

# SK Innovation (096770)

Above

In line

Below

12M rating **BUY (Maintain)**

12M TP **W210,000** from W210,000

Up/downside **+25%**

## Stock Data

KOSPI (Feb 1, pt)	1,958
Stock price (Feb 1, KRW)	168,500
Market cap (USD mn)	14,198
Shares outstanding (mn)	92
52-Week high/low (KRW)	194,000/125,500
6M avg. daily turnover (USD mn)	50.0
Free float / Foreign ownership (%)	65.6/36.2
Major shareholders (%)	
SK Holdings Co Ltd and 1 others	33.4
National Pension Service	8.6

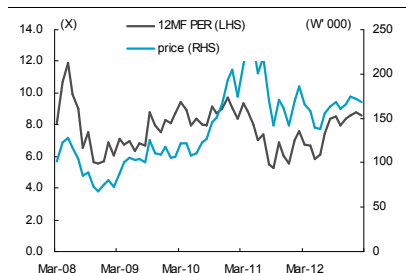
## Valuation

	2011A	2012F	2013F
PER (x)	4.2	10.5	9.1
PBR (x)	0.9	1.0	0.9
ROE (%)	24.4	10.1	10.3
EV/EBITDA (x)	5.1	8.8	7.1
EPS (KRW)	34,004	16,563	18,578
BPS (KRW)	157,089	172,169	189,230

## Performance

	1M	6M	12M
Absolute (%)	(3.2)	7.3	(2.0)
Relative to KOSPI (%p)	(1.2)	3.2	(2.0)

## 12MF PER trend



Source: WISEfn consensus

## Earnings to climb from 1Q13

### What's new: Weak market conditions, earnings as expected

SK Innovation posted 4Q12 sales of W17trn, in line with our estimate, but OP of only W202.1bn, down 77% QoQ, 17% lower than expected. SK Energy posted a W42.4bn operating loss as refining margin fell from USD17.5 per barrel to USD7.5 and inventory valuation losses occurred on falling crude oil and petroleum product prices. Refining and petrochemical earnings were in line with estimates, as poor results were mostly expected. But, lube base oil earnings disappointed heavily. SK Lubricants' OP recorded W2.3bn, well below our estimate of W66.9bn, on sustained price declines

### Pros: Earnings to recover on stable crude oil, refining margin improvement and solid PX spread

We forecast 1Q13 consolidated OP at W477.7bn (+136% QoQ). SK Energy should generate an OP of W160.3bn on a stable refining margin. Of note, the complex refining margin is USD11.1 per barrel in Jan, up sharply from USD3.6 in 4Q12. Dubai crude prices also rose USD3 in Jan, and should remain stable on an economic recovery and fading Middle East tensions. Going forward, crude oil volatility from last year and inventory valuation gains/losses should have a smaller impact on earnings. SK Global Chemicals' OP also decreased on regular maintenance in 4Q12. 1Q13 OP should increase 36% on volume growth from the regular maintenances and solid PX spreads.

### Cons: Earnings bottom on weak demand for lube base oil

SK Lubricants' 4Q12 earnings were weak, but bottomed out. SK Lubricants' 1Q13 OP should improve sharply to W25.2bn as the selling price may increase and utilization rebounds on higher demand. Lube base oil is a raw material to produce lubricants, and is sold at actual contract prices between companies rather than the market price. Therefore, the price is less volatile and reflects the changing cost after a delay. Cost rose 7% from the bottom after falling last year, and was choppy. While the price of lube base oil continued to fall, SK Lubricants' selling price in North American has been stable on a group III premium.

### Conclusion: Growth likely after recovery, maintain BUY and TP

We maintain BUY on SK Innovation with a TP of W210,000, which reflects 7.4x 12MF EBITDA and investment asset value. Earnings should improve sharply YoY as volatility at the refining business fades. And, PX and lube base oil investments should wind down after 2014, catalyzing long-term growth. Of note, we forecast 2013 OP growth of 38% YoY and 2014 growth of 32% YoY.

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(W bn, %, %p)

	4Q12P				Change		2013F	
	KIS est.	Actual	Diff.	Consensus	QoQ	YoY	KIS	Consensus
Sales	17,004.2	17,159.9	0.9	18,461.9	(7.0)	1.4	67,991.4	74,284.9
OP	243.1	202.1	(16.9)	399.2	(77.1)	(44.1)	2,325.6	2,453.5
OP margin	1.4	1.2		2.2			3.4	3.3
EBT	358.8	347.1	(3.3)	387.3	(44.4)	5.1	2,282.9	2,337.5
NP	327.1	228.0	(30.3)	388.0	(55.3)	50.8	1,731.2	1,777.1

Table 1. Revised annual earnings estimates

(W bn, %)

	2012			2013F		
	Previous	Chg.	Revised	Previous	Chg.	Revised
<b>Sales</b>	<b>73,174.6</b>	<b>0.2</b>	<b>73,330</b>	<b>68,576</b>	<b>(0.9)</b>	<b>67,991</b>
Refining	56,646.4	(0.1)	56,589	51,672	(2.5)	50,387
Petrochemicals	12,489.8	0.7	12,572	13,065	(1.7)	12,840
Lubricants	2,840.2	2.2	2,901	2,631	23.3	3,243
E&P and others	1,198.4	5.9	1,269	1,209	25.9	1,521
<b>OP</b>	<b>1,715.9</b>	<b>(1.4)</b>	<b>1,691</b>	<b>2,137</b>	<b>8.8</b>	<b>2,326</b>
Refining	274.0	1.9	279	677	4.5	707
Petrochemicals	761.7	(1.4)	751	838	13.4	950
Lubricants	358.6	(12.6)	314	316	5.4	333
E&P and others	321.6	8.0	347	306	9.5	336
<b>EBITDA</b>	<b>2,285.0</b>	<b>1.2</b>	<b>2,313</b>	<b>2,681</b>	<b>7.0</b>	<b>2,870</b>

Source: Korea Investment &amp; Securities

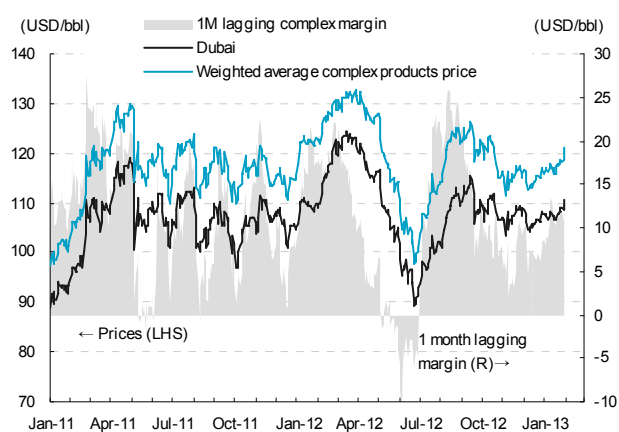
Table 2. SK Innovation's earnings forecast by business

(W bn, %)

	Quarterly earnings								Yearly earnings		YoY Change	
	1Q12	2Q12	3Q12	4Q12P	1Q13F	2Q13F	3Q13F	4Q13F	2012P	2013F	2012P	2013F
<b>Sales</b>	<b>18,834</b>	<b>18,878</b>	<b>18,458</b>	<b>17,160</b>	<b>17,441</b>	<b>16,250</b>	<b>16,358</b>	<b>17,942</b>	<b>73,330</b>	<b>67,991</b>	<b>7.3</b>	<b>(7.3)</b>
Refining	14,380	14,563	14,367	13,280	13,162	11,907	11,917	13,401	56,589	50,387	14.5	(11.0)
Petrochemicals	3,441	3,199	3,077	2,854	3,253	3,227	3,209	3,151	12,572	12,840	(16.5)	2.1
Lubricants	721	789	723	669	648	737	852	1,005	2,901	3,243	7.1	11.8
E&P and others	293	328	291	357	378	379	380	385	1,269	1,521	5.2	19.9
<b>OP</b>	<b>738</b>	<b>(132)</b>	<b>884</b>	<b>202</b>	<b>478</b>	<b>600</b>	<b>621</b>	<b>627</b>	<b>1,691</b>	<b>2,326</b>	<b>(40.5)</b>	<b>37.5</b>
Refining	365	(480)	436	(42)	160	186	170	191	279	707	(77.5)	153.3
Petrochemicals	192	163	242	155	210	239	267	234	751	950	(3.0)	26.5
Lubricants	110	77	124	2	25	92	102	113	314	333	(38.3)	6.1
E&P and others	71	107	82	87	82	83	82	88	347	336	9.0	(3.4)
<b>EBITDA</b>	<b>1,085</b>	<b>63</b>	<b>820</b>	<b>345</b>	<b>612</b>	<b>735</b>	<b>758</b>	<b>765</b>	<b>2,313</b>	<b>2,870</b>	<b>(32.9)</b>	<b>24.1</b>

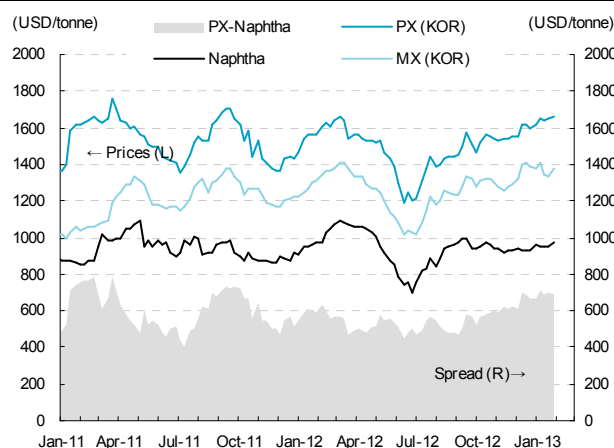
Source: Korea Investment &amp; Securities

Figure 1. Complex refining margin on recovery from Dec 2012



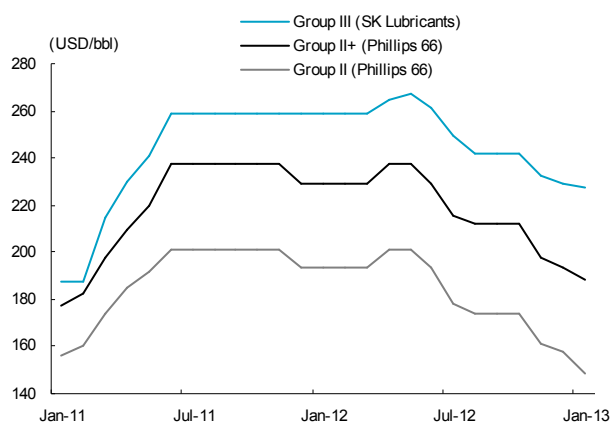
Source: Petronet, Korea Investment &amp; Securities

Figure 2. PX spread to maintain high level



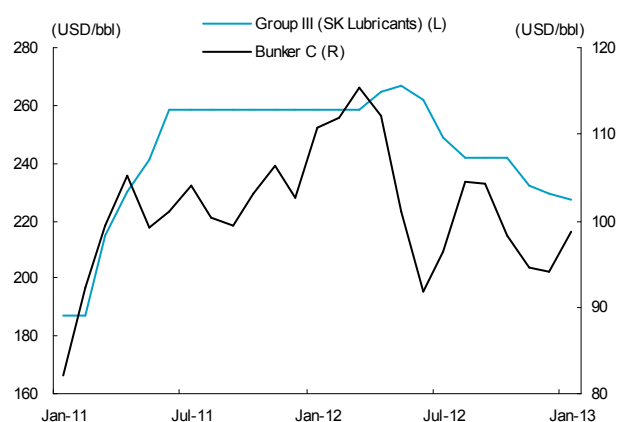
Source: Petronet, Ciscchem, Korea Investment &amp; Securities

**Figure 3. SK Lubricants' selling price is stable despite the falling trend of lube base oil price** **Figure 4. Cost is reflected on lube base oil price on the delayed**



Note: Group II (viscosity 100-110), group II+ (viscosity 70-80), group III (4cST) price FOB Gulf coast basis

Source: Lubes and Greases, Korea Investment & Securities



Note: Group III (4cST) FOB Gulf coast price

Source: Lubes and Greases, Petronet, Korea Investment & Securities

### Company overview & Glossary

SK Innovation was established in 1962 as the first refiner in Korea. SK Innovation is a holdings company in charge of exploration and production (E&P) and information and electronic materials new business and holds SK Energy (refining), SK Global Chemical (chemical) and SK Lubricants (lube) as wholly owned subsidiaries. SK Innovation formed the current structure after splitting off lubricant business in 2009 and refining and chemical businesses in 2011. In 2012, sales are composed of refining 77%, chemicals 17%, lubricant 4% E&P and others 2%. SK Energy acquired Incheon Oil Refinery in 2005 and has CDU capacity of 1,115,000 barrel per day in Incheon and Ulsan with upgrading ratio of 15%. SK Global Chemical has NCC of 860,000 tonne p.a. on ethylene basis and produces synthetic resin and aromatics products. SK Lubricants holds lube base oil plants in Korea and Indonesia, totaling 60,000 barrel per day capacity. SK Innovation is participating 26 fields and 4 LNG projects in E&P business.

- Crude oil : raw petroleum represented by WTI, Brent, Dubai crude oil
- Petroleum product : petroleum produced by refining crude oil such as gasoline, naphtha, jet oil, diesel, heavy oil, asphalt and LPG
- PX (para xylene) : produced with MX and used as a raw material of TPA and DMT
- Lubricant : petroleum used to prevent abrasion and lower frictional resistance on the friction surface, usually used for industrial and automobile purposes
- Lube base oil : raw material of lubricant
- Simple refining margin : difference between the average petroleum product price (weighted by production yield after primary refining) and crude oil price
- Complex refining margin : difference between the average petroleum product price (weighted by production yield after upgrading) and crude oil price

**Balance sheet**

FY-ending Dec. (W bn)	2010A	2011A	2012F	2013F	2014F
Current assets	15,496	19,887	17,901	18,740	20,911
Cash & cash equivalent	2,949	4,380	3,557	3,740	4,503
Accounts & other receivables	5,086	6,755	6,456	6,799	7,505
Inventory	5,863	7,482	6,526	6,799	7,505
Non-current assets	13,910	15,140	15,913	16,866	18,320
Investment assets	1,720	2,353	2,523	2,771	3,059
Tangible assets	10,850	11,377	11,877	12,692	13,713
Intangible assets	1,138	1,206	1,293	1,199	1,323
Total assets	29,406	35,027	33,814	35,606	39,231
Current liabilities	11,745	14,305	13,449	13,391	14,596
Accounts & other payables	6,171	9,934	8,360	7,751	8,556
ST debt & bond	3,306	2,782	3,098	3,348	3,648
Current portion of LT debt	1,991	1,101	1,491	1,791	1,691
Non-current liabilities	6,109	5,890	4,116	4,363	4,619
Debentures	3,899	3,669	2,719	3,119	3,319
LT debt & financial liabilities	1,604	1,315	615	519	499
Total liabilities	17,854	20,195	17,565	17,754	19,215
Controlling interest	11,451	14,577	15,991	17,589	19,749
Capital stock	469	469	469	469	469
Capital surplus	5,878	5,886	5,886	5,886	5,886
Capital adjustments	(143)	(144)	(144)	(144)	(144)
Retained earnings	5,266	8,203	9,450	10,883	12,877
Minority interest	100	254	258	262	267
Shareholders' equity	11,552	14,832	16,249	17,852	20,016

**Cash flow**

FY-ending Dec. (W bn)	2010A	2011A	2012F	2013F	2014F
C/F from operating	311	2,722	1,631	1,075	2,433
Net profit	1,149	3,176	1,549	1,735	2,297
Depreciation	512	521	529	458	472
Amortization	129	84	93	86	95
Net incr. in W/C	(1,679)	(13)	(542)	(1,202)	(436)
Others	200	(1,046)	2	(2)	5
C/F from investing	(755)	814	(1,250)	(1,447)	(1,751)
CAPEX	(444)	(1,192)	(1,115)	(1,360)	(1,579)
Decr. in fixed assets	128	87	87	87	87
Incr. in investment	(103)	(187)	(4)	(82)	(122)
Net incr. in intangible assets	(337)	(182)	(180)	8	(220)
Others	1	2,288	(38)	(100)	83
C/F from financing	690	(2,085)	(1,205)	556	82
Incr. in equity	35	0	0	0	0
Incr. in debts	852	(1,880)	(944)	854	380
Dividends	(198)	(199)	(261)	(298)	(298)
Others	1	(6)	0	0	0
C/F from others	(0)	(4)	0	0	0
Increase in cash	246	1,447	(824)	183	764

Note: Based on K-IFRS (consolidated)

**Income statement**

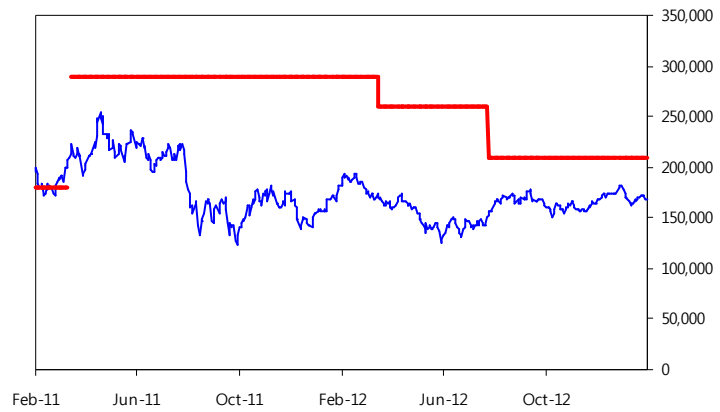
FY-ending Dec. (W bn)	2010A	2011A	2012F	2013F	2014F
Sales	53,722	68,371	73,330	67,991	75,052
Gross profit	3,973	4,820	3,495	4,229	5,174
SG&A expense	1,705	1,860	1,804	1,904	2,101
Other operating gains	(377)	(117)	0	0	0
Operating profit	1,891	2,842	1,691	2,326	3,073
Financial income	856	1,183	1,192	1,164	1,174
Interest income	66	106	116	87	97
Financial expense	1,266	1,321	1,276	1,274	1,299
Interest expense	450	388	343	342	366
Other non-operating profit	22	1,605	73	68	75
Gains (Losses) in associates, subsidiaries and JV	0	0	1	0	0
Earnings before tax	1,502	4,309	1,682	2,283	3,022
Income taxes	353	1,133	133	548	725
Net profit	1,149	3,176	1,549	1,735	2,297
Net profit of controlling interest	1,139	3,169	1,546	1,731	2,292
Other comprehensive profit	(3)	166	166	166	166
Total comprehensive profit	1,146	3,342	1,715	1,901	2,463
Total comprehensive profit of controlling interest	1,137	3,323	1,712	1,897	2,458
EBITDA	2,532	3,448	2,313	2,870	3,639

**Key financial data**

FY-ending Dec.	2010A	2011A	2012F	2013F	2014F
per share data (KRW)					
EPS	12,241	34,004	16,563	18,578	24,595
BPS	123,724	157,089	172,169	189,230	212,275
DPS	2,100	2,800	3,200	3,200	3,200
Growth (%)					
Sales growth	22.5	27.3	7.3	(7.3)	10.4
OP growth	54.3	50.3	(40.5)	37.5	32.1
NP growth	70.1	178.3	(51.2)	12.0	32.4
EPS growth	70.0	177.8	(51.3)	12.2	32.4
EBITDA growth	30.5	36.2	(32.9)	24.1	26.8
Profitability (%)					
OP margin	3.5	4.2	2.3	3.4	4.1
NP margin	2.1	4.6	2.1	2.5	3.1
EBITDA margin	4.7	5.0	3.2	4.2	4.8
ROA	4.3	9.9	4.5	5.0	6.1
ROE	11.9	24.4	10.1	10.3	12.3
Dividend yield	1.1	2.0	1.8	1.9	1.9
Stability					
Net debt (W bn)	7,651	4,226	4,076	4,639	4,349
Debt/equity ratio (%)	94.3	60.8	49.7	50.0	46.5
Valuation (X)					
PER	15.8	4.2	10.5	9.1	6.9
PBR	1.6	0.9	1.0	0.9	0.8
PSR	0.3	0.2	0.2	0.2	0.2
EV/EBITDA	10.1	5.1	8.8	7.1	5.5

**Changes to recommendation and price target**

Company (Code)	Date	Recommendation	Price target
SK Innovation (096770)	03-17-11	NA	-
	03-21-11	BUY	W290,000
	03-21-12	BUY	W260,000
	07-30-12	BUY	W210,000



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