

## ITC Ltd (ITC)

### Back to square one...

In the review meeting of the GST Council on tax rates, the council has raised the specific cess on cigarettes in all categories below 75 mm. Also, it has sharply increased the ad-valorem rate in above 75 mm category. We believe this would increase the blended tax incidence per stick from ₹ 3.2 to ₹ 3.9, resulting in more than ₹ 5000 crore excess tax burden for the industry compared to earlier GST rates or ₹ 3800 crore excess burden compared to pre-GST regime. We believe ITC would need to take a price hike of ~12% to pass on the additional tax burden. We change our volume estimates from earlier 4% to 1% for FY18E and simultaneously change our realisation estimate from 5% to 12%. For FY19E also, we are revising our volume estimates downwards from 4% to 1%.

#### Background

In a bid to keep the indirect tax rate neutral, the government has kept the GST rate plus cess almost similar to earlier excise plus VAT. However, as GST eliminates the cascading effect of taxes, cigarette companies were net beneficiaries of the change. According to our estimates, the companies would either have reduced prices by ~3% or would have added ₹ 1200 crore to EBITDA. We estimated the reasoning of this move was to discourage illicit cigarettes industry, which has become ~20% of the total cigarettes volumes. However, to our surprise, the government miscalculated the indirect tax incident on cigarettes and corrected itself within 17 days of the implementation of GST.

#### Tax incidence to go up by 22.0%

The government has kept the GST rate of 28% and cess of 5% for the below 75 mm category and raised the specific cess per stick from ₹ 1.59 to ₹ 2.17 on below 65 mm category, from ₹ 2.12 to ₹ 2.84 for regular size category and from ₹ 2.86 to ₹ 3.81 for longs. Further, for the above king size category, the government has raised the cess from 5% to 36% and kept the specific cess similar at ₹ 4.1/ stick. We believe the change will increase the indirect tax incidence on the company by 22.0% with the effective estimated price hike coming to 12% to pass on the entire burden. The change in rates brings us back to square one where cigarettes companies are continuously facing an additional tax burden every year. We believe FY18 will be the same. We change our volume growth estimate from 5% earlier to 1% now for FY18.

#### With significant increase in tax incidence downgrade to HOLD

Post the revision in rates, we are factoring in 1.0% volume growth for both FY18E and FY19E. Further, to pass on the tax burden, we estimate that ITC would have to take 12% and 8% price hike for FY18E and FY19E, respectively. Our revenue estimate is, thus, getting revised marginally upwards by 2.2% for FY18E and remains flat for FY19E. However, with increased tax incidence, our PAT estimates are getting revised downwards by 13.6% and 14.6% for FY18E and FY19E, respectively. In a scenario where volume growth would continue to remain under pressure, we assign lower multiple to cigarettes business of 30x against 35x earlier. We value the cigarettes business at ₹ 247 (PE multiple of 30x FY19E EPS), FMCG at ₹ 44 (4x MCap/sales FY19E), paperboards at ₹ 4 (3x FY19E EV/EBITDA), agri-business at ₹ 6 (3x P/BV FY19E) and hotels at ₹ 7 (2x EV/room FY19E) and also add the cash per share of ₹ 10. We downgrade ITC to **HOLD** with a target price of ₹ 317.

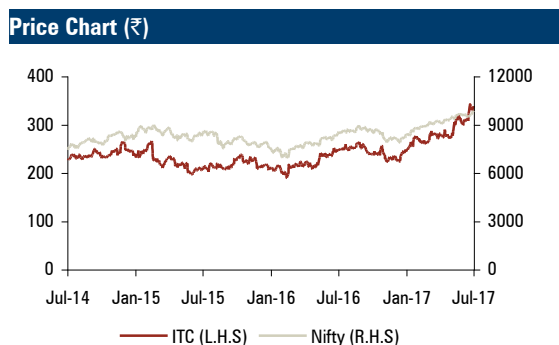
Rating matrix		
Rating	:	Hold
Target	:	₹ 317
Target Period	:	12 months
Potential Upside	:	-6%

What's Changed?	
Target	Changed from ₹ 407 to ₹ 317
EPS FY18E	Changed from ₹ 10.3 to ₹ 8.9
EPS FY19E	Changed from ₹ 11.6 to ₹ 9.9
Rating	Changed from Buy to Hold

Key financials				
₹ Crore	FY16	FY17	FY18E	FY19E
Revenue	51,582.5	55,001.7	61,128.5	66,756.9
EBITDA	13,714.6	14,578.0	14,650.6	16,386.8
Net Profit	9,328.4	10,200.9	10,810.4	12,039.4
EPS (₹)	7.7	8.4	8.9	9.9

Valuation summary				
	FY16	FY17	FY18E	FY19E
P/E	43.9	40.1	37.9	34.0
Target P/E	41.3	37.8	35.7	32.0
Div. Yield	2.5	1.4	2.2	2.2
Mcap/Sales	7.9	7.4	6.7	6.1
RoNW (%)	22.4	22.5	23.8	25.7
RoCE (%)	33.2	32.9	34.1	36.9

Stock data	
Particular	Amount
Market Capitalization (₹ Crore)	409,549.6
Total Debt (FY17) (₹ Crore)	18.0
Cash and Investments (FY17) (₹ Crore)	12,847.1
EV (₹ Crore)	396,720.5
52 week H/L	353 / 222
Equity capital	₹ 1214.7 crore
Face value	₹ 1



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**Exhibit 1: Revision in GST rate and impact on tax incidence**

Per stick (₹)	Post 17th July				Before 17th July			
	below 65 mm	65-70 mm	70-75 mm	above 75 mm	below 65 mm	65-70 mm	70-75 mm	above 75 mm
Net Realisation	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
NCCD	0.1	0.1	0.1	0.2	0.1	0.1	0.1	0.2
GST	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Cess at 5% (36% for above 75mm category)	0.1	0.1	0.1	1.0	0.1	0.1	0.1	0.1
Specific Cess	2.2	2.8	3.8	4.2	1.6	2.1	2.9	4.2
Total Tax Incidence	3.2	3.8	4.8	6.1	2.6	3.1	3.9	5.3
Volume	35%	45%	10%	10%	35%	45%	10%	10%
<b>Cost to company</b>	<b>5.9</b>	<b>6.5</b>	<b>7.5</b>	<b>8.8</b>	<b>5.3</b>	<b>5.8</b>	<b>6.6</b>	<b>8.0</b>
Dealer's margin @ 15%	0.9	1.0	1.1	1.3	0.8	0.9	1.0	1.2
<b>MRP</b>	<b>6.7</b>	<b>7.5</b>	<b>8.7</b>	<b>10.2</b>	<b>6.1</b>	<b>6.7</b>	<b>7.6</b>	<b>9.2</b>
Blended tax incidence	3.9				3.2			
Blended MRP	7.6				6.8			
<b>Increase in tax incidence (%)</b>	<b>22.0</b>							
<b>Estimated price hike (%)</b>	<b>11.9</b>							

Source: Company, ICICIdirect.com Research

**Exhibit 2: Change in estimates post GST tax revision**

(₹ Crore)	FY18E			FY19E		
	Old	New	% Change	Old	New	% Change
Sales	59796.4	61128.5	2.2	67278.1	66756.9	-0.8
EBITDA	17245.5	14650.6	-15.0	19490.8	16386.8	-15.9
EBITDA Margin (%)	28.6	23.8	-484 bps	28.7	24.3	-438 bps
PAT	12508.2	10810.4	-13.6	14135.0	12039.4	-14.8
EPS (₹)	10.3	8.9	-13.6	11.6	9.9	-14.6

Source: Company, ICICIdirect.com Research

## Financial summary

Profit and loss statement		₹ Crore			
	FY16	FY17	FY18E	FY19E	
Total operating Income	51,944.6	55,448.5	61,651.2	67,368.5	
Growth (%)	42.3	6.7	11.2	9.3	
Raw Material Expenses	13,450.0	15,976.3	16,883.1	18,215.8	
Employee Expenses	2,331.6	2,444.3	2,750.8	3,004.1	
Marketing Expenses	0.0	0.0	611.3	734.3	
Administrative Expenses	0.0	0.0	1,406.0	1,535.4	
Excise Duty	15361.9	15359.8	20948.3	22618.8	
Other expenses	7,086.5	7,090.0	4,401.3	4,873.3	
Total Operating Expenditure	38,230.0	40,870.4	47,000.7	50,981.7	
EBITDA	13,714.6	14,578.0	14,650.6	16,386.8	
Growth (%)	1.8	6.3	0.5	11.9	
Depreciation	1,000.7	1,038.0	1,308.9	1,467.9	
Interest	49.1	23.0	45.5	49.7	
Other Income	1,769.3	1,985.9	2,838.7	3,100.1	
PBT	14,434.1	15,503.0	16,134.9	17,969.3	
Total Tax	5,105.7	5,302.1	5,324.5	5,929.9	
PAT	9,328.4	10,200.9	10,810.4	12,039.4	
Growth (%)	-2.9	9.4	6.0	11.4	
EPS (₹)	7.7	8.4	8.9	9.9	

Source: Company, ICICIdirect.com Research

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

Cash flow statement		₹ Crore			
(Year-end March)	FY16	FY17E	FY18E	FY19E	
Profit After Tax	9,328.4	10,200.9	10,810.4	12,039.4	
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	-1,157.8	-2,112.9	
Inc/(dec) in CL and Provisions	701.0	475.8	1,087.8	729.0	
CF from operating activities	9,937.6	7,519.3	12,049.3	12,123.4	
(Inc)/dec in Investments	-3,975.2	-1,632.3	-893.1	-863.5	
(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	-1,540.7	-2,933.5	
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	-1.6	14.7	
CF from financing activities	-7,652.8	-6,473.8	-10,636.8	-10,620.4	
Net Cash flow	-3,325.3	-2,860.7	-128.2	-1,430.5	
Opening Cash	-279.3	-3,604.6	2,747.3	2,619.0	
Closing Cash	5,639.2	2,747.3	2,619.0	1,188.5	

Source: Company, ICICIdirect.com Research

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	44,291.4	45,685.7	
Total Shareholders funds	41,656.4	45,341.0	45,506.2	46,900.4	
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	138.9	153.7	
Total Liabilities	43,677.0	47,371.2	47,544.8	48,963.8	
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	9,378.6	10,242.2	
LT loans & advances	8.1	5.8	55.8	105.8	
Current Assets					
Inventory	8,519.8	7,864.0	9,211.1	10,059.3	
Debtors	1,686.4	2,207.5	2,344.7	2,560.5	
Loans and Advances	3.9	3.4	3.7	4.1	
Other Current Assets	913.4	1,615.5	1,842.2	2,011.9	
Cash	5,639.2	2,747.3	2,619.0	1,188.5	
Current Investments	6471.3	10099.8	9546.1	10425.1	
Current Liabilities	6,354.3	6,830.1	7,917.8	8,646.9	
Creditors	2,228.0	2,551.2	2,847.1	3,109.2	
Provisions	57.6	41.8	46.5	50.8	
Short term debt & other CL	4,068.7	4,237.0	5,024.3	5,486.9	
Application of Funds	43,677.0	47,371.2	47,544.8	48,963.8	

Source: Company, ICICIdirect.com Research

Key ratios					
(Year-end March)	FY16	FY17	FY18E	FY19E	
Per share data (₹)					
EPS	7.7	8.4	8.9	9.9	
Cash EPS	8.5	9.3	10.0	11.1	
BV	34.3	37.3	37.5	38.6	
DPS	8.5	4.8	7.3	7.3	
Cash Per Share	4.6	2.3	2.2	1.0	
Operating Ratios (%)					
EBITDA Margin	26.4	26.3	23.8	24.3	
PBT / Total Operating income	27.8	28.0	26.2	26.7	
PAT Margin	18.0	18.4	17.5	17.9	
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	23.8	25.7	
RoCE	33.2	32.9	34.1	36.9	
RoC	37.3	32.7	32.0	33.5	
Valuation Ratios (x)					
P/E	43.1	39.4	37.2	33.4	
EV / EBITDA	28.9	27.4	27.3	24.5	
EV / Net Sales	7.7	7.3	6.5	6.0	
Market Cap / Sales	7.8	7.3	6.6	6.0	
Price to Book Value	9.7	8.9	8.8	8.6	
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

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