

# Company Initiation



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## ■ AT A GLANCE

SELL HOLD **BUY**

<b>Target price</b>	<b>KRW113,000 (38%)</b>
Current price	KRW82,200
<b>Bloomberg code</b>	<b>021240 KS</b>
Market cap	KRW6.3t/USD5.7b
Shares (float)	77,124,796 (65.2%)
52-week high/low	KRW94,600/KRW62,900
Average daily trading value (60-day)	KRW 16.99b/ USD 15.36m
One-year performance	1M 6M 12M
Coway (%)	+1.5 -1.4 +22.9
Vs Kospi (%pts)	-2.0 +1.0 +26.1

## ■ KEY CHANGES

(KRW)	New	Old	Diff
Recommendation	Buy	Not rated	
Target price	113,000	N/A	N/A
2014E EPS	3,584	N/A	N/A
2015E EPS	3,764	N/A	N/A
2016E EPS	4,020	N/a	N/a

## ■ SAMSUNG vs THE STREET

No of I/B/E/S estimates	8
Target price vs I/B/E/S mean	6.1%
Estimates up/down (4 weeks)	2/0
1-year-fwd EPS vs I/B/E/S mean	0.3%
Estimates up/down (4 weeks)	1/3
I/B/E/S recommendation	Buy

## Coway (021240 KS)

# Stability plus growth

### WHAT'S THE STORY?

**Event:** We believe Coway will keep setting new highs, given its improving earnings and commitment to returning free cash flow to shareholders.

**Impact:** We believe near-term growth concerns are overblown and, despite a lackluster longer-term outlook for earnings, Coway will make a good long-term investment, its share price rising in proportion to its mounting cash.

**Action:** We reinstate coverage of Coway at BUY with a KRW113,000 target.

### THE QUICK VIEW

**Reinstating at BUY with KRW113,000 target:** We reinstate coverage of Coway with a BUY rating and 12-month target price of KRW113,000, equivalent to 22.8x 2015 P/E and 11.5x EV/EBITDA. We value the company on a DCF basis to reflect stable cash flows, solid growth potential, and expected increases in dividend payout. We believe the stock will set new valuation highs as new corporate governance enhances spending transparency and boosts cash flows, and the firm will raise its dividend payout and return more to minority shareholders.

**Stable cash flows and high dividends:** We expect Coway to annually generate at least KRW500b in operating cash flow while keeping capex at KRW250b-300b, for free cash flow of KRW200b. With financial investors in control and motivated by corporate value and shareholder returns, and the government pushing the corporate world to increase dividends, we believe Coway will raise its payout from 50% in 2013 to 55% in 2014 and 60% in 2015 and 2016, implying dividend yields of 2.5% for 2014, 2.8% for 2015, and 3% for 2016, based on the current share price of KRW82,200.

**Scalable rental lineup equals growth potential:** Coway's mattress rental service took off in 2012, and we believe will be the third largest contributor to enterprise-wide growth over the next three years, after the water purifier and overseas businesses. We believe the business is not simply a new growth engine but confirms the firm's supremacy in rental services. By consistently uncovering items that require after-sale maintenance, Coway should grow faster than the overall market for consumer goods—which should appeal to investors at a time of structurally slowing growth in domestic consumption.

**Short-term growth slowdown of little concern:** We estimate that Coway's sales, operating profit, and net profit will increase at respective CAGRs of 7%, 6%, and 6% over 2014-2016, as: 1) rental services—centering on water purifiers and mattresses—and overseas business remain core growth engines and are gradually contributing more to earnings; 2) outright sales should stabilize after being hit hard by stiffening competition; and 3) the firm has more room to cut costs. We believe concerns over a short-term growth slowdown are overblown.

### ■ SUMMARY FINANCIAL DATA

	2013	2014E	2015E	2016E
Revenue (KRWb)	2,118	2,166	2,298	2,451
Net profit (adj) (KRWb)	245	276	290	310
EPS (adj) (KRW)	3,222	3,584	3,764	4,020
EPS (adj) growth (%)	47.5	11.2	5.0	6.8
EBITDA margin (%)	25.4	28.2	28.3	28.1
ROE (%)	28.4	27.2	25.0	23.9
P/E (adj) (x)	25.5	22.9	21.8	20.4
P/B (x)	7.3	6.2	5.5	4.9
EV/EBITDA (x)	11.9	10.4	9.7	9.1
Dividend yield (%)	2.0	2.5	2.8	3.0

Source: Company data, Samsung Securities estimates

## Coway

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## 1. Valuation

### Reinstating coverage at BUY with KRW113,000 target

We reinstate coverage of Coway with a BUY rating and 12-month target price of KRW113,000, equivalent to 30.0x 2015 P/E and 14.3x EV/EBITDA. We value the firm on a DCF basis to reflect stable cash flows, solid growth potential, and expected increases in dividend payout. We assume a WACC of 7.0%, risk-free rate of 2.6%, market premium of 6.5%, and beta of 0.8. We believe the stock will set new valuation highs as new corporate governance enhances spending transparency and boosts cash flows, and the firm will raise its dividend payout and return more to minority shareholders.

Split off from the Woongjin Group and taken over by a private equity fund in Jan 2013 after entering court receivership, Coway rerated to 23x P/E in 2Q14—topping its previous peak of 20x—before pulling back to around 20x now. Despite concerns over its growth potential, we believe Coway deserves to trade at record valuations, given its: 1) stable, ample cash flows; 2) potential to become Korea's most shareholder-friendly company; and 3) business model, which could at any time return the firm to strong growth by adding new rental items requiring little investment.

### DCF valuation

(KRWb)	2012	2013	2014E	2015E	2016E	2017E	2018E	2019E	2020E	2021E	2022E	2023E
FCF												
NOPLAT	113	256	284	298	317	349	385	426	470	518	572	632
Chg (% y-y)	(39.4)	127.4	11.1	4.7	6.4	10.3	10.4	10.4	10.4	10.4	10.4	10.4
EBIT	174	342	380	397	423	466	515	568	627	692	764	843
Chg (% y-y)	(27.9)	95.9	11.1	4.7	6.4	10.3	10.4	10.4	10.4	10.4	10.4	10.4
Taxes on EBIT	62	86	95	100	106	117	129	142	157	174	192	212
Tax rate (%)	35.5	25.1	25.1	25.1	25.1	25.1	25.1	25.1	25.1	25.1	25.1	25.1
Depreciation and amortization	184	198	231	252	265	281	292	292	292	292	292	292
Capex	318	261	300	300	300	300	300	300	300	300	300	300
Net working capital change	24	41	30	19	22	23	26	26	26	26	26	26
PV of FCF			184	214	226	249	267	278	289	300	312	323
<b>Terminal value</b>	<b>11,172</b>											
<b>Sum of PV</b>	<b>2,642</b>											
<b>PV of TV</b>	<b>5,647</b>											
<b>Total enterprise value</b>	<b>8,735</b>											
Value of debt	(17)											
Value of equity	8,735											
<b>Equity value/share (KRW)</b>	<b>113,255</b>											
Current price (KRW)	82,200											
Potential (%)	37.8											
										<b>FCF (terminal year)</b>		598
										<b>WACC (%)</b>		7.0
										<b>g (%)</b>		1.0

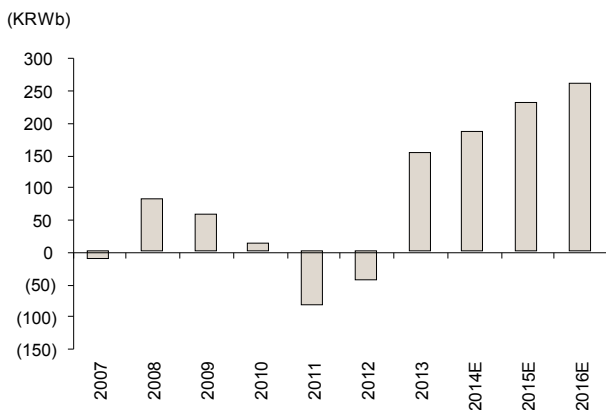
Source: Samsung Securities estimates

Target price sensitivity matrix to terminal growth and WACC

		Terminal growth						
		-0.5%	0%	0.5%	1%	1.5%	2%	2.5%
WACC	3.9%	156,419	171,505	190,900	216,761	252,967	307,274	397,787
	4.4%	138,978	150,532	164,974	183,543	208,301	242,962	294,954
	4.9%	124,795	133,847	144,910	158,739	176,520	200,227	233,417
	5.4%	113,050	120,275	128,944	139,540	152,785	169,814	192,519
	5.9%	103,178	109,034	115,955	124,259	134,409	147,097	163,410
	6.4%	94,773	99,582	105,193	111,824	119,781	129,506	141,663
	6.9%	87,539	91,534	96,142	<b>113,255</b>	107,874	115,499	124,819
	7.4%	81,255	84,605	88,433	92,851	98,005	104,096	111,405
	7.9%	75,749	78,583	81,795	85,465	89,700	94,641	100,481
	8.4%	70,891	73,307	76,024	79,103	82,623	86,684	91,422
	8.9%	66,576	68,649	70,966	73,572	76,525	79,901	83,795
	9.4%	62,722	64,511	66,500	68,722	71,221	74,055	77,293
9.9%	59,261	60,814	62,531	64,438	66,570	68,969	71,687	

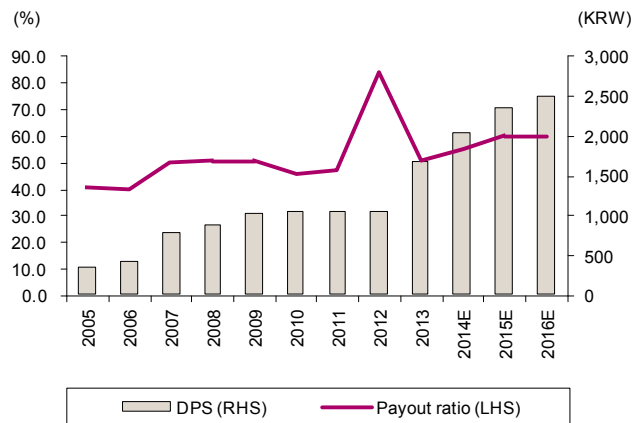
Source: Samsung Securities estimates

Free cash flow trends



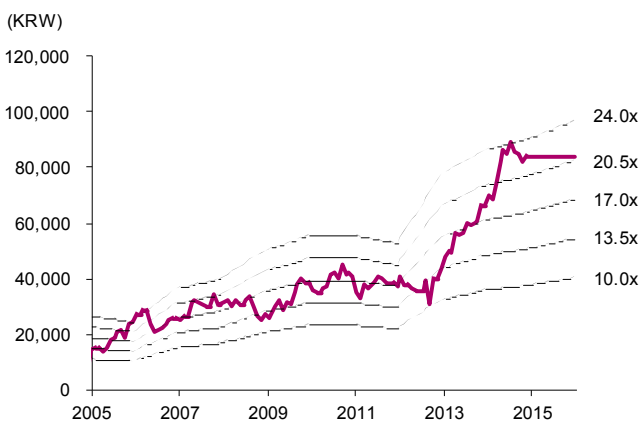
Source: Samsung Securities estimates

Dividend trends



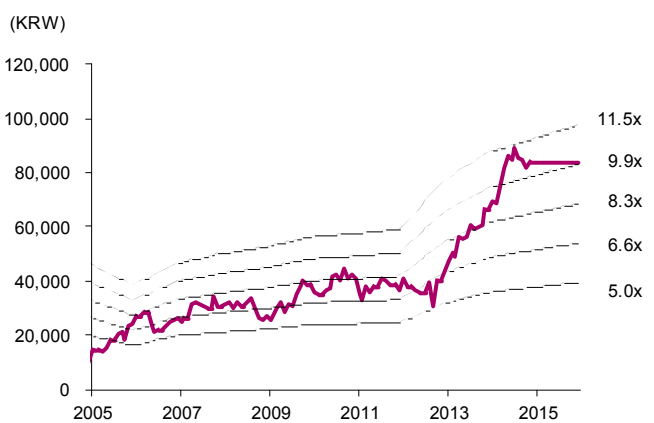
Source: Samsung Securities estimates

Forward P/E band



Source: Company data, Samsung Securities estimates

Forward EV/EBITDA band



Source: Company data, Samsung Securities estimates

## Coway

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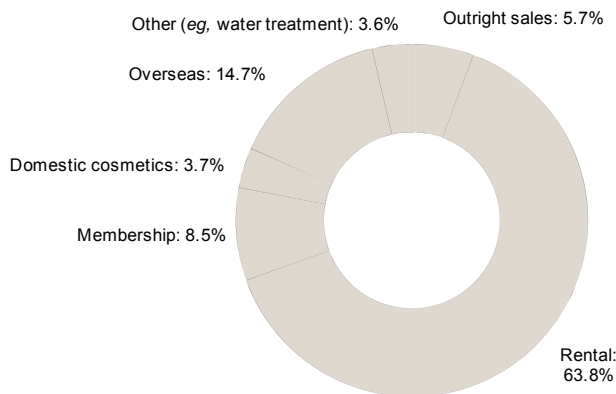
## 2. Stable cash flows and high dividends

### Focused on rentals

#### Generated 71% of 2013 sales from rentals and membership fees

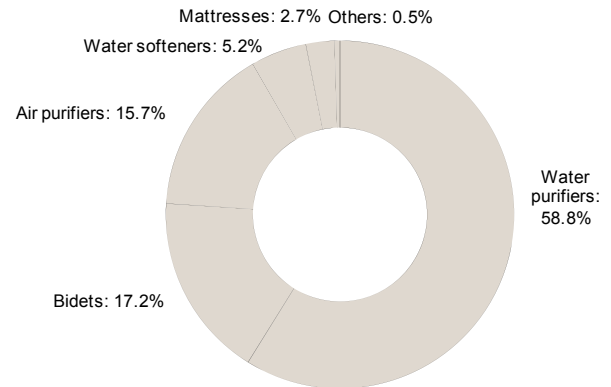
Rentals of home appliances focused on well being and hygiene are Coway's main business. In 2013, it generated 71% of its sales from rentals and membership fees, 7% from outright sales, 4% from domestic cosmetics, and 7% from exports and overseas subsidiaries.

#### Sales breakdown, by service (2014E)



Source: Company data, Samsung Securities estimates

#### Rental service sales, by product



Source: Company data, Samsung Securities estimates

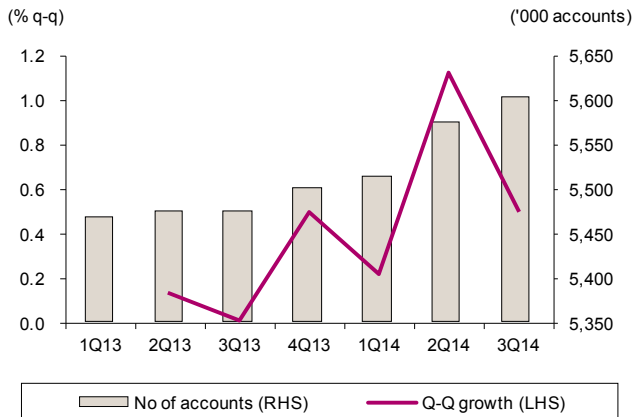
#### Rental business inherently stable

A rental business, by its nature, should generate stable cash flows. Coway's five-year contracts (including a mandatory two-year rental period) initially trigger negative cash flow as product manufacturing costs and sales commissions are recognized, but break even after three or four years as monthly rental fees flow in. Companies that outsource component production and are only responsible for product development and assembly—like Coway—incur little capex after an initial heavy investment in tangible assets. Their businesses tend to post stable free cash flow from its third or fourth year, after a sizable subscriber base has formed.

#### Early leader advantage

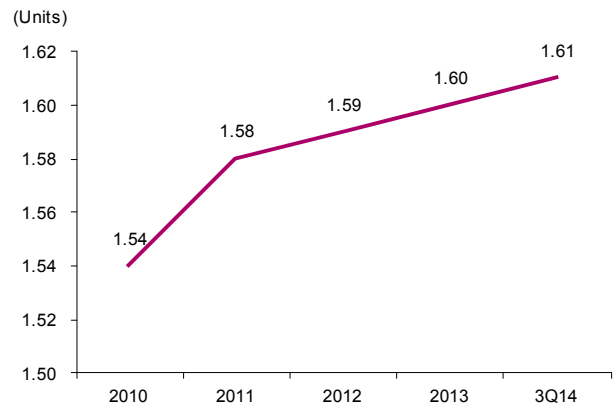
Early movers have an advantage. Competition exists, but rental businesses can easily raise switching costs to lock in subscribers. Coway exempts renewing customers from paying registration fees, and creates non-monetary switching costs by encouraging customers to rent multiple products, the convenience of which make it difficult for them to switch to other providers. Only 21.7% of Coway's subscribers terminate contracts—39.4% take ownership of the product after five years and switch to a membership-service contract, while 38.9% return the product and start a new rental contract with a replacement.

**Rental account trends**



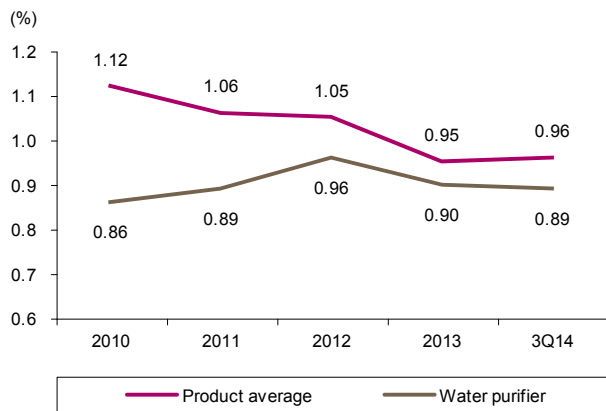
Source: Company data

**Products per customer**



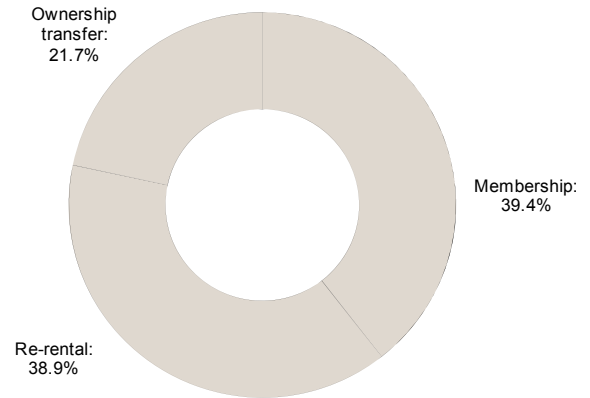
Source: Company data

**Percentage of rental contracts cancelled per month**



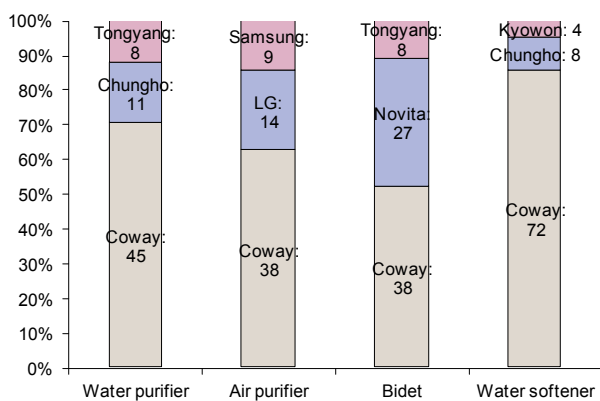
Source: Company data

**Contract retention rate at maturity (5 years)**



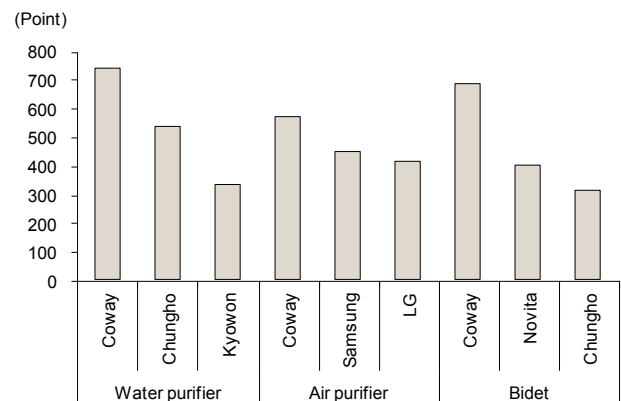
Source: Company data

**Market share breakdown, by product**



Source: Company data

**Brand power breakdown, by product**



Source: Korea Management Association

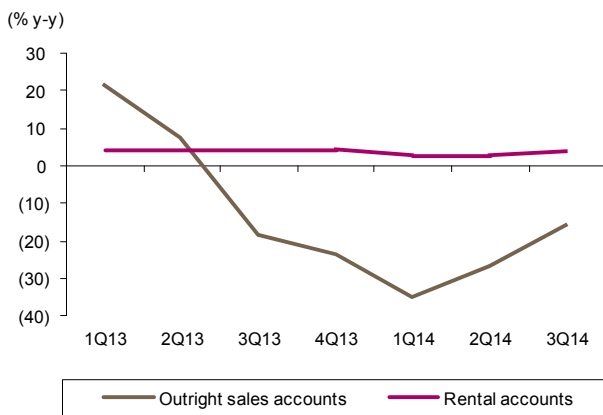
# Coway

## Great services behind market leadership

While Coway's brand is unrivaled, competition has stiffened as product differentiation becomes more difficult and sales channels diversify (eg, home shopping). This has resulted in Coway's outright sales contracting more than 20% from 2013 until 3Q14. Rental sales, however, have consistently grown 3-4% y-y—even when management uncertainties peaked in 2012. This is all the more impressive when considering how Coway has cut ad spending, sales commissions, and other marketing costs.

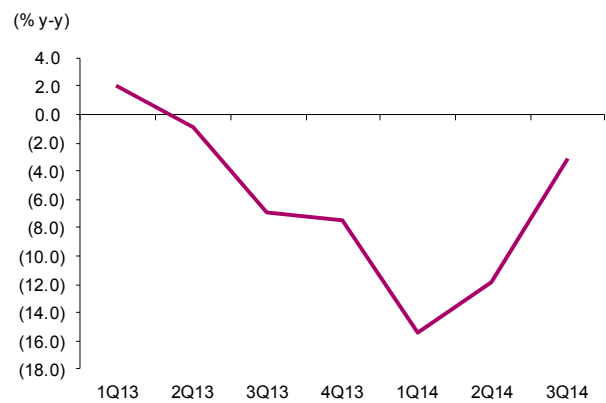
Not all rental companies enjoy stable cash flow, but Coway does by providing great service. Consumers tend to polarize into: 1) a price-sensitive group that tries to make rational purchases of products that differ little in features or quality; and 2) a service-sensitive group that prioritizes sanitation and after-sale maintenance. Coway's competitiveness in service is hard to imitate, and should allow the firm to maintain stable cash flows from the rental business for at least two to three more years. We attribute it to a massive pool of sales and maintenance agents (known as "Codies"), a short mandatory rental period of two years (the sector average is three), and frequent service visits (every two months, vs four at some rivals).

### Accounts growth: Rental vs outright sales



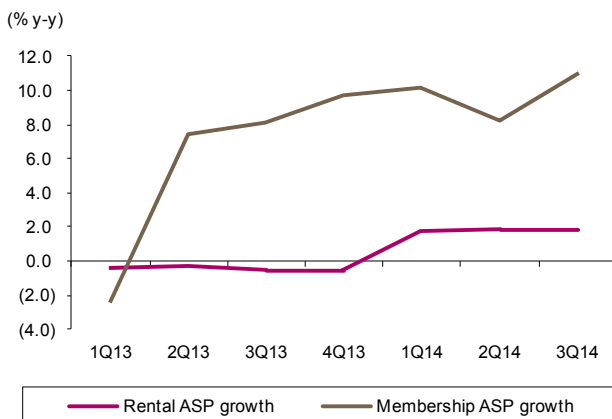
Source: Company data, Samsung Securities estimates

### Marketing cost growth (ads + sales commissions)



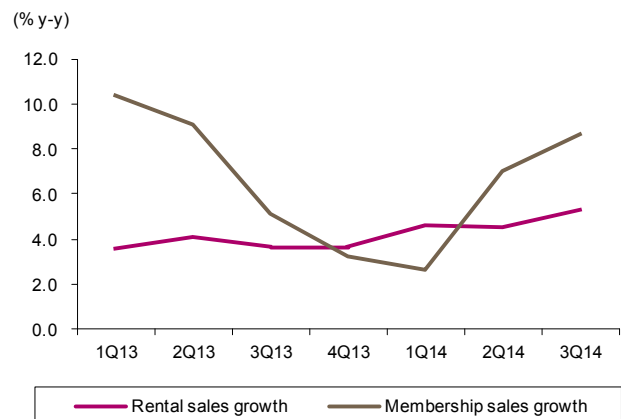
Source: Company data, Samsung Securities estimates

### ASP growth: Rental vs membership



Source: Company data, Samsung Securities estimates

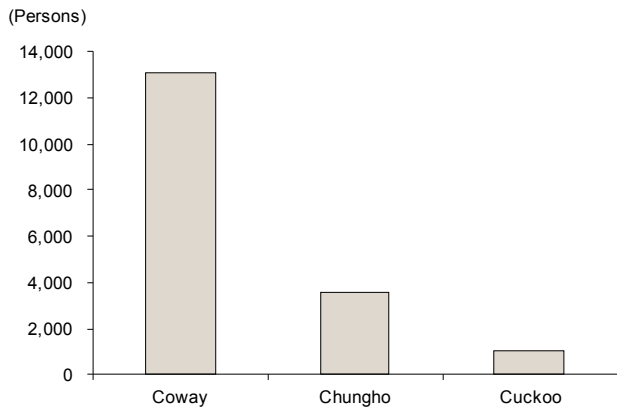
### Sales growth: Rental vs membership



Source: Company data, Samsung Securities estimates

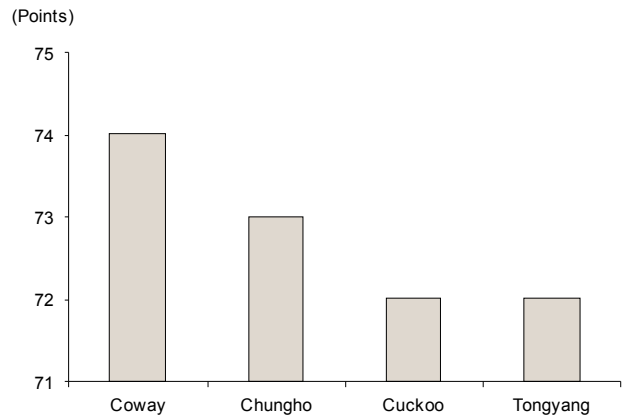
# Coway

## Number of sales agents, by company



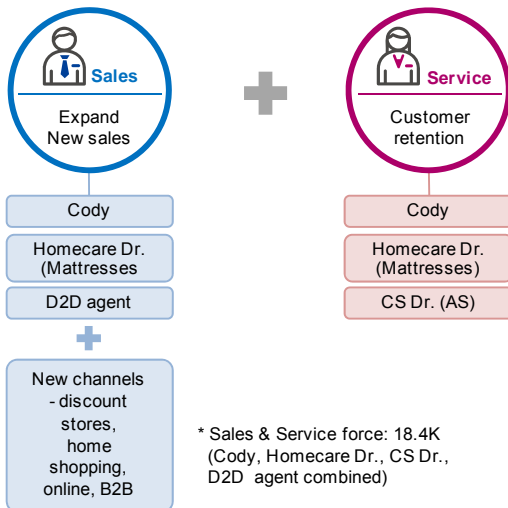
Note: Cuckoo as of end-May; Chungho figure based on online data  
Source: Company data

## National Customer Satisfaction Index: Water purifiers



Source: Korea Productivity Center

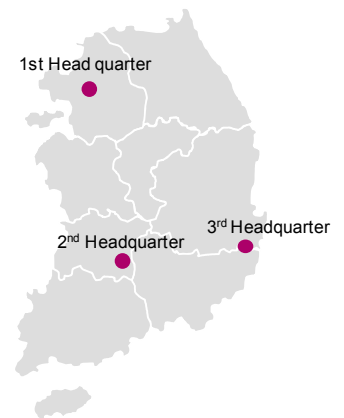
## Coway: Business and service models



Source: Company data



























## Coway: Sales strategy

- 1. Localization**  
(Three regional headquarters)  
→ Sales target manatement  
→ Enhance point of contact service
- 2. Productivity improvement**  
(Reinforce training of Cody)
- 3. Channel diversification**  
(Home shopping, discount stores, online)



Source: Company data

Home appliance sales and rentals: Product overview

(KRW'000)	Coway	Chunho Nice	LG Electronics	Kyowon L&C	Tong Yang Magic	Cuckoo	Winix	Hyundai H&S	Daelim Care	Ruhens	Novita
Logo											
<b>Water purifiers</b>											
Functions	Hybrid features, cold & hot water purification, ice making	Hybrid features, cold & hot water purification, ice making	Cold & hot water purification, ice making	Cold & hot water purification, ice making	Cold & hot water purification, ice making	Cold & hot water purification, ice making	Sparkling, cold & hot water purification	Cold & hot water purification	Cold & hot water purification	Cold & hot water purification	Cold & hot water purification
Outright sales	820-2,930	891-2,970	2,000-2,100	980	428-2,266	619-2,350	460-790	550-990	572-690	180-990	398
Rental sales	16.0-67.5	21.9-53.9	19.4-45.9	18.5-43.0	19.9-43.5	16.9-46.9	17.9-34.9	19.9-35.9	19.8-25.8	13.9-37.0	19.9
Mandatory rental period	2 years	3 years	3 years	2 years	3 years	3 years	3 years	3 years	3 years	3 years	3 years
Ownership transfer point	5 years	5 years	5 years	5 years	5 years	5 years	3 years	4 years	5 years	5 years	5 years
Maintenance frequency	2 months	2 months	2 months	3 months	4 months	4 months	4 months	4 months	4 months	4 months	4 months
Top product											
<b>Air purifiers &amp; dehumidifiers</b>											
Outright sales	390-1,550	869-2,090	38.9-68.9	550-890	298-950	319-808	249-299	600-690	358	693	219-439
Rental sales	21.4-57.4	25.9-79	26-36	22.9-29.5	17.9-29	16.9-21.9	-	22.9	9.9	26.9	-
Mandatory rental period	2 years	3 years	3 years	2 years	3 years	3 years	-	3 years	3 years	3 years	-
Ownership transfer point	5 years	5 years	5 years	5 years	5 years	5 years	3 years	4 years	3 years	3 years	-
Maintenance frequency	2 months	2 months	2 months	3 months	4 months	4 months	4 months	4 months	-	4 months	-
Top product											

Source: Company data, Naver



Home appliance sales and rentals: Product overview

(KRW'000)	Coway	Chunho Nice	LG Electronics	Kyowon L&C	Tongyang Magic	Cuckoo	Winix	Hyundai H&S	Daelim Care	Ruhens	Novita
<b>Logo</b>											
<b>Bidets</b>											
Outright sales	600-819	638-792		750	139-1,097	490-499		550	290-1,430	495-550	209-750
Rental sales	21.4-25.9	18.9-23.9		21.9-25	16.9-22.9	16.9-18.9		19.9-22.9	9.9-33.0	18.9-21.9	-
Mandatory rental period	2 years	3 years		2 years	3 years	3 years		3 years	3 years	3 years	-
Ownership transfer point	5 years	5 years		5 years	5 years	5 years		4 years	5 years	5 years	-
Maintenance frequency	2 months	2 months		3 months	4 months	4 months		4 months	4 months	4 months	-
<b>Top product</b>											
<b>Water softeners</b>											
Outright sales	279-780	847-1,155		815				490	875		
Rental sales	21.0-27.5	27.0-34.9		27.5-35.0				19.9	26.4		
Mandatory rental period	2 years	3 years		2 years				3 years	3 years		
Ownership transfer point	5 years	5 years		5 years				4 years	5 years		
Maintenance frequency	2 months	2 months		2 months				4 months	2 months		
<b>Top product</b>											
	<b>Coway</b>	<b>Hanssem</b>									
<b>Logo</b>											
<b>Mattresses/frames</b>											
Outright sales: Mattresses	540-1,550	140-2,099									
Outright sales: Frames	950-1,350	123-1,606									
Rental sales: Mattresses	19.5-42.9	n/a									
Rental sales: Frames	24.5-37.9	n/a									
Mandatory rental period	26 months	n/a									
Ownership transfer point	3 years	n/a									
Maintenance frequency	4 months	4 months*									
<b>Top product</b>											

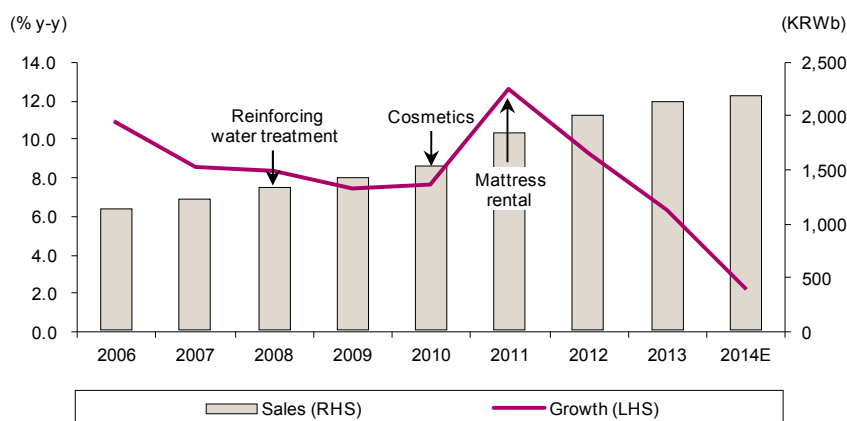
Note: \* Hanssem offers mattress care service under separate subscription but not mattress rental  
 Source: Company data, Naver

## Coway

**Restructuring closes money leaks**

Coway made mistakes in searching for new growth engines, investing in businesses that did not fit its core competence and undermined the stable cash flows that were its strength. When rental sales growth slowed to the mid-single digits for the first time in 2008, it paid KRW20b for Woongjin Chemical's water-treatment business. The business contributed 40-50% of its overall annual sales growth of 7-8% in 2008 and 2009, but a lack of competitiveness—despite additional acquisitions of Green & Tech (KRW28.2b) and KC Samyang Water Systems (KRW6.8b) over 2010-2011—eventually revealed growth limits. In 2010, Coway turned to cosmetics, but the business has posted operating losses as sales have disappointed—the company had expected KRW200b in annual revenues from the operations but will likely generate just KRW80b in 2014.

To boost profits and cash flows, the PEF that took control last year has refocused Coway on the rental service business. The company has put the water treatment business on the block, and is not looking to grow the cosmetics business but rather to narrow operating losses (from an estimated KRW5b in 2014 to nearly breakeven in 2015). It also pulled out of Japan and Italy, where turnarounds appeared unlikely.

**Sales and expansion (2006-2014)**

Source: Company data, Samsung Securities estimates

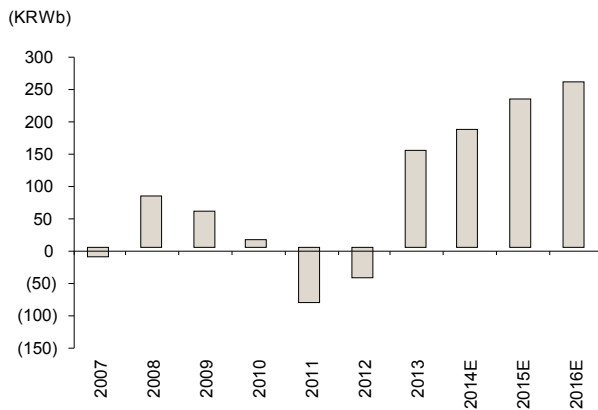
**Dividends likely to rise**

Given the nature of the rental business, Coway's competitiveness, and restructuring, we expect the firm to annually generate at least KRW500b in operating cash flow. Assuming it keeps capex at KRW250b-300b, annual free cash flow should total KRW200b. Even if the company pays out 50% of net profit as dividends, as it has in four of the past five years—the exception being 2012, when management control changed—it should still retain more than KRW50b *pa* in cash, which would drive down ROE if funneled into retained earnings. With financial investors in control and motivated by corporate value and shareholder returns, however, and the government pushing the corporate world to increase dividends, we believe Coway will raise its payout from 50% now to at least 60%. Even at this level, ROE would still decline, so we do not rule out the possibility of the payout going even higher. Factor in its potential for earnings growth, and we believe Coway has the potential to be one of if not the most attractive dividend plays in Korea.

We estimate that Coway's EPS will increase at a 2014-2016 CAGR of 8%, and its dividend payout will rise from 50% in 2013 to 55% in 2014, and 60% in 2015 and 2016. This implies a DPS of KRW2,040 in 2014, KRW2,340 in 2015, and KRW2,480 in 2015, for respective yields of 2.5%, 2.8%, and 3% based on current share price of KRW82,200.

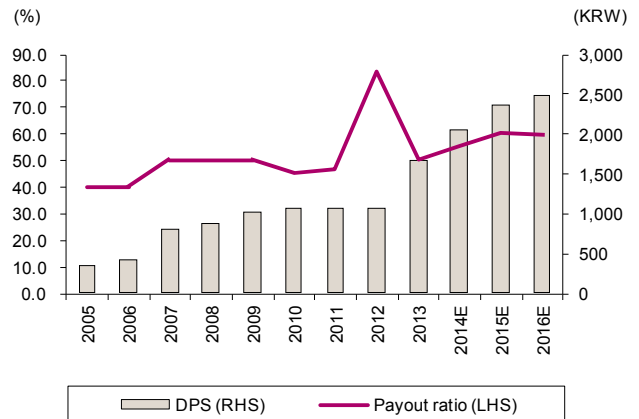
## Coway

## Free cash flow trends



Source: Samsung Securities estimates

## Dividend trends



Source: Samsung Securities estimates

## ROE composition

(%)	2007	2008	2009	2010	2011	2012	2013	2014E	2015E	2016E
<b>ROE</b>	<b>24.90</b>	<b>24.18</b>	<b>26.34</b>	<b>26.82</b>	<b>22.68</b>	<b>21.97</b>	<b>20.06</b>	<b>28.10</b>	<b>27.22</b>	<b>25.02</b>
Financial leverage (assets/equity, x)	1.88	1.78	1.83	1.87	1.99	2.15	2.22	1.98	1.72	1.62
Asset turnover (sales/assets, x)	1.33	1.31	1.21	1.12	1.13	1.14	1.18	1.24	1.24	1.22
Operating margin	13.30	14.47	14.47	15.06	14.23	12.87	11.35	16.00	17.53	17.30
Financial burden (pre-tax profit/operating profit)	99.95	102.43	108.93	113.18	89.72	90.58	104.72	95.47	97.23	97.50
Tax burden (net profit/pre-tax profit)	74.68	69.85	75.61	74.85	78.59	76.80	64.51	74.91	74.91	74.91

Source: Company data, Samsung Securities estimates

## Coway

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### Offers dividend merit and long-term growth potential

### Generated remarkable growth in the past

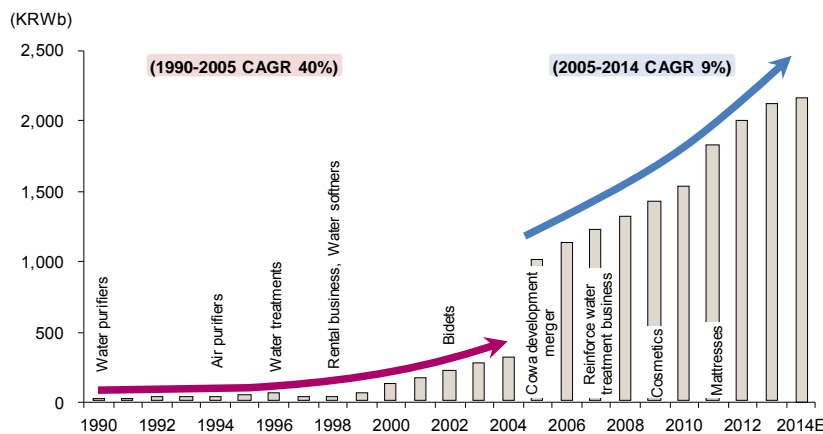
## 3. Scalable rental lineup equals growth potential

### Deserves record valuation

We believe Coway deserves a premium to the market and its own historical peak multiples, because of its dividend merit and the long-term growth potential proven by the successful addition of mattresses to its rental product lineup in 2011. By consistently uncovering items that require after-sale maintenance, Coway should grow faster than the overall market for consumer goods—which should appeal to investors at a time of structurally slowing growth in domestic consumption

After starting out as a water-purifier rental service provider in 1990, Coway added air purifiers, food waste disposers, water softeners, and bidets to its rental lineup at approximately three-year intervals to generate remarkable 15-year CAGRs for sales and operating profit of 32% and 44%, respectively. In the mid-2000s, however, after failing to identify new environmental home appliances suitable for rental services, it ventured into water treatment and cosmetics, which failed to generate the growth it hoped for.

### Sales and expansion (1990-2014)



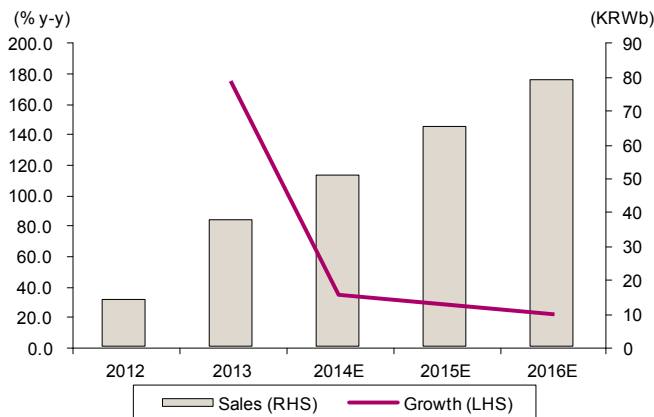
Source: Company data, Samsung Securities estimates

### Mattress rental service launched in 2011

In 2011, Coway launched a new rental service that provided customers mattresses for a small downpayment and ongoing maintenance service (eg, cleaning). The business took off, and by 2013 Coway had become Korea's third-leading sellers of mattresses with a market share of 10%. Rapid growth has come on growing demand for premium mattresses, which has led to a consolidation around large players. Coway has taken share from smaller players, hundreds of which still exist, controlling a combined 20% of the market. This suggests that Coway will be able to sustain mattress sales growth for at least two to three more years. We expect its mattress sales to more than double from KRW37.4b in 2013 to KRW79.1b in 2016 (or from 1.8% to 4.4% of total sales), contributing 12.5% of enterprise-wide sales growth during the period—the third most after the water purifier and overseas businesses.

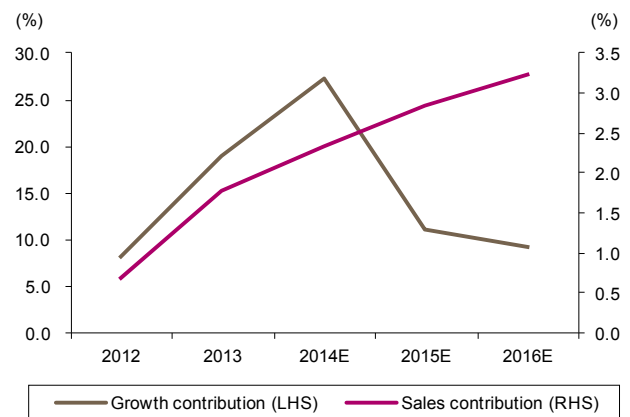
# Coway

## Coway: Mattress rental sales



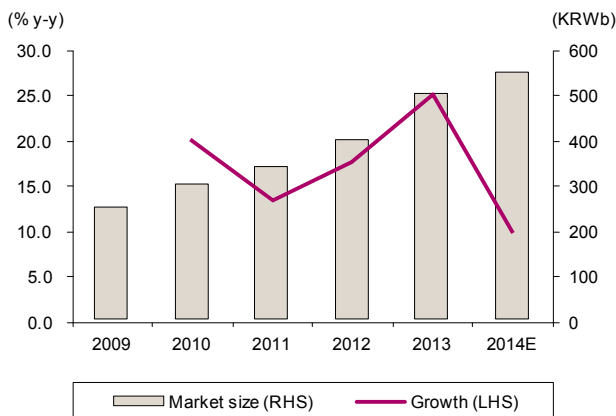
Source: Company data, Samsung Securities estimates

## Coway: Mattress rental contributions to overall sales



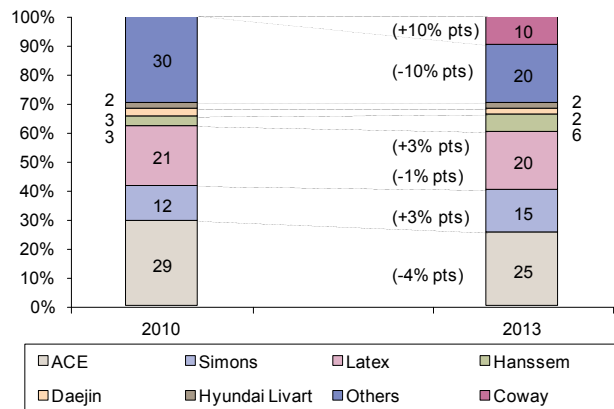
Source: Company data, Samsung Securities estimates

## Korea: Mattress market trends



Source: Furniture industry estimation, Media data

## Korea: Mattress market share breakdown (2010 vs 2013)



Note: Other includes beds made from special raw materials such as soil and rock  
Source: Furniture industry estimation, Media data

## Success in mattresses confirms strength in rental business

We believe the mattress business is not simply a new growth engine but confirms Coway's supremacy in rental services. After entering water treatment and cosmetics—in the hopes of leveraging its distribution networks and knowledge of environmental home appliances, but failing—Coway has refocused on its core competence.

## Coway

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### Rental service and overseas businesses to maintain growth and outright sales to stabilize

### Overseas, water purifier, and mattress businesses most important

## 4. Short-term growth slowdown of little concern

### Solid growth seen until 2016

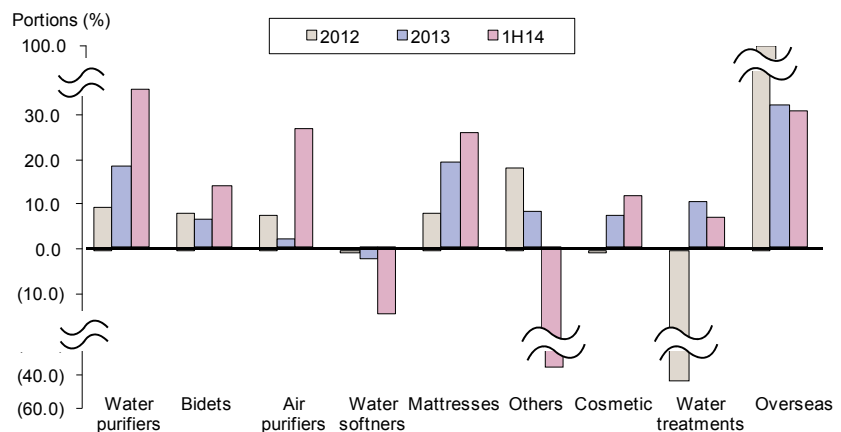
Coway shares have lost about 15% since 2Q14 as top-line growth has slowed. A management reshuffle in early 2013 has spurred profitability gains through cost cutting—operating margin improved by 4.7%pts in 2013 and 2.9%pts y-y in 1H14—but sales growth has slowed, raising concerns as to what will happen from 2H14, when the effect of a turnaround dissipates. Sales and operating profit each fell 1% y-y in 3Q14.

We have analyzed Coway's growth drivers to determine if they can maintain their pace of expansion, as well as sluggish business segments to gauge the chance of a turnaround. We estimate that the firm's sales, operating profit, and net profit will increase at respective CAGRs of 7%, 6%, and 6% over 2014-2016, as: 1) rental services and overseas business remain core growth engines and are gradually contributing more to earnings; 2) outright sales should stabilize after being hit hard by stiffening competition; and 3) the firm has more room to cut costs.

### Core growth engines remain valid

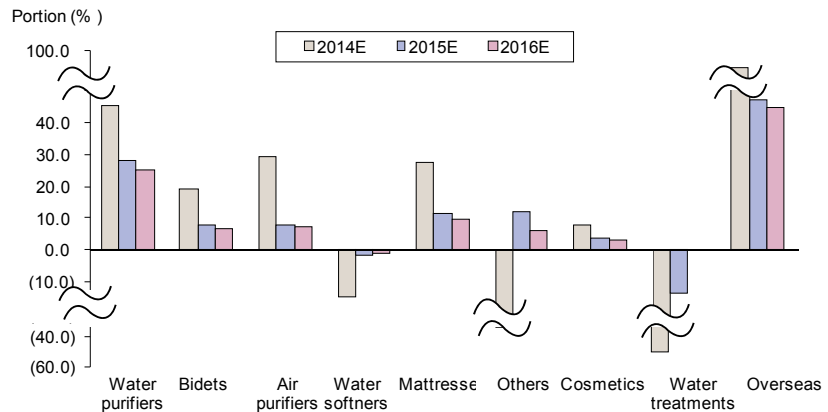
In terms of contribution to sales, the overseas business (exports plus overseas subsidiaries) is Coway's most important, followed by water purifiers and mattresses. We estimate that the three will post 2014-2016 sales CAGRs of 17%, 3%, and 28%, respectively.

### Sales contributions, by business (2012-1H14)



Source: Samsung Securities estimates

## Expected sales contributions, by business (2014E-2016E)



Source: Samsung Securities estimates

**Overseas sales expected to grow 17% annually over 2014-2016**

**China key to overseas growth:** Overseas sales surged at a 55% CAGR over 2012-2014, their contribution to Coway's total sales rising from 5% to 15%. We expect them to increase at a 17% CAGR over 2014-2016, accounting for 18% of total. Overseas sales growth should rebound in 2015, with subsidiaries in Malaysia and the US entering a period of stable growth, the Chinese cosmetics industry improving, political tensions in Thailand receding, and operations in Japan and Italy no longer serving as a drag.

**Stable growth expected in Malaysia and US, turnaround in Thailand**

Coway has operations in Malaysia, the US, China, and Thailand (unprofitable subsidiaries in Italy and Japan were shut down in 2013). The Malaysian and US operations account for more than half of Coway's overseas sales, have increased their top lines at a past-three CAGR of 30-40%, and should generate 10-20% growth over the next three. In 2012, the Malaysian subsidiary became the first to turn a profit, and we believe the US company will break even in 2015. Meanwhile, sales at the Thai unit have fallen since 2013, when it refocused on outright sales after rental services failed, and political unrest began to build. We see no signs of growth momentum now but expect sales to rebound in 2015 as political unrest eases.

**Chinese business to become core of long-term overseas growth**

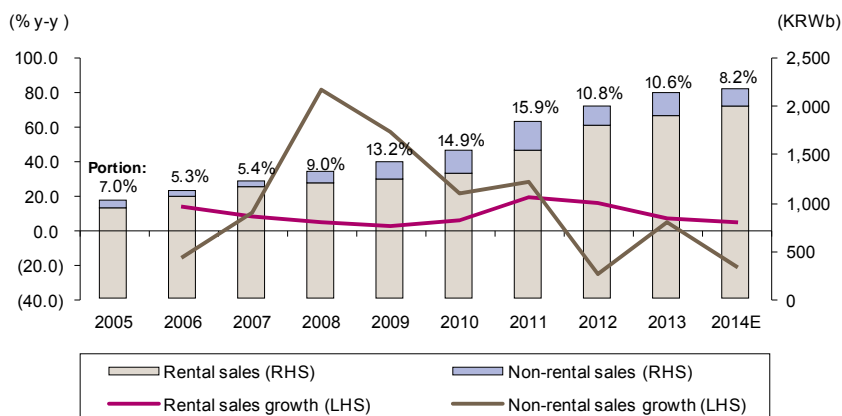
China accounts for about 25% of Coway's overseas sales, and sales there have been sluggish for the past two years. From 2015, however, we expect them to increase at a 15-20% clip, contributing significantly to a rebound in the firm's overseas sales and longer-term growth. ODM exports (of air purifiers to foreign consumer electronics makers operating locally) account for 75% of the Chinese business's sales; a local subsidiary selling water purifiers and cosmetics makes up the other 25%.

**ODM exports of air purifiers key**

The water purifier business has yet to become competitive—the Korean rental service model does not seem to work—and cosmetics generate minimal sales. Consequently, we believe Coway's business in China depends on ODM exports of air purifiers—and we are bullish on their prospects, given China's severe air pollution. ODM exports generate low margins, and potential changes in contract terms make it difficult for the firm to plan for the long term. That said, establishing its own sales network would involve more risk, and clients are unlikely to change suppliers, as Coway's products appear to be well received. In short, we are confident that ODM exports will drive a market expansion in China over the next two to three years.

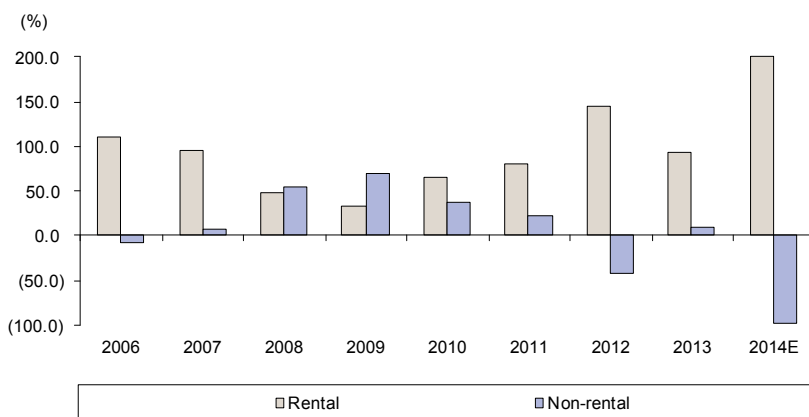
**Accounts growth to offset ARPU decline in rental services:** Rental services account for 60-65% of Coway's total, but growth has slowed to around 3% this year after peaking at 7% in 2012, causing much concern. That said, while ARPU levels are declining as competition stiffens, we expect growth to recover to around 5% as a conversion of customers into new rentals upon contract expiration raises ASPs and account numbers. This will likely require more spending on advertising and sales commissions, but if other costs (such as labor and consulting) are cut, sales growth should not hurt profitability.

**Sales trends: Rental vs non-rental\***



Note: \* Revenue from cosmetics, water treatment, and other sources  
Source: Company data, Samsung Securities estimates

**Sales contributions: Rental vs non-rental\***



Note: \* Revenue from cosmetics, water treatment, and other sources  
Source: Company data, Samsung Securities estimates

**Outright sales declines to reverse or ease**

**Channel diversification to pay off**

Outright sales have been falling with all products, mainly due to new competition, and we do not foresee a meaningful rebound in the medium to long term. We do, however, believe such sales will rebound or their decline will ease over 2015-2016 as channel diversification in 2014 pays off, given that most outright sales have been lost to growing home shopping malls and electronics-specialty stores.



## Coway

## Forecasts, by segment (1)

(KRWb)	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14E	4Q14E	2013	2014E	2015E	2016E
<b>Sales</b>												
Household electronics	406.8	422.5	413.5	412.2	413.8	429.9	431.3	414.3	1,655.0	1,689.3	1,773.3	1,853.1
Outright sales	36.6	47.8	35.4	29.4	27.6	37.4	31.8	25.8	149.3	122.6	134.5	140.3
Rental	327.4	331.9	334.9	339.1	342.4	346.7	352.7	340.6	1,333.4	1,382.3	1,454.3	1,528.4
Membership	42.8	42.8	43.2	43.6	43.9	45.7	46.9	47.9	172.3	184.4	184.4	184.4
Exports	31.5	44.6	38.0	30.6	45.2	55.7	33.0	39.6	144.6	173.5	208.2	249.9
Cosmetics	17.9	22.1	16.6	19.8	21.0	22.3	17.2	19.8	76.4	80.2	84.2	88.4
Other (water treatment)	9.1	7.8	21.1	19.8	14.8	15.4	14.6	15.8	57.7	60.6	60.6	60.6
Consolidated other	42.2	59.5	41.3	41.6	40.2	33.6	29.5	59.5	184.6	162.8	171.8	198.6
<b>Chg ( % y-y)</b>												
Household electronics		6.0	2.5	2.5	1.7	1.7	4.3	0.5	4.0	2.1	5.0	4.5
Outright sales		18.1	(9.3)	(9.3)	(24.7)	(21.8)	(10.4)	(12.2)	3.2	(17.9)	9.7	4.2
Rental		4.1	3.6	3.6	4.6	4.5	5.3	0.4	3.7	3.7	5.2	5.1
Membership		9.1	5.1	3.2	2.6	7.0	8.6	9.8	6.8	7.0	0.0	0.0
Exports		111.4	35.6	0.2	43.6	25.1	(13.0)	29.2	32.0	20.0	20.0	20.0
Cosmetics		35.5	(4.2)	18.1	17.4	0.5	3.6	0.0	13.6	5.0	5.0	5.0
Other (water treatment)		(25.8)	125.6	85.0	63.4	98.4	(31.1)	(19.8)	50.7	5.0	0.0	0.0
Consolidated other		38.7	(14.8)	(29.8)	(4.7)	(43.5)	(28.7)	42.9	(0.8)	(11.8)	5.6	15.6
<b>Portion of total sales (%)</b>												
Household electronics		75.9	77.9	78.7	77.4	77.2	82.1	75.5	78.1	78.0	77.2	75.6
Outright sales		8.6	6.7	5.6	5.2	6.7	6.0	4.7	7.0	5.7	5.9	5.7
Rental		59.7	63.1	64.7	64.0	62.3	67.1	62.0	62.9	63.8	63.3	62.4
Membership		7.7	8.1	8.3	8.2	8.2	8.9	8.7	8.1	8.5	8.0	7.5
Exports		8.0	7.2	5.8	8.5	10.0	6.3	7.2	6.8	8.0	9.1	10.2
Cosmetics		4.0	3.1	3.8	3.9	4.0	3.3	3.6	3.6	3.7	3.7	3.6
Other (water treatment)		1.4	4.0	3.8	2.8	2.8	2.8	2.9	2.7	2.8	2.6	2.5
Consolidated other		10.7	7.8	7.9	7.5	6.0	5.6	10.8	8.7	7.5	7.5	8.1
<b>Sales, by product (KRWn)</b>												
Water purifiers	226.1	231.1	229.1	231.6	231.6	235.6	235.4	237.2	917.9	939.8	976.6	1,015.0
Bidets	66.7	66.9	66.6	67.7	68.5	69.0	69.3	70.2	267.9	277.0	286.5	296.3
Air purifiers	60.7	59.7	59.5	61.3	63.6	64.3	63.4	63.9	241.2	255.2	265.4	276.3
Water softeners	23.8	22.7	21.9	21.8	21.4	20.9	20.4	20.4	90.3	83.1	80.7	78.3
Mattresses	8.1	9.0	9.6	10.8	11.1	13.1	12.1	14.1	37.4	50.5	65.1	79.1
Other (FWTS, outsourcing, etc)	21.5	33.0	26.8	19.0	17.6	26.9	30.8	8.4	100.4	83.7	98.9	108.0
<b>Chg (% y-y)</b>												
Water purifiers	2.4	3.9	1.7	2.2	2.5	1.9	2.7	2.4	2.6	2.4	3.9	3.9
Bidets	4.0	3.5	2.2	1.9	2.7	3.2	4.0	3.7	2.9	3.4	3.4	3.4
Air purifiers	2.3	(0.5)	2.2	0.0	4.8	7.7	6.5	4.3	1.0	5.8	4.0	4.1
Water softeners	(0.2)	(3.3)	(5.5)	(5.9)	(10.2)	(8.0)	(7.0)	(6.3)	(3.7)	(7.9)	(2.9)	(2.9)
Mattresses	na	na	53.3	44.7	38.1	46.0	25.8	31.5	173.3	34.9	28.8	21.6
Other (FWTS, outsourcing, etc)	9.2	18.3	5.8	11.3	(18.1)	(18.6)	15.0	(55.8)	11.4	(16.6)	18.1	9.2
<b>Portion of total sales (%)</b>												
Water purifiers	44.6	41.5	43.2	44.2	43.3	42.3	44.8	43.2	43.3	43.4	42.5	41.4
Bidets	13.1	12.0	12.5	12.9	12.8	12.4	13.2	12.8	12.6	12.8	12.5	12.1
Air purifiers	12.0	10.7	11.2	11.7	11.9	11.6	12.1	11.6	11.4	11.8	11.6	11.3
Water softeners	4.7	4.1	4.1	4.2	4.0	3.8	3.9	3.7	4.3	3.8	3.5	3.2
Mattresses	1.6	1.6	1.8	2.1	2.1	2.4	2.3	2.6	1.8	2.3	2.8	3.2
Other (FWTS, outsourcing, etc)	4.2	5.9	5.0	3.6	3.3	4.8	5.9	1.5	4.7	3.9	4.3	4.4

Source: Company data, Samsung Securities estimates

## Coway

## Forecasts, by segment (2)

(KRWb)	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14	4Q14E	2013	2014E	2015E	2016E
<b>Accounts ('000 units)</b>												
Total	5,793	5,816	5,834	5,866	5,513	5,574	5,603		5,866	5,677	5,677	5,677
Chg (% y-y)	5.6	3.9	2.9	2.2	0.8	1.8	2.3		2.2	3.2	0.0	0.0
Outright sales additions	61	82	62	40	40	60	52		245	191	157	141
Chg (% y-y)	21.3	7.0	(18.6)	(23.9)	(35.3)	(26.9)	(16.2)		(4.1)	(22.0)	(18.0)	(10.0)
Rental accounts	4,658	4,717	4,746	4,800	4,455	4,487	4,538		4,800	4,608	4,608	4,608
Chg (% y-y)	4.0	4.4	4.3	4.2	2.8	2.6	3.4		4.2	3.9	0.0	0.0
Rental additions	318	298	257	292	317	371	311		1,166	1,305	1,305	1,305
Chg (% y-y)	11.7	(9.9)	(12.3)	(5.6)	(0.4)	24.4	20.7		(4.3)	12.0	0.0	0.0
Memberships	1,135	1,100	1,088	1,066	1,058	1,087	1,065		1,066	1,069	1,069	1,069
Chg (% y-y)	13.1	1.6	(2.8)	(5.9)	(6.8)	(1.1)	(2.1)		(5.9)	0.2	0.0	0.0
Rental cancellations	139	126	117	114	129	139	130		496	559	553	553
Monthly churn (%)	1.01	0.90	0.82	0.80	0.90	1.04	0.97		0.90	0.97	1.00	1.00
<b>Earnings summary</b>												
Sales	507.4	556.5	530.5	524.0	535.0	556.9	525.5	549.0	2,118.3	2,166.4	2,298.1	2,450.6
Gross profit	339.8	363.7	346.3	347.5	352.7	369.0	357.3	361.6	1,397.4	1,440.6	1,516.7	1,605.1
Operating profit	69.7	81.9	96.3	91.1	90.3	97.2	95.3	97.0	339.0	379.8	397.6	422.9
Pre-tax profit	75.3	81.0	80.4	90.4	88.4	86.5	85.9	100.8	327.1	369.0	387.4	413.7
Net profit	57.4	59.7	60.1	67.9	66.1	66.3	63.9	74.7	245.1	276.4	290.2	309.9
<b>Margins (%)</b>												
Gross profit	67.0	65.4	65.3	66.3	65.9	66.3	68.0	65.9	66.0	66.5	66.0	65.5
Operating profit	13.7	14.7	18.1	17.4	16.9	17.4	18.1	17.7	16.0	17.5	17.3	17.3
Pre-tax profit	14.8	14.6	15.2	17.3	16.5	15.5	16.4	18.4	15.4	17.0	16.9	16.9
Net profit	11.3	10.7	11.3	13.0	12.4	11.9	12.2	13.6	11.6	12.8	12.6	12.6
<b>Chg (% y-y)</b>												
Sales	6.2	13.7	4.7	0.9	5.4	0.1	(0.9)	4.8	6.3	2.3	6.1	6.6
Gross profit	5.7	9.7	3.0	6.7	3.8	1.5	3.2	4.0	6.3	3.1	5.3	5.8
Operating profit	7.7	27.6	53.2	165.0	29.5	18.6	(1.0)	6.5	49.9	12.0	4.7	6.4
Pre-tax profit	21.4	1,723.3	44.5	282.5	17.5	6.8	6.9	11.5	124.4	12.8	5.0	6.8
Net profit	25.0	(829.6)	40.4	402.6	15.2	11.0	6.4	10.1	160.6	12.8	5.0	6.8
<b>Chg (% q-q)</b>												
Sales	(2.3)	9.7	(4.7)	(1.2)	2.1	4.1	(5.6)	4.5				
Gross profit	4.4	7.0	(4.8)	0.3	1.5	4.6	(3.2)	1.2				
Operating profit	102.8	17.5	17.5	(5.4)	(0.9)	7.6	(1.9)	1.8				
Pre-tax profit	218.5	7.5	(0.7)	12.5	(2.2)	(2.2)	(0.6)	17.3				
Net profit	324.8	4.0	0.7	13.0	(2.7)	0.3	(3.5)	16.9				

Source: Company data, Samsung Securities estimates

**Income statement**

Year-end Dec 31 (KRWb)	2012	2013	2014E	2015E	2016E
<b>Sales</b>	<b>1,993</b>	<b>2,118</b>	<b>2,166</b>	<b>2,298</b>	<b>2,451</b>
Household electronics	3,097	3,247	3,344	3,463	3,626
Exports	110	145	174	208	250
Cosmetics	67	76	80	84	88
Others	38	58	61	61	61
Consolidated others	186	185	163	172	199
Cost of goods sold	678	721	726	781	845
<b>Gross profit</b>	<b>1,315</b>	<b>1,397</b>	<b>1,441</b>	<b>1,517</b>	<b>1,605</b>
Gross margin (%)	66.0	66.0	66.5	66.0	65.5
SG&A expenses	1,088	1,058	1,061	1,119	1,182
<b>Operating profit</b>	<b>226</b>	<b>339</b>	<b>380</b>	<b>398</b>	<b>423</b>
Operating margin (%)	11.3	16.0	17.5	17.3	17.3
Net interest income	(29)	(14)	(11)	(10)	(9)
Net forex-related gains	(0)	(4)	0	0	0
Net equity-method gains	7	0	0	0	0
Other	(58)	6	(0)	(0)	(0)
<b>Pre-tax profit</b>	<b>146</b>	<b>327</b>	<b>369</b>	<b>387</b>	<b>414</b>
Taxes	52	82	93	97	104
Effective tax rate (%)	35.5	25.1	25.1	25.1	25.1
<b>Net profit</b>	<b>94</b>	<b>245</b>	<b>276</b>	<b>290</b>	<b>310</b>
Net margin (%)	4.7	11.6	12.8	12.6	12.7
<b>Operating net profit*</b>	<b>94</b>	<b>245</b>	<b>276</b>	<b>290</b>	<b>310</b>
Operating net margin (%)	92	248	276	290	310
EBITDA	410	537	611	649	688
EBITDA margin (%)	20.6	25.4	28.2	28.3	28.1
Reported EPS (KRW)	1,219	3,178	3,584	3,764	4,020
Adjusted EPS (KRW)**	1,197	3,222	3,584	3,764	4,020
DPS (common, KRW)	1,050	1,660	2,040	2,340	2,480
DPS (preferred, KRW)	0	0	0	0	0
Dividend payout ratio (%)	83.3	50.4	55.0	60.0	59.6

**Cash flow statement**

Year-end Dec 31 (KRWb)	2012	2013	2014E	2015E	2016E
<b>Cash flow from operations</b>	<b>454</b>	<b>537</b>	<b>496</b>	<b>542</b>	<b>573</b>
Net profit	94	245	276	290	310
Depreciation & amortization	184	198	231	252	265
Net forex-translation income	0	0	0	0	0
Net equity-method income	0	0	0	0	0
<b>Gross cash flow</b>	<b>446</b>	<b>528</b>	<b>526</b>	<b>561</b>	<b>595</b>
(-) Change in working capital	8	9	(30)	(19)	(22)
Other	0	(0)	0	0	0
<b>Cash flow from investments</b>	<b>(319)</b>	<b>(76)</b>	<b>(330)</b>	<b>(330)</b>	<b>(330)</b>
Capex	(311)	(258)	(300)	(300)	(300)
<b>Free cash flow</b>	<b>(10)</b>	<b>195</b>	<b>185</b>	<b>231</b>	<b>260</b>
Change in investment assets	150	(1)	(0)	(0)	(0)
Other	(159)	183	(30)	(30)	(30)
<b>Cash flow from financing</b>	<b>(76)</b>	<b>(373)</b>	<b>(126)</b>	<b>(162)</b>	<b>(188)</b>
Change in debt	42	(260)	0	(10)	(14)
Change in equity	(0)	0	(2)	0	0
Dividends	(78)	(78)	(124)	(152)	(174)
Other	(40)	(34)	0	0	0
<b>Change in cash</b>	<b>54</b>	<b>86</b>	<b>40</b>	<b>50</b>	<b>55</b>
Cash at beginning of year	98	152	239	279	329
Cash at end of year	152	239	279	329	384

Note: \* Excluding one off items

\*\* Fully diluted, excluding one-off items

\*\*\* From companies subject to equity-method valuation

Source: Coway, Samsung Securities estimates

**Balance sheet**

Year-end Dec 31 (KRWb)	2012	2013	2014E	2015E	2016E
<b>Current assets</b>	<b>779</b>	<b>691</b>	<b>767</b>	<b>841</b>	<b>923</b>
Cash & equivalents	156	245	285	335	390
Accounts receivable	262	250	271	287	306
Inventories	72	66	76	80	86
Other current assets	290	131	135	138	141
<b>Fixed assets</b>	<b>976</b>	<b>976</b>	<b>1,053</b>	<b>1,109</b>	<b>1,152</b>
Investment assets	81	82	82	82	82
Equity in affiliated companies	0	0	0	0	0
Tangible assets	630	638	715	770	813
Intangible assets	184	177	177	177	177
Other long-term assets	81	80	80	80	80
<b>Total assets</b>	<b>1,755</b>	<b>1,668</b>	<b>1,820</b>	<b>1,950</b>	<b>2,074</b>
<b>Current liabilities</b>	<b>759</b>	<b>677</b>	<b>678</b>	<b>670</b>	<b>658</b>
Accounts payable	46	37	37	40	42
Short-term debt	330	182	328	318	304
Other current liabilities	383	458	312	312	312
<b>Long-term liabilities</b>	<b>211</b>	<b>50</b>	<b>50</b>	<b>50</b>	<b>50</b>
Bond & long-term debt	148	0	0	0	0
Other long-term liabilities	63	50	50	50	50
<b>Total liabilities</b>	<b>970</b>	<b>727</b>	<b>728</b>	<b>720</b>	<b>709</b>
Capital stock	785	941	1,092	1,230	1,366
Capital surplus	41	41	39	39	39
Retained earnings	126	126	126	126	126
Other	701	868	1,021	1,159	1,295
<b>Total equity</b>	<b>(82)</b>	<b>(94)</b>	<b>(94)</b>	<b>(94)</b>	<b>(94)</b>
Net debt	0	0	0	0	0
Book value per share (KRW)	785	941	1,092	1,230	1,366

**Financial ratios**

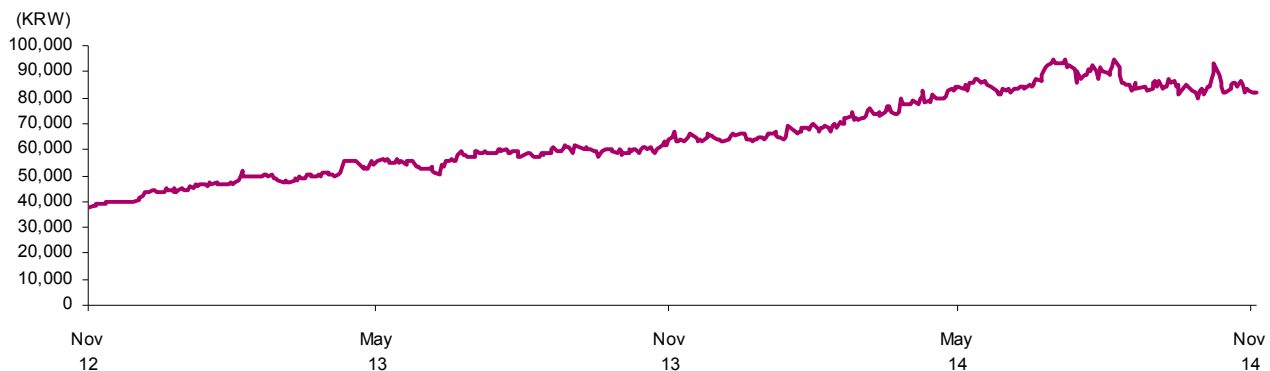
Year-end Dec 31	2012	2013	2014E	2015E	2016E
<b>Growth (%)</b>	<b>9.2</b>	<b>6.3</b>	<b>2.3</b>	<b>6.1</b>	<b>6.6</b>
Sales	(3.7)	49.9	12.0	4.7	6.4
Operating profit	(33.0)	124.4	12.8	5.0	6.8
Pre-tax profit	(43.7)	160.6	12.8	5.0	6.8
Net profit	3.9	31.1	13.7	6.3	5.9
Operating net profit*	(45.2)	169.1	11.2	5.0	6.8
EBITDA					
Adjusted EPS**	12.3	28.4	27.2	25.0	23.9
<b>Ratios</b>	<b>5.6</b>	<b>14.3</b>	<b>15.9</b>	<b>15.4</b>	<b>15.4</b>
ROE (%)	9.4	23.2	26.4	25.4	25.4
ROA (%)	55.1	8.8	3.9	(1.4)	(6.3)
ROIC (%)	5.8	18.3	28.5	30.3	33.5
Net debt to equity (%)	46.4	44.1	43.8	44.3	44.2
Interest coverage (x)	9.0	7.1	6.2	6.1	6.1
Receivables turnover (days)	16.1	11.8	11.9	12.4	12.4
Payables turnover (days)					
Inventory turnover (days)	37.6	25.5	22.9	21.8	20.4
<b>Valuations (x)</b>	<b>9.6</b>	<b>7.3</b>	<b>6.2</b>	<b>5.5</b>	<b>4.9</b>
P/E	16.2	11.9	10.4	9.7	9.1
P/B	26.4	18.7	16.8	15.9	14.8
EV/EBITDA	1.3	2.0	2.5	2.8	3.0
EV/EBIT					
Dividend yield (common, %)					

## Coway

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### ■ Rating changes in past two years

Date 2014/11/19  
 Recommendation BUY  
 Target price (KRW) 113,000

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