MIRAE ASSET
Building on principles

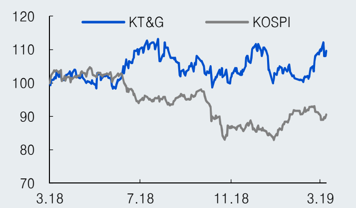
**Tobacco**

Company Update
March 15, 2019

| (Maintain) | Buy |
|---|---|
| **Target Price (12M, W)** | **135,000** |
| Share Price (03/15/19, W) | 107,000 |
| Expected Return | 26% |

| | |
|---|---|
| OP (18F, Wbn) | 1,263 |
| Consensus OP (18F, Wbn) | 1,232 |
| EPS Growth (18F, %) | -21.9 |
| Market EPS Growth (18F, %) | 4.7 |
| P/E (18F, x) | 15.3 |
| Market P/E (18F, x) | 9.0 |
| KOSPI | 2,176.11 |
| Market Cap (Wbn) | 14,690 |
| Shares Outstanding (mn) | 137 |
| Free Float (%) | 73.0 |
| Foreign Ownership (%) | 52.2 |
| Beta (12M) | 0.20 |
| 52-Week Low | 96,000 |
| 52-Week High | 110,500 |

| (%) | 1M | 6M | 12M |
|---|---|---|---|
| Absolute | 7.8 | 3.4 | 8.1 |
| Relative | 8.7 | 10.1 | 23.8 |




*Mirae Asset Daewoo Co., Ltd.*

[F&B]

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# KT&G
(033780 KS)

## Four reasons to buy KT&G

### Four reasons we are optimistic on 2019

**1) Earnings improvement in domestic cigarettes (HNB, duty-free, and regular cigarettes):** For KT&G's HNB cigarettes (LiL and FiiT), we expect revenue to grow 60% and OP margin to expand to 40% in 2019, fueled by HNB cigarette market growth as well as market share gains. For duty-free cigarettes, we see revenue addition of around W12-15bn from price increases (prices were raised from US$25 to US$27 per carton for regular cigarettes and from US$35 to US$37 per carton for HNB cigarettes). For regular cigarettes, we believe overall market contraction (in terms of units) will be partly offset by market share gains, leading to a slight fall in sales volume.

**2) Recovery of direct exports and growth of overseas subsidiaries:** In 2018, KT&G's direct cigarette exports slumped 38.4% YoY due to currency depreciation and excise tax hikes in the Middle East/Russia/CIS. In 2019, we expect exports to increase 22.7% YoY, with exports to the Middle East/Russia/CIS growing 40% and exports to new markets (Latin America, Asia, Africa, etc.) growing 10%. We also project revenue at overseas subsidiaries—Russia, Turkey, Iran, the US, and Indonesia (KT&G-I, Trisakti, and MMM)—to climb 11.1%, driven by growth in the US and Indonesia.

**3) Real estate revenue growth:** We expect the Suwon development project to bring in revenue of W1.7tr at an OP margin of 40% over a five-year period (from 2018 to 2022). In 2019, we look for revenue of W340bn and operating profit of W120bn.

**4) Strong and steady dividend yields:** We estimate 2019-20 dividend yields at around 4% (based on 2019-20F DPS of W4,200 and W4,400, respectively). We expect ample cash flow given the company's limited investment needs, and see upside to its payout ratio, which is low compared to global peers.

### Solid earnings expected in 1Q19

For 1Q19, we forecast revenue and operating profit to grow 15.9% and 20.6% YoY, respectively, supported by a pickup in exports, stronger HNB cigarette revenue, and real estate presale income. In particular, we see direct exports recovering 28.9% YoY in 1Q19, driven by the resumption of imports by UAE-based Alokozay, the company's distributor in the Middle East/Russia/CIS. According to Korea Customs Service data, cigarette exports to the UAE picked up to US$27.51mn (+140.3% YoY) in January-February 2019, from US$11.45mn (-77.8% YoY) in January-February 2018.

### Maintain Buy and TP of W135,000

We expect KT&G to deliver robust earnings in 2019, with revenue growth of 11.6% and operating profit growth of 15.1%. We believe 2019 will be a year of recovery in fundamentals. At 2019-20F P/Es of 13x and 12x, respectively, valuation also looks attractive relative to comparable foreign peers (companies with high exposures to their domestic markets), such as Gudang Garam (Indonesia), HM Sampoerna (Indonesia), and ITC (India).

Furthermore, we believe the company's strong earnings, high dividend yields, and resilience to macro conditions will provide strong downside support to share prices.

| FY (Dec.) | 12/15 | 12/16 | 12/17 | 12/18F | 12/19F | 12/20F |
|---|---|---|---|---|---|---|
| Revenue (Wbn) | 4,170 | 4,503 | 4,667 | 4,476 | 4,994 | 5,259 |
| OP (Wbn) | 1,366 | 1,470 | 1,426 | 1,263 | 1,453 | 1,558 |
| OP margin (%) | 32.8 | 32.6 | 30.6 | 28.2 | 29.1 | 29.6 |
| NP (Wbn) | 1,036 | 1,231 | 1,164 | 909 | 1,074 | 1,156 |
| EPS (W) | 7,544 | 8,965 | 8,476 | 6,622 | 7,825 | 8,420 |
| ROE (%) | 17.5 | 18.6 | 15.7 | 11.5 | 12.8 | 12.9 |
| P/E (x) | 13.9 | 11.3 | 13.6 | 15.3 | 13.7 | 12.7 |
| P/B (x) | 2.2 | 1.9 | 2.0 | 1.7 | 1.6 | 1.5 |
| Dividend yield (%) | 3.3 | 3.6 | 3.5 | 3.9 | 3.9 | 4.1 |

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

## How fast will UAE-bound exports recover?

In 2018, KT&G's cigarette exports slumped 38.4% YoY, after UAE-based Alokozay (the company's distributor in the Middle East/Russia/CIS) temporarily suspended purchases due to currency depreciation and excise tax hikes, which led to a 59.8% YoY decline in exports to the UAE. However, we believe actual consumption of KT&G cigarettes did not fall materially. In 2019-20, we think consumers in the Middle East/Russia/CIS will become more accustomed to higher prices. We expect cigarette exports to the UAE to normalize in the next two years, growing 40% in 2019 and 45% in 2020.

We can point to several past instances of Korean companies overcoming political headwinds. First, in 2013, US sanctions against Iran led to a sharp depreciation of the Iranian currency and a steep rise in the price of Korean cigarettes, prompting a temporary suspension in imports. As the issue was largely political and unrelated to product quality, KT&G's cigarette exports to Iran eventually returned to prior levels two years later, after the sanctions were lifted.

The THAAD backlash against Korean F&B companies provides another example. In 2017, Korean F&B products such as snacks (Orion; 271560 KS/Buy/TP: W155,000/CP: W100,500), instant noodles (Nongshim; 004370 KS/Buy/TP: W350,000/CP: W302,000), and infant formula (Maeil Dairies; 267980 KS/Buy/TP: W100,000/CP: W85,400) were pulled from store shelves, causing revenue to plunge more than 30%. As this issue was also unrelated to product quality, shelf space has been improving since 2H18, supporting a recovery in revenue. In 2H19, we expect sales of several items, including instant noodles and infant formula, to recover to pre-THAAD levels.

Lastly, we highlight the export recovery that took place after Japan's nuclear disaster. In the wake of the nuclear accident, Korea imposed restrictions on fishery imports from Japan, triggering a decline in food trade between the two countries from 2012 to 2015. Trade has been picking up since 2016, though the recovery has been slow due to a combination of politics and concerns over product safety.

## HNB cigarettes vs. liquid e-cigarettes

In June 2017, Philip Morris International (PMI; PM US/CP: US$90.85) launched its HNB cigarette products iQOS (device) and HEETS (sticks) in Korea. This was followed by KT&G's release of its own HNB cigarette products LiL (device) and FiiT (sticks) in late 2017. HNB cigarettes as a share of the overall market have increased to 11-12% between November 2018 and January 2019. We expect that figure to rise to 12.1% in 2019 and 13.1% in 2020. In January-February 2019, we estimate KT&G held 30% of the HNB cigarette market, with PMI and British American Tobacco (BAT; BATS LN/CP: GBX3,079.50) accounting for the remaining 70%. We forecast KT&G's market share to expand to 30.1% in 2019 and 36.2% in 2020.

KT&G has turned an operating profit on HNB cigarettes, after addressing supply shortages through the adoption of high-speed production facilities in June-August 2018 and expanding availability to convenience stores nationwide. We believe KT&G's HNB cigarettes will become as profitable as regular cigarettes (OP margin of 40%) in 1Q19. Given ASP (HNB cigarettes are priced W340 higher than regular cigarettes) and manufacturing cost per pack (stabilization of production facilities and production growth), we expect HNB cigarettes to generate higher OP margins than regular cigarettes in 2H19.

Meanwhile, US-based Juul Labs is set to make its first foray into Asia by launching its liquid e-cigarette Juul in Korea. Juul controls 72% of the US e-cigarette market and is available in nine countries, including Canada, the UK, and Russia. We think the launch of Juul could affect the domestic cigarette market, just as HNB cigarettes did upon their release in 2017. However, Juul's nicotine content, which is currently 3-5%, needs to be lowered to less than 2% to meet domestic regulations, which could compromise the cigarette's taste. When further taking into account online availability, tax issues, KT&G's response, and costs for consumers to replace their HNB cigarette devices, the actual impact could be more modest than expected.

**Table 1. 1Q19 preview** (Wbn, %)

| | 1Q18 | 4Q18 | 1Q19F | | Growth | |
|---|---|---|---|---|---|---|
| | | | Mirae Asset Daewoo | Consensus | YoY | QoQ |
| Revenue | 1,068 | 1,106 | 1,237 | 1,207 | 15.9 | 11.9 |
| Operating profit | 311 | 272 | 375 | 368 | 20.6 | 38.0 |
| Pretax profit | 360 | 236 | 399 | 395 | 11.0 | 69.6 |
| Net profit | 249 | 135 | 283 | 281 | 13.7 | 109.8 |
| OP margin | 29.2 | 24.6 | 30.3 | 30.5 | - | - |
| Net margin | 23.3 | 12.2 | 22.9 | 23.3 | - | - |

Source: Company data, Quantiwise, Mirae Asset Daewoo Research estimates

**Table 2. Quarterly and annual earnings** (Wbn, %)

| | 18 | | | | 19F | | | | 17 | 18 | 19F |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1Q | 2Q | 3Q | 4Q | 1QF | 2QF | 3QF | 4QF | Annual | Annual | Annual |
| Revenue | 1,068 | 1,120 | 1,183 | 1,106 | 1,237 | 1,214 | 1,372 | 1,171 | 4,667 | 4,476 | 4,994 |
| Operating profit | 311 | 323 | 357 | 272 | 375 | 357 | 435 | 287 | 1,426 | 1,263 | 1,453 |
| Pretax profit | 360 | 379 | 358 | 236 | 399 | 363 | 442 | 304 | 1,346 | 1,331 | 1,508 |
| Net profit | 249 | 267 | 259 | 135 | 283 | 259 | 316 | 217 | 1,164 | 909 | 1,074 |
| OP margin | 29.2 | 28.8 | 30.2 | 24.6 | 30.3 | 29.4 | 31.7 | 24.5 | 30.6 | 28.2 | 29.1 |
| Net margin | 23.3 | 23.8 | 21.9 | 12.2 | 22.9 | 21.3 | 23.0 | 18.5 | 24.9 | 20.3 | 21.5 |
| Revenue growth | -9.4 | -3.6 | -7.5 | 5.5 | 15.9 | 8.4 | 16.0 | 5.9 | 3.6 | -4.1 | 11.6 |
| OP growth | -21.3 | -16.4 | -15.4 | 22.1 | 20.6 | 10.5 | 21.8 | 5.3 | -3.0 | -11.4 | 15.1 |
| Pretax profit growth | 8.4 | -4.0 | -17.5 | 26.1 | 11.0 | -4.1 | 23.7 | 28.9 | -15.2 | -1.1 | 13.3 |
| Net profit growth | 6.1 | -2.8 | -15.9 | -61.2 | 13.7 | -2.9 | 21.9 | 60.7 | -5.5 | -21.9 | 18.2 |

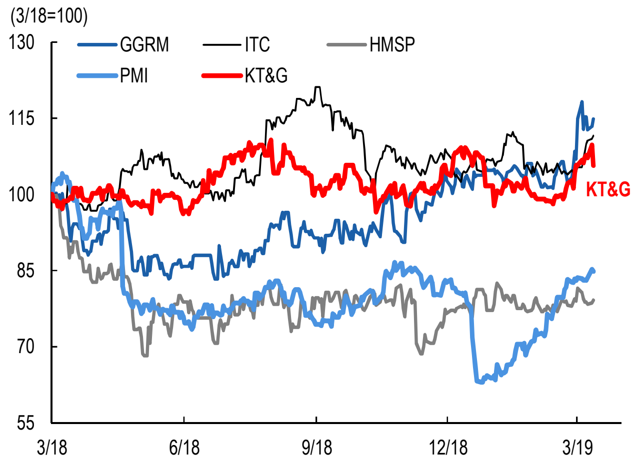
Source: Company data, Mirae Asset Daewoo Research estimates

**Table 3. 2019-20 earnings forecast revisions** (Wbn, %)

| | Previous | | Revised | | % chg. | | Notes |
|---|---|---|---|---|---|---|---|
| | 19F | 20F | 19F | 20F | 19F | 20F | |
| Revenue | 5,025 | 5,286 | 4,994 | 5,259 | -0.6 | -0.5 | |
| Operating profit | 1,455 | 1,532 | 1,453 | 1,558 | -0.1 | 1.7 | |
| Pretax profit | 1,506 | 1,601 | 1,508 | 1,628 | 0.2 | 1.7 | |
| Net profit | 1,073 | 1,156 | 1,074 | 1,156 | 0.2 | 0.0 | |
| OP margin | 29.0 | 29.0 | 29.1 | 29.6 | - | - | |
| Net margin | 21.3 | 21.9 | 21.5 | 22.0 | - | - | |

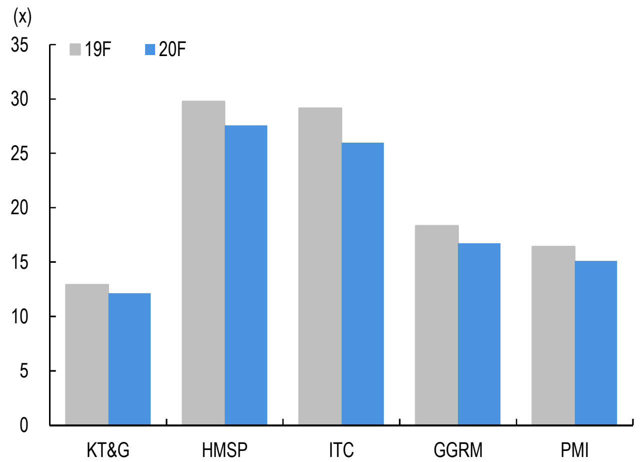
Source: Company data, Mirae Asset Daewoo Research estimates

### Figure 1. Share price performance vs. peers



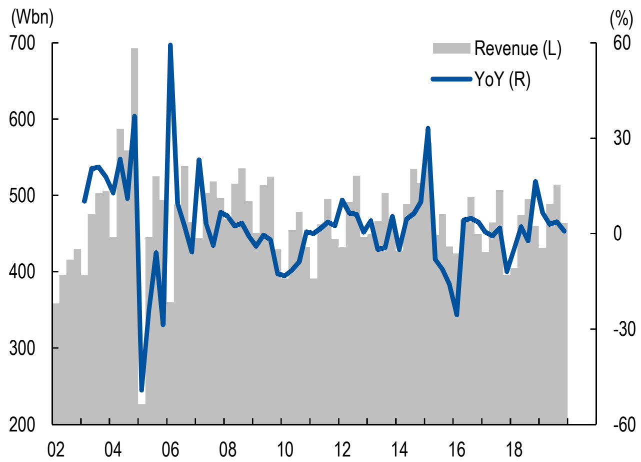

Notes: HMSP=Sampoerna, GGRM=Gudang Garam, PMI=Philip Morris International
Source: Bloomberg, Mirae Asset Daewoo Research

### Figure 2. Peer group valuations (P/E)



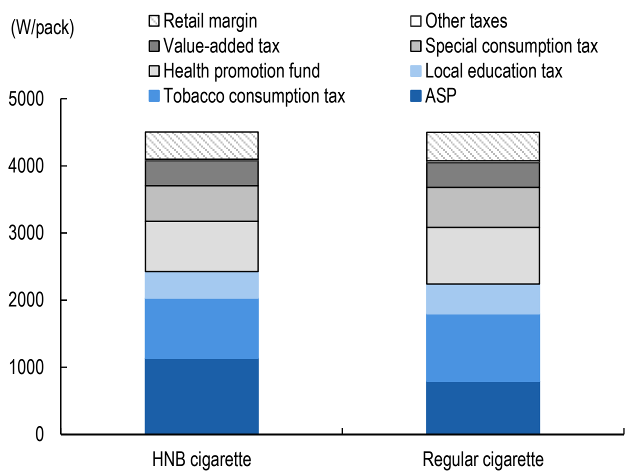

Notes: HMSP=Sampoerna, GGRM=Gudang Garam, PMI=Philip Morris International
Source: Bloomberg, Mirae Asset Daewoo Research

### Figure 3. KT&G's domestic cigarette revenue



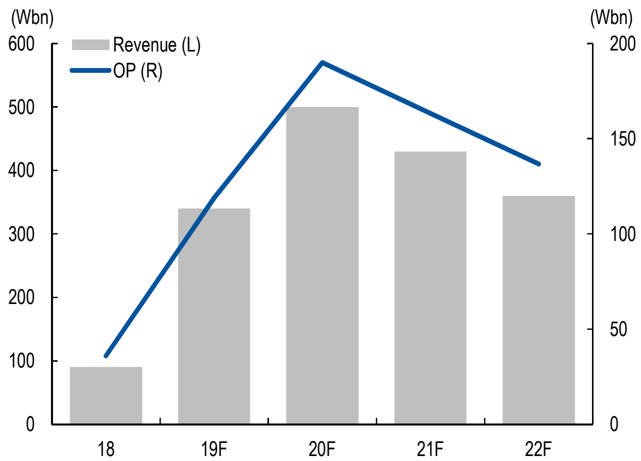

Source: Company data, Mirae Asset Daewoo Research

### Figure 4. ASP difference between HNB cigarettes and regular cigarettes



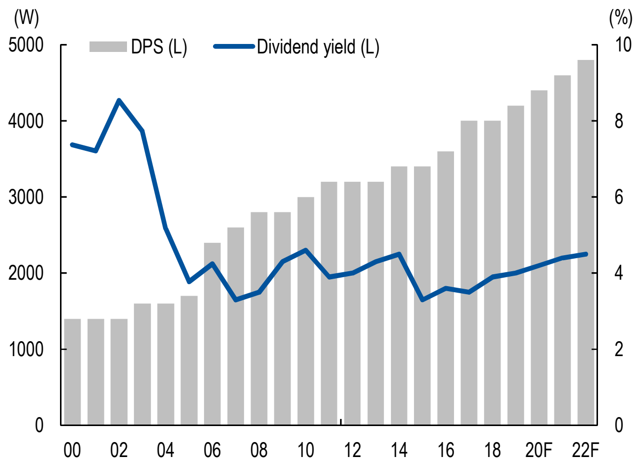

Notes: ASP represents manufacturers' real selling price (including production costs, labor costs, selling costs, OP margin, etc.).
Source: Company data, Mirae Asset Daewoo Research

### Figure 5. KT&G's Suwon development project revenue




Source: Company data, Mirae Asset Daewoo Research

### Figure 6. KT&G's DPS and dividend yield




Source: Company data, Mirae Asset Daewoo Research

## KT&G (033780 KS/Buy/TP: W135,000)

### Comprehensive Income Statement (Summarized)

| (Wbn) | 12/17 | 12/18F | 12/19F | 12/20F |
|---|---|---|---|---|
| **Revenue** | **4,667** | **4,476** | **4,994** | **5,259** |
| **Cost of Sales** | **1,909** | **1,850** | **2,057** | **2,152** |
| **Gross Profit** | **2,758** | **2,626** | **2,937** | **3,107** |
| **SG&A Expenses** | **1,332** | **1,363** | **1,483** | **1,549** |
| **Operating Profit (Adj)** | **1,426** | **1,263** | **1,453** | **1,558** |
| **Operating Profit** | **1,426** | **1,263** | **1,453** | **1,558** |
| **Non-Operating Profit** | **-80** | **68** | **55** | **70** |
| Net Financial Income | 35 | 17 | 19 | 40 |
| Net Gain from Inv in Associates | 6 | 1 | 0 | 0 |
| Pretax Profit | 1,346 | 1,331 | 1,508 | 1,628 |
| Income Tax | 181 | 425 | 437 | 475 |
| Profit from Continuing Operations | 1,164 | 906 | 1,071 | 1,152 |
| Profit from Discontinued Operations | 0 | 0 | 0 | 0 |
| **Net Profit** | 1,164 | 906 | 1,071 | 1,152 |
| Controlling Interests | 1,164 | 909 | 1,074 | 1,156 |
| Non-Controlling Interests | 0 | -3 | -3 | -4 |
| **Total Comprehensive Profit** | **1,212** | **885** | **1,071** | **1,152** |
| Controlling Interests | 1,208 | 888 | 1,077 | 1,159 |
| Non-Controlling Interests | 4 | -3 | -6 | -6 |
| EBITDA | 1,587 | 1,412 | 1,613 | 1,732 |
| FCF (Free Cash Flow) | 822 | 2,524 | 781 | 858 |
| EBITDA Margin (%) | 34.0 | 31.5 | 32.3 | 32.9 |
| Operating Profit Margin (%) | 30.6 | 28.2 | 29.1 | 29.6 |
| Net Profit Margin (%) | 24.9 | 20.3 | 21.5 | 22.0 |

### Statement of Financial Condition (Summarized)

| (Wbn) | 12/17 | 12/18F | 12/19F | 12/20F |
|---|---|---|---|---|
| **Current Assets** | **6,585** | **6,592** | **7,044** | **7,606** |
| Cash and Cash Equivalents | 1,230 | 1,036 | 1,230 | 1,483 |
| AR & Other Receivables | 1,056 | 1,077 | 1,141 | 1,201 |
| Inventories | 2,317 | 2,387 | 2,459 | 2,589 |
| Other Current Assets | 1,982 | 2,092 | 2,214 | 2,333 |
| **Non-Current Assets** | **3,391** | **3,696** | **3,943** | **4,111** |
| Investments in Associates | 51 | 54 | 57 | 60 |
| Property, Plant and Equipment | 1,757 | 1,734 | 1,909 | 2,018 |
| Intangible Assets | 85 | 86 | 93 | 89 |
| **Total Assets** | **9,976** | **10,288** | **10,987** | **11,717** |
| **Current Liabilities** | **1,803** | **1,757** | **1,865** | **1,959** |
| AP & Other Payables | 132 | 137 | 145 | 153 |
| Short-Term Financial Liabilities | 178 | 98 | 108 | 108 |
| Other Current Liabilities | 1,493 | 1,522 | 1,612 | 1,698 |
| **Non-Current Liabilities** | **343** | **369** | **394** | **409** |
| Long-Term Financial Liabilities | 101 | 113 | 123 | 123 |
| Other Non-Current Liabilities | 242 | 256 | 271 | 286 |
| **Total Liabilities** | **2,146** | **2,126** | **2,260** | **2,367** |
| **Controlling Interests** | **7,772** | **8,106** | **8,676** | **9,301** |
| Capital Stock | 955 | 955 | 955 | 955 |
| Capital Surplus | 484 | 484 | 484 | 484 |
| Retained Earnings | 6,745 | 7,136 | 7,705 | 8,331 |
| **Non-Controlling Interests** | **58** | **55** | **51** | **48** |
| **Stockholders' Equity** | **7,830** | **8,161** | **8,727** | **9,349** |

### Cash Flows (Summarized)

| **(Wbn)** | 12/17 | 12/18F | 12/19F | 12/20F |
|---|---|---|---|---|
| Cash Flows from Op Activities | 1,140 | 2,880 | 1,111 | 1,138 |
| Net Profit | 1,164 | 906 | 1,071 | 1,152 |
| Non-Cash Income and Expense | 523 | 525 | 524 | 568 |
| Depreciation | 156 | 145 | 156 | 171 |
| Amortization | 5 | 4 | 4 | 4 |
| Others | 362 | 376 | 364 | 393 |
| Chg in Working Capital | -152 | 1,810 | -47 | -107 |
| Chg in AR & Other Receivables | 124 | -52 | -62 | -60 |
| Chg in Inventories | -78 | -86 | -72 | -131 |
| Chg in AP & Other Payables | -85 | 25 | 4 | 4 |
| **Income Tax Paid** | **-395** | **-361** | **-437** | **-475** |
| Cash Flows from Inv Activities | -330 | -2,962 | -422 | -344 |
| Chg in PP&E | -314 | -333 | -330 | -280 |
| Chg in Intangible Assets | -5 | -5 | -10 | 0 |
| Chg in Financial Assets | -3 | -125 | -161 | -154 |
| **Others** | **-8** | **-2,499** | **79** | **90** |
| Cash Flows from Fin Activities | -434 | -113 | -492 | -538 |
| Chg in Financial Liabilities | 17 | -68 | 20 | 0 |
| Chg in Equity | -26 | 0 | 0 | 0 |
| Dividends Paid | -460 | -460 | -505 | -530 |
| **Others** | **35** | **415** | **-7** | **-8** |
| Increase (Decrease) in Cash | 379 | 305 | 194 | 253 |
| Beginning Balance | 851 | 1,230 | 1,036 | 1,230 |
| **Ending Balance** | **1,230** | **1,036** | **1,230** | **1,483** |

Source: Company data, Mirae Asset Daewoo Research estimates

### Forecasts/Valuations (Summarized)

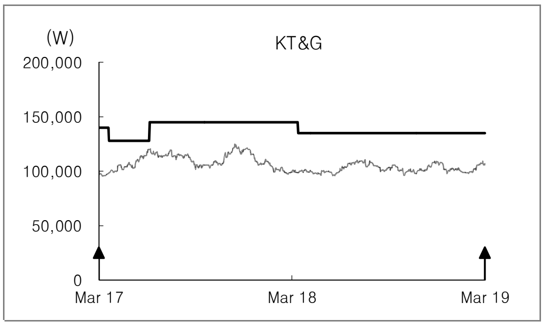
| | 12/17 | 12/18F | 12/19F | 12/20F |
|---|---|---|---|---|
| P/E (x) | 13.6 | 15.3 | 13.7 | 12.7 |
| P/CF (x) | 9.4 | 9.7 | 9.2 | 8.5 |
| P/B (x) | 2.0 | 1.7 | 1.6 | 1.5 |
| EV/EBITDA (x) | 8.4 | 8.1 | 7.4 | 6.7 |
| EPS (W) | 8,476 | 6,622 | 7,825 | 8,420 |
| CFPS (W) | 12,289 | 10,425 | 11,619 | 12,529 |
| BPS (W) | 59,000 | 61,436 | 65,583 | 70,140 |
| DPS (W) | 4,000 | 4,000 | 4,200 | 4,400 |
| Payout ratio (%) | 43.4 | 55.7 | 49.5 | 48.2 |
| Dividend Yield (%) | 3.5 | 3.9 | 3.9 | 4.1 |
| Revenue Growth (%) | 3.6 | -4.1 | 11.6 | 5.3 |
| EBITDA Growth (%) | -2.5 | -11.0 | 14.2 | 7.4 |
| Operating Profit Growth (%) | -3.0 | -11.4 | 15.0 | 7.2 |
| EPS Growth (%) | -5.5 | -21.9 | 18.2 | 7.6 |
| Accounts Receivable Turnover (x) | 4.3 | 4.3 | 4.6 | 4.6 |
| Inventory Turnover (x) | 2.0 | 1.9 | 2.1 | 2.1 |
| Accounts Payable Turnover (x) | 22.9 | 29.0 | 31.1 | 30.8 |
| ROA (%) | 11.8 | 8.9 | 10.1 | 10.2 |
| ROE (%) | 15.7 | 11.5 | 12.8 | 12.9 |
| ROIC (%) | 30.8 | 20.7 | 24.0 | 24.3 |
| Liability to Equity Ratio (%) | 27.4 | 26.1 | 25.9 | 25.3 |
| Current Ratio (%) | 365.2 | 375.1 | 377.6 | 388.3 |
| Net Debt to Equity Ratio (%) | -32.4 | -30.6 | -31.7 | -33.3 |
| Interest Coverage Ratio (x) | 166.3 | 197.5 | 201.4 | 206.6 |

# APPENDIX 1

## Important Disclosures & Disclaimers

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

| Company (Code) | Date | Rating | Target Price |
|---|---|---|---|
| KT&G (033780) | 03/27/2018 | Buy | 135,000 |
| | 06/19/2017 | Buy | 145,000 |
| | 04/03/2017 | Buy | 128,000 |
| | 10/27/2016 | Buy | 140,000 |




| 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 (◆))
* 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 Mirae Asset Daewoo Co., Ltd., 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.

**Equity Ratings Distribution & Investment Banking Services**

| | Buy | Trading Buy | Hold | Sell |
|---|---|---|---|---|
| Equity Ratings Distribution | 81.28% | 9.63% | 9.09% | 0.00% |
| Investment Banking Services | 84.61% | 3.85% | 11.54% | 0.00% |

* Based on recommendations in the last 12-months (as of December 31, 2018)

**Disclosures**

As of the publication date, Mirae Asset Daewoo Co., Ltd. has acted as a liquidity provider for equity-linked warrants backed by shares of KT&G as an underlying asset; other than this, Mirae Asset Daewoo has no other special interests in the covered companies.

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