Stock Update

Result Update

Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

ITC Ltd

Yet another strong quarter; cigarette business outperforms

Consumer Goods	Sharekhan code: ITC
Reco/View: **Buy** ↔	CMP: **Rs. 350**
	Price Target: **Rs. 402** ↑

↑ 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 27.91

Updated Oct 08, 2022

Medium Risk

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

Source: Morningstar

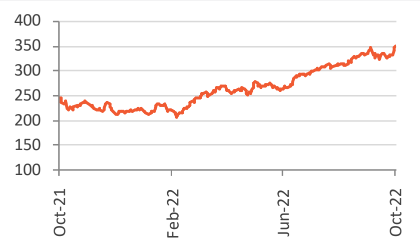
Company details

Market cap:	Rs. 431,828 cr
52-week high/low:	Rs. 350 / 207
NSE volume: (No of shares)	152.5 lakh
BSE code:	500875
NSE code:	ITC
Free float: (No of shares)	1233.8 cr

Shareholding (%)

Promoters	0.0
FII	13.6
DII	42.8
Others	43.6

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	2.7	16.5	34.0	43.0
Relative to Sensex	3.1	10.9	30.5	45.9

Sharekhan Research, Bloomberg

Summary

- ITC posted yet another quarter of strong numbers in Q2FY2023 with revenues and PAT growing by 27% and 21% respectively. OPM stood flat at 36.4% despite inflationary pressures in the FMCG business.
- Cigarette business sales volumes grew by over 20%; non-cigarette FMCG business grew by 21%, Agri business registered strong growth of 44% and the paperboard, paper & packaging business grew by 25% y-o-y.
- We expect growth momentum in the cigarette sales volumes to sustain with government actions on curbing illicit cigarette sales. The hotels business is expected to post strong performance in H2 due to a strong business period. Non-cigarette FMCG revenues would grow in double digits while margins might improve sequentially in the coming quarters.
- ITC's stock price has run-up by 35% in the past six months and is currently trading at 20.9x/18.9x its FY2023E/24E earnings. We maintain Buy with revised PT of Rs. 402.

ITC posted yet another quarter of strong numbers in Q2FY2023 with gross revenues growing by 27% largely led by strong double-digit growth across categories. Excluding the agri business, revenues grew by 6% on sequential basis. Margins sustained y-o-y despite inflationary pressures in the FMCG business and lower margins in the Agri business. Its OPM stood flat at 36.4%. All key business verticals registered strong performance with the cigarette, non-cigarette FMCG, Agri and paperboard, paper & packaging (PPP) business grew by 23%, 21%, 44% and 25% y-o-y, respectively. Excluding the agri-business, gross revenues rose by 23% in Q2. PAT grew by 21% y-o-y to Rs. 4,466.1 crore. Slower PAT growth was mainly on account of lower other income (down 25% y-o-y). For H1FY2023, ITC's revenues and PAT grew by 34%y-o-y and 28%y-o-y respectively.

Key positives

- Cigarette business sales volumes grew by over 20% as against our expectation of 11-12% and street expectation of 15%.
- Non-cigarette FMCG business registered resilient performance with revenues rising 21% led by strong growth in the staples and out-of-home consumption categories; EBIDTA margins stood at 9.5% improved from 7.8% in Q1FY2023.
- The hotels business' revenues grew by 82% to Rs536 crore with occupancies and ARRs recovering to pre-pandemic levels.
- PPP business' revenue grew by 25.0% y-o-y with PBIT margins improving by 518 bps to 27.5% led by strong recovery across end-user segments.

Key negatives

- The agri-business' EBIDTA margins decreased by 203BPS y-o-y to 8.6% in Q2.

Management Commentary

- Stable taxes will help legal cigarette industry to compete with illicit traders. Further, enforcement agencies have taken stringent actions to curb consumption of illicit cigarettes. With no recent price hikes, cigarette sales volumes would continue to grow in the coming quarters.
- ITC will keenly monitor the movement in key input prices. However, the recent correction in the commodity prices, expected normal monsoons and proactive measures taken by government to curb inflation and improve growth augurs well for the company in the medium term.
- With overall improvement in mobility, the hotels business is expected to recover strong in FY2023. PPP business is expected to maintain strong growth momentum. With government banning wheat exports, Agri-business revenue growth is likely to taper down in the quarters ahead.

Revision in estimates – We have fine-tuned our earnings estimates for FY2023 and FY2024 to factor in better than expected performance in Q2FY2023 driven by higher sales in the cigarettes, hotels and PPP businesses. We have introduced FY2025E earnings through this update.

Our Call

View - Retain Buy with a revised price target of Rs.402: With no price hikes in the near term and government action on curbing illicit cigarette will help ITC to maintain volume growth momentum in the cigarette business. Strong growth in non-cigarette FMCG business, recovery in the hotel business and sustained strong growth in the PPP business will drive double-digit revenues and PAT growth over the next two years. The stock currently trades at 24.0x and 20.9x its FY2023E and FY2024 EPS, which is at a discount to some large consumer goods companies. Strong earnings visibility with improving growth prospects of core cigarette business and margin expansion in the non-cigarette FMCG business, along with a high cash generation ability and strong dividend payout will reduce the valuation gap in the coming years. We maintain a Buy on the stock with a revised price target of Rs. 402 (rolling it over to average of FY2024-25E earnings).

Key Risks

The government's policies to curb tobacco product consumption or a sustained slowdown in the consumer demand would act as key risk to our earnings estimates.

Valuation (standalone) Rs cr

Particulars	FY21	FY22	FY23E	FY24E	FY25E
Revenues	48,525	59,746	68,875	75,834	83,636
OPM (%)	32.0	31.7	33.8	34.8	35.0
Adjusted PAT	13,032	15,058	17,766	20,474	22,589
Adjusted EPS (Rs.)	10.7	12.3	14.6	16.8	18.5
P/E (x)	32.8	28.4	24.0	20.9	18.9
P/B (x)	7.3	7.0	6.7	6.3	5.7
EV/EBIDTA (x)	26.1	21.4	17.2	15.1	13.7
RoNW (%)	21.2	25.0	28.2	30.7	31.3
RoCE (%)	21.5	27.1	32.6	35.3	36.4

Source: Company; Sharekhan estimates

Strong Q2 - Double-digit revenue growth across businesses; OPM sustained y-o-y

ITC posted yet another quarter of strong performance in Q2FY2023, with net revenue growing by 26.7% y-o-y (gross revenues grew by 26.6% y-o-y) to Rs. 16,129.9c crore, largely led by strong double digit growth across categories. The cigarette business' net revenues grew by 24% y-o-y to Rs. 4,429.3 crore. The volume growth to be at 20%+ (better than our expectation of 11-12%). Non-cigarette FMCG business grew by 21% y-o-y to Rs. 4,884.8 crore. The Agri &Paper, paperboard & packaging (PPP) businesses registered strong performance with a revenue growth of 44.0% and 25.0%, y-o-y to Rs. 3,997.0 crore and Rs. 2,287.6 crore, respectively. The agri-business' revenue growths was boosted by a rise in exports. Hotels business revenue grew by 82% y-o-y to Rs. 536 crore (sustained on QoQ basis). Gross margin declined by 23bps y-o-y to 57% due to higher input cost in non-FMCG business and unfavourable mix. OPM was sustained at 36.4% on a y-o-y basis despite inflationary pressure in the FMCG business. Operating profit grew by 27.1% y-o-y to Rs. 5,864.3 crore, whereas PAT grew by 20.8% y-o-y to Rs. 4,466.1 crore. Lower PAT growth was mainly due to lower other income (down by 25% y-o-y).

Cigarette volumes grew by 20%+; margins remained stable y-o-y

Gross cigarette sales grew by 23% y-o-y to Rs. 6,953.8.0 crore (up by 5.2% q-o-q). Gross revenues grew by 9% on a 3 years CAGR basis compared with Q1FY2020. Net revenue excluding excise duty grew by ~23%. Cigarette sales volumes grew by 20%+. Sales volume surpassed the pre-COVID level sales volume by around mid-teens. Strong growth was registered across key regions and markets. Cigarette business PBIT grew by 23.6% y-o-y to Rs. 4,429.3 crore. PBIT margin improved by 18 bps y-o-y to 63.7%. Stable taxes will help legal cigarette industry to compete with illicit trades. Further, enforcement agencies have taken stringent actions to curb consumption of illicit cigarettes. With no price hikes in the recent past, cigarette business sales volume growth momentum would sustain in the quarters ahead.

FMCG – Others Segment Q2 revenue growth at 21% y-o-y; EBITDA margins improved by 170 bps q-o-q

In Q2FY2023, revenue grew by 21% y-o-y and by 1.5x over Q2FY2020 to Rs.4,885 crore led by strong growth in staples & convenience foods and discretionary/Out-Of-Home categories.Education & stationery products business continued to witness strong traction. The growth was broad-based channels and markets (both urban and rural) driven by ramp-up in outlet coverage, enhanced penetration and last mile execution. Market and outlet coverage stood higher by appx. 2.0x and 1.3x of pre-pandemic levels. E-Commerce continues to scale up rapidly leveraging account specific strategies, new product introductions (including e-Commerce first brands) and customised supply chain solutions. Availability of products has been further expanded with new trade partners on Quick Commerce and Social Commerce platforms. Modern Trade sales accelerated with resumption of activities, higher store footfalls and joint business planning with key accounts. The segment's EBITDA margin stood at 9.5% (down 50 bps y-o-y, up 170 bps q-o-q). A sharp escalation in input costs is mitigated through multi-pronged interventions including strategic cost management, premiumisation, supply chain agility, judicious pricing actions, fiscal incentives and digital and optimising channel assortments.

Agri-business revenues up by 44% y-o-y while PBIT margins declined by 203 bps y-o-y

In Q2FY2023, agri-business revenues rose by 44% y-o-y to Rs.3,997 crore driven by wheat, rice and leaf tobacco exports and through strategic sourcing support to branded packaged foods businesses from wheat, dairy and spices. The business continues to enhance value capture by steadily growing its value-added portfolio straddling multiple value chains comprising spices, coffee, frozen marine products and processed fruits etc. Construction of the value-added spices manufacturing facility at Guntur is progressing well and is expected to be commissioned shortly. The project for the state-of-the-art facility to manufacture and export Nicotine & Nicotine derivative products being set up by the Company's wholly owned subsidiary, ITC IndiVision Limited, is making steady progress and is expected to be commissioned in Q4FY23. PBIT margins declined by 203 bps y-o-y to 8.6% in Q2FY2023.

Hotel business' revenues grew 81.8% y-o-y; profitability improved y-o-y

The hotel business' revenues grew by 81.8% y-o-y and 1.3x of Q2FY2020 to Rs.536 crore with strong growth registered across locations. Average room rentals (ARR) and occupancies are ahead of pre-pandemic levels driven by retail (packages), leisure, weddings and the MICE segments. Domestic business travel continued to witness progressive normalisation while inbound foreign travel also picked up in Q2FY23. Segment reported PBIT margin of 15.7% against a loss in Q2FY2022 driven by higher RevPAR, operating leverage and structural cost interventions.

PPP business growth at 25% y-o-y; 518 bps y-o-y margin expansion

The paperboard & packaging (PPP) business reported a revenue growth of 25% y-o-y to Rs. 2,287.6 crore driven by strong demand across end-user segments and exports.Value Added Paperboard (VAP) sales grew at a rapid pace aided by higher realisation and strong exports performance. Fine-Paper segment witnessed robust performance with pick up in the Publications & Notebooks segments. PBIT margin of the business expanded by 518 bps y-o-y to 27.5%. Strategic investments in capacity expansion in the VAP segment, pulp import substitution, cost competitive fibre chain, decarbonisation of operations, sharper focus on operational efficiency leveraging data analytics and Industry 4.0 enabled scaling up the Business and margin expansion despite escalation in key input prices.

Results (standalone) Rs cr

Particulars	Q2FY23	Q2FY22	y-o-y (%)	Q1FY23	q-o-q (%)
Gross revenue	**17,159.6**	**13,553.5**	**26.6**	**18,320.2**	**-6.3**
Excise duty	1,029.7	822.6	25.2	1,030.5	-0.1
Net revenue	**16,129.9**	**12,731.0**	**26.7**	**17,289.7**	**-6.7**
Raw Material Consumed	6,938.0	5,446.2	27.4	8,476.8	-18.2
Employee Expenses	936.4	753.2	24.3	862.1	8.6
Other Expenses	2,391.2	1,916.6	24.8	2,303.2	3.8
Total expenditure	10,265.6	8,115.9	26.5	11,642.1	-11.8
Operating Profit	**5,864.3**	**4,615.0**	**27.1**	**5,647.5**	**3.8**
Other income	506.9	677.0	-25.1	312.7	62.1
Interest	10.7	10.5	2.1	9.1	16.9
Depreciation	422.0	401.5	5.1	411.5	2.5
Profit before tax	**5,938.5**	**4,880.1**	**21.7**	**5,539.6**	**7.2**
Tax	1,472.5	1,182.9	24.5	1,370.7	7.4
Reported PAT	**4,466.1**	**3,697.2**	**20.8**	**4,168.9**	**7.1**
EPS (Rs.)	3.6	3.0	20.8	3.4	7.1
			bps		**bps**
GPM (%)	57.0	57.2	-23	51.0	601
OPM (%)	36.4	36.3	11	32.7	369
NPM (%)	27.7	29.0	-135	24.1	358
Tax rate (%)	24.8	24.2	56	24.7	5

Source: Company, Sharekhan Research

Segment Revenue break up Rs cr

Particulars	Q2FY23	Q2FY22	y-o-y (%)	Q1FY23	q-o-q (%)
FMCG - cigarettes	6,953.8	5,641.7	23.3	6,609.0	5.2
FMCG - others	4,884.8	4,036.4	21.0	4,451.4	9.7
Hotels	536.0	294.7	81.8	555.0	-3.4
Agri	3,997.0	2,776.1	44.0	7,473.0	-46.5
Paperboard, Paper and Packaging	2,287.6	1,829.7	25.0	2,267.2	0.9
Total	**18,659.1**	**14,578.7**	**28.0**	**21,355.5**	**-12.6**
Less: Inter segment sales	1,687.9	1,222.5	38.1	2,776.2	-39.2
Gross Sales	**16,971.2**	**13,356.2**	**27.1**	**18,579.3**	**-8.7**

Source: Company, Sharekhan Research

Segment PBIT and PBIT margins

Particulars	PBIT (Rs crore)		Y-o-y %	Margins (%)		Chg in BPS
	Q2FY23	Q2FY22		Q2FY23	Q2FY22	
FMCG - cigarettes	4,429.3	3,583.2	23.6	63.7	63.5	18
FMCG - others	320.6	271.9	17.9	6.6	6.7	-17
Hotels	84.0	-48.0	-	15.7	-16.3	-
Agri	345.2	296.1	16.6	8.6	10.7	-203
Paperboard, Paper and Packaging	629.8	409.0	54.0	27.5	22.4	518
Total	**5,808.8**	**4,512.3**	**28.7**	**31.1**	**31.0**	**18.0**

Source: Company, Sharekhan Research

Outlook and Valuation

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

The domestic cigarettes industry is affected by a sustained rise in taxes and regulatory regime along with a sharp increase in illegal trade in past few years, especially at the premium end, which continues to pose significant challenges to the legal cigarette industry. However, in the recent times government has undertaken stringent actions to curb illicit cigarette sales volume. This along with lower price hikes in the cigarettes portfolio will help cigarette companies post better volume growth.On the FMCG front, a normal monsoon, cooling off of commodity prices and improved consumer sentiments will help volume growth to recover in H2FY2023. Companies are expected to see expansion in margins from H2FY2023. Overall we expect H2FY2023 to be much better as compared to H1FY2023 with expected recovery in the volume growth and likely expansion in the margins in Q3/Q4FY2023.

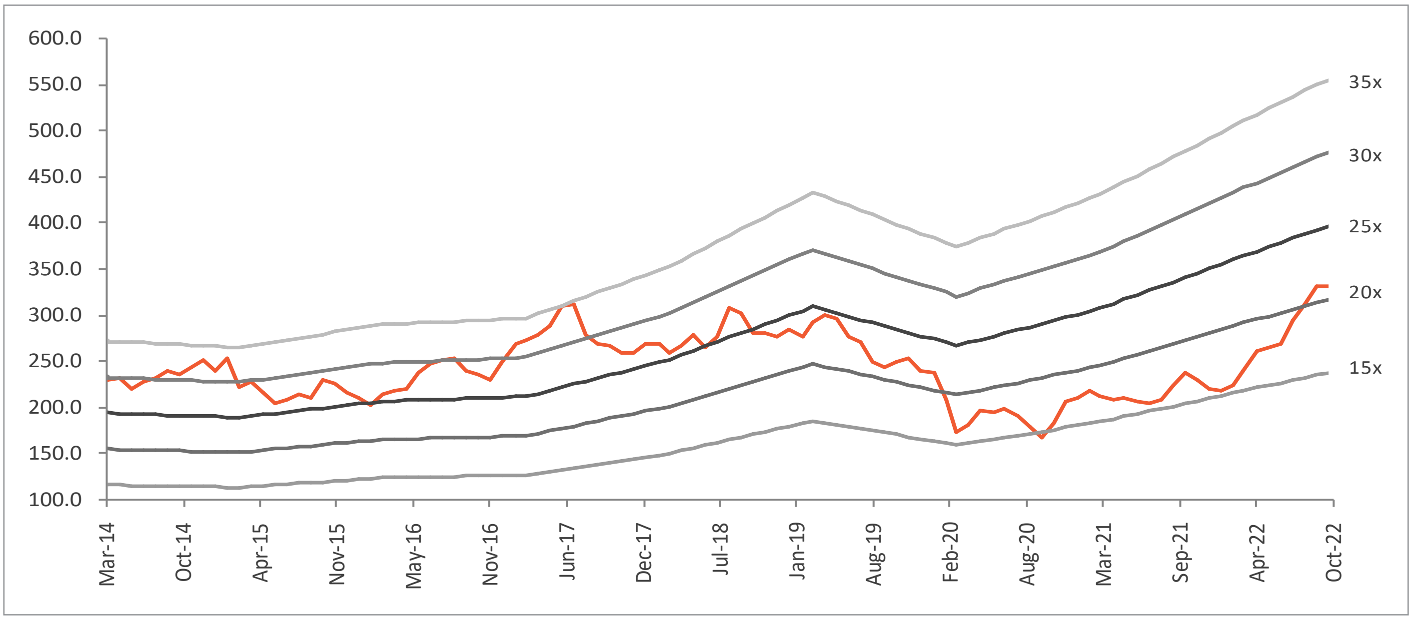
■ Company outlook - Cigarette business regaining normalcy; FMCG margins to scale up

Cigarette sales volumes are expected to improve further with government not increasing taxes on cigarettes for the second consecutive year. Scale-up of stockist network by 2.7x, market coverage by 2.0x, direct outlet servicing by 1.3x and strong traction to new product launches and an increase in e-Commerce salience to about ~7% will help the non-cigarette FMCG business revenues to consistent improve in the medium term. Good monsoon will recovery in the rural demand. PBIT margins of the business will improve led by efficiencies and scale-up in contribution of new businesses. FY2023 and FY2024 will be strong years for the hotels business due to higher demand from domestic leisure travel.

■ Valuation - Retain Buy with a revised price target of Rs.402

With no price hikes in the near term and government action on curbing illicit cigarette will help ITC to maintain volume growth momentum in the cigarette business. Strong growth in non-cigarette FMCG business, recovery in the hotel business and sustained strong growth in the PPP business will drive double-digit revenue and PAT growth over the next two years. The stock currently trades at 24.0x and 20.9x its FY2023E and FY2024 EPS, which is at a discount to some large consumer goods companies. Strong earnings visibility with improving growth prospects of core cigarette business and margin expansion in non-cigarette FMCG business, along with a high cash generation ability and strong dividend payout will reduce valuation gap in the coming years. We maintain a Buy on the stock with a revised price target of Rs. 402 (rolling it over to average of FY2024-25E earnings).

One-year forward P/E (x) band



Source: Sharekhan Research

Peer Comparison

Companies	P/E (x)			EV/EBITDA (x)			RoCE (%)		
	FY22	FY23E	FY24E	FY22	FY23E	FY24E	FY22	FY23E	FY24E
Hindustan Unilever	69.1	60.7	50.3	48.4	42.4	35.4	24.1	27.1	31.8
ITC	28.4	24.0	20.9	21.4	17.2	15.1	27.1	32.6	35.3

Source: Company; Sharekhan Research

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, PPP and hotel businesses. The company has quickly rebound from disruption caused by the lockdown and key businesses are operating at normal levels. The company posted resilient performance in FY2022 with double-digit revenue and PAT growth. We expect the momentum to sustain in FY2023 and FY2024. 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	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

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	British American Tobacco PLC	29.19
2	Life Insurance Corp of India	15.64
3	Unit Trust of India	7.86
4	SBI Funds Management Ltd	3.16
5	Capital Group of Cos Inc	3.03
6	QIB Insurance Company	2.82
7	General Insurance Corp of India	1.75
8	New India Assurance Co Ltd	1.48
9	HDFC AMC	1.37
10	Oriental Insurance Co Ltd	1.1

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

Sharekhan

by BNP PARIBAS

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