

Namyang Dairy Products

(003920 KS)

Escaping trauma

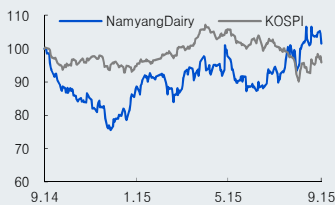
Company Report
September 23, 2015

Not Rated

Target Price (12M, W)	-
Share Price (09/23/15, W)	810,000
Expected Return	-

OP (15F, Wbn)	13
Consensus OP (15F, Wbn)	25
EPS Growth (15F, %)	7,410.7
Market EPS Growth (15F, %)	23.5
P/E (15F, x)	58.2
Market P/E (15F, x)	11.1
KOSPI	1,944.64
Market Cap (Wbn)	583
Shares Outstanding (mn)	1
Free Float (%)	40.6
Foreign Ownership (%)	17.5
Beta (12M)	0.63
52-Week Low	603,000
52-Week High	850,000

(%)	1M	6M	12M
Absolute	8.9	15.5	1.5
Relative	5.0	21.0	5.9



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[F&B/Tobacco]

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The worst is over

Namyang Dairy Products recorded an operating profit in 1H15, after suffering continuous operating losses from 3Q13 to 4Q14. The losses had resulted from 1) the fall in brand royalty and ensuing market share loss in the wake of the 1H13 scandal over Namyang's unfair business practices; 2) compensation paid to small retailers and distributors the company had wronged; and 3) increased losses at the coffee mix unit, which incurred massive capex.

This year, along with the recovery in earnings, the company has seen a pickup in its share of the domestic powdered infant formula market and growth in exports, particularly to China. In addition, new fermented milk and milk beverage products are getting positive receptions. Losses on coffee drinks (French Café) are likely to shrink thanks to lower fixed costs resulting from export growth and reduced marketing spend.

The company's net cash position, which contracted in 2013-14, will likely expand starting in 2015 due to the absence of massive capex.

Improving fundamentals

For the full year, we expect the company to swing to an operating profit on the back of lowered coffee losses, robust domestic infant formula sales, the recovery in fermented milk sales, SKU cuts, and marketing cost reductions. We project operating profit to further improve in 2016 thanks to infant formula export growth, a continued decrease in coffee losses, new product launches, and increasing milk profits. The stock's P/B for 2015-2016 is estimated at only 0.8-0.9x. In light of improving fundamentals, Namyang deserves attention over the long term.

China-bound infant formula exports to grow

In 2014, Namyang's W1.15tr in revenue broke down into milk (29%), fermented milk (21%), powdered infant formula (16%), coffee mix (10%), cheese (3-4%), and beverages and other (20%).

In 1H15, the company's powdered infant formula exports to China jumped more than 90% YoY to W17bn. Full-year powdered infant formula exports are anticipated to soar 95.6% YoY to W45bn, from W23bn in 2014. For 2015, we forecast the margin on infant formula exports to China to exceed 5%. China's powdered infant formula market is forecast to grow from W19tr in 2014 to W21tr in 2015 and W23tr in 2016, according to the National Bureau of Statistics of China, KOTRA, and media reports. Given growing exports, Namyang is considering establishing a Chinese subsidiary.

While targeting areas such as Cheongdo, Dalian, and Hangzhou, Namyang is reliant on five retailers (three local retailers and two Korean ones), whose sales prices vary depending on the area. The company's powdered infant formula products are sold under four brand names in China: Ai ZhiBao, Xing BeiEr, Mingdao Xiu, and Namyang Shanyang Rufen. Sales are driven mainly by large discount stores, while online sales are still minimal. But given the growth of online commerce in China, we believe Namyang will need to boost online sales in order to further expand powdered infant formula exports.

FY (Dec.)	12/12	12/13	12/14	12/15F	12/16F	12/17F
Revenue (Wbn)	1,365	1,230	1,152	1,210	1,268	1,321
OP (Wbn)	64	-17	-26	13	20	29
OP margin (%)	4.7	-1.4	-2.3	1.1	1.6	2.2
NP (Wbn)	61	-46	0	12	20	27
EPS (W)	68,879	-51,361	185	13,917	22,084	30,407
ROE (%)	7.2	-5.4	0.0	1.5	2.3	3.1
P/E (x)	13.7	-	3,448.5	58.2	36.7	26.6
P/B (x)	0.9	1.0	0.7	0.8	0.8	0.8

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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Table 1. Namyang's product categories

Product	(%)
Milk Delicious GT, Einstein	29
Powdered infant formula XO Five Solution , I Am Mother, Baby Love, Namyang Step organic, etc.	16
Fermented milk Bulgaris, IO, Premium Bulgaris, etc.	21
Coffee French Café.	10
Other Cheese, 17 Tea, Natural Water	24

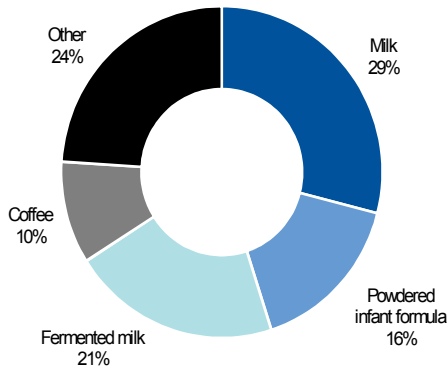
Source: Company data, KDB Daewoo Securities Research

Table 2. Namyang's M/S by product category

	2011	2012	2013	2014	1H15
Milk	26	25	24	23	23
Powdered infant formula	55	54	54	52	53
Fermented milk	32	32	30	31	32

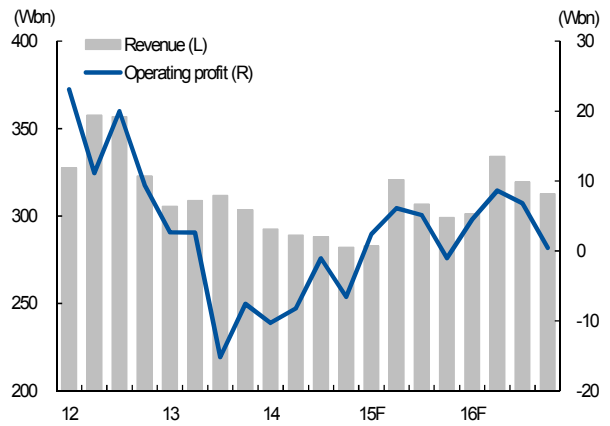
Source: Company data, Korea Food Distribution Journal, KDB Daewoo Securities Research

Figure 1. Revenue breakdown by product category



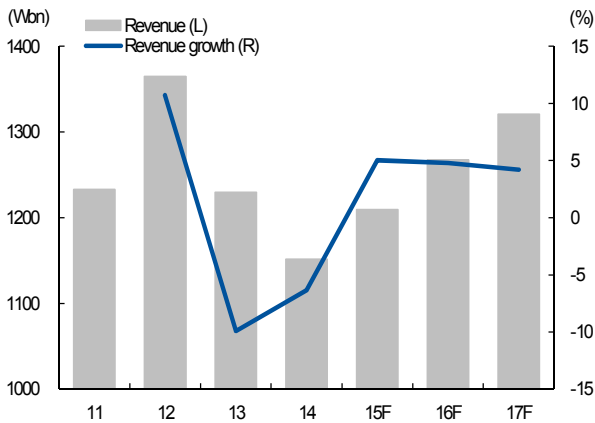
Source: Company data, KDB Daewoo Securities Research

Figure 2. Revenue and OP have been recovering since 1Q15



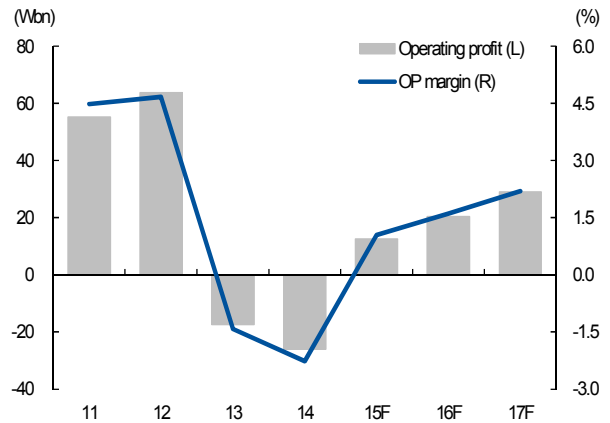
Source: Company data, KDB Daewoo Securities Research

Figure 3. Revenue to grow steadily starting in 2015



Source: Company data, KDB Daewoo Securities Research

Figure 4. Operating profit growth is normalizing



Source: Company data, KDB Daewoo Securities Research

Growth of the Chinese powdered infant formula market

The Chinese powdered infant formula market is projected to grow from W19tr in 2014 to W21tr in 2015 and W23tr in 2016 (based on data from the National Bureau of Statistics of the People’s Republic of China and media reports). In 2013, the country’s infant formula market amounted to RMB60bn (about W10tr), according to a Chinese industrial research report. In our view, the market’s sharp growth is being driven by the easing of the one-child policy, the expansion of distribution channels (online, etc.), and the growing popularity of premium products.

By brand, Mead Johnson (US) leads the market with a share of 12.3%, followed by Dumex (France, 11.7%), Wyeth (US, 11.0%), and Being Mate (China, 8.7%). Among the top 10 brands, six are foreign brands, taking up 50% of the market.

By price level, the market can be broken down into high-end (RMB300 or higher; 9% market share), mid/high-end (RMB200-299; 42%), mid-end (RMB150-199; 29%), and mid/low-end (RMB149 and lower; 20%) segments. Korean products all belong to the high-end and mid/high-end segments, with Maeil Dairies’ Geumjeon Myungjak and Absolute Goong selling at RMB300-400, Namyang’s Imperial and I Am Mother at RMB220-250, and Lotte Food’s Grand Noble at RMB250-300.

As of end-2013, 128 Chinese companies with 500 brands were operating in the Chinese powdered infant formula market. However, restructuring and consolidation will likely bring down the number of players to 50 by end-2018.

From 2007 to 2013, the annual number of newborns in China exceeded 16mn. The number of children aged three or younger in China is estimated at 60mn, with an estimated 20% being fed powdered formulas. With the country’s easing of the one-child policy, the number of newborns is expected to rise to 18-18.5mn annually, boosting the infant formula market by RMB16bn (W2.85tr).

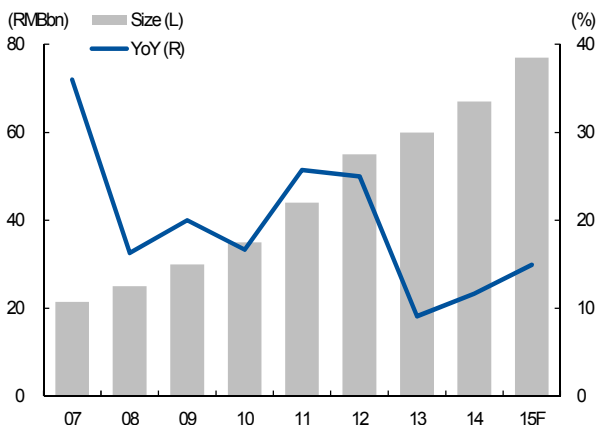
Korea’s powdered infant formula exports to China climbed from US\$56.4mn in 2013 to US\$75.4mn in 2014. This year, YTD exports as of August increased 40.9% YoY to US\$61.3mn. The Netherlands and New Zealand are the leading infant formula exporters to China, and Korea ranks eighth.

Domestic infant formula makers are distributing products via local agents. In light of Chinese consumers’ strong preference for foreign brands, the Chinese market should serve as a huge opportunity for domestic players. As Chinese consumers place the most emphasis on safety and quality, Korean companies should focus more on hygiene and safety.

The Chinese government applies a 5% tariff and 17% VAT on infant formula imports (The implementation of the Korea-China FTA should not affect the tariff on infant formula). This year, China-bound exports of the three major domestic players (Namyang, Maeil Dairies, and Lotte Food) are projected to be below W50bn each, with a combined market share of just 1-2%. As such, it is unlikely they will be able to start local production and sales in China within the next one to two years. When their respective exports exceed W100bn, however, they might consider establishing local production bases and sales channels.

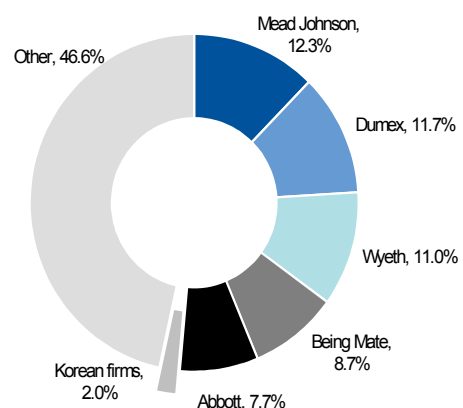
To further expand their footholds in China, domestic companies need to improve product hygiene and safety, strengthen brand power, diversify products, enhance products’ ability to be digested and absorbed (targeting Asian consumers), conduct viral marketing, expand distribution channels to second- to third-tier cities, and bolster online marketing.

Figure 5. Size of China’s powdered infant formula market



Source: Media reports, KOTRA, China Industry Research Reports, KDB Daewoo Securities Research

Figure 6. China’s powdered infant formula M/S breakdown



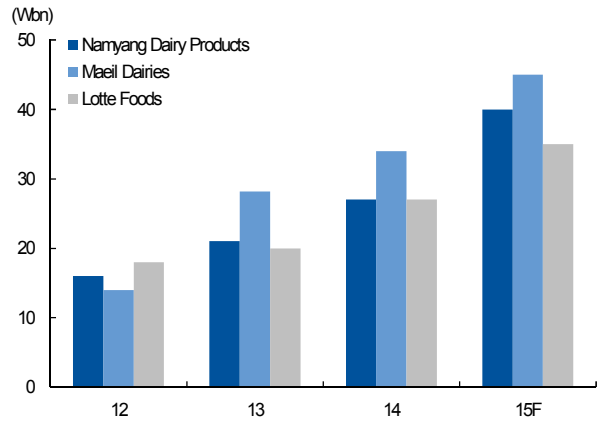
Source: Media reports, KOTRA, China Industry Research Reports, KDB Daewoo Securities Research

Figure 7. Powdered infant formula products that Namyang exports to China



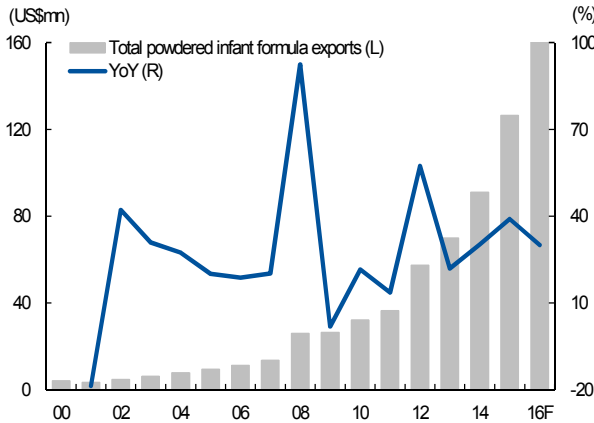
Source: Company data, KDB Daewoo Securities Research

Figure 8. Domestic firms' powdered infant formula export forecast



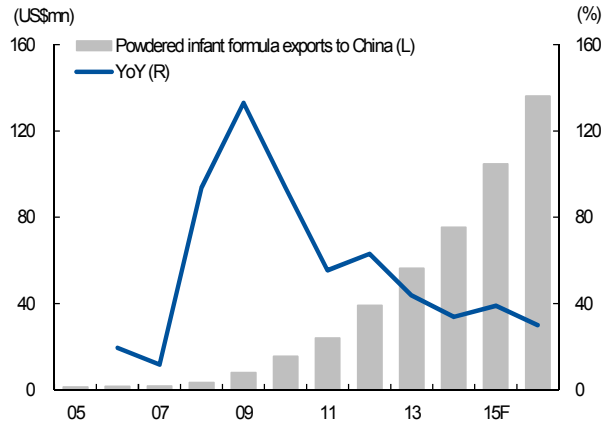
Source: Media reports, company data, KDB Daewoo Securities Research

Figure 9. Domestic firms' annual powdered infant formula exports



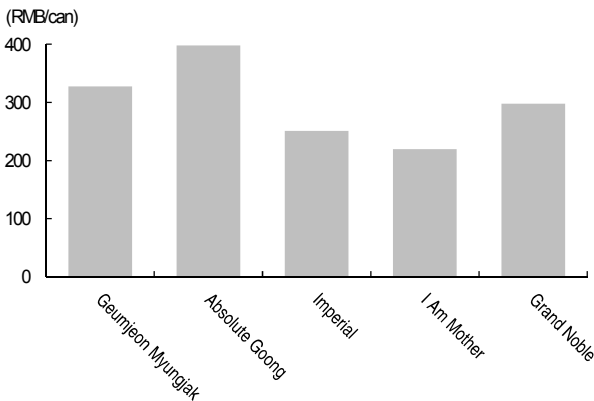
Source: Korea Customs Service, KDB Daewoo Securities Research

Figure 10. Domestic firms' annual powdered infant formula exports to China



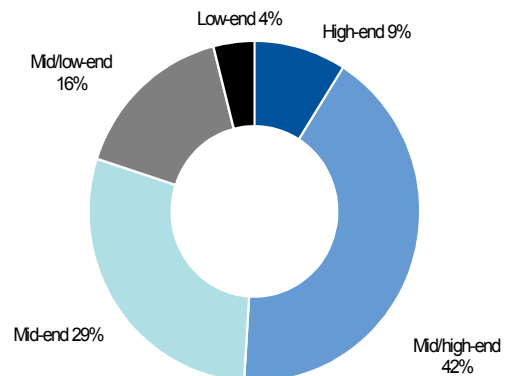
Source: Korea Customs Service, KDB Daewoo Securities Research

Figure 11. Domestic firms' mid/high-end and high-end products exported to China



Source: KOTRA, China Industry Research Reports, KDB Daewoo Securities Research

Figure 12. Powdered infant formula products sold in China: Breakdown by price level



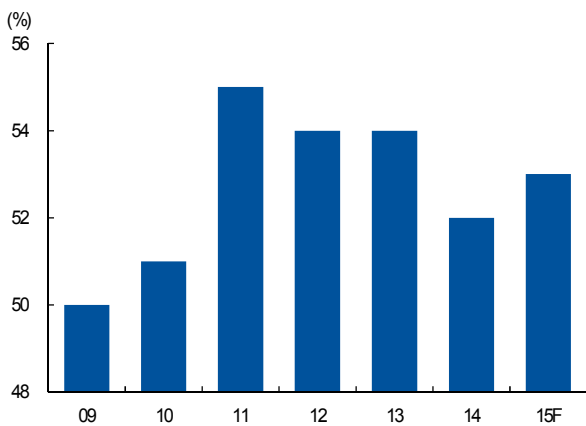
Notes: High-end = RMB300 or higher; Mid/high-end = RMB200-299; Mid-end = RMB150-199; Mid/low-end = RMB149 or lower
 Source: KOTRA, China Industry Research Reports, KDB Daewoo Securities Research

Domestic infant formula ensures high profit margins

For 2015, we estimate the size of the domestic infant formula market at W400bn. Due to high barriers to entry (large capex, brand awareness, etc.), the market remains oligopolistic, with only four to five producers dominating the market. Infant formula products ensure healthy margins, as long as existing producers refrain from excessive marketing competition. Nevertheless, the market has been shrinking since 2000 amid declining birth rates and increased breastfeeding.

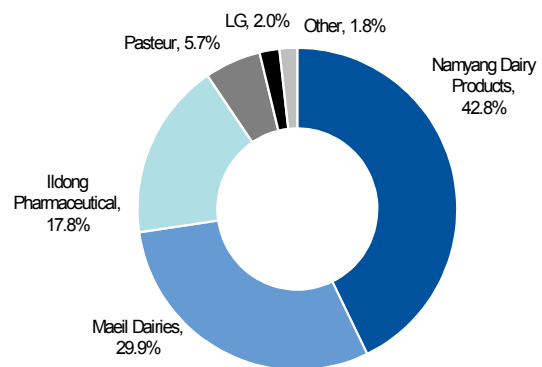
In 1H15, Namyang’s domestic infant formula sales (I Am Mother, XO, and Baby Love) jumped more than 10% YoY due to a low base effect. (Sales were sluggish last year due to the lingering impact of the scandal.) Full-year sales are estimated at W200bn, with a profit margin of 15-20%. Namyang should be able to maintain its domestic infant formula margin for a while, on the back of the growing share of high-margin online sales (over 50%) and its market share recovery.

Figure 13. Namyang’s domestic M/S in powdered infant formula products



Source: Company data, KDB Daewoo Securities Research

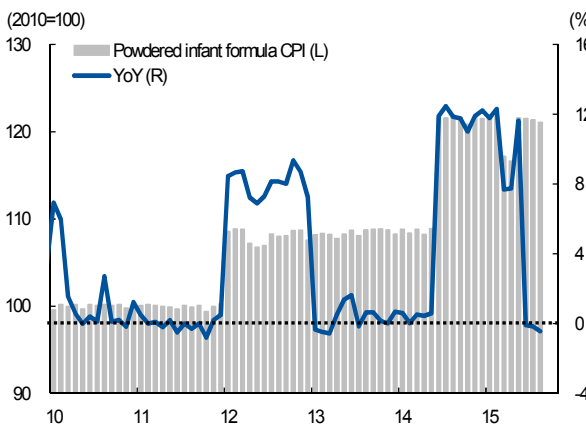
Figure 14. Domestic powdered infant formula M/S breakdown (2014)



Notes: Online sales excluded

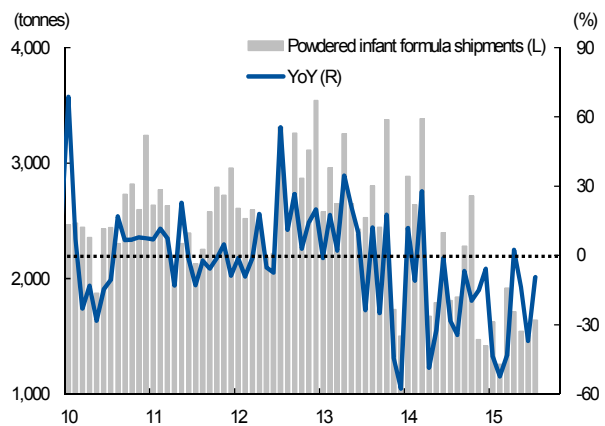
Source: Korea Food Distribution Journal, KDB Daewoo Securities Research

Figure 15. CPI of domestic powdered infant formula has risen



Source: KOSTAT, KDB Daewoo Securities Research

Figure 16. Domestic powdered infant formula shipments are on the decline



Source: KOSTAT, KDB Daewoo Securities Research

Fermented milk/milk sales rise on new product releases

Fermented milk/milk sales are recovering. The recovery of Bulgari sales (annual revenue of W80-90bn) and new products (Chocoemong, Milk 100, Probiotic, etc.) are helping to improve Namyang’s product mix. In particular, the high-margin Chocoemong is delivering monthly revenue of W5-6bn, heightening expectations of a long-awaited new cash cow. But overall, beverages (including milk) generate small profits due to the large number of products. As such, the company will need to improve profits via SKU cuts and more efficient marketing.

Plain milk broke even; Profits may increase in 2016

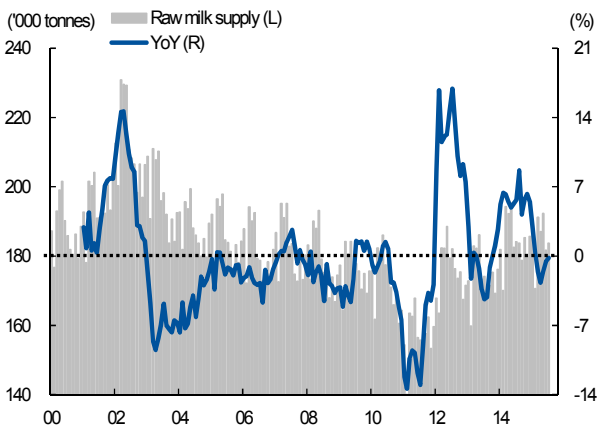
Raw milk is in oversupply, and plain milk consumption is experiencing a structural decline due to the shrinking child population and increase in milk substitutes. And the raw milk price indexation system (inflation → raw milk price increase → milk product price hikes) makes cutting retail prices impossible. Under the raw milk quota system, plain milk producers are required to purchase most of the raw milk produced, and so they bear all losses arising from demand and supply imbalance.

In 2H14-1H15, plain milk producers (mostly Seoul Dairy and Maeil) incurred losses amid increased efforts to deal with raw milk oversupply (discounts, incentive payments, etc.) Oversupply is now easing, but only gradually. Powdered milk inventory surged to 20,000 tonnes due to the oversupply, far above the normal level of 7,000 tonnes.

Namyang’s plain milk business seems to have managed to break even, thanks to its strong brands and raw milk supply contract, which differs slightly from Maeil’s. We expect raw milk oversupply to continue to ease gradually, thanks to 1) the freezing of raw milk prices (for two consecutive years), 2) efforts to reduce raw milk production, 3) the peaking of powdered milk inventory, and 4) increased milk consumption caused by rising demand for flavored milk/fermented milk/coffee-flavored milk.

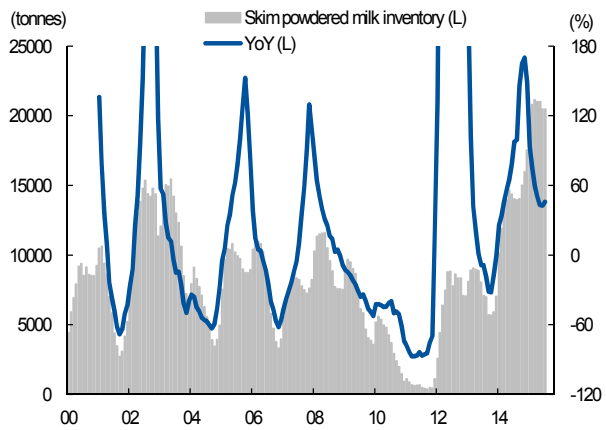
As raw milk oversupply has begun easing since the start of 2H15, Namyang’s plain milk business may see increased profits in 2016.

Figure 17. Domestic raw milk supply has fallen slightly



Source: KOSTAT, KDB Daewoo Securities Research

Figure 18. Skim powdered milk inventory is at a peak



Source: KOSTAT, KDB Daewoo Securities Research

Reducing coffee losses is essential

The anticipated drop in coffee losses this year should drive up Namyang’s overall profitability, given that the company generates profits on milk, fermented milk, and powdered infant formula.

In December 2010, Namyang advanced into the coffee mix market with the French Café brand. The company launched strong marketing campaigns, highlighting the different taste of French Café compared to Dongsuh Foods’ Maxim, and in 2011 generated coffee revenue of W80.5bn, with a market share of 7.3%. Backed by this success, in 2012-13, the company invested W180bn to build a factory in Naju (annual capacity of W300bn) with an integrated system for coffee bean imports, extraction, and packaging.

Namyang’s coffee market share rose to 18-19% in 2012, driven by massive marketing activities, but dropped in 2013 in the wake of the scandal over Namyang’s unfair business practices. Although the company’s coffee market share has since recovered to around 17%, coffee losses have expanded sharply.

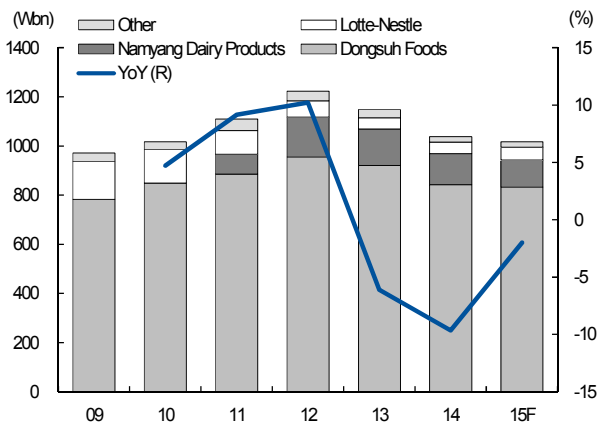
Since 2H14, Namyang has revised its coffee business strategy to focus on profitability rather than revenue. The company found it difficult to achieve its targets (market share of 30% and OP margin of 3%) due to 1) Dongsuh Foods’ efforts to defend Maxim’s market share, 2) the strengthened coffee business of Lotte Nestlé, and 3) the contraction of the coffee mix market.

The coffee mix market, which amounted to W1.223tr in 2012, contracted to W1.149tr (-6.1% YoY) in 2013 and W1.038tr (-9.6% YoY) in 2014 due to 1) increased alternatives to instant coffee, 2) the growth of franchise coffee brands, and 3) the expansion of brewed coffee. We think companies will have to increase marketing spend sharply to raise the share of the coffee mix market, which is currently contracting and dominated by a single player. In 2014, Namyang is estimated to have recorded coffee revenue of W150bn and an operating loss of more than 30bn.

The company’s coffee business would break even if coffee revenue expands to W250bn in 2015. Given the shrinking domestic market, however, we believe the company needs to reduce costs and boost exports to break even. Indeed, the company is making aggressive cost-saving efforts, including reducing fixed costs by raising capacity utilization (to meet growing exports to Poland and Russia). The company also plans to increase coffee mix exports to China if demand grows.

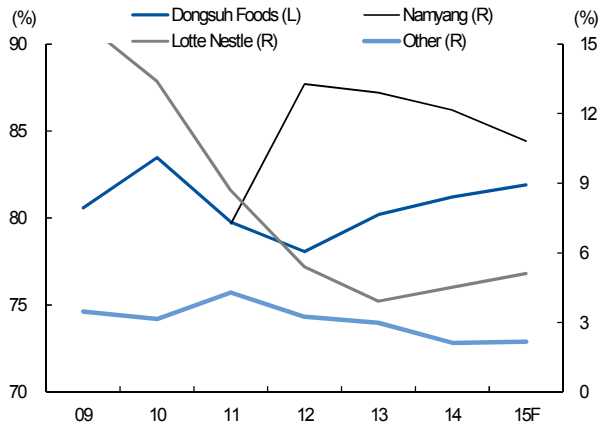
Coffee revenue plummeted 18% YoY in 1H15, and for the full year is forecast to shrink 20% YoY to W110-120bn (market share of 11-12%). However, thanks to cost reduction efforts (e.g., lower marketing spend and reduced fixed costs), operating losses are likely to decrease dramatically.

Figure 19. Size and growth of domestic coffee mix market are on the decline



Source: Korea Food Distribution Journal, KDB Daewoo Securities Research

Figure 20. Namyang’s M/S in the domestic coffee market is falling



Source: Korea Food Distribution Journal, KDB Daewoo Securities Research

Raw material prices, F/X rates, and interest income

Namyang’s earnings are affected by raw material prices, F/X rates, and interest income. Raw milk accounts for 70% of raw material costs. Due to the severe supply glut, raw milk prices have stayed unchanged for two years, and are likely to stay flat this year. As such, we do not expect a rise in raw material costs.

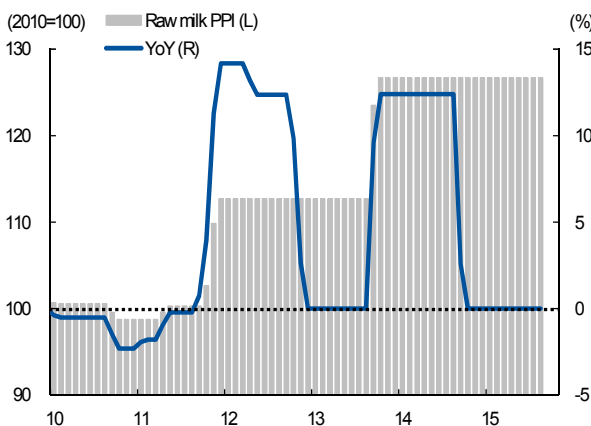
The company relies only minimally on overseas raw materials (e.g., soybean). In addition, given limited foreign currency debts, the company is not sensitive to F/X volatility.

Adhering to a no-debt policy, Namyang holds net cash worth W150bn. Considering the decrease in capex and increase in EBITDA, net cash is likely to increase further starting this year.

On the way to normalization

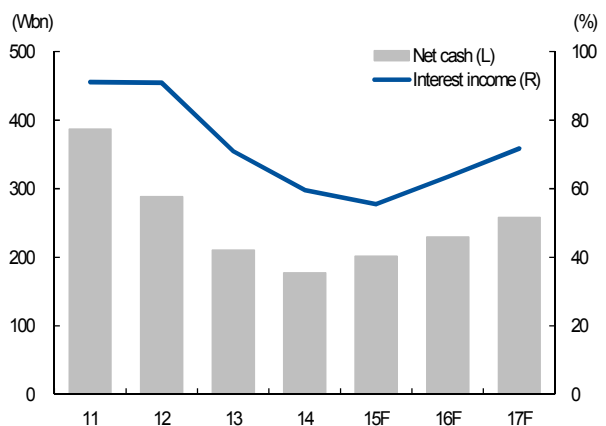
In the wake of the 2013-14 scandal over unfair business practices, Namyang suffered revenue deterioration and operating losses for two straight years. But the company is picking up this year. In 2015, we forecast Namyang to turn to an operating profit on revenue growth of 5.6%. For 2016, we project the company to generate revenue growth of 4.8% and operating profit growth of 61.9% on the back of new products, export growth, recovery of existing brand products, and a decline in coffee mix marketing expenses. Although we do not expect the company to fully rebound to pre-scandal levels in 2015-16, the pickup now being witnessed appears meaningful.

Figure 21. Raw milk price has remained unchanged for two years



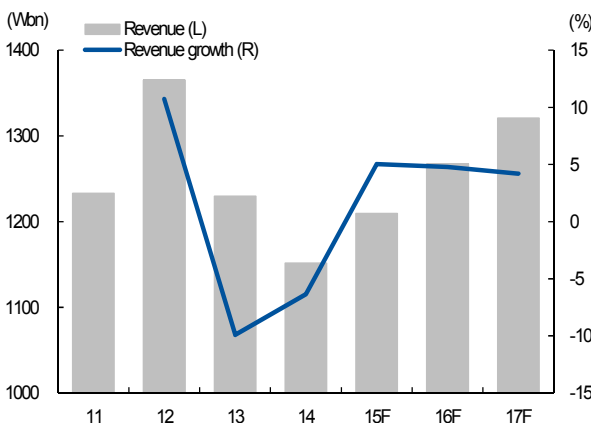
Source: KOSTAT, KDB Daewoo Securities Research

Figure 22. Namyang’s interest income to increase steadily from 2015



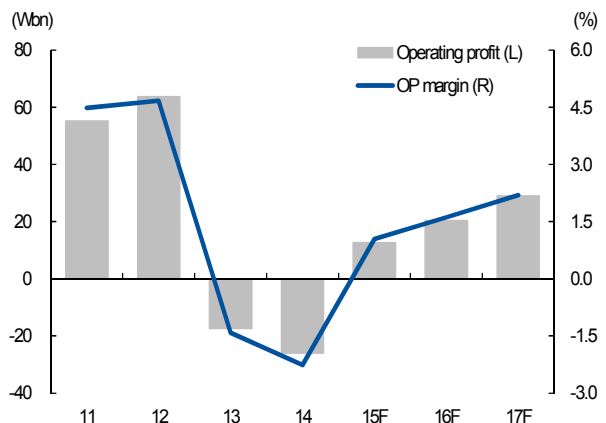
Source: Company data, KDB Daewoo Securities Research

Figure 23. Revenue should also grow steadily from 2015



Source: Company data, KDB Daewoo Securities Research

Figure 24. Operating profit growth is normalizing



Source: Company data, KDB Daewoo Securities Research

Namyang Dairy Products (003920 KS/Not Rated)

Comprehensive Income Statement (Summarized)

(Wbn)	12/14	12/15F	12/16F	12/17F
Revenue	1,152	1,210	1,268	1,321
Cost of Sales	858	874	910	941
Gross Profit	294	336	358	380
SG&A Expenses	319	323	337	351
Operating Profit (Adj)	-26	13	20	29
Operating Profit	-26	13	20	29
Non-Operating Profit	26	7	7	8
Net Financial Income	6	6	6	7
Net Gain from Inv in Associates	0	0	0	0
Pretax Profit	0	20	27	37
Income Tax	0	7	7	10
Profit from Continuing Operations	0	12	20	27
Profit from Discontinued Operations	0	0	0	0
Net Profit	0	12	20	27
Controlling Interests	0	12	20	27
Non-Controlling Interests	0	0	0	0
Total Comprehensive Profit	-2	12	20	27
Controlling Interests	-2	12	20	27
Non-Controlling Interests	0	0	0	0
EBITDA	15	53	57	63
FCF (Free Cash Flow)	-80	16	32	33
EBITDA Margin (%)	1.3	4.4	4.5	4.8
Operating Profit Margin (%)	-2.3	1.1	1.6	2.2
Net Profit Margin (%)	0.0	1.0	1.6	2.0

Cash Flows (Summarized)

(Wbn)	12/14	12/15F	12/16F	12/17F
Cash Flows from Op Activities	-50	31	47	53
Net Profit	0	12	20	27
Non-Cash Income and Expense	21	46	37	37
Depreciation	41	40	37	34
Amortization	0	0	0	0
Others	-20	6	0	3
Chg in Working Capital	-80	-31	-9	-9
Chg in AR & Other Receivables	5	-7	-6	-6
Chg in Inventories	-30	-11	-9	-9
Chg in AP & Other Payables	-5	2	3	3
Income Tax Paid	0	-2	-7	-10
Cash Flows from Inv Activities	48	-14	-24	-29
Chg in PP&E	-13	-15	-15	-20
Chg in Intangible Assets	0	0	0	0
Chg in Financial Assets	26	-12	-9	-9
Others	35	13	0	0
Cash Flows from Fin Activities	-1	-1	-1	-1
Chg in Financial Liabilities	0	0	0	0
Chg in Equity	0	0	0	0
Dividends Paid	-1	-1	-1	-1
Others	0	0	0	0
Increase (Decrease) in Cash	-3	17	22	23
Beginning Balance	62	59	75	98
Ending Balance	59	75	98	121

Source: Company data, KDB Daewoo Securities Research estimates

Statement of Financial Condition (Summarized)

(Wbn)	12/14	12/15F	12/16F	12/17F
Current Assets	503	547	591	634
Cash and Cash Equivalents	59	75	98	121
AR & Other Receivables	134	142	149	155
Inventories	186	197	206	215
Other Current Assets	124	133	138	143
Non-Current Assets	460	436	418	407
Investments in Associates	0	0	0	0
Property, Plant and Equipment	335	310	289	275
Intangible Assets	7	7	7	7
Total Assets	963	983	1,009	1,041
Current Liabilities	108	115	120	125
AP & Other Payables	69	74	77	80
Short-Term Financial Liabilities	0	0	0	0
Other Current Liabilities	39	41	43	45
Non-Current Liabilities	31	33	35	36
Long-Term Financial Liabilities	0	0	0	0
Other Non-Current Liabilities	31	33	35	36
Total Liabilities	139	148	154	161
Controlling Interests	824	835	854	880
Capital Stock	4	4	4	4
Capital Surplus	2	2	2	2
Retained Earnings	841	852	871	897
Non-Controlling Interests	0	0	0	0
Stockholders' Equity	824	835	854	880

Forecasts/Valuations (Summarized)

	12/14	12/15F	12/16F	12/17F
P/E (x)	3,448.5	58.2	36.7	26.6
P/CF (x)	26.2	12.3	12.6	11.2
P/B (x)	0.7	0.8	0.8	0.8
EV/EBITDA (x)	21.6	8.1	7.0	5.9
EPS (W)	185	13,917	22,084	30,407
CFPS (W)	24,430	65,614	64,301	72,250
BPS (W)	955,307	968,216	989,336	1,018,779
DPS (W)	1,000	1,000	1,000	1,000
Payout ratio (%)	413.7	5.5	3.5	2.5
Dividend Yield (%)	0.2	0.1	0.1	0.1
Revenue Growth (%)	-6.3	5.0	4.8	4.2
EBITDA Growth (%)	66.7	253.3	7.5	10.5
Operating Profit Growth (%)	-	-	53.8	45.0
EPS Growth (%)	-	7,422.7	58.7	37.7
Accounts Receivable Turnover (x)	8.5	8.9	8.9	8.8
Inventory Turnover (x)	6.7	6.3	6.3	6.3
Accounts Payable Turnover (x)	12.3	12.7	12.5	12.4
ROA (%)	0.0	1.3	2.0	2.6
ROE (%)	0.0	1.5	2.3	3.1
ROIC (%)	-1.8	1.4	2.7	3.9
Liability to Equity Ratio (%)	16.9	17.7	18.1	18.3
Current Ratio (%)	465.4	476.9	492.8	507.8
Net Debt to Equity Ratio (%)	-21.6	-24.1	-26.9	-29.4
Interest Coverage Ratio (x)	0.0	0.0	0.0	0.0

APPENDIX 1

Important Disclosures & Disclaimers

Equity Ratings Distribution

Buy	Trading Buy	Hold	Sell
72.36%	13.57%	14.07%	0.00%

* Based on recommendations in the last 12-months (as of June 30, 2015)

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