

ITC Limited (ITC IN)

Time to apply a “cigar-butt investing” approach

INDIA | FMCG | Company Update

8 April 2020

ITC's stock has underperformed the sector and benchmarks since ages (-4% CAGR over FY14-20) due to these concerns: (1) environment social and governance (ESG) norms, (2) regulatory/competitive challenges in the core cigarette business, and (3) market's perception of capital misallocation. We believe some of these issues are partly true, but the consumer sector has re-gained its status as most favoured due to the TINA factor, given reasonable visibility emerging on FY21-22 earnings. Time to look at ITC?

Capital misallocation – reality? We think not. We did a thorough check on cumulative cash flows from its operations over the past decade and found: (1) 64% of CFO (cash flow from operations) was paid as dividend (inclusive of DDT), (2) only 15% of CFO was applied in scaling up capacities across segments, with majority deployed in the promising FMCG business, and (3) balance 22% was held as non-core investments (see figure 1 to 4). Paper/agri businesses are generating healthy ROCE (20%/26% in FY19) and are capable of self-funding capex needs; hotel segment is playing spoilsport. Financial re-engineering (apart from a recent increase in dividend payout ratio to 80-85%) can unlock value: (1) share buyback - though it would require equal participation from existing shareholders, (2) demerger of capital guzzling and low-return-generating hotels business (see figure 6) - since incremental expansion is expected to happen through management contract route and hence may not require cash infusion from parents, and (3) listing of ITC InfoTech - revenue of US\$ 375mn in FY19 – since it is completely unrelated to core cigarettes business.

FMCG business showing much-needed promise of value creation: Margins have improved to 3% in FY19 from -10% in FY10 on economies of scale, setting up of integrated manufacturing facilities, rationalization of loss-making categories (apparel/personal care) and improved distribution reach. ROCE, which languished at 6% in FY19 (Figure 7), will start improving on better net assets/turnover ratio (see this at 3x from current 2x); and higher margins. Given its cash-rich balance sheet of Rs 250-300bn, [ITC is perfectly poised to acquire regional/niche brands](#) that are up for sale due to the flagging economic situation.

No light at the end of the tunnel for cigarettes: Despite legal cigarette industry volumes falling at 4% CAGR since FY11, ITC's EBIT has seen +11% CAGR over FY10-19 on sharp price hikes. Illegal / contraband cigarettes, which form 25% of the market, and increased aggression by Godfrey Phillips/VST (together gained 200-300bps market share) have added to ITC's woes. FY21 is going to be a washout year (we are pencilling a 12% volume fall) on: (1) nation-wide lockdown until 15th April (zero cigarette sales); (2) meaningful price increases (c.10%) after a gap of two years, and (3) a section of smokers reducing consumption after going without for three weeks. There is also a higher chance of compensation cess on cigarettes increasing, given states' deteriorating fiscal positions because of the COVID-19 outbreak. We believe that the only way for ITC to revive cigarette volumes in the medium term is to lobby with the Government to put stringent controls on imports of duty-evaded cigarettes / contraband and bring more female smokers to the fold.

Environmental, social, and governance (ESG) concerns are not going away soon: With more global funds becoming ESG compliant (FII shareholding has reduced to 15.18% in 3QFY20 from 20.45% in FY16) and less DIs available to buy stock due to historical under-performance, we believe ESG concerns will continue to cast a shadow (see figure 8).

Inexpensive consumer stocks are the best place to park money in a VUCA (Volatile, Uncertain, Complex and Ambiguous) world: With the investable environment shrinking, and concerns emerging in sectors that have been market darlings (BFSI – NPAs due to covid; IT due to global growth concerns) the consumer sector has re-gained its status as most favoured due to the TINA factor (there is no alternative), given there is reasonable visibility emerging on earnings over FY21-22. We upgrade ITC to BUY with a target of Rs 200 (15x FY22 EPS, 24% ROE, 6% dividend yield, 9% EPS CAGR over FY19-22) vs. Rs 215 earlier (15x FY22 EPS). We suggest investors switch to ITC as HUL's stock might underperform until clarity emerges on the GSK Plc stake sale and due to the recent rally.

BUY (Upgrade)

CMP RS 178

TARGET RS 200 (13%)

SEBI CATEGORY: LARGE CAP

COMPANY DATA

O/S SHARES (MN) :	12293
MARKET CAP (RSBN) :	2197
MARKET CAP (USDBN) :	29.0
52 - WK HI/LO (RS) :	310 / 135
LIQUIDITY 3M (USDMN) :	66.0
PAR VALUE (RS) :	1

SHARE HOLDING PATTERN, %

	Dec 19	Sep 19	Jun 19
FII / NRI :	18.4	18.9	16.8
FI / MF :	39.4	39.3	38.4
NON PRO :	3.0	2.9	2.8
PUBLIC & OTHERS :	39.3	39.0	42.0

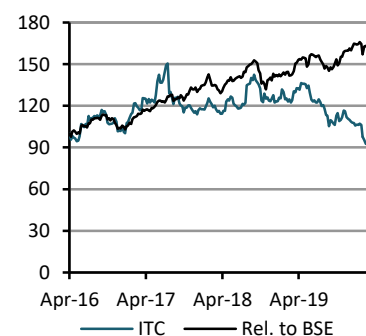
KEY FINANCIALS

Rs mn	FY20E	FY21E	FY22E
Net Sales	4,59,510	4,76,192	5,28,087
EBIDTA	1,70,738	1,66,322	1,97,230
Net Profit	1,37,673	1,35,732	1,60,528
EPS, Rs	11.2	11.1	13.1
PER, x	15.8	16.1	13.6
EV/EBIDTA, x	11.8	12.0	10.0
P/BV, x	3.6	3.5	3.4
ROE, %	23.0	21.7	24.7

CHANGE IN ESTIMATES

(Rs bn)	Revised Est.		% Revision	
	FY21E	FY22E	FY21E	FY22E
Revenue	476	528	-7%	-5%
EBITDA	166	197	-15%	-9%
Core PAT	136	161	-15%	-9%
EPS (Rs)	11.1	13.1	-15%	-9%

PRICE VS. SENSEX



Source: Phillip Capital India Research

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Figure 1: FMCG / Hotels have taken maximum capital

Capital employed (Rs mn)	FY10	FY19	Capital invested
FMCG- Cigarettes	29,608	35,944	6,336
FMCG- Others	16,664	60,758	44,094
Hotels	24,574	54,079	29,505
Agri Business	15,796	29,937	14,142
Paper Boards, Paper and packaging	37,113	62,108	24,995
Total	1,23,753	2,42,826	1,19,072

Source: Company, PhillipCapital India

Figure 2: ITC has done phenomenal work with regards to capital allocation

Particulars (Rs mn)	FY10-FY19
Cumulative CFO	8,25,850
Less	
Dividend	(4,50,019)
DDT	(80,695)
CFO after making dividend payment to equity shareholders	2,95,136
Less : Capital employed across various business	(1,19,072)
Cash left with the company	1,76,064
Opening cash balance as on 1/4/2010	11,263
Current Investments as on 1/4/2010	43,101
Cash balance as on 31/03/2019	2,30,428

Source: Company, PhillipCapital India

Figure 3 : On an average, ITC has been distributing 50% of its CFO as dividend (excluding-DDT)

Particulars	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19
CFO	46,418	53,327	60,156	67,099	69,623	93,089	92,119	1,00,020	1,26,509	1,17,491
Dividend Paid	13,965	38,182	34,435	35,183	41,485	47,719	50,097	68,401	57,700	62,852
% of CFO paid as dividend	30.1%	71.6%	57.2%	52.4%	59.6%	51.3%	54.4%	68.4%	45.6%	53.5%

Source: Company, PhillipCapital India

Figure 4 : 64% / 14% of cumulative CFO has been given as dividend (including DDT) / deployed in other business respectively

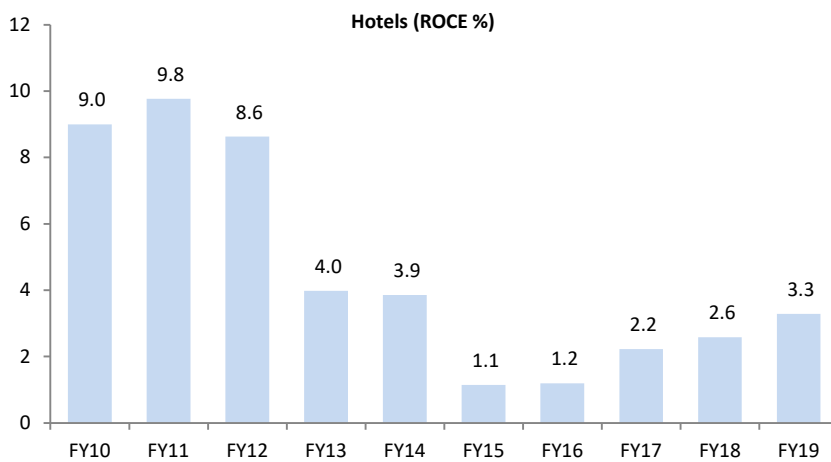
Distribution of cumulative CFO generated over FY11-19	
CFO	100%
Dividend	54.5%
DDT	9.8%
Capital employed across various business	
FMCG- Cigarettes	1%
FMCG- Others	5%
Hotels	4%
Agri Business	2%
Paper Boards, Paper and packaging	3%
Non - core investments + cash balance	14.4%
	21.3%

Source: Company, PhillipCapital India

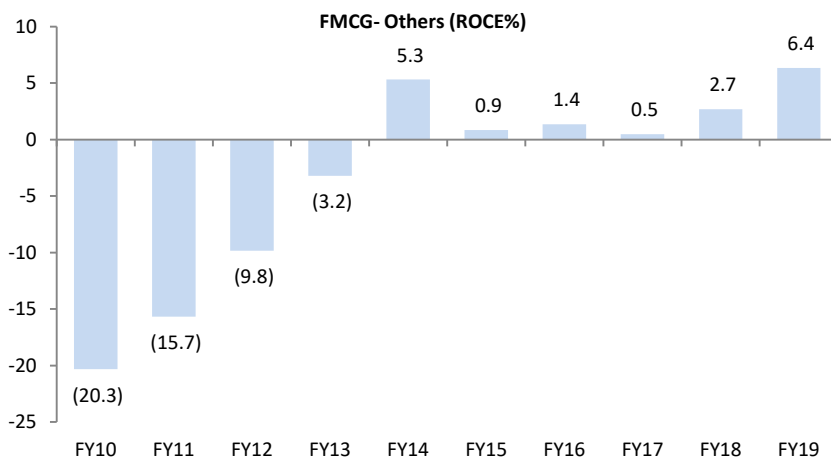
Figure 5: Paper & Agri business capable of self-funding capex needs

ROCE (%)	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17*	FY18	FY19
FMCG- Cigarettes	165.0	187.7	191.9	168.1	172.8	192.4	211.9	375.6	371.2	404.8
FMCG- Others	(20.3)	(15.7)	(9.8)	(3.2)	5.3	0.9	1.4	0.5	2.7	6.4
Total FMCG	97.3	110.1	120.1	110.1	110.4	114.5	105.1	138.6	139.7	154.5
Hotels	9.0	9.8	8.6	4.0	3.9	1.1	1.2	2.2	2.6	3.3
Agri Business	28.0	36.3	37.8	58.2	40.7	46.1	42.5	36.1	28.3	25.9
Paper Boards, Paper and packaging	18.0	21.7	21.5	19.4	16.8	17.0	15.9	16.2	16.8	20.0

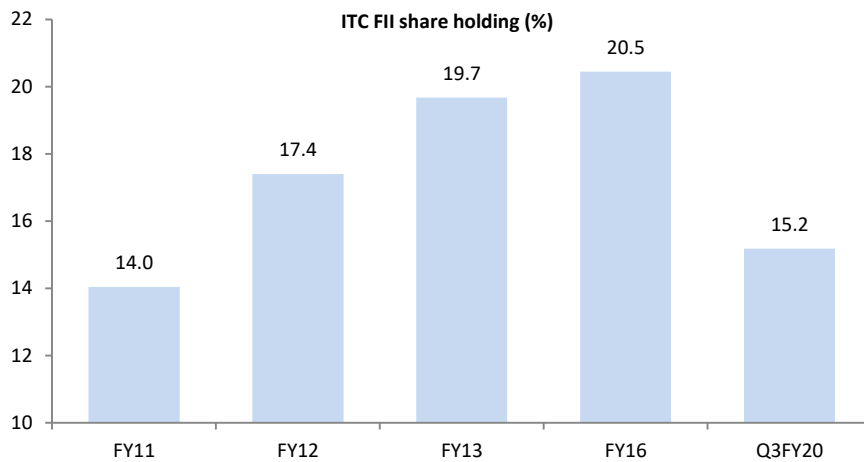
Source: Company, PhillipCapital India ; Cigarette ROCE have moved up significantly due to accounting reclassification

Figure 6: Hotel ROCE under pressure due to continuous capex, global growth concerns


Source: Company, PhillipCapital India

Figure 7 : FMCG ROCE should start inch-up due to improving asset Turnover and better EBIT margin


Source: Company, PhillipCapital India

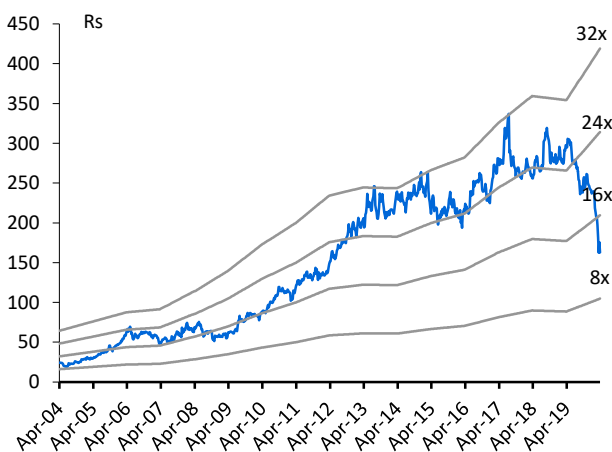
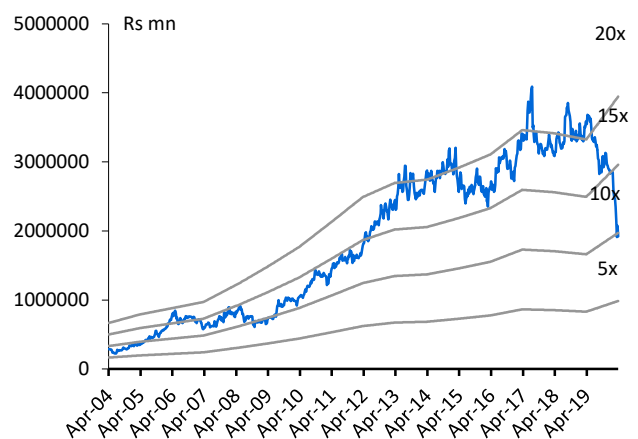
Figure 8 : FII holdings in ITC have been seeing a structural decline since FY16 owing to ESG concerns


Source: Company, PhillipCapital India

Figure 9: ITC EBIT Cagr across various business over a particular timeline

EBIT (cagr %)	FY10-19 (10 yrs)	FY14-19 (5 yrs)	FY16-19 (3 yrs)
FMCG- Cigarettes	11.4	8.1	7.4
FMCG- Others (ROCE%)		16.5	70.2
Total FMCG	12.5	8.3	8.1
Hotels (ROCE %)	(2.0)	4.9	47.2
Agri Business	5.9	(1.4)	(5.9)
Paper Boards, Paper and packaging	6.1	6.8	10.9

Source: Company, PhillipCapital India

Two-year forward P/E band

EV/EBITDA band


Source: Company, PhillipCapital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY19	FY20E	FY21E	FY22E
Net sales	4,44,327	4,59,510	4,76,192	5,28,087
Growth, %	10	3	4	11
Other income	5,630	5,067	5,574	6,131
Total income	4,49,957	4,64,577	4,81,766	5,34,218
Raw material expenses	-1,73,052	-1,79,974	-1,94,371	-2,06,034
Employee expenses	-27,284	-27,284	-28,649	-30,654
Other Operating expenses	-76,566	-86,581	-92,424	-1,00,300
EBITDA (Core)	1,73,055	1,70,738	1,66,322	1,97,230
Growth, %	11.4	(1.3)	(2.6)	18.6
Margin, %	38.9	37.2	34.9	37.3
Depreciation	-13,117	-15,951	-17,075	-18,650
EBIT	1,59,938	1,54,787	1,49,247	1,78,580
Growth, %	11.1	(3.2)	(3.6)	19.7
Margin, %	36.0	33.7	31.3	33.8
Interest paid	-342	-547	-656	-788
Other Non-Operating Income	24,845	29,814	32,796	36,731
Pre-tax profit	0	0	0	0
Tax provided	1,84,442	1,84,055	1,81,387	2,14,524
Profit after tax	-59,798	-46,382	-45,655	-53,996
Net Profit	1,24,643	1,37,673	1,35,732	1,60,528
Growth, %	0	0	0	0
Net Profit (adjusted)	1,24,643	1,37,673	1,35,732	1,60,528
Unadj. shares (m)	12,259	12,259	12,259	12,259
Wtd avg shares (m)	12,259	12,259	12,259	12,259

Balance Sheet

Y/E Mar, Rs mn	FY19	FY20E	FY21E	FY22E
Cash & bank	37,687	50,159	65,077	76,443
Marketable securities at cost	1,25,066	1,25,066	1,25,066	1,25,066
Debtors	36,462	31,473	32,616	36,170
Inventory	75,872	75,536	78,278	86,809
Loans & advances	50	50	50	50
Other current assets	20,552	20,552	20,552	20,552
Total current assets	2,95,690	3,02,836	3,21,639	3,45,090
Investments	1,40,715	1,40,715	1,40,715	1,40,715
Gross fixed assets	2,28,527	2,58,527	2,83,527	3,08,527
Less: Depreciation	-43,663	-59,614	-76,689	-95,338
Add: Capital WIP	34,014	34,014	34,014	34,014
Net fixed assets	2,18,878	2,32,927	2,40,852	2,47,202
Non-current assets	42,698	42,698	42,698	42,698
Total assets	6,97,979	7,19,174	7,45,902	7,75,704
Current liabilities	92,769	93,928	95,202	99,166
Provisions	4,773	4,819	4,869	5,023
Total current liabilities	97,542	98,747	1,00,071	1,04,189
Non-current liabilities	20,939	20,939	20,939	20,939
Total liabilities	1,18,481	1,19,686	1,21,010	1,25,129
Paid-up capital	12,259	12,259	12,259	12,259
Reserves & surplus	5,67,239	5,87,229	6,12,634	6,38,317
Shareholders' equity	5,79,498	5,99,488	6,24,892	6,50,576
Total equity & liabilities	6,97,979	7,19,174	7,45,902	7,75,704

Cash Flow

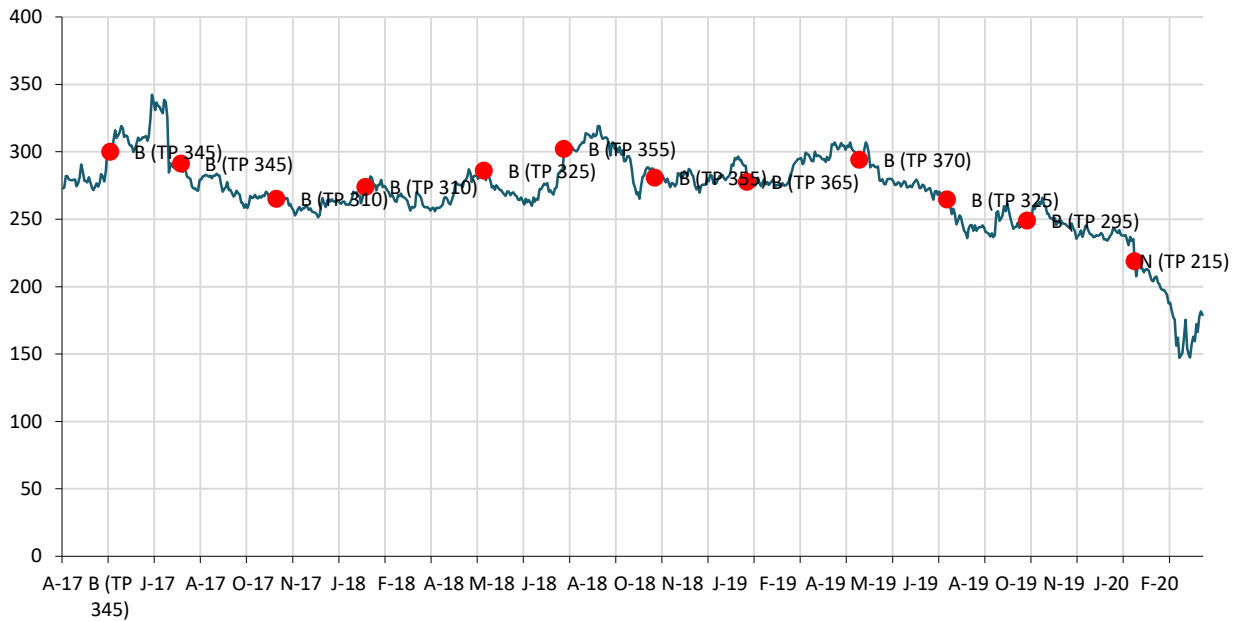
Y/E Mar, Rs mn	FY19	FY20E	FY21E	FY22E
Pre-tax profit	1,84,442	1,84,055	1,81,387	2,14,524
Depreciation	13,117	15,951	17,075	18,650
Chg in working capital	-13,852	6,530	-2,561	-7,967
Total tax paid	-54,903	-46,382	-45,655	-53,996
Other operating activities	0	0	0	0
Cash flow from operating activities	1,28,804	1,60,154	1,50,246	1,71,211
Capital expenditure	-26,079	-30,000	-25,000	-25,000
Chg in investments	-5,777	0	0	0
Chg in marketable securities	-26,031	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	-57,887	-30,000	-25,000	-25,000
Free cash flow	70,917	1,30,154	1,25,246	1,46,211
Equity raised/(repaid)	15,628	0	0	0
Debt raised/(repaid)	-32	0	0	0
Dividend (incl. tax)	-84,585	-1,17,683	-1,10,328	-1,34,845
Cash flow from financing activities	-68,989	-1,17,683	-1,10,328	-1,34,845
Net chg in cash	1,928	12,472	14,918	11,366

Valuation Ratios

	FY19	FY20E	FY21E	FY22E
Per Share data				
EPS (INR)	10.2	11.2	11.1	13.1
Growth, %	15.3	10.5	(1.4)	18.3
Book NAV/share (INR)	47.3	48.9	51.0	53.1
FDEPS (INR)	10.2	11.2	11.1	13.1
CEPS (INR)	11.2	12.5	12.5	14.6
CFPS (INR)	8.9	10.6	9.6	11.0
DPS (INR)	5.8	8.0	9.0	11.0
Return ratios				
Return on assets (%)	18.9	19.5	18.6	21.2
Return on equity (%)	21.5	23.0	21.7	24.7
Return on capital employed (%)	22.0	22.6	21.5	24.4
Turnover ratios				
Asset turnover (x)	1.8	1.8	1.8	1.9
Sales/Total assets (x)	0.7	0.6	0.7	0.7
Sales/Net FA (x)	2.1	2.0	2.0	2.2
Working capital/Sales (x)	0.1	0.1	0.1	0.1
Receivable days	30.0	25.0	25.0	25.0
Inventory days	62.3	60.0	60.0	60.0
Payable days	44.4	43.3	41.8	43.4
Working capital days	30.2	24.0	25.2	28.3
Liquidity ratios				
Current ratio (x)	3.1	3.1	3.3	3.4
Quick ratio (x)	2.3	2.3	2.5	2.5
Interest cover (x)	467.8	283.0	227.4	226.7
Net debt/Equity (%)	(6.5)	(8.4)	(10.4)	(11.7)
Valuation				
PER (x)	17.5	15.8	16.1	13.6
PEG (x) - y-o-y growth	1.1	1.5	(11.4)	0.7
Price/Book (x)	3.8	3.6	3.5	3.4
EV/Net sales (x)	4.5	4.4	4.2	3.8
EV/EBITDA (x)	11.7	11.8	12.0	10.0
EV/EBIT (x)	12.6	13.0	13.3	11.1

Source: Company, PhillipCapital India Research Estimates

Stock Price, Price Target and Rating History



Rating Methodology

We rate stock on absolute return basis. Our target price for the stocks has an investment horizon of one year. We have different threshold for large market capitalisation stock and Mid/small market capitalisation stock. The categorisation of stock based on market capitalisation is as per the SEBI requirement.

Large cap stocks

Rating	Criteria	Definition
BUY	$\geq +10\%$	Target price is equal to or more than 10% of current market price
NEUTRAL	$-10\% > \text{to} < +10\%$	Target price is less than +10% but more than -10%
SELL	$\leq -10\%$	Target price is less than or equal to -10%.

Mid cap and Small cap stocks

Rating	Criteria	Definition
BUY	$\geq +15\%$	Target price is equal to or more than 15% of current market price
NEUTRAL	$-15\% > \text{to} < +15\%$	Target price is less than +15% but more than -15%
SELL	$\leq -15\%$	Target price is less than or equal to -15%.

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