

21 February 2011

Produced by: RBS Asia Limited (Seoul) Branch

Buy

Target price
W159000.00

Price
W140500.00

Equity | Korea | Materials

Flashnote

Kumho Petrochemical

Focus on continued strong operation

We expect Kumho to post a record high operating profit in 1Q11 thanks to strong synthetic rubber prices. Based on our channel checks, this trend will continue to 2Q11, helped by price hikes and capacity additions in BR. The recent share price correction related to insider selling provides an attractive buying opportunity.

A record-high 1Q11 expected

- We expect Kumho Petrochem to post a record high 1Q11 thanks to strength in synthetic rubber prices. We forecast W1,064bn sales (20% yoy) and W165bn operating profit (154% yoy, or 15.5% operating margin) in 1Q11, comparing to the consensus of W1,065bn sales and W111bn operating profit. By division, we forecast 19.0% operating margin for the synthetic rubbers, 7.5% for synthetic resins. A 19% operating margin in synthetic rubbers is a record high quarterly results, in our view.
- We also believe 2Q11 could show qoq growth reflecting 1) BR price and spread hikes after the lunar New Year, 2) BR capacity addition by 120k tonnes from February 2011. Based on our channel checks, BR price stands at above US\$4,000/tonne after the lunar New Year (around 11% price hikes vs. US\$3,600/tonne). This translates into around US\$1,700/tonne BR-BD spread in 2Q11. (vs. US\$1,550/tonne BR-BD spread in 1Q11 and US\$1,374/tonne in 4Q10). Recent BD price increase may have some negative impacts on the spread; however, we believe this is limited as Kumho can pass through the raw-materials cost hikes onto its customers given strong tire demand and natural rubber price.
- One positive development is that BR capacity addition increases revenue and operating profit in the absolute terms without weakening BR price at all. The additional BR sales amounts are assumed to be around 15k tonnes in 1Q11 and 30k tonnes in 2Q11.

Positive development in corporate structure

- The share price of Kumho fell by 12% last week due to selling down by one of insiders related with group restructuring. We view this as a positive development despite short-term pressures on share price.
- As we mentioned in the previous reports, Kumho Petrochemical group is split from the old Kumho Asiana group. To complete this, Mr. Sam-gu Park and his son, Mr. Sae-chang Park should sell their stake at Kumho Petrochem. With the cash proceeds from this, they need to

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1Q11 Earnings forecast

(W/bn)	1Q11 (E)	Consensus	Diff	1Q10	YoY	4Q10	QoQ
Sales	1,064	1,065	-0.1%	887	20.0%	1,022	4.1%
Synthetic rubber	622			498	25.0%	591	5.2%
Synthetic resin	340			288	18.0%	316	7.6%
Others	102			101	1.0%	115	-11.6%
Operating profit	165	111	49.0%	65	154.0%	105	56.7%
Synthetic rubber	118			37	218.6%	66	79.9%
Synthetic resin	26			7	244.7%	25	1.6%
Others	21			21	3.8%	15	46.7%
Recurring profit	185	126	47.2%	104	77.5%	292	-36.7%
Equity method gains	50			13	274.3%	55.1	-9.3%
Net profit	142	96	48.2%	84	69.3%	236	-39.7%
Margin (%)							
Operating profit	15.5%	10.4%		7.3%		10.3%	
Synthetic rubber	19.0%			7.5%		11.1%	
Synthetic resin	7.5%			2.6%		7.9%	
Others	21.0%			20.4%		12.6%	
Recurring profit	17.4%	11.8%		11.8%		28.6%	
Net profit	13.4%	9.0%		9.5%		23.1%	

Source: Company data, RBS forecast

Important disclosures can be found in the Disclosures Appendix.

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purchase some portion of Kumho Tire as they currently don't have any ownership on Kumho Tire, even though they are allowed to manage the company by creditors by early 2015.

- Through the recent selling down, the stakes in Mr. Sam-gu Park and Sae-chang Park is expected to fall to 9.8% from 12% in December 2010, which is below 19.6% owned by Mr. Chan-gu Park and his son, Mr. Chul-wan Park. This is likely to dissipate market concern of possible struggle for the ownership of Kumho Petrochem between Mr. Chan-gu Park and Mr. Sam-gu Park.

Income statement

Wb	FY08A	FY09A	FY10F	FY11F	FY12F
Revenue	3182	2802	3886	4579	4944
Cost of sales	-2703	-2488	-3305	-3728	-4027
Operating costs	-126.4	-96.2	-99.6	-152.3	-184.0
EBITDA	353.5	218.0	482.2	698.6	732.2
DDA & Impairment (ex gw)	-72.2	-101.8	-117.7	-121.8	-120.4
EBITA	281.3	116.2	364.5	576.8	611.8
Goodwill (amort/impaird)	n/a	n/a	n/a	n/a	n/a
EBIT	281.3	116.2	364.5	576.8	611.8
Net interest	-86.3	-105.6	-122.4	-110.6	-78.2
Associates (pre-tax)	-169.1	-733.5	148.5	194.4	214.6
Forex gain / (loss)	-110.2	26.8	2.00	-3.82	-4.39
Exceptionals (pre-tax)	n/a	n/a	170.0	n/a	n/a
Other pre-tax items	57.7	-145.8	40.9	-6.72	-27.7
Reported PTP	-26.7	-841.9	603.5	650.1	716.1
Taxation	6.91	227.0	-141.4	-143.0	-157.5
Minority interests	n/a	n/a	n/a	n/a	n/a
Exceptionals (post-tax)	n/a	n/a	n/a	n/a	n/a
Other post-tax items	0.00	0.00	0.00	0.00	0.00
Reported net profit	-19.7	-614.8	462.1	507.1	558.5
Normalised Items Excl. GW	0.00	0.00	130.2	0.00	0.00
Normalised net profit	-19.7	-614.8	331.9	507.1	558.5

Source: Company data, RBS forecasts

year to Dec

Balance sheet

Wb	FY08A	FY09A	FY10F	FY11F	FY12F
Cash & market secs (1)	13.1	80.4	50.3	236.4	475.2
Other current assets	770.2	695.4	875.3	961.9	999.7
Tangible fixed assets	1273	1357	1400	1368	1358
Intang assets (incl gw)	45.4	35.6	32.2	31.6	31.2
Oth non-curr assets	1613	1032	1184	1152	1373
Total assets	3715	3200	3541	3750	4237
Short term debt (2)	168.1	769.9	392.8	392.8	392.8
Trade & oth current liab	948.9	1289	1660	874.9	792.8
Long term debt (3)	1309	585.1	775.7	1088	1126
Oth non-current liab	126.0	20.9	23.2	26.4	29.5
Total liabilities	2552	2665	2852	2382	2341
Total equity (incl min)	1163	535.1	689.7	1368	1896
Total liab & sh equity	3715	3200	3541	3750	4237
Net debt	1956	2150	2158	1432	1106

Source: Company data, RBS forecasts

year ended Dec

Cash flow statement

Wb	FY08A	FY09A	FY10F	FY11F	FY12F
EBITDA	353.5	218.0	482.2	698.6	732.2
Change in working capital	-250.2	-49.0	27.4	-19.6	4.93
Net interest (pd) / rec	-86.3	-105.6	-122.4	-110.6	-78.2
Taxes paid	n/a	n/a	n/a	n/a	n/a
Other oper cash items	-51.3	218.3	-231.4	-161.8	-185.7
Cash flow from ops (1)	-34.4	281.7	155.9	406.6	473.3
Capex (2)	-334.8	-264.1	-150.0	-80.0	-100.0
Disposals/(acquisitions)	-43.0	-199.7	0.27	229.7	-2.09
Other investing cash flow	-6.20	-4.55	-13.5	-15.8	-16.1
Cash flow from invest (3)	-384.0	-468.4	-163.3	133.9	-118.2
Incr / (decr) in equity	0.00	0.00	0.00	200.0	0.00
Incr / (decr) in debt	435.4	129.3	-22.7	-539.4	-87.5
Ordinary dividend paid	-17.3	-17.3	0.00	-14.9	-28.8
Preferred dividends (4)	n/a	n/a	n/a	n/a	n/a
Other financing cash flow	1.73	142.0	0.04	0.00	0.00
Cash flow from fin (5)	419.8	253.9	-22.7	-354.3	-116.3
Forex & disc ops (6)	n/a	n/a	n/a	n/a	n/a
Incr/(decr) cash (1+3+5+6)	1.40	67.3	-30.1	186.1	238.8
Equity FCF (1+2+4)	-369.2	17.6	5.88	326.6	373.3

Lines in bold can be derived from the immediately preceding lines.
Source: Company data, RBS forecasts

year to Dec

Recommendation structure

Absolute performance, short term (trading) recommendation: A Trading Buy recommendation implies upside of 5% or more and a Trading Sell indicates downside of 5% or more. The trading recommendation time horizon is 0-60 days. For Australian coverage, a Trading Buy recommendation implies upside of 5% or more from the suggested entry price range, and a Trading Sell recommendation implies downside of 5% or more from the suggested entry price range. The trading recommendation time horizon is 0-60 days.

Absolute performance, long term (fundamental) recommendation: The recommendation is based on implied upside/downside for the stock from the target price and, except as follows, only reflects capital appreciation. A Buy/Sell implies upside/downside of 10% or more and a Hold less than 10%. For research produced by Nedbank Capital, a Buy implies upside in excess of 20%, a Sell implies an expected return less than 10%, and a Hold implies a return between 10% and 20%. For UK-based Investment Funds research, the recommendation structure is not based on upside/downside to the target price. Rather it is the subjective view of the analyst based on an assessment of the resources and track record of the fund management company. For research produced by Nedbank Capital and for research on Australian listed property trusts (LPT) or real estate investment trusts (REIT), the recommendation is based upon total return, ie, the estimated total return of capital gain, dividends and distributions received for any particular stock over the investment horizon.

Performance parameters and horizon: Given the volatility of share prices and our pre-disposition not to change recommendations frequently, these performance parameters should be interpreted flexibly. Performance in this context only reflects capital appreciation and the horizon is 12 months.

Market or sector view: This view is the responsibility of the strategy team and a relative call on the performance of the market/sector relative to the region. Overweight/Underweight implies upside/downside of 10% or more and Neutral implies less than 10% upside/downside.

Target price: The target price is the level the stock should currently trade at if the market were to accept the analyst's view of the stock and if the necessary catalysts were in place to effect this change in perception within the performance horizon. In this way, therefore, the target price abstracts from the need to take a view on the market or sector. If it is felt that the catalysts are not fully in place to effect a re-rating of the stock to its warranted value, the target price will differ from 'fair' value.

Distribution of recommendations

The tables below show the distribution of recommendations (both long term and trading). The first column displays the distribution of recommendations globally and the second column shows the distribution for the region. Numbers in brackets show the percentage for each category where there is an investment banking relationship. These numbers include recommendations produced by third parties with which RBS has joint ventures or strategic alliances.

Long term recommendations (as at 21 Feb 2011)

	Global total (IB%)	Asia Pacific total (IB%)
Buy	754 (13)	481 (2)
Hold	445 (7)	250 (1)
Sell	112 (1)	63 (0)
Total (IB%)	1311 (10)	794 (2)

Source: RBS

Trading recommendations (as at 21 Feb 2011)

	Global total (IB%)	Asia Pacific total (IB%)
Trading Buy	1 (0)	1 (0)
Trading Sell	0 (0)	0 (0)
Total (IB%)	1 (0)	1 (0)

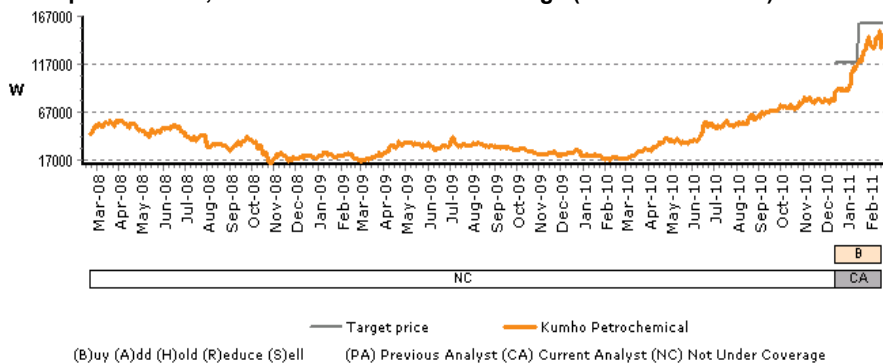
Source: RBS

Valuation and risks to target price

Kumho Petrochemical (RIC: 011780.KS, Rec: Buy, CP: W140500, TP: W159000): We value Kumho on a sum-of-the-parts basis. The downside risks to our target price are a surge in the butadiene price, increasing raw material costs for synthetic rubber and a decreasing self-sufficiency ratio in butadiene, due to renewal of existing contracts with major suppliers. The key upside risk is a strong price spread in synthetic rubbers led by tyre replacement demand in China.

Kumho Petrochem coverage data (011780.KS, 011780 KS)

Stock performance, recommendations and coverage (as at 21 Feb 2011)



Trading recommendation history

Date	Rec	Analyst
n/a	n/a	n/a

Source: RBS

Price perf (at Close 18 Feb 2011)

	(1M)	(3M)	(12M)
Price (W)	121500	79600	19100
Absolute (%)	15.6	76.5	635.6
Rel market (%)	20.4	69.0	492.4
Rel sector (%)	11.0	57.0	440.9

Source: Bloomberg
Market: Korea Composite
Sector: Commodity Chemicals

Angela Choi started covering this stock on 14 Dec 10. Moved to new recommendation structure between 1 November 2005 and 31 January 2006. Source: RBS

Regulatory disclosures

RBS beneficially own 1% or more of a class of common equity securities of this company.: **011780.KS**

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