rate cut. With the self-imposed near-term moratorium on substantial capex eventually being lifted, as well as the possibility of future acquisitions, RoE could come under further pressure over the medium term.**

EBIT dependence on Cigarettes to remain unaltered despite healthy topline growth in Other FMCG

- **Growth lackluster in the Other FMCG business:** ITC's Other FMCG business saw strong topline momentum in FY21 (15% sales growth YoY) owing to healthy in-home consumption of noodles, biscuits, snacks, and atta (wheat flour) amid the COVID-19 outbreak. This has since tapered away, with 1QFY22/2QFY22 sales growth at 10.4%/2.9%. While margin expansion for the business was impressive in FY21, owing to: 1) soft commodity costs, 2) lower trade discounts (on healthy demand), and 3) likely lower ad spends-to-sales ratio, these contributing factors are not sustainable. With the company already calling out sharp input cost inflation in its 1HFY22 result, we forecast FY22E EBIT margin to be under pressure, given the likely impact on 2HFY22 as well. This will result in lower EBIT margin growth in FY22E and possibly FY23E as well compared to our earlier estimates.

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- **Cigarette business contribution to overall EBIT to remain high:** We do not see the contribution of cigarettes to ITC's overall EBIT changing materially until FY23E (~80% in FY23E which is within its ten-year range). As a result, overall earnings growth and multiples will remain under pressure. The contribution of the Other FMCG segment to overall EBIT will remain 6-7% even in FY23E, due to the huge difference in EBIT margin between Cigarettes (~75% in FY23E) and Other FMCG (~7% in FY23E).
- **Cigarette volumes remain tepid:** Cigarette volumes are estimated to have grown by 31%/9% YoY in 1Q/2QFY22 on a low base, with two-year average volume growth remaining negative (-3%/-1.5%). As highlighted in our 2QFY22 result note, we estimate a near term uptick in volumes on the back of: a) a weak base, b) better mobility with easing restrictions, and c) the launch of a modernized and refreshed packs for key brands. The average two-year volume growth ending FY22 is likely to be -0.6% and remains uncertain going forward as well, given the trajectory over the last five years (-1.7% average volume growth over FY16-20), even without any GST increase in the preceding four years, barring the Feb'20 rise. The government has also recently (Oct'21) set up an expert panel tasked with preparing a comprehensive tax policy proposal for all forms of tobacco from a public health perspective. We await the recommendations of the panel and believe that the potential for an adverse policy announcement remains an overhang on the stock. Our base case does not factor in any volume impact of a possible hike in GST for cigarettes.
- **Plague of illicit cigarettes/bidis:** As per our estimate, the illicit cigarette trade accounts for 23-25% of the industry, with 40-50% of illicit cigarette supply accruing from outside India. The salience of illicit cigarettes was lower in CY15 at 17-18%, but gained ground owing to higher taxes on legal cigarettes. This has also encouraged downtrading from lower-end cigarettes to bidis. An increase in GST rates for cigarettes will likely lead to the illicit industry maintaining its grip.
- **ESG-related concerns on Cigarettes remain prominent:** Sustainable/ESG investing has seen its prominence grow globally, with AUMs of over USD35t (source). Within ESG assets in the US, ~75% of the universe is underweight tobacco in the largecap equity space, and 50-70% avoids the sector completely. ITC's high profitability dependence on the Cigarettes business has come under scrutiny of sustainability-compliant investors worldwide in recent years. Philip Morris/British American Tobacco (BAT) witnessed 27%/60% contractions in their multiples in the last five years. Along similar lines, with ~86% of ITC's EBIT coming from Cigarettes in FY21, the stock saw a significant correction in multiples. The contraction in ESG-related multiples are unlikely to abate anytime soon, leading to continued selling from funds that are turning ESG-compliant in both India and globally.

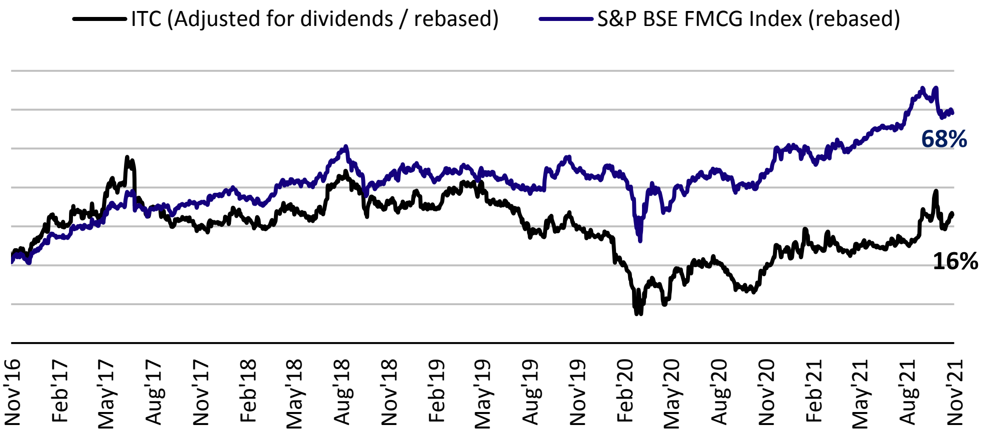
Valuation and view

- While ITC's stock has delivered ~12% return over the last three months, it has considerably underperformed its benchmark and Consumer peers over the last five years as well as the last 12 months.
- The concerns we highlighted in our detailed note in Dec'20 have continued to remain in play with: a) the Cigarettes' business contributing nearly 80% of ITC's overall EBIT, even in FY23E, raising ESG-related concerns, b) weak cigarette EBIT

growth for several years now (4.1% over FY17-23E), c) tepid growth in the Other FMCG segment, and d) overhang of a GST increase on cigarettes.

- With PBT growth over FY20-23E (7.7% CAGR) likely to remain similar to growth in the preceding five years, valuations although relatively cheap compared to its consumer peers in India, are fair considering the concerns stated above. Taking into account the average one-year forward valuation of global peers at 11x, ITC trades at a 45% premium (16.3x).
- We expect a dividend yield of 5-5.5% over the next two years, in line with that of other global Cigarette players.
- We value ITC at 15x Dec'23E EPS and maintain our TP of INR240/share and our **Neutral** rating.

Exhibit 1: ITC's stock significantly underperforms the benchmark over the last five years



*ITC price adjusted for dividends and splits

Source: Bloomberg, MOFSL

Exhibit 2: ITC's stock price significantly underperforms its peers on a three/five-year basis, despite the run up in recent months

Companies (INR)	One-year return	Three-year return	Five-year return
PIDI	48.5	103.2	283.4
APNT	49.3	148.3	259.5
NEST	6.8	84.4	222.4
PAG	80.2	46.7	210.1
HUVR	12.3	42.7	191.6
BRIT	0.7	19.2	146.5
PGHH	41.9	62.2	129.8
DABUR	19.6	51.9	120.6
MRCO	43.2	53.0	114.6
GCPL	29.1	27.4	93.0
CLGT	(5.7)	28.7	63.6
ITC	**20.9**	**(17.8)**	**2.0**
HMN	32.3	21.9	(0.0)

Closing price as of 22nd Nov'21

Source: Company, MOFSL

Stock price underperformance led by earnings and return ratios

- ITC's stock has significantly underperformed the benchmark in the past five years.
- Topline and earnings growth have been tepid in the past five years v/s the preceding five years.
- RoE and RoCE have also fallen significantly in the past decade.

Exhibit 3: Compared to the first five years of the decade…

Y/E March (INR b)	2011	2012	2013	2014	2015	2016	Five-year CAGR (%)
Revenue	**215**	**252**	**299**	**332**	**365**	**366**	**11.3**
Change (%)	16.7	17.2	18.9	11.2	9.8	0.2	
EBITDA	**74**	**89**	**107**	**125**	**135**	**137**	**13.1**
Change (%)	17.1	19.6	20.1	17.2	8.2	1.8	
Margin (%)	34.5	35.3	35.6	37.5	37.0	37.6	310bp
Profit before Taxes	**73**	**89**	**107**	**127**	**140**	**144**	**14.7**
Change (%)	20.8	22.4	20.1	18.5	10.6	3.1	
Margin (%)	33.9	35.4	35.7	38.1	38.3	39.5	560bp
Profit after Taxes	**50**	**62**	**74**	**88**	**96**	**93**	**13.3**
Change (%)	22.6	23.6	20.4	18.4	9.4	-2.9	
Margin (%)	23.2	24.5	24.8	26.4	26.3	25.5	230bp

Source: Company, MOFSL

Exhibit 4: …ITC's topline and earnings growth have been tepid for the past five years…

Y/E March (INR b)	2016	2017	2018	2019	2020	2021	Five-year CAGR (%)
Revenue	**366**	**401**	**406**	**450**	**456**	**455**	**4.5**
Change (%)	0.2	9.6	1.3	10.8	1.4	-0.3	
EBITDA	**137**	**146**	**156**	**173**	**179**	**155**	**2.5**
Change (%)	1.8	6.3	6.6	11.3	3.5	-13.4	
Margin (%)	37.6	36.4	38.3	38.5	39.3	34.2	-340bp
Profit before Taxes	**144**	**155**	**164**	**184**	**193**	**172**	**3.5**
Change (%)	3.1	7.4	6.0	12.2	4.6	-11.1	
Margin (%)	39.5	38.7	40.5	41.0	42.3	37.7	-180bp
Profit after Taxes	**93**	**102**	**108**	**125**	**153**	**130**	**6.9**
Change (%)	-2.9	9.4	6.0	15.3	22.5	-14.6	
Margin (%)	25.5	25.4	26.6	27.7	33.5	28.7	320bp

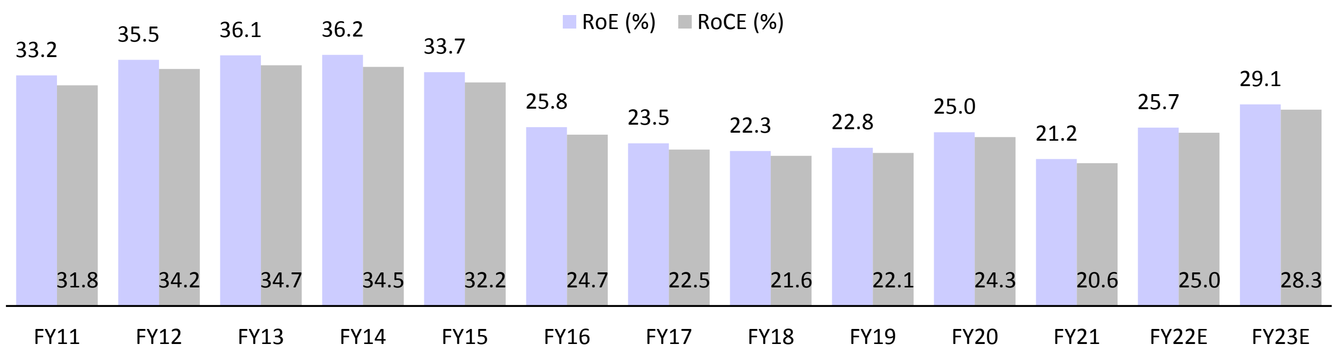
Source: Company, MOFSL

Exhibit 5: …with a similar momentum expected to continue going forward

Y/E March (INR b)	2020	2021	2022E	2023E	Three-year CAGR (%)
Revenue	**456**	**455**	**523**	**569**	**7.7**
Change (%)	1.4	-0.3	14.9	8.9	
EBITDA	**179**	**155**	**191**	**225**	**7.8**
Change (%)	3.5	-13.4	22.8	17.9	
Margin (%)	39.3	34.2	36.5	39.5	20bp
Profit before Taxes	**193**	**172**	**206**	**241**	**7.7**
Change (%)	4.6	-11.1	19.9	17.3	
Margin (%)	42.3	37.7	39.4	42.4	10bp
Profit after Taxes	**153**	**130**	**154**	**181**	**5.8**
Change (%)	22.5	-14.6	18.1	17.3	
Margin (%)	33.5	28.7	29.5	31.7	-180bp

Source: Company, MOFSL

Exhibit 6: The declining trend in RoE/RoCE over the last decade



Source: Company, MOFSL

- The situation has been similar globally with tobacco majors – Philip Morris (PMI) and BAT – reporting weak growth in the last five years.
- While the numbers for BAT may optically look better, it is pertinent to note that in CY17 BAT acquired a majority stake in US rival Reynolds American (already owing 42% up until that point).
- Globally, the industry has seen a declining trend in volumes since CY00. The reason for this has been the increased health consciousness among consumers and governments about the negative health effects of smoking.
- In CY19, the USFDA officially changed the federal minimum age to buy tobacco to 21 from 18 years.

Exhibit 7: Philip Morris International – Financial summary

Y/E December (USD b)	2015	2016	2017	2018	2019	2020	Five-year CAGR (%)
Revenue	**27**	**27**	**29**	**30**	**30**	**29**	**1.4**
Change (%)	-10.0	-0.4	7.7	3.1	0.6	-3.7	
EBITDA	**11**	**11**	**12**	**11**	**12**	**12**	**2.3**
Change (%)	-16.9	2.0	6.2	-1.8	1.7	3.5	
Margin (%)	39.9	40.9	40.3	38.4	38.8	41.7	180bp
Profit before Taxes	**10**	**10**	**11**	**11**	**11**	**11**	**3.2**
Change (%)	-18.0	2.5	6.7	0.8	2.2	3.9	
Margin (%)	36.1	37.2	36.8	36.0	36.6	39.5	340bp
Profit after Taxes	**7**	**7**	**6**	**8**	**8**	**9**	**4.1**
Change (%)	-8.2	3.1	-12.5	30.7	-6.7	11.2	
Margin (%)	26.2	27.2	22.1	28.0	25.9	29.9	370bp

Source: Bloomberg, MOFSL

Exhibit 8: BAT – Financial summary

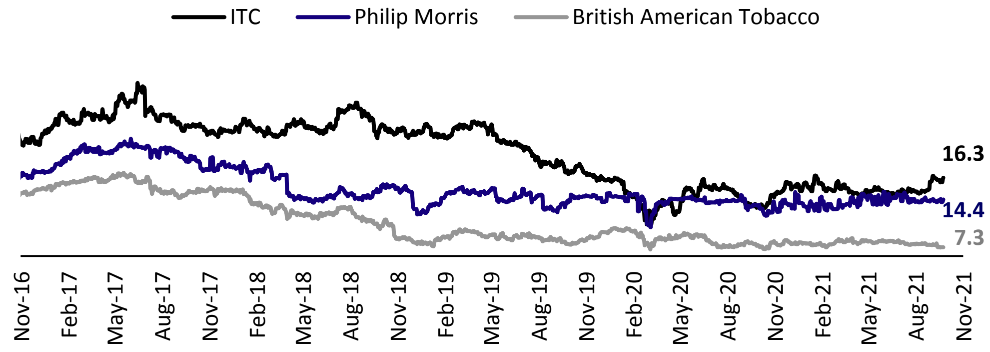
Y/E December (GBP b)	2015	2016	2017	2018	2019	2020	Five-year CAGR (%)
Revenue	**13**	**15**	**20**	**24**	**26**	**26**	**14.5**
Change (%)	-6.2	12.6	32.6	25.2	5.7	-0.4	
EBITDA	**5**	**5**	**8**	**10**	**10**	**11**	**17.8**
Change (%)	-9.3	10.2	38.7	29.5	2.6	11.4	
Margin (%)	37.7	36.9	38.6	39.9	38.8	43.4	570bp
Profit before Taxes	**6**	**6**	**7**	**9**	**9**	**10**	**11.1**
Change (%)	1.9	-3.7	32.7	17.6	1.0	11.5	
Margin (%)	44.7	38.2	38.2	35.9	34.3	38.4	-630bp
Profit after Taxes	**5**	**5**	**38**	**6**	**6**	**7**	**7.7**
Change (%)	33.3	7.0	678.2	-83.5	-5.8	12.2	
Margin (%)	34.5	32.8	192.5	25.4	22.6	25.5	-900bp

Source: Company, MOFSL

Stock price underperformance – the ESG factor

- The biggest factor affecting the share price has been the P/E multiple compression based on the ESG consideration. Cigarette players across the world have been significantly affected as investors are increasingly turning sustainability compliant.
- The sharp rate at which the one-year forward P/E multiples of global Cigarette players have declined in recent years clearly indicates the global trend at play on ITC's stock.

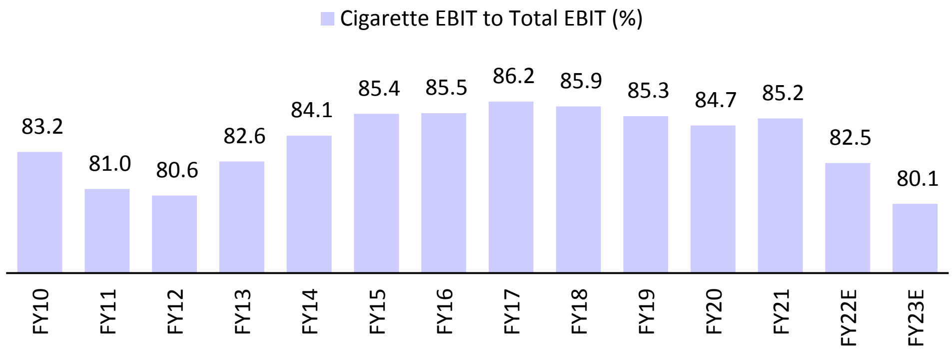
Exhibit 9: One-year forward P/E multiple (x) of global Cigarette players declines sharply in recent years



Source: Company, MOFSL

- ITC has been able to diversify in the last 10 years from a sales perspective, with Cigarettes accounting for 38.3% of net sales (less excise duties) in FY21. Its continued high EBIT contribution from the segment remains a major factor driving down overall stock price performance, in light of ESG concerns around the Cigarettes business.
- Even with strong EBIT growth in the Other FMCG segment, the contribution of Cigarettes to overall EBIT is unlikely to decline much. From 86% in FY21, this is likely to reduce to just 80% in FY23E. Thus, the ESG concerns of investors are unlikely to abate anytime soon.

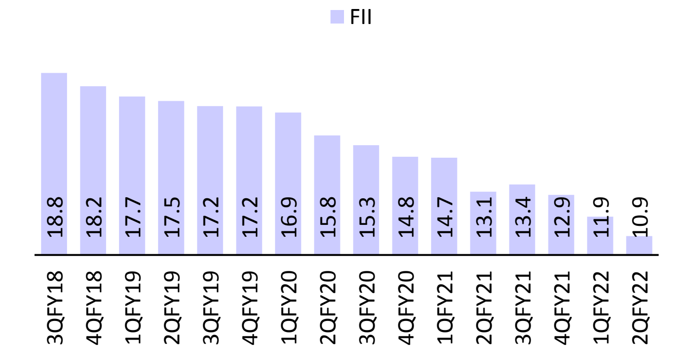
Exhibit 10: Higher EBIT contribution from Cigarettes to continue



Source: Company, MOFSL

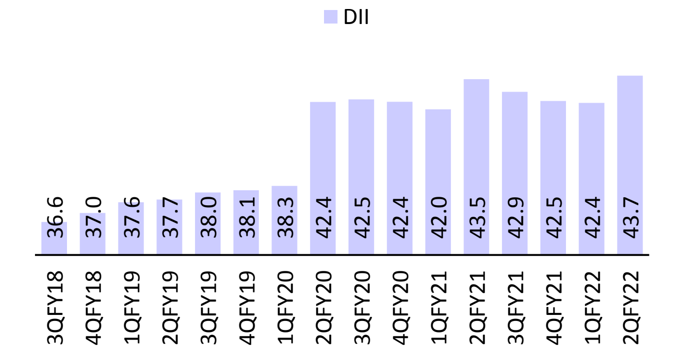
- Global ESG-related concerns are reflected in the shareholding pattern changes seen in the last few years.

Exhibit 11: Global ESG-related concerns reflect…



Source: Company, MOFSL

Exhibit 12: …in shareholding pattern changes (%)



Source: Company, MOFSL

Growth in Cigarette volumes continues to remain muted

- As highlighted in our Dec'20 report, ITC raised prices (by ~10%) after the NCCD increase in the Feb'20 budget – the first significant price increase in over two-and-a-half years.
- The absence of any GST rate increase since Feb'20 presents a strong risk of a likely increase in tax rates on cigarettes, further denting volume growth (currently not factored in our base case projections).
- The government has also recently (Oct'21) set up an expert panel tasked with preparing a comprehensive tax policy proposal for all forms of tobacco from a public health perspective. We await the recommendations of the panel and believe that the potential for an adverse policy announcement remains an overhang on the stock. (news link).
- As per a CY20 report by Tobacconomics, India is still below international standards of best practices when it comes to taxes on cigarettes.

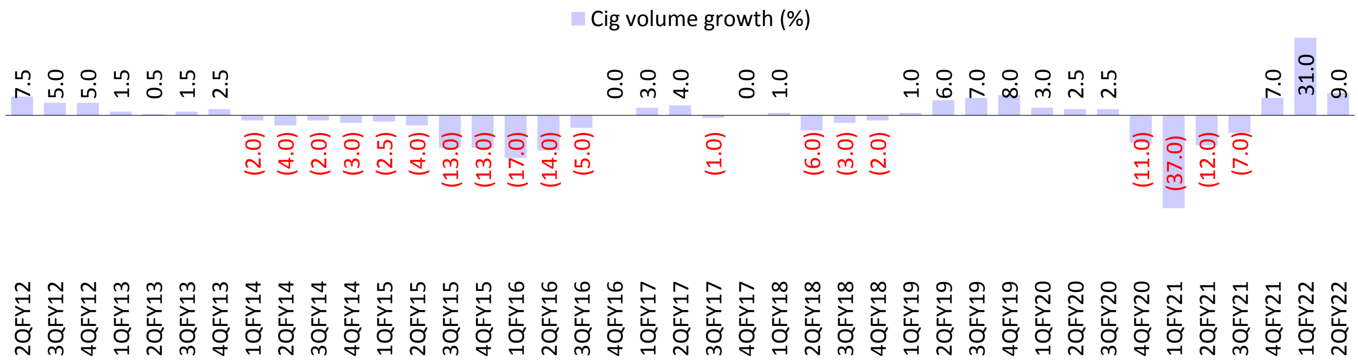
Exhibit 13: Existing GST rates on cigarettes in India

Category of cigarette	CGST (%)	SGST (%)	Compensation cess (%)	Additional cess per '000 sticks (INR)
Filter cigarettes <65mm	18	18	5	2,076
Filter cigarettes between 66-70mm	18	18	5	2,747
Filter cigarettes between 71-75mm	18	18	5	3,668
Filter cigarettes >75mm	18	18	36	4,170

Source: CBIC, MOFSL

- The blended GST rate for ITC would be in the range of 55-60%, with a majority of its portfolio closer to the 50% rate. This is still below WHO's recommended tax rate of 75% on cigarettes. While our estimates do not factor in any increase in GST rates on cigarettes, we believe an increase would likely affect the already tepid demand.

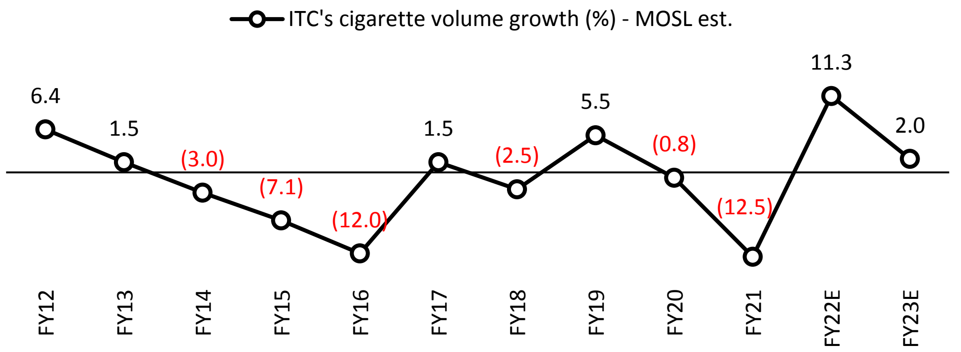
Exhibit 14: Average cigarette volume growth (YoY) has been flat in the last 20 quarters



Source: Company, MOFSL

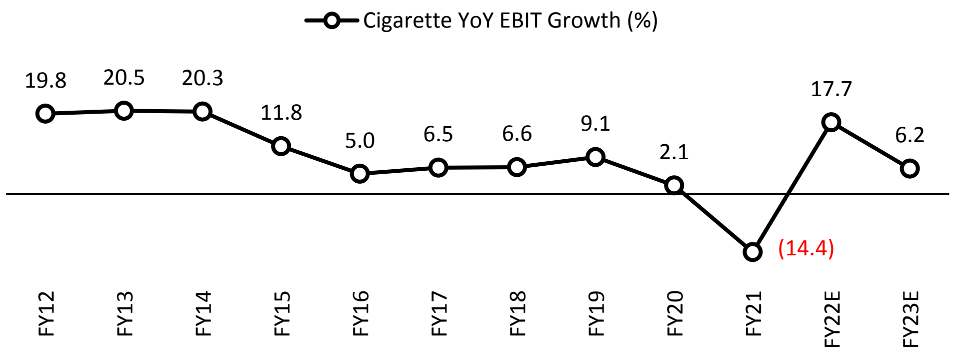
- While lockdowns played a major role in the steep volume decline in recent quarters, price increases taken over Feb-Mar'20 also contributed to the decline.
- Cigarette volumes are likely to see a YoY rebound in FY22 on the back of a very weak base. The two-year growth seen in volumes is likely to be lower than its long-term average.

Exhibit 15: FY21 was the sixth year of negative volume growth in the last 10 years



Source: Company, MOFSL

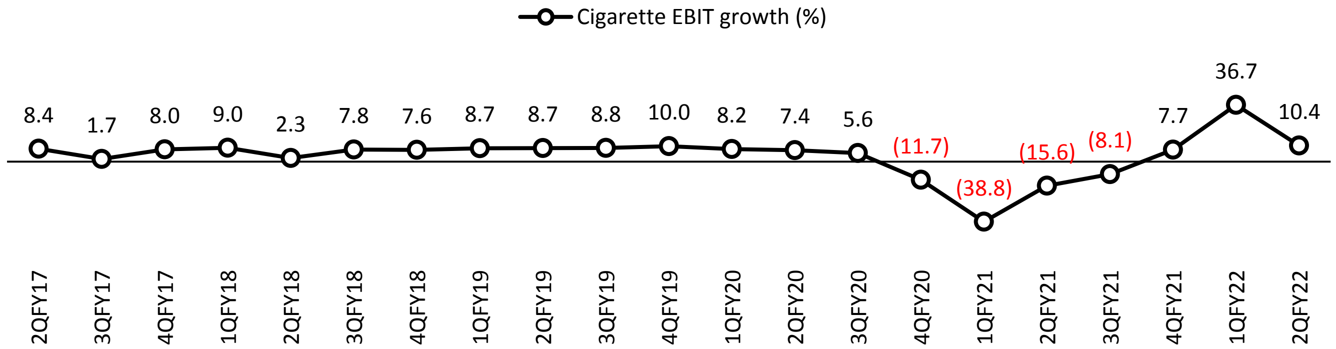
Exhibit 16: ITC has not seen double-digit EBIT growth in Cigarettes for six years in a row



Source: Company, MOFSL

- Notwithstanding the growth in FY22E, on account of the low base, neither Cigarette volumes nor Cigarette EBIT growth rates are likely to improve dramatically going forward.

Exhibit 17: EBIT trends in Cigarettes had been worsening even before the lockdowns



Source: Company, MOFSL

Concerns over the illegal cigarette trade and *bidi* sales continue to grow

- The management, in its quarterly press release, has raised concerns over the continued availability of smuggled cigarettes, despite deterrent actions by concerned authorities.
- With NCCD-led price increases, the gap between the prices of legal and illegal cigarettes (which do not incur any GST) is widening. This poses an even higher risk of the legal Cigarettes business losing further share to illegal Cigarettes (~25% of the market). Recent government efforts to crack down on the illegal trade, if effectively implemented, may mitigate some of the damage.
- The threat of illegal cigarettes is concerning as their lower price points are weaning away consumers and their channels are gaining significantly higher margins than organized players. Our channel checks indicate retailers are able to earn an absolute profit of 3-4x per pack from organized brands from the sale of illegal cigarettes. This results in a perverse incentive for retailers to focus on illegal cigarettes, while causing a double whammy for organized players.
- With the NCCD increase also being higher on the lowest priced (sub-65mm) cigarettes, further concerns have emerged over downtrading to *bidis*. This is particularly true in rural India, which comprises segments of smokers that switch between *bidis* and cigarettes. A weak economic environment has already led to some downtrading within Cigarettes in recent quarters. This has also had an effect on the EBIT margin of Cigarettes during this period.
- The problem is just as grave in terms of other forms of tobacco, with ITC's FY21 annual report estimating that 68% of total tobacco consumed in India remains outside the tax net.

Other FMCG sees extraordinary growth in FY21, but dependence on Cigarettes continue

- Over the years, ITC has done well to expand its Other FMCG business by developing and growing its own brands as well as through an inorganic expansion strategy.
- ITC has continued to diversify its Other FMCG offerings, with the introduction of new categories like Chocolates, Dairy, and Coffee.

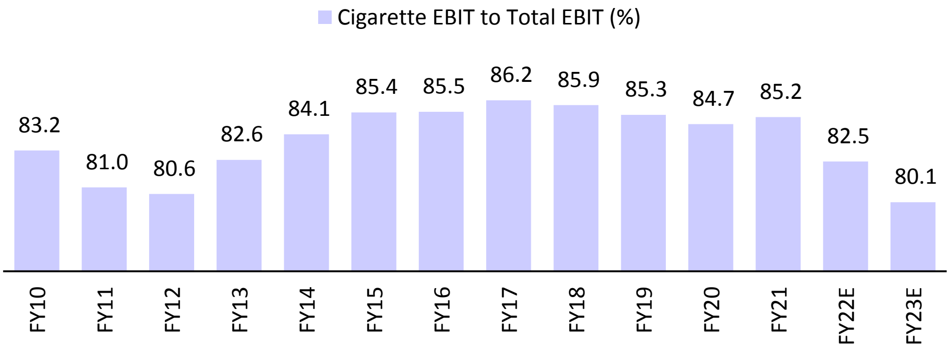
- The 'Other FMCG' business saw a strong topline momentum in FY21 due to healthy in-home consumption of noodles, biscuits, snacks, and *atta* (wheat flour), especially in the first half.
- The impressive margin expansion in FY21 was a result of: 1) soft commodity costs, 2) low trade discounts (on healthy demand), and 3) likely lower ad spends to sales.
- These factors are not sustainable given: 1) the slowdown in in-home consumption as mobility resumes, and 2) the sharp inflation seen in commodity costs, especially Agri-commodities, over 1HFY22. We have assumed a 200bp decline in BRIT's FY22E EBIT margin and continue to assume a flat margin for ITC's Other FMCG business, which is at a significant risk, given the 83% growth in FY21 EBIT, led by a confluence of unsustainable factors.
- Other FMCG contribution to overall EBIT is likely to remain between 6-7% in FY23E, partly due to the huge differential in EBIT margin between Cigarettes (~75%) and Other FMCG (~7% in FY23E). The share of Cigarettes in overall EBIT is likely to fall to 80% in FY23E which is still within the range of 80-86% seen in the last ten years. Thus, overall earnings growth and multiples are expected to remain under pressure.

Exhibit 18: Segmental performance

Net sales (INR b)	**FY18**	**FY19**	**FY20**	**FY21**	**FY22E**	**FY23E**
Cigarettes	191	199	206	173	201	212
FMCG – Others	113	125	128	147	158	177
Hotels	14	17	18	6	12	18
Agri business	81	94	102	126	140	150
Paper and Packaging	50	59	61	56	68	73
Net sales growth (YoY %)						
Cigarettes	0.8	4.1	3.5	(16.1)	16.1	5.6
FMCG – Others	7.8	10.4	2.7	14.7	7.1	12.0
Hotels	5.6	17.4	10.3	(65.8)	86.4	57.1
Agri business	(2.4)	16.5	9.0	22.9	11.0	7.7
Paper and Packaging	(3.1)	11.6	4.2	(8.0)	21.2	6.9
Estimated volume growth (YoY)						
Cigarettes (%)	(2.5)	5.5	(0.8)	(12.5)	11.3	2.0
EBIT (INR b)						
Cigarettes	133	146	149	127	150	159
FMCG – Others	2	3	4	8	9	13
Hotels	1	2	2	(5)	(2)	2
Agri business	8	8	8	8	10	11
Paper and Packaging	10	12	13	11	15	15
EBIT growth (YoY %)						
Cigarettes	6.6	9.1	2.1	(14.4)	17.7	6.2
FMCG – Others	483.6	92.4	34.0	96.8	11.2	37.3
Hotels	26.0	27.1	(11.2)	P/L	NM	L/P
Agri business	(6.3)	(8.5)	1.6	4.0	20.5	6.5
Paper and Packaging	7.9	18.9	5.3	(15.8)	34.0	(1.1)
EBIT Margin (%)						
Cigarettes	69.7	73.0	72.0	73.6	74.5	75.0
FMCG – Others	1.5	2.5	3.3	5.7	5.9	7.2
Hotels	10.0	10.7	8.6	(85.2)	(18.6)	9.2
Agri business	10.5	8.3	7.7	6.5	7.1	7.0
Paper and Packaging	21.0	21.1	21.4	19.6	21.6	20.0

Source: Company, MOFSL

Exhibit 19: Despite a 44% CAGR assumed in Other FMCG EBIT over FY20-23E, ITC's dependence on Cigarettes to total EBIT remains at 80% in FY23E



Source: Company, MOFSL

ITC Infotech

- Recent reports (link) suggest that management may perhaps look to demerge ITC Infotech – the company's IT arm with clients across 29 countries.
- As per the latest company presentation, the pipeline for large deals grew 4x in FY21 from its FY19 baseline.
- The news report also suggests that the management may seek a valuation of INR200-250b (USD2.7-3.4b), which would be 7-9% of ITC's current m-cap. This would value the company at 35-40x its (annualized) 1HFY22 PAT.
- The margin expansion has been on account of an improved business mix and higher resource productivity.

Exhibit 20: While ITC Infotech's revenue grew at 19% CAGR over FY17-21, its contribution to ITC's topline is still insignificant and more so from a profitability perspective

INR m	FY17	FY18	FY19	FY20	FY21
Revenue	**9,361.6**	**10,202.8**	**12,387.1**	**15,607.7**	**18,839.1**
Growth (%)	(2.6)	9.0	21.4	26.0	20.7
% of ITC's revenue	2.4	2.5	2.8	3.5	4.2
PAT	**178.9**	**276.8**	**764.6**	**1,946.9**	**4,477.9**
Growth (%)	(79.7)	54.7	176.2	154.6	130.0
Margin (%)	1.9	2.7	6.2	12.5	23.8
% of ITC's adjusted PAT	0.2	0.3	0.6	1.3	3.4

Source: Company (AOC-1), MOFSL

Capital allocation – some recalibration in capex

- Capex is likely to revert to earlier levels of INR30-35b over the next few years.
- This, excluding acquisitions, which have been fairly frequent in recent years (*Exhibit 19*).
- The company has completed large greenfield investments in the Hotels business. The management intends to focus on an asset-light model, which is evident from the fact that no new projects have been announced in preceding quarters, thus limiting investment in the Hotels business.
- Overall capex is unlikely to reduce because of investments in other businesses.
- While the recalibration in capex towards the Other FMCG business (which has been the highest category of investment in recent years) is likely over FY21-23E, it is also likely to rise later on.

Exhibit 21: Major capex in FMCG – Others in the past six years

Capex breakdown (%)	FY16	FY17	FY18	FY19	FY20	FY21
Cigarettes	12.7	10.0	3.6	5.8	6.5	5.1
FMCG – Others	42.6	45.7	32.9	54.1	42.1	30.3
Hotels	16.9	15.8	24.1	27.4	36.2	12.8
Agri business	7.5	6.3	3.6	2.2	2.7	2.5
Paper and Packaging	20.3	22.2	35.9	10.6	12.4	49.4
Total	**100**	**100**	**100**	**100**	**100**	**100**

Source: Company, MOFSL

- While the recent improvements in profitability in Other FMCG are heartening, the impact on overall EBIT margin is negligible.

Inorganic growth strategy

- Inorganic acquisitions will continue to play an important part in ITC's growth strategy for its Other FMCG business, given the healthy cash balance, despite increased dividend payouts and lower capex in the Hotels business.
- Recent acquisitions enabled the company to enter new categories or enhance its presence. Boosting sales growth through this route is a deliberate strategy that would be an important cornerstone of growth going forward.

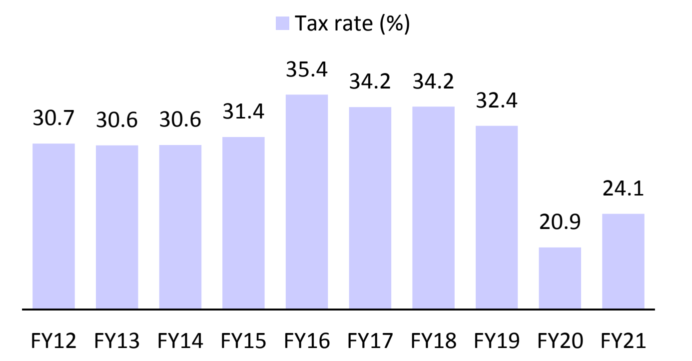
Exhibit 22: Brands acquired by ITC in the last 5-6 years

FY15 FY18 FY19 FY21

Source: Company, MOFSL

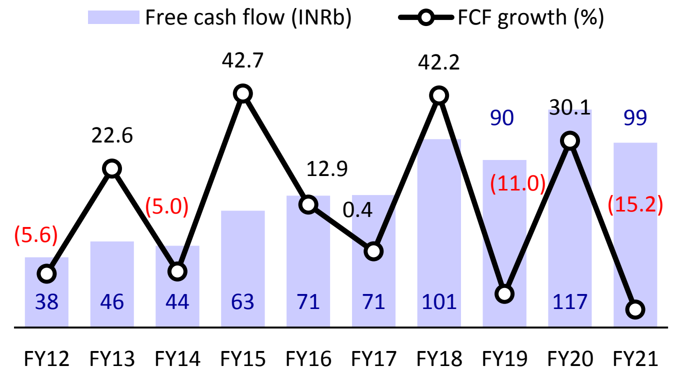
- In 1HFY21, the company acquired the 'Sunrise' brand of spices, with sales of INR6b in FY20, for INR21.5b (link).
- Acquisitions (including goodwill) would add to the capital employed, even as organic capex may be relatively lower over FY21-23E.

Exhibit 23: The reduction in corporate tax rates in FY20…



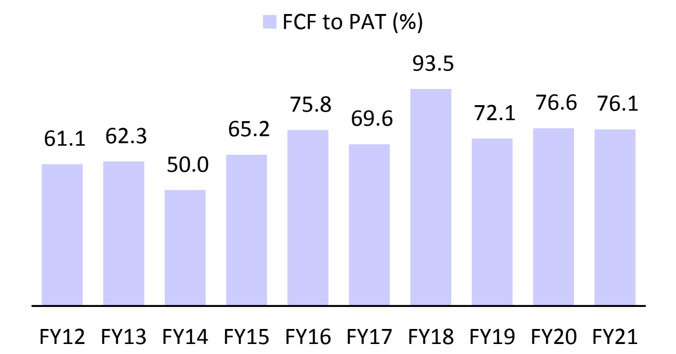
Source: Company, MOFSL

Exhibit 24: …was a key factor contributing to improved FCF



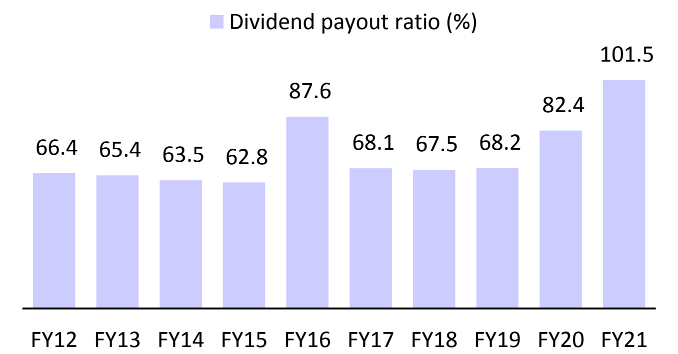
Source: Company, MOFSL

Exhibit 25: ...as well as robust FCF to PAT conversion...



Source: Company, MOFSL

Exhibit 26: ...making a strong case for higher payouts

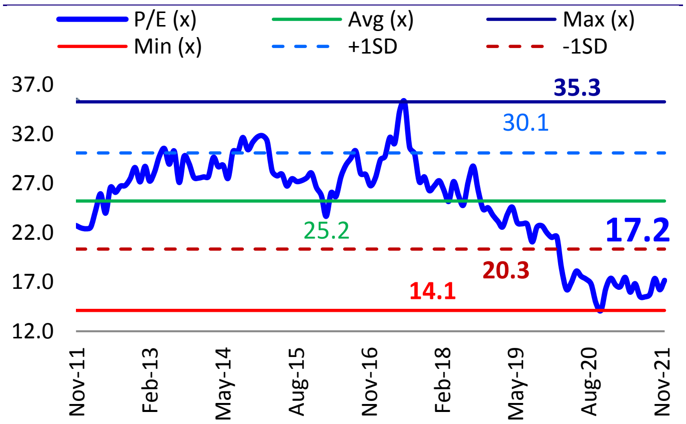


Source: Company, MOFSL

Valuation and view

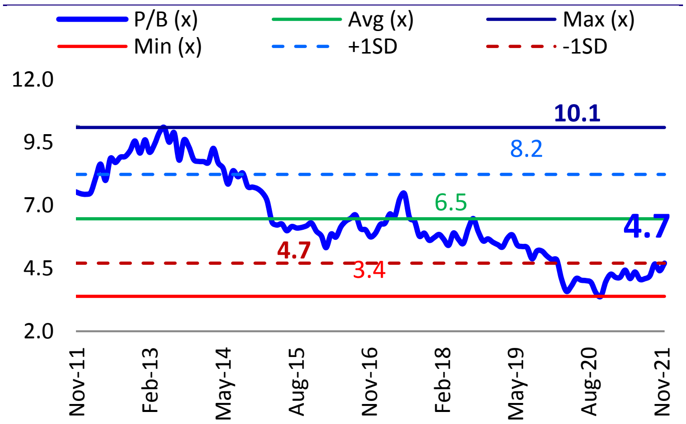
- While ITC's stock has delivered ~12% return over the last three months, it has considerably underperformed its benchmark and consumer Consumer peers over the last five years, as well as the last 12 months.
- The concerns we highlighted in our detailed note in Dec'20 have continued to remain in at play with: a) the Cigarettes' business contributing nearly 80% of ITC's overall EBIT, even in FY23E, raising ESG-related concerns, b) weak cigarette EBIT growth for several years now (4.1% over FY17-23E), c) tepid growth in the Other FMCG segment, and d) overhang of a GST increase on cigarettes.
- With PBT growth over FY20-23E (7.7% CAGR) likely to remain similar to growth in the preceding five years, valuations of 16x FY23E, although relatively cheap compared to its consumer peers in India, are fair considering the concerns stated above. Taking into account the average one-year forward valuation of global peers at 11x, ITC trades at a 45% premium (16.3x).
- We expect a dividend yield of 5-5.5% over the next two years, in line with that of other global Cigarette players.
- We value ITC at a 40% premium to its global peer average and roll forward to Dec'23 multiples (targeting 15x Dec'23E EPS). We maintain our TP of INR240/share and our **Neutral** rating.

Exhibit 27: ITC – one-year forward P/E



Source: Company, MOFSL

Exhibit 28: ITC – one-year forward P/B



Source: Company, MOFSL

Financials and valuations

Income Statement							(INR b)
Y/E March	**FY17**	**FY18**	**FY19**	**FY20**	**FY21**	**FY22E**	**FY23E**
Net Sales	**396.4**	**402.5**	**444.3**	**451.4**	**451.1**	**518.3**	**564.6**
Operational Income	4.5	3.7	5.6	4.8	3.7	4.3	4.5
Total Revenue	**400.9**	**406.3**	**450.0**	**456.2**	**454.9**	**522.6**	**569.1**
Change (%)	9.6	1.3	10.8	1.4	-0.3	14.9	8.9
Gross Profit	**232.9**	**240.1**	**268.3**	**275.5**	**248.4**	**302.3**	**344.5**
Margin (%)	58.1	59.1	59.6	60.4	54.6	57.8	60.5
Other operating expenditure	86.9	84.5	95.0	96.2	93.0	111.5	119.7
EBITDA	**146.0**	**155.6**	**173.3**	**179.3**	**155.3**	**190.8**	**224.8**
Change (%)	6.3	6.6	11.3	3.5	-13.4	22.8	17.9
Margin (%)	36.4	38.3	38.5	39.3	34.2	36.5	39.5
Depreciation	10.4	11.5	13.1	15.6	15.6	17.1	18.5
Int. and Fin. Charges	0.5	1.1	0.6	0.8	0.6	0.4	0.2
Other Inc. – Recurring	19.9	21.3	24.8	30.1	32.5	32.4	35.2
Profit before Taxes	**155.0**	**164.4**	**184.4**	**193.0**	**171.6**	**205.7**	**241.3**
Change (%)	7.4	6.0	12.2	4.6	-11.1	19.9	17.3
Margin (%)	38.7	40.5	41.0	42.3	37.7	39.4	42.4
Tax	52.9	56.0	58.5	44.4	40.4	51.8	60.7
Deferred Tax	0.2	0.3	1.3	-4.1	1.0	0.0	0.0
Tax Rate (%)	34.2	34.2	32.4	20.9	24.1	25.2	25.2
Profit after Taxes	**102.0**	**108.1**	**124.6**	**152.7**	**130.3**	**153.9**	**180.6**
Change (%)	9.4	6.0	15.3	22.5	-14.6	18.1	17.3
Margin (%)	25.4	26.6	27.7	33.5	28.7	29.5	31.7

Balance Sheet							(INR b)
Y/E March	**FY17**	**FY18**	**FY19**	**FY20**	**FY21**	**FY22E**	**FY23E**
Share Capital	12.1	12.2	12.3	12.3	12.3	12.3	12.3
Reserves	441.3	501.8	567.2	628.0	577.7	594.7	623.8
Net Worth	**453.4**	**514.0**	**579.5**	**640.3**	**590.0**	**607.0**	**636.1**
Loans	0.1	0.1	0.0	3.3	3.3	0.1	0.1
Deferred Liability	18.7	19.2	20.4	16.2	17.3	17.3	17.3
Capital Employed	**472.2**	**533.2**	**600.0**	**659.8**	**610.6**	**624.4**	**653.4**
Gross Block	240.2	258.1	300.4	336.3	362.7	380.7	405.7
Less: Accum. Depn.	90.9	102.3	115.5	131.1	146.7	163.8	182.3
Net Fixed Assets	**149.3**	**155.7**	**185.0**	**205.2**	**216.0**	**216.8**	**223.4**
Capital WIP	34.9	50.2	33.9	27.8	33.3	33.3	33.3
Goodwill	0.0	0.0	0.0	0.0	5.8	5.8	5.8
Investments	**185.9**	**234.0**	**265.8**	**306.3**	**270.0**	**260.0**	**268.1**
Curr. Assets, L&A	**172.1**	**183.9**	**213.3**	**213.1**	**190.8**	**223.6**	**245.8**
Inventory	78.6	72.4	75.9	80.4	94.7	91.0	94.0
Account Receivables	22.1	23.6	36.5	20.9	20.9	48.3	52.6
Cash and Bank Balance	27.5	25.9	37.7	68.4	40.0	42.5	52.3
Others	43.9	62.0	63.3	43.3	35.1	41.9	46.9
Curr. Liab. and Prov.	**70.0**	**90.6**	**98.0**	**92.6**	**105.2**	**115.2**	**123.0**
Account Payables	25.5	33.8	33.7	34.5	41.2	45.1	46.2
Other Liabilities	44.4	56.7	64.3	58.1	64.0	70.1	76.8
Net Current Assets	**102.2**	**93.4**	**115.3**	**120.5**	**85.6**	**108.5**	**122.9**
Application of Funds	**472.2**	**533.2**	**600.0**	**659.8**	**610.6**	**624.4**	**653.4**

E: MOFSL estimates

Financials and valuations

Ratios

Y/E March	FY17	FY18	FY19	FY20	FY21	FY22E	FY23E
Basic (INR)							
EPS	**8.4**	**8.9**	**10.2**	**12.4**	**10.6**	**12.5**	**14.7**
Cash EPS	9.3	9.8	11.2	13.7	11.9	13.9	16.2
BV/Share	37.3	42.1	47.3	52.1	47.9	49.3	51.7
DPS	5.7	6.2	6.9	10.2	10.8	12.5	13.2
Payout (%)	68	68	68	82	102	100	90
Valuation (x)							
P/E	27.5	26.1	22.7	18.6	21.8	18.5	15.7
Cash P/E	25.0	23.6	20.6	16.9	19.5	16.6	14.3
EV/Sales	6.6	6.4	5.7	5.4	5.6	4.9	4.4
EV/EBITDA	17.9	16.5	14.6	13.7	16.3	13.3	11.2
P/BV	6.2	5.5	4.9	4.4	4.8	4.7	4.5
Dividend Yield (%)	2.5	2.7	3.0	4.4	4.7	5.4	5.7
Return Ratios (%)							
RoE	23.5	22.3	22.8	25.0	21.2	25.7	29.1
RoCE	22.5	21.6	22.1	24.3	20.6	25.0	28.3
RoIC	40.0	42.4	44.6	49.8	40.4	46.8	52.5
Working Capital Ratios							
Debtor (Days)	18	21	25	23	17	24	33
Asset Turnover (x)	0.8	0.8	0.7	0.7	0.7	0.8	0.9
Leverage Ratio							
Debt/Equity (x)	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Cash Flow Statement (INR b)

Y/E March	FY17	FY18	FY19	FY20	FY21	FY22E	FY23E
OP/(loss) before Tax	155.0	168.5	184.4	191.7	171.6	205.7	241.3
Financial other income	5.5	7.2	8.1	13.1	17.0	32.4	35.2
Depreciation and Amort.	10.4	11.5	13.1	15.6	15.6	17.1	18.5
Interest Paid	-8.4	-8.3	-12.1	-13.8	-11.8	0.4	0.2
Direct Taxes Paid	52.1	57.2	54.9	46.5	39.6	51.8	60.7
Incr. in WC	-0.6	-19.2	5.0	-4.2	3.9	20.4	4.6
CF from Operations	**100.0**	**126.5**	**117.5**	**138.1**	**114.9**	**118.6**	**159.5**
Other items	15.2	-7.6	3.2	44.6	-30.8	11.4	27.2
Incr./Decr. in FA	29.0	25.5	27.6	21.1	15.8	18.0	25.0
Free Cash Flow	**71.0**	**101.0**	**89.9**	**116.9**	**99.1**	**100.6**	**134.5**
Pur of Investments	43.8	34.8	15.3	51.9	-87.0	-10.0	8.1
CF from Invest.	**-57.6**	**-67.8**	**-39.7**	**-28.4**	**40.4**	**3.4**	**-6.0**
Issue of shares	10.7	9.1	9.7	6.3	2.9	16.0	10.0
Incr. in Debt	-0.1	-0.1	-0.1	-0.5	-0.5	-3.2	0.0
Net Interest Paid	0.2	0.5	0.9	0.5	0.4	0.4	0.2
Dividend Paid	68.4	57.7	62.9	84.2	186.2	132.3	153.9
Others	-13.3	-11.1	-11.9	0.0	0.4	0.4	0.4
CF from Fin. Activity	**-71.4**	**-60.2**	**-66.0**	**-78.9**	**-183.8**	**-119.5**	**-143.7**
Incr. of Cash	**-28.9**	**-1.5**	**11.7**	**30.7**	**-28.4**	**2.5**	**9.8**
Add: Opening Balance	56.4	27.5	25.9	37.7	68.4	40.0	42.5
Closing Balance	**27.5**	**25.9**	**37.7**	**68.4**	**40.0**	**42.5**	**52.3**

E: MOFSL estimates

NOTES

Explanation of Investment Rating	
Investment Rating	**Expected return (over 12-month)**
BUY	>=15%
SELL	< - 10%
NEUTRAL	< - 10 % to 15%
UNDER REVIEW	Rating may undergo a change
NOT RATED	We have forward looking estimates for the stock but we refrain from assigning recommendation

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