

Initiating coverage

Korea / Consumer

15 May 2014

BUY

Target price **KRW107,000**

Last price (12 May 2014) **KRW83,200**

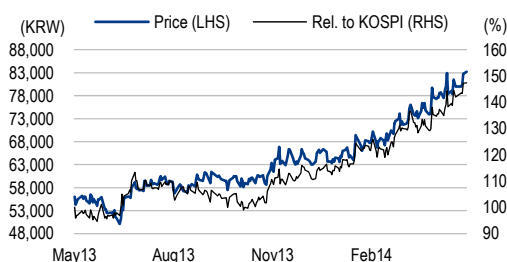
Upside/downside (%) 28.6
KOSPI 1,964.94
Mkt. cap (KRWbn/US\$bn) 6,417/6.3
52-week range (KRW) 50,100 - 83,200
Avg. trading value daily (KRWbn) 17.44
Foreign ownership (%) 54.2

Source: Bloomberg

Forecast earnings & valuation

Fiscal year ending	Dec-13	Dec-14 E	Dec-15 E	Dec-16 E
Revenue (KRWbn)	2,118	2,266	2,432	2,572
EBIT (KRWbn)	339.0	405.9	481.2	542.9
Net profit (KRWbn)	245.1	304.4	361.9	410.4
Net profit(underlying)	245.1	304.4	361.9	410.3
EPS (KRW)	3,178	3,947	4,692	5,321
EPS growth (%)	160.6	24.2	18.9	13.4
P/E (x)	20.9	21.1	17.7	15.6
EV/EBITDA (x)	9.7	10.4	8.8	7.8
Dividend yield (%)	2.5	2.6	3.5	4.3
P/B (x)	5.4	5.7	4.9	4.3
ROE (%)	28.4	29.5	29.7	29.0
Net debt/equity (%)	8.8	(4.1)	(14.5)	(23.0)

Performance



Performance	1M	3M	12M
Absolute (%)	7.1	22.9	57.6
Absolute (US\$, %)	8.4	28.8	67.4
Relative to KOSPI (%)	8.7	21.4	56.5

Source: Bloomberg

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COWAY (021240 KS)

Pleasant surprises in store

We expect Coway's improving cash management, via higher cash returns to shareholders and stronger earnings growth, to lead to a further share re-rating. We initiate coverage of Coway with a BUY rating and a target price of KRW107,000.

Largest wellness appliance rental-service provider

Coway is the largest wellness appliance rental-service provider in Korea, leading the water and air-purifier rental markets with shares of roughly 38-45%. Coway's rental business model is capital intensive in the initial stage of business build-up, as the company has to purchase all the rental appliances it plans to lease. However, once it achieves economies of scale, the rental business becomes highly cash-generative. We think Coway is well positioned to continue to enjoy steady cash flow from rental service business and believe its leadership in the wellness appliance rental-service market will continue.

Potential value enhancement from cash management

We expect strong earnings growth and stable capex to result in a CAGR of 12% free cash flow (FCF) in 2014-16. With Coway's net cash position, we think the healthy free cash growth should lead to a sharp increase in dividend payouts to maximize shareholder value. We believe the ownership by MBK Partners is dividend-friendly. We expect Coway's dividend per share to rise to KRW2,200 in 2014 and KRW2,900 in 2015, respectively (versus the current consensus of KRW1,903 and KRW2,306, respectively).

Robust earnings growth momentum

We project Coway's EPS to grow 24% and 19% YoY in 2014 and 2015, respectively. We think key earnings drivers will include: 1) monthly average revenue per user (ARPU) growth 1-1.5% YoY, following rental service fee hikes in April 2013; 2) healthy rental and membership subscriber growth of 3-4% YoY for 2014-15, on the back of lower subscription-cancellation ratios; and 3) management's continuing efforts on SG&A cost savings. Our 2014-2015 EPS estimates are 8-13% above consensus estimates, as we think the market does not fully appreciate Coway's growth momentum.

Investment risks

While Coway's overall business model is relatively unaffected by economic cycles, any sharp deterioration in consumption could result in high cancellation rates and consumers potentially trading down to cheaper products.

Initiating coverage with a BUY and a target price of KRW107,000

Our target price of KRW107,000 is based on a dividend discount model (DDM), which properly captures Coway's strong cash flows and fast-rising dividend profile. Our target price translates into 22.8x 2015E PER and 11.5x 2015E EV/EBITDA, which are premiums to its five-year historical average valuations. However, we think the premiums are justified, given: 1) Coway's improved corporate governance and better cash management (under new major shareholder, MBK Partners); 2) stronger EPS and EBITDA growth prospects; 3) higher operating profit margin outlook; and 4) greater dividend payout ratios.

I. Recommendation and valuation

We initiate coverage of Coway with a BUY rating and a DDM-based target price of KRW107,000. We used the dividend discount model (DDM) as the main valuation methodology, as we think it can better capture Coway's strong cash flows and fast-growing dividend profile, compared with other valuation methods.

Coway's rental business (68% of consolidated sales) model is capital intensive in the initial stage of business build-up, as the company has to purchase all the rental appliances it plans to lease. However, once it achieves economies of scale, the rental business becomes highly cash-generative. We expect strong operating profit growth and stable capex to drive a CAGR of 12% free cash flow (FCF) in 2014-2016. With Coway's almost net cash position, we think the healthy free cash growth should lead to a sharp increase in dividend payouts to maximize shareholder value.

To calculate Coway's fair value, we assumed that the company's dividend/share would grow at a 3-year CAGR of 29% in 2014-2016, faster than its EPS and free cash flow growth (19% and 12%) during the same period, along with rising dividend payout ratios. We expect dividend payout ratio to rise to 65% in 2016 from 55% in 2014, with Coway using 71% of its free cash flow by 2016 to provide dividends to its shareholders. Also, we applied a terminal growth rate of 3% and a cost of equity of 6.1%. For the cost of equity, we used a risk-free rate of 3%, an equity risk premium of 6.2% and a beta of 0.5, respectively.

Figure 1 DDM valuation

(KRW)	2014E	2015E	2016E	2017E	2018E
DPS forecast/share	2,200	2,900	3,600	4,300	5,000
Cost of equity (%)	6.1	6.1	6.1	6.1	6.1
Discounting factor (x)	1.06	1.13	1.19	1.27	1.34
NPV of DPS	2,074	2,576	3,014	3,393	3,719
Terminal value/share					123,557
Terminal growth rate					3%
PV of terminal value/share					91,895
Fair value/share					107,000
Number of shares (m)					77.1
Fair valuation (KRW bn)					8,252
Cost of equity calculation					
Risk free rate (%)		3.0			
Beta (x)		0.5			
Korea risk premium (%)		6.2			
Cost of equity (%)		6.1			

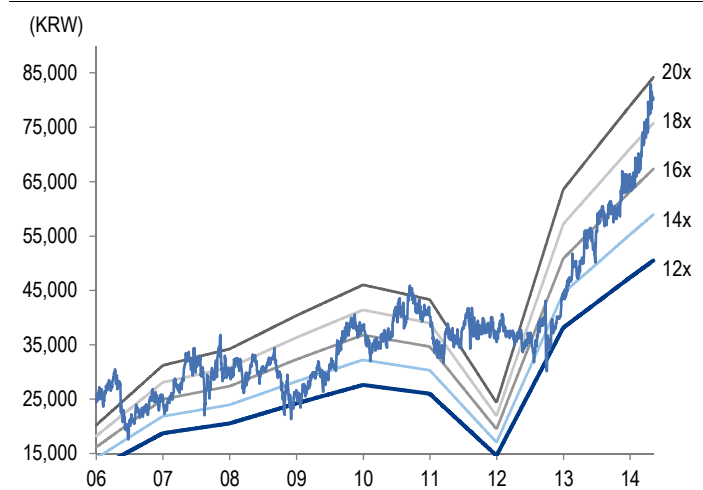
Sensitivity Analysis

Cost of Equity	Implied dividend growth				
	2.0%	2.5%	3.0%	3.5%	4.0%
5.1%	111,000	130,000	157,000	203,000	289,000
5.6%	95,000	109,000	127,000	155,000	199,000
6.1%	84,000	94,000	107,000	125,000	152,000
6.6%	74,000	82,000	92,000	105,000	123,000
7.1%	67,000	73,000	81,000	90,000	103,000

Source: Mirae Asset Research

Our DDM-based target price translates into 22.8x 2015E PER and 11.5x 2015E EV/EBITDA, which are premiums to its five-year historical average valuations of 18x and 7.3x, respectively. We think the premiums to the historical average are reasonable, considering: 1) Coway's improved corporate governance and better cash management policy (under new major shareholder, MBK Partners); 2) stronger EPS and EBITDA growth outlook of 19% and 13% pa for 2014-2016 (versus 5-year average EPS and EBITDA growth of 13% and 6%); 3) higher operating profit margin outlooks of 29% (versus a five-year average of 20%); and 4) greater dividend payout ratios of 60% on average for 2014E-2016E (versus a five-year average of 53%).

Figure 2 Coway historical P/E band chart



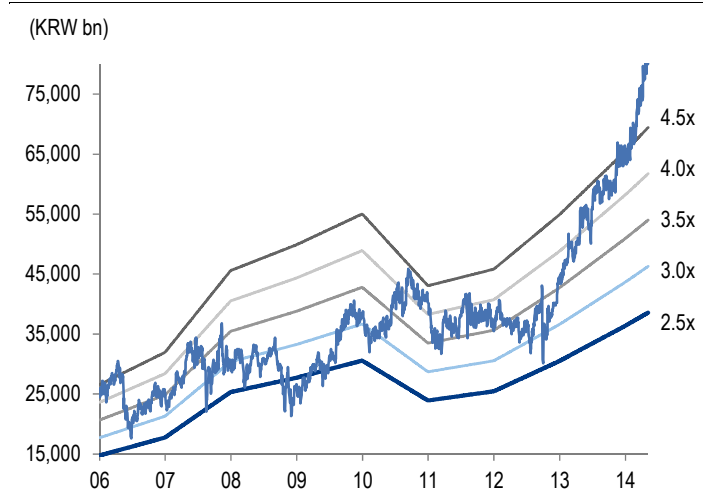
Source: Quantwise, Mirae Asset Research

Figure 3 Coway historical EV/EBITDA band chart



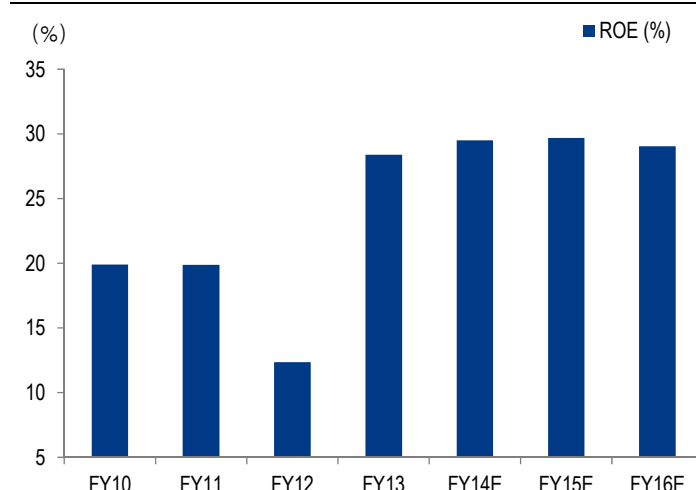
Source: Quantwise, Mirae Asset Research

Figure 4 Coway historical P/B band chart



Source: Quantwise, Mirae Asset Research

Figure 5 Coway historical ROE trend



Source: Company data, Mirae Asset Research

Due to Coway's unique wellness appliance rental-business model, it is difficult to find precisely comparable peers. We therefore chose Korean mid-value consumer names with decent earnings and cash flow growth prospects as Coway's comparable peers. Compared with its peers, Coway has: 1) higher operating profit margin structure; 2) stronger earnings growth prospects; and 3) greater dividend yields; nevertheless, Coway currently trades at a slight discount to other value mid-cap Korean consumer companies. We expect this discount to turn into a premium over the next few years.

Figure 6 Valuation comparison with mid-cap consumer companies

		Coway	Amorepacific	LG H&H	Hotel Shilla	Orion
		021240 KS	090430 KS	051900 KS	008770 KS	001800 KS
Share price	(Local)	83,000	1,459,000	490,000	87,800	834,000
Market cap	(KRW bn)	6,401	8,529	7,653	3,446	4,982
1M avg. turnover	(KRW bn)	19.0	21.8	27.0	29.7	13.6
Recommendation		BUY	BUY	BUY	Not Rated	BUY
TP	(KRW)	107,000	1,600,000	550,000	N/A	1,150,000
Upside	(%)	28.9	9.7	12.2	N/A	37.9
Sales (KRW bn)	13A	2,118	3,100	4,326	2,297	2,485
	14E	2,266	3,499	4,639	2,855	2,573
	15E	2,432	3,856	5,013	3,727	2,828
Operating profit (KRW bn)	13A	339	370	496	87	259
	14E	406	425	541	167	298
	15E	481	491	625	239	343
Net profit (KRW bn)	13A	245	268	357	11	146
	14E	304	321	392	121	189
	15E	362	368	454	175	226
EPS (KRW)	13A	3,178	45,840	22,877	274	24,400
	14E	3,947	54,943	25,078	3,065	31,729
	15E	4,692	62,981	29,084	4,439	37,918
EPS growth (%)	13A	160.6	(0.9)	17.6	(89.3)	(4.0)
	14E	24.2	19.9	9.6	1,018.5	30.0
	15E	18.9	14.6	16.0	44.8	19.5
Operating margin (%)	13A	16.0	11.9	11.5	3.8	10.4
	14E	17.9	12.2	11.7	5.9	11.6
	15E	19.8	12.7	12.5	6.4	12.1
Net margin (%)	13A	11.6	8.6	8.3	0.5	5.9
	14E	13.4	9.2	8.4	4.2	7.4
	15E	14.9	9.5	9.1	4.7	8.0
ROE (%)	13A	28.4	11.0	27.4	1.6	13.8
	14E	29.5	12.2	26.0	16.2	15.0
	15E	29.7	12.8	26.4	19.7	14.5
P/E (x)	13A	26.1	31.8	21.4	320.4	34.2
	14E	21.0	26.6	19.5	28.6	26.3
	15E	17.7	23.2	16.8	19.8	22.0
EV/EBITDA (x)	13A	12.1	11.3	15.7	21.3	17.8
	14E	10.4	9.8	14.3	16.5	15.6
	15E	8.8	8.5	12.4	12.6	13.6
Div. yield (%)	13A	2.0	0.7	0.7	0.2	0.3
	14E	2.7	0.4	0.8	0.4	0.4
	15E	3.5	0.4	0.8	0.5	0.4

Source: Bloomberg, Mirae Asset Research

Lastly, in order to support our DDM-based target price, we also calculated Coway's fair value by using the DCF valuation. As Coway generates strong cash flows that are highly predictable over the long term, we think the DCF method is another appropriate valuation tool to assess fair value.

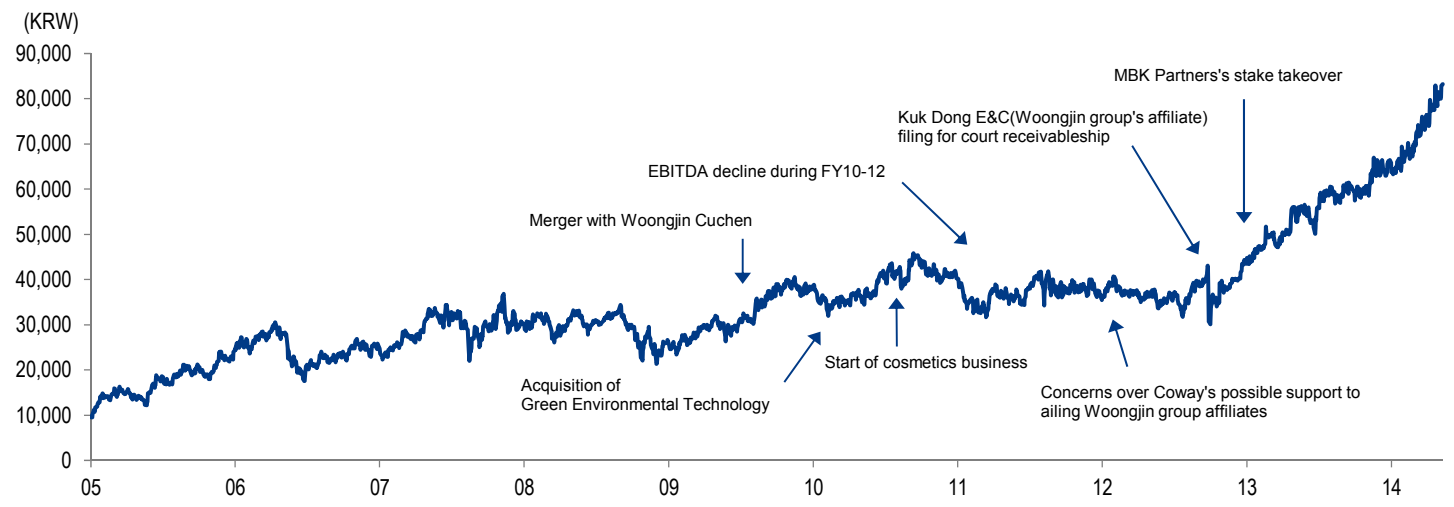
To calculate the fair value, we applied a terminal growth rate of 3%, and a WACC of 5.9%. For WACC, we used a risk-free rate of 3.0%, an equity risk premium of 6.2% and a beta of 0.5. We assumed that sales growth and EBIT margin would decline gradually to 3% and 11%, respectively, through 2023.

Figure 7 Coway's DCF analysis

(KRW bn)	2014E	2015E	2016E	2017E	2018E	2019E	2020E	2021E	2022E	2023E	Terminal
Sales	2,266	2,432	2,572	2,725	2,883	3,036	3,184	3,324	3,455	3,574	3,682
EBIT	406	481	543	596	653	629	597	559	514	463	405
Depreciation & rental asset disposal losses	239	255	267	276	282	294	306	316	325	332	339
Amortization	8	8	8	8	8	8	8	8	8	8	8
Taxes	(101)	(121)	(137)	(151)	(166)	(160)	(152)	(142)	(131)	(117)	(103)
Net working capital	(2)	(45)	(44)	(44)	(43)	(30)	(30)	(30)	(30)	(30)	(30)
CAPEX	(300)	(270)	(270)	(270)	(270)	(283)	(295)	(307)	(317)	(327)	(335)
Cash flow for DCF	249	308	366	414	463	458	433	404	368	328	283
Discount factor	0.9	0.9	0.8	0.8	0.7	0.7	0.7	0.6	0.6	0.6	
PV of FCF	235	274	306	327	345	321	286	251	216	182	
Sum of PV	2,743										
Terminal value											
FCFn+1	283										
WACC	5.9										
g	3.0										
Terminal value	9,806										
Discount factor	0.55										
Present value of terminal value	5,424										
Fair value from core domestic business	8,167										
WACC											
Risk free rate	3.0%										
Equity risk premium	6.2%										
Cost of debt	4.0%										
Cost of equity	6.1%										
Debt to total capital	10.0%										
Value of debt (KRWbn)	(46)										
Value of equity (KRWbn)	8,213										
Equity value/share (KRW)	106,000										
Number of shares outstanding (m)	77										

Source: Mirae Asset Research

Figure 8 Event chart



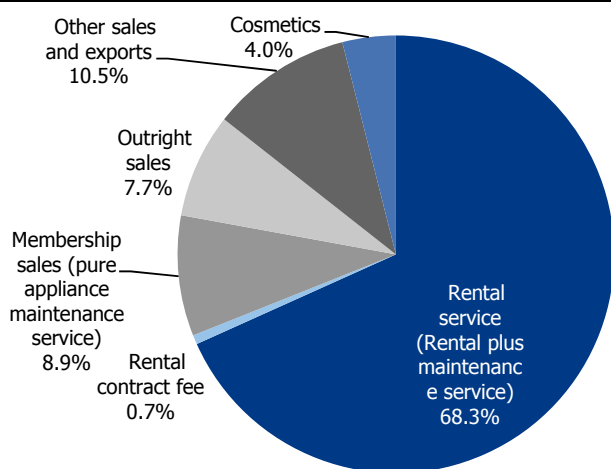
Source: Mirae Asset Research

Business description

Coway is the largest wellness appliance manufacturer/rental-service provider in Korea, leading the water and air purifier rental markets with shares of roughly 38-45%. As of 2013, Coway generates 68.3% of its total consolidated 2013 revenue from the rental service business and 8.9% from membership services. The company's rental services include wellness appliance rentals and maintenance contracts. Approximately 23% of revenues are from other businesses, including domestic cosmetics and appliance sales and exports.

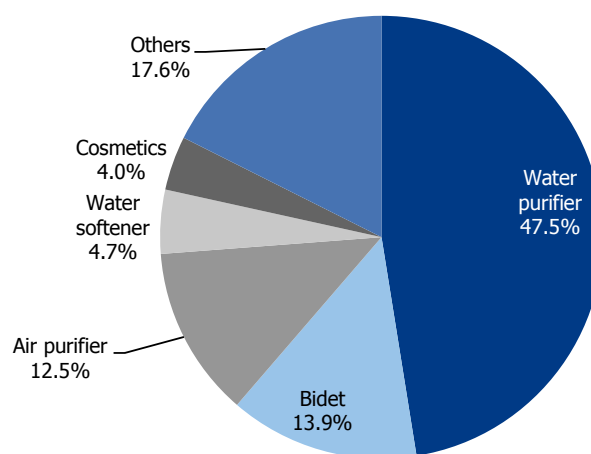
By product type, water purifiers account for 47.5% of consolidated sales, air purifiers for 12.5% and bidets for 13.9% in 2013.

Figure 9 2013 sales breakdown by service type



Source: Company data, Mirae Asset Research

Figure 10 2013 sales breakdown by product type



Source: Company data, Mirae Asset Research

Coway competes with conventional competitors such as Chungho Nais (unlisted) in the water purifier rental market and Novita (unlisted) and Daelim Bidet (unlisted) in the bidet market. It also competes with LGE (066570 KS, BUY, TP: KRW85,000, CP: KRW67,400) and Samsung Hauzen (unlisted) in the wellness appliance sales market.

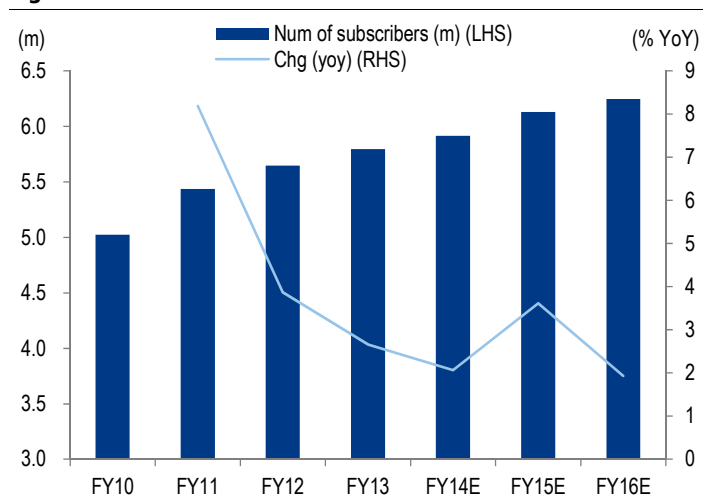
Figure 11 Market shares of Coway and its competitors

Product type	Coway's market share	Competitors
Water purifier	45.0%	C company (11%), T company (8%)
Bidet	38.0%	N company (27%), T company (8%)
Air purifier	38.0%	L company (14%), S company (9%)

Source: Company data, Mirae Asset Research

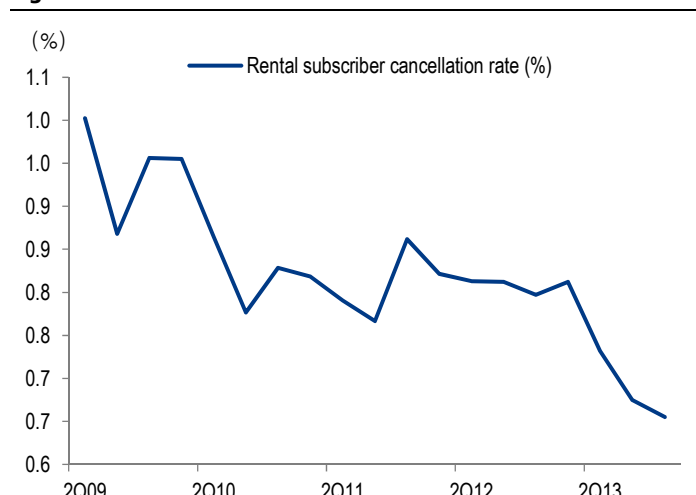
With consumers' growing health consciousness, amid deteriorating water and air quality in Korea, we think overall demand in wellness appliance rental markets should remain firm for the longer term. Also, we think Coway will continue to maintain its leadership in these markets, considering its solid product line and service network, with nearly 12,700 door-to-door service representatives (known in Korea as 'Coway ladies,' or by the acronym CODY). By comparison, we estimate that the number-two water purifier rental-market player, Chungho Nais, has only 2,500 service representatives. As of 4Q13, Coway had accumulated nearly 5.8m rental and membership subscribers. Its subscriber cancellation rate remains very low, at around 0.8%.

Figure 12 Number of subscribers



Source: Company data, Mirae Asset Research

Figure 13 Cancellation ratio trend

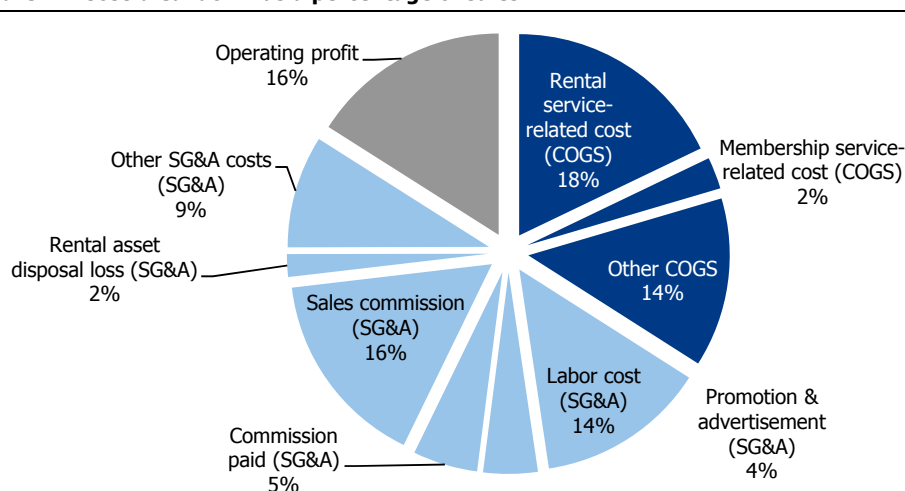


Source: Company data, Mirae Asset Research

Coway's main operating costs are comprised of: 1) rental service-related costs (18% of sales); 2) labor costs for Coway employees in SG&A (14%); 3) sales commissions (16%); 4) promotional and advertising expenses (4%); and 5) rental asset-disposal losses (2%).

The company pays its sales representatives in two ways, through: 1) sales commissions (booked as SG&A) for signing up new subscribers/members; and 2) commissions for the signing of appliance maintenance contracts by customers (booked as appliance-maintenance service commission under COGS). The company writes off its rental assets when subscribers cancel.

Figure 14 Cost breakdown as a percentage of sales



Source: Company data, Mirae Asset Research

Earnings outlook

We project Coway's EPS to grow 24% in 2014 and 19% YoY in 2015, respectively. We think key earnings drivers will include: 1) monthly average revenue per user (ARPU) growth 1-1.5% YoY, following rental service fee hikes in April 2013; 2) healthy rental and membership subscriber growth of 3-4% YoY for 2014E-15E on the back of lower subscription cancellation ratios; and 3) management's continuing efforts on SG&A cost savings.

Figure 15 Income statement summary

(KRW bn)	2012	2013	2014E	2015E	2016E
Sales	1,993	2,118	2,266	2,432	2,572
Chg. (% YoY)	9.2	6.3	7.0	7.3	5.8
Cost of sales	678	721	775	827	879
Chg. (% YoY)	16.8	6.3	7.5	6.7	6.4
Gross profit	1,315	1,397	1,491	1,605	1,693
Chg. (% YoY)	5.7	6.3	6.7	7.6	5.5
Margin (%)	66.0	66.0	65.8	66.0	65.8
SG&A and other operating items	1,088	1,058	1,085	1,123	1,150
Chg. (YoY)	7.9	(2.8)	2.5	3.5	2.3
% of sales	54.6	50.0	47.9	46.2	44.7
Labor cost	290	289	302	314	324
Promotions & advertising	97	93	94	95	92
Commission paid	93	110	114	118	120
Sales commission	346	337	356	375	391
Rental asset disposal loss	60	39	39	40	39
Other expenses	202	191	180	183	183
Operating profit	226	339	406	481	543
Chg. (% YoY)	(3.7)	49.9	19.7	18.5	12.8
Margin (%)	11.3	16.0	17.9	19.8	21.1
Non-operating items	(80)	(12)	(0)	1	4
Interest expense	30	19	7	6	6
Pre-tax profit	146	327	406	483	547
Income tax	52	82	101	121	137
Net profit	94	245	304	362	410
EPS (KRW)	1,219	3,178	3,947	4,692	5,321
Chg. (% YoY)					
Sales		6.3	7.0	7.3	5.8
Gross profit		6.3	6.7	7.6	5.5
SG&A		(2.8)	2.5	3.5	2.3
Operating profit		49.9	19.7	18.5	12.8
Recurring profit		124.4	24.1	18.9	13.4
Net profit		160.6	24.2	18.9	13.4
EPS (KRW)		160.6	24.2	18.9	13.4

Source: Company data, Mirae Asset Research

In April 2013, Coway raised its rental service fees by 5% on average. The fee hikes will only apply to new rental service subscribers and contract renewals for existing subscribers, which represent roughly 20% of Coway's total subscribers. As such, we think the positive impact of the 5% price hike will spread out for the next five years.

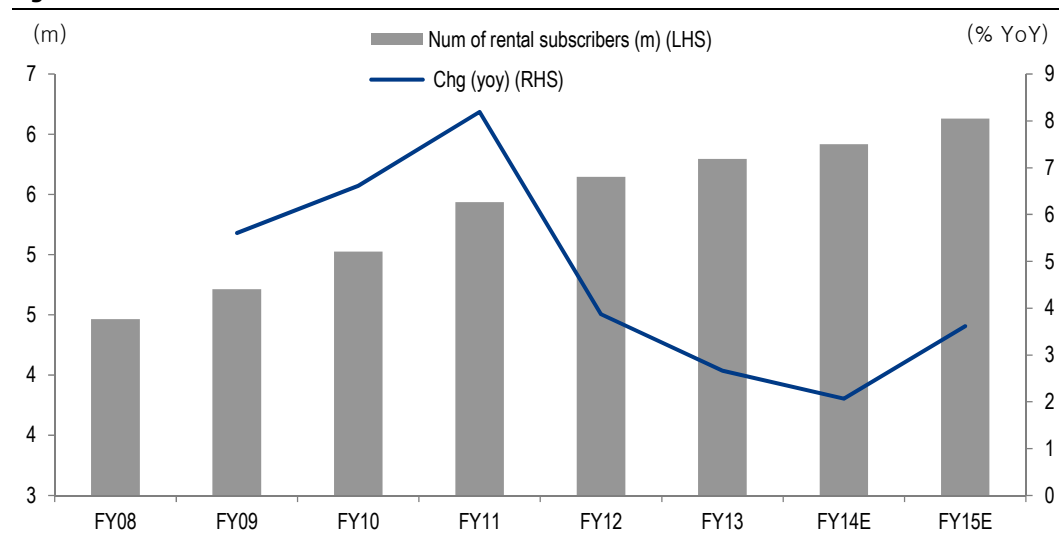
Figure 16 Coway's sales breakdown

(KRW bn)	2012	2013	2014E	2015E	2016E
Consolidated sales	1,993	2,118	2,266	2,432	2,572
I. Parent-only sales	1,807	1,934	2,073	2,220	2,339
Rental service (rental plus maintenance service)	1,262	1,320	1,385	1,455	1,499
Rental contract fee	24	13	14	14	15
Membership sales (pure appliance maintenance service)	161	172	176	181	186
Outright sales	145	149	155	166	176
Other sales and exports	148	202	262	319	377
Cosmetics	67	76	81	84	86
II. Sales from consolidated affiliates	186	185	193	212	233
Chg. (% YoY)					
Consolidated sales		6.3	7.0	7.3	5.8
I. Parent-only sales		7.0	7.2	7.1	5.4
Rental service (rental plus maintenance service)		4.6	4.9	5.0	3.0
Rental contract fee		(44.6)	3.6	5.0	3.0
Membership sales (pure appliance maintenance service)		6.8	2.4	2.8	2.6
Outright sales		3.2	3.7	7.0	6.0
Other sales and exports		36.8	29.4	21.9	18.1
Cosmetics		13.6	6.4	3.0	3.0
II. Sales from consolidated affiliates		(0.8)	4.4	10.0	10.0
Composition (%)					
Consolidated sales	100.0	100.0	100.0	100.0	100.0
I. Parent-only sales	90.7	91.3	91.5	91.3	90.9
Rental service (rental plus maintenance service)	63.3	62.3	61.1	59.8	58.3
Rental contract fee	1.2	0.6	0.6	0.6	0.6
Membership sales (pure appliance maintenance service)	8.1	8.1	7.8	7.5	7.2
Outright sales	7.3	7.0	6.8	6.8	6.8
Other sales and exports	7.4	9.6	11.6	13.1	14.7
Cosmetics	3.4	3.6	3.6	3.4	3.4
II. Sales from consolidated affiliates	9.3	8.7	8.5	8.7	9.1

Source: Company data, Mirae Asset Research

Coway's rental and membership subscriber numbers have grown 3.9% and 2.7% YoY in 2012 and 2013, respectively, on the back of steady wellness appliance market. Based on our expectation of a soft competitive landscape still low health appliance rental and maintenance market diffusion rates, we expect 2014E-15E rental and membership subscriber to grow 2.8% pa in 2014E-15E.

Figure 17 Number of rental subscribers



Source: Company data, Mirae Asset Research

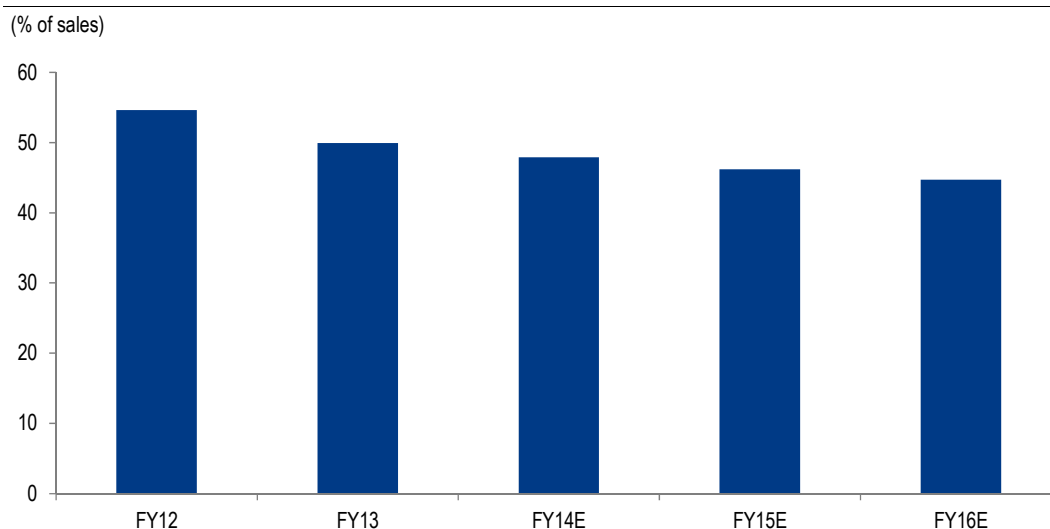
Figure 18 Market diffusion rates and expected penetration ratio

Product	Current diffusion rate	Expected penetration rate
Water purifier	37.9%	55%~60%
Bidet	20.4%	50%~60%
Air purifier	14.3%	45~50%

Source: Mirae Asset Research

Since Coway Holdings' stake takeover from Woongjin group in 2013, Coway management has worked on cost reduction in SG&A expenses. As a result, the company's overall SG&A expenses as a percentage of sales has been reduced to 50% in 2013 from 54.6% in 2012. With: 1) management's ongoing efforts on tightening up its SG&A costs (especially promotional/advertising costs, supply costs and miscellaneous managerial costs); and 2) better operating leverage, helped by healthy top-line growth, we project its SG&A expenses as a percentage of sales to continue to decline by 2.1ppt in 2014E and 1.7ppt in 2015E.

Figure 19 SG&A as percentage of sales trend



Source: Company data, Mirae Asset Research

Overall, our 2014E-2015E EPS estimates are 8-13% above consensus estimates, as we think the market does not fully appreciate Coway's growth momentum.

Figure 20 Consensus vs. Mirae estimates

(KRW bn)	Mirae		Consensus		Diff (%)	
	2014E	2015E	2014E	2015E	2014E	2015E
Sales	2,266	2,432	2,247	2,438	0.9	(0.3)
Operating profit	406	481	380	428	6.7	12.4
Net profit (controlling)	304	362	282	319	8.0	13.3
Margins (%)						
Operating margin	17.9	19.8	16.9	17.6		
Net margin	13.4	14.9	12.5	13.1		

Source: Company data, Bloomberg, Mirae Asset Research

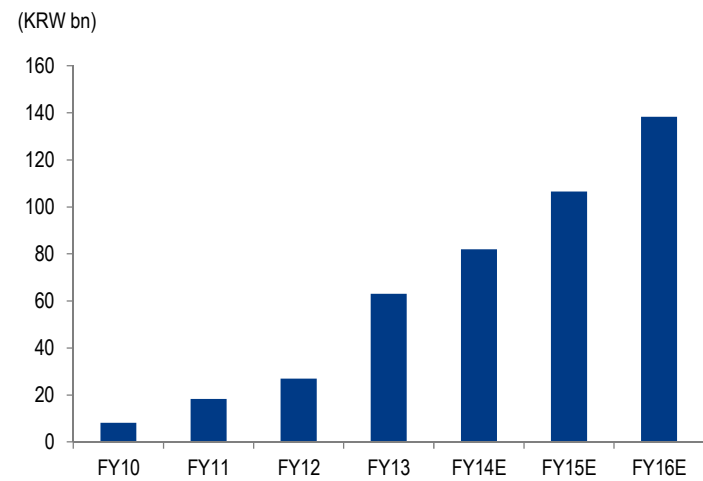
Figure 21 Quarterly earnings estimates

(KRW bn)	1Q13	2Q13	3Q13	4Q13	1Q14P	2Q14E	3Q14E	4Q14E
Sales	507	556	531	524	535	589	575	568
Operating profit	70	82	96	91	90	97	112	106
Net profit	57	60	60	68	68	73	84	80
Margins (%)								
Operating margin	13.7	14.7	18.1	17.4	16.9	16.5	19.5	18.7
Net margin	11.3	10.7	11.3	13.0	12.7	12.4	14.6	14.0

Source: Company data, Mirae Asset Research

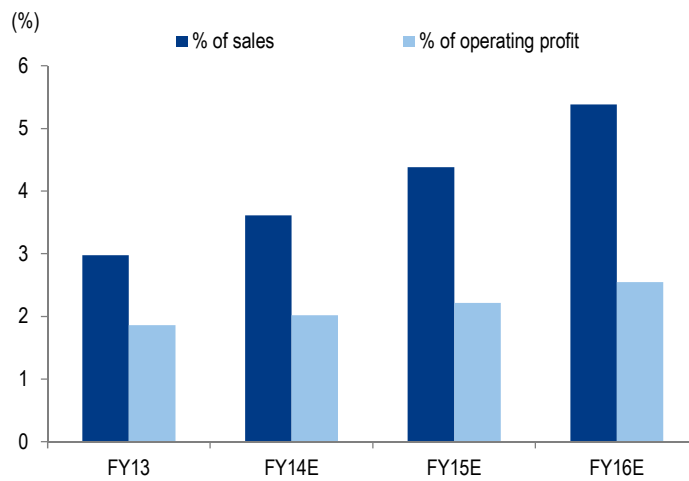
Coway has exported air purifiers as an Original Design Manufacturer (ODM). As of 2013, China exports reached KRW63bn (+134% YoY), represented 3% of consolidated sales. Given the strong growth potential in the Chinese air purifier market for the next few years, we project Coway's China export portion as a percentage of total sales to grow to 5.4% by 2016.

Figure 22 Export to China trend



Source: Company data, Mirae Asset Research

Figure 23 Exports to China as a percentage of consolidated sales and operating profit



Source: Company data, Mirae Asset Research

Sensitivity analysis

Based on our sensitivity analysis, Coway's earnings are most sensitive to ARPU hikes in its rental services. We estimate every 1% ARPU hike in its rental services should raise Coway's 2014E EPS estimates by 2.9%, whereas every 1% increase in rental service-related costs should lower its 2014E EPS estimates by 1%.

Figure 24 Sensitivity analysis

	2014E EPS (%)
1% fee hike in rental service	2.9
1% increase in rental service subscribers	1.9
1% increase in rental service-related costs	(1.0)

Source: Mirae Asset Research

Potential value enhancement from cash management

We expect strong operating profit growth and stable capex to drive a CAGR of 12% free cash flow (FCF) in 2014E-16E. With Coway's almost net cash position, we think the healthy free cash growth should lead to a sharp increase in dividend payouts to maximize shareholder value. We believe ownership by MBK Partners is dividend-friendly.

A sharp rise in free cash flow

Coway's rental business (68% of consolidated sales) model is capital intensive in the initial stage of business build-up, as the company has to purchase all the rental appliances it plans to lease. However, once it achieves economies of scale, the rental business becomes highly cash-generative.

Therefore, Coway's free cash flow has grown 19% pa over the past five years and we expect this trend to continue. We project operating cash flow to grow 6.3% pa in 2014-2016, on the back of healthy EBITDA growth and stable working capital and capital expenditures.

Figure 25 Coway's free cash flow forecast

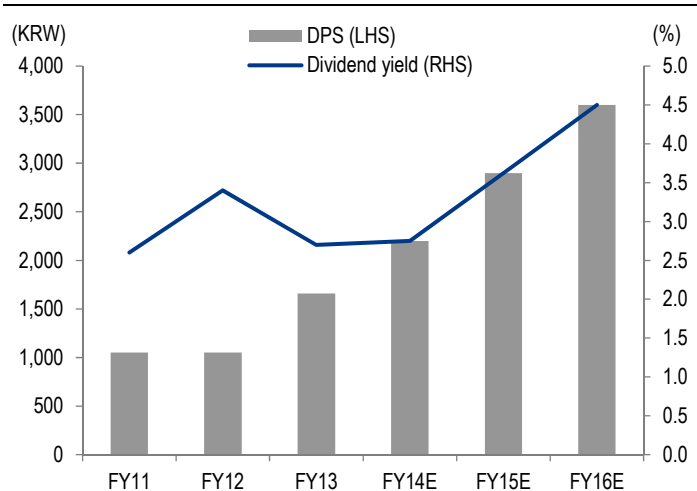
(KRW bn)	2012	2013	2014E	2015E	2016E
Gross cash flow	478	578	555	629	689
Net profit	94	245	304	362	410
Depreciation and amortization	184	198	207	223	235
Others	201	135	44	44	44
Losses (gains) from (of) forex losses	7	5	3	3	3
Losses (gains) from (of) asset sell-offs	(0)	0	1	1	1
Losses (gains) from (of) equity valuation	0	0	0	0	0
Rental asset disposal loss	62	41	39	40	39
Others	132	89	0	0	0
Working capital change increase (-) / decrease (+)	(24)	(41)	(2)	(45)	(44)
Operating cash flow	454	537	553	584	645
Net capex (-)	(314)	(268)	(300)	(270)	(270)
Free cash flow	140	269	253	314	375

Source: Company data, Mirae Asset Research

Coway management spent nearly 50% of its free cash flow to dividend payouts in 2012-2013, with the remaining free cash flow being used for debt reduction. Considering its debt-free conditions and limited chance of new business expansions, we expect management to start to raise dividend payout ratio sometime over the next few years.

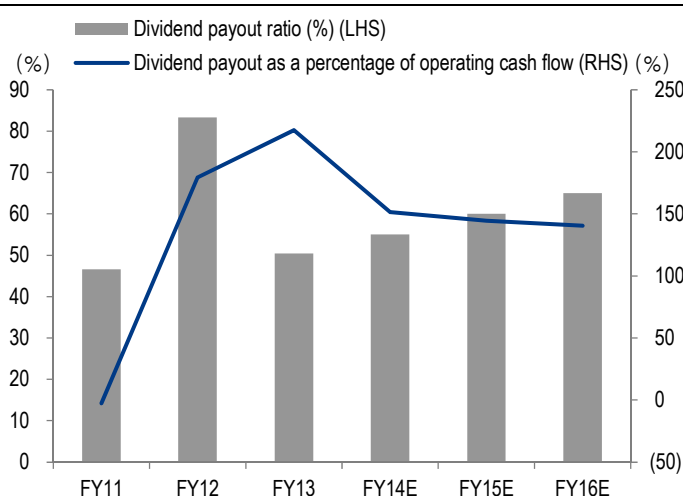
With an increase in dividend payout ratio, we expect Coway's dividend per share to rise to KRW2,200 in 2014 and KRW2,900 in 2015, respectively (versus KRW1,660 in 2013). Our dividend per share estimates for 2014E and 2015E translate into running yields of 2.6% and 3.5%, respectively.

Figure 26 Dividend yield forecast



Source: Company data, Mirae Asset Research

Figure 27 Dividend payout ratio as a percentage of operating cash flow

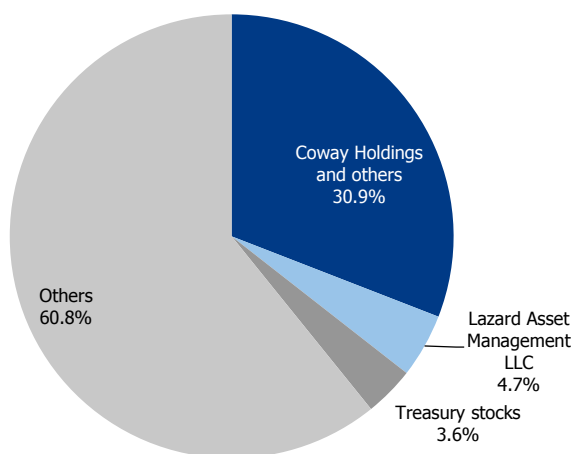


Source: Company data, Mirae Asset Research

Shareholder structure and affiliates

Coway's largest shareholder is Coway Holdings, which owns a 30.9% stake in Coway. Coway Holding is a special-purpose company (SPC), set up by MBK Partners (an independent private equity firm). Coway Holdings invested KRW1.2tn for the 30.9% stake in Coway in January 2013. As of 1Q14, other large shareholders include Lazard Asset Management (4.7%). Foreign shareholders own 54% of Coway.

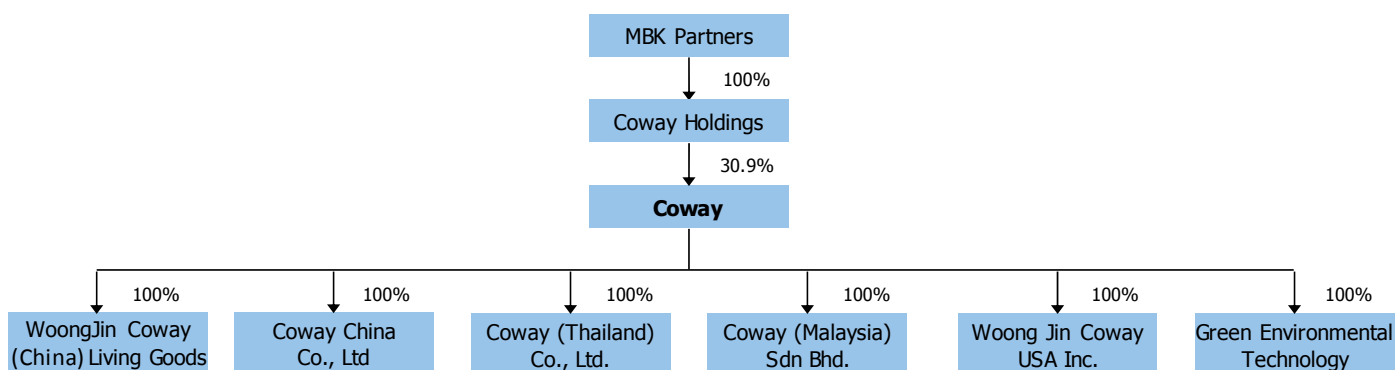
Figure 28 Shareholding structure, as of 29 April 2014



Source: Company data, Mirae Asset Research

Coway currently has: 1) five overseas subsidiaries in its core wellness-appliance rental and manufacturing businesses; and 2) two domestic subsidiaries for water treatment business. Coway holds a 100% stake in each of its affiliates.

Figure 29 Affiliates of Coway



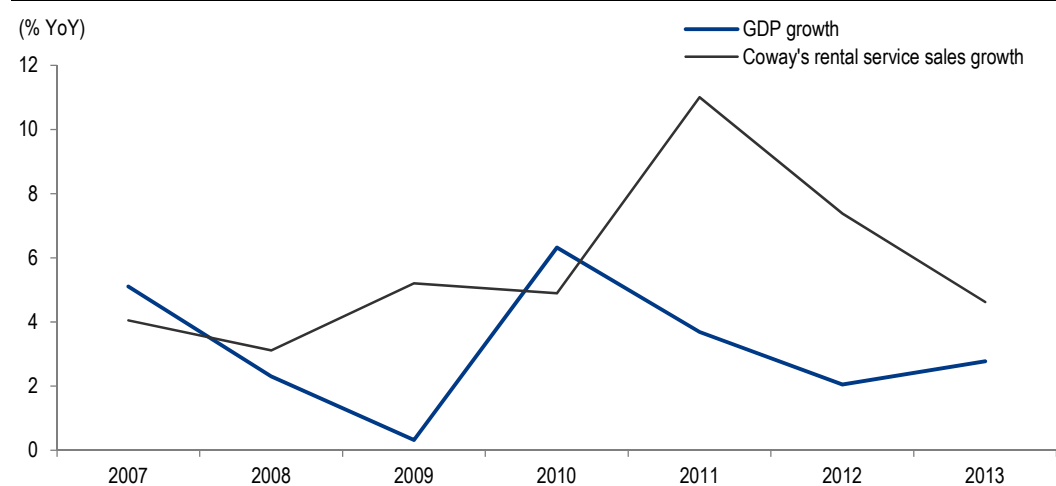
Source: Company data, Mirae Asset Research

Investment risks

Major home appliance manufacturers, such as Samsung and LGE, could strengthen their portfolios in the wellness-appliance sales market for products such as air and water purifiers. Their new products, backed by stronger brand name value, could threaten Coway in the longer term.

While Coway's overall business model is comparatively unaffected by economic cycles, any sharp deterioration in domestic consumption could lead to high cancellation rates and consumers potentially trading down to cheaper products.

Figure 30 Correlation between GDP growth and Coway's rental service sales



Source: Company data, Mirae Asset Research

Due to the nature of the wellness products market, poor cleaning service and sanitary inspection issues among industry peers could cause consumers to lose faith in Coway's services, leading to higher cancellations in the short-term.

Summary financial statements

Profit & loss

Year end Dec 31 (KRWbn)	2013	2014E	2015E	2016E
Revenue	2,118	2,266	2,432	2,572
Cost of goods sold	721	775	827	879
Gross profit	1,397	1,491	1,605	1,693
SG&A	1,058	1,085	1,123	1,150
EBIT (Adj.)	339	406	481	543
EBIT	339	406	481	543
Net interest income (loss)	(14)	(3)	(1)	2
Income (loss) from associates	0	0	0	0
Others	3	3	3	3
Recurring profit	327	406	483	547
Income tax	82	101	121	137
Net profit	245	304	362	410
Net profit (Controlling Interests)	245	304	362	410
EPS (Controlling Interests, KRW)	3,178	3,947	4,692	5,321

Growth & margins (%)	2013	2014E	2015E	2016E
Revenue growth	6.3	7.0	7.3	5.8
Gross profit growth	6.3	6.7	7.6	5.5
EBIT growth	49.9	19.7	18.5	12.8
Net profit growth	160.6	24.2	18.9	13.4
EPS growth	160.6	24.2	18.9	13.4
Gross margin	66.0	65.8	66.0	65.8
EBIT margin	16.0	17.9	19.8	21.1
Net profit margin	11.6	13.4	14.9	16.0

Source: COWAY, Mirae Asset Research estimates

Cash flow

Year end Dec 31 (KRWbn)	2013	2014E	2015E	2016E
Cash flow from operations	537	553	584	645
Net profit	245	304	362	410
Depr. & amortization	198	207	223	235
Others	135	44	44	44
Change in working capital	(41)	(2)	(45)	(44)
Cash flow from investing	(74)	(301)	(271)	(271)
Capital expenditures	(268)	(300)	(270)	(270)
Others	194	(1)	(1)	(1)
Cash flow from financing	(373)	(332)	(167)	(217)
Dividends	(78)	(124)	(167)	(217)
Increase in equity	0	0	0	0
Increase in debt	(262)	(208)	0	0
Beginning cash	156	245	166	311
Ending cash	245	166	311	467

Source: COWAY, Mirae Asset Research estimates

Balance sheet

Year end Dec 31 (KRWbn)	2013	2014E	2015E	2016E
Current assets	691	598	774	958
Cash & equivalents	239	113	122	129
Short-term financial asset	6	52	189	339
Accounts receivable	213	216	232	245
Inventory	66	59	63	67
Other current assets	168	157	168	178
Non-current assets	976	1,069	1,117	1,152
Net fixed assets	638	739	794	836
Investments	2	2	2	2
Other long-term assets	336	328	320	313
Total assets	1,668	1,667	1,891	2,109
Current liabilities	677	373	400	424
Accounts payable	37	39	42	45
Short-term debt	328	0	0	0
Other current liabilities	312	334	358	379
Non-current liabilities	50	172	175	176
Long-term debt	0	120	120	120
Other long-term liabilities	50	52	55	56
Total liabilities	727	545	575	600
Controlling Interests	941	1,122	1,316	1,509
Non-Controlling Interests	0	0	0	0
Shareholder's equity	941	1,122	1,316	1,509
BVPS(KRW)	12,200	14,544	17,065	19,571

Source: COWAY, Mirae Asset Research estimates

Ratio analysis

Year end Dec 31	2013	2014E	2015E	2016E
ROE (%)	28.4	29.5	29.7	29.0
ROA (%)	14.3	18.3	20.3	20.5
Inventory days	11.8	10.1	9.2	9.2
Receivables days	40.9	34.5	33.6	33.9
Payable days	19.8	6.1	6.1	6.1
Net debt/equity (%)	8.8	(4.1)	(14.5)	(23.0)
Interest cover (x)	23.4	153.8	364.9	(319.8)

Source: COWAY, Mirae Asset Research estimates

Recommendations

By stock (12 months)

BUY: A target price + 10% or more above the current price,
HOLD: Target price within - 10% to +10% of the current price
REDUCE: A target price of -10% or less below the current price

By industry

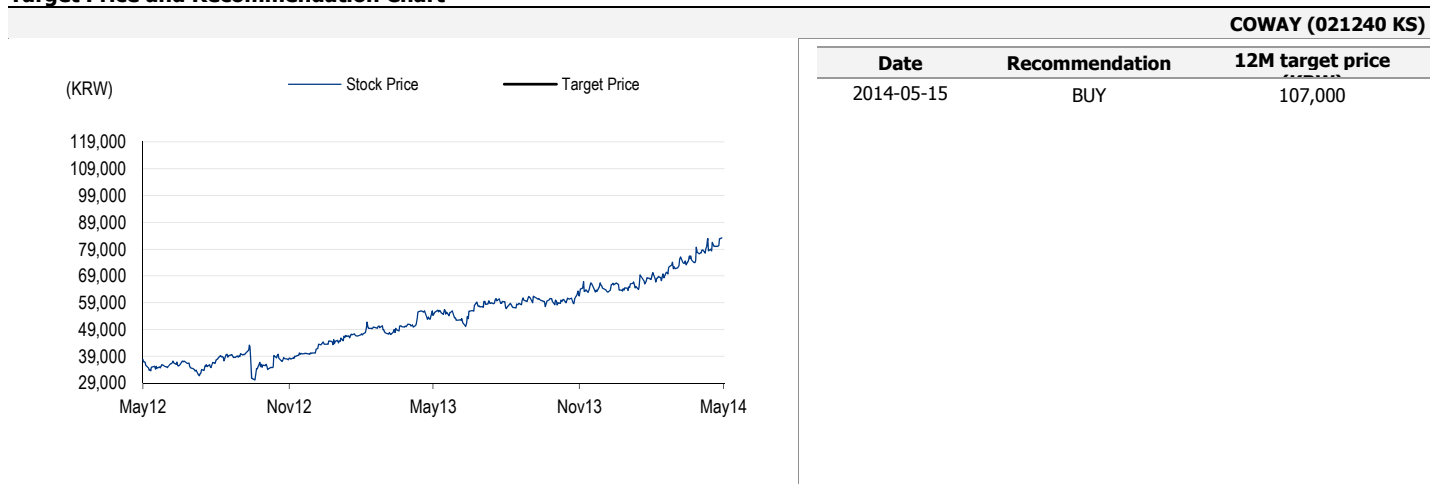
OVERWEIGHT: over +10% of the current industry index
NEUTRAL: -10% to +10% of the current industry index
UNDERWEIGHT: -10% or less than the current industry index

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Stock	Analyst	Type	Securities Held by the Analyst			Holdings of share of over 1%	Participation in Issuance of Securities	Involvement with Affiliates	Treasury Stock Held
			Number of Shares	Purchase Price	Purchase Date				
REMARK: Korean analyst is responsible for Korean securities and relevant sectors only.									

Target Price and Recommendation Chart



Source: Bloomberg, Mirae Asset Research

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