

KT&G (033780)

BUY (Maintain)

TP: W87,000 (Maintain)

KOSPI (May 11)	1,670
Stock price (May 11)	57,400
Shares outstanding (mn)	137.3
Market cap (USD mn)	6,939
52-Week Low/High (won)	56,000/73,200
6M avg. daily turnover (USD mn)	35.2
Free float (%)	81.6
Dividend yield (2010F, %)	5.4
Foreign ownership (%)	53.2
Major shareholders (%)	

Industrial Bank of KOREA	6.9
Franklin Mutual Advisers	4.9

Stock performance	1M	6M	12M
Absolute (%)	(7.9)	(16.4)	(21.6)
Relative to KOSPI (%p)	(4.7)	(21.2)	(39.6)

Price chart



Disposal of Celltrion shares, positive for focusing more on core business

To dispose of entire stake in Celltrion

On Mar 11, KT&G decided to sell its entire stake in Celltrion. KT&G held 13,031 shares (12.2% of total shares) as of end-2009 and sold 1,000 shares in the market on Mar 3 and Mar 4. The company intends to sell the remaining 12,031 shares over a six-month period. According to press reports, KT&G is planning a block deal with domestic and overseas institutional investors. The company decided to sell the shares because 1) they are up 830% from the initial investment of W21.2bn made in 2002, 2) it has only a limited management right due to a shareholding ratio of 12.2% and 3) it believes synergy with subsidiary Yungjin Pharm is low. If we assume KT&G's remaining Celltrion shares will be sold at the Mar 11 closing price, total proceeds from the sale will be W281.2bn, gains on disposal will reach W260.0bn and after-tax cash inflow will amount to W218.3bn. We raise our 2010 EBT estimate by 27.3% reflecting the disposal of Celltrion shares.

Focusing on core business

The effect of the Celltrion disposal on KT&G's valuation is minimal. As we calculated the value of Celltrion at 70% of its market value, KT&G will only benefit W60.0bn from the disposal. Nevertheless, we think the disposal will have a positive impact on the share price. We expect KT&G to invest proceeds from the sale in its tobacco and red ginseng business and believe this to be KT&G's best strategic option. The growth potential of the middle and central Asian tobacco market and KT&G's recent targets; the Southeast Asian and South American tobacco markets is high. In addition, the growth potential of Asia's red ginseng market including China is huge and when considering KT&G's product competitiveness, the overall potential sales growth in the Asian market is phenomenal. We believe management's decision to focus on the core business and commitment to restructuring through the disposal of non-core business is positive for the company. We maintain BUY and our price target of W87,000.

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Yr to	Sales	OP	EBT	NP	EPS	% chg	EBITDA	P/E	EV/EBITDA	P/B	ROE
Dec	(W bn)	(W bn)	(W bn)	(W bn)	(won)	(YoY)	(W bn)	(x)	(x)	(x)	(%)
2008A	2,644.7	975.3	1,181.3	894.3	6,872	37.7	1,110.0	12.3	10.2	3.1	26.8
2009A	2,776.4	1,010.2	985.3	744.9	5,803	(15.6)	1,136.5	12.4	8.2	2.4	20.2
2010F	2,496.9	916.2	1,216.1	946.2	7,438	28.2	1,031.2	7.7	7.0	1.7	22.9
2011F	2,441.5	931.3	960.8	747.5	5,877	(21.0)	1,046.2	9.8	6.8	1.6	16.4
2012F	2,855.8	966.9	1,013.9	788.8	6,201	5.5	1,085.6	9.3	6.4	1.5	16.1

Valuation

(W bn)

	Book value	Target equity value	Valuation method
Operating value		8,497	DCF (WACC 9.2%, ROIC 9.2%, g 0%)
<i>Implied EBITDA Multiple(X)</i>		8.2	
Korea Ginseng Corp	560	1,915	20% discount after applying 2010F KIS F&B sector EV/EBITDA of 8.7%
Yungjin Pharm Co.	51	44	30% discount to market price
Celtrion	195	218	Proceeds from sales after tax
YTN	39	25	30% discount to market price
Shinhan Financial Group	173	108	30% discount to market price
Other investment securities	14	10	30% discount to book value as of Dec 2009
Real estate	22	555	70% of the residential site market price for Suwon site, industrial site market price for Okcheon and three other sites
Treasury stock		290	50% discount to market price
Net debt		285	As of Dec 2009
Total		11,948	
Share price (KRW)		87,028	

Balance sheet

Fiscal year ending Dec. (W bn)	2008A	2009A	2010F	2011F	2012F
Current assets	1,711.0	2,035.8	2,109.1	2,195.0	2,408.9
Cash & cash equivalents	88.4	269.0	463.8	578.7	687.7
Accounts receivable	407.2	417.1	379.5	368.7	425.5
Inventory	1,075.5	1,054.3	991.1	971.9	974.2
Non-current assets	2,671.6	2,752.0	3,123.6	3,337.2	3,598.4
Investments	1,105.5	1,340.8	1,742.2	1,916.2	2,107.5
Tangible assets	1,398.8	1,210.4	1,200.8	1,244.5	1,284.4
Intangible assets	1.2	45.0	40.5	39.6	46.3
Total assets	4,382.6	4,787.8	5,232.7	5,532.2	6,007.3
Current liabilities	643.3	769.6	675.5	648.2	742.8
Accounts payable	27.5	35.0	32.5	48.8	57.1
Short-term debt and bond	0.0	19.3	25.8	34.4	45.8
Current portion of LT debt	0.0	0.0	0.0	0.0	0.0
Non-current liabilities	199.5	165.2	152.3	151.4	175.5
Debentures	0.0	0.0	0.0	0.0	0.0
LT debt and lease	0.0	0.0	0.0	0.0	0.0
Total liabilities	842.7	934.8	827.8	799.6	918.3
Paid-in capital	955.0	955.0	955.0	955.0	955.0
Capital surplus	471.1	470.9	470.9	470.9	470.9
Capital adjustments	(224.6)	(226.9)	(226.9)	(226.9)	(226.9)
Retained earnings	2,307.7	2,525.3	3,077.1	3,404.9	3,761.2
Shareholders' equity	3,539.8	3,853.0	4,404.8	4,732.6	5,088.9

Source: Company data, Korea Investment & Securities estimates

Cash flow

Fiscal year ending Dec. (W bn)	2008A	2009A	2010F	2011F	2012F
C/F from operations	674.3	747.7	789.2	865.2	892.0
Net profit	894.3	744.9	946.2	747.5	788.8
Depreciation	134.0	126.0	114.5	114.4	118.2
Amortization	0.7	0.3	0.5	0.5	0.5
Net incr. in W/C	(232.0)	(376.1)	(14.7)	(41.9)	(55.9)
Others	(122.7)	252.5	(257.3)	44.7	40.4
C/F from investing	(164.6)	(101.8)	(175.5)	(334.7)	(387.0)
Capex	(141.1)	(96.4)	(66.4)	(176.1)	(176.1)
Decr. in fixed assets	21.9	18.0	18.0	18.0	18.0
Net incr. in current assets	27.5	0.0	(5.4)	(6.2)	(7.1)
Incr. in investment	(51.4)	(36.1)	(141.4)	(173.9)	(191.3)
Others	(21.5)	12.8	19.7	3.5	(30.5)
C/F from financing	(536.5)	(465.3)	(418.8)	(415.6)	(396.1)
Incr. in equity	0.0	0.0	0.0	0.0	0.0
Incr. in debt	0.0	0.0	(9.7)	7.1	14.5
Dividends	(340.4)	(360.4)	(356.2)	(394.3)	(419.8)
Others	(196.0)	(104.9)	(53.0)	(28.4)	9.2
Increase in cash	(26.8)	180.6	194.9	114.9	108.9

Source: Company data, Korea Investment & Securities estimates

Income statement

Fiscal year ending Dec. (W bn)	2008A	2009A	2010F	2011F	2012F
Sales	2,644.7	2,776.4	2,496.9	2,441.5	2,855.8
Gross profit	1,621.6	1,621.5	1,531.0	1,543.4	1,686.5
SG&A expenses	646.3	611.2	614.8	612.1	719.6
Operating profit	975.3	1,010.2	916.2	931.3	966.9
Non-operating profit	278.1	93.0	384.8	84.3	104.7
Interest income	21.2	10.8	24.3	33.9	41.0
FX gains	85.0	27.0	0.0	0.0	6.0
Equity gains	145.0	0.0	0.0	0.0	0.0
Non-operating expenses	72.1	117.9	84.8	54.7	57.7
Interest expenses	0.6	1.1	1.0	1.0	1.0
FX losses	10.3	51.8	32.3	3.0	0.0
Equity losses	10.3	0.0	0.0	0.0	0.0
Earnings before tax	1,181.3	985.3	1,216.1	960.8	1,013.9
Income taxes	287.0	240.4	270.0	213.3	225.1
Profit from discontinued	0.0	0.0	0.0	0.0	0.0
Net profit	894.3	744.9	946.2	747.5	788.8
EBITDA	1,110.0	1,136.5	1,031.2	1,046.2	1,085.6

Source: Company data, Korea Investment & Securities estimates

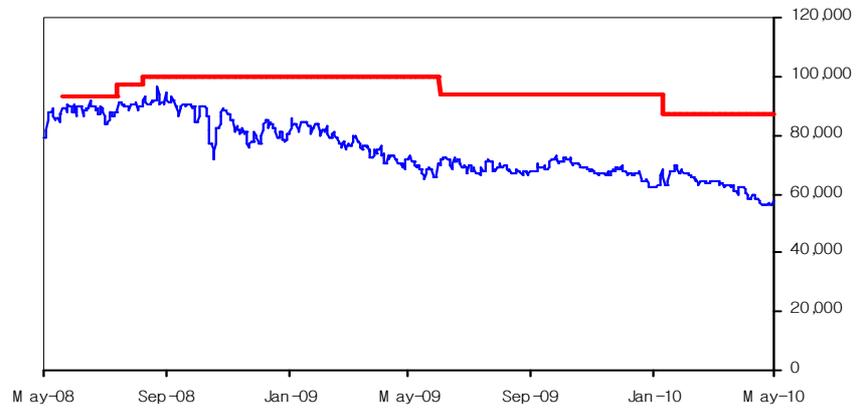
Key financial data

Fiscal year ending Dec.	2008A	2009A	2010F	2011F	2012F
Per-share data (won)					
EPS	6,872	5,803	7,438	5,877	6,201
BPS	27,131	29,389	33,442	35,836	38,382
DPS	2,800	2,800	3,100	3,300	3,400
SPS	18,814	20,027	19,630	19,195	22,452
Growth (%)					
Sales growth	9.6	5.0	(10.1)	(2.2)	17.0
OP growth	19.8	3.6	(9.3)	1.6	3.8
NP growth	35.3	(16.7)	27.0	(21.0)	5.5
EPS growth	37.7	(15.6)	28.2	(21.0)	5.5
EBITDA growth	16.9	2.4	(9.3)	1.4	3.8
Profitability (%)					
OP margin	36.9	36.4	36.7	38.1	33.9
NP margin	33.8	26.8	37.9	30.6	27.6
EBITDA margin	42.0	40.9	41.3	42.8	38.0
ROA	23.3	22.0	18.3	17.3	16.8
ROE	26.8	20.2	22.9	16.4	16.1
Dividend yield	3.5	4.3	5.4	5.7	5.9
Stability					
Net debt (W bn)	(119.5)	(285.4)	(479.2)	(591.7)	(696.3)
Int. coverage (x)	1,507.9	922.6	916.2	931.3	966.9
D/E ratio (%)	0.0	0.5	0.6	0.7	0.9
Valuations (x)					
PER	12.3	12.4	7.7	9.8	9.3
PBR	3.1	2.4	1.7	1.6	1.5
PSR	4.5	3.6	2.9	3.0	2.6
EV/EBITDA	10.2	8.2	7.0	6.8	6.4

Source: Company data, Korea Investment & Securities estimates

Changes to recommendation and price target

Company (Code)	Date	Recommendation	Price target
KT&G (033780)	05-30-08	BUY	W93,000
	07-24-08	BUY	W97,000
	08-18-08	BUY	W100,000
	06-11-09	BUY	W94,000
	01-21-10	BUY	W87,000



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- Hold: Expected to either outperform or underperform the market by less than 15%p.
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- 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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