April 11th, 2016

Initiating Coverage

PT HM Sampoerna Tbk (HMSP)

Massive Puff of Smoke

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PT HM SAMPOERNA Tbk.

NEUTRAL

We initiate coverage on PT HM Sampoerna Tbk (HMSP) as a NEUTRAL, with a 52-week target price of IDR 102,850, representing a 3.9% upside. Our call is mainly due to its premium valuation relatively to peers. Currently, HMSP is trading at 33.8x P/E (compared to its closest rival, GGRM at 19x P/E). However, in the long run, we believe the company would continue to deliver great performance and maintain its position in the industry.

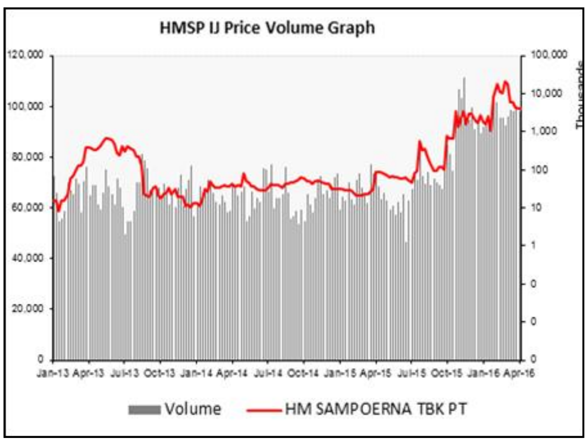
PT Hanjaya Mandala Sampoerna Tbk manufactures hand-rolled and machine-rolled cigarettes. The company distributes its products both in domestic and international market.

Market leader with strong brand equity. HMSP is the market leader in Indonesia cigarette industry, holding 35.2% of total market share. It also leads in all segments with 31%, 39%, and 81% market share for SKM, SKT and SPM respectively. HMSP also owns strong brand equity, proven by its 5 brands dominating the top ten leading cigarette brands.

Current Price: IDR 99,000

52-Week Target Price: IDR 102,850

Strong free cash flow and healthy balance sheet supporting high dividend payout. HMSP owns healthy balance sheet, as it is a zero-debt company since its debt repayment in 2015. In addition, we expect to see strong free cash flow considering its production capacity will be enough in next few years, means no heavy capital expenditure will be needed. HMSP also offers high dividend payout.



Rising middle-income class leads to further "premiumization" trend. The "premiumization" trend as the result of rising middle-income class will benefit HMSP as it focuses on mid and premium price segments. About 68.5% of HMSP products are premium priced, as the rest goes to mid priced products. This will be a positive catalyst to capture more market share in the industry.

Higher than expected excise tax hike. Excise tax along with regional and VAT comprises about 60% of HMSP COGS. Though HMSP possesses pricing power, we view a higher than expected hike could offset the ASP increase effect and eventually lead to margin suppression.

Commodity risks. Any shortage or variances in the quality of HMSP raw materials (tobacco leaves and cloves) as the result of poor harvest season may disrupt its business operations. In addition, both prices of tobacco leaves and cloves will be the key to its profitability.

Share Price Performance	
Price (IDR)	99,000
52-Week High (02/09/16)	112,125
52-Week Low (06/30/15)	69,989
52-Week Beta	0.60
YTD Change/%	5,000 / 5.32%

Stock Information	
Market Cap (IDR)	460,619.6 B
Shares Out/Float (M)	4,652.7 / 349.6

Financial Highlights	2014	2015	2016E	2017F	2018F
Revenue	80,690	89,069	104,985	119,132	136,315
EBITDA	14,384	14,724	15,700	16,531	17,347
EBT	13,718	13,933	15,181	15,972	16,743
Net Income	10,181	10,363	11,290	11,880	12,446
EPS (IDR)	2,306	2,326	2,536	2,669	2,796
Gross Profit Margin	25.4%	24.4%	23.2%	22.1%	20.5%
Net Income Margin	12.6%	11.6%	10.8%	10.0%	9.1%
ROE	75.4%	32.4%	34.7%	35.8%	36.2%
ROA	35.9%	27.3%	28.7%	29.1%	28.9%

Source: Company, Sinarmas Investment Research

Company background

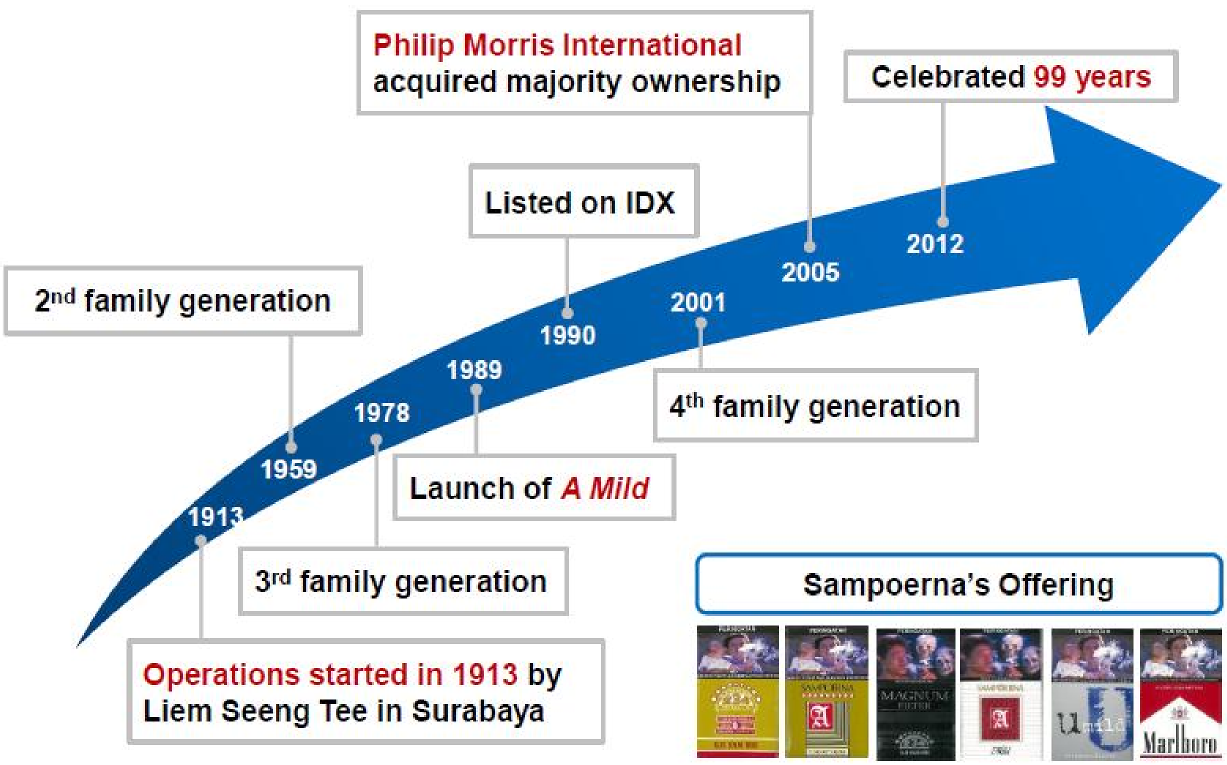
The history of HM Sampoerna started in 1913 when Liam Seng Tee, began its very first business of producing and selling hand-rolled cigarettes under the brand of Dji Sam Soe. Following the success, he then changed the company name into Sampoerna.

In 1959, the business was passed to the second generation, who focused on the production of premium hand-rolled cigarettes, before the third generation took the leadership on 1978. in 1989, the company launched its A Mild brand, which was later considered to be one of the most successful cigarette brands in Indonesia history until now.

A year later, it was listed on IDX. Finally in 2005, HMSP started a new journey after 98% of its stakes were acquired by Phillip Morris International (PMI). Under its new management, HMSP has transformed itself to a well-recognized global cigarette manufacturer, which holds dominant position in the cigarette market.

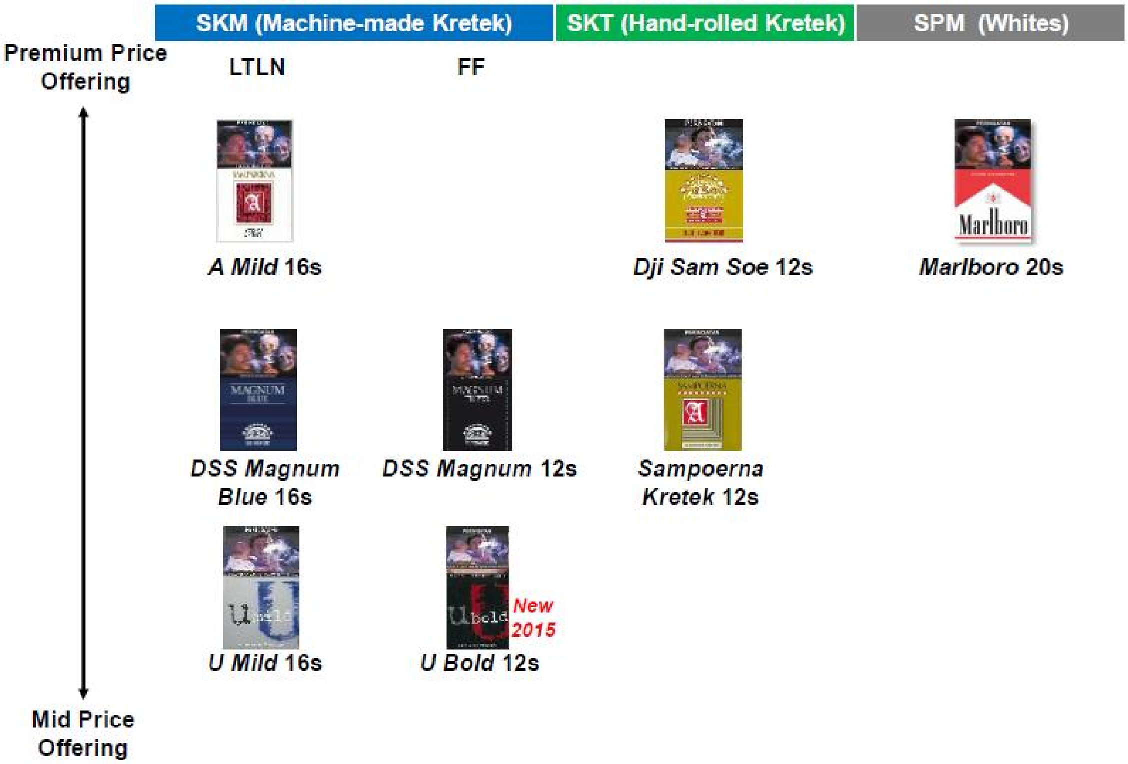
HMSP is now currently the market leader in cigarette industry in Indonesia, owning about 35% of market share, through many leading brands such as Sampoerna A , Dji Sam Soe, U Mild, Sampoerna Kretek and Malboro.

History of HM Sampoerna



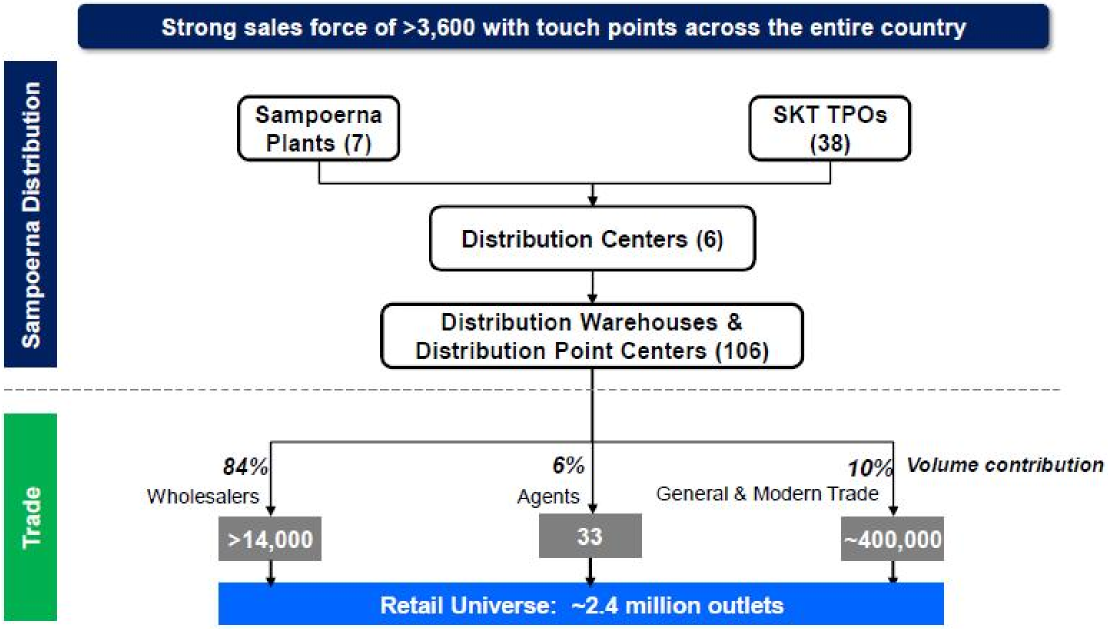
Source: Company

HMSP balanced portfolio



Source: Company

HMSP extensive distribution



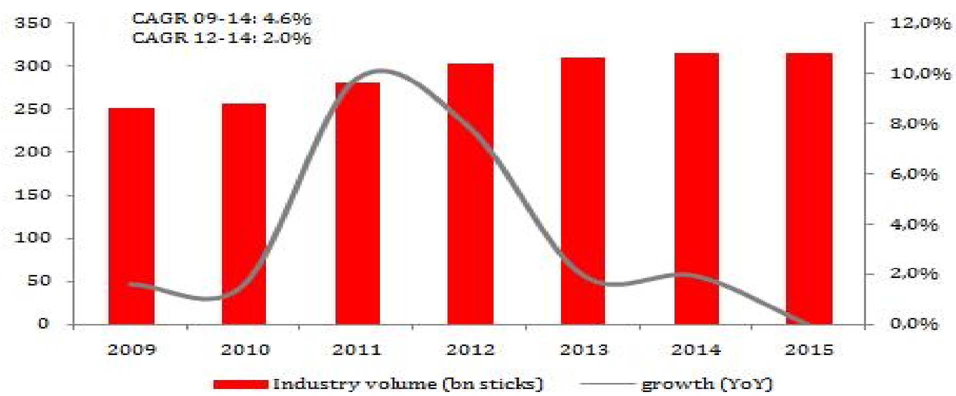
Source: Company

Industry outlook

Kretek cigarettes : culture of Indonesia

Indonesia is an unique kretek cigarettes market, whereas kretek cigarette are made of clove, tobacco and other flavors blend. In Indonesia, kretek cigarettes account for 93% of total Indonesia cigarette market, whereas the rest (7%) goes to the regular white cigarette. There are mainly three types of cigarettes in Indonesia, namely SKT (*Sigaret Kretek Tangan,* or hand-rolled), SKM (*Sigaret Kretek Mesin,* or machine-rolled) and white cigarettes (SPM).

Indonesia - industry cigarettes volume vs annual growth

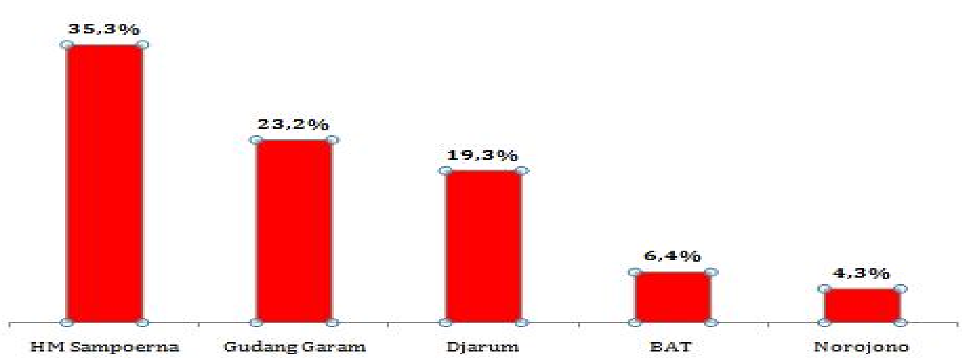


Source: Ministry of finance, Sinarmas Investment Research

Indonesia cigarette industry has shown a rapid volume growth since the last five years, with CAGR 09-14 of 4.6%, totaling 314bn sticks in 2014. However, the industry saw a flat volume last year, mainly due to the economic slowdown. Though, considering the economy recovery, we still expecting to see a potential industry growth of 1-2% in the next few years. This of course, supported by the continued demand inelasticity in the cigarette market.

Five players owned 89% of total industry market share. Indonesia cigarette industry is competitive, with three largest players, namely HM Sampoerna, Gudang Garam and Djarum, holding about 78% of the total market share. The next two largest players, BAT Indonesia and Nojorono have a combined market share of 11%. The rest goes to smaller-sized players which mainly penetrated in local market, without having any nationwide presence.

Five biggest players market share (per 1H15)

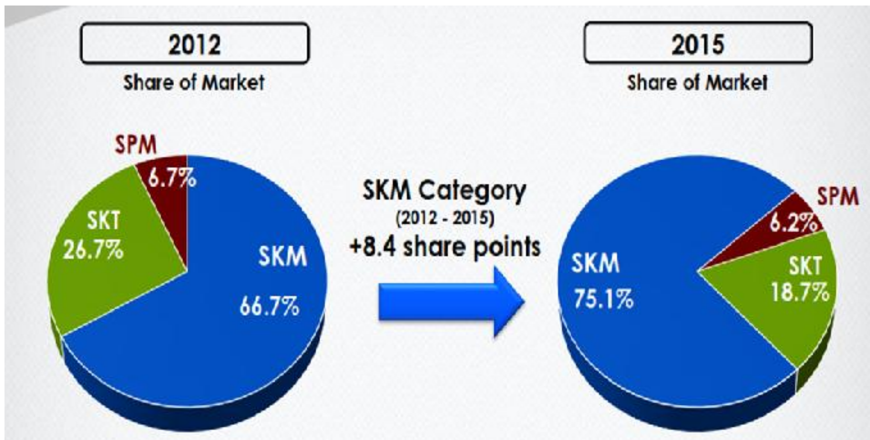


Source: Nielsen, Company, Sinarmas Investment Research

Industry trend: further shifting from SKT to SKM

In the past few years, the industry has started to see a shift in consumer preference from SKT to SKM, and the trend keeps continuing until today. In 2015, the market share of SKM was seen at 75.1%, taking shares from both SKT and SPM . SKT recorded the most significant market share drops over the period, from 26.7% to only 18.7% in 2015. Meanwhile, SPM recorded a slight market share decline, accounted for 6.2% in 2015. This trend will keep on track, therefore we see it to be beneficial for SKM-focused cigarettes producers.

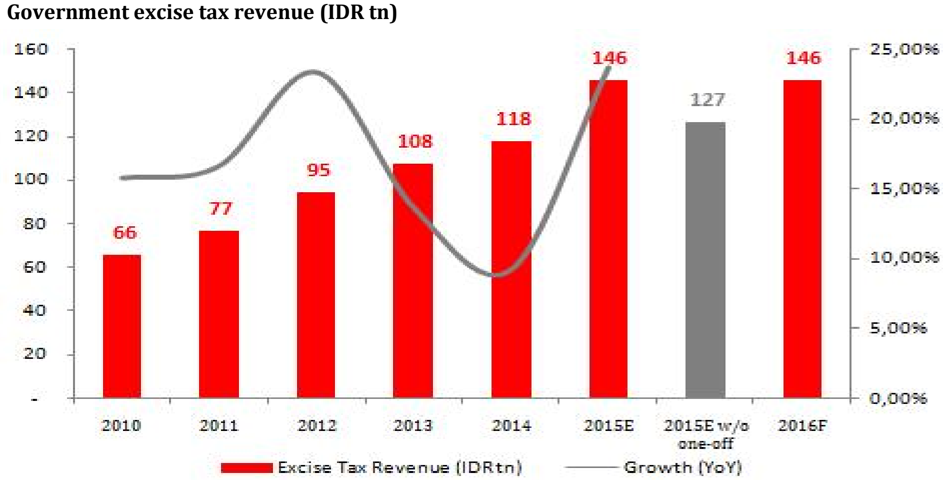
Further shifting trend from SKT to SKM



Cigarette industry main risks: excise tax and VAT hike

Tobacco excise is an important source of government income, accounting for c.8% of total government revenue. Though cigarette industry faces excise tax hike annually, it remains to be the main issue for the industry as 60-70% of cigarette costs are contributed from excise tax along with regional tax and VAT. We still believe that cigarette producers will be easily passing these costs on consumers to maintain its profitability, as long as the excise tax hike remains rational.

Government excise tax revenue (IDR tn)



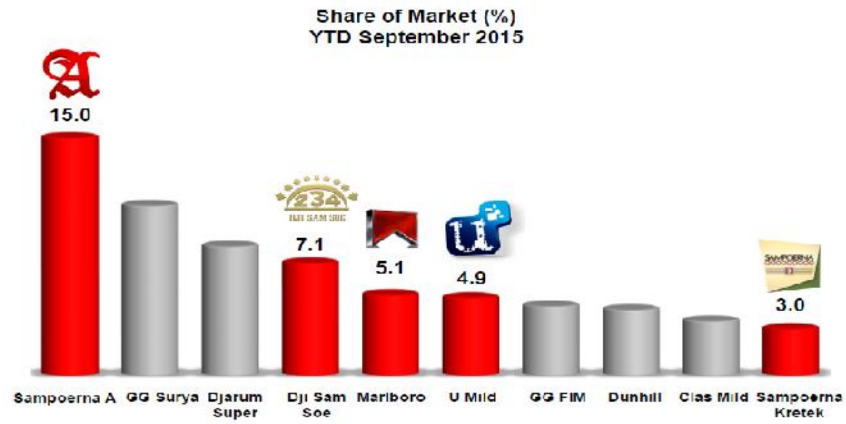
Source: Ministry of finance, Sinarmas Investment Research

Investment theses

Per September 2015, five out of ten most leading cigarette brands were from HMSP's portfolio

- **Strong brand equity.** Being in the business for about 103 years, HMSP has hold strong brand equity which serves to be the strength to maintain its performance amidst the tightening competition. This is mainly supported by its well-known brands. Per September 2015, the data showed that five out of ten most leading cigarette brands were from HMSP's portfolio, consisted of A Mild, Dji Sam Soe, Malboro, U Mild, and Sampoerna Kretek.

HMSP dominates five out of ten most leading cigarette brands in Indonesia

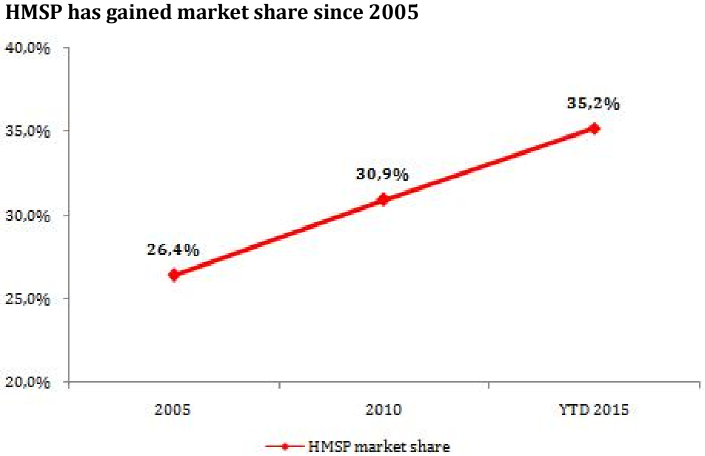


Source: Company

HMSP is the leader of all segments (SKM, SKT and SPM)

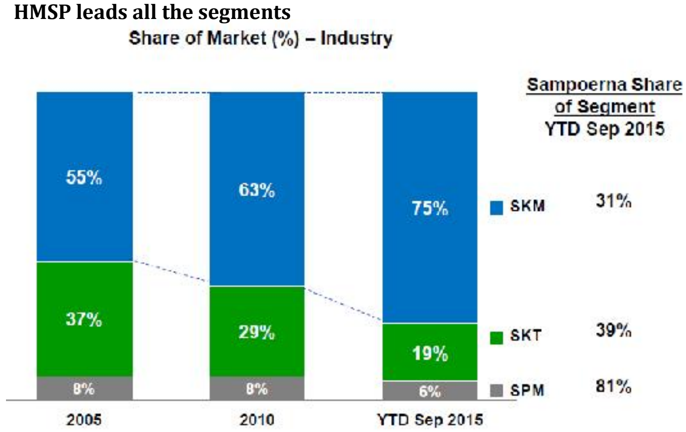
- **Market leader offers future share gains.** HMSP is the market leader for all cigarette segments in Indonesia. Per September 2015, HMSP owned 31%, 39%, and 81% market share in SKM, SKT and SPM segments respectively. Overall, HMSP held market share accounted for 35.2% in the industry. The interesting thing is since 2005, HMSP have succeeded to significantly increase its market share. With top-of-mind brands, we believe there is still more share to be captured by HMSP, especially from smaller-sized players who tend to be vulnerable to excise tax hike issue.

HMSP has gained market share since 2005



Source: Company , Sinarmas Investment Research

HMSP leads all the segments



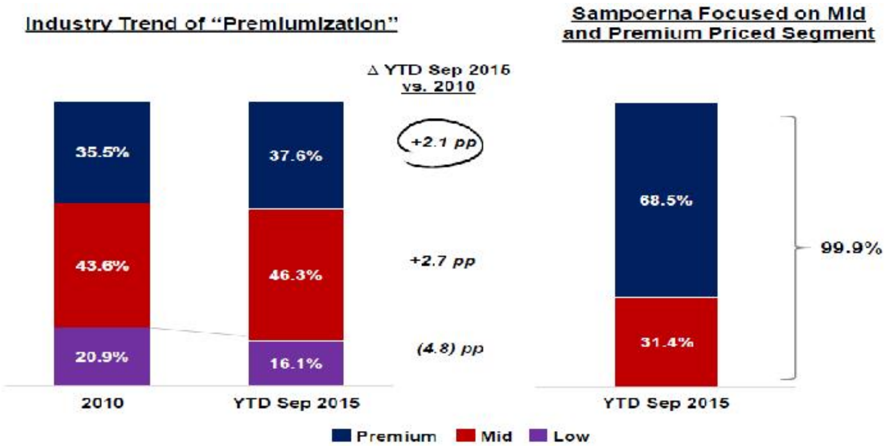
Source: Company

Investment theses

Further "premiumization" trend will benefit HMSP as it focus on mid and premium priced segments

- **Rising middle-income class leads to further "premiumization" trend.** Being a developing country, Indonesia has faced rising middle-income class since a few years earlier. As more low-income class jump to middle-income class, we expect to see a "premiumization" trend. This refers to consumers tend to choose premium products as their disposable income rises. Evidently, the condition also occurs in cigarette industry, which will benefit HMSP as it focus on mid and premium price segments. About 68.5% of HMSP products are premium priced, as the rest goes to mid priced products. The trend will be another driver for HMSP to grab more market share.

Rising middle-income class will enhance the premiumization trend



Source: Company

HMSP offers strong capital return capital with high dividend payout

- **Strong free cash flow and healthy balance sheet, supporting high dividend payout.** HMSP owns healthy balance sheet, as it is a zero-debt company since its debt repayment in 2015. In addition, we also expect to see strong free cash flow considering its production capacity will be enough in next few years, means no heavy capital expenditure will be needed. HMSP also offers strong capital return profile and high dividend payout. Though we expect cigarette sales volume growth to be quite limited, about 1 - 2% per annum, we view HMSP will still able to maintain its profitability contributed from higher selling price.
- **Stock split plan to further boost transaction liquidity.** HMSP has announce its intention to do a stock split with 1:25 ratio in the near term. We view this will be positive to HMSP's stock, as it will be able to boost transaction liquidity.

The risks to our investment theses include

Further excise tax hike in 2016 or far than expected hike next year may be potential risks

- **Further excise tax hike or higher than expected hike next year may impact negatively to margins.** Though we still believe that cigarette producers such as HMSP owns pricing power and could easily pass any tax increase to the consumers, we are still aware of further hike in 2016 or too extreme hike next year. This is because: 1) tightening competition landscape may impact negatively and harm the pricing power of HMSP; 2) HMSP should be more vigilant in determining its pricing strategy in order to maintain market share.
- **Commodity risks: supply and prices level.** Both tobacco leaves and cloves are main raw materials for HMSP production. Any shortage or variances in the quality of its raw materials as the result of poor harvest season may disrupt its business operations. In addition, both prices of tobacco leaves and cloves will be the key to its profitability.
- **Plain packaging for cigarette products will harm HMSP as the market leader.** The "plain packaging cigarette" regulations that diminishes the ability to differentiate tobacco products could be a potential risk, especially for HMSP, the market leader who owns strong brand awareness.
- **Further restrictions in marketing and advertising will limit HMSP, in term of building brand awareness for new products.** Currently, restrictions in marketing and advertising are already in place, and we believe it will not impact negatively to existing cigarette consumption. However, it will limit the effort to built brand awareness for a new-launched products.
- **Millennial health-conscious awareness.** Nowadays, people especially millennial have better awareness on their health. Lots of health awareness programs have been done to protect public against the potential dangers of cigarette. We view this will not reduce cigarette consumption, however will prevent cigarette companies to have a better market penetration.

Our conclusions:

HMSP is the largest cap company in JCI. It is the market leader in Indonesia cigarette industry, leading in all categories due to its various products with strong brand awareness. Looking at its financial outlook, HMSP owns strong profitability and healthy balance sheet, and also offers strong capital return with high dividend payout. Its main risks are the followings: 1) higher than expected excise tax hike; 2) commodity risks.

We are positive on HMSP, yet we believe it will able to maintain its positive performance in 2016. However, we still recommend NEUTRAL considering its premium valuation compared to its peers.

Financial Outlook - 2015 Recap and 2016 Outlook

HMSP financial highlights

in IDR bn	2014	2015	2016E	2017F
Revenue	**80,690**	**89,069**	**104,985**	**119,132**
CoGS	(60,190)	(67,305)	(80,643)	(92,824)
Gross Profit	20,500	21,764	24,342	26,308
EBITDA	14,384	14,724	15,700	16,531
EBT	**13,718**	**13,933**	**15,181**	**15,972**
Tax	(3,537)	(3,569)	(3,891)	(4,092)
Net Income	**10,181**	**10,363**	**11,290**	**11,880**
EPS	2,306	2,326	2,536	2,669
Revenue Growth	7.6%	10.4%	17.9%	13.5%
Gross Profit Growth	25.4%	24.4%	23.2%	22.1%
EBITDA Growth	-4.7%	2.4%	6.6%	5.3%
Net Income Growth	-5.9%	1.8%	8.9%	5.2%
Gross Profit Margin	25.4%	24.4%	23.2%	22.1%
EBITDA Margin	17.8%	16.5%	15.0%	13.9%
Net Income Margin	12.6%	11.6%	10.8%	10.0%

Source: Bloomberg, Sinarmas Investment Research

Amidst the tough environment last year, HMSP managed to book a 10.4% YoY top-line growth as its bottom-line was recorded to flat, only see a 1.8% YoY growth. Top-line growth is mainly supported by increasing ASP as 2015 sales volume is estimated to be flat. However gross profit margin (GPM) was seen at 24.4%, declined from 25.4% in 2014 Along with 1% decrease from its GPM, its net income margin (NIM) shrunk to11.6% (vs 12.6% in 2014).

This year, we expect the economic recovery will bring out a more positive performance for HMSP. We expect revenue and net income to grow by 17.9% and 8.9% YoY respectively. We view the growth will be mostly contributed by ASP increase, as volume growth will be limited expected to be at 1% YoY growth. Therefore, we forecast its NIM to be at 10.8%, decreased from 11.6% in 2015.

HMSP is proposing a stock split plan with ratio of 1:25. We view this will be positive to HMSP's stock, as it will be able to boost transaction liquidity.

Appendix I: Financial Statements

Balance sheet

in IDR bn	2014	2015	2016E	2017F	2018F
Cash	65	1,719	2,208	1,668	1,205
AR	1,010	2,459	1,761	1,998	2,166
Inventories	17,432	19,072	22,588	24,479	26,143
Fixed Assets	5,920	6,281	6,543	6,892	7,093
Total Assets	**28,381**	**38,011**	**39,301**	**40,881**	**43,083**
Account Payables	2,761	3,191	3,624	4,325	4,959
ST Debts	2,835	-	-	-	-
Excise Payables	6,165	-	-	-	-
Total Liabilities	**14,883**	**5,995**	**6,721**	**7,706**	**8,664**
Total Equity	**13,498**	**32,016**	**32,581**	**33,175**	**34,419**

Source: Sinarmas Investment Research

Income statement

in IDR bn	2014	2015	2016E	2017F	2018F
Revenue	**80,690**	**89,069**	**104,985**	**119,132**	**136,315**
CoGS	(60,190)	(67,305)	(80,643)	(92,824)	(108,309)
Gross Profit	20,500	21,764	24,342	26,308	28,006
EBITDA	14,384	14,724	15,700	16,531	17,347
EBT	**13,718**	**13,933**	**15,181**	**15,972**	**16,743**
Tax	(3,537)	(3,569)	(3,891)	(4,092)	(4,297)
Net Income	**10,181**	**10,363**	**11,290**	**11,880**	**12,446**
EPS	2,306	2,326	2,536	2,669	2,796

Source: Sinarmas Investment Research

Appendix I: Financial Statements (Con't)

Cash flow

in IDR bn	2014	2015	2016E	2017F	2018F
Net Income	**10,181**	**10,363**	**11,290**	**11,880**	**12,446**
Depreciation	578	676	526	551	599
Working Capital	951	(13,602)	28	(846)	(1,589)
Operating CF	**11,710**	**(2,563)**	**11,845**	**11,585**	**11,457**
Capital Expenditure	(1,789)	(1,037)	(788)	(900)	(800)
Investing CF	**(1,858)**	**(1,102)**	**(630)**	**(838)**	**(719)**
Debts	393	(2,835)	-	-	-
Dividends	(10,817)	(12,259)	(10,725)	(11,286)	(11,202)
Financing CF	**(10,445)**	**5,319**	**(10,725)**	**(11,286)**	**(11,202)**
Net - Cash Flow	(592)	1,654	489	(539)	(464)
Beginning Cash	657	65	1,719	2,208	1,668
Ending Cash	**65**	**1,719**	**2,208**	**1,668**	**1,205**

Source: Sinarmas Investment Research

Key ratios

	2014	2015	2016E	2017F	2018F
Revenue Growth	7.6%	10.4%	17.9%	13.5%	14.4%
Gross Profit Growth	25.4%	24.4%	23.2%	22.1%	20.5%
EBITDA Growth	-4.7%	2.4%	6.6%	5.3%	4.9%
Net Income Growth	-5.9%	1.8%	8.9%	5.2%	4.8%
EPS Growth	-6.6%	0.9%	9.0%	5.2%	4.8%
ROE	75.4%	32.4%	34.7%	35.8%	36.2%
ROA	35.9%	27.3%	28.7%	29.1%	28.9%
Debt to Equity	21.0%	0.0%	0.0%	0.0%	0.0%

Source: Sinarmas Investment Research

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