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20
YEARS

Initiating Coverage Godfrey Phillips India Ltd.

22-February-2021





Industry	LTP	Base Case Fair Value	Bull Case Fair Value	Recommendation	Time Horizon
Cigarette	Rs.907.85	Rs.965	Rs.1061	Buy on dips to Rs.868 and add more in the Rs.796	2 quarters

HDFC Scrip Code	GODPHIEQNR
BSE Code	500163
NSE Code	GODFRYPHLP
Bloomberg	GP:IN
CMP Feb 22, 2020	907.85
Equity Capital (cr)	10.40
Face Value (Rs)	2
Eq- Share O/S(cr)	5.20
Market Cap(Rscr)	4756
Book Value (Rs)	421
Avg.52 Wk Volume	406941
52 Week High	1394.80
52 Week Low	732.40

Our Take:

Godfrey Phillips is the second-largest player in the Indian cigarette market (~12.9% of market share), with deep penetration and has presence across 800000+ retailers through its 800+ distributors, and 6000+ salesman. The company owns top of the mind brands like Four Square, Red and White, Stellar etc. It manufactures and sells Marlboro in India under a license agreement with Philip Morris. Apart from this, it also has presence into chewing products, mouth freshener, confectionery segment and retail. The Company has posted strong RoE/RoCE of 18%/24% in FY20 with debt-free status and liquid balance sheet. Godfrey is trying to gain a foothold in South India after firmly establishing itself in the North and West. It has already met with initial success in Bangalore with Marlboro branded cigarettes.

The company has a strong track record of consistent free cash flow generation along with high margins which have been gradually improving from 13.9% in FY16 to 20.6% in FY20.

Cigarettes and other Tobacco Products (Prohibition of Advertisement and Regulation of Trade and Commerce, Production, Supply and Distribution) Amendment Act, 2020 can impact adversely volume growth and realization going forward.

Valuations & Recommendation:

We expect that the company will get benefits from the strong market share with volume growth, good presence over the north & west region with expanding presence to South region, leading market position, improving realization & EBIDTA / stick, decent financial which would lead to 5% CAGR in top-line and 9% EPS CAGR over FY20-23E. Moreover, recent tax reform would also boost the profitability for Godfrey, as the company was paying ~32% taxes in the previous years and which will come down to 25-26%. We feel the base case fair value of the stock is Rs.965 (10.1x FY23E EPS) and the bull case fair value is Rs.1061 (11.2x FY23E EPS). Investors could buy the stock on dips to Rs.868 (9.1x FY23E EPS) and further add on dips to Rs.796 (8.4x FY23E EPS).

Fundamental Research Analyst

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Financial Summary

Particulars (Rs cr)	Q3FY21	Q3FY20	YoY-%	Q2FY21	QoQ-%	FY19	FY20	FY21E	FY22E	FY23E
Operating Income (Net of excise)	706	761	-7%	701	1%	2,497.2	2,876.6	2,694.8	3,039.2	3,372.7
EBITDA	167	167	0%	154	8%	403.0	591.6	519.0	582.2	643.4
RPAT	123	114	8%	103	19%	259.9	384.4	380.5	411.4	494.7
Diluted EPS (Rs)	23.61	21.93	8%	19.89	19%	50.0	73.9	73.2	79.1	95.1
RoE-%						13.6	18.2	16.1	15.3	16.4
P/E (x)						18.3	12.4	12.5	11.6	9.6
EV/EBITDA (x)						11.7	8.0	9.1	8.1	7.3

(Source: Company, HDFC sec)

Q3FY21 Result Update

Reported Result

- Revenue of the company posted degrowth by 7% y-o-y to Rs.706 cr. EBITDA Margin for the quarter stood at 24%, up 200bps on YoY basis. Consequently the company had posted net profit growth of 8% y-o-y to Rs.123 cr from Rs.114 cr in the same quarter previous year.

Segment-wise

- Revenue of Cigarette segment has posted 7% y-o-y growth to Rs.753 cr and EBIT of this segment degrow by 6% y-o-y to Rs.148 cr. The International Business gross sales declined by 18% in 9MFY21 mainly due to impact of supply chain disruptions and closure of Rabale factory which caters majorly to the international markets with cigarettes & cut tobacco.
- Revenue of Retail segment has posted 14% y-o-y degrowth to Rs.80 cr and EBIT of this segment has reduced loss y-o-y to Rs.25 cr. The number of stores stand at 90 at the end of Dec 2020. TFS remained open during the lockdown and provided all types of essential goods to consumers.



Long term Triggers

Diversified revenue stream

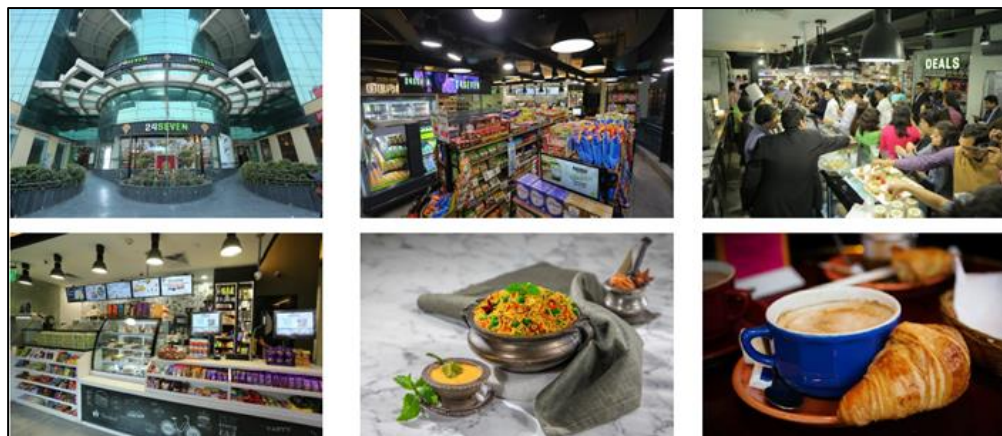
The company mainly operates in tobacco, non-tobacco segment. Tobacco segment divided into domestic (68% of revenue contribution) and international (21% of revenue contribution); non-tobacco segment contributes 11% of revenue which includes Chewing Products, 24Seven food chains, Confectionary. The company has been constantly augmenting its international business through both contract manufacturing, selling processed tobacco and enhancing its own brands like Originals, Black Jack, STELLAR, Jaisalmer etc. It has significant market presence across Latin America, Middle East, South East Asia and Eastern Europe. Company has been exporting to 72 countries through more than 90 partners.

24Seven Convenience Stores (TFS)

The 24Seven chain of convenience stores which offer daily needs groceries, ready-to-eat foods, beverages, cosmetics and personal care products, music and movies, magazines, domestic and international courier services, instant photo development, bill payments, mobile phone recharges, movie tickets and several other offerings.

In FY19, the company set up a large scale kitchen hub in Faridabad (Delhi NCR) to prepare all kinds of ready to eat food items in a highly quality controlled environment, to meet growing demand. As on Q3FY21 the company had 90 stores with Rs. 260Cr contributing 9.8% of GPL 9MFY21 overall revenue.

GPI's 24Seven retail convenience store chain has registered robust gross sales growth of 33.2% YoY to Rs. 410 cr in FY20 and contributed 10.8% to the net sales. 24Seven is India's first and only twenty-four hours convenience store chain with 103 stores count as on March 2020 spread across Delhi NCR and Chandigarh.



Source – Company, HDFC sec Research

Chewing Products & Confectionary

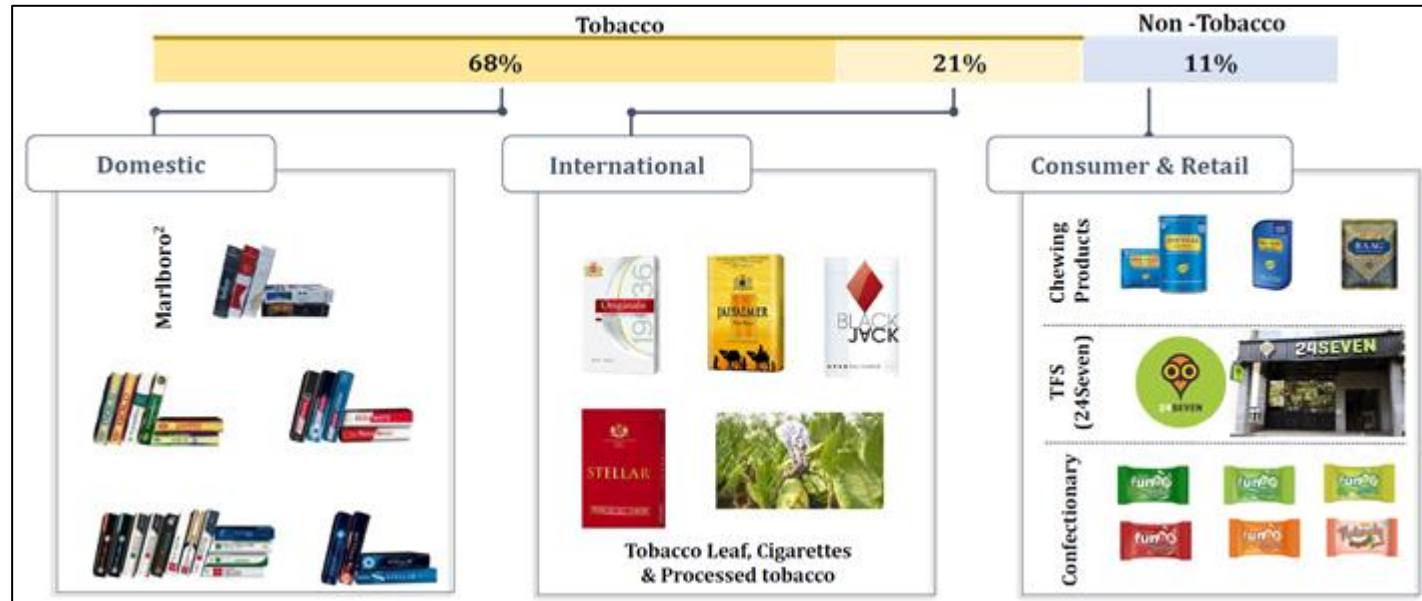


Source – Company, HDFC sec Research

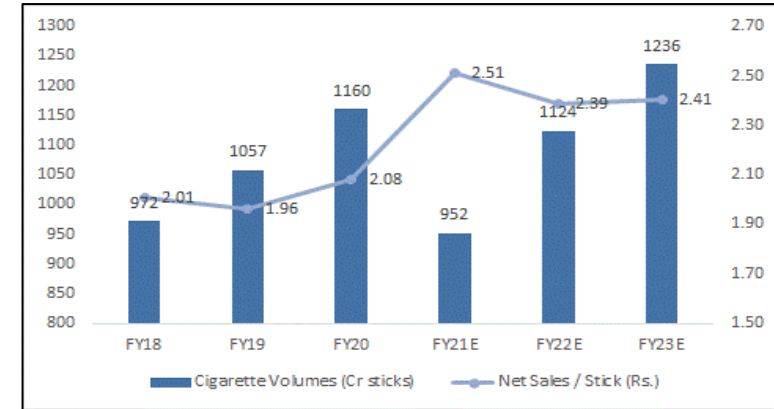
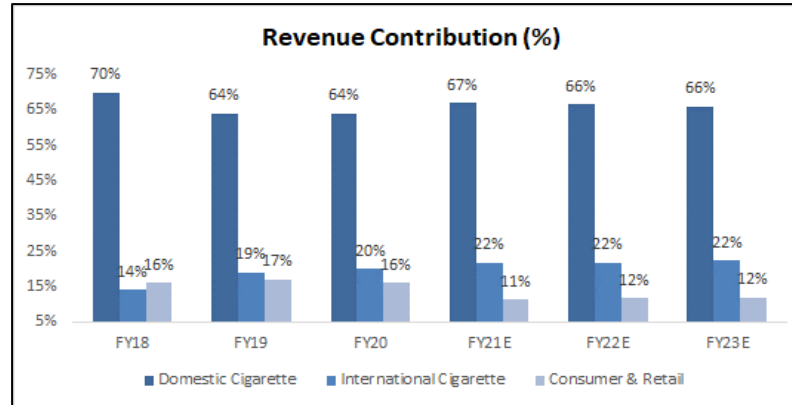


In FY19 the chewing business was close to breakeven and in FY20, business made some significant restructuring, made investments in Pan Vilas brand in premium segment and gradually pulled out itself from non-performing mid premium segment. Company showcased continued growth of 15% in past 2 years in gross sales revenue in the confectionary segment backed by launch of highly innovative Imli Candy.

This division of the company has Network of Exclusive Distributors 800 and Network of Exclusive Field Force 9000. The premium pan masala market size is estimated to be Rs. 2,800 Crore and Pan Vilas has a 20% share in its key market of Gujarat.



Source – Company, HDFC sec Research



Source – Company, HDFC sec Research

Growing international business

Company's international business registered a robust growth of 21.1% primarily driven by exports of unmanufactured tobacco and cut tobacco. The company has done reasonably well in the cut tobacco business across CIS, acquiring multiple new clients. GPI has also started to make a foothold in the markets of North Africa and GCC. In order to augment the capacity and offer new formats, company tied up with factories in UAE and successfully launched new formats such as Super Slims.

Capsule filter cigarettes in various flavours like Blueberry, Mint, Spearmint and Menthol have gained major attraction across markets of Southeast Asia and Latin-America. By way of exports and other receipts company earned Rs. 597 cr (Rs. 493 cr in FY19).

	2019-20	2018-19
Commodity/Product	Value (Rs. In Cr)	Value (Rs. In Cr)
Cigarettes	163.66	178.85
Unmanufactured tobacco/CLB	377.94	266.01
Cut tobacco	55.70	46.19
Candy/Tea	0.48	2.54
Total	597.78	493.59

Source – Company, HDFC sec Research



No new cess or raise of GST on cigarette, bidis

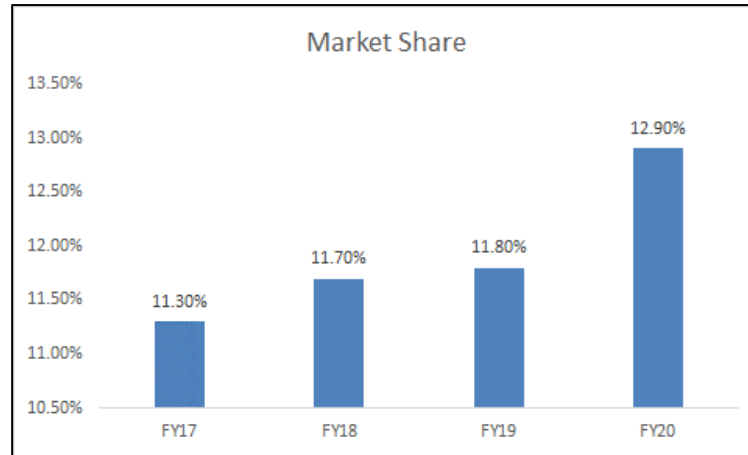
The Centre informed the Rajya Sabha on 11th February, 2021 that there was no proposal to raise the excise duty on cigarettes, 'bidis' and smokeless tobacco. Due to higher taxation on cigarettes, legal industry volumes continued to remain significantly below June 2014 levels. While legal cigarette industry volumes have declined by about 20% between 2010-11 and 2019-20, the illicit duty-evaded cigarette segment has grown by 36% during the same period, accounting for about one-fourth of the domestic industry and making India one of the fastest growing illicit cigarette markets in the world.

Consequently, while the share of legal cigarettes in total tobacco consumption in the country has declined considerably from 21% in 1981-82 to a mere 9% (against global average of 90%), aggregate tobacco consumption in the country has increased over the same period. As a result, despite 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. It is estimated that on account of illegal cigarettes alone, revenue loss to the Government is almost Rs.15000 cr per annum.

Strong market positioning

The company is 2nd largest cigarette manufacturer in India. The company has improved and has sustained its market share in Cigarette segment. A company having 800+ distributors, 800000+ retailers and 6000+ salesman. Company's domestic cigarette market share increased to 12.9% in FY20 from 11.8% in FY19 along with a better product mix and improved realization.

Company's main brands Four Square, Red & White, Cavanders & Stellar continued to perform strongly, especially in its core markets owing to concentrated efforts in sharpening consumer insights, improving capabilities for faster product development and innovations, staying relevant to the evolving consumer needs and implementing cost optimization measures.



Source – Company, HDFC sec Research

The company has manufacturing facilities and R&D centre in Rabale, Mumbai, and Ghaziabad. The company has a tobacco buying unit in Guntur (Andhra Pradesh). Godfrey is trying to gain a foothold in South India after firmly establishing itself in the North and West. It has already met with initial success in Bangalore with Marlboro branded cigarettes. ITC has a strong presence in the South and East regions.

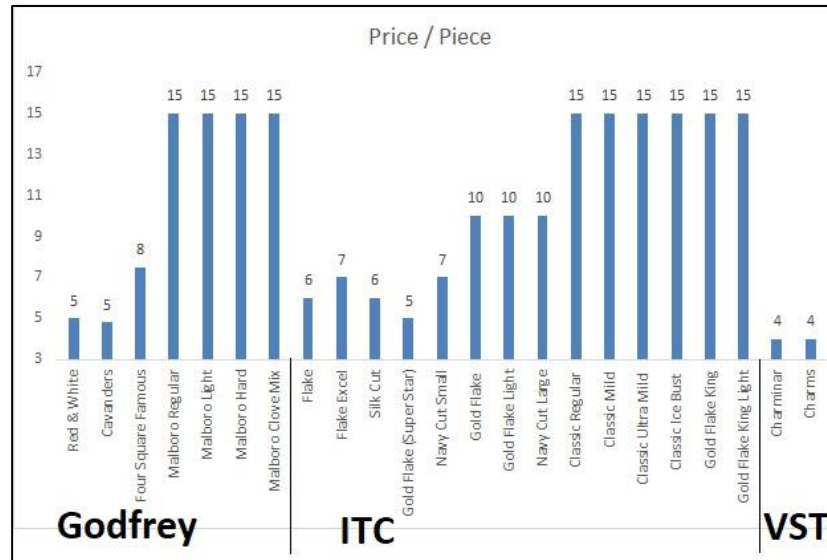
The company has an exclusive procurement and supply agreement with Philip Morris International for the manufacturing and distribution of Marlboro in India.

Small size cigarette acting as a key volume and sales driver

Godfrey Phillips has major pricing and product segment advantage compared to ITC's premium brands. Smokers are preferring Regular Size Filter Tip (RSFT) over the Mini King Size Filter Tip (MKSFT or 72mm) and KSFT. The growing perception that smaller size is less harmful and rising prices is leading smokers to downtrade to smaller sizes.



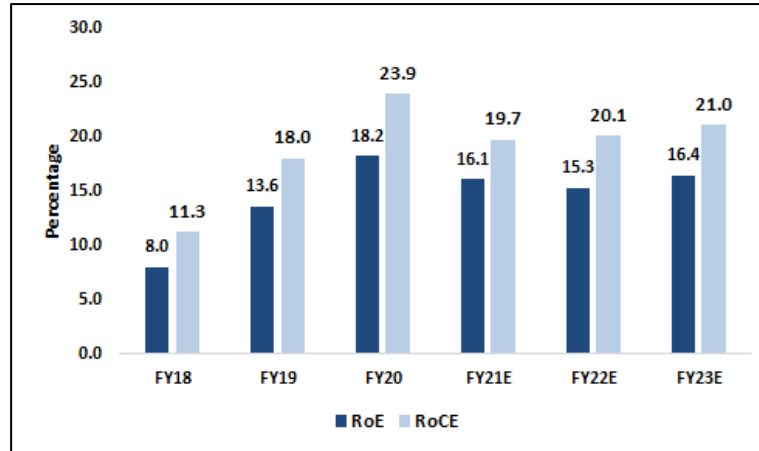
As per the reports, Godfrey's 64mm cigarettes (Four Square, Red & White, Cavendars) has been the major growth driver. It constitutes around 42-45% of the total volume followed by the 69mm (Four Square and its variants) at 55-58%. Four Square generates 70-75% of the company's cigarette revenue with the remaining coming from Red & White and Cavendars.



Source – Other broker report, Company, HDFC sec Research

Decent financial position

The company has been consistently reporting strong return ratio with debt-free cash-rich status (~Rs.1000cr of liquid investment) along with strong CFO and FCF generation. We expect that dividend payout ratio will improve from current level due to higher cash+ investment on the balance sheet. At the end of FY20 company's cash and cash equivalents stood at Rs. 1,200cr+ (approx).



Source – Company, HDFC sec Research

What could go wrong

Covid-19 led lockdown has an impact on growth

March quarter was largely unaffected by lockdown given pre-stocking by dealers, But Q1FY21 has significantly impacted by 45 days production halt as well as the shutdown of most retail shops in the country.

A large number of grocery stores selling essential food, health and hygiene products were permitted to remain open, they operated with significant restrictions concerning the duration of opening hours, timings, number of customers that could be serviced at a time etc. In many geographies, convenience outlets remained closed for extended durations. Non-availability of public transport adversely impacted the availability of manpower involved in value chain operations like warehousing, order capture, transportation and so on. Q2FY21 and Q3FY21 also has witnessed fall in volume. So that H1 FY21 has reported ~26% of volume degrowth.



Search and seizure by the Income Tax Department

The Income Tax Department had searched the office premises of Godfrey Phillips India from February 3, 2021, to February 7, 2021, in connection with a search carried out on a promoter of the Company under Section 132 of the Income Tax Act, 1961.

Family Feud and Ongoing legal battle for GPIL control

At present, there is infighting within the Modi family over the business of late Krishan Kumar Modi, who handled it for five decades, before his death in 2019. Then legal battle for ownership and control is between Mr. Lalit Modi-elder son of Mr. KK Modi and the younger son Mr. Samir Modi the younger son. The family feud over ownership and control continues to be the overhang on the stock price.

Higher taxation such as GST and excise duty will affect the industry profitability. Also, perception as a sin industry to affect adversely. Cigarettes and other Tobacco Products (Prohibition of Advertisement and Regulation of Trade and Commerce, Production, Supply and Distribution) Amendment Act, 2020

The government has drafted the Cigarettes and other Tobacco Products (Prohibition of Advertisement and Regulation of Trade and Commerce, Production, Supply and Distribution) Amendment Act, 2020. The provision for raising the age limit to 21 years (from the current of 18 years) is part of the new bill being piloted by the Union Health Ministry. Trade/commerce in cigarettes or other tobacco product shall be in sealed, intact and original packaging. Contravention of this Section 7 will lead to imprisonment of two years or fine going up to Rs 1 lakh and second conviction leading to prison for 5 years or fine going up to Rs 5 lakh.

The bill also has a provision for coming down on the manufacture and sale of illicit cigarettes and tobacco products. Sale of illicit products will lead to a punishment of imprisonment of 1 year and a fine of Rs 50,000 and a second conviction of imprisonment of 2 years and Rs 1 lakh. The fine on the manufacture of illicit cigarettes is imprisonment of 2 years and a fine of Rs 1 lakh. The penalty for smoking at restricted areas is being increased from Rs 200 to Rs 2,000.

No person shall directly or indirectly advertise cigarettes or any other tobacco products through any medium and no person shall take part in any advertisement that directly or indirectly promotes the use or consumption of cigarettes or any other tobacco products.

If this draft becomes law then the cigarette industry will face difficulties to grow volume and also to improves realization.



Competition from unorganized players

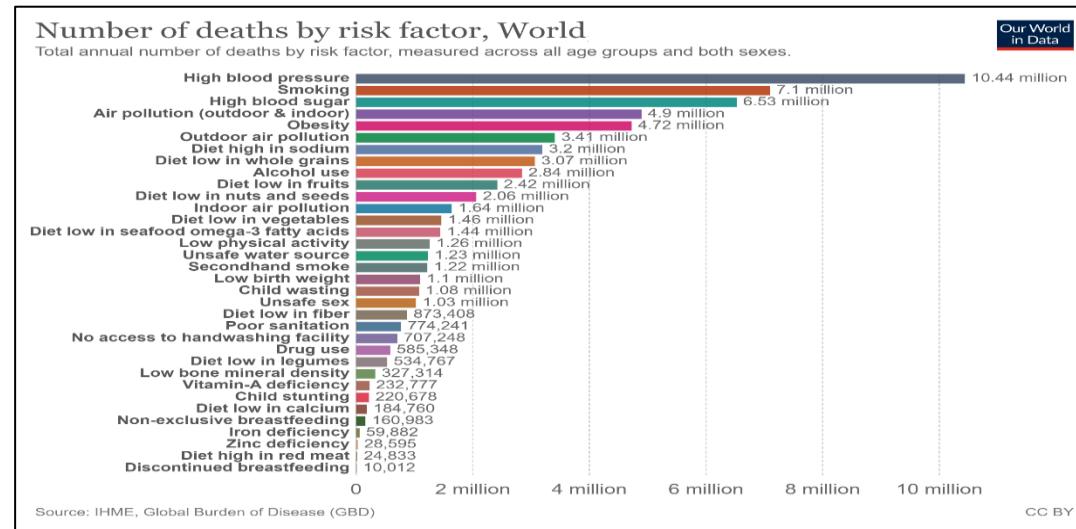
Non duty-paid cigarettes have benefited from the large price distortion arising from exponential tax hikes which has adversely affected large organized players.

Ban on loose Sticks

Continuation of harsher regulations such as selling restrictions and ban on sale of loose sticks in key large states can pose challenges for volume growth of the organized industry.

Healthy lifestyle awareness can affect growth

Cigarettes contain about 600 ingredients. Smoking generates more than 7,000 chemicals. Many of these are poisonous and at least 69 of them can cause cancer. In India, among tobacco use, smoking is one of the major causes of deaths and diseases, accounting for millions of such cases.





Higher competition from bidis and unmanufactured tobacco

In India 'Bidi' consumption is 7-8 times more common than conventional cigarettes and when compared bidis produce equal or higher levels of nicotine, tar, and other toxic chemicals. After inhalation, these compounds not only reach the lungs but are absorbed and can affect almost all organs of the body.

Discriminatory taxation on cigarettes has caused progressive migration from consumption of duty-paid cigarettes to other lightly taxed/tax-evaded forms of tobacco products, comprising illegal cigarettes, bidi, chewing tobacco, gutkha, zarda, snuff, etc.

Funds following ESG investing may not invest in cigarette and tobacco industry

Cigarette and tobacco industry does not fall under ESG (Environment, Social and Governance) framework. ESG concept is widespread in the developed markets. ESG funds are growing in popularity among investors who want to be seen to be making a contribution to cutting global warming and adding to human development, without compromising on financial returns.

Industry

India has a unique pattern of tobacco consumption. Legal Cigarettes account for just 9% of overall tobacco consumed. The balance 91% consumption is represented by traditional products like chewing tobacco, beedis, khaini etc. and illegal Cigarettes. This is unlike the rest of the world where tobacco is synonymous with Cigarettes representing 90% of tobacco consumption.

Cigarette taxes in India are among the highest in the world. Therefore, high tax rates make cigarettes unaffordable to a large section of consumers. As a result, they shift towards the consumption of beedi and other forms of smokeless tobacco. Hence, the overall tobacco market experiences slow growth.

India is the second largest producer of tobacco in the world and reaps enormous benefits in terms of employment in the agricultural sector, income to farmers, revenue generation and foreign exchange earnings. India is also the largest exporter of tobacco and tobacco related products. Various varieties of tobacco are grown across 13 states in the country.

Around 68% of tobacco consumption comes from the unorganized sector which bypasses the purview of the regulatory authorities and do not pay taxes. India is currently the 4th largest illegal cigarette market in the world with illegal cigarettes reaching 26.5 bn sticks in 2018 which is double the level it was in 2005.

About the Company

Godfrey Philips is a K.K.Modi group of company which is one of the leading FMCG company. Company has an exclusive sourcing and supply agreement with Philip Morris International to manufacture and distribute the renowned Marlboro brand in India. Modi group holds 47.09% and Philip Morris holds 25.10% stake in the company.

The company has expanded its product portfolio beyond cigarettes – Marlboro, Four Square (Max, Crush, Prince), Red & White, Cavanders, North Pole, Tipper, Originals, Jaisalmer, Black Jack, Stellar, Black & Gold, Ultima, Double Six, Sahara, and tobacco and entered into chewing products, mouth freshener, confectionery segment and retail. Pan Vilas pan masala, Pan Vilas Silver Dewz – a silver-coated Elaichi (cardamom seed) and Funda Goli candies are all manufactured by the Company. Later on, the company has diversified into the food chain of 24Seven Convenience Stores.

Peer Comparison as per FY20 Financial

Company	CMP (As on 19-02-2021)	Mcap (Rs. Cr)	NPM%	RoE%	RoCE%	D/E(x)	TTM P/E (x)
Godfrey Phillips	915	4756	13	15	20	0.2	15
VST Industries	3627	5586	25	42	52	0.0	18
ITC	216	265896	31	25	33	0.0	20

	Sales (Rs. Cr)				EBIDTA Margin (%)				PAT (Rs. Cr)			
	FY20	FY21E	FY22E	FY23E	FY20	FY21E	FY22E	FY23E	FY20	FY21E	FY22E	FY23E
Godfrey Phillips	2877	2695	3039	3373	21	19	19	19	384	381	411	495
VST Industries	1239	1119	1218	1318	33	37	36	36	304	316	351	391
ITC Ltd	49404	48292	54691	58908	39	35	37	37	15228	13435	16164	17229

Financials

Income Statement

(Rs Cr)	FY18	FY19	FY20	FY21E	FY22E	FY23E
Net Revenue	2326	2497	2877	2695	3039	3373
Growth (%)	-3.2	7.4	15.2	-6.3	12.8	11.0
Operating Expenses	2067	2094	2285	2176	2457	2729
EBITDA	258	403	592	519	582	643
Growth (%)	2.1	56.0	46.8	-12.3	12.2	10.5
EBITDA Margin (%)	11.1	16.1	20.6	19.3	19.2	19.1
Other Income	54.6	79.1	106.9	135.0	150.0	195.0
Depreciation	98.4	98.6	155.2	135.5	142.0	148.2
EBIT	214	384	543	518	590	690
Interest	1.7	1.0	30.2	28.2	41.8	30.7
Shares of Profit in Joint Ventures (net of Tax)	0.0	0.0	0.0	0.0	0.0	0.0
PBT	213	383	513	490	548	660
Tax	74.0	122.8	128.7	109.8	137.1	164.9
RPAT	139	260	384	380	411	495
Growth (%)	1.2	87.1	47.9	-1.0	8.1	20.2
EPS	26.7	50.0	73.9	73.2	79.1	95.1

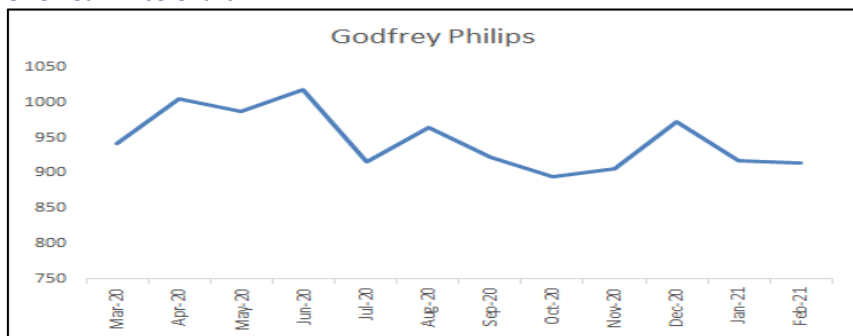
Balance Sheet

As at March	FY18	FY19	FY20	FY21E	FY22E	FY23E
SOURCE OF FUNDS						
Share Capital	10.4	10.4	10.4	10.4	10.4	10.4
Reserves	1783	2028	2177	2531	2839	3177
Minority Interest	37	33	29	28	29	29
Other Equity & Liabilities	0	0	0	0	0	0
Shareholders' Funds	1830	2072	2216	2570	2878	3217
Long Term Debt	1	1	1	1	1	1
Long Term Provisions & Others	73	57	56	56	63	63
Total Source of Funds	1904	2129	2273	2627	2942	3281
APPLICATION OF FUNDS						
Net Block	659	700	676	686	706	726
Non-Current Investments	760	998	1131	1414	1485	1559
Deferred Tax Assets (net)	1	1	0	0	0	0
Long Term Loans & Advances	77	81	84	95	121	164
Other Assets	0	0	0	0	0	0
Total Non Current Assets	1498	1780	1892	2195	2312	2449
Current Investments	173	242	129	148	158	169
Inventories	585	642	688	753	833	906
Trade Receivables	86	69	69	81	100	116
Short term Loans & Advances	50	54	94	169	191	195
Cash & Equivalents	44	46	48	125	167	306
Other Current Assets	31	35	31	33	36	41
Total Current Assets	969	1087	1059	1310	1485	1732
Short-Term Borrowings	27	41	11	300	255	255
Trade Payables	171	290	254	262	269	292
Other Current Liab & Provisions	340	390	391	293	308	329
Short-Term Provisions	25	17	22	22	23	24
Total Current Liabilities	563	738	678	878	855	900
Net Current Assets	406	349	381	432	630	832
Total Application of Funds	1904	2129	2273	2627	2942	3281

Cash Flow Statement

(Rs Cr)	FY18	FY19	FY20	FY21E	FY22E	FY23E
Reported PBT	213	383	513	490	548	660
Non-operating & EO items	-55	-79	-107	-135	-150	-195
Interest Expenses	2	1	30	28	42	31
Depreciation	98	99	155	136	142	148
Working Capital Change	188	59	-30	26	-156	-63
Tax Paid	-74	-123	-129	-110	-137	-165
OPERATING CASH FLOW (a)	372	339	433	435	289	415
Capex	-45	-135	-73	-10	-20	-20
Free Cash Flow	327	204	360	425	269	395
Investments	-350	-242	-135	-293	-97	-118
Non-operating income	55	79	107	135	150	195
INVESTING CASH FLOW (b)	-340	-298	-101	-168	33	57
Debt Issuance / (Repaid)	-3	-16	-1	0	7	0
Interest Expenses	-2	-1	-30	-28	-42	-31
FCFE	322	187	329	397	234	365
Share Capital Issuance	-4	-4	-4	-1	1	1
Dividend	-42	-89	-224	-26	-104	-156
FINANCING CASH FLOW (c)	-51	-109	-259	-55	-138	-186
NET CASH FLOW (a+b+c)	-19	-68	73	213	184	287

One Year Price Chart



Key Ratios

	FY18	FY19	FY20	FY21E	FY22E	FY23E
Profitability (%)						
EBITDA Margin	11.1	16.1	20.6	19.3	19.2	19.1
EBIT Margin	9.2	15.4	18.9	19.2	19.4	20.5
APAT Margin	6.0	10.4	13.4	14.1	13.5	14.7
RoE	8.0	13.6	18.2	16.1	15.3	16.4
RoCE	11.3	18.0	23.9	19.7	20.1	21.0
Solvency Ratio						
D/E	0.0	0.0	0.0	0.1	0.1	0.1
Interest Coverage	128.4	395.4	18.0	18.4	14.1	22.5
PER SHARE DATA						
EPS	26.7	50.0	73.9	73.2	79.1	95.1
CEPS	45.6	68.9	103.8	99.2	106.4	123.6
BV	345	392	421	489	548	613
Dividend	8.0	8.0	34.0	5.0	20.0	30.0
Turnover Ratios (days)						
Debtor days	13	10	9	11	12	13
Inventory days	97	90	84	102	100	98
Creditors days	29	40	43	44	40	39
Working Capital Days	82	60	50	69	72	72
VALUATION						
P/E	34.2	18.3	12.4	12.5	11.6	9.6
P/BV	2.7	2.3	2.2	1.9	1.7	1.5
EV/EBITDA	18.2	11.7	8.0	9.1	8.1	7.3
Dividend Yield	0.9	0.9	3.7	0.5	2.2	3.3
Dividend Payout	17.9	16.0	46.0	6.8	25.3	31.5

Source: Company, HDFC sec Research



Disclosure:

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Any holding in stock – No

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