

# Hyundai Rotem

(064350 KS)

## Next stop: Earnings recovery

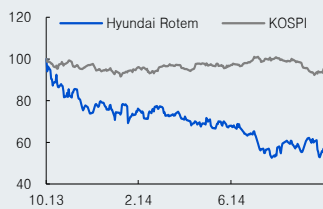
### Machinery

Company Report  
October 28, 2014

(Initiate)	<b>Buy</b>
Target Price (12M, W)	<b>27,100</b>
Share Price (10/29/14, W)	22,100
Expected Return	23%

OP (14F, Wbn)	69
Consensus OP (14F, Wbn)	70
EPS Growth (14F, %)	-62.0
Market EPS Growth (14F, %)	4.9
P/E (14F, x)	33.2
Market P/E (14F, x)	12.3
KOSPI	1,961.17
Market Cap (Wbn)	1,879
Shares Outstanding (mn)	85
Free Float (%)	50.5
Foreign Ownership (%)	25.4
Beta (12M)	-0.26
52-Week Low	20,450
52-Week High	38,750

(%)	1M	6M	12M
Absolute	2.3	-19.5	0.0
Relative	5.7	-19.3	0.0



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### Company snapshot

Hyundai Rotem is Korea's largest railway rolling stock manufacturer. It was founded in 1999 as Korea Rolling Stock Corporation, when the rolling stock divisions of Hyundai Precision & Industries, Daewoo Heavy Industries, and Hanjin Heavy I&C merged as part of a government-led restructuring. The following year, the company purchased the battle-tank and machinery/plant divisions of Hyundai Precision & Industries, becoming an affiliate of the Hyundai Group. The company changed its name to Hyundai Rotem in 2007 and went public in October 2013.

Hyundai Rotem has three main business areas: rolling stock, defense, and plants. The rolling stock division is the company's largest business; it has a domestic monopoly, and has been seeking inroads overseas. We expect growth to remain slow but stable in the short term, but we see strong growth prospects from overseas expansion in the long term. We believe the defense business is poised for steady upward growth, having secured more than three years' worth of production. In our view, the plant business has the strongest growth potential, supported by a captive market and overseas forays.

### A reliable bet during downturns

Although Hyundai Rotem's growth tends to lag during economic upturns, the company generally maintains stable growth amid downturns. Backed by its solid footing in the domestic market, the rolling stock business has been expanding abroad into the US, South America, and Southeast Asia. The defense business has locked in growth for the next decade with the recent mass production of K2 battle tanks and the planned production of a new wheeled combat vehicle in 2016. The plant business has clinched orders for 2015 thanks to captive demand from Hyundai Motor Group (HMG), and has also been making advances overseas, which should support sustainable growth going forward.

### Ample new orders in 2014

In 4Q, we expect Hyundai Rotem's new orders and order backlog to reach record highs of W3.8tr (+29% YoY) and W6.7tr (+12% YoY), respectively, driven by K2 tank and plant orders. The defense unit should gain orders for around 100 K2 tanks before the end of the year, bringing full-year defense orders to over W1.1tr. Orders at the plant unit should also rise markedly, bolstered by capacity ramp-ups by affiliates Kia Motors and Hyundai Steel. For the rolling stock unit, overseas orders remain disappointing, but we still expect overall orders to be stable, helped by KTX orders and replacement demand.

### Initiate coverage with Buy and TP of W27,100

We initiate our coverage on Hyundai Rotem with a Buy rating and target price of W27,100. We applied a sum-of-the-parts methodology, combining 1) the value of the rolling stock business, based on relative P/B valuation with global peers, and 2) the values of the plant and defense businesses, both of which are based on average market valuations. Although overseas orders could slow during global downturns, we believe the company's domestic dominance and captive demand will keep overall orders steady. We look for a stable earnings recovery through 2015, backed by increased order intake in 4Q14.

FY (Dec.)	12/11	12/12	12/13	12/14F	12/15F	12/16F
Revenue (Wbn)	2,770	3,117	3,299	3,310	3,723	4,237
OP (Wbn)	133	175	174	69	181	244
OP margin (%)	4.8	5.6	5.3	2.1	4.9	5.8
NP (Wbn)	68	88	119	57	129	172
EPS (W)	1,070	1,371	1,754	667	1,522	2,019
ROE (%)	6.5	8.1	8.4	3.3	7.1	8.8
P/E (x)	-	-	16.4	33.2	14.5	10.9
P/B (x)	-	-	1.4	1.1	1.0	0.9

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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## Investment points

### 1. Defense business poised for steady upward growth

K2 tank sales are forecast to increase full swing. The Ministry of National Defense (MND) placed its first order in 2010 for 100 units as part of its efforts to deploy next-generation, high-tech weapons and equipment, but delays to the domestic production of tank guns and powertrain stalled the sale. Production finally started at the end of last year, and 40-50 K2 tanks are expected to be manufactured and deployed this year and each year going forward. One hundred tanks (W800bn) to be ordered at the end of this year are anticipated to use mostly domestic components.

Generally, a defense business guarantees stable profits and cash flow. Moreover, the sale of next-generation wheeled combat vehicles (slated to begin in 2016) should propel growth over the medium to long term.

### 2. Plant/machinery business to enjoy stronger orders from group affiliates

Hyundai Motor (HMC) and Kia Motors are expected to continue placing orders for key equipment needed for capacity ramp-ups in Mexico, China, and elsewhere until early 2015 (HMC is responsible for roughly 70% of Hyundai Rotem's total orders). Hyundai Steel and Hyundai Hysco are also expected to order machinery to expand their specialty steel production capacities. Going forward, Hyundai Rotem's plant and machinery unit is expected to create synergies with group affiliate businesses, as the company may partner with Hyundai E&C and Hyundai Amco for overseas plant construction projects.

### 3. Record-high orders and order backlog

This year, Hyundai Rotem is projected to post record orders (W3.8tr) and order backlog (W6.7tr). Sluggish rolling stock sales (amid the global economic downturn and uncertain business environments) should be more than offset by higher orders for K2 tanks and plants. Despite steady order streams (subway extensions, KTX, and orders from the Middle East, Turkey, and Southeast Asia), rolling stock orders are forecast to contract 4.2% YoY to W1.6tr. This is because the company failed to secure large-scale projects due to the won's appreciation and intensifying competition. Meanwhile, plant orders are projected to jump 38% YoY to W1.1tr on the back of Hyundai Steel's capacity expansion for specialty steel and higher exports. And thanks to new orders for K2 tanks, heavy machinery orders are anticipated to soar 128% YoY to W1.1tr.

### 4. Turnaround in 4Q to continue well into 2015

Hyundai Rotem's earnings are likely to turn around in 4Q, on the back of seasonal demand, productivity improvement, cost savings, and favorable F/X movements. The rolling stock unit, which reported losses amid slowing growth due to the won's appreciation, is projected to turn to profit in 4Q thanks to productivity growth. Plant revenue is expected to expand, as now that design and planning have been completed, production can start full swing. Defense revenue is forecast to hit a record in 4Q, driven by productivity improvement (K2 tanks). Quarterly earnings are likely to continue to grow at healthy pace in 2015, aided by increased order-taking in 2014.

### 5. Undervalued relative to peers

The nature of Hyundai Rotem's business makes it hard to find comparable companies. Based on its rolling stock business, which makes the largest revenue contribution, the company garners a P/B or 1.0x, the lowest level among rivals (1.1-2.2x). Although its rolling stock profitability is relatively low, the stock seems undervalued in light of the growth potential and steady cash flow of its defense and plant businesses, as well as its strong dominance in the domestic market.

As of October 27<sup>th</sup>, the company's market cap was roughly W1.8tr. For 2014, we forecast its orders at W3.8tr and revenue at W3.4tr (W3.7tr for 2015). Its 2015F PSR is 0.5x, higher than that of top-tier rivals, but much lower than that of second- and third-tier peers. Given that Hyundai Rotem's robust growth indicators (the highest among peers) and rapid improvement in profitability, we believe the stock is undervalued relative to its rivals.

# Issues

## Train replacement cycle to shorten

Seoul Metro, which operates Lines 1 to 4, started running Korea’s first subway trains in 1974, and the number of trains has increased steadily since then. As of 2014, Seoul Metro owns 1,954 subway trains. The oldest train currently in operation started running in 1989. Although roughly 550 trains were replaced between 2008 and 2010, replacement demand is likely to increase going forward, given that about 57% of the trains (1,112 units) are 20 years or older. A subway train is deemed to have a durable life of 25 years.

Following the ferry sinking and subway collision incidents in 1H14, measures were announced to improve the operation of the Seoul subway system. As part of such efforts, around W888.5bn was allocated to repair or replace aging subway trains by 2022 (W11bn for repair and W877.4bn for replacement). Moreover, several recent accidents on Line 2 are likely to prompt operators to introduce trains equipped with automatic train operation (ATO) systems.

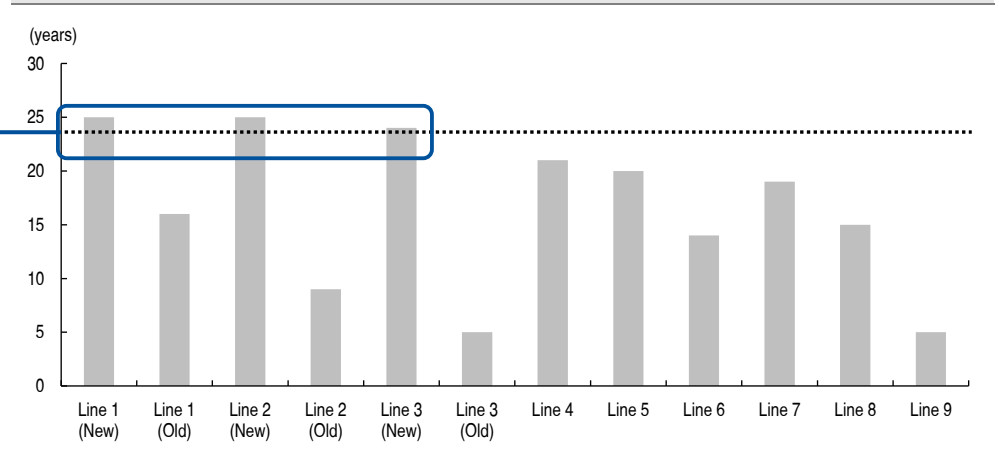
Table 1. Replacement demand for Seoul Metro’s subway trains likely to increase going forward(units)

Year	Age of trains (years)	# of trains added	Line 1	Line 2	Line 3	Line 4
1989	25	142	64	78	0	0
1990	24	126	0	67	59	0
1991	23	198	0	175	23	0
1992	22	134	0	80	54	0
1993	21	202	0	60	14	128
1994	20	310	0	20	0	290
1995	19	72	0	20	0	52
1998	16	20	20	0	0	0
1999	15	40	40	0	0	0
2002	12	36	36	0	0	0
2005	9	54	0	54	0	0
2007	7	70	0	70	0	0
2008	6	210	0	210	0	0
2009	5	270	0	0	270	0
2010	4	70	0	0	70	0
Total		1,954	160	834	490	470
Aging trains		600	64	400	136	-

Source: Seoul Metro, KDB Daewoo Securities Research

Replacement demand to surge in the wake of ferry sinking incident

Figure 1. Average age of subway trains by line



Source: Seoul Metro, KDB Daewoo Securities Research

# Company overview

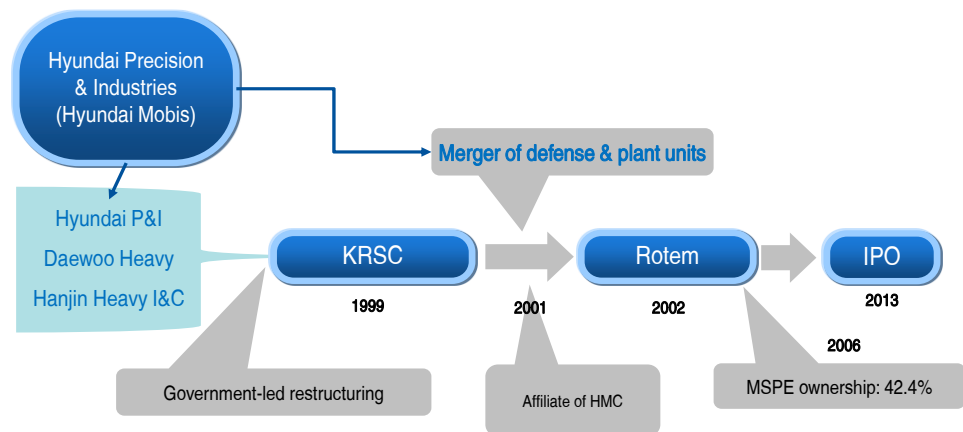
## 1. Incorporation

Hyundai Rotem was founded in 1999 as Korea Rolling Stock Corporation, when the rolling stock divisions of Hyundai Precision & Industries, Daewoo Heavy Industries, and Hanjin Heavy I&C merged as part of a government-led restructuring. The following year, the company purchased the battle-tank and machinery/plant divisions of Hyundai Precision & Industries, becoming an affiliate of the Hyundai Group. The company changed its name to Hyundai Rotem in 2007 (after having changed its name to Rotem in 2002) and went public in October 2013.

## 2. Corporate governance

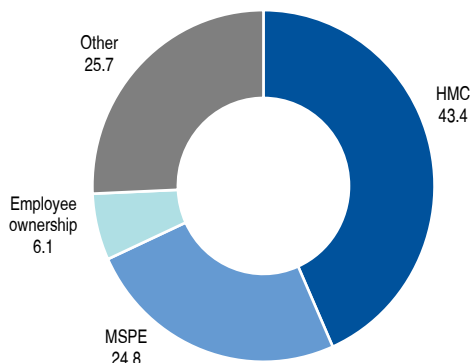
Following the merger, HMC became the largest shareholder (with a 90% stake) after acquiring Daewoo Heavy Industries' stake. The remaining 10% was held by Morgan Stanley Private Equity, which bought the shares from Hanjin Heavy I&C. Later, in 2006, Morgan Stanley raised its ownership to 42.4% by participating in a rights offering. Hyundai Rotem was listed on the stock exchange on October 30<sup>th</sup>, 2013, with major shareholders HMC and Morgan Stanley owning 43.4% and 24.8% of shares, respectively. The company has established subsidiaries in overseas markets, including the US, Turkey, and Brazil, to produce subway trains and/or operate subway systems.

Figure 2. Founding and development of Hyundai Rotem



Source: Company data, KDB Daewoo Securities Research

Figure 3. Ownership structure



Source: Company data, KDB Daewoo Securities Research

Figure 4. Capital investment status

Company	Acquisition date	Purpose	Acquisition value	Ownership	Total assets
Green Air	12/18/2008	Gas supplier	5,978	51%	39,957
Environment Vision	10/1/2006	Environment business	185	30%	2,097
Ui Trans	11/22/2007	Light rail	185	4%	16,063
Hyundai Rotem USA	1/22/2004	Railway production	664	100%	11,539
Hyundai Rotem EU	7/4/2006	Railway production	189	51%	1,397

Source: Company data, KDB Daewoo Securities Research

### 3. Business areas

#### (1) Rolling stock

##### 1. Domestic sales to grow steadily

The railway sector is a backbone industry and SOC that affects wide swaths of society and the economy, as it involves large-scale infrastructure building and huge capital investment. It is also a public business, operated by the government or municipalities.

In accordance with the Seoul Metropolitan Government’s plans (W8tr by 2025), we expect W800bn to be invested annually to replace Seoul’s aging subway facilities and build the light subway system.

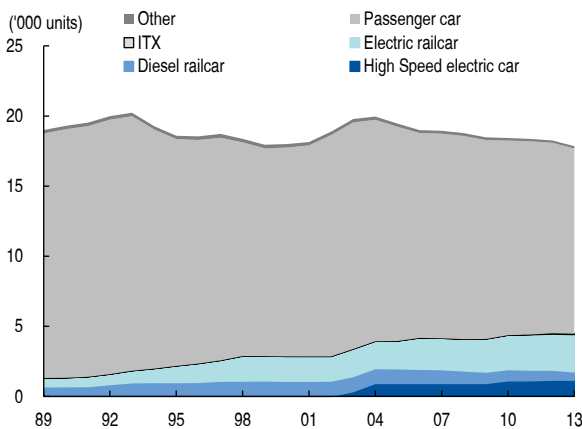
Investments in high-speed railways such as KTX and the planned Great Train Express (GTX) have picked up speed since 2011, when the government unveiled the second phase of its national railroad network plan (2011-20). We expect investments to amount to W16tr for high-speed railway (KTX), W46tr for regular-speed railway, and W26tr for metropolitan railway (GTX).

##### 2. Overseas expansion

Hyundai Rotem holds a de facto monopoly in rolling stock. The company has mainly produced non-motorized cars, but is increasingly focusing on high value-added motorized vehicles. It has secured world-class high-speed train technologies (comparable to global leaders that use similar models), and robust cost competitiveness thanks to the increased use of domestically produced parts.

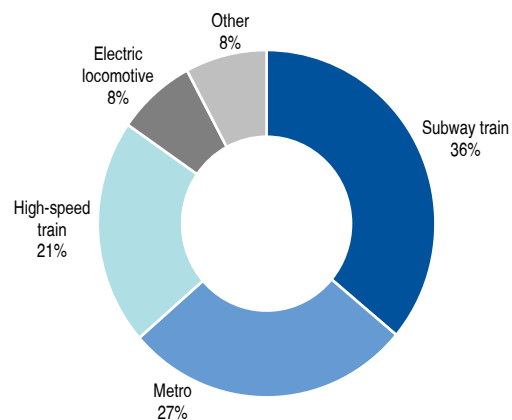
The company aims to become a global railway operator on the back of its stable domestic business. It has already made successful inroads into India, Turkey, Brazil, and the US.

Figure 5. Changes in the domestic railway industry



Source: Company data, KDB Daewoo Securities Research

Figure 6. Hyundai Rotem’s revenue breakdown by product



Source: Company data, KDB Daewoo Securities Research

Figure 7. Train produced by Hyundai Rotem



Source: Company data, KDB Daewoo Securities Research

Figure 8. High-speed train produced by Hyundai Rotem



Source: Company data, KDB Daewoo Securities Research

## **(2) Plant & machinery**

### **1. Steady orders from group affiliates**

Hyundai Rotem's plant and machinery unit is capable of supplying a full lineup of car production facilities. Orders from group affiliates, including HMC and Kia Motors (replacement demand) as well as Hyundai Steel and Hyundai Hysco (new facilities and repair/maintenance), have allowed the company to generate steady revenue. However, the firm is constantly seeking to expand its customer base on the strengths of its business know-how and expertise. Going forward, it plans to increase the proportion of its non-affiliate orders from the current 20% to 50%. Exports account for around 20% of total revenue, and are mainly non-affiliate orders.

### **2. Broadening business portfolio**

Hyundai Rotem has supplied car production facilities and equipment to global names such as Ford, GM, Renault, and Nissan. It also has experience building a water treatment plant in Oman. Going forward, it plans to expand exports to regions with poor growth infrastructure, such as Africa, Asia, and the Middle East.

The company has been diversifying its businesses, mainly to areas such as mining and power generation. It is expanding overseas in partnership with Hyundai E&C, which has wide-ranging experience in overseas construction projects; this should brighten the outlook for Hyundai Rotem's overseas businesses. Over the medium to long term, the firm plans to increase the contribution of other facilities to approximately 50% of plant revenue by expanding overseas operations and new businesses.

**(3) Defense systems**

**1. Steady and stable growth business**

Hyundai Rotem is Korea’s dominant producer of battle tanks and armored vehicles. The company’s defense systems business is highly affected by the government’s defense budget and the military’s weapons deployment plans. According to the MND, the government will spend W199.6tr from 2013 to 2017 on national defense and expand the portion of spending allocated to military capabilities improvement, including the development and deployment of high-end weapons. Despite some potential changes in defense budget plans, Hyundai Rotem’s defense systems business is expected to maintain stable growth in light of the government’s efforts to strengthen self-defense capabilities and the upcoming weapons replacement cycle.

**2. Supplying core weapons to the Korean army over the long term**

Hyundai Rotem is supplying in-house developed K1 and K2 battle tanks to the Korean military. In particular, the K2 model is relatively new compared to competing models developed in the US, France, and Germany. The vehicle features state-of-the-art technologies, including active protection, automatic ammunition loading, automatic tracking, and comprehensive battlefield management systems. Along with self-propelled artillery and armored vehicles, the company’s battle tanks are serving as a core part of the Korean army’s combat capabilities.

Having been designated a developer of wheeled armored vehicles by the Defense Acquisition Program Administration in November 2012, the company plans to mass-produce the vehicles starting in 2016. The company’s defense product supply is expected to increase over the long term on the back of the introduction of new models and the military’s new tank deployment plan.

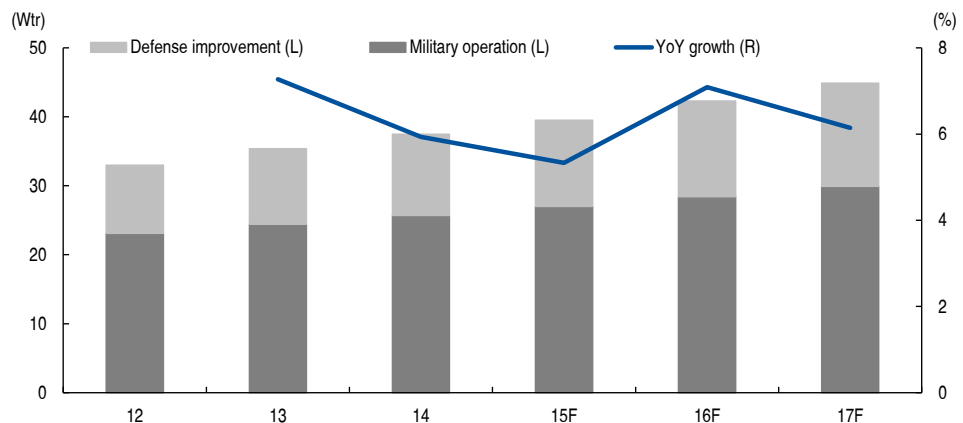
**Figure 9. Newly developed K2 battle tank** **Figure 10. Wheeled armored vehicles to be mass produced starting in 2016**



Source: Company data, KDB Daewoo Securities Research

Source: Company data, KDB Daewoo Securities Research

**Figure 11. 2013-2017 defense budget**



Source: Company data, KDB Daewoo Securities Research

# Industry outlook by business unit

## 1. Domestic railway market outlook

### (1) Stepping up global outreach based on dominance in the domestic market

Hyundai Rotem accounts for almost 100% of the Korean railway systems market. Korail's continuous establishment of new sections in the KTX and other railway lines and replacement of old trains should secure the stability of the company's railway systems business.

In light of the government's urban railway system, land development plans, and related budgets, the business is expected to continue its steady growth. We forecast that the government will increase the railway-system budget in line with Korea's nominal GDP growth rate. In addition, the accelerating replacement of old trains following the Sewol ferry accident earlier this year and the growing demand for trains for newly established railway sections should provide short-term momentum to the business.

**Table 2. Seoul Metro's investment plans** (Wmn)

Project	Total	2014	2015	2016	After 2017
Line 1 train repair	11,000	3,700	7,300	0	0
Replace aging trains (Lines 2, 3)	877,500	100	27,300	37,700	812,400
Line 1 control center	10,100	2,500	7,600	0	0
"Smart" integrated control center	191,800	600	10,600	9,700	170,900
Train reinforcement	275,027	12,864	56,770	68,500	136,893
Train reinvestment	362,800	28,038	97,400	104,200	133,162
Replace aging elevators (Lines 5, 8)	145,400	19,300	38,000	33,500	54,600
Other	11,245	6,532	2,361	1,181	1,171
Total	1,884,872	73,634	247,331	254,781	1,309,126

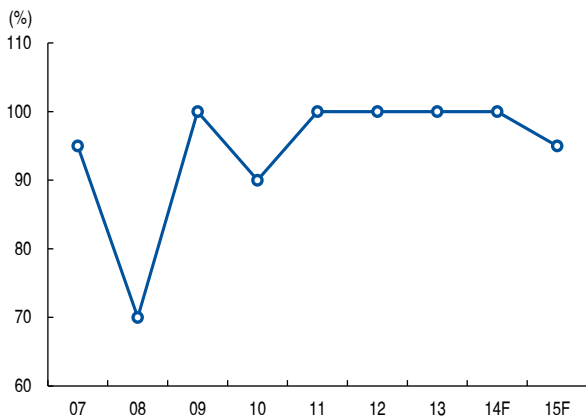
Source: Seoul Metro, KDB Daewoo Securities Research

**Table 3. Seoul Metro train car investment plans** (units, Wbn)

	Total	Line 2		Line 3
		Primary	Secondary	
Period	2014-2022	2014-2018	2016-2020	2018~2022
Units to be replaced	650	266	234	150
Budget	877.5	359.1	315.9	202.5

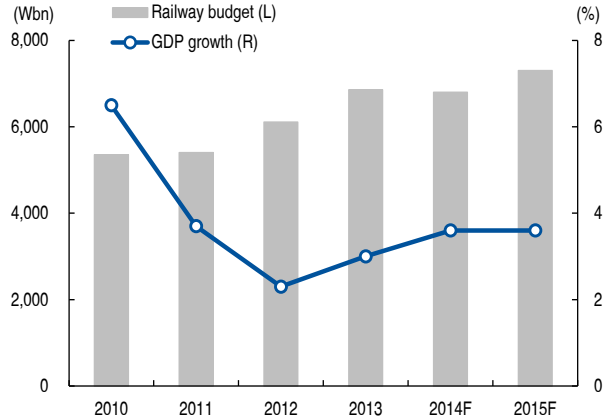
Source: Seoul Metro, KDB Daewoo Securities Research

**Figure 12. Hyundai Rotem's domestic M/S (rolling stock)**



Source: Company data, KDB Daewoo Securities Research

**Figure 13. Domestic GDP vs. railway budget**



Source: Company data, KDB Daewoo Securities Research

**(2) Seoul's light rail transit system project**

In an effort to address the city's chronic traffic problems, the Seoul Metropolitan Government plans to introduce a light rail transit system by investing W5.68tr through 2025. Under the plan, nine light rail lines will be newly established and subway line 9 will be extended. The project has not been approved by the government due to uncertainties related to demand projection and financing. However, the municipal government recently revised its plans, and is moving forward even without yet receiving approval from the Ministry of Land, Infrastructure, and Transportation (MoLIT).

**Table 4. Urban railway plan summary** (Wbn)

Project	Distance	Number of stops	Section	Project budget
Ui line extension	3.50km	3	Ui-dong – Bang-hak-dong	289
Sillim line	8.06km	11	Yeouido – Sillim	833
Dong-buk line	13.34km	15	Wangsimni – Sang-gye	1,575
Myeon-mok line	9.05km	12	Cheongnyangni – Sin-nae	889
Nan-gok line	4.13km	5	Boramae park – Nan-hyang	391
Seo-bu line	16.15km	16	Sae-jul – SNU	1,619
Wi-rye, Sinsa line	14.83km	11	Wi-rye – Sinsa	1,425
Wi-rye line	5.44km	12	Ma-cheon – Bok-jeong	238
Mok-dong line	10.87km	12	Sin-weol – Dangsang	939

Source: Seoul Metropolitan Rapid Transit 10-year master plan, KDB Daewoo Securities Research

**Table 5. Seoul Metropolitan Rapid Transit 10-year master plan** (Wbn)

Project	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	Total
Line 9 (Stage 2,3)	241	371	241	110									963
Line 9 (Stage 4)					6	8	15	25	75	136	186	113	565
Urban railway	241	371	241	110	6	8	15	25	75	136	186	113	1,528
Ui extension line	33	33	33	15	7	22	36	51	29				259
Sillim line	10	42	83	125	115	42							416
Dong-buk line		20	79	158	236	217	79						788
Myeon-mok line				22	67	111	156	89					445
Nan-gok line					10	29	49	69	39				196
Seo-bu line							41	121	202	283	162		810
Wi-rye, sin-sa line							20	60	101	141	81		403
Mok-dong line								24	70	117	164	94	470
Wi-rye line								12	36	60	83	48	238
Light train	43	94	195	320	435	420	380	425	477	601	490	142	4,023
Metropolitan railway	284	465	436	430	441	429	395	450	552	737	676	255	5,551

Source: Seoul Metropolitan Rapid Transit 10-year master plan, KDB Daewoo Securities Research

**Figure 14. Route map for metropolitan railway master plan**



Source: Seoul Metropolitan Rapid Transit 10-year master plan, KDB Daewoo Securities Research

**(3) KTX and GTX**

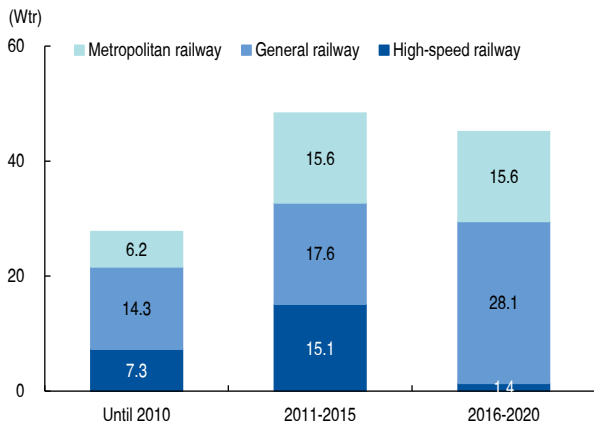
Orders related to the KTX lines have increased steadily since the bullet train began operation in 2004. The Ministry of Land, Infrastructure and Transport (MOLIT), having established a national railway system plan, unveiled the first phase of the plan in 2006 with an expected investment of W20.4tr. From 2006 to 2010, about W22.7tr—about 11% more than the original plan—was spent on Korea’s railway systems.

In 2011, the ministry announced the second phase, with planned investments of W88.1tr over the next 10 years—W16tr for KTX, W46tr for general railway, and W26tr for metropolitan railway (GTX).

With regard to high-speed railway, Korail has already placed orders for trains to run on the Gyeongbu and Suseo lines. For the Honam line, orders for the Osong-Gwangju section have been placed, but the Gwangju-Mokpo section is scheduled to be completed in 2017. We project orders for the Gwangju-Mokpo section at W330bn.

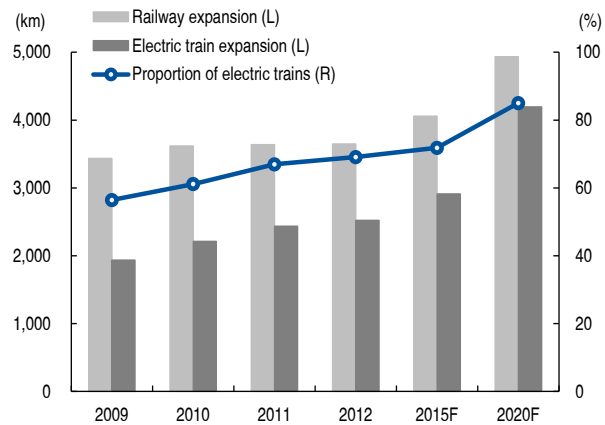
As for general railway, 58 projects, including railway improvement and the construction of double-track electric railways, are currently underway <Table 6>. Projects scheduled to be completed during 2016-2017 (excluding orders that have already been placed) have a budget totaling W20tr. As train orders usually account for 15% of the railway system budget, Korail is anticipated to place train orders worth over W1tr annually through end-2016.

**Figure 15. Government investment in railway**



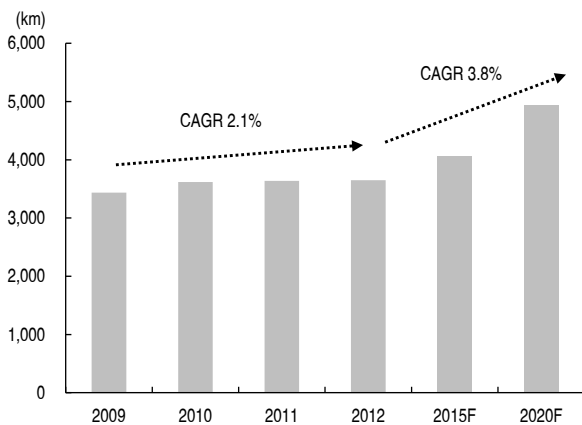
Source: MOLIT, KDB Daewoo Securities Research

**Figure 16. Railway expansion plan**



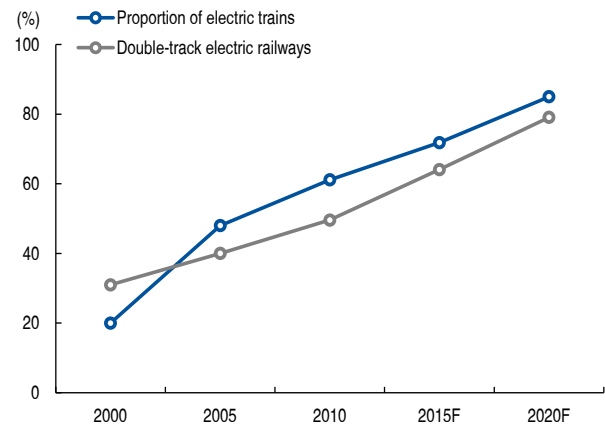
Source: MOLIT, KDB Daewoo Securities Research

**Figure 17. Domestic railway expansion forecast**



Source: MOLIT, KDB Daewoo Securities Research

**Figure 18. Proportion of electric trains vs. double-track electric railways**



Source: MOLIT, KDB Daewoo Securities Research

Table 6. Railway construction projects (2015-2017)

(Wtr, km)

Project	Section	Project budget	Distance (km)	Project type	Scheduled for opening
Donghae line	Ulsan – Pohang	2.3	76.6	Double-track electric railways	3/2015
Seoul line 9 (stage 2)	Sinnonhyeon – jamsil sports complex	2.0	4.5	Newly line	3/2015
Seoulpusan highspeed railway	Daejeon, Daegu	8.0	40.9	Newly line	5/2015
Honam highspeed railway	Osong – Gwangju	8.1	182.3	Newly line	5/2015
Daegu highspeed railway	Sinnam – Myeongdeok	1.0	23.9	Monorail	5/2015
Gyeongjeon Line	Jinju – Gwangyang	0.2	51.5	Subway	6/2015
Incheon Urban railway line 2	Oryu – Unyeon-dong	0.6	29.3	Foundation line	7/2015
Metropolitan highspeed railway	Suseo – Pyeongtaek	3.7	61.0	Newly line	8/2015
Seongnam-yeosu line	Pangyo – Yeosu	1.8	57.0	Double-track electric railways	9/2015
Suwon-incheon line	Songdo – Incheon	1.4	10.4	Double-track electric railways	12/2015
Gyeongbuk Line	Jeomchon – Yeongju	1.0	50.3	Double-track electric railways	12/2015
Busan subway line 1	Sinpyeong – Dadaepo	0.6	8.0	Expansion	1/2016
Donghae line	Pohang – Samcheok	3.0	171.3	One-track railway	2/2016
Sinbundang Line (stage 1)	Jeongja – Kyonggi University	1.5	12.8	Newly line	2/2016
Gyeongjeon Line	Bosung – Ilsung-ri	1.3	79.5	One-track railway	2/2016
Gyeongjeon Line	Bujeon – Masan	1.5	32.6	Double-track electric railways	3/2016
Gyeongin line	Soseo – Wonsi	1.8	23.3	Newly line	4/2016
Yeosu Line	Yeosu – Munkyeong	1.7	95.8	One-track railway	9/2016
Gyeongin line	Daegok – Sosa	1.4	19.6	Newly line	12/2016
Daegu urban railway	Daegok – Seolhwa	0.6	2.6	Newly line	12/2016
Ui line	Ui – Sinseol	0.3	11.4	Newly line	12/2016
Pohang railway	Sin-Pohang – Ilsin port	0.2	11.2	Newly line	12/2016
Airport railway	Incheon airport	0.5	5.5	Newly line	1/2017
Daegu line	Dongdaegu – Yeongcheon	1.0	33.9	Double-track electric railways	1/2017
Honam highspeed railway	Gwangju – Mokpo	3.6	66.8	Newly line	6/2017
Sillim line	Saetgang – SNU	0.8	7.8	Newly line	7/2017
Dongbuk line	Sanggye-dong – Wangsimni	1.6	13.3	Newly line	7/2017
Yeongdong Line	Dongbaek mt – Dogye	0.5	17.8	Newly line	10/2017
Janghang Line	Iksan – Daeya	0.5	16.5	Double-track electric railways	10/2017
Central line	Wonju – Jecheon	1.5	41.1	Double-track electric railways	10/2017
Total		53.9	1,258.5		2015-2017

Notes: Shaded items are Hyundai Rotem's existing orders

Source: The ministry announced the second phase, Future railway DB, KDB Daewoo Securities Research

The GTX project, which has been progressing slowly due to feasibility issues, is expected to gain traction soon. Route A (linking Ilsan and Samsung-dong), which is anticipated to see the largest demand among GTX routes, is likely to attract the participation of private companies. With feasibility proven, construction of the Samsung-dong-Dongtan section of route A is forecast to break ground earlier than originally scheduled. The Gyeonggi Provincial Government is considering bundling orders for routes B and C, which are expected to be less profitable, with route A orders. The provincial government estimates that the project will cost about W13tr. It plans to start operating all routes by 2022 <Table 7, Figure 23>.

The projects to be launched after 2016 under the second phase of the national railway system plan will mostly be general railway and GTX projects. In light of the budget of W45tr for these projects, train orders worth W1tr are expected to be placed annually.

Table 7. GTX project overview

Name	Section	Type	Expansion distance (km)	Budget (Wbn)
Great Train Express	Ilsan – Suseo	Double-track electric railway	46.2	4,603
	Songdo – Cheongnyang-ri	Double-track electric railway	48.7	4,634
	Uijeongbu – Keum-jung	Double-track electric railway	45.8	3,727

Source: MOLIT, KDB Daewoo Securities Research

Figure 19. GTX route proposal



Source: MOLIT, KDB Daewoo Securities Research

**(4) Railway budget to increase 7.4% YoY to W7.3tr in 2015**

The MOLIT’s railway-related budget for 2014 was W6.8tr, similar to last year’s level. The ministry allocated W7.3tr (+7.4% YoY) for railway for 2015, most of which will be spent on improving general railway systems and overall railway safety. For general railway systems, in particular, the proportion of electric trains will be increased. In the aftermath of the ferry accident, spending on railway safety will also be expanded.

Notably, the KTX-related budget as a proportion of total railway spending will contract sharply in 2015, as the construction of three major high-speed railway lines is almost complete. Instead, orders for general trains are forecast to increase.

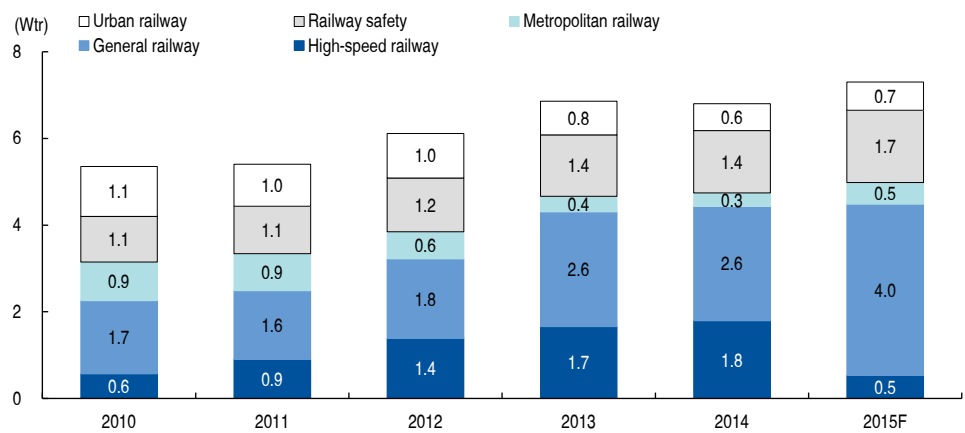
Table 8. Government railway budget

(Wbn)

	2010	2011	2012	2013	2014	2015
High-speed railway	570	900	1,385	1,660	1,793	531
General railway	1,689	1,585	1,835	2,645	2,635	3,951
Metropolitan railway	890	856	629	362	314	503
Railway safety	1,054	1,093	1,239	1,416	1,438	1,664
Urban railway	1,149	972	1,027	776	623	654
Total	5,351	5,406	6,114	6,859	6,803	7,303

Source: MOLIT, KDB Daewoo Securities Research

Figure 20. Government railway budget breakdown



Source: MOLIT, KDB Daewoo Securities Research

## 2. Overseas railway market outlook

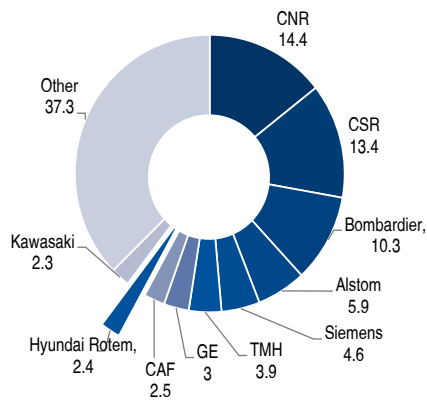
### Intensifying competition in the global market

According to the European Rail Industry (UNIFE), the global railway market will grow at a CAGR of 2.8% until 2017, when it is projected to reach US\$144.1bn. Currently, 78% of the global market (US\$112.4bn) is open to foreign players. Trains account for 48% (US\$53.8bn) of the accessible market, with Bombardier, Alstom, and Siemens taking the lead. Two Chinese train makers, CSR and CNR, claim the largest and second largest shares in the global market, based on large-scale domestic orders, although their technology still lags far behind that of leading global players.

In 2013, Hyundai Rotem reported W1.7tr in railway train sales, accounting for 1.1% of the global market (the 11<sup>th</sup> largest share among global players). We expect the company's train sales to grow to W2tr in 2017, expanding its global market share to 2.0%. The company is steadily expanding its foothold in Turkey, India, the Philippines, and Brazil.

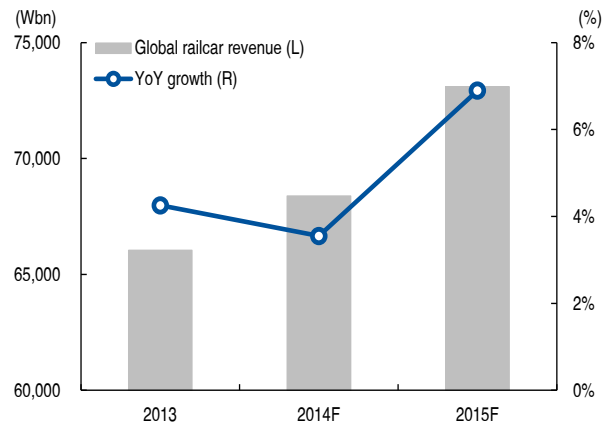
By segment, the global train market is anticipated to grow at a CAGR of 2.3% to US\$53.8bn by 2017, followed by services (CAGR of 3.2%, US\$40.7bn) and systems, including signals (CAGR of 3.5%, US\$17.9bn).

Figure 21. Global railway rolling stock market share



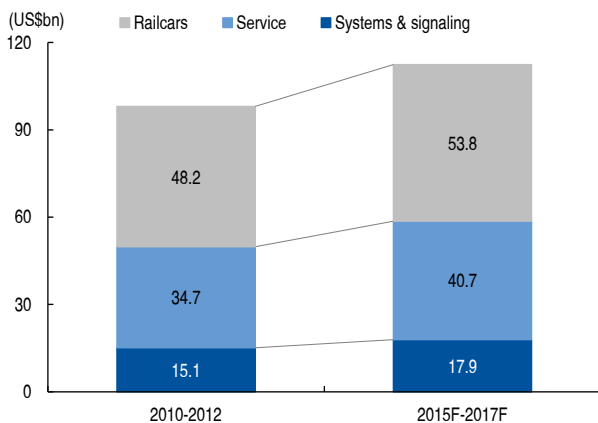
Source: UNIFE, KDB Daewoo Securities Research

Figure 22. Global railway rolling stock revenue



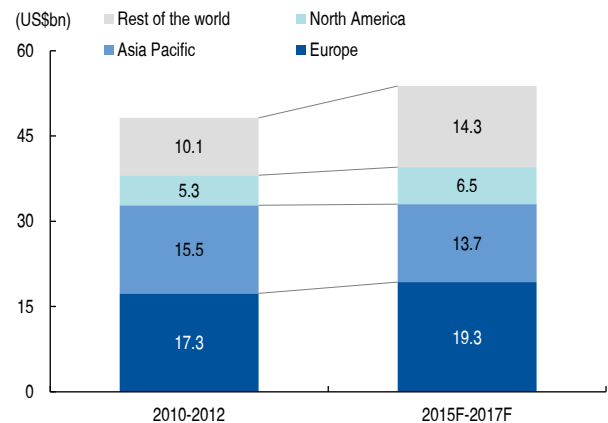
Source: UNIFE, KDB Daewoo Securities Research

Figure 23. Global railway market



Source: UNIFE, KDB Daewoo Securities Research

Figure 24. Railway markets by region



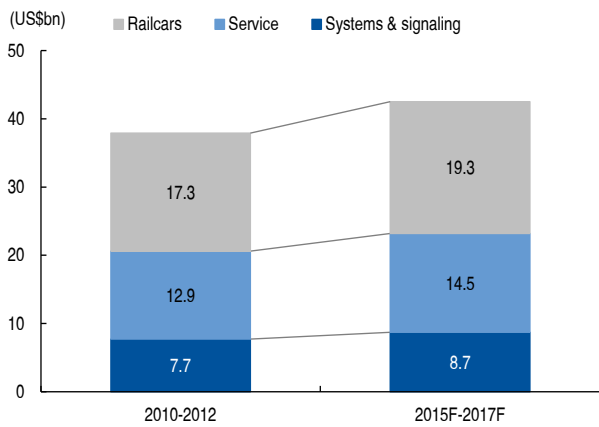
Source: UNIFE, KDB Daewoo Securities Research

In Europe, France and Germany are expected to expand investments in railway systems. If the European economy recovers on the back of stimulus efforts, the railway market is projected to grow at a CAGR of 2.2% until end-2017 (CAGR of 2.2% for railway trains), with the replacement of old trains in the UK serving as the key driver. In addition, subway system and infrastructure projects are forecast to increase in Eastern Europe.

Meanwhile, with Japan having sharply scaled down its railway investment plans, Asia’s second largest railway market is expected to shrink at a CAGR of 0.6% through 2017. Although the Chinese railway market will likely continue to grow, Chinese orders are expected concentrate on the Chinese train makers CSR and CNR, having little impact on other companies. However, India, Australia, and Southeast Asia are anticipated to see massive railway projects as their urban infrastructure plans get under way, and we expect Hyundai Rotem to win orders for these projects.

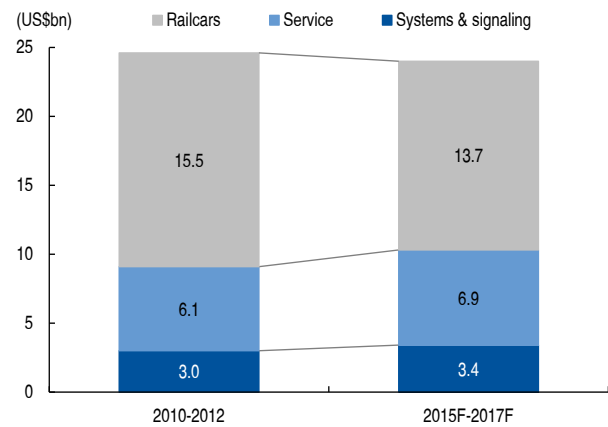
In the US market, large-scale investments in subway and railway systems, including high-speed rail, are expected, as major cities including New York and San Francisco are pursuing environmentally friendly transportation. Aided by these investments, the US railway market is projected to expand at a CAGR of 3.5% until 2017, reaching US\$19.6bn.

Figure 25. European railway market forecast



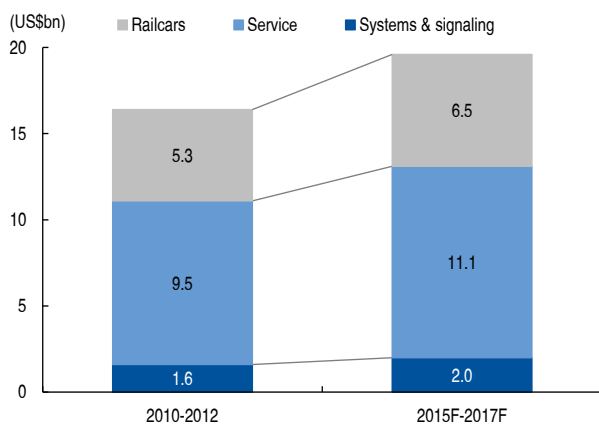
Source: UNIFE, KDB Daewoo Securities Research

Figure 26. Asian railway market forecast



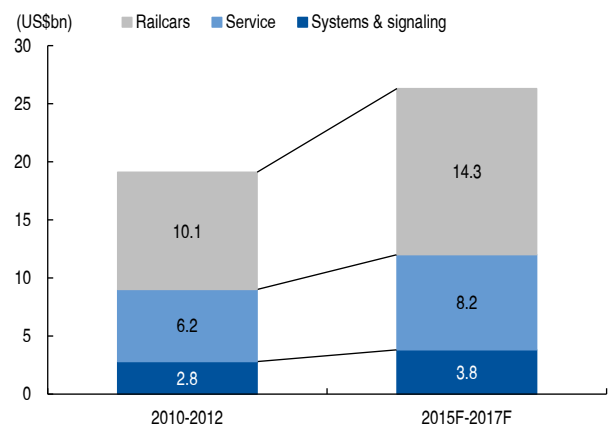
Source: UNIFE, KDB Daewoo Securities Research

Figure 27. North American railway market forecast



Source: UNIFE, KDB Daewoo Securities Research

Figure 28. Other railway market forecast



Source: UNIFE, KDB Daewoo Securities Research

### 3. Plant business

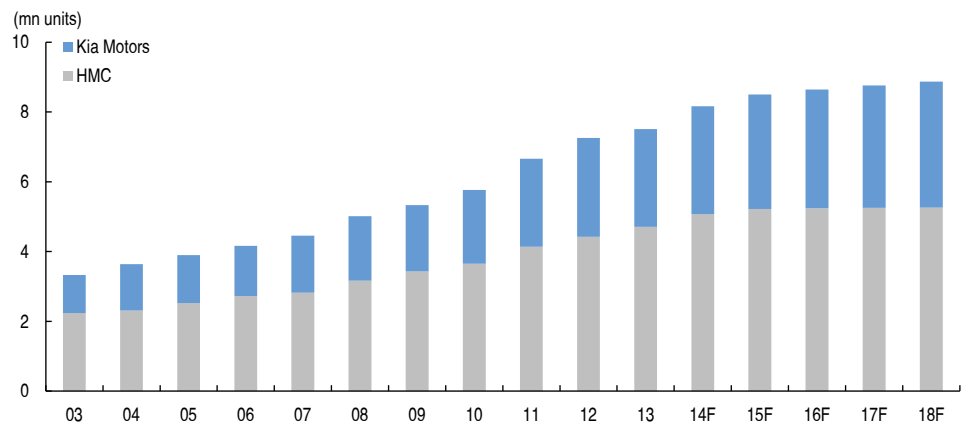
#### (1) Plant business expanding on automotive and steel orders

Through its plant business, Hyundai Rotem designs, manufactures, and builds production lines for auto, steel, and power plants. It is the only company in the world capable of supplying full automotive production lines, and its competency in this area has attracted worldwide interest due to the high product quality and performance of its customers HMC and Kia Motors. As such, the company is steadily receiving orders from global automakers, including Renault, Ford, GM, and Nissan.

As for steel production lines, the company proved its technological capability in the late 2000s by building lines for Hyundai Steel and POSCO Specialty Steel. Since then, it has been steadily accumulating knowhow by performing steel plant projects. Based on its proven technology, the company is seeking to diversify its plant portfolio to include power plants, water treatment, mining, and cement facilities.

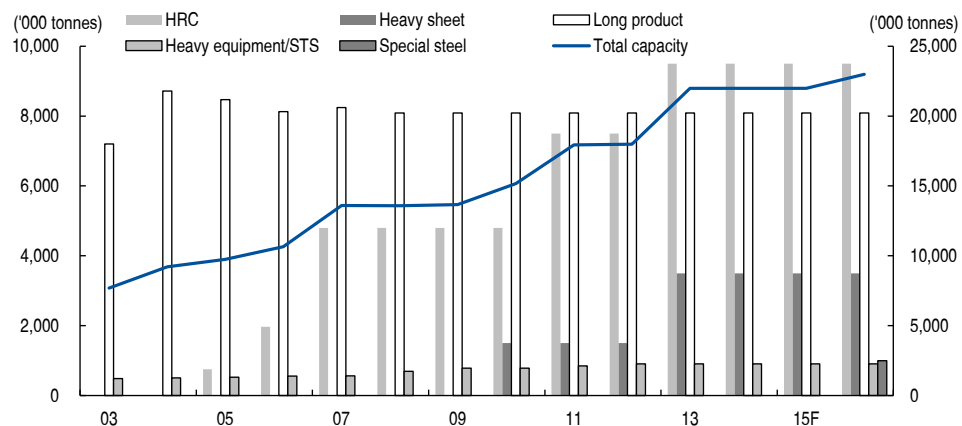
The company plans to gain growth momentum via the plant business, while diversifying its business portfolio based on captive orders. Although the plant unit in the past focused on automotive and steel production lines, the unit plans to expand the proportion of power plant projects in cooperation with Hyundai E&C and Hyundai Engineering. In addition, the unit plans to lower the percentage of orders from group affiliates from 80% to 40% in the long term. If the company achieves both customer and business diversification, it is likely to emerge as a global plant engineering firm.

Figure 29. HMC's expansion plan



Source: Company data, KDB Daewoo Securities Research

Figure 30. Hyundai Steel's expansion plan



Source: Company data, KDB Daewoo Securities Research

**(2) Captive demand from HMG to expand**

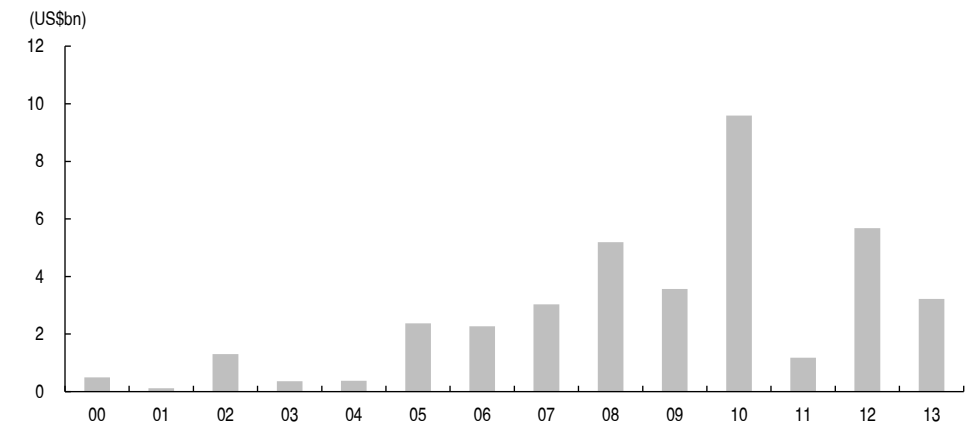
Since rapidly expanding capacity in 2011, HMC has modestly increased capacity with a focus on qualitative growth. Although HMC currently has no capacity expansion plans, the automaker needs to begin a capacity ramp-up by the end of this year in light of projected demand growth in 2016 and beyond. Possible candidates for capacity expansion are Kia Motors’ plant in Mexico, which is experiencing supply shortages, and HMC’s Chinese plants in Chongqing and Hebei, which are expected to see demand growth. If all three plants were to add capacity (for an additional 300,000 units each), Hyundai Rotem would likely benefit significantly. In addition, the company is expected to win steady orders thanks to regular maintenance and projects to boost the efficiency of existing facilities.

Furthermore, Hyundai Steel began construction of a specialty steel plant in April. Given the project’s total investment value of ₩844.2bn, Hyundai Rotem will likely receive production line orders of around ₩300bn. We expect these orders to come in at the end of this year or early next year. The steelmaker has no other capacity expansion plans as of now.

In addition, next year Hyundai Rotem is likely to receive Australian mining project orders (worth around ₩300bn) in cooperation with Hyundai E&C and Hyundai Engineering. After this project, the company’s cooperation with Hyundai E&C is likely to continue to expand at home and abroad, boosting Hyundai Rotem’s earnings.

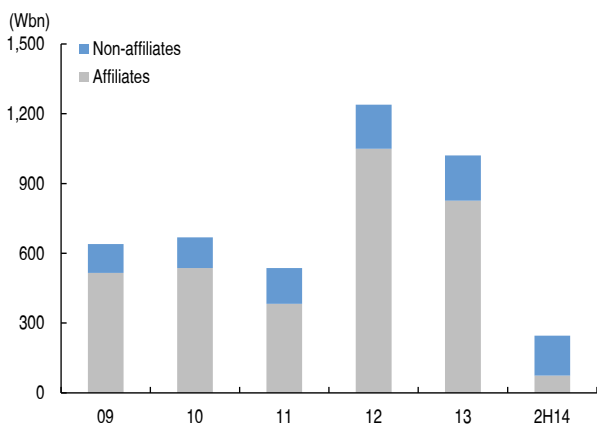
Meanwhile, Hyundai Rotem is continuously seeking ways to reduce the percentage of orders from group affiliate. By 2016, the company aims to lower this percentage to 40%. As such, the company is preparing to advance into new markets, including power and treatment plants.

**Figure 31. Hyundai E&C’s new overseas plant orders**



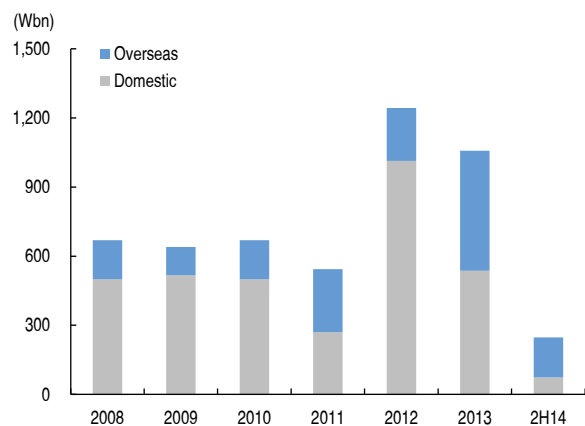
Source: Company data, KDB Daewoo Securities Research

**Figure 32. Hyundai Rotem’s new orders (group & non- group)**



Source: Company data, KDB Daewoo Securities Research

**Figure 33. Hyundai Rotem’s new orders (domestic & overseas)**



Source: Company data, KDB Daewoo Securities Research

#### 4. Defense business is poised for steady upward growth

##### (1) Deployment of major weapons has been delayed

According to a 2013-2016 mid-term defense plan released by the MND, the total national defense budget will increase at a CAGR of 6.4% to W199.6tr. An annual average of W11tr is expected to be spent on improving military strength, while W25tr should be spent on the operation of military forces. In order to bolster the combat power of ground forces, it is essential to replace old equipment with cutting-edge technology. As such, the MND is stepping up its efforts to deploy new tanks, self-propelled guns, and armored vehicles. Of note, although K2 tanks were initially planned to be deployed in 2011, their development was delayed due to powertrain issues.

##### (2) Full-scale K-2 tank production has begun

The company has produced K-9 self-propelled howitzers since 2007, and a total of 70-80 of these artillery pieces have been deployed. Additional units will likely be deployed before 2020, according to the MND’s military reinforcement plan. In addition, the company began producing K2 tanks in 2013 and is set to supply 45 tanks in 2014. We believe the company will produce about 50 K2 tanks annually at least for the next decade.

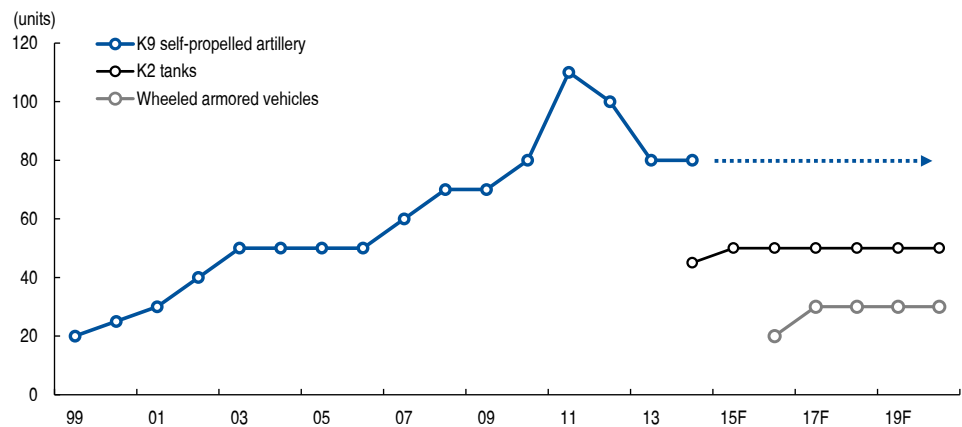
##### (3) Wheeled combat vehicles to be deployed starting in 2016

Wheeled combat vehicles and 30mm wheeled anti-aircraft guns are currently under development to enhance the strength of ground forces. Wheeled combat vehicles—for which Hyundai Rotem won orders in a bidding competition with Doosan Infracore—were initially planned to be deployed in 2012, but their deployment has been delayed. We expect the vehicles to be deployed starting in 2016.

##### (4) Steady upward growth likely

Hyundai Rotem will likely generate revenue of W400bn annually from the full-scale production of K2 tanks that started this year. In addition, if the company produces wheeled combat vehicles full swing, additional revenue of W150-200bn can be anticipated. We project revenue at the defense unit to expand from W430bn in 2013 to W830bn in 2014 and more than W1tr in 2016. Furthermore, the company is seeking to expand into overseas markets. In particular, it has already licensed out some of its technology to a Turkish firm.

Figure 34. K9 self-propelled artillery vs. K2 tank



Source: Company data, KDB Daewoo Securities Research

## Orders and earnings outlook

### 1. Orders outlook: W3.8tr (+28.8% YoY) in 2014 and W3.4tr (-10.3% YoY) in 2015

#### (1) Rolling stock: W1.6tr (-4.2%YoY)

For 2014, we forecast rolling stock orders to fall by -4.2% YoY to W1.6tr. The company already secured orders of around W1.1tr during the first three quarters. In 4Q, we expect subway car replacement orders of W250bn for lines no. 1 and 2, and orders of W100bn for the extension of line no. 9. In addition, the company is currently bidding for projects worth more than W700bn in the Middle East, Turkey, India, and Southeast Asia, increasing the likelihood that it will meet its annual order target.

#### (2) Plant/machinery: W1.1tr (+38% YoY)

At the plant division, we project 2014 orders to increase by 38% YoY to W1.1tr. The company already garnered orders of around W563.4bn during the first three quarters. In 4Q, we expect orders of W106bn for Hyundai Steel's specialty steel production lines (CGL color-coated steel sheets) and combined orders of W360bn for Kia's Mexico plant and a Malaysian pier project. Orders from capacity expansion at HMC's Chinese plants in Chongqing and Hebei are likely to be delayed to 1H15.

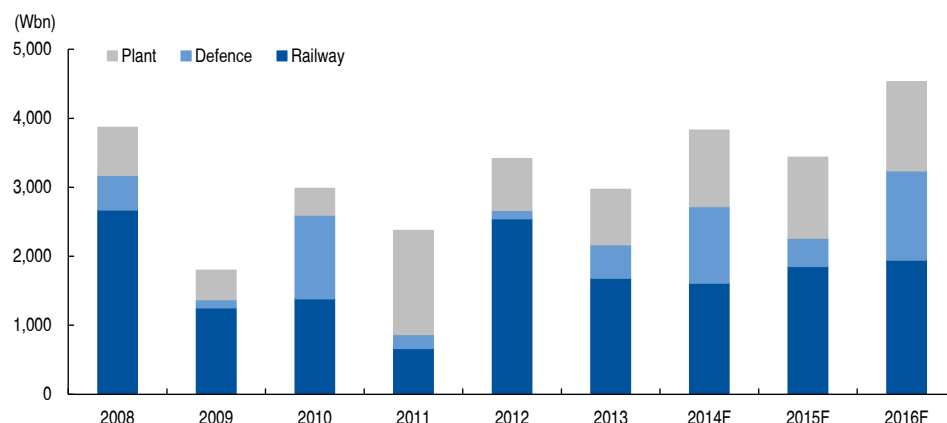
#### (3) Defense: W1.1tr (+128% YoY)

At the defense division, we project 2014 orders to increase by 128% YoY to W1.1tr. The company already garnered orders of around W212.1bn during the first three quarters. In 4Q, the division is expected to receive orders for 100 K2 tanks, which are estimated at around W800bn (W8bn each). Although there will be no additional K2 tank orders in 2015, additional orders are expected to resume in 2016 and continue for more than 10 years. The division's order backlog will likely increase to W2tr at year-end.

#### (4) Order backlog to expand by 12% YoY to W6.7tr

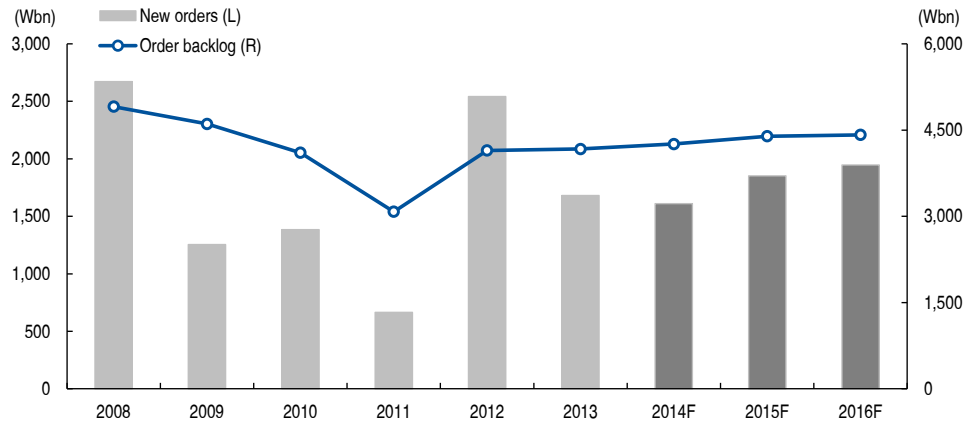
We expect order backlog to expand by 12% YoY to W6.7tr, as massive orders are likely to come in during 4Q. We believe that orders will increase across all the business divisions. Since the company has delivered solid orders despite unfavorable business conditions, its competitiveness and business stability will likely attract attention.

Figure 35. Breakdown of new orders



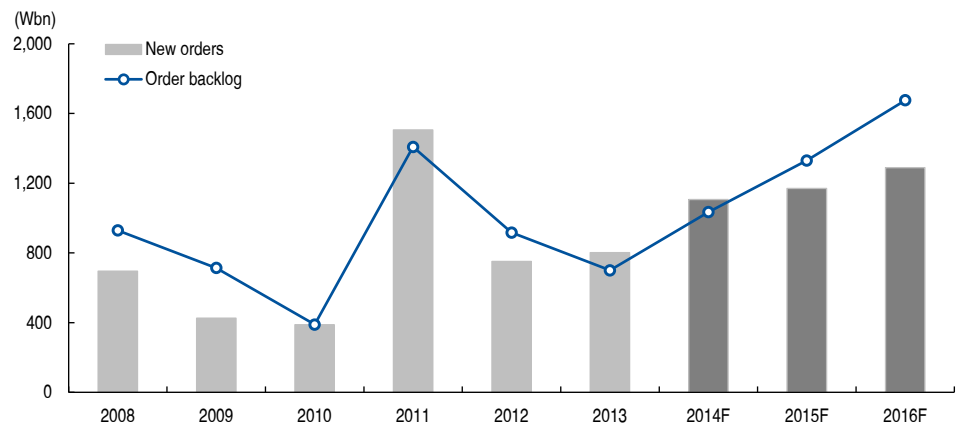
Source: Company data, KDB Daewoo Securities Research

**Figure 36. New orders and order backlog: Railway unit**



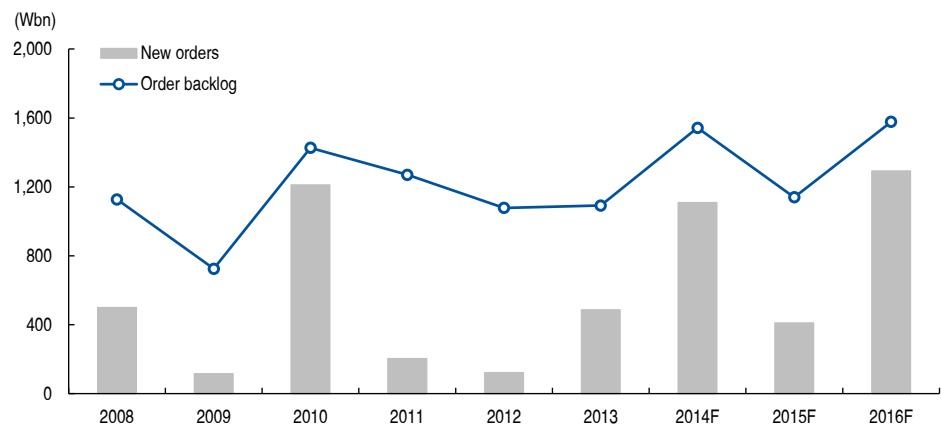
Source: Company data, KDB Daewoo Securities Research

**Figure 37. New orders and order backlog: Plant & machinery unit**



Source: Company data, KDB Daewoo Securities Research

**Figure 38. New orders and order backlog: Defense unit**



Source: Company data, KDB Daewoo Securities Research

Table 9. New orders and order backlog (Wbn, %)

	2012	2013	2014F	2015F	2016F
<b>New orders</b>	<b>3,416</b>	<b>2,970</b>	<b>3,827</b>	<b>3,434</b>	<b>4,528</b>
Railway	2,543	1,682	1,611	1,853	1,946
Defense	122	487	1,109	411	1,293
Plant	751	801	1,106	1,170	1,289
<b>Backlog</b>	<b>6,139</b>	<b>5,962</b>	<b>6,653</b>	<b>6,556</b>	<b>7,178</b>
Railway	4,145	4,170	3,986.0	3,854.6	3,597.7
Defense	1,078	1,092	1,488.9	1,066.4	1,441.5
Plant	916	700	1,178.4	1,634.7	2,139.0
<b>New order growth</b>		<b>-13.1</b>	<b>28.8</b>	<b>-10.3</b>	<b>31.9</b>
Railway (YoY)		-33.9	-4.2	15.0	5.0
Defense (YoY)		298.9	128.0	-63.0	215.0
Plant (YoY)		6.7	38.0	5.8	10.2

Source: Company data, KDB Daewoo Securities Research

Table 10. Hyundai Rotem's new orders in 2014 (Wbn)

Project	New orders (Wbn)	Status	Notes
<b>Railway</b>			
Wonju-Gangwon line: 150 units	449	Awarded	
Seoul Metro Line 1: Replacement demand	126	Awarded	
Suseo high-speed railway: 100 units	324	Awarded	
Supply DMU/technology transfer with TÜVASAŞ	91	Awarded	
Turkey trams	84	Awarded	
India RS9 rent	87	Awarded	
KDB Daewoo forecast of additional orders	450		
<b>New order forecast for 2014 (Railway)</b>	<b>1,550-1,650</b>		
<b>Defense</b>			
K1A1	133	Awarded	
Other	58	Awarded	
K2 tanks	900	Expected	12/2014
<b>New order forecast for 2014 (Defense)</b>	<b>1,100</b>		
<b>Plant</b>			
Hyundai Steel CGL	191	Awarded	
Incheon International Airport boarding bridge	100	Awarded	
Coal-fired power plant	107	Awarded	
Hyundai Steel: Special steel heating furnace	121	Awarded	
GM plant press	54	Awarded	
Bangladesh Dhaka waterworks	39	Awarded	
Hyundai Steel plant	106	Awarded	
Malaysia pier construction	160	Expected	
Kia Mexico expansion	200	Expected	
KDB Daewoo forecast of additional orders	100	Expected	
HMC Chongqing expansion	200~250	Expected	1H15
HMC Hebei expansion	200~250	Expected	
<b>New order forecast for 2014 (Plant)</b>	<b>1,050~1,200</b>		
<b>New order forecast for 2014</b>	<b>3,700~3,850</b>		

Source: Company data, KDB Daewoo Securities Research

## 2. Earnings forecasts

For 2014, we forecast revenue of W3.31tr (+0.3% YoY), operating profit of W68.8bn (-60.6% YoY), and net profit of W58.9bn (-53.3% YoY). Our operating profit figure equals the sum of our forecasts for the three divisions, and assumes an average US\$/W rate of 1,035 (based on our in-house forecast).

For 2015, we project revenue of W3.72tr (+12.5% YoY), operating profit of W180.8bn (+163% YoY), and net profit of W136.2bn (+131% YoY). We expect earnings to recover in 2015 thanks to the sharp rise in orders in 2014.

### (1) Rolling stock

At the rolling stock division, we estimate revenue and operating profit of W1.79tr (+7.4% YoY) and W0.7bn (-98% YoY) for 2014, and W1.98tr (+10.5% YoY) and W47.5bn for 2015, respectively. Because of the lengthy design period, rolling stock revenue is usually recognized one year after an order is placed. Our estimates assume a 50% exposure to exports.

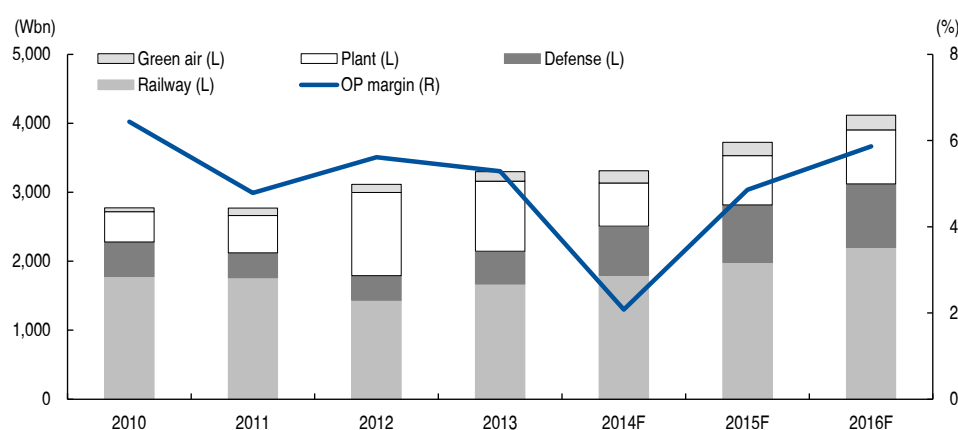
### (2) Plant/machinery

At the plant division, we expect revenue of W627.6bn (-38.3% YoY) and an operating loss of W12.5bn (-112% YoY) for 2014. In 2015, we project the division to return to an operating profit of W44.4bn on revenue of W713.8bn (+13.7% YoY). Our estimates assume a 50% exposure to exports. For plant projects, there is a roughly six-month lag between revenue recognition and order intake, but we note that the pace of revenue recognition could vary for several projects.

### (3) Defense

At the defense division, we project revenue and operating profit of W712.3bn (+50.3% YoY) and W63.6bn (+50.6% YoY) for 2014, and W833bn (+16.9% YoY) and W70.1bn (+10.2% YoY) for 2015, respectively. The time lag between order intake and revenue recognition has little relevance to the defense business, as revenue is recognized according to the MND's schedule. Also, F/X exposure is limited because the bulk of revenue is domestic. Our 2015 earnings estimates reflect the company's full-year order backlog and production plan.

Figure 39. Annual earnings breakdown



Source: Company data, KDB Daewoo Securities Research

### 3. Quarterly earnings outlook

#### (1) Rolling stock

The rolling stock division has incurred costs since 2Q related to parts replacement and safety enhancement in the wake of the Sewol ferry tragedy and subway collisions. In addition, the company upgraded facilities to improve productivity, causing additional costs. Given this, and in light of the fall in the US\$/W rate, 3Q rolling stock earnings were sluggish. However, we forecast rolling stock earnings to recover gradually in 4Q, supported by a rise in the US\$/W rate, a seasonal QoQ rise in revenue, and a plunge in costs.

#### (2) Plant/machinery

Generally, the plant and machinery business contributes to revenue more quickly than does the rolling stock unit. Plants for which orders were taken between 2H13 and 1Q14 began construction in 3Q. Still, margins were weak in 3Q due to a fall in the US\$/W rate. We expect the division to rebound starting in 4Q on the back of revenue growth and a rise in the US\$/W rate.

#### (3) Defense

The company's 3Q defense earnings showed dramatic YoY improvement thanks to the increased production of K-2 tanks. In 4Q, the division is likely to generate significant revenue due to seasonal factors and the fact that defense revenue contribution tends to be concentrated at the end of the year.

#### (4) 3Q earnings review

For 3Q, Hyundai Rotem reported revenue of W791.6bn (-5.9% YoY), operating profit of W13.1bn (-70.5% YoY), and a pretax loss of W3.5bn (turning negative). These results missed the market consensus.

We attribute the tepid earnings to: 1) a sharp decline in rolling stock margins caused by a fall in the US\$/W rate, and 2) delays or sluggishness in plant order-taking. On the other hand, defense earnings drastically expanded thanks to full-swing revenue recognition related to K2 tanks. The pretax loss was largely due to F/X-related losses of W8bn.

Table 11. Earnings breakdown

(Wbn, %, %p)

	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14	4Q14F	1Q15F	2Q15F	3Q15F	4Q15F	2013	2014F	2015F
<b>Revenue</b>	<b>693</b>	<b>781</b>	<b>842</b>	<b>984</b>	<b>698</b>	<b>760</b>	<b>792</b>	<b>1,060</b>	<b>798</b>	<b>863</b>	<b>878</b>	<b>1,185</b>	<b>3,299</b>	<b>3,310</b>	<b>3,723</b>
Railway	320	366	422	563	403	407	403	583	441	462	438	643	1,672	1,796	1,984
Defense	59	135	143	136	144	179	188	201	188	209	211	225	473	712	833
Plant	282	251	243	242	111	135	158	223	124	149	183	258	1,018	628	714
Green Air	32	29	33	43	40	39	42	53	44	43	46	59	137	174	192
<b>Operating profit</b>	<b>44</b>	<b>49</b>	<b>44</b>	<b>37</b>	<b>20</b>	<b>6</b>	<b>13</b>	<b>30</b>	<b>29</b>	<b>42</b>	<b>47</b>	<b>63</b>	<b>174</b>	<b>69</b>	<b>181</b>
Railway	11	7	13	-2	5	-5	-4	5	6	12	11	19	29	1	48
Defense	0	7	9	11	16	13	18	18	15	18	18	19	27	64	70
Plant	29	31	19	24	-5	-6	-4	2	4	8	13	19	103	-13	44
Green Air	4	5	3	4	4	4	4	5	4	4	5	6	16	17	19
<b>OP margin</b>	<b>6.4%</b>	<b>6.3%</b>	<b>5.3%</b>	<b>3.7%</b>	<b>2.9%</b>	<b>0.8%</b>	<b>1.7%</b>	<b>2.8%</b>	<b>3.7%</b>	<b>4.8%</b>	<b>5.3%</b>	<b>5.3%</b>	<b>5.3%</b>	<b>2.1%</b>	<b>4.9%</b>
<b>EBITDA</b>	<b>44.3</b>	<b>82.9</b>	<b>10.6</b>	<b>106.8</b>	<b>38.6</b>	<b>24.3</b>	<b>31.4</b>	<b>47.9</b>	<b>47.2</b>	<b>59.2</b>	<b>63.8</b>	<b>80.0</b>	<b>244.7</b>	<b>142.3</b>	<b>250.2</b>
% YoY	12.6%	30.4%	-46.3%	-9.3%	-12.9%	-70.7%	195.3%	-55.1%	22.3%	143.7%	103.1%	66.8%	1.7%	-41.9%	75.9%
% QoQ	-62.4%	87.2%	-87.2%	904.0%	-63.9%	-37.0%	29.2%	52.6%	-1.6%	25.6%	7.7%	25.3%			
<b>Net profit</b>	<b>31.4</b>	<b>33.4</b>	<b>26.6</b>	<b>34.6</b>	<b>10.7</b>	<b>26.5</b>	<b>-2.8</b>	<b>24.5</b>	<b>20.9</b>	<b>31.0</b>	<b>34.6</b>	<b>49.7</b>	<b>126.1</b>	<b>58.9</b>	<b>136.2</b>
% YoY	24.8%	1029.2%	-27.2%	-0.1%	-65.9%	-20.7%	TTR	-29.3%	95.1%	16.9%	TTB	102.9%	26.9%	-53.3%	131.1%
% QoQ	-9.6%	6.5%	-20.3%	30.0%	-69.1%	147.5%	TTR	TTB	-14.7%	48.2%	11.7%	43.8%			
<b>Net margin</b>	<b>4.5%</b>	<b>4.3%</b>	<b>3.2%</b>	<b>3.5%</b>	<b>1.5%</b>	<b>3.5%</b>	<b>-0.4%</b>	<b>2.3%</b>	<b>2.6%</b>	<b>3.6%</b>	<b>3.9%</b>	<b>4.2%</b>	<b>1.8%</b>	<b>6.7%</b>	<b>7.1%</b>

Source: Company data, KDB Daewoo Securities Research

Table 12. 3Q14P review

(Wbn, %, %p)

	3Q13	2Q14	3Q14P		Growth	
			Preliminary	Consensus	YoY	QoQ
Revenue	842	760	792	819	-6.0	4.2
Operating profit	44	6	13	21	-70.5	127.7
OP margin	5.3	0.8	1.7	2.6	-	-
Pretax profit	35	32	-3	22	TTR	TTR
Net profit	24	26	-3	17	TTR	TTR

Notes: All figures are based on consolidated K-IFRS

Source: Company data, KDB Daewoo Securities Research estimates

Table 13. Quarterly and annual earnings

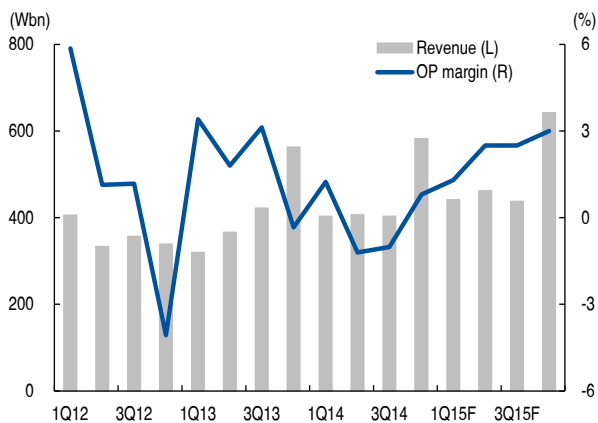
(Wbn, %)

	2013				2014F				3Q14P growth		2013	2014F	2015F
	1Q	2Q	3Q	4Q	1Q	2Q	3QP	4QF	YoY	QoQ			
Revenue	693	781	842	984	698	760	792	1,060	-6.0	4.2	3,299	3,310	3,723
Operating profit	44	49	44	37	20	6	13	30	-70.5	127.7	174	69	181
Pretax profit	39	42	35	47	13	32	-3	30	TTR	TTR	164	72	167
Net profit	28	32	24	35	10	26	-3	23	TTR	TTR	119	57	129
OP margin	6.4	6.3	5.3	3.7	2.9	0.8	1.7	2.8	-	-	5.3	2.1	4.9
Net margin	4.5	4.3	3.2	3.5	1.5	3.5	-0.4	2.3	-	-	3.8	1.8	3.7

Notes: All figures are based on consolidated K-IFRS

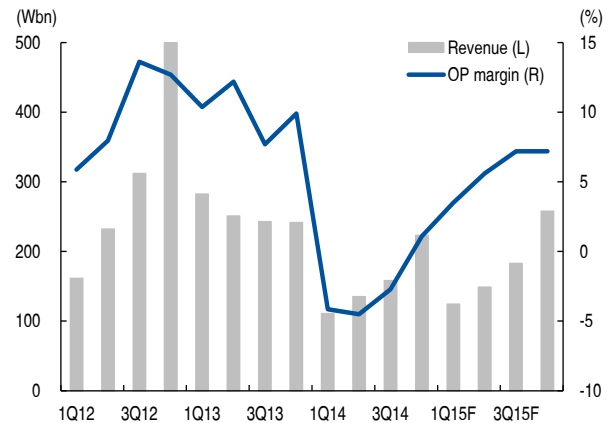
Source: Company data, KDB Daewoo Securities Research estimates

Figure 40. Railway earnings forecast



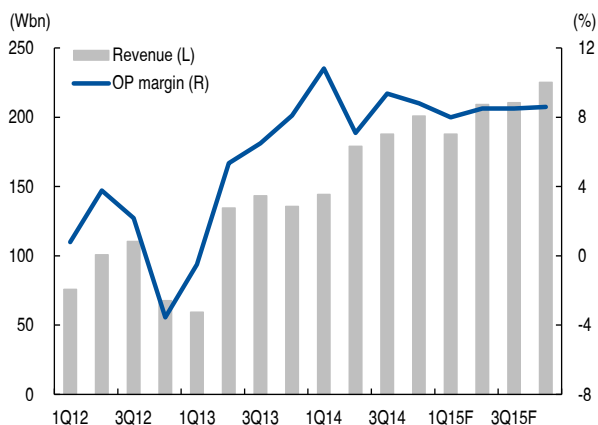
Source: Company data, KDB Daewoo Securities Research

Figure 41. Plant/machinery earnings forecast



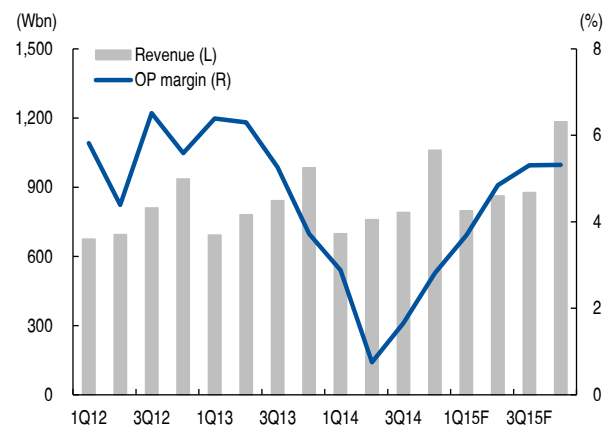
Source: Company data, KDB Daewoo Securities Research

Figure 42. Defense earnings forecast



Source: Company data, KDB Daewoo Securities Research

Figure 43. Quarterly earnings



Source: Company data, KDB Daewoo Securities Research

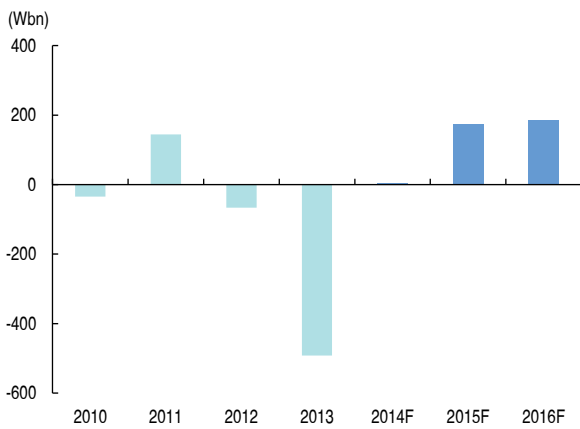
#### 4. Financial analysis

We project Hyundai Rotem’s 2014 results to be tepid. Only minimal cash flow improvement is likely, due to unexpected costs associated with capacity expansion and facility upgrades. However, the company is anticipated to turn around in 4Q and generate ample cash flow in 2015.

The company’s debt-to-equity ratio fell significantly to 139% in 2013 following an IPO worth W400bn. Despite increased working capital, the ratio once again worsened to 175% in 2014, with debt expanding by W300bn. But taking into account the robust 2014 orders and rosy earnings outlook, we expect the ratio to fall to the mid-100% level through 2016. Meanwhile, the current ratio is forecast to improve to 193% in 2014 and 247% in 2015. Given its healthy debt and current ratios, we see the company’s financial condition as healthy.

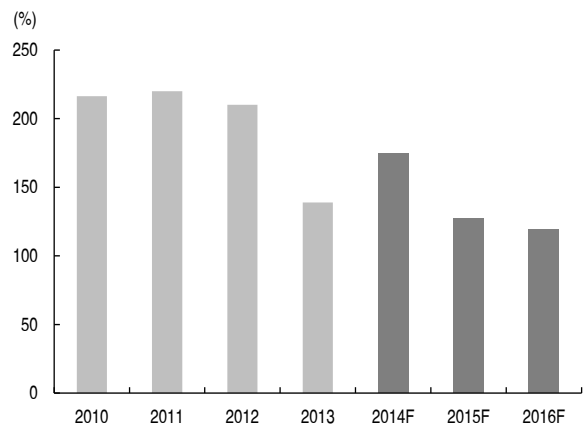
On a further positive note, the accounts receivable turnover ratio has risen from 3.6 in 2011 to 7.5 in 2013 and 9.1 in 2014, suggesting smooth liquidity.

Figure 44. Hyundai Rotem’s FCF trend



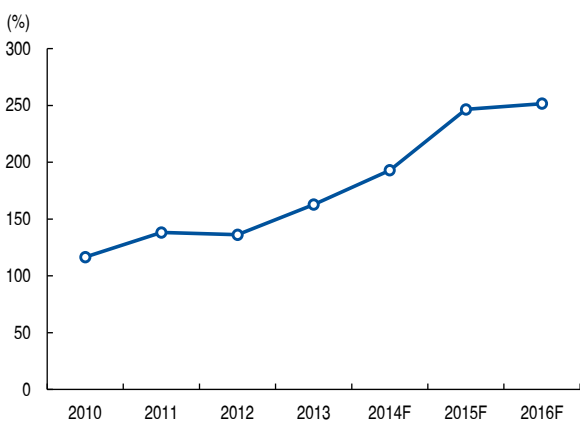
Source: Company data, KDB Daewoo Securities Research

Figure 45. Hyundai Rotem’s debt-to-equity ratio



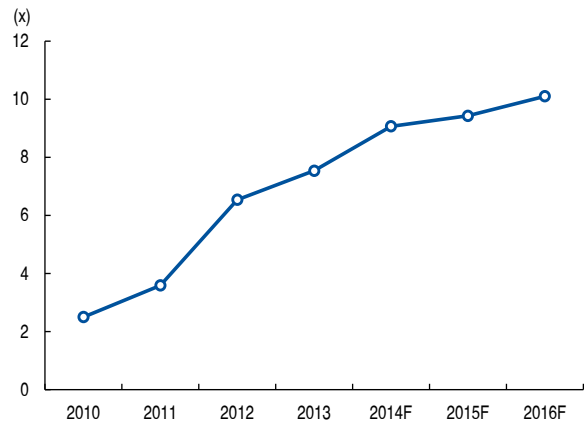
Source: Company data, KDB Daewoo Securities Research

Figure 46. Hyundai Rotem’s current ratio



Source: Company data, KDB Daewoo Securities Research

Figure 47. Hyundai Rotem’s accounts receivable turnover ratio



Source: Company data, KDB Daewoo Securities Research

## Valuation

### Initiate coverage with Buy rating and TP of W27,100

As Hyundai Rotem engages in three unrelated business areas, we derived the value of the rolling stock unit based on relative P/B valuation with global peers, and calculated the enterprise values of the plant/machinery and defense units using the respective average market valuations.

#### (1) Rolling stock

We determined it would be inappropriate to value the rolling stock division using earnings, in light of the unstable earnings streams and low margins of rolling stock companies. As such, we compared the division's asset value to that of rolling stock peers. The asset values of global competitors are equivalent to a 2015F P/B of 1.5x, on average.

We assumed the asset value of the rolling stock division represents approximately 53% of the company's capital, since rolling stock revenue accounts for 53% of the company's overall revenue. We applied a P/B of 1.3x (a 10% discount to the global peer average of 1.5x) to derive the value of the division. Our discount is due to the company's relative weakness in terms of global market presence and competitiveness.

#### (2) Plant/machinery

Finding comparable listed peers for the plant and machinery division was difficult due to the unique characteristics of the company's products. We applied an EV/EBITDA of 8.0x (a domestic manufacturing industry average) to derive the value of the division.

#### (3) Defense

Generally, the Korean defense business tends to generate stable cash flow on the back of long-term order backlogs. Therefore, most defense stocks receive an EV/EBITDA of 10-12x. We applied an EV/EBITDA of 12x to derive the value of the company's defense unit, on expectations for 1) the supply of K2 tanks over at least the next decade, as well as 2) the mass production of new wheeled armored vehicles starting in 2016.

We initiate our coverage of Hyundai Rotem with a Buy rating and a target price of W27,100. Based on a sum-of-the-parts methodology, we summed the asset values and enterprise values of the divisions to derive our target price.

Table 14. Valuation

(Wbn, x)

		2010	2011	2012	2,013	2014F	2015F	2016F	Note
Rolling stock	Capital (Wbn)	132	608	651	984	1,011	1,040	1,107	Based on 53% of overall capital 10% discount to the competitor average
	P/B (x)	1.0	1.0	1.0	1.3	1.3	1.3	1.3	
Fair value - 1	EV (Wbn)	132	608	651	1,280	1,314	1,352	1,439	Considering domestic dominance and business stability
Defense	EBITDA (Wbn)	47	15	18	42	79	84	92	Based on market value
	EV/EBITDA (x)	10.0	10.0	10.0	12.0	12.0	12.0	12.0	
Fair value - 2	EV (Wbn)	466	151	176	506	943	1,009	1,104	(Considering domestic dominance and business stability)
Plant	EBITDA (Wbn)	39	49	150	113	-3	53	64	10% premium to the market value
	EV/EBITDA (x)	7.0	7.0	7.0	8.0	8.0	8.0	8.0	
Fair value - 3	EV (Wbn)	273	344	1,048	900	-20	427	513	(Considering stable customer base)
Other	EBITDA (Wbn)	14	29	32	29	30	31	33	
	EV/EBITDA (x)	10.0	10.0	10.0	10.0	10.0	10.0	10.0	
Fair value - 4	EV (Wbn)	136	287	324	287	301	308	326	(Considering stable customer base)
Net debt - 5		1,065	919	972	928	946	790	612	
Enterprise value	1+2+3+4-5	650	507	1,001	2,045	1,592	2,307	2,770	
Issued stock	('000 shares)	63,940	63,940	63,940	85,000	85,000	85,000	85,000	
Per share value	(W)	10,164	7,924	15,658	24,058	18,725	27,136	32,592	

Source: Company data, KDB Daewoo Securities Research

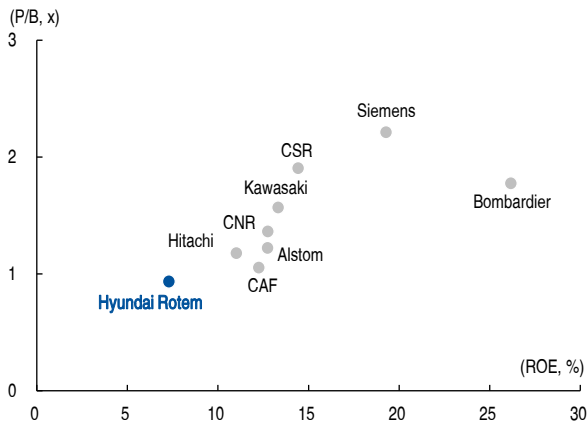
Table 15. Global peer valuation comparison

(Wbn, %, x)

	Hyundai Rotem	Bombardier	Siemens	Alstom	CSR	CNR	CAF	Kawasaki	Hitachi	Average
Revenue contribution of railway unit	<b>54%</b>	48%	9%	29%	72%	71%	93%	11%	9%	
Market cap	<b>1,798</b>	6,014	99,803	10,895	13,758	12,755	1,189	6,732	36,686	
Revenue (Wbn)										
2013	<b>3,150</b>	19,171	109,616	28,436	16,434	-	2,309	14,375	96,726	
2014F	<b>3,263</b>	20,883	99,478	27,122	20,002	19,244	2,050	14,808	93,959	
2015F	<b>3,961</b>	21,993	104,633	26,102	22,422	21,270	2,148	15,753	97,140	
Revenue growth (%)										
2013	<b>5.9</b>	10.6	-2.0	0.0	8.4	5.4	-10.8	7.5	6.4	3.5
2014F	<b>3.6</b>	8.9	-9.2	-4.6	21.7	-	-11.2	3.0	-2.9	1.2
2015F	<b>21.4</b>	5.3	5.2	-3.8	12.1	10.5	4.8	6.4	3.4	7.3
Operating profit (Wbn)										
2013	<b>180</b>	1,067	8,075	1,947	986	-	245	676	5,453	-
2014F	<b>100</b>	1,105	9,972	1,712	1,314	1,361	203	757	5,930	-
2015F	<b>206</b>	1,208	11,532	1,790	1,513	1,550	255	888	6,729	-
OP margin (%)										
2013	<b>5.7</b>	5.6	7.4	6.8	6.0	-	10.6	4.7	5.6	6.6
2014F	<b>3.1</b>	5.3	10.0	6.3	6.6	7.1	9.9	5.1	6.3	6.6
2015F	<b>5.2</b>	5.5	11.0	6.9	6.7	7.3	11.9	5.6	6.9	7.4
Net profit (Wbn)										
2013	<b>108</b>	703	6,021	1,066	750	-	152	370	2,533	-
2014F	<b>85</b>	693	7,317	972	947	987	125	440	2,715	-
2015F	<b>143</b>	792	8,106	1,108	1,097	1,154	142	534	3,429	-
EV/EBITDA (x)										
2013	<b>12.5</b>	8.3	11.1	6.8	13.7	-	6.6	9.5	7.8	9.5
2014F	<b>17.7</b>	7.8	9.1	6.9	10.8	10.0	7.7	8.7	7.2	9.5
2015F	<b>11.5</b>	7.0	8.3	6.8	9.5	8.9	6.9	7.4	6.6	8.1
P/E (x)										
2013	<b>14.0</b>	8.8	17.1	10.5	19.5	-	8.6	18.8	15.1	14.1
2014F	<b>21.6</b>	8.4	13.0	11.3	15.8	12.8	9.6	15.3	13.6	13.5
2015F	<b>13.0</b>	7.5	11.6	10.2	13.6	11.3	8.5	12.7	10.8	11.0
P/B (x)										
2013	<b>1.2</b>	2.8	2.4	1.5	2.3	-	1.1	1.9	1.5	1.8
2014F	<b>1.0</b>	2.1	2.4	1.4	2.1	1.5	1.1	1.7	1.3	1.6
2015F	<b>0.9</b>	1.8	2.2	1.2	1.9	1.4	1.1	1.6	1.2	1.5
P/S (x)										
2013	<b>0.6</b>	0.3	1.0	0.4	0.9	-	3.3	0.5	0.4	0.9
2014F	<b>0.5</b>	0.3	1.0	0.4	0.7	0.7	2.8	0.5	0.4	0.8
2015F	<b>0.5</b>	0.3	1.0	0.4	0.6	0.6	3.1	0.4	0.4	0.8
ROE (%)										
2013	<b>8.1</b>	37.1	14.2	13.6	12.4	-	13.1	10.3	10.6	14.9
2014F	<b>4.7</b>	26.7	18.4	12.8	13.9	13.0	11.3	11.8	9.6	13.6
2015F	<b>7.3</b>	26.2	19.3	12.7	14.4	12.8	12.3	13.3	11.0	14.4
ROA (%)										
2013	<b>2.9</b>	2.4	4.0	2.1	4.3	-	3.3	3.9	2.6	3.2
2014F	<b>1.9</b>	2.7	5.1	2.4	4.6	4.7	2.8	3.6	3.1	3.4
2015F	<b>3.1</b>	2.9	5.9	2.1	4.8	5.0	3.1	4.0	3.9	3.9
EPS (W)										
2013	<b>1,511</b>	394	7,113	3,571	55	-	44,362	221	528	-
2014F	<b>981</b>	411	8,803	3,162	67	83	36,511	266	564	-
2015F	<b>1,630</b>	459	9,824	3,518	78	94	41,307	321	709	-
BPS (W)										
2013	<b>18,157</b>	1,259	51,290	25,333	458	-	333,375	2,278	5,140	-
2014F	<b>21,244</b>	1,627	48,423	25,814	501	701	304,750	2,355	5,915	-
2015F	<b>22,602</b>	1,942	51,995	29,117	560	776	329,567	2,602	6,509	-

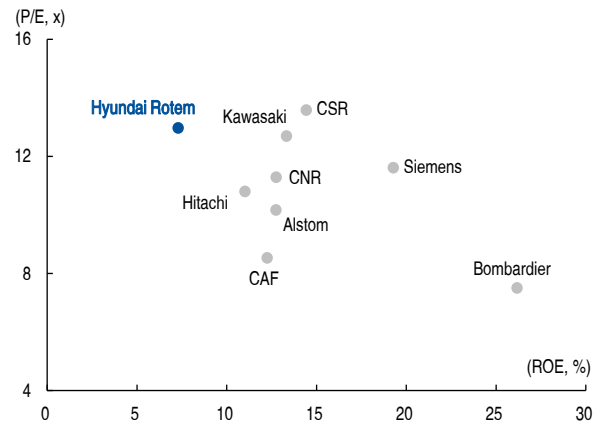
Source: Bloomberg, KDB Daewoo Securities Research

Figure 48. P/B-ROE comparison (2015F)



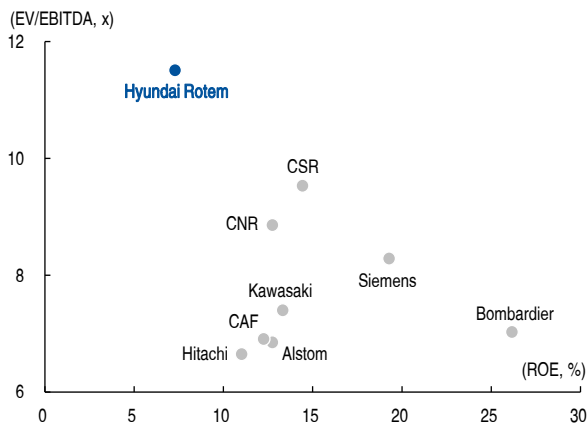
Source: Bloomberg, KDB Daewoo Securities Research

Figure 49. P/E-ROE comparison (2015F)



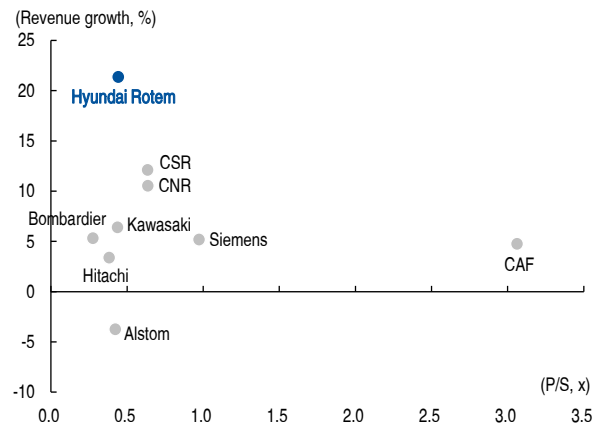
Source: Bloomberg, KDB Daewoo Securities Research

Figure 50. EV/EBITDA-ROE comparison (2015F)



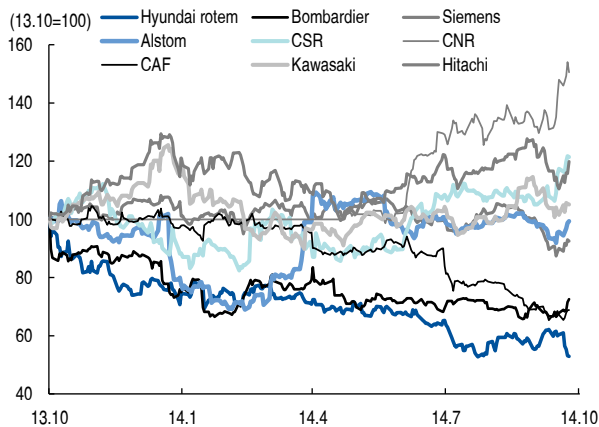
Source: Bloomberg, KDB Daewoo Securities Research

Figure 51. Revenue growth-P/S comparison (2015F)



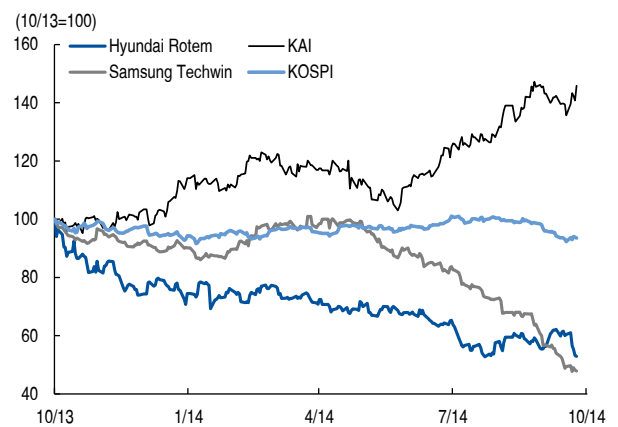
Source: Bloomberg, KDB Daewoo Securities Research

Figure 52. Relative share performances of global railway players



Source: Bloomberg, KDB Daewoo Securities Research

Figure 53. Relative share performances of domestic defense players



Source: Bloomberg, KDB Daewoo Securities Research

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## Risks

### 1. Vulnerable to F/X changes

Hyundai Rotem generates more than 50% of its revenue from exports. This proportion should increase further given the company's overseas expansion strategy. Despite growing exports, however, the company is taking a lukewarm stance on F/X hedging. Indeed, the recent fall in the US\$/W rate dragged down the company's margins. The company remains reluctant to engage in active F/X hedging, except for the strategies of maintaining a low level of imports for parts and hedging F/X risks for overseas debt.

### 2. Excessive dependence on affiliated companies

The plant and machinery unit relies on affiliated companies for more than 80% of orders. Despite the division's highly advanced technological capabilities, it still has few non-affiliated customers. It relies especially heavily on HMC and Kia Motors, and its dependence on Hyundai Steel and Hyundai Hysco is also significant. Without any capacity expansion, order growth is likely to be limited. We believe the unit needs to diversify its customer base to gain growth momentum.

### 3. Intense competition with Chinese companies in overseas markets

In order to enter the global rolling stock market, Hyundai Rotem is attempting to sharpen its competitiveness by building factories in the US, Turkey, and Brazil, as well as engaging in the services business overseas. However, with Chinese firms quickly penetrating the overseas market on the back of their domestic experience, we expect competition to stiffen in the US and the rest of the world.

## Hyundai Rotem (064350 KS/Buy/TP: W27,100)

## Comprehensive Income Statement (Summarized)

(Wbn)	12/13	12/14F	12/15F	12/16F
<b>Revenue</b>	<b>3,299</b>	<b>3,310</b>	<b>3,723</b>	<b>4,237</b>
<b>Cost of Sales</b>	<b>2,967</b>	<b>3,065</b>	<b>3,346</b>	<b>3,775</b>
<b>Gross Profit</b>	<b>332</b>	<b>245</b>	<b>377</b>	<b>462</b>
<b>SG&amp;A Expenses</b>	<b>158</b>	<b>176</b>	<b>197</b>	<b>218</b>
<b>Operating Profit (Adj)</b>	<b>174</b>	<b>69</b>	<b>181</b>	<b>244</b>
<b>Operating Profit</b>	<b>174</b>	<b>69</b>	<b>181</b>	<b>244</b>
<b>Non-Operating Profit</b>	<b>-10</b>	<b>3</b>	<b>-14</b>	<b>-29</b>
Net Financial Income	-54	-40	-34	-29
Net Gain from Inv in Associates	1	-3	0	0
Pretax Profit	164	72	167	215
Income Tax	38	13	30	39
Profit from Continuing Operations	126	59	136	176
Profit from Discontinued Operations	0	0	0	0
<b>Net Profit</b>	<b>126</b>	<b>59</b>	<b>136</b>	<b>176</b>
Controlling Interests	119	57	129	172
Non-Controlling Interests	7	2	7	4
<b>Total Comprehensive Profit</b>	<b>130</b>	<b>58</b>	<b>136</b>	<b>176</b>
Controlling Interests	123	57	133	172
Non-Controlling Interests	7	2	3	4
EBITDA	245	142	250	309
FCF (Free Cash Flow)	-492	-20	169	191
EBITDA Margin (%)	7.4	4.3	6.7	7.3
Operating Profit Margin (%)	5.3	2.1	4.9	5.8
Net Profit Margin (%)	3.6	1.7	3.5	4.1

## Statement of Financial Condition (Summarized)

(Wbn)	12/13	12/14F	12/15F	12/16F
<b>Current Assets</b>	<b>2,577</b>	<b>3,436</b>	<b>3,036</b>	<b>3,259</b>
Cash and Cash Equivalents	117	899	348	420
AR & Other Receivables	385	404	436	460
Inventories	193	223	235	247
Other Current Assets	1,882	1,910	2,017	2,132
<b>Non-Current Assets</b>	<b>1,698</b>	<b>1,661</b>	<b>1,615</b>	<b>1,572</b>
Investments in Associates	2	2	2	2
Property, Plant and Equipment	1,428	1,360	1,321	1,286
Intangible Assets	154	178	167	157
<b>Total Assets</b>	<b>4,275</b>	<b>5,097</b>	<b>4,652</b>	<b>4,831</b>
<b>Current Liabilities</b>	<b>1,583</b>	<b>1,793</b>	<b>1,397</b>	<b>1,491</b>
AP & Other Payables	454	480	516	546
Short-Term Financial Liabilities	505	738	238	238
Other Current Liabilities	624	575	643	707
<b>Non-Current Liabilities</b>	<b>902</b>	<b>1,466</b>	<b>1,292</b>	<b>1,211</b>
Long-Term Financial Liabilities	602	1,162	962	862
Other Non-Current Liabilities	300	304	330	349
<b>Total Liabilities</b>	<b>2,485</b>	<b>3,259</b>	<b>2,689</b>	<b>2,703</b>
<b>Controlling Interests</b>	<b>1,714</b>	<b>1,759</b>	<b>1,878</b>	<b>2,039</b>
Capital Stock	425	425	425	425
Capital Surplus	408	408	408	408
Retained Earnings	882	928	1,047	1,208
<b>Non-Controlling Interests</b>	<b>76</b>	<b>78</b>	<b>85</b>	<b>89</b>
<b>Stockholders' Equity</b>	<b>1,790</b>	<b>1,837</b>	<b>1,963</b>	<b>2,128</b>

## Cash Flows (Summarized)

(Wbn)	12/13	12/14F	12/15F	12/16F
Cash Flows from Op Activities	-409	9	189	211
Net Profit	126	59	136	176
Non-Cash Income and Expense	181	139	134	133
Depreciation	58	62	59	55
Amortization	12	11	10	10
Others	111	66	65	68
Chg in Working Capital	-644	-121	-16	-30
Chg in AR & Other Receivables	-456	-75	-29	-23
Chg in Inventories	-37	-30	-12	-12
Chg in AP & Other Payables	-72	-56	30	26
<b>Income Tax Paid</b>	<b>-20</b>	<b>-27</b>	<b>-30</b>	<b>-39</b>
Cash Flows from Inv Activities	-24	-23	-30	-28
Chg in PP&E	-83	9	-20	-20
Chg in Intangible Assets	-22	0	0	0
Chg in Financial Assets	41	5	-10	-8
<b>Others</b>	<b>40</b>	<b>-37</b>	<b>0</b>	<b>0</b>
Cash Flows from Fin Activities	441	797	-711	-111
Chg in Financial Liabilities	-42	793	-700	-100
Chg in Equity	476	0	0	0
Dividends Paid	0	-11	-11	-11
<b>Others</b>	<b>7</b>	<b>15</b>	<b>0</b>	<b>0</b>
Increase (Decrease) in Cash	3	783	-551	72
Beginning Balance	113	117	899	348
<b>Ending Balance</b>	<b>117</b>	<b>899</b>	<b>348</b>	<b>420</b>

Source: Company data, KDB Daewoo Securities Research estimates

## Forecasts/Valuations (Summarized)

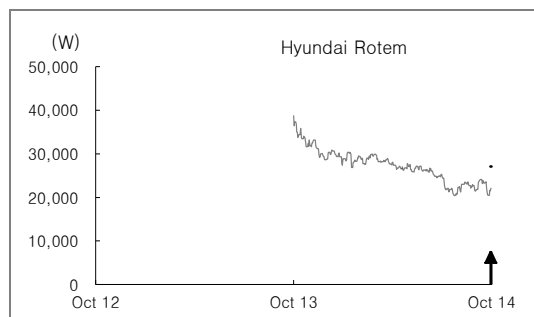
	12/13	12/14F	12/15F	12/16F
P/E (x)	16.4	33.2	14.5	10.9
P/CF (x)	6.4	9.5	6.9	6.1
P/B (x)	1.4	1.1	1.0	0.9
EV/EBITDA (x)	14.1	20.4	11.0	8.3
EPS (W)	1,754	667	1,522	2,019
CFPS (W)	4,526	2,326	3,181	3,639
BPS (W)	20,159	20,696	22,093	23,987
DPS (W)	125	125	125	125
Payout ratio (%)	8.4	18.0	7.8	6.0
Dividend Yield (%)	0.4	0.6	0.6	0.6
Revenue Growth (%)	5.8	0.3	12.5	13.8
EBITDA Growth (%)	1.7	-42.0	76.1	23.6
Operating Profit Growth (%)	-0.6	-60.3	162.3	34.8
EPS Growth (%)	27.9	-62.0	128.2	32.7
Accounts Receivable Turnover (x)	7.5	8.9	9.4	10.0
Inventory Turnover (x)	18.8	15.9	16.2	17.6
Accounts Payable Turnover (x)	7.5	7.9	8.1	8.6
ROA (%)	3.2	1.3	2.8	3.7
ROE (%)	8.4	3.3	7.1	8.8
ROIC (%)	5.0	1.9	4.9	6.6
Liability to Equity Ratio (%)	138.9	177.4	137.0	127.0
Current Ratio (%)	162.7	191.6	217.4	218.5
Net Debt to Equity Ratio (%)	51.9	51.5	40.3	28.8
Interest Coverage Ratio (x)	2.9	1.3	3.3	6.1

## APPENDIX 1

### Important Disclosures & Disclaimers

#### 2-Year Rating and Target Price History

Company (Code)	Date	Rating	Target Price
Hyundai Rotem(064350)	10/28/2014	Buy	27,100



#### 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.

\* The achievement of the target price may be impeded by risks related to the subject securities and companies, as well as general market and economic conditions.

#### Disclosures

We managed the IPO of Hyundai Rotem, which listed on October 30, 2013.

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