

'Lender of last resort'?

The GST Council is scheduled to meet coming Friday, Sep 28th to, inter alia, decide on a way to raise funds to help re-build Kerala after the state faced massive losses from severe flooding last month (Aug'18). The natural consequence of this is, expectedly, renewed pressure on ITC's share price. Interestingly, the GST Council may not need any parliamentary approval for this additional levy since Article 279A of the Constitution has already been amended to allow the GST Council to recommend 'any special rate or rates for a specified period, to raise additional resources during any natural calamity or disaster'. We expect the stock to recover once the event is out of the way this week, as we do not expect the fresh levy to be all that severe (mid to high single-digit price hike would be enough to offset the impact, we believe) and more importantly, we do not think any new tax arising out of this event is a signal of any change in the government's recent more-benign stance on tobacco taxation. One point we would agree, though, is that frequent calling on tobacco companies to act akin to 'the lender of last resort' is not too good for the stock's PE multiple over the medium-term, since taxes of any kind, once levied, tends to be permanent.

- **What is the amount involved?** As per media reports: 1) INR200bn would be required for re-building Kerala after the recent floods. 2) Kerala FM had asked for c.INR25bn of aid for rehabilitation work. The Union FM has supposedly not agreed with Kerala FM's suggestion to levy a 10% cess on Kerala's own State-GST (this would have yielded just INR8-10bn p.a., as per our workings), and instead proposed a national cess to deal with these calamities; one of the options is to look at a 'disaster cess' on a few goods, such as luxury items, to fund natural calamities in Kerala and other states, whenever they arise. Note that the surplus from the existing compensation cess pool cannot be used for disaster-relief purpose as that pool, as per the Act, can be used only for the purpose specified, viz to compensate states for revenue shortfall for five years and any surplus thereafter would be distributed between Centre and all States. As per our workings, if INR25bn is all that is sought to be raised for disaster relief, then we do not see any major additional hit for tobacco companies, if this entire amount is sought to be collected from goods that are classified as 'demerit' in nature. Even if the entire levy is only on cigarette companies, our workings indicate that 28p per stick average cess and a resultant 5-6% cigarette price-hike would be sufficient to deal with the situation (refer Exhibit 1).
- **How bad could the situation get if the Council seeks to collect INR100bn from luxury and demerit goods?** We admit that this is just a scenario analysis, as we have no idea of the quantum of cess that the government is seeking to collect at this stage, and over what period of time does it intend to do so. Assuming the government is seeking to collect INR100bn (50% of the estimated total amount required for rehabilitation work in Kerala), and let's say this is sought to be collected from all goods currently classified as demerit or luxury, viz. tobacco, coal, soft drinks, motor vehicles etc, in the same proportion as their current contribution to the compensation cess pool (we estimate ITC to be currently contributing c.24% to the compensation cess pool), then there could be a need to raise taxes by 35p per stick, which would translate into a 7-8% price-hike to mitigate, as per our workings. Interestingly, this would also yield 4% higher GST to the government (over and above the new 'disaster cess'), given the partially ad-valorem nature of GST.

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Recommendation and Price Target

Current Reco.	BUY
Previous Reco.	BUY
Current Price Target (12M)	340
Upside/(Downside)	16.0%
Previous Price Target	340
Change	0.0%

Key Data – ITC IN

Current Market Price	INR293
Market cap (bn)	INR3,586.5/US\$48
Free Float	54%
Shares in issue (mn)	12,023.3
Diluted share (mn)	12,240.9
3-mon avg daily val (mn)	INR4,220/US\$58.1
52-week range	323/250
Sensex/Nifty	36,542/11,054
INR/US\$	72.5

Price Performance

%	1M	6M	12M
Absolute	-5.6	13.6	11.7
Relative*	-1.1	2.8	-3.4

* To the BSE Sensex

Financial Summary

Y/E March	FY17A	FY18A	FY19E	FY20E	FY21E
Net Sales	417,230	421,237	462,906	515,757	575,727
Sales growth (%)	6.8	1.0	9.9	11.4	11.6
EBITDA	154,359	164,830	183,232	208,500	237,913
EBITDA (%)	36.6	38.8	39.3	40.1	41.0
Adjusted net profit	102,884	108,301	121,597	137,752	157,111
EPS (INR)	8.5	8.9	9.9	11.2	12.8
EPS growth (%)	9.4	4.8	11.9	12.9	13.7
ROIC (%)	37.4	38.3	38.6	39.2	41.2
ROE (%)	23.1	21.9	22.0	22.7	23.4
PE (x)	34.6	33.0	29.5	26.1	23.0
Price/Book Value (x)	7.7	6.8	6.2	5.6	5.1
EV/EBITDA (x)	21.6	20.1	18.0	15.7	13.6
Dividend Yield	1.6	1.8	2.0	2.3	2.7

Source: Company data, JM Financial. Note: Valuations as of 26/Sep/2018

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Exhibit 1. Scenario Analysis: Possible tax and price-hikes required to fund Kerala disaster relief**Scenario 1****INR 25bn to be collected entirely from cigarette companies over a year's time**

	INR mn
Total amount required	25,000
ITC's estimated share thereof	20,000
Estimated FY19 cig vol	70,310
Avg additional tax per stick - INR	0.28

Rs/stick	FY19E - Current	FY19E - with addtl cess	Difference
MRP - avg	8.04	8.49	5.6%
Less: Dealer margin	0.96	1.02	
Less: Specific Cess	2.82	2.82	
Transaction Value for ITC	4.25	4.64	
Ad Val Cess payable by co	0.49	0.54	
Base GST payable by co	0.82	0.90	
NCCD	0.12	0.12	
Net Realisation per stick	2.81	3.09	
Less: additional disaster relief cess		0.28	
	2.81	2.81	

Total indirect taxes per stick - Rs	4.26	4.66	0.40
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Scenario 2**INR100bn to be collected from luxury/demerit goods over a year's time**

	INR mn
Total amount required to be collected	100,000
Total compensation cess collection in last 5M	400,050
Annualised cess collection	960,120
ITC's estimated compensation cess FY19	233,112
ITC's share in cess pool	24%
ITC's estimated share of the new disaster cess	24,279
Estimated FY19 cig vol	70,310
Avg additional tax per stick - INR	0.35

Rs/stick	FY19E - Current	FY19E - with addtl cess	Difference
MRP - avg	8.04	8.62	7.2%
Less: Dealer margin	0.96	1.03	
Less: Specific Cess	2.82	2.82	
Transaction Value for ITC	4.25	4.76	
Ad Val Cess payable by co	0.49	0.55	
Base GST payable by co	0.82	0.92	
NCCD	0.12	0.12	
Net Realisation per stick	2.81	3.17	
Less: additional disaster relief cess		0.35	
	2.81	2.82	

Total indirect taxes per stick - Rs	4.26	4.77	0.51
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Source: Company, GST documents, JM Financial

Financial Tables (Consolidated)

Profit & Loss Statement					(INR mn)
Y/E March	FY17A	FY18A	FY19E	FY20E	FY21E
Net sales	417,230	421,237	462,906	515,757	575,727
Sales Growth	6.8%	1.0%	9.9%	11.4%	11.6%
Other operational income	4,166	3,260	3,583	3,992	4,456
Total Revenue	421,395	424,498	466,489	519,749	580,184
Cost of Goods Sold/Op. Exp.	154,121	148,563	166,205	185,656	207,689
Personnel cost	36,317	37,609	41,190	45,738	50,884
Other expenses	76,598	73,496	75,862	79,854	83,698
EBITDA	154,359	164,830	183,232	208,500	237,913
EBITDA Margin	36.6%	38.8%	39.3%	40.1%	41.0%
EBITDA Growth (%)	6.8%	6.8%	11.2%	13.8%	14.1%
Depn & Amort	11,528	12,363	13,828	15,675	17,633
EBIT	142,831	152,467	169,404	192,825	220,279
Other Income	17,615	18,319	21,256	22,884	25,419
Finance Cost	243	899	942	998	1,056
PBT before Excep & Forex	160,204	169,886	189,719	214,711	244,642
Excep & forex Inc/Loss(-)	0	4,129	0	0	0
PBT	160,204	174,015	189,719	214,711	244,642
Taxes	55,491	59,164	66,104	74,812	85,241
Extraordinary Inc/Loss(-)	0	4,129	0	0	0
Assoc. Profit/Min. Int.(-)	1,818	2,139	2,018	2,147	2,290
Reported Net profit	102,894	112,712	121,597	137,752	157,111
Adjusted Net Profit	102,884	108,301	121,597	137,752	157,111
Net Margin (%)	24.4%	25.5%	26.1%	26.5%	27.1%
Diluted share capital (mn)	12,147	12,204	12,241	12,278	12,314
Diluted EPS (Rs)	8.5	8.9	9.9	11.2	12.8
Diluted EPS Growth	9.4%	4.8%	11.9%	12.9%	13.7%
Total Dividend + tax	69,447	75,772	85,118	99,181	117,833
Dividend Per Share (Rs)	4.7	5.1	5.7	6.7	7.9

Source: Company, JM Financial

Balance Sheet					(INR mn)
Y/E March	FY17A	FY18A	FY19E	FY20E	FY21E
Shareholders' Fund	464,129	525,101	577,963	637,634	702,600
Share capital	12,147	12,204	12,241	12,278	12,314
Reserves & Surplus	451,982	512,897	565,722	625,356	690,286
Preference Share Capital	0	0	0	0	0
Minority Interest	2,947	3,345	5,446	7,685	10,076
Total Loans	457	359	359	359	359
Def. Tax Liab / Assets (-)	18,338	18,750	17,978	17,105	16,110
Total - Equity & Liab	485,872	547,555	601,747	662,783	729,144
Net Fixed Assets	196,234	220,323	236,584	251,854	268,764
Gross Fixed Assets	180,944	199,197	229,286	260,231	294,775
Intangible Assets	0	0	0	0	0
Less: Depn. & Amort.	22,010	33,957	47,785	63,460	81,094
Capital WIP	37,299	55,083	55,083	55,083	55,083
Investments	175,814	220,529	246,992	276,631	309,827
Current Assets	186,936	201,557	206,790	231,718	257,740
Inventories	81,862	75,845	88,777	100,325	111,991
Sundry Debtors	24,743	26,823	28,535	31,793	35,490
Cash & Bank Balances	29,686	39,215	24,671	27,393	29,657
Loans & Advances	44,075	46,680	41,662	46,418	51,815
Other Current Assets	6,571	12,995	23,145	25,788	28,786
Current Liab. & Prov.	73,111	94,853	88,619	97,421	107,187
Current Liabilities	69,408	92,034	85,365	93,801	103,150
Provisions & Others	3,703	2,820	3,254	3,620	4,036
Net Current Assets	113,825	106,704	118,171	134,297	150,553
Total - Assets	485,872	547,555	601,747	662,783	729,144

Source: Company, JM Financial

Cash Flow Statement					(INR mn)
Y/E March	FY17A	FY18A	FY19E	FY20E	FY21E
Profit before Tax	160,204	174,015	189,719	214,711	244,642
Depn. & Amort.	11,528	12,363	13,828	15,675	17,633
Net Interest Exp. / Inc. (-)	-17,372	-17,420	-20,315	-21,886	-24,362
Inc (-) / Dec in WCap.	444	17,364	-26,069	-13,503	-14,110
Others	6,386	5,368	-2,790	-3,020	-3,285
Taxes Paid	-54,916	-59,996	-66,045	-74,714	-85,123
Operating Cash Flow	106,273	131,694	88,328	117,263	135,394
Capex	-30,715	-27,985	-30,089	-30,945	-34,544
Free Cash Flow	75,558	103,709	58,239	86,318	100,851
Inc (-) / Dec in Investments	-10,749	-50,814	-26,463	-29,639	-33,196
Others	8,955	7,660	21,256	22,884	25,419
Investing Cash Flow	-32,509	-71,139	-35,296	-37,701	-42,321
Inc / Dec (-) in Capital	10,670	9,128	7,037	7,037	7,037
Dividend + Tax thereon	-83,330	-70,884	-75,772	-85,118	-99,181
Inc / Dec (-) in Loans	-95	31	0	0	0
Others	-255	-486	1,160	1,241	1,335
Financing Cash Flow	-73,010	-62,211	-67,575	-76,840	-90,810
Inc / Dec (-) in Cash	754	-1,656	-14,543	2,722	2,264
Opening Cash Balance	28,932	40,871	39,215	24,671	27,393
Closing Cash Balance	29,685	39,215	24,671	27,393	29,657

Source: Company, JM Financial

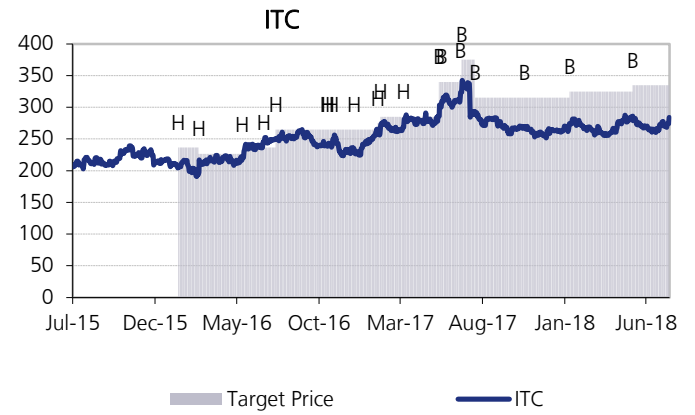
Dupont Analysis					
Y/E March	FY17A	FY18A	FY19E	FY20E	FY21E
Net Margin	24.4%	25.5%	26.1%	26.5%	0.0%
Asset Turnover (x)	0.9	0.8	0.8	0.8	0.0
Leverage Factor (x)	1.0	1.0	1.0	1.0	0.0
RoE	23.1%	21.9%	22.0%	22.7%	0.0%
Key Ratios					
Y/E March	FY17A	FY18A	FY19E	FY20E	FY21E
BV/Share (Rs.)	38.2	43.0	47.2	51.9	57.1
ROIC	37.4%	38.3%	38.6%	39.2%	41.2%
ROE	23.1%	21.9%	22.0%	22.7%	23.4%
Net Debt/Equity (x)	-0.4	-0.5	-0.5	-0.5	-0.5
P/E (x)	34.6	33.0	29.5	26.1	23.0
P/B (x)	7.7	6.8	6.2	5.6	5.1
EV/EBITDA (x)	21.6	20.1	18.0	15.7	13.6
EV/Sales (x)	8.0	7.9	7.1	6.3	5.6
Debtor days	22	23	23	23	23
Inventory days	72	66	70	71	71
Creditor days	96	131	111	111	111

Source: Company, JM Financial

History of Earnings Estimate and Target Price

Date	Recommendation	Target Price	% Chg.
20-May-16	Hold	233	
29-Jun-16	Hold	237	1.4
21-Jul-16	Hold	265	12.0
24-Oct-16	Hold	265	0.0
26-Oct-16	Hold	265	0.0
3-Nov-16	Hold	265	0.0
14-Dec-16	Hold	265	0.0
27-Jan-17	Hold	275	3.8
1-Feb-17	Hold	285	3.6
16-Mar-17	Hold	285	0.0
21-May-17	Buy	340	19.3
26-May-17	Buy	340	0.0
30-Jun-17	Buy	350	2.9
2-Jul-17	Buy	375	7.1
27-Jul-17	Buy	315	-16.0
27-Oct-17	Buy	315	0.0
19-Jan-18	Buy	325	3.2
16-May-18	Buy	335	3.1
29-Jun-18	Buy	335	0.0

Recommendation History



APPENDIX I

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