Stock Update

Company Update

Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

ITC Ltd

Eyeing profitable growth ahead

Consumer Goods	Sharekhan code: ITC

Reco/View: Buy	↔	CMP: **Rs. 453**	Price Target: **Rs. 515** ↔

↑ 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 Aug 08, 2023

Medium Risk

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

Source: Morningstar

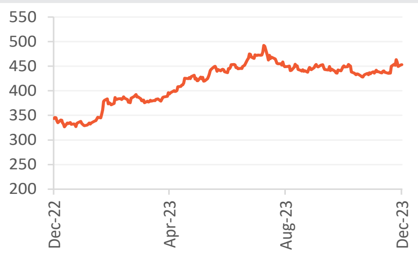
Company details

Market cap:	Rs. 5,65,057 cr
52-week high/low:	Rs. 500 / 325
NSE volume: (No of shares)	101.9 lakh
BSE code:	500875
NSE code:	ITC
Free float: (No of shares)	1247.1 cr

Shareholding (%)

Promoters	0.0
FII	44.2
DII	41.9
Others	13.9

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	3.9	0.7	1.9	31.1
Relative to Sensex	-3.2	-2.3	-8.1	19.9

Sharekhan Research, Bloomberg

Summary

- In a three-pronged move, ITC is focusing on three growth horizons - 1) Extend and grow the core business, 2) Building emerging businesses and 3) Creating viable opportunities under new vectors for growth.
- FMCG business' EBITDA margins to consistently improve by 80-100 bps y-o-y; RoCE to rise 300-350 bps p.a. (currently at 18% excluding intangibles).
- Prudent capex of Rs. 3,000-3,400 crore p.a. with a 35-40% investment in FMCG business, 30% investment in paperboard, paper & packaging and the remaining 30-35% in new vectors/ digitalisation and backward integration.
- We retain a Buy with an unchanged PT of Rs. 515. Stock trades at attractive valuations of 23x/20x its FY2025E/26E earnings.

At ITC's analyst and investors' meet, the company outlined its focus on carving growth strategies in each business and exploring fresh opportunities in new vectors. First, in the cigarettes business it aims to gain share from illicit cigarettes. In the foods segment, it would play on the theme of a shift from unbranded to branded products. In agri-products it expects to hike the contribution of value-added products. In the personal care segment, it looks to reshape portfolio to improve growth prospects. Further, it will be investing into new vectors of growth (food tech, sustainable packaging & start-up investments), scout for relevant inorganic initiatives and invest in capacities to further enhance the core businesses. Along with prudent capital allocation plan, the company has always rewarded its shareholders with good dividend payout (stood at Rs. 1,02,000 crore for 10 years ahead of free cash generation of Rs. 95,000 crore).

- **Non-cigarette FMCG business contribution scaling up:** ITC's non-cigarette business grew by 2.5x in last 10 years and its contribution to overall revenues have gone-up to 27% (from 17% in FY2013). All the non-cigarette businesses (excluding the agri segment) saw good growth in EBIDTA ahead of the revenue growth aiding strong improvement in the profitability of the overall business. RoCE of non-cigarette business improved by 730 bps to 21.7% in FY2023 from 14.3% in FY2013. The key pillar for scale-up in the contribution of non-cigarette business was other FMCG business which grew by almost 5x over the same period with EBIDTA margins consistently improving to low double digits. With strategies in place the contribution of non-cigarette FMCG business will consistent scale-up in the coming years.
- **Other FMCG business' EBIDTA margins and RoCE will consistently improve:** ITC's other FMCG business' EBIDTA margins improved by 770 bps over FY2017-23 (stood at 10.2% in FY2023). Management aims to achieve 80-100 bps expansion in margins per annum. This will be driven by 30-40 bps improve because of change in mix driven by premiumisation, 20 bps due to increase in scale of business, 30bps expansion due to cost optimisation and rest due to digitalisation and benefits from ICML facilities. Food business margins have seen upward trend of 1% due to efficiencies led by integrated consumer goods and logistic facilities (ICML). This along with improved capacity utilisation will aid a 300-350 bps improvement in RoCE of other FMCG business (stood at 18% in FY23).
- **Prudent capital allocation:** ITC is focusing on three big buckets – 1) Invest in innovations to drive organic growth, 2) Invest in new vectors of growth (food tech & nicotine) & 3) M&A (looking to build capabilities through M&A). It is planning to do a capex of Rs.3,000-3,400crore per annum of which 35-40% for putting capacities in core and new segments in FMCG business, around 30-35% in the paper business to expand capacity under paper business, rest of the capital investment will be done in new vectors and various digital projects. Funding for investment for organic and inorganic initiatives will be done through internal accruals.

Our Call

View - Retain Buy with an unchanged PT of Rs. 515: The company has carved its growth plan very well by focusing on growing the core businesses, building-up the emerging business and investing in new vectors in the coming years that will be supported by prudent capital investment funded by higher cashflows. This will help earnings grow in double digits in the coming years. The stock continues to trade at attractive valuation of 23x/20x its FY2025E/26E earnings. We maintain our Buy recommendation on the stock with an unchanged PT of Rs. 515.

Key Risks

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	FY23	FY24E	FY25E	FY26E
Revenues	70,251	75,693	85,550	96,019
OPM (%)	34.1	36.6	37.1	37.4
Adjusted PAT	18,700	21,412	24,229	27,272
Adjusted EPS (Rs.)	15.1	17.2	19.5	21.9
P/E (x)	29.5	25.8	22.8	20.3
P/B (x)	8.3	7.7	7.0	6.1
EV/EBIDTA (x)	22.9	19.8	17.3	15.3
RoNW (%)	29.1	30.5	31.5	31.5
RoCE (%)	32.7	35.1	37.1	37.6

Source: Company; Sharekhan estimates

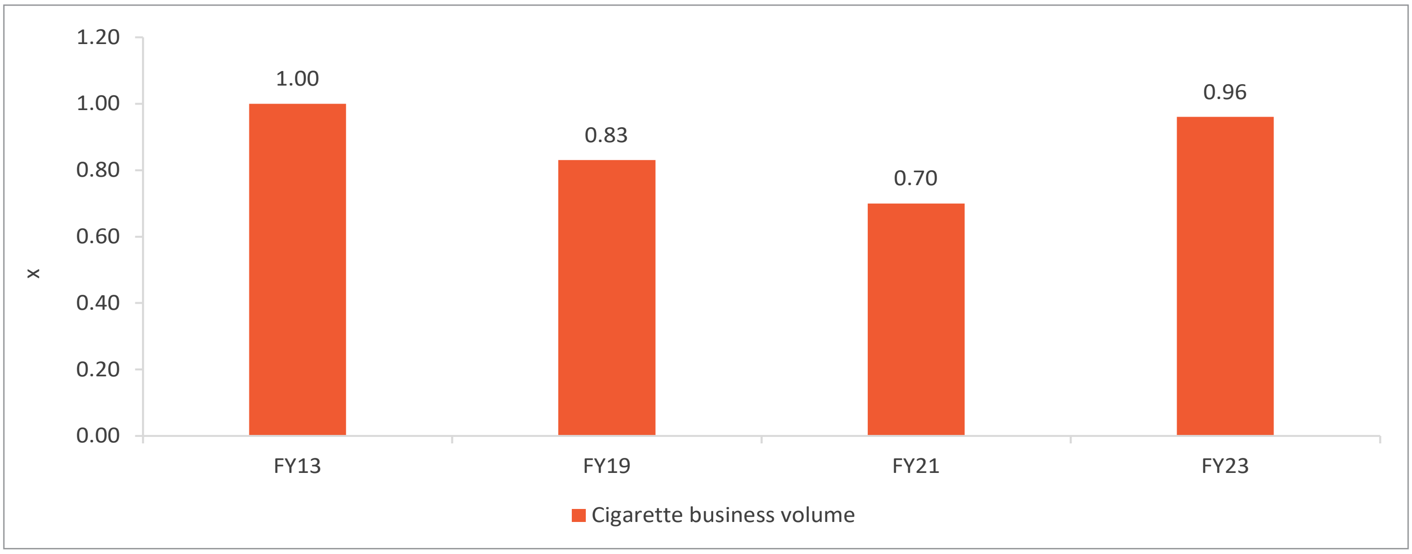
Focus on profitable growth

ITC is focusing on growth avenues in every business it operates to drive consistent growth 1) Cigarettes – by gaining share from illicit cigarettes 2) Foods – play on theme of shift from unbranded to branded products 3) Agri products – increase contribution of value-added products and 4) personal care – reshape of portfolio to improve growth prospects.

Stable tax regime to drive cigarette volumes

Cigarette volumes fell 20% over FY2013-19 owing to a double-digit hike in taxes with illicit cigarettes gaining share in the domestic market. However, a stable tax policy has helped ITC claw back volumes from illicit trades in the past five years. Volumes recovered to 0.96x of sales volumes in FY2013. Illicit cigarette contributes around one-third of overall cigarette sales in India. Continuance of a stable tax policy and relevant portfolio intervention will help ITC to achieve steady volume growth in its core cigarette business in the coming years. Regular premium interventions are gaining strong traction, with premium product' contribution has gone up to 17% to overall sales volume of the cigarette business. Four new variants launched under the Classic brand in the past five years contributed ~25% of the portfolio while new launches done under Gold flake brand contributes around 19%. Introduction of capsule pod was a successful innovation.

Recovery in cigarette volumes

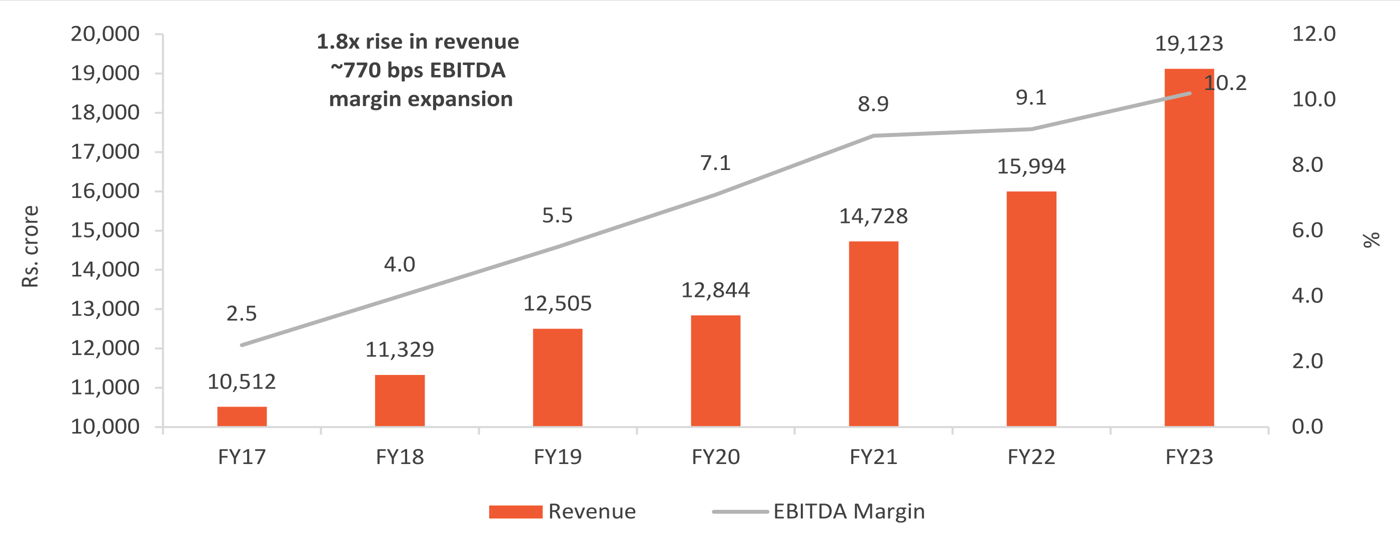


Source: Company, Sharekhan Research

Other FMCG biz – focus on achieving consistent margin improvement

ITC's FMCG business (ex-cigarettes) reported over 14% revenue CAGR and 310 bps margin expansion over the past 3 years supported by its diverse portfolio, purpose-led brands, agile, resilient and efficient supply chain, smart omni-channel network and value accretive M&A. Management guided that the company aims for 80-100 bps y-o-y improvement in FMCG margins every year, with ~30-40 bps coming from revenue and mix, ~20 bps from economies of scale and ~30 bps from cost optimisation (ICML (100 bps in the medium term), digitisation, logistics, etc). RoCE of the FMCG business is expected to rise from 18% (excl. Intangibles acquired) to 26-28% in medium term.

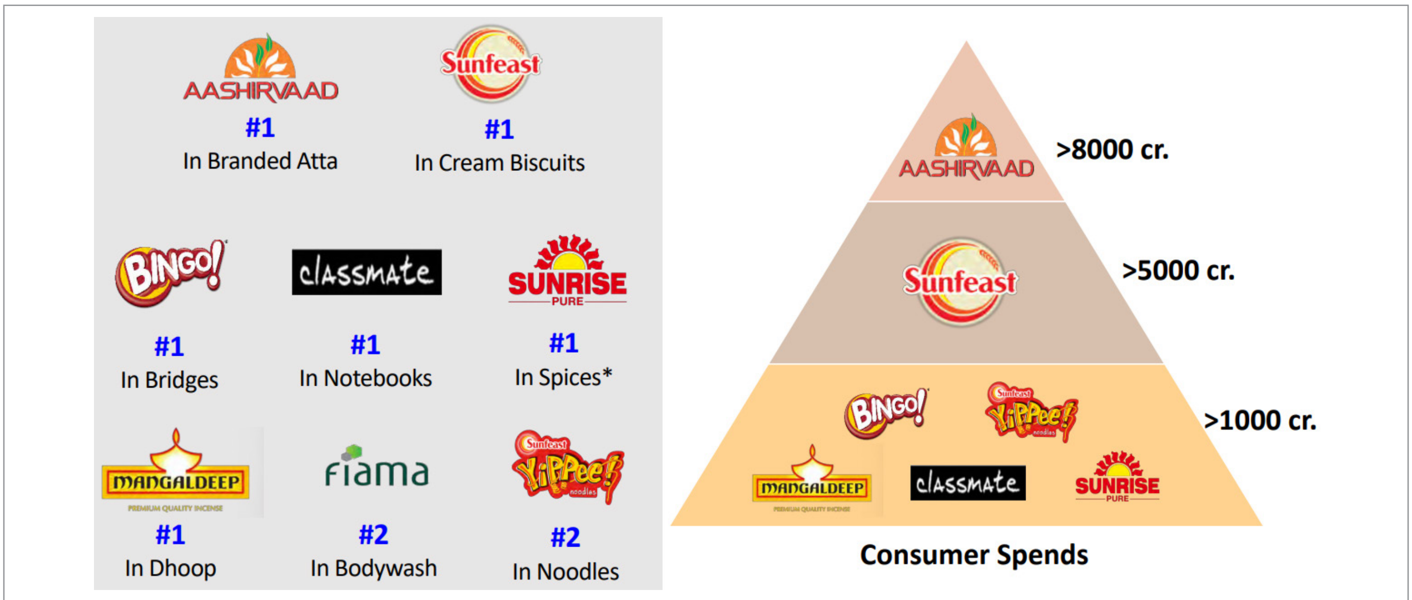
Rise in FMCG revenue and margins



Source: Company, Sharekhan Research

- **Foods business:** ITC has identified four vectors that will aid growth in the foods business, namely 1) Unbranded to branded conversion (fortifying core by addressing adjacencies through power brands), 2) Penetrating emerging markets (focus on driving brand penetration through consistent brand building following the CCM approach), 3) Building newer avenues (Developing newer capabilities for the future: e-commerce, cold chain, exports and acquisitions), and 4) Future ready portfolio (Building future proposition through innovation on back of deep consumer insights). Moreover, the company focuses on three strategies including a) Fortifying the core by strengthening Aashirvaad's presence in the kitchen through adjacencies, up-trading the consumers by creating newer vectors of value addition, winning local cultures through CCM (Culture Centric Marketing) approach and identifying and nurturing the white space of millets through 'ITC Mission Millets', b) Building future ready propositions through innovation which is powered by agile and real time consumer insights, and c) driving profitable growth through smart manufacturing, improving value capture and mix premimisation. As a result of the company's continuous efforts, it has made progress in terms of market share (MS) across categories, with Atta MS up by ~190 bps in 3 years, choco fills adding 400 bps MS in 3 years, sunrise MS rising by 1,100 bps since acquisition (currently has 53% MS in West Bengal and 10% in Assam), classmate adding 260 bps MS in two years and 110 bps rise in MS in agarbatti in 1 year.

Leadership across categories with multiple brands having consumer spends over Rs. 1,000 crore



Source: Company presentation

- **Personal care:** The management stated that personal care business has been more difficult to develop. However, the company has refreshed the portfolio in the past few years and is entering areas in which there is value preposition and lower penetration. ITC has levers in place to grow Fiama (personal wash category) and Savlon (health & hygiene) and scale up Nimyle (home care). In the personal care business, the company eyes growth to be achieved through market development.

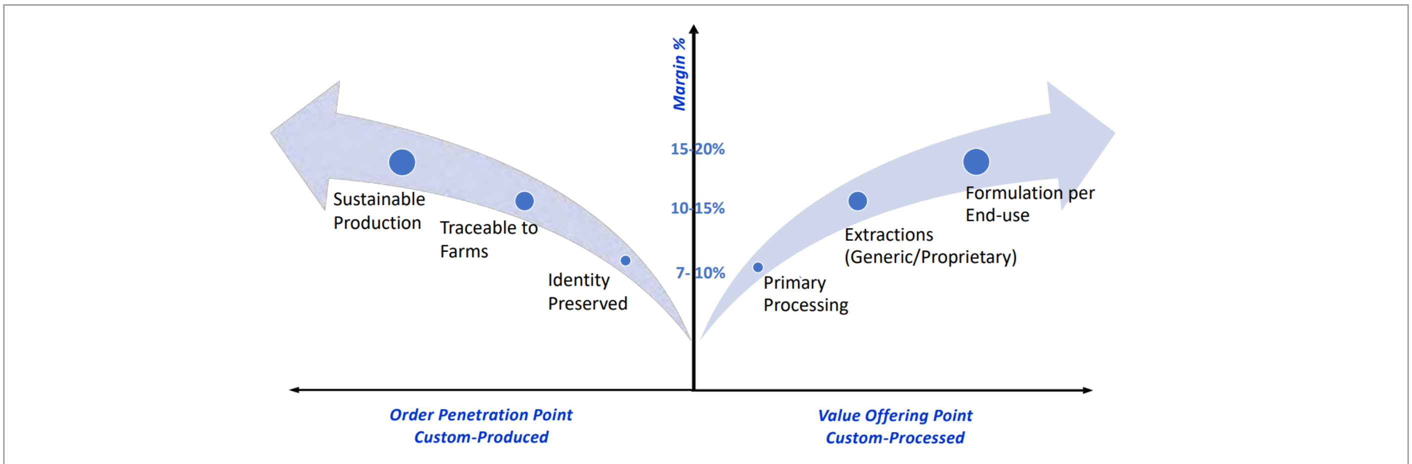
ITC's market development strategy for personal care

Source: Company presentation

Agri business – will add value-added products to drive profitability

Agri business posted an 18% revenue and a 9% EBITDA CAGR over FY18-23 to Rs. 18,172 crore and Rs. 1,394 crore, respectively, with RoCE improving to 53.9% in FY23 from 33.8% in FY18. In the agri business, the company plans to focus on value added categories such as nicotine & derivatives in tobacco and spices & other products in other agri products. Management indicated that nicotine is a niche segment and a very high margin business (~50% margins) with high barriers to entry and expected to have huge demand supply gap in the coming years. In the spices segment, the company plans to focus on spices, shrimps and wheat-based products (horizon 1) and coffee, fruits & vegetables and medicinal & aromatic plant extracts (horizon 2). Thus, ITC aims to grow its agri business on the back of newer segments that are developing globally. ITCMAARS is a platform providing multiple benefits to the company including faster speed to market with physical reach in 100,000 villages across 220 districts, reduced cost of customer acquisition aided by connect with 4 million farmers via sanchalaks and creative monetisation models due to intimate knowledge of 20+ crop value chains. Moreover, management indicated that agri margins have bottomed out and the company expects recovery in margins from hereon.

Vectors of value addition in agri business



Source: Company presentation

Hotel business – strong performance in last five years

Hotel business revenue and EBITDA clocked a 13% and 22% CAGR during FY18 to FY23 to Rs. 2,585 crore and Rs. 832 crore, respectively, with RoCE (for gestated properties) improving to 16% in FY23 from 5% in FY18. Over the long-term period of 20 years, the company's revenue and EBITDA grew at 11% and 15% CAGR with 2.6x rise in room inventory. ITC's hotel business portfolio comprises of 131 hotels with ~12,000 rooms across 80 destinations having presence in the luxury (38% of room inventory), upper upscale and boutique (23% of room inventory), and mid-market and heritage (39% of room inventory) segments. The company opened 22 hotels during Jan 2022 and Dec 2023 and is expected to open another 25 hotels in the next 24 months (Jan 2024 – Dec 2025) with a target to reach 200 hotels with 18,000 keys over 5 years (with two-thirds of keys in the managed portfolio). In the hotel business, the company plans to focus on asset light strategy for expansion and continue to deliver responsible luxury to its customers. Additionally, industry tailwinds from demand supply gap (Supply likely to grow by 7.1% and demand by 10.5% during FY24-27), recovery in FTA and rise in domestic demand would further aid hotel business growth. Better productivity and improved efficiency will continue to support margins of hotel business.

Key strengths of hotel business

Source: Company presentation

Paper business – will scale-up capacity; add value added products

Revenue and EBITDA grew at 12% and 15% CAGR over FY18-23 to Rs. 9,081 crore and Rs. 2,642 crore, respectively, with RoCE rising to 29.1% in FY23 from 17.5% in FY18. The paper business has a fully integrated business model in place and provides one-stop shop packaging solutions to its customers. The company plans to drive growth in the paper business through i) Scale-up of value-added portfolio, ii) Greenfield investment (to drive next phase of growth), iii) New west facility for packaging and iv) Sustainable paperboard/packaging solutions. Additionally, the business is structurally well placed as global pulp prices likely to have bottomed out and there are green shoots of demand revival across markets. Moreover, margins are expected to improve aided by in-house pulp manufacturing, secure, cost-competitive and sustainable fibre chain, and ITC's manufacturing excellence.

New vectors will be key growth levers in long run

ITC has identified new vectors such as Food Tech services, high margin nicotine business and value-added launched in paperboard business to be some of the key growth drivers in long run. Food Tech venture synergises its institutional strengths in Foods, Hotels and Digital. The company has successfully launched the business in the city of Bengaluru with 3 brands – ITC Master Chef Creations, ITC Aashirvaad Soul Creations and ITC Sunfeast Baked Creations delivered through 19 cloud kitchens. Average order value for brand such as Soul creation stands at Rs. 450-500 per order while for Masterchef creations and Sunfeast Baked Creations it stands at around Rs. 900 per order. The investment in cloud kitchen is less and can see strong upside in profitability in short span of time. Some of ITC's cloud kitchen in Bangaluru are generating EBIDTA margins of 15%+. The company has recently introduced the venture in the city of Chennai with 4 cloud kitchens and will be entering the market of Mumbai in next six months. Further the company is looking at tapping at growing demand of nicotine in the global markets. The nicotine-based end-user product market is pegged at $5 billion globally, according to industry estimates. ITC will leverage on the institutional capabilities of its leaf tobacco business and aims to manufacture purest form of nicotine following the stringent norms of US and European countries. It's a high margin business with 50% contribution margins and can provide strong profitability support to ITC's agri business.

Other key analyst meet highlights

- **Urban segment holding better; rural recovery to be gradual:** Management has guided that urban markets are holding better as compared to rural markets. Though green shoots are visible in rural markets due to receding inflation and price reduction, but the management does not expect a very sharp rural recovery. Rural markets are likely to see better trajectory in the next couple of quarters.
- **Multi-pronged growth strategy:** The company has adopted a multi-pronged growth strategy consisting of multiple growth drivers with focus on innovation and supported by agile, resilient and efficient supply chain and digital first culture. ITC has laid out a three-horizon growth framework including 1) Extending and defending core businesses, 2) Build emerging businesses (Beverages, frozen foods, liquid wash, homecare, nicotine, value added agri, and sustainable packaging - platforms 1 & 2), and 3) Create viable options for future growth opportunities (Chocolates, premium skincare, Food-tech, ITCMAARS, sustainable packaging - platform 3 and startup investments).
- **Focus on purposeful innovation:** ITC has identified specialised research platforms and plans to translate mega trends into agile and purposeful innovation. Management stated that innovation has various prospects including innovating new products and innovation for cost optimisation. The company has leveraged its innovation platforms to launch first-to-market differentiated products. ITC FMCG has launched over 300 products in the past 3 years.

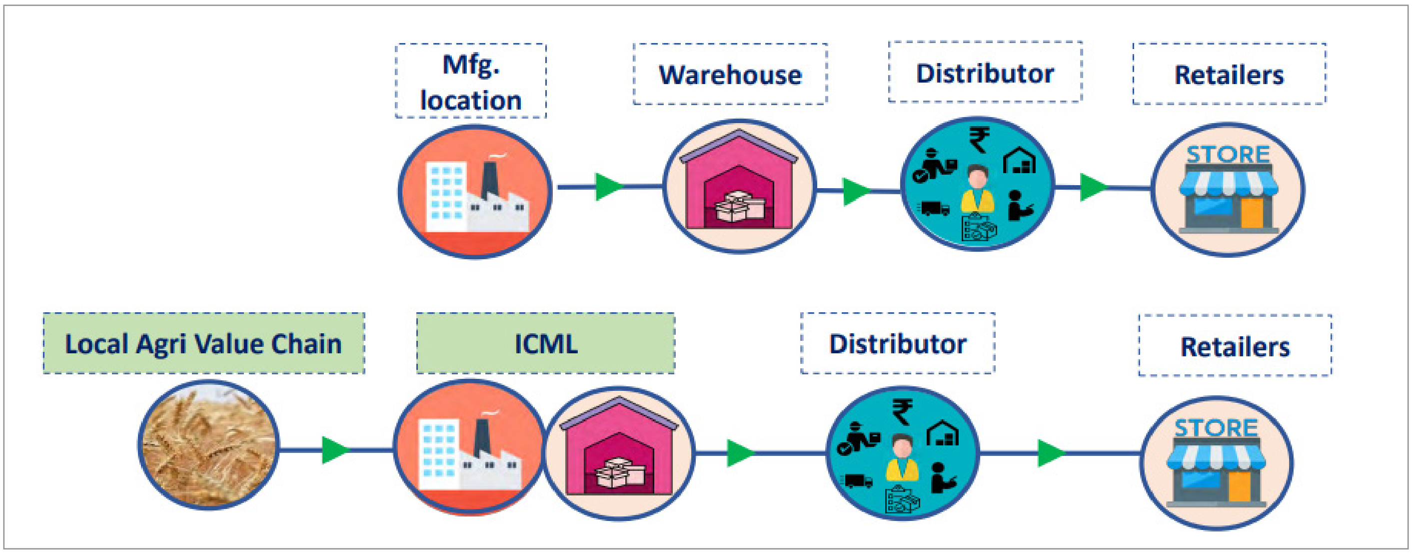
Portfolio of differentiated first-to-market products

Source: Company presentation

- **Rising salience of new-age distribution channels:** The management indicated that general trade is still the predominant channel for distribution with market coverage having grown by 3x and stockist network having grown by 8x during FY19-23. At present, ITC's total reach (ex-cigarette FMCG business) stands at 7 million outlets with direct reach at 2.6 million outlets. However, salience of other channels is rising (share of alternate channels rose from 17% in FY20 to 25% in FY23) and is expected to continue to improve in the coming years. Currently, modern trade contributes 15% to FMCG revenue while digital channel contributes 16% to FMCG revenue (including 10% from B2C and third-party E-B2B and 6% from own app Unnati).

- **Leveraging ICML to create structural advantage:** The company currently has 11 Integrated Consumer Goods Manufacturing and Logistics facilities (ICMLs) through which it creates structural advantage. ICMLs are set up in proximity to large consumption centres leading to shorter lead time, aiding in delayered operations through direct shipments and benefiting from cross category synergies in the form of freight optimisation and common infrastructure and utilities.

ICML leads to better efficiency and lower lead time



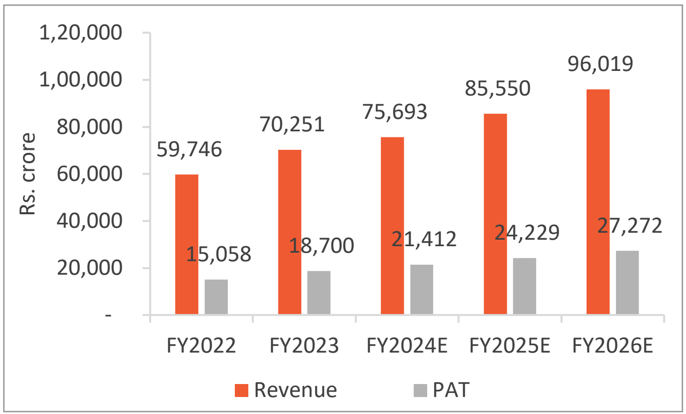
Source: Company presentation

- **Strong cash flow generation and dividend payout:** ITC cumulatively generated ~Rs. 95,000 crore over the past 10 years and paid ~Rs. 1,02,000 crore dividend over the same period.

- **Prudent capital allocation strategy:** The company is focusing on Three big buckets – 1) invest in innovations to drive organic growth, 2) invest in new vectors of growth (Food tech & nicotine) & 3) M&A (looking to build capabilities through M&A). It is planning to do a capex of Rs.3,000-3,400 crore p.a. Out of which around 35-40% for putting capacities in core and new segments in FMCG business, 30-35% in paper business to expand capacity under paper business (exist plant location and new greenfield facility in new location with phase wise expansion, rest of the capital investment will be done in new vectors and various digital projects. Funding for investment for organic and inorganic initiatives will be done through internal accruals.

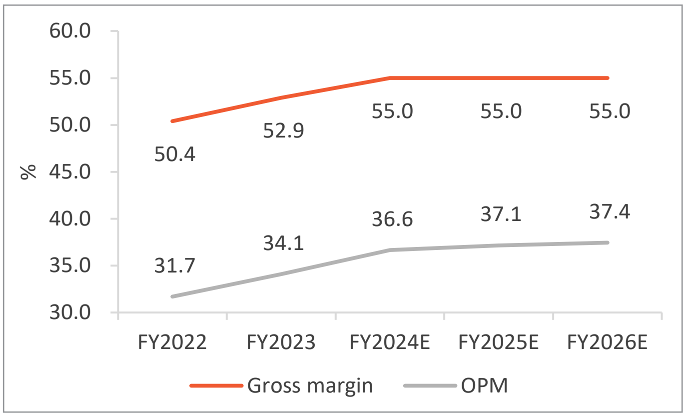
Financials in charts

Revenue & PAT to rise at 11% and 13% CAGR



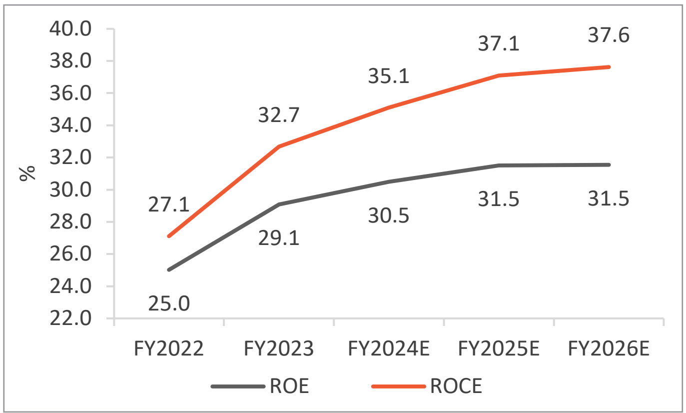
Source: Company, Sharekhan Research

Margins to improve from FY23 levels



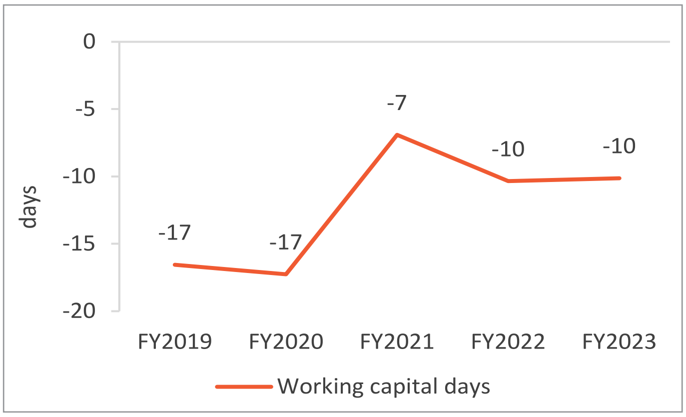
Source: Company, Sharekhan Research

Sharp rise in return ratios



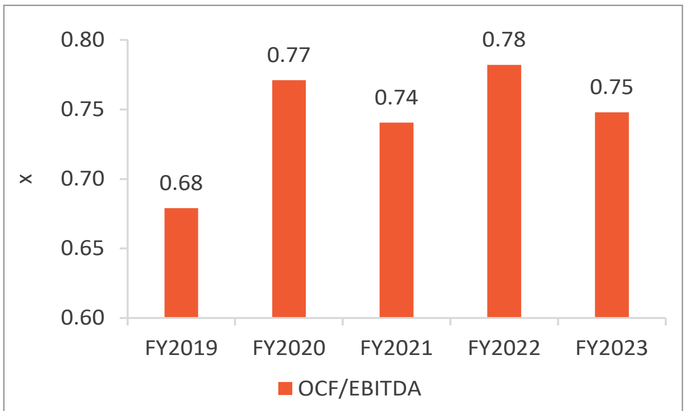
Source: Company, Sharekhan Research

Trend in working capital days



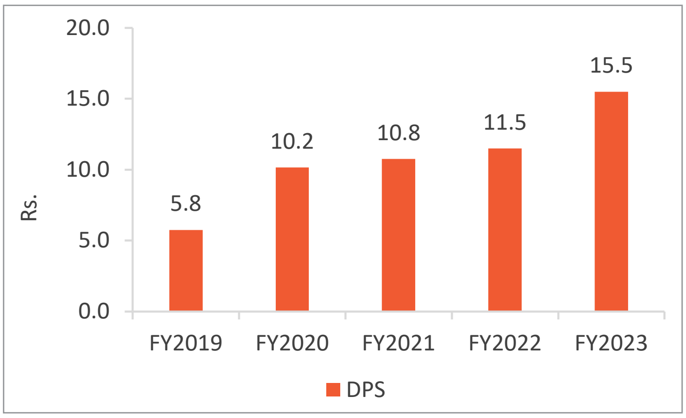
Source: Company, Sharekhan Research

Strong OCF/EBITDA



Source: Company, Sharekhan Research

Consistent dividend payout



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector view - Tax rate hike remains a risk for cigarettes; FMCG to perform well

The domestic cigarettes industry was affected in the past by a sustained rise in taxes and regulatory regime along with a sharp rise in illegal trade in the past few years, especially at the premium end, which continues to pose significant challenges to the legal cigarettes industry. However, in recent times, the government has undertaken stringent actions to curb illicit cigarette sales volume. This along with lower price hikes in the cigarette portfolio will help cigarette companies post better volume growth. On the FMCG front, normal, widespread monsoons and government support (especially prior to elections) might help rural demand gradually pick up. For margins, stable raw material prices post the recent correction in some of the key inputs (including crude oil and vegetable oils) will help margins consistently improve in the coming quarters.

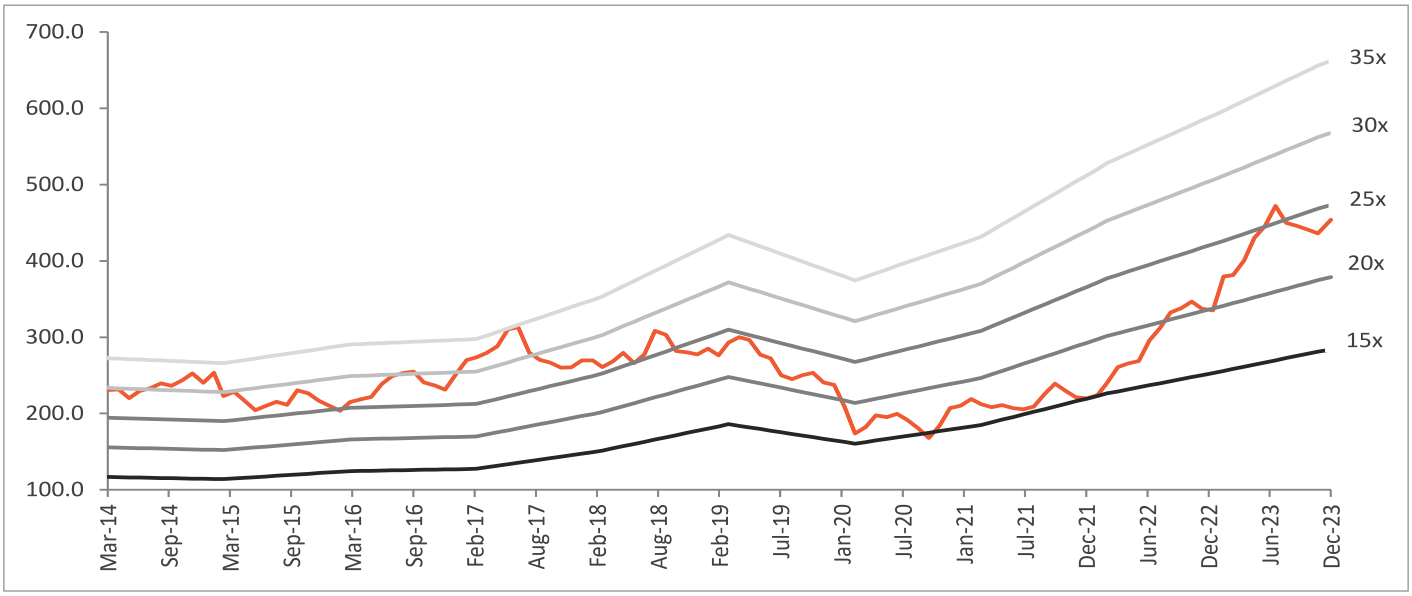
■ Company outlook - Cigarette sales momentum to sustain; FMCG margins to scale up

In H1FY2024, revenues declined by 2.2% y-o-y to 34,701 crore, OPM expanded by 352 bps y-o-y to 38% and PAT grew by 13.8% y-o-y to Rs. 9,830 crore. Cigarette volume growth momentum to sustain with the government not increasing taxes on cigarettes for the second consecutive year. Market coverage for FMCG products was stepped up to 2x pre-pandemic levels. Direct reach enhancement was around 1.25x over pre-pandemic levels, strong traction to product launches, and an increase in e-commerce salience to ~10% will help the non-cigarette FMCG business's revenue to consistently grow in mid-teens to high teens in the coming years. PBIT margin of the business will improve, led by efficiencies and scale-up in the contribution of new businesses. FY2024 and FY2025 will continue to be strong years for the hotels business due to higher demand from domestic leisure travel, improvement in MICE segment and corporate travels, and expected comeback in foreign tourist arrivals.

■ Valuation - Retain Buy with an unchanged PT of Rs. 515

The company has carved its growth plan very well by focusing on growing the core businesses, building-up the emerging business and investing in new vectors in the coming years that will be supported by prudent capital investment funded by higher cashflows. This will help earnings grow in double digits in the coming years. The stock continues to trade at attractive valuation of 23x/20x its FY2025E/26E earnings. We maintain our Buy recommendation on the stock with an unchanged PT of Rs. 515.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer Comparison

Companies	P/E (x)			EV/EBITDA (x)			RoCE (%)		
	FY23	FY24E	FY25E	FY23	FY24E	FY25E	FY23	FY24E	FY25E
Hindustan Unilever	58.7	54.0	47.3	42.7	38.7	33.4	25.6	28.0	31.1
ITC	29.5	25.8	22.8	22.9	19.8	17.3	32.7	35.1	37.1

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 1.5x each over FY2019-FY2023.

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 FY2023 with double-digit revenue and PAT growth. We expect the momentum to sustain in 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. Post demerging of asset-heavy hotels business, the return profile of ITC will substantially improve in the coming years.

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	29.02
2	Life Insurance Corp of India	15.21
3	Unit Trust of India	7.81
4	SBI Funds Management Ltd	3.12
5	Capital Group of Cos Inc	1.76
6	General Insurance Corp of India	1.73
7	GQG Partners LLC	1.48
8	New India Assurance Co Ltd	1.48
9	HDFC AMC	1.10
10	Oriental Insurance Co Ltd	1.09

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

Sharekhan

by BNP PARIBAS

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