

12M rating **BUY (Initiate)**

12M TP **W48,000**

Up/downside **+41%**

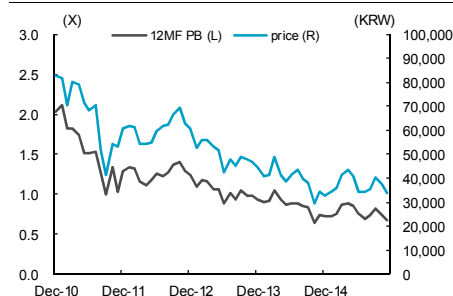
#### Stock Data

KOSPI (Nov 13, pt)	1,973
Stock price (Nov 13, KRW)	34,000
Market cap (USD mn)	754
Shares outstanding (mn)	26
52-Week high/low (KRW)	44,300/29,800
6M avg. daily turnover (USD mn)	3.1
Free float / Foreign ownership (%)	67.4/13.3
Major shareholders (%)	
Samsung SDI Co., Ltd and 8 others	31.3
KOREA Investment Trust Management Co.	11.0

#### Performance

	1M	6M	12M
Absolute (%)	(14.4)	(23.1)	5.1
Relative to KOSPI (%p)	(12.1)	(16.4)	4.4

#### 12MF PB trend



Source: WISEfn consensus

## Multi-year upturn ahead

### Short-term concerns overblown

We initiate coverage of Samsung Fine Chemicals (SFC) with BUY and a TP of W48,000 at a target 1.0x 2016F PB. We recommend taking the recent share price retreat after the announcement that it would take over Lotte Chemical as a buying opportunity. Excluding potential one-off costs such as employee compensation of ~W47bn, the acquisition itself does not erode its fundamentals or potential growth outlook, in our view. In fact, SFC is taking the first step into a multi-year growth phase with all three divisions set to deliver substantial growth momentum.

### First step into a multi-year growth phase

We peg SFC's 2016F OP to increase 191% YoY and jump almost five-fold through 2018 from the 2015 figure. The combination of 1) turnaround at its earnings driver, chlorine & cellulose (C&C) division, 2) adding a new growth engine to its cash cow ammonia derivatives division and 3) the removal of all loss-making businesses at the electronic chemical materials (ECM) division is visible and the company is already on track to deliver massive earnings growth.

### A matter of time

We expect SFC's C&C division to generate almost 80% of the OP increase through 2018. First, we believe it is a matter of time (depending on how fast demand improves) before we see the epichlorohydrin (ECH) spread touch bottom during 2016 and head toward its peak cycle. Second, OP from its cellulose products should witness 29% CAGR for the next three years as the margins return to normal with better economies of scale, in our view.

	2013A	2014A	2015F	2016F	2017F
Sales (W bn)	1,314	1,210	1,203	1,407	1,514
OP (W bn)	(20)	(24)	31	89	121
EBT (W bn)	0	70	140	67	124
NP of con. int. (W bn)	3	61	112	50	92
EBITDA (W bn)	39	46	110	168	200
Net debt (W bn)	405	333	195	231	210
OP margin (%)	(1.5)	(2.0)	2.5	6.3	8.0
ROE (%)	0.3	5.3	9.2	4.0	7.0
Dividend yield (%)	0.7	0.9	0.9	0.9	0.9
EPS (KRW)	131	2,402	4,391	1,959	3,630
chg. (% YoY)	(95.4)	1,733.6	82.8	(55.4)	85.3
BPS (KRW)	44,027	46,358	48,384	50,022	53,311
DPS (KRW)	300	300	300	300	300
PE (x)	340.1	13.6	7.7	17.4	9.4
PB (x)	1.0	0.7	0.7	0.7	0.6
EV/EBITDA (x)	39.6	25.6	9.7	6.6	5.4

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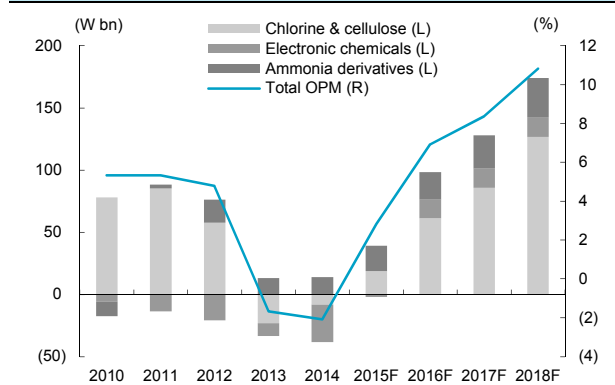
## The best buying opportunity

We initiate coverage of Samsung Fine Chemicals (SFC) with BUY and a TP of W48,000 at a target 1.0x 2016F PB. Our target multiple is derived from an analysis of its peers' ROE versus PB after removing potential one-off costs stemming from the Lotte Chemical acquisition in 2016. We believe the recent share price retreat caused by the announcement on October 30 that it would take over Lotte Chemical offers a great buying opportunity. Even in the worst-case scenario, we believe fair value is W37,000 that offers 9% upside potential. The bull case could reveal almost 70% upside and fully reflect earnings momentum for the next three years (please see the valuation section for more details). Once again we recommend exploiting the noise arising from the Lotte Chemical acquisition as we believe SFC is now taking the first step into a multi-year growth phase with all three divisions – C&C, ammonia derivatives and ECM – set to deliver substantial earnings momentum.

## Multi-year growth

We believe SFC will stand out among its chemical rivals as we expect its 2016F OP to increase 191% YoY and jump almost five-fold through 2018 from the 2015 figure. SFC has spent the past three years doing business realignment: 1) reshaping the earnings driver, C&C division, to cope with its overinvestment during 2012 and 2013, 2) adding a new growth engine to its cash cow ammonia derivatives division and 3) removing all loss-making businesses at the ECM division, once a so-called growth engine for SFC. We expect the C&C division will remain its earnings driver for the next three years and generate almost 80% of the OP increase as earnings recover. Another 13% of the profit gain will come from ECM almost immediately from 4Q15 after having completed restructuring. The rest will come from ammonia derivatives on bigger sales of urea solution (Eurox).

**Figure 1. Total OPM vs. cumulative OP by division**

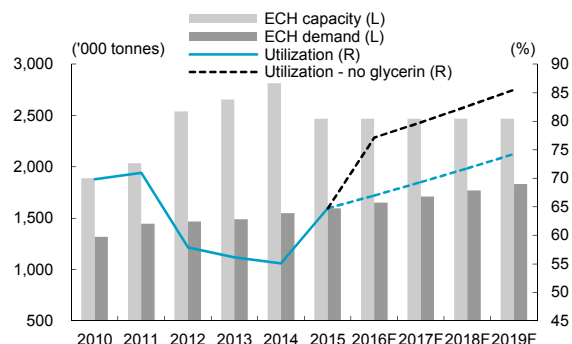


Source: Samsung Fine Chemicals, Korea Investment & Securities

## Earnings turnaround: C&C

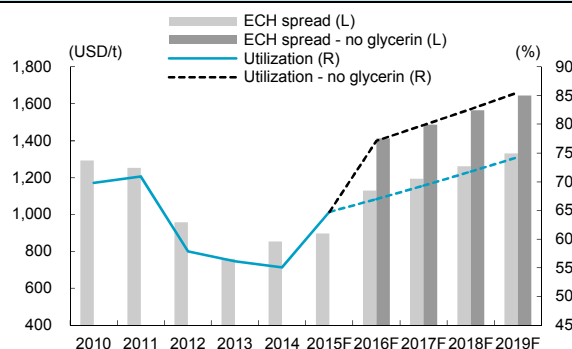
We forecast the C&C division's OP to jump almost seven-fold from 2015 to 2018, mainly due to 1) potential ECH upturn and 2) gradual utilization increase for its cellulose products. First, we believe it is a matter of time before we see the ECH spread touch bottom during 2016 and reach a peak level by 2018 or much sooner given 1) no new capacity additions, 2) strong propylene oxide (PO) margins and 3) massive oversupply for its feedstock propylene. The ECH spread has dipped below the break-even point of USD900/t since 2012 mainly due to new capacities from China and SFC. However, after having gone through a four-year downturn, many ECH players scrapped or converted their plants to very profitable PO output while ECH business losses effectively prevented any new entrant. More importantly, if oil prices remain at USD40-50/bbl, we may see a faster ECH spread rebound as glycerin-based ECH plants will eventually lose cost competitiveness. These plants account for 13% of global capacity. Glycerin is a byproduct of biodiesel and recent cheap oil is casting a shadow over the viability of this fuel. This, in turn, makes glycerin relatively more expensive than propylene as a feedstock for ECH, as glycerin supplies are cut on biodiesel run rate drops.

**Figure 2. ECH supply-demand dynamics**



Source: CIS Chem, Korea Investment & Securities

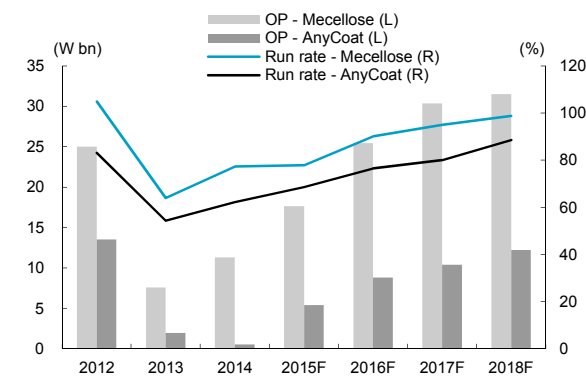
**Figure 3. ECH utilization vs. spread**



Source: CIS Chem, Korea Investment & Securities

Second, we expect OP from the cellulose business to witness 29% CAGR for the next three years as margins return to normal with better economies of scale. Cellulose products (i.e., SFC's Hecellose and AnyCoat) are pulp-based niche market products for a range of industrial, body care, food and pharmaceutical uses. It is an oligopoly with four global majors – Dow Chemical, Shinetsu, Ashland and SFC – dominating the market. Its stable yet fat margins dramatically fell close to zero or even went into red during 2013-2014 as the company failed to lift utilization after doubling capacity. However, the margins are bottoming fast in tandem with rising utilization every year. Its Hecellose and Mecellose are expected to reach full capacity by 2016-2017 while AnyCoat will reach 90% utilization by 2018. We see a great likelihood for sales to increase on top of margins getting back to the previous lucrative level as not only global demand is growing at 4-8% p.a., but Dow will scrap its old 14,000tpa plant in 4Q15, which accounts for 3-5% of global capacity. The shortfall in capacity will be filled only by Shinetsu's new 9,000tpa starting in 4Q15 and Ashland's new 5,000tpa plant scheduled to come on stream in 2017.

**Figure 4. Annual run rate vs. OP (Mecellose & AnyCoat)**



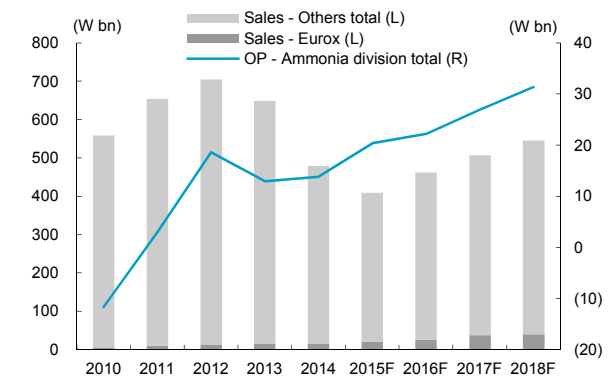
Source: Samsung Fine Chemicals, Korea Investment & Securities

## A hidden jewel: Ammonia derivatives

The ammonia derivatives division turned into a steady earnings generator from a loss-making business from 4Q11 thanks to SFC's decisive call in April 2011 to exit production and shift to pure trading. That said, this cash cow division has a hidden jewel, Eurox (urea solution, a catalytic reduction agent used in diesel engines equipped with SCR, selective catalytic reduction), that will allow the division's OP to achieve 12% CAGR for the next three years. Eurox contributed only 5% to the division's sales in 1H15. However, its lucrative margin and growth potential are substantial enough to transform the cash cow division into one of the main growth engines. We expect Eurox sales to see 34% CAGR for the next three years as Euro 6

emissions standards will be applied to all diesel vehicles in Korea by September 2016. Urea solution for SCR is a domestic distribution network oriented business with SFC having a 70% domestic market share.

**Figure 5. OP vs. sales (Eurox & others)**



Source: Samsung Fine Chemicals, Korea Investment & Securities

## Restructured: ECM

ECM, once considered a growth engine by exploiting opportunities from its captive client Samsung Group, mostly failed to enhance profits. Trial and error processes for new products such as lithium ion battery positive materials, liquid crystal polymer, BT powder for MLCC, etc., generated massive losses for the past nine years. That said, SFC cleaned up the past mess, leaving only profitable products, printer toner and TMAC (feedstock for semiconductor and TFT-LCD developer), as of September 2015. This will improve the division's earnings from a W2bn operating loss in 2015F to W15bn OP in 2016F.

## Valuation

We anticipate the biggest negative impact from the Lotte Chemical acquisition to be employee compensation of W47bn and we estimate that half will be recognized in 2Q16. If we present this one-off cost coupled with no meaningful earnings improvement as our worst case, it leaves fair value at W37,000 in an ROE versus PB analysis. On the other hand, in an EBITDA versus EV/EBITDA analysis, our EBITDA CAGR of 35% forecast for the next three years gives a 9.8x EV/EBITDA multiple for the stock, which in turn delivers a fair value of W59,000 using SoTP valuation.

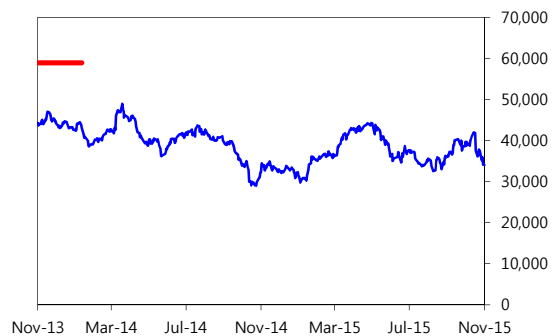
### ■ Company overview & Glossary

SFC produces fine chemicals, general chemicals and electronic materials. Cellulose type products are the company's main products. For the ammonia business, the company shifted it to a trading business which lets the company secure stable margins. Electro-chemical materials division produces TMAC, toner and etc.

- ECH: Epichlorohydrine
- TMAC: Tetramethyl Ammonium Chloride

### Changes to recommendation and price target

Company (Code)	Date	Recommendation	Price target
Samsung Fine Chemicals (004000)	11-13-15	BUY	W48,000



### Balance sheet

FY-ending Dec. (W bn)	2013A	2014A	2015F	2016F	2017F
Current assets	507	597	571	600	650
Cash & cash equivalents	87	97	174	155	185
Accounts & other receivables	212	196	186	214	227
Inventory	198	159	165	183	189
Non-current assets	1,393	1,249	1,303	1,355	1,407
Investment assets	419	279	223	236	250
Tangible assets	929	927	967	1,008	1,049
Intangible assets	43	38	35	32	30
Total assets	1,900	1,846	1,877	1,957	2,059
Current liabilities	202	184	216	285	502
Accounts & other payables	186	126	149	167	174
ST debt & bonds	10	28	34	34	134
Current portion of LT debt	0	14	17	64	173
Non-current liabilities	572	466	414	384	184
Debentures	299	299	300	300	100
LT debt & financial liabilities	183	89	46	17	17
Total liabilities	774	650	631	669	686
Controlling interest	1,126	1,187	1,239	1,281	1,366
Capital stock	129	129	129	129	129
Capital surplus	331	331	331	331	331
Other reserves	(9)	(9)	(9)	(9)	(9)
Retained earnings	567	622	726	769	853
Minority interest	0	9	7	7	7
Shareholders' equity	1,127	1,196	1,246	1,288	1,373

### Cash flow

FY-ending Dec. (W bn)	2013A	2014A	2015F	2016F	2017F
C/F from operations	71	24	319	89	146
Net profit	3	59	108	50	92
Depreciation	52	64	75	75	75
Amortization	7	6	4	4	4
Net incr. in W/C	6	(25)	139	(27)	(12)
Others	3	(80)	(7)	(13)	(13)
C/F from investing	(360)	96	(206)	(117)	(117)
Capex	(320)	(76)	(160)	(161)	(161)
Decr. in fixed assets	20	45	45	45	45
Incr. in investment	(63)	92	13	0	0
Net incr. in intangible assets	(0)	(2)	(1)	(1)	(1)
Others	3	37	(103)	0	0
C/F from financing	333	(109)	(36)	10	1
Incr. in equity	0	1	0	0	0
Incr. in debt	349	(103)	(33)	17	9
Dividends	(17)	(8)	(8)	(8)	(8)
Others	1	1	5	1	0
C/F from others	0	(0)	0	0	0
Increase in cash	43	10	77	(19)	30

Note: K-IFRS (consolidated)

### Income statement

FY-ending Dec. (W bn)	2013A	2014A	2015F	2016F	2017F
Sales	1,314	1,210	1,203	1,407	1,514
COGS	1,206	1,094	1,048	1,184	1,252
Gross profit	108	117	154	223	262
SG&A expenses	129	141	124	134	141
Operating profit	(20)	(24)	31	89	121
Financial income	3	3	4	4	3
Interest income	2	2	4	4	3
Financial expenses	7	19	17	16	14
Interest expenses	6	18	15	15	14
Other non-operating profit	21	100	113	(24)	0
Gains (Losses) in associates, subsidiaries and JV	4	11	9	13	13
Earnings before tax	0	70	140	67	124
Income taxes	(3)	12	32	17	32
Net profit	3	59	108	50	92
Net profit of controlling interest	3	61	112	50	92
Other comprehensive profit	(14)	7	(50)	0	0
Total comprehensive profit	(10)	66	58	50	92
Total comprehensive profit of controlling interest	(10)	68	60	50	92
EBITDA	39	46	110	168	200

### Key financial data

FY-ending Dec.	2013A	2014A	2015F	2016F	2017F
Per-share data (KRW)					
EPS	131	2,402	4,391	1,959	3,630
BPS	44,027	46,358	48,384	50,022	53,311
DPS	300	300	300	300	300
Growth (%)					
Sales growth	(8.2)	(7.9)	(0.7)	17.0	7.6
OP growth	NM	NM	NM	191.2	36.2
NP growth	(95.4)	1,731.1	82.8	(55.4)	85.3
EPS growth	(95.4)	1,733.6	82.8	(55.4)	85.3
EBITDA growth	(68.2)	18.6	139.0	53.1	19.0
Profitability (%)					
OP margin	(1.5)	(2.0)	2.5	6.3	8.0
NP margin	0.3	5.1	9.3	3.5	6.1
EBITDA margin	2.9	3.8	9.1	12.0	13.2
ROA	0.2	3.1	5.8	2.6	4.6
ROE	0.3	5.3	9.2	4.0	7.0
Dividend yield	0.7	0.9	0.9	0.9	0.9
Dividend payout ratio	228.7	12.5	6.8	15.3	8.3
Stability					
Net debt (W bn)	405	333	195	231	210
Debt/equity ratio (%)	43.7	36.0	31.9	32.2	30.8
Valuation (x)					
PE	340.1	13.6	7.7	17.4	9.4
PB	1.0	0.7	0.7	0.7	0.6
EV/EBITDA	39.6	25.6	9.7	6.6	5.4

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BUY	Hold	Underweight (Sell)
76.7%	19.9%	3.4%

Note: % of companies under coverage with this rating

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Prepared by: Daniel Lee

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