

Coway (021240.KS)

Negatives already reflected in share price

Company Comment | Aug 3, 2016

Coway's 2Q16 results missed consensus on one-off losses stemming from a recall of its ice-making water purifiers; however, if stripping out this item, we view the firm's earnings as remaining healthy. Also, we believe that its customer defection rate has been low since the water purifier incident. As such, Coway's operations should stabilize gradually from 2H16. Reflecting its disappointing 2Q16 results, Coway's share price has corrected of late. Now trading at a 2017F P/E of 17x, the firm offers valuation merit.

2Q16 results miss consensus on booking of large-scale one-off losses

On a non-consolidated basis, Coway booked 2Q16 sales of W590.9bn (down 0.9%, y-y) and operating profit of W21.4bn (down 80.9%, y-y), with both figures falling far short of the market projections on the recording of one-off losses of W122.1bn stemming from rental fee refunds and rental asset disposals due to a recall of three of its water purifier models with built-in ice makers after nickel from the water purifiers was detected in the water.

However, if excluding these one-off losses, Coway's 2Q16 sales and operating profit would have jumped 12.0% and 28.5% y-y, respectively. Thus, it appears that the recall has not negatively affected the business performance of the firm's other product categories. We also believe that around 80% of Coway's customers for ice-making water purifiers have switched to its other water purifier offerings, indicating a low customer defection rate. Accordingly, we expect Coway's operations to stabilize gradually from 2H16.

Also positive, solid earnings growth momentum is sustaining at Coway's overseas business domain sustained—its 2Q16 export revenue grew 53% y-y. Meanwhile: 1) Coway's 2Q16 cancellation rate came in at 1.01%; and 2) if stripping out the recall-related one-off expenses, its rental asset disposal expense/sales ratio would have amounted to only 2.4%.

Negatives fully reflected in share price

Viewing 2016 earnings deterioration expectations as already being reflected in Coway's share price, we maintain a Buy rating and target price of W125,000.

While it remains to be seen how rapidly Coway regains its earnings visibility, we advise paying attention to its secure business model, which: 1) remains relatively free from the impact of changes in the macroeconomic environment; and 2) continues to provide stable cashflow.

With its shares now trading at a 2017F P/E of 17.0x, we view the recent drop in Coway's share price as offering a good opportunity to buy a stake in a company well poised to continue generating stable earnings going forward.

Buy (maintain)

TP **W125,000 (maintain)**
CP ('16/08/02) **W85,900**

| Sector | Other consumer goods |
|-----------------------------|----------------------|
| Kospi/Kosdaq | 2019.03 / 700.9 |
| Market cap (common) | US\$5,957.7mn |
| Outstanding shares (common) | 77.1mn |
| 52W high ('15/08/06) | W113,000 |
| low ('15/09/08) | W79,200 |
| Average trading value (60D) | US\$1.76mn |
| Dividend yield (2016E) | 2.12% |
| Foreign ownership | 54.2% |
| Major shareholders | |
| Coway Holdings & 9 others | 31.1% |
| NPS | 6.0% |

| Share perf | 3M | 6M | 12M |
|--------------|-------|-------|-------|
| Absolute (%) | -12.3 | -11.5 | -12.2 |
| Relative (%) | -14.0 | -16.5 | -11.7 |

| | 2015 | 2016E | 2017F | 2018F |
|---------------------|-------|-------|-------|-------|
| Sales | 2,161 | 2,317 | 2,575 | 2,729 |
| Chg | 7.3 | 7.2 | 11.1 | 6.0 |
| OP | 463 | 337 | 519 | 571 |
| OPM | 21.4 | 14.6 | 20.2 | 20.9 |
| NP to parent | 349 | 250 | 387 | 425 |
| EPS | 4,531 | 3,242 | 5,022 | 5,505 |
| Chg | 43.8 | -28.5 | 54.9 | 9.6 |
| P/E | 18.6 | 26.5 | 17.1 | 15.6 |
| P/B | 5.1 | 4.8 | 4.3 | 3.9 |
| EV/EBITDA | 9.6 | 13.1 | 9.3 | 8.5 |
| ROE | 30.0 | 18.9 | 26.6 | 26.1 |
| Debt/equity | 37.3 | 36.3 | 34.6 | 31.1 |
| Net debt | -16 | -84 | -169 | -308 |

Units: W/bn, %, won, x

Note: EPS, P/E, P/B, and ROE based on net profit (excl minority interests)

Source: NH I&S Research Center estimates



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2Q16 review

(Units: Wbn, %)

| | 2Q15 | 3Q15 | 4Q15 | 1Q16 | 2Q16P | | | | | 3Q16E |
|--------------------------------------|-------|-------|-------|-------|--------|-------|-------|-----------|--------|-------|
| | | | | | Actual | y-y | q-q | Estimates | Consen | |
| Sales | 527.5 | 545.7 | 582.1 | 577.6 | 523.0 | -0.9 | -9.5 | 590.1 | 626 | 591.6 |
| Operating profit | 111.7 | 125.6 | 126.8 | 126.9 | 21.4 | -80.9 | 2.5 | 130.9 | 112 | 99.1 |
| <i>Operating margin</i> | 21.2 | 23.0 | 21.8 | 22.0 | 4.1 | | | 22.2 | 17.9 | 16.8 |
| Pre-tax profit | 111.4 | 131.6 | 119.4 | 121.8 | 18.0 | -83.8 | -85.2 | 132.9 | 101 | 58.2 |
| Net profit (excl minority interests) | 85.0 | 100.4 | 88.9 | 92.2 | 12.3 | -85.6 | -86.7 | 100.8 | 88 | 40.1 |

Note: IFRS non-consolidated; Source: Coway, FnGuide, NH I&S Research Center estimates

Earnings forecasts (IFRS non-consolidated)

(Units: Wbn, won, x, %)

| | | 2015 | 2016E | 2017F | 2018F |
|--------------------------------------|------------|---------|---------|---------|---------|
| Sales | - Revised | 2,161.3 | 2,317.2 | 2,575.4 | 2,729.0 |
| | - Previous | - | 2,397.3 | 2,557.8 | 2,710.1 |
| | - Change | - | -3.3 | 0.7 | 0.7 |
| Operating profit | - Revised | 463.0 | 337.2 | 519.2 | 570.9 |
| | - Previous | - | 541.5 | 569.1 | 637.6 |
| | - Change | - | -37.7 | -8.8 | -10.5 |
| <i>Operating margin</i> | - Revised | 21.4 | 14.6 | 20.2 | 20.9 |
| EBITDA | | 674.7 | 500.1 | 692.2 | 739.9 |
| Net profit (excl minority interests) | | 349.4 | 250.0 | 387.3 | 424.6 |
| EPS | - Revised | 4,531 | 3,242 | 5,022 | 5,505 |
| | - Previous | - | 5,251 | 5,505 | 6,145 |
| | - Change | - | -38.3 | -8.8 | -10.4 |
| P/E | | 18.6 | 26.5 | 17.1 | 15.6 |
| P/B | | 5.1 | 4.8 | 4.3 | 3.9 |
| EV/EBITDA | | 9.6 | 13.1 | 9.3 | 8.5 |
| ROE | | 30.0 | 18.9 | 26.6 | 26.1 |

Source: NH I&S Research Center estimates

Quarterly earnings forecasts

(Units: Wbn, %)

| | 1Q15 | 2Q15 | 3Q15 | 4Q15 | 1Q16 | 2Q16P | 3Q16E | 4Q16F | 2015 | 2016E | 2017F |
|-------------------------------|------------|------------|-------------|-------------|-------------|-------------|------------|------------|--------------|--------------|--------------|
| Sales | 506 | 527 | 546 | 582 | 578 | 523 | 592 | 625 | 2,161 | 2,317 | 2,575 |
| Rental | 363 | 371 | 376 | 380 | 380 | 316 | 382 | 379 | 1,491 | 1,458 | 1,580 |
| Membership fees | 30 | 41 | 49 | 50 | 46 | 54 | 51 | 52 | 171 | 203 | 218 |
| Lump-sum revenue | 30 | 41 | 46 | 54 | 50 | 54 | 48 | 57 | 171 | 209 | 216 |
| Exports | 33 | 29 | 36 | 41 | 57 | 60 | 61 | 68 | 139 | 246 | 313 |
| Cosmetics | 23 | 21 | 19 | 20 | 20 | 17 | 19 | 21 | 83 | 77 | 79 |
| Financial leases (mattresses) | | | 15 | 26 | 21 | 29 | 21 | 31 | 41 | 102 | 133 |
| Other | 11 | 9 | 10 | 16 | 6 | 5 | 10 | 16 | 46 | 36 | 36 |
| Sales growth (y-y, %) | 2.7 | 0.8 | 10.0 | 16.5 | 14.1 | -0.9 | 8.4 | 7.4 | 7.3 | 7.2 | 11.1 |
| Rental | 6.1 | 7.0 | 6.7 | 6.0 | 4.6 | -14.8 | 1.5 | -0.2 | 6.5 | -2.2 | 8.4 |
| Membership fees | -31.7 | -9.5 | 4.5 | 7.0 | 52.0 | 30.6 | 4.2 | 3.6 | -7.0 | 18.8 | 7.6 |
| Lump-sum revenue | 16.4 | 10.7 | 43.5 | 102.9 | 68.2 | 30.6 | 5.0 | 5.0 | 40.7 | 22.3 | 3.0 |
| Exports | -27.0 | -48.0 | 8.5 | 23.9 | 71.8 | 106.2 | 70.0 | 65.0 | -16.8 | 76.5 | 27.5 |
| Cosmetics | 10.5 | -5.3 | 8.3 | 1.1 | -13.1 | -17.9 | 3.0 | 3.0 | | -6.8 | 1.5 |
| Financial leases (mattresses) | | | | | | | 40.0 | 20.0 | | 149.7 | 30.0 |
| Other | -28.2 | -38.6 | -31.7 | 18.1 | -45.3 | -52.1 | 0.0 | 0.0 | -21.0 | -21.1 | 0.0 |
| Gross profit | 347 | 361 | 377 | 397 | 387 | 330 | 376 | 387 | 1,482 | 1,467 | 1,588 |
| Gross margin | 68.5 | 68.4 | 69.1 | 68.3 | 67.0 | 63.2 | 63.5 | 61.9 | 68.6 | 63.3 | 61.7 |
| Operating profit | 99 | 112 | 126 | 127 | 127 | 21 | 99 | 103 | 463 | 337 | 519 |
| Growth (y-y, %) | 10.2 | 14.4 | 29.5 | 36.1 | 28.3 | -80.9 | -21.0 | -18.9 | 22.6 | -27.2 | 54.0 |
| Operating margin | 19.5 | 21.2 | 23.0 | 21.8 | 22.0 | 4.1 | 16.8 | 16.5 | 21.4 | 14.6 | 20.2 |

Source: Coway, NH I&S Research Center estimates

Financial impact of ice-making water purifier scandal on Coway's 2Q16 earnings: Firm recalled three ice-making water purifier models

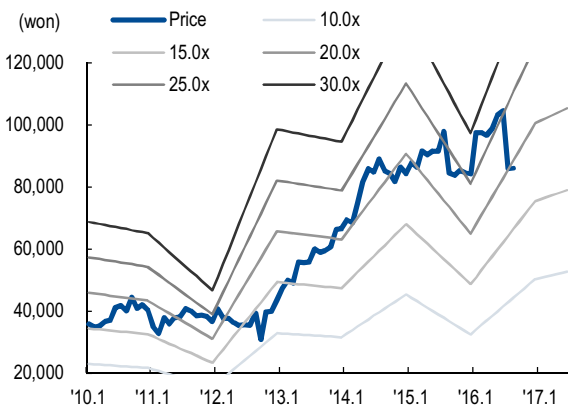
(Unit: Wbn)

| | | |
|-------------------------------|--------------|--|
| Operating impacts | 122.1 | |
| Sales | 67.9 | Refund costs for 106,152 recalled water purifiers |
| COGS | 4.6 | Set aside allowances for asset disposal expenses (W3.2bn) and installation fees (W1.5bn) |
| SG&A expenses | 49.6 | Rental asset disposal costs (W30.1bn); established allowances of W19.5bn for sales commissions, paid commissions, and service outsourcing fees |
| Non-operating expenses | 2.9 | Mold disposal expenses due to discontinuation of three water purifier models |
| Total one-off expenses | 125.0 | |

Note: From the above items, accelerated future costs booked in 2Q16 totaled W39bn (rental asset disposal expenses of W30.1bn; installation commissions of W1.5bn; sales commissions of W7.4bn); if excluding these future costs, net one-off expense amounts came to W83.1bn (excluding non-operating expenses)

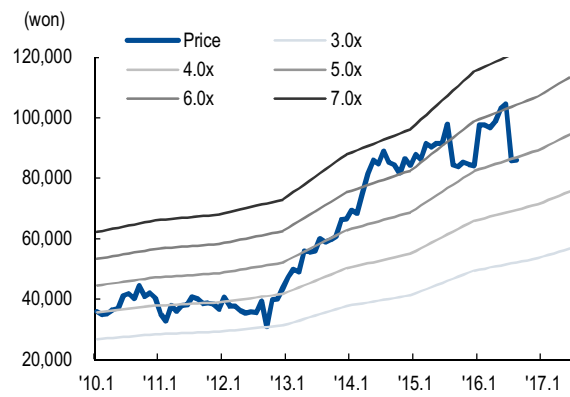
Source: Coway, NH I&S Research Center

Forward P/E band



Source: DataGuide Pro

Trailing P/B band



Source: DataGuide Pro

STATEMENT OF COMPREHENSIVE INCOME

| (Wbn) | 2015/12A | 2016/12E | 2017/12F | 2018/12F |
|---|----------|----------|----------|----------|
| Sales | 2,161 | 2,317 | 2,575 | 2,729 |
| <i>Growth (%)</i> | 7.3 | 7.2 | 11.1 | 6.0 |
| COGS | 679 | 850 | 987 | 1,053 |
| Gross Profit | 1,482 | 1,467 | 1,588 | 1,676 |
| <i>Gross margin (%)</i> | 68.6 | 63.3 | 61.7 | 61.4 |
| SG&A | 1,019 | 1,130 | 1,069 | 1,105 |
| Operating Income | 463 | 337 | 519 | 571 |
| <i>Growth (%)</i> | 22.6 | -27.2 | 54.0 | 10.0 |
| <i>Operating margin (%)</i> | 21.4 | 14.6 | 20.2 | 20.9 |
| EBITDA | 675 | 500 | 692 | 740 |
| Non-Operating Profit | -2 | 3 | 8 | 7 |
| Financial Income(Costs) | -3 | -1 | 0 | 1 |
| Other Non-Operating Profit | 1 | -6 | 0 | 0 |
| Gains(Losses) in Associates, Subsidiaries and JVs | 0 | 10 | 8 | 6 |
| Pre-tax Profit from Cont. Op. | 461 | 340 | 527 | 578 |
| Income Taxes | 111 | 90 | 140 | 153 |
| Profit from Continuing Op. | 349 | 250 | 387 | 425 |
| Net Profit | 349 | 250 | 387 | 425 |
| <i>Growth (%)</i> | 43.8 | -28.5 | 54.9 | 9.6 |
| <i>Net margin (%)</i> | 16.2 | 10.8 | 15.0 | 15.6 |
| Net Profit of Parent | 349 | 250 | 387 | 425 |
| Net Profit to Non-Controlling | 0 | 0 | 0 | 0 |
| Other Comprehensive Income | -4 | 0 | 0 | 0 |
| Total Comprehensive Income | 346 | 250 | 387 | 425 |

Valuation / Profitability / Stability

| | 2015/12A | 2016/12E | 2017/12F | 2018/12F |
|------------------------------|----------|----------|----------|----------|
| Price/ Earnings (x) | 18.6 | 26.5 | 17.1 | 15.6 |
| Price/ Book Value (x) | 5.1 | 4.8 | 4.3 | 3.9 |
| Price/ Gross Cash Flow (x) | 8.4 | 13.1 | 9.5 | 8.9 |
| Price/ Sales (x) | 3.0 | 2.9 | 2.6 | 2.4 |
| EV/ EBITDA (x) | 9.6 | 13.1 | 9.3 | 8.5 |
| EV/ EBIT (x) | 14.0 | 19.4 | 12.4 | 11.1 |
| Fully diluted EPS (won) | 4,531 | 3,242 | 5,022 | 5,505 |
| BVPS (won) | 16,459 | 17,824 | 19,938 | 22,256 |
| Sales PS (won) | 28,023 | 30,044 | 33,393 | 35,385 |
| ROE (%) | 30.0 | 18.9 | 26.6 | 26.1 |
| ROA (%) | 21.1 | 13.8 | 19.6 | 19.7 |
| ROIC (%) | 32.5 | 21.2 | 31.0 | 32.6 |
| Dividend Yield (%) | 3.3 | 2.3 | 3.5 | 3.8 |
| Payout Ratio (%) | 59.5 | 57.9 | 57.9 | 57.9 |
| Total Cash Dividend (Wbn) | 208 | 145 | 224 | 246 |
| Cash DPS (won) | 2,800 | 1,945 | 3,013 | 3,303 |
| Net debt(cash)/ equity (%) | -1.2 | -6.1 | -11.0 | -17.9 |
| Debt/ equity (%) | 37.3 | 36.3 | 34.6 | 31.1 |
| Interest-Bearing Debts (Wbn) | 90 | 96 | 102 | 109 |
| Current Ratio (%) | 156.1 | 166.2 | 188.8 | 230.3 |
| Total shares (mn) | 77 | 77 | 77 | 77 |
| Par value (won) | 500 | 500 | 500 | 500 |
| Share price (won) | 84,100 | 85,900 | 85,900 | 85,900 |
| Market Cap (Wbn) | 6,486 | 6,625 | 6,625 | 6,625 |

STATEMENT OF FINANCIAL POSITION

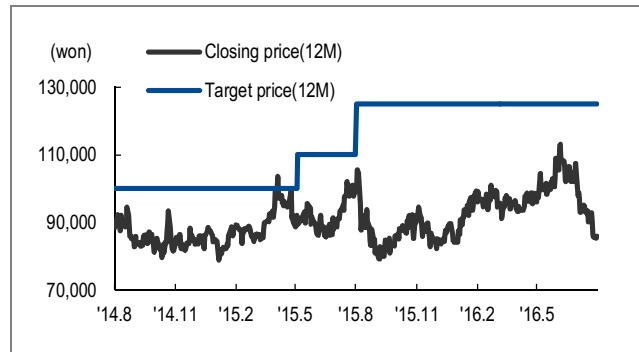
| (Wbn) | 2015/12A | 2016/12E | 2017/12F | 2018/12F |
|----------------------------------|----------|----------|----------|----------|
| Cash and Cash Equivalents | 87 | 160 | 250 | 395 |
| Accounts Receivables | 354 | 336 | 374 | 396 |
| Total Current Assets | 658 | 739 | 895 | 1,089 |
| Tangible Assets | 625 | 636 | 675 | 660 |
| Investment Assets | 122 | 126 | 130 | 134 |
| Non-Current Assets | 1,084 | 1,134 | 1,174 | 1,162 |
| Assets | 1,742 | 1,874 | 2,070 | 2,250 |
| Short-Term Debt | 80 | 86 | 92 | 99 |
| Account Payables | 48 | 50 | 53 | 52 |
| Current Liabilities | 422 | 445 | 474 | 473 |
| Long-Term Debt | 10 | 10 | 10 | 10 |
| Long-Term Allowance | 13 | 14 | 15 | 16 |
| Non-Current Liabilities | 51 | 54 | 58 | 61 |
| Liabilities | 473 | 499 | 532 | 534 |
| Capital Stock | 41 | 41 | 41 | 41 |
| Capital Surplus | 132 | 132 | 132 | 132 |
| Retained Earnings | 1,199 | 1,305 | 1,468 | 1,646 |
| Non-Controlling Interests Equity | 0 | 0 | 0 | 0 |
| Shareholders' Equity | 1,269 | 1,375 | 1,538 | 1,716 |

CASH FLOW STATEMENT

| (Wbn) | 2015/12A | 2016/12E | 2017/12F | 2018/12F |
|------------------------------------|----------|----------|----------|----------|
| Operating Cash Flow | 475 | 491 | 442 | 519 |
| Net Profit | 349 | 250 | 387 | 425 |
| Depreciation & Amortization | 212 | 163 | 173 | 169 |
| + Loss(Gains) from Subs | 0 | 0 | 0 | 0 |
| + FC translation loss(profit) | -6 | 0 | 0 | 0 |
| Gross Cash Flow | 771 | 504 | 700 | 746 |
| - Incr. (Decr.) in WC | -214 | 77 | -118 | -74 |
| Investing Cash Flow | -264 | -212 | -211 | -153 |
| + Decr. In Tangible Assets | 9 | 0 | 0 | 0 |
| - Incr. In Tangible Assets (capex) | -271 | -171 | -209 | -152 |
| + Disp.(Acq.) of Inv. Assets | 1 | -4 | -4 | -4 |
| Free Cash Flow | 205 | 320 | 233 | 367 |
| Net Cash Flow | 211 | 278 | 231 | 365 |
| Financing Cash Flow | -230 | -205 | -141 | -220 |
| Equity Financing | 1 | 0 | 0 | 0 |
| Debt Financing | -231 | -205 | -141 | -220 |
| Incr.(Decr.) in Cash | -19 | 74 | 90 | 145 |
| Ending Cash and Cash Equivalents | 87 | 160 | 250 | 395 |
| Net Debt (Cash) | -16 | -84 | -169 | -308 |

Rating and target price update

| Company | Code | Date | Rating | Target price |
|---------|-----------|------------|--------|---------------|
| Coway | 021240.KS | 2015.08.05 | Buy | W125,000(12M) |
| | | 2015.05.07 | Buy | W110,000(12M) |
| | | 2014.04.22 | Buy | W100,000(12M) |



NH Investment & Securities stock ratings

1. Rating based on a stock's forecasted absolute return over a period of 12 months from the date of publication.

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- Hold : -15% to +15%
- Sell : Less than -15%

2. Regarding listed companies under NH I&S' coverage, our stock ratings break down as follows (as of Jul 29, 2016).

- NH I&S' stock rating distribution

| Buy | Hold | Sell |
|-------|-------|------|
| 78.3% | 21.7% | 0.0% |

- The stock rating on an individual company can change at irregular intervals. Our stock rating distribution is calculated on a weekly basis.

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- The analyst and his/her spouse do not own any securities of Coway as of the preparation date.
- This report correctly reflects the analyst's opinion and was written without any external influence or intervention.

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