8 December 2020

Company Update | Sector: Consumer

ITC

BSE SENSEX	S&P CNX
45,609	13,393

CMP: INR202 TP: INR200 (-1%) Neutral

Muted earnings and ROEs limit upside

Cigarettes EBIT dependence to remain unaltered by ongoing 'Other FMCG' growth

We retain our Neutral rating on the ITC stock due to the following factors:

- **While ITC efforts on the overall ESG (environmental, social, and corporate governance) front are truly commendable, the concern over its Cigarettes business from an ESG perspective remains at play – as more funds turn ESG-compliant (both globally and in India), affecting the valuations of global cigarette companies, including ITC.**
- **Even if ongoing growth and profitability improvement in 'Other FMCG' leads to a 50% EBIT growth CAGR over FY20–23E, the Cigarettes business' contribution to overall EBIT just barely reduces from 85% in FY20 to 82% in FY23E. Hence, this does not really move the needle from a Cigarettes dependency perspective. Part of the margin growth in 'Other FMCG' in 1HFY21 could also be ephemeral, driven by a combination of elevated in-home consumption and soft commodity costs (which have very high benefits for low gross margin companies).**
- **In our view, the possibility of GST hikes in the Feb'21 budget or any of the GST council meets remains high given weak government finances amid the current COVID environment. Importantly, even in the 31-month period between Jul'17 (GST increase) and Feb'20 (NCCD increase) – when there was no GST increase in Cigarettes – cigarette volumes and EBIT performance had been tepid.**
- **The earnings growth outlook in the latter half of the last decade, considerably weakened v/s the former half, and ROEs saw sharp decline (despite corporate tax cuts). The FY20–FY23E outlook does not appear likely to change on either of these fronts. PBT growth in the last 5 years has been ~6.6% and is likely to be around 7.3% in the next 3 years. With acquisition-led growth gaining traction and self-imposed near-term moratorium on substantial capex eventually being lifted, ROE could come under further pressure over the medium term.**

Key issues plaguing ITC

- **ESG-related concerns on Cigarettes remain prominent –** ITC's historical focus on the 'triple bottom line' has meant that in the broader ESG framework, its performance has been remarkably good. However, its high dependence on the Cigarettes business has come under scrutiny of sustainability-compliant investors worldwide in recent years. Notably, Philip Morris and BAT have witnessed 31% and 54% contractions, respectively, in their multiples in the last three years. Along similar lines, with ~ 85% of ITC's EBIT coming from Cigarettes even in FY20 the stock also saw significant correction in multiples. The ESG-related multiples contraction is not likely to abate anytime soon, leading to continued selling from funds that are turning ESG-compliant in both India and globally.

ITC Limited

Stock Info

Bloomberg	ITC IN
Equity Shares (m)	12,259
M.Cap.(INRb)/(USDb)	2491.2 / 34
52-Week Range (INR)	248 / 135
1, 6, 12 Rel. Per (%)	8/-30/-30
12M Avg Val (INR M)	5231
Free float (%)	100.0

Financials & Valuations (INR b)

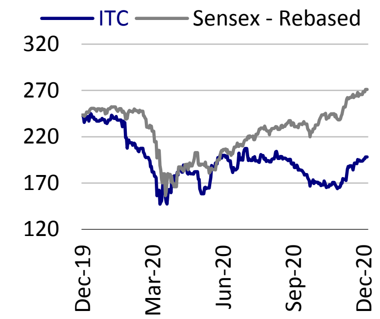
Y/E March	2020	2021E	2022E	2023E
Sales	456.2	428.0	497.7	543.0
Sales Gr. (%)	1.4	-6.2	16.3	9.1
EBITDA	179.3	152.6	197.4	220.2
EBITDA Mrg.(%)	39.3	35.6	39.7	40.6
Adj. PAT	152.7	125.9	160.1	178.5
Adj. EPS (INR)	12.4	10.2	13.0	14.5
EPS Gr. (%)	22.2	-17.6	27.2	11.5
BV/Sh.(INR)	52.1	55.0	58.5	62.3
Ratios				
RoE (%)	25.0	19.1	22.9	24.0
RoCE (%)	24.3	18.7	22.5	23.6
Payout (%)	82.4	80.0	80.0	80.0
Valuations				
P/E (x)	16.3	19.7	15.5	13.9
P/BV (x)	3.9	3.7	3.5	3.2
EV/EBITDA (x)	11.7	13.6	10.4	9.2
Div. Yield (%)	5.0	4.1	5.2	5.8

Shareholding pattern (%)

As On	Sep-20	Jun-20	Sep-19
Promoter	0.0	0.0	0.0
DII	43.5	42.0	42.4
FII	13.1	14.7	15.8
Others	43.5	43.3	41.8

FII Includes depository receipts

Stock Performance (1-year)



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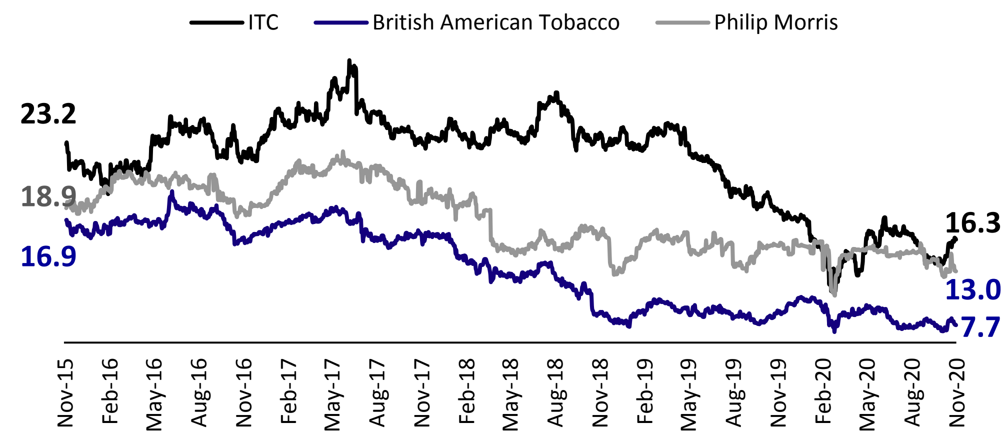
- **Ongoing strong growth in Other FMCG EBIT does not materially reduce Cigarettes biz's contribution in overall EBIT mix even in FY23E –** The 'Other FMCG' business is seeing strong topline momentum in 1HFY21 owing to the healthy in-home consumption of noodles, biscuits, snacks, and *atta* (wheat flour) amid the COVID environment. Even more impressive is the margin expansion seen in the current year as a result of (1) soft commodity costs, (2) low trade discounts (on healthy demand), (3) likely lower ad spends to sales, and (4) relatively lower capex across segments for the next two years – as indicated by the company towards the end of last year given the weak overall environment at the time. Several of these factors are not sustainable given (1) in-home consumption led demand in 1HFY21, (2) extremely soft commodity prices, which benefit low-margin businesses more, and (3) likely lower ad spends, in line with peers, which have already started normalizing. Even if one assumes a healthy 50% EBIT CAGR in Other FMCG over the next two years, ITC's dependence on the Cigarettes business at an EBIT level does not change materially between FY20 (85%) and FY23E (82%). As a result, overall earnings growth and multiples remain under pressure. The Other FMCG segment's contribution to overall EBIT remains below 7% even in FY23E. This is partly attributable to the huge differential in EBIT margins between Cigarettes (~70%) and Other FMCG (7.9% even in FY23E).
- **Cigarettes biz volumes in negative territory in FY21 for seventh year in the last 11 years –**While some of the recent impact may be ascribed to the temporary factors like the lockdown, some of which had sustained across metros and impacted supply, other factors like (1) a surprise increase in National Calamity Contingent Duty (NCCD) in the Feb'20 budget, (2) substantial price increases taken post the NCCD increase, and (3) the vast illegal Cigarettes market may recur. It is notable that even without any GST increase in the preceding 2.5 years, cigarette volumes and EBIT growth were disappointing (even prior to the COVID impact). Annual EBIT for Cigarettes has failed to reach the double digit growth in the last five years.
- **Other near- to medium-term challenges –** These include (1) downtrading within cigarettes and from lower-end cigarettes to bidis, led by a weak environment, (2) a possible further increase in GST on cigarettes, given weak central government finances, (3) the margin-dilutive impact of capsule cigarettes, and (4) growth in illegal cigarettes (~25% currently) increasing post the NCCD increase in the Feb'20 budget and a possible GST increase going forward. This would lead to a higher impact for organized cigarette players as they would lose consumers, while retailers would get perverse incentive to focus on illegal cigarettes. We expect cigarette volumes to be in the negative CAGR zone in FY21–23E.
- **Earnings growth trajectory unlikely to recover materially –** The mid-single-digit PBT trend witnessed in the past five years would continue. Despite the corporate tax cuts (of which ITC is a significant beneficiary), return ratios have come off by ~1000bp from the mid-30 levels seen during 2011–15.

Valuation and view

- The earnings growth trajectory is unlikely to recover significantly from the mid-single-digit PBT trend in the past five years. While PBT CAGR was 6.6% in the last five years, it is likely to be around 7.3% between FY20-FY23E as per our forecasts.
- Despite the corporate tax cuts (of which ITC was a significant beneficiary), return ratios have come off by ~1000bp from the mid-30 levels seen during 2011–15. If a sustained high dividend payout beyond the stated 80-85% levels, combined with lower capex (given the weak demand environment), eventuates, it would offer some respite amidst a tough outlook for ITC's revenue growth and earnings growth prospects.
- A strong dividend yield alone is not enough of a comfort, particularly as it is in line with global peers in the Cigarettes business.
- Despite ongoing improvement in Other FMCG metrics, no material shift is likely in EBIT dependence on the Cigarettes business. The business' contribution to total EBIT is likely to be 82% in FY23E v/s around 85% in FY20.
- Valuations would trade closer to global tobacco peers given (1) the dependence on the Cigarettes business remaining high, as in the past (82% of EBIT even in FY23E), (2) far weaker earnings growth and ROCE v/s the former part of the decade, and (3) the persistent risk of further ESG-based selling by investors. BAT trades at 8.1x CY21 EPS and Philip Morris at 13.9x CY21 EPS. Taking the average multiples of these two global peers and giving ITC a ~30% premium, as well as rolling forward to December 2022 EPS, we get TP of INR200 (14x December 22 EPS). Maintain **Neutral**.

Exhibit 1: One-year forward P/E multiples (x) of global cigarette players decline sharply in recent years



Source: Company, MOFSL

ITC's remarkable 'triple bottom line' efforts at sustainability

- ITC's sustainability strategy is aimed at creating significant value for the nation through a superior 'triple bottom line' performance that builds and enriches the country's economic, social, and environmental capital.
- ITC is the only company, in the world of comparable dimensions, to have achieved the global environmental distinction of being carbon-positive (for 15 consecutive years), water-positive (for 18 years in a row), and solid waste recycling positive (for 13 years in succession). All of this data is as of FY20.
- In FY20, around 41% of ITC's total energy requirements were met from renewable energy sources – such as biomass, wind, and solar – despite the addition of several integrated consumer goods manufacturing and logistics (ICML) facilities.
- For the past 13 years ended FY20, the company has been recycling over 98% of the solid waste generated by its units, and over 99% was recycled during the year. Additionally, around 85,000MT of externally sourced post-consumer waste paper was used as raw material during the year.
- ITC has been ranked no. 1 globally among peers with market capitalizations of USD38–51b, and overall no. 3 globally on ESG performance in the Food Products industry by Sustainalytics – a renowned global ESG ratings company. ITC has been rated 'AA' by MSCI-ESG – the highest among tobacco companies globally.
- ITC has recently launched a first-of-its-kind model for the sustainable management of multi-layered plastic packaging waste in Pune in partnership with SWaCH – a leading waste-pickers' cooperative – and with active patronage and cooperation from the Pune Municipal Corporation. Leveraging the resident expertise from the ITC Life Sciences and Technology Centre, the company has found viable options to convert multi-layered plastic waste into useful items of consumption. Efforts are underway to scale up this initiative and replicate the model in other parts of the country.

Exhibit 1: ITC – transforming lives and landscapes

Source: Company, MOFSL

Stock price underperformance – the earnings and return ratios factor

- ITC’s share price has seen sharp decline after its 3QFY20 results, exacerbated by the NCCD imposed in the budget the following day.
- The stock has actually been the biggest underperformer by far among the large-cap consumer companies from a stock price front in the past six years.

Exhibit 2: ITC’s stock price significantly underperforms v/s peers

Companies (INR)	30’Nov'14	30’Nov'20	CAGR (%)
BRIT	824.7	3,634.1	28.0%
PIDI	459.6	1,528.7	22.2%
APNT	743.7	2,217.35	20.0%
NEST	6,226.1	17,657.6	19.0%
HUVR	786.6	2,137.2	18.1%
PAGE	9,491.8	22,761.8	15.7%
MRCO	161.65	364.95	14.5%
GCPL	317.43	699.8	14.1%
Dabur	241.1	499.6	12.9%
PGHH	5,579.5	10,552.4	11.2%
CLGT	929.5	1,508.9	8.4%
Emami	386.3	441.25	2.2%
ITC	**242**	**193.7**	**-3.6%**

Source: Company, MOFSL

- Topline and earnings growth have been tepid in the past five years v/s the preceding five years.
- ROE and ROCE have also come down significantly in the past decade.

Exhibit 3: Topline and earnings growth tepid for the past five years…

Y/E March (INR b)	2015	2016	2017	2018	2019	2020	5Y CAGR (%)
Revenue	**365**	**366**	**401**	**406**	**450**	**456**	**4.6**
Change (%)	9.8	0.2	9.6	1.3	10.8	1.4	
EBITDA	**135**	**137**	**146**	**156**	**173**	**179**	**5.8**
Change (%)	8.2	1.8	6.3	6.6	11.3	3.5	
Margin (%)	37.0	37.6	36.4	38.3	38.5	39.3	230bp
Profit before Taxes	**140**	**144**	**155**	**164**	**184**	**193**	**6.6**
Change (%)	10.6	3.1	7.4	6.0	12.2	4.6	
Margin (%)	38.3	39.5	38.7	40.5	41	42.3	400bp
Profit after Taxes	**96**	**93**	**102**	**108**	**125**	**153**	**9.7**
Change (%)	9.4	-2.9	9.4	6.0	15.3	22.5	
Margin (%)	26.3	25.5	25.4	26.6	27.7	33.5	720bp

Source: Company, MOFSL

Exhibit 4: … Compared with preceding five years

Y/E March (INR b)	2010	2011	2012	2013	2014	2015	5Y CAGR (%)
Revenue	**184**	**215**	**251**	**299**	**332**	**365**	**14.7**
Change (%)	16.4	16.7	17.2	18.9	11.2	9.8	
EBITDA	**63**	**74**	**89**	**106**	**125**	**135**	**16.3**
Change (%)	24.8	17.1	19.6	20.1	17.2	8.2	
Margin (%)	34.4	34.5	35.3	35.6	37.5	37.0	260bp
Profit before Taxes	**60**	**73**	**89**	**107**	**127**	**140**	**18.4**
Change (%)	24.7	20.8	22.4	20.1	18.5	10.6	
Margin (%)	32.7	33.9	35.4	35.7	38.1	38.3	560bp
Profit after Taxes	**41**	**50**	**62**	**74**	**88**	**96**	**18.7**
Change (%)	24.7	22.6	23.6	20.4	18.4	9.4	
Margin (%)	22.1	23.2	24.5	24.8	26.4	26.3	420bp

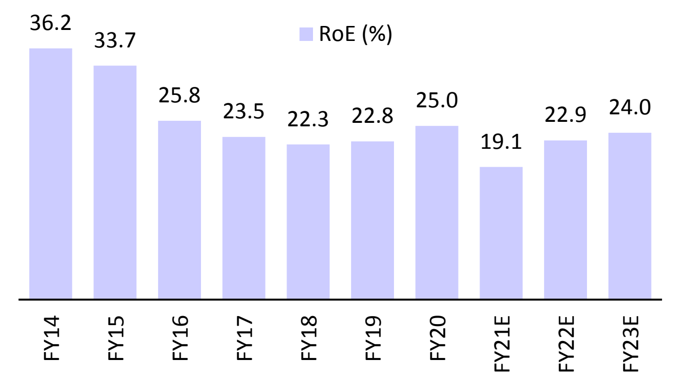
Source: Company, MOFSL

Exhibit 5: Do not expect any material change over the next three years

Y/E March (INR b)	2020	2021E	2022E	2023E	3Y CAGR (%)
Revenue	**456**	**428**	**498**	**543**	**6.0**
Change (%)	1.4	-6.2	16.3	9.1	
EBITDA	**179**	**153**	**197**	**220**	**7.1**
Change (%)	3.5	-14.9	29.4	11.6	
Margin (%)	39.3	35.6	39.7	40.6	130bp
Profit before Taxes	**193**	**168**	**214**	**239**	**7.3**
Change (%)	4.6	-12.9	27.2	11.5	
Margin (%)	42.3	39.3	43.0	43.9	160bp
Profit after Taxes	**153**	**126**	**160**	**179**	**5.4**
Change (%)	22.5	-17.6	27.2	11.5	
Margin (%)	33.5	29.4	32.2	32.9	-60bp

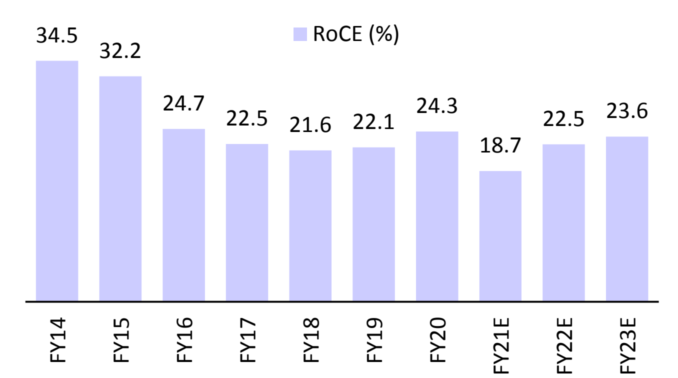
Source: Company, MOFSL

Exhibit 6: RoE to remain low…



Source: Company, MOFSL

Exhibit 7: …and ROCE to report similar trend

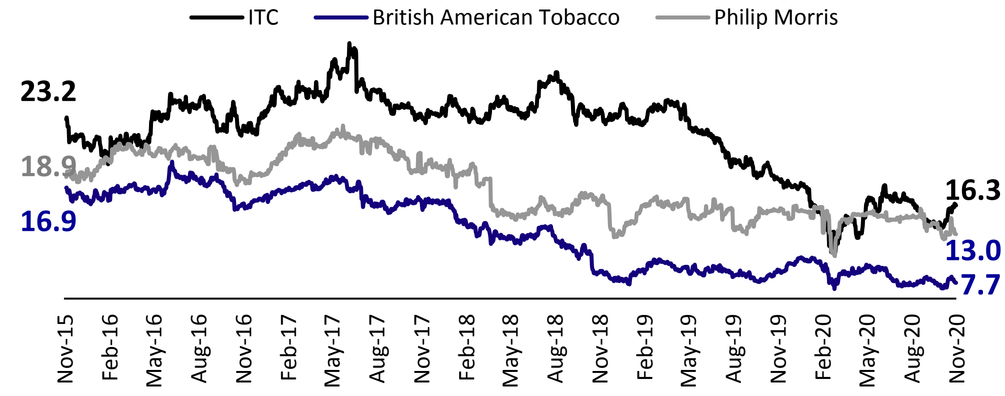


Source: Company, MOFSL

Stock price underperformance – the ESG factor

- The bigger factor affecting share price has been the P/E multiple's compression based on the ESG consideration. Under this, Cigarette players across the world have been significantly affected as investors are increasingly turning sustainability compliant, both in India and globally
- The sharp rate at which the one-year forward P/E multiples of global cigarette players have declined in recent years clearly indicates the global trend at play on ITC's stock.

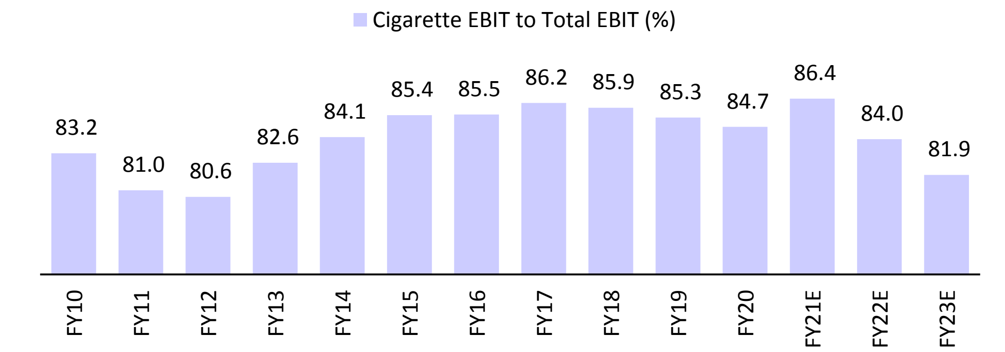
Exhibit 8: One-year forward P/E multiples (x) of global cigarette players decline sharply in recent years



Source: Company, MOFSL

- ITC has been able to diversify in the last 10 years from a sales perspective, with Cigarettes now accounting for close to 40% of sales. Nevertheless, its continued high EBIT contribution from the segment remains a major factor driving down overall stock price performance – in light of ESG concerns around the Cigarettes business.
- Even with strong EBIT growth in the Other FMCG segment, the contribution of Cigarettes to overall EBIT is unlikely to decline much. From 85% in FY20, this is likely to reduce to just 82% in FY23E. Accordingly, the ESG concerns of investors are unlikely to abate anytime soon.

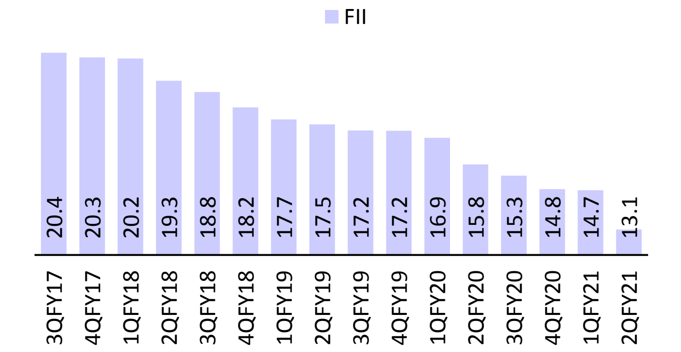
Exhibit 9: High EBIT contribution from Cigarettes



Source: Company, MOFSL

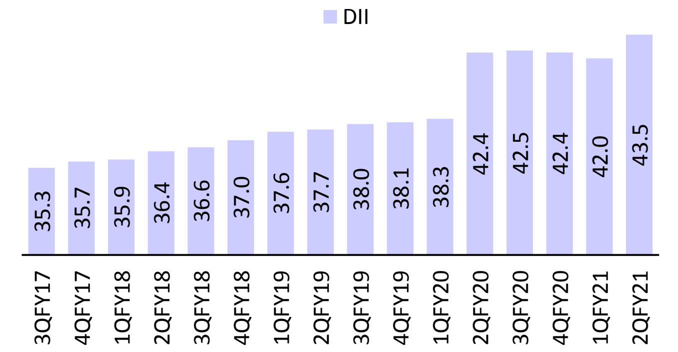
- Global ESG-related concerns are also reflected in the shareholding pattern changes seen in the last few years.

Exhibit 10: Global ESG-related concerns reflected…



Source: Company, MOFSL

Exhibit 11: …in shareholding pattern changes (%)



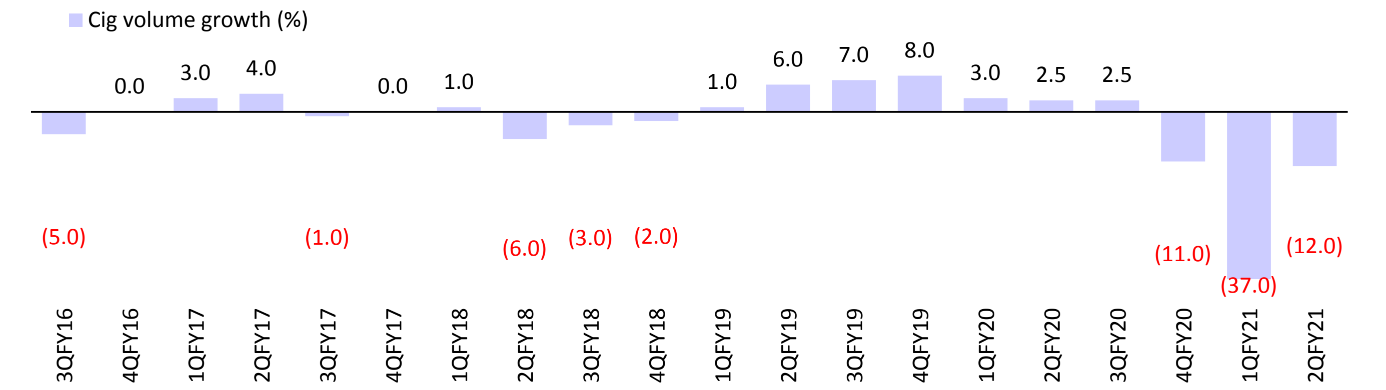
Source: Company, MOFSL

- Certain other factors are also affecting investor confidence in the stock:
  - The recent underperformance in terms of volume despite no GST hike for over 2.5 years
  - The tapering off of EBIT growth for Cigarettes in recent quarters even prior to the lockdown impact
  - The surprise increase in NCCD in the Feb'20 budget
  - The high weightage of ITC in the DII portfolio of consumer stocks due to accumulation in recent years, when FIIs were selling (as was witnessed in the table above)

GST/NCCD increases, impacting volumes

- After the increase in NCCD in the Feb' 20 budget, the company took a price increase (we reckon around 10%) that hit markets across the country in Mar'20.
- This is the first significant price increase posted in over 2.5 years, largely attributable to GST rates remaining constant between Jul'17 and the Feb'20 national budget.

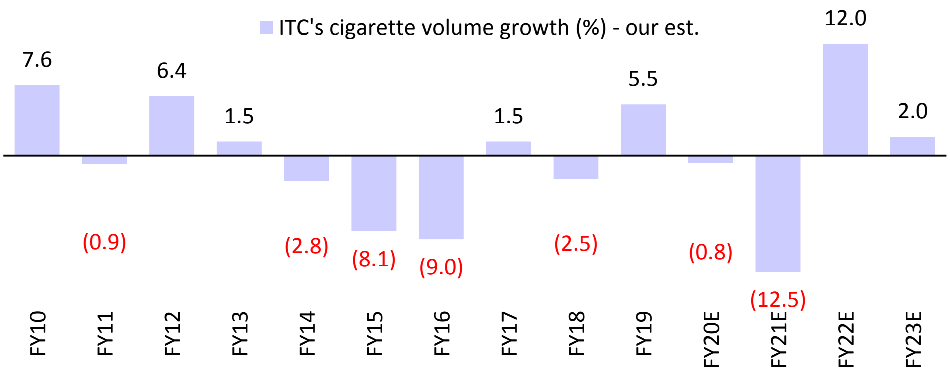
Exhibit 12: Tepid average cigarette volume growth of -2.0% in the last 20 quarters on a YoY basis



Source: Company, MOFSL

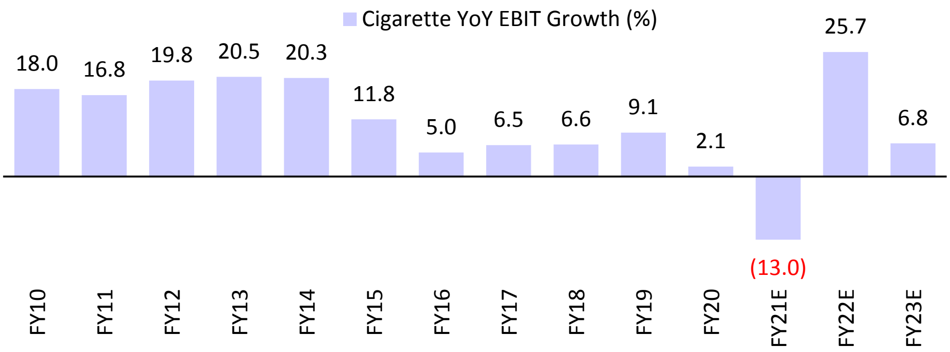
- While lockdowns have played a major role in the steep volume decline since then, price increases taken over Feb–Mar'20 were also a factor in the decline.
- Cigarette volumes are likely to see recovery in FY22 off a very weak base in FY21. Nonetheless, the two-year growth seen in volumes is still likely to be lower than the long-term average, which has also been weak.

Exhibit 13: FY21 could be seventh year of negative volume growth in last 11 years



Source: Company, MOFSL

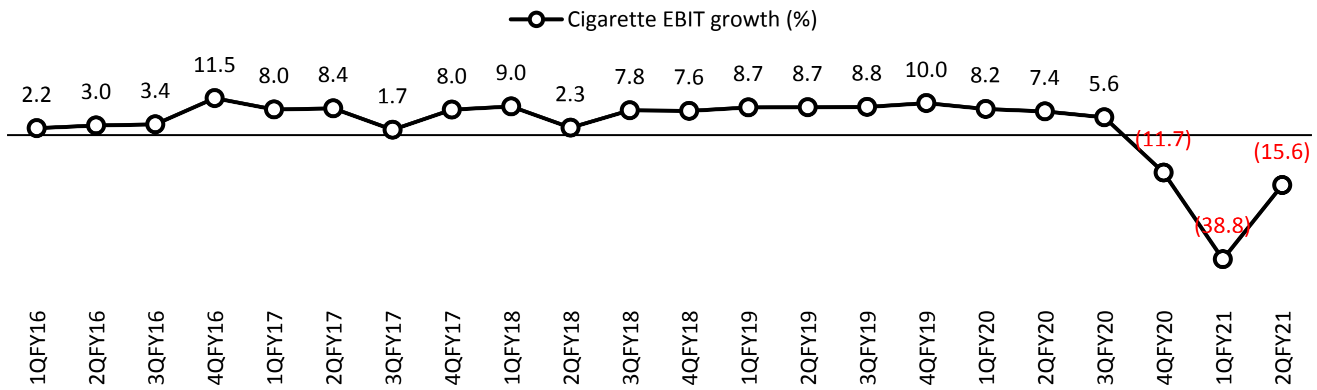
Exhibit 14: ITC has not seen double-digit EBIT growth in Cigarettes for five years in row



Source: Company, MOFSL

Neither cigarette volumes nor cigarette EBIT growth are likely to change over FY20–FY22E. We expect volume and EBIT decline at a CAGR of 1% and 5.8%, respectively, over these two years.

Exhibit 15: EBIT trend in Cigarettes worsening since before lockdown impact

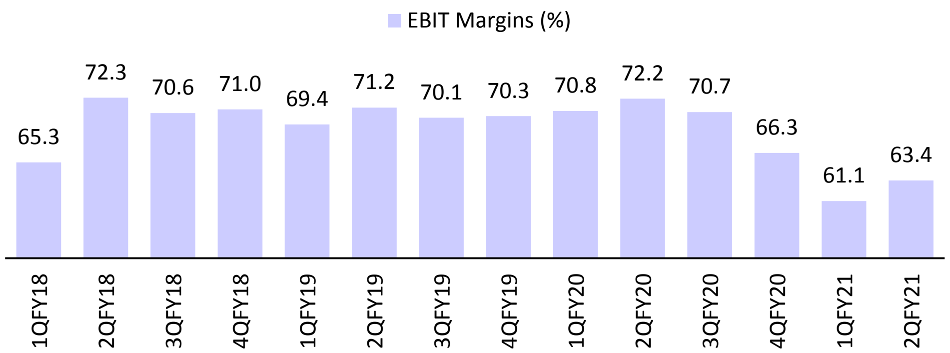


Source: Company, MOFSL

Concerns over illegal cigarette trade; bidi sales continue to grow

- With NCCD-led price increases, the gap between the pricing of legal and illegal cigarettes (which do not incur any GST) is widening. Therefore, this poses an even higher risk of the legal Cigarettes business losing further share to illegal cigarettes (~25% of the market). Recent government efforts to crack down on illegal trade, if effectively implemented, may mitigate some of the damage.
- The threat of illegal cigarettes is concerning not only due to their lower price points weaning away consumers but also due to their channels gaining significantly higher margins than organized players. Our channel checks indicate retailers are able to make absolute profits per pack from illegal cigarettes as high as 3–4x the profit from organized brands. This results in a perverse incentive for retailers to focus on illegal cigarettes, while causing a double whammy for organized players.
- With the NCCD increase also being higher on the lowest priced (sub-65mm) cigarettes, further concerns have emerged over downtrading to bidis. This is particularly true in rural India, which comprises segments of smokers that switch between bidis and cigarettes. A weak economic environment has already led to some downtrading within the Cigarettes category in recent quarters, which has also had an effect on cigarette EBIT margins during the period.
- We believe significant risk of a further GST increase in the Feb'21 budget remains, given weak government finances; in a weak demand environment, this could affect cigarette volumes further in FY22.

Exhibit 16: Some downtrading within Cigarettes category halts EBIT margin expansion



Source: Company, MOFSL

Capsule cigarette supply issues addressed, but profitability concerns remain for few quarters

- In recent years, before the lockdown, almost the entire growth in cigarette volumes across India was led by 'capsule cigarettes' – which release a flavor when pressed. As the pricing of the cigarettes is the same despite the addition of the capsule, an increase in the share of capsule cigarettes (now 30% of category volumes) is margin-dilutive. This is another key factor due to which cigarette EBIT margins have been weak (as observed in Exhibit 18).
- ITC had lost some market share up to 1HFY20 (overall share is still over 80%, but share in capsules is relatively lower in the mid-50% range) due to the limited local manufacturing of capsules. Thus, there was a dependence on imports, an

issue that has now been addressed through the augmentation of local production capacities.

- However, if growth in cigarettes continues to be led by mainly capsule cigarettes going forward as well, we reckon the company could reconsider its market share target and aim to protect overall profitability as well, particularly at the lower end cigarettes level.
- On the other hand, a sharper NCCD increase at the lower end segments may actually enable gains in market share (within the legal trade) as competition is more prevalent in the lower end segments.

Newer growth avenues in Other FMCG – Chocolates and Dairy priority segments

- **Chocolates** – Products under the brand 'Fabelle' are now available outside of ITC Hotels, with distribution now expanded to the general FMCG trade Channel in Bangalore. Based on these learnings, we reckon a broader rollout is likely soon.
- **Dairy** – The company is taking the gradual approach to growth, moving state by state. Currently, this ITC division supplies fresh milk and ghee in Bihar (where it was first established) and West Bengal. While the company is cognizant of the massive opportunity in the segment, we reckon it is adopting the gradual approach to expansion – as opportunities are massive in each state and ITC seeks to get the sourcing right with its entry into every new state.
- **Coffee** – This segment, which is part of the Agri business, is (for now) a large supplier to other coffee majors in the country – ITC's own brand 'Sunbeam' is only available in a few outlets. While longer term opportunity is high, our channel checks indicate the scale-up in this category would, however, be slower v/s Dairy and Chocolates over the next two years.

Other FMCG sees extraordinary growth in FY21, but dependence on Cigarettes EBIT continues

- The 'Other FMCG' business is seeing strong topline momentum in the current year due to the healthy in-home consumption of noodles, biscuits, snacks, and *atta* (wheat flour). Even more impressive is the margin expansion seen in the current year as a result of (1) soft commodity costs, (2) low trade discounts (on healthy demand), (3) likely lower ad spends to sales, and (4) relatively lower capex across segments for the next two years – as indicated by the company towards the end of last year given the weak overall environment at the time. Several of these factors are not sustainable; even if one assumes a healthy 50% EBIT CAGR in Other FMCG over the next two years, ITC's EBIT dependence on non-cigarette businesses does not change materially over FY20–FY23E. Thus, overall earnings growth and multiples would remain under pressure.
- Even after assuming a 3.4x increase in Other FMCG EBIT between FY20 and FY23E, the very sharp CAGR of ~50% may not materialize if (1) in-home consumption slows significantly v/s FY21 levels and (2) sharp inflation is seen in commodity costs v/s extremely benign levels currently. Other FMCG contribution to overall EBIT remains below 7%, partly due to the huge differential in EBIT margins between Cigarettes (~70%) and Other FMCG (7.9% even in FY23E). The share of Cigarettes in overall EBIT reduces from 85% in FY20 to only 82% in FY23E.

Exhibit 17: Segmental performance

Sales (INR b)	2018	2019	2020	2021E	2022E	2023E
Cigarettes	229	207	212	201	234	249
FMCG – Others	113	125	128	145	161	181
Hotels	14	16	18	4	12	19
Agri business	81	94	102	105	118	127
Paper and packaging	50	55	58	55	63	67
Sales growth (YoY %)						
Cigarettes	(32.7)	(9.5)	2.4	(5.0)	16.4	6.1
FMCG – Others	7.8	10.4	2.6	12.9	11.2	12.0
Hotels	5.6	17.4	10.6	(78.2)	195.6	57.1
Agri business	(2.4)	16.5	9.0	2.6	12.1	8.1
Paper and packaging	(3.1)	11.6	4.2	(10.3)	14.5	6.9
Estimated volume growth (YoY)						
Cigarettes %	(2.5)	5.5	(0.8)	(12.5)	12.0	2.0
EBIT (INR b)						
Cigarettes	133	146	149	129	162	173
FMCG – Others	2	3	4	8	11	14
Hotels	1	2	2	(6)	(1)	2
Agri business	8	8	8	7	8	9
Paper and packaging	10	12	13	11	12	13
EBIT growth (YoY %)						
Cigarettes	6.6	9.1	2.1	(13.0)	25.7	6.8
FMCG – Others	483.6	92.4	34.0	97.5	32.8	28.3
Hotels	26.0	27.1	(11.2)	P/L	-	P/L
Agri business	(6.3)	(8.5)	1.6	(15.6)	23.8	8.1
Paper and packaging	7.9	18.9	5.3	(15.3)	10.3	10.1
EBIT Margin (%)						
Cigarettes	58.3	70.3	66.8	64.2	69.2	69.7
FMCG – Others	1.5	2.5	3.5	5.8	6.9	7.9
Hotels	10.0	10.8	11.5	(143.3)	(5.4)	9.5
Agri business	10.5	8.3	7.0	6.3	7.0	7.0
Paper and packaging	21.0	22.4	22.8	20.2	19.4	20.0

Source: Company, MOFSL

Capital allocation – some recalibration in capex

- The management has indicated that capex is likely to be lower over the next two years v/s the recent trend as well as earlier guidance of INR25–30b. The company has also completed large green-field investments in Hotels. Moreover, with largely maintenance capex for the next two years, capex would be only around 10% of total capex for this period. Ongoing COVID-related occupancy issues are also likely to curb hotel-related investments for the next 2–3 years.
- We further reckon that while the recalibration of capex in the Other FMCG business (which has been the highest category of investment in recent years) is likely over FY20–22E, it is also likely to rise again later on.

Exhibit 18: Major capex in FMCG – Others in past five years

Capex breakdown (%)	FY16	FY17	FY18	FY19	FY20
Cigarettes	12.7	10.0	3.6	5.8	6.5
FMCG – Others	42.6	45.7	32.9	54.1	42.1
Hotels	16.9	15.8	24.1	27.4	36.2
Agri business	7.5	6.3	3.6	2.2	2.7
Paper and packaging	20.3	22.2	35.9	10.6	12.4
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Company, MOFSL

- While the recent improvement in profitability in Other FMCG is heartening, the impact on overall EBIT margins is negligible.

Inorganic acquisitions – a strategy to boost growth?

- There has been an increasing focus on acquisitions in recent times, particularly in 'Other FMCG', to enter new categories or enhance presence. Boosting sales growth through this route is a deliberate strategy that would be an important cornerstone for growth going forward.

Exhibit 19: Certain brands acquired by ITC in last 4–5 years

FY15 FY18 FY19 FY21

Source: Company, MOFSL

- In 1HFY21, the company also acquired the 'Sunrise' brand of spices, with sales of INR6b in FY20, for a consideration of INR21.5b (Link).

Exhibit 20: Sunrise brands' portfolio of products

Source: Company, MOFSL

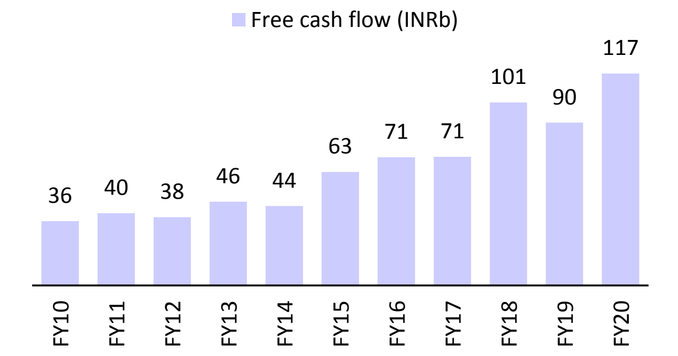
- Acquisitions (including goodwill) would add to the capital employed, even as organic capex may be relatively lower over FY20–22E.

Dividend payout elevated

- We reckon that with the recalibration of capex, multiple years of corporate tax benefits (starting from FY20), and healthy operating cash flows of INR100–INR140b in recent years, there is strong potential for a special dividend for the next two years.
- The company has already given guidance for 80–85% of ordinary dividend payout.

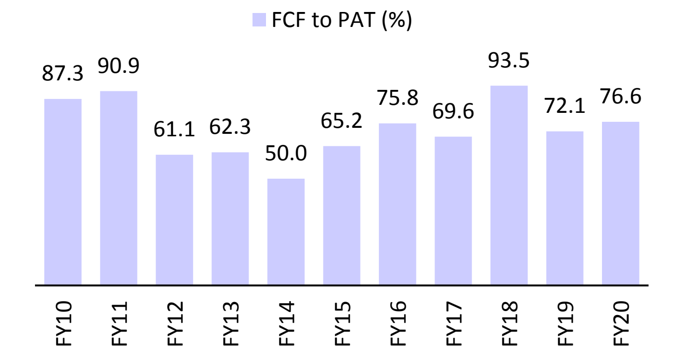
- Our alternative research team has also written a [detailed note earlier this year on RoE] movement in Indian companies over the last decade. We have highlighted, as part of a case study, how an increased dividend payout at ITC in the earlier part of the decade led to not only high return ratios but also a rerating of the stock. However, dividend payout has plateaued since then, resulting in sharp decline in return ratios, as generated cash continues to accumulate.

Exhibit 21: Healthy free cash flow in recent years…



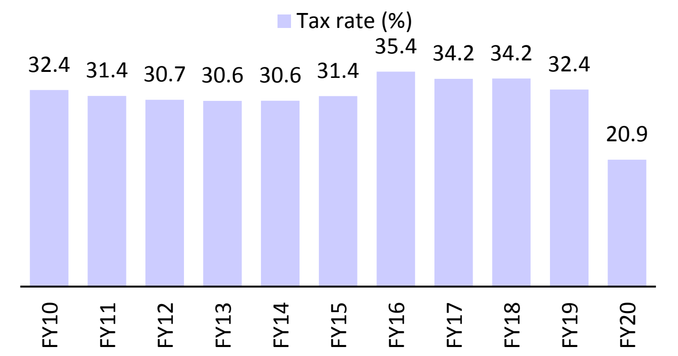
Source: Company, MOFSL

Exhibit 22: …robust FCF to PAT conversion over the years…



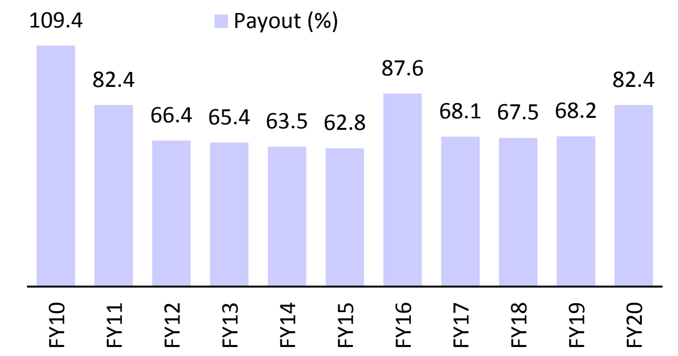
Source: Company, MOFSL

Exhibit 23: …reduction in corporate tax rate…



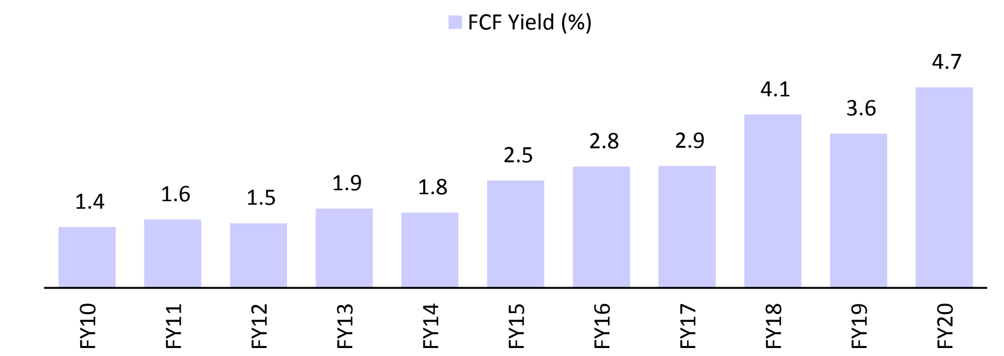
Source: Company, MOFSL

Exhibit 24: …made a strong case for special dividend in FY20



Source: Company, MOFSL

Exhibit 25: Strong FCF yield for the past few years

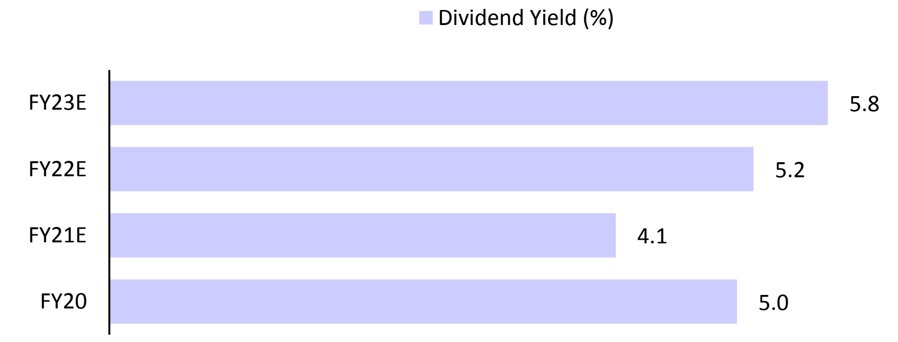


Source: Company, MOFSL

Strong dividend yield in line with global tobacco peers' yields

As a result of increased payout guidance, dividend yield for ITC would be high for the next few years. Special dividend could also be high for the next two years as the company has guided for lower than historical capex, given the slower pace of topline and earnings growth.

Exhibit 26: ITC's dividend yield estimated to remain robust



Source: Company, MOFSL

High dividend yield is, however, a feature for global tobacco peers Philip Morris and BAT.

Exhibit 27: Dividend yield of global peers

	Dividend Yield (%)		
	CY21E	CY22E	CY23E
Philip Morris	6.5	6.7	6.9
BAT	5.6	5.9	6.3

*Dividend yield is as on current date Source: Bloomberg, MOFSL

This is particularly true as multiples have contracted for the global tobacco majors, just as they have for ITC in recent years.

Valuation and view

- The earnings growth trajectory is not likely to recover anytime soon from the mid-single-digit PBT trend in the past five years.
- Despite the corporate tax cuts (of which ITC is a significant beneficiary), the rate of corporate tax has come off by ~1000bp from the mid-30 level seen during 2011–15. If a sustained high dividend payout, combined with lower capex (given the weak demand environment), then eventuates, it would offer some respite in a bleak operating environment.
- A strong dividend yield alone is not enough of a comfort, particularly as it is in line with global peers in the Cigarettes biz.

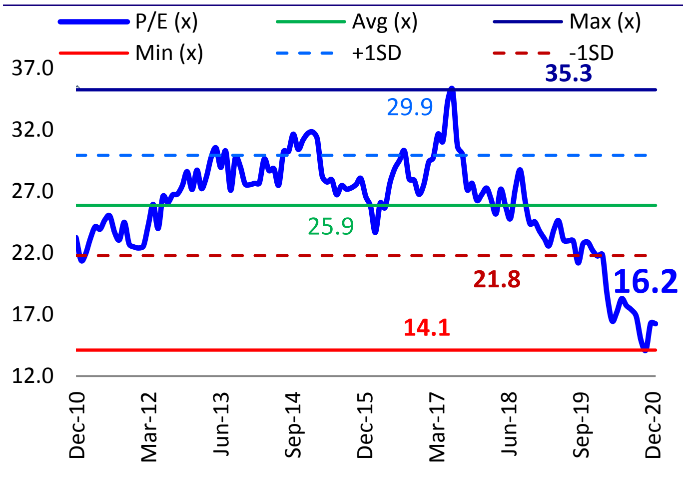
Exhibit 28: Global peer valuations

	Yr. End	EV/EBITDA (x)				PE (x)			
		FY20	FY21E	FY22E	FY23E	FY20	FY21E	FY22E	FY23E
ITC	**Mar**	**11.7**	**13.6**	**10.4**	**9.2**	**16.3**	**19.7**	**15.5**	**13.9**
Philip Morris	Dec	13.6	12.0	10.8	10.1	15.4	13.9	12.5	11.5
BAT	Dec	11.1	8.8	8.4	8.0	10.7	8.1	7.6	7.1

Source: Bloomberg, MOFSL

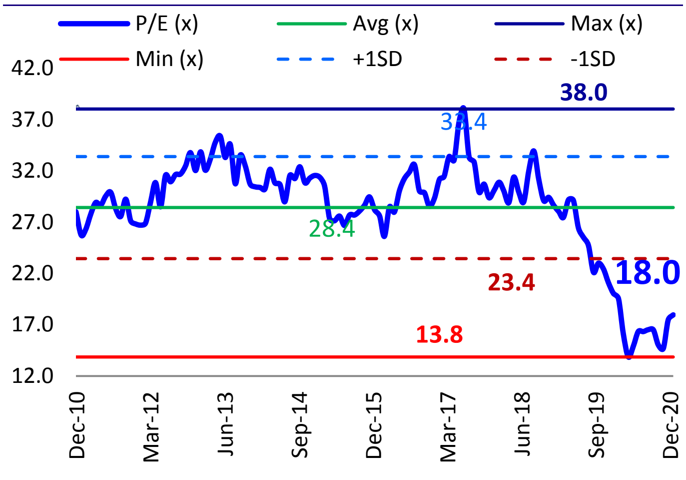
- Despite ongoing improvement in Other FMCG metrics, no material shift is likely in EBIT dependence on the Cigarettes business. The business' contribution to total EBIT is likely to be 82% in FY23E v/s around 85% in FY20.
- Valuations would be closer to global tobacco peers given (1) the dependence on the Cigarettes business remaining high, as in the past (82% of EBIT even in FY23E), (2) far weaker earnings growth and ROCE v/s the former part of the decade, and (3) the persistent risk of further ESG-based selling by investors.
- BAT trades at 8.1x CY21 EPS and Philip Morris at 13.9x CY21 EPS. Taking the average multiples of these two global peers and giving ITC a ~30% premium, as well as rolling forward to December 2022 EPS, we get TP of INR200 (14x December 22 EPS). Maintain **Neutral**.

Exhibit 29: ITC – 1-year forward P/E



Source: Company, MOFSL

Exhibit 30: ITC – Trailing P/E



Source: Company, MOFSL

Financials and valuations

Income Statement (INR m)

Y/E March	2016	2017	2018	2019	2020	2021E	2022E	2023E
Net Sales	**3,62,206**	**3,96,419**	**4,02,547**	**4,44,327**	**4,51,361**	**4,23,667**	**4,92,727**	**5,37,712**
Operational Income	3,621	4,468	3,729	5,630	4,836	4,353	4,998	5,248
Total Revenue	**3,65,827**	**4,00,887**	**4,06,275**	**4,49,957**	**4,56,197**	**4,28,020**	**4,97,725**	**5,42,959**
Change (%)	0.2	9.6	1.3	10.8	1.4	-6.2	16.3	9.1
Gross Profit	**2,23,312**	**2,32,908**	**2,40,142**	**2,68,260**	**2,75,501**	**2,49,503**	**3,06,494**	**3,38,083**
Margin (%)	61.0	58.1	59.1	59.6	60.4	58.3	61.6	62.3
Other operating expenditure	85,938	86,903	84,503	94,966	96,211	96,930	1,09,128	1,17,909
EBITDA	**1,37,374**	**1,46,004**	**1,55,639**	**1,73,294**	**1,79,290**	**1,52,573**	**1,97,366**	**2,20,174**
Change (%)	1.8	6.3	6.6	11.3	3.5	-14.9	29.4	11.6
Margin (%)	37.6	36.4	38.3	38.5	39.3	35.6	39.7	40.6
Depreciation	10,007	10,380	11,454	13,117	15,633	15,944	16,799	17,699
Int. and Fin. Charges	719	453	1,096	580	804	724	818	924
Other Inc. - Recurring	17,693	19,859	21,298	24,845	30,137	32,278	34,159	37,022
Profit before Taxes	**1,44,341**	**1,55,030**	**1,64,388**	**1,84,442**	**1,92,989**	**1,68,183**	**2,13,908**	**2,38,573**
Change (%)	3.1	7.4	6.0	12.2	4.6	-12.9	27.2	11.5
Margin (%)	39.5	38.7	40.5	41.0	42.3	39.3	43.0	43.9
Tax	48,961	52,857	55,998	58,492	44,420	42,332	53,841	60,049
Deferred Tax	2,096	164	286	1,306	-4,112	0	0	0
Tax Rate (%)	35.4	34.2	34.2	32.4	20.89	25.17	25.17	25.17
Profit after Taxes	**93,284**	**1,02,009**	**1,08,104**	**1,24,643**	**1,52,682**	**1,25,851**	**1,60,067**	**1,78,524**
Change (%)	-2.9	9.4	6.0	15.3	22.5	-17.6	27.2	11.5
Margin (%)	25.5	25.4	26.6	27.7	33.5	29.4	32.2	32.9
Non-rec. (Exp)/Income	0	0	4,129	0	-1,321	0	0	0
Reported PAT	**93,284**	**1,02,009**	**1,12,233**	**1,24,643**	**1,51,361**	**1,25,851**	**1,60,067**	**1,78,524**

Balance Sheet (INR m)

Y/E March	2016	2017	2018	2019	2020	2021E	2022E	2023E
Share Capital	12,147	12,147	12,204	12,259	12,292	12,292	12,292	12,292
Reserves	4,04,417	4,41,262	5,01,796	5,67,239	6,27,999	6,64,170	7,07,183	7,53,888
Net Worth	**4,16,564**	**4,53,410**	**5,14,001**	**5,79,498**	**6,40,292**	**6,76,462**	**7,19,475**	**7,66,180**
Loans	165	79	69	32	3,298	56	56	56
Deferred Liability	18,674	18,717	19,179	20,441	16,177	16,177	16,177	16,177
Capital Employed	**4,35,403**	**4,72,205**	**5,33,249**	**5,99,972**	**6,59,766**	**6,92,695**	**7,35,708**	**7,82,413**
Gross Block	2,20,933	2,40,156	2,58,097	3,00,430	3,36,314	3,54,314	3,73,314	3,93,314
Less: Accum. Depn.	80,516	90,896	1,02,350	1,15,467	1,31,100	1,47,044	1,63,843	1,81,542
Net Fixed Assets	**1,40,417**	**1,49,259**	**1,55,747**	**1,84,963**	**2,05,214**	**2,07,270**	**2,09,471**	**2,11,772**
Capital WIP	23,884	34,913	50,169	33,915	27,763	27,763	27,763	27,763
Investments	**1,33,245**	**1,85,853**	**2,33,972**	**2,65,780**	**3,06,306**	**3,25,850**	**3,38,058**	**3,42,043**
Curr. Assets, L&A	**2,02,636**	**1,72,134**	**1,83,925**	**2,13,322**	**2,13,070**	**2,31,906**	**2,69,727**	**3,19,672**
Inventory	85,198	78,640	72,372	75,872	80,381	72,095	77,814	83,757
Account Receivables	16,864	22,075	23,570	36,462	20,920	39,465	45,898	50,088
Cash and Bank Balance	56,392	27,473	25,949	37,687	68,433	71,357	86,558	1,19,235
Others	44,182	43,946	62,035	63,300	43,337	48,989	59,456	66,591
Curr. Liab. and Prov.	**64,780**	**69,954**	**90,564**	**98,008**	**92,588**	**1,00,095**	**1,09,311**	**1,18,837**
Account Payables	22,280	25,512	33,823	33,683	34,467	36,424	39,535	42,345
Other Liabilities	42,500	44,442	56,742	64,325	58,121	63,671	69,776	76,492
Net Current Assets	**1,37,856**	**1,02,180**	**93,361**	**1,15,314**	**1,20,482**	**1,31,811**	**1,60,416**	**2,00,835**
Application of Funds	**4,35,403**	**4,72,206**	**5,33,249**	**5,99,972**	**6,59,766**	**6,92,695**	**7,35,708**	**7,82,413**

E: MOFSL Estimates

Financials and valuations

Ratios								
Y/E March	**2016**	**2017**	**2018**	**2019**	**2020**	**2021E**	**2022E**	**2023E**
Basic (INR)								
EPS	**7.7**	**8.4**	**8.9**	**10.2**	**12.4**	**10.2**	**13.0**	**14.5**
Cash EPS	8.5	9.3	9.8	11.2	13.7	11.5	14.4	16.0
BV/Share	34.3	37.3	42.1	47.3	52.1	55.0	58.5	62.3
DPS	6.7	5.7	6.2	6.9	10.2	8.2	10.4	11.6
Payout %	88	68	68	68	82	80	80	80
Valuation (x)								
P/E	26.3	24.1	22.8	19.9	16.3	19.7	15.5	13.9
Cash P/E	23.8	21.8	20.6	18.0	14.8	17.5	14.0	12.7
EV/Sales	6.3	5.7	5.5	4.9	4.7	4.9	4.2	3.7
EV/EBITDA	16.6	15.5	14.2	12.5	11.7	13.6	10.4	9.2
P/BV	5.9	5.4	4.8	4.3	3.9	3.7	3.5	3.2
Dividend Yield (%)	3.3	2.8	3.1	3.4	5.0	4.1	5.2	5.8
Return Ratios (%)								
RoE	25.8	23.5	22.3	22.8	25.0	19.1	22.9	24.0
RoCE	24.7	22.5	21.6	22.1	24.3	18.7	22.5	23.6
RoIC	45.7	40.0	42.4	44.6	49.8	38.9	49.0	52.5
Working Capital Ratios								
Debtor (Days)	17	18	21	25	23	26	32	33
Asset Turnover (x)	0.8	0.8	0.8	0.7	0.7	0.6	0.7	0.7
Leverage Ratio								
Debt/Equity (x)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Cash Flow Statement								(INR m)
Y/E March	**2016**	**2017**	**2018**	**2019**	**2020**	**2021E**	**2022E**	**2023E**
OP/(loss) before Tax	1,44,341	1,55,030	1,68,517	1,84,442	1,91,668	1,68,183	2,13,908	2,38,573
Financial other income	3,408	5,475	7,157	8,128	13,086	32,278	34,159	37,022
Depreciation and Amort.	10,007	10,380	11,454	13,117	15,633	15,944	16,799	17,699
Interest Paid	-8,025	-8,416	-8,312	-12,084	-13,832	724	818	924
Direct Taxes Paid	48,277	52,130	57,196	54,859	46,501	42,332	53,841	60,049
Incr in WC	2,518	-631	-19,202	4,997	-4,180	8,405	13,404	7,742
CF from Operations	**92,119**	**1,00,020**	**1,26,509**	**1,17,491**	**1,38,062**	**1,01,837**	**1,30,121**	**1,52,384**
Other items	-1,720	15,164	-7,587	3,174	44,650	57,374	7,798	23,269
Incr Decr in FA	21,377	28,971	25,478	27,595	21,136	18,000	19,000	20,000
Free Cash Flow	**70,743**	**71,049**	**1,01,030**	**89,896**	**1,16,926**	**83,837**	**1,11,121**	**1,32,384**
Pur of Investments	33,866	43,756	34,769	15,325	51,921	19,544	12,208	3,985
CF from Invest.	**-56,962**	**-57,563**	**-67,834**	**-39,746**	**-28,408**	**19,830**	**-23,410**	**-716**
Issue of shares	5,317	10,670	9,128	9,691	6,253	10,000	10,000	10,000
Incr in Debt	-143	-129	-78	-69	-473	-3,241	0	0
Net Interest Paid	231	218	453	867	455	724	818	924
Dividend Paid	50,097	68,401	57,700	62,852	84,222	1,24,766	1,00,681	1,28,054
Others	-9,497	-13,298	-11,095	-11,909	-11	-11	-11	-11
CF from Fin. Activity	**-54,651**	**-71,376**	**-60,199**	**-66,006**	**-78,909**	**-1,18,743**	**-91,510**	**-1,18,990**
Incr of Cash	**-19,494**	**-28,919**	**-1,524**	**11,739**	**30,745**	**2,924**	**15,201**	**32,678**
Add: Opening Balance	75,886	56,392	27,473	25,949	37,687	68,433	71,357	86,558
Closing Balance	**56,392**	**27,473**	**25,949**	**37,687**	**68,433**	**71,357**	**86,558**	**1,19,236**

E: MOFSL Estimates

NOTES

Explanation of Investment Rating	
Investment Rating	**Expected return (over 12-month)**
BUY	>=15%
SELL	< - 10%
NEUTRAL	< - 10 % to 15%
UNDER REVIEW	Rating may undergo a change
NOT RATED	We have forward looking estimates for the stock but we refrain from assigning recommendation

*In case the recommendation given by the Research Analyst is inconsistent with the investment rating legend for a continuous period of 30 days, the Research Analyst shall within following 30 days take appropriate measures to make the recommendation consistent with the investment rating legend.

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