Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Stock Update

ITC Ltd

Strong Q3; cigarette volumes grew in double digits

Consumer Goods	Sharekhan code: ITC
Reco/View: Buy ↔	CMP: Rs. 235 / 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	27.43
Updated Jan 08, 2022	

Medium Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

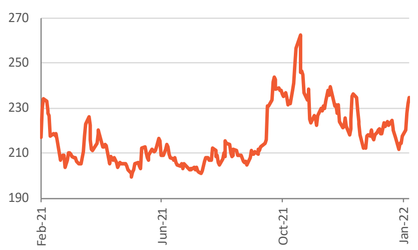
Company details

Market cap:	Rs. 2,88,719 cr
52-week high/low:	Rs. 265 / 199
NSE volume: (No of shares)	226.1 lakh
BSE code:	500875
NSE code:	ITC
Free float: (No of shares)	1232.3 cr

Shareholding (%)

Promoters	0.0
FII	11.0
DII	43.7
Others	45.3

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	6.4	3.5	8.9	8.2
Relative to Sensex	8.2	5.6	1.0	-8.8

Sharekhan Research, Bloomberg

Summary

- ITC's Q3FY2022 cigarettes sales volume growth stood at 12-13% (net revenues grew by 12.6%); Cigarette EBIT margin (based on net sales) improved by 117 bps on y-o-y basis. Sales volume stood flat compared to pre-COVID levels.
- Non-cigarette FMCG business revenues grew 9% in Q3FY2022 on a high base (two-years CAGR stood at 11%). Agri-business revenues doubled to Rs. 4962.4 crore led by higher exports.
- Cigarette sales volumes are set to improve further as government has not hiked taxes on cigarettes for second consecutive year. Non-cigarette FMCG biz would grow in single digits while paperboard, paper & packaging business would clock strong double-digit growth in the near term.
- The company declared an interim dividend of Rs. 5.25 per share. Stock is trading at discounted valuations of 16.7x/15.0x its FY2023/24E EPS. We maintain a Buy recommendation on the stock with PT of Rs. 280.

ITC posted strong numbers in Q3FY022 with all the businesses posting strong revenue growth. Gross revenues (including other operating income) grew by 33.6% y-o-y to Rs. 16,806.9 crore with strong 13% growth in the cigarette business, 2x growth in Agri business and ~40% growth in the paperboard, paper and packaging (PPP) business. Excluding agri business the gross revenues was up by 16.2%, beating ours as well as the street's expectation of high single-digit revenue growth. Gross margins and OPM are down by 614 bps to 51.3% and 416 bps to 32.2% due to an unfavourable mix. However excluding low margin Agri business OPM was up by ~80 bps on y-o-y basis. EBIDTA margins of the non-cigarette FMCG business was slightly lower by 50 bps to 9.1% despite significant raw material inflation. Cigarette business margins improved by 117 bps y-o-y.

Key positives

- Cigarette business volumes grew by 12-13% ahead our as well as street expectation of 7-8%. PBIT margins improved by 117 bps
- Hotel business revenues grew by 2.0x to Rs. 473.4 crore led by improvement in occupancies & ARRs; PBIT turned positive at Rs. 51 crore.
- Agri-business revenues grew by 2x driven by higher exports of wheat, rice, spices and leaf tobacco.
- PPP business revenue grew by 39% y-o-y on back of higher sales volume

Key negatives

- Gross margins decreased by 614 bps due to unfavourable mix.
- Agri business margins are down by 195 bps y-o-y to 6.0%

Management Commentary

- ITC is eyeing double-digit revenue growth and higher PAT growth in the medium term with sustained margin expansion on back of six core growth strategies emphasising on innovation, digitalisation, cost optimisation, sustainability and creating a strong talent base.
- With taxes on cigarettes not being increased for the second consecutive year, the cigarette business sales volume is expected to further improve in the coming quarters. However tax rate hike in the upcoming GST council meet has to be keenly monitored.
- Scale-up of stockist network by 1.7x, market coverage by 1.5x, strong traction to new product launches and increase in e-Commerce salience (sales 3x of FY20 levels) will help the non-cigarette FMCG business revenues to consistent improve in the medium term. Rural slowdown might moderate the growth to high single digit in the near term.
- With an overall improvement in the mobility, the hotel business is expected to recover strong in FY2023. PPP business is expected to maintain the strong growth momentum.

Revision in estimates – We have raised earnings estimates for FY2022/23/24 to factor in the strong performance in Q3FY022.

Our Call

View - Retain Buy with an unchanged price target of Rs. 280: Cigarette business sales volume are expected to improve in the coming quarters. ITC's management has enhanced focus and redefined growth strategies for all its business vertical to improve growth prospects in the medium to long term. The stock is currently trading at 16.7x and 15.0x its FY2023 and FY2024 EPS, which is at a stark discount to some large consumer goods stocks. Strong earnings visibility with improving growth prospects of core cigarette business and margin expansion in non-cigarette FMCG business and a high cash generation ability with strong dividend payout will reduce the valuation gap in the coming years. We maintain a Buy on the stock with an unchanged price target of Rs. 280.

Key Risks

Any increase in taxes on cigarettes or the 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	55,245	60,565	66,887
OPM (%)	32.0	33.9	35.9	36.4
Adjusted PAT	13,032	14,506	17,092	19,036
Adjusted EPS (Rs.)	10.7	11.9	14.0	15.6
P/E (x)	22.0	19.7	16.7	15.0
P/B (x)	4.9	4.8	4.6	4.4
EV/EBIDTA (x)	17.0	13.9	11.9	10.6
RoNW (%)	21.2	24.4	28.0	29.8
RoCE (%)	21.5	27.1	31.1	33.5

Source: Company; Sharekhan estimates

Strong performance in Q3: ITC gross revenues grew by 34% y-o-y to Rs. 16806.9 crore with cigarette business revenues growing by 14%, agri business growing by 2x and PPP business growing by ~40%. Revenues were ahead of our as well as street expectation of Rs. 13,213.7 crore and Rs. 13265.4 crore, respectively. Gross margins and OPM are down by 614 bps to 51.3% and 416 bps to 32.2% due to unfavourable mix. However excluding low margin Agri business OPM was up by ~80 bps on y-o-y basis. EBIDTA margins of non-cigarette FMCG business was slightly lower by 50 bps to 9.1% despite significant raw material inflation. Cigarette business margins improved by 100 bps y-o-y. Operating profit grew by 19.2% y-o-y to Rs. 5,102.1 crore. Reported PAT grew by 13.5% y-o-y to Rs. 4156.2 crore (ahead of our as well as street expectation of Rs. 3,767 crore and Rs. 3,857 crore).

Cigarette business volume grew by 12-13%; Margins improved on y-o-y basis: Cigarette business gross sales grew by 13.6% y-o-y to Rs. 6,244.1 crore (up by 11% Q-o-Q). Net revenue excluding excise duty grew by ~13%. Cigarette sales volume grew by 12-13% on low base of 5% volume decline. The same has recovered to pre-COVID level sales. Gross sales stood at 14% higher than Q3FY2020 (normal base quarter). A broad-based recovery across key markets. Robust recovery continued across markets aided by increase in mobility and, agile supply chain and market servicing. Cigarette business EBIT grew by 14% y-o-y. EBIT margins improved by 117 bps to 74.5%. The company is focusing on maximising the cigarette potential within the tobacco basket (with legal cigarettes constituting ~8% of tobacco consumption in India), countering illicit trade and reinforcing market standing. With no increase in taxes on cigarette for second consecutive year, the cigarette business sales volume is expected to further improve in the coming quarters. However, tax rate hike in the upcoming GST council meet has to be keenly monitored.

Non-cigarette FMCG posted decent performance in tough environment: ITC's non-cigarette FMCG business reported revenue of Rs. 4,090.4 crore, up by 9.3% y-o-y on a high base (two year CAGR of 11). Snacks, Confectionery, Beverages performed well as 'Discretionary/'Out-of-Home' categories recorded strong growth on sequential and y-o-y basis. Staples & Convenience Foods posted resilient performance driven by robust growth mainly in Sunfeast Biscuits, Sunrise Spices, Aashirvaad Salt. Hygiene products witnessed demand volatility and moderated sequentially in line with lower Covid caseload intensity. However the same remained significantly above pre-pandemic levels. The business EBIDTA margin decreased by just 50 bps to 9.1% despite unprecedented increase in the commodity inflation. Sharp escalation in input costs largely offset through strategic cost management programmes, premiumisation, judicious pricing actions, fiscal incentives and favourable business mix.

Agri business revenues grew by 2x led by higher export orders: ITC's agri business revenues grew by 2x to Rs. 4962.4 crore driven by strong revenue growth in wheat, rice, spices, leaf tobacco exports leveraging strong customer relationships, robust sourcing network and agile execution. Proactive supply chain management aided in timely execution of customer orders despite port congestion, container shortage and a surge in ocean freight rates. However, EBIT margins of the business decreased by 195 bps to 6.0% affected unfavourable mix.

Strong recovery in hotel business due to improved mobility: Hotel business revenues grew by 101% y-o-y to Rs. 473.4 crore (grew by 61% on QoQ basis). Easing of travel restrictions, pickup in leisure travel and onset of the festive/wedding season boosted ARR and Occupancy levels. Business recovered to 86% of pre-COVID levels as compared with normalised base quarter of Q3FY2020. The company posted PBIT of Rs. 51 crore as against loss of Rs. 67 crore in Q3FY021.

Paperboards, paper, and packaging (PPP) business reported robust revenue growth (~40% y-o-y): The PPP business reported revenue of Rs. 2,046.5 crore, up 38.5% y-o-y, on the back of a demand revival across most end-user segments and exports. value-added paperboard segment grew at a rapid pace aided by higher realisation, strategic capacity expansion and strong export performance. Higher realisations, investments in pulp import substitution, cost-competitive fibre chain, sharper focus on operational efficiency leveraging data analytics and Industry 4.0 enabled margin expansion despite escalation in key input prices. EBIT of the business grew by 57.3% y-o-y to Rs. 448.5 crore, while margins improved by 262 bps to 21.9%. IT stable on q-o-q basis as compared to 22.4% in Q2FY2022.

Results (standalone) Rs cr

Particulars	Q3FY22	Q3FY21	Y-o-Y %	Q2FY22	Q-o-Q %
Gross revenue	**16,806.9**	**12,580.4**	**33.6**	**13,553.5**	**24.0**
Excise duty	944.6	793.0	19.1	822.6	14.8
Net revenue	**15,862.3**	**11,787.4**	**34.6**	**12,731.0**	**24.6**
Raw Material Consumed	7,720.4	5,013.1	54.0	5,446.2	41.8
Employee Expenses	765.2	720.1	6.3	753.2	1.6
Other Expenses	2,274.7	1,772.9	28.3	1,916.6	18.7
Total expenditure	10,760.2	7,506.0	43.4	8,115.9	32.6
Operating Profit	**5,102.1**	**4,281.4**	**19.2**	**4,615.0**	**10.6**
Other income	809.9	971.0	-16.6	677.0	19.6
Interest	10.7	13.8	-22.4	10.5	2.3
Depreciation	409.3	390.9	4.7	401.5	2.0
Profit before tax	**5,492.0**	**4,847.6**	**13.3**	**4,880.1**	**12.5**
Tax	1,335.8	1,184.8	12.7	1,182.9	12.9
Reported PAT	**4,156.2**	**3,662.9**	**13.5**	**3,697.2**	**12.4**
EPS (Rs.)	3.4	3.0	13.5	3.0	12.4
			bps		**bps**
GPM (%)	51.3	57.5	-614	57.2	-589
OPM (%)	32.2	36.3	-416	36.3	-409
NPM (%)	26.2	31.1	-487	29.0	-284
Tax rate (%)	24.3	24.4	-12	24.2	8

Source: Company; Sharekhan Research

Segment Revenue break up Rs cr

Particulars	Q3FY22	Q3FY21	Y-o-Y %	Q2FY22	Q-o-Q %
FMCG - cigarettes	6,244.1	5,498.4	13.6	5,641.7	10.7
FMCG - others	4,090.6	3,743.7	9.3	4,036.4	1.3
Hotels	473.4	235.2	101.3	294.7	60.6
Agri	4,962.4	2,481.8	100.0	2,776.1	78.8
Paperboard, Paper and Packaging	2,046.5	1,477.5	38.5	1,829.7	11.8
Total	**17,816.9**	**13,436.6**	**32.6**	**14,578.7**	**22.2**
Less: Inter segment sales	1,183.1	763.3	55.0	1,222.5	-3.2
Gross Sales	**16,633.9**	**12,673.3**	**31.3**	**13,356.2**	**24.5**

Source: Company; Sharekhan Research

Segment PBIT and PBIT margins Rs cr

Business (Rs. cr)	PBIT (Rs. crore)		Y-o-Y %	Margins (%)		Chg in bps
	Q3FY22	Q3FY22		Y-o-Y %	Q2FY22	
FMCG – cigarettes	3,950.7	3,452.8	14.4	63.3	62.8	48
FMCG – others	241.9	239.3	1.1	5.9	6.4	-48
Hotels	50.6	-67.3	-	10.7	-28.6	-
Agri	295.3	196.1	50.6	6.0	7.9	-195
Paperboard, Paper and Packaging	448.5	285.0	57.3	21.9	19.3	262
Total	**4,986.9**	**4,105.9**	**21.5**	**28.0**	**30.6**	**-256.8**

Source: Company; Sharekhan Research

Outlook and Valuation

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

The domestic cigarette industry is affected by a 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 cigarettes were skipped from increased taxes in two consecutive Union Budget, there is sustained risk of regulatory hurdles implemented to curb tobacco product consumption. On the other hand, medium to long term 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 a sustainable revenue growth in the medium to long run.

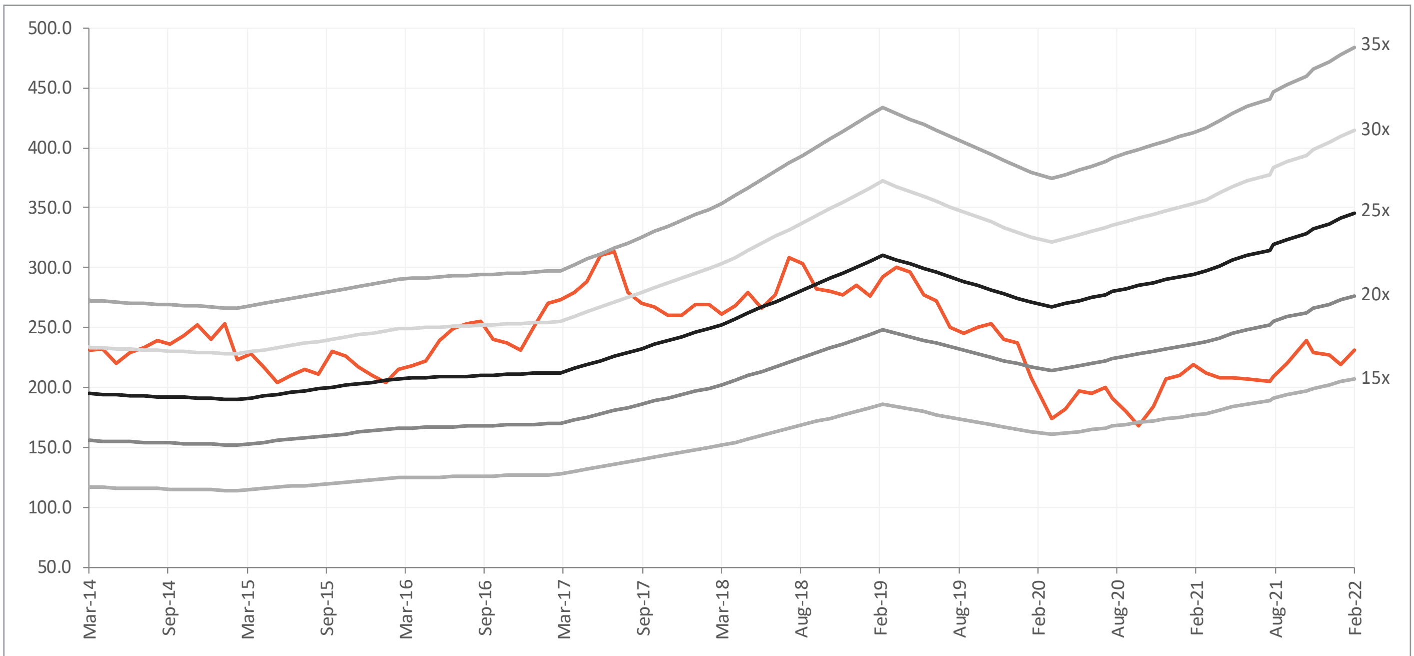
■ Company outlook – Cigarette business regaining normalcy; FMCG margins to scale up

Cigarette sales volume are expected to improve further with government not increasing taxes on cigarettes for second consecutive year. Scale-up of stockiest network by 1.7x, market coverage by 1.5x, strong traction to new product launches and increase in e-Commerce salience (sales 3x of FY20 levels) will help the non-cigarette FMCG business revenues to consistent improve in the coming quarters. PBIT margins of the business will improve led by efficiencies and scale up in the contribution of new businesses.

■ Valuation – Retain Buy with an unchanged price target of Rs. 280

Cigarette business sales volume are expected to improve in the coming quarters. ITC's management has enhanced focus and redefined growth strategies for all its business vertical to improve growth prospects in the medium to long term. The stock is currently trading at 16.7x and 15.0x its FY2023 and FY2024 EPS, which is at a stark discount to some large consumer goods stocks. Strong earnings visibility with improving growth prospects of core cigarette business and margin expansion in non-cigarette FMCG business and a high cash generation ability with strong dividend payout will reduce the valuation gap in the coming years. We maintain a Buy on the stock with an unchanged price target 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	FY21E	FY23E
Hindustan Unilever	66.4	59.6	50.0	47.2	42.1	36.0	36.5	24.9	30.0
ITC	22.0	19.7	16.7	17.0	13.9	11.9	21.5	27.1	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
Supratim Dutta	Executive Director and Chief Financial Officer
Nakul Anand	Executive Director
Sumant Bhargavan	Executive Director
Rajiv Tandon	Executive Director
Rajendra Kumar Singhi	Executive Vice President & 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 Corp. of India	1.76
9	HDFC Asset Management Co. Ltd.	1.68
10	New India Assurance Co. Ltd.	1.49

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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by BNP PARIBAS

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