HDFC securities

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20 YEARS

Initiating Coverage

ITC Limited

17-May-2021

RETAIL RESEARCH

ITC Limited

Industry	LTP	Base Case Fair Value	Bull Case Fair Value	Recommendation	Time Horizon
FMCG	Rs. 212	Rs. 228	Rs. 250	Buy at LTP and add on dips to Rs189-195 band	2 quarters

HDFC Scrip Code	ITCLTDEQNR
BSE Code	500875
NSE Code	ITC
Bloomberg	ITC:IN
CMP May 14, 2021	212
Equity Capital (cr)	1230.5
Face Value (Rs)	1
Eq- Share O/S(cr)	1230.5
Market Cap (Rscr)	252331
Book Value (Rs)	52.7
Avg.52 Wk Volume	33324897
52 Week High	239
52 Week Low	161

Share holding Pattern % (March 31, 2021)	
Promoters	0
Institutions	55.3
Non Institutions	44.7
Total	100.0

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Our take

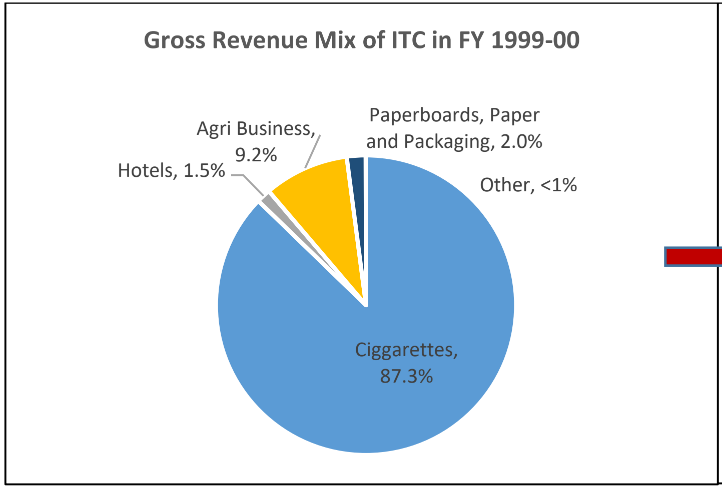
ITC Ltd: A True Indian Conglomerate

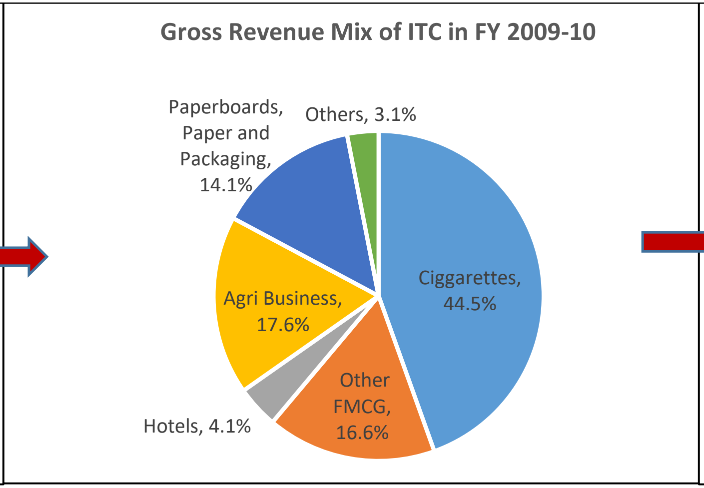
ITC has a diversified presence in cigarettes, FMCG, hotels, packaging, paperboards & specialty papers and agri-business. Apart from having a near borderline monopoly in its traditional business of cigarettes, ITC is the country's leading FMCG marketer, a clear market leader in the Indian paperboard and packaging industry, a globally acknowledged pioneer in farmer empowerment through its wide-reaching agribusiness, and a preeminent hotelier in India - a trailblazer in 'Responsible Luxury' chain of hotels. ITC's wholly-owned subsidiary, ITC Infotech, is a specialized global digital solutions provider. Over the past decade, the company's relatively new consumer goods businesses have established a vibrant portfolio of many world-class Indian brands that create and retain value. ITC's world class FMCG brands including Aashirvaad, Sunfeast, Yippee, Bingo, B Natural, ITC Master Chef, Fabelle, Sunbean, Fiama, Engage, Vivel, Savlon, Classmate, Paperkraft, Mangaldeep, Aim, and others have garnered encouraging consumer franchise within a short span of time. While many of these brands are market leaders in their respective segments, others are making appreciable progress.

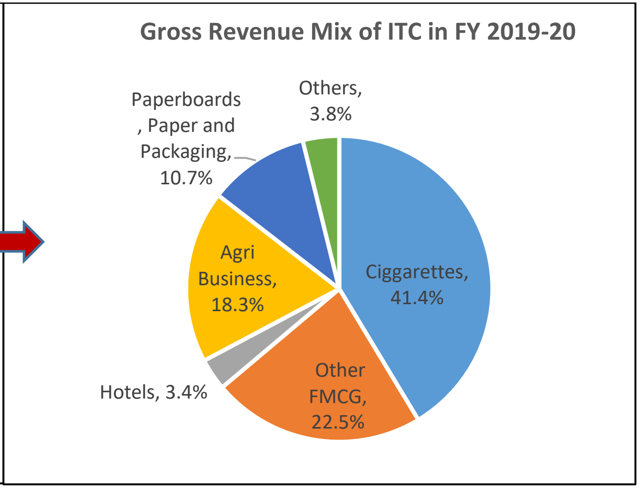
The competitiveness of ITC's diverse businesses rests on the strong foundations of institutional strengths derived from its deep consumer insights, cutting-edge research & development, differentiated product development capacity, brand-building capability, world-class manufacturing infrastructure, extensive rural linkages, efficient trade marketing and distribution network and dedicated human resources. The company's ability to leverage internal synergies across its diverse businesses lends it a unique type of competitive advantage.

ITC Limited

A glimpse at past 3 decades of ITC







Valuations and recommendation

Cigarettes in good health despite near-term overhang: The cigarettes division contributes to ~84% of ITC's profits. Resurgence of Covid-19 and subsequent lockdowns (with cigarettes being a non-essential category), punitive taxation, and rising illegal market are the near-term overhangs but the long-term story of this segment remains intact. Against the backdrop of strong demographics, we believe that cigarette volumes will recover once Covid threat subsides, driven by (1) improving consumer sentiment, (2) recovery in rural consumption (upgrade from bidi to mini cigarette) which forms 2/3rd volume share, (3) improving standard of living, (4) stable tax environment and (5) curbing illicit trade (driven by the WHO treaty). Our thesis assumes that tax hikes (price hike not more than general inflation) will not be as steep as witnessed in the past five years. In this scenario, ITC can deliver mid to high single digit volume growth. Additionally, the volumes have gradually recovered in H2FY21 and company has gained market share.

FMCG business is in sweet spot: ITC's FMCG business gained momentum due to COVID-19 as revenue in 9MFY21 grew by 14% Y-o-Y, while EBIT witnessed 2.3X growth (driven by hygiene and personal care categories) as margins doubled. Taking the advantage of the favorable market, the company came up with 100+ launches post lockdown. We expect this strong momentum to continue in the near future.
ITC, in its packaged food portfolio, has successfully built power brands like Aashirvaad, Sunfeast and Bingo. Its strengths are backward integration, large appetite to invest in brands, and pan-India distribution. With improving consumption dynamics, ITC can scale its existing portfolio (a 13x opportunity) through several brand extensions and enter new categories. We believe ITC's strategy will also be around profitable growth after achieving a meaningful scale.

The paperboards and packaging business grew by 17% in 9MFY21 as offtake continued to improve across most major end-user segments while margins increased by 237 bps due to a favorable mix. The agri business had a good Q3FY21 with 18.5% Y-o-Y growth, driven by trading opportunities in rice, soya, and wheat exports. However, leaf exports were impacted by subdued demand for leaf tobacco in international markets, which affected profitability. The hotels business (3.4% of revenue) is likely to stay impacted due to travel restrictions after the onset of the second wave of COVID-19.

Capital allocation concerns resolved, expect favorable returns, going ahead: In terms of capital allocation, major capex in hotels and FMCG has already taken place, according to the management. The company has developed a sizeable footprint in hotels and successfully entered various FMCG categories; the focus now would be to scale these businesses before incurring any further investments, which shall drive the returns, going ahead. With reduced cash requirements, ITC has changed its dividend payout ratio to 80-85% vs. ~67% earlier, highlighting the commitment towards shareholder wealth creation.

At 14.4x FY23 EPS, ITC trades at a steep discount to the FMCG sector. The company is one of the leading FMCG companies in the country and, at these valuation, there is limited downside risk, and the risk-reward ratio in the current market scenario is favorable for ITC. We recommend a buy on the stock at LTP and add on dips to Rs. 189-195 band with a base case target of Rs.228 (15.5x FY23E EPS) and a bull case target of Rs.250 (17x FY23E EPS).

Financial Summary (Rs Cr)

Particulars (Rs cr)	Q3FY21	Q3FY20	YoY-%	Q2FY21	QoQ-%	FY20	FY21E	FY22E	FY23E
Net Revenues	12580	12013	4.7	11977	5.0	49404	48569	54600	60631
EBITDA	4281	4613	(7.2)	4061	5.4	19260	17244	20330	23416
APAT	3663	3777	(3.0)	3232	13.3	15228	13630	15909	18189
Diluted EPS (Rs)	3.00	3.10	(3.1)	2.60	13.3	12.4	11.1	12.9	14.7
P/E (x)						17.1	19.1	16.4	14.4
EV/EBITDA						11.6	12.8	10.7	9.1
RoE-%						24.9	20.7	23.0	24.8

(Source: Company, HDFC sec)

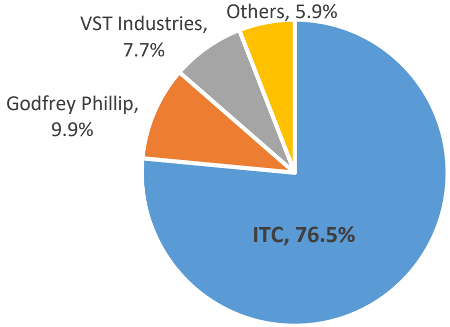
Long-term triggers

The behemoth of Indian cigarette industry

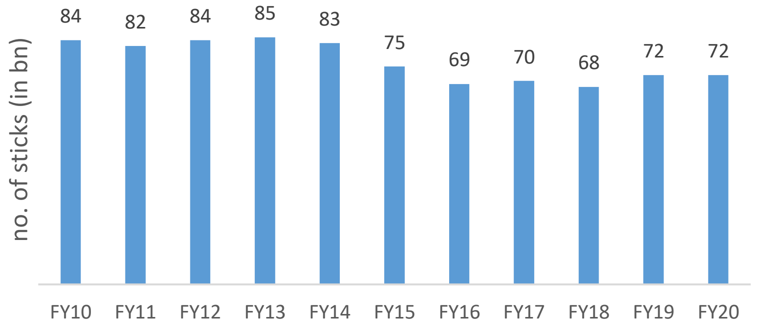
The tobacco industry, like alcohol industry, is both stringently regulated and ‘media dark’ and it offers strong competitive advantage to the existing players. They can’t advertise their products. They can’t package it the way they like. If a newcomer really wants to build a stronghold, it will need to do so through strong distribution that can reach the most remote corners of this country. These subtle features make ITC an impenetrable fortress. The company has an 84% market share in value terms in the organized sector, which is a borderline monopoly. The cigarette business, with its extensive contribution of ~41% to gross revenue, continues to provide the company a firm foundation for growth. The volumes have witnessed a dip post FY12 due to rampant rise in sales of illegal cigarettes and a sharp rise in taxes. However, despite this, EBIT has consistently increased over the years, showcasing the pricing power the company enjoys. In our estimate, EBIT per stick has increased by a whopping 7.3X over the past 20 years. We believe favourable demographics, curbing of illicit trade, and brand innovations will drive the volume growth over the long term.

Well established portfolio of in-house parent brands

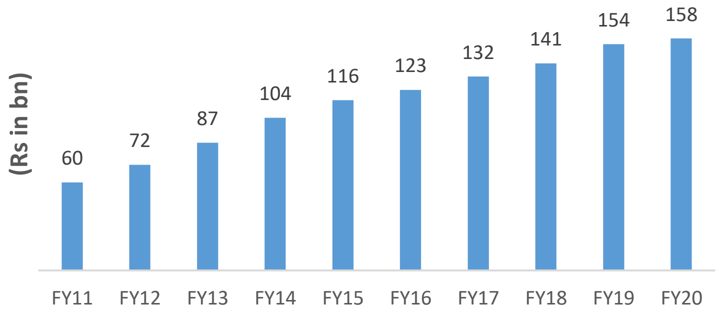
ITC dominates the organised cigarette industry with ~77% volume market share



Post FY12 ITC's volumes dipped due to rise of illicit cigarette market

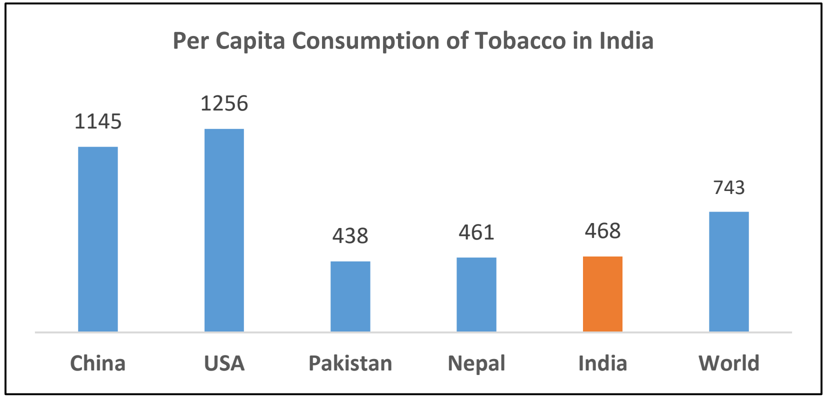


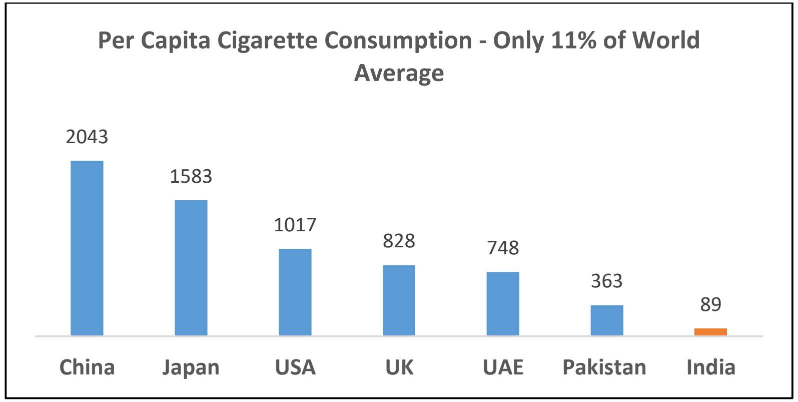
Despite dip in volumes EBIT has increased at ~12% CAGR indicating supreme pricing power of ITC



<u>**Cigarettes Industry in India - the good, the bad and the ugly**</u>

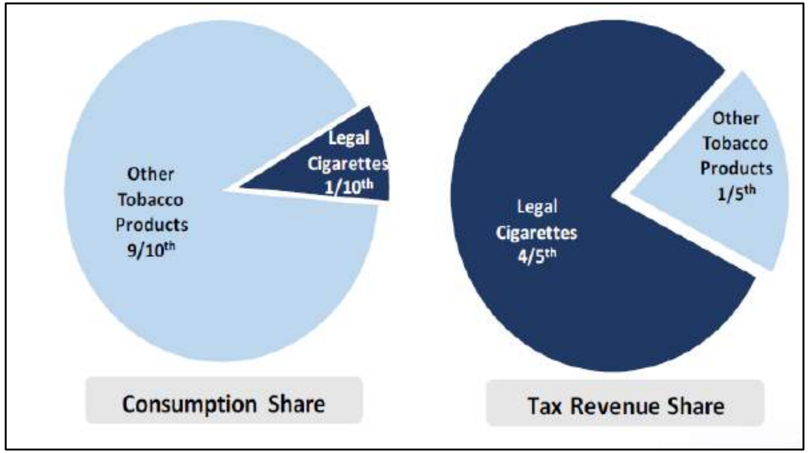
Underpenetrated market: World consumes 5,500bn cigarettes/year, and India contributes a mere ~2% to that. India consumes only 15% of tobacco in the form of cigarettes. India's tobacco consumers are dominated by smokeless tobacco (Khaini, Gutka and Paan Masala) users. Besides this, the annual per capita adult cigarette consumption in the country is 11% of the world average. Out of the 42% of adult Indian males who consume tobacco, only 7% smoke cigarettes vs 14% who smoke bidis and 30% who use smokeless tobacco. Cigarette smoking is the least harmful of all forms of tobacco consumption vs chewing tobacco or smoking bidis. The government plans to undertake initiatives to discourage the use of other more harmful forms of tobacco consumption mentioned above. This would be a positive for ITC, which has the largest market share in legal cigarettes in the country.

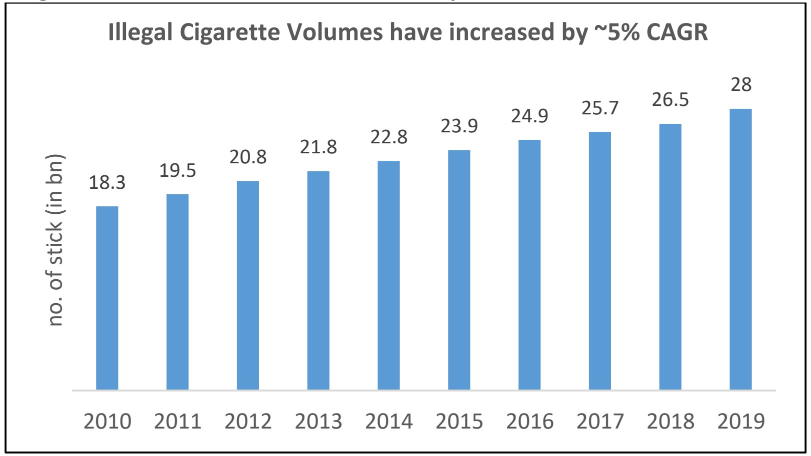




Punitive taxation: The cigarettes category remains heavily impacted by punitive and discriminatory taxation. In the period between 2011-12 and 2017-18, taxes on cigarettes almost trebled (on a comparable basis). In July 2017, the industry was further impacted by a sharp increase of 13% in tax incidence under the GST regime. The short period of relative stability in taxes was halted in February 2020 with a sharp increase of 13% in tax. Cigarette taxes have hit the threshold of diminishing returns. As amply demonstrated over the past decade, whilst Central Excise Duty rates increased by a CAGR of 15.7% between 2012-13 and 2016-17, tax revenue from cigarettes grew at merely 4.7% CAGR during the same period. The government took cognizance of the same and did not raise taxes in Budget 2021. Discriminatory taxation on cigarettes has caused progressive migration from consumption of duty-paid cigarettes to other lightly taxed/tax-evaded forms of tobacco products, comprising illegal cigarettes, bidi, chewing tobacco, gutkha, zarda, snuff, etc. However, despite higher taxes pressures, pictorial warnings, and ban on smoking in public places, ITC has registered ~6% growth (CAGR) and improvement in profitability in the past five years, which highlights the company's sheer dominance in the industry.

Legal Cigarettes contribute more than 4/5th of Tax Revenue, despite constituting less than 1/10th of Tobacco Consumption





Illegal cigarette market on the rise: The punitive taxes on the cigarette industry have led to an alarming rise in illicit cigarette trade in the country. Euromonitor International ranks India as the fourth-largest illicit cigarette market globally – a dubious distinction arising, courtesy the punitive taxation on cigarettes, which has created a web of enormously attractive tax arbitrage and lucrative opportunities for unscrupulous players. It is estimated that on account of illegal cigarettes alone, the revenue loss to the government is almost Rs. 15,000 Cr per annum. About 68% of the total tobacco consumed in the country remains outside the tax net. While legal cigarette industry volumes have declined by about 20% between 2010-11 and 2019-20, the illicit duty-evaded cigarette segment has grown by 36% during the same period, accounting for about one-fourth of the domestic industry and making India one of the fastest growing illicit cigarette markets in the world. The government has made efforts to crack down on illegal cigarette players in the country and has found success in many regions.

Losing market share to smaller players: ITC's market share Pan-India is untouchable; however, the company has been losing market share to smaller players, especially in the southern states. Peers like Godfrey Phillips and VST have outgrown ITC by 100-150bps by entering new markets. While this is a cause for concern for ITC, the management is confident in regaining the share lost through product innovation, brand positioning, and competitive pricing.

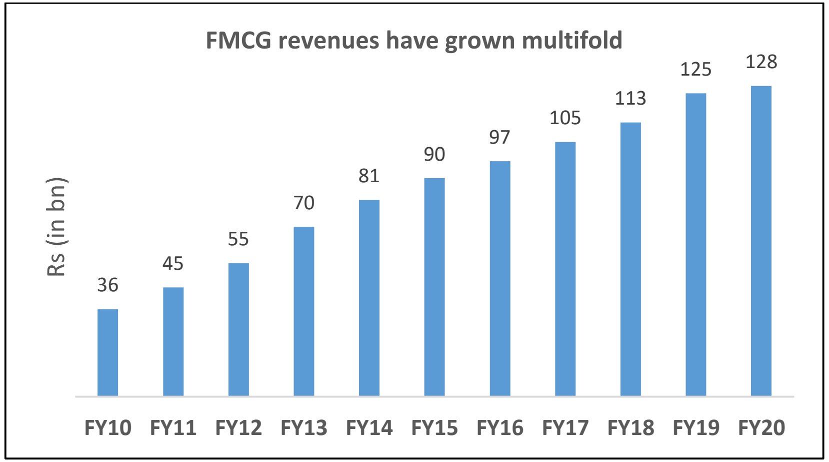
Impact of COVID-19 and the way forward: ~84% of ITC profits are attributed to the cigarettes business. In the lockdown, cigarettes are not considered essential commodities; hence, ITC's revenue was impacted in H1FY21, and recovery has been gradual in H2FY21. Besides, as per media sources, the sales of illegal cigarettes in H1FY21 had relatively skyrocketed as smokers ran out of options. Some smokers are even avoiding cigarettes to build immunity and good health during these troubled times, as cigarette smoking can be injurious to lung health. With restriction imposed on restaurant, bars and travel industry, social smoking would also go down. Return to normalcy in terms of pre-Covid revenue and growth in the cigarettes business is not expected in the short term with second wave of Covid-19 and subsequent regional lockdowns.

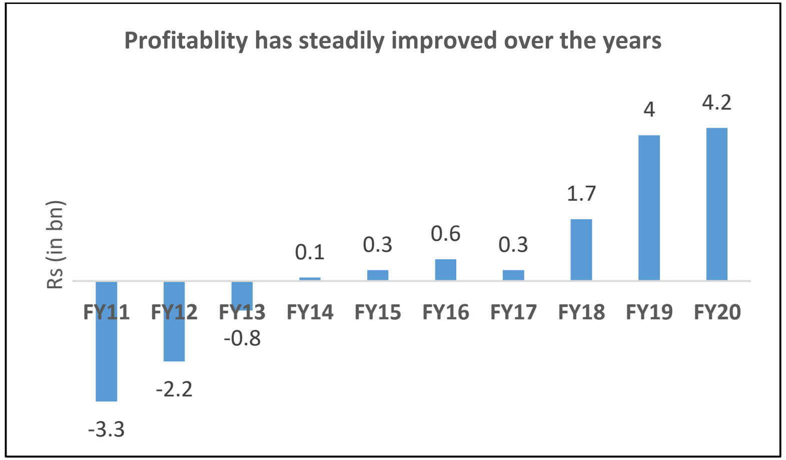
To counter some of these negatives, the company has introduced many innovative products and variants in the recent past like Classic Double Burst, Gold Flake Mint Switch, Flake Mint Switch, Bristol Magnum, Navy Cut Century and a new brand, Wave. The company has progressively developed the capacity to manufacture 100% of its capsule requirement. Currently, about 80-85% of total capsule requirements are manufactured in-house. ITC has a 60%+ market share in capsules; the overall share is >75%. An imported capsule is 20 paise/stick costlier than that produced in-house. Most of the competition relies on imports for their capsule requirements. ITC is only the second company in the world to produce capsules. Capsule cigarettes (switch) contribute 11-12% of revenue.

FMCG: Growth is value accretive

In 2001, ITC entered the non-cigarette FMCG space with the launch of branded food products. Gradually, the company moved into noodles, biscuits, soaps, skin care, deodorants, and other product categories. The business has grown multi-fold over past two decades with revenue from this segment increasing from Rs. 109 Cr in FY03 to Rs. 12,844 cr in FY20, making ITC the third largest FMCG player. Although it took nearly 12 years to post a profit in the FMCG segment, the profitability has been improving due to enhanced scale, better product mix (increasing premiumisation), investment in supply chain, and various cost saving initiatives.

The company has undertaken several new launches/re-launches and acquisitions in the packaged food and personal care categories. ITC is interested in acquiring those brands which it can leverage with its strong procurement and distribution network. Most of the launches are in new formats (shower gel, pocket deo, innovative sanitizers, etc.) where competition is low and it would be easier for the company to scale up the acquired brands. ITC's addressable market offers a 13x opportunity headroom. The management has set an ambitious target of Rs. 1,00,000 Cr revenue in FMCG business (ex-cigarettes) by 2030, which is nearly 8X its current sales (Rs. 12,800 Cr). It also wants to improve its EBITDA margin to 10% by FY23; however, we believe the margin in the near term would remain slightly low on account of investments in brands and gestation costs of acquisitions.





Acquire and reload: ITC has a history of highly rewarding acquisitions, although it was slow to acquire in the past and was limited to small purchases (with none of the earlier acquisitions costing more than a couple hundreds of crores). It bought Savlon—an antiseptic liquid and soap brand at that time—and prickly-heat powder *Shower to Shower* from US-based multinational Johnson & Johnson in 2015 for an estimated sum of Rs 250-300 Cr. It had picked up the juice brand B Natural for Rs 100 cr in 2014. Four years later, it entered the home care market, acquiring the Nimyle brand of floor cleaners for an undisclosed sum. In contrast to this history of small purchases, last year, ITC acquired spices manufacturer Sunrise Foods for Rs. 2,150 Cr. The spices maker had revenue of nearly Rs 600 crore in FY20. Sunrise also adds to ITC's presence in spices through the Aashirvaad and MasterChef brands. Having piles of cash gives the company a further headroom for inorganic growth.

FMCG business is skewed towards packaged food: The company has been successful in building brands, particularly in the packaged food portfolio (Aashirvaad, Sunfeast, Bingo, Yippee, etc.), which contributes ~75% of the FMCG business. We foresee significant scope for brand extension in Aashirvaad and Sunfeast brands. Besides, chocolates, juices and dairy business have immense potential to attain scale. In the medium term, the foods business is expected to be the heavy lifter for the segment, with contribution increasing from 16% of total revenue in FY16 to 22% in FY20 while the acquisition of Sunrise Foods will further add 6-7% to the revenues.

Personal care growth is led by innovation: ITC has also developed strong brands in the non-packaged food business (personal care, apparels, education & stationary, *agarbatti*), which contributes the remaining 25%. Personal care portfolio growth is driven by several innovative launches. Engage pocket deo (~Rs 60) now contributes more than a third of the deo portfolio; it has 11% market share in the deo segment. Fiama has become stronger in the shower gel business and is at number 2 with 18% market share. The shower gel business is ~10% of the soaps business. COVID-19 has been a blessing for this segment. Savlon is on the path to report 4X growth in FY21 while Nimyle, a floor cleaner and disinfectant brand, is said to have reached consumer spends of ~Rs. 200 cr in FY21.

Savlon: a quiet success story: ITC's next Rs 1000 Cr brand, Savlon, is one of the company's most successful acquisitions. The brand witnessed a CAGR of 50% and a 15-16X growth after its trademark was acquired from Johnson & Johnson India in 2015. According to the management, Savlon is expected to touch the Rs 1,000 Cr sales mark in FY21, which is 4X the sales (Rs. 250 cr) reported in FY20. It is the first brand in the personal care business division to touch this revenue milestone. The growth witnessed in Savlon is due to heightened demand for health and hygiene products during the pandemic coupled with ITC expanding its distribution and product portfolio. The company has launched nine products under Savlon since the onset of the pandemic; these include disinfectant sprays, masks, cloth sprays, wipes, soaps and body washes. When ITC had acquired Savlon from Johnson & Johnson five years ago, the brand used to clock only Rs.50 cr in sales. We expect Savlon to further thrive amidst the second wave of Covid-19. The growth of Savlon tells us a lot about the management's ability to leverage the company's brand name and operational efficiency to grow smaller brands in the space.

East India dairy business: ITC sells fresh dairy products such as milk, curd, paneer, and lassi in 24 cities in Bihar, while in Bengal, it has tapped the Kolkata market. It entered fresh dairy with its Aashirvaad Svasti brand in February 2018. In the past two years, it has garnered

8-10% market share in Kolkata. The company is now launching a premium variant of pouch milk under the Select variant, which will offer consumers a daily quality assurance report through "Doodh-er Report card" or a report card for milk. The management is looking to expand its foothold in the east India market and can enter new cities in the coming quarters. Apart from fresh dairy, ITC also has milk shakes under the Sunfeast Wonderz brand and ghee under the Aaashirvaad brand. Aashirvaad ghee is available in six states and on the e-commerce platform; the milk shake was launched in the south but is expected to be launched in other markets too.

FMCG segment mapping: ITC's addressable market offers a 13x opportunity headroom

Brand	Current Presence	Possible Extension	Brand Position	Market Position	Est. market Size (in Rs. Cr.)	Est. ITC Revenue (in Rs. Cr.)	Key Competitors
				Food			
Aashirvad	- Wheat - Ghee - Spices - Instant Mixes - Ready-to-eat - Rice - Milk, Curd, Paneer, - Salt	- Pickles - Grains (White Flour, semolina	Mid	No.1	15,000	4,200	- Pillsbury Atta - Silver Coin - Mothers' Recipe
Sunfeast	- Biscuits - Cookies - Cakes - Beverages - Pasta	-Modern milk products - Rusk/ Bread - Chocolate - Oats -Breakfast packaged food	Mid to premium	No. 1 in premium biscuit segment	59,000	3,500	-Britannia - Parle - PriyaGold - Anmol
Bingo	Packaged Snacks	-Other snacking products	Mid	No. 1	21,900	2,000	-Lays(Pepsi) -Diamond (Prataap Snacks) - Haldiram
Yipee	-Noodles -Pasta	-Oats	Mid	No. 2	15,300	1,000	-Maggi(Nestle) -Top Ramen (Nissin)
-Mint-O -Gum-On -Candyman	- Confectionery	- More Variants	Mid	Top 5	4,080	500	
B-Naturals	Juices	-Health Supplements	Mid	Emerging	3,000	100	-Real(Dabur)

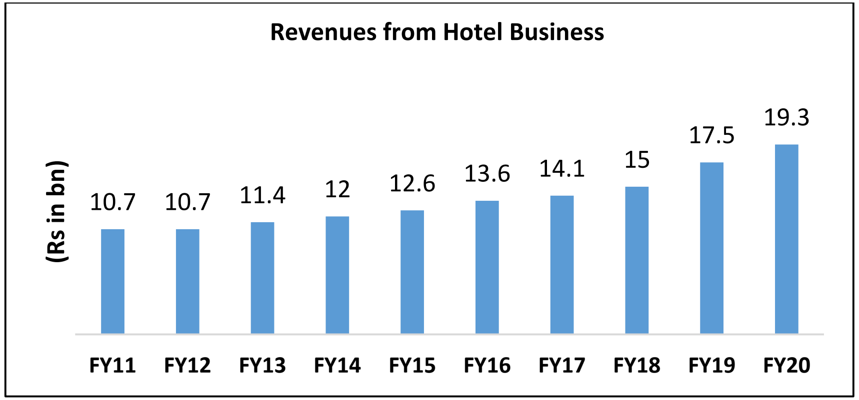
							-Tropicana (Pepesi)
Fabelle	Chocolate	-Mid to Mass Chocolates	Super-premium	Emerging	8,000	10	-Cadbury (Mondelez) - Nestle
Personal Care							
Fiama	-Shower Gel - Soap Bar - Talc - Body Oils	- Shampoo - Shaving Cream - Face Wash	Premium	No. 2	2,000	360	-Nivea(Beiersdorf Global) - Palmolive - Dove (HUL)
-Vivel -Superia	- Soap Bar	- More Variants	Mass to Mid	NA	20,000	600	-Lux, Lifebuoy, Dove, Pears, Hamam (HUL) - Godrej No. 1, Cinthol (GCPL) - Santoor (Wipro)
Engage	-Deos -Perfume -Pocket Perfume	- Face Wash - Talc	Premium	No. 2	4,000	440	-Fogg (Vini Cosmetics) - Wild Stone - Park Avenue - Axe
Essenza Di Wills	-Perfume	- Face Cream - Moisturizer	Super-premium	Emerging	2,000	NA	-Fogg (Vini) - Skinn (Titan) -Park Avenue (Raymond)
Savlon	-Anti Septic Liquid - Soap - Handwash - Hand Sanitizer -Disinfectant Liquid	- Shower Gel - Shaving Cream	Mid	No. 2	1,000	200	Dettol (Reckitt Benckiser)
Charmis	-Cold Cream	- Moisturizer	Mid	NA	NA	NA	-Nivea(Beiersdorf Global) - Pond’s (HUL)
Dermafique	-Anti-aging	-More-variants	Premium	Emerging	NA	NA	-Olay(P&G) -Lakme (HUL) - Nivea (BG)
Shower to Shower	Talc	-Shower Gel -Soap Bar -Talc	Mid	NA	400	24	-Himalaya -Dermi Cool (Reckitt Benckiser) -Boroplus (Emami) -Nycil (Kraft Heinz)
Home Care							
Nirmyle	Floor Cleaner	-Kitchen Cleaner - More Variants	Mid	Emerging	10,000	NA	-Lizol (Reckitt Benckiser) - Domex (HUL)

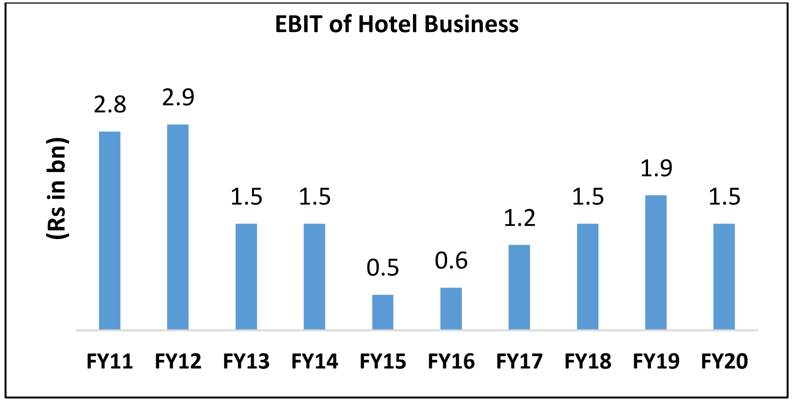
Others							
-Classmate -Paperkraft	-Notebooks -Pen -Pencil -Geometric Box -Art Instruments	-More Variants -Office Stationery	Premium	No. 2	10,000	1,000	-Navneet -Luxzor
Wills	Life Style	-Increase Product Range -Enter into mid-premium	Premium	NA	NA	719	-All leading men's formal wear band
-AIM -Ship -Home Lites	Safety Matched	-Cigarette and gas stove lighters	Mid	No. 1	1,000	236	-Highly Unorganised
-Mangaldeep	Dhoop & Agarbattis	-Other Variants - Air Freshners	Mid	No. 1 in Dhoop and No. 2 in Agarbattis	7,000	800	-Cycle Pure Agarbathies -Moksh Agarbatti -Hem Agarbatti

ITC has strong portfolio of 25 mother brands

Hotels business: recovery prolonged amidst COVID 2.0

The hotels business of ITC remains amongst the fastest growing hospitality chains in the country with 109 properties and over 10,250 rooms under four distinct brands – 'ITC Hotels' in the luxury segment, 'Welcomhotel' in the upper-upscale segment, 'Fortune' in the mid-market to upscale segment and 'WelcomHeritage' in the leisure & heritage segment. ITC has adopted an 'asset right' strategy with higher share of management contracts (50% revenue mix). This strategy envisages a large part of incremental room additions, going forward, to accrue through management contracts, which should expand the RoCE once the Covid threat has gone down and the economy recovered.





The hotel industry was coming out of a deep lull after the 2007 peak, when ARRs and occupancy rates were at lifetime highs. Room supplies in the past decade have moderated as the industry looked to match demand. Just when industry started to pick up growth momentum driven by increase in inbound and domestic tourism, meetings & conventions and retail segments, the onset of the Covid-19 pandemic cut short the revival.

Hospitality sector: affected by COVID, recovery to take time: The travel & hospitality sector is amongst the most severely impacted ones in the wake of the COVID-19 pandemic. With severe cutbacks in travel for leisure as well as business, and heightened sensitivity around hygiene and social distancing, revenue streams across all segments of operations have been significantly impacted. The revival of the sector is dependent not only on the timing and degree of relaxation of lockdown measures but also on the pick-up in business and leisure travel and consumers gaining assurance of the hygiene and safety standards at hotel properties. While there are significant near-term challenges on account of the outbreak of the pandemic, the sector continues to hold immense potential in view of the robust long-term economic and tourism prospects of the country.

Unique business model – solid backward integration

What distinguishes ITC's business model from the rest of the players in the space is the extent to which the company owns its distribution chains. A large part of the activities of agri and agri products as well as paper and paperboards groups involve provision of services to its own companies (inter-segment sales).

ITC has diligently worked on building what's now one of its key strengths - backward integration. It sources commodities through its e-Choupal with its 4-million-plus farmer network and uses its expertise in the hotel business (ITC owns the second largest hotel chain in India) to understand the Indian palette for the food business. Its paper mills supply paper and recycled board for notebooks and the packaging and printing division packaging for all FMCG products, including cigarettes. In short, it has reasonable control over input costs and margins, which have become the biggest headaches for its rival consumer-goods makers. Sourcing integration acts like an insurance in times of high inflation.

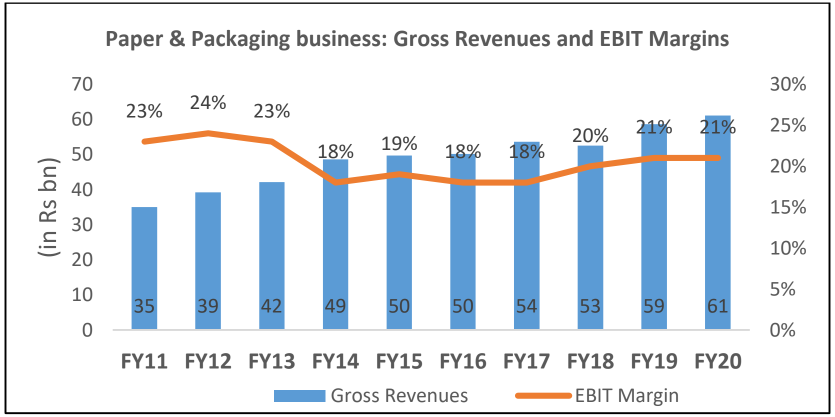
The logic behind ITC's backward integration is straightforward, while understanding of other businesses is more arcane. The company believes that it has a 'strong FMCG DNA' because of its involvement in the cigarette business over the past 110 years. The company is capable of creating and sustaining strong brands, which is the fundamental reason why it is present in the FMCG business. Moreover, it has a strong distribution network, in many ways unique (ITC's cigarette offerings are available at >2 mn paan shops across the country), which can be exploited better. ITC, for example, now produces the following products that are/can potentially be marketed from paan shops— matches, incense sticks, Grade 1 soap and shampoos (Superia), Sunfeast biscuits, stationery products, candies, and chips (Bingo). ITC leverages strengths across several segments which may not always be replicable. For example, Aashirvaad's unique blend is helped by ITC's superior procurement design (e-choupal). The distribution strength created by Aashirvaad feeds into distribution strengths of other products.

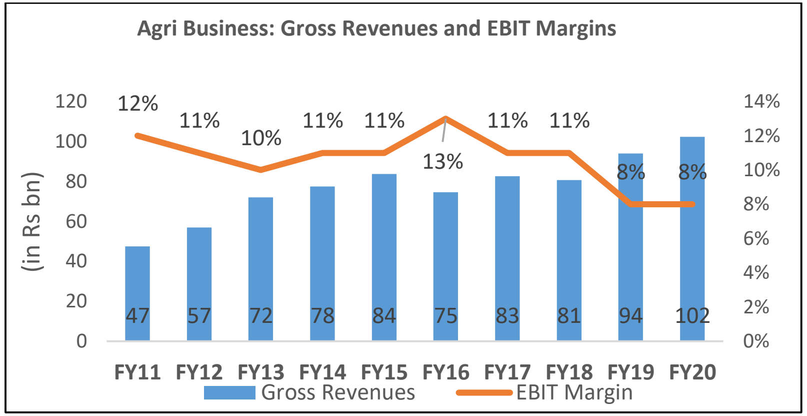
Top-down strategy

ITC's success in cracking various categories in the FMCG business can be attributed to its "top-down" approach. It's a strategy that it has perfected in its mainstay cigarette business and replicated in the personal care, food and stationery operations.

Typically, ITC enters a new category at the premium end, builds the brands, and then rolls out a mass range. For example, it entered the stationery segment with the premium Paperkraft range in 2002 and then followed it up with the mass-market Classmate range in the subsequent year. By 2007, Classmate became the largest notebook brand in the country. Indian consumers prefer to buy premium and imported products, rather than "cheaper" options. We believe if ITC has started at the bottom end of the market, it would have had issues breaking the consumer mindset in being accepted then as a premium brand.

Add to above achievements the advantages of better margins and a juicy sales mix, it's no wonder that ITC is replicating the strategy across categories. The company entered the food business in 2001 with premium ready-to-eat brand Kitchens of India and, in 2003, launched the Aashirvaad range of mid-segment ready meals. Similarly, in 2005, when it forayed into the personal care market, it was through the super-premium brand Essenza Di Wills in perfumes, bath, and body care. This was followed by the premium brand Fiama Di Wills in 2007, the mid-market brand Vivel, and eventually the mass-market Superia.





Agri business is a volatile one

Agribusiness is largely a trading business which consists of unmanufactured tobacco (over one-third of revenue mix) and other agri products and commodities (wheat, soya, spices, coffee, etc.). Like any other commodity business, the agribusiness is prone to high volatility. However, over a period of time, ITC has been able to develop a strong network with farmers which provides extensive backward linkages to the business and has reduced the volatility. ITC's 'e-Choupal' model created a significant two-way multi-dimensional channel with farmers. Through 'e-Choupal', the company is now connected with more than 4 mn farmers across 40,000 villages. Strong procurement via its agribusiness is a key driver in supporting its food business.

Tobacco production is highly remunerative

India is the world's second largest producer of tobacco. Tobacco is grown in poor and marginal soils that are unsuitable for cultivation of other crops. It is a labor intensive crop and highly remunerative, providing higher returns vs. other crops in the region. Considering the government's impetus on driving the rural economy through creating jobs (focus on labor intensive sectors), we don't foresee the government raising cigarette taxes to an extent that will impact tobacco farmers.

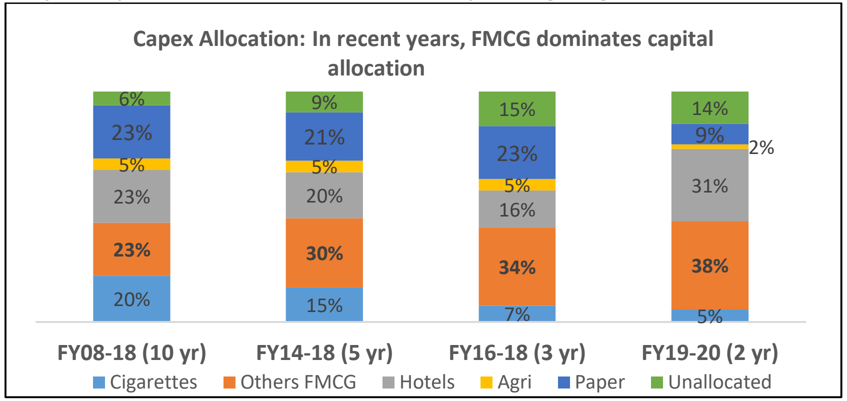
ITC has consolidated its leadership position as the largest Indian exporter of unmanufactured tobacco. To offset the declining offtake by global majors in recent times, which is aggravated by Covid-19, it has acquired several new customers in recent years, generating substantial revenue last year. Further, it is exploring export opportunities in the nicotine derivatives space in view of the increasing demand for nicotine salts, liquid nicotine, etc., in certain international markets. This tobacco production continues to provide strategic sourcing support to ITC's cigarettes business, meeting all requirements at competitive prices, thereby giving the company a massive edge over competitors.

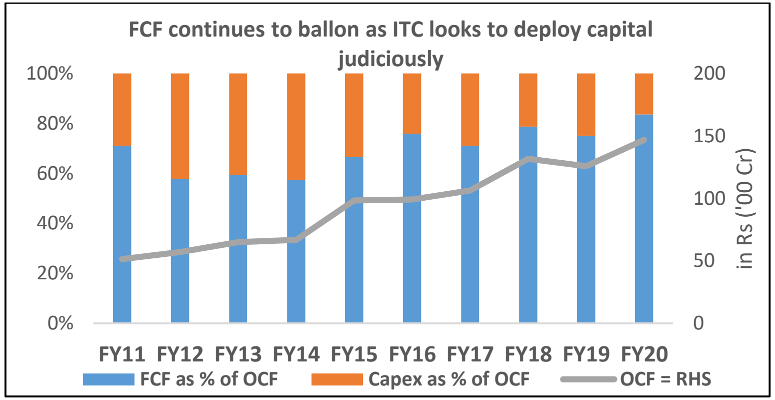
Paper industry: good opportunity

ITC's Paperboard and Paper business contributes >80% of this segment's revenue while the rest is led by printed materials. The paper business is also a strategic move for backward integration of the cigarette business. A large portion of this business is being consumed internally. In recent years, ITC's paper business was impacted by the slowdown in end-user industries such as FMCG (incl. cigarettes), liquor and pharmaceuticals coupled with cheaper imports. On the brighter side, benign input costs, greater use of in-house pulp vs. imports and richer product mix continued to drive EBIT growth. Within paperboards (ITC holds leadership position), value-added paperboards are expected to grow at 10.5% CAGR, driven by growth in FMCG, pharma and F&B industries.

We expect that with higher growth in FMCG and other end-user industries, ITC's paper business can sustain low double-digit revenue growth. The operating leverage and higher contribution from the value-added products would further improve the margin profile of this business.

Major Capex done, return ratios to improve going ahead:





Focus on incremental RoCE: Over the years, FMCG (ex-cigarettes) has been the area of focus as demonstrated by increasing capital allocation towards the business. This has been followed by hotels and paper segments. The company has built a solid footprint in the hotels business and now with increasing focus on asset-right strategy, the intensity of capex in the hotels business will reduce, going ahead, with current projects either completed or in final stages of completion. Therefore, capital allocation in the non-FMCG business would be limited, going ahead. Even the capex for FMCG business is expected to be kept under check as the company would focus on scaling up various new categories it entered in the recent past and take them to the top, before exploring other areas.

Our take on the possibility of demerger: The cigarette business is still doing the heavy lifting (84% of profits despite just ~41% revenue contribution). Except paper & packaging business, FMCG, agri and hotels are weak in cash generation yet and, therefore, are unlikely to support their growth requirements. Under FMCG, the company has entered several new categories in past few years. These are small businesses, which will take time to mature. Additionally, there are gestation costs and costs to build brands. Besides, there are synergy benefits being derived out of multiple segments. As mentioned in the previous section, ITC has developed a solid backward integration. A large part of the activities of agri and agri products as well as paper and paperboards groups involve provision of services to its FMCG business, including cigarettes. Thus, we don't foresee any major benefit from a demerger and the possibility of it happening in the near future is quite low, in our view. The street however is hopeful of splitting the company into two or three companies. Any move in this direction could lift the valuation of the stock; however the extent of rise could depend on the mode of split.

Short-term triggers:

FMCG sector thrives in pandemic: The sector had been seeing a slowdown since mid-2018, with growth rates steadily declining for the 15-18 months from mid-teens to around half of that by Jan/Feb 2020. With the onset of the pandemic in India, FMCG companies were among the first to take a serious hit. But after the government responded by imposing a nationwide lockdown, the sector surprisingly surged and it has carried the momentum for the past few quarters. In 9MFY21, ITC's FMCG (ex-cigarettes) business witnessed sales growth of ~15% and EBIT growth of 2.3X with EBIT margins more than doubling, led by stellar growth in personal care and hygiene categories. Taking advantage of the surge in demand, ITC launched over 100 new products across categories in 9MFY21. We expect a 10% growth in Q4FY21 and expect the momentum to continue in FY22.

Recovery in cigarette volume may be prolonged: The cigarettes segment, which was severely impacted in the first couple of quarters of FY21 due to the COVID outbreak and subsequent lockdowns across the nation, witnessed gradual recovery in Q3FY21 (~3.5% revenue growth and ~7% volume decline Y-o-Y) with the company gaining market share. We expect 5% revenue growth in gross cigarette revenue in Q4FY21. However, with resurgence of the pandemic and impositions of lockdowns across states, the recovery in volumes will be impacted in the near term.

A move in the right direction: Over the years, the contribution of cigarettes in revenue mix has come down and FMCG's has been steadily rising. ITC's management has made efforts to diversify its business, in trying to reduce its dependence on the cigarettes business. As a result of this, the company is making structural interventions and harnessing synergies across its various businesses to enhance the company's operational efficiencies and expand the FMCG growth engine. ITC is embracing digital technologies to drive productivity, improve market servicing, draw actionable insights for sharp-focused interventions, augment sales force capabilities, and deepen connect with retailers. It has continued to make strategic acquisitions (Sunrise Foods, B-Naturals, Savlon, Nimyle, etc.) to expand its footprint. The massive growth of some of these brands speaks volumes about the management's ability to leverage the ITC brand name and create operational efficiencies to grow smaller brands.

Reaching the last mile: In a bid to ensure seamless supply of essential items to consumers, ITC has overhauled its distribution network and come up with a number of innovative solutions to reach the consumer's doorstep. The company has adopted a two-pronged strategy to reach retail stores and consumers during the lockdown. Through its 'Store on Wheels' initiative, it has stitched together several partnerships with national and local partners to deliver products to the consumers' doorsteps. Besides this, ITC also has an e-commerce platform (itcstore.in), which was launched back in 2019. It has availability of more than 400 products that are accessible across the top six cities at present. For the last-mile delivery, it had tied up with e-commerce players like Zomato, Dunzo, Swiggy and even Domino's during the lockdown imposed in April 2020. With resurgence of the Covid pandemic and the looming fear of lockdowns across regions, the company can further leverage these initiatives.
ITC will need to make heavy investment into developing its portal, creating better analytics, competitive pricing and logistics infrastructure. This will help it to become a successful alternative to existing e-commerce players. It might need to be selective about its expansion and offerings as e-commerce is a separate business.

Rise in ESG constraints: In recent years, global tobacco stocks (regarded as 'sin stocks' due to health hazard), including ITC, have borne the brunt of Environmental, Social and Corporate Governance (ESG) concerns, which has pushed some FPIs to reduce/sell their stake in the company and lowered the price-to-earnings multiples of companies in the industry. FPI holding in the company has steadily fallen from 17.96% in Mar 2018 to 12.78% in Mar 2021. However, ITC is rated AA by MSCI on ESG, the highest among global tobacco players and better than most Indian FMCG companies. This is because it has several offsetting factors on the ESG front; for instance, it has been carbon positive for 15 years, water positive for 18 years, and solid waste recycling positive for 13 years. However, we believe the concern for capital allocation more than anything else has been the main reason for the stock's underperformance; with no major capex planned for the foreseeable future (as per management guidance), the return ratios should improve, leading to stock's rerating.

Strong cashflow generation and balance sheet: ITC has a strong track record of generating free cash flows (average of ~Rs. 9,435 cr over the past five years), thanks to its cigarette business, which has been a cash spewing machine. As of 30th September, it had net cash balance of ~Rs. 36,000 cr. The management has guided that capex in the FMCG and hotels segment is almost over and the focus would now be on scaling these businesses. This would increase the return ratios. Also, in the purview of lower capex requirements ahead, the company has come up with a new dividend policy and the payouts will be around 80-85% (higher than the decadal average of ~67%), making ITC’s dividend yield one of the best in the FMCG industry. High cash reserves also give headroom for strategic acquisitions. Management has guided that acquisitions will always be on the radar but they need to be able to create value for the company.

Key risks

- Profitability and cash generation are heavily skewed towards the cigarettes business, which is not expected to see any significant recovery in the short term.

- Punitive taxation by the government on the cigarettes business could increase the illegal sales of the product.

- Investors that emphasize on strong ESG values tend to exclude ITC because of the nature of its business even though the company is one of the highest rated ESG companies in the world. ESG acceptance becomes more widespread resulting in further shrinkage in valuations.

- Hospitality sector is one of the worst affected by the ongoing pandemic and now with the coming of the second wave, recovery in this business may be further prolonged, which would impact ITC.

  Poor capital allocation in the future can lead to lower returns for the company.

- Potential sale of the 7.93% government stake in ITC held by SUUTI.

- Potential change in smoker behaviour (especially fringe smokers) post the lockdown period.

ITC Limited

About the company

Established in 1910, ITC Ltd is a diversified conglomerate in the fast moving consumer goods (FMCG) space; its products span across the following segments: foods, personal care, cigarettes and cigars, branded apparel, education & stationery products, incense sticks and safety matches; its businesses also include hotels, paperboards and packaging, agri business and information technology. The company was incorporated on 24 August 1910 under the name Imperial Tobacco Company of India Ltd. As the company's ownership progressively Indianized, its name was changed to India Tobacco Company Ltd in 1970 and then to I.T.C. Limited in 1974. In recognition of the ITC's multi-business portfolio encompassing a wide range of businesses, the full stops in the company's name were removed effective September 18, 2001. The company now stands rechristened 'ITC Ltd,' where 'ITC' is today no longer an acronym or in an initialized form.

Key business verticals

Cigarettes: ITC is the market leader in cigarettes in India with a market (volume) share of over 75%+. With more than one hundred years of expertise in developing products to match the evolving taste of the consumers, ITC's cigarette business continues to be relentless in its pursuit of strengthening its leadership position in every segment of the market in India. ITC's wide range of brands, includes Insignia, India Kings, Classic, Gold Flake, American Club, Wills Navy Cut, Players, Scissors, Capstan, Berkeley, Bristol, Flake, Silk Cut, Duke & Royal.

Other FMCG: ITC’s FMCG Business excluding cigarettes includes Branded Packaged Foods Businesses (Staples & Meals; Snacks; Dairy & Beverages; Biscuits & Cakes; Chocolates, Coffee & Confectionery); Education and Stationery Products; Personal Care Products; Safety Matches and Agarbattis; Apparel. In 2001, ITC entered the non-cigarette FMCG space with the launch of branded food products. Gradually, the company moved into noodles, biscuits, soaps, skin care, deodorants and other product categories. ITC built some strong brands along the way and at present it is the third largest firm in this space.

Hotels: Launched in 1975, ITC Hotels, is one of the fastest growing hospitality chains in India with 108 properties in over 70 locations. ITC Hotel’s properties are classified under four distinct brands:

*ITC Hotels***:** These are super deluxe and premium hotels located at strategic business and leisure locations. (ITC Maratha, ITC Maurya, etc.)

WelcomHotel: It offers five-star hospitality for the discerning business and leisure traveler. (Welcomhotel Dwarka, Welcomhotel Bella Vista, etc.)

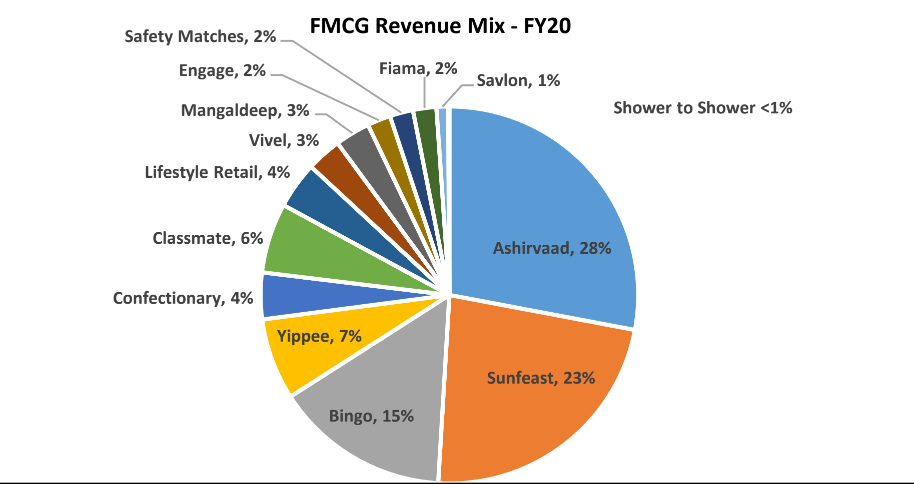
Fortune Hotel: It operates mid-market to upscale properties in the first-class, full-service business hotel segment all over India, in major metros, mini metros, state capitals and business towns, promising business and leisure travelers a wide choice of destinations and accommodation
WelcomHeritage: brings together a chain of palaces, forts, havelis and resorts that offer a unique experience.

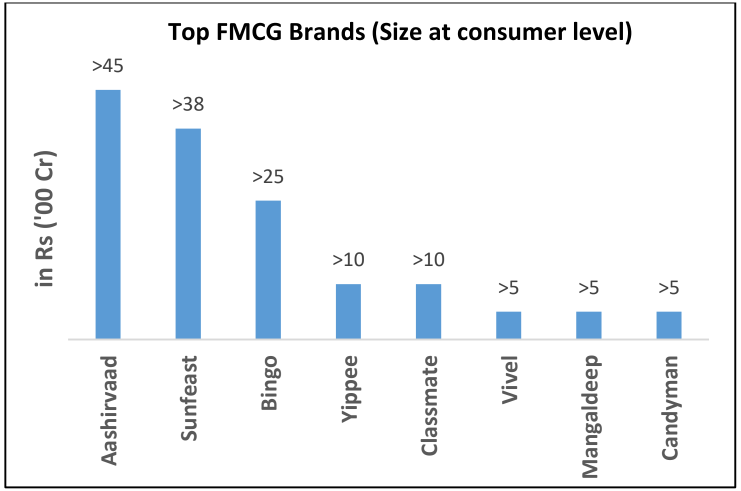
Paperboards, paper and packaging: ITC is the market leader in paperboard and specialty paper segment**.** Its packaging & printing business is the largest value-added converter of paperboard packaging in South Asia. It converts over 70,000 tonnes of paper, paperboard and laminates per annum into a variety of value-added packaging solutions for the food & beverage, personal products, cigarette, liquor and consumer goods industries.

Agribusiness: It is the country's second largest exporter of agri products. It currently focuses on exports and domestic trading of feed ingredients (soyameal), food grains (wheat & wheat flour, rice, pulses, barley and maize), marine products (shrimps and prawns), processed fruits (fruit purees/concentrates, frozen fruits, organic fruit products) and coffee. ITC is also India’s largest buyer, processor, consumer & exporter of cigarette tobaccos along with being the fifth largest exporter in the world, creating a global benchmark as the single largest integrated source of quality tobaccos.

Others businesses: Other businesses includes IT Services, Branded residences, etc. In IT services, under ITC Infotech, the company provides technology solutions and services to enterprises across industries such as banking & financial services, healthcare, manufacturing, consumer goods, travel and hospitality.

Key Milestones	
Year	**Particulars**
1910	Incorporated on August 24, 1910 under the name of 'Imperial Tobacco Company of India Limited
1925	Packaging & Printing Business was set up as a strategic backward integration for ITC's Cigerettes Business
1975	Launched its hotel business by the name 'ITC-Welcomgroup Hotel Chola'.
1979	Entered into manufacturing paperboards, packaging & printing business
1985	Set up Surya Tobacco Co. in Nepal, now a subsidiary of ITC.
1990	Set up the Agri Business Division for export of agri-commodities based on partnership with farmers
2000	Launched a line of greeting cards under the brand name ‘Expressions, further extension in stationery
	Entered in lifestyle retailing business with the Wills Sport
	ITC InfoTech India was set up in 2000 to provide outsourcing solutions
	Introduced e-Choupal initiative in 2000 with soya farmers in Madhya Pradesh
2001	Entered food business in 2001 with the introduction of ‘Kitchens of India’
2002	Entered the confectionery and staples segments with the launch of the brands mint-o and Candyman confectionery and Aashirvaad Atta
	Entered in marketing of safety matches
2003	Entered the biscuits segment with Sunfeast
	Forayed into the marketing of Agarbattis (incense sticks)
2005	Entered personal care with Essenza Di Wills, an exclusive range of fine fragrances and bath & body care products
2007	Entered the fast growing branded snacks category with Bingo!
	Launched the 'Superia' range of Soaps and Shampoos in the mass-market segment followed by Vivel range
2010	Entered the Indian instant noodles market with Sunfeast Yippee!
	Expanded its product portfolio in personal care with the launch of Engage deodorants
	Expanded the tobacco portfolio with launch of its handrolled cigar, Armenteros, in the Indian market
2014	Entered e-cigarette business
2015	Acquired Savlon and ‘Shower to Shower’ from Johnson & Johnson Ltd., India
	Entered the Fruit-based juices and beverages market with the launch of B Natural Fruit beverages
	Forayed into the dairy segment with the launch of Aashirvaad Svasti Ghee in November 2015.
	Acquired the brand Nimyle to enter the floor cleaner space
2020	Acquired entire stake in Sunrise Foods





Cigarette Industry – Peer Comparison (as on FY20)

Company	Volumes (no. of sticks in mn)	Revenue (in Rs. Cr)	EBIT (in Rs. Cr.)	EBIT Margin
ITC	72,590	21,202	14,853	70.1%
Godfrey Phillip	11,604	2,699	550	20.3%
VST Industries	8,753	1,239	373	30.1%

Hotel Industry – Peer Comparison (as on FY20)

Company	Revenue (in Rs. Cr.)	EBIT (in Rs. Cr.)	EBIT Margin	No. of Hotels*	No. of Rooms*
ITC	1,837	158	8.6%	108	10,200
Indian Hotels	4,463	696	15.6%	214	26,000
Lemon Tree Hotels	679	157	23.1%	84	8,294

***no. of hotels and rooms as on December 2020**

ITC Limited

Financials

Income Statement

(Rs Cr)	FY19	FY20	FY21E	FY22E	FY23E
Net Revenues	48353	49404	48569	54600	60631
Growth (%)	11.3	2.2	-1.7	12.4	11
Operating Expenses	29946	30144	31326	34270	37215
EBITDA	18406	19260	17244	20330	23416
Growth (%)	**11.7**	**4.6**	**-10.5**	**17.9**	**15.2**
EBITDA Margin (%)	**38.1**	**39**	**35.5**	**37.2**	**38.6**
Depreciation	1397	1593	1707	1825	1944
EBIT	17010	17667	15536	18504	21472
Other Income	2174	2375	2755	2893	2755
Interest expenses	45	24	21	19	17
PBT	19138	20019	18270	21379	24210
Tax	6314	4791	4640	5469	6299
APAT	12786	15228	13630	15909	18189
Growth (%)	14	19.1	-10.5	16.7	14.3
EPS	10.4	12.4	11.1	12.9	14.7

Balance Sheet

As at March	FY19	FY20	FY21E	FY22E	FY23E
SOURCE OF FUNDS					
Share Capital	1226	1226	1226	1226	1226
Reserves	56855	63728	66026	70254	74481
Shareholders' Funds	**58081**	**64954**	**67252**	**71480**	**75707**
Long Term Debt	8	8	8	8	8
Short Term Debt	2	2	2	2	3
Net Deferred Taxes	1993	2125	2267	2421	2576
Other Non-Current Liabilities	248	248	248	248	248
Total Source of Funds	**60332**	**67337**	**69778**	**74160**	**78542**
APPLICATION OF FUNDS					
Net Block	19153	20691	21334	22179	23023
CWIP	6362	5537	4876	4348	3820
Goodwill	231	231	231	231	231
Long Term Loans & Advances	1696	1835	1985	2148	2311
Total Non Current Assets	**27442**	**28294**	**28427**	**28906**	**29385**
Inventories	7944	7913	7800	8301	8803
Trade Receivables	4035	2947	2946	3212	3479
Cash & Equivalents	27835	35745	38692	42744	46797
Other Current Assets	3085	3239	3401	3571	3742
Total Current Assets	**42900**	**49845**	**52839**	**57830**	**62821**
Trade Payables	3510	3676	3674	4007	4340
Other Current Liab & Provisions	6501	7126	7814	8569	9324
Total Current Liabilities	**10010**	**10802**	**11488**	**12576**	**13664**
Net Current Assets	32890	39043	41351	45254	49156
Total Application of Funds	**60332**	**67337**	**69778**	**74160**	**78542**

ITC Limited

Cash Flow Statement

(Rs Cr)	FY19	FY20	FY21E	FY22E	FY23E
Reported PBT	19138.1	20018.9	18270.2	21378.8	24209.6
Non-operating & EO items	0	0	0	0	0
Interest Expenses	-1267.4	-1394.2	-1510.6	-1634.8	-1759
Depreciation	1396.6	1592.7	1707.3	1825.5	1943.7
Working Capital Change	-1052.1	1618.1	487.8	-13.1	-513.9
Tax Paid	-6191.6	-4791.4	-4640.3	-5469.4	-6298.5
OPERATING CASH FLOW (a)	**12023.7**	**17044.1**	**14314.4**	**16087**	**17581.9**
Capex	-2785.5	-2305.8	-1689.8	-2141.8	-2593.9
Free Cash Flow	9238.2	14738.3	12624.6	13945.2	14988
Investments	-2990.6	-1500	-1500	-1500	-1500
Non-operating income	1318.2	1417.8	1531.2	1653.7	1776.2
INVESTING CASH FLOW (b)	**-4457.9**	**-2388**	**-1658.6**	**-1988.1**	**-2317.7**
Debt Issuance / (Repaid)	-18.8	0.2	0.2	0.2	0.2
Interest Expenses	-45.4	-23.6	-20.6	-18.9	-17.3
FCFE	9174	14714.9	12604.2	13926.5	14971
Share Capital Issuance	5.4	0	0	0	0
Dividend	-7564.7	-8483.6	-12296	-11687.9	-11079.7
Others	0	0	0	0	0
FINANCING CASH FLOW (c)	**-7623.6**	**-8507.1**	**-12316.4**	**-11706.6**	**-11096.7**
NET CASH FLOW (a+b+c)	**-57.8**	**6149.1**	**339.4**	**2392.4**	**4167.5**

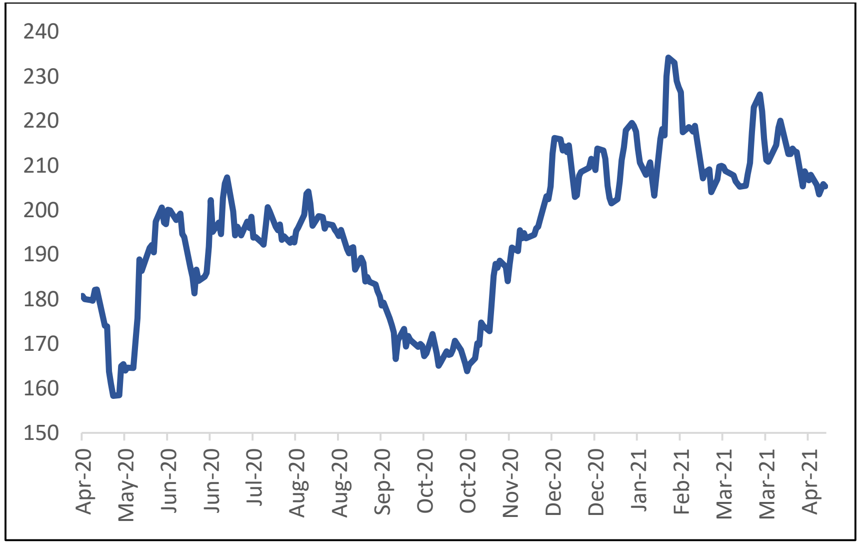
Key Ratios

Particulars	FY19	FY20	FY21E	FY22E	FY23E
EBITDA Margin (%)	38.1	39	35.5	37.2	38.6
EBIT Margin (%)	35.2	35.8	32	33.9	35.4
APAT Margin (%)	26.4	30.8	28.1	29.1	30
RoE (%)	23.2	24.9	20.7	23	24.8
RoCE (%)	23.1	24.8	20.6	23	24.7
Solvency Ratio					
Net Debt/EBITDA (x)	-1.5	-1.9	-2.2	-2.1	-2
Net D/E (x)	-0.5	-0.6	-0.6	-0.6	-0.6
PER SHARE DATA					
EPS (in Rs.)	10.4	12.4	11.1	12.9	14.7
CEPS (in Rs.)	11.6	13.8	13.3	14.5	15.7
BV (in Rs.)	47.1	52.7	54.6	58.1	61.5
Dividend (in Rs.)	5.8	8.3	9.5	10.4	11.3
Cash Conversion Cycle (days)	38.2	24.4	20	16.8	14.2
Debtor days	30.5	21.8	22.1	21.5	20.9
Inventory days	60	58.5	58.6	55.5	53
Creditors days	26.5	27.2	27.6	26.8	26.1
VALUATION					
P/E (x)	20.3	17.1	19.1	16.4	14.4
P/BV (x)	4.5	4	3.9	3.7	3.4
EV/EBITDA (x)	12.6	11.6	12.8	10.7	9.1
EV / Revenues (x)	4.8	4.6	4.6	4	3.5
Dividend Yield (%)	2.7	3.9	4.5	4.9	5.3

(Source: Company, HDFC sec)

ITC Limited

One Year Price Chart



(Source: Company, HDFC sec)

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