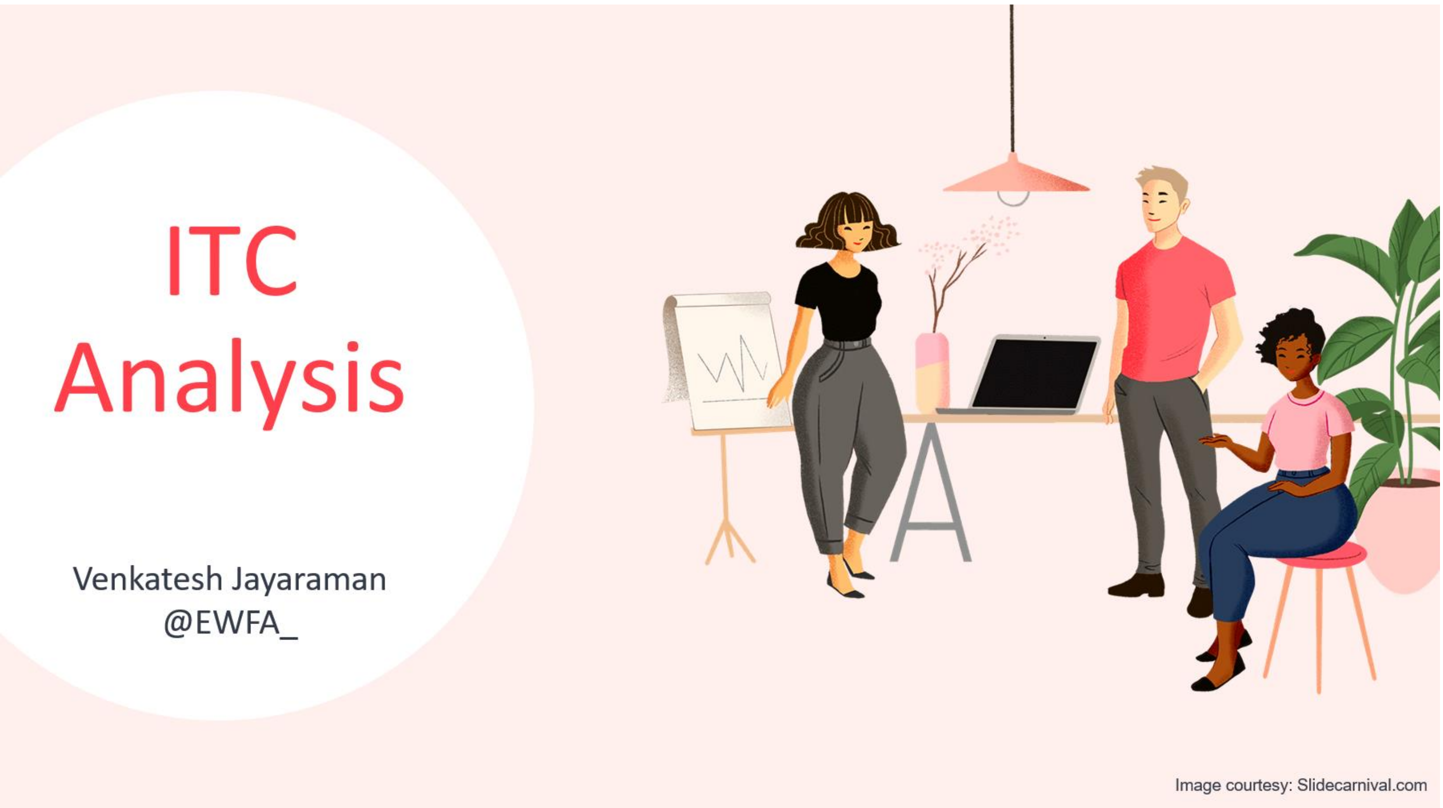


ITC Analysis – A Deep Dive Report

My Analysis of ITC, Views on possible Strategy and Question for the readers to deep dive!

Jayaraman, Venkatesh (@EWFA)

Not a Kind of Analyst Report with Target Prices!

DISCLAIMER

PLEASE DO NOT READ THIS DOCUMENT WITHOUT READING AND UNDERSTANDING THIS DISCLAIMER. THIS IS NOT A USUAL DISLAIMER MENTIONING THIS STOCK IS NOT A RECOMMENDATION. THIS DISCLOSURE COVERS WHAT THIS REPORT IS ABOUT, WHAT IT IS/NOT & WHAT ARE ITS BOUNDARIES!

"Smoking is Injurious to Health"…Similarly buying this stock based on this report alone is much more injurious to your portfolio and wealth.

- This report intends only to:
    - Analyse the Financial Statements from 2002 to 2020
    - Gather information from the past Annual reports for insights and better understanding of ITC Strategies and NOT FOR INVESTMENT DECISIONS
- This report is NOT:
    - An Analyst Report with various financial ratios, future earnings projection and target prices
    - Any kind of recommendation on the stock to 'Buy' or "Not Buy'
    - Intended to SUPPORT YOU IN MAKING DECISION on 'buy' or 'not buy'
- What is covered in this report?
    - I focussed on Cigarette and FMCG Business of this company
    - Reason: They contribute most of the revenue as well as most of the controversy around ITC!
- What is not covered?
    - All other business (Though I have touched upon Hotels Business in brief) other than Cigarette and FMCG
    - Reason: My limited understanding of dynamics of other business
    - So do not tell, that I am "Selective"…Yes I have been selective due to my limitation
    - And that is another reason, why I emphasize not to make any decision based on this report!

MOST IMPORTANT: I don't own this stock and may or may not in future!...In short, I don't have my skin in this game…atleast for the moment.

So I repeat, Don't make any investment decision from this report!

This is not definitely a delicious or juicy report tempting to you buy ITC. Focus is to bring as much facts as possible, analyse the facts, interpret the strategy of ITC and in the journey throw questions back to you to deep dive to get more details on the company's strategy and challenge your current understanding.

Do not skim through pages, or read here-and-there randomly. But read it in sequence to get the essence of the message. I had spent nearly 50-60 hours to create this report. At the maximum, I request you to give an undivided 60 minutes to read and understand.

Criticisms are welcome but: (1) After reading this report fully, as answers for your criticisms could be there in some part of the report and (2) with proper reasoning or facts for your view point.

Contents

List of Figures

Image courtesy: Slidecarnival.com

[LinkedIn Landing Page]

[YouTube Channel]

Purpose of this work!

Many would be puzzled as you read the disclaimer. This is not a buy report nor do I hold it. Then what is the purpose or intend of this work.

WHY THIS ANALYSIS AND REPORT?

*There is not one but **Three** reasons for this work*

Reason 1 – Tobacco Industry Study

- I am doing a study of Tobacco Industry with companies in the listed space
- Towards that was reading the Annual Reports of these companies and ITC was also one of them
- It was when I felt, that ITC <u>may</u> not be truly a Tobacco company - infact for the first 40-50 pages, of the Annual Report would look like a FMCG company
- As I read the Annual Report could find many interesting things which I felt was worth covering as a report

Soon, will come back with the report of Tobacco Industry

Reason 2 – How to Analyse Stock

- Analysing a stock is much beyond looking the financial numbers in a screener
- Numbers are there everywhere for everyone to see – Investors must look beyond numbers
- More important than numbers are (1) Drawing inferences from these numbers, (2) Getting insights on management strategy, (3) Asking questions to challenge your knowns and to uncover the unknowns etc. is what all I have been wanting to write using a stock example
- I wished to use this report to show those practical aspects

Reason 3 – Too much Attention & Chatter in Social Media

- This stock has the maximum attention in the investing world and the noise in the Social Media is very high
- I have noticed that even one casual tweet about ITC (either for or against) brings in a chain of critic responses
- Discussions and arguments are like clash of two diverge ideologies…With people directly & indirectly mocking the other camp
- Often many such argument and views were based on emotions and not facts
- The arguments were focussed on "Who is right and who is wrong?" and at times, try hard to prove that one was right and the other camp is wrong
- Through this report, I have attempted to study the concerns (Both for and against) in the lens of available facts, similarities in other industry/investing world and my limited understanding on FMCG business and corporate business strategies
- In brief, I tried to sit on both sides of the table and see what the other side misses

Hope this report will bring smile in both the camps 😊

How to Navigate this Report?

As said in the disclaimer, the report focus on data from 2002 – 2020, share inferences from these data, pose questions to investors/readers and also share my own views. You will come across these icons in the various parts of the report. Let us understand what content each icon carries.

Inferences

- The report has numbers from financial statements, charts (derived from these numbers) or any available public information i.e. Management interview
- The inferences section carry my inferences on the data.

Questions

- Having presented the *facts and inference*, I throw back the question for you to ponder or deep dive further
- These questions will help to challenge your views that you might be holding presently
- You must seek answers on own your before making a investing decision based on that *facts and inference*
- By seeking answer to these questions by yourself you will be able to make judgment and an informed investing decision with conviction to "Invest" or "Not to Invest"
- While there is nothing wrong that you discuss with others to seek answers… Your own conviction of the answer is much important
- You will come across section whenever I discuss some information, fact or inference which carries value in making an investment decision.

My Views

- Not to only throw questions, I have even shared my views in some areas
- REMEMBER that they are my views and I could be completely wrong (i.e. What is said would happen or might not happen or may take years to happen)
- You are completely free to ignore, if these views are not coherent with your view points – Let us agree to disagree.

Threats & Opportunities

- Every success carries seeds of failure and every failure carry seeds of success
- In similar lines, many of the risk or threat that the business world sees could turn to be an opportunity and similarly many opportunities could turn out to be a threat – Investment decision should consider these dual bi-polar possibilities
- This is bit tricky to understand here, but will understand whenever you come across this section
- The perceived risk or threat are discussed in **red** color font and the potential opportunity in **green** color font.

The word 'may' is used in the context of a balanced probability of occurrence and non-occurrence of a future event. Hence readers must exercise caution before making any investment decision, when reading the statements using the word 'may'. To emphasize it, I have underlined the word 'may' in such occurrences.

Let us see the Context in Brief, before We Begin…

What is all about?

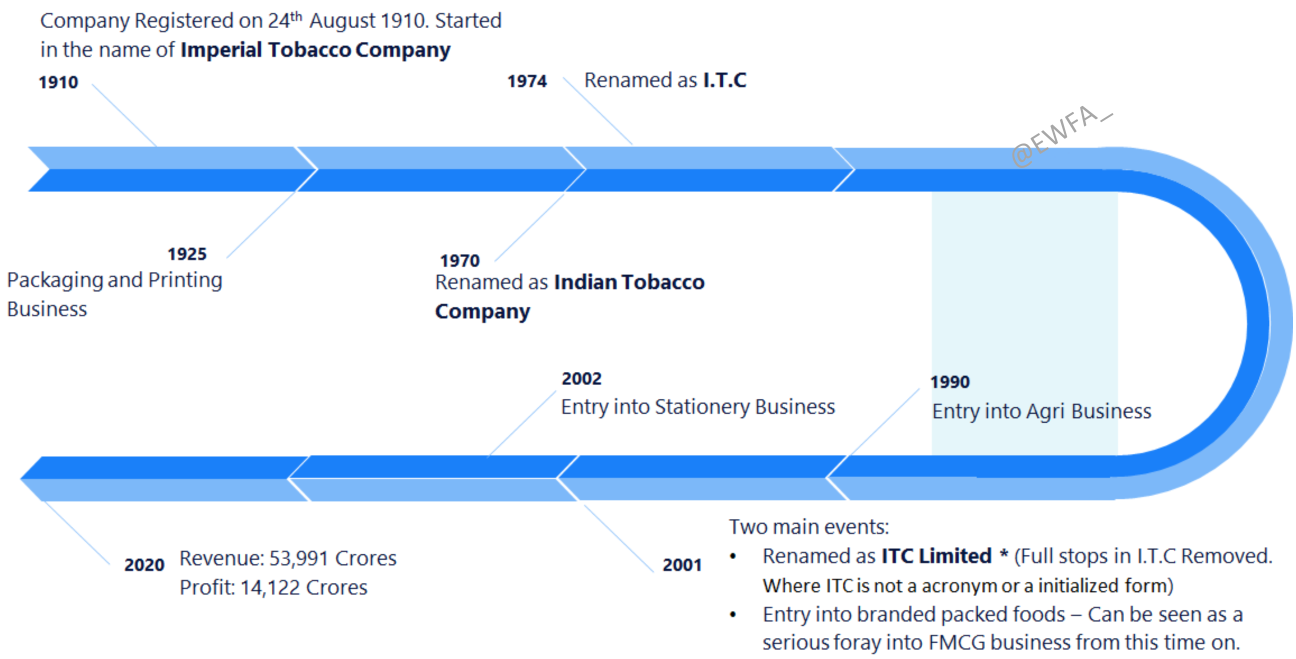
Let us understand more about ITC with respect to:

- What is their legacy?
- What they do?
- What is their size?
- Who are the show runners / Promoters
- Management

While a few of the information is publicly available, I do bring here a few interesting statistics from numbers of 2002 to 2020 and my inferences.

ITC Legacy

Let us quickly see their journey from 1910.



Source: https://www.itcportal.com/about-itc/profile/history-and-evolution.aspx

Inferences

- The company has 110 years of legacy! Very few companies in the world have survived 100+ years and ITC one among them
- In India, there are two more companies, which have this credit i.e. Britannia Industries and Kansai Nerolac
- Being in game for 100 years is no small feat:
  - Imagine if you come across someone who is aged 100+ years and also healthy!
  - You wonder what was their life style, what food they ate and what is the secret sauce for good health even after 100 years

- Same goes for ITC! Undoubtedly there is something in their DNA without which it is difficult to survive for all these years
- High level story: Started as a single product (Cigarettes) and now one of the largest multi-business company with 6 business.

Questions

In 1974, the company renamed as only ITC without mention of "Tobacco". Could this be a conscious decision to avoid "Negative Brand Image"? We don't know the thought process for a decision made some 45 years back. But this is one possibility.

What they do?

ITC is into multiple businesses. Below is the summary from the 2020 annual report:

Business	2020 Revenue (Crores)	Revenue Split (%)	CAGR (%-age)		
			18 Years	10 Years	5 years
Cigarette	23,679	41	6.2	2.72	-5.76
FMCG	12,875	23	42.45	13.40	4.30
Agri Business	10,453	18	13.06	10.47	4.52
Paper & Packing	6,107	11	10.39	6.57	2.95
Hotels	1,926	3	10.67	7.01	8.93
Others	2,202	4	21.92	11.74	4.51

Inferences

- Cigarettes
  - Forms ~40% of revenue
  - Last 5 year growth for Cigarette has been negative
- FMCG
  - Forms 23% of revenue
  - CAGR: 42.45% in 18 years while only 4.30 CAGR in the last 5 years
- Agri Business: Forms 18% of revenue
- Hotel Business, contribute only around 3% of revenue

Questions

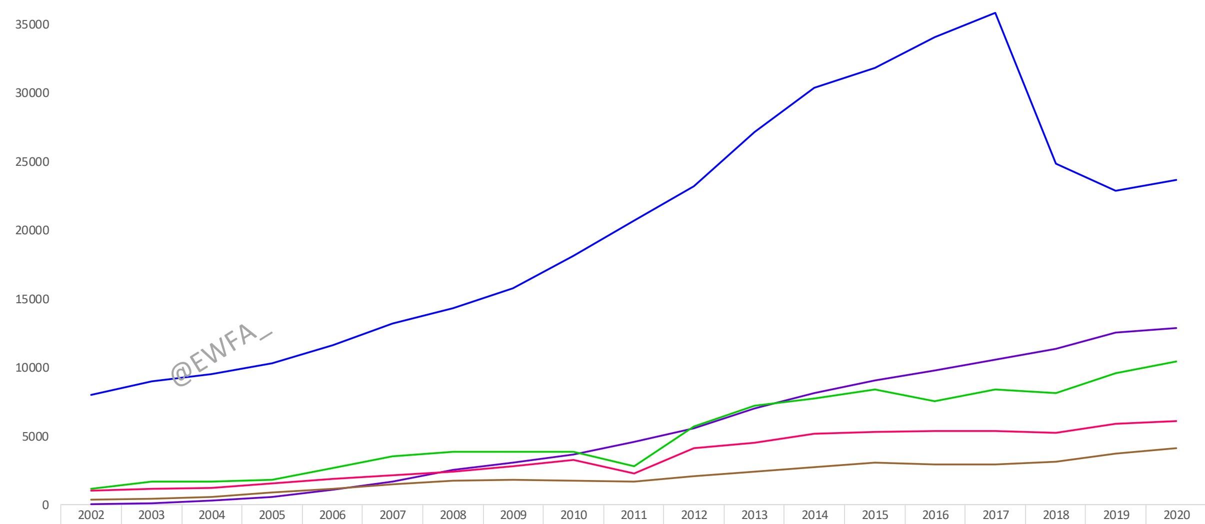
ITC has 6 business, so investing in ITC is not buying one business, but 6 different business and involves analysis of 6 businesses. Ask yourself these questions:

- Do you have the needed sector knowledge and time for analysing the top 3-4 business that contribute to revenue, if not all 6?

- Each product has its own dynamics, in terms of: (1) Competition landscape, (2) Size of the ticket, (3) Current market position (Number 1 or 2 or entry), (4) Risk & Opportunities. As a investor DO YOU have this knowledge/information to analyse most of the products (if not all) by ITC? – Only if the answer 'Yes', should you consider investing in ITC.
    - Consider the example of match stick (One of the product of ITC)
    - Who are the competitors of ITC in this segment?
    - That is the threat to this product? Kitchen lighters, Cigarette lighters etc.
    - Environmental impact: Amount of wood to deliver fire for a few seconds
    - Market share: Size of total market and %-age market share by ITC
    - Price dynamics: Low ticket item in the overall monthly consumer budget - An increase from INR 10 to INR 11 may not impact sales.

Approaching a stock like ITC is a different game altogether. Are you as an investor able to handle it? Ask yourself

Let us see the revenue of these business since 2002.



	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Cigarette	8020.92	8986.48	9522.71	10324.99	11639.52	13207.01	14326.39	15754.68	18111.83	20721.27	23232.32	27136.12	30417.58	31855.85	34062.67	35877.66	24848.09	22913.27	23679.13
FMCG	22.06	109.2	303.84	563.9	1090.49	1698.53	2526.6	3035.47	3661.26	4595.06	5563.72	7037.71	8140.94	9053.97	9750.64	10537.46	11357.38	12535.04	12875.08
Agri Business	1147.78	1658.14	1681.56	1780.06	2654.22	3501.27	3868.44	3845.98	3862.14	2815.16	5695.31	7200.73	7752.05	8380.48	7562.74	8384.86	8155.04	9565.39	10453.87
Paper & Packing	1031.01	1162.86	1239.27	1565.31	1886.22	2100.06	2364.33	2821.96	3233.61	2264.12	4129.79	4504.37	5166.04	5281.57	5327.7	5362.86	5249.64	5860.16	6107.18
Hotels + Others	372.51	445.95	576.02	875.11	1162.64	1467.84	1714.55	1796.72	1703.88	1697.45	2095.65	2384.85	2753.29	3022.56	2898.58	2928.07	3097.1	3713.36	4129.21

Figure 1: Revenue (in Crores) across Different Business of ITC

Source: ITC Annual reports from 2002 – 2020

Inferences

- Cigarette Business
    - Secular growth till 2017, however decline in the last 3 years
    - Major share of revenue for all these 18 years
- FMCG Business: Secular growth since 2002 (Inception)

Size and Position of ITC

We will understand more about ITC and its size with numbers:

- ITC Numbers
    - Market Cap: 2.35 Lakh Crores, and ranks the 11th position in the Market cap position
    - Number of factories: 200
    - ITC products are exported to 90 countries
    - Over the last 5 years added 1,66,000 crores to the exchequer
    - Top 3 contributors to the exchequer
    - Number of employees: 36,500
    - e-Choupal: world's largest rural digital infrastructure serving more than 4 million farmers
- FMCG Business
    - Third largest FMCG company in India
    - ITC FMCG products reach over 140 million households
- Hotels: 109 Properties in 73 locations

Source: https://www.itcportal.com/about-itc/shareholder-value/ITC-Corporate-Presentation.pdf & 2020 Annual Report

Promoters

British American Tobacco Company (BATC aka BAT) were the initial promoters of ITC. However, their stakes have been continuously decreasing all these years. Below is the holding structure of ITC.

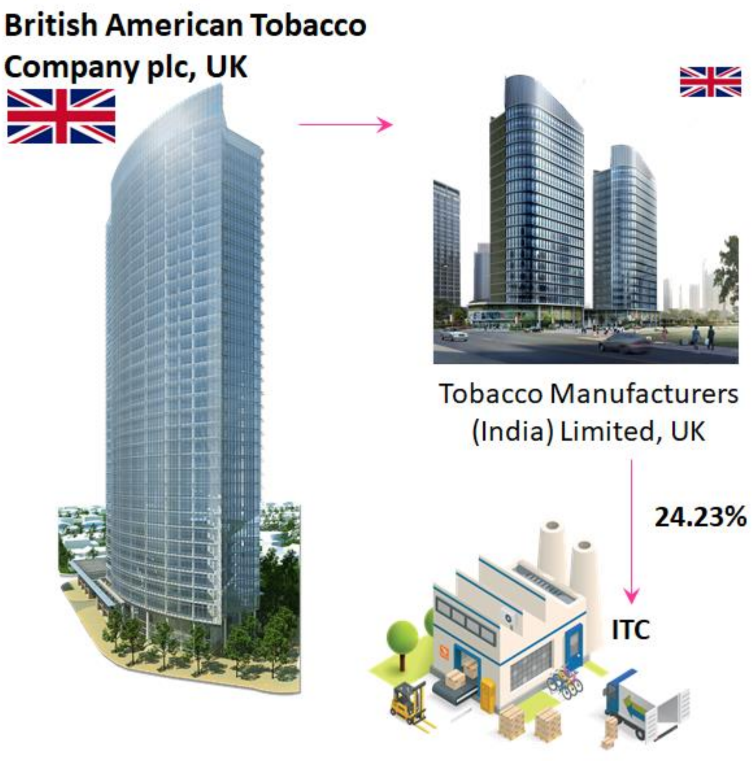


Figure 2: Holding Structure of ITC

Details from the latest Annual Report of BAT, showing Tobacco Manufacturers (India) Limited, United Kingdom and ITC limited as their subsidiaries.

Isle of Man
c/o Boston MFO, 2nd Floor, St Mary's Court, 20 Hill Street, Douglas, IM1 1EU, Isle of Man
Abbey Investment Company Limited
The Raleigh Investment Company Limited
Tobacco Manufacturers (India) Limited

India
Virginia House, 37, J.L. Nehru Road, Kolkata, 700 071, India
ITC Limited (29.49%)
Azamabad, Andhra Pradesh, Hyderabad, 500 020, India
VST Industries Limited (32.16%)[8]

Figure 3: Images from Annual Report of British American Tobacco Company

Who else are major holders?

Name of the Holder	%-age Holding
Life Insurance Corporation of India (LIC)	16.25
Specified Undertaking of the Unit Trust of India (SUUTI)	7.93
Myddleton Investment Company Limited	3.96
General Insurance Corporation of India (GIC)	1.76
The New India Assurance Company Limited (NIC)	1.49
Rothmans International Enterprises Limited	1.26
Government of Singapore	1.24
The Oriental Insurance Company Limited	1.11
ICICI Prudential Life Insurance Company Limited	1.10

Source: Details from MGT-9 Section of 2020 Annual Report

Inferences

- No defined/clear promoters though the parent **British American Tobacco (BAT) plc, UK** holds single major stake of 24.23% through its subsidiary "Tobacco Manufacturers of India"
- Government of India (GOI) holds a much higher stake (27.43%) than BAT, through various entities LIC, SUUTI, GIC and NIC

The holdings by LIC and SUUTI needs some attention from investors perspective.

LIC: There is a case in Mumbai Court for LIC holding ITC. LIC being a life insurance company, is it correct for it to hold the shares of ITC, which is into sin business. As of now this litigation is little over 3 years.

Read: https://www.livemint.com/Companies/JmPjOJRGrPkPkY94w8uoUI/PIL-filed-against-government-LIC-for-holding-stake-in-ITC.html for more details.

The government of India, through five state-run insurance companies and Specified Undertaking of Unit Trust of India, owns a 32% stake in ITC. Photo: Reuters

PIL filed against government, LIC for holding stake in ITC

2 min read . Updated: 14 Apr 2017, 04:20 AM IST

Jayshree P. Upadhyay

The PIL filed by Tata trustee R. Venkataramanan and others argues that it doesn't make sense for the government to hold a stake in ITC when its tackling heath issues arising out of tobacco consumption

There would be a few questions around the minds of investor…as to

- What is this litigation all about? (The link above could help. Seek internet for more article/news)
- When would it end?
- Would the ruling be in favour of LIC?
- If ruling is not in favour, would LIC or the Government take it up at higher court of the land?

Questions

- What importance does the ruling carry on the fundamentals of ITC business, or its day to day business?
- What importance does it have on the share prices of ITC?

My Views

Even if the highest court of the land gives a judgment LIC should not hold ITC, it would not be an abrupt or urgent stake sale of LIC considering:

- The interest of minority shareholders
- This being a government holding and
- The concerns of the Government, that BAT should not get high stakes due to any change in stakes by LIC. (Reason, Read the articles: https://paranjoy.in/article/why-bat-should-not-be-allowed-to-take-over-itc and https://www.moneylife.in/article/why-is-the-government-brazenly-batting-for-itc/29467.html)

Courts would give adequate time for government to (1) Think over and transfer the stakes of LIC to another entity or (2) any other decision in the interest of minority shareholders

By any means it is going to take time considering the long path of: (1) Judgment from Mumbai high court, (2) Possibilities of moving to the highest court of the land and a (3) Final judgment which may not be favourable to LIC. – So, let us not worry for the moment.

SUUTI: First need to understand what is SUUTI and how it has some stakes in ITC.

- SUUTI stands for *The Specified Undertaking of Unit Trust of India*
- SUUTI was formed in Feb 2003 following the collapse of UTI Scheme U-64
- The equity holdings of the scheme were transferred to SUUTI
- UTI had stakes in ITC, which is how SUUTI has stakes in ITC
- Government has been long considering to sell the assets of SUUTI and has been selling its holdings in SUUTI (Which includes ITC) in parts periodically
- There could be a time when all the stocks of SUUTI could be completely sold by Government.

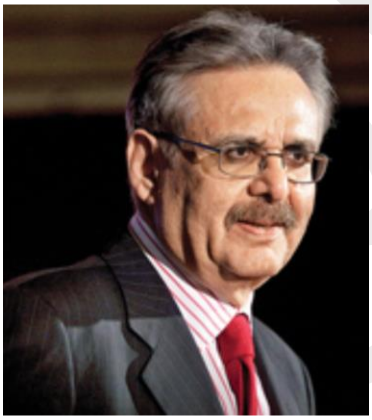
More details about SUUTI can be had from http://www.suuti.in/

WITH NO PROMOTERS, WHO RUNS THE COMPANY? PROFESSIONAL MANAGEMENT

Management

Let us see some details about Management

- **Sanjiv Puri** (58), is the Chairman & Managing Director of ITC effective May 13, 2019.
- He was appointed as CEO from February 5, 2017
- He has earlier served as president of FMCG Business.
- He joined ITC in January 1986 and has served ITC in various levels in this last 34 years
- Sanjiv is an alumnus of the Indian Institute of Technology, Kanpur, and Wharton School of Business.



- **Y.C. Deveshwar** was the earlier CEO who joined ITC Limited in 1968 and retired in 2017 - He was in ITC for 48 long years
- He became the Chairman of ITC in 1996 was the longest-serving CEO of any Indian company.

Source:
https://www.itcportal.com/about-itc/leadership/board-of-directors/sanjiv-puri.aspx
https://en.wikipedia.org/wiki/Yogesh_Chander_Deveshwar

Threats & Opportunities

Threats

- Key person leaving the company or change of management

- The board is in immense pressure ITC to do something to improve the stock prices – This is evident from recent interviews by management and huge number of tweets tagging ITC on the same
- This may lead to some hasty decisions, which may be detrimental to the long-term growth thesis.

Opportunity

ITC may have a huge value unlock from the FMCG business, the current CEO with the background of FMCG may be positive for the growth of FMCG business in future.

Criticism on Management for high compensation and poor Capital Allocation

There is lot of criticism against the management, with the key ones being:

- High management salaries and lot of employee stock options
- Poor capital allocation and being into too many things

My Views

Management Salaries

- Retail investor cannot control management and are not into shareholder activism
- If you do not like ITC management due to the compensation factors the simplest thing to do is not to buy ITC – But before making any decision try the below (May be an internet search can help):
    - Is ITC management the only one to have such huge management compensation?
    - Do make a list of companies with high management salaries and compare with ITC

Poor Capital allocation

- One of the test for management is capital allocation
- If in your views, ITC management is not good in capital allocation, do not invest in ITC
- But remember many of the capital allocations were made in far distant future, for which we are commenting today
- We really do not know the rationale for such past decision
- Most such decisions are legacy decisions and management is clear not to take new project
- Actions of distant past should not stop the investor from seeing the present actions and its implications in future.

It is into too many things…

ONE COMMON VIEW "ITC IS INTO TOO MANY THINGS AND NOT FOCUSSED"

Before discussing this aspect, let us see what Mr. Bharat Shah says about growth. In his book, he talks about two kinds of Growth (1) Focussed Growth and (2) Diversified Growth.

While Focussed Growth (in core business) is preferred, Diversified Growth can happen if:

1. Existing business denies adequacy of growth
2. If Management believes that it is in a position to achieve success in its new activity
3. Purse is heavy and idea is few and
4. Idea of grandeur overtakes the economic logic

LET US EXTEND THIS FOUR REASONING TO ITC TO SEE WHAT COULD HAVE HAPPENED FOR ITC?

First reasoning, "*Existing business denies adequacy of growth*" was very much applicable to ITC

- Cigarette industry is subject to regulatory concerns like no advertising, different laws in states (in India), heavy taxes, disclaimers over the product and TV programs, restrictions to marketing, and the list goes on…This is global (A few things may be more or less) situation and not only in India or for ITC
- So, the core business no doubt had limited growth opportunities, infact there could be even risk of stagnant or negative growth in the coming years
- So, the existing business denies adequacy of growth and ITC had to look beyond their current business of Tobacco / Cigarettes in a business, which is *free to grow without regulatory concerns.*

Second reasoning, "*If Management believes that it is in a position to achieve success in its new activity*"

Not much to comment, except to infer that Management in the past has believed that they can succeed in the new businesses they enter. The outcome of this belief needs to be studied on the background of how the different business are doing.

Third reasoning, "*Purse is heavy and idea is few*"

- This is a bit difficult to substantiate with data as different business were started at different times:
  - FMCG being the latest, itself is 18+ years
  - Packaging and printing business is the oldest that was started ~95 years back!
- Hence it would not be possible to figure out the reasoning (If there were very few ideas at that point of time to choose a particular business) behind entering the different businesses

- But with reasonable judgement can say that **Cigarette business** had huge cash flows and avenue was needed deploy the same
- Their entry into related business did complement each other and creating Synergy

How Different Business Complement each Other

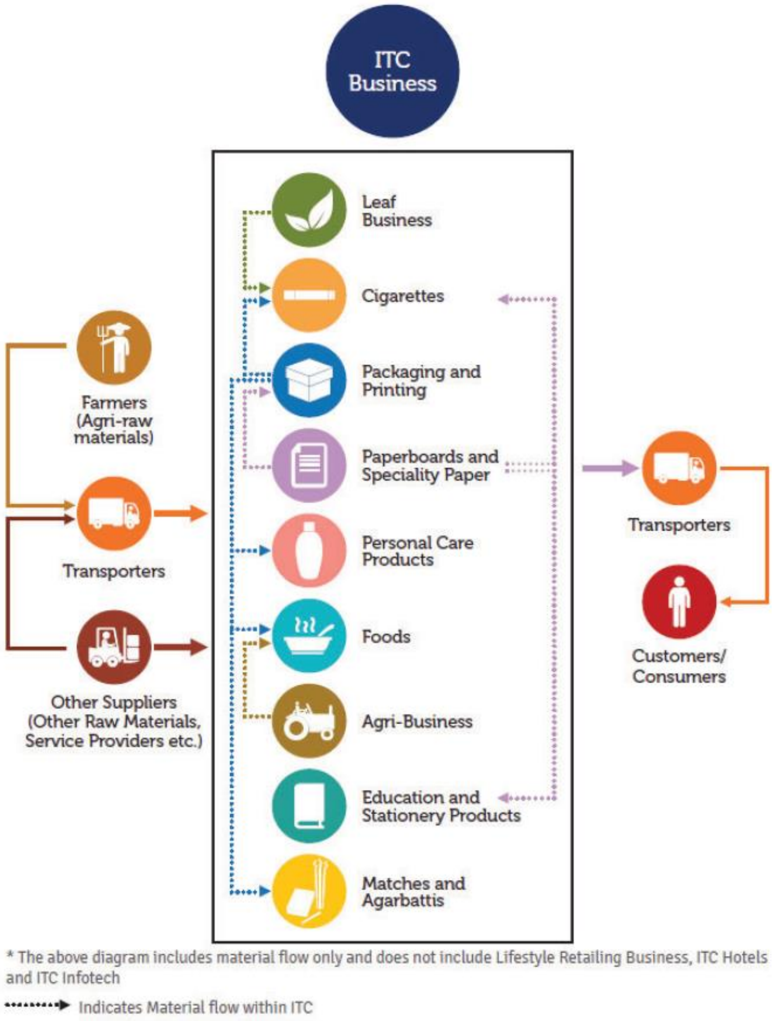


Figure 4: How different Business of ITC complement each other

Reference: Academic Thesis from https://sg.inflibnet.ac.in/

Different Business Complement each Other…Not fully True

There is an equally strong contra view, to the argument that their different business provide synergy. Many of the business diversification do reflect the capital misallocation of the past. One such business is Hotels, which undoubtedly causes huge drag on the profits of ITC.

However, many such decisions are legacy decision. There is no use to question the moves / decisions made 20+ years back. The company and management has learnt lessons over the years and need to see what the company does from now on.

Fourth reasoning, “*Idea of grandeur overtakes the economic logic*”

- This is subjective and the view varies between individuals
- The company is not owned a promoter group or a single promoter who wants to build an empire
- One can see that all these diversifications were done with best intentions at different point of time:
    - Some might have brought good results and some might not have not,
    - Even the business which did not bring good results, is as of today – what holds in future is something that needs to be seen.

To quote Bharat Shah views on Managements that are into multiple business: “*There is only a limited capability that humans have and even the best of the managements have capability confined only to a particular area or very limited number of activities at best. Even when best of the managements try their hands into unrelated or less related activities, record of their success has been rather patchy and uncertain. Which is why that skepticism of the markets when these so called related or unrelated diversifications are attempted because the track record of success is rather patch which is reflected in the kind of discount that markets tend to place on these attempts.*”

Diversified Business – A International Overview

Let us quickly see a few international corporates. Co-incidentally the 3 examples picked are from Japan and well-known names globally.

Honda Motors

- A well-known Japanese name in Two and Four wheeler sector,
- It has its own Aircraft manufacturing business **HondaJet**
- Honda Aircraft Company is a wholly owned subsidiary of Honda Motor Company. (https://www.hondajet.com/)

Toyota Motors,

- This is another Japanese Automotive major has its own Space Program
- They work with JAXA (Which is like ISRO in India) to create a Lunar vehicle
- They are also investing in Aircraft Manufacturing.

Jan. 16, 2020

Toyota and Joby Aviation are Flying to New Heights Together

News Release, Management, Innovation, CASE, Electric

PDF

- Toyota to share expertise in manufacturing, quality and cost controls for the development and production of Joby Aviation's breakthrough eVTOL aircraft
- Toyota has invested $394M as lead investor in Joby's Series C financing

SANTA CRUZ, CA (January 15, 2020)—Toyota is exploring a new flight path for mobility through a new collaboration with Joby Aviation (Joby), an aerospace company that is developing and commercializing all-electric vertical take-off and landing (eVTOL) aircraft to enable the deployment of fast, quiet and affordable air transportation services. The collaboration reflects Toyota's recognition of the long-term potential of the urban air mobility market to meet the evolving needs of society, as well as Joby's position as an industry leader in working to deliver safe and affordable air travel to everyone.

Mitsubishi Heavy Industries

- This is another familiar name is known in Heavy Industries, Auto sector, Electricals and Motors
- They are also into the Aircraft Manufacturing
- They have their own Aircraft Program called Mitsubishi Regional Jet (MRJ) which is expected to come to service soon. (https://www.mhi.com/products/air/mrj.html)

One commonality in these three companies is that they are well known international brands in Automotive Manufacturing or Heavy Industries. They are into Aircraft Manufacturing which is could be seen as diverse from their core business and has (1) Stringent regulation from Aviation Authorities, (2) Capital intensive and (3) Long gestation Period (From Design to Manufacture, to approval from Aviation Authorities and launch in market & (4) Long Pay-back period.

Inferences

- These three companies are diversified into much varied and capital-intensive Aircraft Manufacture
- View and Contra view
    - View: These companies have invested heavily in this venture, which could have been avoided. These companies have to compete with majors Airbus, Boeing and Embraer! (With exception of Toyota, who are into Niche area) who are well established and command a good market share.

    - Contra View: The Management of these companies have in the past developed a big international brand. If they had taken such a decision, then they would have a bigger strategy, which is missing the common eyes. Hence, they are likely to succeed in these diversification as well.
- In the above cases, the reason of this diversification could be anything, Growth, Lack of growth in Auto sector etc.
- I do not know, if these diversifications were successful or it will be successful in future… But only can generalize saying such decisions were made in the best interest of the corporation.

CAN THIS SAME LOGIC AND BENEFIT OF COUBT BE EXTENDED TO ITC FOR THEIR VARIOUS DIVERSIFICATIONS?

Let me put another Analogy

- A investor can hold 6-8 stocks in a focussed portfolio and up to 15 stocks in a well-diversified portfolio
- An investor has limited available bandwidth in terms of time for analysing and tracking the business
- Reason for such diversification: Ups and downs in different business at different point of time protects the investor portfolio than it would be if only one stock was owned
- Within such diversified portfolio, it is agreed and understandable that 1 or 2 ideas may not succeed to give the required results.

Similarly…

Why should not a company diversify to 6 business, which has the luxury to extend bandwidth by hiring the necessary professionals to manage the business. Would such diversification not protect the company in the ups-and downs in different Business? Again, we need to understand that one or two business may fail to give expected results.

WHAT IT COULD HAVE ITC DONE?

Let us see what could ITC have done without entering FMCG business. Going back to 2001 the various CAGR for the 10-year period from 1992 to 2001:

- Revenue CAGR: 12.65%
- Profit CAGR: 27.25%
- Price CAGR: 8.25% (Market cap based on year end closing prices of 1992 and 2001)

The Net Profit Margin was 11.5% in 2001.

Source: https://www.itcportal.com/about-itc/shareholder-value/annual-reports/itc-annual-report-2001/pdfs/p136.pdf

ITC was making huge profits and had healthy cash flows.

What all could have ITC done with this cash flow?

- It could have paid hefty dividends every year or onetime special dividends now-and-then
- Periodic buy-backs (I heard a view that ITC had not resorted to this option as the stakes of BAT could go up, which was not favoured by Government of India)
- May be in the need for growth brought other Tobacco companies

Instead what it did?

- In 2002 ITC forayed into FMCG Business which was primarily in the hand of big MNCs (2001 Annual Report has no mention about FMCG, so the view that they forayed into 2002 would be reasonably correct)
- In FMCG, ITC did very much the same thing which today start-up does, the only difference: Managed the start-up with their own money!
- Cash flow Tobacco business was used to build a brand-new business
- No idea where ITC would have been in terms of size and growth, if other business (Started post 2002) was not there and cigarette was the only business
- Today a vast majority of house hold in some way or the other use ITC products.

ITC Achieved a Complete brand transformation from a Tobacco company to FMCG

This brand transformation is not complete and takes time to payoff and business owners/investors need to have patience.

LET US MOVE ON TO THE BUSINESS THAT HAS MAJOR REVENUE SHARE

Cigarette Business

About the Business

- Cigarette being the core product from beginning, ITC has over 100 years of expertise in this product
- Brands: Insignia, India Kings, Classic, Gold Flake, American Club, Navy Cut, Players, Scissors, Capstan, Berkeley, Bristol, Flake, Silk Cut, Duke & Royal
- Armenteros Cigarette: These are hand rolled Cigars launched in 2010
- ITC has a near monopoly in the cigarette segment, making eight out of every ten cigarettes sold in India. (Source: https://www.valueresearchonline.com/stories/34841/the-tobacco-king-itc/)

Sin Business

What is a Sin Business?

- The business which revolve around gambling, alcohol, tobacco, and weapons companies are seen as sin business
- There is no single standard definition for sin stocks, but the categories are tied to seven deadly sins:
    1. Pride,
    2. Greed – Gambling, Casinos
    3. Lust – Adult entertainment companies / Videos with Lust content

4. Envy,
5. Gluttony – Alcohol and Tobacco
6. Wrath - Weapons
7. Sloth

- Positive aspect of investing in such companies
    - Most of these are habit forming and have a consistent demand even during poor economic conditions
- Negative aspect of investing in such companies
    - Biggest risk: These businesses are subject to governmental regulations, restrictions and taxes
    - Ethical view by individuals and fund house not to invest in sin business

There are no boundaries on How A Sin Business is Seen

The way "Sin Business" is seen is in the eyes of the individual/investor. Let us take 2 examples to understand this:

Example 1: Weapon company

- It manufactures fighter aircraft or missile for its armed forces
- In war time, these fighter aircraft or missile will be deployed and will kill not only soldiers but innocent civilians as well
- Which of the view you take makes all the difference:
    - *Patriotic view* about that company, as it manufactures something which the armed forces use it to defend the honour of your motherland or
    - *Ethical view* that the company manufactures something that kills soldiers and civilians of the country that is in war with your motherland!

Example 2: Videos with Lust Content

- Best example which I can name is Alphabet Inc, which has YouTube
- YouTube has wide variety of contents ranging from humour, education, teaching, movies, songs and even lust videos
- Alphabet on its part tries to restrict such lust videos below a certain age group
- Now which of the view you take?
    - Since there are lust videos, do you brand the entire Alphabet as sin business?
    - Don't consider as sin business as such lust videos form a small part of YouTube business which again is a small set of the portfolio of business held by Alphabet?

There is no Right or Wrong answer – It Depends on the Individual

So, ITC Being a Sin Business…Should one invest?

- One camp pulls down that the other for investing in Sin Business
- One needs to understand that is a personal choice of the investor
- If you are not comfortable to invest in a Sin Business – Do not invest…Infact don't even read this file further nor any other blog/articles on these companies, but do not thrust your views on the other camp.

Many friends smoke and I do advice to stop/reduce. Once the discussion went harsh with they telling "Not to interfere in their personal choices". SAME GOES HERE. It is the personal choice of investor! None has the right to question/interfere in the personal choice of another investor, who is comfortable to own it.

1. It is ok for the company to be listed in the stock exchange
2. It is ok for Government to permit the operations and collects taxes from the profit
3. It is ok for employees to work and manufacture the cigarette for their living
4. But huge concerns are raised to investors who invest in such companies – If it is ok for the above three reasons then it is absolutely ok for an investor to invest in such company!

One could see profiting from a sin business as unethical, a discussion on which can run for hours without conclusion. So, it is best left to the judgment, comfort and personal choice of the Investor.

Implications on Investor

A vast holding by fund houses is a good indicator and reflection about a business. More and more fund houses are avoiding Sin Business – This may render this company lesser popular among the fund houses in the coming years.

But is it purely a Cigarette Company?

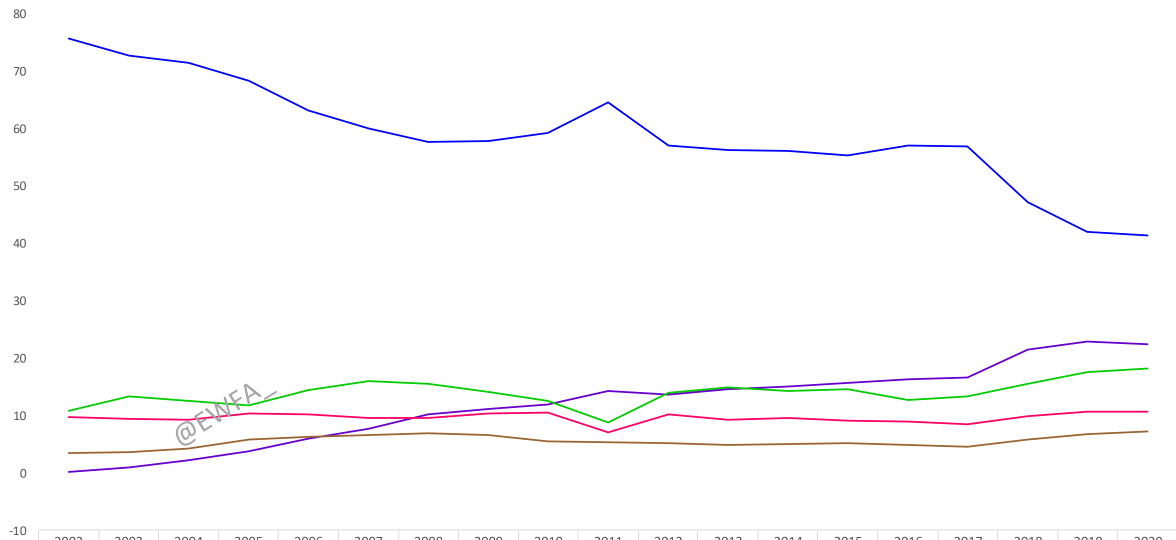
What is there in Annual Report? In the recent years less than 50% of the revenue comes from Cigarette business.

II. PRINCIPAL BUSINESS ACTIVITIES OF THE COMPANY:

Sl. No.	Name and Description of main Products / Services	NIC Code of the Products / Services	% to total Turnover of the Company	
			Gross Turnover	Net Turnover
1	**FMCG**			
	- Cigarettes etc.	12003, 21002, 46307, 46909	45.77%	44.50%
	- Branded Packaged Food Products	10304, 10308, 10501, 10502, 10504, 10509, 10611, 10612, 10712, 10732, 10733, 10735, 10740, 10750, 10792, 10795, 10798	22.40%	22.93%
	- Others (Personal Care Products, Apparel, Education and Stationery Products, Safety Matches, Agarbattis etc.)	20231, 20234, 20236, 20237, 20293, 46491, 46496, 46497, 46909, 47711	5.26%	5.38%
2	**Hotels**			
	- Hotels Sales / Income from Hotel Services	55101, 56101, 56210, 56301, 74909	3.94%	4.03%
3	**Agri Business**			
	- Wheat, Soya, Spices, Coffee, Unmanufactured Tobacco, Aqua etc.	12001, 10202, 10302, 10304, 10795, 20213, 10209, 10309, 10406, 10611, 10792, 46201, 46207, 46301, 46305, 46306, 47300, 47737	12.75%	13.04%
4	**Paperboards, Paper & Packaging**			
	- Paperboards and Paper	17016	8.68%	8.89%
	- Printed Material	17022, 17029, 22203	1.20%	1.23%

Figure 5: Principal Business from MGT-9 of 2020 Annual Report

Let us check the revenue share from Cigarette and other business from the period 2002 – 2020:



	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Cigarette	75.71	72.69	71.47	68.34	63.14	60.10	57.77	57.81	59.24	64.57	57.06	56.22	56.09	55.31	57.15	56.87	47.14	41.98	41.36
FMCG	0.21	0.88	2.28	3.73	5.92	7.73	10.19	11.14	11.98	14.32	13.66	14.58	15.01	15.72	16.36	16.70	21.55	22.96	22.49
Agri Business	10.83	13.41	12.62	11.78	14.40	15.93	15.60	14.11	12.63	8.77	13.99	14.92	14.29	14.55	12.69	13.29	15.47	17.52	18.26
Paper & Packing	9.73	9.41	9.30	10.36	10.23	9.56	9.53	10.35	10.58	7.05	10.14	9.33	9.53	9.17	8.94	8.50	9.96	10.74	10.67
Hotels + Others	3.52	3.61	4.32	5.79	6.31	6.68	6.91	6.59	5.57	5.29	5.15	4.94	5.08	5.25	4.86	4.64	5.88	6.80	7.21

Figure 6: Revenue Mix in Percentage of Various Products from 2002 to 2020

Inferences

In the 18 year period from 2002 to 2020:

- Cigarettes
  - The revenue share of cigarette business declined from ~75% in 2002 to ~41% in 2020
  - Stable revenues from 2012 till 2017
  - Steep decline in revenue share from 2017 till 2020
  - In the last 3 years the contribution of cigarette business to revenue is less than 50%
  - The revenue share from cigarettes continue to the highest, though it is less than 50% in the last 3 years
- FMCG
  - The business has grown from contributing 0.21% of revenue in 2002 to ~22% in 2020
  - This is 100 times increase in revenue share in 18 years since inception (Probably 2002 could be the start of FMCG business)
- Hotels and other business put together have been contributing ~3% in 2002 to 7% in 2020

ITS CHIEF PRODUCT IS HABIT-FORMING AND ITC OWNS 80 PERCENT OF THE CIGARETTE MARKET!

Threats & Opportunities

Threat 1 – Imported and Illegal Cigarettes

- Legal cigarettes account for less than 1/10th of tobacco consumed in India due to taxation and regulations (Implies that the remaining 90% are from illegal market)
- High taxation can be evident from the fact that despite cigarette accounting for less than 1/10th of the tobacco consumed in the country, duty-paid cigarettes contribute more than 4/5th of the revenue generated from the tobacco sector.

Source: ITC 2020 Annual Report

Opportunity in this threat

- If organized players are losing market share, then equally true is that Government is losing a huge share of its tax due to the imported/illegal business:
  - ITC 2020 Annual Report: *It has been estimated that on account of illegal cigarettes alone, revenue loss to the Government is almost 15000 crores per annum*
  - India losses 13,000 crore due to illegal cigarette https://www.deccanherald.com/national/india-loses-rs-13000-crore-every-year-due-to-illegal-cigarettes-report-911228.html
- This may push government to take stringent actions on illegal imports (or) reduce taxes on Tobacco products

- Either of it will benefit the organized players with increase in market share, where ITC is the biggest beneficiary as we saw earlier that ITC sells 8 or 10 cigarettes.

Threat 2 – Change in Lifestyle / Habits

- Muted growth caused due to health awareness, imported cigarette and stringent regulations.
- An article from Phillip Morris, saying that this business may not be there after 10-15 years down the line. (https://www.businesstoday.in/current/world/cigarette-sales-may-end-in-10-15-years-in-many-nations-says-philip-morris-ceo/story/417027.html)

Before we close the discussion on this business, let me give an option for one common view on social media on this business

Many argue that cigarette business is good in terms of cash flows, but ITC has diluted by being into too many things.

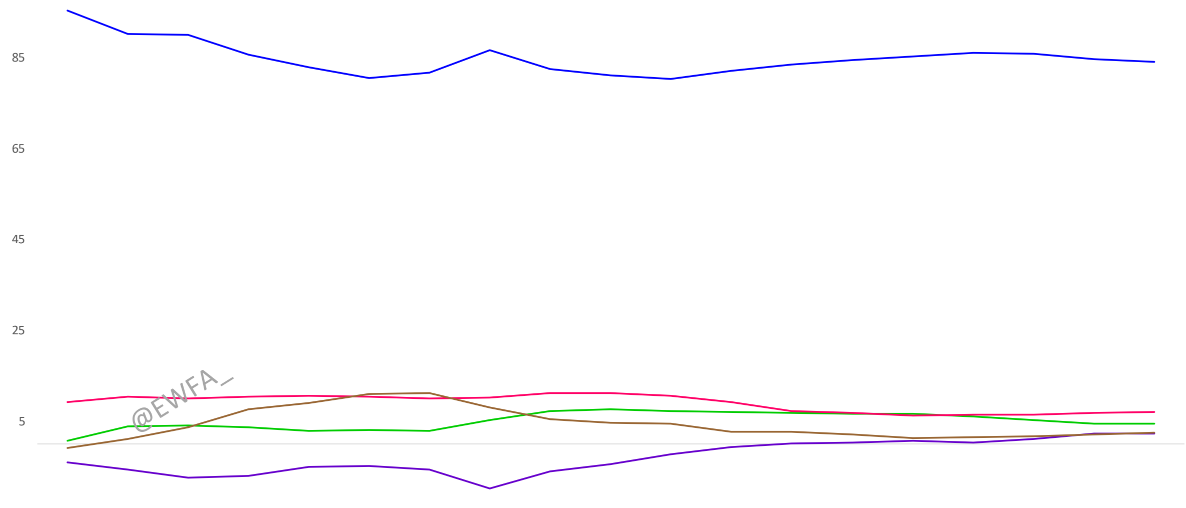
Most simple option: If you want to benefit from cigarette growth story, there are pure cigarette companies in the listed space. Forget ITC, go-ahead and invest in pure cigarette companies. – Nothing stops!

FMCG Business

About the Business

- The revenue share of FMCG business has grown 100 times from 0.21% in 2002 to ~22% in 2020 (Figure 6: Revenue Mix in Percentage of Various Products from 2002 to 2020)
- From Zero to 12,875 Cr. of sales in 20 years is no small feat (Figure 1: Revenue (in Crores) across Different Business)
- Despite this strong growth in revenue, the FMCG business has been big concern to investors and controversial topic. – Why is it so?

For quick understanding of this concern, let us see the profit share in % of various business of ITC (We earlier saw revenue share in Figure 6)



	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Cigarette	95.36	90.24	90.03	85.69	82.87	80.57	81.77	86.58	82.48	81.14	80.40	82.13	83.45	84.46	85.25	86.06	85.86	84.69	84.05
FMCG	-4.14	-5.63	-7.57	-7.16	-5.20	-4.87	-5.69	-9.79	-6.14	-4.48	-2.40	-0.84	0.10	0.23	0.61	0.17	1.04	2.18	2.26
Agri Business	0.62	3.87	3.90	3.54	2.73	3.07	2.84	5.12	7.23	7.66	7.19	6.91	6.69	6.56	6.57	6.04	5.11	4.36	4.40
Paper & Packing	9.13	10.41	9.97	10.28	10.56	10.36	9.96	10.17	11.05	11.08	10.47	9.11	7.15	6.69	6.27	6.30	6.33	6.81	6.93
Hotels + Others	-0.97	1.12	3.67	7.66	9.03	10.87	11.12	7.91	5.39	4.61	4.34	2.70	2.62	2.06	1.30	1.43	1.65	1.97	2.36

Figure 7: Profit Share in Percentage of Various Products from 2002 to 2020

Inferences

This gives a different story.

- The profit contribution of FMCG business is 2.26% while the revenue share was ~22% - What does this difference mean?
- The FMCG Business earns less profits when compared to its sales
- This is because of low profit margins of the FMCG business - This aspect of FMCG is the biggest concern for investors of ITC

In social media, this the widely shared counter point (or even mocks!) when there are cheers for the revenue growth of FMCG is the FMCG Margins

Concern is valid – No doubt, but to understand better of what can be expected, let us see the past!

Margin Trajectory

The below graph is the profit margin curve of FMCG business from 2002 – 2020.

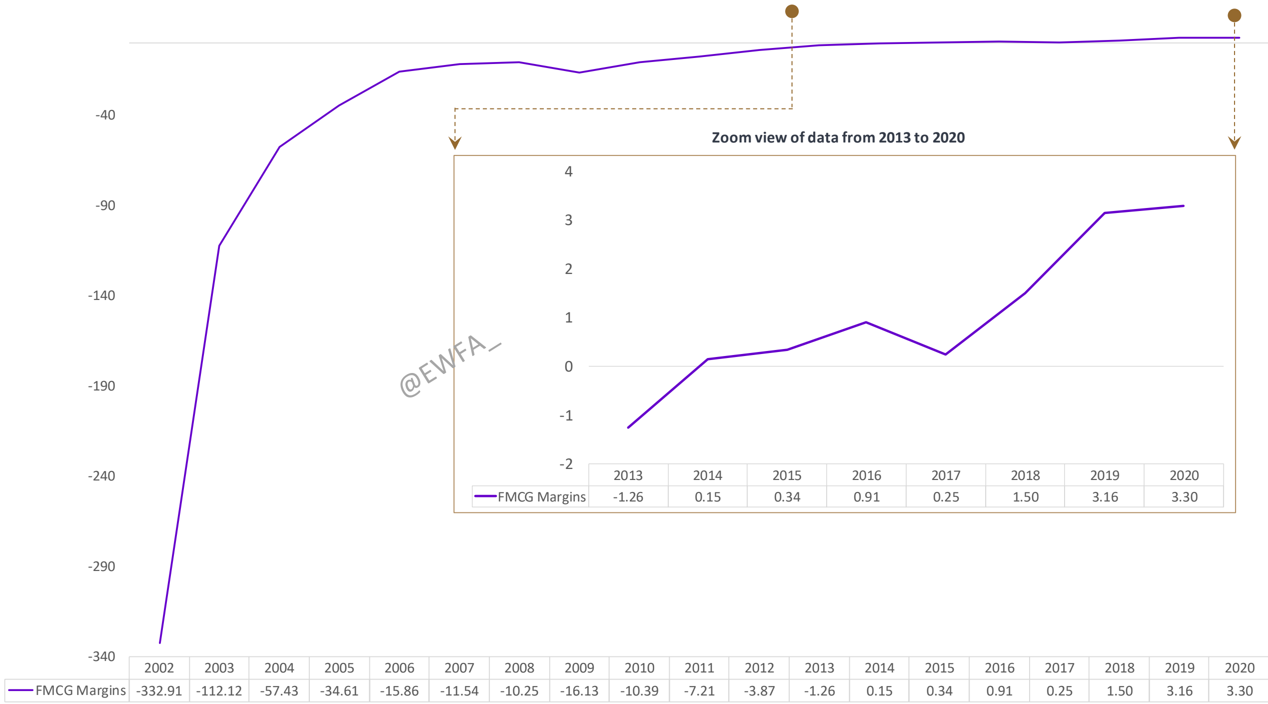


Figure 8: Profit Margin (in %) Trajectory of FMCG Business from 2002 to 2020

Inferences

- Typical view of a start-up: Huge loss in the beginning (-332.91% in 2002) during this time, the volumes were less and coupled with huge expenses like advertising, distribution network etc.
- Gradual improvement in margins year on year steadily
- Break even in 2014, i.e. FMCG business becomes profitable and margins continue to sustain and improve after breakeven
- The last few years show positive profit margin but the YoY change is volatile and not smooth to attempt any predictability or draw meaningful inferences - This could be attributed to low base effect.

Year	Profit %	YoY %
2014	0.15	
2015	0.34	126
2016	0.24	167
2017	0.25	-61
2018	1.50	500
2019	3.16	110
2020	3.30	4

STABILIZATION OF THIS MARGINS WOULD BE A PRIMARY FACTOR

Questions

What is that you see in future as the Margin? You need to clearly seek answers before you make investment decision based on future margin.

Do you believe that the profit margin of FMCG food business will continue to improve in future?

- **No** – Then try to answer these questions
  - What did the company do or what is the reason for improving its margins from -332% in 2001 to 3% to 2020? - Bring out 4 to 5 reasons for this change
  - Having listing 4 to 5 reasons, answer why you believe that the same reasons (you identified) will not help to drive the margins from 3% now to say 6% in another 3 years or 10% in 5 to 6 years?
- **Yes** – Then try to answer these questions
  - List out 5 reasons for this -332% in 2001 to 3% in 2020
  - Why do you believe that these same will continue to help in increasing the margins in the coming years?
  - What can be the show spoiler that ITC would not be able to continue to expand its margins
  - What is the future margins that you can predict with confidence for future i.e. 2023 or 2025.

Whichever camp you are, please make a decision to "Buy" or "Not Buy" only after YOU identify the answers by yourself (Not based on random views in SM or main media) and you have a strong conviction in the answers.

My Views

- 10 Years ago, the story behind ITC was burning its cash in FMCG business which was having negative margin/loss
- Over the last 5 years profits started coming but it was low, but now it is branded as "Low margin business" or having "Wafer thin margins"
- What is the margin in future?
  - Currently ITC may be playing the volume game
  - When the volume game is saturated the price game starts
  - The highest possible volume (Revenue from the highest possible market share) and even a gradually expanding profit margin may be the biggest game change for FMCG business.

LET US UNDERSTAND MORE OF THIS PRICE & VOLUME GAME

Price and Volume Game

Net profit comes from profit on net sales covering all the costs. So, the Net profit can be increased by:

- Increasing sales for a constant profit margin
- Constant sales with an increasing profit margin – This has some constraints as the profit margin which is influenced by cost, cannot be controlled beyond a certain extend
- The best combination could be gradual increase in profit margin after the highest possible sales i.e. Highest market share

Markets and long-term investors are focussing on the margins of ITC with hopes of higher future margins leading to higher profits. But appears that management may be focussing more on increasing the revenue than the margins. The investor expectations of management actions are contrary to the core.

Why management does so? Is it for good or bad? To understand better as to Why Management may be doing so, we need to understand a few ideas around:

- Product characteristics
- Price Differentiation and why it is needed for new product
- Capacity to Suffer

Product characteristics

Consider some snacks say a cream biscuit as example (specifically taking an example in FMCG sector). What are the characteristics that this product could have? A few could be packing, taste, easy availability in market and price.

Let us explore how a manufacturer can create a differentiation around these characteristics in a competitive market, so that consumer choose their product.

(1) Packing

- The very basic requirement is that the packing must protect the underlying product i.e. cream biscuit, from nature, germs and keep it fresh
- Additional aspect can be pleasant colors or better aesthetics and convey mandatory nutritional information
- So, packing may not be a differentiator for purchase

(2) Taste

- Products from standard company almost taste identical
- Taste is very crucial product characteristic for the food industry, without which one cannot be in the market
- But would that be a big differentiator?

- Let us see it differently…You are eating biscuits from three different brands with lights off in a dark room
- Are you able to make out the brand of each biscuit from its taste?
- Taste is a basic essential requirement which is very much identical across brands and may not be a big differentiator

(3) Availability in Market

- Consumer goes to shop to buy the brand of biscuit they use
- But stock is not there, but finds other two brands
- May be consumer may choose to wait for a day or two, if there is a strong brand stickiness
- Else mostly they choose to pick the one from the available two brands*
- Manufacturers must ensure availability of their product across the market – This may be a crucial differentiator as absence of their product naturally pushes the consumer to pick the next available option.

*Note: For some reason, if biscuit of one of the available brand is at lower price than the other, the cheaper one becomes the obvious choice atleast on a "trial basis" or "See what is different that this brand is X rupees cheap".

(4) Price

- With all other parameters remaining same the primary focus of consumer is price
- If there are three brands and all have the same taste/quality and one of them is cheaper by even 5%, the consumer focus is on the brand which gives 5% lesser price
- Remember cheaper prices does not mean cheaper products, consumer still looks for quality products at cheaper prices.

LET US SEE MORE IN PRICE DIFFERENTIATION, WHICH IS CRUCIAL FOR A NEW ENTRY PRODUCT

Price Differentiation

We need to discuss more on this and let us consider a Hypothetical situation.

- Consider a biscuits market where there are already three brands of Biscuits, i.e. Brand H, N and B
- All these three have similar taste and are priced between INR 29 to 30 a packet
- Now a new company introduces its biscuit under Brand T
    - If Brand T is launched with INR 30 a packet, a consumer who is already a user of Brand H, N or B, would prefer to stick to their current brand due to brand loyalty (also called as client stickiness)
    - For Brand T to break this client stickiness, it needs to have a low price when launching its product
- So Brand T is launched at INR 25 a packet:

- This creates an impulse in consumer mind to give a try, see why it is cheaper than his current Brand
- At INR 25, Brand T is around 16.7% lesser than the price of Brand H, N and B
- Remember that this reduced price of ~16.7% is what takes a cut on profits and profit margins of Brand T, in turn on the company which launches this brand T – *Impacting the business owner and investors*

- Whether the consumer shifts his brand royalty to T is a difficult question to answer, but would like to try Brand T.

PAST INDUSTRY VIEWS

Launching a new product at a lower price, thereby creating a price differentiation for initial entry is not something new and it has happened in the past:

- Indian Telecom sector: When Jio was launched at prices which everyone wanted to try or buy. Even despite the poor connectivity in the initial stages in 2016, there was huge preference for Jio in consumers mind then.
- Indian Airline Industry: The same has been seen in Airline industry with one of the airliners made it very big from their low-ticket fares.

This price differentiation is the major criteria for the consumers to raise their eyebrows and try that product once atleast, which may open doors for a decision to switch to the new brand.

Now having made the customer to try and if other parameters are same as the brand used currently, the consumer most likely would prefer to use Brand T.

But now comes the question in the mind of Business owner and Investors… "*These low margins are not sustainable. The price mast be increased in par with other brands*"

What happens, if Brand T increase its price immediately?

- In a few months after gaining the initial consumers, if Brand T raised price to 30 INR to be in par with Brand H, N and B…it is highly possible that the consumer switches back to their initial brand
- In order to strengthen the brand loyalty, the price should continue to be same INR 25 or significantly less than Brand H, N and B
- So, Brand T cannot raise the price immediately after getting few customers as it leads to dual risk of:
    1. Losing newly earned customer due to loss of price differentiation
    2. Difficult to get new future consumers – **Biggest Risk**

Can Price be increased later?

As you read this, your inner mind throws a question "*If prices are increased later, would the consumer not switch to Brand A?*"

- Building and establishing consumer stickiness/brand loyalty takes a few years
- Post which consumer would not mind paying INR 0.5 or more, that too when the price of Brand T is still less than other available brands
- Once consumer loyalty or stickiness or habits are formed, Brand T can increase its prices
- It does not mean that in one go the selling price of INR 25 will go to INR 30 in par with Brand H, N and B
- It will slowly increase to INR 26, stay in that bracket for few months/years, then to INR 27 and so on
- But reaching INR 30 in line with other brands would also happen, but over long period of time and based on management strategy and decision of management of Brand T

CONSUMERS MAY NOT NOTICE IN CASE THEY ARE SMALL TICKET ITEMS…

Another aspect is that such purchases are made along with other essentials. Thus, the consumer may not even know that the price has been raised. Only when buying biscuits alone does the consumer know that the price has been raised from INR 25 to 26.

How big is the impact of increase in price on profitability?

Whether Brand T increase their selling price at par with other brands or not, even moving from INR 25 to 29 is going to give huge improvements in profit margins. It is hard to appreciate the change that even a INR 1 can make, without getting into the numbers in details. Say the current cost for Brand T is INR 24, and Profit is INR 1 as the selling price is INR 25. This gives around 4% margin. See the image below for the increase in profit margin for every INR increase in selling price.

Parameter	Phase 1	Phase 2	Phase 3	Phase 4	Phase 5	Phase 6
Selling Price	25	26	27	28	29	30
Profit Margin (%)	4.00	7.69	11.11	14.29	17.24	20.00
% Margin Increase		92.31	44.44	28.57	20.69	16.00
Over all increase	400%	(Between Phase 1 and 6)				

% Margin Increase is the difference in Margin as % between successive phase

This increase profit margin on high volumes (Sales / Revenue) would bring in a big number for the profits.

So, When in future will such increase in profit margin happen?

- Let us assume that the market size of this biscuit is 300 million consumers (This is just for explanation, otherwise the market size is usually measured on monetary size i.e. INR 100 Crore market) for better understanding of this case
- When the company launches brand T today at INR 25, it has a consumer base of 0
- Over a span of 2 years, it has captured a share of 10,000 consumers

- At this stage, the differential pricing when compared to other brands is INR 5 and increasing the price to INR 30 will definitely increase the profitability of Brand T to the extend of INR 50,000
- As owners and investors, it would be enticing and tempting to increase this profits for profitability
    - While this increase profits by 50,000, the brand T loses the price differentiation
    - Even assuming that it retains the 10,000 consumers but make the ride tough to add consumers in the remaining 300 million as there is no price differentiation
- So, Brand T has to maintain lower prices for some more time to gain more consumers

When should the company increase the price of Brand T?

Sit back and see the table below as an Owner of Business / Investor and think over the answer to this. When you would like to increase the prices?

How to read the table?

- If I as business owner decide to increase my price from INR 25 to INR 30 after "2 + X1" years (The second row in the table below), I will have 100,000 customers which is around 0.03% of market share,
- The profitability improves from 100,000 INR to 600,000 INR
- But due to loss in price differentiation, I would find it difficult to capture the remaining market of 299.9 million, which is around 99.97% or the market share.

Now see the table in detail and decide after which slab of "Years" should you take the decision to raise the price.

The Cost Prices: INR 24

	Parameters with SP = INR 25		# Consumers	%-Market	Parameters with SP = INR 30		future consumers	%-Market
Years	Revenue	Profit	gained (Million)	Share gained	Revenue	Profit	lost (Million)	Share lost
2	2,50,000	10,000	10,000	0.0033	3,00,000	60,000	299.99	99.9967
2 + X1	25,00,000	1,00,000	1,00,000	0.0333	30,00,000	6,00,000	299.90	99.9667
2 + X2	2,50,00,000	10,00,000	10,00,000	0.3333	3,00,00,000	60,00,000	299.00	99.6667
2 + X3	25,00,00,000	1,00,00,000	1,00,00,000	3.3333	30,00,00,000	6,00,00,000	290.00	96.6667
2 + X4	2,50,00,00,000	10,00,00,000	10,00,00,000	33.3333	3,00,00,00,000	60,00,00,000	200.00	66.6667

Inferences

- As a business person and also as an investor, it should be after winning all the 300 million consumers – But that would not likely happen
- So, an ideal situation is after winning maximum possible consumers and the highest possible market share

When would Brand T reach maximum consumers?

One Indicator is…

- At a stage when the sales of Brand T remain same for several business cycles. – It is the *saturation point for volume growth aka volume saturation*

- It is like a stage that even with INR 25 (INR 5 less than comparable brands H, N and B) there is no further increase in sales
- This can be seen as a point where it has captured the maximum number of consumers/market share
- From now the company can think about bridging the gap of INR 5 in par with other brands in the market as the lower price is not adding new customers
- Again, it will not happen in one go but in a series of business cycles increase from INR 0.5 to 1 at a time.

So How much price can be increased After volume saturation?

- Like how there is a saturation point for volume growth, the price rise also has a saturation point
- Beyond a certain price increase, the volumes will drop – This is the saturation point for price rise
- Which implies further price rise cannot happen without taking a hit on volumes i.e. Lesser sales/revenue
- Again, the price rise cannot be in one go from INR 25 to 30
- It happens in steps: Increase from INR 25 to 26, stay in that bracket for a year or so, then increase from INR 26 to 27 and so on.

A single image of what all we discussed in this section.

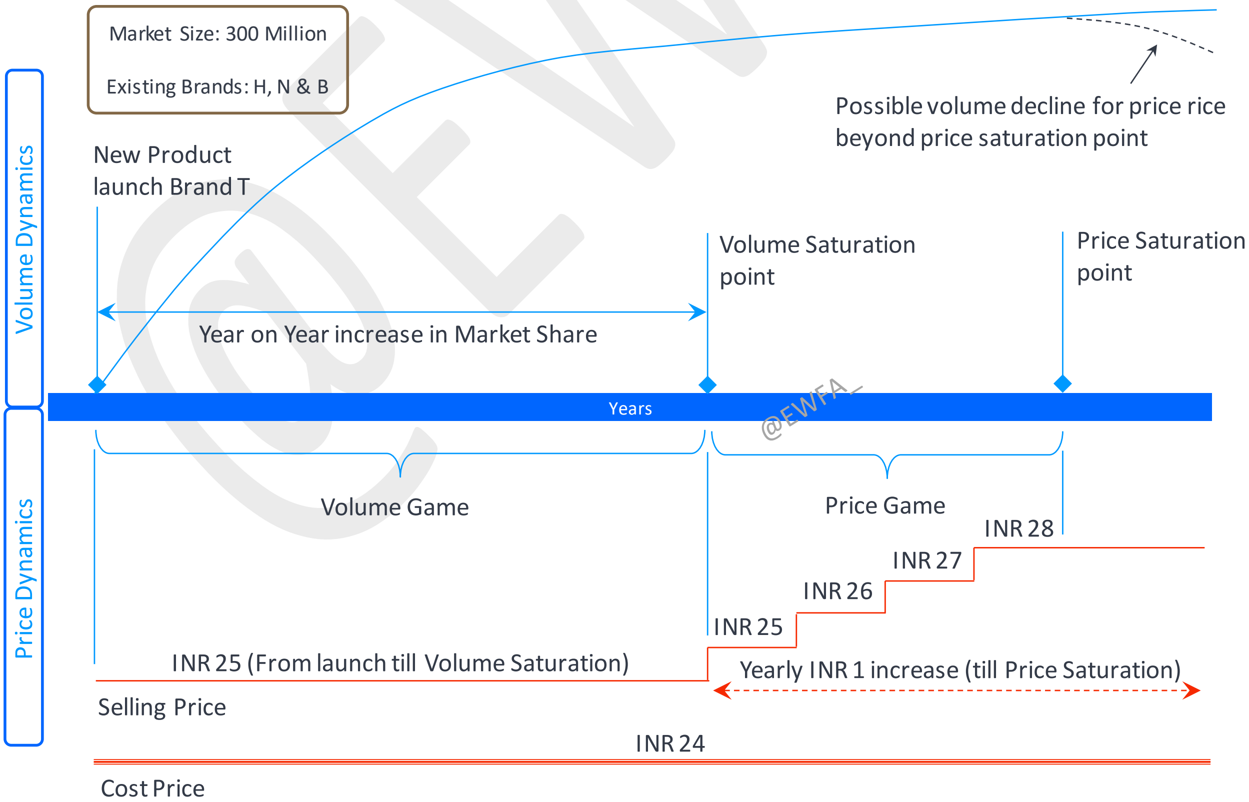


Figure 9: Volume and Price Dynamics for a New Product in the Market

It looks it would be Years before there is a Material Gain

YES, IT TAKES YEARS. ENTERING A MARKET WITH NEW PRODUCT INTO A COMPETITIVE MARKET AND GAINING MARKET SHARE IS NOT CHILD'S PLAY. IT TAKES LOT OF HARD WORK, SACRIFICE CURRENT GAINS AND TAKES NUMBER OF YEARS BEFORE THIS CAN BECOME A REALITY.

There is something additionally one need to understand the idea of "Capacity To Suffer", when we see that such transformation takes years.

Capacity to Suffer

This is the term of idea coined by Tom Russo:

According to him, companies with the 'capacity to suffer' forgo the opportunity to take a short-term profit and are instead ready to suffer in the short term in favour of investing for the long term.

To invest in companies with a 'capacity to suffer', investors must be able to suffer along with it. In other words, investors need a high tolerance for short-term pain.

Best example that Tom Russo quote is that of Nestle. Below is the portion of interview by the then Nestle CEO

Everybody speaks about Nespresso, "25 years of which plenty were losing money," rather than losing money we were investing in the future belief. And I think a company like ours should be able to do that. I mean, if we cannot organize ourselves to invest upfront in certain dimensions that there are promising future platforms, well then, we wouldn't be as successful as we are today. - CEO Paul Bulcke's response (Read the full article at https://www.gurufocus.com/news/351512/nestle-and-capacity-to-suffer)

So it is not sufficient that you identify a company or business that has this characteristic of "Capacity to Suffer", but we as business owners and individuals must also have this "Capacity to Suffer", to bear the short term pain of low profits and wait for the long term story to pay off.

REALITY COULD BE DIFFERENT

So far what we saw was the theory part, where we did not discuss anything about competition action i.e. Brand H, N and B. Reality would be much different with many more factors coming to play, a few being:

- Competition would not be silent losing their market share to the new brand. They come out with their own differentiators in the form of price reduction, freebies, offers, advertisement etc
- Other factor could be increase in price of raw materials forcing the new Brand T to increase its selling price of manage with still less profit margin

- Markets size also increase year on year:
    - In the above case, in Year 1, the market size appears to be 300 Million, which will increase every year.
    - So, In Year 5, the market size would have expanded to 340 Million consumers
    - What would Brand T do then? To capture the market size of the new 40 Million consumers? – This is an uncertain thing to answer 5 years before hand.

Availability – Key differentiator for new brands

In an existing brand, availability may not be a key product characteristic. But for a new brand it matters a lot:

- A shop keeper has limited shelf space in shop and would prefer to have brand which are (1) Popular, (2) Fast moving and (3) gives them higher margins (The last one being a the most important one)
- Why would they bring new brand T at the expense of Brand H, N and B, which are already doing well
- Filling their shelf with more of new brand T and less of already established Brand H, N and B is a bigger decision the dealer or shop keeper has to take
- Towards this they must be encouraged, motivated and enticed to try Brand T – This is a additional cost when launching new product.

Key Messages

- New products need to be launched at lower prices in compared to existing products in the market
- This strategy creates a price differentiation which helps the new product to capture the market
- The new product continues to increase its market share with this low price strategy,
- However, this would not help to capture the entire market share
- At some point despite low prices, the market share would not increase – This can be seen as *Volume Saturation*
- From here on, the product price can be gradually increased gradually without affecting the market share
- This also cannot go on for ever, rising the prices beyond a certain level reduces the market share (Loss of revenue) – This can be seen as *Price Saturation*
- This journey takes years to succeed and give benefit to business owners

COMING BACK TO CASE OF ITC

Let us apply the same for ITC

- This phenomenon what we saw is what is expected for the FMCG business and possibly the strategy that ITC is using

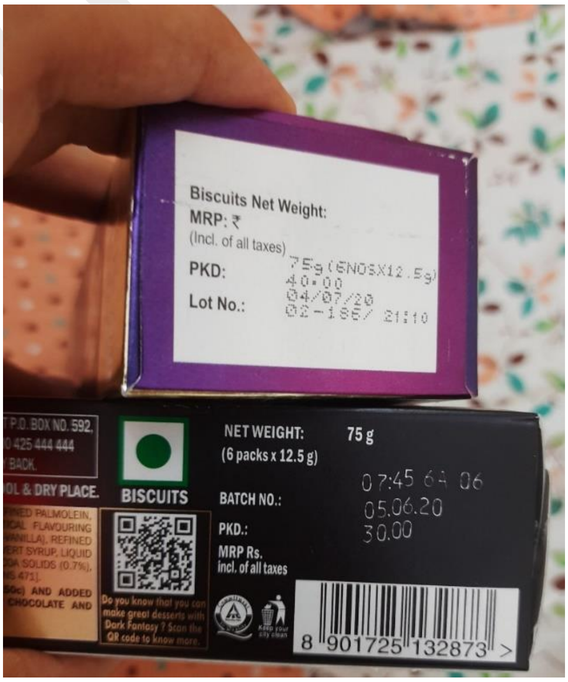
- However, this phenomenon is not straight as we discussed in the example, because it has wide range of products which have different market sizes and currently ITC would have different market share… To better illustrate with hypothetical numbers:

Product	Market Potential	Current Market Share
Biscuits	200 million consumers	5% (Huge market to capture, maintain low prices)
Noodles	100 million consumers	60% (Near Saturation, price at par with competitors)
Chips	500 million consumers	15%
Snacks X		
Snacks Y		

- Different FMCG products are in different stages (i.e. Nascent to Matured) in the market
- The end users are different i.e. Biscuits and chocolates for kids, wheat for family consumption etc
- For FMCG profits to grow, this phenomenon has to be successfully happen in most of the product offerings if not in all!

My Views

- ITC undoubtedly is following this strategy of low price to capture the market share
- At some point (On capturing the required market share) on saturation ITC will start increasing the product prices
- At this stage, there <u>may</u> be surge in profits coupled with the high volumes (Revenue)
- This price differentiation can be seen in most products of ITC
- In the example on the right, the difference in price is INR 10
- Imagine what would be the increase in profits from this product even, if the price was increased by INR 8, i.e. The product price is INR 38 still less than competition, that too after achieving a decent market share in this segment
- In product segments where the price of ITC and competitor products are closeby, it can be interpreted that ITC believes that it has achieved highest market share in that product segment and hence does not maintain price differentiation. These are the product which could have good margins.



Courtesy: One Twitter friend in this reply to a Tweet of Muthukrishnan (@dmuthuk)

Questions

Compared to other places here you have more questions to seek answers!

Q1: “Low Price, High Market Share followed by High Prices” Strategy

Do you believe that ITC follows this strategy of low cost to capture market share and would increase the price after these products capture good market share?

- **No** - Try to answer below questions
  - Why you believe ITC is selling products at low margins?
  - Why would it continue to have low margins in future also?
- **Yes** - Try to answer below questions
  - Are you able to estimate when would this phenomenon going to reach maturity? i.e. Highest market share followed by gradual increase in profit margins
    - If Yes, Put down as ___ years (Try to fill the below Table 1)
      - But sincerely doubt, if even ITC management would be able to put down that they can do it in XX years.
      - They can increase market share in the coming years and can be predicted, but when would it saturate, to start increasing the product prices would remain a grey area
      - For some reason, if this can be accurately predicted or known publicly, the price of ITC would not be at what it is now! - As a huge uncertainty is eliminated and it is known clearly that in XX years, the margins would increase.
  - If you are not able to estimate the number of years, but you know that this phenomenon would happen (but don’t know when it would happen) – Then the simplest strategy would be to make regular SIP purchases at CMP levels below YOUR CALCULATED VALUATION OF ITC!

If you have the details, then work out the below table to strengthen your conviction.

Table 1: Revenue and Margin Projection for 2021 - 2025

	2020	2021	2022	2023	2024	2025
Revenue (Cr.)	12,875	?	?	?	?	?
Margin	3.30	?	?	?	?	?
Profits (Cr.)	425	?	?	?	?	?

The 2020 Figures are from 2020 AR of ITC. For 2021 – 2025:

- Revenue: Bring out your expected growth rate;
- Margin: Your expected profit margins;
- Arrive at the profits for 2021 – 2025;
- Then calculate the profit growth (CAGR) between 2020 and 2025.

Q2: Visibility of future product launches

- Do you have visibility of what all products they are going to come out in future in the FMCG space?
- A year back Sanitizer / Soap was not an important product; but now there is a huge demand that ITC is exploiting.
- Similarly, what all new products could come in future? May be Pet foods as well!
- We as investors do lack this visibility and may have to depend on management commentary
- Management would be making such strategic decision based on the market demand from time to time.

As I write this, I could one interesting tweet where ITC is selling Onion Flakes! I hope this is a new product launch and have not heard about this earlier. Similarly, there could be many such launches in the coming years as well.

Courtesy: Rajesh (@rajesh_ny)

We need to agree to the fact that we retail investors have limited visibility of future product launches and its strategy.

Q3: Your own Behaviour

It can be seen from the hypothetical example that it is going to take years, before the phenomenon happens i.e. Highest market share followed by gradual increase in profit margins in a few years. So even if this phenomenon going to happen for sure in xx years (according to your estimation). Do you as an investor have the patience to wait and hold the stock all these years and reap the benefits?

Remember that a different investment behaviour comes to picture.

- **Conviction**, in your analysis that this will surely happen in xx years
- **Patience**, to hold on to the stock for xx years bravely facing the intermediate shocks withstanding the mocks by friends and social media
- **Committed for long term,** without disturbing the invested capital

Q4: Capacity to Suffer

- Do you think ITC is a candidate that fits in the "Capacity to Suffer" analogy used by Tom Russo i.e. To forego the present gains or bigger future gains?
- If Yes, do you have the "Capacity to Suffer" in terms of waiting patiently for years for the story to pan up i.e. (1) Highest market share in FMCG sector, (2) Gradual increase in margins post achieving highest market share, (3) leading to high profits from FMCG business followed by (4) Stock prices reflecting the new fundamentals
- If for some reasons, this does not happen, do you have the mental ability to accept that such things do happen in investing.

For sure ITC is not a stock that can give handsome returns in a couple of months. The real big story i.e. FMCG growth with huge market share and high profit margins must happen and markets must see it sustain before rewarding the stock with higher prices. This easily would take years.

Threats & Opportunities

Threat 1 – Hazards to Consumer due to Product Consumption

- Food Industry is a high-risk industry in terms of hazards to consumer due to product consumption
- Given the best hygiene and industrial conditions, this possibility appears remote, but few things have happened in the past even with the strongest brands:
    - Worms in Cadbury chocolate in 2003
    - Maggi fiasco recently in 2014
- When such things happen:
    - The brand reputation takes a hit, the customer base erodes sharply
    - It would be difficult to get back to track and may take years to get back the customer base, and the profits take a huge dent
    - Needless to say, the share prices take a bigger hit

Threat 2 – FMCG Space is Highly Competitive

- FMCG undoubtedly a very competitive space filled with big MNC, Indian players and even unorganized players
- ITC also would have spend on promo, advertising etc., to capture and increase market share
- Competitor is not going to keep watching and easily give their market share easily to ITC!
    - They would come out with their own counter strategies like price cut, product differentiation, freebies, advertising, small size packet with single digit pricing and so on
    - So, for ITC, it is not going to be a smooth ride to capture market share despite the low price strategy
- There may be "price war" kind of situation like how it happened in the airline industry
    - Such price war brings down the margins of the overall industry
    - In such event of price war in FMCG space the margins of ITC would not have much scope for expansion
    - The margins of ITC competitors also remain low/stagnate, there by restricting the possibilities of ITC to increase their prices in future
- Such a thing would affect the price part of the Price Volume game and eventually the possibility of spin off of FMCG business (Discussed below in Opportunity 1)

- Whether ITC can manage to increase their margin or all players are forced to decrease their margins is what will unfold only in future.

Opportunity1 – Spin off of FMCG as a separate entity

(This is a very speculative opportunity that is expected)

- ITC may at one stage spin off the FMCG food business as a separate listed entity and come out with a new branding something like "ITC Food Products"
- To the extreme the name ITC itself may vanish from that new entity and some new name would come
- Such complete rebranding has happened in the past where UTI became Axis Bank
- This move may bring the biggest "Value Unlock" for the FMCG story
- It may also happen that the entire Non-Tobacco business may be made as a separate entity

Questions

Do you as an investor believe that this would happen?

- No – What do you see stopping ITC from such a move?
- Yes – Then try to answer this question
  - When do you (in how many years) expect this to happen? i.e. Food/FMCG as separate listed entity
  - Then you need to invest based on this outcome only based ON YOUR (Not someone else opinion) estimation of number of years and your conviction on it

My Views

- This may happen in distant future (I could be totally wrong and this may not even happen)
- So what is that distant future?
- One indicator of when this would happen is when the management sees that food business can grow and sustain itself from the profit it generates
- Which in turn depends on the earlier discussed phenomenon: High volumes follow by expansion of margins close to or at par with peers
- When this would happen? Many years in to the distant future, may be 5 or 10 years
- For the moment, I believe that the cash flow from cigarette business is needed for the growth food business (though in the converse, I have heard arguments that ITC did not use the cash flow from its Tobacco Business for FMCG) – Hence this spinoff is not an immediate possibility

- I repeat that this may or may not happen and even if it happens, it is not before FMCG business has good margins and cash flow is steady – Which may be years down the line, and I don't know when ☺

Before we close the discussion on this business, let me give an option for a common view on social media on this business

View in Social Media 1: For every tweet on ITC revenue growth particularly on FMCG, there are prompt replies pointing out

- FMCG margins or low
- Such low margins are not sustainable
- One step above people flash comparison charts of margins of ITC vs other competitors like HUL, Nestle etc.

Perfectly Right.

The good part is that you know that ITC FMCG margins are low which you don't like and you also have in your hand 2-3 companies that are superior to ITC in profit margin. You profiting from investment is more important than proving in SM or others that ITC is not a better option than HUL or Nestle. Go-ahead and deploy your investments in the companies that you see having better margins than ITC. *Can we have it simpler like below?*

- You have a strong argument that the ITC margins are lower and you also have competitor names which have higher margins
- Simply ignore ITC, take time to analyse HUL or Nestle (Or any other FMCG company that has better margins than ITC) and if satisfactory go ahead and invest loads of money in that company!
- To make your analysis easier, make a comparative table using various parameters something like below, bring in the needed details to find the best in the FMCG space

	ITC	**HUL**	**Nestle**	**Other FMCG**
Growth Rates				
Profit Margin				
RoCE / RoE				
Parameter - 1				
Parameter - 2				
P/Book				
P/Earnings				
PEG				
Other valuation models				

- But vast majority would NOT invest saying…For HUL or Nestle or other FMCG players
  - Valuations are high
  - Valuations are not in comfort zone

- Over valued!

Unfortunately, many want to only compare margins during such arguments, but putting valuation part conveniently under the carpets.

If you are not comfortable on ITC margins and not investing in other FMCG companies that have good margins. Then you need sit back and reflect on yourself on this tricky situation and find out - Why?

To wrap up…ITC now seen as tobacco company. But with growth of FMCG, the cigarette share of revenue will go down and ITC will be seen as FMCG company. We need to wait for that, which could be years.

Hotel

(Shared very limited views because of limited understanding of the business)

About the Business

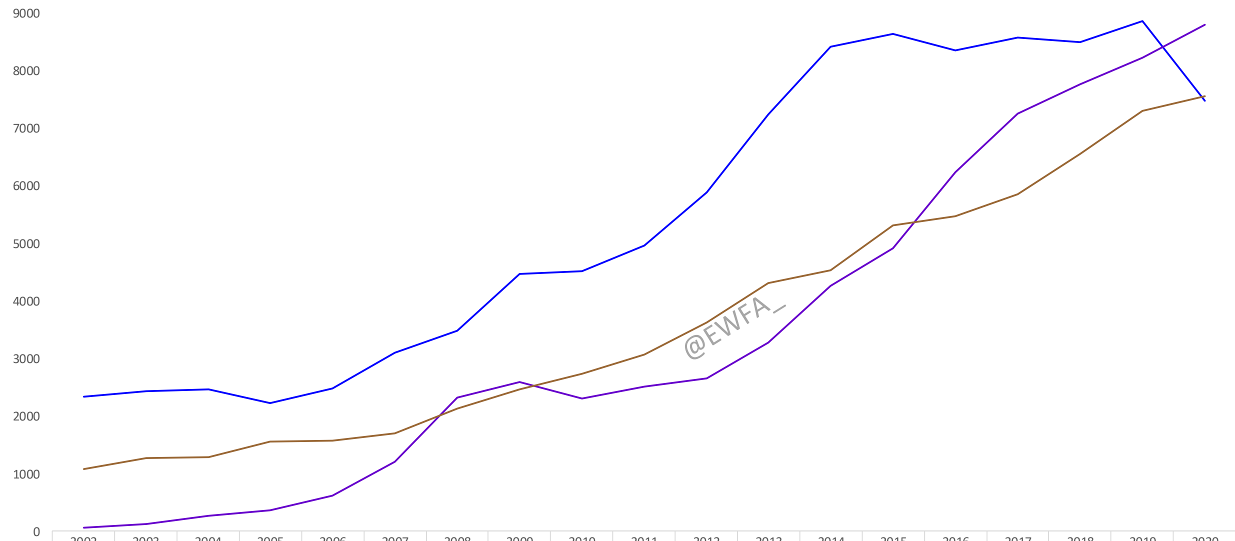
ITC has 109 properties over 73 locations. ITC Hotels are in 4 Brands:

- ITC Hotels in the Luxury segment
- Welcomhotel offers 5-star hospitality in the Upper-Upscale segment
- 'Fortune' in the Mid-market to Upscale segment: There are around 42 hotels with 3100 rooms
- 'WelcomHeritage' in the Leisure & Heritage segment: There are around 36 properties with 900 rooms

Source: https://www.itcportal.com/about-itc/shareholder-value/ITC-Corporate-Presentation.pdf

What is the controversy around this business?

- Hotels account for 3% of revenue share and 0.82% of profit share (Source: ITC 2020 Annual Report)
- This tilted numbers clearly show that Hotel business is a big drag on the overall profits
- While this can be ignored, as the 3% revenue contribution is negligible, there is a bigger concern – The size of Assets (Check the chart below)



	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Cigarette	2334.41	2441.87	2461.4	2234.38	2477.68	3106.26	3492.11	4465.67	4522.4	4969.05	5885.55	7240.69	8416.95	8647.38	8351.08	8573.92	8508.2	8863.69	7483.78
FMCG	69.49	121.87	274.1	362.52	625.58	1203.58	2327.75	2585.75	2300.48	2517.87	2653.68	3277.88	4258.63	4922.38	6238.11	7257.61	7760.11	8224.57	8809.78
Hotels	1080	1273	1285.68	1564.89	1579.52	1708.02	2133.42	2463.92	2743.59	3069.93	3633.65	4309.68	4531.28	5314.24	5470.24	5849.59	6564.68	7302.46	7563.12

Figure 10: Assets Size of Cigarette, FMCG and Hotels Business from 2002 to 2020

Inferences

- Till 2015 the total asset of Hotels was higher than FMCG
- In 2020 the size of the asset of Hotels and Cigarette business is very much similar, while cigarette contribute to 84% or profit share hotels contribute to 0.82% of profit share (Figure 6: Revenue Mix in Percentage of Various Products from 2002 to 2020 and Figure 7: Profit Share in Percentage of Various Products from 2002 to 2020)
- The ratio is 1:100, i.e. For the same asset base the profit share by Hotels business is ~100 times more than profit share by Cigarette business
- The returns from hotels business in relation to the size of the assets invested is very low.

Impact due to Pandemic

This is going to be an added pain to the hotels business

- Hotels is one of the hardest hit segments in the current pandemic and flight restrictions
- Nothing great can be expected in the next few quarters or a year or two (Infact one may even expect losses given the unavoidable fixed costs)

What is not good or the controversy about this Hotel Business?

There is one article by Manurishi Gupta outlining 10 points on ITC. The first point fully covers the aspects on Hotel Business. Do read the below article:

http://manurishiguptha.blogspot.com/2020/10/10-blunders-1-arrogant-company-millions.html

Threats & Opportunities

Opportunity – Historical Cost of the Hotel Assets

The huge invested assets base is the delicious part as these are held at historic cost and is store of hidden value. But the value unlock will depend on what the management decides to do:

- Hotels as separate entity
- Sell out hotels business completely
- As part of restructuring a new business model could emerge

Again, none can predict the timelines when these can be expected to happen. These <u>may</u> not happen at all.

Conclusion

I close this report with a few concluding remarks

- If there are any questions which are not clear in this report:
    - Do ask them over Twitter
    - I will respond over a short write up or a YouTube video, addressing all the queries
    - However, will not be answering to queries beyond the contents covered in this report
- The other reports that would follow:
    - The Cigarette Industry Report
    - Analysis of another stock in similar lines, which is NOT listed in India, only to show how to approach stock analysis
- Stock analysis is more than numbers, but:
    - Drawing inferences from these numbers
    - Getting insights on strategy of the management
    - Asking questions to challenge your knowns and to uncover the unknowns etc. are the important things beyond numbers

Hope this report achieved the objective of showing you, how to approach stock analysis. If you liked it, share your comments.

Hopefully in a few months <u>may</u> come with an updated report covering other business, if I am able to gather details from someone who works in those Industry.

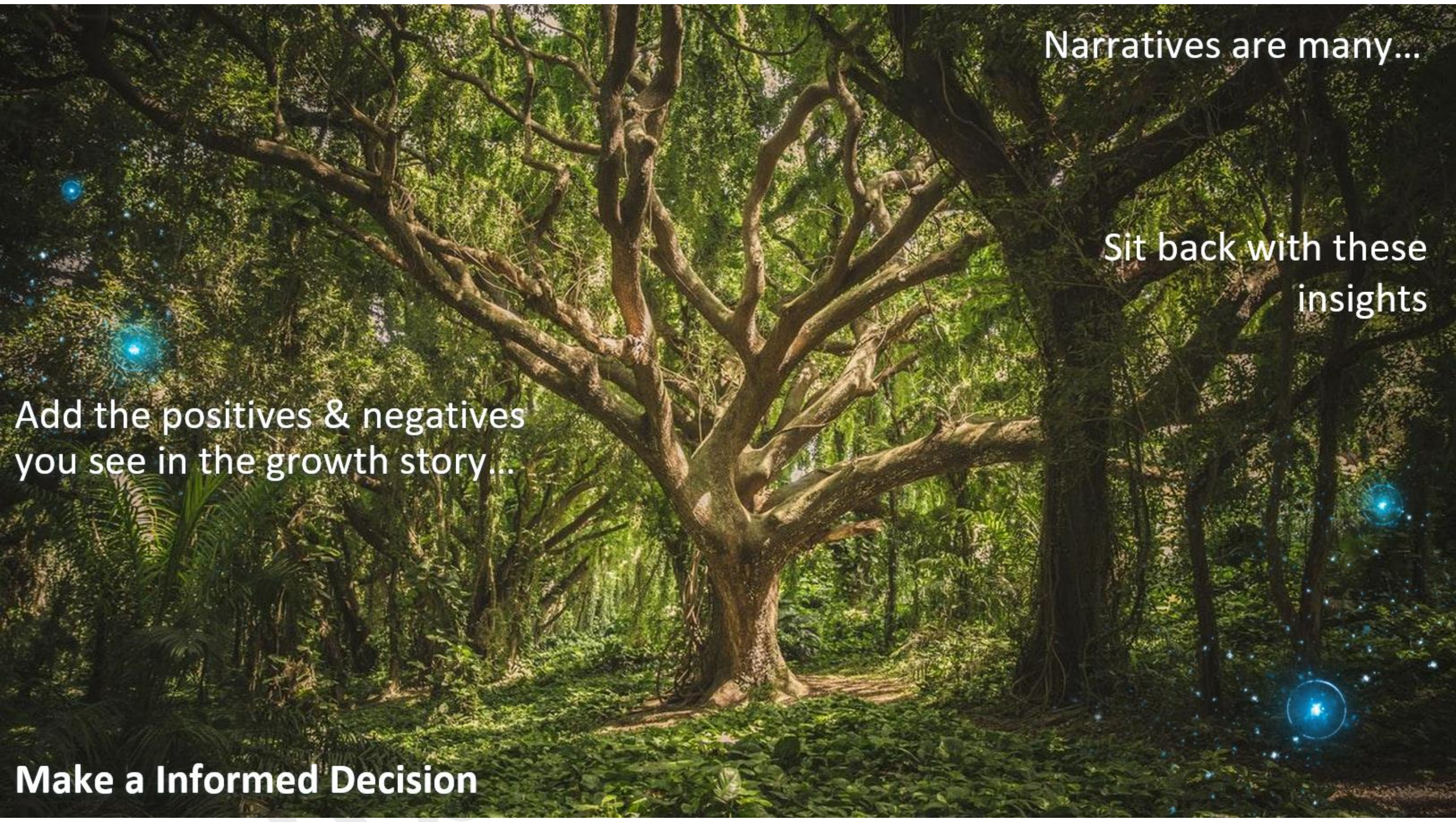


Image courtesy: Slidecarnival.com