

Korea Kumho Petrochemicals (011780.KS): Earnings at inflection point; initiate with Buy

Source of opportunity

We initiate on Kumho Petrochemical with a Buy rating and a 12-month, SOTP-based target price of W250,000, which offers 18% upside potential.

(a) **Earnings at inflection point:** We believe that margins are likely to bottom out after 3Q11, and we look for SBR margins to recover to around 15% in 4Q11 on the back of recent normalizing price levels for BD. Also, we see signs of demand stabilization thanks to the recent tightening impact in China on rubber demand; we anticipate restocking opportunities over the coming quarters.

b) **Long-term growth sustained:** GS's solid outlook on global tire demand is about 10% for 2012E. Structural tightness for synthetic rubber should be supported by the decent demand outlook for emerging markets such as in China (we estimate about 14% PC tire growth through 2017). In particular, we focus on the long-term growth outlook in the replacement tire market demands following the automobile market expansion over the last few years, along with potential SSBR needs from the developed markets in the coming years while still in earlier stages.

c) **Restructuring story intact with meaningful improvement in balance sheet quality:** We expect Kumho to see continued balance sheet improvement, as one of the world's largest synthetic rubber producer. The company continues to its restructuring, stepping out of its previous group-related woes. We expect Kumho's net debt/equity to come down to 33% in 2012E from 206% in 2010, on the back of stronger free cash flows from operations.

Catalysts

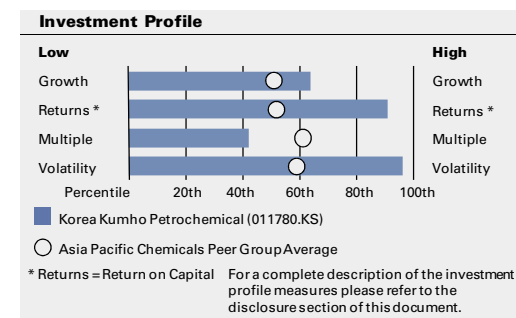
Stronger earnings momentum in 4Q11, with margins recovering would drive growth. We expect synthetic Rubber – Butadiene margins to remain at healthy levels in the longer run.

Valuation

Our 12-month P/B vs. ROE based target price is W250,000, implying 18% upside potential. We believe valuation remains compelling at P/B of 2.9X 2012 vs. ROE of 41% and 8.3X 2012E P/E.

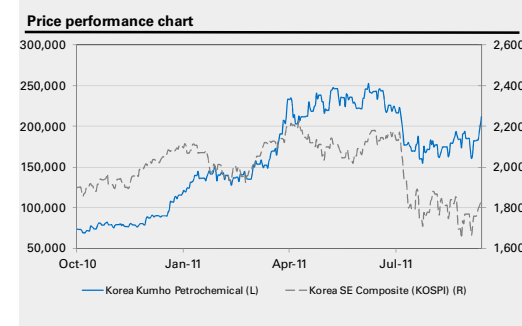
Key risks

Our key downside risks to our investment thesis and target price are weaker-than-expected global GDP trends, further tightening measures taken in China, and end tire demand weaknesses.



Key data	Current
Price (W)	212,000
12 month price target (W)	250,000
Market cap (W bn / US\$ mn)	5,390.0 / 4,663.0
Foreign ownership (%)	22.9

	12/10	12/11E	12/12E	12/13E
EPS (W)	18,404	26,571	25,404	32,193
EPS growth (%)	175.0	44.4	(4.4)	26.7
EPS (diluted) (W)	18,404	22,173	25,404	32,193
EPS (basic pre-ex) (W)	18,404	26,571	25,404	32,193
P/E (X)	11.5	8.0	8.3	6.6
P/B (X)	6.4	4.3	2.9	2.0
EV/EBITDA (X)	4.2	5.4	4.9	3.5
Dividend yield (%)	0.5	0.5	0.5	0.5
ROE (%)	71.4	57.6	41.4	36.2



Share price performance (%)	3 month	6 month	12 month
Absolute	(14.0)	15.8	186.5
Rel. to Korea SE Composite (KOSPI)	(0.2)	35.1	196.5

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 10/14/2011 close.

Exhibit 54: Korea Kumho Petrochemicals Summary Financials

Profit model (W bn)	12/10	12/11E	12/12E	12/13E	Balance sheet (W bn)	12/10	12/11E	12/12E	12/13E
Total revenue	5,718.5	6,817.4	7,512.6	8,247.6	Cash & equivalents	210.4	676.2	863.4	1,359.9
Cost of goods sold	(4,747.2)	(5,439.9)	(5,959.3)	(6,418.4)	Accounts receivable	425.0	506.7	558.4	613.0
SG&A	(317.5)	(350.0)	(367.5)	(385.9)	Inventory	516.9	616.2	679.0	745.5
R&D	--	--	--	--	Other current assets	283.1	283.1	283.1	283.1
Other operating profit/(expense)	0.0	0.0	0.0	0.0	Total current assets	1,435.4	2,082.2	2,383.9	3,001.5
EBITDA	833.3	1,306.8	1,503.8	1,800.4	Net PP&E	2,151.8	2,181.4	2,170.5	2,119.0
Depreciation & amortization	(179.4)	(279.3)	(318.1)	(357.2)	Net intangibles	50.9	41.9	34.8	29.0
EBIT	653.9	1,027.5	1,185.7	1,443.2	Total investments	611.4	652.3	703.4	767.3
Interest income	7.6	17.5	34.2	54.9	Other long-term assets	145.8	145.8	145.8	145.8
Interest expense	(141.7)	(104.9)	(101.8)	(81.5)	Total assets	4,395.2	5,103.6	5,438.4	6,062.6
Income/(loss) from uncons. subs.	3.5	40.9	51.1	63.9	Accounts payable	437.7	521.8	575.0	631.2
Others	187.7	40.0	0.0	0.0	Short-term debt	1,396.3	1,323.4	977.3	665.7
Pretax profits	710.9	1,020.9	1,169.2	1,480.5	Other current liabilities	371.6	373.0	380.0	380.1
Income tax	(173.9)	(247.1)	(282.9)	(358.3)	Total current liabilities	2,205.6	2,218.2	1,932.2	1,677.1
Minorities	(65.9)	(95.0)	(108.8)	(137.8)	Long-term debt	1,023.6	975.4	746.9	541.2
Net income pre-preferred dividends	471.1	678.9	777.5	984.5	Other long-term liabilities	97.4	97.4	97.4	97.4
Preferred dividends	(3.2)	(3.3)	(3.5)	(3.6)	Total long-term liabilities	1,120.9	1,072.8	844.3	638.6
Net income (pre-exceptionals)	467.9	675.5	774.0	980.9	Total liabilities	3,326.5	3,291.0	2,776.5	2,315.6
Post-tax exceptionals	0.0	0.0	0.0	0.0	Preferred shares	15.1	15.1	15.1	15.1
Net income	467.9	675.5	774.0	980.9	Total common equity	848.4	1,497.2	2,237.7	3,185.1
EPS (basic, pre-exception) (W)	18,404	26,571	25,404	32,193	Minority interest	205.2	300.2	409.0	546.8
EPS (basic, post-exception) (W)	18,404	26,571	25,404	32,193	Total liabilities & equity	4,395.2	5,103.6	5,438.4	6,062.6
EPS (diluted, post-exception) (W)	18,404	22,173	25,404	32,193	BVPS (W)	33,369	49,142	73,446	104,539
DPS (W)	1,000	1,050	1,100	1,100					
Dividend payout ratio (%)	5.4	4.0	4.3	3.4					
Free cash flow yield (%)	22.4	11.4	12.3	16.3					
Growth & margins (%)	12/10	12/11E	12/12E	12/13E	Ratios	12/10	12/11E	12/12E	12/13E
Sales growth	(17.1)	19.2	10.2	9.8	ROE (%)	71.4	57.6	41.4	36.2
EBITDA growth	70.4	56.8	15.1	19.7	ROA (%)	7.0	14.2	14.7	17.1
EBIT growth	492.5	57.1	15.4	21.7	ROACE (%)	12.5	24.9	26.8	32.0
Net income growth	175.0	44.4	14.6	26.7	Inventory days	57.5	38.0	39.7	40.5
EPS growth	175.0	44.4	(4.4)	26.7	Receivables days	49.4	24.9	25.9	25.9
Gross margin	17.0	20.2	20.7	22.2	Payable days	69.3	32.2	33.6	34.3
EBITDA margin	14.6	19.2	20.0	21.8	Net debt/equity (%)	206.7	89.5	32.3	(4.1)
EBIT margin	11.4	15.1	15.8	17.5	Interest cover - EBIT (X)	4.9	11.8	17.5	54.2
Cash flow statement (W bn)	12/10	12/11E	12/12E	12/13E	Valuation	12/10	12/11E	12/12E	12/13E
Net income pre-preferred dividends	471.1	678.9	777.5	984.5	P/E (analyst) (X)	11.5	8.0	8.3	6.6
D&A add-back	179.4	279.3	318.1	357.2	P/B (X)	6.4	4.3	2.9	2.0
Minorities interests add-back	65.9	95.0	108.8	137.8	EV/EBITDA (X)	4.2	5.4	4.9	3.5
Net (inc)/dec working capital	234.2	(96.9)	(61.3)	(64.8)	Dividend yield (%)	0.5	0.5	0.5	0.5
Other operating cash flow	(390.9)	(40.9)	(51.1)	(63.9)					
Cash flow from operations	559.7	915.4	1,091.9	1,350.7					
Capital expenditures	(275.6)	(300.0)	(300.0)	(300.0)					
Acquisitions	0.0	0.0	0.0	0.0					
Divestitures	112.0	0.0	0.0	0.0					
Others	(5.0)	0.0	0.0	0.0					
Cash flow from investments	(168.6)	(300.0)	(300.0)	(300.0)					
Dividends paid (common & pref)	(13.2)	(28.6)	(30.0)	(37.0)					
Inc/(dec) in debt	(219.9)	(121.0)	(574.7)	(517.2)					
Common stock issuance (repurchase)	0.0	0.0	0.0	0.0					
Other financing cash flows	(78.9)	0.0	0.0	0.0					
Cash flow from financing	(312.1)	(149.6)	(604.7)	(554.2)					
Total cash flow	79.0	465.8	187.2	496.5					

Note: Last actual year may include reported and estimated data.

Source: Company data, Goldman Sachs Research estimates.

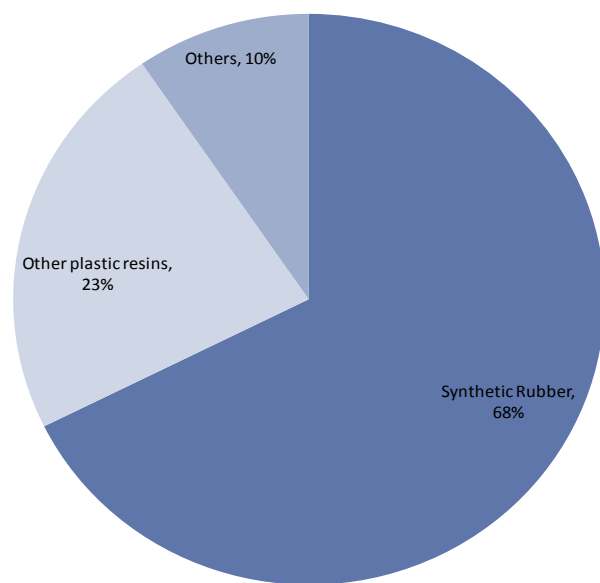
Source: Company data, Goldman Sachs Research estimates.

Exhibit 55: Our SOTP analysis for Kumho Petrochemical

SOTP (W bn, %)	Stake (%)	2012E Base (W bn)	Implied Value (W bn)	% of total NAV	Comment
Kumho Petrochemicals (Parent)		1,018	6,617	72%	Applying 6.5X 2012E EV/EBITDA (mid-cycle avg for Kumho Petrochemical)
Kumho P&B Chem	78.2%	314	1,436	16%	Applying 6.5X 2012E EV/EBITDA with 10% holding co discount
Total operating value			8,053		
Investment Assets		555	388	4%	Applying 30% investment holdings discount
Treasury shares		1,085	759	8%	Applying current market price value and 30% investment holding discount
Total investment asset value			1,148		
subtract 2012E Net Debt (W bn)			886		
subtract 2012E Minority Interest (W bn)			405		
subtract Preferred shares			587		
No. of shares (mn)			30		Fully diluted no. of shares post potential CB conversion
Total NAV (W bn)			7,323		
Total NAV per share (W /sh)			250,000		
Implied P/B			3.4		
Implied P/E			10.0		
ROE (%)			41%		

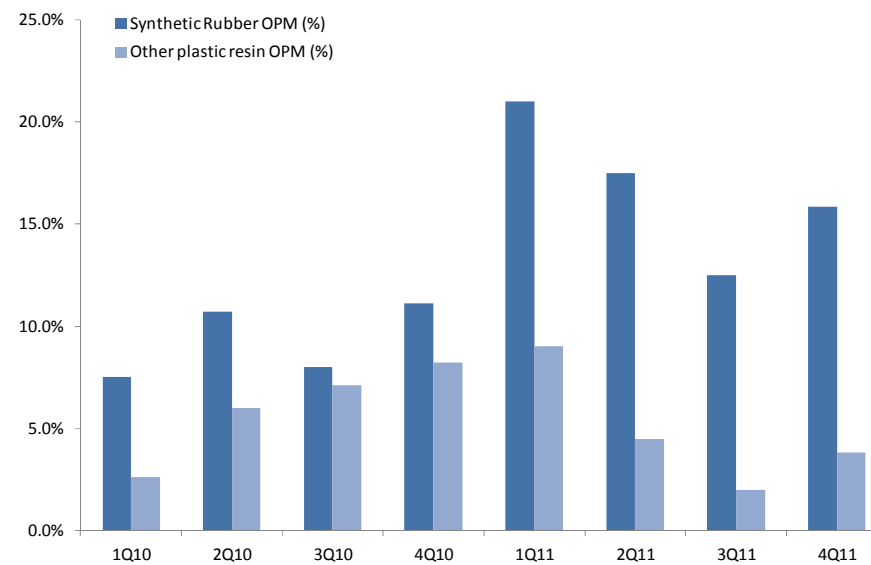
Source: Company data, Datastream, Goldman Sachs Research estimates.

Exhibit 56: Kumho's parent EBIT 2012E breakdown (%)



Source: Company data, Goldman Sachs Research estimates.

Exhibit 57: We expect 3Q11 to roughly bottom out Kumho's quarterly OPM (%) trends (parent)



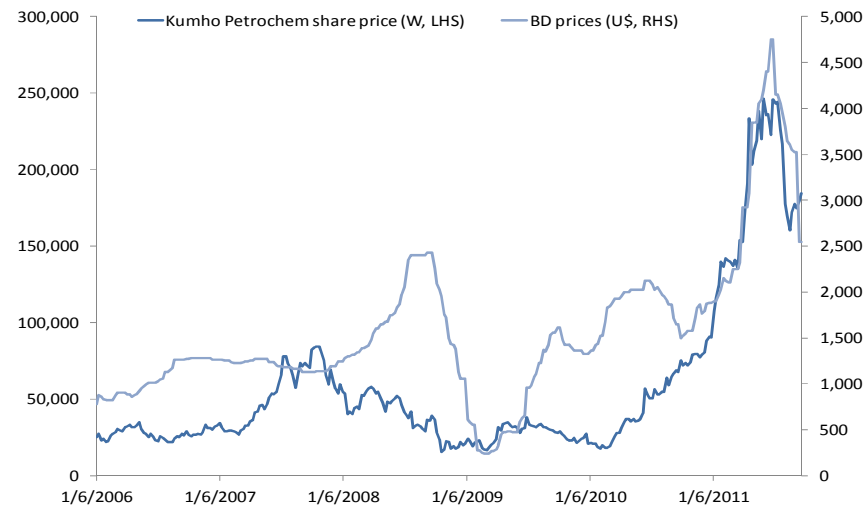
Source: Company data, Goldman Sachs Research estimates.

Exhibit 58: Historical EV/EBITDA trends (parent basis)



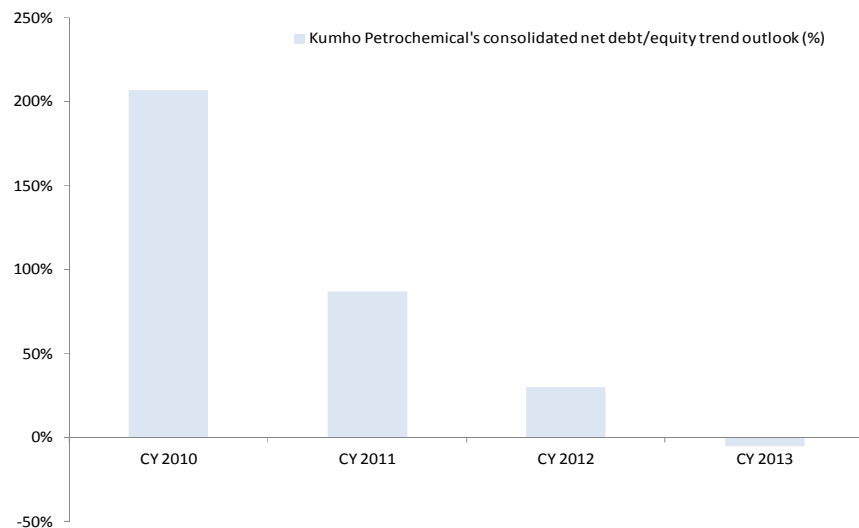
Source: Company data, Datastream, Goldman Sachs Research estimates.

Exhibit 59: Kumho share price vs. BD prices



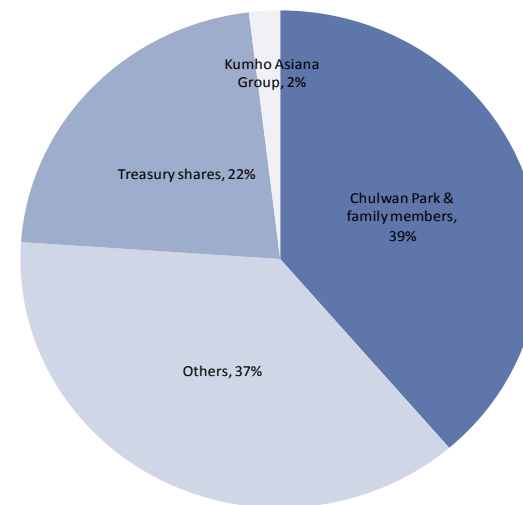
Source: Company data, Goldman Sachs Research estimates.

Exhibit 60: Kumho to see balance sheet quality improvement, in our view
Kumho Petrochemical's Inet debt/equity (%) trends



Source: Company data, Goldman Sachs Research estimates

Exhibit 61: Shareholding structure



Source: Company data, Goldman Sachs Research