

Kakao

(035720 KS/Trading Buy)

Kakao to merge with Kakao M to separate platform and content

- Kakao announced plans to merge with Kakao M (formerly LOEN Entertainment) at a 1:0.8 ratio on September 1st
- Combination of Kakao and Melon to strengthen AI business and boost Melon's paid subscribers
- Kakao M's music/video production business to be spun off; Content production business to be enhanced

1. Separation of platform and content to enhance specialization

Yesterday, Kakao announced plans to merge with its subsidiary Kakao M (016170 KQ/CP: W93,200). Acquired by Kakao in March 2016, Kakao M reorganized its Melon platform, music content, and video content businesses into a company-in-company (CIC) structure in October 2017 and officially changed its name from LOEN Entertainment to Kakao M in March 2018. On September 1st, the Melon platform business will merge with Kakao. We believe the separation of platform and content production will enhance the specialization of each business.

1) Platform operation: Kakao's integration of the Melon platform has already been underway. In March 2018, the "Melon with Kakao" function, which allows users to directly access Melon's music streaming service on the KakaoTalk app, was renamed "Kakao Melon." Kakao Friends characters have also been incorporated into Melon.

Looking ahead, Kakao and Kakao M are likely to combine their user info and share data. We could potentially see a rise in Kakao M's paid subscribers. Melon's paid subscribers have increased to 4.65mn in May 2018 from 3.6mn in March 2016, when it was acquired. We think the positive effects of the Kakao account linkage could be further amplified.

We also expect music content to be more widely utilized in Kakao's AI business. Some of the key features of Kakao's AI speaker Kakao Mini are music streaming and personalized recommendations. On its Melon app, Kakao M currently offers AI services like "Smart it" (voice search and music recommendations) and the Lony chatbot.

2) Content production: After merging with Kakao M, Kakao plans to spin off Kakao M's music and video production units into a separate company. Kakao M has a vertically integrated value chain across platform and content, but the different natures of the platform and content businesses have led to issues like slow decision-making and conflicting interests. We believe separating the content production business will help facilitate video content production, distribution, and investment.

We maintain our Trading Buy rating on Kakao. We believe the latest deal will have a limited near-term impact on Kakao's value, as the company already owns 76.42% of Kakao M (consolidated).

In the medium and long term, we think the combination of platform and AI and the strengthening of the content business could have positive implications for revenue. We plan to revisit our target price once we get a clearer picture of business plans and development.

FY (Dec.)	12/15	12/16	12/17	12/18F	12/19F	12/20F
Revenue (Wbn)	932	1,464	1,972	2,446	2,806	3,024
OP (Wbn)	89	116	165	100	176	195
OP margin (%)	9.5	7.9	8.4	4.1	6.3	6.4
NP (Wbn)	76	58	109	98	145	156
EPS (W)	1,269	874	1,602	1,297	1,900	2,049
ROE (%)	3.0	1.9	2.9	2.4	3.5	3.6
P/E (x)	91.2	88.1	85.5	89.9	61.3	56.8
P/B (x)	2.7	1.5	2.3	2.2	2.1	2.0
Dividend yield (%)	0.1	0.2	0.1	0.1	0.1	0.1

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

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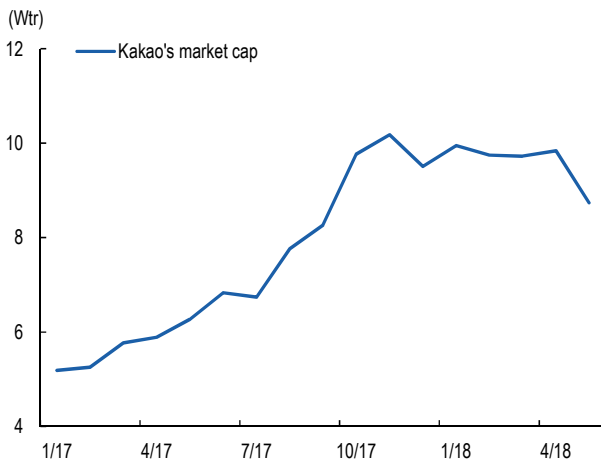
2. Merger overview

Table 1. Details of merger between Kakao and Kakao M

Merger ratio	Kakao : Kakao M = 1 : 0.8023366 (based on common stock)
Kakao merger price	₩115,808
Kakao M merger price	₩92,917
Kakao's current Kakao M stake	76.42% (consolidated subsidiary)
New issue	7,012,650 shares (9.2% of current shares outstanding)
Kakao's current shares outstanding	76,273,522 shares
Surviving entity	Kakao
Merging entity	Kakao M
Record date	June 1 st
Submission of dissent	June 4 th -18 th
Merger date	September 1 st
Listing of new shares	September 18 th

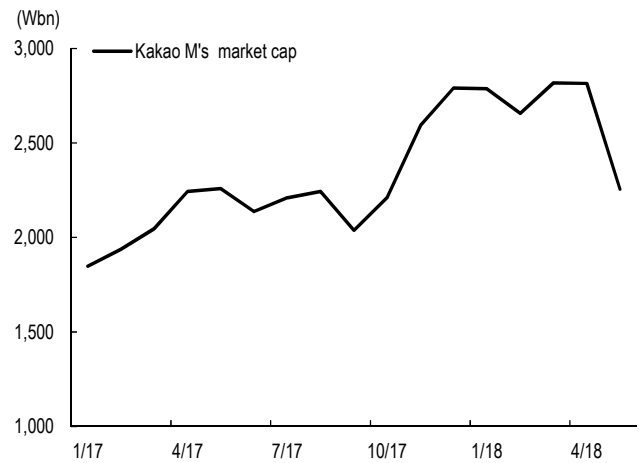
Source: Company data, Mirae Asset Daewoo Research

Figure 1. Kakao's market cap



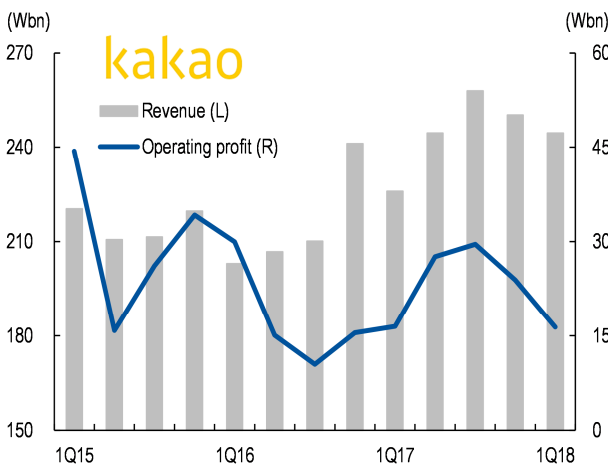
Source: Mirae Asset Daewoo Research

Figure 2. Kakao M's market cap



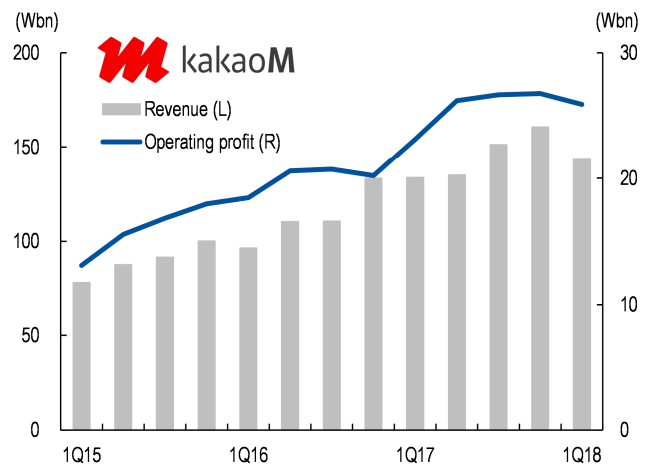
Source: Mirae Asset Daewoo Research

Figure 3. Kakao's parent earnings



Note: All figures are based on parent data.
Source: Mirae Asset Daewoo Research

Figure 4. Kakao M's earnings trend



Note: All figures are based on consolidated data.
Source: Mirae Asset Daewoo Research

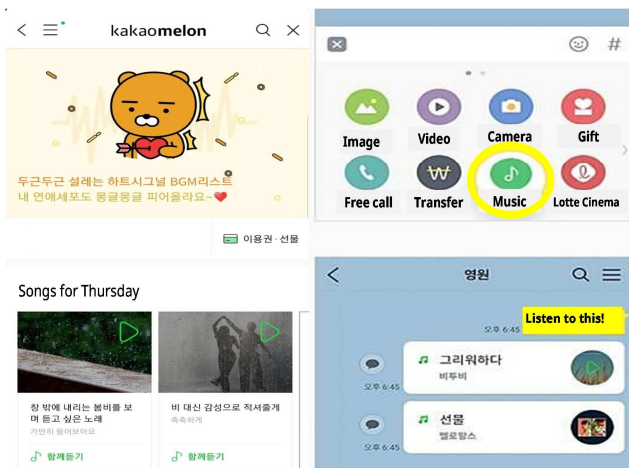
3. Platform: Integration already underway

Kakao’s integration of the Melon platform has already been underway. In March 2018, the “Melon with Kakao” function, which allows users to access Melon’s music streaming service on KakaoTalk without separately opening the Melon app, was renamed “Kakao Melon.” Kakao Friends characters have also been incorporated into Melon. For instance, the music streaming platform has offered free promotional Kakao Friends emoticons to attract monthly subscribers, and users can include KakaoTalk emoticons when writing music reviews.

Looking ahead, Kakao and Kakao M are likely to combine their user info and share data. We could potentially see a rise in Kakao M’s paid subscribers. Melon’s paid subscribers have increased to 4.65mn in May 2018 from 3.6mn in March 2016, when it was acquired. KakaoTalk’s domestic monthly active users (MAU) are around 43.52mn. We think the positive effects of linking Kakao accounts to Melon could be further amplified.

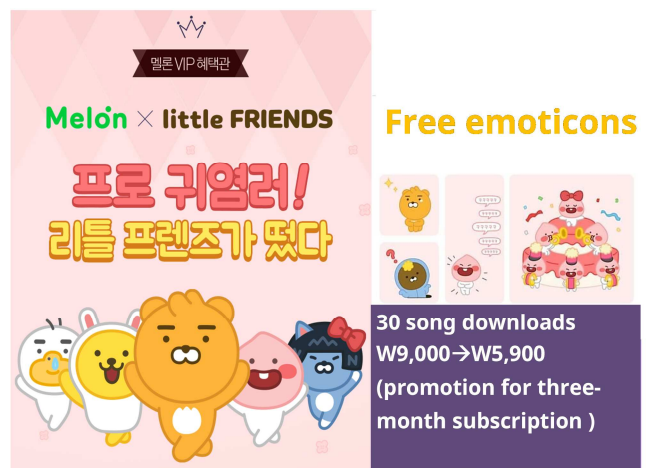
We also expect music content to be more widely utilized in Kakao’s AI business. Some of the key features of Kakao’s AI speaker Kakao Mini are music streaming and personalized recommendations. Kakao M also offers AI services on its Melon app, including “Smart i” (voice search and recommendations) and the Lony chatbot. We believe the organizational integration will bring new momentum to the AI business.

Figure 5. Users can directly access Melon’s music streaming service on the KakaoTalk app



Source: Company materials, Mirae Asset Daewoo Research

Figure 6. Kakao Friends characters have also been incorporated into Melon



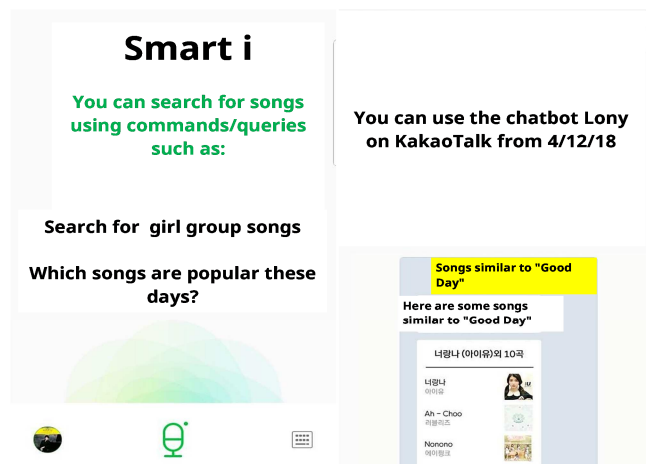
Source: Company materials, Mirae Asset Daewoo Research

Figure 7. A key feature of the Kakao Mini AI speaker is music streaming



Source: Company materials, Mirae Asset Daewoo Research

Figure 8. On its Melon app, Kakao M currently offers AI services (Smart i and Lony chatbot)



Source: Company materials, Mirae Asset Daewoo Research

4. Content: Independent entertainment production business to expand

After merging with Kakao M, Kakao plans to spin off Kakao M's music and video production units into a separate company. We think this will lead to the expansion of the video content business. Kakao M has a diverse range of entertainment/content businesses, which include artist management subsidiaries like Fave (IU), Starship (K.will, Monsta X), King Kong Entertainment (Lee Kwang-soo, Lee Dong-wook), Cre.Ker Entertainment (MelodyDay, etc.), Plan A (Apink, Huh Gak), and Mun Hwa In (Oohyo, Seen Root). The company also owns drama production company Mega Monster.

Kakao M has a vertically integrated value chain across platform and content. While such a structure has benefits, the different natures of the platform and content businesses have led to issues like slow investment decision-making and revenue opportunity limitations due to conflicting interests.

We believe separating the content production business will help facilitate content production and distribution and IP investments. In this respect, it is worth noting the recent push by management agencies like SM Entertainment (041510 KQ/Buy/TP: W47,000/CP: W38,900) and YG Entertainment (122870 KQ/Trading Buy/TP: W30,000/CP: W27,350) into content production (TV dramas and entertainment shows), as well as CJ E&M's (130960 KQ/Buy/TP: W115,000/CP: W88,500) expansion of its TV drama production business and supply channel diversification through the spinoff of Studio Dragon (253450 KQ/Buy/TP: W110,000/CP: W93,000).

As for over-the-top (OTT) platforms, we think video content distribution through apps like Melon, KakaoTV, and KakaoPage could gather steam. Indeed, Kakao Page, a webtoon/novel platform operated by Kakao's subsidiary Podotree, began expanding its offerings to drama and movie VODs this year.

Figure 9. Kakao M's entertainment/content businesses



Note: As of 2017
Source: Mirae Asset Daewoo Research

Figure 10. Kakao M's drama production subsidiary Mega Monster



- Competitiveness in content creation based on proven IP and "group writing" system
- Multi-platform distribution to maximize content revenue
- Business growth via co-production/distribution of global content



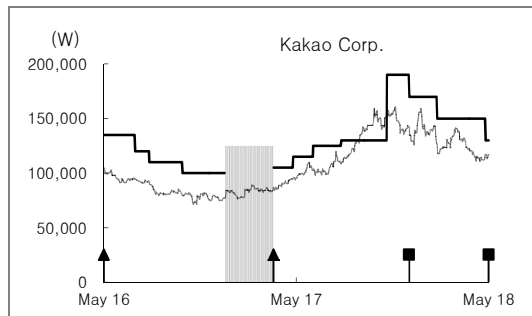
Source: Mega Monster, Mirae Asset Daewoo Research

APPENDIX 1

Important Disclosures & Disclaimers

2-Year Rating and Target Price History

Company (Code)	Date	Rating	Target Price
Kakao Corp. (035720)	05/11/2018	Trading Buy	130,000
	02/08/2018	Trading Buy	150,000
	12/17/2017	Trading Buy	170,000
	11/05/2017	Buy	190,000
	08/10/2017	Buy	130,000
	06/18/2017	Buy	125,000
	05/11/2017	Buy	115,000
	04/04/2017	Buy	105,000
	01/02/2017	No Coverage	
	10/13/2016	Buy	100,000
	08/11/2016	Buy	110,000
	07/15/2016	Buy	120,000
	05/12/2016	Buy	135,000



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 (◆))

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	Buy	Trading Buy	Hold	Sell
Equity Ratings Distribution	75.00%	11.11%	13.89%	0.00%
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* Based on recommendations in the last 12-months (as of March 31, 2018)

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