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Company Update



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Coway (021240)

Nickel-scandal concerns easing

- A government fact-finding committee on Sep 12 announced the findings of its investigation into Coway's water purifiers, some of which dispensed nickel-tainted water. The market has been keen to know whether these machines might have been harmful to human health. The government committee concluded that the chances of such were low.
- As the committee's conclusions suggest Coway is almost certain to avoid further massive costs, we believe the firm's recent share-price rebound is justified.
- Although the risk of large cuts to earnings forecasts has dissipated, it should take some time for operations to normalize, boding ill for results in 2H. We expect operations to normalize from early 2017 and thus recommend investors accumulate shares. We maintain BUY on the stock and reiterate our 12-month target price of KRW135,000.

WHAT'S THE STORY?

Government findings quash chances of more nickel scandal-related costs: A fact-finding committee—comprising officials from the Ministry of Trade, Industry and Energy, the Ministry of Environment, the Korea Food and Drug Administration, and experts from consumer advocacy groups, academia, and private research institutions—on Sep 12 announced the conclusions of its probe into what caused defects in some of Coway's water purifiers and what damage tainted water might have had on human health.

- **Defect-related costs recognized in 2Q:** The committee pointed to design and manufacturing defects as the cause of the problem and ordered Coway to recall all the products in question. Coway had already recalled all affected products in July and recognized related costs fully in 2Q results. So far, 96% of affected products have been recalled.

(Continued on the next page)

AT A GLANCE

SELL HOLD BUY

Target price KRW135,000 (47.9%)

Current price KRW91,300

Market cap	KRW7.0t/USD6.4b
Shares (float)	77,124,796 (65.4%)
52-week high/low	KRW113,000/KRW80,000
Avg daily trading value (60-day)	KRW25.1b/ USD22.9m

ONE-YEAR PERFORMANCE

	1M	6M	12M
Coway (%)	2.8	-4.5	10.3
Vs Kospi (%pts)	3.1	-8.5	4.7

KEY CHANGES

(KRW)	New	Old	Diff
Recommend.	BUY	BUY	
Target price	135,000	135,000	0.0%
2016E EPS	3,057	3,153	-3.0%
2017E EPS	5,110	5,116	-0.1%

SAMSUNG vs THE STREET

No of estimates	13
Target price	112,000
Recommendation	3.6

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

SUMMARY FINANCIAL DATA

	2015	2016E	2017E	2018E
Revenue (KRWb)	2,315	2,421	2,609	2,821
Net profit (adj) (KRWb)	343	233	391	427
EPS (adj) (KRW)	4,492	3,057	5,110	5,578
EPS (adj) growth (% y-y)	39.3	(31.9)	67.1	9.2
EBITDA margin (%)	29.8	22.9	30.2	30.5
ROE (%)	30.1	18.6	28.6	27.3
P/E (adj) (x)	20.3	29.9	17.9	16.4
P/B (x)	5.9	5.8	4.9	4.4
EV/EBITDA (x)	10.2	12.8	8.8	8.0
Dividend yield (%)	3.1	2.7	3.5	3.8

Source: Company data, Samsung Securities estimates

- **Health-related compensation costs to be minimal:** After looking at the levels of nickel found in the purifiers and the possible effects on their health, the committee concluded that there is little risk to the affected customers. According to World Health Organization guidance, a nickel-hypersensitive adult who drank two liters of nickel-tainted water every day for their whole life (70 years) would be at risk. The customers affected by Coway's defective machines, however, were exposed for less than two years. Of note, the US Environmental Protection Agency says drinking water containing nickel at a concentration of less than 0.5mg/L is safe for children for as long as 7 years. Of 1,010 Coway purifiers tested, the water with the highest concentration of nickel was below this level. The company has said that it will operate a call center offering health advice to affected customers and partially support the costs of treating dermatitis that occurred among affected customers. The related costs, however, should not be enough to undermine the firm's fundamentals.

Operations to normalize in 2017, but lower anticipation for 2H16 earnings: We forecast that Coway's sales will grow 2.5% y-y to KRW1.25t in 2H and operating profit fall 27% y-y to KRW183.4b, a respective 1% and 14% below consensus, as we remain conservative on the timing of business normalization, the firm's scandal-caused cancellation ratio, and other costs. Looking to 2017, however, we expect sales and operating profit to grow 8% and 66% y-y, respectively, to KRW2.61t and KRW530b (for a margin of 20.3%), the former 1% below consensus and the latter 4% above. Coway's aggressive moves to compensate consumers should benefit operations in 2017.

Maintaining Buy rating and target price: Despite the nickel scandal resulting in large costs and deterioration of operations in 2016, we maintain our 12-month target price for Coway at KRW135,000 (equivalent to 26.5x 2017 P/E and based on a DCF valuation that assumes a WACC of 5.9% and terminal growth of 0.5%), believing the firm's long-term growth and cashflow trends remain intact. We expect operations to normalize from early 2017 after the firm's aggressive responses to the nickel scandal, which has minimized brand-equity erosion. Notably, roughly 80% of affected customers opted for replacement models over cancellation. We also expect the environmental appliance market to enjoy long-term growth, benefiting the company. Furthermore, Coway's businesses overseas—including in China—enjoy full-blown growth from 2017, leading to a rerating of the firm's enterprise value. In sum, we reiterate BUY on the stock and advise investors to use any share-price corrections in 2H (caused by weak earnings) as an opportunity to accumulate.

Results and forecasts

	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16E	4Q16E	2015P	2016E	2017E	2018E
Earnings summary												
(KRWb)												
Sales	548.2	555.3	580.4	631.3	623.7	555.0	605.2	636.6	2,315.2	2,420.6	2,608.6	2,821.2
Gross profit	373.0	384.7	402.3	426.4	416.6	355.9	404.2	423.3	1,586.4	1,600.0	1,786.9	1,932.5
Operating profit	100.3	110.5	123.9	128.6	123.6	11.8	71.1	112.4	463.3	318.9	530.0	576.4
Pre-tax profit	101.1	108.9	121.7	122.7	125.3	5.2	69.4	110.7	454.5	310.5	521.6	569.8
Net profit	77.6	82.7	92.4	90.5	95.2	2.8	52.3	82.6	343.1	232.9	391.2	427.3
Margins (%)												
Gross profit	68.0	69.3	69.3	67.5	66.8	64.1	66.8	66.5	68.5	66.1	68.5	68.5
Operating profit	18.3	19.9	21.4	20.4	19.8	2.1	11.7	17.6	20.0	13.2	20.3	20.4
Pre-tax profit	18.4	19.6	21.0	19.4	20.1	0.9	11.5	17.4	19.6	12.8	20.0	20.2
Net profit	14.1	14.9	15.9	14.3	15.3	0.5	8.6	13.0	14.8	9.6	15.0	15.1
Chg (% y-y)												
Sales	2.5	(0.3)	10.4	16.3	13.8	(0.1)	4.3	0.8	7.2	4.6	7.8	8.1
Gross profit	5.8	4.3	12.6	20.2	11.7	(7.5)	0.5	(0.7)	10.6	0.9	11.7	8.1
Operating profit	11.1	13.7	30.1	57.4	23.2	(89.3)	(42.6)	(12.6)	27.1	(31.2)	66.2	8.7
Pre-tax profit	14.3	25.9	41.6	71.5	23.9	(95.2)	(43.0)	(9.8)	36.7	(31.7)	68.0	9.2
Net profit	17.4	24.8	44.5	69.6	22.7	(96.6)	(43.3)	(8.7)	37.4	(32.1)	68.0	9.2
Chg (% q-q)												
Sales	1.0	1.3	4.5	8.8	(1.2)	(11.0)	9.0	5.2				
Gross profit	5.2	3.1	4.6	6.0	(2.3)	(14.6)	13.6	4.7				
Operating profit	22.8	10.1	12.2	3.8	(3.9)	(90.4)	500.8	58.1				
Pre-tax profit	41.3	7.8	11.7	0.8	2.1	(95.8)	1,226.0	59.5				
Net profit	45.4	6.6	11.7	(2.0)	5.2	(97.1)	1,786.6	57.8				
Sales breakdown												
Household electronics	439.3	457.9	481.3	504.3	495.0	441.4	494.9	499.3	1,882.9	1,930.5	2,035.3	2,158.6
Outright sales	30.0	41.4	45.6	54.2	50.5	54.1	50.1	51.6	171.2	206.3	236.2	269.2
Rental	363.3	371.2	376.4	380.2	380.1	316.2	376.4	382.7	1,491.1	1,455.4	1,500.9	1,565.6
Membership	46.0	45.4	44.5	43.7	42.9	42.5	43.2	42.1	179.6	170.7	170.7	170.7
Financial lease			14.8	26.1	21.5	28.6	25.2	22.9	40.9	98.2	127.7	153.2
Exports	33.0	39.0	35.8	41.4	56.7	59.8	50.1	49.8	149.3	216.5	270.6	324.7
Cosmetics	23.1	21.1	18.6	20.2	20.1	17.3	15.8	17.4	83.1	70.6	77.7	85.4
Other (water treatment)	10.6	9.4	10.0	16.1	5.8	4.5	8.0	18.6	46.1	36.9	36.9	36.9
Consolidated other	42.1	27.9	34.7	49.3	46.1	32.1	36.4	51.6	194.9	166.1	188.2	215.6
Chg (% y-y)												
Household electronics	6.2	6.5	11.6	16.6	12.7	(3.6)	2.8	(1.0)	10.3	2.5	5.4	6.1
Outright sales	8.8	10.7	43.5	102.9	68.2	30.6	10.0	(4.8)	38.6	20.5	14.5	14.0
Rental	6.1	7.0	6.7	6.0	4.6	(14.8)	0.0	0.6	6.5	(2.4)	3.1	4.3
Membership	4.9	(0.8)	(5.0)	(6.7)	(6.8)	(6.4)	(3.0)	(3.7)	(2.0)	(5.0)	0.0	0.0
Financial lease							70.0	(12.2)		140.0	30.0	20.0
Exports	(27.0)	(30.0)	8.5	23.9	71.8	53.3	40.0	20.1	(10.8)	45.0	25.0	20.0
Cosmetics	10.5	(5.3)	8.3	1.1	(13.1)	(17.9)	(15.0)	(14.2)	3.3	(15.0)	10.0	10.0
Other (water treatment)	(28.2)	(38.6)	(31.7)	18.1	(45.3)	(52.1)	(20.0)	15.6	(21.0)	(20.0)	0.0	0.0
Consolidated other	4.7	(17.1)	17.7	13.6	9.4	15.1	5.0	4.7	32.9	(14.7)	13.3	14.5
Portion of total sales (%)												
Household electronics	80.1	82.5	82.9	79.9	79.4	79.5	81.8	78.4	79.9	79.8	78.0	76.5
Outright sales	5.5	7.5	7.9	8.6	8.1	9.7	8.3	8.1	7.3	8.5	9.1	9.5
Rental	66.3	66.8	64.9	60.2	60.9	57.0	62.2	60.1	63.3	60.1	57.5	55.5
Membership	8.4	8.2	7.7	6.9	6.9	7.7	7.1	6.6	7.6	7.1	6.5	6.0
Financial lease			2.6	4.1	3.4	5.2	4.2	3.6	1.7	4.1	4.9	5.4
Exports	6.0	7.0	6.2	6.6	9.1	10.8	8.3	7.8	6.3	8.9	10.4	11.5
Cosmetics	4.2	3.8	3.2	3.2	3.2	3.1	2.6	2.7	3.5	2.9	3.0	3.0
Other (water treatment)	1.9	1.7	1.7	2.5	0.9	0.8	1.3	2.9	2.0	1.5	1.4	1.3
Consolidated other	7.7	5.0	6.0	7.8	7.4	5.8	6.0	8.1	8.3	6.9	7.2	7.6

Source: Company data, Samsung Securities estimates

Accounts overview

('000)	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16
Number of accounts										
Total	5,469	5,539	5,571	5,617	5,661	5,714	5,730	5,771	5,794	5,846
Chg (% y-y)	3.5	3.2	2.8	2.8	3.5	3.2	2.8	2.8	2.4	2.3
Rental account	4,455	4,487	4,538	4,601	4,666	4,747	4,780	4,832	4,861	4,921
Chg (% y-y)	(2.0)	(8.1)	(8.1)	(7.6)	4.7	5.8	5.3	5.0	4.2	3.7
Membership	1,014	1,052	1,034	1,016	994	967	950	939	933	924
Chg (% y-y)	7.5	(0.1)	8.7	8.4	(2.0)	(8.1)	(8.1)	(7.6)	(6.2)	(4.4)
Rental cancellations	129	139	130	130	134	143	151	138	146	148
Monthly churn (%)	0.1	1.3	21.5	95.9	3.2	2.7	16.2	6.9	9.1	4.0
Rental account additions	317	371	311	332	341	371	338	359	351	385
Chg (% y-y)	1.0	1.0	1.1	1.0	7.5	(0.1)	8.7	8.4	2.9	3.7
Outright sales account additions	40	60	52	32	40	60	63	63	66	68
Chg (% y-y)	4.7	5.8	5.3	5.0	0.1	1.3	21.5	95.9	67.2	12.2

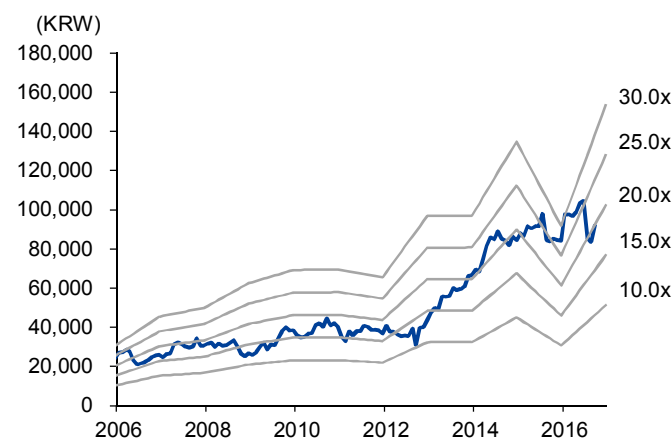
Source: Company data, Samsung Securities estimates

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	28.3	8.1	28.4	13.2	83
2014	2,160	364	332	250	3,225	0.1	28.3	7.1	25.2	12.2	12
2015	2,315	463	454	343	4,492	39.3	20.3	5.9	30.1	10.2	(38)
2016E	2,421	319	311	233	3,057	(31.9)	29.9	5.8	18.6	12.8	30
2017E	2,609	530	522	391	5,110	67.1	17.9	4.9	28.6	8.8	(81)
2018E	2,821	576	570	427	5,578	9.2	16.4	4.4	27.3	8.0	(200)

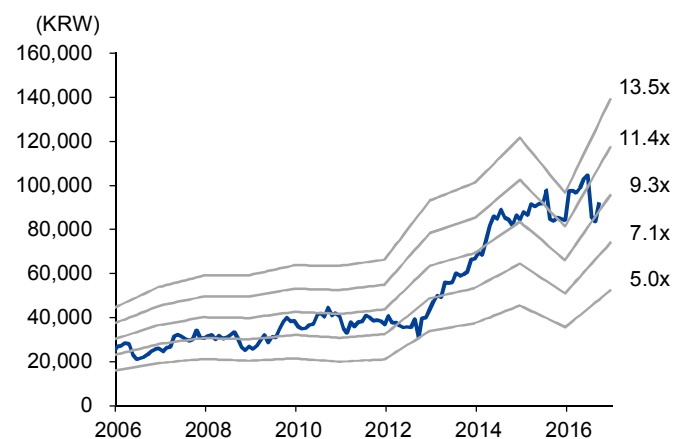
Source: Company data, Samsung Securities estimates

Forward P/E



Source: Company data, Samsung Securities estimates

Forward EV/EBITDA

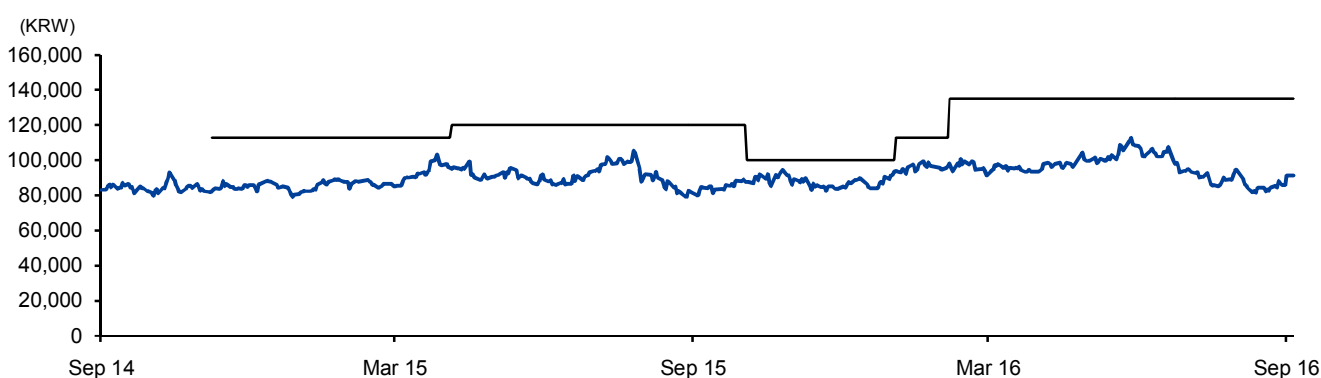


Source: Company data, Samsung Securities estimates

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Target price changes in past two years



Rating changes in past two years

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

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BUY★★★	Expected to increase in value by 30% or more within 12 months and is highly attractive within sector
BUY	Expected to increase in value by 10% or more within 12 months
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SELL★★★	Expected to decrease in value by 30% or more within 12 months

Industry

OVERWEIGHT	Expected to outperform market by 5% or more within 12 months
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UNDERWEIGHT	Expected to underperform market by 5% or more within 12 months

Percentage of ratings in 12 months prior to Jun 30, 2016

BUY (71.2%) | HOLD (28.8%) | SELL (0%)

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