Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

ITC Ltd

Risk-reward favourable

Consumer Goods		Sharekhan code: ITC		
Reco/View: Buy	↔	CMP: Rs. 422	Price Target: Rs. 515	↔

↑ Upgrade ↔ Maintain ↓ Downgrade

Summary

- We reiterate our Buy on ITC with an unchanged PT of Rs. 515. Post the recent correction in the stock price, valuation at 22x/20x its FY2025E/FY2026E EPS looks attractive with favourable risk reward.
- Major uncertainties hovering around the stock are over, as BAT has sold 3.5% stake in the company. BAT is unlikely to reduce its stake below 25%.
- Business fundamentals of ITC are intact with steady growth in the core cigarette business and non-cigarette FMCG business witnessing consistent improvement in EBITDA margins.
- Efficient capital allocation plan and strong dividend payout make it a preferred pick in the large-cap FMCG space with attractive valuations.

British American Tobacco (BAT) sold its 3.5% stake in ITC at ~Rs. 400 per share through a block deal. Thus, uncertainties lingering around BAT's stake sale are no more, unless it decides to sell an additional stake in ITC in the coming months. Post the stake sale, BAT will hold a 25.5% stake in ITC and is unlikely to reduce its stake below 25% in the near term. Business fundamentals of ITC are intact with the core cigarette business likely to see consistent improvement in volume growth (recovered to 0.96x of FY2013 cigarette sales volume) in the backdrop of a stable cigarette tax environment, while the non-cigarette FMCG business is seeing consistent improvement in profitability in the past few years. The company has strategies in place to achieve consistent double-digit earnings growth in the coming years. The stock has corrected by ~12% from its recent high and is trading at an attractive valuation. Given that the uncertainties related to the stake sale are over, we believe it is the right time to enter into a quality large-cap company in the FMCG space with attractive valuations and a good dividend distribution policy.

- **Uncertainties related to BAT's stake sale are over:** BAT sold 43.7 crore shares (3.5% of its stake) at an average price of Rs. 400 per share via a block deal. Post the stake sale, BAT will hold a 25.5% stake in ITC. It is unlikely to reduce its stake below 25%. Any further stake sale can happen after 180 days of the locking period. Post the stake sale by BAT, there will not be any major uncertainties hovering around the stock. This will reduce stress on ITC's stock, which corrected ~12% from its high post the news of BAT selling its stake in ITC.
- **Long-term business fundamentals intact:** The company is focusing on growth avenues in every business it operates to drive consistent growth: 1) Cigarette – by gaining share from illicit cigarettes, 2) Foods – play on the theme of a shift from unbranded to branded products, 3) Agri products – increase the contribution of value-added products, and 4) Personal care – reshape the portfolio to improve growth prospects. Contribution of the non-cigarette business has increased to 27% from ~17% in FY2013. The key pillar for scale-up in the contribution of the non-cigarette business was other FMCG business, which grew by almost 5x over the same period with EBIDTA margin consistently improving to low double digits. With strategies in place, we expect fast scale-up in the non-cigarette FMCG business and EBITDA margins improving by 100-150 bps per annum in the coming years.
- **Strong cash flow generation with prudent capital allocation plan and consistent dividend payout:** ITC is planning to do a capex of Rs. 3,000-3,400 crore p.a. Out of this, 35-40% would be for putting capacities in core and new segments in FMCG business, 30-35% to expand capacity under the paper business (existing 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 the organic and inorganic initiatives will be done through internal accruals. Along with a prudent capital allocation plan, the company has always rewarded its shareholders with a good dividend payout (stood at Rs. 1,02,000 crore for 10 years, which is higher than free cash generation of Rs. 95,000 crore during the same period).

Our Call

View – Retain Buy with an unchanged PT of Rs. 515: Major uncertainties hover around ITC's stock are over as BAT has sold its 3.5% stake in the company. ITC has carved its growth plan very prudently by focusing on growing the core business, building up the emerging business, and investing in new vectors in the coming years. This will be supported by prudent capital investment funded by higher cashflows in the coming years. This will help the company's earnings to grow in double digits in the coming years. The stock has corrected by ~12% from its recent high and is trading at 22x and 20x its FY2025E and FY2026E earnings. Risk reward is favourable in the quality large-cap space with a consistent growth outlook and a good dividend payout policy. We maintain our Buy rating on the stock with an unchanged SOTP-based target price (TP) of Rs. 515.

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	FY23	FY24E	FY25E	FY26E
Revenues	70,251	70,413	79,370	89,195
OPM (%)	34.1	37.3	37.3	37.6
Adjusted PAT	18,700	20,699	23,139	26,125
Adjusted EPS (Rs.)	15.1	16.7	18.6	21.0
P/E (x)	27.5	24.9	22.3	19.7
P/B (x)	7.8	7.2	6.6	5.8
EV/EBIDTA (x)	21.3	19.4	17.2	15.1
RoNW (%)	29.1	29.5	30.3	30.8
RoCE (%)	32.7	33.1	34.7	35.6

Source: Company; Sharekhan estimates

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		↔	

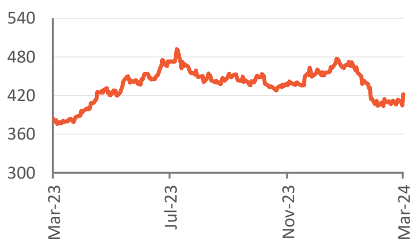
Company details

Market cap:	Rs. 5,27,217 cr
52-week high/low:	Rs. 500 / 370
NSE volume: (No of shares)	120.4 lakh
BSE code:	500875
NSE code:	ITC
Free float: (No of shares)	1,247.6 cr

Shareholding (%)

Promoters	0.0
FII	44.1
DII	42.0
Others	13.9

Price chart



Price performance

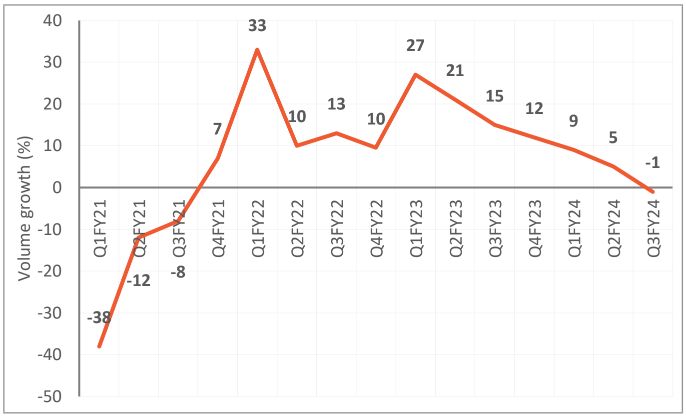
(%)	1m	3m	6m	12m
Absolute	3.7	-7.4	-6.9	10.0
Relative to Sensex	2.1	-12.0	-14.8	-14.9

Sharekhan Research, Bloomberg

Cigarette business volumes to grow by 4-5% in the near term

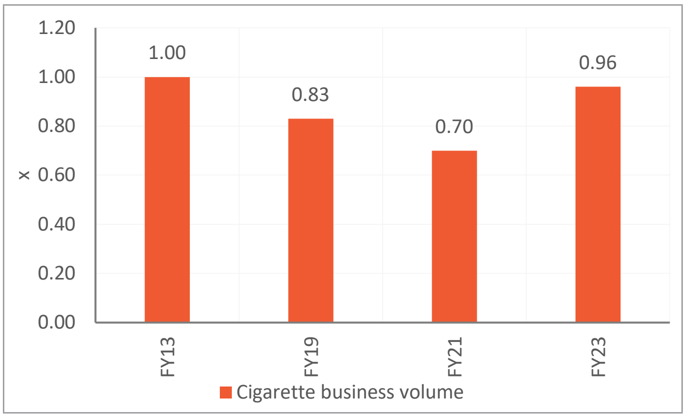
In a stable tax regime, ITC was able to claw back sales volume from illicit cigarettes in the last five years. The company's volumes have recovered to 0.96x of sales volume achieved in FY2013. Illicit cigarette contributes about one-third of overall cigarette sales in India. Continuance of a stable tax policy and relevant portfolio intervention will help ITC achieve steady volume growth in its core cigarette business in the coming years. We expect ITC's cigarette sales volume to grow by 4-5% in the near term unless there is no major increase in the tax rates of cigarettes.

Trend in ITC's cigarette sales volume growth



Source: Company, Sharekhan Research

Recovery in ITC's cigarette sales volume

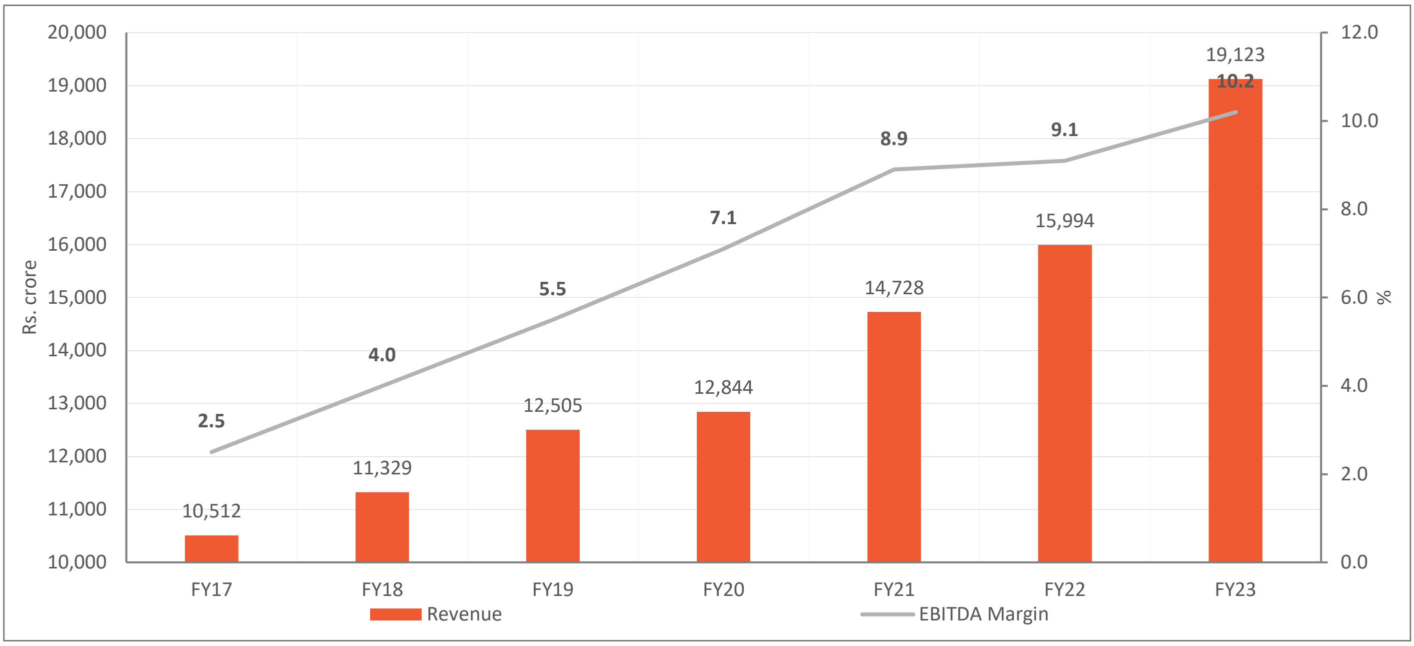


Source: Company, Sharekhan Research

Non-cigarette FMCG business to see consistent margin improvement

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

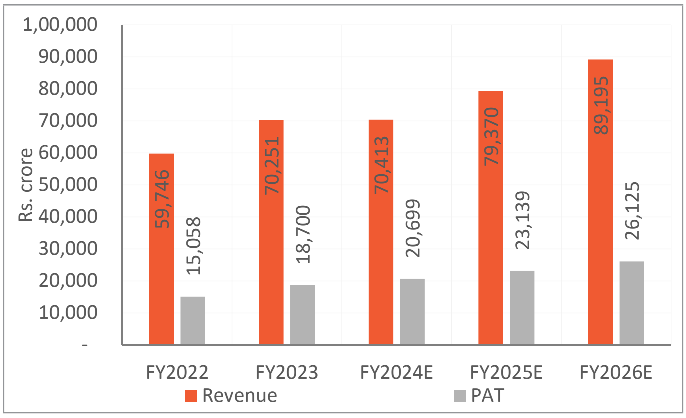
Rise in FMCG revenue and margins



Source: Sharekhan Research

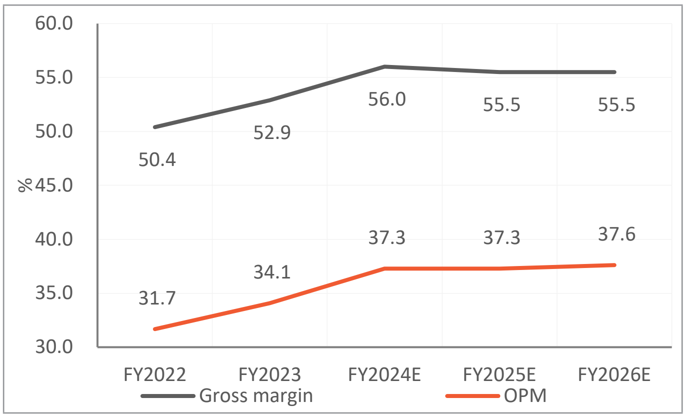
Financials in charts

Revenue and PAT to rise at 8% and 12% CAGR



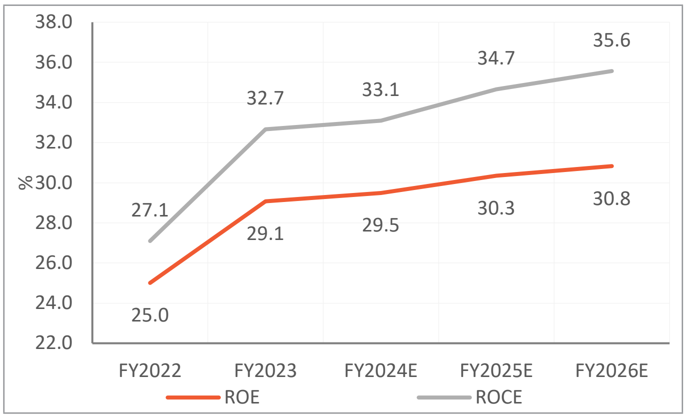
Source: Company, Sharekhan Research

Margins to improve from FY2023 levels



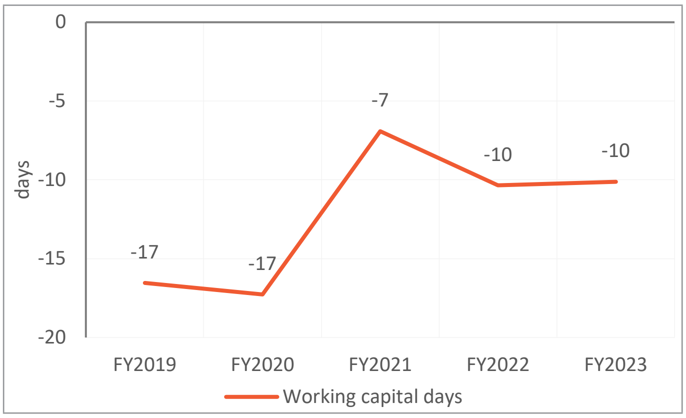
Source: Company, Sharekhan Research

Sharp rise in return ratios



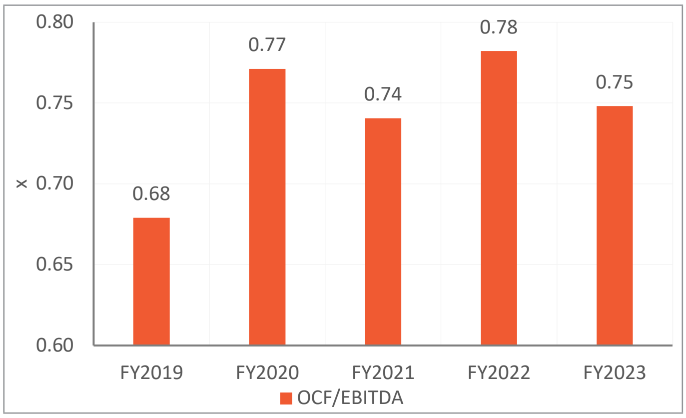
Source: Company, Sharekhan Research

Trend in working capital days



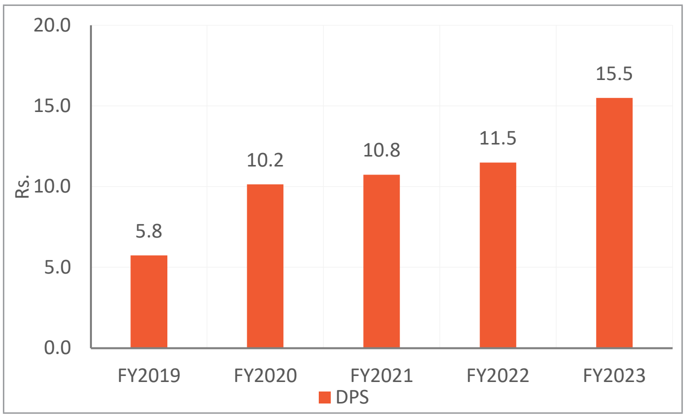
Source: Company, Sharekhan Research

Strong OCF/EBITDA



Source: Company, Sharekhan Research

Consistent dividend payout



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector Outlook – Tax rate hike remains a risk for cigarettes; FMCG to perform well

The domestic cigarette industry in the past was affected by a sustained rise in taxes and regulatory regime along with a sharp increase in illegal trade in the past few years, 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. 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 before the elections) might help rural demand to 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 to consistently improve in the coming quarters.

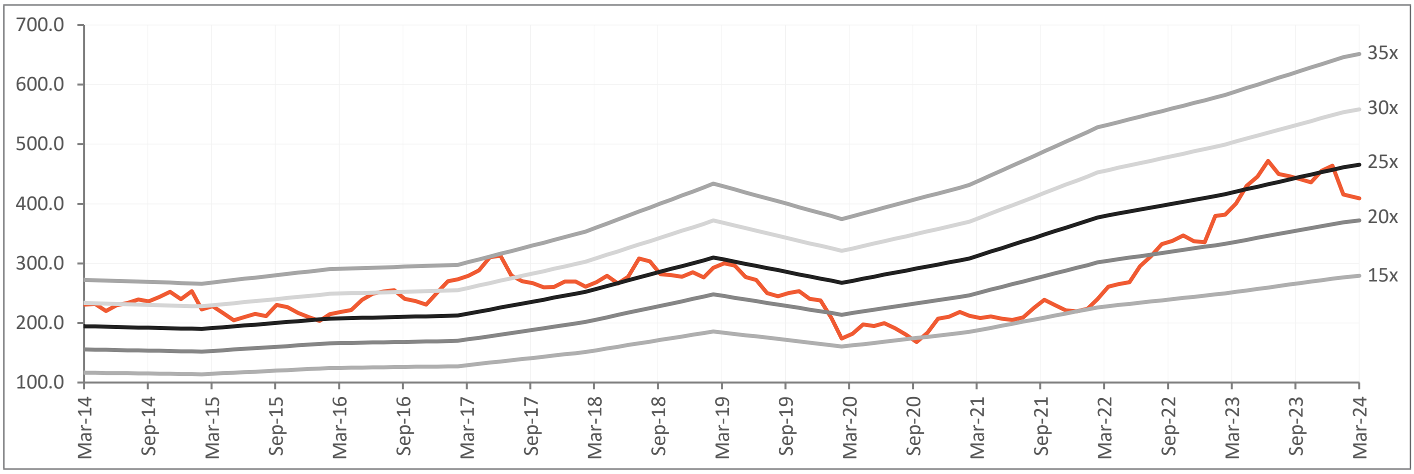
■ Company Outlook – Cigarette sales momentum to sustain; FMCG margins to scale up

Cigarette volume growth momentum is expected to sustain with the government not increasing taxes on cigarettes for the second consecutive year. In the near term, a higher base will lead to lower growth in the cigarette business. 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 increased 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. A good monsoon will lead to some recovery in rural demand. 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 the MICE segment and corporate travels, and an expected comeback in foreign tourist arrivals.

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

Retain BUY with an unchanged PT of Rs. 515: Major uncertainties hover around ITC's stock are over as BAT has sold its 3.5% stake in the company. ITC has carved its growth plan very prudently by focusing on growing the core business, building up the emerging business, and investing in new vectors in the coming years. This will be supported by prudent capital investment funded by higher cashflows in the coming years. This will help the company's earnings to grow in double digits in the coming years. The stock has corrected by ~12% from its recent high and is trading at 22x and 20x its FY2025E and FY2026E earnings. Risk reward is favourable in the quality large-cap space with a consistent growth outlook and a good dividend payout policy. We maintain our BUY rating on the stock with an unchanged SOTP-based TP of Rs. 515.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer Comparison

Particulars	P/E (x)			EV/EBITDA (x)			RoCE (%)		
	FY23	FY24E	FY25E	FY23	FY24E	FY25E	FY23	FY24E	FY25E
Hindustan Unilever	54.4	52.7	47.8	39.5	37.3	33.6	25.6	27.0	29.1
ITC	27.5	24.9	22.3	21.3	19.4	17.2	32.7	33.1	34.7

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 2.5x each over FY2013-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 the demerging of the asset-heavy hotels business, the return profile of ITC will substantially improve going ahead.

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 and Company Secretary

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	British American Tobacco PLC	25.50
2	Life Insurance Corp of India	15.20
3	Unit Trust of India	7.81
4	SBI Funds Management Limited	3.07
5	GQG Partners LLC	1.75
6	General Insurance Corp. of India	1.74
7	Capital Group of Cos Inc.	1.66
8	New India Assurance Co. Limited	1.47
9	ICICI Prudential AMC Limited	1.26
10	HDFC AMC Limited	1.15

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

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