The 10-second briefing

K-beauty: still very hot

- Due to Chinese demand, we expect Korea cosmetics companies to see 2015 EPS growth of 23% YoY vs. 8% YoY for global peers
- Trend-setting Korean companies are focused not just on expanding in China but in developed markets, too
- Due to their earnings-growth prospects, the Korean stocks look undervalued relative to global peers; Amorepacific is our top pick

Korea Cosmetics Sector

- Positive (initiation)
- Neutral
- Negative

How do we justify our view?

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Investment case

We believe the Korean cosmetics stocks are set to set outperform their global peers this year due to: 1) increasing Chinese tourism to Korea, plus business expansion via online channels, 2) more brands entering other international markets, and 3) global-peer-leading EPS growth for 2015 and beyond, against which they appear undervalued compared with the global majors.

Rising tourism from China, plus online expansion. Sales from counters at duty-free shops (DFS) in Korea, which contribute some 20% of domestic cosmetics revenue, should continue to grow amid increasing tourist arrivals from China. And, taking advantage of their geographical proximity, Korean companies are expanding their reach in China through cross-border e-commerce and B2C sites.

Going beyond China. The Korean companies are broadening their horizons beyond China, and their BB and CC creams have been well-received in Europe and the US. We believe cushion foundations and facial masks are next in line to go global, which should expand the Korean cosmetics firms' revenue growth.

Better growth prospects, yet undervalued relative to global peers. We forecast the Korean companies to see an EPS CAGR of 22.6% in 2015-17, outpacing the global peer average of 8.2% (Bloomberg forecasts). On this basis, Korean stocks look undervalued, with an average 2015E PEG of 1.5x versus global peers' 2.5x.

Catalysts

Forthcoming IPOs. Within the sector there are 3 IPOs scheduled for this year (1 ODM company and 2 one-brand shops). Historically, IPOs in the sector have had a positive impact on related stocks, and we highlight Cosmax, Korea Kolmar, AmoreG, and Able C&C as the biggest potential beneficiaries of new listings this time around.

Valuation

On our forecasts, the Korean companies (excluding outliers) would see average EPS growth of 30.5% YoY in 2015, compared with 12.8% YoY for their global competitors. Moreover, their increasing penetration of international markets should support robust earnings growth over our forecast horizon, in our opinion.

Our top large-cap pick is **Amorepacific** (090430 KS, KRW3,374,000, Outperform [2]), which we believe is ready to go global with its trend-setting cushion foundation.
Among the small- and mid-caps, our top pick is **Sansung L&S** (016100 KQ, KRW62,700, Buy [1]), a manufacturer of facial masks that is starting to penetrate the China market with its Leaders brand.

And we like **Cosmax** (192820 KS, KRW133,500, Outperform [2]), which we believe merits a premium valuation as we forecast it to deliver sustained earnings growth and see it as taking the next steps to secure long-term growth backed by its main partner, L'Oreal.

Risks

The main risk to our sector view would be greater-than-expected competition from cosmetics players based in China. Secondary risks include inventory leaking to the black market and widespread availability of counterfeit products.

Key stock calls

	New	Prev.
Amorepacific (090430 KS)		
Rating	Outperform	
Target	3,800,000	
Upside	▲ 12.6%	
Sansung Life & Science (016100 KQ)		
Rating	Buy	
Target	90,000	
Upside	▲ 43.5%	
Cosmax (192820 KS)		
Rating	Outperform	
Target	150,000	
Upside	▲ 12.4%	
LG Household & Health Care (051900 KS)		
Rating	Outperform	
Target	850,000	
Upside	▲ 6.3%	
Amorepacific Group (002790 KS)		
Rating	Outperform	
Target	1,500,000	
Upside	▲ 6.4%	

Source: Daiwa forecasts.

- Positive (initiation)
- Neutral
- Negative

How do we justify our view?

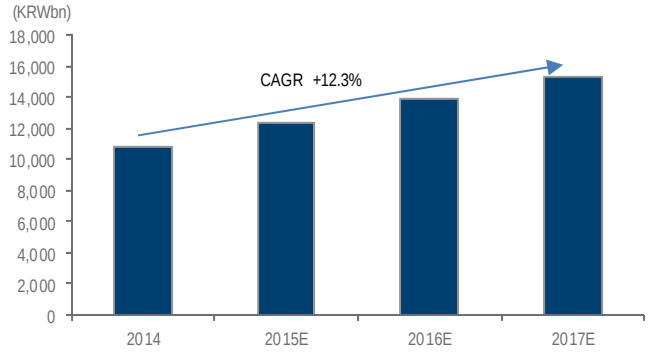
- Growth outlook ✓✓✓✓✓
- Valuation ✓✓✓✓✓
- Earnings revisions ✓✓✓✓✓

Growth outlook ✓✓✓✓✓

We forecast the Korean cosmetics companies in our coverage group to see a combined revenue CAGR of 12.3% in 2015-17.

To reach this conclusion, we factor in 15-18% yearly growth in the number of tourist arrivals from Mainland China in 2015-17. We also assume the companies expand their sales exposure to the online market in China, which we believe is currently equivalent in size to 60.8% of the total sales of Korean cosmetics.

Korea Cosmetics Sector: aggregate revenue of under coverage



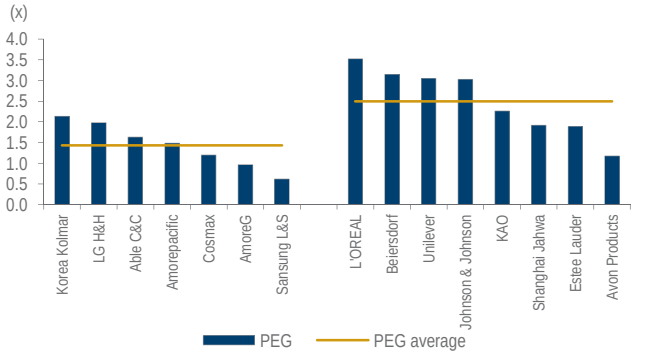
Source: Daiwa

Valuation ✓✓✓✓✓

The Korean companies currently are trading at discounts to their global peers. They are trading at just a 1.5x PEG for 2015E, compared with 2.5x for the global majors (Bloomberg figures).

Yet comparing forecast earnings growth for the 2 groups for 2015 and 2015-17, the Korean companies are well ahead, supported not only by demand from Chinese shoppers but expansion into new international markets.

Global peer valuation: PEG comparison



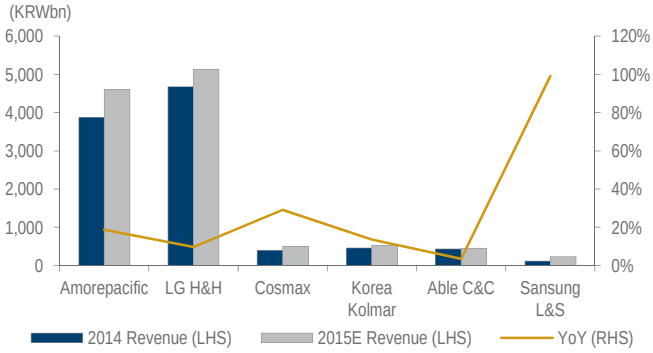
Source: Bloomberg, Daiwa estimates for Korea companies under coverage

Earnings revisions ✓✓✓✓✓

We expect DFS sales to be the main driver of revenue growth for the major cosmetics companies in 2015. We assume the number of visitors from China to Korea increases by 21.5% YoY to 7.4m this year, which we expect to support DFS sales growth of 52.5% YoY for Amorepacific and 70.7% YoY for LG H&H.

Across our coverage, we look for Sansung L&S to show the strongest revenue growth in 2015 (up 95.2% YoY to KRW234bn), backed by surging demand for its facial masks. And we expect Amorepacific to see a 20.1% YoY rise in its 2015 revenue to KRW4.6tn as it leverages its exposure to the DFS and China markets.

Korea Cosmetics Sector: revenue trends and growth (2014-15E)



Source: Factset, Daiwa

Sector stocks: key indicators

								EPS (local curr.)					
		Share	Rating		Target price (local curr.)			FY1			FY2		
Company Name	Stock code	Price	New	Prev.	New	Prev.	% chg	New	Prev.	% chg	New	Prev.	% chg
Able C&C	078520 KS	33,000	Sell		22,000			1,273			1,429		
Amorepacific	090430 KS	3,374,000	Outperform		3,800,000			98,345			124,978		
Amorepacific Group	002790 KS	1,410,000	Outperform		1,500,000			45,274			54,446		
Cosmax	192820 KS	133,500	Outperform		150,000			3,924			5,486		
Korea Kolmar	161890 KS	64,100	Hold		64,000			1,732			2,040		
LG Household & Health Care	051900 KS	800,000	Outperform		850,000			27,563			32,667		
Sansung Life & Science	016100 KQ	62,700	Buy		90,000			3,039			4,677		

Source: Daiwa forecasts

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We expect the strength in Korean cosmetics to continue, supported by: 1) rising numbers of tourists from China, which should sustain domestic revenue growth, 2) penetration of online channels, which is opening up new sales-growth opportunities, and 3) Korea's reputation for plastic surgery and dermatology, which should give its cosmetics players the upper hand in international markets.

High visibility on continued growth in Chinese tourist arrivals

The number of visitors from China to Korea has been rising since 2013. At the top of these tourists' lists of things to do while in Korea is shopping, particularly for Korean cosmetics products. As a result of this new source of demand, Korea's cosmetics industry saw a return to double-digit revenue growth in 2014 after recording 4 consecutive years of single-digit growth.

Assuming that tourist arrivals from China continue to see double-digit growth, we look for this revenue-growth trend to be sustained in 2015-18.

Domestic demand: lower-priced products to the fore amid subdued sentiment

Prior to 2009, the domestic market for Korean cosmetics was flourishing amid growing demand for high-end products. But the economic downturn hit consumer sentiment and the ensuing return to "rational consumption" had a big impact on the Korean cosmetics industry.

One-brand shops such as Missha and The Face Shop specialising in low-end goods were able to meet the renewed demand for cheaper items. However, channels featuring high-end products, such as department stores and door-to-door sales, started to see their revenue growth slow.

■ **Korean consumers: average propensity to consume**

(KRW '000)	2008	2009	2010	2011	2012	2013	2014
Avg. propensity to consume	75.9%	76.6%	77.3%	76.7%	74.1%	73.4%	72.9%
Income	3,391	3,432	3,632	3,842	4,077	4,162	4,303
Expenditure	2,718	2,776	2,961	3,115	3,217	3,262	3,356
Surplus	673	656	671	727	860	900	947

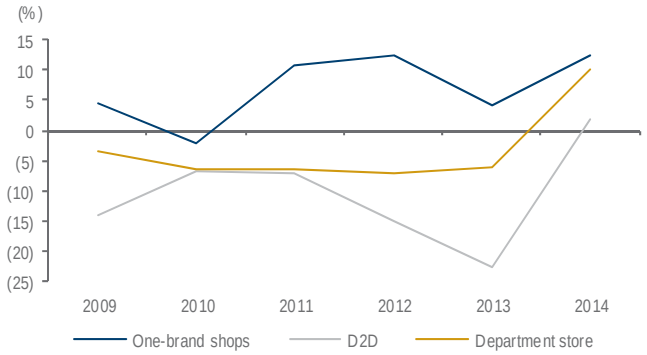
Source: Statistics Korea

■ **Domestic cosmetics: retail sales growth**

(KRWtn)	2009	2010	2011	2012	2013	2014
Cosmetics retail sales	11.5	12.2	13.4	14.1	14.9	16.3
YoY(%)	12.7%	7.9%	9.3%	6.5%	7.1%	12.8%

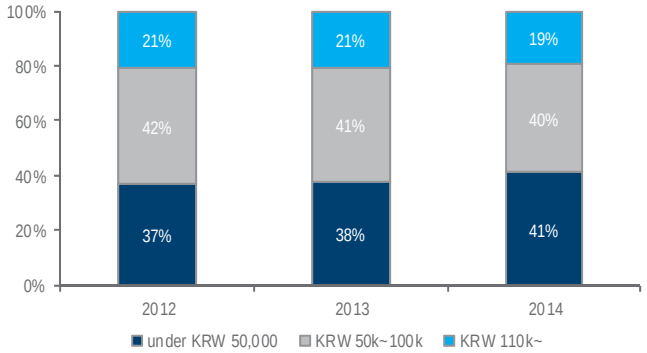
Source: Statistics Korea

■ **Korean cosmetics distribution channels: YoY growth**



Source: Amorepacific, Daiwa

■ **Korean department stores: product breakdown by price**



Source: Kanta World Panel

Rise in tourists from China: more than enough to offset the domestic slowdown

Korea's cosmetics market started to see some respite from sluggish domestic demand in 2013, when the number of tourist arrivals from China rose. Against the backdrop of high-profile territorial disputes between Japan and China, travellers from China have looked to Korea as a holiday destination in preference to Japan.

Hence, the number of visitors to Korea from China increased by 52.5% YoY to 4.3m in 2013. The growth trend continued in 2014, with the number of tourist arrivals from China rising by 41.6% YoY to 6.1m.

The Korea Tourism Organization expects the number of visitors from China to rise by 18.5% YoY to 7.2m in 2015. We think the continued growth in visitors from China is attributable to the following factors: 1) increased income and spending power of China consumers, 2) Hong Kong's restrictions on the number of tourists visiting from the Mainland, and 3) China's post-1980s generation (八零后, bālínghòu) is very familiar with Korean culture.

Generally speaking, demand for outbound travel rises once a country's GDP per capita reaches USD10,000, which happened in China in 2012. According to the China Outbound Tourism Research Institute, only 7.2% of China's population travelled outside the country in 2013, and the institute forecasts a 16% CAGR in the number of outbound travellers in 2014-18.

Hong Kong was the preferred destination for travellers from Mainland China for many years, but the city has seen an increase in social tensions centring on visitors from China in recent months. Local residents have complained that visitors from across the border are snapping up large quantities of everything from iPads to baby milk powder, leading to product shortages and higher prices.

Recently, Hong Kong's chief executive, CY Leung, said the city would speak with the Mainland authorities about tightening restrictions on visitor arrivals from China. Against this backdrop, the number of Mainland visitors to Hong Kong over the Lunar New Year holiday declined YoY for the first time in 20 years. We highlight Korea, the second-favourite destination of travellers from China, as a big potential beneficiary of the change.

■ China travellers: top 6 destinations in 9M14

	Number of tourists	% of total
Hong Kong	5,370,884	45.7%
South Korea	3,546,921	30.2%
Thailand	2,884,539	24.5%
Taiwan	2,671,350	22.7%
Macau	2,434,431	20.7%
Japan	1,394,203	11.9%
Total	11,759,000	100.0%

Source: Travel China Guide

But even if visitors from China continue to head for Korea, how can we be sure they will contribute to the domestic cosmetics industry? According to data from the Korea Tourism Organization, shopping accounted for more than 50% of China travellers' total spending in Korea in 2010-13. In fact, these visitors' average spending of USD1,431 was more than double the figure for visitors from all other countries.

■ China visitors to Korea: breakdown of expenditure

(USD)	2010	2011	2012	2013	Foreign visitor average
Shopping	839	1051	1409	1431	706
Accommodations	341	315	292	386	399
Food	222	288	285	344	278
Entertainment	69	80	86	95	59
Attraction tickets	16	24	99	101	36
Total	1487	1758	2171	2357	1478
% on shopping	56.4%	59.8%	64.9%	60.7%	47.8%

Source: Korea Tourism Organization

Moreover, visitors from China don't just like to shop — they like to shop for Korean cosmetics. Data from Korea's Ministry of Culture, Sports and Tourism indicates that half of China visitors' shopping money went towards cosmetics and toiletries from 2010-13, and more than 70% in 2013.

■ China visitors to Korea: breakdown of shopping expenditure

(%)	2010	2011	2012	2013	Tourist average
Cosmetics & toiletries	55.6	68.9	68.5	73.1	50.1
Apparel	50.9	43.7	51.3	40.8	38.5
Food	19.4	32.4	29.8	32.7	34.6
Shoes	19.9	14.6	21.4	13.5	14.4
Ginseng	31.2	26.8	19.1	18.9	12.9
Kimchi	12.6	15.8	8	9.3	12.8
Leather Goods	5.3	7	10.9	14.8	10.5
Jewellery	9.2	8	9.6	11	9.2
Tobacco	18.9	12.4	0	7.2	6.7
Liquor	7.6	5.9	3.6	3.7	5.8

Source: Ministry of Culture, Sports and Tourism

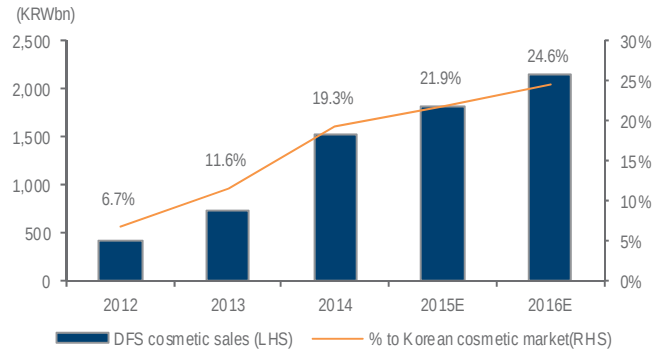
With the surge in visitors from China, we estimate the DFS channel in Korea now accounts for 20% of the domestic cosmetics market. And we expect the revenue contribution of the DFS channel to increase over our forecast horizon, assuming that visitor numbers continue to rise while domestic demand remains sluggish.

■ Korean cosmetics: price differences between T-mall (China) and DFS (Korea)

(CNY)	T-mall	Korea DFS	Difference
Sulhwasoo Ja Eum Sang Essence	660	569	13.8%
Laneige Sleeping Mask	230	125	45.7%
Whoo Lotion	380	300	21.1%
Innisfree pore clay mask	99	88	11.1%
Missha BB cream	166	87.5	47.3%

Source: T-mall, Daiwa

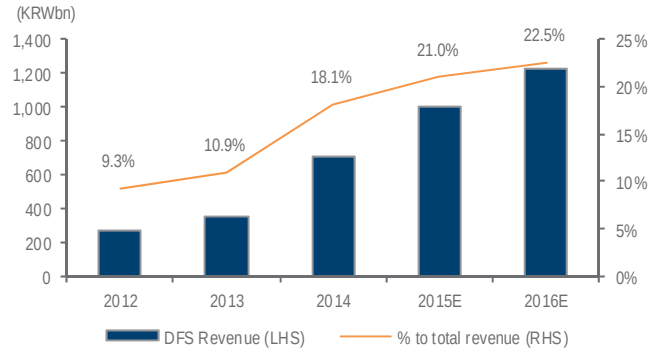
■ Korea DFS: proportion of overall cosmetics market sales



Source: Daiwa

For both Amorepacific and LG H&H, the DFS channel is now the major source of revenue and profit. DFS contributed 18.1% of Amorepacific's total sales in 2014. Chinese tourists account for 80% of Amorepacific's cosmetics sales in the DFS channel, which suggests the company is deriving 14.5% of its total sales from China visitors using the DFS channel. Since DFS is a high-margin channel, its operating-profit contribution is more significant still — we estimate it was responsible for nearly a third of Amorepacific's operating profit in 2014.

■ Amorepacific: DFS revenue contribution

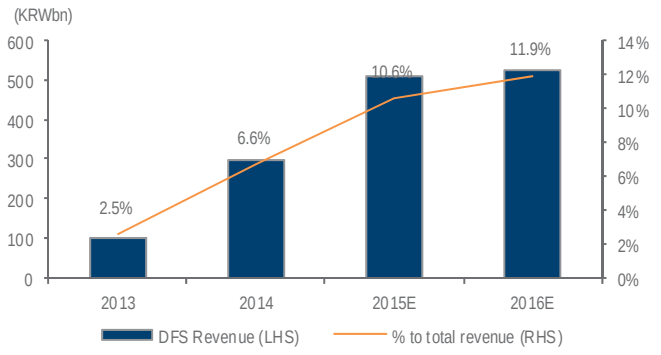


Source: Amorepacific, Daiwa

At LG H&H, meanwhile, DFS sales account for smaller proportions of both revenue and operating profit. We estimate the DFS channel contributed around 7% of the company's revenue and 18% of its operating profit for 2014.

In this context, we believe the DFS channel is an important contributor to the Korean cosmetics sector and hence should not be overlooked by investors assessing companies' revenue and earnings prospects.

■ LG H&H: DFS revenue contribution



Source: LG H&H, Daiwa

Word-of-mouth promotion in China

An interesting by-product of the growth in tourist arrivals from China is that Korean cosmetics brands are building their brand equity in China despite the fact some have little or no direct presence there. IOPE, an Amorepacific cushion-foundation brand, is one example of this trend. Although IOPE is mainly targeted at domestic consumers, visitors from China seem familiar with the brand. Amorepacific launched IOPE at DFS stores on a trial basis in 2Q14, and the initiative looks to have been a success (generating revenue of KRW35.2bn in just 9 months). IOPE opened 15 new DFS counters in 2014 and plans to enter the China market in 2015.

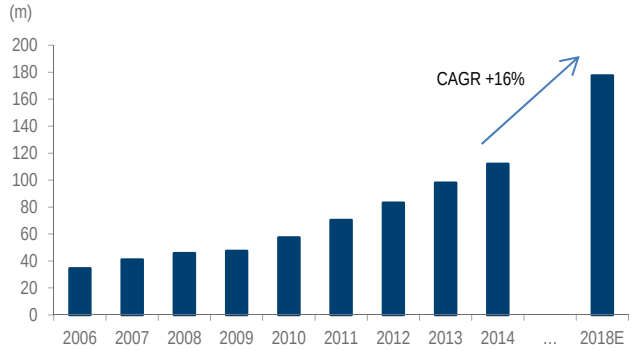
We see the makings of a virtuous cycle here — as more consumers in China become familiar with Korean brands through word of mouth, these brands should grow in prominence and brand equity.

No concerns about Chinese tourists returning to Japan

After several years of political tensions, travellers from China are once again heading for Japan, likely encouraged by the weakness of the Yen. But we are not concerned about the impact of this trend on the Korean cosmetics companies, for the following reasons: 1) the absolute number of outbound travellers from China is forecast to increase by 18m in 2015, or nearly 3 times the number visiting Korea in 2014, and 2) the number of people visiting Hong Kong fell markedly in February and March 2015, and some may have gone instead to Korea.

The following chart illustrates Euromonitor's 16% CAGR forecast in the number of travellers leaving China in 2014-18. This would translate into an additional 18m people travelling in 2015 alone. Considering that 6.1m people from China visited Korea in 2014, it would not be an imminent concern if some visitors were to travel to Japan instead, in our view.

■ Number of travellers leaving China

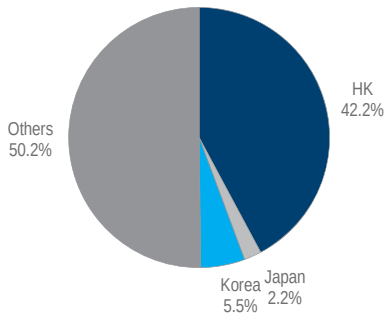


Source: COTRI, CTA, Euromonitor

Closer to home, social tensions and public protests in Hong Kong look to have had an impact on Chinese residents' plans to visit what is traditionally their most-visited city. Despite the Lunar New Year holiday falling in February this year, the number of inbound tour groups from Mainland China visiting Hong Kong was down 32.3% YoY for the month. And for the first week of March, the average daily number of inbound tour groups from Mainland China was just 180, down sharply from 400 a year earlier

Only 2.2% (2.4m tourists) of the total number of travellers from China visited Japan last year, while 5.5% (6.1m) went to Korea. Given this lower 2014 base for Japan, its growth rate for the current year will seem high but won't necessarily affect the Korean tourist market, in our view.

■ Travellers from China: destination by country



Source: COTRI, CTA, Euromonitor, Korea Tourism Organization, JTM, Hong Kong Tourism Board

Indeed, the January and February data for visitor numbers from China to Korea seem to support our thesis. In those 2 months, a total of 911,132 people from China visited Korea, up 46.2% YoY. In our forecasts we assume a 21.5% YoY increase for the full year, so we look to be off to a good start. If these growth rates are sustained in the coming months, we may revisit our forecasts with an upward bias.

■ Number of travellers from China to Korea

Source: Korea Tourism Organization

Internet penetration presents opportunities

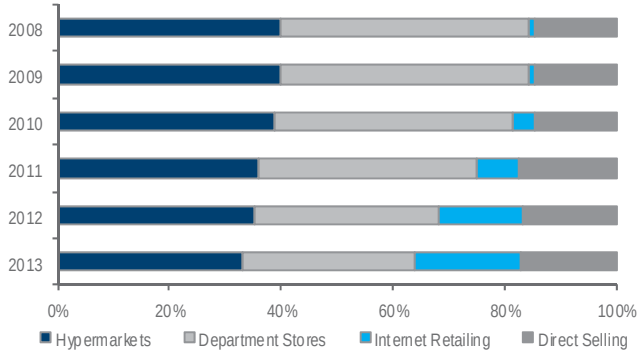
Online channel: low-cost expansion

Harnessing the online channel is a good way for latecomers to broaden their exposure to the consumers in a particular market without having to invest large sums in expansion. In this regard, the Korean companies are concentrating their efforts in China's large cities, whereas the lower-tier cities, which are dominated by domestic brands, are attracting the attention of the multinational cosmetics players.

Controlling the channel itself, and inventory levels within the channel, can be difficult in smaller cities. Indeed, even the multinationals are struggling in these markets, as their products are not widely available in the dominant domestic multi-brand cosmetics stores. Amorepacific tried to penetrate lower-tier cities with its Mamonde brand back in 2011, but it withdrew from these cities after incurring losses. Given their low penetration of the China market at this stage, we think it is sensible for Korea companies to focus initially on the major cities.

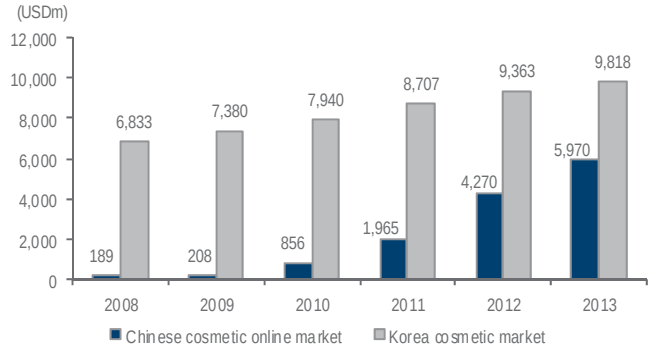
This is where the benefits of the online channel can be felt. In 2013, 13% of all consumers using the online channel had purchased cosmetics, according to Euromonitor. This data indicates that the value of online cosmetics transactions in China in 2013 was equivalent to 60.8% of the value of the Korea cosmetics market.

■ China cosmetics market: breakdown by distribution channel



Source: Euromonitor

■ China online cosmetics market: sales relative to Korea cosmetics market

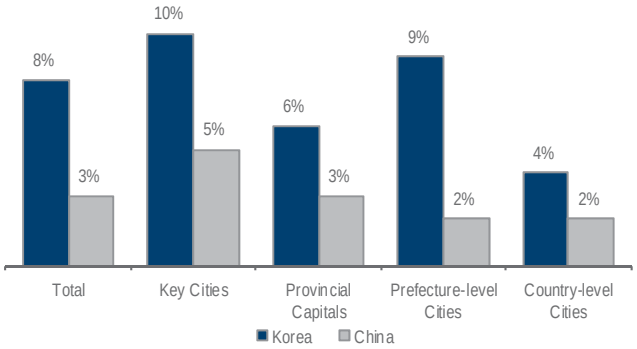


Source: Euromonitor

Latecomers to China, like Amorepacific and LG H&H, can not only advertise their brands using major Internet channels, they can also realise the benefits of opening new virtual stores. This is why The Face Shop has decided to concentrate on the online channel rather than opening offline stores.

Once the necessary infrastructure is in place in smaller cities, we believe that online shopping will be more productive for the cosmetics companies than offline shopping. Compared with large cities, small cities tend to have less access to reliable distribution channels, and consumers are therefore more willing to buy through credible websites. We have seen a similar phenomenon in Korea (see following chart).

■ China vs. Korea: online channel's contribution to consumer staples consumption



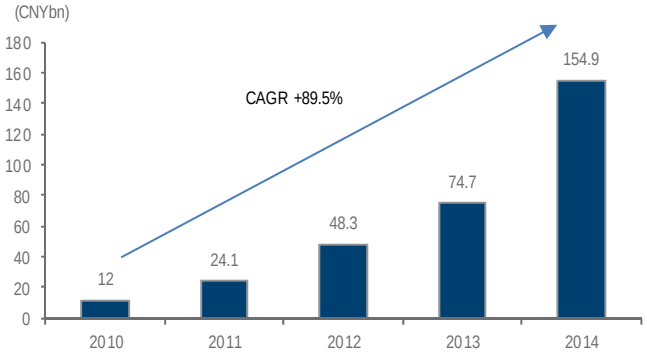
Source: Kantar Worldpanel
Note: key cities include Seoul, Beijing, Shanghai, Guangzhou, Qingdao

Purchasing through cross-border e-commerce

Consumers in China can, of course, place orders on international websites, and we see this as a trend that will benefit the Korean cosmetics players. Using this channel, buyers can typically access a wider range of products at lower prices compared with offline retail.

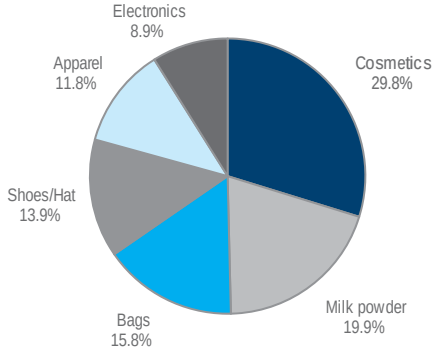
When buying from international websites, consumers in China favour cosmetics purchases. According to the China e-Business Research Center, cosmetics accounted for 30% of all cross-border e-commerce volume for China in 2013, with transactions totalling CNY16.3bn, which is equivalent to 7.4% of China's cosmetics retail market.

■ China cross-border e-commerce market



Source: China e-Business Research Center

■ China consumer purchases from international websites



Source: China e-Business Research Center

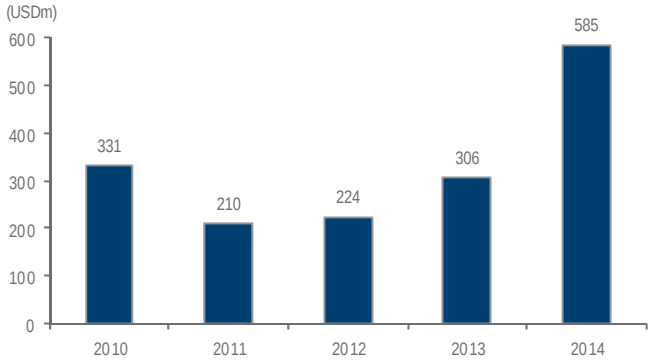
With the number of transactions being undertaken on international websites continuing to rise, we think it is reasonable to assume the total trading value will increase, too. Since 2012, the Chinese government has actively endorsed cross-border e-commerce as a way to prevent smuggling and counterfeiting. Products may only be listed on China-based sites after the vendor has been approved by the country's General Administration of Customs.

In our view, this system — which is now being in trials in 10 districts — will lead to a safer, more reliable channel through which Chinese consumers can purchase imported goods, which in turn should assuage consumer concerns about the security of online transactions.

Private companies are actively joining this market. Alibaba, the largest online shopping site, has opened T-mall global, a B2C platform designed to bring together international manufacturers and China-based consumers. And, earlier this year, there were 2 new market entrants: 1) NetEase (網易), one of the top-4 search engines in China, opened its cross-border e-commerce site Koala (考拉), and 2) SF Express (顺丰快递), a major logistics company, launched SF Hai Tao (顺丰海淘).

Currently, Korean brands only make available around half of their stock keeping units (SKUs) in China. Inventory control, authorisation, and miscellaneous costs prevent the companies from taking all of their products to international markets. For example, securing authorisation for exports to China can take 6 months to a year. The upshot is that new products are not immediately available in key markets, which has fuelled China-based consumer interest in shopping on international sites.

■ Cosmetics exports from Korea to China

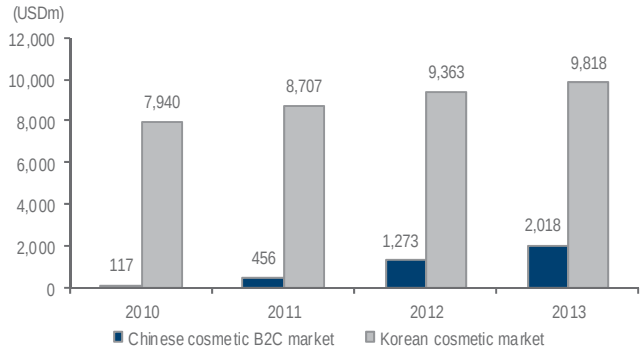


Source: Korea Customs Service

Taking advantage of Chinese B2C sites

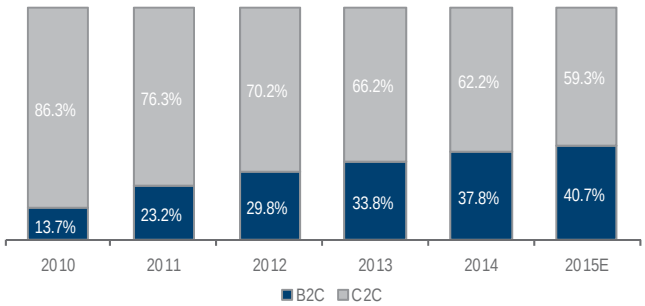
The China-based B2C sites are a relatively new opportunity for the Korean companies. According to data from Euromonitor, in 2013 the China B2C market for cosmetics was worth about USD2.0bn, equivalent to 20.6% of the Korea cosmetics market. B2C sites are growing in popularity at the expense of C2C sites, likely because B2C sites reduce the possibility of a buyer ending up with counterfeit goods.

■ China B2C market for cosmetics



Source: Euromonitor, iResearch, Daiwa

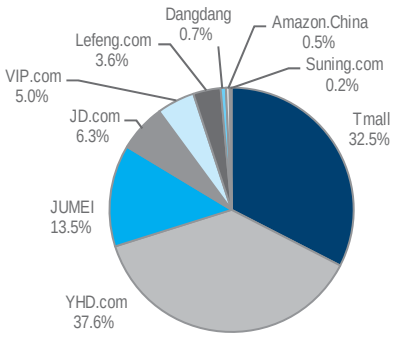
■ China online cosmetics market share: B2C vs C2C



Source: iResearch, China Internet Watch
Note: As of August 2014

For cosmetics companies, selling through online B2C can be advantageous in 3 ways: 1) they can sell without first securing China Food and Drug Administration approval, which saves time and money, 2) there is little danger of the inventory finding its way onto the black market, and 3) B2C sites are gaining popularity because they are perceived as more trustworthy than C2C sites, which should also help to safeguard the brand equity of the major players. Hence, as Korean companies are relative latecomers to the China market, utilising these channels seems the best way for them to quickly target new consumers and new cities.

■ China cosmetics B2C platform: market share



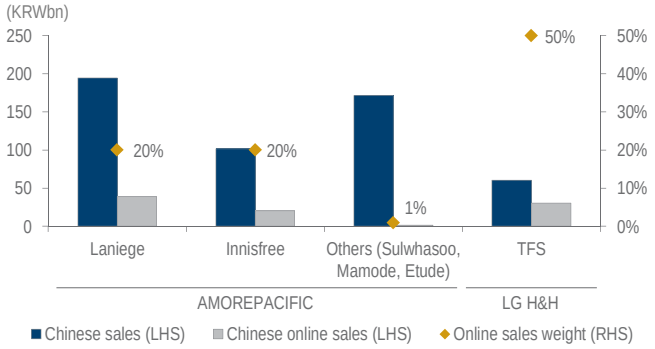
Source: iResearch, China Internet Watch
Note: As of August 2014

Online positioning

It wasn't until 2014 that Korean cosmetics started to have an impact on B2C sites. The most active company in this regard has been Amorepacific, which has established a presence on 7 major B2C platforms. In 2014, 13% of all of Amorepacific's revenue from Chinese consumers was generated through online channels (for well-known brands such as Laneige and Innisfree, 20% of sales come from online channels). The company already operates an Etude online store and plans to open one for Innisfree in 2015.

LG H&H has a bigger presence online, with The Face Shop deriving 50% of its sales from the online channel. It also has a presence on T-mall and other B2C sites. The company does not open its own sites but rather makes use of established online sites.

■ Chinese online segment: sales and contribution by brand



Source: Companies
Note: Revenue contribution is as proportion of Chinese business revenue

Scope for market penetration overseas

Unlike the global cosmetics companies, which entered the Mainland China market in the 1980s and 1990s, the Korean companies didn't start establishing a presence there until the early 2000s. Yet we think the Korean companies are well placed to gain market share at the upper end while keeping would-be domestic rivals in check.

We highlight 3 factors that we believe will support the market penetration of Korean cosmetics in China and other international markets: 1) consumers view Korean cosmetics as trendy and reasonably priced, 2) Korean products are also seen as well suited to Asian consumers, and 3) Korea's reputation for being a leader in dermatology and plastic surgery should have a halo effect on its cosmetics producers and allow them to complete globally.

Still room for new counters

As late movers in China, Korean cosmetics companies have relatively few stores in Mainland China and, hence, modest market shares. But, backed by the high profile of their brands, they still have scope to expand their presence there, in our opinion.

Amorepacific is focusing on expanding Innisfree (50-60 new counters targeted this year, from 104 in 2014). But it would still have less of a presence than Shanghai Jawha's Herboist, which has 1,116 counters. On this basis, we think Amorepacific's target to have 800 counters in China looks reasonable. In another example, Whoo, a prestige brand of LG H&H, has only 89 counters and is targeting to have 120-130, which we think is viable given that Lancome currently has 183 counters.

■ China cosmetics market: market share (%)

Company	2010	2011	2012	2013
P&G	14.9	14.5	14.1	13.5
L'Oréal	8.4	8.7	8.9	9.1
Unilever	3.5	3.6	3.7	3.7
Shiseido	4.2	4.3	3.9	3.6
Mary Kay	2.5	2.5	2.6	2.8
Colgate-Palmolive Co	2.8	2.7	2.8	2.8
Amway Corp	3.1	3.1	2.8	2.7
Beiersdorf AG	2.6	2.5	2.4	2.4
Johnson & Johnson Inc	2.1	2.0	2.0	2.0
Estée Lauder	1.3	1.6	1.8	1.9
Shanghai Jahwa United Co Ltd	1.5	1.6	1.7	1.8
Jala (Group) Co Ltd	1.1	1.3	1.4	1.5
Nu Skin Enterprises Inc	0.2	0.3	0.5	1.4
AmorePacific Corp	0.7	0.8	0.9	1.2

Source: Euromonitor

■ China cosmetics market: number of counters for Korean companies vs. global and local companies

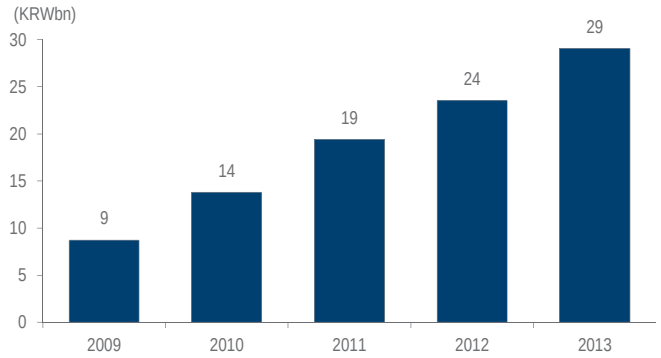
Price range	Global/Local brand	No. of counters	Korean brand	No. of counters
Mass	MAYBELLINE	4,684	Mamonde	2,630
	Herbroist	1,116	Innisfree	108
Masstige	YUESAI	587	Laniege	518
Luxury	BIOTHERM	123	Whoo	89
	LANCOME	183	Sulwhasoo	46

Source: Daiwa

Success in the US and Europe

In 2011, Dr. Jart, a brand under the Have & Be umbrella, started to supply its products to drugstores in the US, including its BB cream and Ceramidin liquid serum. These items proved popular in the market, which prompted international brands to come out with similar offerings. Yet Dr. Jart has maintained its position in the market and continues to supply prominent drugstore chains in the US.

■ Dr. Jart (Have & Be): revenue trend



Source: Kisline

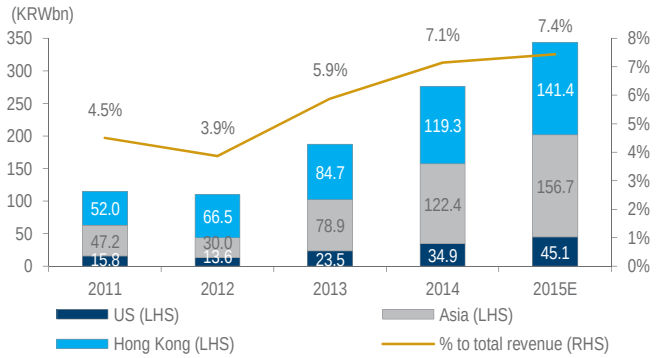
■ Dr. Jart: popular products sold through Sephora in the US

Source: Sephora

Amorepacific is also making progress in international markets other than China. Although this segment's total contribution to revenue isn't yet significant, it is growing (see following chart). First, the company is expanding its US business. In 2014, it started supplying Laniege to the retailer Target and it now distributes the brand to 810 stores across most of its skin care product lines. As a result of this breakthrough, the formerly loss-making US business moved into the black in 2014.

And it is making strides in Asia, too. Due to the company's previous focus on rapid expansion, the overseas affiliates had been incurring losses. Amorepacific started to focus on profitability last year and, after slowing its new store opening schedule, its overseas affiliates reported revenue growth of 28% YoY and moved into the black for 2014.

■ Amorepacific: overseas revenue



Source: Company, Daiwa estimates

Through a similar strategy, Sansung L&S is planning to enter the US and European markets with its facial mask packs, as it sees the segment as underdeveloped. In our view, these forays into the international market will ultimately enhance the Korean companies' global competitiveness.

Fast trends: attract new consumers and lock in existing ones

Korea's one-brand shops and ODMs: rapid change in market composition

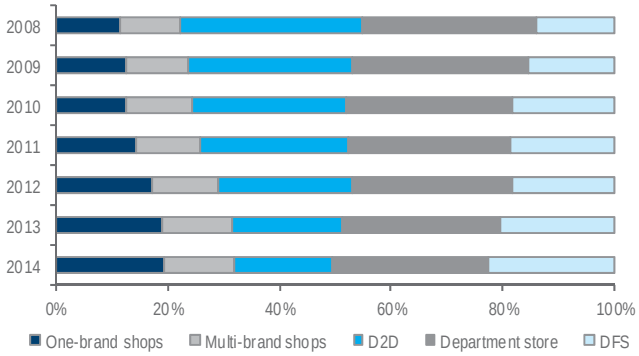
Among the reasons that consumers in international markets are embracing Korean cosmetics are the products' perceived trendiness and reasonable price points. We think both traits stem from the role of Korea's one-brand shops and the country's ODM industry. BB/CC creams and cushion foundations are good examples of made-in-Korea products that, with the help of multinationals, have gone global.

Missha was the first one-brand shop in Korea. Before it debuted in 2003, cosmetics were sold in multi-brand stores. Missha changed this market norm by selling only its own brands. Unlike traditional cosmetics companies, however, Missha did not have its own production facilities or R&D centres. And, with this separation of production from distribution, product release cycles became shorter than ever. Today, a typical one-brand shop releases 200-300 new products annually, whereas high-end brands might launch fewer than 10 products in a year.

In addition, because their production was outsourced, the brands were able to lower prices. At a time when most products were selling for more than KRW10,000, Missha's were retailing for just KRW3,300. The brand has gone on to become a success as a result of these low price points and short product cycles.

Indeed, Missha's rise to prominence has led to a proliferation of other one-brand shops and ODM companies, and has prompted Amorepacific and LG H&H to outsource the production of some of their products. The result: Korean cosmetics companies are now particularly well versed in producing trendy and affordable products.

■ Korea: domestic market breakdown by distribution channel



Source: Amorepacific, Daiwa estimates

Missha found itself with another hit product when it launched its First Treatment Essence in late 2011. Prior to this product's success in the market, we think consumers viewed one-brand shops as specialising in mediocre products at appealing prices. Missha challenged this perception with the launch of its First Treatment Essence for KRW42,000 (150ml), compared with KRW159,000 for SK-II's Facial Treatment Essence (150ml).

Consumer reaction was surprisingly positive, and the following years Missha released another hit product, Night Repair Science Activator Ample, which competed directly with Estee Lauder's Advance Night Repair. This product was likewise well received, and we believe it also played a role in changing consumer perceptions for the better. It was around this time that Amorepacific, Korea's No.1 cosmetics company based on revenue, shifted focus from the channel to product innovation and brands.

■ Missha: direct competition with global high-end products

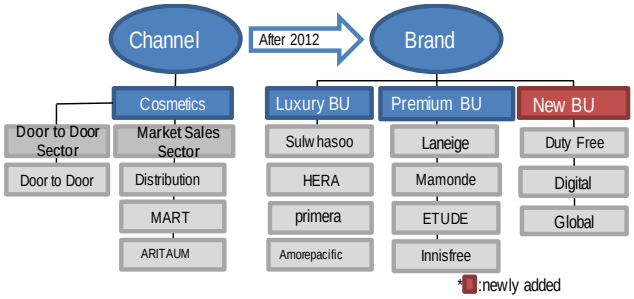
Source: Able C&C

Amorepacific, coping with domestic competition, led global competitiveness

It used to be that Amorepacific could sell whatever product or brand it produced, since it had dominant control over all channels in the market. However, Missha's success showed that consumers were prepared to switch to less-pricey items during tough economic times.

At the same time, Amorepacific's D2D and department store sales were performing poorly, and as a result the company resolved to focus on its brands and the competitiveness of its products. Hence, in 2012 it changed its corporate structure from channel-oriented to brand-oriented.

■ Amorepacific: change in structure



Source: Amorepaciific

The first thing Amorepacific did was to promote its brands through its innovative cushion foundation product. Although cushion foundations had been on the market for several years, they didn't really take off until 2012, when Amorepacific started offering them across its range of brands. Consumers responded to the product's convenience and effectiveness, and it went on to become a major success. According to a recent report in the Korean-language *Joongang Daily*, Amorepacific's cushion foundations brought in revenue of KRW900bn in 2014 alone, which is equivalent to 25% of the company's total cosmetics sales for the same period.

We believe that cushion foundations gave the company the opportunity to compete in the global market. Despite going head to head with international brands in department stores, Amorepacific still managed to gain market share.

The company has also made sure to launch a steady stream of innovative products to keep consumers interested (see following table). We think its finishing essence and make-up base for CC cream have fared well in the face of intense domestic competition.

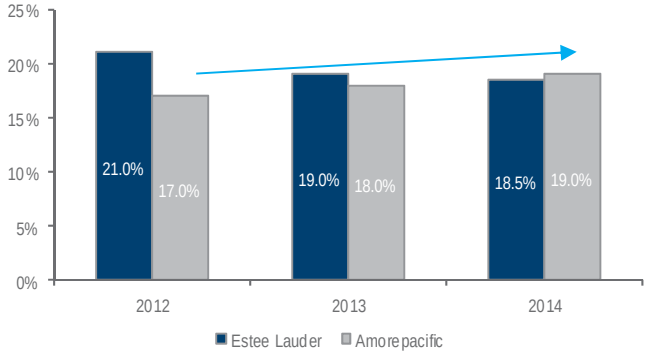
■ Amorepacific: innovative product releases

	Sulwhasoo	Laneige	Innisfree
2012	Innerise Complete Serum	Purify-Tox Boosting Essence	The Green Tea Seed Oil
	Snowise Whitening Spot Serum Hydro-Aid Moisturizing Lifting UV Protection Cream	Firming Sleeping Pack	Fermented Soybean Firming Serum
2013	Luminature Essential Finisher		Soybean Energy Essence
			Green Persimmon Pore Essence
	Microdeep Intensive Filling Patch		
2014	Capsulized Ginseng Fortifying Serum	Time Freeze Intensive Cream	Orchid Enriched Cream
	HERA Magic Starter	BB Cushion Pore Control	Jeju Volcanic Pore Solution Kit

Source: Press releases
Note: Innovative products in bold

In our view, Amorepacific's efforts to compete with domestic one-brand shops and their suppliers (ODM companies) brought the company to a level where it was able to take on and beat other global players.

■ Korean department store market share: Estee Lauder vs. Amorepacific



Source: Amorepacific

In a 5 November 2014 article in *Fashionista*, Estee Lauder's CEO, Fabrizio Freda, was quoted as acknowledging the success of the Korean companies in breaking onto the international stage and indicating his company would look to embrace Korean trends. We take this as another sign that Korea cosmetics companies are ready to go truly global.

Copy-cat products may be an opportunity

With global companies now keeping a close eye on developments in the Korea cosmetics market, some products first developed in Korea are serving as an inspiration for the multinationals' product-development efforts. This trend first started in 2011, when Clinique rolled out its own BB creams, and it has continued with Lancome recently launching its cushion foundations. While there is concern in the market that this development casts a cloud over the Korean brands' revenue-growth prospects, we believe it presents an opportunity for market expansion.

■ CC creams: from Hera (Amorepacific) to Lancome (L'oreal)

Source: Company

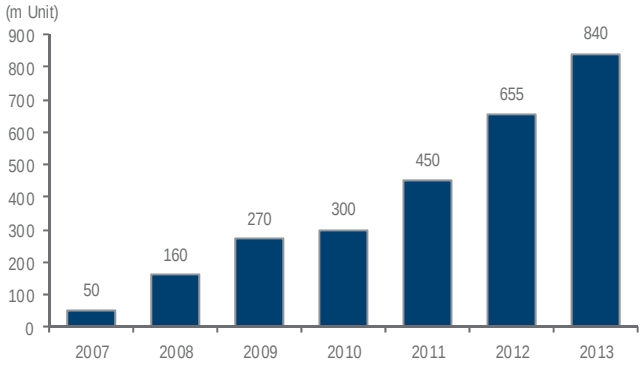
■ Lancome: cushion foundation

Source: L'oreal

For example, Missha launched its first BB cream in 2007. Years later, in 2012, another Korean brand, Dr. Jart, entered the US market with its own BB cream through retailer Sephora. It was the arrival of Dr. Jart's BB cream in the US that prompted global cosmetics companies to rush into this product category. Yet Missha's sales have been unaffected.

Indeed, the involvement of the global giants has raised the profile of BB cream internationally. In China in particular, Missha has tapped into this higher profile for BB creams and played up its credentials as the developer of the original product. And the approach seems to have worked: on China's Singles Day (11 November 2014), Missha generated revenue of CNY16m from its No.1 ranking in colour cosmetics sales on the T-mall Internet site. Moreover, total sales volume for Missha's BB cream increased nearly threefold between 2010 and 2013.

■ Missha BB cream: unit sales

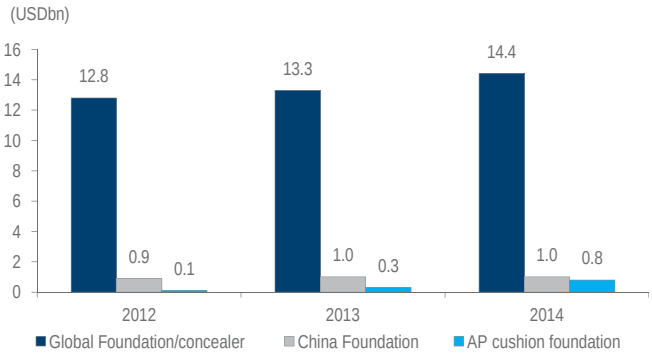


Source: Able C&C

Separately, Amorepacific's big hit product, its cushion foundation, attracted the attention of L'oreal, which recently followed up with its own cushion foundation product under its luxury Lancome brand. But, just as with Missha's BB cream and the products it inspired, we believe L'oreal's entry into the market could be an opportunity for Korean companies to play into an expanding international market.

Amorepacific's cushion foundation is a market heavyweight in its category (KRW900bn in sales in 2014). But the China and global markets are worth an estimated KRW1.2tn (USD1.1bn) and KRW15.8tn (USD15.5bn), respectively, according to Euromonitor. In our view, as the multinationals start offering similar products, Amorepacific should improve its efforts to penetrate the global market.

■ China foundation market vs Amorepacific's cushion foundation sales



Source: Euromonitor, Amorepacific
Note: Based on retail price

Being Asian: key advantage in China

Compared with the global names, we believe the Korean brands are better attuned to the requirements of Asian consumers. For example, Asian women tend to favour white skin and flawless complexions (no freckles). It is not unheard of for consumers in the region to layer 5 or more skincare products, with the goal of lightening their skin's appearance and providing all-important "luminosity".

■ Sulwhasoo: 10-stage skin care

Source: Amorepacific

In Japan, the skin care market is almost 3 times the size of the colour cosmetics market, according to Euromonitor. Women in Western markets, by contrast, tend to put more emphasis on colour cosmetics. But within the skin care category, consumer demand varies greatly by region — for example, Asians tends to value bright skin whereas Caucasian women are more concerned about wrinkles (in France, there is no "whitening" category).

Likely in a bid to boost its credentials in the Asian market, L'oreal acquired 2 China-based brands, Yue Sai and Mininurse, in 2003 and 2004. However, the revenue performance of these brands has not been impressive, in our view. We believe the Korean companies are better placed geographically and culturally to understand the requirements of Asian consumers and keep up with regional trends.

Being able to incorporate traditional ingredients and formulas in their cosmetics products is another way the Korean companies can attract consumer attention and leverage their Asian credentials. In China, products are increasingly drawing upon the experience of traditional Chinese medicine (TCM) in their formulations and marketing. We think this trend works to the advantage of the Korean brands, too.

For example, Amorepacific launched its high-end brand, Sulwhasoo, featuring a blend of traditional Korean ingredients, in China a few years ago, while the popularity of LG H&H's Whoo brand has surged since China's first lady, Peng Liyuan, purchased it while on a trip to Korea last year.

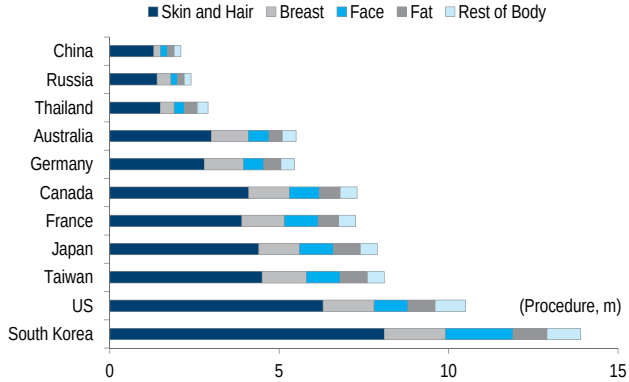
Dermatology and plastic surgery: another competitive edge

Chinese brands are making good progress in their domestic market, in our view. But we contend that the Korean companies have a clear competitive edge that allows them to differentiate themselves.

Most of China's domestic brands are positioned at mid- to lower price points, though some are now launching luxury brands. By and large, international brands are not going to compete on price in China, as the domestic players have the edge in that respect. Rather, global brands will seek to differentiate themselves – and justify their higher-end positioning and prices – on the grounds of product features and expertise in the field.

In this respect, we believe the good reputation of Korean beauty products is supported by the country's status as a leader in high-value-added industries such as dermatology and plastic surgery. According to the International Society of Aesthetic Plastic Surgery, Korea has the highest rate of cosmetic surgery per capita in the world. It is not unusual for Koreans to seek surgical assistance from experts before making a major lifestyle change, such as entering college or starting a new job.

■ Aesthetic plastic surgery: procedures per 1,000 people



Source: International Society of Aesthetic Plastic Surgery
Note: As of 2011

At the same time, with the growing influence of Korean culture, led by the rise of K-pop and TV dramas, there is growing interest in Korean beauty products among consumers in other countries. Medical tourism to Korea, especially for aesthetic plastic surgery and dermatology, is expanding rapidly — and visitors from China seem to be at the front of the queue. Perhaps unsure of the quality of domestic hospitals and treatments, residents of China are increasingly making the trek to Korea for procedures. At the same time, some of the major Korean hospitals now operate counselling centres in China, which have encouraged visitors to head to Korea for cosmetic surgery.

■ Korean plastic surgeon advisory centres in China

Name	Location
Regen Beauty Medical Group	Beijing
TOPCLASS Plastic Surgery	Wuhan
Wonjin Aesthetic Surgery Clinic	Beijing
BK Plastic Surgery	Shanghai

Source: Companies

In addition, as the Chinese government is loosening the regulations on foreign-invested hospitals in China, Korean dermatologists and plastic surgeons are increasingly seeking to work there. Top-tier plastic surgery providers have established bases in China, including Regen (038340 KQ), which recently had a back-door listing on the KOSDAQ.

■ Korean dermatology and plastic surgery clinics in China

	Name	Location
Dermatology	Oracle Clinic	Beijing, Qingdao, Sichuan, Tianjin, Dalian
	Leaders Clinic	Beijing, Tianjin
	Seoul Leaguer	Shanghai
Plastic surgery	Regen Beauty Medical Group	Harbin, Nanjing (to be established in 1H15)
	BK Plastic Surgery	Shanghai
	YK Wonjin Surgery Clinic	Shanghai

Source: Daiwa

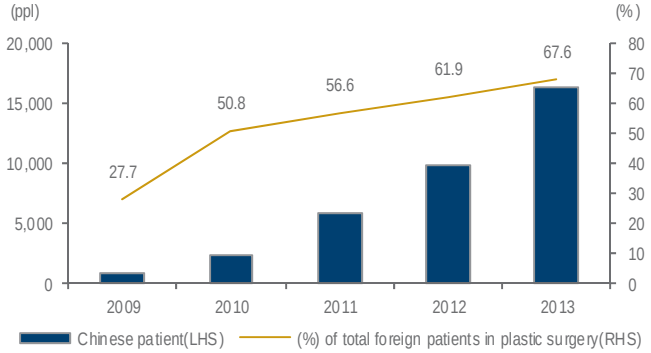
In terms of the number of visits, Korea now ranks 11th globally for medical tourism. Of these patients, around 20% visit Korea for dermatology and plastic surgery assistance. The number of tourists from China visiting Korea for plastic surgery has risen by 20 times in the past 5 years. While the absolute number of visitors is still low (16,000 in 2013), we think the growth rate in recent years speaks to the growing interest of Chinese consumers in the Korean beauty industry.

■ Number of medical tourists to Korea by examination (2014)

	No. of patients	(%)
Department of internal medicine	68,453	24.4%
Medical Screening Center	28,135	10.0%
Dermatology	25,101	8.9%
Plastic Surgery	24,075	8.6%
Total	280,545	

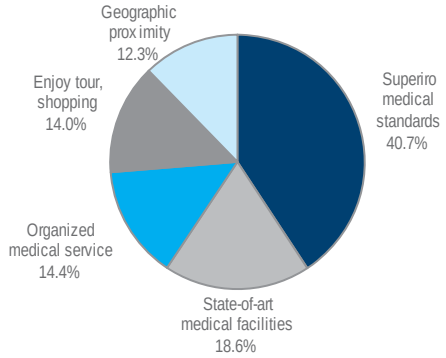
Source: Korean National Assembly Health, Welfare Committee

■ Chinese medical tourists visiting Korea for plastic surgery



Source: Ministry of Health and Welfare

■ Reason given for Chinese medical tours to Korea



Source: Korea Tourism Organization

Besides, having plastic surgery in Korea can be cheaper than in other developed markets, which ties in with the value proposition of Korean cosmetics: decent quality, reasonable prices.

■ Rhinoplasty surgery: price comparison by country

Countries	Price
South Korea	USD4,000-6,000
Singapore	USD6,000-8,000
Australia	USD8,000-10,000
America	USD10,000-12,000

Source: SeoulTouchUp.com

In sum, we believe Korea's globally accepted expertise in plastic surgery and dermatology procedures produces a halo effect for the country's cosmetics industry. Also, we think this presents an opportunity for the cosmeceutical players in particular.

The terms cosmeceutical refers to cosmetics products with medicinal or drug-like benefits. Currently, the category accounts for 13% of the cosmetics market globally, according to RNCOS. Cosmeceuticals' share of the cosmetics market is forecast by RNCOS to rise to 16% by 2017, backed by advances in technology that are accelerating the commercialisation of products.

By taking advantage of Korea's reputation for expertise in dermatology and plastic surgery, we think the country's cosmeceutical products will see more revenue-growth opportunities in international markets.

Likely with this in mind, LG H&H, Korea's second-largest cosmetics firm, acquired domestic cosmeceutical player CNP Cosmetics in 2014.

Meanwhile, among the cosmeceutical brands, Sansung L&S's Leaders Cosmetics looks to be growing in popularity among Chinese shoppers and the company is targeting to enter the China market this year.

■ **Korean cosmeceutical brands**

	2013			2014		
(KRWbn)	Net Revenue	Operating Profit	OPM	Net Revenue	Operating Profit	OPM
Leaders Cosmetics	16.6	24.1	1.5%	61.0	25.3	41.5%
CNP Cosmetics	24.0	480.0	20.0%	25.7	4.9	19.1%
Goeun Sesang Cosmetics	12.3	-32.7	-2.7%	NA	NA	NA
Ami Cosmetics	21.0	20.2	1.0%	NA	NA	NA
Regen Cosmetics	5.8	81.2	14.1%	8.8	1.7	18.9%

Source: Companies, Daiwa

Korean brand Dr. Jart is a pioneer in the cosmeceutical field, having launched its BB cream in the US through Sephora in 2012. Harnessing its roots in dermatology, the product proved to be a hit in the market and prompted global brands to follow up with their own versions. We think the success of this product has been a milestone in bringing Korean cosmeceuticals to the attention of the global players.

In a similar vein, Sansung L&S is planning on entering the US and European markets with its facial mask packs. Demand is growing in this category yet the company believes these markets are underpenetrated. If the company is successful in this effort, it should further raise the profile of Korean players in developed markets, in our view.

Valuations and key stock calls

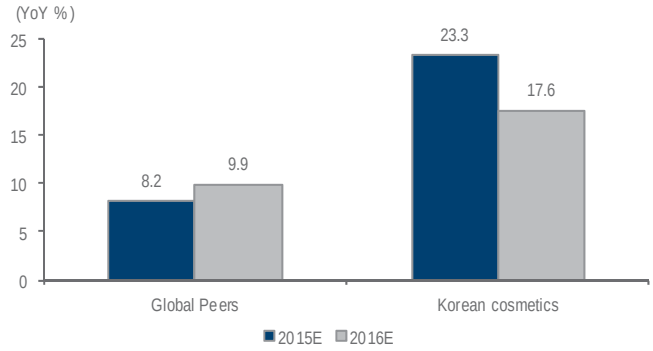
Our forecasts have the Korean cosmetics companies leading the way in earnings growth this year and beyond, yet they are trading at discounts to international peers.

Valuation

We see scope for Korean cosmetics stocks to be rerated as the market comes to recognise the extent of their earnings-growth potential relative to international players.

We forecast Korean companies in our coverage universe (excluding outliers) to deliver EPS growth of 23% YoY in 2015, compared with 8% YoY growth on average for the global players (Bloomberg data).

■ Korea vs. global: 2015-16E EPS YoY growth comparison

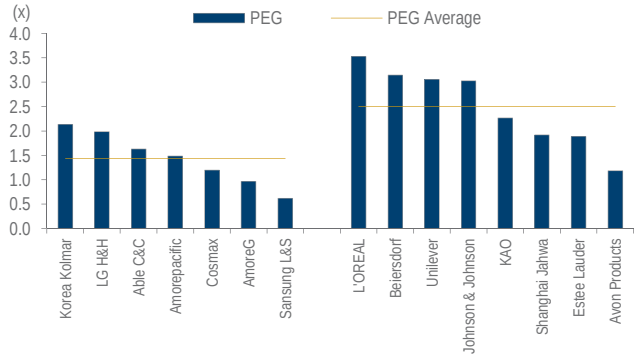


Source: Bloomberg, Daiwa estimates
Note: Data excludes outliers (Able C&C, Sansung L&S and Avon Products)

Moreover, we think the Korean companies have the edge over their international peers on earnings growth in 2015-17. Our forecasts call for the Korean cosmetics players to see a 2015-17E EPS CAGR of 24.2%, well above the 10% CAGR for major global peers (Bloomberg data).

Yet a comparison of the 2015E PEG ratios of the Korean and global companies suggests the Korean companies' better earnings-growth prospects aren't fully reflected in their valuations. Hence, we look for the Korean stocks to outperform their global peers over a 12-month investment horizon.

■ Korea vs. global: PEG ratio comparison



Source: Bloomberg, Daiwa estimates for Korea companies under coverage

Stock picks

Within the sector, we favour companies with some or all of the following attributes: 1) the brand equity and market strategy to ensure their longevity, 2) exposure to international markets, and 3) high earnings visibility.

Large-cap brand companies

We initiate coverage of **Amorepacific** with an Outperform (2) rating and 12-month target price of KRW3,800,000. Amorepacific is our top pick within the sector, as we believe it offers the best revenue growth potential, not just in 2015 but over our forecast horizon.

OEM/ODM companies

Of the 2 major ODM companies, we prefer **Cosmax** over **Korea Kolmar**. We initiate coverage of Cosmax with an Outperform (2) rating and 12-month target price of KRW150,000. While the stock is trading at a premium to its domestic peers on 2015E PER, we believe its premium valuation is warranted as the company's main clients are going global and the company is working on normalising operations at its US plant.

Mid- and small-cap brand companies

Among the mid- and small-cap brands, **Sansung L&S** is our top pick, with a Buy (1) rating and 12-month target price of KRW90,000. We like Sansung L&S for its strong revenue growth and view its valuation as attractive. As for Able C&C, we are worried that more price competition could arise this year.

■ Major cosmetics players: earnings outlooks

	PER (x)		EPS growth (%)	
Company	15E	16E	15E	16E
Amorepacific*	34.3	27.0	47.8	27.1
LG Household & Health Care*	29.0	24.5	24.4	18.5
Able C&C*	25.9	23.1	173.8	12.2
Cosmax*	34.0	24.3	56.7	39.8
Korea Kolmar*	37.0	31.4	13.4	17.7
AmoreG*	31.1	25.9	21.0	20.3
Sansung L&S*	20.6	13.4	215.5	53.9
L'OREAL	27.9	25.9	(31.7)	7.9
Shanghai Jahwa	22.7	21.5	58.0	5.8
Estee Lauder	30.0	25.4	(10.7)	18.4
SHISEIDO	28.8	38.7	16.4	(25.7)
KAO	33.0	27.4	17.2	20.2

*Source: Bloomberg, *Daiwa forecasts*

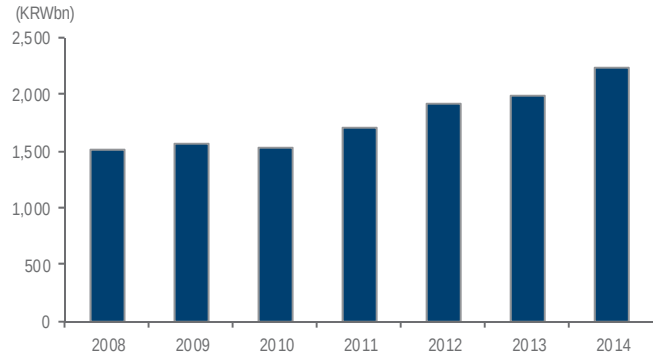
Share-price catalysts

Investor interest should increase on planned IPOs in 2015

We believe that the shares of the ODM companies and one-brand shops stand to benefit from positive investor sentiment on the planned IPOs of related companies this year. Two one-brand shop companies and 1 ODM company are planning to file for stock-market listings this year, and all 3 are seeking funding to strengthen their overseas expansion efforts.

One-brand shops had been realising sustained revenue growth from new store openings up until 2012. But with their scope for store expansion declining and Amorepacific aggressively penetrating the market, the brands have shifted to competing on price. We see no end in sight to this trend, and we believe it is one reason the brands are increasingly looking overseas for new growth engines.

■ Korea: value of one-brand shop market



Source: Amorepacific, Daiwa

■ One-brand shops: key metrics

	Revenue			Operating profit			Net profit	
(KRWbn)	2013	2014	YoY	2013	2014	YoY	2013	YoY
THE FACE SHOP	547.2	610.4	25.0%	94.9	72.9	19.0%	64.0	8.3%
MISSHA	442.4	438.3	-2.2%	13.2	6.7	-49.2%	6.5	-83.3%
ETUDE	337.3	307.5	20.2%	26.1	65.5	11.5%	19.5	4.6%
INNISFREE	332.8	459.6	45.1%	49.8	71.0	37.2%	39.3	40.3%
SKIN FOOD	173.8	-	-	3.0	-	-	1.9	-75.3%
TONYMOLY	170.3	-	-	19.4	-	-	18.7	47.2%
NATURE REPUBLIC	171.7	-	-	-0.5	-	-	-2.9	-58.6%
IT'S SKIN	53.0	-	-	8.7	-	-	7.1	217.3%
THE SAEM	33.2	-	-	-10.6	-	-	-16.2	23.8%

Source: DART
Note: K-IFRS consolidated

Major one-brand shops Tonymoly and Nature Republic are planning to go public this year. As one-brand shops rely on OEM/ODM companies for their production, their planned expansion should be a revenue-growth opportunity for the OEM/ODM companies.

Cosmecca Korea, an OEM/ODM company, is also considering a stock-market listing this year. We think its listing would serve to highlight to investors the expansion potential of the country's OEM/ODM players, which we think could also increase interest in stocks such as Cosmax, Korea Kolmar, and Coson (069110 KQ).

Risks to our sector view

We highlight 3 factors that could affect the revenue-growth prospects of Korean cosmetics companies and hence pose a risk to our sector view: 1) intensifying competition from domestic Chinese brands, 2) counterfeit products and black-market sales, and 3) possible political tensions between China and Korea.

Will Chinese domestic cosmetics players be a threat?

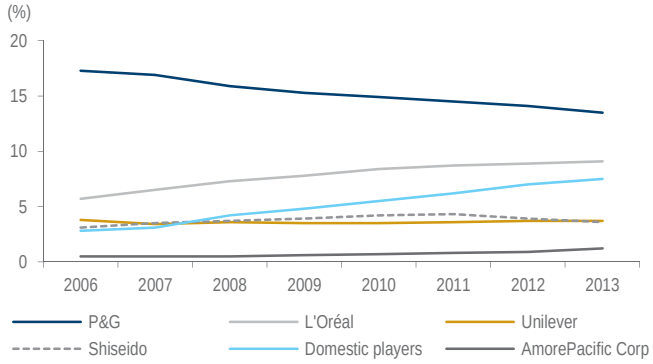
There has been some concern in the market about the prospect of the domestic players in China growing in prominence and building brand equity to the point where they can challenge international brands. We do not see this as an immediate concern, not least because many of the domestic players lack the requisite technology and production facilities.

As it stands, most of the domestic cosmetics companies are strong in China's lower-tier cities, which have become an area of focus for the global brands looking to build their market penetration. We expect the domestic brands to have a hard time defending their market share when they are at a disadvantage in technology and facilities.

Indeed, we think it is likely that some cosmetics companies in China will ultimately go the M&A route. However, we have seen no such activity as yet, and even if it were to occur we believe it would take the domestic players 2-3 years to catch up with the international brands.

In other words, Korea cosmetics companies should have a 2- to 3-year window in which to invest in their brands and R&D as a means of maintaining their edge over prospective rivals in China.

■ China: cosmetics market share



Source: Euromonitor

Note: Domestic players category includes Shanghai Jahwa, Jala, Jiansu Longliqi, Shanghai Inoherb, and Guangdong Marubi

Are counterfeit products and the black market big problems?

Counterfeit products and black-market sales pose a threat to the Korean cosmetics companies in terms of reputational risk and forfeited revenue. But these are also factors that in some respects are beyond the control of the companies.

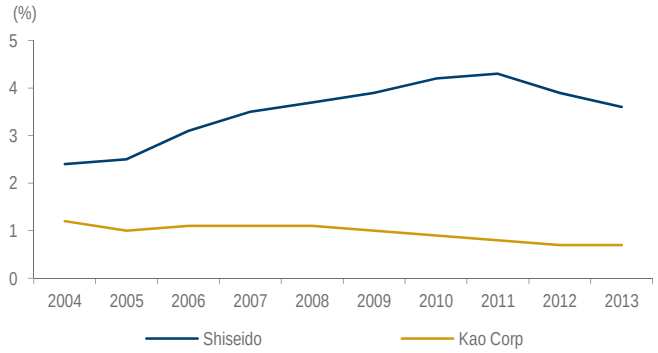
Keeping control of the distribution channels for their products is a critical way for companies to manage such risks, in our view. They are not in a position to realise total control of overseas markets, but if they can establish distribution channels that are credible in the eyes of consumers, they can mitigate the risk of counterfeit products and black-market sales.

Since the Korean companies are not active in China's lower-tier cities, they can utilise online channels, especially B2C sites, which we see as offering sound revenue-growth prospects if online beauty products continue to expand rapidly.

Possibility of China-Korea dispute affecting consumer sentiment

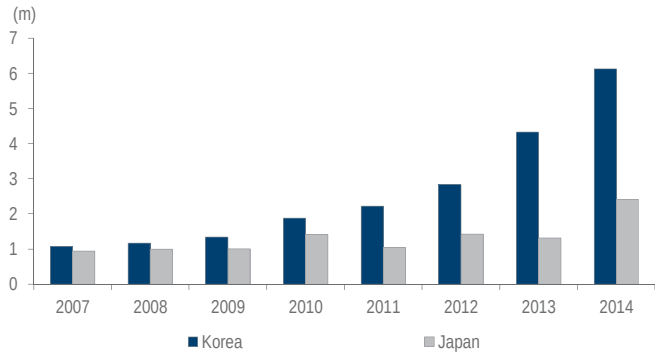
While nearly impossible to determine, we cannot rule out the possibility of a political dispute arising between China and Korea, which likely would have negative implications for the revenues of Korean cosmetics companies. Back in 2011, the Japanese cosmetics companies saw their China revenues decline against the backdrop of territorial disputes between the 2 nations. At the same time, visitor arrival numbers from China to Japan were sluggish compared with those from other countries. A China-Korea political dispute could, if long-running, prompt us to revisit our forecasts with a downward bias.

■ China cosmetics market: Japan brands' market share



Source: Euromonitor

■ China tourists: visitor numbers to Korea and Japan



Source: Japan Tourism Marketing Co, Korea Tourism Organization

Appendices

A look at consumers in China and the leading Korean brands

Appendix 1: the China market

How do consumers in China learn about cosmetics?

The leading Korean cosmetics players have established a presence in the China market and hence have direct exposure to consumers there. But many consumers in China like to buy cosmetics products in bulk, including items not yet on sale in China. How are they finding out about these products?

From our interview with a cosmetics wholesaler that exports to Mainland China, we learned that Korean television programmes are fuelling Chinese consumer demand for Korean cosmetics. TV shows such as Get it Beauty, which features the latest trends, beauty tips and product reviews, are prominent. Production company CJ E&M makes the show available in China on Youku.com, a video-hosting service specifically targeting the China market, which allows China-based consumers to keep abreast of the fast-changing trends and fashions in Korea.

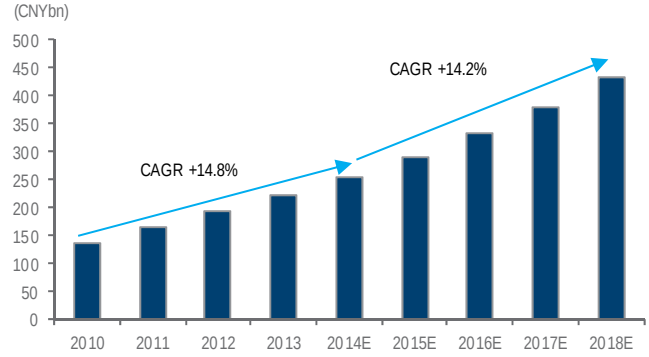
Word of mouth is another important factor, particularly online. According to Internet giant Baidu, searches for product feedback account for 13.7% of all search queries from China relating to cosmetics. Consumers in China are increasingly accustomed to buying items online, but we think this interest in what other consumers have to say reflects lingering doubts about the consumer friendliness of e-commerce and the quality of goods available online.

Finally, celebrity marketing always helps. Look no further than the case of high-end brand Whoo, whose sales surged after China's first lady, Peng Liyuan, was seen purchasing Whoo cosmetics in 2014.

The China cosmetics market

According to Frost & Sullivan, the China cosmetics market was worth about CNY254bn (up 14.8% YoY) in 2014, and industry consultants forecast a 14.2% CAGR over the next 4 years (CNY432bn by 2018).

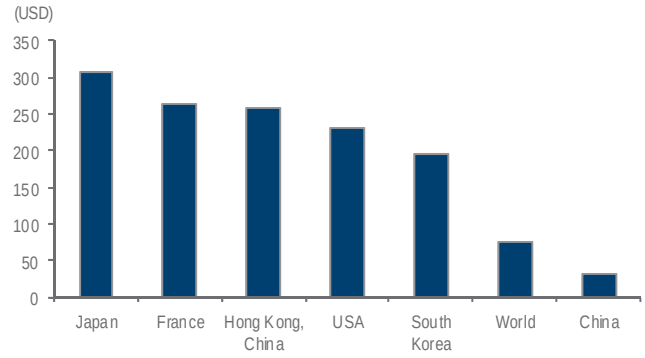
■ China: size of cosmetics market and growth forecasts



Source: Frost & Sullivan

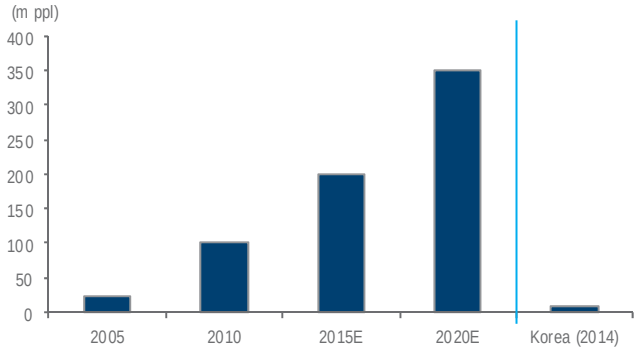
We think the market's growth is likely to be supported by increasing price points and quantities bought. By international standards, China cosmetics consumption per capita is still low, but we believe it is reasonable to assume that continued economic growth and increased spending power will spur usage. Japan's Shiseido estimates that only 16% of China's population uses cosmetics products currently, and it expects the absolute number of cosmetics users there to increase almost two-fold over the next 5 years.

■ Cosmetics consumption per capita by country



Source: Euromonitor

■ China: number of people using cosmetics



Source: Shiseido

Appendix 2: Korean cosmetics brands at a glance

Amorepacific and LG H&H are arguably the 2 pillars of the Korea cosmetics industry. They are the only players with brand portfolios spanning the low end to the high end.

Most of the other listed companies concentrate on either marketing (Able C&C) or production (Korea Kolmar, Cosmax, Coson).

However, Genic (123330 KQ, not rated) is trying a different approach by having its own brand and operating an ODM business at the same time.

■ **Korean cosmetics brands by company**

Company	Brand	Note
AMOREPACIFIC	Sulwhasoo	• Top of domestic department stores in market share
	LANEIGE	• One of the best-known brands in China
	HERA	
	IOPE	• Being introduced to the China market in 1H15
	Mamonde	• Finished restructuring in China
AMORE Group	Innisfree	• Ranked second among domestic one-brand shops. Increasing awareness in China
	ETUDE	• No. 4 one-brand shop specialising in colour cosmetics
LG HOUSEHOLD & HEALTHCARE	Whoo	• Ranked top in sales at major DFS stores
	O HUI	
	SU:M	
	Sooryehan	
	THE FACE SHOP	• Ranked top among domestic one-brand shops
ABLE C&C	MISSHA	• Ranked third among domestic one-brand shops
	A'PIEU	• Second brand of Missha

Source: Daiwa

The 10-second briefing

Amorepacific
090430 KS

Target (KRW): **3,800,000**
Upside: **12.6%**
25 Mar price (KRW): **3,374,000**

Initiation: cushion foundation taking it to the next level

- Amorepacific stands to be the biggest beneficiary of rising numbers of visitors from China, in our view
- Overseas, the company continues to expand its presence and looks set to improve the quality of its earnings growth
- Initiating with an Outperform (2) call and 12-month target price of KRW3,800,000

1 Buy
2 Outperform (initiation)
3 Hold
4 Underperform
5 Sell

How do we justify our view?

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Investment case

We forecast solid growth in Amorepacific's revenue over 2015-17, backed by its cashcow DFS sales being supported by stable growth in visitors from China. The company continues to expand its presence overseas, with more brands now going global. We forecast its 2015 revenue to be KRW4.7tn (up 20.1% YoY), with operating profit of KRW799bn (up 41.8% YoY).

Quality growth overseas. The profitability of Amorepacific's overseas business improved in 2014, with its China business expanding its operating margin by 8pp to 11.1% and other overseas business moving into the black with an operating margin of 5.9%. Even without active store expansion, overseas revenue jumped by 20.7% YoY (excluding Hong Kong, newly consolidated in 2014) and contributed 21.5% of revenue. We believe this growth is a testament to the company's increasing brand equity globally, which we see being a lasting trend.

Cushion foundation a growth driver. Global sales of foundation totalled KRW15.5tn in 2014, during which Amorepacific sold KRW9bn worth. We believe MNCs' product releases, such as the recent launch of L'oreal's own cushion foundation product, won't hit Amorepacific's revenue but rather will present market-expansion opportunities.

Catalysts

Change in cosmetics tax. We believe one share-price catalyst would be a future change in China's taxation policy on cosmetics. Upon a planned change (timing unknown), lower-end cosmetics will be exempt from the tax. Upon this exemption, Amorepacific should be able to build rapidly the Etude (mass-market colour cosmetics) brand in China.

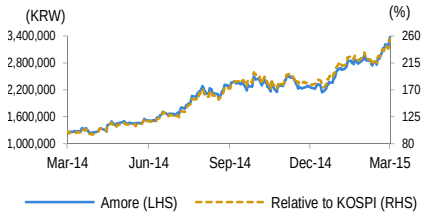
Valuation

Backed by a DCF-based 12-month target price of KRW3,800,000, we initiate coverage with an Outperform (2) call. The stock is currently trading at 1.5x 2015E PEG, vs. a global peer average of 2.5x. We believe a valuation discount is not warranted given Amorepacific's faster earnings growth, improving profitability, and proven ability to set global trends.

Risks

We estimate that visitors from China contribute 80% of the company's DFS sales. Political disputes between China and Korea could reduce the number of tourists visiting from China and hurt the company's cashcow business.

Share price performance



12-month range	1,235,000-3,374,000
Market cap (USDbn)	17.92
3m avg daily turnover (USDm)	41.22
Shares outstanding (m)	6
Major shareholder	Amorepacific Group (35.4%)

Financial summary (KRW)

Year to 31 Dec	15E	16E	17E
Revenue (bn)	4,651	5,475	6,097
Operating profit (bn)	799	1,016	1,202
Net profit (bn)	575	730	864
Core EPS (fully-diluted)	98,345	124,978	147,939
EPS change (%)	47.8	27.1	18.4
Daiwa vs Cons. EPS (%)	18.4	24.5	(88.4)
PER (x)	34.3	27.0	22.8
Dividend yield (%)	0.3	0.3	0.3
DPS	9,000	9,000	9,000
PBR (x)	5.8	4.9	4.1
EV/EBITDA (x)	18.9	14.9	n.a.
ROE (%)	18.3	19.6	19.4

Source: FactSet, Daiwa forecasts

1 Buy
2 Outperform (initiation)
3 Hold
4 Underperform
5 Sell

How do we justify our view?

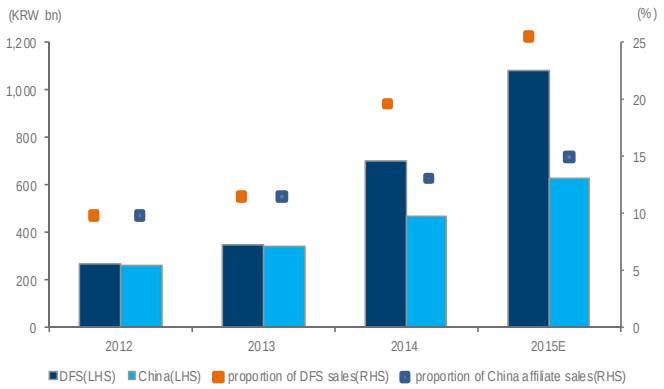
- Growth outlook ✓✓✓✓✓
- Valuation ✓✓✓✓✓
- Earnings revisions ✓✓✓✓✓

Growth outlook ✓✓✓✓✓

We forecast Amorepacific to record 2015E revenue of KRW4.7tn (up 20.1% YoY), backed by DFS sales totalling KRW1.1tn (up 53.9% YoY). Our forecasts have its China business realising 37.9% YoY growth in revenue to KRW644.3bn on the back of increased sales online and a 50% YoY rise in new store openings for Innisfree.

Assuming that highly profitable DFS sales account for a larger proportion of sales, plus an increased profit contribution from overseas business, we forecast Amorepacific's operating profit to expand by 41.8% YoY to KRW799bn for 2015E.

Amorepacific: DFS and China's revenue and proportion

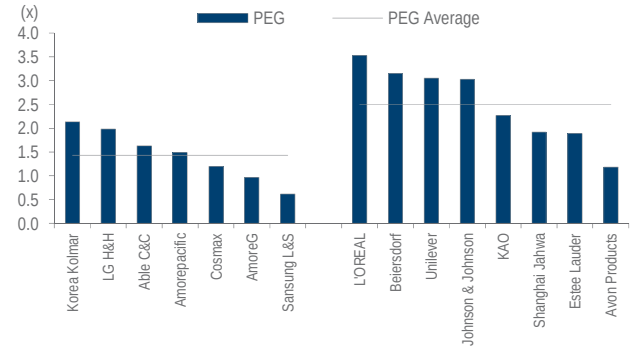


Source: Company, Daiwa estimates

Valuation ✓✓✓✓✓

Our 12-month target price for Amorepacific, based on a DCF valuation, is KRW3,800,000. On the basis of its 2015E PEG relative to global peers, we believe Amorepacific shares are undervalued. We find the stock is trading currently at 1.5x 2015E PEG, compared with a global peer average of 2.5x.

Amorepacific: 2015E PEG comparison



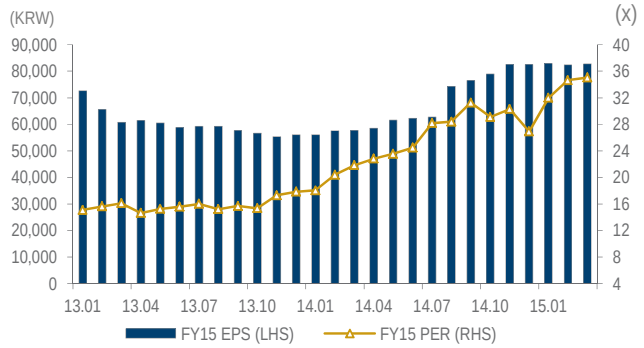
Source: Bloomberg, Daiwa forecasts

Earnings revisions ✓✓✓✓✓

The Bloomberg-consensus 2015E EPS for Amorepacific has been raised over since 2H14, likely as the market has been factoring in the brighter prospects for DFS sales and overseas business.

Our 2015E EPS forecasts are 18% above the Bloomberg consensus forecasts. If growth in the number of visitors from China to Korea were to exceed our forecast (21.5% YoY for 2015), we would have to revisit our earnings forecasts with an upside bias.

Amorepacific: consensus EPS forecast revisions (2015E)



Source: Bloomberg

Financial summary

Key assumptions

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Chinese inbound growth (yoy%)	39.7	18.4	27.8	52.5	41.6	21.5	19.4	17.4
DFS sales growth (yoy%)	0.0	55.1	45.3	31.5	102.1	53.9	35.2	12.1
Online DFS sales growth (yoy%)	0.0	0.0	0.0	0.0	139.8	24.9	22.8	20.8
No. of Innisfree China stores	0.0	0.0	0.0	45.0	108.0	163.0	263.0	363.0
Door to door sales growth (yoy%)	9.5	4.7	1.0	(13.4)	(2.9)	3.3	1.0	1.0

Profit and loss (KRWbn)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Domestic Cosmetics	1,656	1,825	1,989	2,088	2,579	3,049	3,459	3,695
Domestic Mass Beauty & Sulloc	349	403	438	468	463	480	511	542
Other Revenue	54	327	422	544	832	1,122	1,505	1,860
Total Revenue	2,059	2,555	2,849	3,100	3,874	4,651	5,475	6,097
Other income	74	82	102	124	116	130	143	156
COGS	(556)	(775)	(847)	(912)	(1,028)	(1,192)	(1,392)	(1,538)
SG&A	(1,162)	(1,407)	(1,637)	(1,819)	(2,282)	(2,660)	(3,067)	(3,357)
Other op.expenses	(74)	(82)	(102)	(124)	(116)	(130)	(143)	(156)
Operating profit	340	373	365	370	564	799	1,016	1,202
Net-interest inc./(exp.)	11	13	14	14	16	19	21	24
Assoc/forex/extraord./others	4	56	(3)	(0)	(46)	(28)	(33)	(37)
Pre-tax profit	356	442	377	383	534	790	1,004	1,189
Tax	(71)	(102)	(92)	(96)	(145)	(215)	(274)	(325)
Min. int./pref. div./others	0	0	(1)	(1)	0	0	0	0
Net profit (reported)	285	340	283	287	389	575	730	864
Net profit (adjusted)	285	340	283	287	389	575	730	864
EPS (reported)(KRW)	48,678	58,195	48,477	49,016	66,497	98,290	124,908	147,856
EPS (adjusted)(KRW)	48,678	58,195	48,477	49,016	66,497	98,290	124,908	147,856
EPS (adjusted fully-diluted)(KRW)	48,705	58,228	48,504	49,043	66,534	98,345	124,978	147,939
DPS (KRW)	5,500	6,000	6,500	6,500	6,500	9,000	9,000	9,000
EBIT	340	373	365	370	564	799	1,016	1,202
EBITDA	445	494	515	549	732	989	1,224	1,428

Cash flow (KRWbn)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Profit before tax	356	442	377	383	534	790	1,004	1,189
Depreciation and amortisation	74	82	102	124	116	130	143	156
Tax paid	0	(59)	(79)	(78)	(118)	(175)	(222)	(263)
Change in working capital	(35)	(18)	(126)	(18)	(36)	(36)	(38)	(29)
Other operational CF items	(49)	(43)	1	16	(31)	(45)	(56)	(65)
Cash flow from operations	345	403	276	427	465	665	832	988
Capex	(302)	(317)	(232)	(323)	(350)	(350)	(350)	(250)
Net (acquisitions)/disposals	0	(33)	0	0	0	0	0	0
Other investing CF items	(84)	(24)	(22)	(25)	155	(46)	(48)	(37)
Cash flow from investing	(385)	(374)	(254)	(349)	(195)	(396)	(398)	(287)
Change in debt	0	45	8	90	0	0	0	0
Net share issues/(repurchases)	0	0	0	0	0	0	0	0
Dividends paid	(38)	(41)	(45)	(45)	(45)	(62)	(62)	(62)
Other financing CF items	0	1	2	4	39	40	44	34
Cash flow from financing	(38)	4	(35)	49	(6)	(22)	(18)	(28)
Forex effect/others	0	(4)	(3)	(4)	0	0	0	0
Change in cash	(78)	29	(17)	123	264	248	415	673
Free cash flow	44	86	44	103	115	315	482	738

Source: FactSet, Daiwa forecasts

Financial summary continued ...

Balance sheet (KRWbn)

As at 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Cash & short-term investment	272	330	311	469	768	1,053	1,496	2,203
Inventory	181	226	267	283	353	424	499	556
Accounts receivable	151	184	220	250	313	375	442	492
Other current assets	1	3	1	1	1	1	1	1
Total current assets	605	743	799	1,003	1,435	1,853	2,438	3,252
Fixed assets	1,179	1,737	1,868	2,060	2,286	2,520	2,740	2,846
Goodwill & intangibles	31	115	121	133	133	133	133	133
Other non-current assets	249	212	287	231	68	83	105	n.a.
Total assets	2,064	2,808	3,076	3,426	3,921	4,589	5,415	6,346
Short-term debt	0	16	23	40	40	40	40	40
Accounts payable	256	311	303	361	451	542	637	710
Other current liabilities	100	92	142	165	189	215	234	257
Total current liabilities	355	418	467	567	681	797	912	1,007
Long-term debt	92	11	12	10	13	16	19	21
Other non-current liabilities	68	241	254	281	319	360	403	438
Total liabilities	515	669	732	858	1,013	1,172	1,334	1,466
Share capital	35	35	35	35	35	35	35	35
Reserves/R.E./others	1,514	2,094	2,299	2,520	2,860	3,369	4,034	4,833
Shareholders' equity	1,549	2,128	2,334	2,554	2,895	3,404	4,069	4,867
Minority interests	0	10	10	14	13	13	13	13
Total equity & liabilities	2,064	2,808	3,076	3,426	3,921	4,589	5,415	6,346
EV	19,443	19,425	19,452	19,311	19,015	18,732	18,292	n.a.
Net debt/(cash)	(180)	(304)	(277)	(419)	(715)	(997)	(1,437)	(2,143)
BVPS (KRW)	264,209	363,371	398,552	436,349	494,619	581,760	695,528	832,253

Key ratios (%)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Sales (YoY)	16.4	24.1	11.5	8.8	25.0	20.1	17.7	11.4
EBITDA (YoY)	11.0	10.9	4.3	6.7	33.3	35.0	23.8	16.7
Operating profit (YoY)	13.2	9.6	(2.0)	1.2	52.4	41.8	27.1	18.3
Net profit (YoY)	25.0	19.6	(16.7)	1.1	35.7	47.8	27.1	18.4
Core EPS (fully-diluted) (YoY)	25.0	19.6	(16.7)	1.1	35.7	47.8	27.1	18.4
Gross-profit margin	73.0	69.7	70.3	70.6	73.5	74.4	74.6	74.8
EBITDA margin	21.6	19.3	18.1	17.7	18.9	21.3	22.4	23.4
Operating-profit margin	16.5	14.6	12.8	11.9	14.5	17.2	18.6	19.7
Net profit margin	13.8	13.3	9.9	9.2	10.0	12.4	13.3	14.2
ROAE	20.1	18.6	12.7	11.7	14.3	18.3	19.6	19.4
ROAA	15.3	14.0	9.6	8.8	10.6	13.5	14.6	14.7
ROCE	22.5	19.6	16.1	14.8	20.2	24.8	26.7	26.5
ROIC	22.7	17.9	14.1	13.1	18.9	25.2	29.2	32.5
Net debt to equity	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Effective tax rate	20.0	23.1	24.5	25.1	27.2	27.3	27.3	27.3
Accounts receivable (days)	25.3	23.9	25.9	27.7	26.5	27.0	27.2	27.9
Current ratio (x)	1.7	1.8	1.7	1.8	2.1	2.3	2.7	3.2
Net interest cover (x)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Net dividend payout	11.3	10.3	13.4	13.3	9.8	9.2	7.2	6.1
Free cash flow yield	0.2	0.4	0.2	0.5	0.6	1.6	2.4	3.7

Source: FactSet, Daiwa forecasts

Company profile

Amorepacific is the leading cosmetics company in Korea, with a 32% market share (2013). Cosmetics accounted for 85% of the company's sales in 2013, and household goods and green tea the remainder. Amorepacific, Laneige, IOPE, Hera, Sulwhasoo, and Etude are its major cosmetics brands, and it sells its products through discount stores, specialty stores, department stores, and door to door. It also has operations in China, Europe and North America.

Cushion foundation set to go global

We expect Amorepacific to continue to outperform its peers this year, backed by: 1) improving profitability for its overseas business, 2) its cushion foundation product going global, and 3) robust growth in revenue, supported by DFS.

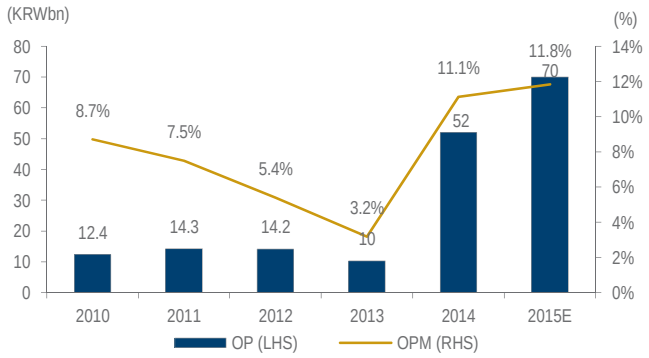
Quality growth overseas

Based on our expectation of increased profitability of its China business and improving profitability of other international branches, we forecast an improvement in the quality of earnings growth for Amorepacific's overseas business in 2015E. On our forecasts, its overseas operating margin will widen by 4pp YoY in 2015, from 7.4% in 2014. Moreover, we expect this improvement in the quality of growth to underline the company's brand equity at the global level.

China, Innisfree and online expansion boosting profitability

Backed by our forecast for expansion in the high-margin sales of Innisfree and the online channel, we expect the company's China division to maintain a double-digit operating profit margin in 2015E.

■ Amorepacific: China operating-profit margin

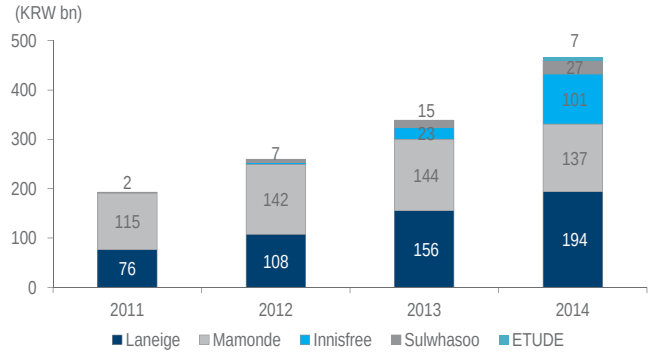


Source: Company, Daiwa forecasts

Innisfree has been a hit in China. Its revenue in China increased by 333% YoY to KRW101.4bn in 2014, equivalent to 21.7% of overall China revenue. Because the stores themselves play a role in advertising the brand, Innisfree does not require substantial marketing expenses. This is reflected in its operating margin, which we estimate to 12-13%, compared with an operating margin of 11.1% for the China business as a whole. Plus, with sales of the brand having started on T-mall, China's largest B2C site, in 4Q14, we expect further margin expansion for Innisfree.

Online expansion of other brands should also be positive for Amorepacific. Around 20% of sales for Laneige, the company's main brand in China, come from online platforms. However, compared with global brands, this is a relatively low figure (eg, 50% of L'oreal's mass brand revenue comes from online sales). Laneige enjoys good brand recognition and started to expand its online presence last year, which we expect to result in the gap between it and global brands in terms of the online sales contribution narrowing.

■ Amorepacific: China sales by brand



Source: Company, Daiwa forecasts

Cushion foundation is on the verge of going global

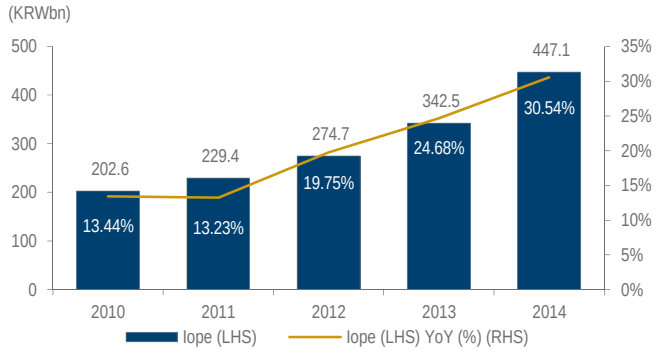
In our view, Lancome's recently launched cushion foundation product should be viewed as an opportunity for Amorepacific rather than a threat. We believe that Amorepacific now has the upper hand in the colour cosmetics segment, which had been a weakness for the company.

Cushion foundation in Korea

Since cushion foundation hit the market in 2008, more than 50m units have been sold. According to a survey undertaken by TNS Korea, 75% of all Korean women have used the product, which is now the most popular type of foundation in the domestic market. Amorepacific's IOPE brand, the first to launch in the market, has sold 20m units since 2008. The brand's revenue has grown strongly over the past 7 years, with

its 2013 and 2014 sales totalling KRW100bn and KRW200bn, respectively.

■ IOPE: revenue and revenue growth



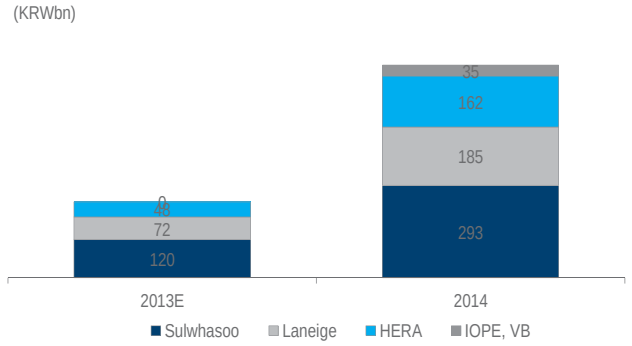
Source: Company

Global foundation market now worth USD14.4bn

Amorepacific launched its cushion foundation in selected international markets in 2012. Laneige in particular has benefited from the cushion foundation line, which has helped it to penetrate the US market. In 2014, Laneige started to be sold in branches of US retailer Target. Meanwhile, in ASEAN markets, 60% of its Laneige's revenue comes from sales of its blemish-banishing (BB) cushion.

Another beneficiary of the trend is IOPE, a "masstige" skin care brand. Despite not being sold in China, the brand's profile there has grown over the years, as it was the first cushion foundation product. Supported by a boom in demand in Korea, the brand has been able to open 15 new DFS stores and the company is preparing to enter the China market with the brand this year.

■ Amorepacific: DFS sales by brand

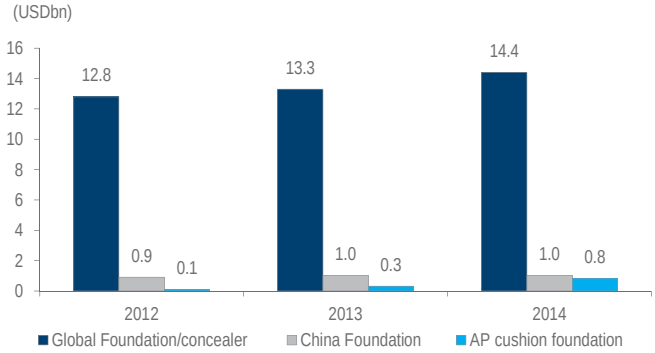


Source: Company

We believe there will be similar growth opportunities for other Amorepacific brands, as they all offer cushion foundation products. According to Euromonitor, the global cushion foundation market is worth USD14.4bn, of which the China market accounts for around 7.7%.

In 2014, Amorepacific recorded cushion foundation revenue of KRW900bn (USD800mn). MNCs are now launching their own cushion foundation lines, which we think serves as an endorsement of Amorepacific's first-to-market products. Hence, we believe the company has scope for further revenue growth in this segment.

■ Foundation: global market size and Amorepacific's cushion foundation sales



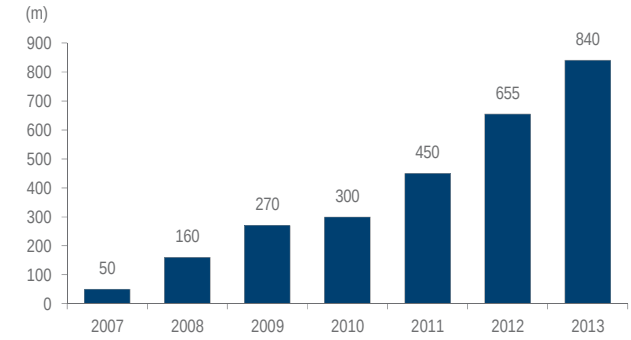
Source: Euromonitor, Amorepacific
Note: Based on retail prices

BB cream — clear precedent for Korean products going global

BB creams are a good example of a Korean cosmetics product that has been emulated by the major international players. Although BB creams hit the Korean market in the late 2000s, it was not until 2011 that the global brands started to offer their own BB creams. The likes of L'oreal and Chanel started to sell their own BB creams, giving the product line worldwide exposure.

In Korea, Missha is a top-tier brand in the BB cream segment. Coinciding with the global rise to prominence of BB creams, sales of Missha's own BB cream surged in 2011. We believe the increased consumer awareness of the product, especially overseas, has underpinned this robust sales growth.

■ Missha: BB cream sales



Source: Able C&C

Global brands Lancome and KIKO recently launched their own BB cream products. Just as with cushion foundation, however, we see this not so much as a threat to Amorepacific's revenue but as an opportunity for the company to sell its BB creams to an expanding market.

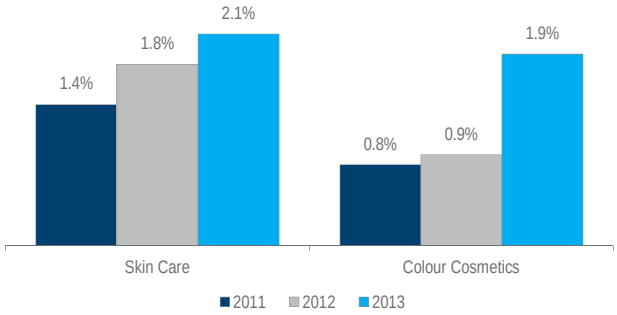
■ Lancome: cushion foundation

Source: L'oreal

Sharpening its competitive edge in colour cosmetics

According to Euromonitor data, Amorepacific's share of China's colour cosmetics market increased from 0.9% to 1.9% from 2012 to 2013, whereas its skin care market share increased by only 0.3pp to 2.1% in the same timeframe. We believe the main reason for the company's much faster market-share growth in the colour cosmetics market was the launch of Laneige's colour foundation in China.

■ Amorepacific: share of China market for skin care products and colour cosmetics



Source: Euromonitor

In our view, Korean women are particularly concerned about their skin texture, and as a result Amorepacific's skin care products are highly competitive. The company's colour cosmetics are arguably less competitive today, but we think the success of its cushion foundation products will boost its prospects in this category.

More DFS sales growth to come

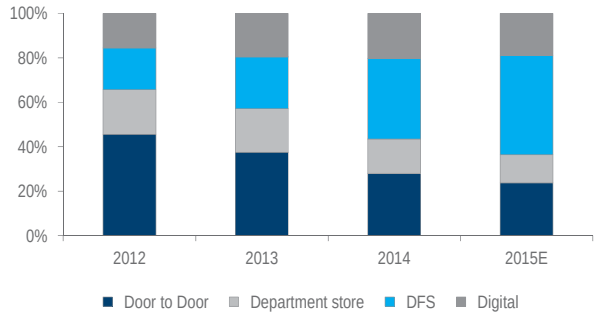
We believe that the growth in DFS sales will continue to outpace the overall growth in domestic revenue in 2015, as there are more DFS stores being opened and online sales are on the rise. At the same time, Korean DFS operators are heading overseas, which should give manufacturers like Amorepacific an opportunity to expand their global exposure through the DFS channel.

Amorepacific has devoted significant sums to marketing in China. Rather than focus on short-term profitability, it is working instead to boost Chinese consumers' awareness of its brands. Hence, while the company's marketing expenses in Korea run at around 12-13% of its sales, its marketing expenditure in China accounts for 28-35% of sales there.

For this reason, the China operation has been unprofitable for the past few years. But the company's sustained brand-building efforts in China look to have paid off, judging by the surge in the number of visitors from China to Korea. Around 80% of DFS sales for Amorepacific last year were to tourists from China, which means that visitors from China contributed around 14.5% of Amorepacific's total revenue in 2014.

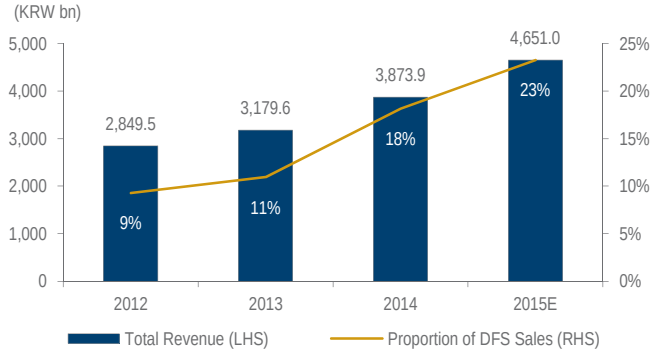
We forecast the company's DFS sales to expand by 53.9% YoY to KRW1.1tn in 2015, as a result of increasing offline store sales, a rising online sales contribution, and the contribution from a greater number of overseas DFS stores. Given we expect growth in DFS sales to outpace that of other channels this year, we look for the DFS channel to contribute 23% of Amorepacific's sales in 2015, up from 18.1% in 2014.

■ Amorepacific: domestic revenue channel breakdown



Source: Company, Daiwa

■ Amorepacific: DFS sales as proportion of total revenue



Source: Company, Daiwa estimates

Offline store openings

IOPE made its debut in the DFS channel in 2014 and now has counters in 15 DFS stores. The Sulwhasoo and Hera brands each have 28 counters, and IOPE will likely be hoping to secure more counters for itself. The company plans to roll out IOPE in the China market this year, which we think will support its counter expansion through DFS.

■ DFS: counter-opening history by brand

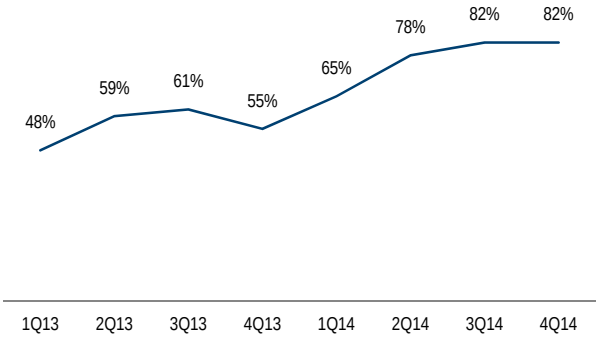
Company	Brand	Number of counters
Amorepacific	Sulwhasoo	28
	Laneige	29
	IOPE	15
LG H&H	Whoo/OHUI	37
	Sum	26
Sansung L&S	Leaders	16

Source: Company

In addition, the Korean government is keen to see more DFS stores open as the existing stores are often very crowded. Currently there are 17 downtown DFS stores in Korea. In view of the increase in the number of tourists from China, the government is prepared to allow 4 new stores to open. We believe Amorepacific will benefit from this initiative, as its products are already in high demand.

In our view, the company has 2 main ways of boosting its sales per person. First, it can revise the restrictions on the number of units that can be purchased by an individual. In response to DFS operators' complaints that Amorepacific brand stores were too crowded due in part to such sales limits, the company recently loosened the restrictions. Second, the company can sell products in sets targeted at specific groups of customers. Whereas consumers in Korea tend to purchase individual items, visitors from China seem to prefer to buy in bulk. Hence, Amorepacific has started selling its products in sets.

■ Amorepacific: contribution to DFS sales by visitors from China

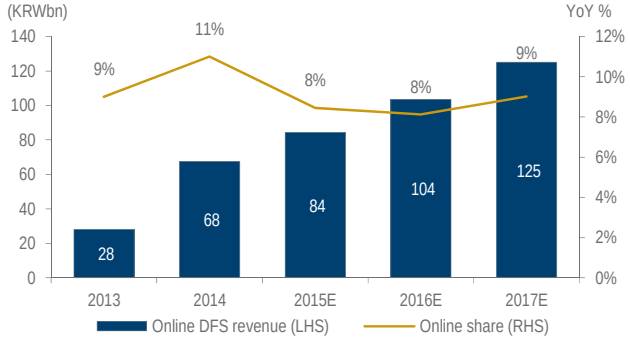


Source: Company

Online DFS sales forecast to surge

Spurred by China demand, online DFS sales for Amorepacific increased threefold in 2014. Last May, Alibaba started to allow residents of China to make payments on Korean websites. Lotte, which runs Korea's largest DFS network, was one of the first companies to adopt the system, and we believe this was a factor in the rapid growth in Amorepacific's online DFS sales growth.

■ Amorepacific: online DFS revenue and proportion of online sale



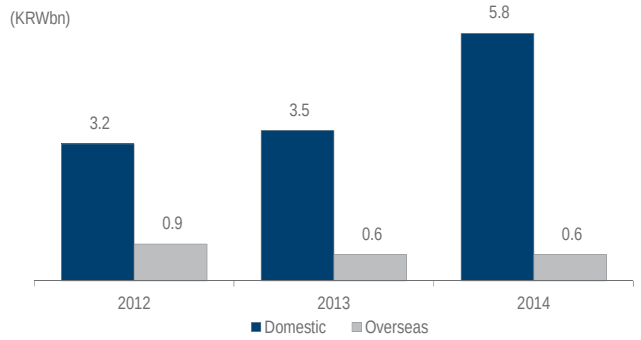
Source: Company, Daiwa

By using online channels, the company can overcome some of the physical constraints of offline channels. Buoyed by Chinese demand, Amorepacfic's DFS online sales will see a CAGR of 21.8% for 2015-17E, on our forecasts.

Overseas opportunities

The company currently has 120 points of sale at DFS stores internationally. However, its international sales per counter are just 11% of what its domestic counters bring in, likely because Amorepacific has less brand equity overseas. Still, we look for international consumers' awareness of Amorepacific and its brands to improve gradually over the coming years. Moreover, we note the company plans to educate its overseas DFS sales staff in a bid to boost sales.

■ Amorepacific: domestic vs overseas DFS sales per counter



Source: Amorepacific, Daiwa
Note: Adjusted to retail price

Valuation

Initiating coverage with target price of KRW3,800,000 and Outperform (2) rating

We initiate coverage of Amorepacific with an Outperform (2) call and derive our 12-month target price of KRW3,800,000 using a DCF valuation, which we think is an appropriate way of capturing its long-term earnings-growth prospects. We assume a terminal growth rate of 2%, which we think is justified by the company's emergence as a global brand.

■ Amorepacific: DCF valuation

(KRW bn)	2015E	2016E	2017E	2018E	2019E	2020E	2021E
Operating EBIT	799.5	1,015.8	1,202.1	1,359.0	1,527.5	1,716.9	1,929.8
NOPAT	580.4	737.5	872.7	986.6	1,157.8	1,301.4	1,462.8
Gross Cash flow	710.6	880.8	1,028.5	1,148.0	1,324.6	1,473.1	1,639.2
Free Cash Flow to firm (FCFF)	324.5	492.6	749.6	863.0	1,035.1	1,178.8	1,339.4
Present Value of FCFF	309.7	442.4	633.6	686.4	774.9	830.5	888.0
Sum of FCFF	4,565						
Terminal Value	16,822						
Corporate Value	21,387						
Net Cash	715						
Appraised value	22,102						
# of Shares Outstanding (mn)	5.8						
Appraised value per share (KRW)	3,780,849						

Key assumptions	
Beta	1.0%
WACC (%)	6.5%
Terminal growth rate (%)	2.0%

Source: Daiwa estimates

Catalysts

Planned relaxation of cosmetics tax rules in China

The China government currently imposes a 30% tax on colour cosmetics and functional skin care products, but it plans to revise the system such that lower-end cosmetics will be exempt from the tax. We note that no formal timeframe for this change has been announced.

Amorepacific distributes Etude, a mass-market colour cosmetics brand, in China. Compared with Innisfree, Etude is seeing relatively slow revenue growth, likely because the 30% tax has weighed on market demand.

However, at some point in the future the brand's products will be tax exempt, which we think will give the company an opportunity to build the brand and expand its market presence in China. To this end, Etude expects to open 10-15 new stores in China this year.

■ Innisfree vs Etude: cumulative number of stores in China

Brand	2012	2013	2014	2015E
Innisfree	5	45	108	160
Etude	0	5	12	30

Source: Company data, Daiwa

Risks to our call

Demand in China

Although Amorepacific's brands have been well received to date by consumers in China, it is possible that political tensions (such as those between Japan and China in recent years) and policy changes could weigh on demand for the company's products. This is the main risk to our Outperform (2) call on Amorepacific.

The 10-second briefing

Sansung Life & Science

016100 KQ

Target (KRW): **90,000**
Upside: **43.5%**
25 Mar price (KRW): **62,700**

Initiation: leader of the pack

- Strong brand awareness and demand in China should see cosmetics revenue rise at a CAGR of 29.7% for 2015-17E
- Differentiates its brand by positioning it as a dermatological product, and producing it in-house
- Moving into the West with the aim of becoming a global leader in facial-mask packs; initiating with a Buy (1) rating

1 Buy (initiation)
2 Outperform
3 Hold
4 Underperform
5 Sell

How do we justify our view?

Iris Park
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Investment case

The company's cosmetics brand, Leaders, benefits from high brand awareness among the Chinese. Along with its burgeoning duty-free business, the company is expanding into the Chinese online B2C market. As it expands within China, we forecast its cosmetics revenue to rise by a 29.7% CAGR over 2015-17 to KRW306bn, leading to a 33.4% operating profit CAGR.

Focused on differentiating its brand. By positioning its Leaders products as having dermatological benefits, the company has succeeded in differentiating its brand from those of its competitors. In addition, management's decision to buck the trend and move production in-house has further helped differentiate the brand.

Pioneering Western markets to solidify its position as a leader in facial masks. The company plans to enter Europe and the US where the facial-mask market is relatively immature, with its Leaders brand due to officially debut in European drugstores within 1H15. Like BB creams, Leaders could expand the company's facial-mask market reach and give it a first-mover advantage among global brands.

Catalysts

Expanding skincare sales. As the company has its roots in skincare, it will continue to develop value-added skincare products in an effort to become recognised as a comprehensive skincare brand, not just a facial-mask brand.

Valuation

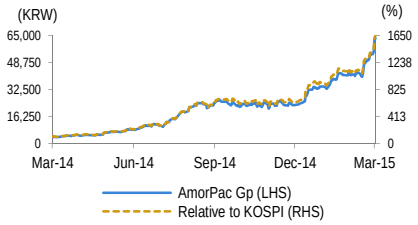
We initiate coverage with a 12-month target price of KRW90,000, equivalent to a 2015E PER of 30x. We believe the stock is significantly undervalued versus peers with exposure to the China market (2015E PER of 21x vs. 31.1x for domestic peers).

We believe it deserves to be rerated as it is likely to have the fastest sales growth and highest profitability in the sector, thanks to its concentration on the rapidly expanding and profitable facial-mask pack business.

Risks

The main risk to our call would be a tighter-than-expected supply of felt used for its facial masks, due to: 1) higher-than-expected sales growth for facial masks, and/or 2) more competitors entering the facial-mask market causing a shortage of felt.

Share price performance



12-month range	3,845-62,700
Market cap (USDbn)	1.02
3m avg daily turnover (USDm)	21.10
Shares outstanding (m)	18
Major shareholder	Pan-gil Kim (22.5%)

Financial summary (KRW)

Year to 31 Dec	15E	16E	17E
Revenue (bn)	234	318	362
Operating profit (bn)	66	103	118
Net profit (bn)	52	80	92
Core EPS (fully-diluted)	3,039	4,677	5,344
EPS change (%)	215.5	53.9	14.3
Daiwa vs Cons. EPS (%)	75.5	113.0	n.a.
PER (x)	20.6	13.4	11.7
Dividend yield (%)	0.0	0.0	0.0
DPS	0	0	0
PBR (x)	9.9	5.8	3.9
EV/EBITDA (x)	15.6	9.5	7.7
ROE (%)	62.4	54.6	39.9

Source: FactSet, Daiwa forecasts

1 Buy (initiation)
2 Outperform
3 Hold
4 Underperform
5 Sell

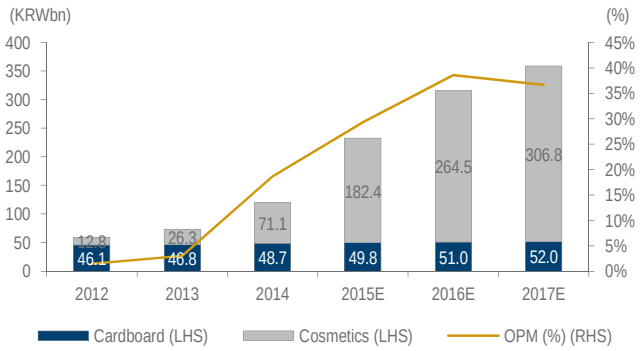
How do we justify our view?

- Growth outlook ✓✓✓✓✓
- Valuation ✓✓✓✓✓
- Earnings revisions ✓✓✓✓✓

■ Growth outlook ✓✓✓✓✓

We forecast 2015 revenue of KRW234bn (+95% YoY), as the company's cosmetics division fully exploits its exposure to duty-free shops (DFS) and China B2C websites, from which we forecast revenue of KRW178.1bn (+159.8% YoY) for 2015. Starting in 2016, we expect the company to start selling in off-line channels in China having obtained China Food and Drug Administration approval (no approval required for online sales). As such, we forecast a strong revenue CAGR of 24.3% over 2015-17, driven by the cosmetics division, whose revenue we forecast to rise at a CAGR of 29.7% over the same period, as a result of the company's exposure to overseas markets like Europe and the US.

■ Sansung L&S: revenue and operating margin



Source: Company, Daiwa forecasts

■ Valuation ✓✓✓✓✓

We initiate coverage of Sansung L&S with a Buy (1) rating and 12-month DCF-based target price of KRW90,000. We see the stock's current valuation as attractive, trading currently at a 2015E PER of 21x, vs. 31.1x for most of its Korean peers. Given the revenue growth rate that we expect, as well as its strong profitability and exposure to the China market, we believe the stock deserves to be rerated and trade in line with the other Korean cosmetics companies.

■ Sansung L&S: PEG comparison

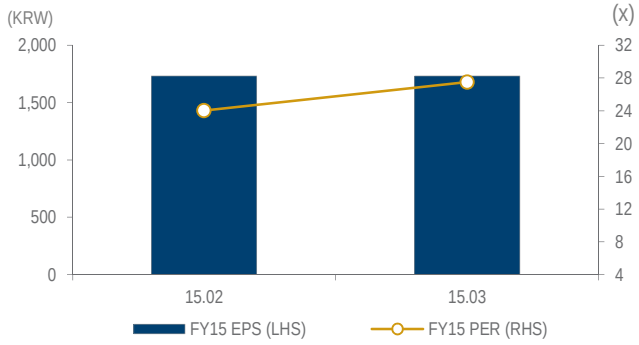
Company	PER (x)		EPS growth (%)	
	2015E	2016E	2015E	2016E
Amorepacific*	34.3	27.0	47.8	27.1
LG Household & Health Care*	29.0	24.5	24.4	18.5
Able C&C*	25.9	23.1	173.8	12.2
Cosmax*	34.0	24.3	56.7	39.8
Korea Kolmar*	37.0	31.4	13.4	17.7
AmoreG*	31.1	25.9	21.0	20.3
Sansung L&S*	20.6	13.4	215.5	53.9
L'OREAL	27.9	25.9	(31.7)	7.9
Shanghai Jahwa	22.7	21.5	58.0	5.8
Estee Lauder	30.0	25.4	(10.7)	18.4
SHISEIDO	28.8	38.7	16.4	(25.7)
KAO	33.0	27.4	17.2	20.2
Beiersdorf	29.1	26.8	18.8	8.7

*Source: Bloomberg, *Daiwa forecasts*

■ Earnings revisions ✓✓✓✓✓

No analyst covered this stock until February 2015. Our 2015 EPS forecast is 76% higher than the consensus figure, as we forecast revenue to be 25% higher than the market expects. As for 2016, we are 113% more positive on the company's EPS compared to the consensus as we expect better margin improvements on higher revenue growth expectations.

■ Sansung L&S: 2015 EPS forecasts and PER



Source: Bloomberg

Financial summary

■ Key assumptions

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Felt mask pack ASP (KRW)	n.a.	n.a.	545.0	620.0	757.5	911.9	1,148.2	1,227.6
Felt mask pack production (mn unit)	n.a.	n.a.	0.7	3.1	7.4	17.3	19.7	21.8
Coconut jellymask pack ASP (KRW)	n.a.	n.a.	n.a.	1,223.0	1,320.4	1,475.2	1,523.8	1,553.3
Coconut jellymask pack production (mn unit)	n.a.	n.a.	n.a.	1.4	3.4	3.4	7.0	8.4
Chinese inbound growth (yoy%)	39.7	18.4	27.8	52.5	41.6	21.5	19.4	17.4
Prostemics revenue (KRW bn)	n.a.	n.a.	1.9	7.0	10.0	11.0	11.9	12.6

■ Profit and loss (KRWbn)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Cardboard	40	44	46	47	49	50	51	52
Cosmetics	n.a.	1	13	26	71	182	265	306
Other Revenue	n.a.	0	0	(0)	0	2	3	4
Total Revenue	39	45	59	73	120	234	318	362
Other income	1	1	2	3	4	3	4	4
COGS	(34)	(39)	(47)	(55)	(75)	(116)	(144)	(157)
SG&A	(5)	(6)	(12)	(16)	(22)	(52)	(72)	(88)
Other op.expenses	(1)	(1)	(2)	(3)	(4)	(3)	(4)	(4)
Operating profit	1	0	1	2	22	66	103	118
Net-interest inc./(exp.)	0	0	1	1	1	1	1	1
Assoc/forex/extraord./others	(1)	19	(6)	(6)	(0)	1	2	2
Pre-tax profit	0	19	(4)	(2)	23	69	106	121
Tax	(0)	(4)	1	3	(5)	(13)	(21)	(24)
Min. int./pref. div./others	0	0	0	(1)	(2)	(3)	(5)	(6)
Net profit (reported)	(0)	15	(3)	(1)	17	52	80	92
Net profit (adjusted)	(0)	15	(3)	(1)	17	52	80	92
EPS (reported)(KRW)	(9)	847	(156)	(47)	922	2,909	4,477	5,116
EPS (adjusted)(KRW)	(9)	847	(156)	(47)	922	2,909	4,477	5,116
EPS (adjusted fully-diluted)(KRW)	(10)	884	(163)	(49)	963	3,039	4,677	5,344
DPS (KRW)	0	0	0	0	0	0	0	0
EBIT	1	0	1	2	22	66	103	118
EBITDA	1	1	3	5	26	70	107	122

■ Cash flow (KRWbn)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Profit before tax	0	19	(4)	(2)	23	69	106	121
Depreciation and amortisation	1	1	2	3	4	3	4	4
Tax paid	(0)	(0)	(0)	1	(1)	(3)	(5)	(6)
Change in working capital	(2)	(2)	(1)	(3)	(7)	(5)	(3)	(3)
Other operational CF items	2	(18)	4	6	5	(14)	(21)	(20)
Cash flow from operations	2	(0)	1	5	23	49	81	96
Capex	(2)	(15)	(13)	(3)	(10)	(16)	(6)	(6)
Net (acquisitions)/disposals	0	0	0	0	0	0	0	1
Other investing CF items	3	2	2	4	1	(8)	(6)	(4)
Cash flow from investing	1	(13)	(11)	1	(8)	(24)	(12)	(9)
Change in debt	0	11	9	(4)	(4)	0	(1)	0
Net share issues/(repurchases)	0	0	0	0	0	0	0	0
Dividends paid	0	0	0	0	0	0	0	0
Other financing CF items	0	0	0	0	0	1	1	1
Cash flow from financing	0	11	9	(4)	(4)	1	0	1
Forex effect/others	0	(0)	(0)	0	0	0	0	0
Change in cash	3	(3)	(0)	3	10	26	70	88
Free cash flow	(1)	(16)	(11)	3	13	33	75	91

Source: FactSet, Daiwa forecasts

Financial summary continued ...

Balance sheet (KRWbn)

As at 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Cash & short-term investment	8	3	12	14	21	53	127	218
Inventory	1	2	3	5	7	13	18	20
Accounts receivable	6	9	9	11	17	33	45	51
Other current assets	0	0	0	0	0	0	0	0
Total current assets	15	15	24	30	45	99	190	288
Fixed assets	15	30	41	41	47	60	62	64
Goodwill & intangibles	1	1	1	1	1	1	1	1
Other non-current assets	5	24	8	3	4	7	10	11
Total assets	37	69	74	75	97	167	262	364
Short-term debt	0	5	7	9	6	6	6	6
Accounts payable	4	5	5	9	14	28	37	43
Other current liabilities	0	0	3	4	5	8	10	11
Total current liabilities	4	10	16	22	25	41	53	60
Long-term debt	0	6	12	6	3	3	2	2
Other non-current liabilities	1	5	2	1	5	6	7	9
Total liabilities	5	20	30	29	33	50	63	70
Share capital	5	9	9	9	9	9	9	9
Reserves/R.E./others	27	40	34	34	50	99	177	265
Shareholders' equity	32	49	43	43	59	108	186	274
Minority interests	0	0	2	3	5	8	13	19
Total equity & liabilities	37	69	74	75	97	167	262	364
EV	1,113	1,130	1,135	1,129	1,117	1,089	1,019	935
Net debt/(cash)	(8)	7	8	1	(13)	(45)	(119)	(210)
BVPS (KRW)	1,861	2,848	2,491	2,499	3,423	6,312	10,817	16,031

Key ratios (%)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Sales (YoY)	(0.0)	14.3	30.6	24.0	64.2	95.2	35.9	13.7
EBITDA (YoY)	(4.3)	(9.4)	157.0	66.4	372.9	168.0	53.9	13.9
Operating profit (YoY)	21.3	(34.2)	166.0	154.3	885.7	197.5	55.5	14.4
Net profit (YoY)	n.a.	n.a.	n.a.	n.a.	n.a.	215.5	53.9	14.3
Core EPS (fully-diluted) (YoY)	n.a.	n.a.	n.a.	n.a.	n.a.	215.5	53.9	14.3
Gross-profit margin	13.5	13.7	21.1	24.3	37.2	50.4	54.8	56.6
EBITDA margin	3.6	2.8	5.6	7.5	21.6	29.7	33.6	33.7
Operating-profit margin	1.3	0.7	1.5	3.1	18.5	28.2	32.3	32.5
Net profit margin	(0.4)	33.7	(4.8)	(1.2)	13.8	22.3	25.2	25.3
ROAE	n.a.	37.6	n.a.	n.a.	32.5	62.4	54.6	39.9
ROAA	n.a.	28.6	n.a.	n.a.	19.2	39.5	37.4	29.3
ROCE	1.6	0.7	1.4	3.6	33.2	66.6	61.8	46.2
ROIC	(2.8)	0.7	1.6	4.5	35.5	86.3	109.0	115.3
Net debt to equity	n.a.	14.8	18.6	2.7	n.a.	n.a.	n.a.	n.a.
Effective tax rate	228.1	21.1	n.a.	n.a.	21.1	19.3	19.4	19.5
Accounts receivable (days)	59.1	63.8	57.8	51.5	42.8	38.6	44.3	48.0
Current ratio (x)	4.0	1.4	1.6	1.4	1.8	2.4	3.5	4.8
Net interest cover (x)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Net dividend payout	n.a.	0.0	n.a.	n.a.	0.0	0.0	0.0	0.0
Free cash flow yield	n.a.	n.a.	n.a.	0.3	1.2	2.9	6.7	8.1

Source: FactSet, Daiwa forecasts

Company profile

Sansung Life & Science, based in Korea, was formed from the merger of Sansung P&C Corp and Leaders Cosmetics. The company has 2 main business divisions: corrugated cardboard and cosmetics. The cardboard division provides single-faced, double-faced, and double-wall corrugated cardboard, while the cosmetics division includes face masks and skincare products. The company currently operates primarily in Korea and China, where its Leaders brand is a hit product, and has plans to expand into Europe and the US later this year.

Initiation: leader of the pack

We believe the stock will be rerated this year as: 1) cosmetics revenue rises by a CAGR of 29.7% for 2015-17E, driven by increasing penetration in China, 2) potentially making its brand a globally accepted one, and 3) it enters Europe and the US to seal its competitiveness and long-term revenue growth.

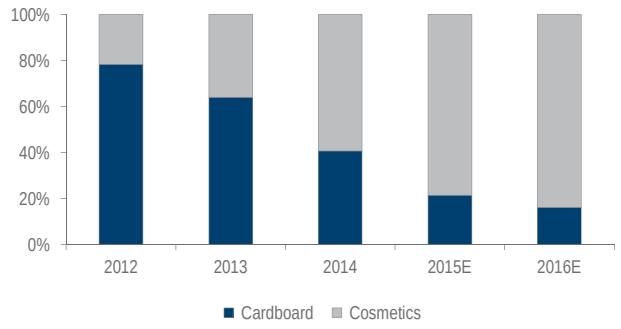
Cosmetics division: the main business

Although historically the company's main business was the manufacture of cardboard, its cosmetics revenue has now outpaced its cardboard revenue, and accounted for nearly 60% of total sales for 2014. Most of the company's cosmetics sales are for its facial masks, supported by strong demand from China.

78.5% of 2015E revenue likely from cosmetics

Accordingly, we forecast 78.5% of Sansung L&S's sales to come from its cosmetics business for 2015. This is why we believe the company should be classified as a cosmetics company rather than a maker of cardboard, and believe the stock will be rerated to match the valuations of its Korean cosmetic-company peers.

■ Sansung L&S: revenue contribution by division

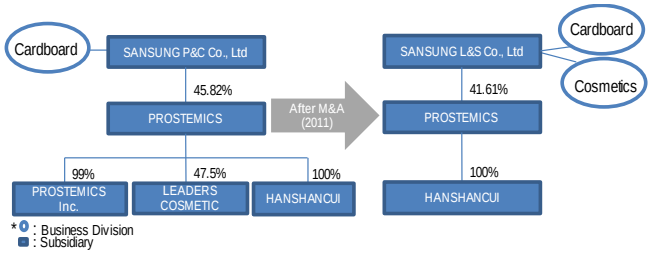


Source: Sansung L&S, Daiwa forecasts

Initially, the company was engaged only in the production of corrugated cardboard. Things changed when it acquired Leaders Cosmetics in 2011. Leaders is a brand that was developed by a chain of Korean dermatology clinics called Leaders Dermatology. Sansung L&S was indirectly linked to this brand through its affiliate, Prosetmics.

With Sansung L&S's main business, corrugated cardboard, showing little hope of revenue growth, the company decided to acquire 100% of Leaders Cosmetics in 2011. CEO Mr Chul-Hong Park, joined Sansung L&S to head up the cosmetics business that year.

■ Sansung L&S: before and after the acquisition of Leaders Cosmetics



Source: Daiwa

Recognised as a dermatological brand in China

The brand has differentiated itself as a dermatological brand by choosing the right target market at the right time, ie, China, and via the duty-free channel when Mainland tourists started to pour into Korea in 2H13. The brand has been exporting its facial masks to China since late-2011, and initially partnered with Beijing Hanmi, the largest Korean pharmaceutical with a sales team of 1,000 in China, to distribute it online.

This partnership, which lasted 2 years, was terminated and the company has established contracts with other partners (it now has other intermediaries distributing its products). The brand is also distributed in Mainland drugstores such as Watsons and Mannings, via a wholesaler.

Also in 2011, Leaders Dermatology opened 2 aesthetics branches in Beijing. This also differentiated the brand as it then became recognised as being a medical cosmetic (a.k.a. cosmeceutical: cosmetics +pharmaceutical) by emphasising its roots in dermatology.

Lotte noticed the brand's increasing awareness among Chinese consumers and in 2012 introduced the Leaders brand at its Sogong branch, the largest domestic duty-free store in Korea and a main Chinese tourist hot spot.

The brand has been a success in Lotte's duty-free store, particularly as more Chinese have poured into Korea since 2H13, and this prompted other duty-free-store operators to start selling the brand in 2014.

Leaders opened 16 new duty-free counters last year alone. We can extrapolate the demand for the brand in Korea by comparing the number of duty-free counters it occupies to those taken up by Amorepacific's IOPE. While the IOPE brand is also popular with Chinese consumers, Amorepacific opened fewer stores last year (15) than the Leaders brand.

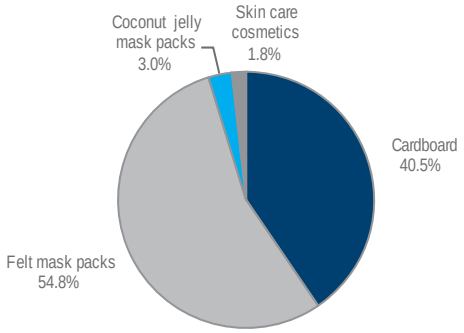
■ **Duty-free counters in Korea**

Company	Brand	Number of stores as of 2014
Amorepacific	Sulwhasoo	28
	Laneige	29
	IOPE	15
LG H&H	Whoo/OHUI	37
	Sum	26
Sansung L&S	*Leaders*	17

Source: Company

Although the Leaders brand is well known for its facial masks, it has a wide product mix, comprising around 150 products. Half of these are facial masks. Of its cosmetics revenue, felt facial masks account for about 92% of all sales.

■ **Sansung L&S: sales breakdown by product (2014)**



Source: Company

■ **Leaders: main products**

	Product line	Distribution channel	Price range	Sales weight (2014)
Felt mask pack	Insolution	DFS, Drugstores	KRW3,000	92%
	Step-solution	Online, China C2C sites		
	Mediu	Online, China B2C sites		
Coconut-jelly mask pack		Online, DFS	KRW5,000	5%
Skincare products		Online, DFS, China C2C/B2C sites	KRW25,000-300,000	3%

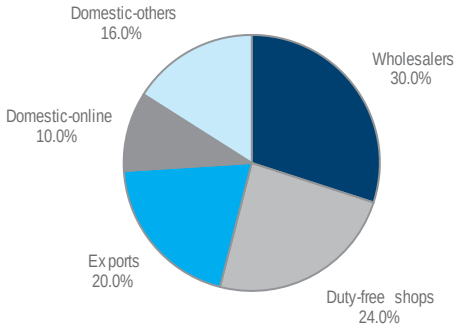
Source: Company

China demand accounted for 60% of sales in 2014

For the company's cosmetics sales, its most notable sales channel is the duty-free channel, which accounts for 24% of all sales. Wholesalers currently distribute the brand in China, but the company is trying to contain the growth of this channel as it plans to enter the China market directly. At the end of 2014, the company started to distribute facial masks via T-mall, the 2nd-largest Chinese B2C site. And in February 2015, it started supplying to Jumei.com, China's 3rd largest B2C website. It plans to enter more B2C channels this year. B2C sites are convenient in that they don't require product authorisation from the government. This is why the company started with online B2C distribution to directly enter the China market.

For 2014, the company's sales exposure to China was around 60%, which is much higher than that for all the Korean cosmetics companies that already have established distribution channels in China. We see the brand's exposure to China increasing as it expands its reach in the country to offline channels as well as the current online channels. As such, we estimate that nearly 85% of this year's sales will be generated by Chinese demand.

■ **Sansung L&S: cosmetics sales breakdown by channel (2014)**



Source: Company

■ **Korean cosmetic companies: China exposure (2014)**

	China revenue (KRWbn)	% of total revenue
Amorepacific	961.8	24.8%
LG H&H	396.9	8.3%
Cosmax	123.3	31.8%
Korea Kolmar	27.0	5.9%
Able C&C	38.8	8.8%
Sansung L&S	5.3	59.8%

Source: Daiwa

Note: Amorepacific's China revenue includes that from its China affiliate and domestic duty-free China sales

Note: LG H&H's China revenue includes household goods and cosmetics revenue in China

Expanding production capacity 2-fold

In 2014, the company had 14 production lines for facial masks. With this capacity, it produced 46m felt facial masks and 5m coconut-jelly ones for the year. The company plans to add 2 more lines to make the felt masks and started double-shift production in 1Q15, as demand is still on the rise.

Earlier this year, the company moved its coconut-jelly facial-mask facility to Vietnam, which is closer to the origins of its raw material, coconuts, which it sources from Vietnam. The company will expand its production capacity to 150m felt masks (3x production for 2014) and 13.5m coconut-jelly masks per year on the back of its new facility starting operations in March. With this capacity, it should be able to generate KRW150bn in revenue from felt facial masks and KRW22bn from coconut-jelly masks, based on our forecasts.

■ **Sansung L&S: facial-mask production capacity**

	Felt facial masks		Coconut-jelly facial masks	
	Capability (m masks per year)	No. of lines	Capability (m masks per year)	No. of lines
2014	46.9	5 automated lines, 4 manual lines	5.0	4 automated lines
2015E	150.0	11 automated lines, 4 manual lines	13.5	NA

Source: Company, Daiwa forecasts

To prepare itself for global expansion starting this year, the company will build a new felt facial-mask production facility, although we do not yet know the details. However, we do know the new facility will be 4x larger than the current plant, and as such, expect production capacity to be at least 4x greater by the end of 2016.

Strong brand presence leading rapid revenue growth

The Leaders brand has high recognition among Chinese consumers, due to its presence in Korean duty-free stores and via well-known China websites. For example, on Taobao, the largest Chinese C2C website, the brand has been ranked a top-3 bestselling brand for the past 6 months. Considering that other brands' rankings are constantly changing, having a stable ranking at the top proves the brand awareness, in our view. This gaining in popularity may be short-lived, as it can be with many Korean cosmetics brands, but we believe the trend for Leaders is sustainable.

Management's decision to develop and manufacture in-house also supports the Leaders brand's status as a best-in-class dermatological brand in Korea, looking at the revenue it generated last year. The Leaders brand outpaced other dermatological brands, with its revenue nearly 3 times that of the 2nd-largest brand, CNP cosmetics, in 2014.

■ **Sansung L&S: one of its felt facial masks**

Source: Company

■ **Taobao: facial-mask sales ranking**

	May 2014	November 2014	March 2015
1	CHOISKYCN (CH)	*Leaders* (KR)	SNP (KR)
2	OLDEFY (CH)	CHOISKYCN (CH)	Clinie (KR)
3	My Beauty Diary (TW)	OLDEFY (CH)	*Leaders* (KR))
4	MG (CH)	MG (CH)	MG (CH)
5	*Leaders* (KR)	Fresh (FR)	CHOISKYCN (CH)
6	Laneige (KR)	My Beauty Diary (TW)	Yunifang 御泥坊 (CH)
7	Fresh (FR)	Nature Republic (KR)	Laneige (KR)
8	1908 (CH)	Innisfree (KR)	Innisfree (KR)
9	御泥坊 (CH)	御泥坊 (CH)	Herborist (CH)
10	Innisfree (KR)	Laneige (KR)	Dr. Morita (TW)

Source: Taobao

■ **Korean cosmeceutical brands**

	2013			2014		
(KRW bn)	Net Revenue	Operating Profit	OPM	Net Revenue	Operating Profit	OPM
Leaders Cosmetics	16.6	24.1	1.5%	61.0	25.3	41.5%
CNP Cosmetics	24.0	480.0	20.0%	25.7	4.9	19.1%
Goeun Sesang Cosmetics	12.3	-32.7	-2.7%	NA	NA	NA
Ami Cosmetics	21.0	20.2	1.0%	NA	NA	NA
Regen Cosmetics	5.8	81.2	14.1%	8.8	1.7	18.9%

Source: Company, Daiwa

A look at Genic, another facial-mask manufacturer

Although many local investors compare Sansung L&S to Genic (123330 KQ, not rated) as they are both facial-mask manufacturers, we believe the 2 companies differ for 3 main reasons: 1) brand awareness, 2) distribution channels, and 3) different focus on R&D.

Genic's share price performance from 3Q12 to earlier this year was disappointing due to a deterioration in its revenue from 2012-14, due to several reasons. First, its product was better known as the one used by the company's celebrity representative, Korean actress Ha Yumi, rather than by its own brand name, Celderma.

The company promoted the product as the "Hayumi pack".

When the company terminated the contract with Ms. Ha in 2012, sales declined by 74.1% per year from 2012-14, as few consumers were aware that the Celderma and Hayumi pack were the same.

The second reason for the downturn in Genic's revenue from 2012-14 was because it was kicked out of the home-shopping channel. Genic's facial masks were sold through various home-shopping channels for more than 3 years, from 2010-13. In this distribution channel, operators regularly (about every 3 years) change their product line-ups to keep customers interested.

As home shopping promotes bulk sales, the unit price is cheaper than it is for other channels. This pricing strategy is not applicable to other channels, which are unable to sell in bulk, so the company had to raise its prices by 50% when it moved to other channels in 2012. As customers were used to cheaper prices, they were not willing to purchase the more expensive unfamiliar Celderma brand.

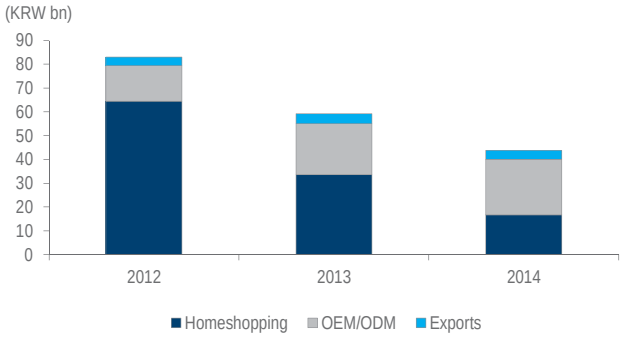
Both Genic and Sansung L&S focus on R&D but their areas of focus differ: while Sansung's is on developing and manufacturing the essence infused into the mask, Genic is more concerned with developing better masks that deliver more essence to the skin, while outsourcing the development of the essence.

During the manufacturing process, facial masks are soaked in 25-30 grams of a fluid essence. This content, or the essence, is the main element absorbed by the skin and is thus more important, in our view.

■ Genic: market capitalisation

Source: Dataguide

■ Genic: sales



Source: Genic

To clarify how Sansung L&S's brand differs from Genic's, we looked at consumer awareness of the Leaders brand. Unlike Genic, which we think is still defined by the actress who previously fronted the brand's advertising, Ha Yumi, Leaders is known by its brand name.

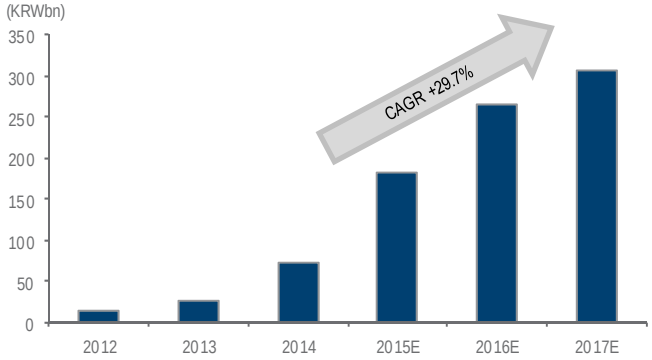
Also, we like Sansung L&S's distribution strategy, as it is more exposed to duty-free counters and online B2C channels and has little presence on home-shopping channels.

Sansung L&S prefers to promote duty-free counters and B2C channels where it is less exposed to potential price distortions and inventory leaks to the black market. Nevertheless, the brand still has strong ties with its initial developer, Leaders Dermatology. Although Leaders Cosmetics and Leaders Dermatology are not related in terms of share structure, the linkup is via Mr. Park, the CEO of Leaders Cosmetics and also the president of the Leaders Dermatology network. Through this tie-up, the company co-works closely with dermatologists to maintain superior content.

Cosmetics sales CAGR of 30% over 2015-17, on our forecasts

We forecast a cosmetics revenue CAGR of 30% over 2015-17E, and reach KRW306bn by 2017, driven by channel and geographic expansion. The company has started distributing through some of the well-known China B2C websites. In addition, it will launch its products in Europe and the US within 1H15. Next year, it plans to expand its China reach by starting to sell via the offline channels.

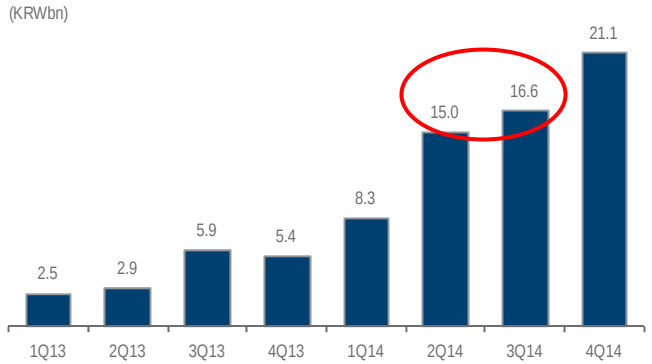
■ Sansung L&S: cosmetics division revenue



Source: Company, Daiwa forecasts

Demand for Leaders' facial masks was high in 2014, but the company's lack of capacity and shortage of its main raw material, felt, put a stop to additional sales growth. As the company is fully prepared for sales growth this year by bringing on extra capacity, we expect it to keep up with rising demand for facial masks. For 2015, we forecast the company to see cosmetics revenue of KRW182bn, up 156% YoY.

■ Sansung L&S: stagnant QoQ growth for 3Q14, driven by shortage of felt



Source: Company

We forecast 2015 revenue for the company as a whole of KRW234bn (+95% YoY), supported by strong cosmetics sales of KRW182bn (+156% YoY) as mentioned above. We see the company's DFS sales and China online B2C sales as being the backbone of the rapid sales growth. We expect modest revenue growth for the cardboard business (KRW49.8bn, 2.2% YoY) as the company is a 2nd-tier player in this competitive market, with little pricing power.

2015 DFS sales to be stronger than last year

The company generated KRW14.6bn, or 24% of its cosmetic sales, from the DFS channel for 2014. We expect this to jump to KRW50.5bn (+244.8% YoY) for 2015. In 2014, 16 new DFS stores were opened and we expect 2015 to be the first full year of sales recognition for all of the 17 DFS counters where Sansung L&S has a presence. In addition, we factor that the number of Mainland visitors will increase by 21.5% YoY for 2015.

■ Leaders: DFS counter opening history

Year	Month	Location
2012	Aug.	Lotte Main(Sogong) DFS
2014	Feb.	WORLD branch
	Mar, Apr.	Incheon International Airport branches (No.1 and No.2)
	May	Lotte Jeju Zhongmun branch
	Jun.	Galleria Duty Free Jeju Airport branch, Shilla Seoul branch
	Jul.	Shilla Jeju, Seoul Donghwa, Jeju halla, Seoul Walkerhill
	Aug.	Shilla Incheon International Airport Terminal 2, Daegu Airport
	Sep.	Lotte Busan
	Oct.	Shinsegae Busan, Lotte COEX
	Nov.	Shilla Singapore, Macau
	Dec.	Lotte Japan Kansai, Singapore Changi Airport
2015	Feb.	Hong Kong Galleria DFS

Source: Company, Daiwa

We expect Sansung L&S to open additional DFS counters this year. Brands that are highly popular with China consumers have nearly 30 DFS counters in Korea, while Leaders has only 17 so far, and we see room for growth. In addition, the company is opening new DFS counters overseas, and we expect Sansung L&S to open DFS counters in Thailand and Cambodia this year.

The company recently opened a Hong Kong DFS counter, which is significant in that it is its first counter opened at a DFS outside of Korea. With its increased global exposure, we believe the company's brand competitiveness will continue to improve.

■ Number of Korean brands in DFS stores

Company	Brand	Number of stores
Amorepacific	Sulwhasoo	28
	Laneige	29
	IOPE	15
LG H&H	Whoo/OHUI	37
	Sum	26
Sansung L&S	*Leaders*	17

Source: Companies, Daiwa

China's online B2C market

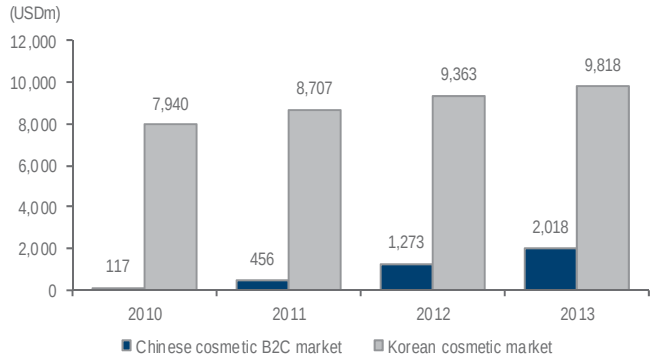
Sansung L&S has made a deal with Jumei and is in the process of making deals with several of China's online B2C sites. Selling via online B2C sites is beneficial in 3 ways: 1) it can sell without SFDA approval, saving on costs and time, 2) it can prevent inventory flowing onto black markets, and 3) B2C sites are becoming more popular for their trustworthiness.

Direct entry to the China market requires SFDA approval, which takes 6 months to over a year to obtain. Through the B2C sites, the company can reach Mainland customers without these barriers. The B2C platform also eliminates consumer worries about price distortions and counterfeit goods. As Sansung L&S is making deals with various Chinese B2C online

channels, we believe it will eventually end up with a more stable distribution channel compared with the individual intermediaries it used to deal with.

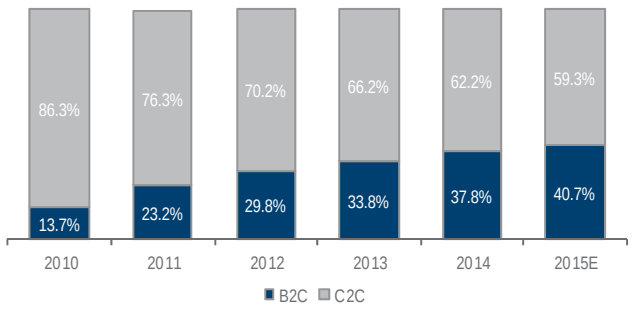
The increasing popularity of online B2C sites is another positive factor. China's cosmetics market share of B2C websites increased to 37% in early 2014, up from 13.5% in 2010, according to iResearch. And Mainland consumers are losing confidence in C2C websites as they carry a lot of counterfeit products, according to iResearch.

■ China: cosmetics B2C market size



Source: Euromonitor, iResearch, Daiwa

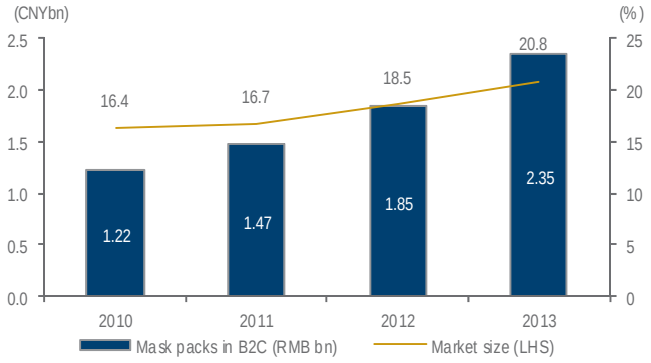
■ China: online cosmetics market share: B2C vs. C2C



Source: iResearch, China Internet Watch
Note: As at August 2014

About CNY2.4bn worth of facial masks, equivalent to the size of the total Korean facial-mask market, are traded via online B2C channels. This is equivalent to 20.8% of all sales through all distribution channels. Considering that only 13% of all cosmetics are traded online in China, according to Euromonitor, this number is significant.

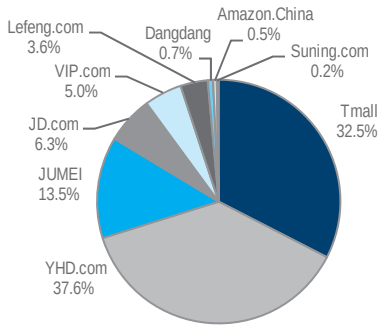
■ Facial masks sold via online B2C platforms: sales and channel proportion



Source: iResearch, China Internet Watch, Frost&Sullivan, Daiwa

T-mall, the 2nd-largest online B2C platform in China, already carries the Leaders brand. And in February 2015, Jumei, the 3rd-largest cosmetics B2C platform in China also started selling the brand. Accordingly, we forecast Sansung L&S to generate B2C revenue of KRW70.5bn for 2015.

■ China cosmetics B2C platform market share



Source: iResearch, China Internet Watch
Note: As at August 2014

China facial-mask market has entered its growth stage

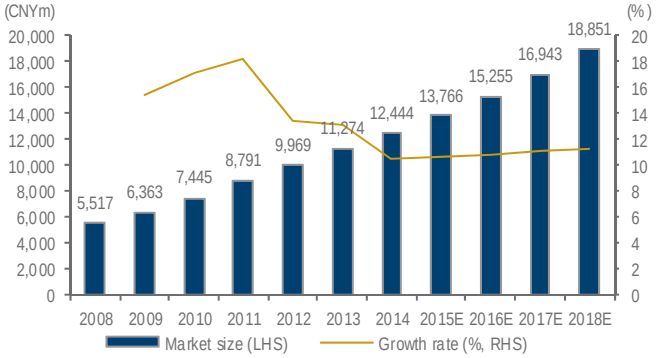
According to Euromonitor, China's facial-mask market has just entered its growth stage and is expected to show better market value growth than the whole cosmetics market over the 2015-18E period. This is one of the reasons the company should experience strong and steady revenue growth for the next 3 years. According to Euromonitor, the value of the China facial-mask market was estimated at CNY12.4bn for 2014. It expects the total skincare market to a see a market-value CAGR of 9.7% for the 2015-18 period, and for facial-mask sales to grow by 11.0% YoY over the same period.

■ China: cosmetics market size by category

(CNYm)	2014	2015E	2016E	2017E	2018E	Revenue CAGR (2015-18E)
Body care	3,833	3,974	4,144	4,345	4,588	4.9%
- Firming/Anti-Cellulite Care	1,192	1,262	1,344	1,441	1,556	7.2%
- General Purpose Care	2,641	2,712	2,799	2,904	3,031	3.8%
Facial Care	133,795	144,877	158,088	173,709	192,059	9.9%
- Acne Treatments	622	645	671	700	732	4.3%
- Facial masks	12,444	13,766	15,255	16,943	18,851	11.0%
- Facial Cleansers	13,886	14,488	15,164	15,931	16,788	5.0%
- Facial Moisturisers	60,095	64,078	68,934	74,719	81,560	8.4%
- Lip Care	1,537	1,613	1,711	1,830	1,978	7.0%
- Anti-Agers	34,595	38,593	43,403	49,176	56,035	13.2%
- Toners	10,616	11,695	12,951	14,411	16,115	11.3%
Hand Care	3,303	3,567	3,865	4,201	4,582	8.7%
- Premium Hand Care	354	395	442	497	561	12.5%
- Mass Hand Care	2,949	3,173	3,423	3,704	4,021	8.2%
Skin Care	140,931	152,418	166,097	182,256	201,228	9.7%

Source: Euromonitor forecasts

■ China: facial-mask market size and growth rate



Source: Euromonitor forecasts

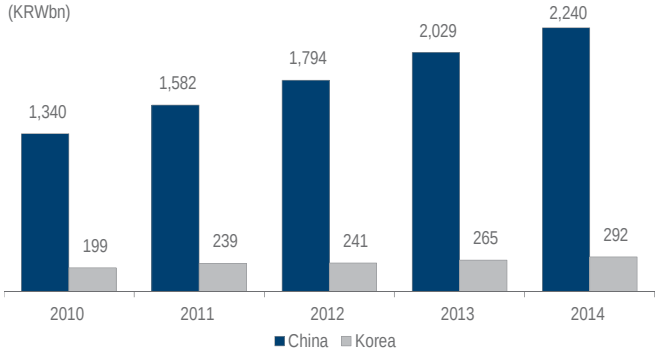
It was only a few years ago that lower-end cosmetics goods were introduced to consumers in China. We believe that given the availability of cheaper facial masks, these masks are now perceived as a necessity by many women.

Their cost-effectiveness is another factor driving sales growth. Although most masks contain the same amount of fluid essence as a bottle of serum (typically 25-30ml), they cost one-tenth of the price of a bottle of serum. Considering the relatively low income levels of many Mainlanders, facial masks are a rational skincare method.

The penetration rate of facial masks in Japan and Korea is over 70%, whereas it is only 44% in China, according to Kanta WorldPanel, a consumer behaviour research institute. Accordingly, any increase in either the frequency of use or and spending on these products would support the revenue growth of the China facial-mask market.

According to Kantar WorldPanel, the absolute size of China's facial-mask market is almost 10 times that of the Korean market, presenting more opportunities for Korean brands there.

■ Facial-mask market size: Korea vs. China



Source: Korea Cosmetic Association, Euromonitor

Brand competitiveness should support growth at times of intensifying competition

As the facial-mask market is rapidly expanding in China, competition within China's facial-mask market is intensifying. We believe the company has a brand that will be able to enjoy a decent slice of the ever-growing China facial-mask market for the following reasons: 1) price competitiveness, 2) high brand awareness, 3) active product renewals, and 4) interesting marketing activities.

The Leaders brand is positioned in the middle of the pack in terms of price. The absolute price difference between Leaders products and those of high-end packs is significant, whereas the price differential vs. lower-priced goods is less obvious. This means that Leaders should be able to meet the demand from consumers moving to more expensive goods.

■ Price comparison by brand

Brand	Company (Country)	Price per mask (CNY)
SK II	P&G (US)	126
CHOISKYCN	CHOISKYCN (China)	42
It's skin	Hanbul Cosmetics	26
SNP Animal Mask	SNP (Korea)	22
Leaders	Sansung L&S (Korea)	12
Clinie (NMF)	L&P Cosmetics/Mediheal (Korea)	10
SNP	SNP (Korea)	10
MG	L'Oreal (China)	7
Pechoin	Pechoin (China)	7
Innisfree	AmorePacific (Korea)	7
My Beauty Diary	President Pharmaceutical Corporation (Taiwan)	6
Yunifang	Yunifang (China)	6

Source: Euromonitor

The Leaders brand is a preferred brand of facial mask by Mainland tourists and peddlers (代公), according to the company. The high demand for this brand at DFS counters supports the brand's demand among

Mainlanders. The brand had only one DFS store in 2013, but opened 16 new stores last year at the request of the DFS operators. Sansung L&S has raised its prices twice in the past year but demand has been resilient. We believe this is further proof of the brand's equity.

The brand has also proved its competitiveness on Taobao, the largest Chinese C2C website. The brand has maintained its top-3 ranking for the past 6 months, whereas other brands (see the following table) have experienced volatility. But the brand's ranking fell earlier this year because the company is containing sales through wholesalers, which distribute on these sites. It is doing this so that it can concentrate on its DFS channel, where the Sansung L&S has more flexibility in managing pricing and inventory.

■ Taobao: facial-mask sales ranking

	April 2014	May 2014	November 2014	March 2015
1	MG (CH)	CHOISKYCN (CH)	*Leaders* (KR)	SNP (KR)
2	御泥坊 (CH)	OLDEFY (CH)	CHOISKYCN (CH)	Clinie (KR)
3	My Beauty Diary (TW)	My Beauty Diary (TW)	OLDEFY (CH)	*Leaders* (KR))
4	CHOISKYCN (CH)	MG (CH)	MG (CH)	MG (CH)
5	Fresh (FR)	*Leaders* (KR)	Fresh (FR)	CHOISKYCN (CH)
6	OLDEFY (CH)	Laneige (KR)	My Beauty Diary (TW)	Yunifang 御泥坊 (CH)
7	*Leaders* (KR)	Fresh (FR)	Nature Republic (KR)	Laneige (KR)
8	Laneige (KR)	1908 (CH)	Innisfree (KR)	Innisfree (KR)
9	Innisfree (KR)	御泥坊 (CH)	御泥坊 (CH)	Herborist (CH)
10	1908 (CH)	Innisfree (KR)	Laneige (KR)	Dr. Morita (TW)

Source: Taobao

Utilising its production facility and R&D capability, Sansung L&S is releasing new products all year long. It launches 80 new products on average annually, using different active ingredients. As facial masks tend to be used frequently, launching new products not only helps to lure new consumers but also retain existing ones.

Starting in 2015, the company decided to hire a celebrity to promote the brand. The specifics have not been disclosed but the company plans to use a Korean celebrity popular in China to endorse the brand. Celebrity marketing is useful in that it draws attention to the brand and increases the awareness of it among consumers. As the brand has a certain level of recognition in China, advertising will strengthen the brand's competitiveness.

China's retail store channel to be targeted next year

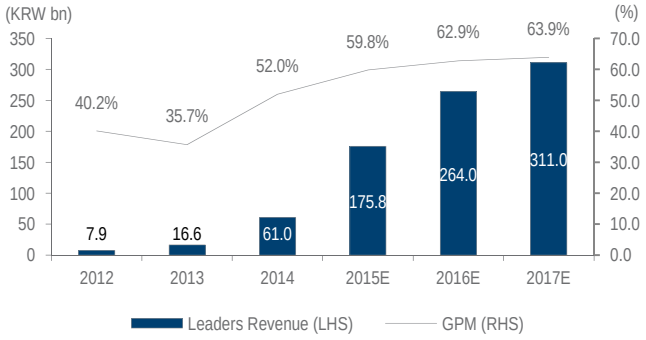
The company is currently working with the China SFDA to get permission to see its products in the country. Starting in 2016, the company will be able to do so. To prepare for this, it is seeking deals with various off-line channels, ie, it already has ties with prominent drugstores in China. Entering the off-line market is meaningful in that most of Leaders' Taobao sales are concentrated in certain cities, which means it would gain more exposure to the rest of China. Local brands, in contrast, have vast exposure to the whole of the country.

ASP increases a boost to margins

We forecast an operating-profit CAGR for the cosmetics division of 36.3% over 2015-17E, with the operating profit for the division reaching KRW101.6bn in 2017. The main factors for this growth are economies of scale and a higher ASP.

The proportion of variable costs as a percentage of total COGS for one mask is a little over one third. With increasing revenue, the company should be able to experience greater economies of scale.

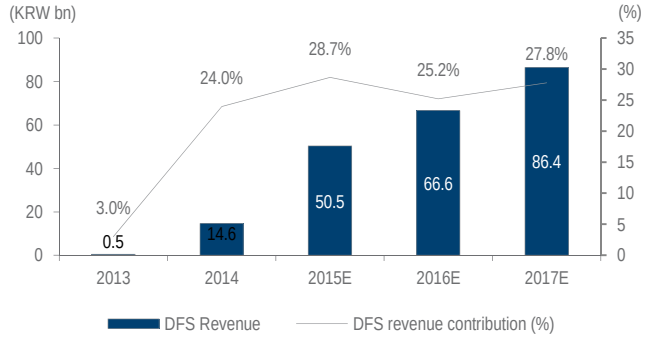
■ Sansung L&S: cosmetics division revenue and gross profit margin



Source: Company, Daiwa forecasts
Note: non-consolidated revenue

In addition, the ASP of the company's facial masks is increasing due to 2 factors: a more favourable channel mix and price increases. The ASP was KRW758 in 2014. The reason for the gap in the retail price (KRW3,000) and the company's ASP is because the company currently sells mainly through intermediaries. These intermediaries are in charge of supplying Sansung L&S's products to various distribution channels, including the domestic drugstores, DFS, and China B2C websites. As for the intermediaries that supply to DFS, the company sells its products at almost 50% more than via other channels. An increase in the DFS sales contribution would pull up the ASP.

■ Sansung L&S: DFS sales contribution

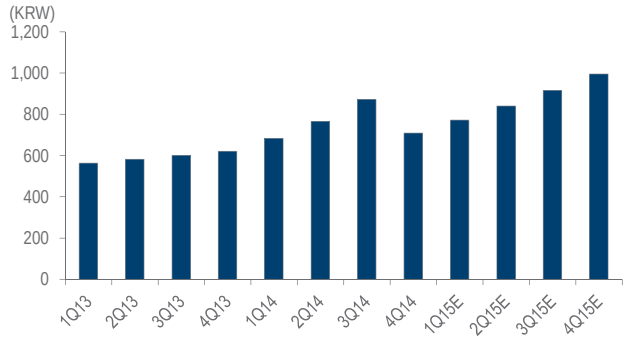


Source: Company, Daiwa forecasts

The company has also stopped selling low ASP products this year and this should also boost the ASP in 2015. In 2014, the company's revenue came from sales of facial masking costing KRW2,000 and KRW3,000. It increased the ASP of select products in 2Q14 by 30%.

In 4Q14, the ASP fell by 10% QoQ, on the back of a new product being launched. The company wanted to test its marketability and thus launched it at KRW2,000, which is 50% lower than its other main products. The product turned out to be a success, and thus the company has raised the price to KRW3,000.

■ Sansung L&S: quarterly ASP



Source: Company, Daiwa forecasts

In 2014, the company's overall ASP for felt masks was KRW758/mask. We forecast this year's ASP to increase by 16.8% YoY to KRW885. We have factored into our model the increase in the proportion of DFS sales and ASP increases.

Experienced management is differentiating the brand

Emphasising R&D and production capability

We believe that having Mr. Park Chul Hong at the head of the cosmetics division is the key to the Leaders brand's success. After graduating from medical school, he pursued a career in cosmetics business management. He is the mastermind behind various cosmetics: Leaders' wrinkle-off essence, Leaders' facial masks, Regen's facial mask, and It's Skin's snail cream. His background has enabled him to make distinctive moves to differentiate the Leaders brand.

■ Mr. Park Chul Hong's profile

1997-2002	Hanbul Cosmetics technology/product marketing team leader
2001-03	Vice-president of Swiss Medilabor marketing and technology - Medilabor, a Switzerland-based company that does hospital and cosmetic marketing
2003-05	Vice-president of Goweonsesang Network - Launch for Goweonsesang brand and cosmetics development
2005-11	Vice-president of It's Skin (Hanbul Cosmetic brand) marketing team
2011-12	Regen Plastic Surgery hospital and cosmetics development/ launch
2005-present	President of Cliders Holdings (a Management Service Organisation [management of hospitals] company of Leaders Dermatology Network)
	CEO of Leaders Cosmetic
	Prostemics marketing company Prostemics, subsidiary of Sansung L&S, is a stem-cell research company

Source: Company, Daiwa

■ Various initiatives driven by Mr. Park

Brand	Product name	2014 Revenue (KRWbn)	Note
Leaders	Wrinkle-off	*NA*	Sold over KRW 300bn in 2013
Leaders	Facial Mask	61	Sold over KRW85.5bn over the past 3 years
Regen's	Facial Mask	8.3	Made by an OEM (Genic) company
It's Skin	Snail cream	240	Major hit product last year

Source: Company, Daiwa

Mr. Park emphasises the importance of R&D. He is the main link between the brand and the doctors employed by Leaders Dermatology. He ensures that the doctors continue to participate in the R&D process even after Leaders cosmetics was acquired by Sansung L&S. Recently, leading chemist Pierre Bottiglieri was encouraged to join the company to strengthen its R&D capability. Mr. Bottiglieri has decades of experience formulating products for Swiss cosmetic brands.

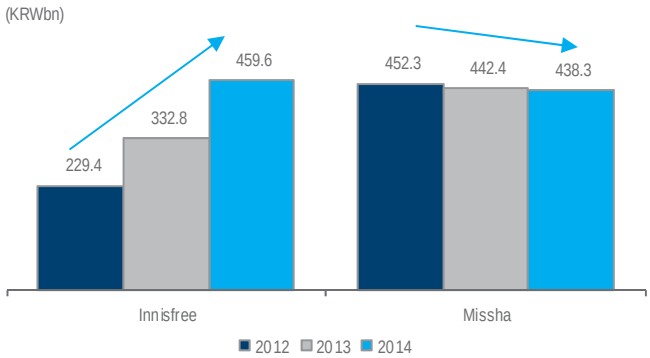
Mr. Park also decided to build a production facility for the company, different to the other players in the industry. While other brands were outsourcing manufacturing to lower costs, Mr. Park stood by his conviction that having a factory was necessary to quickly respond to market changes.

By putting an emphasis on in-house R&D and production, the company is able to differentiate itself in terms of quality. Relying on external production diminishes the ability for quality control. Moreover, Sansung L&S is currently producing the essence of its masks. This is where the brand can differentiate itself in terms of quality.

For a cosmetics brand to survive in the longer term, the importance of having a strong R&D capability and production facility cannot be overrated, in our view. A good example of this would be to compare Missha and Innisfree, the top 2 single-brand shops in Korea. Both brands are positioned in the same category, lower-end skincare product. For the past 2 years, their sales have strongly converged. And we believe this stems from their different R&D and production capabilities. Missha experienced high rate of revenue growth until 2013 when competition intensified. Missha's mega-hit products, First treatment essence and Night Repair Science Activator Ample, were a copy of SK-II and Estee Lauder's respective products.

With these products a major success, copying successful products has now become the industry norm. Missha, however, has not been able to come up with another hit product because it has lacked R&D and production facility, and this could stop other companies from trying to copy cosmetics goods. Innisfree, on the other hand, is a brand that has now successfully differentiated itself. As an affiliate of Amorepacific, the brand develops and produces its products in house. With these products luring more consumers, Innisfree does not need heavy promotions and discounts.

■ Missha vs. Innisfree revenue trend: importance of R&D and production capability



Source: Able C&C, AmoreG

■ Innisfree's best-sellers: all developed and produced in house

Source: Innisfree

From 2H14 and earlier this month, Mr. Park increased his stake in Sansung L&S, and this was in spite of the share price surging 4 times over a 6-month period during the past year. We believe this reflects his confidence in the brand's long-term revenue growth. The company has given Mr. Park a stock option, increasing his stake in Sansung L&S by 1.3%. This stock option has a 3-year lock-up period.

■ Mr. Park's stake changes in Sansung L&S

Stock acquisition Date	Cumulative # of shares	Ownership	Average share price (KRW)	Note
2011.12.06	86,777	0.48%	-	Stock acquisition by M&A
2014.07.29	108,777	0.61%	10,791	Personal investment
2014.11.26	126,777	0.71%	20,997	Personal investment
2015.03.20	356,777	1.99%	44,500	Stock option. 3-year lock-up
2015.03.23	503,554	2.8%	53,670	Personal investment

Source: DART

Pioneer in new markets: seeking long-term revenue growth and market share

As Sansung L&S plans to be an early-mover in Europe and the US with its Korean facial masks, we think the company can maintain its high revenue growth over the mid-to-long term. With its strong production facility and R&D capability, we believe the company's facial masks will become as big a phenomenon as the BB cream, the make-up product that Korea launched in the US.

Korean cosmetics setting trends: BB cream, CC cream and cushion foundation

BB creams are a good example of Korean cosmetics leading market trends. The product has been a major success in the Korean market since 2007, but it did not become a global hit until 2011. It was a Korean medical cosmetic brand, Dr. Jart, which introduced the product to US consumers. And once Dr. Jart launched its BB

cream in Sephora, it became a hit. It was then that the major beauty companies took action and produced their own versions. The success of the BB cream continued with the arrival of the CC cream. These products paved the way for Korean cosmetics to invade the West.

Cushion foundation is another example of Korean companies creating a global trend. This product is Amorepacific's major hit product, and was released in 2008. The product has since been a huge success globally. This triggered L'Oreal to launch its own cushion foundation. Lancome (L'Oreal's high-end brand) recently launched a cushion foundation.

■ **Cushion foundation: Amorepacific's brands vs. L'Oreal's Lancome**

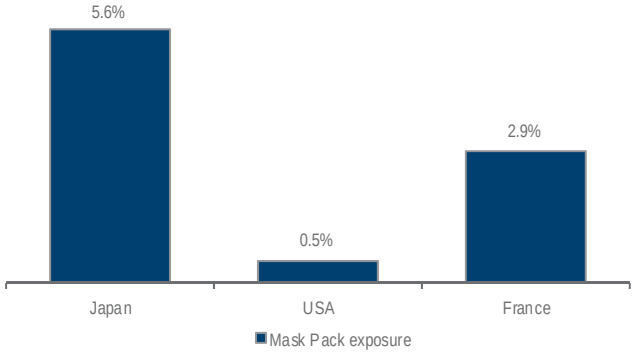
Source: Amorepacific, L'Oréal

The global cosmetics companies acknowledge that Korea is responsible for creating many trends in the cosmetics business. Estee Lauder's CEO Fabrizio Freda said that he has seen Korean brands breaking into the international arena and doing very well. He also said that he has "seen this coming for a long time and the way to compete with Korea is to embrace these trends and to bring them around the world. Our brands – Clinique, namely – has been one of the first to bring BB creams and CC trends to the US, which was actually a Korean trend."

A leader in the Europe and US facial-mask markets

Facial masks are a necessity for Asian women, according to Kantar WorldPanel. This is not the case in the West. While facial masks account for at least 5.6% of all skincare products in Japan, this rate declines to 0.5% and 2.9% for the US and France, respectively.

■ **Proportion of facial masks in the skincare category**



Source: Eurnomoitor
Note: For 2013

Consumers in the West had not been that familiar with face masks, but recently this category has been gaining more attention. According to NPD research group, the category saw 60% sales growth over the July 2013-June 2014 period. NBC's *Today* highlighted that facial masks are one of the 10 trends to follow for 2015. And this trend is also picking up in Europe. The value of the facial-mask market has outpaced that for the other skincare categories (see the following table).

■ **Facial masks are starting to gain consumer recognition in Western countries**

	Sales value (Jul '13~Jun '14)	(YoY)
UK	USD8.5m	11%
Italy	USD9.4m	8%
Spain	USD5.5m	2%
US	USD65.5m	60%

Source: NPD Research

Estee Lauder acquired a US facial-mask company that produces high-end goods. In January 2015, the global beauty conglomerate announced that it will acquire GLAMGLOW, a US-based high-end facial-mask manufacturer.

We think an increasing interest in facial masks globally will be a good opportunity for Sansung L&S' Leaders brand, given that its products are backed by its R&D capability and production facilities. Products to be sold in developed markets are different from those that are popular in China. The masks aimed at developed countries are made of coconut jelly and are 2-3 times more expensive than felt masks.

The company has built a plant in Vietnam, from where it can source coconuts directly, the main raw material in the jelly masks. The company tested its chances in Europe in 3Q14, and exported its OEM-produced facial masks to that market, selling them via offline channels such as B2B. It received positive feedback from consumers. Talks with European drugstores are ongoing and the company expects exports to take off in

1H15. Mr. Bottiglieri will assist the company make headway in this new market as he has been working in this market for 40 years. As for the US market, Sansung L&S will register 20 of its products with the US FDA this year.

The success of Dr. Jart sheds light on the possibility of Korean medical cosmetic (a.k.a. cosmeceutical) goods gaining share of the Western market. As Sansung L&S is the leading company in this particular field, based on its sales figures, we believe it stands a good chance of becoming a pioneer in facial masks in the West.

And Sansung L&S's potential success in these markets is unlikely to end here. As the price points of coconut-jelly facial masks are targeted at the higher-end markets, we expect the success of this product to spread globally. In the long term, we believe the company will start selling these products in China as well.

In our forecasts, we assume conservative coconut-jelly-mask sales of KRW3.4bn, the same sales figure as for 2014. Once the company confirms deals with distribution channels in Europe or the US, we may adjust up our forecasts.

Catalysts

Expanding into other skincare products

The company was originally famous for its skincare products domestically, with its flagship product the 'Wrinkle-off essence', priced at KRW185,000 (USD185). And over the past 10 years, this product has seen accumulated sales of KRW300bn in Korea. Although the company's sales are mainly comprised of facial masks, the company is always looking to sell more of its other skincare products as well. There is no imminent progress on new products currently. However, as the company has a record of successfully producing products that are developed in house, we advise investors to keep track of the company's skincare product sales trends.

IPO of affiliate, Prostemics

The company's affiliate, Prostemics, is to be listed on the KOSDAQ in April 2015 through a merger with KB Special Purpose Acquisition Company (SPAC) No.3. This company is also a cosmetics manufacturer, but differs in that it produces stem-cell cosmetics. Its main customer is Aphrozone, a social-commerce organisation like Nuskin, which accounts for at least 70% of its revenue. After the listing, the company plans to expand its production capacity. As this company's revenue will be consolidated into Sansung L&S' income statement, we believe the revenue growth of this company could be a positive catalyst for Sansung L&S' shares.

Key risks to our call

Shortage of raw materials – main risk

Last year, the company found it hard to source enough felt to meet its production needs and thus demand. This was due to the company's unprecedented cosmetics sales growth of 173% YoY for 2014. The company managed to diversify its supply and guaranteed a sufficient amount from its existing and new suppliers.

Although the company has secured the felt it needs for this year, last year's problems might reoccur due to significant demand from China. As the facial-mask market is outperforming the whole industry, more companies are likely to enter this business. As the company has its own brand, rising competition is not our concern. However, we are worried that as more companies move into the facial-mask market, the shortage of felt that we saw last year might occur again.

A secondary risk would be if the company's cardboard business were to continue to make an operating loss and if this loss is greater than we expect it to be. However, this business did show some signs of recovery (smaller operating loss) in 4Q14, reporting a smaller loss compared with previous quarters. The company is a secondary player in a competitive market, and thus has less control over pricing. This is why it is hard for us to predict when this business will turn around.

Valuation: undervalued vs. peers

We initiate coverage of Sansung L&S with a Buy (1) rating and 12-month target price of KRW90,000. We derived our target price by using a DCF valuation. As Sansung L&S plans to expand its business in China in 2015-16, we believe the implied PER of 30x from our target price is justified considering the company's growth and profitability potential.

■ **Sansung L&S: DCF valuation**

(KRWbn)	2015E	2016E	2017E	2018E	2019E	2020E
Operating EBIT	65.9	102.5	117.3	133.4	151.7	172.6
NOPAT	52.7	82.0	93.8	106.7	115.0	130.8
Gross Cash flow	56.2	86.3	98.2	111.2	119.6	135.5
Free Cash Flow to firm (FCFF)	32.7	74.8	89.2	101.7	109.6	125.0
Present Value Interest Factor (PVIF)	0.95	0.88	0.82	0.77	0.71	0.66
Present Value of FCFF	31.0	66.0	73.3	77.8	78.2	83.1
Sum of FCFF	409					
Terminal Value	1,199					
Corporate Value	1,608					
Net Cash	13					
Appraised value	1,628					
# of Shares Outstanding (m)	17.9					
Appraised value per share	90,408					

Source: Daiwa forecasts

■ **Sansung L&S: key assumptions**

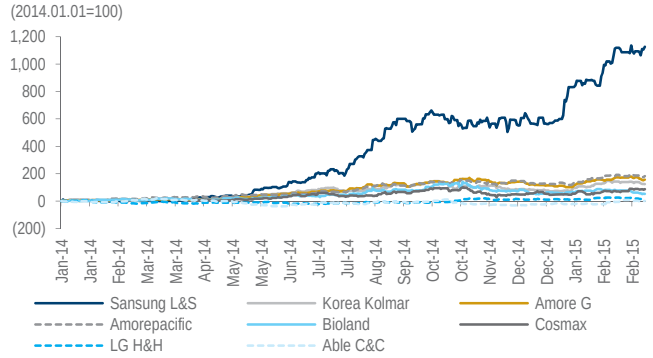
Cost of Equity (%)	11.4
Cost of Debt (%)	7.0
Terminal growth rate (%)	1.5
WACC (%)	6.1

Source: Daiwa

Best share price performance among Korea cosmetics companies in 2014

The company's shares have outperformed its peers in Korea during the past year. An increase in cosmetics sales of 170.6% YoY helped the company to turn around its net loss of KRW2.2bn in 2013 to a net profit of KRW17.1bn in 2014. At the same time, its cosmetics sales contribution surpassed that of its main business (cardboard), and thus the company is now perceived by investors as being a cosmetics company. We believe this stock will outperform its peers once again in 2015, as it is trading at 2015E PER of 21x vs. peers' 31.1x.

■ **Share-price performances of the major Korea cosmetics companies (2014)**



Source: Dataguide

We are convinced that the company's expansion within the DFS channel and via China's online channel, will lead to a near doubling in revenue for 2015, with the cosmetics division leading the growth. The rapid expansion of the cosmetics division will support the company's operating margin, from 18.5% for 2014 to 28.2% for 2015E.

Comparing the revenue growth rate of +95% YoY in 2015 and the company's overall profitability, we believe this stock is undervalued. Its high exposure to the China market and high profitability should also give the stock room to be re-evaluated as a cosmetics company (rather than a maker of cardboard) that has a distinctive competitive edge in China.

■ **Cosmetics companies peer valuation comparison**

Company	PER (x)		EPS growth (%)	
	2015E	2016E	2015E	2016E
Amorepacific*	34.3	27.0	47.8	27.1
LG Household & Health Care*	29.0	24.5	24.4	18.5
Able C&C*	25.9	23.1	173.8	12.2
Cosmax*	34.0	24.3	56.7	39.8
Korea Kolmar*	37.0	31.4	13.4	17.7
AmoreG*	31.1	25.9	21.0	20.3
Sansung L&S*	20.6	13.4	215.5	53.9
L'OREAL	27.9	25.9	(31.7)	7.9
Shanghai Jahwa	22.7	21.5	58.0	5.8
Estee Lauder	30.0	25.4	(10.7)	18.4
SHISEIDO	28.8	38.7	16.4	(25.7)
KAO	33.0	27.4	17.2	20.2
Beiersdorf	29.1	26.8	18.8	8.7

*Source: Bloomberg, *Daiwa forecasts*

The 10-second briefing

Cosmax

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Initiation: premium valuation warranted

- Major beneficiary of the rise of Korean cosmetics products to global prominence
- Close ties with L'Oréal: always one step ahead of competitors
- EPS forecast to see CAGR of 26.8% over 2015-17; initiating with an Outperform (2) rating and 12-month TP of KRW150,000

Target (KRW): **150,000**
Upside: **12.4%**
25 Mar price (KRW): **133,500**

1 Buy
2 Outperform (initiation)
3 Hold
4 Underperform
5 Sell

How do we justify our view?

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Investment case

We initiate coverage of Cosmax, Korea's second-largest cosmetics ODM, with an Outperform (2) call. We believe it is poised for mid-to-long-term strong earnings growth, and hence view its relatively high-looking PER of 34.0x for 2015E as justified.

Hit cosmetics producer. A number of Cosmax's products are hits, such as colour-correcting (CC) cream and cushion foundation. The company has proven to be flexible and swift to react to demand. With Korean cosmetics growing in prominence, Cosmax will continue to see strong revenue growth at the global level, in our view.

Close ties with L'Oréal. Through its acquisition of 2 of L'Oréal's factories, one in Indonesia in 2011 and one in the US in 2012, Cosmax has strengthened its ties with the cosmetics giant. By aligning itself with a global major, we think Cosmax is set for mid-to-long-term earnings growth. Most Korean players rely on China for growth, whereas Cosmax is targeting the developed and developing markets.

Strong earnings growth forecast. We forecast an EPS CAGR of 26.8% over 2015-17, and believe Cosmax has the production capacity to support such growth. Also, we expect the profitability of its overseas affiliates to improve as scale economies are realised.

Catalysts

Forthcoming IPOs. Two of Cosmax's clients, one-brand shops Tony Moly and Nature Republic, are planning IPOs this year to support overseas growth. Cosmecca Korea, the No. 3 cosmetics ODM by revenue in Korea, is also going public this year. We believe these IPOs will highlight the value of overseas expansion and the competitiveness of Korean ODMs.

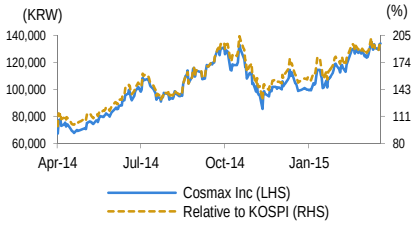
Valuation

We initiate coverage with an Outperform (2) rating and 12-month TP of KRW150,000, based on a 2015E PER of 38.6x, the stock's historical peak. It is trading currently at a 2015E PER of 34.0x, a marked premium to its domestic peers' average of 31.1X. But we believe this premium valuation is justified by our 26.3% EPS CAGR forecast for 2015-17, backed by Cosmax's ability to draw upon its strong presence in China and relationship with L'Oréal.

Risks

Expenses. Excessive R&D and personnel costs would weigh on its earnings and valuation, in our view.

Share price performance



12-month range	67,200-135,500
Market cap (USDbn)	1.09
3m avg daily turnover (USDm)	8.84
Shares outstanding (m)	9
Major shareholder	Cosmax BTI (25.6%)

Financial summary (KRW)

Year to 31 Dec	15E	16E	17E
Revenue (bn)	506	645	755
Operating profit (bn)	42	57	68
Net profit (bn)	35	49	57
Core EPS (fully-diluted)	3,924	5,486	6,308
EPS change (%)	56.7	39.8	15.0
Daiwa vs Cons. EPS (%)	24.3	30.7	10.5
PER (x)	34.0	24.3	21.2
Dividend yield (%)	0.4	0.4	0.5
DPS	600	600	700
PBR (x)	9.7	7.5	6.0
EV/EBITDA (x)	21.9	17.1	14.1
ROE (%)	34.1	34.8	31.4

Source: FactSet, Daiwa forecasts

1 Buy
2 Outperform (initiation)
3 Hold
4 Underperform
5 Sell

How do we justify our view?

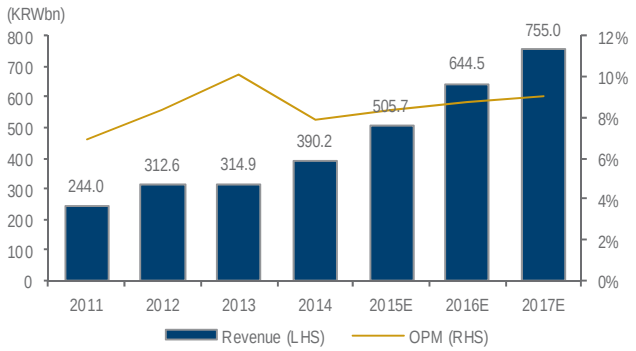
- Growth outlook ✓✓✓✓✓
- Valuation ✓✓✓✓✓
- Earnings revisions ✓✓✓✓✓

Growth outlook ✓✓✓✓✓

We forecast overall revenue of KRW506bn for 2015 (up 29.7% YoY) and look for domestic sales to recover (to KRW308bn, up 17.1% YoY), given the low base in 2014 and expected high demand for cushion foundation, one of Cosmax's most popular products. The China operations (KRW171.8bn, up 39.3% YoY, on our forecasts) should continue to thrive as the company's major clients are doing well in terms of revenue growth. The US factory is due to commence production this year, and we estimate it will contribute KRW18.0bn in additional revenue.

As domestic revenue recovers and the high-margin Chinese business continues to grow, we forecast the company's operating profit to improve by 37% YoY to KRW44bn for 2015.

Cosmax: revenue and OPM



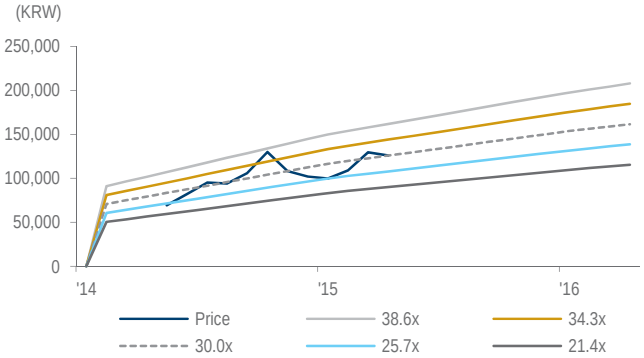
Source: Cosmax, Daiwa estimates

Valuation ✓✓✓✓✓

Although the stock is trading currently at a premium to its peers on 2015E PER, we believe this is justified given our forecast EPS CAGR of 26.8% for 2015-17.

Currently, the stock is trading at a 2015E PER of 34.0x, compared with its historical peak multiple of 38.6x.

Cosmax: 12-month forward PER band



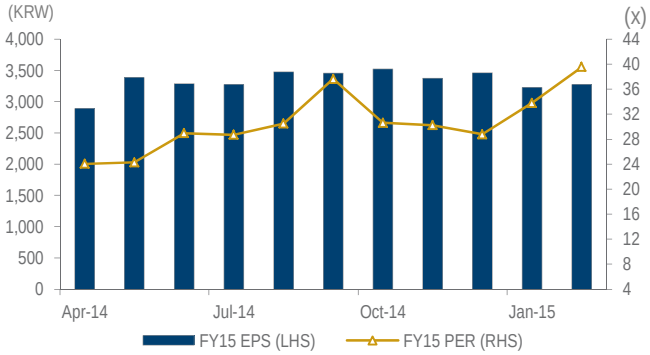
Source: Daiwa

Earnings revisions ✓✓✓✓✓

The stock was rerated by the market earlier this year, in our view to reflect its US factory operation launch and better 2015 earnings expectation.

We think it is possible the consensus may revise up its 2015 earnings forecasts after the company announces 1Q15 results if clients' cushion foundation and DFS sales exceed expectations.

Cosmax: consensus 2015E EPS and PER



Source: Bloomberg

Financial summary

Key assumptions

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
One brand shops growth (yoy%)	n.a.	n.a.	n.a.	n.a.	15.4	12.9	10.9	9.3
China cosmetic market growth (yoy%)	n.a.	n.a.	n.a.	n.a.	14.8	14.5	14.3	14.1
Cosmax China&Guangzhou growth (yoy%)	n.a.	n.a.	n.a.	n.a.	54.4	39.3	33.4	26.3
Cosmax USA growth (yoy%)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	26.2	50.0

Profit and loss (KRWbn)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Korea	n.a.	n.a.	n.a.	n.a.	263	308	334	354
China	n.a.	n.a.	n.a.	n.a.	123	172	229	289
Other Revenue	n.a.	n.a.	n.a.	n.a.	4	26	82	112
Total Revenue	n.a.	n.a.	n.a.	n.a.	390	506	645	755
Other income	n.a.	n.a.	n.a.	n.a.	7	7	8	8
COGS	n.a.	n.a.	n.a.	n.a.	(326)	(425)	(541)	(632)
SG&A	n.a.	n.a.	n.a.	n.a.	(33)	(39)	(47)	(54)
Other op.expenses	n.a.	n.a.	n.a.	n.a.	(6)	(7)	(7)	(8)
Operating profit	n.a.	n.a.	n.a.	n.a.	31	42	57	68
Net-interest inc./(exp.)	n.a.	n.a.	n.a.	n.a.	4	5	5	5
Assoc/forex/extraord./others	n.a.	n.a.	n.a.	n.a.	(6)	(3)	(5)	(6)
Pre-tax profit	n.a.	n.a.	n.a.	n.a.	29	44	56	68
Tax	n.a.	n.a.	n.a.	n.a.	(6)	(8)	(7)	(12)
Min. int./pref. div./others	n.a.	n.a.	n.a.	n.a.	0	(1)	0	1
Net profit (reported)	n.a.	n.a.	n.a.	n.a.	23	35	49	57
Net profit (adjusted)	n.a.	n.a.	n.a.	n.a.	23	35	49	57
EPS (reported)(KRW)	n.a.	n.a.	n.a.	n.a.	2,505	3,924	5,486	6,308
EPS (adjusted)(KRW)	n.a.	n.a.	n.a.	n.a.	2,505	3,924	5,486	6,308
EPS (adjusted fully-diluted)(KRW)	n.a.	n.a.	n.a.	n.a.	2,505	3,924	5,486	6,308
DPS (KRW)	n.a.	n.a.	n.a.	n.a.	500	600	600	700
EBIT	n.a.	n.a.	n.a.	n.a.	31	42	57	68
EBITDA	n.a.	n.a.	n.a.	n.a.	43	56	71	84

Cash flow (KRWbn)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Profit before tax	n.a.	n.a.	n.a.	n.a.	29	44	56	68
Depreciation and amortisation	n.a.	n.a.	n.a.	n.a.	7	7	8	8
Tax paid	n.a.	n.a.	n.a.	n.a.	(2)	(2)	(3)	(3)
Change in working capital	n.a.	n.a.	n.a.	n.a.	(29)	(22)	(26)	(21)
Other operational CF items	n.a.	n.a.	n.a.	n.a.	(3)	8	(13)	(16)
Cash flow from operations	n.a.	n.a.	n.a.	n.a.	1	35	22	35
Capex	n.a.	n.a.	n.a.	n.a.	(42)	(16)	(16)	(15)
Net (acquisitions)/disposals	n.a.	n.a.	n.a.	n.a.	8	8	8	8
Other investing CF items	n.a.	n.a.	n.a.	n.a.	(12)	(11)	(12)	(11)
Cash flow from investing	n.a.	n.a.	n.a.	n.a.	(46)	(19)	(20)	(18)
Change in debt	n.a.	n.a.	n.a.	n.a.	44	10	9	16
Net share issues/(repurchases)	n.a.	n.a.	n.a.	n.a.	0	0	(0)	0
Dividends paid	n.a.	n.a.	n.a.	n.a.	(5)	(4)	(5)	(5)
Other financing CF items	n.a.	n.a.	n.a.	n.a.	4	1	1	1
Cash flow from financing	n.a.	n.a.	n.a.	n.a.	44	6	5	12
Forex effect/others	n.a.	n.a.	n.a.	n.a.	0	0	0	0
Change in cash	n.a.	n.a.	n.a.	n.a.	(1)	23	6	28
Free cash flow	n.a.	n.a.	n.a.	n.a.	(40)	19	6	20

Source: FactSet, Daiwa forecasts

Financial summary continued ...

Balance sheet (KRWbn)

As at 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Cash & short-term investment	n.a.	n.a.	n.a.	n.a.	20	45	54	85
Inventory	n.a.	n.a.	n.a.	n.a.	59	76	97	113
Accounts receivable	n.a.	n.a.	n.a.	n.a.	94	122	155	182
Other current assets	n.a.	n.a.	n.a.	n.a.	7	9	11	13
Total current assets	n.a.	n.a.	n.a.	n.a.	179	251	317	393
Fixed assets	n.a.	n.a.	n.a.	n.a.	126	126	135	143
Goodwill & intangibles	n.a.	n.a.	n.a.	n.a.	3	4	4	4
Other non-current assets	n.a.	n.a.	n.a.	n.a.	22	28	31	31
Total assets	n.a.	n.a.	n.a.	n.a.	330	410	487	571
Short-term debt	n.a.	n.a.	n.a.	n.a.	66	66	66	66
Accounts payable	n.a.	n.a.	n.a.	n.a.	87	112	143	168
Other current liabilities	n.a.	n.a.	n.a.	n.a.	48	47	57	58
Total current liabilities	n.a.	n.a.	n.a.	n.a.	200	225	266	291
Long-term debt	n.a.	n.a.	n.a.	n.a.	0	0	1	1
Other non-current liabilities	n.a.	n.a.	n.a.	n.a.	46	59	60	77
Total liabilities	n.a.	n.a.	n.a.	n.a.	247	284	326	369
Share capital	n.a.	n.a.	n.a.	n.a.	6	6	6	6
Reserves/R.E./others	n.a.	n.a.	n.a.	n.a.	n.a.	119	154	196
Shareholders' equity	n.a.	n.a.	n.a.	n.a.	84	125	161	203
Minority interests	n.a.	n.a.	n.a.	n.a.	(1)	(0)	0	(1)
Total equity & liabilities	n.a.	n.a.	n.a.	n.a.	330	410	487	571
EV	n.a.	n.a.	n.a.	n.a.	1,247	1,223	1,214	1,183
Net debt/(cash)	n.a.	n.a.	n.a.	n.a.	46	22	12	(18)
BVPS (KRW)	n.a.	n.a.	n.a.	n.a.	9,219	13,826	17,728	22,392

Key ratios (%)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Sales (YoY)	n.a.	n.a.	n.a.	n.a.	0.0	29.6	27.5	17.1
EBITDA (YoY)	n.a.	n.a.	n.a.	n.a.	0.0	29.0	27.4	17.8
Operating profit (YoY)	n.a.	n.a.	n.a.	n.a.	0.0	36.8	34.0	20.7
Net profit (YoY)	n.a.	n.a.	n.a.	n.a.	0.0	56.7	39.8	15.0
Core EPS (fully-diluted) (YoY)	n.a.	n.a.	n.a.	n.a.	0.0	56.7	39.8	15.0
Gross-profit margin	n.a.	n.a.	n.a.	n.a.	16.4	16.0	16.1	16.2
EBITDA margin	n.a.	n.a.	n.a.	n.a.	11.1	11.0	11.0	11.1
Operating-profit margin	n.a.	n.a.	n.a.	n.a.	7.9	8.4	8.8	9.1
Net profit margin	n.a.	n.a.	n.a.	n.a.	5.8	7.0	7.7	7.5
ROAE	n.a.	n.a.	n.a.	n.a.	54.3	34.1	34.8	31.4
ROAA	n.a.	n.a.	n.a.	n.a.	13.6	9.5	11.0	10.7
ROCE	n.a.	n.a.	n.a.	n.a.	41.4	24.8	27.1	27.6
ROIC	n.a.	n.a.	n.a.	n.a.	18.7	25.0	30.9	31.6
Net debt to equity	n.a.	n.a.	n.a.	n.a.	55.1	17.2	7.7	n.a.
Effective tax rate	n.a.	n.a.	n.a.	n.a.	21.8	18.2	12.6	17.4
Accounts receivable (days)	n.a.	n.a.	n.a.	n.a.	43.9	77.8	78.4	81.4
Current ratio (x)	n.a.	n.a.	n.a.	n.a.	0.9	1.1	1.2	1.3
Net interest cover (x)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Net dividend payout	n.a.	n.a.	n.a.	n.a.	20.0	15.3	10.9	11.1
Free cash flow yield	n.a.	n.a.	n.a.	n.a.	n.a.	1.6	0.5	1.7

Source: FactSet, Daiwa forecasts

Company profile

Cosmax was established in Korea in November 1992. As an original development and design manufacturing (ODM) company, Cosmax provides cosmetics products to both local Korean and foreign brands, such as L'Oreal and Johnson & Johnson. It currently holds second place in terms of sales in the Korean cosmetics OEM/ODM market among over 200 competitors. The company launched its business in China in 2004, and in 2014, this business accounted for 33.2% of total consolidated sales.

Positive outlook argues for premium valuation

Cosmax has traded at a premium to its domestic peers for the past 4 years. We believe this trend will continue as the company benefits from the boom in Korean cosmetics and its close ties with L'Oréal. As such, we forecast an EPS CAGR of 26.8% over 2015-17.

Major beneficiary of Korean cosmetics going global

Cosmax has a record of producing hit products in Korea, like CC creams and cushion foundation. More and more global companies and Chinese clients are keeping a close eye on Korea's cosmetics trends, and as the company produces these goods in a timely manner, we expect the demand for hit items to drive its earnings over the next 3 years.

▪ **Cosmax: hit products**

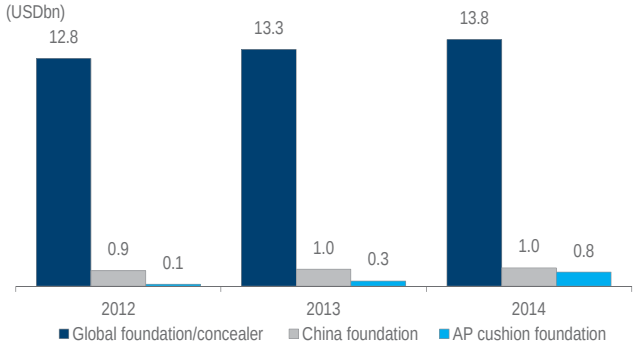
Source: Daiwa

The company has 2 plants in China (in Shanghai and Guangzhou), a market that is rapidly embracing Korean trends in beauty and cosmetics. We believe that cushion foundation, in particular, will make a meaningful contribution to Cosmax's revenue and earnings over the next 3 years at least, with partner L'Oréal now in the throes of taking it global.

According to a local news release, 75% of all Korean women have used this product, and it is rapidly replacing existing foundation products.

Euromonitor estimate the global foundation market is worth some USD14.4bn, of which China accounts for 7.7%, or USD1.1bn. If Cosmax can bring its cushion foundation to China, the product could be a strong catalyst for further revenue growth, in our opinion.

▪ **Foundation: size of the global and China markets**



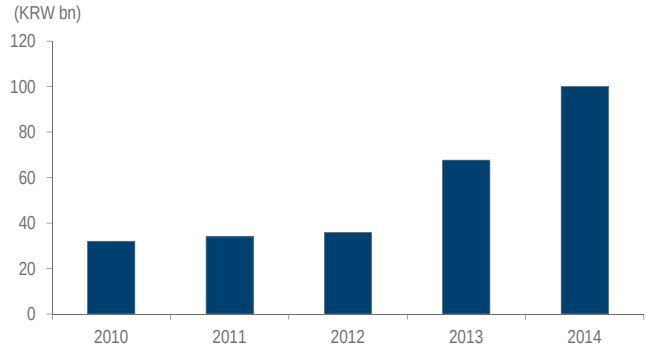
Source: Euromonitor

Meanwhile, we are confident of Cosmax's success in the US, given the continuing popularity of BB cream in the US market. Dr. Jart, a Korean brand of "cosmeceuticals", or medical cosmetics, has had great success in the US since it was launched there in 2012. While the global brands have subsequently released their versions of BB cream, we think the success of Korean products since 2012 has enhanced consumers' perceptions of Korean cosmetics in general.

Closer to home, we expect Cosmax to be a big beneficiary of the continued growth that we expect in the number of visitors from Mainland China to Korea. Our frame of reference here is StyleNanda, one of Cosmax's clients.

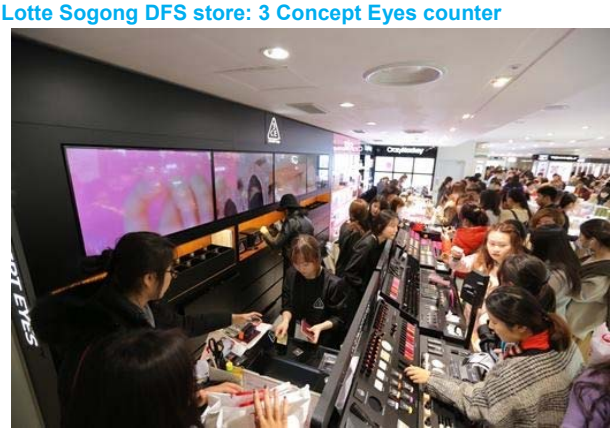
Earlier this year, StyleNanda launched its cosmetic brand, 3 Concept Eyes, at the Lotte Sogong DFS, one of the largest and most popular DFS stores in Korea. The brand generated KRW20-30bn in revenue in 2014, and we forecast it to generate another KRW20-30bn from this shop alone in 2015, given the store's size and popularity.

■ StyleNanda: revenue trend



Source: Press releases
Note: Figure includes apparel and cosmetics. 2014 revenue is an estimate

■ Lotte Sogong DFS store: 3 Concept Eyes counter



Source: Press releases

■ StyleNanda: popularity in the Lotte Sogong DFS store

	2013	2014	2015
1	MCM	StyleNanda	StyleNanda
2	StyleNanda	MCM	LINE Friends
3	New Balance	Too cool for school	Too cool for school
4	Too cool for school	New Balance	Wonder place
5	TDF	Wonder place	New Balance
6	MLB	LINE Friends	MCM
7	Chanel	HERA	LG H&H (Shampoo)
8	SM Town	SM Town	RED EYE
9	Laneige	TDF	HERA
10	Lapalette	REDEYE	Studio White

Source: Press releases

Separately, the 3 Concept Eyes brand is considering opening a cosmetics flagship store in the upmarket tourist shopping area of Garosoogil in May 2015. While the sales contribution from this flagship store may be smaller than that generated by the Lotte Sogong DFS store, having a presence in this popular area will give the brand valuable exposure, and could lead to it being sold in more of Cosmax's stores, hence boosting the company's domestic sales. Moreover, we think it should bring more clients to the brand.

After months of production line remodelling, the US factory is due to commence operations this year, starting with L'Oréal orders. We look for this plant to generate revenue of KRW18bn this year and contribute 4% of total revenue, because we believe the company will attract new customers with trend-setting products like cushion foundation, while having L'Oréal's orders as a cash cow. This development could well set the stage for the company's entry into the South American markets, in our view.

■ Cosmax: production capability around the world (units of cosmetics)

Source: Company
Note: expected level at the end of 2015

Close ties with L'Oréal

The relationship between Cosmax and L'Oréal goes back to 2004. After starting out producing products in the Maybelline line, the tie-up now produces a range of goods across several price points, including high-end brands. The companies' ties strengthened when L'Oréal sold Cosmax its Indonesia and US plants in 2011 and 2012, respectively. The plants provided Cosmax with an opportunity to penetrate new markets at a relatively low cost.

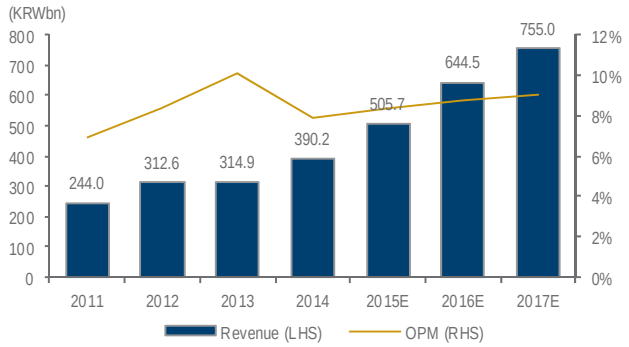
Having L'Oréal as a major partner demonstrates Cosmax's capability to other global MNCs, a number with which it is already negotiating deals. In our view, Cosmax and L'Oréal's long relationship has a lot to do with the quality and competitiveness of Cosmax's products.

By doing business with a major MNC, Cosmax is in a better position to gauge which market has future potential. This is why it can be prepared for the next stage of growth, while other Korean players are mainly focused on China. When its sales in the US market stabilise within a few years, the company will turn to other markets to support its long-term growth.

Rapid revenue growth with high visibility

Cosmax's domestic business is its cash cow, while its overseas affiliates also support its revenue growth. As such, we forecast Cosmax's revenue to increase at a CAGR of 22.2% from 2015-17, with revenue reaching KRW755bn in 2017. EPS growth is likely to be higher at a 2015-17 CAGR of 26.8% on our forecasts, with the high-margin Chinese business expanding its sales weighting, while the US and Indonesia affiliates also contribute to earnings.

■ Cosmax: revenue and OPM forecast



Source: Company, Daiwa

Valuation

We initiate coverage of Cosmax with an Outperform (2) rating and 12-month target price of KRW150,000, derived by applying the company's past 3-year-high PER of 38.6x to 2015E EPS. Using DCF methodology is not applicable to Cosmax, in our view, as the company is constantly investing in new factories overseas. We apply the stock's historical high PER given our strong earnings outlook for Cosmax, with the company expanding its footprint to the US starting in 2Q15, and broadening its reach to developed markets.

We forecast the China business to deliver revenue growth of 39.3% YoY in 2015, the highest among all of the regions of Cosmax's business, reflecting the strength of demand from its clients in the China market. At the same time, we see revenue growth the Korean business recovering on increasing demand for Cosmax's cushion products.

Catalysts

There are currently 3 IPOs in related businesses in the pipeline for 2015. Two are Cosmax's clients (Tony Moly and Nature Republic), and the other is a competitor (Cosmecca Korea). Both clients are going public to expand their market exposure overseas. Cosmax produces best-selling products for both brands, and with these brands going global, there is the prospect of more orders in the future for Cosmax.

■ Tony Moly and Nature Republic: bestsellers both manufactured by Cosmax

Source: Daiwa

Cosmecca Korea, the 3rd largest ODM company in Korea, could also be a catalyst for the stock. It is likely that when Cosmecca is listed later this year, it will focus on the growth potential of its Suzhou plant in China. Cosmecca started to run this plant only in May 2014, whereas Cosmax has had a China presence in China since 2004. In our view, when investors assess the merits of investing in Cosmecca Korea's IPO, we believe they will recognise Cosmax as the stronger competitor.

■ Comparison: key metrics of Korean ODM companies

(KRWbn, %)	Cosmax (as of 2014)	Korea Kolmar (as of 2014)	Cosmecca (as of 2013)
Revenue	390.0	461.3	62.9
Operating Income	31.0	46.8	1.9
Net Income	23.0	32.8	1.1
Revenue Growth (YoY, %)	23.3%	63.4%	-2.3%
OPM	7.9%	10.2%	3.0%

Source: DART, Daiwa

Risks to our call

In our view, the biggest risk to our Outperform (2) rating on Cosmax would be unexpected expenditure. The company tends to allocate significant sums to R&D, an approach that can weigh on earnings in the short term and yet may not yield the hit products to support long-term earnings growth.

A secondary risk would be slower-than-expected progress for the plant that the company acquired in Indonesia back in 2011.

The 10-second briefing

LG Household & Health Care

051900 KS

Target (KRW): **850,000**
Upside: **6.3%**
25 Mar price (KRW): **800,000**

Initiation: a mixed bag

- Household goods and beverages: earnings poised to rise in 2015 from low base in 2014
- Cosmetics: should show strong earnings growth, tempered by worries about rapid sales expansion of D2D
- Without sizeable M&A, current valuation seems justified; initiating with Outperform (2) rating and TP of KRW850,000

1 Buy
2 Outperform (initiation)
3 Hold
4 Underperform
5 Sell

How do we justify our view?

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Investment case

We initiate on LG H&H, Korea's second-largest personal care and cosmetics producer, with an Outperform (2) rating and 12-month TP of KRW740,000. After China's first lady, Peng Liyuan, purchased LG H&H's Whoo cosmetics in 3Q14, the company's high-end cosmetics brand sales rose markedly for full-year 2014. And we expect this momentum to continue in 2015. We forecast the company's duty-free store (DFS) sales to rise by 70% YoY to KRW507.4bn for 2015, contributing 9.9% of revenue. The spill-over effect on door-to-door (D2D) sales should continue, leading to 9.7% YoY growth to KRW221.8bn for 2015, on our forecasts.

Normalising prices for household goods and beverages. A dip in consumer sentiment as a result of the Sewol ferry disaster in April 2014 led beverage companies to lower prices in 2014. LG H&H is now trying to bring its prices back to a normal level in order to boost profitability. It has done so for the household category without hurting market share. Earlier this year, Lotte-Chilsung, the No.1 beverage company in Korea, said it would focus on improving its margins. LG H&H has opted to follow this trend to recover its margin on beverage sales.

Catalysts

IPOs of other one-brand shops. Planned IPOs by Tonymoly and Nature Republic this year could serve to highlight to investors the global expansion of one-brand shops. In our view, this development would underline the value of LG H&H's The Face Shop, as the largest player in the one-brand shop field.

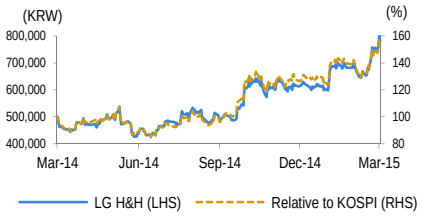
Valuation

We have a 12-month TP of KRW850,000, based on a DCF valuation. The stock is trading at a 2015E PER of 29.0x, lower than both its past-5-year average and its peers. However, we see the discount as justified, considering that our forecasts earnings growth rates and profitability are below those recorded in previous years.

Risks

Rapid growth of D2D sales. While LG H&H's D2D sales have been outperforming the market over the past year on demand from Mainland China, the channel is in a downturn as domestic consumers shift to other channels (Internet or DFS). As such, the possibility of inventory flowing into China could be a risk to the mid- to long-term revenue growth of Whoo.

Share price performance



12-month range	424,000-800,000
Market cap (USDbn)	11.35
3m avg daily turnover (USDm)	26.58
Shares outstanding (m)	16
Major shareholder	LG Corp (34.0%)

Financial summary (KRW)

Year to 31 Dec	15E	16E	17E
Revenue (bn)	5,129	5,519	5,920
Operating profit (bn)	595	691	815
Net profit (bn)	404	479	568
Core EPS (fully-diluted)	27,563	32,667	38,729
EPS change (%)	24.4	18.5	18.6
Daiwa vs Cons. EPS (%)	6.3	8.6	14.7
PER (x)	29.0	24.5	20.7
Dividend yield (%)	0.5	0.5	0.5
DPS	4,050	4,050	4,050
PBR (x)	7.1	5.9	4.9
EV/EBITDA (x)	18.6	15.8	13.2
ROE (%)	22.0	21.8	21.5

Source: FactSet, Daiwa forecasts

1 Buy
2 Outperform (initiation)
3 Hold
4 Underperform
5 Sell

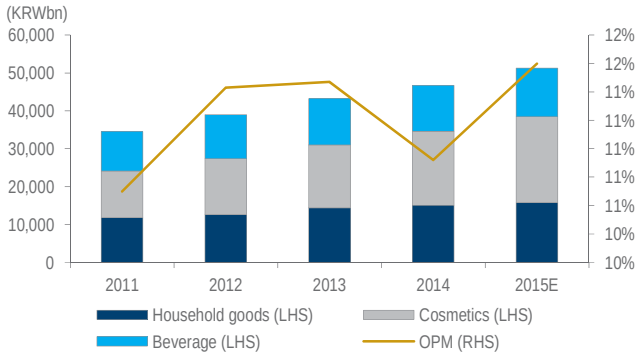
How do we justify our view?

- Growth outlook ✓✓✓✓✓
- Valuation ✓✓✓✓✓
- Earnings revisions ✓✓✓✓✓

Growth outlook ✓✓✓✓✓

We expect the company's net profit growth to recover this year, after a slowdown in 2014 in the face of subdued consumer sentiment. We look for revenue of KRW5.1tn (up 9.7% YoY), with the cosmetics division providing the biggest boost to overall revenue growth (making a revenue contribution of KRW2.3tn, up 16.5% YoY). The operating profit margin should improve as the company continues its efforts to overcome the competition. We forecast operating profit of KRW595bn (up 16.5% YoY) for 2015.

LG H&H: revenue by division and operating-profit margin



Source: Company, Daiwa estimates

Valuation ✓✓✓✓✓

The stock is trading at a 2015E PER of 29.0x, lower than its past-5-year valuation and below peer Amorepacific's (090430 KS, KRW3,374,000, Outperform [2]) 2015E PER of 34.3x. Without the boost from an additional earnings growth factor, such as sizeable M&A, we see this valuation level as justified.

LG H&H: DCF valuation

(KRWbn)	2015E	2016E	2017E	2018E	2019E	2020E	2021E
Operating EBIT	595.1	691.1	815.2	921.2	1,031.7	1,155.5	1173.9
NOPAT	428.5	501.8	591.8	589.9	730.3	845.1	889.8
Gross Cashflow	538.3	620.3	719.7	727.5	877.7	1,001.4	1054.2
Free Cash Flow to firm (FCFF)	304.1	376.1	459.7	475.0	625.0	748.4	816.1
Present Value Interest Factor (PVIF)	0.95	0.90	0.84	0.79	0.74	0.70	0.6
Present Value of FCFF	289.8	336.9	387.0	375.9	464.8	523.1	520.8
Sum of FCFF	2,951						
Terminal Value	11,093						
Corporate Value	14,044						
Net Debt	715						
Appraised value	13,329						
# of Shares Outstanding (mn)	15.6						
Appraised value per share (KRW)	850,000						

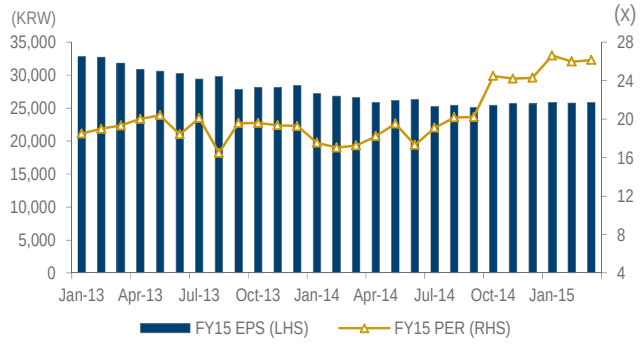
Source: Daiwa

Earnings revisions ✓✓✓✓✓

The Bloomberg consensus 2015 EPS forecast for LG H&H has been revised downwards over the past 2 years, on subdued consumer sentiment affecting the company's main businesses. Our EPS forecast is higher than the consensus figure, as we are more bullish on tourist arrivals from China as well as beverage revenue growth.

Unless there is a significant rise in the number of tourists from China visiting Korea, LG H&H's main group of customers, we think the scope for further margin expansion would be limited.

LG H&H: consensus 2015E EPS and PER



Source: Bloomberg

Financial summary

■ Key assumptions

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Household goods sales growth (yoy%)	8.8	15.2	7.2	13.9	4.1	5.1	2.2	2.2
Duty-free sales growth (yoy%)	0.0	0.0	0.0	0.0	200.6	70.0	36.1	28.0
Chinese inbound growth (yoy%)	39.7	18.4	27.8	52.5	41.6	18.5	16.7	15.0
Mass cosmetic sales growth (yoy%)	0.0	12.4	9.5	1.6	(11.3)	2.4	2.1	1.8
Beverage sales growth (yoy%)	18.5	45.7	10.3	6.2	(0.3)	4.3	5.0	5.3

■ Profit and loss (KRWbn)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Household good	1,026	1,182	1,266	1,442	1,502	1,579	1,614	1,650
Beautiful	1,084	1,228	1,479	1,662	1,956	2,278	2,569	2,864
Other Revenue	716	1,047	1,151	1,222	1,219	1,272	1,335	1,407
Total Revenue	2,826	3,456	3,896	4,326	4,677	5,129	5,519	5,920
Other income	80	93	109	110	121	110	119	128
COGS	(1,334)	(1,736)	(1,903)	(2,032)	(2,102)	(2,253)	(2,377)	(2,510)
SG&A	(1,165)	(1,350)	(1,547)	(1,798)	(2,064)	(2,280)	(2,451)	(2,594)
Other op.expenses	(80)	(93)	(109)	(110)	(121)	(110)	(119)	(128)
Operating profit	327	370	446	496	511	595	691	815
Net-interest inc./(exp.)	(28)	(28)	(30)	(34)	(11)	(12)	(12)	(13)
Assoc/forex/extraord./others	35	43	27	22	(55)	(31)	(33)	(36)
Pre-tax profit	335	385	443	484	445	552	648	769
Tax	(55)	(101)	(118)	(108)	(126)	(155)	(177)	(210)
Min. int./pref. div./others	5	7	8	8	5	6	8	9
Net profit (reported)	284	291	333	385	325	404	479	568
Net profit (adjusted)	284	291	333	385	325	404	479	568
EPS (reported)(KRW)	18,203	18,648	21,305	24,643	20,790	25,872	30,662	36,352
EPS (adjusted)(KRW)	18,203	18,648	21,305	24,643	20,790	25,872	30,662	36,352
EPS (adjusted fully-diluted)(KRW)	19,393	19,867	22,698	26,254	22,149	27,563	32,667	38,729
DPS (KRW)	2,700	3,550	3,800	3,800	4,050	4,050	4,050	4,050
EBIT	327	370	446	496	511	595	691	815
EBITDA	407	463	554	607	632	705	810	943

■ Cash flow (KRWbn)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Profit before tax	335	385	443	484	445	552	648	769
Depreciation and amortisation	80	93	109	110	121	110	119	128
Tax paid	(40)	(68)	(84)	(123)	(137)	(169)	(194)	(230)
Change in working capital	(57)	(99)	(220)	(92)	(32)	(34)	(29)	(30)
Other operational CF items	2	(22)	(9)	10	69	(76)	64	67
Cash flow from operations	319	289	238	390	466	383	608	704
Capex	(110)	(155)	(168)	(134)	(187)	(200)	(215)	(230)
Net (acquisitions)/disposals	(406)	2	(203)	(8)	0	0	0	0
Other investing CF items	(13)	17	1	(350)	(90)	(2)	(2)	(2)
Cash flow from investing	(529)	(135)	(370)	(493)	(278)	(202)	(217)	(232)
Change in debt	262	(62)	168	260	(276)	(1)	(43)	66
Net share issues/(repurchases)	0	(0)	0	0	0	0	0	0
Dividends paid	(42)	(45)	(59)	(63)	(67)	(67)	(67)	(67)
Other financing CF items	(0)	(1)	(1)	(11)	351	23	5	11
Cash flow from financing	219	(108)	109	185	8	(46)	(105)	10
Forex effect/others	(0)	0	(0)	(0)	0	0	0	0
Change in cash	10	46	(23)	82	196	135	287	482
Free cash flow	209	134	70	255	279	183	393	474

Source: FactSet, Daiwa forecasts

Financial summary continued ...

Balance sheet (KRWbn)

As at 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Cash & short-term investment	47	95	77	156	356	493	781	1,265
Inventory	233	306	317	376	411	451	485	521
Accounts receivable	298	365	398	443	423	464	499	535
Other current assets	0	1	0	7	20	21	23	25
Total current assets	579	767	792	981	1,210	1,429	1,789	2,346
Fixed assets	583	810	968	955	1,029	1,120	1,216	1,335
Goodwill & intangibles	664	664	841	1,286	1,346	1,332	1,319	1,305
Other non-current assets	118	129	163	213	43	256	277	280
Total assets	1,945	2,369	2,764	3,435	3,629	4,138	4,601	5,267
Short-term debt	155	133	116	318	130	230	280	330
Accounts payable	405	484	449	494	420	461	496	532
Other current liabilities	57	113	375	170	240	255	268	282
Total current liabilities	618	731	940	982	790	946	1,044	1,143
Long-term debt	361	396	325	745	849	848	806	873
Other non-current liabilities	122	182	228	233	235	258	263	274
Total liabilities	1,100	1,308	1,493	1,960	1,875	2,052	2,113	2,290
Share capital	89	89	89	89	89	89	89	89
Reserves/R.E./others	700	909	1,113	1,320	1,595	1,922	2,318	2,801
Shareholders' equity	788	997	1,202	1,409	1,683	2,010	2,407	2,890
Minority interests	57	63	70	67	71	75	80	87
Total equity & liabilities	1,945	2,369	2,764	3,435	3,629	4,138	4,601	5,267
EV	12,997	12,963	12,894	13,423	13,137	13,104	12,829	12,469
Net debt/(cash)	469	434	364	907	622	585	304	(62)
BVPS (KRW)	44,482	56,295	67,816	79,516	92,417	113,456	135,851	163,086

Key ratios (%)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Sales (YoY)	85.3	22.3	12.7	11.0	8.1	9.7	7.6	7.3
EBITDA (YoY)	69.0	13.7	19.6	9.5	4.2	11.5	14.9	16.5
Operating profit (YoY)	65.3	13.0	20.4	11.4	3.0	16.4	16.1	17.9
Net profit (YoY)	25.1	2.4	14.2	15.7	(15.6)	24.4	18.5	18.6
Core EPS (fully-diluted) (YoY)	25.1	2.4	14.2	15.7	(15.6)	24.4	18.5	18.6
Gross-profit margin	52.8	49.8	51.2	53.0	55.1	56.1	56.9	57.6
EBITDA margin	14.4	13.4	14.2	14.0	13.5	13.7	14.7	15.9
Operating-profit margin	11.6	10.7	11.4	11.5	10.9	11.6	12.5	13.8
Net profit margin	10.1	8.4	8.5	8.9	6.9	7.9	8.7	9.6
ROAE	41.0	33.0	30.6	29.7	21.1	22.0	21.8	21.5
ROAA	18.5	13.5	13.0	12.4	9.2	10.4	11.0	11.5
ROCE	31.3	25.1	27.0	23.4	19.4	20.2	20.5	21.0
ROIC	23.9	19.2	20.6	19.1	15.4	17.0	18.4	20.7
Net debt to equity	59.5	43.5	30.3	64.4	37.0	29.1	12.6	n.a.
Effective tax rate	25.8	27.0	27.5	22.8	28.2	28.0	27.4	27.4
Accounts receivable (days)	31.1	35.0	35.7	35.4	33.8	31.6	31.8	31.9
Current ratio (x)	0.9	1.0	0.8	1.0	1.5	1.5	1.7	2.1
Net interest cover (x)	11.6	13.3	15.0	14.5	46.6	49.6	57.7	61.7
Net dividend payout	14.8	19.0	17.8	15.4	19.5	15.7	13.2	11.1
Free cash flow yield	1.7	1.1	0.6	2.0	2.2	1.5	3.1	3.8

Source: FactSet, Daiwa forecasts

Company profile

LG Household & Health Care, a Korea-based company, focuses on manufacture of household goods, cosmetics and beverages. The household goods include laundry detergents, aromatics, hygiene products under the brand names of Perioe, SAY, Elastine, TECH, Saffron, and others. The cosmetics, including skin care, hair care products, are provided under the names of O HUI, Whoo, SOORYEHAN, and ISA KNOX. In addition, the refreshing segment provides carbonated and non-carbonated beverages. The company operates in many overseas markets, such as in the US, China, Taiwan, Vietnam, and other European countries.

Mixed feelings on growth

We expect LG H&H to see a recovery in revenue growth this year. But we have concerns: 1) revenue growth for the household goods and beverage businesses will be from a low base for 2014, 2) market stagnation is likely to persist this year, and 3) high growth in the D2D channel raises questions about the long-term growth prospects for Whoo.

2015E revenue growth to reflect low base, not market recovery

The domestic market for household goods and beverages has seen growth in total revenue slow and in some cases reverse in recent years amid subdued consumer sentiment. In response, companies have had to compete on price, which has eroded profitability.

Reflecting its status as a major player in this segment, LG H&H has been seeking to return the prices of its household goods to previous levels. At the same time, it has managed to expand its market share, which we see as a testament to the company's competitiveness.

It plans to do the same in the beverage segment this year. As price competition continues to ease and prices normalise, we believe LG H&H as a whole will experience a return to revenue growth in 2015.

We would be more confident in the prospects for the stock, however, if these segments as a whole were showing signs of price normalisation. But we do not expect them to do so this year. As the revenue growth that we forecast for LG H&H in the household goods and beverage segments will be from a low YoY base, we do not expect this growth to be a factor that prompts the market to rerate the stock.

■ **Korea: size of home care products markets**

Segment	2010	2011	2012	2013	2014
Total (KRW bn)	755	765	780	740	722
Laundry detergent	400	400	400	380	NA
Fabric softener	230	240	256	230	NA
Dishwashing detergent	125	125	124	130	NA

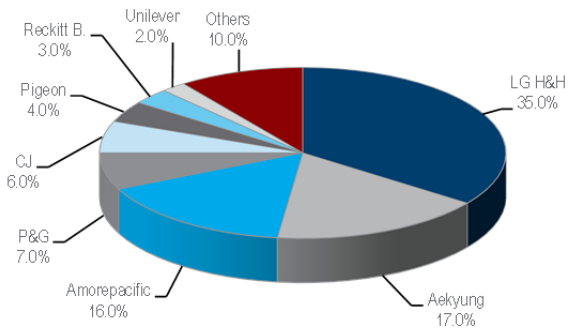
Source: Company

Korea: size of personal care products markets

Segment	2010	2011	2012	2013	2014
Total (KRW bn)	960	1,010	1,024	990	950
Hair care	360	370	374	350	NA
Oral care	420	450	450	430	NA
Body care	180	190	200	210	NA

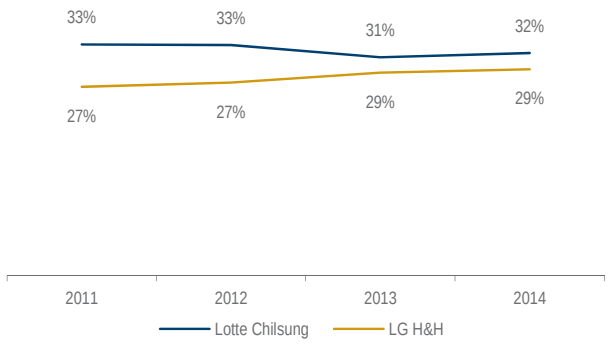
Source: Company

■ **Korea household goods segment: market share by company (2014)**



Source: Company, AC Nielsen

■ **Korea beverages segment: market share by major players (2014)**

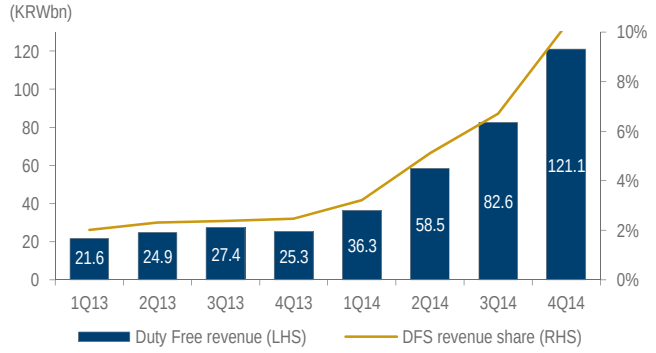


Source: Company, AC Nielsen

Strong D2D sales are a worry

LG H&H's luxury cosmetics brand, Whoo, has grown in prominence and popularity after China's first lady was seen purchasing Whoo products. As a result, DFS sales have surged since 2H14, mainly on rising sales of the Whoo product line.

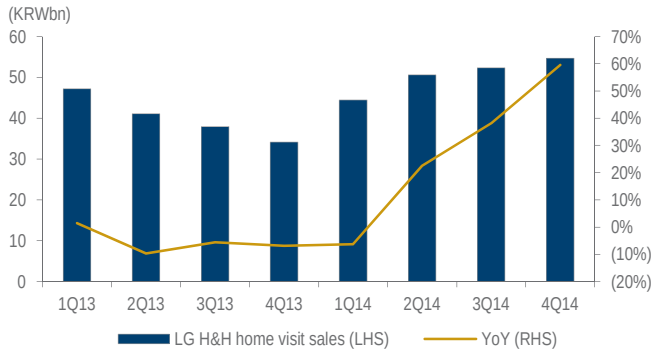
■ LG H&H: DFS revenue and as proportion of total revenue



Source: Company

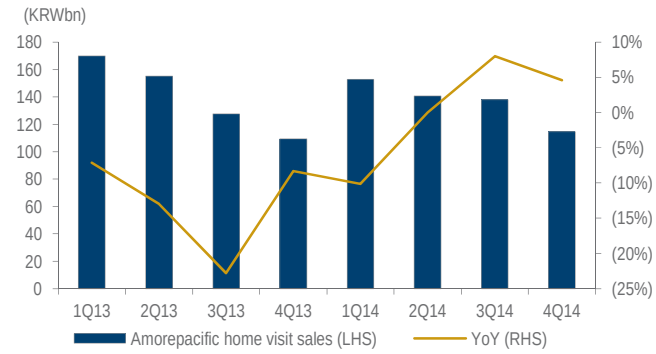
The Whoo effect also showed in LG H&H's D2D revenue, which was up 25.6% YoY in 2014 — much more than simply a reflection of a low base, in our view. Indeed, for the same period, Amorepacific, which has the popular Sulwhasoo brand among others, experienced a revenue decline YoY in its D2D sales. For 3Q14, Amorepacific's YoY revenue growth did pick up, but this was primarily due to a low 3Q13 base.

■ LG H&H: D2D revenue and YoY growth



Source: Company

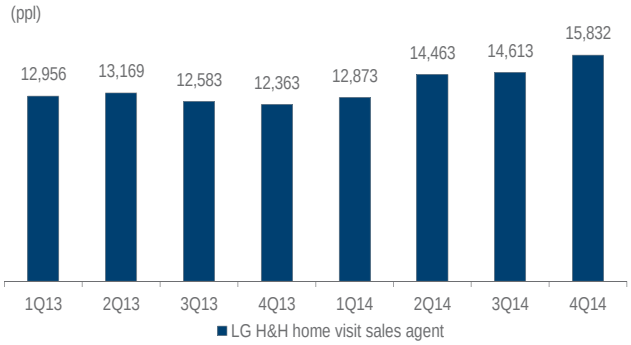
■ Amorepacific: D2D revenue and YoY growth rate



Source: Amorepacific

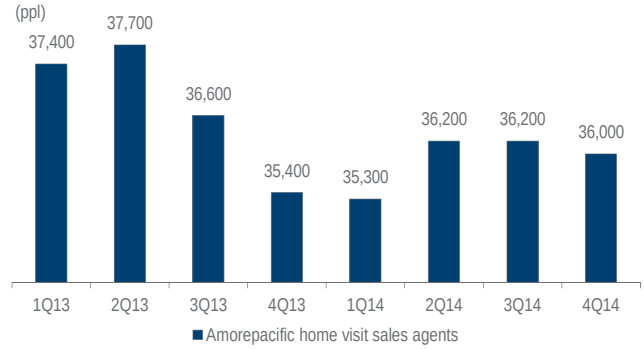
A look at the number of D2D beauty counsellors also highlights the divergence in the 2 companies' performances. Amorepacific's counsellor headcount declined from 2Q14 to 4Q14, in line with the broader industry trend. Earlier this year, Amorepacific dismissed counsellors who had specialised in selling to customers from Mainland China. However, LG H&H bucked the industry norm of 1Q being the high point for the number of counsellors; instead, its counsellor headcount increased QoQ over the course of 2014.

■ LG H&H: number of D2D counsellors



Source: Company

■ Amorepacific: number of D2D counsellors



Source: Amorepacific

However, we believe is it likely that some of LG H&H's D2D sales have flowed to Mainland China. For example, we note that on Taobao, a leading C2C site in China, the ranking of Whoo products is rising rapidly. If, as a result, some of its products have found their way into unauthorised channels, the company could face a problem with channel control, which we view as essential to its efforts to maintain the luxury brand image of Whoo. By extension, a continuation of this trend could have implications for the long-term revenue growth of the Whoo brand.

Valuation

We initiate coverage of LG H&H with a DCF-based 12-month target price of KRW850,000 and an Outperform (2) rating. In our DCF valuation we assume a terminal growth rate of 2% to reflect stabilisation in the company's domestic business.

■ LG H&H: DCF valuation

(KRWbn)	2015E	2016E	2017E	2018E	2019E	2020E	2021E
Operating EBIT	595.1	691.1	815.2	921.2	1,031.7	1,155.5	1173.9
NOPAT	428.5	501.8	591.8	589.9	730.3	845.1	889.8
Gross Cashflow	538.3	620.3	719.7	727.5	877.7	1,001.4	1054.2
Free Cash Flow to firm (FCFF)	304.1	376.1	459.7	475.0	625.0	748.4	816.1
Present Value Interest Factor (PVIF)	0.95	0.90	0.84	0.79	0.74	0.70	0.6
Present Value of FCFF	289.8	336.9	387.0	375.9	464.8	523.1	520.8
Sum of FCFF	2,951						
Terminal Value	11,093						
Corporate Value	14,044						
Net Debt	715						
Appraised value	13,329						
# of Shares Outstanding (mn)	15.6						
Appraised value per share (KRW)	850,000						

Key assumptions	
Beta	0.94
WACC (%)	6.9%
Terminal growth rate (%)	2.0%

Source: Daiwa

The M&A effect: harvest time

Historically, LG H&H has traded at a premium to Amorepacific, likely due to its higher revenue growth rate backed by a steady stream of M&A activity. These deals have been big enough to a play a role in supporting double-digit YoY revenue growth. However, as the company has grown in size, it has found it more difficult to find eligible M&A targets that would allow it sustain its historical revenue growth rates. As a result, it started looking outside Korea.

Although the deals it has made since 2012 have not made much progress in terms of their contribution to overall revenue growth, we note the company has a goal of restructuring acquired companies within 3 years of completing the deal. Hence, in the coming months we look for it to start highlighting material signs of improvement at acquired companies, which would signal to the market that its strategy is a sound one. In the near term, we expect Ginza Stefany and Everlife to show signs that the consolidation process is bearing fruit.

■ LG H&H: M&A history

Business	Date	Company	Deal size (KRW, bn)	Financing
Refreshing	2007.1	Coca Cola	385	Corporate Bond: KRW 200 bn, CP: KRW 120
				Cash: KRW 70 bn
	2009.1	Diamond Water	11.2	Cash: 11.2bn
	2010.03	HANKOOK BEVERAGE	14.1	Cash
	2010.1	Haitai Beverage	KRW 10,000+, net debt KRW 123 bn	Corporate Bond: KRW 80 bn
	2013.1	Yungjin Pharm	14.1	Cash
Beautiful	2010.01	The Face Shop	391.8	Corporate Bond: KRW 300 bn, CP: KRW 50 bn, Cash: KRW 49 bn
	2012.01	VOV	55	Cash
	2012.02	Ginza Stefany Inc	188.4	Corporate bond: KRW 150 bn, Cash: KRW 38.4 bn
	2013.01	Everlife Co., Ltd.	329.4	Corporate Bond; KRW 290 bn
	2013.01	TFS Singapore	17.2	Cash
	2013.06	Fruits&Passion (Canada)	17.4	Cash
	2014.02	R&Y (Japan)	40.2	Cash
	2014.10	CNP (Korea)	54.2	Cash

Source: LG Household & Health Care

Catalyst: IPOs of other one-brand shops

Planned IPOs by LG H&H's competitors this year could highlight to investors the global expansion of one-brand shops. Both Tonymoly and Nature Republic are planning to go public as part of their efforts to boost their market penetration overseas. LG H&H's The Face Shop is the largest such player in the domestic field, and we think these listings could underline its market position and value.

Risk to our view

While we have an Outperform (2) rating on LG H&H, one concern we have is the long-term revenue growth outlook for Whoo. If growth in the Whoo line falls short of our expectations, we might revisit our forecasts with a downward bias.

The 10-second briefing

Amorepacific Group
002790 KS

Target (KRW): **1,500,000**
Upside: **6.4%**
25 Mar price (KRW): **1,410,000**

Initiation: pretty positive picture

- Amorepacific and Innisfree should continue to perform strongly in revenue and earnings growth
- Etude is going through a restructuring in 2015, and its operations may take time to return to normal
- Initiating with Outperform (2) rating; we prefer the "other Amore", Amorepacific, for its earnings growth and valuation

1 Buy
2 Outperform (initiation)
3 Hold
4 Underperform
5 Sell

How do we justify our view?

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Investment case

Amorepacific Group is the holding company of Korea's market-leading cosmetics brand, Amorepacific (AP). It differs from AP in that it operates the lower-end one-brand shops Innisfree and Etude, and also has a pharma business called Aestura (formerly Pacific Pharmaceutical).

Outstanding affiliates. Amorepacific Group is the major shareholder of AP and Innisfree, the 2 best-performing companies in terms of revenue in Korea's cosmetics industry. Hence, if AP and Innisfree deliver strong earnings growth, Amorepacific Group's share price should be positively affected.

Restructuring of Etude. Affiliate Etude is currently rebuilding its brand equity and overseas distribution channel. Although its contribution to the group's earnings is well below those of Amorepacific or Innisfree in absolute terms, the restructuring may still have an impact on the stock, in our view.

Catalysts

Forthcoming IPOs of other one-brand shops. Planned IPOs by competitors Tonymoly and Nature Republic this year could serve to highlight to investors the global expansion of one-brand shops. In our view, this development would underline the value of Amorepacific Group's stakes in the domestic industry's top-tier brands.

Change in cosmetics tax system. We believe that one potential share-price catalyst is a planned change (timing unknown) in the Chinese government's policy whereby lower-end cosmetics will become exempt from a tax on cosmetics and skin care products. Amorepacific distributes Etude, a mass-market colour cosmetics brand, in China, and through tax exemption should be able to build the brand there rapidly.

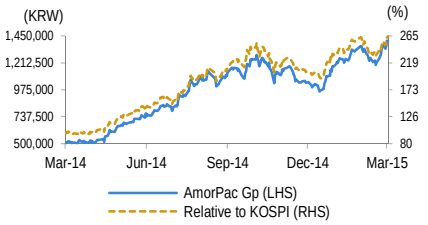
Valuation

We initiate coverage with an Outperform (2) rating and an NAV-based 12-month TP of KRW1,500,000, in which we factor in the value of its affiliate stakes. An upside risk to our valuation would be an earlier-than-expected recovery for Etude and Aestura.

Risks

Etude may need time. Amorepacific Group plans to get this affiliate's operations back on track in 2015, but intense competition could slow the restructuring process, which would likely weigh on Amorepacific Group's share price.

Share price performance



12-month range	504,000-1,410,000
Market cap (USDbn)	10.22
3m avg daily turnover (USDm)	15.15
Shares outstanding (m)	8
Major shareholder	Kyung-bae Suh (55.7%)

Financial summary (KRW)

Year to 31 Dec	15E	16E	17E
Revenue (bn)	5,568	6,406	7,101
Operating profit (bn)	849	1,047	1,187
Net profit (bn)	334	402	432
Core EPS (fully-diluted)	45,274	54,446	58,538
EPS change (%)	21.0	20.3	7.5
Daiwa vs Cons. EPS (%)	46.5	45.2	12.6
PER (x)	31.1	25.9	24.1
Dividend yield (%)	0.2	0.2	0.2
DPS	3,300	3,300	3,300
PBR (x)	4.0	3.6	3.1
EV/EBITDA (x)	11.9	9.7	8.4
ROE (%)	13.7	14.6	13.9

Source: FactSet, Daiwa forecasts

1 Buy
2 Outperform (initiation)
3 Hold
4 Underperform
5 Sell

How do we justify our view?

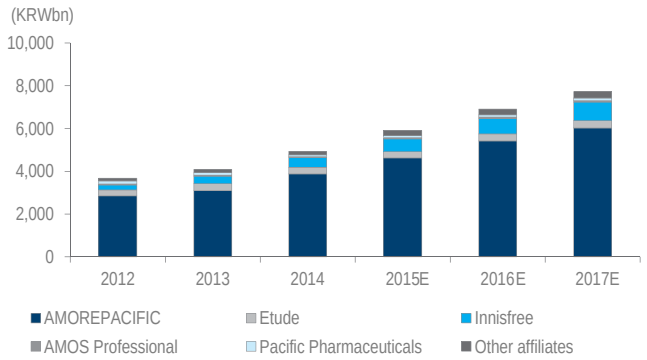
- Growth outlook ✓✓✓✓✓
- Valuation ✓✓✓✓✓
- Earnings revisions ✓✓✓✓✓

Growth outlook ✓✓✓✓✓

We forecast Amorepacific Group to record revenue of KRW5.6tn, up 18.2% YoY, for 2015E. The main drivers should be Amorepacific (AP) and Innisfree, with revenue growth of 20.1% YoY and 64.2% YoY, respectively. Since the 2 affiliates account for more than 90% of consolidated sales, the group's revenue growth should be similarly positive, in our view.

However, with Etude going through a normalisation process, Amorepacific Group's revenue growth this year is likely to fall short of the 20.1% YoY growth that we forecast for AP. On our forecasts, Amorepacific Group's 2015E operating profit would be KRW849bn (up 28.9% YoY).

Amorepacific Group: sales breakdown by affiliates



Source: Company, Daiwa forecasts

Valuation ✓✓✓✓✓

Given Amorepacific Groups' status as a holding company, we derive our 12-month target price of KRW1,500,000 on the basis of its NAV.

We initiate coverage with an Outperform (2) rating. If AP and Innisfree were to deliver better-than-expected results for 2015, we would have to revisit our earnings forecasts for Amorepacific Group with an upward bias.

Amorepacific Group: NAV valuation

(KRWbn)	Value	Note
Amorepacific Common Share	9,314	Target price of KRW 3.8 million
Amorepacific Preferred Share	265	Share price as of 25 March 2015
ETUDE	552	2015 expected net profit * PER of 30x * 80.5% stake
Innisfree	2,223	2015 expected net profit * PER of 40x * 81.8% stake
AMOS Professional	156	2015 expected net profit * PER of 20x
Pacificpharm	69	Book value as of end 2014
Pacific Glas	43	Book value as of end 2014
Pacific Package	36	Book value as of end 2014
Jangwon	42	Book value as of end 2014
Cosvision	4	Book value as of end 2014
Subsidiary Value	11,954	24% discount for unlisted companies
Net Cash	272	Book value as of end 2014
NAV	12,227	
No. of Shares (1,000 shares)	7,979	Excluding treasury shares
NAV per Share (KRW)	1,532,318	
Current Price	1,410,000	
Discount to NAV	8.0%	

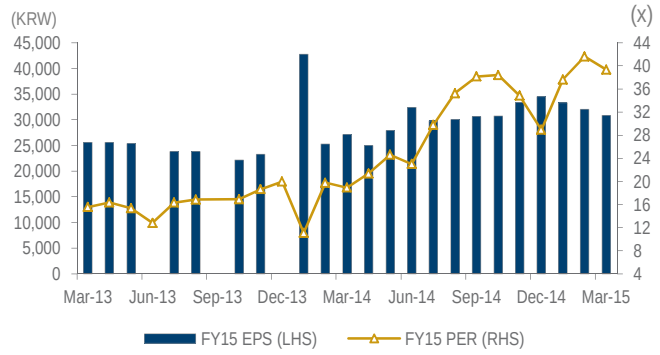
Source: Daiwa forecasts

Earnings revisions ✓✓✓✓✓

The Bloomberg consensus forecast of Amorepacific Group's 2015E earnings was revised up for much of 2014, likely as the market incorporated upside earnings surprises for AP.

Our earnings forecasts are higher than the consensus as we are more bullish on the prospects for Innisfree and Amorepacific.

Amorepacific Group: consensus EPS revisions (2015E)



Source: Bloomberg

Financial summary

Key assumptions

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Chinese inbound growth (yoy%)	39.7	18.4	27.8	52.5	41.6	21.5	19.4	17.4
No. of Innisfree China stores	n.a.	n.a.	n.a.	45.0	108.0	163.0	263.0	363.0
No. of Etude China stores	n.a.	n.a.	n.a.	5.0	12.0	30.0	60.0	100.0

Profit and loss (KRWbn)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Amorepacific	2,272	2,555	2,850	3,100	3,874	4,601	5,323	5,895
Innisfree	265	259	275	83	140	230	333	457
Other Revenue	(2,432)	245	307	712	697	738	750	749
Total Revenue	105	3,059	3,432	3,895	4,711	5,568	6,406	7,101
Other income	0	0	0	100	127	157	174	160
COGS	(2)	(961)	(1,014)	(1,199)	(1,308)	(1,485)	(1,689)	(1,857)
SG&A	(5)	(1,663)	(1,967)	(2,226)	(2,745)	(3,234)	(3,670)	(4,057)
Other op.expenses	(0)	(0)	(0)	(100)	(127)	(157)	(174)	(160)
Operating profit	98	435	450	470	658	849	1,047	1,187
Net-interest inc./(exp.)	8	24	27	23	26	32	37	47
Assoc/forex/extraord./others	20	76	20	12	23	29	33	37
Pre-tax profit	108	511	471	482	682	877	1,081	1,225
Tax	(5)	(95)	(135)	(124)	(127)	(184)	(237)	(292)
Min. int./pref. div./others	200	(228)	(192)	(192)	(279)	(359)	(442)	(501)
Net profit (reported)	303	188	144	166	276	334	402	432
Net profit (adjusted)	303	188	144	166	276	334	402	432
EPS (reported)(KRW)	38,021	23,542	18,071	20,791	34,621	41,878	50,361	54,147
EPS (adjusted)(KRW)	38,021	23,542	18,071	20,791	34,621	41,878	50,361	54,147
EPS (adjusted fully-diluted)(KRW)	40,844	25,290	19,413	22,373	37,429	45,274	54,446	58,538
DPS (KRW)	1,800	2,050	2,300	2,550	3,300	3,300	3,300	3,300
EBIT	98	435	450	470	658	849	1,047	1,187
EBITDA	98	535	577	627	832	1,009	1,221	1,373

Cash flow (KRWbn)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Profit before tax	108	511	471	482	682	877	1,081	1,225
Depreciation and amortisation	0	0	0	100	127	157	174	160
Tax paid	0	(78)	(105)	(104)	(159)	(204)	(251)	(285)
Change in working capital	(58)	(7)	(151)	(37)	(108)	(53)	(51)	(41)
Other operational CF items	(32)	66	132	99	149	367	(43)	(23)
Cash flow from operations	18	493	346	540	691	1,144	909	1,036
Capex	(335)	(369)	(305)	(385)	(6)	(333)	(333)	(333)
Net (acquisitions)/disposals	0	(25)	(5)	0	0	0	0	0
Other investing CF items	369	(7)	(130)	(26)	(588)	(111)	(109)	(90)
Cash flow from investing	34	(401)	(440)	(412)	(594)	(444)	(441)	(423)
Change in debt	0	(10)	47	17	80	6	0	0
Net share issues/(repurchases)	0	0	0	0	(20)	0	0	0
Dividends paid	(12)	(40)	(44)	(49)	(51)	(54)	(27)	(27)
Other financing CF items	(1)	53	(32)	45	(53)	76	53	45
Cash flow from financing	(13)	3	(29)	13	(44)	27	26	18
Forex effect/others	0	(4)	(3)	(4)	0	0	0	0
Change in cash	38	91	(126)	137	53	728	494	632
Free cash flow	(318)	124	41	154	685	811	576	704

Source: FactSet, Daiwa forecasts

Financial summary continued ...

Balance sheet (KRWbn)

As at 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Cash & short-term investment	271	775	763	894	989	1,820	2,415	3,132
Inventory	0	284	334	342	372	440	506	561
Accounts receivable	4	257	275	290	249	294	339	375
Other current assets	0	25	6	27	66	78	90	100
Total current assets	275	1,341	1,379	1,552	1,676	2,633	3,350	4,168
Fixed assets	84	1,962	2,053	2,229	2,445	2,243	2,402	2,575
Goodwill & intangibles	(85)	626	637	651	694	694	694	694
Other non-current assets	1,321	331	454	496	648	686	727	736
Total assets	1,595	4,260	4,522	4,929	5,463	6,256	7,174	8,173
Short-term debt	0	16	25	84	162	162	162	162
Accounts payable	2	411	385	416	415	491	565	626
Other current liabilities	0	124	119	144	128	152	177	199
Total current liabilities	2	550	529	644	705	805	903	987
Long-term debt	27	34	16	15	18	21	24	27
Other non-current liabilities	81	319	343	361	435	490	544	591
Total liabilities	110	902	888	1,020	1,158	1,316	1,472	1,604
Share capital	44	44	44	44	44	44	44	44
Reserves/R.E./others	1,441	1,806	1,934	2,081	2,255	2,543	2,876	3,256
Shareholders' equity	1,485	1,851	1,978	2,126	2,300	2,588	2,921	3,300
Minority interests	0	1,507	1,656	1,783	2,006	2,352	2,781	3,268
Total equity & liabilities	1,595	4,260	4,522	4,929	5,463	6,256	7,174	8,173
EV	9,709	12,023	12,175	12,228	12,448	11,964	11,798	11,569
Net debt/(cash)	(244)	(726)	(722)	(794)	(808)	(1,637)	(2,229)	(2,942)
BVPS (KRW)	199,807	249,135	266,364	288,231	311,874	351,054	396,283	447,836

Key ratios (%)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Sales (YoY)	34.7	2,813.5	12.2	13.5	20.9	18.2	15.1	10.8
EBITDA (YoY)	37.2	445.1	8.0	8.6	32.7	21.3	21.0	12.5
Operating profit (YoY)	37.3	344.3	3.6	4.3	40.1	28.9	23.4	13.4
Net profit (YoY)	273.6	(38.1)	(23.2)	15.1	66.5	21.0	20.3	7.5
Core EPS (fully-diluted) (YoY)	273.6	(38.1)	(23.2)	15.2	67.3	21.0	20.3	7.5
Gross-profit margin	97.9	68.6	70.5	69.2	72.2	73.3	73.6	73.9
EBITDA margin	93.4	17.5	16.8	16.1	17.7	18.1	19.1	19.3
Operating-profit margin	93.2	14.2	13.1	12.1	14.0	15.2	16.3	16.7
Net profit margin	289.0	6.1	4.2	4.3	5.9	6.0	6.3	6.1
ROAE	21.1	11.3	7.5	8.1	12.5	13.7	14.6	13.9
ROAA	19.6	6.4	3.3	3.5	5.3	5.7	6.0	5.6
ROCE	8.4	22.1	15.7	15.0	19.1	23.9	29.7	32.1
ROIC	8.0	18.0	11.2	11.2	16.5	20.0	23.2	24.5
Net debt to equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Effective tax rate	4.7	18.7	28.6	25.7	18.6	21.0	21.9	23.8
Accounts receivable (days)	12.8	15.6	28.3	26.5	20.9	17.8	18.0	18.3
Current ratio (x)	145.1	2.4	2.6	2.4	2.4	3.3	3.7	4.2
Net interest cover (x)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net dividend payout	4.7	8.7	12.7	12.3	9.5	7.9	6.6	6.1
Free cash flow yield	n.a.	1.1	0.4	1.4	6.1	7.2	5.1	6.3

Source: FactSet, Daiwa forecasts

Company profile

AMOREPACIFIC Group is a holding company with 3 major businesses (cosmetics, pharmaceuticals and others). The group's subsidiaries include Amorepacific, Etude, Innisfree, AMOS Professional, Pacificpharma, PACIFICGLAS, and COSVISION. It specialises in the manufacture, marketing and sale of a range of products, including cosmetics, daily, organic, and inorganic chemical products.

Several positives but a few negatives

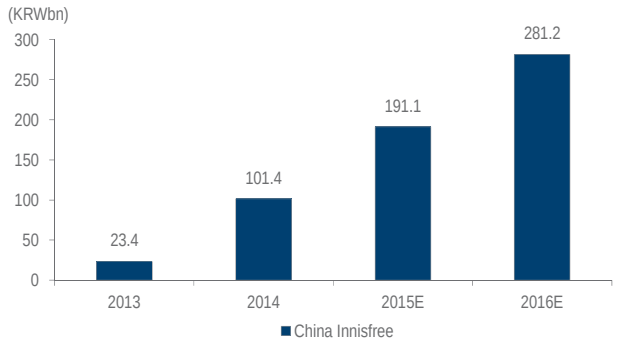
Amorepacific Group is a holding company with major stakes in AP (090430 KS), Innisfree and Etude. Forced to choose between the 2 Amores, we prefer AP.

Positive outlook for Innisfree, though Etude slightly cloudy

Innisfree expanding rapidly in China

Since debuting in China in 2012, Innisfree's revenue there has quickly expanded. In particular, we believe the branding of its Jeju Island line, which plays up the products' use of organic ingredients, has been well received in China.

■ Innisfree: China revenue



Source: Company, Daiwa estimates

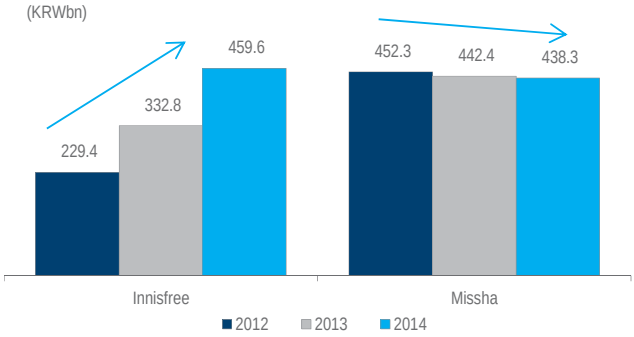
Innisfree differs from other one-brand shops in that it has access to AP's production and R&D capabilities. This attribute provides an interesting contrast with Missha. Both are positioned in the same category: lower-end skin care products. Over the past 2 years, however, there has been a marked divergence in their sales trends. Missha consistently saw robust sales growth until 2013, when competition intensified.

Missha's mega-hit products, First Treatment Essence and Night Repair Science Activator Ample, were inspired by popular products offered by SK-II and Estee Lauder, respectively. When these products became hits in the domestic market, emulating popular items became the norm for some companies. However, Missha was not able to come up with another hit product, as it lacked its own R&D and production facilities, which could have made it more difficult for other companies to copy its products.

Innisfree, on the other hand, has successfully differentiated itself, in our view. As an affiliate of Amorepacific Group, the brand develops and produces its own products internally. Moreover, because these products have proved popular with consumers, Innisfree has not had to resort to heavy promotions or discounts.

We believe that a similar scenario could play out in the China market. Competition from domestic players is intensifying, but we think Innisfree has the upper hand because it can use AP's hardware (production facilities) and software (R&D expertise).

■ Missha vs Innisfree: revenue trends



Source: Able C&C, Company

■ Innisfree's best-sellers: developed and produced internally

Source: Innisfree

Etude undergoing restructuring

We expect the benefits of Etude's turnaround efforts to start to materialise within 2015. Etude is another one-brand shop brand in which Amorepacific Group has the

majority stake. The brand is mainly positioned in the low-end colour cosmetics segment, and a large proportion of its customers are teenagers, who tend to switch brands depending on whatever discounts and promotions are on offer at the time. We believe this lack of customer loyalty is one reason Amorepacific Group is now working to reposition the brand. But that process is likely to take time, particularly as Etude's senior management team was changed only recently.

Compared with Innisfee, Etude looks to have fewer opportunities in China because of the cost structure of the market. Colour cosmetics are currently subject to a 30% luxury tax in China, and while the government has indicated its plans to remove the tax, there is no visibility on when that will happen. When the tax is shelved, however, we believe the company will be able to push the Etude brand aggressively in China. As the situation stands, it plans to open 15-20 new stores in China in 2015, whereas Innisfree opened 40 new stores there in its second year of operation there.

■ **Innisfree vs Etude: cumulative number of stores in China**

Brand	2012	2013	2014	2015E
Innisfree	5	45	108	160
Etude	0	5	12	30

Source: Company, Daiwa

Valuation

Initiating with Outperform (2) rating and potential upside to TP of 6.4%

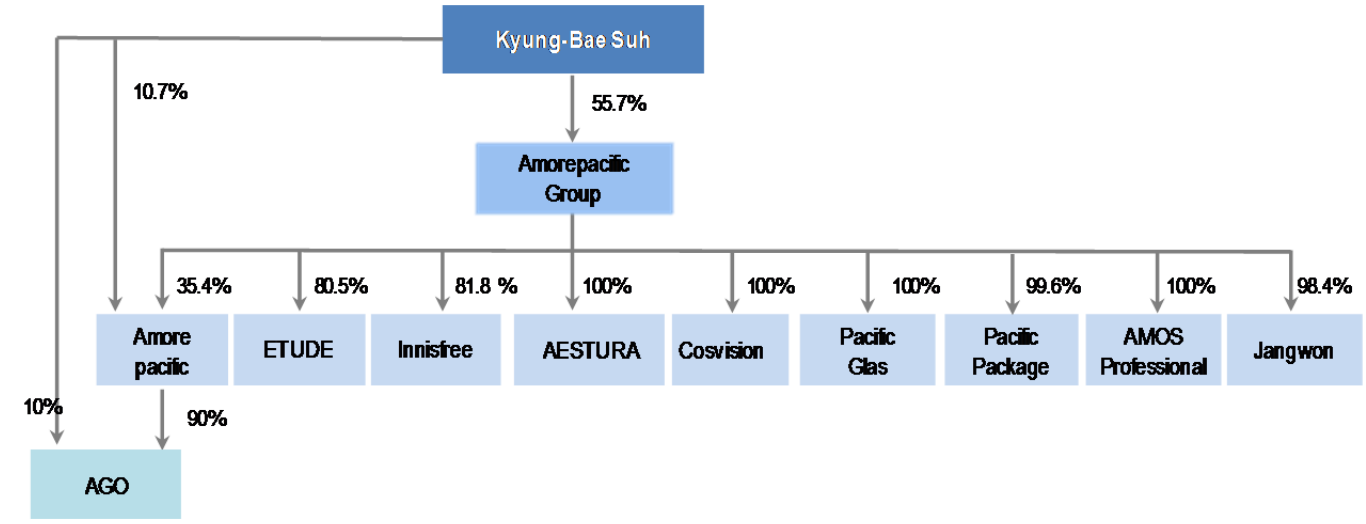
We use an NAV valuation to determine our target price for Amorepacific Group. For the main 4 companies in which it is the major shareholder (AP, Innisfree, Etude, AMOS Professional), we have sought to ascribe a fair operating value. Reflecting their rapid revenue growth internationally, we value Innisfree and Etude on PER multiples of 40x and 30x, respectively. As the other affiliates do not generate meaningful profits, we value them on the basis of their book value.

■ **Amorepacific Group: NAV valuation**

(KRWbn)	Value	Note
Amorepacific Common Share	9,314	Target price of KRW 3.8 million
Amorepacific Preferred Share	265	Share price as of 25 March 2015
ETUDE	552	2015 expected net profit * PER of 30x * 80.5% stake
Innisfree	2,223	2015 expected net profit * PER of 40x * 81.8% stake
AMOS Professional	156	2015 expected net profit * PER of 20x
Pacificpharm	69	Book value as of end 2014
Pacific Glas	43	Book value as of end 2014
Pacific Package	36	Book value as of end 2014
Jangwon	42	Book value as of end 2014
Cosvision	4	Book value as of end 2014
Subsidiary Value	11,954	24% discount for unlisted companies
Net Cash	272	Book value as of end 2014
NAV	12,227	
No. of Shares (1,000 shares)	7,979	Excluding treasury shares
NAV per Share (KRW)	1,532,318	
Current Price (KRW)	1,410,000	
Discount to NAV	8.0%	

Source: Daiwa forecasts

■ **Amorepacific Group: structure**



Source: Company

Potential share-price catalyst: IPOs of other one-brand shops

Planned IPOs of competitors

Amorepacific Group's competitors, Tonymoly and Nature Republic, are both planning IPOs this year, which we think could serve to highlight to investors the value of Korean cosmetics players penetrating international markets.

Moreover, we think Amorepacific Group will stand out for its status as a major shareholder of Innisfree and Etude, which in turn can access AP's R&D capability and production facilities. If the abovementioned IPOs do occur, we believe they could prompt within the market a positive reassessment of these 2 brands and Amorepacific Group itself.

■ Korea: major one-brand shops

(KRWbn)	Revenue			Operating Profit			Net Profit		
	2013	2014	YoY	2013	2014	YoY	2012	2013	YoY
THE FACE SHOP	547.2	610.4	11.50%	94.9	72.9	-23.15%	59.1	64	8.30%
MISSHA	442.4	438.3	-0.01%	13.2	6.7	49.2%	38.8	6.5	-83.30%
ETUDE	337.3	307.5	-8.80%	26.1	65.5	150.9%	18.6	19.5	4.60%
INNISFREE	332.8	459.6	38.10%	49.8	71	42.50%	28	39.3	40.30%
SKIN FOOD	173.8	-	-	3	-	-	7.7	1.9	-75.30%
TONYMOLY	170.3	-	-	19.4	-	-	12.7	18.7	47.20%
NATURE REPUBLIC	171.7	-	-	-0.5	-	-	-7	-2.9	-58.60%
IT'S SKIN	53	-	-	8.7	-	-	2.2	7.1	217.30%
THE SAEM	33.2	-	-	-10.6	-	-	-13.1	-16.2	23.80%

Source: DART, Company

Risks to our call

The major downside risk to our Outperform (2) rating would be if Etude's restructuring takes more time to bear fruit than we currently expect. We forecast Etude to see revenue growth of 1.0% YoY (in 2015E), assuming the bulk of the restructuring is completed in 1H15. If the process takes longer than we expect, however, we would have to revisit our assumptions for Etude with a downward bias, which would have implications for our valuation of Amorepacific Group.

A secondary risk would be a slowdown in the revenue growth of affiliate companies due to unforeseen political disputes between China and Korea. AP, which accounts for 82.1% of Amore Pacific Group's consolidated revenue, derives 26% of its revenue from the China segment. If political tensions between the 2 nations were to arise, the revenue of AP and hence Amorepacific Group might be affected.

The 10-second briefing

Korea Kolmar

161890 KS

Target (KRW): **64,000**
Downside: **0.2%**
25 Mar price (KRW): **64,100**

Initiation: fairly valued

- We forecast modest revenue growth of 13.5% YoY to KRW523.6bn in 2015 from a high base
- Beijing Kolmar should resume strong revenue growth in 2015, but China sales contribution still lower than for peers
- Trading at fair value considering earnings growth and limited China exposure, in our view; initiating with Hold (3) rating

1 Buy
2 Outperform
3 Hold (initiation)
4 Underperform
5 Sell

How do we justify our view?

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Investment case

Korea Kolmar dominates Korea's cosmetics and pharmaceuticals OEM/ODM markets, with 4 plants in Korea and 1 in China. With its Beijing plant, the company caters to China's lucrative cosmetics market.

Modest growth forecast for domestic business. The company's main clients are one-brand stores, a segment in which we expect competition to intensify. But Korea Kolmar is diversifying its client base, which should assuage concern about its revenue growth. From a high base, we forecast 2015 revenue of KRW523.6bn (up 13.5% YoY) and operating profit of KRW53bn (up 13.5% YoY).

Beijing Kolmar to resume growth. After facing teething problems (staff management, local accounting norms), the China plant should resume its strong revenue growth this year, backed by increased capacity. We forecast revenue from China to increase from KRW27bn in 2014 to KRW44.4bn in 2015 (up 62.1% YoY).

Catalysts

Possible deal with US major. Korea Kolmar has been in talks for years with a US cosmetics company about a possible ODM deal. With its state-of-the-art plant in Sejong city now complete, we believe such an arrangement could begin in 2015.

Forthcoming IPOs. Cosmecca Korea, Korea's third-largest cosmetics ODM by revenue, plans to go public this year, which may serve to highlight Korea Kolmar's superior R&D and production facilities. In addition, 2 of the company's main cosmetics customers (Tony Moly and Nature Republic) plan public listings in 2015, and ODMs should benefit from their expansion, in our view.

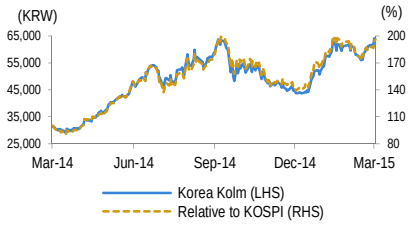
Valuation

We initiate with a Hold (3) rating and 12-month TP of KRW64,000, based on a 2015E PER of 36.7x. Our target multiple is a 5% discount to Cosmax's (192820 KS, KRW133,500 Outperform [2]) 2015E target PER of 38.6x, given Korea Kolmar's lower revenue growth and limited China exposure.

Risks

The main upside risk to our view would be faster-than-expected client diversification. The main downside risk would be lower-than-expected revenue growth for Beijing Kolmar.

Share price performance



12-month range	29,000-64,100
Market cap (USDbn)	1.23
3m avg daily turnover (USDm)	9.37
Shares outstanding (m)	21
Major shareholder	Korea Kolmar Holdings (19.1%)

Financial summary (KRW)

Year to 31 Dec	15E	16E	17E
Revenue (bn)	524	592	660
Operating profit (bn)	53	61	71
Net profit (bn)	37	43	51
Core EPS (fully-diluted)	1,732	2,040	2,411
EPS change (%)	13.4	17.7	18.2
Daiwa vs Cons. EPS (%)	(8.0)	(5.8)	(15.1)
PER (x)	37.0	31.4	26.6
Dividend yield (%)	0.3	0.3	0.4
DPS	180	220	250
PBR (x)	n.a.	n.a.	n.a.
EV/EBITDA (x)	19.9	17.2	14.5
ROE (%)	18.5	18.3	18.2

Source: FactSet, Daiwa forecasts

1 Buy
2 Outperform
3 Hold (initiation)
4 Underperform
5 Sell

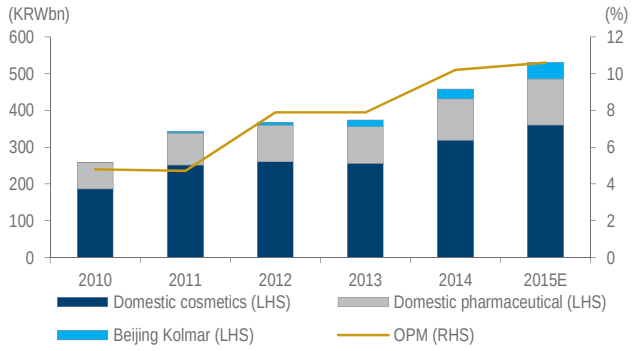
How do we justify our view?

- Growth outlook ✔✔✔✔✔
- Valuation ✔✔✔✔✔
- Earnings revisions ✔✔✔✔✔

Growth outlook ✔✔✔✔✔

We forecast moderate revenue growth of 13.5% YoY to KRW523.6bn overall for Korea Kolmar in 2015 as we expect its major clients to engage in fierce price competition. In terms of the individual businesses, we forecast domestic cosmetics to post revenue of KRW360bn (up 12.5% YoY), pharmaceuticals to see a 12.0% YoY rise in revenue to KRW125.5bn, and the China operation to post revenue of KRW44.4bn (up 62.1% YoY). The company's overall operating profit should come in at KRW53bn in 2015, up 13.5% YoY. With the proportion of high-margin products rising for Beijing Kolmar, we forecast the operating profit margin for this business to increase by 0.4pp to 10.6%.

Korea Kolmar: revenue by division and operating profit margin

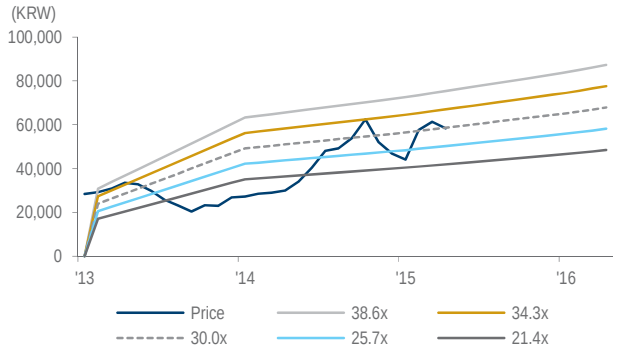


Source: Company, Daiwa estimates

Valuation ✔✔✔✔✔

The stock is trading currently at a 2015E PER of 37.0x, compared with 34.0x for its closest peer Cosmax. We believe the discount is justified considering the difference between the 2 companies in terms of revenue growth, Chinese business exposure, and number of overseas affiliates (ie, outside China). Until these differences narrow, we believe this valuation gap will persist.

Korea Kolmar: 12-month PER band



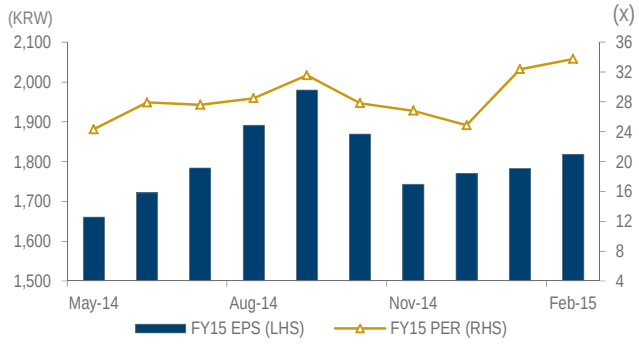
Source: Daiwa

Earnings revisions ✔✔✔✔✔

The Bloomberg consensus revised down its 2015 EPS forecast for Korea Kolmar in 2H14, likely due to the disappointing performance of Beijing Kolmar, though the market's forecast has risen this year.

Our forecasts are broadly in line with the consensus numbers. We think there could be potential upside to 2015 forecasts for the Korea cosmetics business, with major clients planning to go public in order to raise funds to expand their overseas businesses.

Korea Kolmar: Bloomberg consensus EPS and PER



Source: Bloomberg

Financial summary

Key assumptions

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
One brand shop growth (yoy%)	n.a.	n.a.	n.a.	15.00	15.36	13.50	12.00	10.00
Atomy growth (yoy%)	n.a.	n.a.	n.a.	50.00	35.00	30.00	25.00	20.00
Global MNC sales growth (yoy%)	n.a.	n.a.	n.a.	8.00	35.00	40.00	35.00	30.00
Pharmaceutical CMO industry growth (yoy%)	n.a.	n.a.	n.a.	1.61	2.70	12.00	10.80	9.72

Profit and loss (KRWbn)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Cosmetics	n.a.	n.a.	124	190	319	360	401	439
Pharmaceuticals	n.a.	n.a.	50	78	112	125	139	153
Other Revenue	n.a.	n.a.	4	15	30	38	52	69
Total Revenue	0	0	178	282	461	524	592	660
Other income	0	0	3	5	7	7	7	8
COGS	0	0	(142)	(226)	(360)	(409)	(461)	(512)
SG&A	0	0	(21)	(37)	(54)	(62)	(70)	(77)
Other op.expenses	0	0	(3)	(5)	(7)	(7)	(7)	(8)
Operating profit	0	0	14	20	47	53	61	71
Net-interest inc./(exp.)	0	0	(1)	(2)	(2)	(2)	(2)	(1)
Assoc/forex/extraord./others	0	0	(1)	(3)	(4)	(2)	(2)	(2)
Pre-tax profit	0	0	12	14	41	49	57	67
Tax	0	0	(1)	(2)	(10)	(12)	(14)	(17)
Min. int./pref. div./others	0	0	0	0	0	0	0	0
Net profit (reported)	0	0	11	12	31	37	43	51
Net profit (adjusted)	0	0	11	12	31	37	43	51
EPS (reported)(KRW)	n.a.	n.a.	559	619	1,527	1,732	2,040	2,411
EPS (adjusted)(KRW)	n.a.	n.a.	559	619	1,527	1,732	2,040	2,411
EPS (adjusted fully-diluted)(KRW)	n.a.	n.a.	559	619	1,527	1,732	2,040	2,411
DPS (KRW)	0	0	0	105	160	180	220	250
EBIT	0	0	14	20	47	53	61	71
EBITDA	0	0	19	28	60	66	75	85

Cash flow (KRWbn)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Profit before tax	0	0	12	14	41	49	57	67
Depreciation and amortisation	0	0	3	5	7	7	7	8
Tax paid	0	0	(0)	(2)	(4)	(5)	(6)	(7)
Change in working capital	0	0	(4)	1	(13)	(17)	(8)	(8)
Other operational CF items	0	0	3	7	5	(5)	(6)	(8)
Cash flow from operations	0	0	14	25	34	28	43	52
Capex	0	0	(5)	(18)	(37)	(18)	(18)	(8)
Net (acquisitions)/disposals	0	0	(16)	(53)	22	(8)	(9)	(9)
Other investing CF items	0	0	(1)	(2)	(1)	0	0	0
Cash flow from investing	0	0	(22)	(72)	(16)	(26)	(27)	(17)
Change in debt	0	0	8	56	(24)	(0)	0	0
Net share issues/(repurchases)	0	0	0	0	13	0	0	0
Dividends paid	0	0	0	(2)	(2)	(3)	(4)	(5)
Other financing CF items	0	0	0	1	1	2	2	1
Cash flow from financing	0	0	8	55	(12)	(2)	(2)	(3)
Forex effect/others	0	0	(0)	0	0	0	0	0
Change in cash	0	0	0	8	7	1	14	32
Free cash flow	0	0	8	7	(3)	10	25	44

Source: FactSet, Daiwa forecasts

Financial summary continued ...

Balance sheet (KRWbn)

As at 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Cash & short-term investment	0	0	37	97	80	88	111	152
Inventory	0	0	36	32	37	42	48	53
Accounts receivable	0	0	75	70	92	104	118	132
Other current assets	0	0	0	0	0	0	0	0
Total current assets	0	0	148	199	209	235	277	337
Fixed assets	0	0	79	94	128	139	151	153
Goodwill & intangibles	0	0	4	4	4	3	3	3
Other non-current assets	0	0	(0)	(2)	(4)	(4)	(4)	(4)
Total assets	0	0	230	295	336	374	428	488
Short-term debt	0	0	39	47	23	40	40	40
Accounts payable	0	0	64	60	75	75	85	94
Other current liabilities	0	0	10	19	46	35	37	38
Total current liabilities	0	0	113	126	144	150	161	172
Long-term debt	0	0	0	0	0	0	0	0
Other non-current liabilities	0	0	19	55	13	9	11	12
Total liabilities	0	0	132	181	157	159	172	184
Share capital	0	0	10	10	11	11	11	11
Reserves/R.E./others	0	0	88	104	169	204	245	293
Shareholders' equity	0	0	98	114	180	215	256	303
Minority interests	0	0	0	0	0	0	0	0
Total equity & liabilities	0	0	230	295	336	374	428	488
EV	1,353	1,353	1,353	1,301	1,294	1,302	1,279	1,238
Net debt/(cash)	0	0	2	(50)	(57)	(48)	(71)	(112)
BVPS (KRW)	n.a.	n.a.	5	6	9	10	12	14

Key ratios (%)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Sales (YoY)	n.a.	n.a.	n.a.	58.8	63.4	13.5	13.1	11.5
EBITDA (YoY)	n.a.	n.a.	n.a.	46.7	113.1	9.4	13.7	14.4
Operating profit (YoY)	n.a.	n.a.	n.a.	40.1	138.0	13.5	14.9	15.9
Net profit (YoY)	n.a.	n.a.	n.a.	10.7	153.3	19.7	17.7	18.2
Core EPS (fully-diluted) (YoY)	n.a.	n.a.	n.a.	10.7	146.8	13.4	17.7	18.2
Gross-profit margin	n.a.	n.a.	19.9	20.1	21.8	21.9	22.2	22.4
EBITDA margin	n.a.	n.a.	10.8	10.0	13.0	12.5	12.6	12.9
Operating-profit margin	n.a.	n.a.	7.9	7.0	10.2	10.2	10.3	10.7
Net profit margin	n.a.	n.a.	6.1	4.3	6.6	7.0	7.3	7.7
ROAE	n.a.	n.a.	22.3	11.4	20.8	18.5	18.3	18.2
ROAA	n.a.	n.a.	9.5	4.6	9.7	10.3	10.7	11.1
ROCE	n.a.	n.a.	20.5	13.2	25.7	23.3	22.2	22.2
ROIC	n.a.	n.a.	25.1	20.0	37.5	27.6	26.2	28.4
Net debt to equity	n.a.	n.a.	2.2	n.a.	n.a.	n.a.	n.a.	n.a.
Effective tax rate	0.0	0.0	10.6	16.6	25.0	25.0	24.7	24.5
Accounts receivable (days)	n.a.	n.a.	77.4	93.8	63.9	68.4	68.5	69.0
Current ratio (x)	n.a.	n.a.	1.3	1.6	1.5	1.6	1.7	2.0
Net interest cover (x)	n.a.	n.a.	13.2	9.8	20.7	27.0	36.4	51.1
Net dividend payout	n.a.	n.a.	0.0	17.0	10.5	10.4	10.8	10.4
Free cash flow yield	0.0	0.0	0.6	0.5	n.a.	0.8	1.9	3.2

Source: FactSet, Daiwa forecasts

Company profile

Korea Kolmar is an ODM company offering contract designing, manufacturing and distribution services for health and beauty products. Its product portfolio includes skin care, make-up, body care, hair care, perfumes and pharmaceutical and quasi drugs. It has 4 research and development centres, and 6 manufacturing facilities.

The 10-second briefing

Able C&C
078520 KS

Target (KRW): **22,000**
Downside: **33.3%**
25 Mar price (KRW): **33,000**

Initiation: back to a low-price strategy

- We forecast a modest revenue recovery in 2015 as the company shifts its focus to low-end products
- It is seeking to boost profitability by cutting unnecessary costs
- Initiating with a Sell (5) rating and TP of KRW22,000; concern over possibility of domestic market competition intensifying

1 Buy
2 Outperform
3 Hold
4 Underperform
5 Sell (initiation)

How do we justify our view?

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Investment case

Moderate recovery likely for 2015. We forecast Able C&C's revenue to rebound by 3.4% YoY to KRW453.5bn this year. We also look for profitability to improve on continued cost-cutting, and expect its operating-profit margin to widen by 2.1pp to 3.6% in 2015.

Shift in strategy. The company has switched focus this year by lowering prices. In February, it launched a new cushion foundation product priced at KRW4,800. Also, it has cut by 10% the prices of its bestselling items, The First Treatment Essence and Night Repair Science Activator Ample. As these products were previously priced at KRW42,000, well above the company's ASP of KRW12,000, we believe a YoY decline in its ASP is highly likely in 2015.

Domestic business to focus on improving profitability. Able C&C's operating margin narrowed to 1.5% in 2014, from 11.9% in 2012, due to substantial marketing expenditures, which the company targets to cut by 30% (KRW10bn) this year. It will also continue to close loss-making stores. Through these efforts, we expect it to save KRW20bn in 2015, which should support a 2.1pp YoY rise in its overall operating margin to 3.6%.

Catalysts

IPOs of other one-brand shops. Forthcoming public offerings by competitors should highlight to investors the global expansion of one-brand shops. Tonymoly and Nature Republic plan to go public this year. In 2014, Able C&C derived 12.6% of its revenue overseas. Although this proportion is lower than for the top-tier brands, we think it underlines the business potential of global expansion.

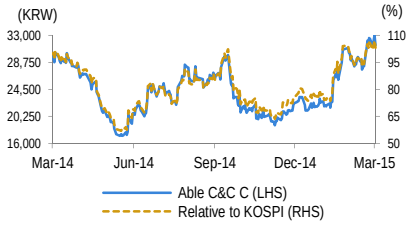
Valuation

The stock is trading currently at a 25.9x 2015E PER, vs. the domestic sector's average multiple of 31.1x. We believe the stock merits a discount to the sector, as we expect its revenue growth and profitability to trail those of its peers. With a DCF-based 12-month target price of KRW22,000, we initiate coverage with a Sell (5) rating.

Risks

Price competition. The main upside and downside risks to our call would be more or less intense price competition than we currently assume in 2015. Skin Food, a major competitor to Able C&C's Missha brand, recently dropped its "no sale" policy, while the launch of Amazon Korea could prompt lower-tier brands to make steeper discounts.

Share price performance



12-month range	17,181-33,000
Market cap (USDbn)	0.38
3m avg daily turnover (USDm)	12.33
Shares outstanding (m)	13
Major shareholder	Young Pil Seo (29.1%)

Financial summary (KRW)

Year to 31 Dec	15E	16E	17E
Revenue (bn)	453	496	547
Operating profit (bn)	16	20	24
Net profit (bn)	16	18	22
Core EPS (fully-diluted)	1,273	1,429	1,791
EPS change (%)	173.8	12.2	25.3
Daiwa vs Cons. EPS (%)	(14.7)	(23.6)	(20.4)
PER (x)	25.9	23.1	18.4
Dividend yield (%)	0.3	0.3	0.3
DPS	100	100	100
PBR (x)	2.3	2.1	1.9
EV/EBITDA (x)	15.7	13.2	10.9
ROE (%)	9.0	9.4	11.0

Source: FactSet, Daiwa forecasts

1 Buy
2 Outperform
3 Hold
4 Underperform
5 Sell (initiation)

How do we justify our view?

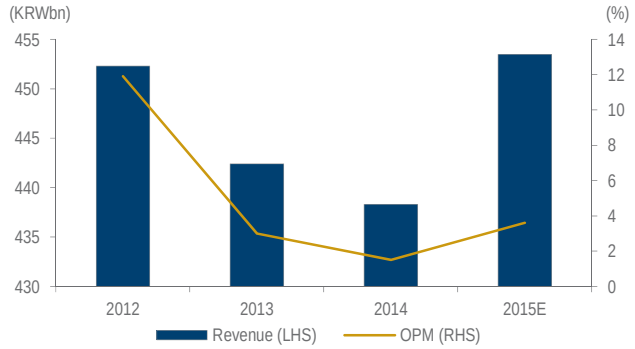
- Growth outlook ✔✔✔✔✔
- Valuation ✔✔✔✔✔
- Earnings revisions ✔✔✔✔✔

Growth outlook ✔✔✔✔✔

We forecast Able C&C to see modest revenue growth of 3.4% YoY to KRW453.5bn in 2015. As for its domestic revenue, we forecast a turnaround from a 1% YoY contraction in 2014 to growth of 2.3% YoY in 2015 (to KRW407.5bn). The company is now seeking to attract consumers with low-end products, but we are concerned this approach might trigger price competition, which in turn could be a drag on efforts to boost profitability.

Factoring in only the company's efforts to cut unnecessary costs, we forecast its overall operating margin to improve by 2.1pp to 3.6% this year.

Able C&C: revenue and operating profit margin



Source: Able C&C, Daiwa estimates

Valuation ✔✔✔✔✔

We initiate coverage of Able C&C with a Sell (5) rating and 12-month target price of KRW22,000. We derive our target price using a DCF valuation (see table for underlying assumptions).

The stock is trading currently at a 25.9x 2015E PER. We expect its revenue growth rate and profitability, as well as its exposure to China through its affiliate, to be inferior to those of its peers, and hence see the prevailing valuation gap between the stock and the sector as reasonable.

Able C&C: DCF valuation

(KRWbn)	2015E	2016E	2017E	2018E	2019E	2020E	2021E
Operating EBIT	16.2	19.7	23.9	26.3	27.9	29.6	31.3
NOPAT	11.8	14.3	17.4	19.7	21.3	23.0	24.7
Gross Cash flow	16.3	18.9	22.1	24.6	26.3	28.2	30.0
Free Cash Flow to firm (FCFF)	8.1	6.8	8.9	8.9	9.4	9.9	10.2
Present Value Interest Factor (PVIF)	0.96	0.91	0.86	0.82	0.78	0.74	0.70
Present Value of FCFF	7.8	6.2	7.7	7.3	7.3	7.3	7.1
Sum of FCFF	51						
Terminal value	151						
Total OpIC Value	202						
Net Cash	80						
Appraised value	282						
# of Shares Outstanding (m)	12.8						
Appraised share value (KRW)	22,000						

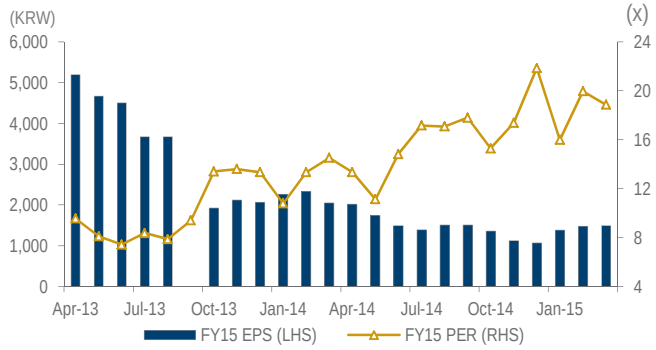
Source: Daiwa

Earnings revisions ✔✔✔✔✔

Although the Bloomberg consensus 2015 EPS forecast for Able C&C declined steadily throughout 2014, the share price has moved in the opposite direction, likely due to expectations of margin expansion.

We believe the company will have to prove it can come up with another hit item for the consensus earnings forecast to rise significantly from its current level. In the absence of another hit product, we expect Able C&C to face difficulty growing earnings in both the domestic and overseas markets.

Able C&C: Bloomberg-consensus EPS forecast and PER trend



Source: Bloomberg

Financial summary

■ Key assumptions

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Number of domestic directly owned stores (unit)	n.a.	n.a.	249.0	293.0	307.0	322.0	337.0	352.0
Sales per directly owned store (KRW m)	n.a.	n.a.	679.0	520.0	500.0	475.0	498.0	523.0
Number of domestic franchise stores (unit)	n.a.	n.a.	369.0	438.0	499.0	534.0	569.0	604.0
Sales per franchise store (KRW m)	n.a.	n.a.	739.0	660.0	480.0	456.0	478.0	502.0

■ Profit and loss (KRWbn)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Korea	n.a.	n.a.	425	401	398	408	449	493
China	n.a.	n.a.	18	34	39	47	55	64
Other Revenue	n.a.	n.a.	9	7	1	(1)	(7)	(10)
Total Revenue	243	330	452	442	438	453	496	547
Other income	5	6	8	5	6	4	5	5
COGS	(74)	(93)	(131)	(141)	(141)	(145)	(158)	(173)
SG&A	(139)	(203)	(268)	(288)	(290)	(292)	(319)	(350)
Other op.expenses	(5)	(6)	(8)	(5)	(6)	(4)	(5)	(5)
Operating profit	29	34	54	13	7	16	20	24
Net-interest inc./(exp.)	1	2	4	4	3	3	4	4
Assoc/forex/extraord./others	2	3	4	4	(2)	1	1	1
Pre-tax profit	33	39	61	21	8	20	24	29
Tax	(8)	(8)	(15)	(5)	(2)	(5)	(6)	(7)
Min. int./pref. div./others	0	0	0	0	0	0	0	0
Net profit (reported)	25	31	46	16	6	16	19	22
Net profit (adjusted)	25	31	46	16	6	16	18	22
EPS (reported)(KRW)	2,668	2,998	3,979	1,288	453	1,241	1,472	1,746
EPS (adjusted)(KRW)	2,668	2,998	3,979	1,288	453	1,241	1,393	1,746
EPS (adjusted fully-diluted)(KRW)	2,095	2,575	3,738	1,325	465	1,273	1,429	1,791
DPS (KRW)	450	550	350	60	100	100	100	100
EBIT	29	34	54	13	7	16	20	24
EBITDA	34	40	62	19	13	21	25	29

■ Cash flow (KRWbn)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Profit before tax	33	39	61	21	8	20	24	29
Depreciation and amortisation	5	6	8	5	6	4	5	5
Tax paid	0	(8)	(12)	(12)	(4)	(9)	(10)	(13)
Change in working capital	(3)	11	(23)	10	(28)	(2)	(6)	(7)
Other operational CF items	(0)	1	3	8	8	0	1	2
Cash flow from operations	34	49	38	32	(10)	15	13	16
Capex	(8)	(8)	(11)	(10)	(6)	(6)	(6)	(6)
Net (acquisitions)/disposals	(7)	(6)	(5)	(4)	(3)	(2)	(1)	0
Other investing CF items	(12)	(20)	(22)	(19)	0	(1)	(7)	(10)
Cash flow from investing	(27)	(34)	(38)	(33)	(9)	(9)	(14)	(16)
Change in debt	(0)	(0)	(0)	0	0	0	0	0
Net share issues/(repurchases)	(0)	(0)	(0)	(0)	(0)	0	0	0
Dividends paid	(0)	(2)	(4)	(5)	(3)	(1)	(1)	(1)
Other financing CF items	(0)	1	(0)	6	(0)	1	1	1
Cash flow from financing	(0)	(2)	(4)	1	(4)	0	(0)	(0)
Forex effect/others	0	0	(0)	(0)	(0)	0	0	0
Change in cash	6	12	(4)	(0)	(23)	6	(1)	(1)
Free cash flow	26	41	27	22	(16)	9	7	10

Source: FactSet, Daiwa forecasts

Financial summary continued ...

Balance sheet (KRWbn)

As at 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Cash & short-term investment	48	79	95	111	81	89	95	103
Inventory	17	30	44	28	39	41	44	49
Accounts receivable	23	28	40	35	37	38	41	46
Other current assets	0	3	1	1	2	2	2	3
Total current assets	88	140	179	176	159	170	184	200
Fixed assets	11	16	20	24	22	25	27	29
Goodwill & intangibles	3	4	3	3	3	2	2	1
Other non-current assets	25	28	33	36	44	46	51	56
Total assets	127	188	235	239	228	243	263	286
Short-term debt	0	0	0	0	0	0	0	0
Accounts payable	34	57	67	62	51	53	58	64
Other current liabilities	4	10	9	2	1	1	1	1
Total current liabilities	38	67	76	63	52	54	59	65
Long-term debt	1	0	1	1	1	2	2	2
Other non-current liabilities	3	8	6	6	6	6	7	8
Total liabilities	41	74	83	70	59	62	68	75
Share capital	4	5	5	6	6	6	6	6
Reserves/R.E./others	82	109	147	163	163	175	188	205
Shareholders' equity	86	113	152	168	170	181	195	212
Minority interests	0	0	0	0	0	0	0	0
Total equity & liabilities	127	188	235	239	228	243	263	286
EV	373	342	328	311	341	333	327	319
Net debt/(cash)	(48)	(79)	(93)	(110)	(80)	(88)	(94)	(101)
BVPS (KRW)	9,436	11,326	13,490	13,549	13,641	14,573	15,675	17,027

Key ratios (%)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Sales (YoY)	34.2	35.8	36.9	(2.2)	(0.9)	3.4	9.5	10.2
EBITDA (YoY)	44.8	17.2	54.2	(70.0)	(30.9)	64.7	17.4	17.6
Operating profit (YoY)	52.0	14.1	59.8	(75.4)	(48.8)	140.3	21.7	21.3
Net profit (YoY)	82.2	23.3	48.2	(64.2)	(64.8)	173.8	12.2	25.3
Core EPS (fully-diluted) (YoY)	81.2	22.9	45.2	(64.6)	(64.9)	173.8	12.2	25.3
Gross-profit margin	69.5	71.8	71.1	68.0	67.8	68.0	68.2	68.4
EBITDA margin	14.1	12.2	13.7	4.2	2.9	4.7	5.0	5.3
Operating-profit margin	12.1	10.2	11.9	3.0	1.5	3.6	4.0	4.4
Net profit margin	10.3	9.4	10.2	3.7	1.3	3.5	3.6	4.1
ROAE	34.2	31.1	34.6	10.2	3.4	9.0	9.4	11.0
ROAA	23.1	19.7	21.7	6.9	2.5	6.7	7.0	8.1
ROCE	39.6	33.6	40.1	8.1	4.0	9.2	10.4	11.7
ROIC	61.3	73.1	85.9	17.5	6.4	13.7	15.7	17.4
Net debt to equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Effective tax rate	23.8	20.8	24.8	21.7	29.2	22.7	23.1	23.4
Accounts receivable (days)	30.3	27.8	27.1	30.8	29.9	29.9	29.1	29.0
Current ratio (x)	2.3	2.1	2.4	2.8	3.1	3.2	3.1	3.1
Net interest cover (x)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net dividend payout	16.9	18.3	8.8	4.7	22.1	8.1	6.8	5.7
Free cash flow yield	6.2	9.7	6.3	5.1	n.a.	2.1	1.8	2.3

Source: FactSet, Daiwa forecasts

Company profile

Able C&C provides and distributes a wide range of cosmetics products under the brand names MISSHA, A'PIEU, BeautyNET, The Style, M and others. Its products include skincare, body care, make-up and hair-care cosmetics. The company has stores in Hong Kong, Japan, Taiwan, China, the UAE, Bahrain, Oman, Venezuela, the US and Paraguay in the form of franchise, retail, and online shops.

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