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Demerger to ease ITC's free cash flows

1 **The planned demerger of ITC's hotel division signals a change in its growth strategy of using the cash flows generated by highly profitable but slow-growing tobacco business for investment in other businesses,** such as hotel and paper, paperboard & packaging. In FY23, the FMCG-cigarette division generated 75% of ITC's consolidated PBIT of ₹18,883 crore, but it only accounted for 6% of capex by the firm. Nearly a fifth of capex worth ₹589 crore went to the hotel division; the paper, paperboards & packaging division absorbed 25 per cent of capex (₹745 crore). **KRISHNA KANT** writes **II, 1**

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ITC DEMERGER A WIN-WIN

Firm's cash flows to improve; India's 2nd-biggest hotel group to take shape

KRISHNA KANT
Mumbai, 24 July

The planned demerger of ITC's hotel division into an independent listed company marks the end of an era for the tobacco and fast-moving consumer goods (FMCG)
1 giant. The company had merged the erstwhile listed ITC Hotels with itself in April 2005 to create a diversified and vertically integrated conglomerate with leading presence in tobacco, personal care, ready to eat foods, paper & packaging, food & agri products and hotels. Prior to it, the company had merged ITC Bhadrachalam Paperboards with itself in April 2002.

The demerger signals a reversal in ITC's historical growth strategy of using the cash flows generated by highly profitable but slow-growing tobacco business to invest in other business such as FMCG, hotels and paper, paperboard & packaging.

For example, in the 2022-23 financial year (FY23), the FMCG -cigarettes division generated 75 per cent of ITC's consolidated PBIT (profit before interest and tax) worth ₹18,883 crore, but the division only accounted for 6 per cent of all capital expenditure (capex) incurred by the company. Nearly a fifth of capex worth ₹589 crore went to hotels division while paper, paper boards and packaging division absorbed another 25 per cent of the capex worth ₹745 crore. In all, in the last ten years, ITC has cumulatively spent ₹24,095 crore on capex; out of which 30 per cent (worth ₹7436 core) went to non-cigarette FMCG, 25 per cent (worth ₹6348 crore) went to hotels and 22 per cent (or ₹5560 crore) were invested in paper and paperboards side.

Analysts expect an improvement in ITC free cash flows after the demerger that absorbed a significant portion of its cash flows but contributed very little to its overall revenues and earnings. In FY23, the hotel division's contribution to ITC's consolidated revenues and PBIT were just 3.5 per cent and 2.2 per cent, respectively, even though the division accounted for 17.6 per cent of all its assets.

The rise in free cash due to the demerger is likely to result in a step-up in dividend pay-outs by the company which is positive for its shareholders. The demerger may also lead to an improvement in ITC's return on equity (RoE) and return on capital employed (RoCE) which was pulled down by the hotel division — a cash guzzler with poor profitability and return ratios. This is another positive for ITC's valuation, which continues to trade at a discount to FMCG peers such as Hindustan Unilever and Nestle.

"The high capex (in the hotel division) has always been a bone of contention for investors. For example, over the last 5/10/15/20-years, average annual free cash flows (FCF) has been negative in the range between ₹150 and ₹300 crore.

RoCE has also been in single-digits for most years, well below cost of capital," wrote analysts at Jefferies in their note on demerger.

The demerger will however create India's second biggest hospitality group — in terms of revenues and asset base — just behind industry leader Indian Hotels Company.

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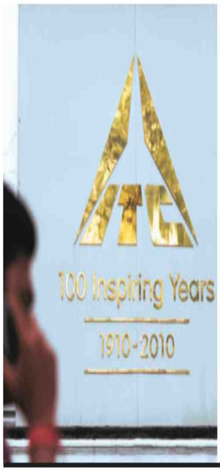
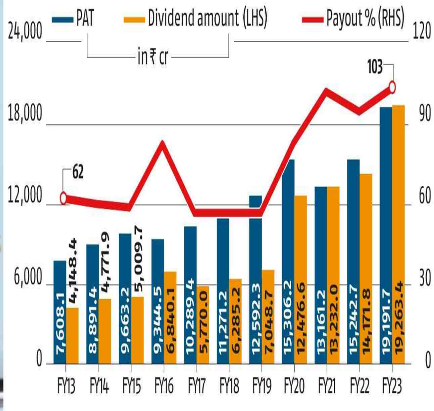


BIG JUMP



ROOM SERVICE

Financials of ITC Hotels and other hospitality chains (₹ crore)

	Net sales	PBIT	Networth	Assets	M-cap
ITC Hotels	2,689.1	557.3	6,976.2	7,896.5	NA
Indian Hotels	5,809.9	1,530.7	7,982.0	11,924.9	55,672.6
EIH	2,018.8	489.4	3,374.6	3,772.6	13,617.3
Chalet Hotels	1,128.5	427.3	1,727.8	4,443.6	9,534.7
Lemon Tree Hotels	875.0	355.4	853.7	3,596.3	7,217.4

Source: Capitaline

Compiled by BS Research Bureau