Korea Investment
& Securities Co., Ltd.

Woongjin Coway (021240)

Company Report / Household

March 28, 2011

BUY (Initiate)

TP: W47,000

Stock Data

• KOSPI (Mar 25)	2,054
• Stock price (Mar 25)	36,850
• Shares outstanding (mn)	77.1
• Market cap (USD mn)	2,551
• 52-Week Low/High (won)	31,700/45,850
• 6M avg. daily turnover (USD mn)	11.3
• Free float (%)	67.3
• EPS (2010F, won)	2,322
• BPS (2010F, won)	8,536
• Dividend yield (2010F, %)	2.7
• Foreign ownership (%)	47.9
• Major shareholders (%)	
WoongJin Holdings	28.4
Emerging Market Fund (LAZARD EMERGING MARKETS PORTFOLIO)	7.0

• Stock performance	1M	6M	12M
Absolute (%)	12.3	(18.8)	4.2
Relative to KOSPI (%p)	7.7	(30.1)	(17.4)

Contents

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Gearing up for further growth

Recommend BUY and price target of W47,000

We initiate coverage of Woongjin Coway (Coway) with BUY and a price target of W47,000. We are upbeat about the company due to: 1) growth momentum at the mainstay and new businesses, 2) profitability improvement gaining pace from 2H11, and 3) a big dividend payout ratio and favorable shareholders' policy. We derived the price by applying the past five-year average PER of 18x the 2011F EPS of W2,580. The price has 27.6% upside.

Get ready for further growth

Coway delivered a sales CAGR of 7.8% from 2007 to 2010 rather than the previous double-digit growth. We expect the annual average sales growth to recover to 10.7% over the next three years due to the following. First, net subscriber additions at the environmental home appliances business should drive up the segment's annual average sales growth from 5.6% over the past three years to 7.6% over the next three years. Second, domestic cosmetics sales are stronger than expected. When the company entered the cosmetics arena in September 2010, the business' contribution to annual sales was a mere 1.5% but is expected to rise to 6.4% in 2013F. Third, branching out into water treatment systems and exports should fuel mid to long-term growth with market expansion, buyout opportunities and a wider customer base. Robust growth momentum at core subsidiaries, one in China and Woongjin Chemical, is also noteworthy.

Profitability improvement in 2H11; EPS CAGR of 13% over the next three years

We forecast Coway's operating margin to dip from a high of 15.1% in 2010 to 14.2% in 2011F. Greater marketing costs for the cosmetics business that was launched in 4Q10 and the release of new products in 1H11 should continue to push down operating profit during 1H11. But operating profit should turn upward on economies of scale and lower advertising costs in 2H11 and thus, we estimate operating profit to swell 19% YoY in 2H11. Although we see operating profit gaining a mere 6.5% YoY in 2011F, there will be a roller coaster of weakness in 1H11 and strength in 2H11. In 2012F, we expect operating profit to jump 14% YoY. Finally, the company should see an EPS CAGR of 13% over the next three years backed by robust sales and improving equity-method gains attributed to strong earnings at subsidiaries.

Concerns over protecting market share and lingering Woongjin Group risk

While Coway's forte lies in its unrivalled dominance in water purifiers, it also faces two risk factors: SMEs' low-price strategy and major firms' advance on the water purifier business. But rather than being worried about these risks, we believe it is more important to draw attention to Coway's unrivalled competitive edge stemming from the development of new products and superior service quality offered by 13,000 "codys," its after-sale service agents. The risk associated with Woongjin Group is another issue. Woongjin Holdings' (parent company) debt burden and the possibility of financially supporting an ailing affiliate raised concerns about a divestiture of Coway shares and subsequent capital outflow. But at present, Woongjin Holdings owns only 28.4% of Coway so a further stake reduction is unlikely. Moreover, there has never been a case where a Woongjin Holdings affiliate provided financial assistance to another and we believe this is unlikely to occur going forward.

I. Valuation

Market concerns have peaked and are set to subside

Recommend BUY with a price target of W47,000

We initiate coverage of Woongjin Coway (Coway) with BUY and a price target of W47,000. The price has 27.6% upside. We derived the price by applying the past five-year average PER of 18x the 2011F EPS of W2,580. The company's valuation is passing a trough but a re-rating as seen in 2009 is hard to expect. At that time, expectations were running high for the cosmetics business in China. As such, we applied the average PER over the past three years. We expect the valuation to rise in earnest when the domestic cosmetics and new businesses enter the growth phase.

Woongjin Coway's historical valuation

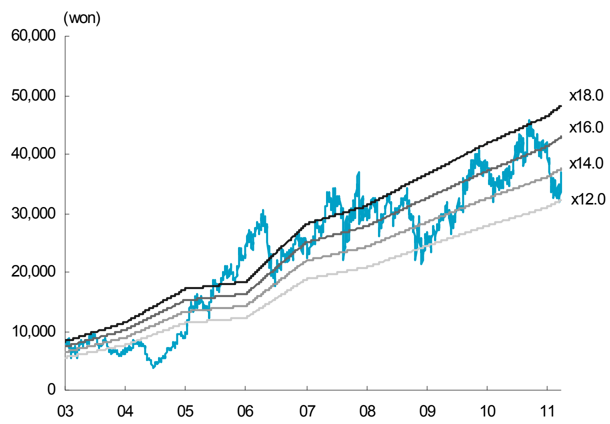
(x)

	Five-year avg.	2006	2007	2008	2009	2010
End of period	**19.3**	25.3	19.5	15.4	18.9	17.4
Avg.	**18.4**	24.0	18.6	17.0	15.8	16.6
High	**22.6**	29.9	23.5	19.8	19.9	19.7
Low	**13.8**	17.3	14.1	12.3	11.5	13.8

Source: Korea Investment & Securities

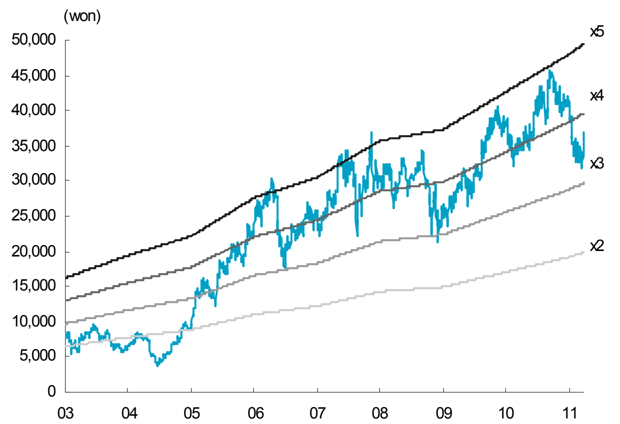
We are upbeat about the company due to the following. First, growth momentum should gain pace from 2011. We peg the 2011F sales to grow 12.8% YoY on the back of the strong rental business, a major source of revenue, and the cosmetics business' full sales contribution. Second, economies of scale building at the cosmetics business should clear away concerns about profitability erosion. Overall, profitability should start improving in 2H10. Third, subsidiaries should continue to deliver robust earnings led by Woongjin Chemical that will likely post sequential record earnings in 2011 thanks to healthy industry conditions. Although expectations for the cosmetics business in China have been lowered, we still expect a stable 20%-level growth. Fourth, the valuation is at low. The stock trades at a 2011F PER of 14.3x. Despite the rally driven by the announcement of share buyback, the stock still trades at a 2011F PER of 14.3x that is on par with the lower-end average of 13.8x and below the five-year average of 18.4x.

At the lower end of the PER band



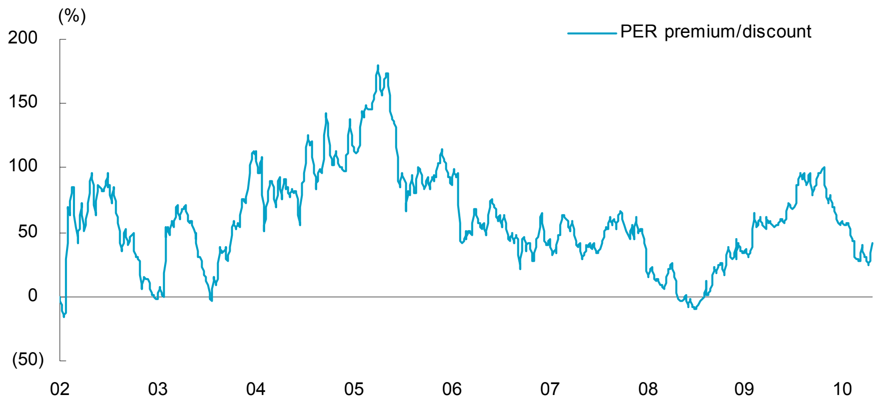
Source: Korea Investment & Securities

At the lower end of the PBR band



Source: Korea Investment & Securities

PER premium/discount to Kospi



Source: Quantiwise, Korea Investment & Securities

Fair price of W56,500 using DCF model

To verify the validity of our price target, we used the DCF model. In calculating free cash flow, we took into consideration the rental asset disposal loss, a non-cash cost. Meanwhile, we evaluated investment securities using sum-of-parts. We applied a 30% discount to the current market cap of Woongjin Chemical in which Coway holds 45% and for the Chinese subsidiary, applied a PER of 20x the 2011F net profit. The sum of the core business worth W4.3trn and the investment stake worth W360.4bn minus the 2011F net debt of W300.4bn led to a per-share value of W56,500. We conservatively assumed a perpetual growth rate at 0% and cost of capital at 6.2%.

Fair price of W56,500 using DCF model

(W bn)

	2011F	2012F	2013F	2014F	2015F
Operating profit	243.6	277.7	303.0	335.7	352.5
Corporate tax rate	24.4%	24.4%	24.4%	24.4%	24.4%
NOPLAT	184.2	209.9	229.1	253.8	266.5
Depreciation/amortization	152.6	164.3	174.7	184.6	193.7
Rental asset disposal loss	46.3	49.3	51.5	55.3	58.7
Chg. in working capital	(63.1)	(54.4)	(46.7)	(51.3)	(51.3)
Capex	(185.3)	(190.0)	(193.2)	(200.5)	(200.5)
FCF	**134.6**	**179.1**	**215.4**	**241.9**	**267.0**
Weighted avg. cost of capital (%)	6.2%				
Debt (%)	32.8%				
Financial cost (%)	5.7%				
Shareholders' equity (%)	67.2%				
Cost of equity	7.2%				
Risk-free rate of return	4.0%				
Beta	0.63	Three-year avg.			
Risk premium	5.0%				
Present value of FCF	852.7				
Remaining value	3,446.2				
Operating value	**4,298.8**				
Investment securities	**360.4**				
Chinese subsidiary	186.3	PER of 20x (Chinese peer avg.) the 2011F net profit			
Woongjin Chemical	174.1	30% discount to the Feb 25 market cap			
Others	29.2	20-30% discount to fair price or market price			
Enterprise value	**4,659.2**				
Net cash	**(300.4)**				
Value of capital	**4,359**				
Shares outstanding	77,124,796				
Per-share value (KRW)	**56,517**				

Source: Korea Investment & Securities

Given the inherent limitations to the DCF model where a fair price fluctuates according to changes in WACC and perpetual growth rate, we set the range of weighted average cost of capital between 5.2% and 7.2% and the perpetual growth rate between -1% and 1%. As a result, the price target ranges between W43,453 and W81,896.

Price target according to changes in WACC and perpetual growth rate (KRW)

		Perpetual growth rate				
		-2.0%	**-1.0%**	**0.0%**	**1.0%**	**2.0%**
WACC (discount rate)	4.2%	60,687	70,491	84,939	108,351	152,823
	5.2%	51,729	**58,553**	**67,990**	**81,896**	104,431
	6.2%	44,973	**49,946**	**56,517**	**65,603**	78,993
	7.2%	39,702	**43,453**	**48,243**	**54,572**	63,324
	8.2%	35,479	38,386	42,000	46,616	52,714

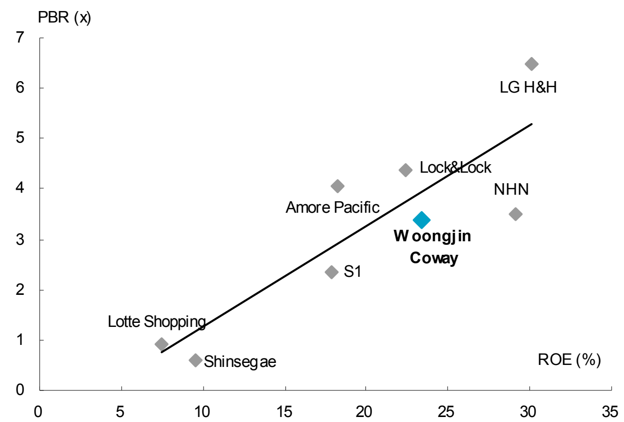
Source: Korea Investment & Securities

Attractive valuation compared to peers

The environmental appliances business represents 89% of the total. Coway differs from general household appliances vendors in that the company excels in accessibility thanks to door-to-door sales and an extensive network of after-sale service agents (codys). While general household appliances are semi-durable goods, Coway's products require constant maintenance, which enables the company to maintain a high ASP and generate additional profit. We made a valuation comparison with domestic plays commanding a dominant presence in their respective markets as Coway relies on domestic consumption for more than 90% of sales and its mainstay products – water purifiers and bidets – command more than half their respective segments. Given the unique business structure such as rental services and door-to-door sales, a peer comparison is also valid with subscriber-based companies or door-to-door sales firms.

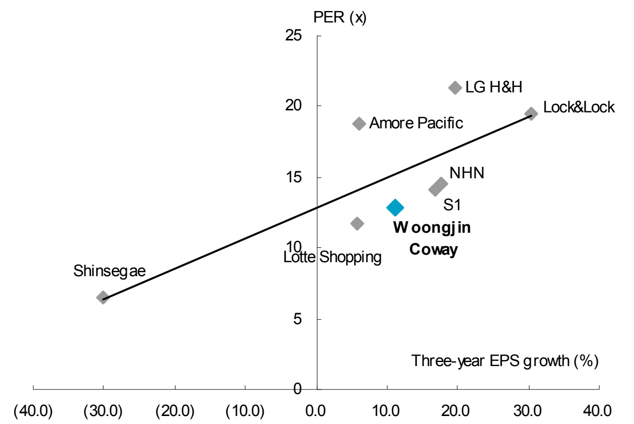
We put S1, AmorePacific, LG Household & Health Care (LG H&H) and Lock&Lock into a peer group given their domestic demand-dependent characteristics, dominant presence and earnings stability. Considering the four companies trade at a 2011F PER of 18.4x and PBR of 4.3x, Coway is undervalued. Although Coway's 2011F growth potential is not as competitive as its peers, we expect profit improvement to accelerate from 2012. According to the 2011F PBR-ROE and PER-EPS (three-year growth) comparison, the company is below the trend line. We believe growing pains in 2011 offer a good entry point on expectations that the company should gain growth momentum and stand abreast with peers in terms of valuation.

PBR/ROE comparison: Undervalued compared to peers



Source: Korea Investment & Securities

Discounted PER compared to EPS growth



Source: Korea Investment & Securities

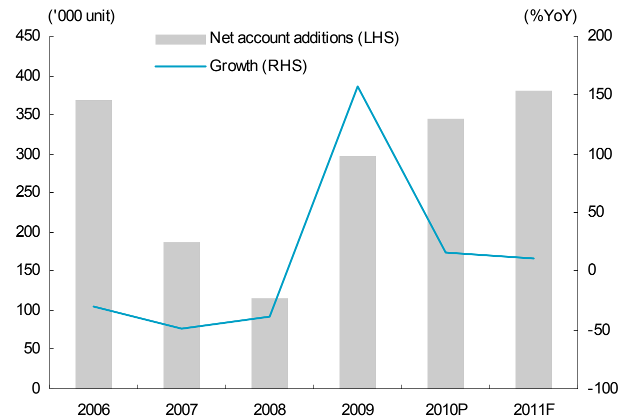
II. Investment points

1. Strong to the core and renewed growth momentum in 2011

Net account additions at the environmental appliances business

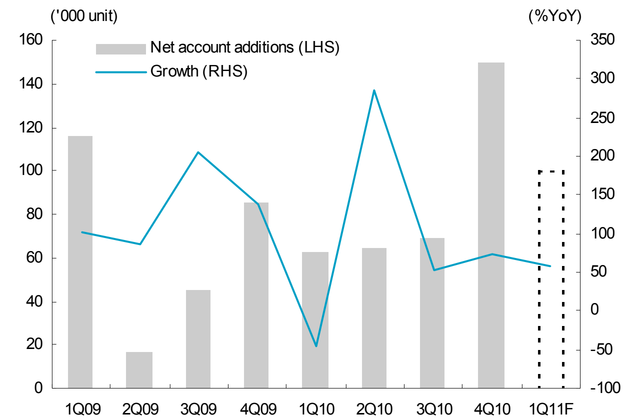
We expect stronger growth momentum at the environmental appliances division that accounts for more than 80% of the company's sales. At the environmental appliances division, net rental account additions plunged during 2007 and 2008 but rebounded from 2009. During the 2007-2008 period, the company placed a greater focus on retaining customers rather than attracting new customers and the rental churn rate spiked partly due to ownership transfers to customers upon the contract expiration. But net account additions[1] swelled from 2009 thanks to a stabilizing churn rate and increase in rental memberships. The net account additions skyrocketed a whopping 157% YoY to 298,000 in 2009 and climbed 16.4% YoY to 346,000 in 2010. In particular, net additions amounted to 150,000 in 4Q10 alone and membership growth at end-2010 should affect 2011. The company's net account additions target stands at 350,000 in 2011. Given that the net additions reached 78,000 during January-February, we believe the goal is achievable.

Net account additions recover from 2009



Source: Korea Investment & Securities

Quarterly net additions surged in 4Q10-1Q11



Source: Korea Investment & Securities

Strong growth potential for environmental appliances

The environmental appliances business should continue to expand thanks to: 1) rising incomes and increasingly health-conscious consumers, 2) renewed growth momentum as the revenue stream has diversified to include memberships and outright sales, 3) a decline in the churn rate on the back of its market-leading position and resulting customer loyalty, and 4) new product effects.

Health-conscious consumers to drive environmental appliances business

The environmental appliances market is bound to grow when income levels go up and consumers are more conscious of health and wellbeing issues. Korea's water purifier market is worth W1.5trn and recorded a CAGR of 7.5% over the past six years but the penetration rate remains at the 30% level. Except for water purifiers, the company's mainstay product, the air purifier and bidet markets are in the growth phase and the water softener and food waste disposal markets are in the infant stage. Korea's air purifier market amounts to W500bn and has posted an impressive CAGR 12.2% over the past six years and has strong growth potential as the penetration rate is limited to 12.1%. The bidet market was worth W400bn in 2010, marking a 13-fold increase from W30bn in 2000. The air purifier penetration rate is a meager 8.2% in Korea. The food waste disposal and water softener

[1] Net account additions include both rental and membership accounts.

segments are too small to assess their value.

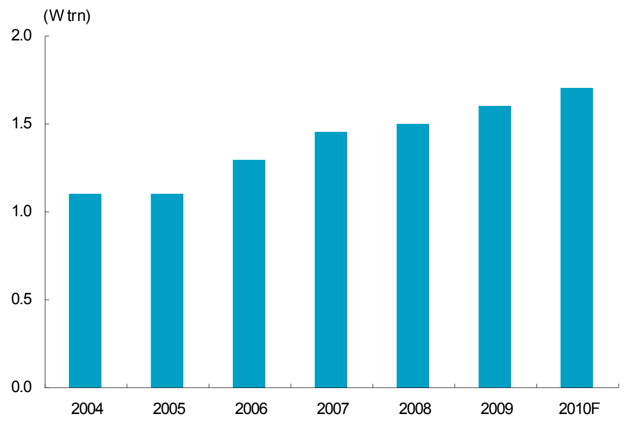
We believe Korea's environmental appliances market should follow its Japanese counterpart. Japan's environmental appliances market is far ahead of Korea's as its penetration rate amounts to 55-60% for water purifiers, 20% for air purifiers and 70% for bidets. The company estimates market saturation at 55-60% for water purifiers, 45-50% for bidets and 50-60% for air purifiers, which supports our view that Korea's environmental appliances market has great room for growth.

Environmental appliances markets in Korea and Japan

	Korea			Japan
	Market value	Penetration	Expected saturation rate	Penetration
Water purifiers	W1.5trn	30.0%	55-60%	55-60%
Air purifiers	W500bn	12.1%	50-60%	20%
Bidets	W400bn	8.2%	45-50%	70%

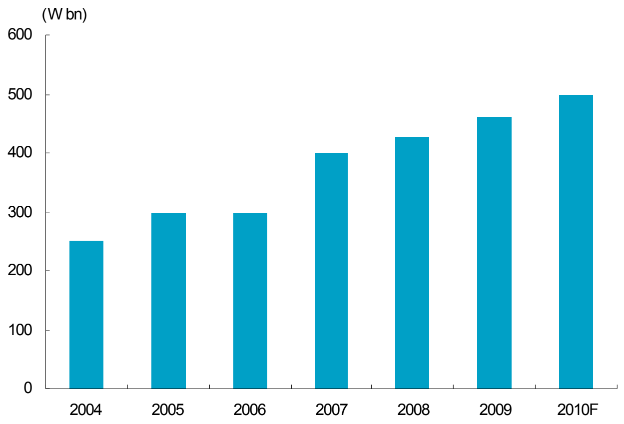
Source: Company data, Korea Investment & Securities

Korean water purifier market at a six-year CAGR of 7.5%



Source: Korea Direct Selling Association, Korea Investment & Securities

Korean air purifier market at a six-year CAGR of 12.2%

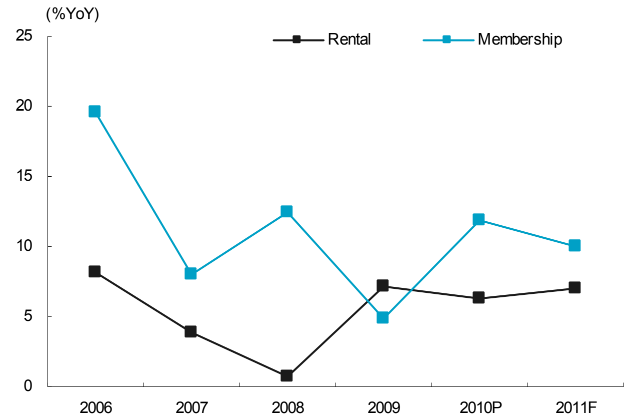


Source: Korea Air Cleansing Association, Korea Investment & Securities

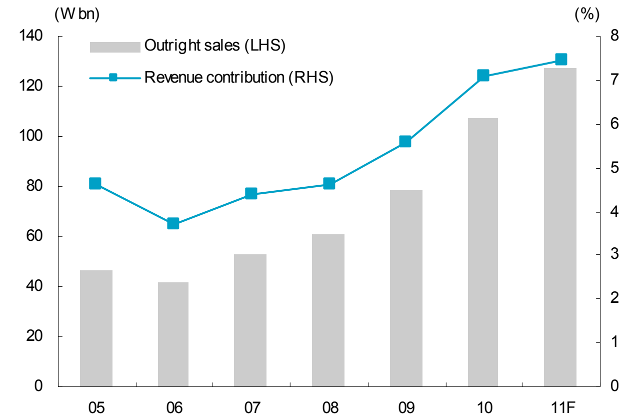
Diverse revenue stream

It is notable that the environmental appliances business has experienced healthy membership growth and brisk outright sales in recent years. The company's rental accounts swelled at the early stage during 2001 and 2004. As rental contracts started to expire from 2005 and some rentals joined the membership program upon their contract expiry, the number of members sharply increased and created a sustainable revenue structure for the company. Moreover, a recent increase in outright sales also contributes to expanding the environmental appliances business. Customers who have made a lump-sum payment tend to take out a membership to get maintenance service, which in turn expands the membership base and becomes a sustainable revenue source.

Fast increase in memberships	Moderate increase in outright sales



Source: Company data, Korea Investment & Securities

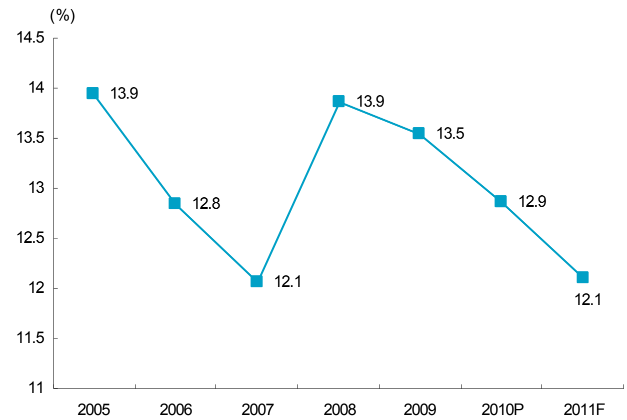


Source: Company data, Korea Investment & Securities

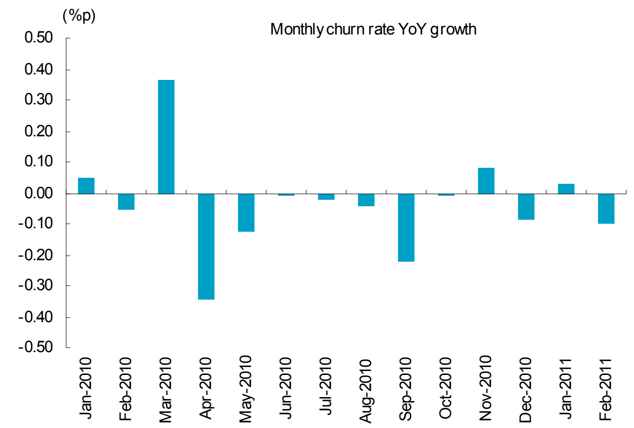
Moderate decline in churn rate

Net account additions depend on the number of new accounts signed and old accounts terminated. The average duration of a rental contract spans four years thanks to strong brand loyalty and the churn rate fell to 12.9% in 2010 after having peaked at 13.9% in 2008. Although the life cycle of rental contracts played a role in the growth trend, we draw attention to the company's effective marketing campaign such as "Payfree" and strenuous efforts to enhance its service offerings. We estimate the churn rate at 12.1% in 2011 compared to the company's target of 10.8%. The monthly churn rate is down YoY and remained low at 1.04% in January and 0.9% in February this year.

Churn rate falling since 2009	Monthly churn rate on a YoY decline



Source: Company data, Korea Investment & Securities



Source: Company data, Korea Investment & Securities

New products to bolster 2011 earnings

The company has aggressively released products on the back of its superb market presence and cash flow. In particular, new products have an immediate impact on net account additions. Net account additions were robust in 4Q10 thanks to the release of water purifiers and air-purifying humidifiers. The company plans to roll out eight water purifiers, 11 air purifiers, five bidets, one food waste disposer and five water softeners this year. Product releases should enable the company to attract rental customers, increase outright sales, prevent customer defections upon the renewal of rental contracts and bolster ARPU. As the company's target is the mainstream market, we believe new products can make significant contributions to both the top and bottom lines. In particular, air-purifying humidifiers represent 80% of the Japanese air purifier market versus Korea's 21%. As such, we believe

Korea's air-purifying humidifiers market has strong growth potential. Product releases are mostly scheduled after June, which would help expand the customer base in 2H11. We expect new products to account for 10% of 1,220,000 new rental accounts in 2011, and this figure equals 34.9% of net account additions (350,000) expected in 2011.

2011 new product lineup

Source: Company data, Korea Investment & Securities

2. New and growing businesses

1) Domestic cosmetics: A triumphant entry, bright future

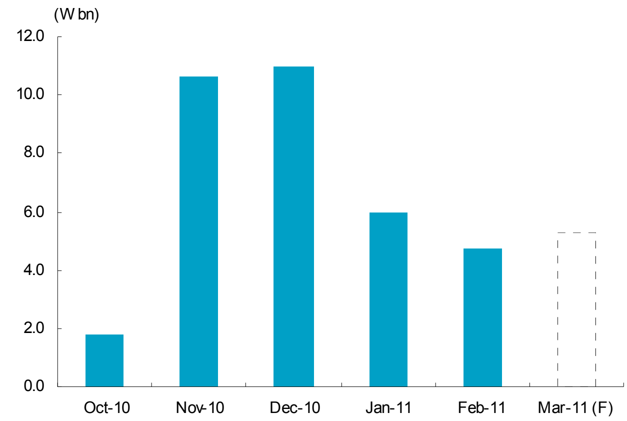
Re:NK made a successful landing

Coway launched its prestige cosmetics brand Re:NK in October 2010. Although it seems very premature to judge it a success or not, what is apparent is the brand's sales have been stronger than expected despite only about half a year since its launch. What is undeniable is the brisk sales have been achievable thanks to aggressive marketing and the R&D activities funded by Coway's strong capital base. The door-to-door prestige cosmetics brand reported W23.4bn in sales in 2010 and exceeded the company's target by W10bn.

Re:NK has made a solid entry to the cosmetics market with the support of aggressive promotion and huge advertising spending (a campaign starring actress Ko Hyun-jeong). Coway's advertising spending jumped from 2.8% of total sales annually to 3.7% in 2010. The cosmetics division alone spent W11bn on adverts in 4Q10, mainly for prime-time spots on terrestrial TV stations. The repeat buyer rate for Re:NK will serve as a measure of customer satisfaction going forward. We think the brand's full-year sales target of W60bn will be achievable given the positive customer response and growing brand awareness in the initial stage. Re:NK's sales are estimated at a north of W6bn in January and W4bn in February. About

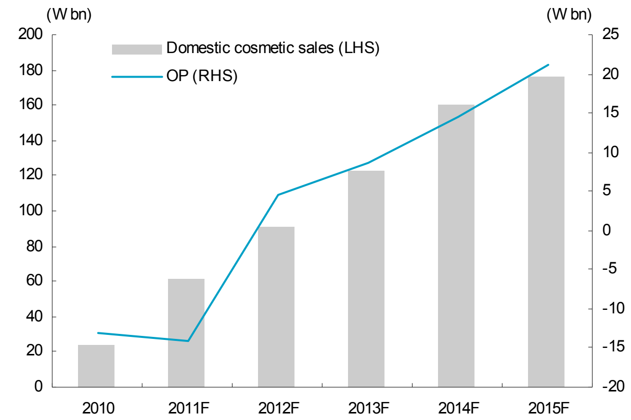
W5bn in monthly sales will be easily achievable considering fewer business days caused by the Lunar New Year holiday in February.

Re:NK's monthly sales



Source: Company data, Korea Investment & Securities

Domestic cosmetics sales and OP



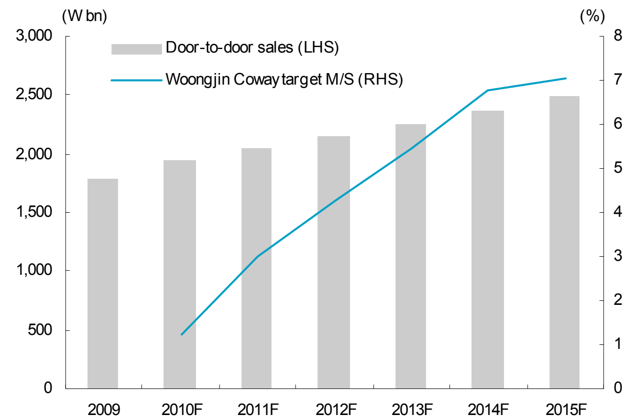
Source: Company data, Korea Investment & Securities

Prestige door-to-door segment is the target market

Coway has the prestige door-to-door segment as its target market for cosmetics. Target customers are women in their 30s and 40s. Korea's cosmetics market size is estimated at W8.4trn in 2010, of which W2.2trn, or 26%, is door-to-door sales. The company has taken advantage of its knowhow in door-to-door sales to push the cosmetics business with the number of sales agents for Re:NK on a sharp rise. Aside from which, a vast network of 13,000 codys and more than 3mn rental and membership subscribers will be of good use to promote the cosmetics brand.

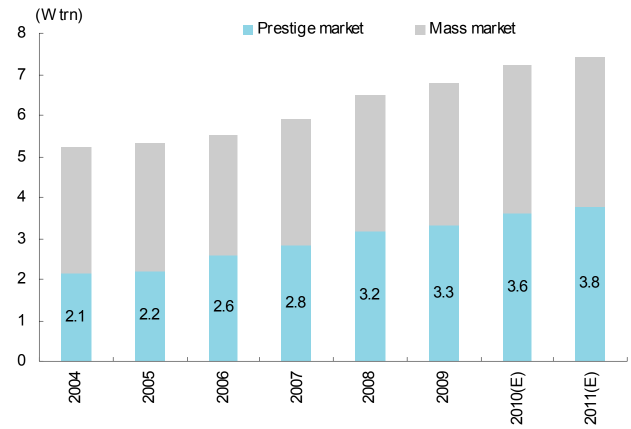
Re:NK's prices are in the same range as premium brands such as Sulhwasoo by AmorePacific and OHUI by LG H&H. Korea's prestige cosmetics brands are distributed through department stores and door-to-door sales and the premium market is growing faster than the mass market. According to an industry source, the domestic cosmetics market grew 5.2% per annum over the past seven years and by segment, the premium market expanded 8.5% per annum compared to the mass market's 2.4% growth. The premium products' portion of total cosmetics sales is estimated at 50% in 2010, up from 41% in 2004.

Domestic cosmetics' door-to-door sales and Woongjin Coway's target market share



Source: Company data, Korea Investment & Securities

Strong growth of prestige cosmetics market in Korea



Source: Company data, Korea Investment & Securities

Entry to duty-free shops and wider products lineup help sustain growth

Coway's cosmetics sales and profits should exceed its own guidance. For LG H&H, the O HUI brand makes more than W200bn in sales annually with an operating margin of 15%. Coway aims to generate sales of W60bn in 2010F and W91.3bn in 2011F with an operating margin of 5% from Re:NK and the target will be easily achievable. Coway added Re:NK Whitening and Re:NK Homme in March and plans to launch a herbal medicine cosmetics brand in 2H11. In addition, the company is considering expanding the cosmetics distribution channel to duty-free shops. The diversified sales channels and products lineup will help sustain growth.

2) Water treatment systems and exports, a mid to long-term growth driver

M&As of water treatment firms – a longer-term growth driver

Coway entered the water treatment systems arena by taking over Woongjin Chemical and a transfer of goodwill from its water treatments division. Coway is nurturing water treatment systems as a mid to long-term growth driver. The division's sales amounted to W22.4bn, 1.5% of the total, in 2010, which should be W47bn if taking into account Green Entech, which the company took over in early 2010.

Large companies such as Hyundai Rotem, Samsung Engineering and Kolon, and smaller firms such as Coway rule Korea's water treatments market. Korea's water treatment systems are transitioning from physical and chemical processes to a membrane filtering method that is better for environmental protection and simpler to apply. The filter membranes include micro-filters (MF), ultra-filters (UF), nano-filters (NF) and reverse-osmosis (RO).

Development of water treatment technology

	1G (1800s-present)	2G (1920s-present)	3G (1990s-present)
Technology	Physical and chemical process	Bio process	Membrane separation
Method	– Chemicals are used for coagulation and adsorption of contaminants and for sand filtering	– Aerobic and anaerobic microorganisms are used to degrade contaminants	– Various membranes are used for filtering contaminants
Characteristic	– Chemical materials – Many sludge – Huge capex	– Less secondary contamination compared to physical and chemical processes – Unable to remove degradable materials	– Environmentally friendly – Simple operation – Compact size – Modulation

Source: SERI, Korea Investment & Securities

Water treatment membranes by type

Type	Size of contaminants	Filtering	Purpose
MF	100nm-10 ㎛	Floating materials, bacteria	Tap water and sewage treatment
UF	1-100nm	Suspended materials, protein, polysaccharide high molecular materials	sewage treatment (incl. industrial wastewater)
NF	1nm	Organic materials (selective)	Pre-desalination treatment, tap water treatment (removal of agricultural chemicals)
RO	Smaller than 1nm	Ionic materials, heavy metals	Desalination, pure water production, water purification

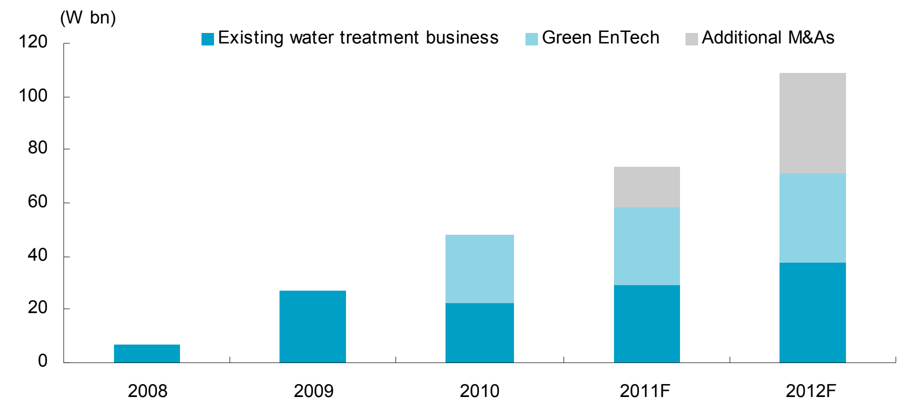
Source: SERI, Korea Investment & Securities

Coway has obtained a technology to produce RO filters through the goodwill transfer from Woongjin Chemical. The company also has UF technology since taking over Green Entech in early 2010. Coway plans to emerge as a comprehensive water treatment company by taking advantage of Green Entech's technological prowess in biophysical and chemical processes.

Although it is a low-margin business, Coway is placing more focus on government projects to enhance its technological abilities and build a good reference list. The company plans to further develop technologies and drive top-line growth through small-scale M&As in 2011.

The water treatment division's sales should increase from W47.8bn in 2010 to W108.8bn in 2012F on the acquisition of Green Entech and additional M&As. The company has a more aggressive sales target of W230bn in 2013. Possible additional M&As are not reflected in our earnings. We estimate the division's operating margin at around 5%.

Water treatments: Mid to long-term growth driver



Source: Company data, Korea Investment & Securities

Exports: Paving a road for mid to long-term growth

Exports amounted to W69.2bn in 2010 or 4.5% of total sales. The company's overseas sales comprise direct sales via a subsidiary abroad, OEM business and sales to other partners. Coway serves as an OEM distributor for major global brands such as Whirlpool, Bosch&Siemens and Philips. Exports surged 37.4% YoY in 2010 (in USD terms), led by overseas subsidiaries. In particular, the Malaysian subsidiary's net account additions climbed from less than 20,000 at end-2009 to 50,000 by end-2010 and should break even by exceeding 100,000 in 2011. We expect exports to jump 38% YoY to W93.4bn in 2011F. Coway will add three overseas subsidiaries (Indonesia, India and Middle East) in 2H11. The company is pursuing new customers abroad and aiming at breaking even in exports in 2011.

3. Robust earnings at subsidiaries

1) Cosmetics in China: Taking a step back to go forward; Likely to sustain 20% growth

Robust business in China: Distribution through sales agents in provinces

Coway markets its cosmetics and environmental appliances through Woongjin Coway China Living Goods. The Chinese subsidiary's sales totaled W46.4bn in 2010, which break down to W35.8bn for cosmetics and W10.6bn for environmental home appliances. The cosmetics division reported W11.6bn in operating profit whereas appliances made an operating loss of W1.6bn. The cosmetics business is a cash cow for the subsidiary.

The cosmetics sales in China have more focus on distribution through a wholesale agent rather than on retail. The Chinese subsidiary supplies cosmetics to a sales agent in a province with 60% of the selling price going to the agent and 40% to the subsidiary. Sales agents in the provinces will often re-distribute the products to sub-agents. Coway has wholesale agents in nine of China's 28 provinces (including semi-autonomous regions and Taiwan) and saw an operating margin of 32.5% in 2010. The cosmetics business in China is now focused mainly on tier-2 and tier-3 cities and the company is seeking to broaden its presence into southern areas of the country such as Jiangsu, Anhui and Zhejiang.

Cosmetics market positioning in China by brand

	Terreau	Hebeir	Nouris	Meiqing	Ruhen	Cellart
ASP (RMB)	190	130	65	50	250	500
Sales portion (%)	17	16	26	3	21	17
Release	Jun 2003	Jan 2004	Mar 2005	May 2008	Dec 2004	Apr 2009
Products	52	35	31	6	20	25

Source: Company data, Korea Investment & Securities

Woongjin Coway's cosmetics sales agents in China by region

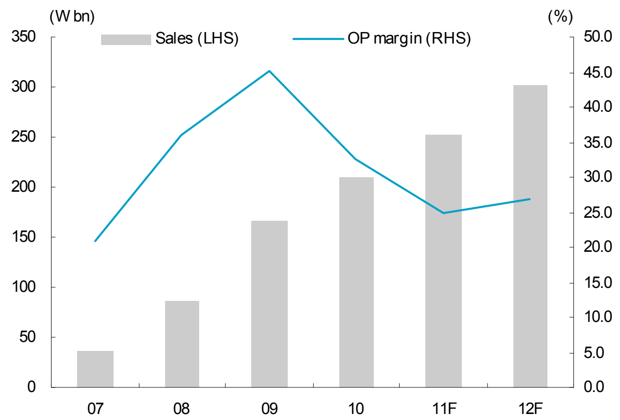
Source: Company data, Korea Investment & Securities

Growth will be a bit slower in 2010 and 2011 but 20% is achievable

The cosmetics sales in China soared from RMB11mn in 2004 to RMB200mn in 2010. But concerns were raised over future growth potential as the pace slowed from 93% YoY in 2009 to 26% YoY in 2010. By quarter, the sales growth was a paltry 8% YoY in 3Q10 and 17% YoY in 4Q10. The operating margin fell to 23% in 4Q10 due to sales channel additions and heavy marketing, leading to concerns about profitability erosion.

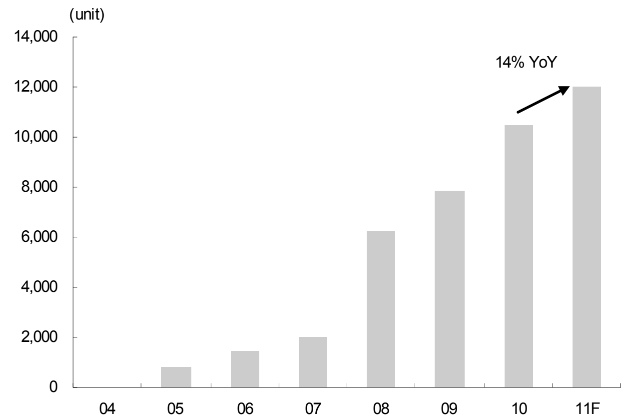
The Chinese subsidiary should work to enhance operating efficiency at existing shops and strengthen the retail sales networks in 2011. Although the pace of new store additions will be slower than in the past, we believe the company's guidance of 20% sales growth is achievable as: 1) cosmetics consumption in China should grow 8% per annum for the next three years, and 2) the number of stores increases 14% YoY in 2011F.

Cosmetics sales and OP in China



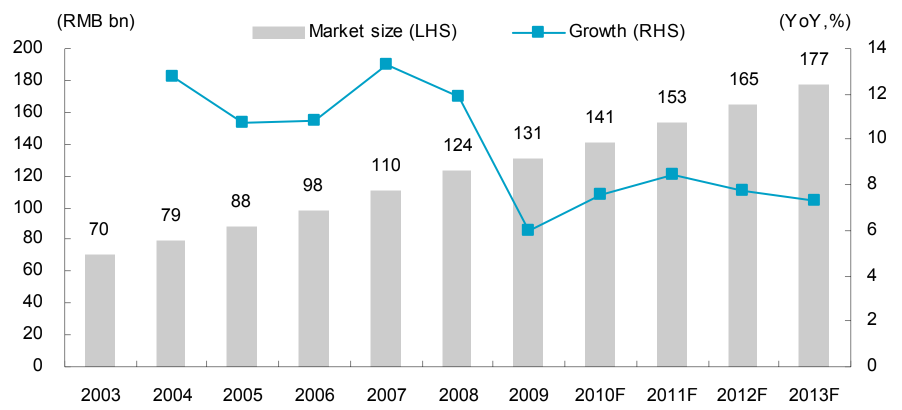
Source: Company data, Korea Investment & Securities

Stores in China



Source: Company data, Korea Investment & Securities

Strong cosmetics consumption in China



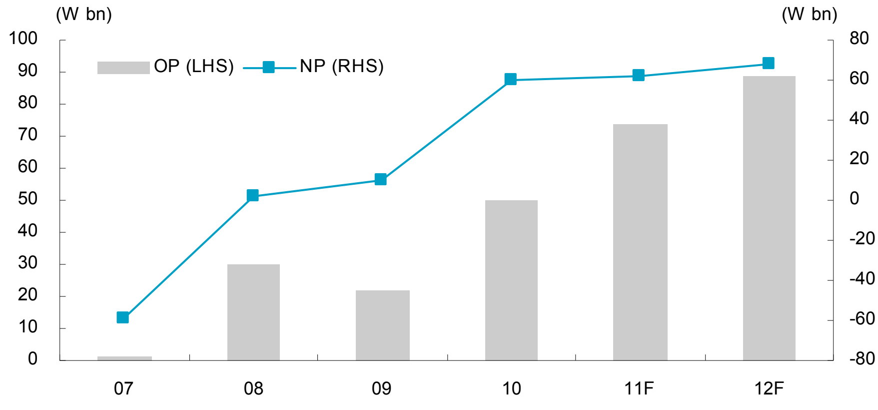
Source: Euromonitor, Korea Investment & Securities

2) Woongjin Chemical – Robust industry conditions and strong filter business

Record-high earnings in 2011

Woongjin Chemical, in which Coway owns 45%, turned around in 2008 after going through a corporate debt-workout process. Since then, the company has grown to become a major subsidiary and made equity-method gains of W25.9bn in 2010. Woongjin Chemical recorded W911.9bn in sales and W60.2bn in net profit in 2010 and presented a guidance for 2011 to achieve sales of about W1.01trn, operating profit of W62.5bn and net profit of W61.6bn. The fiber division, representing 80% of total sales, is delivering strong growth backed by rising cotton prices and big demand for synthetic fibers. In addition, the high-margin filter business is growing fast pushed by the expanding water treatment market and enhanced global competitiveness. Globally, the company ranks fourth in the RO filter market and is exploring opportunities in the MF market.

Woongjin Chemical's earnings forecast



Source: Company data, Korea Investment & Securities

4. Favorable shareholders' policy

Stable dividend payout ratio and big ROE

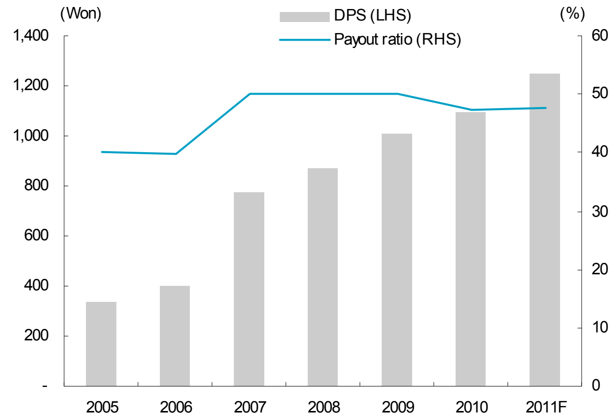
Dividend payout ratio of 50% and share buyback

Coway has maintained a nearly 50% dividend payout ratio since 2007. Assuming the ratio at 50% in 2011, the 2011F dividend per share would amount to W1,250 which equals a 3.4% dividend yield. As such, the company deserves investors' attention as a dividend play. What draws our attention more is the company's continuous efforts to enhance shareholders' value. On Mar 21, Coway decided to buy back 2mn treasury shares, 2.6% of total outstanding shares, for W65.6bn. If we assume a 6% funding rate given the company's net debt position, the erosion on 2011 EPS would be marginal at around 1%. The company has stuck to a consistent and generous dividend policy based on share buyback and cancellation, which points to a favorable shareholders' policy in the future.

Sustainable lofty ROE

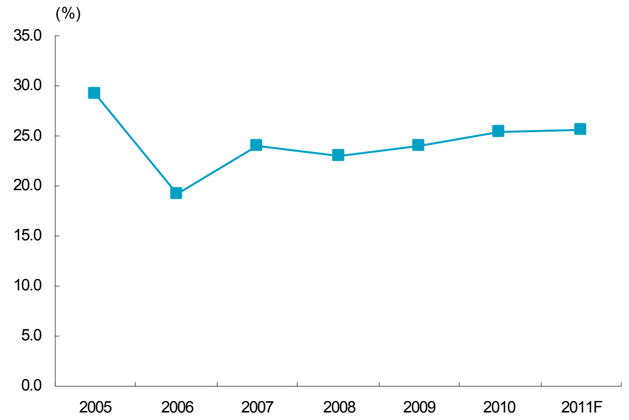
The big dividend payout ratio and steady profit growth are bolstering ROE. We peg the 2011F ROE at 25.5% and the figure is sustainable. Given its mid to long-term ROE target set at 30%, we expect more dramatic measures to drive up earnings and enhance shareholders' value.

Dividend payout ratio around 50%



Source: Company data, Korea Investment & Securities

ROE remains high



Source: Company data, Korea Investment & Securities

III. Earnings outlook

Sales already growing and profitability to start improving in 2H11

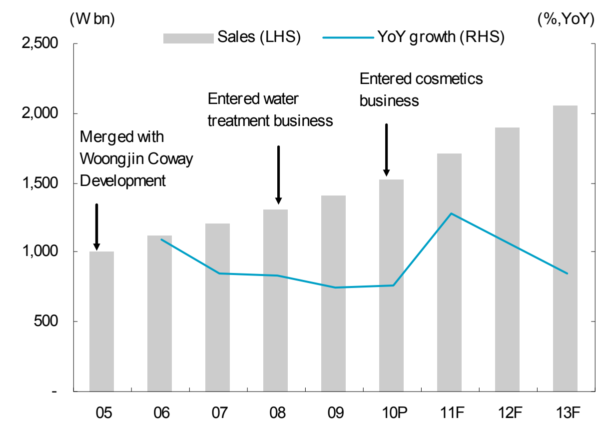
Sales CAGR of 10.7% over the next three years

Coway had a sales CAGR of 7.8% over 2007-2010, which was weaker than the double-digit growth achieved prior to 2006. However, we see sales growth improving to 12.8% YoY in 2011F mainly backed by: 1) the recovery of the mainstay environmental appliances business, 2) a newly launched domestic cosmetics business, and 3) robust growth of the water treatments and export divisions. The company's environmental appliances business has seen an increase in net account additions while the domestic cosmetics business that launched in 2H10 has been enjoying breakneck sales growth. Although the water treatments and export businesses tend to be somewhat volatile, their sales should begin to accelerate in 2H11 helped by small M&A deals, the addition of new OEM bases and launch of overseas subsidiaries. Thus, we forecast a sales CAGR of 10.7% over the next three years as sales swell from W1.5trn in 2010 to the W2trn level in 2013F.

Profitability in a trough in 1H11

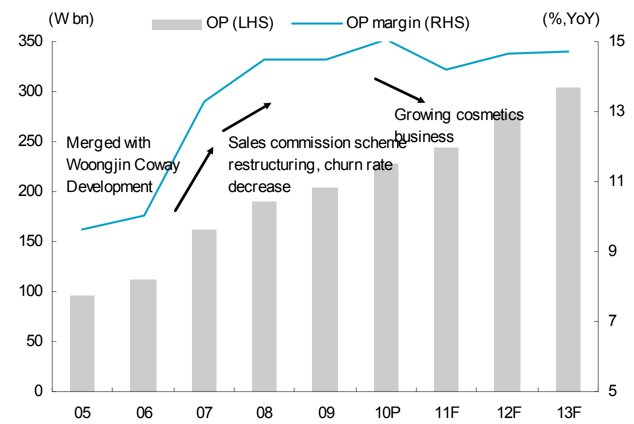
We estimate Coway's operating margin to dip from a high of 15.1% in 2010 to 14.2% in 2011F. Profitability began to erode rapidly in 4Q10 due to marketing and promotion costs for the new cosmetics business. The company's advertising costs-to-sales, which was normally around 2.8%, climbed to 3.7% in 2010 largely due to TV advertising and promotional expenses for the cosmetics business. We believe operating profit will continue to slide during 1H11 with new product releases. But operating profit should turn upward and balloon 19% YoY in 2H11F backed by accelerating sales growth, moderate spending and a low base of comparison. We expect operating profit to gain a mere 6.5% in 2011F, demonstrating weakness in 1H11 and strength in 2H11.

Stronger sales growth in 2011



Source: Company data, Korea Investment & Securities

Profitability improvement in 2012

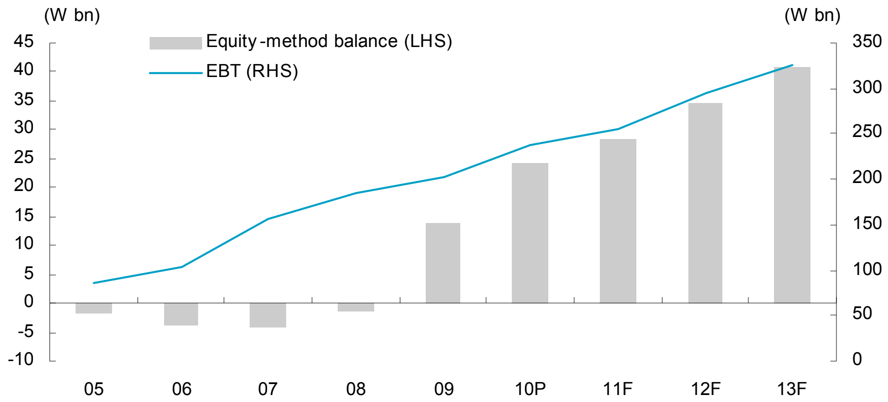


Source: Company data, Korea Investment & Securities

EPS CAGR of 12.9% over the next three years

We estimate Coway will deliver an EPS CAGR of 12.9% over the next three years backed by a gradual improvement in operating profit and robust equity-method gains. Although operating profit should climb only 11% YoY in 2011F, EPS is poised for 16.9% YoY growth in 2012F driven by profitability improvement and strong earnings at subsidiaries.

Equity-method balance vs. EBT



Source: Company data, Korea Investment & Securities

Earnings estimates and breakdown by segment

	2006	2007	2008	2009	2010F	2011F	2012F	2013F
Rental accounts ('000, end of period)	3,478	3,612	3,640	3,899	4,145	4,433	4,679	4,915
Rental ARPU (KRW)	22,261	21,871	22,049	22,316	21,938	22,116	22,126	22,091
Membership accounts ('000, end of period)	658	711	799	838	938	1,031	1,125	1,218
Membership ARPU (KRW)	11,675	14,116	15,054	14,054	13,869	13,995	14,187	14,397
Churn rate (%)	12.8	12.1	13.9	13.5	12.9	12.1	11.7	11.7
Sales (W bn)	1,118	1,213	1,314	1,412	1,519	1,713	1,897	2,058
% change (YoY)	10.9	8.5	8.4	7.4	7.6	12.8	10.7	8.5
Rental	1,020	1,102	1,156	1,197	1,255	1,355	1,449	1,533
% change (YoY)		8.1	4.9	3.5	4.8	8.0	6.9	5.9
Outright sales	41.5	53.0	60.4	78.6	107.4	127.3	146.5	163.3
% change (YoY)	-10.7	27.8	14.0	30.0	36.6	18.5	15.1	11.5
Cosmetics					23.4	60.8	91.3	123.2
% change (YoY)						160.0	50.0	35.0
Water treatments	0.0	0.0	7.1	27.1	22.4	29.1	37.9	45.4
% change (YoY)				281.7	-17.3	30.0	30.0	20.0
Exports	6.5	19.2	44.6	55.7	69.2	93.4	121.4	139.7
% change (YoY)	0.0	195.4	132.3	24.9	24.2	35.0	30.0	15.0
Others	49.8	38.7	46.0	53.5	42.8	47.1	50.8	53.4
% change (YoY)	-14.4	-22.3	18.7	16.4	-20.0	10.0	8.0	5.0
COGS (W bn)	380.4	384.7	407.2	460.0	493.8	557.8	624.7	680.5
% of sales	34.0	31.7	31.0	32.6	32.5	32.6	32.9	33.1
Rental COGS	340.7	333.7	323.3	336.8	348.2	375.1	401.4	425.5
% of sales	33.4	30.3	28.0	28.1	27.8	27.7	27.7	27.7
Outright sales COGS	13.7	18.8	20.4	24.9	37.1	44.0	50.6	56.4
% of sales	33.0	35.5	33.8	31.7	34.6	34.6	34.6	34.6
Cosmetics COGS					3.5	9.1	13.7	18.5
% of sales					15.0	15.0	15.0	15.0
Water treatments COGS			4.6	21.6	16.8	21.8	27.3	32.7
% of sales				79.7	75.0	75.0	72.0	72.0
Exports COGS			29.9	37.6	53.1	70.1	91.1	104.7
% of sales			67.0	67.5	76.7	75.0	75.0	75.0
Others COGS	26.0	32.2	29.0	39.1	38.5	37.7	40.7	42.7
% of sales	52.2	83.1	63.1	73.1	90.1	80.0	80.0	80.0
OP (W bn)	112.3	161.3	190.1	204.3	228.8	243.6	277.7	303.0
% change (YoY)	15.9	43.7	17.9	7.4	12.0	6.5	14.0	9.1
OP margin (%)	10.0	13.3	14.5	14.5	15.1	14.2	14.6	14.7
Non-operating balance (W bn)	-9.9	-5.6	-5.4	-1.5	7.9	11.3	16.3	23.0
Interest balance	-7.0	-6.4	-8.1	-9.4	-14.5	-17.3	-18.3	-18.1
Equity-method balance	-3.9	-4.1	-1.4	13.9	24.4	28.5	34.6	41.0
Others	0.9	4.9	4.0	-6.0	-1.9	0.0	0.1	0.1
EBT (W bn)	102.4	155.7	184.8	202.7	236.7	254.9	294.0	326.0
% change (YoY)	19.1	52.0	18.7	9.7	16.8	7.7	15.3	10.9
NP (W bn)	74.9	116.3	129.1	153.3	176.7	193.7	223.4	247.7
% change (YoY)	23.1	55.2	11.0	18.8	15.3	9.6	15.3	10.9

Source: Korea Investment & Securities

IV. Company overview

No. 1 in domestic environmental appliances market; Building fresh engines for further growth

Stability of the core business stands out from the pack

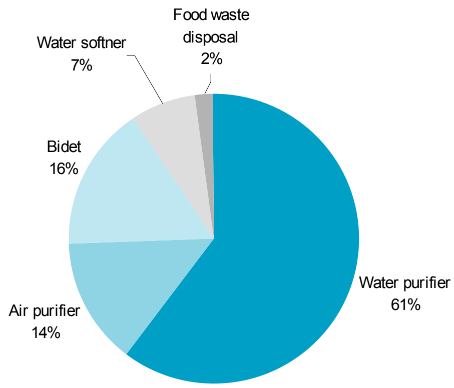
Coway leads the domestic environmental appliances market serving 4.43mn customers as of end-2010. The company is a far-ahead leader in the water purifier, bidet and air purifier markets with a nearly 50% share. The main products are categorized as home appliances but the difference lies in that the company provides door-to-door sales and regular maintenance with as many as 13,000 codys. Thus, a major source of revenue is not lump-sum outright sales but rental and membership services. Sales reached W1.52trn in 2010, which broke down to rental services (73%), membership services (10%) and outright sales (7%). Meanwhile, cosmetics, emerging as a future growth engine, represented only 1.5% of total sales in 2010. Water treatment systems and exports accounted for 1.5% and 4.6%, respectively. By product, water purifiers generated 53% of sales, trailed by bidets (15%) and air purifiers (13%).

Woongjin Coway's business structure

Business	2010 sales (weight)	2010 gross profit (weight)	Products	Price range	Competitors and market share (%)
Rental	1,107 (73%)	804 (78%)	Water purifier Bidet Air purifier Water softener Food waste disposal	Water purifier: Monthly fee of W26,000-44,000 (two-year contract, registration fee zero) Air purifier: Monthly fee of W25,900 (two-year contract, registration fee W100,000) Bidet: Monthly fee of W24,000-34,000 (two-year contract, registration fee zero) Water softener: Monthly fee of W35,000 (two-year contract, registration fee zero) Food waste disposal: Monthly fee of W24,000-32,500 (three-year contract, registration fee zero)	Water purifier: Woongjin Coway (52%) Chungho Nais (11%) Amway (8%) Others (29%) Bidet: Woongjin Coway (48%) Novita (21%) Daelim (8%) Others (23%) Air purifier: Woongjin Coway (50%) Samsung Electronics (16%) LG Electronics (5%) Others (29%) Water softener: Woongjin Coway Novita Chungho Nais
Membership	148 (10%)	102 (10%)	Water purifier Bidet Air purifier Water softener Food waste disposal	Water purifier: Monthly fee of W15,000 Bidet: Monthly fee of W8,800 Air purifier: Monthly fee of W8,000 Water softener: Monthly fee of W12,000 Food waste disposal: Monthly fee of W10,000	
Outright sales	107 (7%)	70 (7%)	Water purifier Bidet Air purifier Water softener Food waste disposal	Water purifier: W700,000-1,600,000 Bidet: W500,000-800,000 Air purifier: W700,000 Water softener: W750,000 Food waste disposal: W240,000-1,300,000	
Cosmetics	23 (2%)	27 (3%)	Re:NK - Women and men lines	Skin: W40,000-60,000 Lotion: W40,000-70,000 Serum: W70,000-150,000 Cream: W60,000-140,000 Eye cream: W70,000-95,000	AmorePacific LG Household & Health Care Others
Water treatments	22 (1%)	6 (1%)	Water filtering/processed water treatment Waste-water treatment Water recycling Packaged water filtering/softening equipment		Colon, Hanwha E&C
Exports	69 (5%)	16 (2%)	Water purifier, air purifier and bidet		Global environmental home appliance vendors

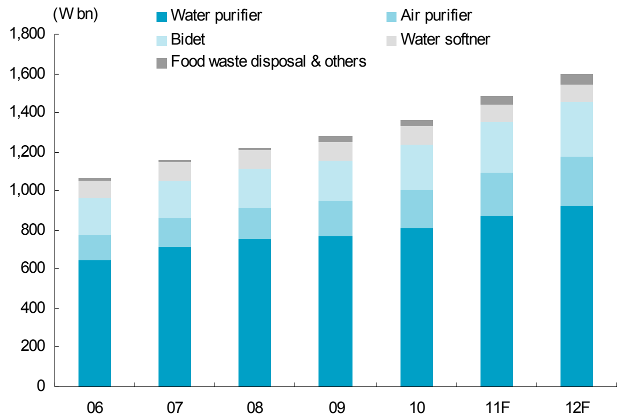
Source: Company data, Korea Investment & Securities

Sales breakdown in 2010



Source: Company data, Korea Investment & Securities

Fast-growing air purifier and bidet sales



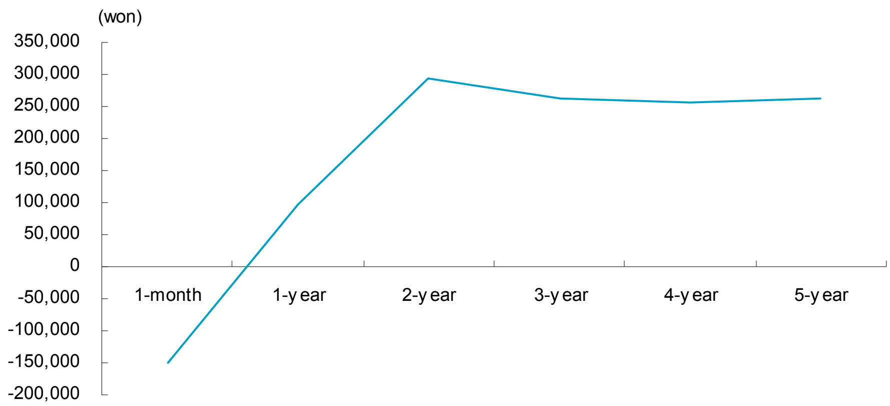
Source: Company data, Korea Investment & Securities

Although it is hard to grasp operating margins by division, the margin at the environmental appliances business seems to be around 20% thanks to economies of scale. The cosmetics business has yet to break even as it is still in the initial phase of operation. Conditions are not different at the water treatments and exports businesses.

Constant flow of profits from diverse areas

Mainstay products such as water purifiers, bidets and air purifiers are not necessities but tend to enjoy growing demand as income levels rise. Thus, it is necessary to create demand by raising awareness among consumers. In addition, the products require regular maintenance such as filter changes as they are not considered semi-durable appliances like refrigerators and TVs. Incorporating the features, the company introduced a rental business model where consumers pay a registration fee and a monthly fee of W20,000-30,000. The business model is only possible at financially healthy companies as they need to shoulder the initial investment. This turned out to be a win-win strategy for customers and Coway as customers do not have to pay a lump sum and the company enjoys stable cash flow until the five-year contract expires. The rental service breaks even within a year and spans four years on average. After the contract expires, the company can make an additional profit by renewing the contract for a new model, transferring ownership at low prices or providing membership services. Recently, outright sales are also increasing. The lump-sum payment helps generate additional profit as it often accompanies a low-priced membership registration.

Cash flow at water purifier rental business



Source: Company data, Korea Investment & Securities

Defensive to economic conditions; Sales and operating profit on the rise since 2004

The company's earnings are not susceptible to economic conditions. Under the company's business structure, the blend of registration fees and monthly fees contribute to stable cash flow for an average four-five years and thus subscriber additions mean a steady increase in sales and operating profit. The number of subscribers has been increasing since 2004. Even during the financial crisis in 2008, sales and operating profit expanded 8.4% YoY and 17.9% YoY, respectively, on the back of the existing subscriber base although rental subscriber additions gained a mere 0.8% YoY. With stable cash flow and impressive profitability, the annual operating margin has never deviated from 13-15%.

V. Risk factors

Concerns over protecting market share and lingering Woongjin Group risk

Low-price strategy adopted by smaller rivals and market penetration by major firms have always been concerns

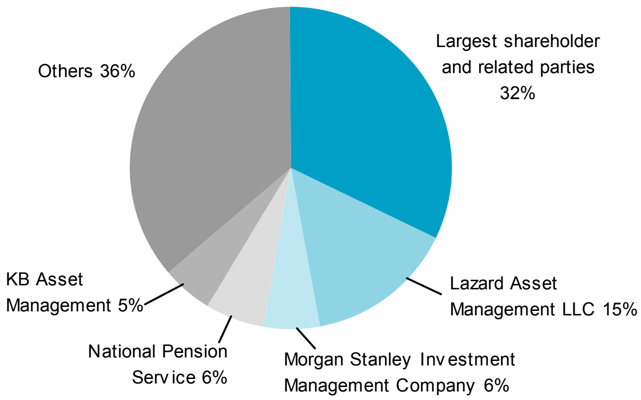
Coway's unrivalled market share in water purifiers has been the company's strength but the question of whether the company can remain ahead of competitors has always been a concern. We believe the risk factors include SMEs' low-priced products and LG Electronics' (LGE) entry to the water purifier market. But as Coway's health-related appliances are viewed as relatively high involvement products, a trio of quality, hygiene and maintenance always take precedence over price when consumers choose Coway products. In addition, the door-to-door service network backed by 13,000 codys add to the company's unparalleled competitiveness. Although LGE already entered the water purifier market, it has a picayune 2% market share. Thus, rather than being overly concerned about the aforementioned risks, we believe it is more important to focus on Coway's unrelenting market dominance, its proactive development of new products using stable cash flow and superior service quality.

Woongjin Group risk: No need to worry about additional stake reduction or providing funds to assist affiliates

The risk associated with Woongjin Group is another issue. At present, Kukdong E&C (Kukdong), an affiliate of Coway, is a problem child for Woongjin Group and there were concerns that Coway, with its cash cow role within the group, would have to provide financial assistance to Kukdong. In addition, excessive borrowing by Woongjin Holdings raised concerns over the possibility of a stake divestiture. Woongjin Holdings disposed 3% of its stake in Coway in 2010 and the proceeds were used to pay down debt. But at present, Woongjin Holdings' debt burden has eased somewhat and Kukdong's contingent liabilities continue to shrink. Moreover, Woongjin Holdings currently owns a mere 28.4% of Coway so a further stake reduction is unlikely. As for providing financial assistance to affiliates, we believe it is unrealistic as there has never been a case of an affiliate financially supporting another and such is unlikely to occur going forward. Above all, Coway's latest decision to buy back its shares is solid evidence of the company's determination to not use company money to prop up ailing affiliates.

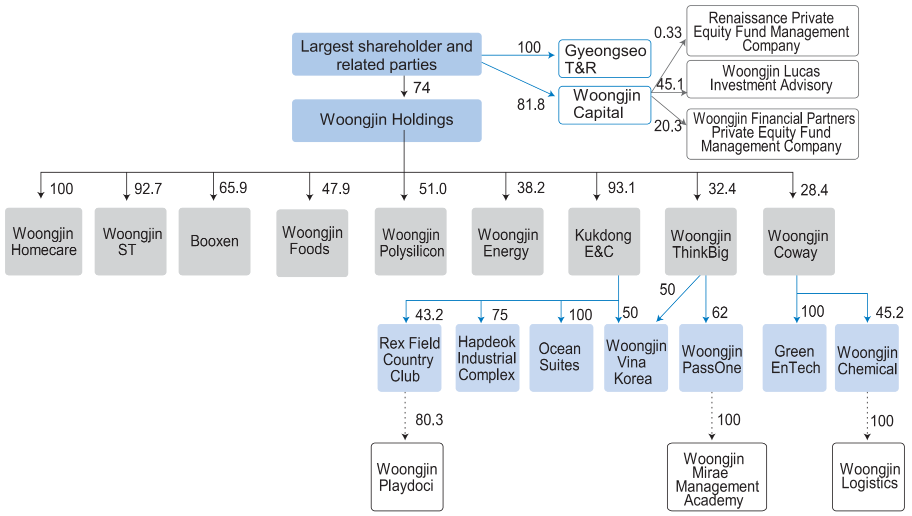
Appendix

Woongjin Coway's ownership structure



Source: Company data, Korea Investment & Securities

Woongjin Group's corporate governance



Source: Company data, Korea Investment & Securities

Balance Sheet

Fiscal year ending Dec. (W bn)	2008A	2009A	2010P	2011F	2012F
Current assets	476	509	523	566	633
Cash & cash equivalent	76	64	76	51	57
Accounts receivable	150	195	177	210	238
Inventory	58	55	59	66	73
Fixed assets	596	761	857	933	1,007
Investments	114	131	191	215	238
Tangible assets	356	418	447	471	495
Intangible assets	65	141	152	171	190
Total assets	1,071	1,271	1,380	1,500	1,639
Current liabilities	399	542	501	517	534
Accounts payable	34	29	31	35	39
Short-term borrowing	108	120	132	143	155
Current portion of LT debt	0	120	64	64	64
Long-term debt	76	48	171	173	175
Debentures	0	0	0	0	0
Long-term borrowings	60	30	151	151	151
Total liabilities	475	590	671	690	710
Paid-in capital	39	41	41	41	41
Capital surplus	109	142	142	142	142
Capital adjustments	6	(32)	(97)	(97)	(97)
Retained earnings	441	530	623	724	844
Shareholders' equity	597	681	709	810	930

Source: Company data, Korea Investment & Securities estimates

Income Statement

Fiscal year ending Dec. (W bn)	2008A	2009A	2010P	2011F	2012F
Sales	1,314	1,412	1,519	1,713	1,897
Gross profit	907	952	1,025	1,155	1,272
SG&A expense	717	747	796	912	994
Operating profit	190	204	229	244	278
Non-op. profit	21	27	44	42	48
Interest income	3	3	3	3	3
FX gains	12	1	4	4	4
Equity gains	4	18	30	29	35
Non-op. expense	27	29	36	31	32
Interest expense	11	13	18	20	21
FX losses	1	6	5	5	5
Equity losses	6	4	8	0	0
Earnings before tax	185	203	237	255	294
Income taxes	56	49	60	61	71
Profit from discontinued	0	0	0	0	0
Net profit	129	153	177	194	223
EBITDA	331	352	396	421	465

Source: Company data, Korea Investment & Securities estimates

Cash Flow

Fiscal year ending Dec. (W bn)	2008A	2009A	2010P	2011F	2012F
C/F from operating	305	312	325	281	323
Net profits	129	153	177	194	223
Depreciation	126	128	139	146	152
Amortization	15	20	28	31	35
Net incr. in W/C	(36)	(49)	2	(63)	(54)
Others	71	59	(21)	(27)	(33)
C/F from investing	(255)	(276)	(241)	(226)	(226)
Capex	(171)	(218)	(185)	(190)	(193)
Decr. in fixed assets	29	14	18	20	17
Net incr. in current assets	(4)	(0)	(0)	(1)	(1)
Incr. in investment	(82)	3	(38)	4	12
Others	(26)	(75)	(35)	(59)	(61)
C/F from financing	(2)	(52)	(72)	(80)	(91)
Incr. in equity	0	0	0	0	0
Incr. in debts	56	51	77	12	12
Dividends	(58)	(65)	(77)	(84)	(93)
Others	0	(39)	(71)	(8)	(10)
Increase in cash	48	(12)	12	(25)	6

Source: Company data, Korea Investment & Securities estimates

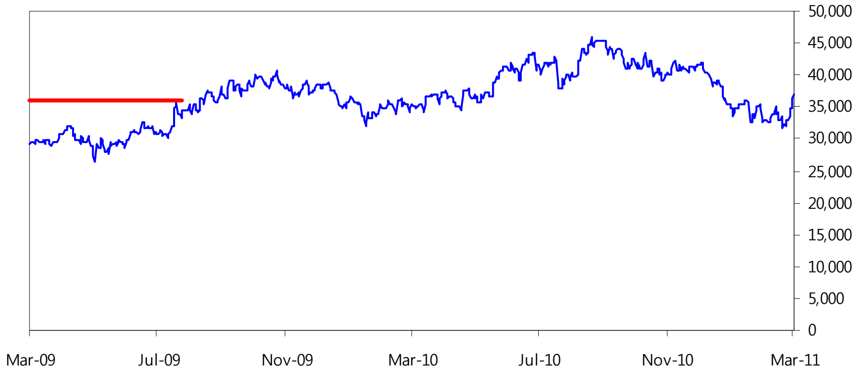
Key Financial Data

Fiscal year ending Dec.	2008A	2009A	2010P	2011F	2012F
per share data (won)					
EPS	1,734	2,034	2,322	2,580	3,017
BPS	7,144	7,469	8,536	9,596	10,911
DPS	870	1,010	1,100	1,250	1,400
SPS	17,659	18,736	19,963	22,813	25,607
Growth (%)					
Sales growth	8.4	7.4	7.6	12.8	10.7
OP growth	17.9	7.4	12.0	6.5	14.0
NP growth	11.0	18.8	15.3	9.6	15.3
EPS growth	10.8	17.3	14.2	11.1	16.9
EBITDA growth	9.4	6.3	12.4	6.3	10.4
Profitability (%)					
OP margin	14.5	14.5	15.1	14.2	14.6
NP margin	9.8	10.9	11.6	11.3	11.8
EBITDA margin	25.2	25.0	26.1	24.6	24.5
ROA	12.9	13.1	13.3	13.5	14.2
ROE	22.9	24.0	25.4	25.5	25.7
Dividend yield	3.3	2.6	2.7	3.4	3.8
Stability					
Net debt (W bn)	86	200	265	300	306
Int. coverage (x)	16.8	16.3	13.0	12.1	13.3
D/E ratio (%)	28.1	39.6	48.9	44.3	39.8
Valuation (x)					
PER	15.4	18.9	17.4	14.3	12.2
PBR	3.7	5.1	4.7	3.8	3.4
PSR	1.5	2.0	2.0	1.6	1.4
EV/EBITDA	6.2	8.9	8.3	7.2	6.6

Source: Company data, Korea Investment & Securities estimates

Changes to recommendation and price target

Company (Code)	Date	Recommendation	Price target
Woongjin Coway (021240)	08-18-09	NM	W0
	03-25-11	BUY	W47,000



- **Guide to Korea Investment & Securities Co., Ltd. stock ratings based on absolute 12-month forward share price performance**
  - BUY: Expected to give a return of +15% or more
  - Hold: Expected to give a return between -15% and +15%
  - Underweight: Expected to give a return of -15% or less

- **Guide to Korea Investment & Securities Co., Ltd. sector ratings for the next 12 months**
  - Overweight: Recommend increasing the sector's weighting in the portfolio compared to its respective weighting in the Kospi (Kosdaq) based on market capitalization.
  - Neutral: Recommend maintaining the sector's weighting in the portfolio in line with its respective weighting in the Kospi (Kosdaq) based on market capitalization.
  - Underweight: Recommend reducing the sector's weighting in the portfolio compared to its respective weighting in the Kospi (Kosdaq) based on market capitalization.

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