The effect of Excise Tax increase on Valuation of Gudang Garam (GGRM) and HM Sampoerna (HMSP)

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Recommendation:

BUY GGRM with target price of Rp 97.700

BUY HMSP with target price of Rp 2.800

-We believe the market selloff over recent tax hikes is overdone

-Forecasted dividend yields for both HMSP and GGRM are high at current price

-Our valuations for both GGRM and HMSP suggest they are both under priced

Recent increase in taxes sparks industry wide selloff

The Indonesian government has a history of increasing excise tax rate on cigarettes as part of its attempt to reduce smoking rate in Indonesia. The average annual excise tax increase during 2010 - 2018 is 9.7%, considerably lower than the recently announced 23% excise tax increase effective January 2020. The announcement led to massive selloffs for major cigarette manufacturers Gudang Garam (GGRM) and HM Sampoerna (HMSP), leading the stock prices to dip 18.2% and 20.6% respectively.

Long term fundamentals still strong

We do not think the government will continue to increase the excise tax aggressively in the coming years. Historically, a large increase in the tax is always followed by a relatively small increase the following year. The cigarette business are large contributors of tax income to Indonesia and the government likely wouldn't want to excessively pressure the sector. Both GGRM and HMSP has shown strong operational resilience in the face of changing consumer preferences and increasingly strict regulations. Net profits and sales volume of both GGRM and HMSP has continued to grow (see table 3 and 4) despite rising tax costs, likely due to strong brand loyalty and the addictive nature of their products.

Dividend yield attractive at current valuations

Both GGRM and HMSP have been consistent in paying out dividends to their shareholders. The excise tax recently announced will only be effective in 2020, and sales figure for the 2019 should be unaffected by it. For the past 4 years, the dividend per share (DPS) for GGRM had been set at IDR 2,600. We expect the company to maintain this rate which at the current price would translate to a dividend yield of 4,8%. Meanwhile, HMSP's strong cash flow also led us to believe that the company will continue to pay out dividends no less than 2018's amount of IDR 117/share which would represent a 4,9% yield at current price. The recent sharp declines in both stock prices combined with their history of consistent dividend payments indicate that both GGRM and HMSP might be undervalued at their current market prices.

PT. GUDANG GARAM Tbk

GGRM Key Figures (As of 2 Oct 2019)

Current Price	IDR 50,850
Market Cap (Rp):	97.8 T
Shares O/S:	1.9 Billion
EPS (Annualized):	4,450
P/E Ratio:	11.4
P/BV Ratio:	2.20
Debt to Equity Ratio:	0.50

ANGGARDA PARAMITA 1913

PT HM SAMPOERNA Tbk.

HMSP Key Figures (As of 2 Oct 2019)

Current Price	IDR 2240
Market Cap (Rp):	260.6 T
Shares O/S:	1.9 Billion
EPS (Annualized):	116
P/E Ratio:	19.3
P/BV Ratio:	9.14
Debt to Equity Ratio:	0.51

Our Valuation for GGRM

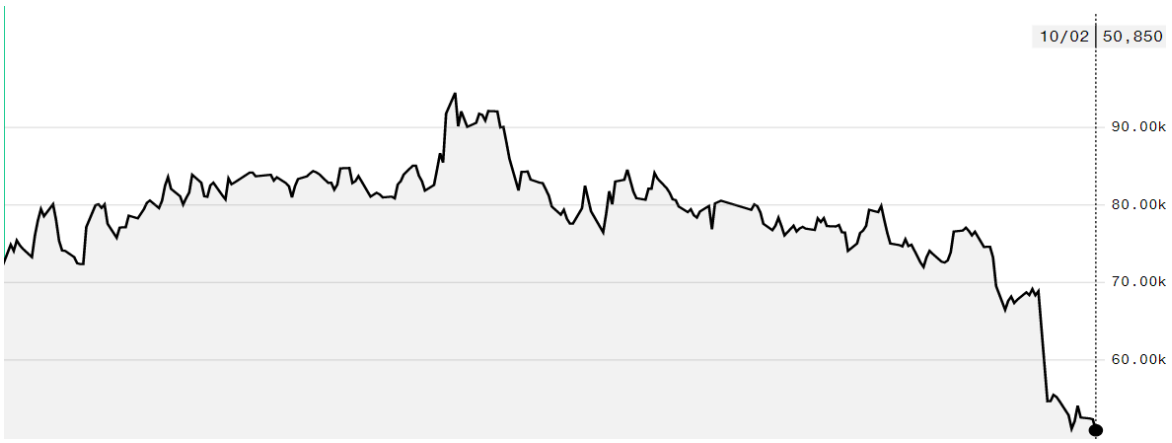
Our discounted cash flow model for GGRM suggest relative undervaluation. We use FCFF forecast and discount using WACC. Growth rate is based on 3 years net income compounded annual growth rate (CAGR). Terminal growth rate is based on the latest Indonesia inflation rates. Risk free rate is based on 30-years Indonesian government bond yield subtract the country risk premium. Market return is taken on 9 years IDX CAGR.

Key Assumptions	
Growth rate	5.07%
Rf	5.91%
Rm	10.44%
Beta	0.77
WACC	8.17%
Terminal Growth	3.30%

Table 1. GGRM DCF Valuation

	Year					
(in Millions of Rupiah)	2019E	2020E	2021E	2022E	2023E	2024E
+ Net Income	11,033,021	10,543,377	11,077,926	11,639,577	12,229,704	12,849,750
+ Interest Expense	1,351,123	1,291,161	1,356,623	1,425,404	1,497,672	1,573,604
- Tax Shield on Interest Expense	-337,780	-322,790	-339,156	-356,351	-374,418	-393,401
+ Non-cash Expense (DA)	3,201,652	3,059,562	3,214,683	3,377,667	3,548,915	3,728,845
- Change in (Current Asset - Current Liabilities)	-2,070,898	-1,978,991	-2,079,327	-2,184,749	-2,295,515	-2,411,898
- Capital Expenditures (CAPEX)	-4,404,377	-4,208,911	-4,422,303	-4,646,514	-4,882,092	-5,129,614
Free Cash Flow	8,772,742	8,383,408	8,808,447	9,255,035	9,724,265	10,217,285
PV of FCFF	8,569,816	7,570,942	7,353,970	7,143,215	6,938,501	6,739,653
Total PV of FCFF	44,316,097					
Net Debt	698,494					
Shareholders Value	45,014,590					
Share Price (Rp)	23,395					
Terminal Value	216,723,937					
PV of Terminal Value	142,958,143					
Terminal Price (Rp)	74,299					
Fair Value per Share (Rp)	**97,700**					

Figure 1. GGRM 1-Year Share Price Performance



Source: Bloomberg

Our Valuation for HMSP

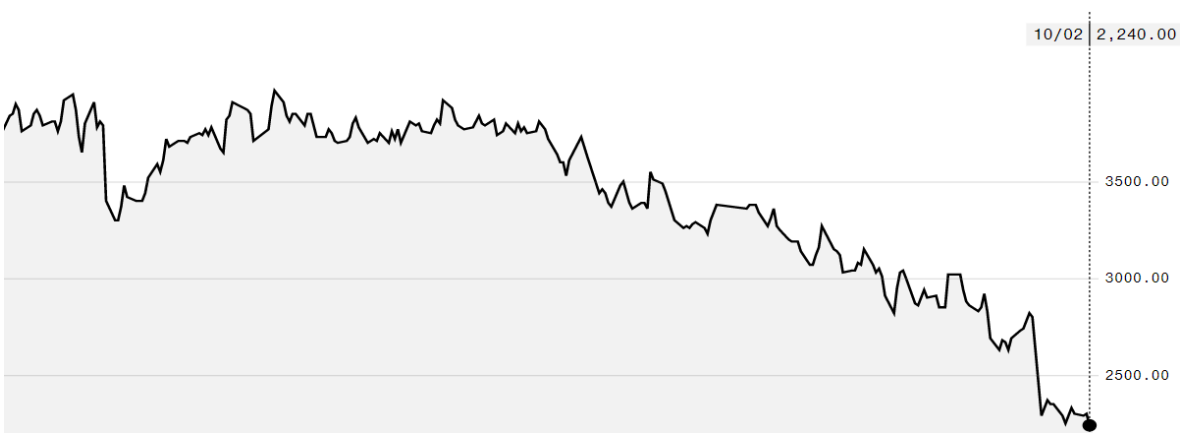
Our discounted cash flow model for HMSP suggest relative undervaluation. We use FCFF forecast and discount using WACC. Growth rate is based on 3 years revenue compounded annual growth rate (CAGR). Terminal growth rate is based on the latest Indonesia inflation rates plus 1% premium because of HMSP's superior competitive advantage. Risk free rate is based on 30-years Indonesian government bond yield subtract the country risk premium. Market return is taken on 9 years IDX CAGR.

Key Assumptions	
Growth rate	5.70%
Rf	5.91%
Rm	10.44%
Beta	0.95
WACC	9.21%
Terminal Growth	4.30%

Table 2. HMSP DCF Valuation

	Year					
(in millions of Rupiah)	2019E	2020E	2021E	2022E	2023E	2024E
+ Net Income	15,931,187	15,316,313	16,189,343	17,112,136	18,087,527	19,118,516
+ Interest Expense	32,104	30,865	32,624	34,483	36,449	38,527
- Tax Shield on Interest Expense	-8,026	-7,716	-8,156	-8,621	-9,112	-9,632
+ Non-cash Expense (DA)	1,062,610	1,021,598	1,079,829	1,141,379	1,206,438	1,275,205
- Change in (Current Asset - Current Liabilities)	-1,256,276	-1,256,276	-1,256,276	-1,256,276	-1,256,276	-1,256,276
- Capital Expenditures (CAPEX)	-1,158,548	-1,113,833	-1,177,322	-1,244,429	-1,315,361	-1,390,337
Free Cash Flow	14,603,051	13,990,951	14,860,043	15,778,673	16,749,665	17,776,003
PV of FCFF	14,224,644	12,479,082	12,136,488	11,799,974	11,469,759	11,146,022
Total PV of FCFF	73,255,968					
Net Debt	16,220,400					
Shareholders Value	89,476,368					
Share price (Rp)	769					
Terminal Value	377,604,310					
PV of Terminal Value	236,767,839					
Terminal Price (Rp)	2,036					
Fair Value per Share (Rp)	**2,800**					

Figure 2. HMSP 1-Year Share Price Performance



Source: Bloomberg

Conclusion: GGRM and HMSP are still fundamentally strong companies. Cigarettes manufacturers face the risks of added pressure from government and society, but those with strong brand loyalty and large market share is well positioned to manage those challenges. We believe that the recent drop in prices provide attractive entry points for both companies. Our models suggest higher upside for GGRM (**92.1%** vs **25.0%** for HMSP), in part due to GGRM's significantly cheaper valuation. While short term volatility is likely, we believe the long term prospects of both companies are still outstanding

Table 3. GGRM Income Growth Related to Excise Tax Increase

Tahun	Sales (bn sticks)	Sales Growth (%)	Excise Tax Increase (%)	Sales (Tr IDR)	Sales Growth (%)	ASP (IDR/sticks)	ASP Growth (%)	Net Profit (Tr IDR)	Net Income Growth (%)
2010	67.9	5.70%	16.00%	37.7	14.30%	555.2	8.20%	4.1	20.00%
2011	68.6	1.10%	6.00%	41.9	11.10%	610.5	10.00%	5	19.60%
2012	73.2	6.80%	16.30%	49	17.10%	669.4	9.60%	4.1	-17.90%
2013	76.6	4.50%	8.50%	55.4	13.10%	724.1	8.20%	4.4	7.70%
2014	80.6	5.30%	0.00%	65.2	17.60%	808.8	11.70%	5.4	23.10%
2015	78.6	-2.50%	8.70%	70.4	7.90%	895.2	10.70%	6.5	19.60%
2016	77.1	-1.90%	11.20%	76.3	8.40%	989.3	10.50%	6.7	3.40%
2017	78.7	2.10%	10.50%	83.3	9.20%	1058.5	7.00%	7.8	16.20%
2018	85.2	8.30%	10.00%	95.7	14.90%	1123.3	6.10%	7.8	0.50%

Table 4. HMSP Income Growth Related to Excise Tax Increase

Tahun	Sales (bn sticks)	Sales Growth (%)	Excise Tax Increase (%)	Sales (Tr IDR)	Sales Growth (%)	ASP (IDR/sticks)	ASP Growth (%)	Net Profit (Tr IDR)	Net Income Growth (%)
2010	78.8	3.80%	16.00%	43.4	11.30%	550.5	7.20%	6.4	26.20%
2011	91.7	16.40%	6.00%	52.9	21.80%	576.4	4.70%	8.1	25.60%
2012	107.7	17.40%	16.30%	66.6	26.00%	618.6	7.30%	9.9	23.30%
2013	111.3	3.30%	8.50%	75	12.60%	674.1	9.00%	10.8	8.80%
2014	105.5	-5.20%	0.00%	80.7	7.60%	764.8	13.50%	10.2	-5.90%
2015	109.8	4.10%	8.70%	89.1	10.40%	811.2	6.10%	10.4	1.80%
2016	105.5	-3.90%	11.20%	95.5	7.20%	904.9	11.60%	12.8	23.10%
2017	101.3	-4.00%	10.50%	99.1	3.80%	978.2	8.10%	12.7	-0.70%
2018	101.4	0.10%	10.00%	106.7	7.70%	1052.7	7.60%	13.5	6.80%

Table 5. GGRM's financial performance

	2017	2018	YoY	1H18	1H19	YoY
Income statement (IDR bn)						
Revenue	83,306	95,708	14.90%	45,305	52,745	16.40%
Gross Profit	18,222	18,644	2.30%	8,989	9,958	10.80%
Operating Profit	11,237	11,157	-0.70%	5,046	5,972	18.40%
Profit before tax	10,437	10,479	0.40%	4,750	5,709	20.20%
Net Profit	7,755	7,793	0.50%	3,556	4,281	20.40%
Profitability						
Divident Payout Ratio	64.50%	64.20%		-	-	
Gross Margin	21.90%	19.50%		19.80%	19.60%	
Operating Margin	13.50%	11.70%		11.10%	11.80%	
Net Margin	9.30%	8.10%		7.80%	8.40%	
Return on Equity	22.70%	22.00%		-	-	

Table 6. HMSP's financial performance

	2017	2018	YoY	1H18	1H19	YoY
Income statement (IDR bn)						
Revenue	99,091	106,742	7.70%	49,158	50,720	3.20%
Gross Profit	24,216	25,491	5.30%	11,429	12,327	7.90%
Operating Profit	16,098	16,981	5.50%	7,623	8,238	8.10%
Profit before tax	16,895	17,961	6.30%	8,061	8,870	10.00%
Net Profit	12,671	13,538	6.80%	6,113	6,770	10.70%
Profitability						
Divident Payout Ratio	98.40%	101.00%		-	-	
Gross Margin	24.40%	23.90%		23.30%	24.30%	
Operating Margin	16.20%	15.90%		15.50%	16.20%	
Net Margin	12.80%	12.70%		12.40%	13.30%	
Return on Equity	37.10%	38.30%		-	-	

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