Quicker recovery in Q1 driven by Core Cigarette biz and FMCG

ITC reported a better than expected Q1FY21 revenue at Rs 9,436crs vs est. 9,205crs (3% higher vs our estimates), it de-grew 17% YoY impacted by disruptions in operations due to nationwide lockdowns.The beat on estimates was majorly on back of better than expected performnce of its cigratTes biz and robust growth in FMCG business. Gross profit came in at Rs 5,489crs (est. Rs 5,855crs) falling 24% YoY and GM at 58% (est. 63%) fell by 539 bps impacted by negative operating leverage and adverse product mix. EBIT declined 46% at Rs 2,248crs while EBIT margins fell by 954bps YoY at 24% (est. 32%) impacted by 39% fall in cigarette EBIT, partially mitigated through aggressive cost control measures. PAT of Rs 2,343crs vs est. Rs 3,055crs was down 26% YoY offset by lower tax rates at 25% vs 34% in Q1FY20. The volume declines in cigarettes was in the range of 40-45%, lower than street expectations of over 45% on the back of rapid scale up of operations vs peers. The strong performance by FMCG segment was on the back on increased in-home consumpion, surge in demand for health and hygiene products and consumers' prefernce towards trusted brands. Hotel segment witnessed a washout quarter as revenue were down 94% due to complete standstill in operations given travel restrctions. Agri biz grew by 4% led by trading opportunities in oilseeds and rice, while the paper borads biz. continued to be sluggish (33% fall in revenue) owing to decline in demand from end user industries. Managemnt highlighted that other than the Hotels segment, progressive normalisation was witnessed in the later part of the first quarter across all operating segments. **Maintain BUY with a revision in TP to Rs. 243/share given undemanding valuations, +5% dividend yield with efficient capital allocation and faster than expected recovery across key businesses except Hotels.**

Key takeaways

- **Cigarette faster than expected recovery**: Cigarette biz Revenue/EBIT declined 29%/38% respectively largely driven by over 45% decline in volumes owing to COVID-19 led lockdowns impacting its availability. Volume degrowth was much lower than what the street was expecting at 45-50% driven by resumption of manufacturing operations post mid-May and rapid scale up thereafter, sales & distribution ramp up and possible market share gains (Godfrey Phillip plant was shut for large part in Q1). Sales were also supported by launch of new variants in DSFT (mass segments) and innovative pack sizes (largely targeted at loose cigarette consumption by introducing pack of 5cigs vs standard 10cigs pack) thereby expanding target audience in key markets. EBIT Margins contracted by 970 bps YoY at 61% impacted by weak operating leverage and inferior mix.
- **Strong performance by FMCG-Others:** FMCG Segment delivered a strong performance with its sale growing by 10% (underlying sales growth 19% excl education) driven by staples, convenience foods, health & hygiene products, new products launches and consumers' preference towards trusted and well established brands. However Education and Stationery Products Business (ESPB) remained impacted as schools/colleges remained shut. Segment EBIT surged 61%, and EBIT margins expanded by 117bps to 3.7% supported by extreme focus on cost reduction and operating leverage benefits notwithstanding incremental costs due to COVID-19, gestation and start-up costs of new categories/ facilities.

Our View:

Progressive normalization of operations across segments, share gain possibilities in core cigarette business, faster growth in FMCG sales vs peers given increased in-home consumption and consumers' preference towards trusted brands could support an earlier than expected recovery in earnings going ahead. However, near term uncertainty remains given localized lockdowns in several parts of the country, posing operational challenges, impacting recovery momentum. At CMP stock trades at 15x FY22E EPS valuation are undemanding alongside a +5% (high) dividend yield. Maintain BUY with TP of Rs. 243/share. Key risks to our call: 1) any increase in compensation cess to cover for states loss, 2) uncertainty on lockdown relaxations, 3) SUUTI stake sale overhang.

Key Financials (Consolidated)

(Rs. Cr)	FY19	FY20	FY21E	FY22E
Net Sales	48,353	49,404	49,800	54,904
EBITDA	18,406	19,260	17,269	20,842
Net Profit	12,824	15,717	13,669	16,368
EPS (Rs.)	10.5	12.8	11.1	13.3
PER (x)	19.1	15.6	18.0	15.0
EV/EBITDA (x)	13.1	12.6	14.0	11.7
P/BV (x)	4.1	4.1	4.0	4.0
ROE (%)	21.7	26.3	22.4	26.8

Source: Company, Axis Research

(CMP as of July 24, 2020)

CMP (Rs)	200
Upside /Downside (%)	22%
High/Low (Rs)	273/135
Market cap (Cr)	2,45,546
Avg. daily vol. (6m) Shrs.	1,49,89,506
No. of shares (Cr)	1,229

Shareholding (%)

	Jun-20	Mar-20	Dec-19
Promoter	0.0	0.0	0.0
FIIs	14.6	14.6	15.2
MFs / UTI	9.4	9.9	9.6
Banks / FIs	8.0	8.0	8.0
Others	67.9	67.4	67.2

Financial & Valuations

Y/E Mar (Rs. bn)	2020	2021E	2022E
Net Sales	494.0	498.0	549.0
EBITDA	192.6	172.7	208.4
Net Profit	157.2	136.7	163.7
EPS (Rs.)	12.8	11.1	13.3
PER (x)	15.6	18.0	15.0
EV/EBITDA (x)	12.6	14.0	11.7
P/BV (x)	4.1	4.0	4.0
ROE (%)	26.3	22.4	26.8

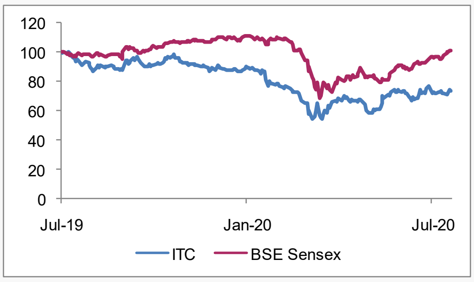
Change in Estimates (%)

Y/E Mar	FY21E	FY22E
Sales	-	-
EBITDA	-	-
PAT	-	-

Axis vs Consensus

EPS Estimates	2021E	2022E
Axis	11.1	13.3
Consensus	11.6	13.3
Mean Consensus TP (12M)		234

Relative performance



Source: Capitaline, Axis Securities

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Key takeaways (Cont'd)

- **Hotels business**: Hotels Segment witnessed a wash out quarter as revenues stood at Rs. 23crs, de-growth of 94% YoY adversely impacted as operations came to a standstill due to lockdowns and continued restrictions on travel and hotel operations. Negative operating leverage weighed on segment profits as it reported EBIT Loss at Rs. 243crs; while aggressive reduction in controllable fixed costs partly mitigated the impact.
- **Agriculture business :** Agri Business division revenue was up 4% on the back of trading opportunities in oil seeds and rice. Whereas EBIT degrew by 12% and EBIT margins contracted 85 bps YoY impacted by subdued demand for leaf tobacco in international markets and adverse business mix.
- **Paper & Paperboard business**: Paper & Paperboard Revenues/EBIT were lower by 33%/54% YoY owing to sluggish demand in key end-user industries like liquor, cupstock, tobacco, hosiery, FMCG packaging etc. However robust growth in exports partly mitigated the weak domestic demand conditiong.

Q1FY21 Key Financials

	Q1FY21	Q1FY21E Axis Estm	Var (%)	Q1FY20	% Change (Y-o-Y)	Q4FY20	% Change (Q-o-Q)
Volume Growth	**-40%**	**-35%**	**-500bps**	**5.0**	**-500bps**	**-11.5**	**-1150bps**
Net Sales	9,436	9,205	2.5	11,361	(16.9)	11,300	(16.50)
Gross Profit	5,489	5,855	(6.2)	7,221	(24.0)	7,233	(24.1)
Gross Margin (%)	58.2	63.6	-543 bps	63.6	-539 bps	64.0	-584 bps
Staff costs	697	-	-	690	1.0	667	4.6
Other operating expenses	2,211	-	-	2,107	5.0	2,523	(12.4)
EBITDA	2,647	3,351	(21)	4,566	(42.0)	4,164	(36.4)
EBITDA margin (%)	28.0	36.4	-835 bps	40.2	-1214 bps	36.8	-880 bps
Other Income	897	-	-	620	44.6	756	18.7
Interest	17	-	-	15	10.3	15	14.0
Depreciation	398	-	-	359	10.9	393	1.4
PBT	3,128	-	-	4,812	(35.0)	4,512	(30.7)
Tax	786	-	-	1,638	(52.0)	715	9.9
Tax rate (%)	25.1	-	-	34.0	-892 bps	15.8	927 bps
Adj. PAT	2,343	3,055	(23.3)	3,174	(26.2)	3,797	(38.3)
Adj. EPS	1.9	2.5	(23.3)	2.6	(26.2)	3.1	(38.3)

Source: Company; Axis Securities

Q1FY21 Segmental Performance

	Q1FY21	Q1FY20	YoY (%)	Q4FY20	QoQ (%)
Segment Gross Sales Standalone					
Cigarette	3,854	5,433	-29.1%	5,131	-24.9%
FMCG Others	3,375	3,060	10.3%	3,184	6.0%
Hotel	23	393	-94.2%	466	-95.2%
Agri Business	3,746	3,611	3.7%	1,887	98.5%
Paper Board	1,026	1,528	-32.8%	1,459	-29.6%
Segment EBIT					
Cigarette	2,356	3,849	-38.8%	3,403	-30.8%
FMCG Others	125	78	60.7%	147	-14.7%
Hotel	-243	10	NM	43	NM
Agri Business	179	203	-11.9%	123	45.2%
Paper Board	160	330	-51.4%	286	-44.0%
Segment EBIT Margin %					
Cigarette	61.1%	70.8%	-970bps	66.3%	-518bps
FMCG Others	3.7%	2.5%	117bps	4.6%	-90bps
Hotel	NM	2.6%	NM	9.1%	NM
Agri Business	4.8%	5.6%	-85bps	6.5%	-175bps
Paper Board	15.6%	21.6%	-599bps	19.6%	-398bps

Other Key Takeaways

1) **Cigarette business :** Manufacturing operations for the business resumed from mid-May and thereafter rapidly scaled up after having witnessed unprecedented disruption caused by lockdown. As of today all factories have reached pre-COVID (90-95%) with sales & dsitribution bring normalized. To remain ahead of competition ITC has launched new new variants in the economy segmet (DSFT segment – Gold Flake Star – Super Mint, Royal) and introduced innovative pack size by launching 5cigs pack (vs a standard 10 cigs pack) in select markets so as to straddle accros price points and target consumers in competitive markets. The company leveraged its extensive footprint to scale up availability through grocery channel while the stockist network was augmented to service rural/semi-urban areas. Besdies, ITC continues to offer attractive promotions across trade channels for launches made in premium KSFT segment during Q4FY20. We believe, closure of competitor plants for a good part of Q1 and disruption in illegal trade could benefit organized players like ITC, a leader in the space. However, re-imposition of localized lockdowns pose operational challenges to the business (closure of shops, disruption of supply & distribution chains) thereby disrupting business continuity.
2) **FMCG – Others :** FMCG-Others segment revenue was up 12.2% on a comparable basis (up 18.8% excl. Education and Stationery Products Business (ESPB). Staples, Convenience Foods and Health & Hygiene products, representing around 75% of the portfolio (in base period excl. ESPB), recorded robust growth of 34%; Discretionary categories with higher 'out-of-home' consumption de-grew by 25%, but are witnessing progressive normalisation with improved growth momentum. In the staples space, Aashirvad Atta fortified its leadership position and reported a robust growth across markets in both volume and value terms. Staples, noodles, biscuits, dairy, sanitizers, hand wash, floor cleaners, etc. witnessed strong demand on the back of rising awareness towards health and hygiene, more time spent at home leading to surge in in-home consumsion and consumers' preference for trusted brands. Division wise -

   - ✓ **Branded Packaged Foods** business delivered a robust performance during the quarter driven by Atta, Noodles, Biscuits and Fresh Dairy. 'Yippee!' Noodles,'Sunfeast' Biscuits and Cakes posted substantial growth driven by increased 'at-home' consumption. Most categories in which ITC oeprates gained market share in Q1FY21. 'Aashirvaad Atta' posted strong growth and further fortified its leadership position in the branded packaged atta industry. ITC's chocolates and confectionery categories which are discretionary in nature were severely impacted due to subdued demand.
   - ✓ **Personal Care Products** business recorded substantial growth in revenue driven by heightened awareness and demand for hygiene products such as hand sanitizers, handwash, antiseptic liquids and floor cleaners in the wake of COVID-19 pandemic. ITC rapidly expanded manufacturing capacity manifold and enhanced availability of 'Savlon' and 'Fiama' range of products.
   - ✓ **New launches**: During Q1FY21, launches were made in health and hygiene segment with 12 innovative and relevant products (especially in Savlon brand) wwere launched. The Hygiene portfolio was augmented with the launch of 'Nimwash'- Vegetables & Fruit Wash Liquid. 2 new variants in 'B Natural' Juices were launched addressing immunity needs in partnership with Amway.
   - ✓ **Education and Stationery Products Business (ESPB):** ESPB was severely impacted during the quarter due to deferment of new academic sessions and closure of schools/colleges across the country. In the near term division to continue witness challenging times given no clarity/variations on resumption in timelines of school/colleges across states.
   - ✓ **Agarbatti business:** The industry was confronted with significant operational challenges, especially in the initial lockdown phase, mainly due to higher focus on essential products. Wef 1st April'20 , GST on all safety matchs have been harmonised at 12% vs 18% for mechanised/semi-mechanised and 5% for handmade matches earlier, thereby levelling the playing field which bodes well for the company. The Business continues to focus on scaling up the availability of its products, launching innovative products,and enhancing supply chain efficiency to drive growth.
   - ✓ **Distribution channels**: In Q1FY21, ITC expanded presence in Modern Trade and e- commerce channels that grew at +20% / 90% resp. Sales in rural markets grew rapidly leveraging the stockist channel. During the lockdown phase, nearly 2/3rd of the throughput was delivered direct to customer/market from factories leading to reduction in time-to-market.
3) **Hotels business:** Operations during the quarter came to a standstill with operations limited mainly to service stranded guests and wherever required, as quarantine facilities. The Business resumed operations in accordance with the prescribed

guidelines, from the second week of June'20, with a refreshed and revamped service design. However the outbreak of COVID-19 pandemic have led to severe restrictions on travel and heightened sensitivity social distancing restricting the busienss to bounce back in near term.

4) **Paper boards :** Segment revenue/EBIT declined by 33%/51% largely on account of the disruptions caused by the outbreak of the COVID-19 pandemic and subsequent fall in demand from end user industrty (educational institues, printing bisnesses, FMCG packaging, liquor, cupstone, hosiery etc.). Robust exports growth partially offset the weak domestic demand environment.
5) **Agri Business:** The Agri Business recorded a growth of 3.7% in revenue driven by trading opportunities mainly in oil seeds and rice. However subdued demand for leaf tobacco in international markets and adverse business mix weighed led to an EBIT decline of over 12% YoY.

Valuation & Outlook

We maintain BUY on ITC and keep our TP of Rs. 243/share as we value it at 18xFY22E EPS. We see multiple positives for ITC and beeleive it is better placed in the FMCG Staples as well as discretionary space given 1) healthy recovery in cigarette business aided by possible market share gains, 2) sustainably improving FMCG segment profitability with share gains in key categories, 3) prudent capital allocation drving a healthy balance sheet, 4) compellong valuations in the FMCG pack at 15x FY22E EPS with a modest earnings visibility in the near term, 5) increased dividend payout (+5% dividend yield going forward). Key risks to our call are: 1) SUUTI stake sale overhang, 2) adverse government regulation on sin goods/ compensation cess, 3) quicker resumption and scale up of competition's manufacturing and increased sale of illicit cigarette trade, 4) sporadic lockdowns across geographies impacting business operations.

Financials

Profit & Loss

(Rs Cr)

Y/E March	FY19	FY20E	FY21E	FY22E
Net sales	**48,353**	**49,404**	**47,132**	**51,081**
Growth, %	11.3	2.2	-4.6	8.4
Other income	2,174	2,598	2,858	3,201
Total income	48,353	49,404	47,132	51,081
Raw material expenses	-17,420	-17,345	-17,119	-17,945
Employee expenses	-4,178	-4,296	-4,254	-4,466
Other Operating expenses	-8,348	-8,503	-9,165	-9,413
EBITDA (Core)	**18,406**	**19,260**	**16,595**	**19,257**
Growth, %	11.7	4.6	-13.8	16.0
Margin, %	38.1	39.0	35.2	37.7
Depreciation	-1,397	-1,645	-1,674	-1,644
EBIT	**17,010**	**17,615**	**14,921**	**17,613**
Growth, %	11.6	3.6	-15.3	18.0
Margin, %	35.2	35.7	31.7	34.5
Interest paid	-45	-55	-56	-57
Other Non-Operating Income	2,174	2,598	2,910	3,259
Pre-tax profit	**19,138**	**20,158**	**17,775**	**20,815**
Tax provided	-6,314	-4,442	-4,479	-5,245
Profit after tax	12,824	15,717	13,296	15,569
Net Profit	**12,824**	**15,717**	**13,296**	**15,569**
Growth, %	15.8	22.6	-15.4	17.1
Net Profit (adjusted)	**12,835**	**15,584**	**13,296**	**15,569**
Unadj. shares (cr)	1,226	1,229	1,229	1,229

Source: Company, Axis Securities

Balance Sheet

(Rs Cr)

As at 31st Mar	FY19	FY20E	FY21E	FY22E
Cash & bank	4,152	3,110	2,847	1,620
Debtors	4,035	2,301	2,319	2,557
Inventory	7,860	7,128	7,541	8,005
Loans & advances	7,197	5,181	5,181	5,181
Total current assets	23,152	17,629	17,797	17,271
Investments	25,043	25,043	25,043	25,043
Gross fixed assets	23,888	26,888	29,888	32,888
Less: Depreciation	-4,716	-6,361	-8,035	-9,877
Add: Capital WIP	4,136	3,730	3,730	3,730
Net fixed assets	23,308	24,257	25,583	26,741
Total assets	**71,504**	**66,929**	**68,423**	**69,056**
Current liabilities	9,990	4,736	5,009	5,315
Provisions	51	51	51	51
Total current liabilities	10,042	4,788	5,060	5,366
Non-current liabilities	2,304	2,304	2,304	2,304
Total liabilities	12,346	7,092	7,364	7,670
Paid-up capital	1,226	1,229	1,229	1,229
Reserves & surplus	57,915	58,590	59,812	60,139
Shareholders' equity	59,158	59,837	61,059	61,386
Total equity & liabilities	**71,504**	**66,929**	**68,423**	**69,056**

Source: Company, Axis Securities

Cash Flow (Rs Cr)

Y/E March	FY19	FY20E	FY21E	FY22E
Pre-tax profit	19,138	20,158	18,398	22,379
Depreciation	1,397	1,645	1,674	1,842
Chg in working capital	-1,056	-956	-159	-395
Total tax paid	-6,185	-4,442	-4,728	-5,751
Cash flow from operating activities	13,175	17,539	15,302	18,074
Capital expenditure	-2,875	-2,593	-3,000	-3,000
Chg in investments	-2,991	0	0	0
Cash flow from investing activities	-5,866	-2,593	-3,000	-3,000
Free cash flow	7,309	14,945	12,302	15,074
Equity raised/(repaid)	6,648	679	1,222	327
Dividend (incl. tax)	-8,498	-15,041	-12,448	-16,301
Cash flow from financing activities	4,412	-11,497	-9,936	-15,974
Net chg in cash	11,721	3,448	2,366	-900
Opening cash balance	2,900	4,152	3,110	2,847
Closing cash balance	**4,152**	**3,110**	**2,847**	**1,620**

Source: Company, Axis Securities

Ratio Analysis (%)

Y/E Mar	FY19	FY20E	FY21E	FY22E
Per Share data				
EPS (INR)	10.5	12.8	11.1	13.5
Growth, %	13.6	22.2	(13.0)	21.6
Book NAV/share (INR)	48.3	48.7	49.7	49.9
FDEPS (INR)	10.5	12.8	11.1	13.5
CEPS (INR)	11.6	14.1	12.5	15.0
DPS (INR)	5.8	10.2	8.4	11.0
Return ratios				
Return on assets (%)	19.0	22.8	20.2	24.2
Return on equity (%)	21.7	26.3	22.4	27.1
Return on capital employed (%)	22.1	25.5	21.8	26.2
Turnover ratios				
Asset turnover (x)	1.6	1.5	1.4	1.5
Sales/Net FA (x)	2.1	2.1	2.0	2.1
Working capital/Sales (x)	0.2	0.2	0.2	0.2
Working capital days	68.0	72.3	72.9	68.7
Liquidity ratios				
Current ratio (x)	2.3	3.7	3.6	3.2
Quick ratio (x)	1.5	2.2	2.0	1.7
Dividend cover (x)	1.8	1.3	1.3	1.2
Valuation				
PER (x)	19.1	15.6	17.9	14.7
Price/Book (x)	4.1	4.1	4.0	4.0
Yield (%)	2.9	5.1	4.2	5.5
EV/Net sales (x)	5.0	4.9	4.9	4.4
EV/EBITDA (x)	13.1	12.6	14.0	11.6
EV/EBIT (x)	14.1	13.7	15.5	12.7

Source: Company, Axis Securities

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