

Overweight (Maintain)

Industry Report
March 14, 2019

PT. Mirae Asset Sekuritas Indonesia

Consumer

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Tobacco

On the ground: Some ASPs hiked slightly YTD; expect positive volume growth

Strong performance of lower-priced brands

Over the past several years, we have noticed a trend of lower-income smokers choosing cheaper, lower-margin brands. Therefore, cigarette companies, and especially HMSP, have suffered margin deterioration owing to the strong performance of cheaper products. GGRM, meanwhile, claims to see better sales volume growth from Surya Professional (IDR1,050/ stick) in 2018 due to its lower price per stick compared to the other flagship brands, as lower-income people normally buy cigarettes per stick rather than per pack.

Nevertheless, GGRM's margin trend looks better than HMSP's. This is partly because GGRM's margins are helped by the fact that GGRM pays no royalties as HMSP does for its Marlboro-type brands. In recent years, for example, we note that HMSP has been diversifying into lower-priced brands in an attempt to maintain its market share (which dropped to 32.7% in 4Q18 from a high of 36.6% in 3Q13.)

In addition to mild machine-made (SKM LTLN) Magnum Mild, HMSP has also expanded its mid-tar machine-made brands into Marlboro types such as Marlboro Filter Black (launched in 2017) and Marlboro Mild Black (launched in 2018). Royalty payments made up 3.2% of HMSP's 3Q18 operating expenses. All else being equal and excluding royalty expenses, OP margin would have been 26bps higher in 3Q18. Regardless, in 2019, we should see some margin improvements and expect positive sales volume growth, due to zero excise tax growth.

Some ASPs hiked slightly YTD; expect positive volume growth

We have discovered that HMSP hiked some prices in February, including for Marlboro Filter Black (by around 1-1.2% MoM) and Dji Sam Soe Magnum Filter 12 (by around 5% MoM). The latter is geared toward the premium market, and we do not expect the ASP increase to negatively impact sales volume; rather, we think margin expansion (further supported by muted excise tax growth) is likely. Regarding HMSP's cheaper brand, we see a chance of consumers "trading up" their cigarette brand preference. Meanwhile, we have not discovered any material price increases for GGRM's variants as of now. Thus, for GGRM, we look for positive sales volume growth in 1Q19, backed by recovering purchasing power, especially among lower-income people. Notably, minimum wage growth is higher than the tier-1 SKM excise tax growth, which is positive to purchasing power.

Reiterate Overweight on the sector; GGRM is our top pick

We expect GGRM's 4Q18 earnings, which will be released at the end of the month, to be in line with our expectation. According to Philip Morris International (PMI), the parent entity of HM Sampoerna (HMSP), Indonesia's cigarette industry grew slightly in 4Q18 (+0.7% YoY), while HMSP's sales volume was flat YoY. We believe GGRM's slow ASP increase in 4Q18 contributed to positive sales volume growth in the quarter, and we expect the trend to continue in 2019. We reiterate our Overweight stance on the sector, with GGRM as our top pick. The company's valuation should re-rate higher on the back of 1) its better margin outlook for 2019 and 2) its unjustified valuation discount to its closest peer, HMSP.

Tobacco companies covered in this report

Company name	Ticker	Rating	Market cap (IDRbn)	Target price (IDR/share)	Gross margin (%)		ROE (%)		P/E (x)	
					FY19F	FY20F	FY19F	FY20F	FY19F	FY20F
HM Sampoerna	HMSP	Trading buy	442,008.7	4,300	25.5	25.5	41.0	42.7	29.6	27.7
Gudang Garam	GGRM	Buy	174,755.3	101,000	23.4	24.9	21.1	22.8	16.3	13.5

Source: Mirae Asset Sekuritas Indonesia Research

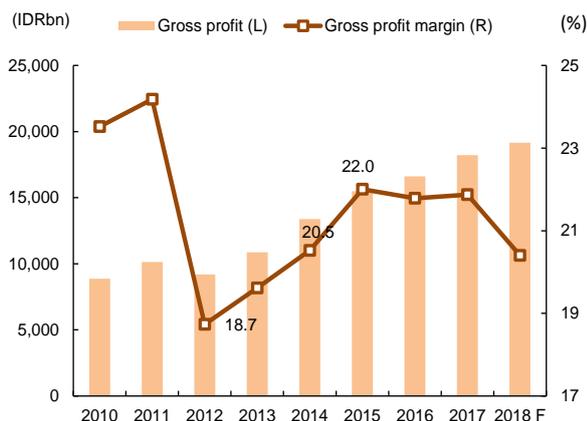
Strong performance of lower-priced brands

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Nevertheless, GGRM's margin trend looks better than HMSP's. This is partly because GGRM's margins are helped by the fact that GGRM pays no royalties as HMSP does for its Marlboro-type brands. In recent years, for example, we note that HMSP has been diversifying into lower-priced brands in an attempt to maintain its market share (which dropped to 32.7% in 4Q18 from a high of 36.6% in 3Q13.)

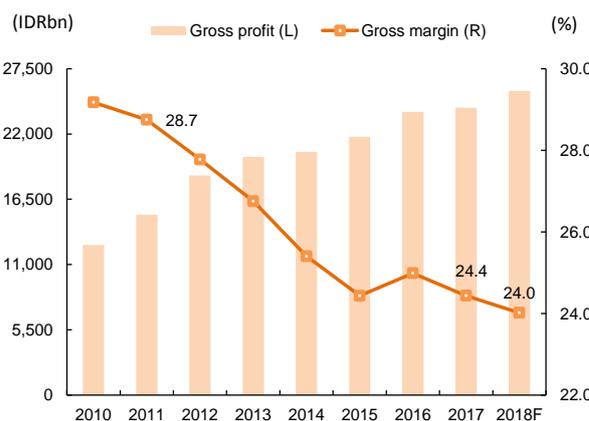
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Figure 1. GGRM's gross margin



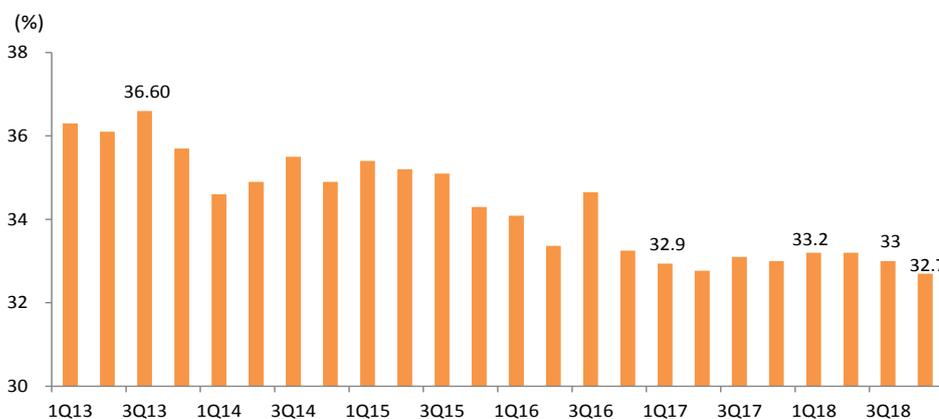
Source: Company data, Mirae Asset Sekuritas research

Figure 2. HMSP's gross margin



Source: Company data, Mirae Asset Sekuritas research

Figure 3. HMSP's market share



Source: PMI, Company data, Mirae Asset Sekuritas research

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Table 1. HMSP brands' prices per pack in the retail space

Brand	(IDR/pack)		
	As of End of Jan-19	As of End of Feb-19	As of 12-Mar-19
A Mild 16	24,800	24,800	24,800
A Mild 12	18,000	18,000	18,000
A Platinum	24,800	24,800	24,800
Dji Sam Soe Super premium 12	20,800	20,800	20,800
Magnum Mild	16,800	16,800	16,800
Dji Sam Soe Magnum Filter 12	18,100	19,000	19,000
U Mild	20,000	20,000	20,000
U Bold	13,800	13,800	13,800
Marlboro Filter black	25,500	25,800	25,800
Marlboro Red 20	26,500	26,500	26,500

Source: Mirae Asset Sekuritas research

Table 2. GGRM brands' prices per pack in the retail space

Brand	(IDR/pack)		
	Jan-19	Feb-19	12-Mar-19
Surya 16	23,000	23,000	23,000
Surya PRO 16	16,800	16,800	16,800
GG Mild 16	17,500	17,500	17,500
GG Signature Mild 16	16,500	16,500	16,500

Source: Mirae Asset Sekuritas research

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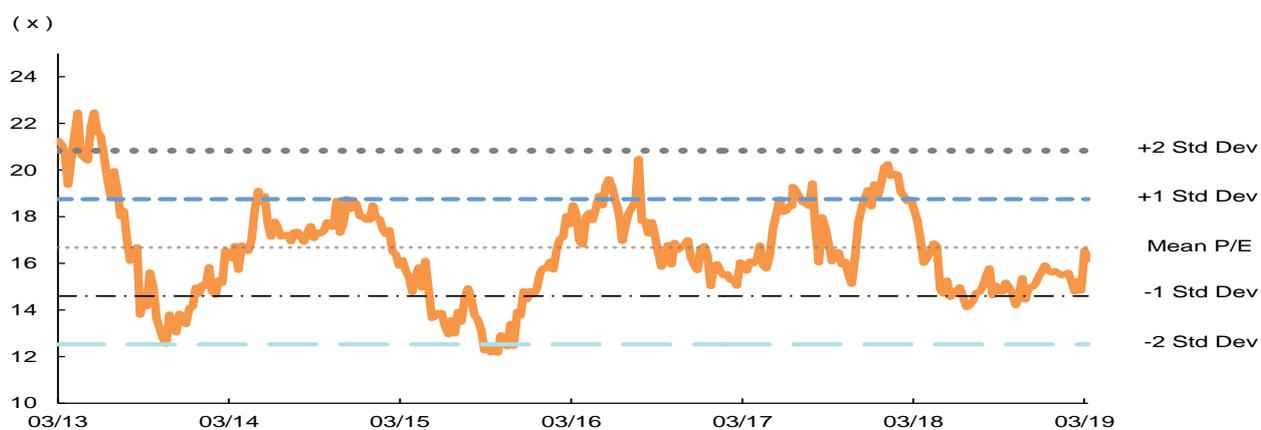
Table 3. GGRM Ex-factory prices

(IDR/pack)

Cigarettes type	As of March 2018	As of June 2018	As of October 2018
Hand rolled			
GG Merah	11,300	11,500	11,500
Machine rolled (Full flavor)			
GG international (12)	15,300	15,550	15,550
GG Surya (16)	19,600	20,000	20,500
Machine rolled (Mild)			
Surya pro mild (16)	13,750	13,750	13,750
GG Mild	14,700	14,700	14,700

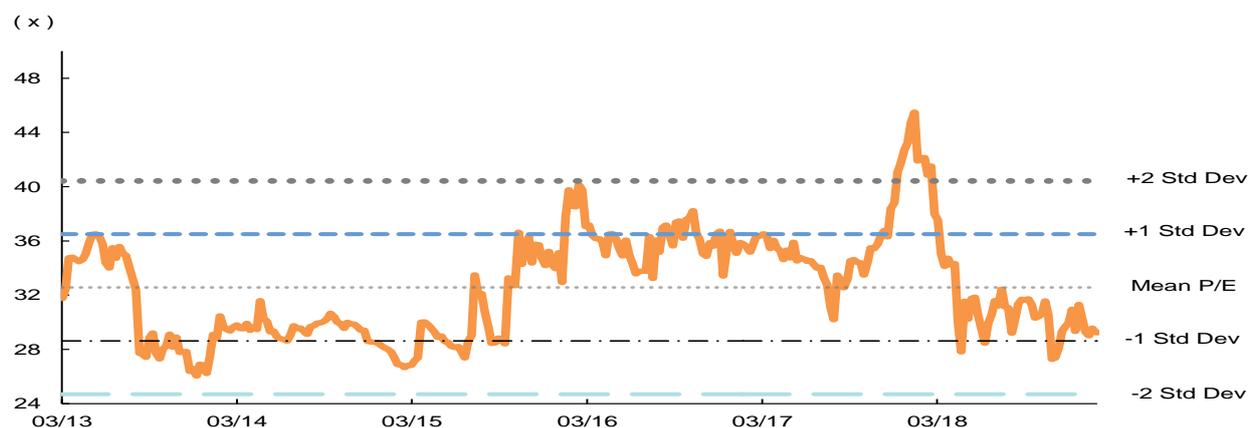
Source: Company data, Mirae Asset Sekuritas research

Figure 4. GGRM forward P/E Band



Source: Bloomberg, Company data, Mirae Asset Sekuritas research

Figure 5. HMSP forward P/E Band



Source: Bloomberg, Company data, Mirae Asset Sekuritas research

APPENDIX 1

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