Korean Air (003490 KS)

Transportation

Strong turnaround

Raise TP to W70,000; Maintain Buy call

We maintain our Buy call on Korean Air and raise our target price to W70,000 (from W62,000). We arrived at our target price by applying a P/B of 1.6x (the company's P/B level during the middle of the previous up cycle) to our 12-month forward BPS of W43,623. We believe our target P/B is reasonable, considering that: 1) the company's highest P/B level during 2007~present was 2.5x, and 2) the airline industry seems set to enter an up cycle. In reflection of strong passenger flight demand and oil price falls, we raised our 2012 and 2013 operating profit estimates to W708.3bn (from W451.4bn) and W1.34tr (from W1.05tr), respectively. We anticipate Korean Air's shares to fare well relative to those of its peers, driven by: 1) robust demand for long-haul routes (especially for Korea-US routes), 2) emerging signals of meaningful improvements to the cargo market, and 3) the recovery of earnings momentum.

2Q Review: Results beat the consensus

Korean Air's 2Q consolidated operating profit came in at W128.5bn (W100.1bn on a non-consolidated basis), exceeding both our estimate and the consensus (our estimate was in the upper part of the market estimate range). The airline delivered significant margin improvement in the quarter, as: 1) revenues expanded 11.1% YoY on robust international revenue passenger kilometers (RPK; up 10.1% YoY), and 2) fuel costs only inched up 3.1% YoY (fuel consumption: up 0.2% YoY). On the non-operating side, the airline incurred a net loss of W158.5bn due to F/X-related losses (W136.2bn) and equity-method losses (W47.9bn). This result was weaker than our expectations. However, had the US$/W rate at end-2Q (W1,145) matched our assumption (W1,130), the company's 2Q net profit/loss result would not have missed our estimate by much. Since we believe that earnings at Hanjin Shipping Holdings improved in 2Q, we think that Korean Air's 2Q equity-method losses stemmed largely from its S-Oil shares.

Uncertainties surrounding KAI to linger

Meanwhile, uncertainties surrounding Korean Air's potential acquisition of Korea Aerospace Industries (KAI) should linger for the time being. Korean Air has confirmed that it would only be willing to acquire KAI if the acquisition price was reasonable. Korean Air held W1.23tr in cash and cash equivalents as of end-2Q. It should be noted that the airline recently issued corporate bonds worth W400bn, and that corporate bonds due in 2H (mostly in 3Q) amount to W500bn. Given that the company's cash level seems sufficient to cover 2H bond-related payments, the recent bond issues could be viewed as part of the company's efforts to finance the acquisition. But if the acquisition price of KAI is not especially high, Korean Air should be able to finance the deal with cash. In addition, the airline believes that it could raise additional capital given the current ample liquidity situation in the capital market. Therefore, unless Korean Air pays a high price to acquire KAI, the acquisition is unlikely to have a significant impact on the company's corporate value, in our view.

Earnings & Valuation Metrics

FY	Revenues (Wbn)	OP (Wbn)	OP Margin (%)	NP (Wbn)	EPS (Won)	EBITDA (Wbn)	FCF (Wbn)	ROE (%)	P/E (x)	P/B (x)	EV/EBITDA (x)
12/10	11,640	1,236	10.6	563	7,678	2,361	2,818	19.5	9.1	2.1	7.2
12/11	12,269	460	3.8	-219	-2,983	1,803	1,770	-8.4	-	1.5	9.2
12/12F	13,412	708	5.3	678	9,239	2,113	1,331	24.7	5.6	1.4	7.9
12/13F	14,358	1,339	9.3	1,000	13,635	2,622	1,410	28.7	3.8	1.0	6.1
12/14F	14,951	1,523	10.2	985	13,425	2,764	1,571	22.6	3.9	0.8	5.3

Note: All figures are based on consolidated K-IFRS; NP refers to net profit attributable to controlling interests
Source: Company data, KDB Daewoo Securities Research estimates

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Buy (Maintain)

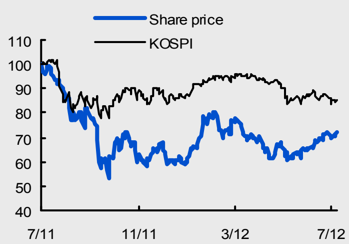
Target Price (12M, W)	**70,000**
Share Price (07/19/12, W)	51,800
Expected Return (%)	35.1
EPS Growth (12F, %)	TTB
Market EPS Growth (12F, %)	17.1
P/E (12F, x)	5.6
Market P/E (12F, x)	9.3
KOSPI	1,822.96
Market Cap (Wbn)	3,728
Shares Outstanding (mn)	73
Avg Trading Volume (60D, '000)	472
Avg Trading Value (60D, Wbn)	23
Dividend Yield (12F, %)	0.0
Free Float (%)	68.2
52-Week Low (W)	38,050
52-Week High (W)	72,300
Beta (12M, Daily Rate of Return)	1.17
Price Return Volatility (12M Daily, %, SD)	2.8
Foreign Ownership (%)	13.9

Major Shareholder(s)
Hanjin et al. (25.67%)
National Pension Service (9.21%)
Treasury shares (6.17%)

Price Performance

(%)	1M	6M	12M
Absolute	9.5	10.0	-26.1
Relative	13.2	14.8	-11.7

Key Business
An airline that focuses on both passenger and cargo transportation.



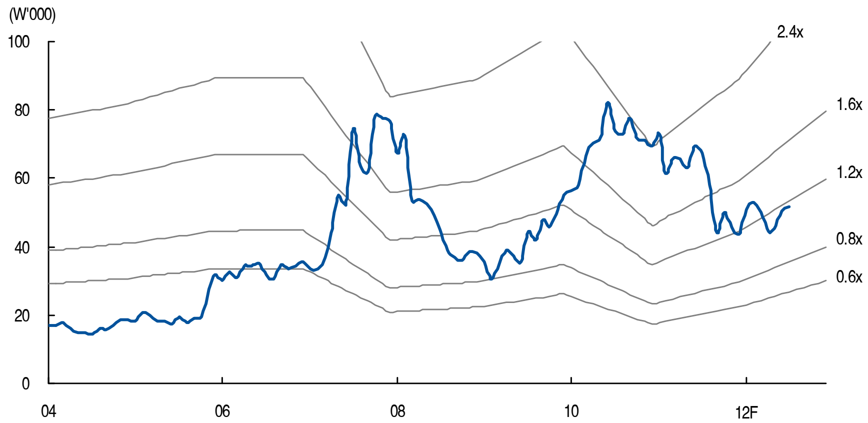
Raise TP to W70,000; Maintain Buy call

1) Raise TP to W70,000

We maintain our Buy call on Korean Air and raise our target price to W70,000 (from W62,000). We arrived at our target price by applying a P/B of 1.6x (the company's P/B level during the middle of the previous up cycle) to our 12-month forward BPS of W43,623. In reflection of strong passenger flight demand and oil price falls, we raised our 2012 and 2013 operating profit estimates to W708.3bn (from W451.4bn) and W1.34tr (from W1.05tr), respectively. We also revised up our 3Q operating profit forecast from W304.4bn to W435.4bn, but the figure is still lower than 3Q10 result. Given that the company guided for an operating profit higher than the 3Q10 level, our forecast seems conservative.

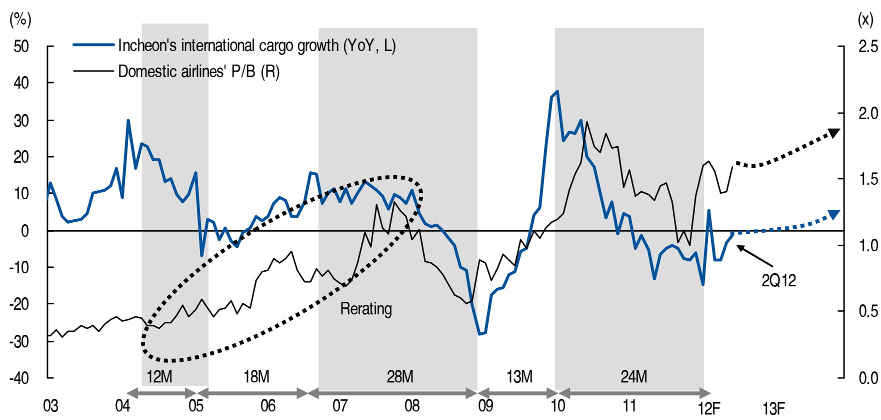
Our bright outlook for the company is based on the following: 1) 1) robust demand for long-haul routes (especially for Korea-US routes), 2) emerging signals of meaningful improvements to the cargo market after three years of stagnation, and 3) the recovery of earnings momentum after almost two years of downtrend since 3Q10.

Figure 1. Korean Air's P/B band



Source: KDB Daewoo Securities Research

Figure 2. IIA's international cargo traffic growth vs. domestic airlines' P/B



Source: Bloomberg, IIA, KDB Daewoo Securities Research

Table 1. Earnings forecast revisions (Wbn, W, %)

	2011	Previous		Revised		Chg. %	
		12F	13F	12F	13F	12F	13F
Revenues	12,269	13,275	14,221	13,412	14,358	1.0	1.0
Operating profit	460	451	1,055	708	1,339	57.0	26.9
Pretax profit	-260	616	906	803	1,342	30.4	48.1
Net profit	-219	483	671	671	993	38.9	48.0
EPS	-2,983	6,680	9,239	9,239	13,635	38.3	47.6

Note: Figures are based on consolidated K-IFRS

Source: Company data, FN Guide, KDB Daewoo Securities Research

Table 2. Quarterly earnings forecasts (Wbn, %, %p)

	2011				2012F				2Q12 growth		2011	2012F	2013F
	1Q	2Q	3Q	4Q	1Q	2QP	3QF	4QF	QoQ	YoY			
Revenues	2,821	2,944	3,313	3,191	2,998	3,272	3,691	3,451	9.1	11.1	12,269	13,412	14,358
Operating profit	163	-20	240	77	-99	129	435	243	TTB	TTB	460	708	1,339
Pretax profit	369	35	-717	53	-28	-220	720	331	RR	TTR	-260	803	1,342
Net profit	271	21	-536	45	-64	-158	612	281	RR	TTR	-200	671	993
OP margin	5.8	-0.7	7.2	2.4	-3.3	3.9	11.8	7.0	-	-	3.8	5.3	9.3
Pretax margin	13.1	1.2	-21.7	1.7	-0.9	-6.7	19.5	9.6	-	-	-2.1	6.0	9.3
NP margin	9.6	0.7	-16.2	1.4	-2.1	-4.8	16.6	8.2	-	-	-1.6	5.0	6.9
RPK growth (YoY,%)	3.0	6.4	10.6	10.2	9.7	10.1	8.5	10.2	0.4	3.6	7.6	9.6	10.2
L/F (%)	77.7	78.3	79.1	74.8	75.7	79.0	78.0	75.0	4.3	0.7	77	77	77
Jet fuel (US$/bbl)	121	131	126	129	132	112	123	123	-15.1	-14.6	127	122	125
US$/W rate	1,120	1,084	1,085	1,145	1,131	1,119	1,120	1,090	-1.1	3.3	1,109	1,115	1,064

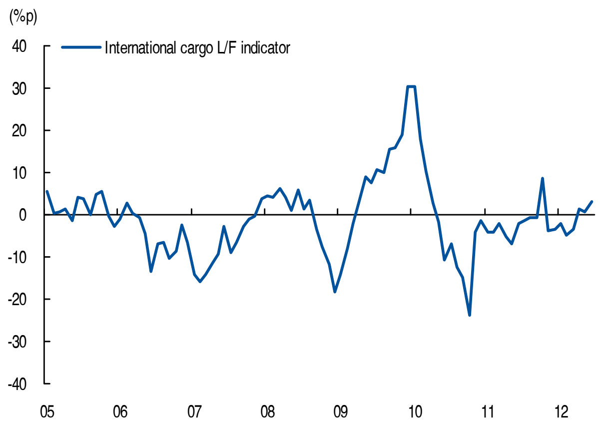
Note: Figures are based on consolidated K-IFRS

Source: Company data, FN Guide, KDB Daewoo Securities Research

2) Cargo market likely to pick up

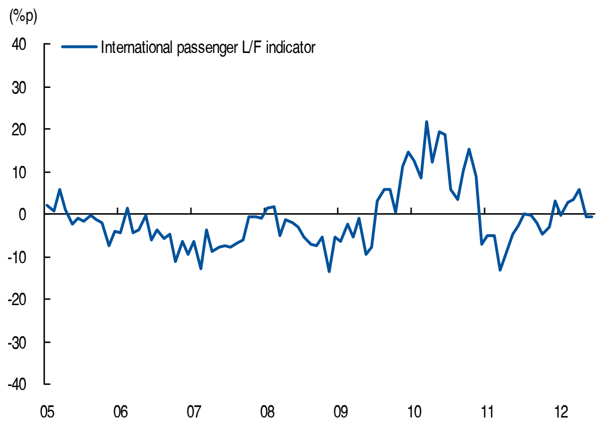
While passenger demand has been steadily growing, cargo demand remained depressed, as the KORUS FTA and the 2012 Summer Olympics did not boost demand as much as anticipated in 1H. However, the cargo market is showing signs of slight improvement (after over two years of slowing growth). Air cargo load factor is clearly recovering, as airlines cut supply in response to tepid demand (June load factor edged up 1.9%p YoY to 77.5%). Improvements in load factor suggest stable cargo supply/demand and increased likelihood of a rate hike. The cargo yield, which fell from US$0.33 in April to US$0.30 in June, is also anticipated to rebound to above US$0.31 in 2H on a more favorable supply/demand situation and seasonal demand.

Figure 3. International cargo L/F indicator



Source: IIA, KDB Daewoo Securities Research

Figure 4. International passenger L/F indicator



Source: IIA, KDB Daewoo Securities Research

2Q12 Review: Results beat the consensus

Korean Air's 2Q consolidated operating profit came in at W128.5bn (W100.1bn on a non-consolidated basis), exceeding both our estimate and the consensus (our estimate was in the upper part of the market estimate range). The airline delivered significant margin improvement in the quarter, as: 1) revenues expanded 11.1% YoY on robust international revenue passenger kilometers (RPK; up 10.1% YoY), and 2) fuel costs inched up only 3.1% YoY (fuel consumption: up 0.2% YoY).

On the non-operating side, net interest expense remained flat YoY at W136bn. However, the airline incurred a net loss of W158.5bn due to F/X-related losses (W136.2bn) and equity-method losses (W47.9bn). This result was weaker than our expectations. However, had the US$/W rate at end-2Q (1,145) matched our assumption (1,130), the company's 2Q net profit/loss would not have missed our estimate by much. Since we believe that earnings at Hanjin Shipping Holdings improved in 2Q, we think that Korean Air's 2Q equity-method losses stemmed largely from its S-Oil shares.

Table 3. 2Q12 earnings and consensus (Wbn, %)

	2Q11	1Q12	2Q12P			Growth	
			Actual	Daewoo Est.	Consensus	YoY	QoQ
Revenues	2,944	2,998	3,272	3,203	3,177	11.1	9.1
Operating profit	-20	-99	128	92	68	TTB	TTB
OP margin	-0.7	-3.3	3.9	2.9	2.1	-	-
Pretax profit	35	-28	-220	6	-94	TTR	RR
Net profit	21	-64	-158	5	-64	TTR	RR

Note: Figures are based on consolidated K-IFRS

Source: Company data, FN Guide, KDB Daewoo Securities Research

Table 4. 2Q12 earnings in detail (Wbn, %)

	2Q11	1Q12	2Q12P	Growth	
				YoY	QoQ
Operating revenue	2,944	2,998	3,272	11.1	9.1
Operating expense	2,964	3,097	3,143	6.0	1.5
Operating profit	-20	-99	129	TTB	TTB
Non-operating profit/loss	55	70	-349	TTR	TTR
Foreign currency translation gains/losses	165	147	-136	-	-
Net interest expense	-135	138	-136	-	-
Equity-method gains	39	47	-48	-	-
Net profit before income tax	36	-29	-220	TTR	RR
Net profit	21	-67	-159	TTR	RR

Note: Figures are based on consolidated K-IFRS

Source: Company data, FN Guide, KDB Daewoo Securities Research

Table 5. Korean Air's shareholding in related companies (Wmn)

Name of related company	Shareholding	1Q12 Equity method gains/losses	1Q12 Book value
S-Oil Corporation	28.4%	84,067	2,354,787
Hanjin Transportation Co., Ltd.	21.6%	68	111,557
Hanjin Shipping Holdings Co., Ltd.	27.4%	-32,832	57,447
Grandstar Cargo Int'l Airlines Co., Ltd.	25.0%	-2,674	7,867
Tianjin Hanjin-Sino Trans Air Cargo Terminal Co., Ltd.	61.9%	-76	9,303
Hanjin GTNS	25.0%	75	310
Hanjin Central Asia MChJ.	100.0%	-	176
Incheon Aviation Tech.	90.0%	-	11,700
Wangsan Leisure Development	100.0%	-	6,000
Total		48,628	2,559,147

Source: DART, KDB Daewoo Securities Research

RPK for Korean Air's Japanese and China routes jumped 28% and 18%, respectively. And RPK for the US routes and transit demand recovered, growing by 4% and 15%, respectively. Rates increased 3.3% YoY (dollar basis), and load factor climbed 0.7 %p YoY to 79%.

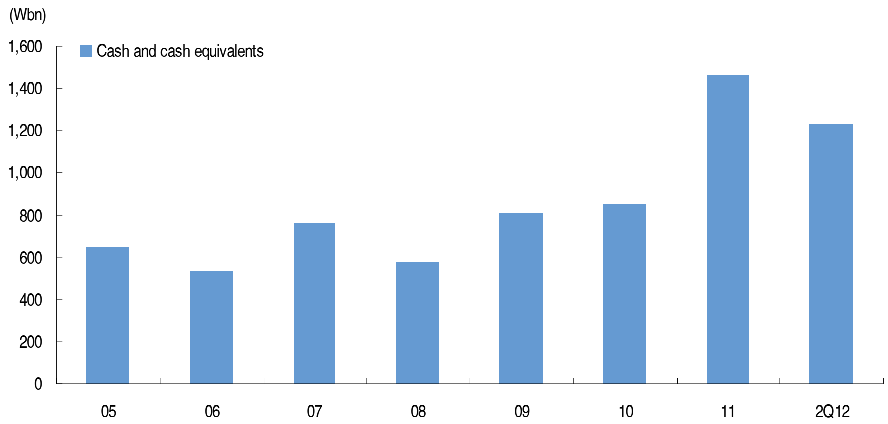
Meanwhile, FTK contracted 12.2% YoY. Cargo revenues declined across all routes YoY (13% in total), but particularly hard on US and European routes (down 19% and 11%, respectively).

Uncertainties surrounding KAI to linger

Korean Air has confirmed that it would only be willing to acquire KAI if the acquisition price was reasonable. The company held W1.23tr in cash and cash equivalents as of end-2Q, and recently issued corporate bonds worth W400bn. Although W500bn of corporate bonds are coming due in 2H (mostly in 3Q), it appears that the company is increasing its cash holdings to finance the acquisition.

If the acquisition price is not especially high, Korean Air should be able to finance the deal with cash. In addition, the airline believes that it could raise additional capital given the current ample liquidity situation in the capital market. Therefore, unless Korean Air pays a high price to acquire KAI, the acquisition is unlikely to have a significant impact on the company's corporate value, in our view. However, given the company's debt-to-equity ratio of over 800% as of end-2Q, a leveraged buyout may worsen the financial position of the company. Thus, uncertainties surrounding the acquisition deal should linger for the time being.

Figure 5. Korean Air's cash and cash equivalents



Source: KDB Daewoo Securities Research

Table 6. Korean Air's corporate bond repayment schedule (Wbn)

Type	Expiration date	Annual interest	As of end-1Q12
#36-1 Debenture	8/06/12	6.50%	230
#36-3 Debenture	8/06/12	6M LIBOR + 6.80%	85
#27-2 Debenture	9/17/12	5.00%	50
#37-1 Debenture	10/29/12	6.10%	100
#29-2 Debenture	11/12/12	5.00%	40
2H12 Total			505
#39 Debenture	1/15/13	3M LIBOR + 4.45%	68
#38-1 Debenture	2/24/13	5.95%	100
#30-2 Debenture	3/06/13	5.00%	100
#31-2 Debenture	5/14/13	5.00%	80

Source: DART, KDB Daewoo Securities Research

Korean Air (003490 KS/Buy/TP: W70,000)

Comprehensive Income Statement (Summarized)

(Wbn)	12/11	12/12F	12/13F	12/14F
Revenues	12,269	13,412	14,358	14,951
Cost of Sales	10,540	11,148	11,276	11,608
Gross Profit	1,729	2,264	3,082	3,342
SG&A Expenses	1,269	1,556	1,743	1,819
Operating Profit (Adj)	460	708	1,339	1,523
Operating Profit	460	708	1,339	1,523
Non-Operating Profit	-721	95	3	-202
Net Financial Income	535	554	534	489
Net Gain from Inv in Associates	124	61	151	151
Pretax Profit	-260	803	1,342	1,321
Income Tax	-61	132	349	344
Profit from Continuing Operations	-200	671	993	978
Profit from Discontinued Operations	0	0	0	0
Net Profit	-200	671	993	978
Controlling Interests	-219	678	1,000	985
Non-Controlling Interests	19	-7	-7	-7
Total Comprehensive Profit	-275	555	877	862
Controlling Interests	-279	583	905	890
Non-Controlling Interests	4	-28	-28	-28
EBITDA	1,803	2,113	2,622	2,764
FCF (Free Cash Flow)	1,770	1,331	1,410	1,571
EBITDA Margin (%)	14.7	15.8	18.3	18.5
Operating Profit Margin (%)	3.8	5.3	9.3	10.2
Net Profit Margin (%)	-1.8	5.1	7.0	6.6

Statement of Financial Condition (Summarized)

(Wbn)	12/11	12/12F	12/13F	12/14F
Current Assets	3,350	4,068	4,719	5,341
Cash and Cash Equivalents	1,466	1,795	2,310	2,837
AR & Other Receivables	971	1,303	1,388	1,449
Inventories	435	471	502	524
Other Current Assets	272	294	314	327
Non-Current Assets	19,038	18,898	18,976	18,841
Investments in Associates	2,612	2,571	2,722	2,873
Property, Plant and Equipment	14,196	13,787	13,432	13,117
Intangible Assets	343	314	288	264
Total Assets	22,388	22,966	23,695	24,182
Current Liabilities	6,626	6,882	7,021	7,120
AP & Other Payables	426	460	491	512
Short-Term Financial Liabilities	4,666	4,763	4,763	4,763
Other Current Liabilities	1,534	1,659	1,768	1,845
Non-Current Liabilities	12,994	12,782	12,494	12,055
Long-Term Financial Liabilities	9,275	9,027	8,817	8,255
Other Non-Current Liabilities	3,030	2,910	2,676	2,643
Total Liabilities	19,619	19,664	19,516	19,175
Controlling Interests	2,460	3,033	3,938	4,793
Capital Stock	367	367	367	367
Capital Surplus	233	233	233	233
Retained Earnings	1,939	2,613	3,613	4,564
Non-Controlling Interests	309	269	242	214
Stockholders' Equity	2,769	3,302	4,179	5,007

Cash Flows (Summarized)

(Wbn)	12/11	12/12F	12/13F	12/14F
Cash Flows from Op Activities	1,866	2,302	2,320	2,682
Net Profit	-200	671	993	978
Non-Cash Income and Expense	2,162	1,470	1,629	1,787
Depreciation	1,312	1,373	1,254	1,215
Amortization	31	31	28	26
Others	-138	13	136	136
Chg in Working Capital	-76	453	195	261
Chg in AR & Other Receivables	-49	-193	-86	-60
Chg in Inventories	-83	-35	-31	-22
Chg in AP & Other Payables	-65	44	30	21
Income Tax Paid	-20	-291	-497	-344
Cash Flows from Inv Activities	-427	-494	-849	-828
Chg in PP&E	-616	-587	-900	-900
Chg in Intangible Assets	-2	-2	-2	-2
Chg in Financial Assets	64	20	0	0
Others	127	75	53	74
Cash Flows from Fin Activities	-833	-1,469	-956	-1,328
Chg in Financial Liabilities	-1,151	-1,139	-2,400	-1,200
Chg in Equity	-3	0	0	0
Dividends Paid	0	0	0	-34
Others	322	-630	-747	-731
Increase (Decrease) in Cash	614	330	515	527
Beginning Balance	852	1,466	1,795	2,310
Ending Balance	1,466	1,795	2,310	2,837

Forecasts/Valuations (Summarized)

	12/11	12/12F	12/13F	12/14F
P/E (x)	-	5.6	3.8	3.9
P/CF (x)	2.8	1.8	1.7	1.7
P/B (x)	1.5	1.4	1.0	0.8
EV/EBITDA (x)	9.2	7.9	6.1	5.3
EPS (W)	-2,983	9,239	13,635	13,425
CFPS (W)	15,330	28,382	31,122	30,347
BPS (W)	28,899	37,096	49,791	61,784
DPS (W)	0	0	500	0
Payout ratio (%)	0.0	0.0	3.4	0.0
Dividend Yield (%)	0.0	0.0	1.0	0.0
Revenue Growth (%)	5.4	9.3	7.1	4.1
EBITDA Growth (%)	-23.6	17.1	24.1	5.4
Operating Profit Growth (%)	-62.8	53.9	89.0	13.8
EPS Growth (%)	TTR	TTB	47.6	-1.5
Accounts Receivable Turnover (x)	13.4	12.9	12.2	12.1
Inventory Turnover (x)	31.0	29.6	29.5	29.2
Accounts Payable Turnover (x)	46.8	44.4	44.3	43.8
ROA (%)	-0.9	3.0	4.3	4.1
ROE (%)	-8.4	24.7	28.7	22.6
ROIC (%)	4.0	4.8	8.6	10.2
Liability to Equity Ratio (%)	708.6	595.6	467.0	383.0
Current Ratio (%)	50.6	59.1	67.2	75.0
Net Debt to Equity Ratio (%)	443.1	357.1	264.8	199.2
Interest Coverage Ratio (x)	0.8	1.2	2.3	2.7

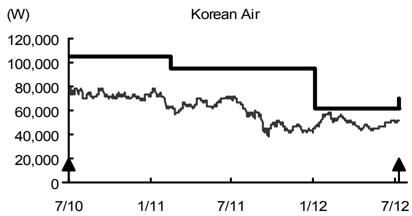
Source: Company data, KDB Daewoo Securities Research estimates

Important Disclosures & Disclaimers

Disclosures

As of the publication date, Daewoo Securities Co., Ltd. has acted as a liquidity provider for equity-linked warrants backed by shares of Korean Air as an underlying asset, and other than this, Daewoo Securities has no other special interests in the covered companies.
As of the publication date, Daewoo Securities Co., Ltd. issued equity-linked warrants with Korean Air as an underlying asset, and other than this, Daewoo Securities has no other special interests in the covered companies.

Stock Ratings	Buy	Relative performance of 20% or greater
	Trading Buy	Relative performance of 10% or greater, but with volatility
	Hold	Relative performance of -10% and 10%
	Sell	Relative performance of -10%
Industry Ratings	Overweight	Fundamentals are favorable or improving
	Neutral	Fundamentals are steady without any material changes
	Underweight	Fundamentals are unfavorable or worsening



* Ratings and Target Price History (Share price (—), Target price (----), Not covered (■), Buy (▲), Trading Buy (■), Hold (●), Sell (◆))
* Our investment rating is a guide to the relative return of the stock versus the market over the next 12 months.
* Although it is not part of the official ratings at Daewoo Securities, we may call a trading opportunity in case there is a technical or short-term material development.
* The target price was determined by the research analyst through valuation methods discussed in this report, in part based on the analyst's estimate of future earnings.
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