Matching the parameters of ITC

N.R Parasuraman

Chetan Chapcha knew that explanations will be difficult. The senior management team (the so-called Strategy group) have been obsessed with one company and wanted to compare things parameter by parameter. In previous direct interactions and group meetings, Chetan had tried his best to impress upon the group that comparing oneself with a giant will be futile. Chetan advanced the following arguments for his view:

- Companies have a learning curve as they go along and that cannot be emulated
- A company with vast resources always has a better chance for "trying things out"
- The concept of Real Options and the occasional losses of "premium" can easily be afforded by the larger company
- Ratios and parameters have severe limitations in any case, and so what appears "bigger" or "different" may not actually be so.

But these have not been accepted. In fact, Chetan felt that many times the committee did not even hear him out completely. His line of thought was that every company has to develop on whatever strengths it has and and there would be no meaning in checking up all individual parameters. What mattered ultimately is the Return on Equity and so long as this is reasonable, companies should be happy.

The background

When Chetan joined Cryptodiversify Ltd. It was a small firm with a peculiar name. that was in 2006. A fresh pass-out from SDMIMD, Chetan was taken in the Finance department for budgeting and control accounts management. Soon, thanks to the overall growth of the company and its operations, he was promoted, and eventually made CEO of the company, in 2017. During these 11 years, the company grew by 200% and developed diversified areas of business. Some of the

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diversifications, - like the foray into restaurants business was unorthodox when it happened, but subsequent events vindicated the strategy. China Mangalu, the CEO and promoter of the company was a person of high ambitions and nothing was enough for him.

The obsession with ITC

Chetan realized that the biggest stumbling block in the discussion would be the perceived "hero-worship" of ITC as a company and the stretagies and financial parameters of the giant company. In several discussions in the past, the directors have directly and indirectly alluded to ITC's diversification, ITC's growth, ITC's allocation of resources and ultimately ITC's sterling performance. Quite objectively, Chetan considered some of the arguments to be sound, but he disagreed that a smaller company like Cryptodiversify should "ape" the bigger company parameter by parameter. Such a step would neither be fully feasible nor advisable. For the 5th time in the day, Chethan studied the broad parameters of ITC Ltd.

The financial overview of ITC Ltd

Although the Board were all keen followers of ITC, Chetan thought it fit to include the following paragraph as a preliminary reading before he went to his analysis and recommendations. This was an extract from Capitaline database:

ITC Ltd is one of India's foremost private sector companies. ITC has a diversified presence in Cigarettes, Hotels, Paperboards & Specialty Papers, Packaging, Agri-Business, Packaged Foods & Confectionery, Information Technology, Branded Apparel, Personal Care, Stationery, Safety Matches and other FMCG products. While ITC is an outstanding market leader in its traditional businesses of Cigarettes, Hotels, Paperboards, Packaging and Agri-Exports, it is rapidly gaining market share even in its nascent businesses of Packaged Foods & Confectionery, Branded Apparel, Personal Care and Stationery. (Source: Capitaline Financial database. www.capitaline.com. Visited on 1st July, 2019)

ITC Ltd			
Industry : Cigarettes			
Year	Mar 17	Mar 18	Mar 19
Key Ratios			
Current Ratio	1.79	1.47	1.4
Turnover Ratios			
Fixed Assets	3.48	2.49	2.2
Inventory	6.77	5.87	6.18
Debtors	28.48	19.42	15.25
Interest Cover Ratio	343	154.76	318.78
ROCE (%)	35.6	34.92	33.72
RONW (%)	23.45	23.2	22.8
https://www.capitaline.com			

The broad financial position read as follows:

ITC Ltd				
Industry : Cigarettes				
Financial Overview (Rs. In crores)				
	Mar-16	Mar-17	Mar-18	Mar-19
Networth	41,656.43	45,340.96	51,400.07	57,949.79
Capital Employed	41,826.04	45,522.03	51,613.63	58,135.46
Gross Block	15,005.32	16,895.59	18,690.08	22,852.69
Net Working Capital (Incl. Def. Tax)	8,557.35	5,743.69	3,831.87	5,399.95
Current Assets (Incl. Def. Tax)	17,284.31	14,982.86	15,011.31	17,459.45
Current Liabilities and Provisions (Incl. Def. Tax)	8,726.96	9,239.17	11,179.44	12,059.50
Total Assets/Liabilities (excl Reval & W.off)	50,553.00	54,761.20	62,793.07	70,194.96
Gross Sales	51,944.57	55,448.46	44,329.77	45,784.39
Net Sales	36,582.67	40,088.68	40,627.54	44,995.65
Other Income	1,769.26	1,985.91	2,542.74	2,484.54
Value Of Output	36,779.22	39,444.51	39,585.69	45,175.79
Cost of Production	19,105.87	21,035.07	20,658.37	24,024.35
Selling Cost	2,114.41	2,132.77	2,232.86	2,618.28
PBIDT	15,506.68	16,586.33	18,106.67	19,813.90
PBDT	15,434.75	16,541.00	17,997.07	19,755.86
PBIT	14,506.00	15,548.29	16,961.30	18,502.20
PBT	14,434.07	15,502.96	16,851.70	18,444.16
PAT	9,328.37	10,200.90	11,223.25	12,464.32
Revenue earnings in forex	3,643.74	4,609.00	4,189.00	4,673.00
Revenue expenses in forex	1,460.44	1,301.00	1,506.00	4,320.00
Capital expenses in forex	211.25	527	532	0
Book Value (Unit Curr)	51.77	37.33	42.12	47.27
Market Capitalisation	2,63,988.63	3,40,673.36	3,12,307.91	3,63,713.60

The broader financial figures are shown below:

https://www.capitaline.com

ITC Ltd			
Industry : Cigarettes			
Year	Mar 17	Mar 18	Mar 19
Price Earning (P/E)	33.39	27.82	29.17
Price to Book Value (P/BV)	7.51	6.08	6.28
Price/Cash EPS (P/CEPS)	30.31	25.25	26.4
EV/EBIDTA	20.38	17.11	18.17
Market Cap/Sales	6.14	7.05	7.94
https://www.capitaline.com			

ITC Ltd			
Industry : Cigarettes			
Financial Performance			
Year End	Mar-17	Mar-18	Mar-19
Equity	1,214.74	1,220.43	1,225.86
Networth	45,340.96	51,400.07	57,949.79
Enterprise Value	3,37,951.93	3,09,731.02	3,59,956.00
Capital Employed	45,522.03	51,613.63	58,135.46
Gross Block	16,895.59	18,690.08	22,852.69
Sales	55,448.46	44,329.77	45,784.39
Other Income	1,985.91	2,542.74	2,484.54
PBIDT	16,586.33	18,106.67	19,813.90
PBDT	16,541.00	17,997.07	19,755.86
PBIT	15,548.29	16,961.30	18,502.20
PBT	15,502.96	16,851.70	18,444.16
RPAT	10,200.90	11,223.25	12,464.32
Book Value (Rs)	37.33	42.12	47.27
EPS (Rs.)	8.4	9.2	10.17
Dividend (%)	475	515	575
Payout (%)	67.05	51.41	50.43
Rate of Growth (%)			
Net Worth	8.85	13.36	12.74
Sales	6.75	-20.05	3.28
PAT	9.35	10.02	11.06
M Cap	29.05	-8.33	16.46
https://www.capitaline.com			

The value driver parameters read as follows

Cryptodiversity and its operations

Originally, the company was started as a garments exporter. The promoters even at that time, were dreaming of a diversified set up. So much so, in the mission and vision statements of the company, a statement read "To do multiple sectors of business and be a muti-faceted company". The company, set up in 2001, had the foresight to include diversification and possible areas in their Memorandum of Association. The garments exports business enabled the company to have good revenues and at the same time earn fringe benefits from the Government in respect of rewards for earning foreign exchange. As the years progressed, the company started foraying into other areas - notably restaurants chain, then pharmaceutical distribution, and the one launched last year - department stores. China Mangalu was always particular that whatever the diversification chosen, it should be uncorrelated, going by the Markowitz principles of optimizing risk and return.

The latest financial statements in abstract read as follows:

Year End	**Mar-17**	**Mar-18**	**Mar-19**
Equity	118.3	122.043	122.586
Networth	445	445	445
Enterprise Value	29688	30973.1	35995.6
Capital Employed	20112	5161.363	5813.546
Gross Block	1480	1520	1560
Sales	4700	4650	4900
Other Income	198.591	254.274	248.454
SOURCE: Annual reports of Cryptodiversity for last three years			

Cryptodiversity (Rs. In crores)

SOURCE: Annual reports of Cryptodiversity for last three years

Issues at hand

The important issues that needs to be covered in the report are:

1. Given the extent of diversification of ITC, and the relatively smaller areas of diversification that Cryptodiversify has (only 4 divisions), would it make sense to study and eventually emulate the parameters of ITC?

2. How effective are ratios in these situations?
3. Diversification is a factor of risk parameters, availability of resources, a reasonable market for the new division and based on a necessity. In Cryptodiversity's case, Chetan felt, there was really no necessity for this. Company was adequately diversified into4 divisiosn, and given the scale of operations, the risk-return matrix was going fine. The ROE and ROA were good. How do we adequately address the argument of the Board that each ratio parameter has to match subject to small differences.
4. Real options frameworks needed to be revisited. The broad theory will have us believe that if a new division shows a negative NPV, it need not be rejected outright, but we could explore for nested possibilities and future expansions and include this on the lines of a call option. The setting up of this negative NPV project will then result in the company getting a right without an obligation to embark upon an expansion. This decision will be taken based on developments over a period of time. The longer the period available the better. If after this period, the expansion does not look feasible, then the ideas is dropped. At that point of time the only loss the company incurs is the negative NPV of the original projects, which is like a call premium paid on a call that is not eventually exercised. In other words, such diversification hopes for volatility and if the volatility is favourable the project makes a killing, otherwise suffers a loss. Chetan was of the emphatic opinion that this game can be played only by those companies who have very high reserves and are desperate for investment opportunities. In Cryoptodiversity's case,, vertical expansion is easier. That made more sense and would probably return better results. Going into diversification for the sake of it and sinking good money for the possibility of expansion did not appeal to him. Also, the question of assessment of volatility of the diversification possibility was always going to be difficult.
5. Which of the ratios of a giant should be considered for emulation? What are the parameters of comparison?
6. As a conclusion, what should be the strategic recommendation to the management- consolidate on the gains of the existing divisions, or try to diversify further, and take the risk of fall in returns in the ensuing years, but hoping for long term gains?

ITC - a description

A statement in ITC's annual report of 2018 caught Chetan's attention:

"The centrally anchored initiative of conducting external independent reviews of key business processes with high 'value at risk' continued during the year. The Risk Management Committee met thrice during the year and was updated on the status and effectiveness of the risk management plans. The Audit Committee was also updated on the effectiveness of your Company's risk management systems and policies".

SOURCE: ITC annual report. Capitaline Financial database (www.capitaline.com)

Value at risk involves a good estimation of volatility. The measure is very appealing when you know the possible volatility and use statistical principles under the Normal curve to come the 95% or 99% probability of not losing more than a stipulated amount. Cryptodiversity did not have the wherewithal to measure risk like this. Besides, this should be a matter of policy rather than being reckoned on a one-off basis.

Chetan realized that he needed to be clear in his note on the following:

- The ratios calculation of the two companies and how they compare
- A broad framework for diversification, naïve diversification, redundant diversification, risk-return pre and post diversification
- How do we select projects for diversification? How do we measure the statistical measures required for this?
- What is the applicability of the real options framework to this situation?
- How can one develop a sustainable real options framework for the organization? What time period into the future do we look into? How much of losses can be suffer calling it "call premium"?
- Final suggestions and views

Chetan knew that was going to face stiff opposition from the Board. He decided to be ready with all conceptual background. In case his arguments are not accepted, he will have to explore his options. He was clear that whatever the common-sized statements and ratios would show cannot be taken on face value to determine strategies. He would have a preferred a clear Real Options model with separate projection on variability that would throw more light on possible scenarios.