

Korea Gas (036460)

12M rating **BUY (Maintain)**
12M TP **W62,000** from W62,000
Up/downside **+36%**

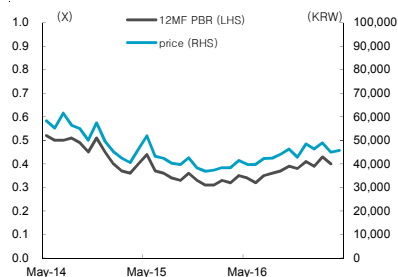
Stock Data

KOSPI (Apr 26, pt)	2,208
Stock price (Apr 26, KRW)	45,700
Market cap (USD mn)	3,750
Shares outstanding (mn)	92
52-Week high/low (KRW)	49,300/38,100
6M avg. daily turnover (USD mn)	7.2
Free float / Foreign ownership (%)	43.9/12.9
Major shareholders (%)	
Ministry of Strategy & Finance and 1 other	46.6
NPS	7.8

Performance

	1M	6M	12M
Absolute (%)	2.1	(1.6)	12.4
Relative to KOSPI (%p)	0.3	(11.2)	3.1

12MF PB trend



Source: WISEfn consensus

1Q17 preview: Improvement in sight

1Q17F OP up 4.8% YoY

We estimate 1Q17 revenue at W7.2tn and OP at W936.8bn. While revenue falls 7.2% YoY, OP should grow 4.8% YoY and slightly beat the consensus forecast (W922bn). Although natural gas sales volume rose 0.6% YoY, the sales figure should shrink due to a lower selling price under the cost-linked pricing scheme (raw material cost down 5.7%). OP growing 4.8% is thanks to 1) a 3.8% YoY increase in the 2017 guaranteed profit (investment return) that will be set in early May and 2) greater overseas E&P profit. Meanwhile, domestic natural gas sales volume and sale price affect KOGAS' revenue but are unrelated to OP thanks to the government's compensation for capital invested in domestic projects

After falling 14% YoY in 2016, guaranteed profit to grow 8% p.a. through 2020F

KOGAS generates 93% of its OP via domestic guaranteed profit (investment compensation) that comes from LNG imports and gas wholesale. The rise in guaranteed profit slowed for the past several years and it even shrank 14.1% YoY in 2016. But from 2017, the weighted average cost of equity (WACC) that had trended downward and the rate base (value of assets invested in domestic projects) that temporarily narrowed are both on the rise. That is, the rate base and the rate of return are both picking up starting in 2017. We forecast the domestic guaranteed profit will advance 3.8% YoY to W1tn in 2017 and rise more sharply from 2018, achieving 8% CAGR through 2020 (Table 4). Furthermore, Korea's energy policy will be realigned with the focus shifting from coal and nuclear to LNG-fueled power generation. Accordingly, the government is expected to change its projection of LNG demand for power generation from a 4.2% p.a. drop during 2014-2029 to a 2.6% p.a. increase over the period. As such, the outlook is bright for KOGAS over the long-term beyond 2020.

Fading uncertainty about overseas E&P; Probable policy momentum

Uncertainties about overseas E&P, which weighed on KOGAS' shares, should gradually fade after the 1Q17 earnings release. In particular, Iraq's Zubair oil field, the biggest E&P profit source, has achieved maximum production in 2017. With no additional investment needed, KOGAS will likely begin to recoup its spending. As this is deemed a meaningful achievement for the unregulated business, it should positively affect investor sentiment toward E&P and the company's cash flow and dividend payment. Furthermore, investors should pay closer attention to KOGAS' domestic business with the government's shift in policy focus to natural gas becoming visible after the presidential election. KOGAS now trades at 0.4x 2017F

Yr to	Sales	OP	NP	EPS	% chg	EBITDA	PE	EV/EBITDA	PB	ROE	DY
Dec	(W bn)	(W bn)	(W bn)	(KRW)	(YoY)	(W bn)	(x)	(x)	(x)	(%)	(%)
2015A	26,053	1,008	319	3,594	(29.4)	2,355	10.3	13.4	0.3	3.2	0.5
2016A	21,108	918	(674)	(7,740)	NM	2,535	NM	11.9	0.5	(7.0)	-
2017F	20,733	1,069	512	5,845	NM	2,769	7.8	10.4	0.4	5.4	1.3
2018F	22,855	1,235	638	7,278	24.5	2,829	6.3	10.6	0.4	6.4	1.6
2019F	22,883	1,335	713	8,135	11.8	2,943	5.6	10.5	0.4	6.7	1.9

Note: Net profit and EPS attributed to controlling interest

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PB but an improvement for ROE driven by domestic business should re-rate the stock. We maintain KOGAS as our top utilities pick and leave our TP unchanged at W62,000 (0.52x target PB to the 2017-2018F average BPS).

Table 1. 1Q17F OP up 4.8% YoY

(W bn, %)

	1Q16	1Q17F	Chg.	Note
Sales	7,765	7,208	(7.2)	Natural gas sales volume up 0.6%, Raw material prices down 5.7%
OP	894	937	4.8	2017F guaranteed profit up 3.8%; Better overseas business
EBT	671	834	24.2	
NP	511	650	27.2	

Source: Korea Investment & Securities

Table 2. Earnings estimates

(W bn)

	1Q16	2Q16	3Q16	4Q16	1Q17F	2Q17F	3Q17F	4Q17F	2015	2016	2017F	2018F
Sales	7,765	3,537	3,628	6,179	7,208	4,095	4,196	5,234	26,053	21,108	20,733	22,855
Separate	7,612	3,261	3,341	5,964	7,002	3,838	3,933	4,989	25,482	20,177	19,763	21,782
Consolidated subsidiaries	215	334	357	328	322	320	328	327	753	1,234	1,298	1,426
YoY (%)	(24.0)	(28.8)	(17.3)	(4.7)	(7.2)	15.8	15.6	(15.3)	(30.1)	(19.0)	(1.8)	10.2
COGS	6,765	3,465	3,736	5,809	6,164	3,981	4,271	4,825	24,668	19,775	19,242	21,183
SG&A cost	106	78	82	150	107	79	84	152	377	416	422	437
OP	894	(6)	(190)	220	937	35	(159)	256	1,008	918	1,069	1,235
YoY (%)	3.3	(275.3)	30.8	(22.6)	4.8	nm	nm	16.6	(6.0)	(9.0)	16.5	15.4
OPM (%)	11.5	(0.2)	(5.2)	3.6	13.0	0.9	(3.8)	4.9	3.9	4.3	5.2	5.4
EBT	671	(212)	(387)	(922)	834	(68)	(262)	153	277	(850)	657	818
NP	511	(106)	(298)	(782)	650	(53)	(204)	119	319	(674)	512	638

Source: Company data, Korea Investment & Securities

Table 3. Consolidated subsidiary earnings estimates

(W bn)

	2014	2015	2016	2017F	2018F
Sales	712	753	1,234	1,298	1,426
Four main E&P projects	523	636	1,071	1,133	1,259
Iraq Zubair	403	411	540	553	567
Iraq Badra	35	82	145	207	215
Myanmar	69	97	79	73	95
Australia GLNG	16	46	306	300	383
Other subsidiaries	189	117	163	165	167
OP	134	25	43	141	186
Four main E&P projects	161	120	91	188	234
Iraq Zubair	134	102	112	120	120
Iraq Badra	8	14	16	28	28
Myanmar	45	67	52	47	63
Australia GLNG	(25)	(62)	(89)	(7)	22
Other subsidiaries	(27)	(95)	(48)	(50)	(52)

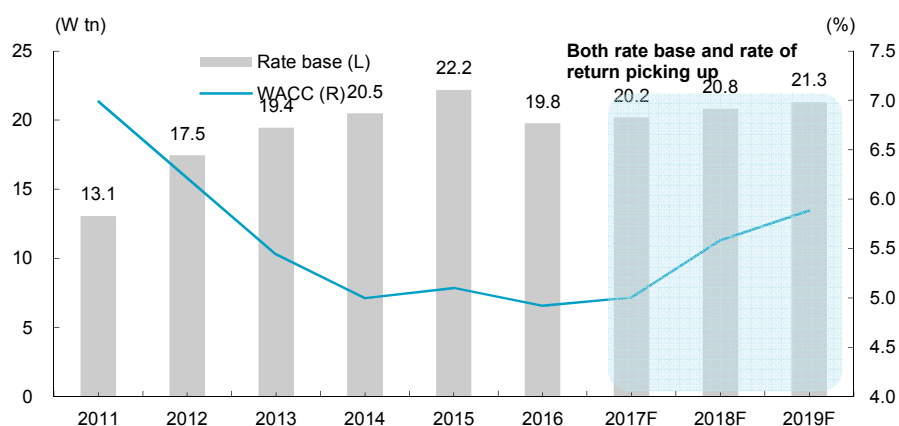
Source: Company data, Korea Investment & Securities

Table 4. Guaranteed profit outlook for KOGAS' regulated businesses (gas wholesale/regulated E&P) (W bn)

	2011	2012	2013	2014	2015	2016	2017F	2018F	2019F
Avg. net capacity in operation + investment assets + fixed assets	7,483	10,375	14,103	15,720	17,291	18,243	18,757	19,180	19,602
Working capital	5,882	7,353	8,049	7,347	7,261	3,718	3,792	3,902	4,016
Assets re-evaluation (deducted items)	289	259	2,707	2,575	2,339	2,178	2,364	2,271	2,317
Rate base	13,076	17,468	19,445	20,492	22,212	19,782	20,185	20,811	21,300
Equity capital ratio (%)	0.33	0.28	0.27	0.24	0.30	0.33	0.34	0.35	0.35
Rf (%)	4.30	3.89	3.24	3.00	2.84	1.97	1.53	1.98	2.38
Beta	0.69	0.65	0.57	0.54	0.50	0.57	0.72	0.83	0.85
Borrowed capital ratio (%)	0.67	0.72	0.73	0.76	0.70	0.67	0.66	0.65	0.65
Funding rate (%)	5.00	4.63	4.18	4.01	3.99	3.83	3.61	3.66	3.70
After-tax WACC (%)	5.30	4.71	4.12	3.79	3.87	3.73	3.79	4.23	4.46
Pre-tax WACC (%)	6.99	6.22	5.44	5.00	5.10	4.92	5.00	5.58	5.89
Investment return (guaranteed profit)	914	1,086	1,058	1,024	1,133	973	1,010	1,162	1,254

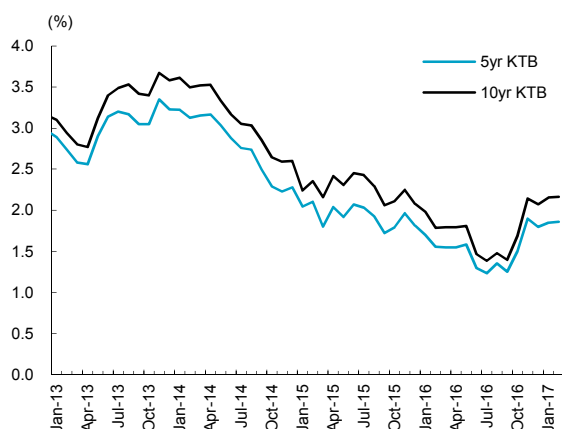
Source: Company data, Korea Investment & Securities

Figure 1. Rate base and WACC: Both picking up from 2017



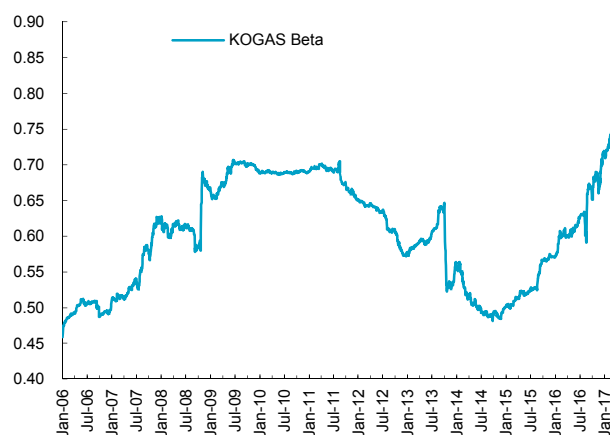
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Figure 2. Gov't bond yield: Higher yield means bigger WACC

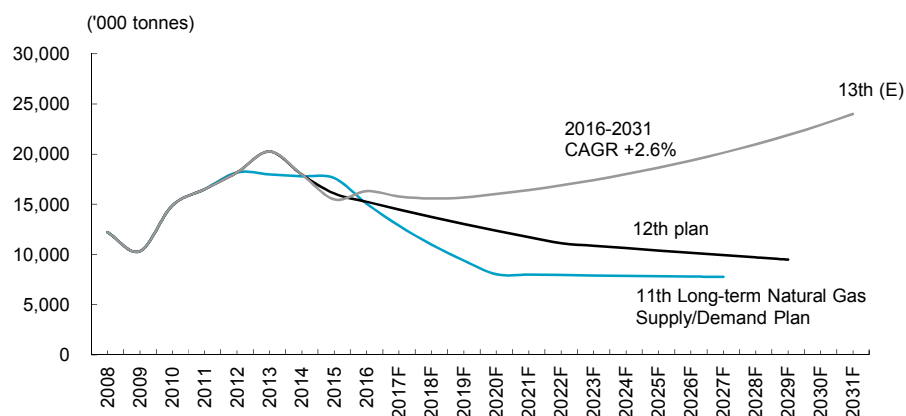


Source: Bank of Korea, Korea Investment & Securities

Figure 3. KOGAS Beta (daily Beta from past five years): Bigger Beta reflected in WACC



Source: Company data, Korea Investment & Securities

Figure 4. LNG demand for power generation

Note: 13th plan estimates grounded on an increased weighting of LNG power generation in the eighth electricity supply and demand plan

Source: 12nd-13th Natural Gas Supply/Demand Plan, Korea Investment & Securities

Company overview & Glossary

Korea Gas (KOGAS) is Korea's sole importer of natural gas. Aside from POSCO Energy, SK E&S and Korea Midland Power (subsidiary of Korea Electric Power Corp. or KEPCO), all corporations use gas imported by KOGAS. Korea's gas market system is such that KOGAS imports LNG and sells to city gas and power generation purposes with a set profit margin. City gas is used by private companies and citizens for industrial applications, heating and cooking while gas for power generation is used by KEPCO's power generation companies (gencos) and independent power producers (IPPs) as fuel. KOGAS only earns a set profit margin (on gas sales) that is agreed with the government, so its earnings system is very stable while changes to LNG prices do not affect earnings. However, overseas resources exploration & production (E&P) earnings (~7% of consolidated OP) can be affected by oil prices.

Balance sheet

FY-ending Dec. (W bn)	2015A	2016A	2017F	2018F	2019F
Current assets	10,015	8,544	8,305	8,114	7,345
Cash & cash equivalents	138	483	475	229	458
Accounts & other receivables	4,815	5,006	4,918	5,028	4,348
Inventory	1,795	1,070	1,051	1,143	1,098
Non-current assets	32,371	31,384	31,117	31,989	34,344
Investment assets	2,348	2,295	2,254	2,205	2,070
Tangible assets	26,455	26,042	25,962	26,865	29,381
Intangible assets	2,521	2,416	2,281	2,285	2,288
Total assets	42,385	39,928	39,422	40,103	41,690
Current liabilities	5,729	5,556	5,216	4,526	4,468
Accounts & other payables	1,401	2,043	1,990	1,234	1,236
ST debt & bonds	1,233	0	123	134	136
Current portion of LT debt	2,429	2,632	2,228	2,370	2,481
Non-current liabilities	26,600	24,985	24,360	25,158	26,164
Debentures	21,904	21,098	20,787	20,922	21,463
LT debt & financial liabilities	2,442	2,158	1,874	2,363	2,826
Total liabilities	32,328	30,541	29,576	29,684	30,633
Controlling interest	10,057	9,274	9,733	10,306	10,944
Capital stock	462	462	462	462	462
Capital surplus	1,325	1,325	1,325	1,325	1,325
Other reserves	900	900	900	900	900
Retained earnings	6,419	5,725	6,184	6,757	7,395
Minority interest	(0)	113	113	113	113
Shareholders' equity	10,057	9,386	9,846	10,418	11,057

Cash flow

FY-ending Dec. (W bn)	2015A	2016A	2017F	2018F	2019F
C/F from operations	5,456	4,769	2,450	1,122	2,857
Net profit	319	(674)	512	638	713
Depreciation	1,347	1,617	1,699	1,594	1,608
Amortization	0	0	0	0	0
Net incr. in W/C	3,856	3,138	288	(989)	733
Others	(66)	688	(49)	(121)	(197)
C/F from investing	(2,247)	(2,079)	(1,393)	(2,204)	(3,794)
Capex	(2,272)	(1,841)	(1,619)	(2,497)	(4,124)
Decr. in fixed assets	3	1	0	0	0
Incr. in investment	181	(156)	88	185	333
Net incr. in intangible assets	(172)	(58)	135	(5)	(3)
Others	13	(25)	3	113	0
C/F from financing	(3,266)	(2,377)	(1,065)	835	1,167
Incr. in equity	0	104	0	0	0
Incr. in debt	(3,238)	(2,460)	(1,012)	901	1,241
Dividends	(22)	(15)	0	(53)	(66)
Others	(6)	(6)	(53)	(13)	(8)
C/F from others	(15)	32	0	0	0
Increase in cash	(71)	345	(9)	(246)	229

Note: K-IFRS (consolidated)

Income statement

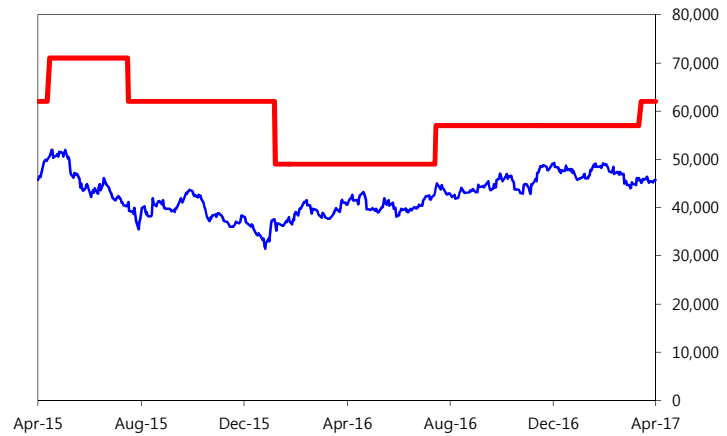
FY-ending Dec. (W bn)	2015A	2016A	2017F	2018F	2019F
Sales	26,053	21,108	20,733	22,855	22,883
COGS	24,668	19,775	19,242	21,183	21,095
Gross profit	1,385	1,333	1,492	1,672	1,788
SG&A expenses	377	416	422	437	453
Operating profit	1,008	918	1,069	1,235	1,335
Financial income	716	754	299	388	386
Interest income	23	34	46	37	35
Financial expenses	1,428	1,550	967	1,146	1,211
Interest expenses	776	841	791	899	964
Other non-operating profit	(109)	(1,086)	207	206	206
Gains (Losses) in associates, subsidiaries and JV	90	115	47	136	198
Earnings before tax	277	(850)	657	818	914
Income taxes	(42)	(176)	144	180	201
Net profit	319	(674)	512	638	713
Net profit of controlling interest	319	(674)	512	638	713
Other comprehensive profit	39	(87)	0	0	0
Total comprehensive profit	359	(761)	512	638	713
Total comprehensive profit of controlling interest	359	(764)	512	638	713
EBITDA	2,355	2,535	2,769	2,829	2,943

Key financial data

FY-ending Dec.	2015A	2016A	2017F	2018F	2019F
Per-share data (KRW)					
EPS	3,594	(7,740)	5,845	7,278	8,135
BPS	110,053	101,569	106,549	112,747	119,662
DPS	170	0	600	750	850
Growth (%)					
Sales growth	(30.1)	(19.0)	(1.8)	10.2	0.1
OP growth	(6.0)	(8.9)	16.5	15.4	8.1
NP growth	(28.6)	NM	NM	24.5	11.8
EPS growth	(29.4)	NM	NM	24.5	11.8
EBITDA growth	6.1	7.7	9.2	2.2	4.0
Profitability (%)					
OP margin	3.9	4.3	5.2	5.4	5.8
NP margin	1.2	(3.2)	2.5	2.8	3.1
EBITDA margin	9.0	12.0	13.4	12.4	12.9
ROA	0.7	(1.6)	1.3	1.6	1.7
ROE	3.2	(7.0)	5.4	6.4	6.7
Dividend yield	0.5	-	1.3	1.6	1.9
Dividend payout ratio	4.7	NM	10.3	10.3	10.4
Stability					
Net debt (W bn)	28,369	25,568	24,568	25,804	26,816
Int.-bearing debt/equity (%)	283.5	279.7	256.4	251.0	247.7
Valuation (x)					
PE	10.3	NM	7.8	6.3	5.6
PB	0.3	0.5	0.4	0.4	0.4
EV/EBITDA	13.4	11.9	10.4	10.6	10.5

Changes to recommendation and price target

Company (Code)	Date	Recommendation	Price target
Korea Gas (036460)	04-30-15	BUY	W62,000
	05-11-15	BUY	W71,000
	08-12-15	BUY	W62,000
	02-02-16	BUY	W49,000
	08-10-16	BUY	W57,000
	04-10-17	BUY	W62,000



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BUY	Hold	Underweight (Sell)
77.4%	21.7%	0.9%

Note: % of companies under coverage with this rating

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Prepared by: Seungkyun Kang

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