Korea Investment
& Securities Co., Ltd.

true friend

Daelim Ind. (000210)

Company Brief / Construction

August 2, 2013

12M rating	**BUY (Maintain)**
12M TP	**W121,000**
Up/downside	**+35%**

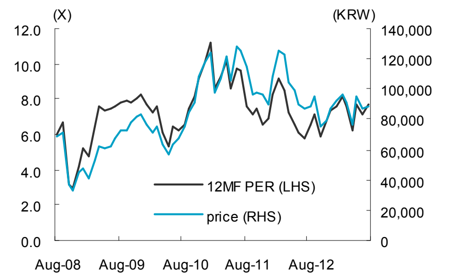
Stock Data

KOSPI (Aug 1, pt)	1,921
Stock price (Aug 1, KRW)	89,900
Market cap (USD mn)	2,785
Shares outstanding (mn)	35
52-Week high/low (KRW)	102,000/67,600
6M avg. daily turnover (USD mn)	21.4
Free float / Foreign ownership (%)	76.0/41.1
Major shareholders (%)	
DaeLim Corporation and 9 others	24.0
National Pension Service (NPS)	8.9

Performance

	1M	6M	12M
Absolute (%)	4.2	(2.3)	1.6
Relative to KOSPI (%p)	0.7	(0.4)	(0.6)

12MF PER trend



Source: WISEfn consensus

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Unmatched competitiveness

Value chain completed from in-house design to operation

Recently, Chinese firms have won most large-scale power plant packages in Algeria and the sweeping order-taking sounds an alarm. Although Chinese engineering, procurement and construction (EPC) players' presence is now minimal in the Middle East and the ASEAN regions, Korean builders must guard against multifaceted competition from China in the long-term. We find the so-called "economic moats" that protect the builders' power business against competition in their in-house design and operation abilities. Korean builders have expanded the value chains from EPC to financing in independent power projects (IPP). But most of the builders have outsourced operation with some covering only the detailed design. But Daelim Industrial (Daelim) is different. Pocheon Power, Korea's largest LNG IPP in which Daelim directly raised W1.2tn in project financing (unprecedented for Korean builders) will be on-stream in 2014. Pocheon Power will complete Daelim's power value chain as the company covers all stages from project financing to in-house design and operation.

Pocheon Power's superior cost advantage

Pocheon Power boasts a superior cost advantage as it 1) has a low transmission loss factor given its proximity to Seoul and the surrounding region, 2) is a very large IPP by capacity and 3) uses J-type turbines, the latest model released by Mitsubishi Heavy Industries (MHI). Even assuming an electricity price of W140/kWh (W150 at present based on Cost Based Power market), we estimate Pocheon Power's 2015F EBITDA at W174bn, which translates to a 4% increase in Daelim's EBT. If Pocheon Power operates for 30 years, the net present value (NPV) of Pocheon Power owned by Daelim would reach W216bn. Given that payments are settled monthly in the power generation business, Pocheon Power is an important cash cow that helps increase liquidity for Daelim.

Unmatched competitiveness, still our top pick

The Philippines' Petron refinery project is lucrative because Daelim is in charge of operations in addition to EPC services. The technology-based company has begun to apply its total solution to the power generation business as well. The builder could flaunt its capacity in emerging markets that require operational services due to abundant private contracts and present weak systems. The firm is growing its market share in ASEAN (e.g., a recently won Malaysian IPP project worth W1.3tn) because it is protected by unmatched competitiveness such as own designs and operations that cannot be easily copied. We maintain a SotP-based TP of W121,000.

	2011A	2012A	2013F	2014F	2015F
Sales (W bn)	7,988	10,253	11,053	11,448	12,435
OP (W bn)	437	486	553	637	740
EBT (W bn)	519	560	583	674	849
NP of con. int. (W bn)	366	391	431	498	628
EBITDA (W bn)	492	548	614	696	796
Net debt (W bn)	285	(418)	51	(17)	(133)
OP margin (%)	5.5	4.7	5.0	5.6	6.0
ROE (%)	8.5	8.5	8.7	9.2	10.6
Dividend yield (%)	0.1	0.6	0.6	0.6	0.6
EPS (KRW)	9,469	10,128	11,200	12,934	16,305
chg. (% YoY)	9.6	7.0	10.6	15.5	26.1
BPS (KRW)	114,427	123,800	133,977	145,883	161,151
DPS (KRW)	100	500	500	500	500
PER (x)	9.5	8.6	7.9	6.9	5.5
PBR (x)	0.8	0.7	0.7	0.6	0.6
EV/EBITDA (x)	7.6	5.2	5.5	4.8	4.1

Still top pick with TP W121,000

We continue to mark Daelim as our top pick. From the long-term perspective, we view the current valuation (7.4x PE) as a good entry point given its focus on the power business as a future growth driver. In this report, we provided analysis of Daelim's competitiveness in the power market by thoroughly examining the Pocheon IPP project, in which Daelim has 33% equity interest.

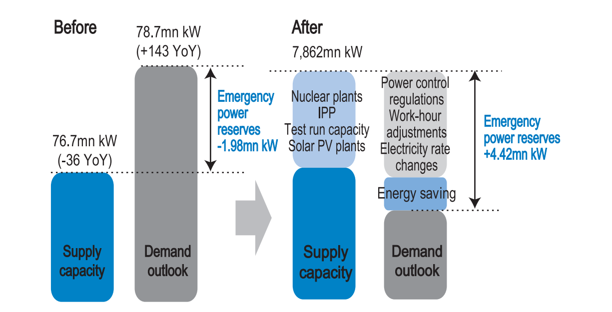
Table 1. TP W121,000 (W bn)

	Value	Note
1) Operation value	**4,190**	
Construction	**3,839**	
NOPLAT	384	12MF
Target PE	10.0	Market PE
Petrochemicals	350	
NOPLAT	58	12MF
Target PE	6.0	6x
2) Investment securities	**80**	
Construction subsidiaries	(220)	40% loss provisioning for Samho's unstarted construction project
YNCC	300	6x 12MF PE
3) Net debt	**51**	2013F
Shareholders' value (1+2-3)	4,218	
Outstanding shares ('000)	34,800	
Fair value per share (KRW)	**121,000**	

Source: Company data, Korea Investment & Securities

In Korea, there was a large-scale brownout in summer 2011 and the power supply constraints continue in 2013 in relation to the bribery scandal involving nuclear plant construction contracts. The number of malfunction reports for power generators increased from 113 in 2010 to 161 in 2012. The government's solutions are narrowed down in two ways. 1) Demand side: Encouraging higher indoor temperatures, and from the design stage on, requiring the use of energy-efficient construction materials. 2) Supply side: Improving the power supply conditions with the energy storage system (ESS) and expanding IPP.

Figure 1. Government's power supply plans



Source: Korea Investment & Securities

Pocheon IPP, an incubator for energy business

Korean construction companies have made lengthy efforts to advance on the IPP market and in particular, Daelim has moved ahead of rivals with visible progress. The company geared up by establishing Pocheon Power, a special purpose company (SPC) in 2008. Pocheon Power will complete the construction of nos. 1 and 2 power generators in May and November 2014, respectively, for which construction started in early 2012. And the upcoming power generators' capacity is factored in the government's fourth and fifth electricity supply plans. Daelim was able to raise project financing worth W1tn through Pocheon Power and accumulated a track record of applying in-house developed design technology. Aside from the Pocheon project, Daelim is seeking additional IPP projects domestically and reviewing the possible acquisition of a stake in Millmerran Power Station in Australia. As such, Daelim is moving to enter the energy business and the Pocheon IPP is an important stop on the entire road map.

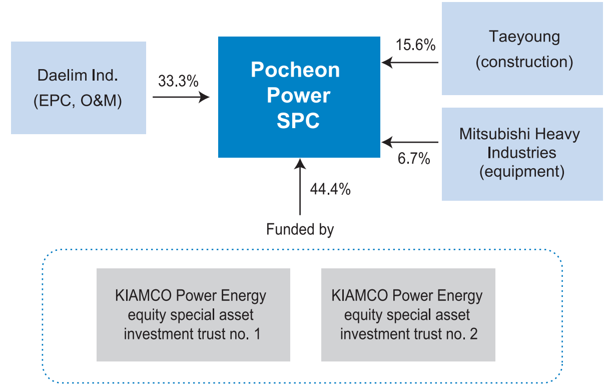
Among Korean builders, only KEPCO E&C, Hyundai Engineering and Daelim have the capacity for basic power plant designs, while others specialize in designs in detail. Daelim has proven its in-house design capacity via the Korean K-Power project and Saudi Arabia's Shoaiba project won in 2011. A builder with in-house design capacity can be more flexible during the most costly main equipment selection and reduce errors. Indeed, the firm saved W200bn from an estimated project cost of W1.4tn through the main equipment change.

Table 2. Pocheon combined power plant overview

Project title	Pocheon cogeneration power project
Location	Chudong-ni, Changsu-myeon, Pocheon, Gyeonggi
Capacity	1,450MW (two 750MW units at 30˚C)
Total investment	W12,365mn
Construction period	September 2011-November 2014; To complete unit 1 in May 2014 and unit 2 in November 2014
Site area	547,000m^2
Type	LNG-based combined power plant (gas and steam turbines), 51.5% total efficiency
Generation volume	11.18bn kWh/yr (2015-2024 avg., usage rate 81.6%)
Fuel	1.5mn tonnes of KOGAS-supplied natural gas/yr

Note: Usage rate refers to electricity used as % of total electricity produced
Source: Pocheon Power

Figure 2. Pocheon Power's SPC participants



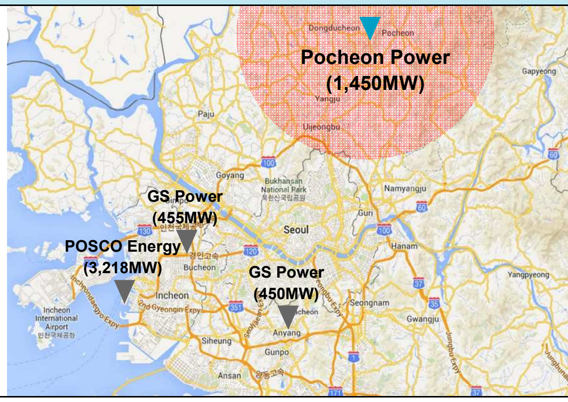
Source: Pocheon Power

Pocheon Power with cost advantage – closer and smarter

In Korea, 445 power producers including KEPCO subsidiaries enter a bid held by the Korea Power Exchange to sell electricity to KEPCO. Then, KEPCO supplies the purchased power to consumers. The Korean power market is a cost-based pool where electricity purchase prices are determined by adding a fixed cost compensational price (capacity price, CP) to a variable cost (system marginal price, SMP) of power from the last choice of producer. Thus, it is more likely to run generators and enjoy bigger margins if a producer 1) is equipped with high-efficiency generators, 2) runs a large capacity plant or 3) can secure fuels at low costs. Even with an idle plant due to weak demand, the private producers' profits will not likely turn to losses as they are paid a CP. Meanwhile, the application of an adjustment coefficient is planned for private producers' earnings due to the controversy over their excessive profits, especially amid the prospect of much better profitability from coal-fired power plants. However, LNG-fired plants will not likely be subjected to the new practice.

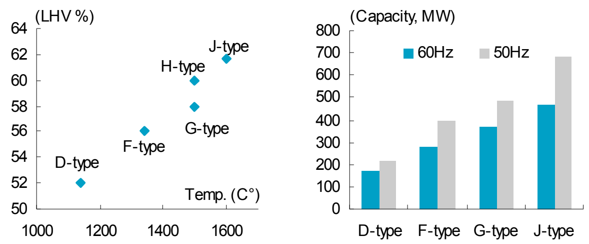
We believe Pocheon Power is very efficient for the following three reasons. 1) It has a low transmission loss factor given its proximity to Seoul and the surrounding region. Of note, Pocheon Power is the only IPP north of Seoul. Although GS Power is the private operator closest to central Seoul, it has a small capacity. As such, additional power can be supplied by Pocheon Power. 2) It is one of the largest IPPs by capacity. 3) It uses MHI's latest J-type turbines. Of note, turbines are crucial for a power generator's efficiency. An increase in the lower heating value (LHV) and the fuel combustion temperature leads to a more efficient turbine. Thus, assuming a CP of W140/kWh (down 7% from the current W150) and two generators both in operation, Pocheon Power's 2015F EBITDA would reach W174bn, which translates to a 4% increase in Daelim's 2015F EBT. Assuming the CP goes up 1% p.a. and most of the NP is paid out as cash dividends, the NPV of Pocheon Power owned by Daelim would reach W216bn.

Figure 3. IPPs near Seoul (Pocheon Power is the only IPP north of Seoul)



Source: Google, Korea Investment & Securities

Figure 4. Power generating efficiency of MHI's turbines by type



Note: LHV is short for lower heating value
Source: MHI

Table 3. Economic moat ratings by power generating business

	Financing	Engineering	Purchasing	Construction	O&M
Daelim	○	○	○	○	○
Samsung C&T	○	△	○	○	△
Hyundai E&C	△	○	○	○	X
Samsung Engineering	X	△	○	○	X
GS E&C	X	△	○	○	X

Note: Moat sizes are ○ for wide, △ for narrow and X for none
Source: Korea Investment & Securities

Total solution encompassing operations is a tough act to copy

Energy industry players in the global IPP market are categorized into 1) power generation companies for domestic electricity (KEPCO, etc.), 2) global IPP developers (AES, etc.) and 3) trading companies with funding strengths (Marubeni, Mitsui, etc.). Korean EPC companies have enhanced their profitability and broadened business opportunities by participating in a wide array of value chains aside from EPC.

Daelim is the first Korean builder that starts to build competence in operation & maintenance (O&M), which differentiates the company from rivals (see Table 3.). Many Korean builders have entered power generation EPC, which also involves planning and funding, but mostly depend on outsourcing for operations. While Daelim currently outsources O&M for the Pocheon IPP, it also plans to hire 1.5x more O&M staffs than needed to internalize such abilities over the long run. This is a value that cannot be copied in the short-term

Meanwhile, why is Daelim focusing on ASEAN as its mainstay power market? It is due to the large number of no-bid contracts and IPP orders in ASEAN. This means there is much potential for ways to seek returns such as early stage business consulting or arranging financial deals. Daelim has the following attributes. 1) It has EPC ability with selective machinery procurement and also has more change order opportunities than rivals. 2) The firm can provide total solutions to ASEAN, which is in dire need of system building for operational services after construction is completed. Daelim plans to selectively take part in acquiring equity holdings in and operations of power plant projects. It has chosen the power generation business as a core future growth driver and is taking a share of the market using its unique competitive edge, as per the road map it has been drawing for years.

Changes to recommendation and price target

Company (Code)	Date	Recommendation	Price target
Daelim Ind. (000210)	08-12-11	BUY	W168,000
	08-06-12	BUY	W128,000
	09-28-12	Hold	-
	01-16-13	BUY	W121,000

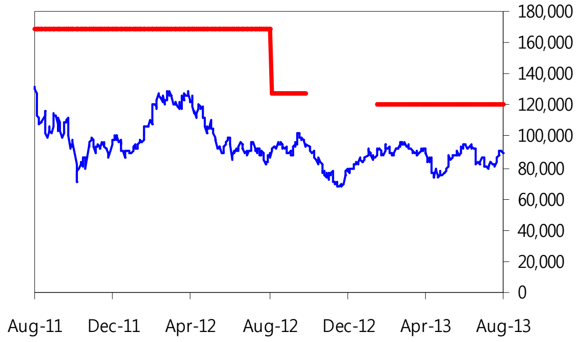


Table 4. Analysis of Pocheon Power's profits/losses

		Assumption	2014	2015	2016	2017	…	2042	2043	2044
Power generation capacity	Bn kWh/yr	11,450MW capacity	5.9	11.9	11.9	12.0	…	11.4	11.4	11.4
Utilization	%		81.6%	82.0%	82.0%	83.0%	…	79.0%	79.0%	79.0%
CP	KRW/kWh	1% increase p.a.	140	141	143	144		185	187	191
Sales	W bn		826	1,677	1,693	1,731		2,113	2,134	2,177
OP	W bn		5	134	119	104		106	107	109
Depreciation	W bn	30-yr straight line amortization	10	40	40	40		40	40	27
EBITDA	W bn		15	174	159	144		146	147	135
Interest expenses	W bn	5% avg. funding rate	12	45	43	40		-	-	-
NP (Daelim)	W bn	40% ownership	2	27	23	19		32	32	33
NPV	W bn	40% ownership	2	23	18	14		3	2	2
Debt	W bn		957	907	857	807		-	-	-
		Pocheon Power NPV	**219**							

Note: Assuming Daelim exercises call option on 7% Mitsubishi stake in 2014.

Source: Pocheon Power, company data, Korea Investment & Securities

Balance sheet

FY-ending Dec. (W bn)	2011A	2012A	2013F	2014F	2015F
Current assets	7,159	7,292	7,429	7,695	8,358
Cash & cash equivalents	1,325	1,477	1,216	1,259	1,368
Accounts & other receivables	3,313	3,481	3,753	3,887	4,222
Inventory	1,378	1,155	1,245	1,289	1,400
Non-current assets	3,606	3,714	3,845	3,889	4,057
Investment assets	1,600	1,693	1,824	1,890	2,053
Tangible assets	1,635	1,517	1,477	1,435	1,393
Intangible assets	77	79	85	88	96
Total assets	10,765	11,006	11,274	11,584	12,416
Current liabilities	4,650	4,779	4,330	4,226	4,433
Accounts & other payables	2,572	2,961	3,095	3,205	3,109
ST debt & bonds	473	336	356	353	352
Current portion of LT debt	468	341	414	492	564
Non-current liabilities	1,478	1,309	1,623	1,564	1,586
Debentures	468	448	698	648	638
LT debt & financial liabilities	685	432	462	437	427
Total liabilities	6,127	6,088	5,953	5,791	6,018
Controlling interest	4,417	4,779	5,171	5,631	6,220
Capital stock	219	219	219	219	219
Capital surplus	513	507	507	507	507
Capital adjustments	0	0	0	0	0
Retained earnings	3,623	4,005	4,417	4,895	5,504
Minority interest	221	140	150	162	177
Shareholders' equity	4,637	4,919	5,322	5,793	6,397

Income statement

FY-ending Dec. (W bn)	2011A	2012A	2013F	2014F	2015F
Sales	7,988	10,253	11,053	11,448	12,435
COGS	7,058	9,219	9,915	10,178	10,982
Gross profit	930	1,034	1,137	1,270	1,453
SG&A expenses	492	548	584	633	713
Operating profit	437	486	553	637	740
Financial income	95	96	65	69	73
Interest income	72	64	65	64	68
Financial expenses	129	102	75	83	84
Interest expenses	105	79	75	83	84
Other non-operating profit	78	36	20	0	40
Gains (Losses) in associates, subsidiaries and JV	38	45	20	50	80
Earnings before tax	519	560	583	674	849
Income taxes	140	159	141	163	205
Net profit	380	401	442	511	644
Net profit of controlling interest	366	391	431	498	628
Other comprehensive profit	(95)	(20)	(20)	(20)	(20)
Total comprehensive profit	285	381	422	491	624
Total comprehensive profit of controlling interest	268	372	412	479	609
EBITDA	492	548	614	696	796

Cash flow

FY-ending Dec. (W bn)	2011A	2012A	2013F	2014F	2015F
C/F from operations	501	780	(283)	147	271
Net profit	380	401	442	511	644
Depreciation	50	57	55	52	50
Amortization	5	5	6	6	6
Net incr. in W/C	(128)	99	(773)	(376)	(359)
Others	194	218	(13)	(46)	(70)
C/F from investing	(647)	(296)	(323)	(83)	(194)
Capex	(302)	(156)	(16)	(13)	(9)
Decr. in fixed assets	3	2	2	2	2
Incr. in investment	(411)	(172)	(131)	(34)	(102)
Net incr. in intangible assets	(3)	(9)	(12)	(9)	(14)
Others	66	39	(166)	(29)	(71)
C/F from financing	190	(331)	345	(20)	32
Incr. in equity	132	0	0	0	0
Incr. in debt	78	(290)	364	(1)	51
Dividends	(20)	(19)	(19)	(19)	(19)
Others	0	(22)	0	0	0
C/F from others	0	(1)	0	0	0
Increase in cash	44	152	(261)	44	109

Note: K-IFRS (consolidated)

Key financial data

FY-ending Dec.	2011A	2012A	2013F	2014F	2015F
Per-share data (KRW)					
EPS	9,469	10,128	11,200	12,934	16,305
BPS	114,427	123,800	133,977	145,883	161,151
DPS	100	500	500	500	500
Growth (%)					
Sales growth	7.4	28.4	7.8	3.6	8.6
OP growth	12.9	11.1	13.9	15.2	16.1
NP growth	9.6	7.0	10.3	15.5	26.1
EPS growth	9.6	7.0	10.6	15.5	26.1
EBITDA growth	12.9	11.4	12.0	13.3	14.5
Profitability (%)					
OP margin	5.5	4.7	5.0	5.6	6.0
NP margin	4.6	3.8	3.9	4.4	5.1
EBITDA margin	6.2	5.3	5.6	6.1	6.4
ROA	3.7	3.7	4.0	4.5	5.4
ROE	8.5	8.5	8.7	9.2	10.6
Dividend yield	0.1	0.6	0.6	0.6	0.6
Stability					
Net debt (W bn)	285	(418)	51	(17)	(133)
Debt/equity ratio (%)	45.9	31.8	36.3	33.3	31.0
Valuation (x)					
PE	9.5	8.6	7.9	6.9	5.5
PB	0.8	0.7	0.7	0.6	0.6
PS	0.4	0.3	0.3	0.3	0.3
EV/EBITDA	7.6	5.2	5.5	4.8	4.1

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- BUY: Expected to give a return of +15% or more
- Hold: Expected to give a return between -15% and +15%
- Underweight: Expected to give a return of -15% or less
- Korea Investment & Securities does not offer target prices for stocks with Hold or Underweight ratings.

■ **Guide to Korea Investment & Securities Co., Ltd. sector ratings for the next 12 months**

- Overweight: Recommend increasing the sector's weighting in the portfolio compared to its respective weighting in the Kospi (Kosdaq) based on market capitalization.
- Neutral: Recommend maintaining the sector's weighting in the portfolio in line with its respective weighting in the Kospi (Kosdaq) based on market capitalization.
- Underweight: Recommend reducing the sector's weighting in the portfolio compared to its respective weighting in the Kospi (Kosdaq) based on market capitalization.

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Korea Investment & Securities Co., Ltd. has issued ELW with underlying stocks of Daelim Ind. and is the liquidity provider.

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