Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Stock Update

ITC Limited

FMCG continues the good run; cigarette sales recovered sequentially

Consumer Goods	Sharekhan code: ITC	Result Update

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. 226**	
Price Target: **Rs. 265**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

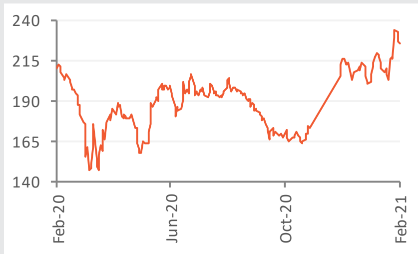
Company details

Market cap:	Rs. 2,78,096 cr
52-week high/low:	Rs. 239/135
NSE volume: (No of shares)	330.6 lakh
BSE code:	500875
NSE code:	ITC
Free float: (No of shares)	1,230.5 cr

Shareholding (%)

Promoters	0.0
FII	14.2
DII	42.9
Others	42.9

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	11.6	22.0	11.0	6.1
Relative to Sensex	7.0	3.8	-23.2	-18.8

Sharekhan Research, Bloomberg

Summary

- ITC's Q3FY2021 cigarettes sales volume declined by ~7% (net sales declined by ~8%), better than 12% volume decline (net sales decline of 14%) in Q2FY2021.
- Non-cigarette FMCG maintained its double-digit revenue growth momentum and margin scale up; business revenue grew by 11% on comparable basis and margins were up by 150 bps to 9.2% (YTD EBIDTA margin stood at 8.9% versus FY2020 EBIDTA margin of 6.8%).
- With no increase in tax rate on cigarettes, we expect cigarette sales volume to gradually pick up; FMCG is gaining good traction and will maintain its double-digit revenue growth and OPM expansion. Hotel business is expected to come back on track in FY2022.
- The stock is currently trading at discounted valuation of 16.1x its FY2023E EPS. Consistent improvement in non-cigarette FMCG margins along with normalisation of cigarette would be key re-rating trigger for the stock. We maintain Buy with a revised PT of Rs. 265.

ITC's Q3FY2021 performance was largely in-line with street expectation. Revenue grew by 4.7% y-o-y to Rs. 12,580.4 crore and adjusted PAT declined by 6% y-o-y to Rs. 3,662.9 crore (OPM declined by 437 bps to 34.0%). The cigarette business's net revenue (excluding the excise duty) declined by ~8% y-o-y with volume decline of ~7% (versus volume decline of 12% in Q2FY2021). Cigarette business PBIT decreased by 8% in Q3, better than ~16% decline in Q2. Non-cigarette FMCG business revenue grew by 11% on comparable basis with sustained demand for health and hygiene products and double-digit growth in the snacking and noodles category. EBIDTA margin of the non-cigarette FMCG business improved by 150 bps to 9.2% on a y-o-y basis (Including Sunrise brand, it is 10%). Agri business revenue grew by 18.5% to Rs. 2,482 crore, while business margin declined by 230 bps due to adverse mix. Hotel business turned EBIDTA positive in Q3 due to sequential improvement in revenue and focus on cost reduction (down by 44% in Q3). With no hike on cigarettes in the Union Budget, we do not expect any price hike in the cigarette portfolio, which will help cigarette sales volume to improve in the coming quarters. Demand for hygiene and essentials products (including atta and biscuits)is expected to normalise in the coming quarters. Improving penetration of key categories, higher rural demand, recovery in out-of-consumption categories, and strong traction to new launches would help the non-cigarette FMCG business to maintain double-digit revenue growth in the coming quarters. Margin expansion of the non-cigarette FMCG business would sustain with scale up in revenue of products/categories and better revenue mix. With receding virus scare and mobility improving, pent-up demand would help the hotel business to post strong performance in FY2022. The company declared interim dividend of Rs. 5 (half of last fiscal dividend of Rs. 10.15).

Key positives

- Margins of the non-cigarette FMCG business improved by 150 bps y-o-y to 9.2%.
- Savlon reported revenue of Rs. 1,000 crore in 9MFY2021.
- Hotel business EBIDTA returned to the positive trajectory due to focused cost-saving initiatives.
- Agri business revenue grew by 18.5% in Q3 versus 13% growth in Q2.

Key negatives

- Paperboard, paper, and packaging (PPP) revenue and PBIT decreased by 5% and 14%.

Our Call

View - Retained Buy with a revised PT of Rs. 265: With no major increase in taxes on cigarettes in Union Budget, we expect cigarette sales volume to normalise in the next two quarters. The non-cigarette FMCG business is expected to deliver strong performance due to better reach and strong traction to new launches. Management's enhance focus and redefined growth strategies have aided scale of the non-cigarette FMCG business margins. The stock is currently trading at 16.1x its FY2023E EPS. Any sustained scale-up in the margins of the cigarette business coupled with normalisation in the core cigarette business would be key triggers for valuation uptick. We maintain our Buy recommendation on the stock with a revised PT of Rs. 265 (19x its FY2023E EPS).

Key risk

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

Valuation (Consolidated) Rs cr

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Revenues	45,784	46,807	43,518	50,261	56,739
OPM (%)	37.8	38.3	35	37.4	38.1
Adjusted PAT	12,387	15,170	12,504	15,149	17,089
Adjusted EPS (Rs.)	10.1	12.4	10.2	12.4	14
P/E (x)	22.4	18.2	22.1	18.2	16.1
P/B (x)	4.8	4.3	4.4	4.3	4.1
EV/EBIDTA (x)	14.5	13.9	16.2	13.1	11.4
RoNW (%)	22.5	24.8	19.7	23.7	25.7
RoCE (%)	27.8	25.5	20.3	25.4	28.2

Source: Company; Sharekhan Research

Revenue grew by 4.7%; OPM affected by unfavourable mix: Gross revenue grew by 4.7% y-o-y to Rs. 12,580 crore, driven mainly by the agri business and FMCG-others segment, which sustained double-digit comparable revenue growth. Core cigarette business grew by 3.5%. Non-cigarette FMCG revenue grew by ~11% (comparable) during the quarter. Hotel business posted a decline of 57.4% in revenue. Gross margin declined significantly to 53.8% from 60.4% in Q3FY2020 largely due to change in revenue mix with lower cigarette business contribution. OPM also plunged to 34% in Q3FY2021 from 38.4% in Q3FY2020, major loss mitigated by stringent cost-reduction initiatives. Operating profit declined by 7.2% y-o-y to Rs. 4,281.3 crore. Adjusted PAT decreased by ~6% to Rs. 3662.9 crore. Reported PAT declined by 11.6% due to one-time adjustment in the base quarter.

Cigarette business volumes fell by 7%, margins stood flat: Cigarette business sales volume declined by 7% in Q3FY2021, improving from a 12% decline in Q2. Volumes and revenue witnessed sequential recovery, led mainly by metros and large town markets due to progressive easing of restrictions and enhanced mobility. On a y-o-y basis, net revenue was lower by 7.6% compared to 14.4% y-o-y in Q2. The company has strengthened its direct reach in target markets across all traditional trade channels; stockist network was also augmented to service rural/semi-urban markets more efficiently. Cigarette business EBIT decreased by 8% y-o-y. Margins as percentage of net sales stood flat at 72%. ITC took a price hike of 5-8% in its cigarette portfolio prior to the announcement of Union Budget. With no hike on cigarettes in the Union Budget, we do not expect any further price hike in the cigarette portfolio, which will help cigarette sales volume to improve in the coming quarters.

Non-cigarette FMCG business registered good growth; Margins expanded y-o-y: ITC's non-cigarette FMCG business revenue increased by 11% in Q3FY2021 on comparable basis. Growth moderated from 18% in Q2 as demand health and hygiene, noodles, and biscuit products normalise compared to H1. Bingo snacks regained double-digit growth, while sequential recovery was seen in confectionary and deodorants. Further, traditional trade channels saw a strong uptick, while e-commerce is growing faster and currently constitutes 5% of ITC's domestic revenue. The modern trade channel staged a strong recovery after soft H1. Sales in rural markets remained strong, while urban markets witnessed progressive improvement, aided by increased mobility and easing of restrictions. Market and outlet coverage were stepped up to 1.3x and 1.1x, respectively, compared to pre-Covid levels. Direct-to-market shipments also scaled up substantially to ensure freshness and reduced time-to-market in categories such as atta, snacks, and biscuits, which will also help in reducing cost in the coming quarters. EBIDTA margin of the non-cigarette FMCG business improved by 150 bps to 9.2% y-o-y (including Sunrise brand it is 10%). Essential consumer goods such as staples, noodles, biscuits, dairy, and sanitisers witnessed robust demand and gained market share. Normalisation in the growth of some categories (including hygiene, atta, and biscuits) will be mitigated by improvement in the out-of-home consumption categories. Most of these categories are registering robust growth. The company launched 100 new products in 9MFY2021 and most of these products are getting strong traction.

Agri business performing well: Revenue of the agri business grew by 18% y-o-y, driven by higher wheat supplies for Aashirvaad atta and trading opportunities in rice, soya, and wheat exports. PBIT margin fell by 229 bps, mainly lower exports of leaf tobacco in Q3FY2021 and unfavourable mix. The company leveraged the e-Choupal network to enhance direct procurement amidst challenging operating conditions. Exports of value-added spices to food safe markets continue to gain strong traction.

Hotel business saw sequential improvement: Revenue declined by 57.4% y-o-y, driven by severe disruptions in operations with the onset of COVID-19 pandemic. However, the company saw sequentially recovery with improvement in room and F&B business. EBITDA has turned positive in December 2020. The company managed to reduce fixed cost by ~44%. Thus, segmental EBIDTA loss stood at Rs. 67.8 crore in Q3FY2021, better than loss of Rs. 184.9 crore in Q2FY021. With receding virus scare and improving mobility, pent-up demand would help the hotel business to post strong performance in FY2022.

Paperboards, paper, and packaging (PPP) business remained muted: Revenue declined by 5% y-o-y in Q3FY2021 to Rs. 1,477.5 crore. The segment witnessed strong recovery in volumes with exports continuing to grow at a rapid pace. Softer realisations weighed on revenue growth. Consumer offtake continued to improve across publications, notebooks, and wedding cards. Further, improvement in speciality paper was led by pharma and décor segment. The PPP business' PBIT margin was down by 218 bps to 19.3%. The business provides strong support to cigarette and non-cigarette FMCG business along with offering superior packaging services externally.

Results (Standalone) Rs cr

Particulars	Q3FY21	Q3FY20	y-o-y (%)	Q2FY21	q-o-q (%)
Net revenue	12580.4	12013.0	4.7	11976.8	5.0
Total expenditure	8299.1	7400.3	12.1	7916.1	4.8
Operating Profit	4281.35	4612.67	-7.18	4060.6	5.4
Other income	971.0	983.6	-1.3	609.8	59.2
Interest	13.8	12.4	10.8	13.8	0.1
Depreciation	390.9	416.2	-6.1	382.5	2.2
Profit before tax	4847.6	5167.6	-6.2	4274.1	13.4
Tax	1184.8	1269.3	-6.7	1041.9	13.7
Adjusted PAT	3662.9	3898.4	-6.0	3232.2	13.3
Exceptional item	0.0	243.6	-	0.0	-
Reported PAT	3662.9	4141.9	-11.6	3232.2	13.3
EPS (Rs.)	3.0	3.2	-6.0	2.6	13.3
			bps		**Bps**
GPM (%)	53.8	60.4	-658	53.8	3
OPM (%)	34.0	38.4	-437	33.9	13

Source: Company; Sharekhan Research

Segmental revenue Rs cr

Particulars	Q3FY21	Q3FY20	YoY %
FMCG - Cigarettes	5498.4	5311.0	3.5
FMCG - Others	3561.8	3312.3	7.5
Hotels	235.2	552.3	-57.4
Agri	2481.8	2094.7	18.5
Paperboard, Paper, and Packaging	1477.5	1555.4	-5.0
Total	**13254.8**	**12825.7**	**3.3**
Less: inter segment sales	763.1	913.5	-16.5

Source: Company; Sharekhan Research

Segmental PBIT Rs cr

Business segments	PBIT (Rs. crore)			Margins (%)		
	Q3FY21	Q3FY20	YoY %	Q3FY21	Q3FY20	Chg in BPS
FMCG - Cigarettes	3452.8	3756.0	-8.1	62.8	70.7	-793
FMCG - Others	207.4	107.6	92.7	5.8	3.2	257
Hotels	-67.8	87.3	-	-28.8	15.8	--
Agri	196.1	213.4	-8.1	7.9	10.2	-229
Paperboard, Paper, and Packaging	285.0	334.0	-14.7	19.3	21.5	-218
Total	**4073.4**	**4498.3**	**-9.4**	**30.7**	**35.1**	**-434**

Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector View – Cigarette would remain under regulatory hurdle, FMCG long-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, continue to pose significant challenges to the legal cigarette industry in the country. Though cigarette was skipped from the 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.

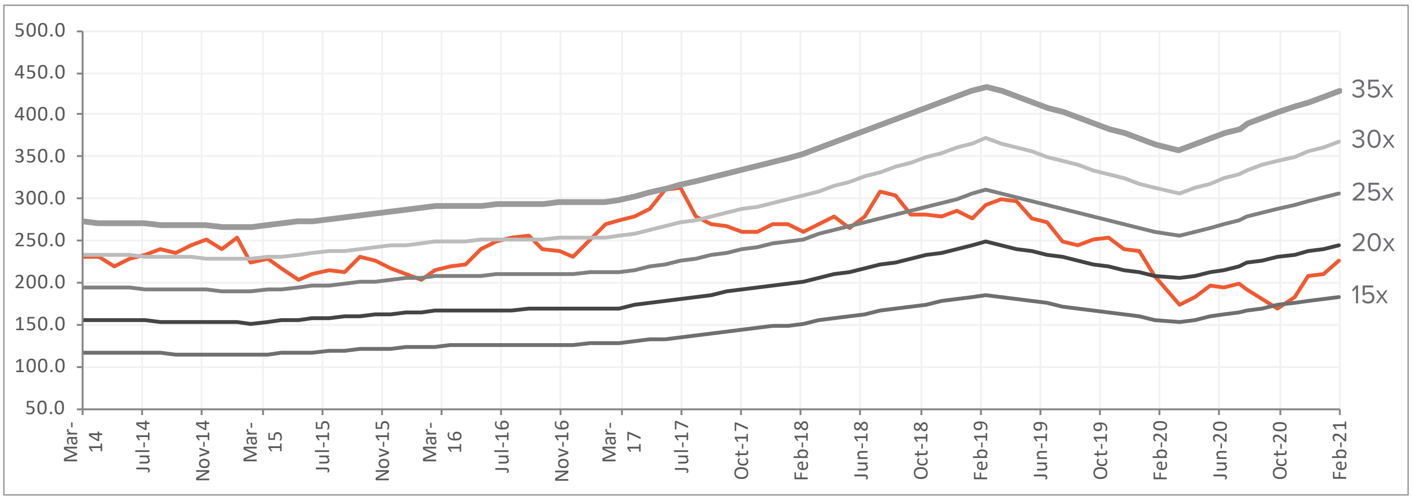
■ Company Outlook – Non-cigarette FMCG to maintain good run; Cigarette business to improve gradually

Demand for hygiene and essentials products is expected to normalise in the coming quarters. Improving penetration of key categories, higher rural demand, recovery in out-of-consumption categories, and strong traction to new launches would help the non-cigarette FMCG business to maintain double-digit revenue growth in the coming quarters. Margin expansion of the non-cigarette FMCG business would sustain with scale up in revenue of products/categories and better revenue mix. ITC's cigarette sales volume is expected to see sequential improvement. With receding virus scare and mobility improving, pent-up demand would help the hotel business to post a strong performance in FY2022.

■ Valuation – Retain Buy with revised PT of Rs. 265

With no major increases in taxes on cigarettes in the Union Budget, we expect cigarette sales volume to normalise in the next two quarters. The non-cigarette FMCG business is expected to deliver strong performance due to better reach and strong traction to the new launches. Management's enhance focus and redefined growth strategies have aided scale of the non-cigarette FMCG business margins. The stock is currently trading at 16.1x its FY2023E EPS. Any sustained scale-up in the margins of the cigarette business coupled with normalisation in the core cigarette business would be key triggers for valuation uptick. We maintain our Buy recommendation on the stock with a revised PT of Rs. 265 (19x its FY2023E EPS).

One-year forward P/E (x) band



Source: Sharekhan Research

Peer Comparison

Particulars	P/E (x)			EV/EBIDTA (x)			RoCE (%)		
	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E
Hindustan Unilever	67.1	50.9	44.4	45.5	36.8	31.9	37.1	28.3	30.7
ITC	22.1	18.2	16.1	16.2	13.1	11.4	20.3	25.4	28.2

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 the past few years) by scaling up the fast-growing consumer goods and hotel businesses. The company has quickly rebound from the disruption caused by the 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 the non-cigarette FMCG business and improvement in margins 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	16.3
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 (old data)

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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