

July 3, 2017

₹ 342

ITC Ltd (ITC)

Eliminating 'Tax on Tax'...

With the clarity emerging on new indirect tax rates on cigarettes, we believe net tax incidence on ITC would come down by 4.5% mainly due to elimination of cascading effect of taxes. Considering anti profiteering clause in place cigarettes prices are likely to come down by 2.5%. After five consecutive year of increase in duties & taxes on cigarettes, GST implementation has come as advantage for cigarettes companies. We believe the company would continue to concentrate on low priced (64 & 69 mm) cigarettes to derive higher volume growth. Notably 64 mm category volume contribution has increased from ~20% to ~32% in last one year. We have built in 4% volume growth for the FY18E and 5% price hikes as the company has increased prices earlier this year to the tune of 11-14% on above 69 mm portfolio. We remain positive on the stock and raise our target price to ₹ 407 per share.

Excise on cigarettes scrapped, NCCD to continue

Before the implementation of GST the cigarette industry attracted VAT (at 25%), basic and additional excise duty and NCCD. Under new tax structure excise duty & Additional Excise Duty (AED) is abolished whereas National Calamity Contingent Duty (NCCD) would continue to be levied on cigarettes. Ad valorem VAT is replaced by the GST rate of 28% and excise duty is replaced by GST compensation cess of 5% plus specific duty as per the cigarette size. Though, we believe that the tax rate has remained similar but the cascading effect of tax structure will be eliminated under GST. We believe that this may result in 4.5% reduction in the overall tax incidence and also a window for the company to reduce the prices by ~2.5%, which may be a volume driver.

Rise in taxes for beedi may be an additional driver

The high incidence of taxation on cigarettes in India have over the years have led to diversion of consumption of tobacco to lightly taxed or tax-evaded tobacco products like beedis, chewing tobacco, guthka and illegal cigarettes. The legal cigarettes account only for 11% of the total tobacco industry contributing 87% of the tax revenue from the sector. However, we believe that the imposition of 18% GST on beedi leaves and 28% on beedi sector would be negative for the beedi industry as the expected tax incidence was lower at 18% against VAT incidence of 20%. We believe that any price hike taken in beedis in order to pass on the additional tax incidence might lead to a gradual shift in consumers towards consumption of low priced cigarettes. In addition, this will bring down the tax evasion from the beedi players as they would have to come under the taxation regime in order to get the benefit of the input tax credit. Further, this may provide the organised players an opportunity to launch cigarettes at lower price points, providing a push to the overall organised cigarette market.

Lower tax incidence to boost volumes, maintain Buy

We are factoring in 4.0% volume CAGR and 7.5% realisation CAGR in FY17-19E for the cigarette business. Additionally, ITC's focus on growing its FMCG business (estimated to grow at a 12.3% CAGR over FY17-19E) by entering newer segments and tapping opportunity in foods segment would be a catalyst for topline growth in the long run. We reiterate our BUY recommendation on the stock with a target price of ₹ 407 valuing it on SOTP basis. We have valued the cigarettes business at ₹ 334 (higher multiple of 35x FY19E EPS given the lower tax incidence), FMCG at ₹ 44 (4x MCap/sales FY19E), paperboards at ₹ 5 (3x FY19E EV/EBITDA), agri-business at ₹ 5 (3x P/BV FY19E) and hotels at ₹ 7 (2x EV/room FY19E) and also added the cash per share of ₹ 12.

Rating matrix

Rating	:	Buy
Target	:	₹ 407
Target Period	:	12 months
Potential Upside	:	26%

What's changed?

Target	Changed from ₹ 345 to ₹ 407
EPS FY18E	Unchanged
EPS FY19E	Unchanged
Rating	Unchanged

Key financials

₹ Crore	FY16	FY17	FY18E	FY19E
Revenue	51,582.5	55,001.7	59,796.4	67,278.1
EBITDA	13,714.6	14,578.0	17,245.5	19,490.8
Net Profit	9,328.4	10,200.9	12,508.2	14,135.0
EPS (₹)	7.7	8.4	10.3	11.6

*From FY16 onwards, financials are reported as per Ind AS

Valuation summary

	FY16	FY17	FY18E	FY19E
P/E	42.2	38.6	31.5	27.8
Target P/E	53.1	48.5	39.6	35.0
Div. Yield	2.6	1.5	2.3	2.3
Mcap/Sales	7.6	7.2	6.6	5.8
RoNW (%)	22.4	22.5	26.5	27.9
RoCE (%)	33.2	32.9	38.1	40.2

*From FY16 onwards, financials are reported as per Ind AS

Stock data

Particular	Amount
Market Capitalization (₹ Crore)	393,393.5
Total Debt (FY17) (₹ Crore)	18.0
Cash and Investments (FY17) (₹ Crore)	12,847.1
EV (₹ Crore)	380,564.5
52 week H/L	325 / 222
Equity capital	₹ 1214.7 crore
Face value	₹ 1

Price performance

	1M	3M	6M	12M
ITC	10.6	21.4	42.4	39.9
VST Industries	19.7	29.8	54.0	118.3
Godfrey Phillip	6.2	12.4	26.3	48.0

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Indirect tax incidence will go down by 4.5% and we believe the company would pass on the benefit to comply with anti profiteering clause. We estimate 4% volume growth for FY18E & FY19E

Exhibit 1: Lower tax incidence under GST

(₹ Per stick)	Earlier	Under GST	Difference	Comments
Net realisation	2.7	2.7		
Excise Duty / NCCD	2.2	0.1		Excise duty & Additional excise duty has been abolished whereas NCCD continues to be levied
Gross Realisation	4.9	2.8		
VAT @ 25% / GST @ (28%+5%)	1.2	0.9		Cascading effect on taxes has been
Cess	0.0	2.2		
Total tax incidence	3.4	3.3	-4.5%	Total tax incidence would reduce by 4.5%
Dealers Margin @ 15%	0.9	0.9		
MRP	7.0	6.9	-2.5%	With anti profiteering clause in place, the companies are require to pass on the benefit with price cuts

Source: Company, ICICIdirect.com Research

Exhibit 2: Earlier tax structure

	VAT (%)	Excise duty (₹ Per stick)	NCCD (₹ Per stick)	AED (₹ Per stick)
Less than 65 mm		1.28	0.09	0.31
65-70mm	25	1.74	0.09	0.39
70-75		2.34	0.15	0.54
More than 75 mm		3.38	0.24	0.81

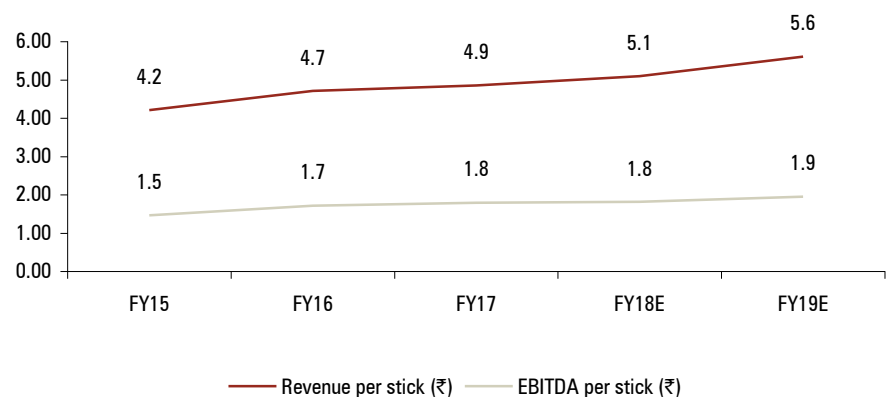
Source: Company, ICICIdirect.com Research

Exhibit 3: Tax structure under GST

	NCCD (₹/stick)	GST	Cess
Less than 65 mm	0.09		5% + ₹ 1.59/stick
65-70mm	0.09	28%	5% + ₹ 2.12/stick
70-75	0.15		5% + ₹ 2.86/stick
More than 75 mm	0.24		5% + ₹ 4.17/stick

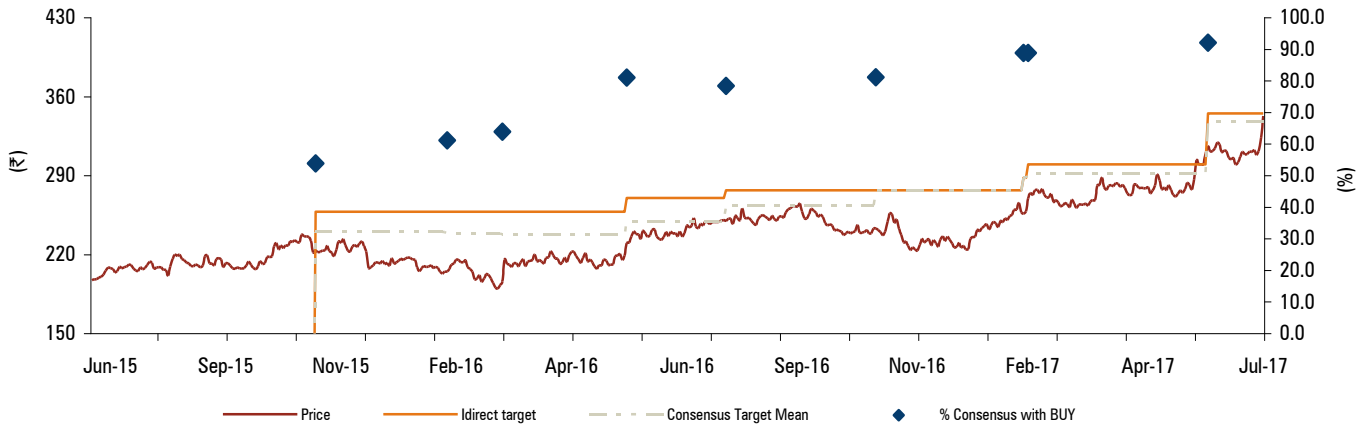
Source: Company, ICICIdirect.com Research

Exhibit 4: Revenue per stick & EBITDA per stick (₹)



Source: Company, ICICIdirect.com Research

Recommendation history vs. Consensus



Source: Bloomberg, Company, ICICIdirect.com Research

Key events

Date	Event
Dec-10	ITC shuts all its five cigarette manufacturing units awaiting clarity from the government on the pictorial representation of packs
Feb-11	The Gol leaves excise duty unchanged in its FY12 Budget; a key positive for the company
Feb-12	Gol increases basic excise duty on cigarettes by whopping 20% in its FY13 Budget
Sep-12	Inaugurates its largest luxury hotel, Grand Chola, in Chennai. It has a capacity of ~600 rooms
Dec-12	Begins the construction of milk processing unit in Munger, Bihar
Feb-13	The Gol in its Budget again raises the basic excise duty on cigarettes by 18%
May-13	For the first time during the quarter the company reports a profit in its FMCG (others) business
Jul-14	Gol increases excise duty on cigarettes for a third consecutive year. It announces an increase of 11-72% in excise duty in its FY15E Budget
Oct-14	Health Ministry proposes ban on loose cigarettes, higher penalty on smoking in public places
Dec-14	Volume declines significantly in Q3FY15 as excessive price hike in last two years impacts growth
Feb-15	Acquisition of Shower To Shower, Savlon brands from Johnson & Johnson
Feb-15	Excise hike of 25% in below 65 mm category & 15% in above 65 mm category in Budget 2015
Feb-16	Excise hike of 10% on cigarettes in Budget 2016
Feb-17	Excise hike of 6% on cigarettes in Budget 2017

Source: Company, ICICIdirect.com Research

Top 10 Shareholders

Rank	Name	Latest Filing Date	% O/S	Position (m)	Change (m)
1	British American Tobacco PLC	31-Mar-17	24.52	2,978.3	0.0
2	Life Insurance Corporation of India	31-Mar-17	16.26	1,975.1	242.5
3	UTI Asset Management Co. Ltd.	31-Mar-17	9.08	1,102.6	-242.5
4	Myddleton Investments Co., Ltd.	31-Mar-17	4.00	486.3	0.0
5	General Insurance Corporation of India	31-Mar-17	1.75	213.1	-1.2
6	The New India Assurance Co. Ltd.	31-Mar-17	1.69	205.5	-6.1
7	Oriental Insurance Company Ltd.	31-Mar-17	1.39	169.4	-7.0
8	Rothmans International Enterprises, Ltd.	31-Mar-17	1.28	155.0	0.0
9	GIC Private Limited	31-Mar-17	1.27	154.9	-6.8
10	Aberdeen Asset Management (Asia) Ltd.	31-May-17	1.14	138.6	0.0

Source: Reuters, ICICIdirect.com Research

Shareholding Pattern

(in %)	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
Promoter	-	-	-	-	-
FII	20.6	20.8	21.3	20.8	20.8
DII	35.1	34.9	35.0	35.7	35.7
Others	44.4	44.2	43.7	43.5	43.5

Recent Activity

Buys			Sells		
Investor name	Value	Shares	Investor name	Value	Shares
Life Insurance Corporation of India	1048.25m	242.52m	UTI Asset Management Co. Ltd.	-1048.25m	-242.52m
Aberdeen Asset Management Company Ltd. (Thailand)	41.78m	10.63m	Capital Research Global Investors	-104.7m	-29.44m
SBI Funds Management Pvt. Ltd.	26.08m	6.03m	Carmignac Gestion	-52.8m	-14.84m
ICICI Prudential Asset Management Co. Ltd.	15.12m	3.5m	Lyxor Asset Management	-58.08m	-12.02m
Matthews International Capital Management, L.L.C.	11.78m	2.73m	Fidelity Worldwide Investment (UK) Ltd.	-42.13m	-9.75m

Source: Reuters, ICICIdirect.com Research

Financial summary

Profit and loss statement		₹ Crore			
	FY16	FY17	FY18E	FY19E	
Total operating Income	51,944.6	55,448.5	60,319.1	67,889.6	
Growth (%)	42.3	6.7	8.8	12.6	
Raw Material Expenses	13,450.0	15,976.3	16,699.3	18,287.8	
Employee Expenses	2,331.6	2,444.3	2,690.8	3,027.5	
Marketing Expenses	0.0	0.0	598.0	740.1	
Administrative Expenses	0.0	0.0	1,375.3	1,547.4	
Excise Duty	15361.9	15359.8	17404.9	19884.8	
Other expenses	7,086.5	7,090.0	4,305.3	4,911.3	
Total Operating Expenditure	38,230.0	40,870.4	43,073.7	48,398.8	
EBITDA	13,714.6	14,578.0	17,245.5	19,490.8	
Growth (%)	1.8	6.3	18.3	13.0	
Depreciation	1,000.7	1,038.0	1,308.9	1,467.9	
Interest	49.1	23.0	44.5	50.1	
Other Income	1,769.3	1,985.9	2,776.8	3,124.3	
PBT	14,434.1	15,503.0	18,668.9	21,097.1	
Total Tax	5,105.7	5,302.1	6,160.7	6,962.0	
PAT	9,328.4	10,200.9	12,508.2	14,135.0	
Growth (%)	-2.9	9.4	22.6	13.0	
EPS (₹)	7.7	8.4	10.3	11.6	

Source: Company, ICICIdirect.com Research

*From FY16 onwards, financials are reported as per Ind AS

Balance sheet		₹ Crore			
(Year-end March)	FY16	FY17	FY18E	FY19E	
Liabilities					
Equity Capital	804.7	1,214.7	1,214.7	1,214.7	
Reserve and Surplus	40,851.7	44,126.2	45,989.2	49,479.1	
Total Shareholders funds	41,656.4	45,341.0	47,203.9	50,693.8	
LT Borrowings & Provisions	25.8	18.0	28.0	38.0	
Deferred Tax Liability	1,867.4	1,871.7	1,871.7	1,871.7	
Others Non-current Liabilities	127.3	140.6	159.3	178.8	
Total Liabilities	43,677.0	47,371.2	49,262.9	52,782.3	
Assets					
Gross Block	21,781.3	23,696.7	25,696.7	27,696.7	
Less: Acc Depreciation	8,189.3	9,227.4	10,536.3	12,004.2	
Net Block	13,592.0	14,469.3	15,160.4	15,692.5	
Capital WIP	2,419.2	3,537.0	2,100.0	2,100.0	
Net Intangible Assets	419.0	410.9	430.9	450.9	
Non-current Investments	6,853.2	8,485.5	9,174.2	10,322.1	
LT loans & advances	8.1	5.8	55.8	105.8	
Current Assets					
Inventory	8,519.8	7,864.0	9,010.4	10,137.8	
Debtors	1,686.4	2,207.5	2,293.6	2,580.5	
Loans and Advances	3.9	3.4	3.7	4.1	
Other Current Assets	913.4	1,615.5	1,802.1	2,027.6	
Cash	5,639.2	2,747.3	4,869.1	4,799.0	
Current Investments	6471.3	10099.8	9338.1	10506.4	
Current Liabilities	6,354.3	6,830.1	7,745.3	8,714.4	
Creditors	2,228.0	2,551.2	2,785.0	3,133.5	
Provisions	57.6	41.8	45.5	51.2	
Short term debt & other CL	4,068.7	4,237.0	4,914.8	5,529.7	
Application of Funds	43,677.0	47,371.2	49,262.9	52,782.3	

Source: Company, ICICIdirect.com Research

Cash flow statement		₹ Crore			
(Year-end March)	FY16	FY17E	FY18E	FY19E	
Profit After Tax	9,328.4	10,200.9	12,508.2	14,135.0	
Add: Depreciation	1,000.7	1,038.0	1,308.9	1,467.9	
(Inc)/dec in Current Assets	-1,092.4	-4,195.4	-657.7	-2,808.6	
Inc/(dec) in CL and Provisions	701.0	475.8	915.2	969.1	
CF from operating activities	9,937.6	7,519.3	14,074.6	13,763.4	
(Inc)/dec in Investments	-3,975.2	-1,632.3	-688.7	-1,147.9	
(Inc)/dec in LT loans & advances	1.2	2.3	-50.0	-50.0	
(Inc)/dec in Fixed Assets	-1,417.4	-3,025.1	-583.0	-2,020.0	
Others	198.3	-1.7	0.0	0.0	
CF from investing activities	-5,610.1	-3,906.2	-1,336.4	-3,217.9	
Issue/(Buy back) of Equity	3.2	410.0	0.0	0.0	
Inc/(dec) in loan funds	-12.9	-7.8	10.0	10.0	
Dividend paid & dividend tax	-8,181.6	-6,895.2	-10,645.2	-10,645.2	
Inc/(dec) in Sec. premium	0.0	0.0	0.0	0.0	
Others	11.5	19.2	18.7	19.5	
CF from financing activities	-7,652.8	-6,473.8	-10,616.4	-10,615.6	
Net Cash flow	-3,325.3	-2,860.7	2,121.8	-70.1	
Opening Cash	-279.3	-3,604.6	2,747.3	4,869.1	
Closing Cash	5,639.2	2,747.3	4,869.1	4,799.0	

Source: Company, ICICIdirect.com Research

Key ratios					
(Year-end March)	FY16	FY17	FY18E	FY19E	
Per share data (₹)					
EPS	7.7	8.4	10.3	11.6	
Cash EPS	8.5	9.3	11.4	12.8	
BV	34.3	37.3	38.9	41.7	
DPS	8.5	4.8	7.3	7.3	
Cash Per Share	4.6	2.3	4.0	4.0	
Operating Ratios (%)					
EBITDA Margin	26.4	26.3	28.6	28.7	
PBT / Total Operating income	27.8	28.0	31.0	31.1	
PAT Margin	18.0	18.4	20.7	20.8	
Inventory days	60.3	52.2	55.0	55.0	
Debtor days	11.9	14.6	14.0	14.0	
Creditor days	15.8	16.9	17.0	17.0	
Return Ratios (%)					
RoE	22.4	22.5	26.5	27.9	
RoCE	33.2	32.9	38.1	40.2	
RoC	37.3	32.7	38.7	40.3	
Valuation Ratios (x)					
P/E	42.2	38.6	31.5	27.8	
EV / EBITDA	28.3	26.8	22.5	19.9	
EV / Net Sales	7.5	7.1	6.5	5.8	
Market Cap / Sales	7.6	7.2	6.6	5.8	
Price to Book Value	9.4	8.7	8.3	7.8	
Solvency Ratios					
Debt/EBITDA	0.0	0.0	0.0	0.0	
Debt / Equity	0.0	0.0	0.0	0.0	
Current Ratio	2.8	3.2	2.9	2.9	
Quick Ratio	1.4	2.0	1.7	1.7	

Source: Company, ICICIdirect.com Research

ICICIdirect.com coverage universe (FMCG)

Sector / Company	CMP		Rating	M Cap (₹ Cr)	EPS (₹)			P/E (x)			Price/Sales (x)			RoCE (%)			RoE (%)		
	(₹)	TP(₹)			FY17E	FY18E	FY19E	FY17E	FY18E	FY19E	FY17E	FY18E	FY19E	FY17E	FY18E	FY19E	FY17E	FY18E	FY19E
Colgate (COLPAL)	1,111	990	Hold	27,904	21.2	23.6	26.0	52.3	47.2	38.0	6.2	5.7	5.2	64.1	71.4	70.4	45.3	50.2	49.3
Dabur India (DABIND)	292	305	Hold	49,990	7.2	7.5	8.0	40.3	39.0	38.0	6.5	6.0	5.5	28.0	25.6	25.5	26.4	23.4	22.6
GSK CH (GLACON)	5,354	6,074	Buy	22,775	156.1	176.3	199.2	34.3	30.4	30.5	5.2	4.5	4.0	30.8	30.3	31.3	21.0	21.2	21.7
Hindustan Unilever (HINLEV)	1,080	1,120	Hold	234,662	20.8	22.8	26.7	51.9	47.4	41.9	6.9	6.4	5.8	74.9	82.2	85.6	66.6	66.7	69.0
ITC Limited (ITC)	342	407	Buy	393,394	8.4	10.3	11.6	40.7	33.2	35.0	7.2	6.6	5.8	32.9	38.1	40.2	22.5	26.5	27.9
Jyothy Lab (JYOLAB)	356	397	Hold	6,625	11.1	10.7	12.7	32.0	33.1	31.3	3.9	3.5	3.2	28.1	29.0	30.5	30.9	27.1	28.0
Marico (MARLIM)	314	341	Hold	41,532	6.3	6.9	8.4	49.9	45.5	40.4	7.0	6.0	5.1	44.6	45.1	49.4	34.9	34.6	37.7
Nestle (NESIND)	6,737	7,420	Buy	64,106	103.9	133.4	154.5	64.9	50.5	48.0	6.8	6.0	5.3	34.9	36.7	44.3	36.2	40.0	44.1
Tata Global Bev (TATGLO)	151	147	Hold	9,773	7.2	7.7	8.2	20.9	19.6	18.0	1.4	1.4	1.3	8.8	9.1	9.3	7.2	7.7	7.8
VST Industries (VSTIND)	3,750	4,130	Buy	5,791	108.3	134.6	164.6	34.6	27.9	25.1	6.1	5.3	4.7	45.0	49.0	51.5	31.1	34.1	36.2
Prabhat Dairy (PRADAI)	131	140	Buy	1,160	4.8	6.4	9.5	24.7	18.5	12.5	0.8	0.7	0.6	8.0	9.7	12.2	5.1	6.8	9.7
McLeod Russel (MCLRUS)	174	183	Hold	1,855	7.8	5.6	9.2	NA	31.0	20.0	23.5	16.8	15.1	6.2	5.8	6.5	3.3	2.3	3.6

Source: Company, ICICIdirect.com Research

RATING RATIONALE

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Strong Buy: > 15%/20% for large caps/midcaps, respectively, with high conviction;

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