



ITC will continue to outperform the sector

Notwithstanding improving business performance ITC went through painful price underperformance and high disbelief on the street regarding its food business, which prompted us to initiate ITC as our [‘Lionheart Series’ stock in September’20](#). It had all the right ingredients for our ‘Lionheart series’ i.e. cigarette business with strong moat (cash-cow), high FCF among FMCG peers, yet high disbelief on its diversification and huge valuation discount to its peers. In our deep dive analysis into ITC’s foods business we conclude that it is at the cusp of a take-off both in terms of top-line and margins, hitherto concerns on cigarette business are overdone. Three months into our report ITC’s share price has already started rewarding our judgement with valuation (P/E) multiple expanding ~20% from 12.1x to 14.5x FY23E. With improved disclosures from ITC on ESG and 2QFY21 performance (pointed by us in our report) the Investors are now warming up to invest in ITC, whilst few remain sideways. We are of the strong opinion that ITC is far below its fair value and will exhibit strong outperformance to its peers.

Past share price underperformance relating to core business are overdone

ITC’s share price loss had prompted investors to question its core business model, however, the company’s strong business model, controlling market share in cigarettes and tailwinds for FMCG (81% added by foods) provides confidence that re-rating for ITC will continue to play ahead. We opine cigarette taxation could weigh high, yet ITC has all ammunition to control volume. Given the high valuation discount to FMCG peers and consistent focus towards growing the foods business (both organic and inorganic) we expect ITC will reward investors.

Improved disclosures on ESG should wane out investor’s concerns

After talking to investors we reckon that the ESG buzzword had created a perception that all sin good companies are in the ESG negative list for FIIs. However, as the dust is settling and meaning of ESG is becoming transparent, investors are acknowledging ITC’s achievements on the ESG front and revisiting earlier perceptions. It is important that ITC has been Carbon/Water/Solid Waste Recycling positive for 15/18/13 years in a row and is rated AA by MSCI-ESG (Highest among global tobacco companies) and is included in the Dow Jones Sustainability Emerging Market Index should win investor’s confidence.

All four growth drivers propelling FMCG segment margins

We have argued in our Lionheart report earlier, food segment (forms ~81% of revenues) is driving other-FMCG business, which supports our research, suggesting all four growth drivers (1) optimizing brand spends (2) improving product mix (3) realization led improvement and (4) operating leverage; have started propelling FMCG segmental margins. Notably, SQ’20 EBITDA margin expanded 300bps to 9.7% as high margin products (noodles, biscuits) grew faster and benefits from scale aided margins. Further we expect margins to inch-up in-line with industry.

ITC’s inexpensive valuation leaves enough runway for stock re-rating

We believe, with improved disclosures recommended by us (ESG roadmap, 2QFY21 results presentation) should gain confidence, and yet renewed focus on maintaining cigarette market share, tailwinds from foods business, strong FCF, high dividend yield and compelling valuations proved to be attractive for long term investors. We move to FY23E estimates and reiterate strong Buy rating with DCF-based Target price of Rs.353, implying 23.6x FY23E EPS. Key risks are sharp increase in any form of taxation & higher leaf tobacco prices.

Financial and valuation summary

YE Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Revenues	4,44,327	4,51,361	4,12,322	5,04,090	5,55,085
EBITDA	1,67,425	1,74,206	1,38,710	1,93,985	2,11,671
EBITDA margin (%)	37.7	38.6	33.6	38.5	38.1
Adj. Net profit	1,24,643	1,52,682	1,26,109	1,69,869	1,83,841
Adj. EPS (Rs)	10.1	12.4	10.3	13.8	14.9
EPS growth (%)	13.6	22.5	(17.4)	34.7	8.2
PE (x)	21.4	17.5	21.2	15.7	14.5
EV/EBITDA (x)	14.3	13.4	16.7	11.9	10.8
PBV (x)	4.6	4.2	4.0	3.9	3.7
RoE (%)	22.8	25.0	19.4	25.3	26.3
RoCE (%)	22.8	25.0	19.4	25.2	26.3

Source: Bloomberg, Centrum Broking

Buy
Target Price: Rs353
Current Price: Rs216
Forecast return: 64%

Market Data

Bloomberg:	ITC IN
52 week H/L:	248/135
Market cap:	Rs2661.6bn
Shares outstanding:	12305mn
Free float:	56.3%
Avg. daily vol. 3mth:	32039380

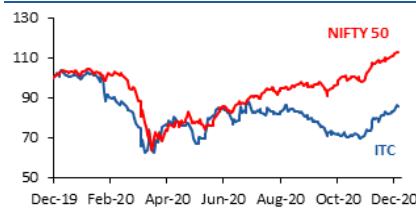
Source: Bloomberg

Changes in the report

Rating:	Unchanged
Target Price:	Unchanged
EPS:	Unchanged

Source: Centrum Broking

ITC relative to Nifty 50



Source: Bloomberg

Shareholding pattern

	Sep-20	Jun-20	Mar-20	Dec-19
Promoter	0.0	0.0	0.0	0.0
FIIs	13.0	14.6	14.7	15.2
DILs	39.6	39.2	39.7	36.4
Public/other	47.4	46.2	45.7	48.5

Source: BSE



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Thesis Snapshot

Estimate revisions

YE Mar (Rs mn)	FY21E New	FY21E Old	% chg	FY22E New	FY22E Old	% chg
Revenue	4,12,322	4,12,322	-	5,04,090	5,04,090	-
EBITDA	1,38,710	1,38,710	-	1,93,985	1,93,985	-
EBITDA margin	33.6	33.6	0 bps	38.5	38.5	0 bps
Adj. PAT	1,26,109	1,26,109	-	1,69,869	1,69,869	-
Diluted EPS (Rs)	10.3	10.3	-	13.8	13.8	-

Source: Centrum Broking

ITC versus Nifty 50

	1m	6m	1 year
ITC IN	15.1	11.6	(9.3)
Nifty 50	6.0	36.5	13.5

Source: Bloomberg, NSE

Key assumptions

	FY21E	FY22E	FY23E
Cigarette Volume Growth (%)	(22.0)	26.5	3.0

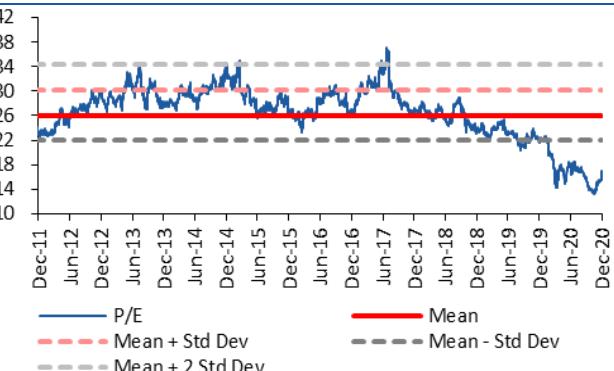
Source: Centrum Broking

Valuations

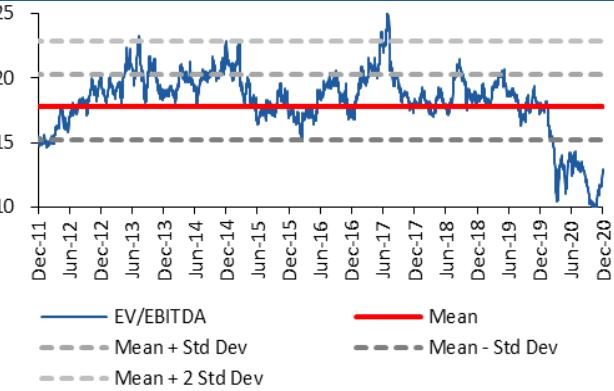
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Valuations	Rs/share
DCF-based target price (Rs)	353
WACC (%)	9.0
Terminal growth (%)	3.0

P/E mean and standard deviation



EV/EBITDA mean and standard deviation



Source: Bloomberg, Centrum Broking

Peer comparison

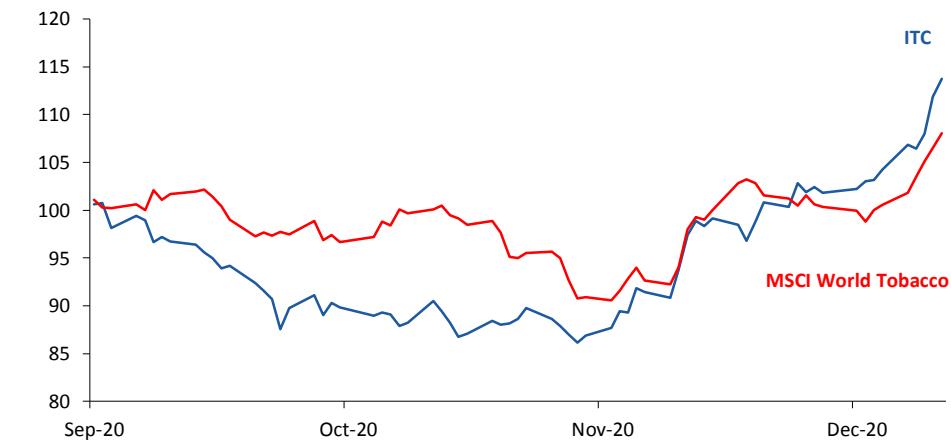
Company	Mkt Cap (Rs mn)	CAGR (FY19-23E)				P/E (x)				EV/EBITDA (x)				FY19			
		Sales	EBITDA	PAT	FY20	FY21E	FY22E	FY20	FY21E	FY22E	FY20	FY21E	FY22E	FY20	FY21E	FY22E	
ITC	2,655	5.7	5.5	5.5	17.4	21.1	15.6	17.2	21.6	15.4	25.0	19.4	25.3				
Godfrey Phillip	53	1.4	0.7	2.3	13.6	15.2	13.0	9.1	9.5	7.9	19.6	16.0	16.8				
VST Industries	61	1.5	3.9	4.6	20.1	19.8	18.4	13.0	12.9	12.0	40.0	33.9	32.4				

Source: Company, Centrum Broking

Cigarette Is driving sentiments, yet investors are eyeing delivery by other segments to justify stock rerating

ITC is the market leader with a lion's share in the legal cigarette industry. Given the high base Cigarette business is likely to continue posting a single digit EBIT growth retaining its volume share. We believe ITC is well positioned and focused to maintain its market position, with cigarette segment continuing to support dividend yield as other businesses march towards their full potential. Given these factors will see ITC demanding better valuation than global peers.

Exhibit 1: ITC has started outperforming global peers



Source: Bloomberg

Investors justified share price underperformance by sounding off ESG concerns

After talking to investors we reckon that the ESG buzzword had created a perception that all sin good companies are in the ESG negative list for Foreign Institutional Investors (FIIs). However, as the dust is settling and meaning of ESG is becoming transparent, investors are acknowledging ITCs achievements on the ESG front and revisiting earlier perceptions. ITC has been Carbon/Water/Solid Waste Recycling positive for 15/18/13 years and is rated AA by MSCI-ESG (Highest among global tobacco companies) and is included in the Dow Jones Sustainability Emerging Market Index. Given its strong credentials on ESG parameters and road map to improve further by 2030 it is evident to check re-rating for ITC.

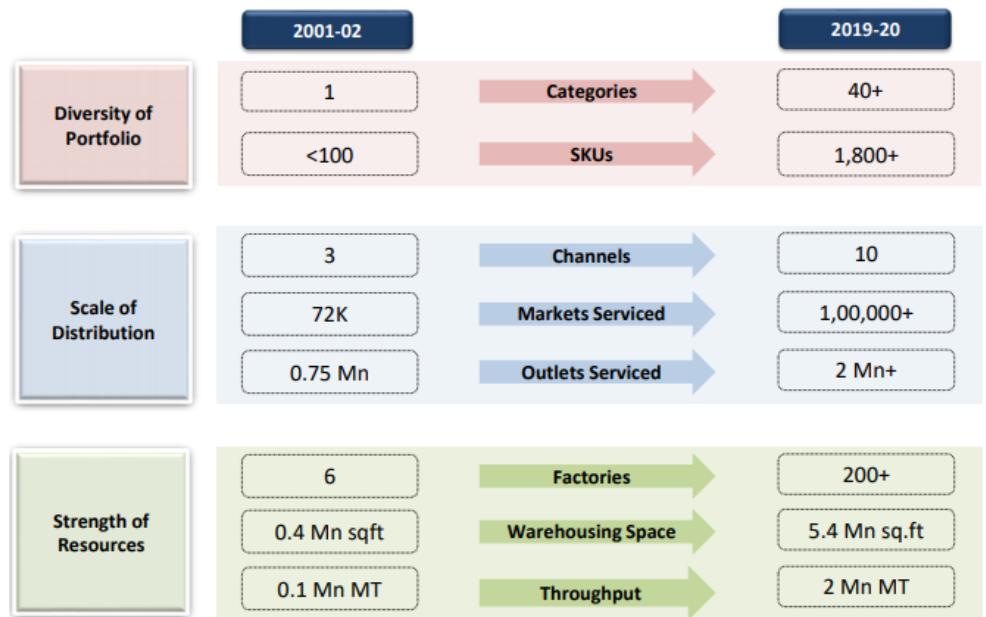
Exhibit 2: An Exemplar In Triple Bottom Line Performance



Source: Company

Exhibit 3: ITCs Social Investment Initiatives


Source: Company

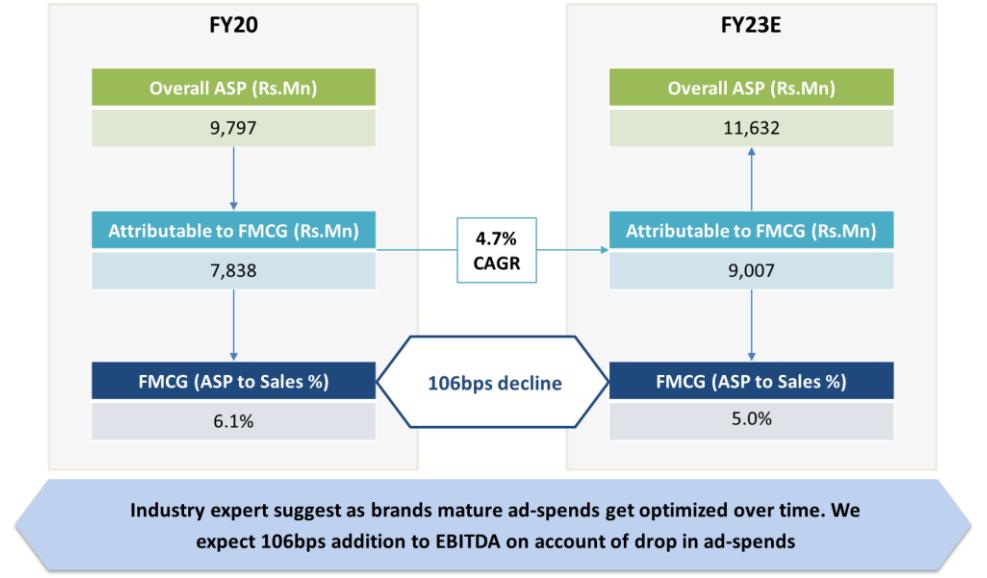
Exhibit 4: ITCs FMCG Business Transformation


Source: Company

All four growth drivers propelling FMCG segment margins

We have argued in our Lionheart report earlier, food segment (forms ~81% of revenues) is driving other-FMCG business, which supports our research, suggesting all four growth drivers (1) optimizing brand spends (2) improving product mix (3) realization led improvement and (4) operating leverage; have started propelling FMCG segmental margins. Notably, SQ'20 EBITDA margin expanded 300bps to 9.7% as high margin products (noodles, biscuits) grew faster and benefits from scale aided margins. We expect strong double digit margin delivery from ITC could result in change in investor sentiments.

Exhibit 5: Maturing brands lead to decline in advertising spends to sales %



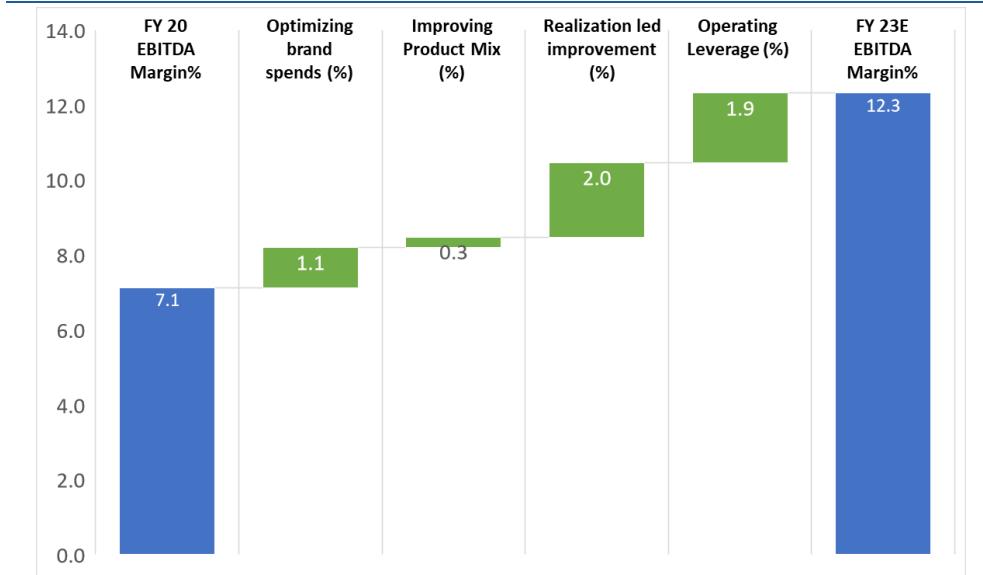
Source: Centrum Research

Exhibit 6: Operating leverage to lift EBITDA Margin

Particulars	FY20 (Rsmn)	FY23E (Rsmn)
FMCG Revenue	128,442	178,504
Total FMCG Gross Margin	36,009	54,156
Less: Reported EBITDA	9,140	22,038
Implied Opex of FMCG Segment	26,869	32,118
Less: ASP Attributable to FMCG	7838	9,007
Opex excl. ASP	19,032	23,111
Fixed	45%	8,564
Variable	55%	10,467
	14.8%	12.9%

We assume variable costs will increase in tandem with revenue growth, however, fixed costs will drive operating leverage and lift EBITDA margin by 187bps

Source: Centrum Broking

Exhibit 7: We estimate 519 bps increase in FMCG EBITDA margin over FY20-FY23E


Source: Centrum Broking

Exhibit 8: Segment financial summary

Segmental	FY19	FY20	FY21	FY22	FY23
Gross revenues (post inter-segment eliminations)					
Cigarettes	207,130	212,017	185,157	238,905	247,335
% Growth	-9.5	2.4	-12.7	29.0	3.5
Other FMCG	124,878	128,442	142,299	159,634	178,504
% Growth	10.4	2.6	10.8	12.2	11.8
Hotels	16,482	18,166	8,562	17,956	25,246
% Growth	17.4	10.6	-52.9	109.7	40.6
Agri business	60,670	62,421	66,524	74,852	83,890
% Growth	33.3	-2.7	6.6	12.5	12.1
Paperboards, paper, and packaging	43,054	42,400	35,797	45,596	54,263
% Growth	13.5	6.4	-15.6	27.4	19.0
Total	452,214	463,447	438,339	536,944	589,238
% Growth	2.9	2.4	-5.4	22.5	9.7
Revenue Salience					
Cigarettes	45.8	45.7	42.2	44.5	42.0
Other FMCG	27.6	27.7	32.5	29.7	30.3
Hotels	3.6	3.9	2.0	3.3	4.3
Agri business	13.4	13.5	15.2	13.9	14.2
Paperboards, paper, and packaging	9.5	9.1	8.2	8.5	9.2
EBIT margin (on net revenues-net of ED, %)					
Cigarettes	73.0	74.2	70.8	74.3	74.8
Other FMCG	3.1	3.3	4.6	6.6	8.6
Hotels	10.7	8.6	-28.0	9.2	9.7
Agri business	8.3	7.7	7.7	9.2	9.4
Paperboards, paper, and packaging	21.1	21.4	21.5	21.9	22.2
Total	38.6	38.8	33.0	37.8	37.3
EBIT Salience					
Cigarettes	84.9	84.7	82.9	80.3	77.1
Other FMCG	2.3	2.4	4.8	5.5	7.4
Hotels	1.0	0.9	-1.8	0.9	1.2
Agri business	4.5	4.5	6.5	6.3	6.6
Paperboards, paper, and packaging	7.2	7.4	7.5	7.0	7.8

Source: Company, Centrum Broking

P&L					
YE Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Revenues	4,44,327	4,51,361	4,12,322	5,04,090	5,55,085
Operating Expense	1,73,052	1,72,351	1,56,826	1,91,226	2,10,571
Employee cost	27,284	26,582	23,871	28,881	31,525
Others	76,566	78,221	92,916	89,999	1,01,319
EBITDA	1,67,425	1,74,206	1,38,710	1,93,985	2,11,671
Depreciation & Amortisation	13,117	15,633	14,109	17,312	20,056
EBIT	1,54,308	1,58,574	1,24,601	1,76,673	1,91,615
Interest expenses	342	557	557	557	557
Other income	30,475	34,973	35,357	38,598	41,317
PBT	1,84,442	1,92,989	1,59,401	2,14,715	2,32,375
Taxes	59,798	40,308	33,292	44,845	48,534
Effective tax rate (%)	32.4	20.9	20.9	20.9	20.9
PAT	1,24,643	1,52,682	1,26,109	1,69,869	1,83,841
Minority/Associates	0	0	0	0	0
Recurring PAT	1,24,643	1,52,682	1,26,109	1,69,869	1,83,841
Extraordinary items	3,626	(15,139)	0	0	0
Reported PAT	1,28,269	1,37,542	1,26,109	1,69,869	1,83,841
Ratios					
YE Mar	FY19A	FY20A	FY21E	FY22E	FY23E
Growth (%)					
Revenue	10.4	1.6	(8.6)	22.3	10.1
EBITDA	10.4	4.1	(20.4)	39.8	9.1
Adj. EPS	13.6	22.5	(17.4)	34.7	8.2
Margins (%)					
Gross	61.1	61.8	62.0	62.1	62.1
EBITDA	37.7	38.6	33.6	38.5	38.1
EBIT	34.7	35.1	30.2	35.0	34.5
Adjusted PAT	28.1	33.8	30.6	33.7	33.1
Returns (%)					
ROE	22.8	25.0	19.4	25.3	26.3
ROCE	22.8	25.0	19.4	25.2	26.3
ROIC	32.9	38.4	30.2	41.3	44.3
Turnover (days)					
Gross block turnover ratio (x)	2.0	1.8	1.5	1.7	1.8
Debtors	25	23	20	19	20
Inventory	156	165	175	149	155
Creditors	71	72	77	68	72
Net working capital	253	301	342	295	286
Solvency (x)					
Net debt-equity	(0.5)	(0.5)	(0.5)	(0.5)	(0.5)
Interest coverage ratio	489.7	312.6	248.9	348.1	379.9
Net debt/EBITDA	(1.6)	(1.9)	(2.5)	(1.9)	(1.8)
Per share (Rs)					
Adjusted EPS	10.1	12.4	10.3	13.8	14.9
BVPS	47.1	52.1	53.6	55.7	57.9
CEPS	11.2	13.7	11.4	15.2	16.6
DPS	5.7	10.1	8.7	11.7	12.7
Dividend payout (%)	55.0	90.7	85.0	85.0	85.0
Valuation (x)					
P/E	21.4	17.5	21.2	15.7	14.5
P/BV	4.6	4.2	4.0	3.9	3.7
EV/EBITDA	14.3	13.4	16.7	11.9	10.8
Dividend yield (%)	2.6	4.7	4.0	5.4	5.9

Source: Company, Centrum Broking

Balance sheet					
YE Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Equity share capital	12,259	12,292	12,292	12,292	12,292
Reserves & surplus	5,67,239	6,27,999	6,46,911	6,72,391	6,99,968
Shareholders fund	5,79,498	6,40,292	6,59,203	6,84,684	7,12,260
Minority Interest	0	0	0	0	0
Total debt	79	3,298	3,298	3,298	3,298
Non Current Liabilities	1,745	2,343	2,140	2,616	2,881
Def tax liab. (net)	20,441	16,177	16,177	16,177	16,177
Total liabilities	6,01,764	6,62,108	6,80,817	7,06,774	7,34,615
Gross block	2,21,765	2,55,847	2,76,022	2,96,197	3,16,671
Less: acc. Depreciation	(42,309)	(55,866)	(69,975)	(87,287)	(1,07,343)
Net block	1,79,457	1,99,981	2,06,047	2,08,910	2,09,328
Capital WIP	33,915	27,763	27,763	27,763	27,763
Net fixed assets	2,18,878	2,32,978	2,39,043	2,41,906	2,42,325
Non Current Assets	27,518	19,751	19,223	20,464	21,154
Investments	47,030	36,736	36,736	36,736	36,736
Inventories	75,872	80,381	70,407	85,387	93,265
Sundry debtors	36,462	20,920	24,142	29,170	31,741
Cash & Cash Equivalents	2,71,617	3,38,003	3,52,441	3,68,248	3,92,513
Loans & advances	13,653	15,108	13,801	16,873	18,580
Other current assets	6,949	8,477	7,744	9,468	10,426
Trade payables	33,683	34,467	31,769	39,185	43,529
Other current liab.	62,280	54,599	49,876	60,977	67,146
Provisions	252	1,179	1,077	1,317	1,450
Net current assets	3,08,338	3,72,643	3,85,814	4,07,667	4,34,400
Total assets	6,01,763	6,62,108	6,80,817	7,06,774	7,34,615
Cashflow					
YE Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Profit Before Tax	1,84,442	1,91,668	1,59,401	2,14,715	2,32,375
Depreciation & Amortisation	13,117	15,633	14,109	17,312	20,056
Net Interest	(16,243)	(19,343)	(19,727)	(22,968)	(24,276)
Net Change – WC	(4,997)	4,180	1,593	(6,811)	(2,892)
Direct taxes	(54,859)	(46,501)	(33,292)	(44,845)	(48,534)
Net cash from operations	1,17,491	1,38,062	1,22,084	1,57,402	1,76,729
Capital expenditure	(27,595)	(21,136)	(20,175)	(20,175)	(20,475)
Acquisitions, net	0	0	0	0	0
Investments	(38,514)	(53,945)	0	0	0
Others	15,291	19,914	20,284	23,525	24,834
Net cash from investing	(50,818)	(55,167)	110	3,351	4,359
FCF	66,673	82,895	1,22,193	1,60,752	1,81,088
Issue of share capital	9,691	6,253	0	0	0
Increase/(decrease) in debt	39	(44)	0	0	0
Dividend paid	(74,869)	(84,222)	(1,07,192)	(1,44,389)	(1,56,265)
Interest paid	(867)	(896)	(557)	(557)	(557)
Others	0	0	0	0	0
Net cash from financing	(66,006)	(78,909)	(1,07,750)	(1,44,946)	(1,56,822)
Net change in Cash	667	3,986	14,444	15,806	24,266

Source: Company, Centrum Broking

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ITC Ltd



Source: Bloomberg

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