

Equities

4 January 2012 | 7 pages

Japan Tobacco (2914)

Alert: Consumption tax hike likely to be positive for JT

- Conclusion** — On December 30, a government tax panel approved plans to raise the consumption tax to 8% in April 2014 and to 10% in October 2015. The government is expected to submit relevant bills to the regular Diet session by the end of March. If the bills are passed we believe the implications for JT's earnings would be positive. We estimate a consumption tax hike to 8% would only increase the retail price of a pack of cigarettes by ¥20. This would probably have only a limited effect on sales volume and we calculate it would boost JT's OP by more than ¥20bn.
- Consumption tax hike to 8% from 5% in 2014** — This would probably increase the price of a pack of Mild Seven to ¥430 from ¥410, increasing the after-tax price of a single cigarette to ¥5.51 from ¥5.23. Based on our FY3/15 forecast for JT cigarette sales volume of 101.1bn units, we calculate this would boost OP by ¥21.6bn (price hike impact of +¥28.3bn less volume decline impact of -¥6.7bn). We estimate demand elasticity of 0.2–0.3 for a price hike of this size, meaning that the volume decline only has a limited impact on profit.
- Breakdown of current retail price** — The current Mild Seven retail price of ¥410/pack breaks down to tobacco tax of ¥244.88, consumption tax of ¥19.52, and a retailer margin of ¥41.00. The price after deducting these amounts is ¥104.6, which works out to a price per cigarette of ¥5.23.
- Breakdown of prospective retail price** — If the Mild Seven retail price increases to ¥430/pack, the breakdown changes to tobacco tax of ¥244.88, consumption tax of ¥31.85, and a retailer margin of ¥43.00. The price after deducting these amounts is ¥110.27, which works out to a price per cigarette of ¥5.51.

Company Update

Buy	1
Price (04 Jan 12)	¥378,000
Target price	¥450,000
Expected share price return	19.0%
Expected dividend yield	2.2%
Expected total return	21.3%
Market Cap	¥3,599,117M
	US\$46,949M

Price Performance (RIC: 2914.T, BB: 2914 JP)



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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Japan Tobacco

Valuation

Our ¥450,000 target price is based on a DCF model. Using earnings forecasts for FY3/12-FY3/15 we derive a theoretical price of ¥445,000, and base our target price on this. We assume a 3% risk-free rate, a 5% equity-risk premium, a beta of 1.05, a 47% tax rate, and a zero terminal growth rate, producing a WACC of 6.5%.

Risks

We see the following as risks for our target price: 1) economic turmoil in Eastern Europe and Asia could impede growth in earnings from overseas cigarettes businesses; 2) the value of sterling, the ruble, and other key currencies could drop sharply against the dollar, impairing earnings from overseas cigarette sales; 3) class action lawsuits against tobacco companies could spread beyond the US; 4) tax increases could put downward pressure on domestic cigarette consumption; 5) JT's domestic market share could decline if foreign competitors lower their prices; and 6) JT's domestic market share could decline due to damages to certain key factories from earthquake; 7) investors could shift away from JT into cyclical in response to economic recovery. If these factors manifest themselves differently than we have anticipated, the share price may fail to reach our target price.

On the other hand, a sharp increase in shipments of higher-priced products or the reduction of factory or personnel costs could result in upside risk. Should the effects of these risk factors differ from our assumptions, the shares may overshoot our target price.

Appendix A-1

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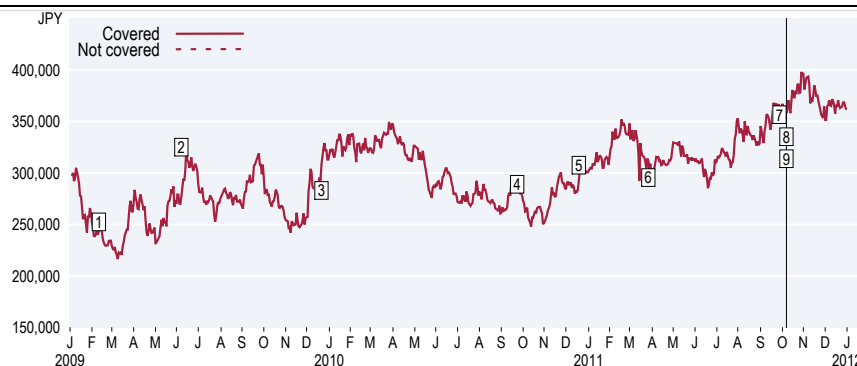
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Japan Tobacco (2914)

Ratings and Target Price History Fundamental Research

Analyst: Nobuyoshi Miura



	Date	Rating	Target Price	Closing Price
1	11-Feb-09	1M	*380,000	240,000
2	8-Jun-09	1M	*460,000	277,000
3	22-Dec-09	1M	*480,000	308,000

* Indicates change

	Date	Rating	Target Price	Closing Price
4	23-Sep-10	1M	*390,000	282,200
5	20-Dec-10	1M	*410,000	291,900
6	27-Mar-11	1M	*370,000	314,000

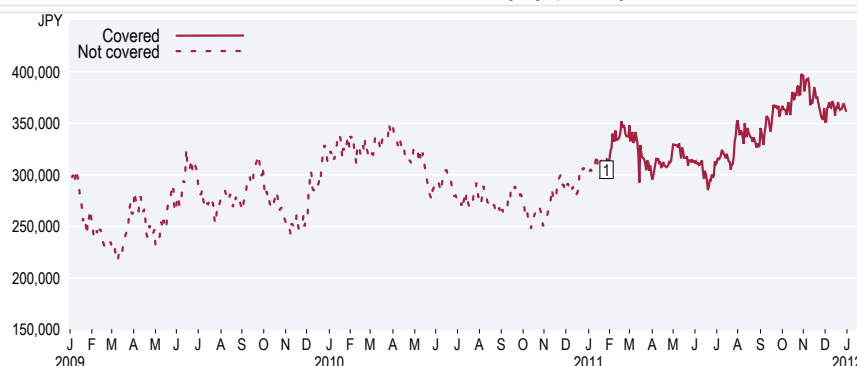
	Date	Rating	Target Price	Closing Price
7	28-Sep-11	1M	*450,000	356,500
8	7-Oct-11	Stock rating system changed		
9	7-Oct-11	*1	450,000	358,000

Rating/target price changes above reflect Eastern Standard Time

Japan Tobacco (2914)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Nobuyoshi Miura



	Date	Rating	Target Price	Closing Price
1	27-Jan-11	*ADD MP	-	315,500

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Data current as of 31 Dec 2011

	12 Month Rating			Relative Rating		
	Buy	Hold	Sell	Buy	Hold	Sell
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