Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

# ITC Ltd

## Growth prospects intact; Attractive valuation

| Consumer Goods | Sharekhan code: ITC |
|---|---|

| Reco/View: Buy | ↔ | CMP: **Rs. 384** | Price Target: **Rs. 450** | ↔ |
|---|---|---|---|---|

↑ 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 28.03

Updated Mar 21, 2023

**Medium Risk**

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

*Source: Morningstar*

### Company details

| | |
|---|---|
| Market cap: | Rs. 4,76,633 cr |
| 52-week high/low: | Rs.394/249 |
| NSE volume: (No of shares) | 123.2 lakh |
| BSE code: | 500875 |
| NSE code: | ITC |
| Free float: (No of shares) | 1241.2 cr |

### Shareholding (%)

| | |
|---|---|
| Promoters | 0.0 |
| FII | 43.8 |
| DII | 42.2 |
| Others | 14.0 |

### Price chart


### Price performance

| (%) | 1m | 3m | 6m | 12m |
|---|---|---|---|---|
| Absolute | 1.9 | 15.4 | 15.7 | 53.1 |
| Relative to Sensex | 1.8 | 18.8 | 12.7 | 52.6 |

*Sharekhan Research, Bloomberg*


**Summary**

- We reiterate Buy on ITC with an unchanged PT of Rs. 450. Attractive valuations at 23x/21x its FY2024/FY2025E EPS and double-digit earnings growth visibility make it our preferred pick in the large consumer goods space from a medium to long-term perspective.
- Recent amendment in the Finance Bill 2023 on tobacco/tobacco products is unlikely to have any material impact on tax rates on cigarettes. Volume growth momentum in the cigarette business is likely to sustain in the quarters ahead.
- Consistent good growth in the cigarette business, strong tailwinds in the hotel business and scale-up in non-cigarette FMCG business makes its earning visibility better compared with peers.
- ITC will continue to invest approximately Rs. 3,000 crore p.a. to support its key businesses and accelerate growth in the coming years.


**ITC has delivered resilient performance in past few quarters, despite an uncertain demand environment and sustained inflationary pressures on margins. The resilient performance was driven by good recovery in its core cigarette business (in the post COVID era), steady double-digit growth in the non-cigarette FMCG business, and accelerated growth in the hotel and paperboard, paper and packaging (PPP) business. In the recent amendments in the Finance Bill 2023, the maximum compensation cess chargeable on tobacco products is capped at Rs. 4,170 per 1000 sticks + 290% ad-valorem. ITC's cigarette business is unlikely to be impacted by the same. We expect volume growth momentum in the cigarette business to continue in the quarters ahead. Going ahead, non-cigarette FMCG business is expected to grow in double digits and its OPM (10% in Q3) is expected to consistently improve, while the hotel business will benefit from strong industry tailwinds in the coming years. Hence, compared to other large peers, ITC has much better earning visibility (15% CAGR over FY2022-FY2025).**

- **Cigarette biz volume growth to sustain; no major impact of amendments in the Finance Bill:** The maximum compensation cess chargeable on tobacco products is capped at Rs. 4,170 per 1,000 sticks + 290% ad-valorem. ITC's cigarette business is unlikely to be impacted by it, as the existing cap has been retained, although it will impact pan masala and other forms of chewing tobacco products. Since there hasn't been a significant increase in the cess rate in the past three years, legal cigarette companies (like ITC) have been able to compete with illicit cigarettes. Going ahead, ITC is expected to maintain volume growth momentum in its core cigarette business with a marginal price hike in portfolio and improved profitability..
- **Drivers in place to achieve double-digit earnings growth:** ITC is set to achieve a 15% earnings CAGR over FY2022-FY2025 on account of sustained volume growth momentum in the cigarette sales, 17% revenue CAGR in non-cigarette FMCG business with consistent improvement in OPM, 20% plus growth in the hotel business, and consistent improvement in the profitability of PPP business. Any accelerated growth in the non-cigarette FMCG business along with margin expansion will further boost the company's earnings going ahead.
- **Thrust on sustained investment in accelerating growth:** The company has generated strong cumulative free cash of >Rs. 35,000 crore in the last three years. Management will continue to invest in the growth prospects of the key businesses (including non-cigarette FMCG and hotel) to accelerate their growth over the next two to three years. Management is planning to invest Rs. 3,000 crore per annum in capacity expansion, back-end strengthening, and investment in brands of key businesses going ahead.

**Our Call**

**View – Retain Buy with an unchanged PT of Rs. 450:** ITC is expected to maintain its volume growth momentum in the cigarette business, given no price hikes in the near term and government curbing illicit cigarette sales. Strong growth in the non-cigarette FMCG business, stellar recovery in the hotel business, and sustained growth in the PPP business will drive double-digit revenue and PAT growth over the next two years. The stock currently trades at 25.5x, 22.8x, and 20.6x its FY2023E, FY2024E, and FY2025E EPS, which is at a discount to some large consumer goods companies. Strong earnings visibility with improving growth prospects of the core cigarette business and margin expansion in the non-cigarette FMCG business, along with a high cash-generation ability and strong dividend payout, will consistently improve valuations in the coming years. We maintain our Buy recommendation on the stock with an unchanged price target (PT) of Rs. 450.

**Key Risks**

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

**Valuation (standalone)** Rs cr

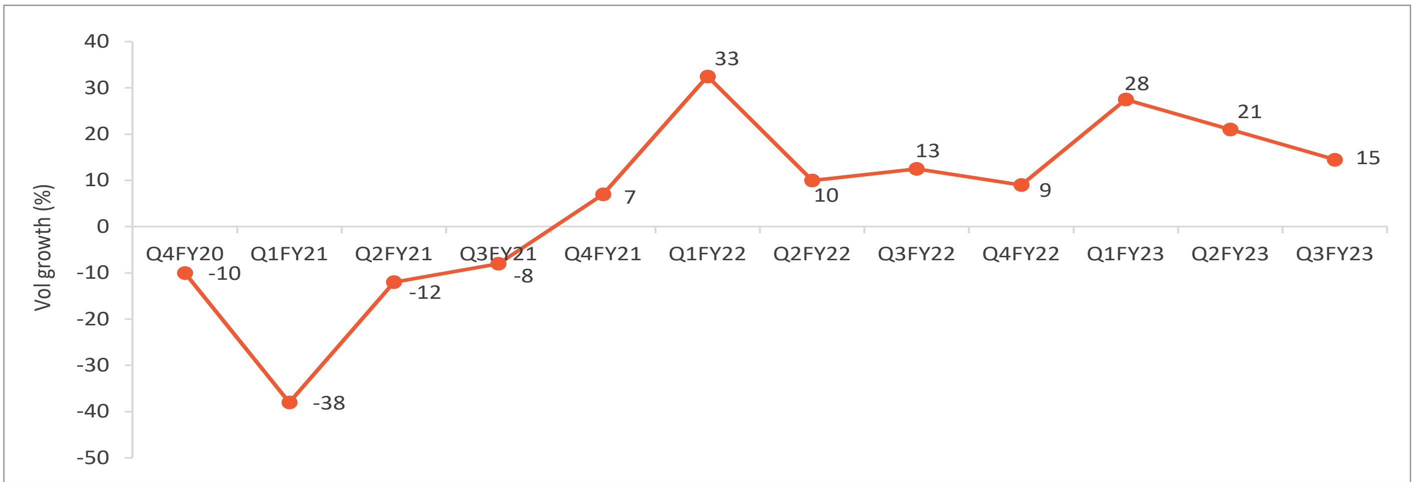
| Particulars | FY22 | FY23E | FY24E | FY25E |
|---|---|---|---|---|
| Revenues | 59,746 | 69,951 | 77,000 | 84,898 |
| OPM (%) | 31.7 | 34.7 | 35.2 | 35.6 |
| Adjusted PAT | 15,058 | 18,347 | 20,524 | 22,769 |
| Adjusted EPS (Rs.) | 12.3 | 15.0 | 16.8 | 18.7 |
| P/E (x) | 31.1 | 25.5 | 22.8 | 20.6 |
| P/B (x) | 7.7 | 7.3 | 6.8 | 6.2 |
| EV/EBIDTA (x) | 23.7 | 18.3 | 16.3 | 14.6 |
| RoNW (%) | 25.0 | 29.0 | 30.5 | 31.3 |
| RoCE (%) | 27.1 | 33.9 | 36.1 | 37.3 |

*Source: Company; Sharekhan estimates*

### Cigarette business volume growth momentum to sustain in the coming quarters

Government of India has proposed an amendment in the Schedule of the GST (Compensation to States) Act, 2017 in the finance bill, which capped GST Compensation Cess on pan masala and gutka at 51% of the retail sales price per unit and for tobacco and manufactured tobacco substitutes, including tobacco products to 100% of retail sale price per unit. The maximum compensation cess chargeable on tobacco products is capped at Rs. 4,170 per 1000 sticks + 290% ad-valorem. The same is unlikely to have any impact on the cigarette business, as the existing cap has been retained, while it will impact sales of pan masala and other forms of chewing tobacco products. However, since the government has not increased the tax rate on cigarettes significantly over the past three years, legal cigarette players (such as ITC) have been able to compete with illicit cigarette sales . In Union Budget 2023-2024, the government increased marginally increased tax by 2%. The company took a marginal price hike of 1% in its portfolio and is unlikely to take any significant price hikes going ahead. Hence, we expect volume growth momentum in the core cigarette business to continue in the quarters ahead.

**Volume growth trend in the cigarette business**

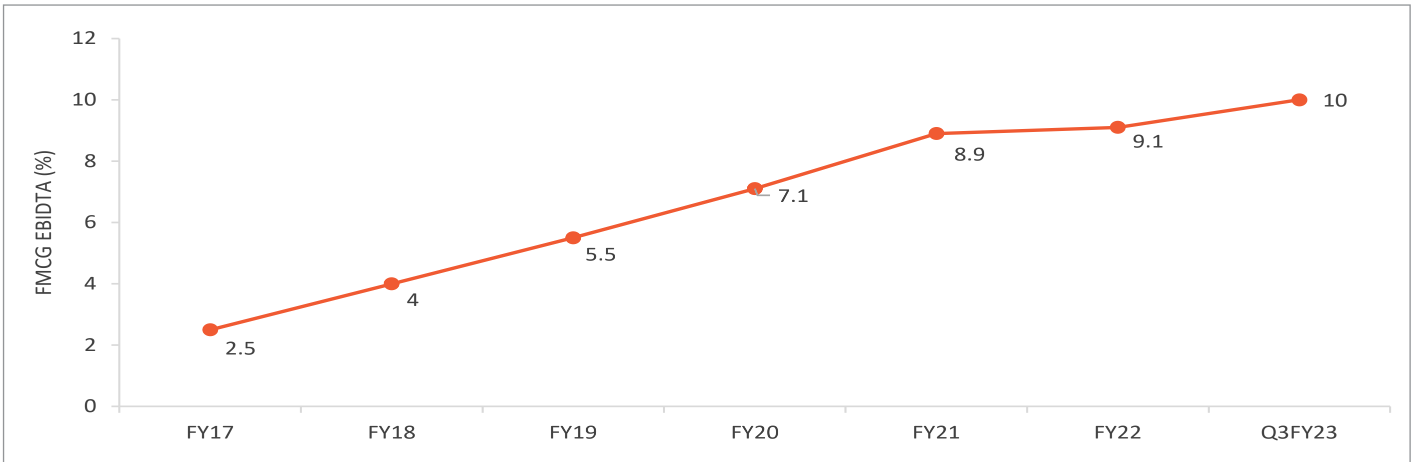



*Source: Company, Sharekhan Research*

### Non-cigarette FMCG scaling-up well; OPM reached 10%

ITC's non-cigarette FMCG business reported a 7% revenue CAGR over FY2020-FY2022. The business is scaling much faster, at ~20% CAGR, over FY2020-FY2023, with strong growth across channels and markets, driven by ramp-up in outlet coverage, new product launches, and enhanced penetration. On the category front, biscuits, noodles, snacks, dairy, and frozen foods are growing in strong double digits, while personal care categories such as personal wash is gaining good traction. OPM has consistently improved to 10% in Q3FY2023. Strategic cost management, premiumisation, supply-chain ability, and judicious pricing actions will help improve margins going ahead.

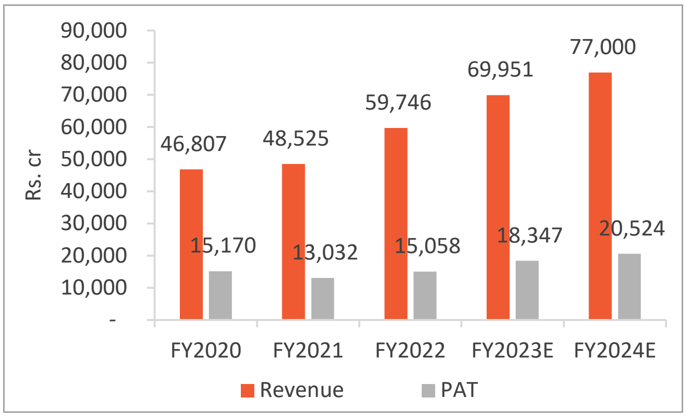
**Consistent improvement in OPM of non-cigarette FMCG business**




*Source: Company, Sharekhan Research*

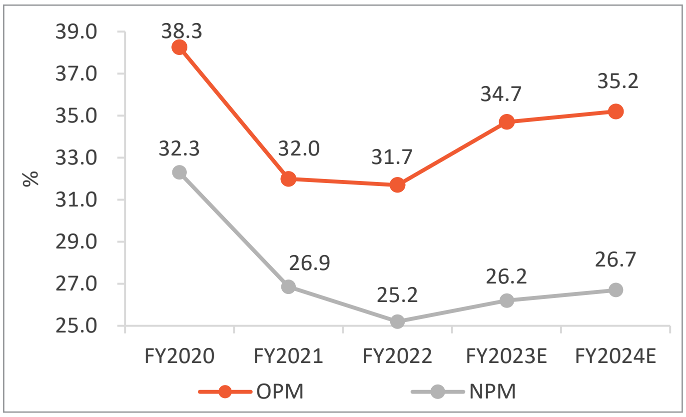
## Financials in charts

**Trend in revenues and PAT**



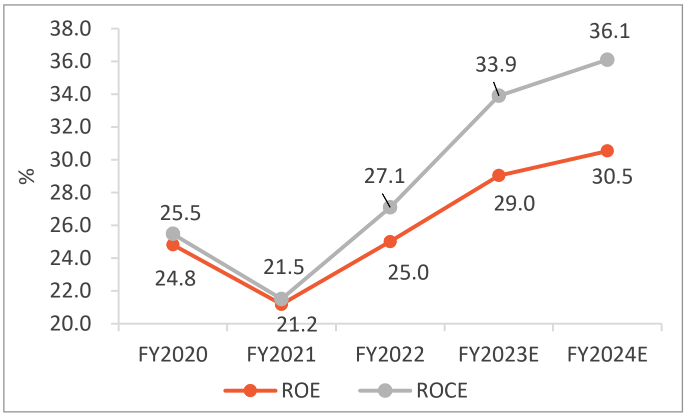

*Source: Company, Sharekhan Research*

**OPM & NPM to improve in the coming years**



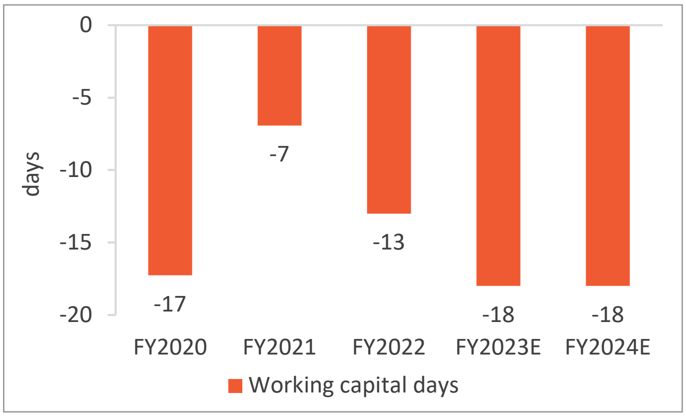

*Source: Company, Sharekhan Research*

**Return profile to consistently improve**



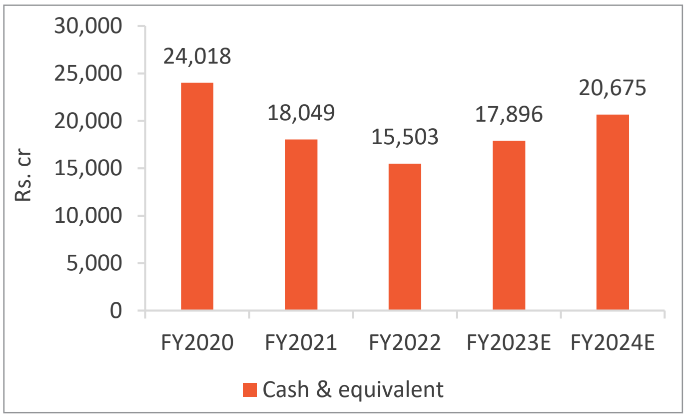

*Source: Company, Sharekhan Research*

**Working capital days remaining negative**



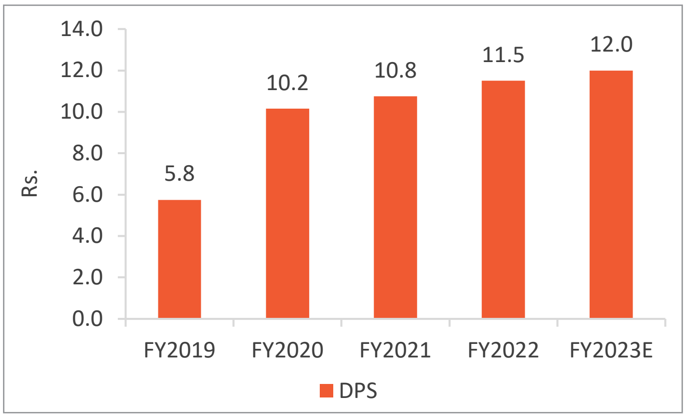

*Source: Company, Sharekhan Research*

**Strong cash balance**




*Source: Company, Sharekhan Research*

**Dividend pay increases in past two years**




*Source: Company, Sharekhan Research*

## Outlook and Valuation

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

The domestic cigarette industry is affected by the increase in taxes and regulatory regime along with a sharp rise in illegal trade over FY2016-FY2020, especially at the premium end, which continues to pose significant challenges to the legal cigarette industry. However, in recent times, the government has undertaken stringent actions to curb illicit cigarette sales. Moreover, the marginal tax increase led to lower price hikes in the cigarette portfolio, thus helping cigarette companies to register better volume growth in the past few quarters. On the FMCG front, normal monsoon, drop in commodity prices, and improved consumer sentiments will help volume growth to recover in H2FY2024. Companies are expected to post better margins from H2FY2023. Overall, FMCG companies will benefit on account of expected recovery in volume growth and margin expansion due to decreasing input prices in FY2024.

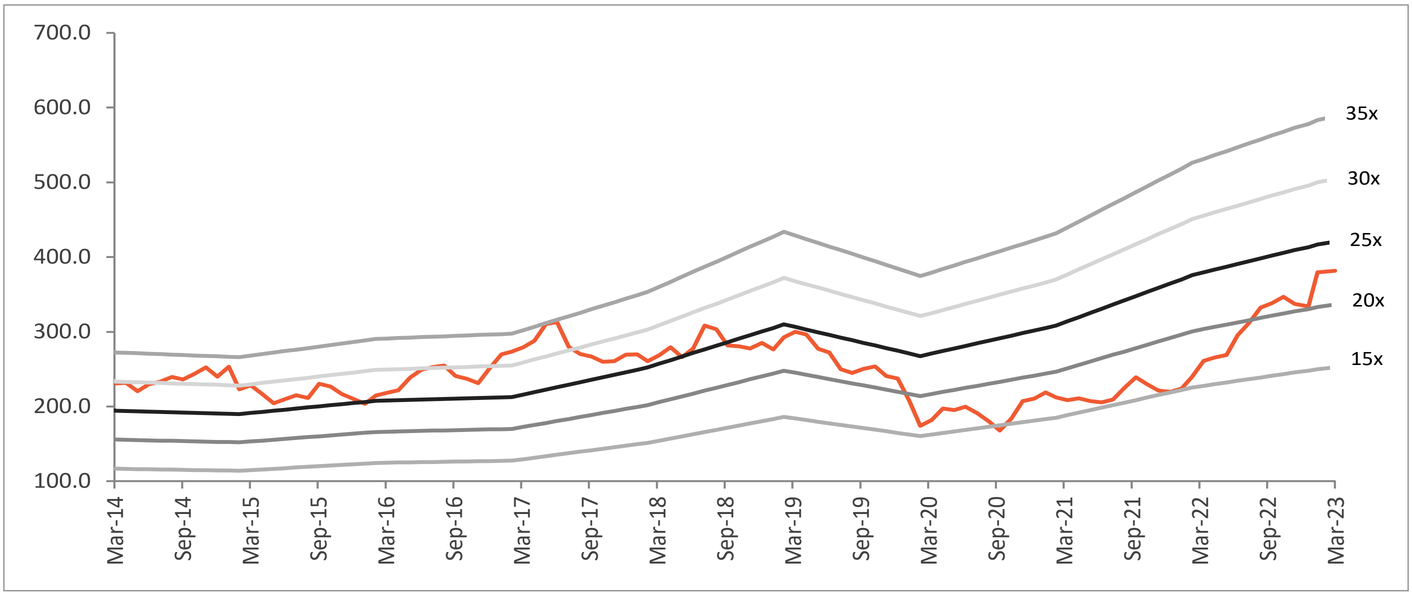
■ **Company outlook - Cigarette business sales momentum to sustain; FMCG margins to scale up**

Cigarette sales volume is expected to improve further with the government not increasing taxes on cigarettes for the second consecutive year. Scale-up of the stockist network by 2.7x, market coverage by 2.0x, direct outlet servicing by 1.3x, strong traction to new product launches, and increased e-commerce salience to about ~7% will help the non-cigarette FMCG business's revenue to consistently improve in the medium term. Good monsoon will lead to recovery in rural demand. PBIT margin of the business will improve, led by efficiencies and scale-up in the 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 an unchanged PT of Rs450**

ITC is expected to maintain its volume growth momentum in the cigarette business, given no price hikes in the near term and government curbing illicit cigarette sales. Strong growth in the non-cigarette FMCG business, stellar recovery in the hotel business, and sustained growth in the PPP business will drive double-digit revenue and PAT growth over the next two years. The stock currently trades at 25.5x, 22.8x, and 20.6x its FY2023E, FY2024E, and FY2025E EPS, which is at a discount to some large consumer goods companies. Strong earnings visibility with improving growth prospects of the core cigarette business and margin expansion in the non-cigarette FMCG business, along with a high cash-generation ability and strong dividend payout, will consistently improve valuations in the coming years. We maintain our Buy recommendation on the stock with an unchanged price target (PT) of Rs. 450.

**One-year forward P/E (x) band**




*Source: Sharekhan Research*

**Peer Comparison**

| Companies | P/E (x) | | | EV/EBIDTA (x) | | | RoCE (%) | | |
|---|---|---|---|---|---|---|---|---|---|
| | FY22 | FY23E | FY24E | FY22 | FY23E | FY24E | FY22 | FY23E | FY24E |
| Hindustan Unilever | 68.0 | 63.0 | 53.2 | 47.6 | 43.9 | 37.3 | 24.1 | 25.9 | 30.1 |
| ITC | 31.1 | 25.5 | 22.8 | 23.7 | 18.3 | 16.3 | 27.1 | 33.9 | 36.1 |

*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 |
| Rajendra Kumar Singhi | Executive Vice President & Company Secretary |

*Source: Company*

**Top 10 shareholders**

| Sr. No. | Holder Name | Holding (%) |
|---|---|---|
| 1 | British American Tobacco PLC | 29.16 |
| 2 | Life Insurance Corp of India | 15.54 |
| 3 | Unit Trust of India | 7.85 |
| 4 | SBI Funds Management Ltd. | 3.18 |
| 5 | Capital Group of Cos Inc. | 2.94 |
| 6 | General Insurance Corp of India | 1.75 |
| 7 | New India Assurance Co. Ltd. | 1.48 |
| 8 | HDFC AMC | 1.26 |
| 9 | GQG Partners LLC | 1.14 |
| 10 | GQG Partners EME Funds | 1.14 |

*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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