

28 September 2017

ITC Limited – BUY

CMP : 262
Target Price : 323
Upside : 23%+
Stop Loss : 223 (closing basis)

Investment Thesis

Recently, the stock price of ITC Limited (ITC) corrected by ~30% from 52-week high of Rs.368 as the company has to incur additional tax burden of 20-22% in FY18E post GST implementation.

Being the leader in the Indian cigarette industry with ~75% market share, ITC commands pricing power in the segment. However, it has been witnessing moderation in volume growth since FY14. The strain on volumes was largely led by incessant price hikes taken to pass on increasing excise duty. The cumulative growth in tax incidence on cigarettes, after considering the latest increase in cess rates, stands at a staggering 202% during last 6 years, hurting the volume growth for the company as every hike is passed on by way of gradual price hikes. The legal cigarette industry's volume has declined by ~25% since 2012-13 due to huge tax burden on account of the continuous increase in excise duties. In order to push volumes amid hikes, as a strategy, cigarette companies forayed into the 64 mm segment to vary their sales mix. ITC has also extended its existing brands, Scissors, Bristol and Capstan in the 64 mm segment at Rs.5/stick to revive its volume growth and target downtrading consumers.

GST council revised the specific cess on cigarettes after recognizing the anomaly in the effective tax incidence. Post revision, the GST rate continues to remain unchanged at 28% and cess of 5% for the below 75 mm category (changed to 36% for king size), however, the specific cess per stick has been raised for below 75 mm categories in the tune of 33-36%. We expect, this revision in rates would lead to increase in the indirect tax incidence on the company in FY18E and would require price hike of 10-12% in order to pass on the entire burden. ITC has already undertaken 6-8% price hike post announcement of revised rates in order to pass on the additional tax burden.

Financials

- During the past 5 years, revenue of ITC grew at CAGR of 10.0% while PAT grew at CAGR of 10.5% in the same period.

Consol. (Rs.Mn.)	FY15	FY16	FY17	FY18E	FY19E
Revenue	388,348	394,270	428,036	492,242	566,078
EBITDA	142,016	150,515	154,359	177,513	204,140
% growth	8.8	6.0	2.6	15.0	15.0
PAT	96,632	99,116	102,894	117,711	134,662
EPS (INR)	12.1	12.3	8.5	9.7	11.1
P/E (x)	23.4	22.9	33.3	29.1	25.4
RoE (%)	30.5%	29.3%	22.2%	23.1%	24.1%

- ITC has reported 4.3% YoY growth in gross sales in Q1FY18 led by 6.6%, 9.0% and 6.1% YoY growth in cigarette, FMCG and hotel segments, respectively.

Stock Data

Market Cap (INR MN)	3,182,652
Market Cap (\$ MN)	48,442.0
Shares O/S (in MN)	12,147.4.0
Avg. Volume (3 month)	14,852,000
52-Week Range (Rs.)	368 / 222

Shareholding Pattern

Promoters	0.00%
FII's	20.08%
Institutions	35.79%
Others (incl. body corporate)	44.13%

Performance (%)	1M	6M	1Yr
Absolute	-0.9%	5.9%	11.8%
BSE FMCG	0.8%	14.1%	15.8%

Key Ratios

Div Yield	1.7%
TTM PE	33.0x
ROE	22.4%
TTM EPS (INR)	8.54/-

- However, net sales of ITC declined by 1% YoY as excise duty for the quarter increased significantly by 20.2% YoY primarily due to tax increase in 2017 Budget and change in sales mix.
- EBITDA of ITC increased by 6.2% YoY to Rs.37,464mn due to 9.6% YoY decline raw material cost in the quarter. However, investment behind brand building led to rise in other expense by 7.3%. As a result, EBITDA margin has expanded by 54bps YoY to 27.1% as against 26.6%.
- Healthy revenue growth and margin expansion led to 7.4% YoY growth in PAT of ITC to Rs.25,605mn for Q1FY18.

Key Business Highlights

- ITC is engaged in the marketing of fast moving consumer goods (FMCG), which operates through four segments, FMCG, Hotels, Paperboards, Paper and Packaging, and Agri Business.
- ITC's FMCG segment includes cigarettes and others, such as branded packaged foods businesses, Apparel, Education and Stationery Products, Personal Care Products, Safety Matches and Agarbattis.
- ITC has very well known brands, which includes, Aashirvaad, Sunfeast Dark Fantasy, Bingo, Yumitos, YiPee, Candyman, Classmate, Fiana Di Wills, Superia, Engage, Wills Lifestyle, John Players, Mangaldeep and Aim, among others.

Valuation

- ITC plans to stimulate the distribution strategy for the FMCG business by increasing direct reach to one lakh villages in India. These one lakh villages account for ~80% of rural consumption. This shows ITC's aggressive approach towards growing its FMCG business (19.1% of FY17 revenues). ITC's growth from the segment has been phenomenal at ~17% CAGR in FY08-17. With the FMCG sector witnessing a continuous slowdown in volumes (ITC's volume growth dipped from 16-18% in FY12 to 5-7% in FY17), this initiative would be a shot in the arm for ITC. Further, we believe that with continuous regulatory pressure, aggressive price hikes in cigarettes, ITC would be far more aggressive to grow its FMCG business.
- With recent acquisitions like B Natural juices in 2014 and Savlon, Shower to Shower from Johnson & Johnson in 2015 along with new launches in FY16 (Sunfeast Farmlite All Good biscuits), entry into premium chocolates segment with Fabelle, extension of B Natural beverage portfolio to 9 variants, ITC has signal its intention to be one of the leading Indian FMCG players. Aashirvaad and Sunfeast are now brands with annual sales of over Rs.30,000mn and Rs.25,000mn, respectively while Classmate and Bingo are also Rs.10,000+ mn brands. It also entered dairy segment with the launch of Aashirvaad Svasti ghee and Sunfresh dairy whitener in FY16. We believe, ITC has been sharpening its focus on core FMCG business with foray into new product categories whilst strengthening its presence in existing ones.
- With undisputed leader in cigarettes business, extended its brands in the 64 mm segment to revive its volume growth, price hike to pass on the GST rate hike burden, increasing distribution network to directly reach to one lakh villages and recent acquisitions to expand its business into FMCG, we value ITC at 29.00x FY19E EPS of Rs.11.10 to arrive at target price of Rs.323.00, an upside of ~23%.

Risk & Concern

- Recent hike in GST rate and cess may adversely impact volume growth of cigarette business as the company may not pass on full impact to the customers.
- Any sharp price hike by ITC in the cigarette business may adversely impact volume growth potential in the cigarette business.
- FMCG segment is highly competitive, hence any entry of new competitor like Patanjali may adversely impact FMCG business.

Graphs & Charts

Figure 1: Net Sales Trend

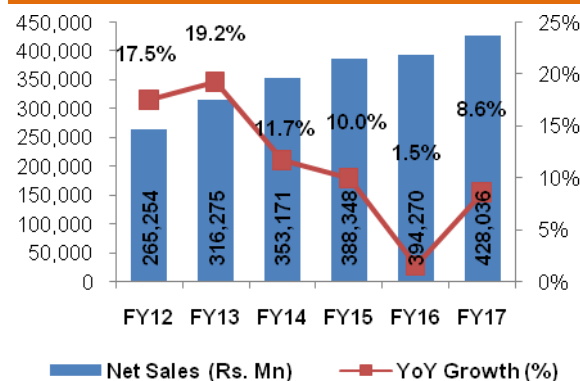


Figure 2: EBITDA & EBITDA Margin Trend

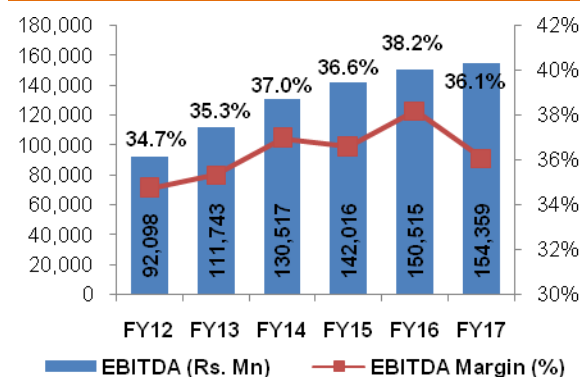


Figure 3: PAT Trend

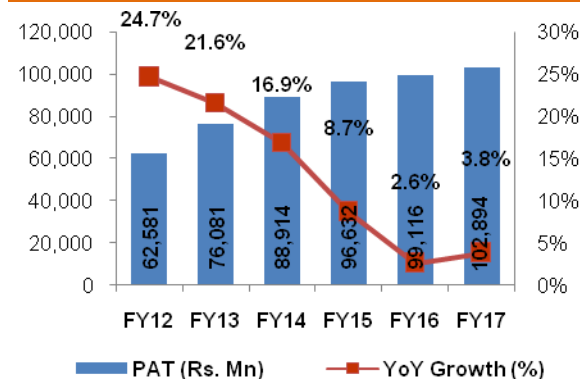
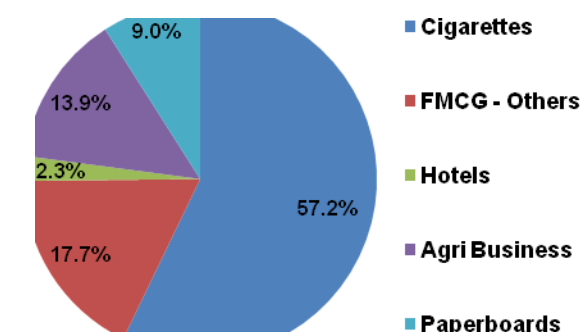


Figure 4: Revenue Segmentation (FY17)



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