



ITC Limited

Date: 07-April-2020

OVERVIEW

Recommendation: BUY CALL with a target of ₹300 (at ₹308,000 crore Market Cap)

Valuation: Undervalued

Current Market Price: 181

Time Horizon: 3 Years

About the company:

ITC Ltd is one of India's foremost private sector companies. ITC has a diversified presence in Cigarettes, Hotels, Paperboards & Specialty Papers, Packaging, Agri-Business, Packaged Foods & Confectionery, Information Technology, Branded Apparel, Personal Care, Stationery, and Safety Matches and other FMCG products.

FMCG Brands: Aashirvad, Sunfeast, Bingo, Yippee, B Natural, ITC Master, Sunfeast Mom's Magic, Sunfeast Dark fantasy, Farmlite, ITC Hotels, Fabelle, Sunbean, Wills Lifestyle, Fiamma, Vivel, Engage, Shower to Shower, Savlon, Classmate, Paperkraft, John Players, Mint-o, Candyman, Mangaldeep, AIM, Superia, Kitchens of India

ITC has launched 50 new products in the FMCG space going against the tide of economic slowdown.



Pros:

- Huge profit margins of 67% on sale in cigarette business.
- Consistent in being a dividend aristocrat.
- Company with highest operating profit margins as an aggregate business.
- Scaling up the product line in the FMCG space
- A debt free business
- Huge net cash flows from cigarette business offers the company to utilize the earnings to grow its non-cigarette businesses and virtually no new capital is required by its cigarette business to operate.

Cons:

- Increasing taxes on cigarette business
- Rise in trade of illegal cigarette industry.
- No return for shareholders for the last five years
- No promoters holding



ECONOMIC MOAT

Company History: 1910

Company Management

MD & CEO: Sanjiv Puri

Chairmen: Yogesh Chander Deveshwar

Brand leadership

FMCG:

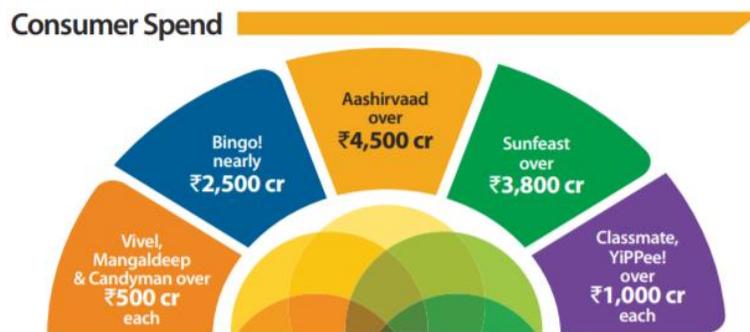
Name of the brand	Segment	its position in the segment
Aashirvaad	Branded Atta	01
Sunfeast	Cream biscuits	01
Bingo	Bridges segment of snack foods	01
Classmate	Notebooks	01
Yippee	Noodles	02
Engage	Deodorants	02
Fiama	Body wash	02
Mangaldeep	Dhoop	01
Mangaldeep	Incense sticks	02



Cigarette Business:

ITC Ltd sells 81% of the Cigarettes, Bidi in Asia, where 275 million people use tobacco products and the total cigarette market is worth close to \$11 billion (around Rs. 757399.4 million).

Consumer spends of well-known FMCG brands:



Competitive Moat of ITC:

- We consider ITC'S cigarettes business as a competitive moat in Warren Buffett's approach as it has a net profit margin of 67% on sales and the profit earned from cigarettes business is utilized by the company in coming up with new FMCG products.
- ITC limited operates as a complete value chain business. The raw material required by different business of ITC limited are being supplied by one of the business which ITC itself operates and owns. For reference raw tobacco required for cigarettes is supplied by the company only. The raw material required for producing FMCG food products is supplied by the Agri. Business of ITC itself and various spices and FMCG products produced are then used in ITC hotels as raw materials. THUS, this model of business helps in growing revenues and helps in maximum optimization and increases the efficiency. And down the line as various businesses scale up the aggregate cost of raw material will also get reduced and thus it can help in increasing the net profits of the company.



- We see cigarette as a price inelastic product and that nature in itself is a moat as with the increase in prices of cigarette due to the increase in taxes on sale of cigarettes, the demand for cigarettes doesn't fall in the long run. Thus, to some degree the cigarette business provides the company with a pricing power in the long run.
- ITC another moat is the optimal utilization of excess profits earned from cigarette business and start new business in diversified space which further reduces its only dependence on the cigarette business for profits in the long run.



TAKE ON ITC

We believe Mr. Market has highly undervalued the company and it is available at a discounted rate. We value ITC Ltd currently at a forward PE of 12.80 (FY21) at an earnings growth at 15%. Many investors get confused whether to consider ITC Ltd a cigarette manufacturing business as majority of profits are driven by cigarettes business or a FMCG stock as since 2000 it has foray into FMCG business too. But we consider ITC'S cigarettes business as a competitive moat in Warren Buffett's approach as it has a net profit margin of 67% on sales and the profit earned from cigarettes business is utilized by the company in coming up with new FMCG products. The profit margins from the FMCG-others has also doubled from 1.5% to 3.16%.

Cigarettes business is often considered as a sin business and it concerns investor whether the business will prosper as with every coming budget the government increases taxes on sale and the company in return tends to pass the same tax burden to the cigarettes buyers but according to us cigarettes is a price inelastic product in terms of economics and the demand of price inelastic product doesn't decrease to a increase in price of cigarettes .thus, ITC Ltd has a pricing power in terms of cigarettes and we consider it a moat of ITC limited.

ITC limited has currently launched 17 new products in the FMCG space and will be launching 50 new products in aggregate in the coming year. In the vision of the company , ITC limited has set a target of ₹100,000 crores or 1 trillion rupees revenue from non-cigarette businesses by the year 2030 which can be attained if the company's non-cigarette revenue grows at a CAGR of 14.23%, which seems possible to us the way the company is launching new products and improving margins.

We believe that ITC limited has one of the strongest balance sheet in its sector in term of its business and the investment it has made from the retained earnings and it is a cash rich company. In terms of the market share in the cigarette industry, ITC cigarettes had 82% market share and offering the company an approx. monopoly and specifically speaking there are only two competitors in Indian businesses which are Godfrey Phillips and VST industries.



FUTURE OUTLOOK OF ITC

- Since here, we are recommending long term stocks, if we see ITC limited 10 years down the line from here
- The company targets ₹100,000 crores revenue from its non-cigarette businesses
- And assuming the cigarette business grows at 7% from here, the revenue will be ₹54000
- Total revenue assumed equals ₹154,000 crores and if we value ITC at 6X its revenue
- The market cap will stand at ₹154,000*6 which is ₹924,000 crores
- Thus, I can grow 4.20 times in terms of market cap by the year 2030

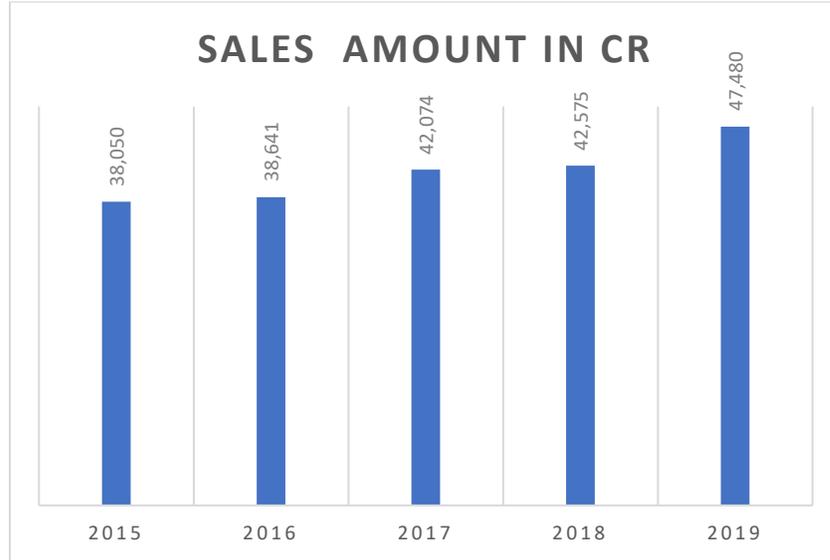
Economy and Industry Analysis:

- The economy from the economic slowdown now has the corona pandemic effect addition has filled the consumer with the fear of unknown in creating the demand required. The coming three quarters can observe further slowdown and the coming quarter for ITC limited also can see a negative growth in revenue and bottom line but nothing last forever and the Indian economy is all set to see a GDP of 8% in the coming years once the corona pandemic vanishes.
- The cigarette and the tobacco as the history itself suggests that with the tax increase every year has shown adequate growth. The companies in this industry instead of the taxes were able to pass on the tax burden to the consumers and take benefit as due to the price inelastic nature of the products.
- One of the biggest threats in the cigarette industry is the rise in smuggling of foreign cigarettes and increase in illegal trades as it directly eats up the market share of the whole Indian cigarette industry, but we believe as ITC limited has 82% market share in India in cigarettes, this threat will not impact its growth to a major extend.

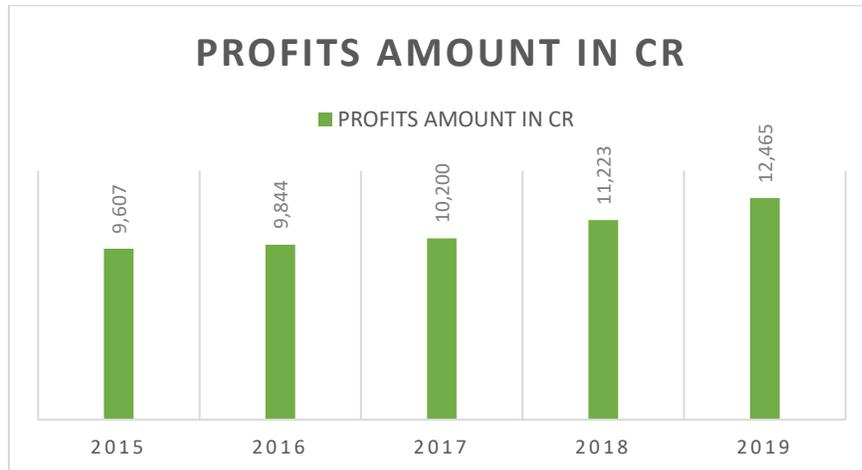


FINANCIAL HIGHLIGHTS

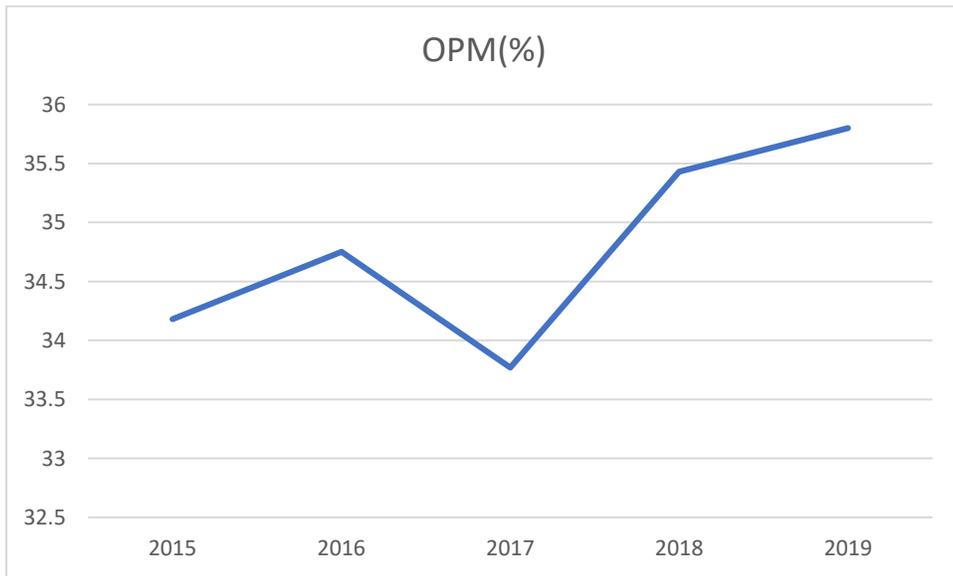
Sales Growth



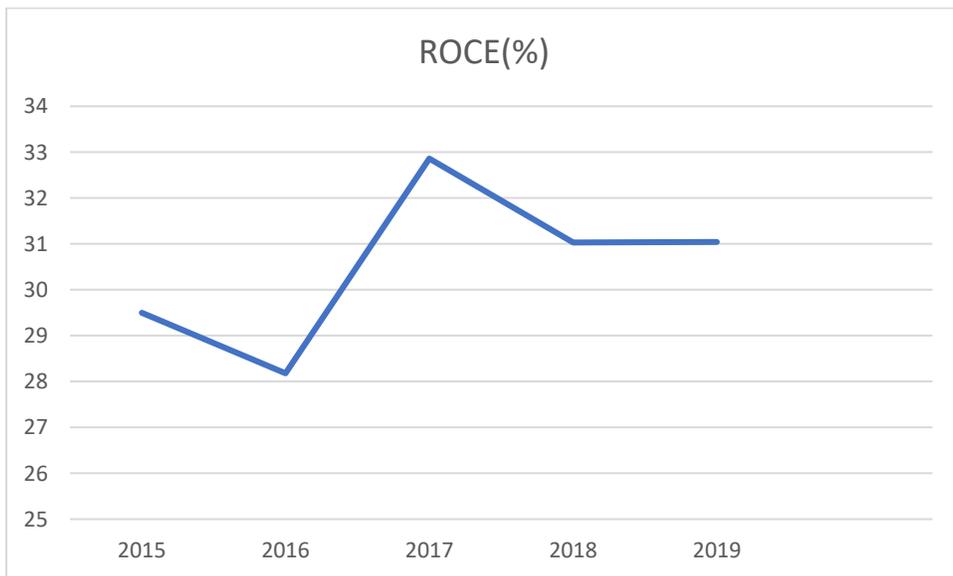
Profit Growth



Operating Profit Margins



Return on capital employed



Dividend Policy:

Company will pay 80-85 percentage of net profit as dividend as per its revised dividend distribution policy. Thus, the investor buying the stock at current valuation can get up-to 5.63% dividend yield.

COMPETITOR ANALYSIS

ITC

Divisions	Revenue (Crores)	Profits (Crores)	Margins For 2019(%)	Margins For 2018(%)	Change in Margins From 2018 To 2019
Cigarettes	22913.27	15411.77	67.26	56.85	18.31%
FMCG Others	12535.04	395.55	3.16	1.5	110.66%
Hotels	1746.74	185.69	10.63	9.7	9.58%
Agri. Business	9565.39	793.38	8.29	10.31	-19.59%
Paper Business	5860.16	1239.23	21.15	19.85	6.54%
Others	1966.62	172.45	8.77	7.91	10.87%
Net Values	49348.43	12835.9	26.01	24.26	7.21%

GODREY PHILIP

Divisions	Revenue (Crores)	Profits (Crores)	Margins For 2019(%)	Margins For 2018(%)	Change In Margins From 2018 To 2019
Cigarettes And Tobacco	2316.33	396.34	17.11	8.58	99.18%
Retail And Related Products	260.88	-82.71	-31.7	-11.96	-165.05%
Others (Other Op. Incomes)	5.01	4.62	92.22	89.4	3.15%
Net Values	2582.22	260	10.07	6.95	44.90%



HUL

Divisions	Revenue (Crores)	Profits (Crores)	Margins For 2019(%)	Margins For 2018(%)	Change In Margins From 2018 To 2019
Homecare	12874	2156	16.75	14.63	14.47%
Beauty And Personal	17800	4751	26.69	25.34	5.33%
Food And Refreshments	7131	1230	17.25	15.25	13.11%
Others	1505	178	11.83	9.98	18.51%
Net Values	39310	6060	15.42	14.42	6.90%

ITC's market cap is less than half of the market cap of Hindustan Unilever but the net profit earned by ITC limited is more than double the profits earned by Hindustan Unilever.

Company	Market cap	Net profits
ITC	219,000 crores	12824 crores
HUL	466,330 crores	6060 crores



VALUATIONS

Current Situation:

- Share Price: ₹177.50
- Market Cap: ₹2,19,000 Crore
- Total Shares Outstanding: 1225.86 Crore
- Dividend Yield: 3.30%
- Eps: ₹10.46
- Book Value: ₹46.78
- PE Ratio (TTM): 16.96
- 1 Year Returns: -42%

Per Share Valuations:

- Dividend Per Share: ₹5.75
- Free-Cashflow Per Share: ₹6.98
- Operating Cashflow Per Share: ₹9.60
- Price/Free-Cashflow Ratio: 25times
- Operating Revenue Per Share: ₹36.71
- Operating Profit Per Share: ₹14.25
- Current Investment Per Share: ₹10.20
- Non-Current Investment Per Share: ₹13.43



Other Valuation Parameters:

- PBIDT Margin: 43.98%
- PBIT Margin: 41.06%
- PBT Margin: 40.99%
- Net Profit Margin: 26.04%
- Return On Equity: 21.50%
- Return On Assets: 17.85%
- Return On Capital Employed 30.70%
- Retain Earnings Ratio 49.60%

Valuation Matrix:

- At 15X its net earnings of FY23 with a bottom line growth of 10%.
- At 6X its revenue of FY23 with a revenue growth of 8%
- At 25x its free cash flow of FY23 with a growth of 12%



TARGETS

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Disclaimer: This report is just an analysis of a listed company and I hereby confirm everything mentioned above to be true to my knowledge. Please contact your financial advisor before acting on the recommendation. The author or the website or anyone associated with it is not responsible for any loss incurred.



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