

2016. 7. 7

# Company Update



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## AT A GLANCE

SELL HOLD **BUY**

**Target price** KRW135,000 (36.9%)

**Current price** KRW98,600

Market cap	KRW7.6t/USD6.5b
Shares (float)	77,124,796 (65.4%)
52-week high/low	KRW113,000/KRW79,200
Avg daily trading value (60-day)	KRW16.8b/ USD14.4m

## ONE-YEAR PERFORMANCE

	1M	6M	12M
Coway (%)	-6.5	12.6	11.3
Vs Kospi (%pts)	-5.0	11.0	17.0

## KEY CHANGES

(KRW)	New	Old	Diff
Recommend.	BUY	BUY	
Target price	135,000	135,000	0.0%
2016E EPS	3,614	5,071	-28.7%
2017E EPS	5,343	5,558	-3.9%

## SAMSUNG vs THE STREET

No of estimates	13
Target price	124,750
Recommendation	3.9

BUY★★: 5 / BUY: 4 / HOLD: 3 / SELL: 2 / SELL★★: 1

## Coway (021240)

### Nickel scandal to hurt this year

- Reports that Coway allegedly covered up evidence of nickel compounds found in water dispensed from some of its purifiers have sparked criticism of the firm and concerns over its brand value and long-term competitiveness.
- Coway's CEO publicly apologized on Jul 4—a day after the local press reported on the issue—and yesterday the company said it would refund rental fees on the products in question and compensate customers in other ways as well.
- While its profits will likely lack momentum this year, we maintain BUY on Coway on anticipation its business will normalize and its Chinese operations will take off in 2017. We change our valuation basis to 2017 (when one-off costs should not affect earnings) and maintain our target price of KRW135,000 (equivalent to 25x P/E).

### WHAT'S THE STORY?

**Nickel compounds found in purified water:** Coway has come under fire this week after the press reported on Jul 3 that nickel compounds were found in water dispensed from four models of ice-making water purifiers it produced between Jul 2014 and Dec 2015. The news also alleged that the firm covered up knowledge of the issue for a year, and further reports argued that nickel is carcinogenic. Investors worry that the company's brand value will suffer, as it has been strong consumer confidence that has driven Coway to steady growth and dominance of the market for water purifiers and other home-appliance rentals. Shares fell 7.0% on Jul 4 and 2.2% on Jul 5 before rising 0.8% yesterday.

**Company apologizes, will compensate customers:** Coway's CEO publicly apologized on Jul 4, and yesterday the company said it would: 1) recall and dispose of all models in question, including those sold after defects were fixed; 2) refund all related rental fees; 3) replace the products with high-end ones and provide a six-month rental-fee discount upon request; 4) organize a medical consulting team; and 5) direct its sales representatives to be attuned to resolving consumer worries.

**Short-term costs:** We estimate that Coway will incur KRW130b in one-off costs related to the scandal, including: 1) KRW60b in rental fee refunds for 110,000 accounts at an average monthly fee of KRW40,000-50,000; 2) KRW50b in recall-related expenses; 3) replacement-related costs, included forfeited rental fees for six months—which should lead to a higher COGS; and 4) other costs linked to sales commissions.

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### SUMMARY FINANCIAL DATA

	2015	2016E	2017E	2018E
Revenue (KRWb)	2,315	2,523	2,718	2,939
Net profit (adj) (KRWb)	343	276	409	447
EPS (adj) (KRW)	4,492	3,614	5,343	5,830
EPS (adj) growth (% y-y)	39.3	(19.5)	47.8	9.1
EBITDA margin (%)	29.8	24.2	29.8	30.1
ROE (%)	30.1	21.7	28.6	27.0
P/E (adj) (x)	22.0	27.3	18.5	16.9
P/B (x)	6.4	6.0	5.0	4.5
EV/EBITDA (x)	11.0	12.5	9.2	8.3
Dividend yield (%)	2.8	2.2	3.3	3.7

Source: Company data, Samsung Securities estimates

**Long-term risk:** The market appears more worried about the impact on Coway's long-term value than about the short-term costs. With outrage seemingly directed more at the alleged cover-up than the faulty water purifiers themselves, reduced confidence in the firm could lead to more contracts being cancelled and difficulty selling and renting home appliances in general. For our part, we advise waiting to see how Coway's responses impact new sign-ups and cancellations in 2H before trying to estimate how much its brand has been damaged.

**Cutting forecasts:** We cut our 2016 sales and operating profit forecasts for Coway by a respective 2% and 29%, assuming a rise in COGS ratio and KRW130b in related costs recognized over 2Q-3Q16. We now expect outright and rental sales in 2H to miss our previous estimates, and cancellations to increase when contracts expire. We revise down our 2017 sales and operating profit forecasts by 2% and 4%, respectively, cutting them less than our 2016 projections as we assume the company's efforts to regain consumers' confidence will largely succeed. We feel Coway's dominance results as much from strong distribution networks and aftersales services as it does from product competitiveness, and do not believe customers will defect to rivals en masse as long as the company devises effective measures to protect them.

**Maintaining BUY and target price:** We maintain a 12-month target price on Coway of KRW135,000 (equivalent to 25x 2017 P/E and based on a DCF valuation that assumes a WACC of 6.1% and terminal growth of 0.5%). We change our valuation basis to 2017, when we believe the firm's operations will normalize thanks to aggressive responses to the scandal. Despite long-term uncertainty and a likely lack of earnings momentum this year, we maintain BUY on Coway, believing: 1) it remains the sector's leading player in terms of product, distribution, and services; and 2) its stable core earnings—stemming from a unique business model—will garner attention amid macroeconomic uncertainty. Overseas potential should provide another catalyst when detailed plans for a tie-up with Chinese electronics maker Haier become visible at end-2016.

### Full-year forecast revisions

(KRWb)	2015	New		Old		Chg (%)	
		2016E	2017E	2016E	2017E	2016E	2017E
Sales	2,315	2,523	2,718	2,560	2,766	(1.4)	(1.7)
Operating profit	463	376	553	524	574	(28.2)	(3.7)
Pre-tax profit	454	368	546	518	568	(29.0)	(3.9)
Net profit	343	276	409	388	426	(28.9)	(4.0)
EBITDA	691	610	809	759	830	(19.6)	(2.5)
EPS (KRW)	4,492	3,614	5,343	5,071	5,558	(28.7)	(3.9)

Source: Company data, Samsung Securities estimates

### DCF valuation

(KRWb)	2015	2016E	2017E	2018E	2019E	2020E	2021E	2022E	2023E	2024E	2025E	2026E
<b>EBIT</b>	<b>463</b>	<b>376</b>	<b>553</b>	<b>601</b>	<b>656</b>	<b>722</b>	<b>758</b>	<b>796</b>	<b>836</b>	<b>878</b>	<b>922</b>	<b>968</b>
Tax	114	93	137	149	163	180	189	198	208	218	229	241
Capex	329	342	356	356	356	356	358	360	362	363	365	367
Change in working capital	54	21	18	20	23	26	26	27	27	27	27	27
Depreciation	220	227	249	275	304	315	317	318	320	322	323	325
Amortization	8	8	8	8	8	8	8	8	8	8	8	8
<b>Free cash flow</b>	<b>195</b>	<b>154</b>	<b>298</b>	<b>358</b>	<b>426</b>	<b>483</b>	<b>510</b>	<b>538</b>	<b>568</b>	<b>599</b>	<b>631</b>	<b>666</b>
<b>Terminal value</b>	<b>11,645</b>											
Terminal growth (%)	0.5%											
NPV of FCF	3,199											
<b>Present value of terminal value</b>	<b>6,533</b>											
<b>Enterprise value</b>	<b>9,732</b>											
Equity value (adjusted)**	10,189											
Shares outstanding	77,125											
<b>Fair value per share (KRW)</b>	<b>136,156</b>											
Current share price (KRW)*	98,600											
Upside (%)	38.1%											

Note: \*As of Jul 6 close;

\*\*Reflects a one-month adjustment to end-2016 discount rate

Source: Company data, Samsung Securities estimates

### Valuation summary

Year-end	Sales	Op prof	Pre-tax prof	Net prof	EPS	Chg	P/E	P/B	ROE	EV/EBITDA	Net debt
Dec 31	(KRWb)	(KRWb)	(KRWb)	(KRWb)	(KRW)	(% y-y)	(x)	(x)	(%)	(x)	(KRWb)
2013	2,118	339	327	245	3,222	47.5	30.6	8.8	28.4	14.2	83
2014	2,160	364	332	250	3,225	0.1	30.6	7.6	25.2	13.2	12
2015	2,315	463	454	343	4,492	39.3	22.0	6.4	30.1	11.0	(38)
2016E	2,523	376	368	276	3,614	(19.5)	27.3	6.0	21.7	12.5	0
2017E	2,718	553	546	409	5,343	47.8	18.5	5.0	28.6	9.2	(150)
2018E	2,939	601	596	447	5,830	9.1	16.9	4.5	27.0	8.3	(281)

Source: Company data, Samsung Securities estimates

## Results and forecasts

	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16E	3Q16E	4Q16E	2015P	2016E	2017E	2018E
<b>Earnings summary</b>												
<b>(KRWb)</b>	548.2	555.3	580.4	631.3	623.7	638.6	614.6	645.8	2,315.2	2,522.7	2,718.1	2,938.8
Sales	373.0	384.7	402.3	426.4	416.6	435.5	413.1	435.1	1,586.4	1,700.3	1,861.9	2,013.1
Gross profit	100.3	110.5	123.9	128.6	123.6	84.5	48.8	118.8	463.3	375.6	552.7	600.8
Operating profit	101.1	108.9	121.7	122.7	125.3	81.3	45.7	115.6	454.5	367.8	545.6	595.7
Pre-tax profit	77.6	82.7	92.4	90.5	95.2	60.7	34.1	86.1	343.1	275.9	409.2	446.7
Net profit												
<b>Margins (%)</b>												
Gross profit	68.0	69.3	69.3	67.5	66.8	68.2	67.2	67.4	68.5	67.4	68.5	68.5
Operating profit	18.3	19.9	21.4	20.4	19.8	13.2	7.9	18.4	20.0	14.9	20.3	20.4
Pre-tax profit	18.4	19.6	21.0	19.4	20.1	12.7	7.4	17.9	19.6	14.6	20.1	20.3
Net profit	14.1	14.9	15.9	14.3	15.3	9.5	5.5	13.3	14.8	10.9	15.1	15.2
<b>Chg (% y-y)</b>												
Sales	2.5	(0.3)	10.4	16.3	13.8	15.0	5.9	2.3	7.2	9.0	7.7	8.1
Gross profit	5.8	4.3	12.6	20.2	11.7	13.2	2.7	2.0	10.6	7.2	9.5	8.1
Operating profit	11.1	13.7	30.1	57.4	23.2	(23.6)	(60.6)	(7.7)	27.1	(18.9)	47.1	8.7
Pre-tax profit	14.3	25.9	41.6	71.5	23.9	(25.4)	(62.5)	(5.8)	36.7	(19.1)	48.3	9.2
Net profit	17.4	24.8	44.5	69.6	22.7	(26.6)	(63.1)	(4.8)	37.4	(19.6)	48.3	9.2
<b>Chg (% q-q)</b>												
Sales	1.0	1.3	4.5	8.8	(1.2)	2.4	(3.8)	5.1				
Gross profit	5.2	3.1	4.6	6.0	(2.3)	4.5	(5.1)	5.3				
Operating profit	22.8	10.1	12.2	3.8	(3.9)	(31.7)	(42.2)	143.3				
Pre-tax profit	41.3	7.8	11.7	0.8	2.1	(35.1)	(43.8)	153.2				
Net profit	45.4	6.6	11.7	(2.0)	5.2	(36.2)	(43.8)	152.5				
<b>Sales breakdown</b>												
Household electronics	439.3	457.9	481.3	504.3	495.0	515.2	500.6	507.4	1,882.9	2,018.2	2,128.7	2,258.2
Outright sales	30.0	41.4	45.6	54.2	50.5	54.6	50.1	51.7	171.2	206.9	236.9	270.0
Rental	363.3	371.2	376.4	380.2	380.1	391.6	382.0	386.8	1,491.1	1,540.6	1,591.7	1,662.5
Membership	46.0	45.4	44.5	43.7	42.9	44.0	43.2	42.3	179.6	172.4	172.4	172.4
Financial lease			14.8	26.1	21.5	25.0	25.2	26.5	40.9	98.2	127.7	153.2
Exports	33.0	39.0	35.8	41.4	56.7	58.5	50.1	51.1	149.3	216.5	270.6	324.7
Cosmetics	23.1	21.1	18.6	20.2	20.1	21.1	19.5	18.2	83.1	78.9	86.8	95.5
Other (water treatment)	10.6	9.4	10.0	16.1	5.8	7.6	8.0	15.5	46.1	36.9	36.9	36.9
Consolidated other	42.1	27.9	34.7	49.3	46.1	36.2	36.4	53.6	194.9	172.3	195.2	223.5
<b>Chg (% y-y)</b>												
Household electronics	6.2	6.5	11.6	16.6	12.7	12.5	4.0	0.6	10.3	7.2	5.5	6.1
Outright sales	8.8	10.7	43.5	102.9	68.2	32.0	10.0	(4.8)	38.6	20.8	14.5	14.0
Rental	6.1	7.0	6.7	6.0	4.6	5.5	1.5	1.7	6.5	3.3	3.3	4.4
Membership	4.9	(0.8)	(5.0)	(6.7)	(6.8)	(3.0)	(3.0)	(3.1)	(2.0)	(4.0)	0.0	0.0
Financial lease							70.0	1.7			30.0	20.0
Exports	(27.0)	(30.0)	8.5	23.9	71.8	50.0	40.0	23.3	(10.8)	45.0	25.0	20.0
Cosmetics	10.5	(5.3)	8.3	1.1	(13.1)	0.0	5.0	(10.2)	3.3	(5.0)	10.0	10.0
Other (water treatment)	(28.2)	(38.6)	(31.7)	18.1	(45.3)	(20.0)	(20.0)	(3.3)	(21.0)	(20.0)	0.0	0.0
Consolidated other	4.7	(17.1)	17.7	13.6	9.4	30.0	5.0	8.8	32.9	(11.6)	13.3	14.5
<b>Portion of total sales (%)</b>												
Household electronics	80.1	82.5	82.9	79.9	79.4	80.7	81.4	78.6	79.9	80.0	78.3	76.8
Outright sales	5.5	7.5	7.9	8.6	8.1	8.6	8.2	8.0	7.3	8.2	8.7	9.2
Rental	66.3	66.8	64.9	60.2	60.9	61.3	62.2	59.9	63.3	61.1	58.6	56.6
Membership	8.4	8.2	7.7	6.9	6.9	6.9	7.0	6.6	7.6	6.8	6.3	5.9
Financial lease			2.6	4.1	3.4	3.9	4.1	4.1	1.7	3.9	4.7	5.2
Exports	6.0	7.0	6.2	6.6	9.1	9.2	8.2	7.9	6.3	8.6	10.0	11.0
Cosmetics	4.2	3.8	3.2	3.2	3.2	3.3	3.2	2.8	3.5	3.1	3.2	3.2
Other (water treatment)	1.9	1.7	1.7	2.5	0.9	1.2	1.3	2.4	2.0	1.5	1.4	1.3
Consolidated other	7.7	5.0	6.0	7.8	7.4	5.7	5.9	8.3	8.3	6.8	7.2	7.6

Source: Company data, Samsung Securities estimates

## Income statement

Year-end Dec 31(KRWb)	2014	2015	2016E	2017E	2018E
<b>Sales</b>	<b>2,160</b>	<b>2,315</b>	<b>2,523</b>	<b>2,718</b>	<b>2,939</b>
Cost of goods sold	727	729	822	856	926
<b>Gross profit</b>	<b>1,434</b>	<b>1,586</b>	<b>1,700</b>	<b>1,862</b>	<b>2,013</b>
Gross margin (%)	66.4	68.5	67.4	68.5	68.5
SG&A expenses	1,069	1,123	1,325	1,309	1,412
<b>Operating profit</b>	<b>364</b>	<b>463</b>	<b>376</b>	<b>553</b>	<b>601</b>
Operating margin (%)	16.9	20.0	14.9	20.3	20.4
<b>Non-operating gains (losses)</b>	<b>(32)</b>	<b>(9)</b>	<b>(8)</b>	<b>(7)</b>	<b>(5)</b>
Financial profit	3	1	1	2	3
Financial costs	12	4	4	3	3
Equity-method gains (losses)	0	0	0	0	0
Other	(23)	(6)	(5)	(5)	(5)
<b>Pre-tax profit</b>	<b>332</b>	<b>454</b>	<b>368</b>	<b>546</b>	<b>596</b>
Taxes	83	111	92	136	149
Effective tax rate (%)	24.9	24.5	25.0	25.0	25.0
Profit from continuing operations	250	343	276	409	447
Profit from discontinued operations	0	0	0	0	0
<b>Net profit</b>	<b>250</b>	<b>343</b>	<b>276</b>	<b>409</b>	<b>447</b>
Net margin (%)	11.6	14.8	10.9	15.1	15.2
Net profit (controlling interests)	250	343	276	409	447
Net profit (non-controlling interests)	(0)	(0)	(0)	(0)	(0)
EBITDA	578	691	610	809	884
EBITDA margin (%)	26.8	29.8	24.2	29.8	30.1
EPS (parent-based) (KRW)	3,237	4,449	3,577	5,306	5,793
EPS (consolidated) (KRW)	3,237	4,449	3,577	5,305	5,792
Adjusted EPS (KRW)*	3,225	4,492	3,614	5,343	5,830

## Cash flow statement

Year-end Dec 31(KRWb)	2014	2015	2016E	2017E	2018E
<b>Cash flow from operations</b>	<b>537</b>	<b>513</b>	<b>513</b>	<b>670</b>	<b>732</b>
Net profit	250	343	276	409	447
Non-cash profit and expenses	240	231	263	286	313
Depreciation	206	220	227	249	275
Amortization	8	8	8	8	8
Other	27	3	28	29	30
Changes in A/L from operating activities	47	(61)	(26)	(25)	(28)
<b>Cash flow from investments</b>	<b>(299)</b>	<b>(329)</b>	<b>(342)</b>	<b>(356)</b>	<b>(356)</b>
Change in tangible assets	(296)	(317)	(342)	(356)	(356)
Change in financial assets	0	1	0	0	0
Other	(3)	(13)	0	0	0
<b>Cash flow from financing</b>	<b>(328)</b>	<b>(213)</b>	<b>(170)</b>	<b>(214)</b>	<b>(246)</b>
Change in debt	(163)	(77)	38	(50)	(1)
Change in equity	0	0	0	0	0
Dividends	(124)	(148)	(208)	(163)	(245)
Other	(42)	12	0	0	(0)
Change in cash	(91)	(31)	0	100	130
Cash at beginning of year	239	147	116	116	216
Cash at end of year	147	116	116	216	346
<b>Gross cash flow</b>	<b>490</b>	<b>574</b>	<b>539</b>	<b>695</b>	<b>760</b>
<b>Free cash flow</b>	<b>211</b>	<b>182</b>	<b>144</b>	<b>286</b>	<b>345</b>

Note: \* Excluding one off items, \*\* Fully diluted, excluding one-off items

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

Source: Company data, Samsung Securities estimates

## Balance sheet

Year-end Dec 31(KRWb)	2014	2015	2016E	2017E	2018E
<b>Current assets</b>	<b>597</b>	<b>653</b>	<b>679</b>	<b>802</b>	<b>958</b>
Cash & equivalents	147	116	116	216	346
Accounts receivable	229	283	309	333	360
Inventories	62	70	76	82	89
Other current assets	158	184	178	171	164
<b>Fixed assets</b>	<b>1,025</b>	<b>1,122</b>	<b>1,207</b>	<b>1,284</b>	<b>1,335</b>
Investment assets	81	78	78	78	78
Tangible assets	675	700	785	862	913
Intangible assets	171	169	169	169	169
Other long-term assets	98	176	176	176	176
<b>Total assets</b>	<b>1,622</b>	<b>1,775</b>	<b>1,887</b>	<b>2,087</b>	<b>2,294</b>
<b>Current liabilities</b>	<b>526</b>	<b>473</b>	<b>516</b>	<b>471</b>	<b>476</b>
Accounts payable	59	60	65	70	76
Short-term debt	16	8	12	7	7
Other current liabilities	451	405	439	394	393
<b>Long-term liabilities</b>	<b>56</b>	<b>64</b>	<b>64</b>	<b>64</b>	<b>64</b>
Bonds & long-term debt	1	8	8	8	8
Other long-term liabilities	55	56	56	56	56
<b>Total liabilities</b>	<b>582</b>	<b>537</b>	<b>580</b>	<b>535</b>	<b>540</b>
<b>Owners of parent equity</b>	<b>1,039</b>	<b>1,237</b>	<b>1,305</b>	<b>1,551</b>	<b>1,752</b>
Capital stock	41	41	41	41	41
Capital surplus	126	127	127	127	127
Retained earnings	986	1,177	1,245	1,491	1,692
Other	(114)	(108)	(108)	(108)	(108)
<b>Non-controlling interests' equity</b>	<b>1</b>	<b>1</b>	<b>1</b>	<b>1</b>	<b>1</b>
<b>Total equity</b>	<b>1,039</b>	<b>1,238</b>	<b>1,306</b>	<b>1,552</b>	<b>1,753</b>
Net debt	12	(38)	0	(150)	(281)

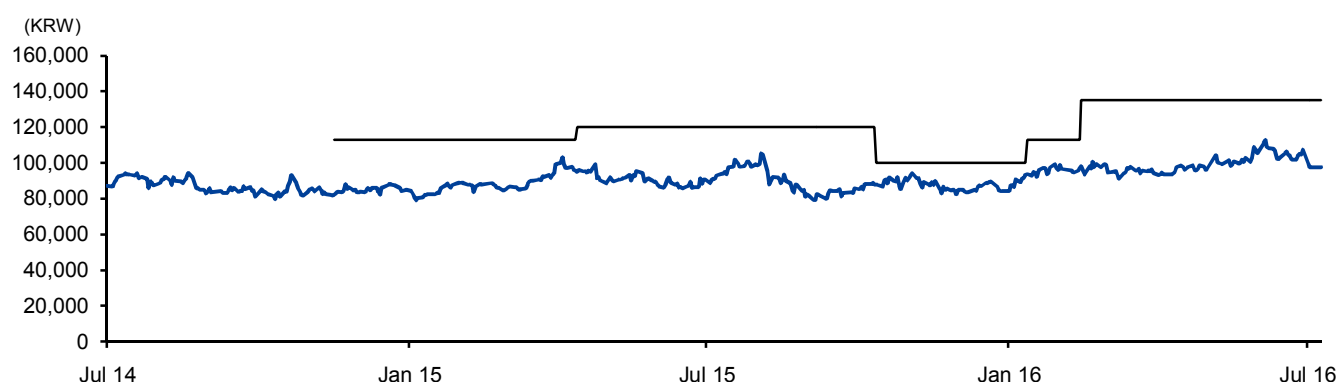
## Financial ratios

Year-end Dec 31	2014	2015	2016E	2017E	2018E
<b>Growth (%)</b>					
Sales	2.0	7.2	9.0	7.7	8.1
Operating profit	7.5	27.1	(18.9)	47.1	8.7
Net profit	11.6	14.8	10.9	15.1	15.2
Adjusted EPS**	0.1	39.3	(19.5)	47.8	9.1
<b>Per-share data (KRW)</b>					
EPS (parent-based)	3,237	4,449	3,577	5,306	5,793
EPS (consolidated)	3,237	4,449	3,577	5,305	5,792
Adjusted EPS**	3,225	4,492	3,614	5,343	5,830
BVPS	12,934	15,465	16,345	19,531	22,145
DPS (common)	2,000	2,800	2,200	3,300	3,600
<b>Valuations (x)</b>					
P/E***	30.5	21.9	27.2	18.4	16.9
P/B***	7.6	6.4	6.0	5.0	4.4
EV/EBITDA	13.1	11.0	12.4	9.2	8.3
<b>Ratios (%)</b>					
ROE	25.2	30.1	21.7	28.6	27.0
ROA	15.2	20.2	15.1	20.6	20.4
ROIC	22.8	31.1	22.4	30.6	31.3
Payout ratio	59.4	60.6	59.3	59.9	59.9
Dividend yield (common)	2.0	2.8	2.2	3.4	3.7
Net debt to equity	1.1	(3.0)	0.0	(9.7)	(16.0)
Interest coverage (x)	31.6	106.8	102.5	160.2	233.1

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## Target price changes in past two years



## Rating changes in past two years

Date	2014/7/6	11/19	2015/4/16	10/15	2016/1/15	2/17
Recommendation	BUY	BUY	BUY	BUY	BUY	BUY
Target price (KRW)	46,000	113,000	120,000	100,000	113,000	135,000

Samsung Securities uses the following investment ratings.

### Company

<b>BUY★★★</b>	Expected to increase in value by 30% or more within 12 months and is highly attractive within sector
<b>BUY</b>	Expected to increase in value by 10% or more within 12 months
<b>HOLD</b>	Expected to increase/decrease in value by less than 10% within 12 months
<b>SELL</b>	Expected to decrease in value by 10% or more within 12 months
<b>SELL★★★</b>	Expected to decrease in value by 30% or more within 12 months

### Industry

<b>OVERWEIGHT</b>	Expected to outperform market by 5% or more within 12 months
<b>NEUTRAL</b>	Expected to outperform/underperform market by less than 5% within 12 months
<b>UNDERWEIGHT</b>	Expected to underperform market by 5% or more within 12 months

## Percentage of ratings in 12 months prior to Mar 31, 2016

BUY (69.8%) | HOLD (30.2%) | SELL (0%)

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