



# Daehan Flour Millss (001130)

May 5, 2007  
Flour Mills

## BUY

Target Price : ₩231,500  
Current Price : ₩204,000  
Safety Margin : 6.6%

Market Cap. : ₩344.8 bn

ROE : 8.8%

OP Margin: 11.5%

PER : 9.2 x

PBR: 0.76 x

Div. Yield: 0.66%

52wks Beta : 0.86

52wks High : ₩229,000

52wks Low : ₩115,500

Foreign Shares : 15.8%

Major Shareholder :

Jong-gak Lee

& affiliates (32.00%)

## SERT

김경한. Colin K. Kim

김수민. Brian Kim

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### ▶ Exaggerated concerns have pulled down the stock.

We maintain our opinion BUY, with the target price of KRW 227,600, derived by DCF and EV/EBITDA multiple method. Recent plunge in share price seems to be largely attributed to the investors' concern about (1) increasing international grain price, (2) lawsuit result affecting the firm's pricing power, and (3) false rumour in the market that Warren Buffet sold his stake. We believe the company is still undervalued considering its stable performance and limited effect of negative factors.

### ▶ Raw material price surge will cease shortly.

Recent surge in wheat price is expected to come into an effect from 2Q 2007. However, we have come up with a conclusion that wheat price will be stabilized in a few months, considering futures price on CBOT and analysis of USDA. Another considerable factor, foreign exchange rate, is expected to go sideways or slightly increase.

### ▶ Diminished pricing power is a worry, but m/s is still strong.

We are concerned that Daehan Flour Mills may not retain its pricing power due to a lawsuit filed against cartel in flour mills industry. However, considering stable demand of flour and sustainable market share of the company, the impact will not be significant. The company's position more involved in B2B is also a relief.



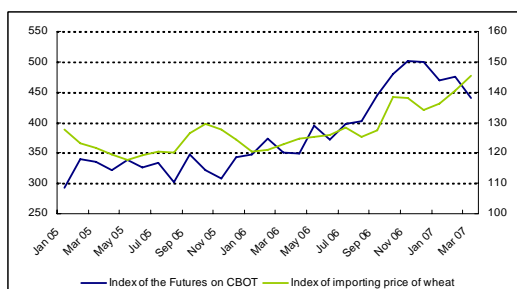
## Part I. Cost Analysis

Total production cost of Daehan Flour Mills is largely dependent on two key variables – (1) price of wheat at which it buys, and (2) foreign exchange rate movement.

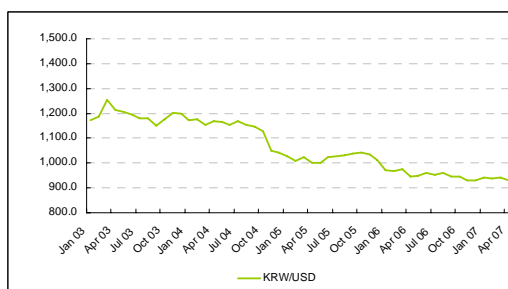
### ► Price of wheat is expected to be stabilized in 2007.

Owing to international demand exceeding production and stock level, the price of wheat has been increasing for the past twelve months, growing by more than 20% YoY. It is worth having a look at the price movement of the futures traded on CBOE as future price tends to lead the spot price with a time lag. Reaching its peak at the end of 2006, the future price began to go down. Furthermore, one of the reports of USDA (United States Department of Agriculture) expects that the price of wheat will be stabilized in 2007 after surging for a year, in accordance with the market condition towards balance between demand and supply. Therefore, we estimate that wheat price will reach its highest shortly, and will go into slight correction at least for the next few months. Nevertheless, the production level of wheat is so vulnerable to weather changes and natural disasters that we should keep close eyes on the possible swift in trend.

*Index of Futures & imported wheat price*



*Foreign Exchange Rate – KRW/USD*



We assume that wheat price will go sideways around 130 in the index which measures relative price level comparing with that at the beginning of 2002. Currently, the cost of buying wheat accounts for 80% of COGS, on average over the past 10 years, and it has been very stable. Therefore, we assume that the increase in wheat price by 1% will lead the increase in COGS by 0.8%.

▶ Profit erosion by changes in foreign exchange rate will be limited.

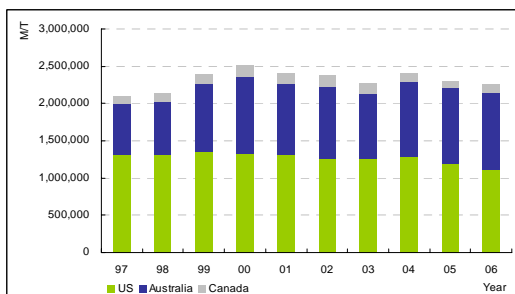
Another important factor is foreign exchange rate. For the past two years, Daehan Flour Mills has benefited from the appreciation of Korean won, which partly gave rise to the stock price surge. In 2007, Major economic institutes and experts predict that Korean won will go sideways or weaken slightly against US Dollar; SERI and LGERI estimate it would be ₩910/\$ and ₩900~950/\$, respectively, whereas FX dealers say that it is possible to increase to ₩1,000/\$. Since Daehan Flour Mills pays for its purchase of wheat by US Dollar, the depreciation of won will result in the cost increase. However, it is not likely that it goes beyond ₩1,000/\$, and the profit erosion will be limited that far.

Notwithstanding the difficulty in expecting the future exchange rate, we assume in this report that it will be around ₩950/\$. Again, the won depreciation of 1% will roughly result in the increase in COGS by 1%.

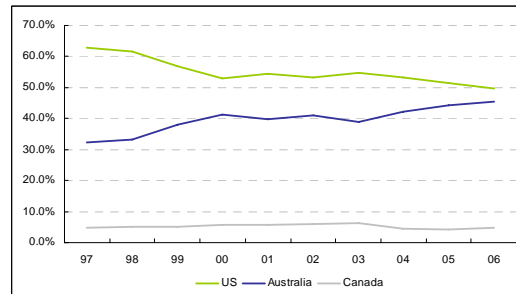
▶ Diversification of suppliers leads the increasing import from Australia.

Daehan Flour Mills is currently buying wheat mainly in three countries – the US, Australia, and Canada. In the past, the company imported most wheat from the US, which still accounts for almost half of total import of wheat. However, the amount of import from Australia has been increasing constantly, reaching 45% last year. It is in line with the firm's effort of diversification of suppliers, as well as lower transportation cost from Australia.

Import distribution by countries



Trend of import distribution



## Part II. Market Analysis

In 2006, the size of flour market amounts to KRW 720bn and major players include Daehan Flour Mills, CJ and Dong-a Flour Mills with 25% m/s each, followed by Samyang with 9% m/s.

### ▶ Stagnant demand in bakery market will be offset by demand in restaurants

Daehan Flour Mills is more involved in B2B market with bakery, restaurant business entities as its main customers, rather than B2C market. Demand for flour products is not likely to grow in baked goods market due to the overall stabilization of bakery market. However, demand for raw or frozen noodle products will increase in restaurants, which will lead to higher demand for value added flour products used in noodle. As increasing demand in restaurants will offset the decline in bakery market, the overall flour mills market is predicted to stabilize.

### ▶ Market share appears sustainable with little competition.

From 2001, each player's market share in flour mills product market has remained almost the same. It is difficult to expect new market entrants because flour milling business requires considerable capital investment for assets in the initial development stage. In addition, incumbent companies have also implicitly made an agreement to maintain each other's market position. As the flour milling market is predicted to be stagnant, the players are not likely to be competitive and wage price war against each other in the near future. Therefore, Daehan Flour Mills will be able to sustain dominant market share.

### ▶ Sales will grow in accordance with the market growth.

Flour market is in the mature stage with average annual growth rate of 1.35% for the last 10 years. Despite stabilizing market growth, Daehan Flour Mills could continue to grow thanks to price leadership. The company's performance was possible because it has always increased retail price more than the change in wheat price. From 2002 to 2006, retail price increased by 1.1%, whereas price of wheat rose by 1.04%. DFM's sales is expected to increase steadily in proportion to the market growth of 1.35%, maintaining its

current market share.

▶ **Recent lawsuit will defer DFM from increase its retail price.**

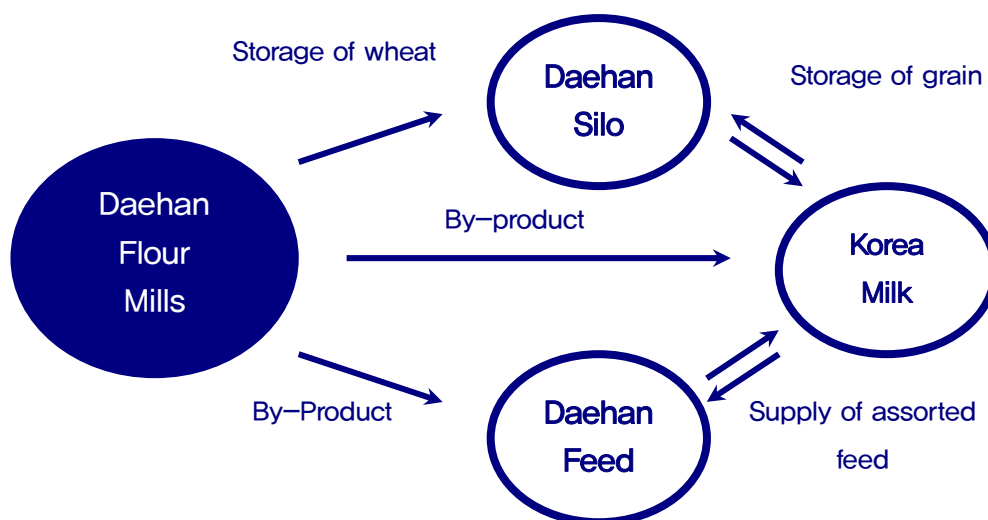
We are concerned that Daehan Flour Mills may not retain its pricing power due to a lawsuit filed against price fixing in flour mills industry. Last year, eight flour mills manufacturers were sued against fixing flour price by restraining production for six years. Daehan Flour Mills has to pay KRW 12mn fine, which is higher amount than any other players involved in the collusion.

It was a surprise that the market leader, CJ, recently has increased its retail selling price of flour in this situation. Considering lots of criticism about alliance of key players in the flour mills industry, Daehan Flour Mills is not likely to raise its product price for a certain period. Recent stock price plunge seems to reflect this concern in the market that the company would not easily transfer pressure from increasing wheat price to retail price.

### Part III. Subsidiaries

▶ **Unrivalled in online high school education market**

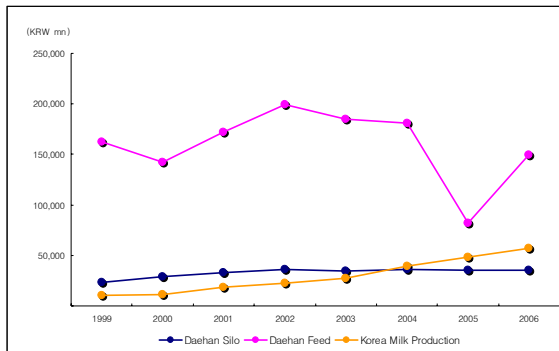
Daehan Flour Mills generate around a quarter of its net profit from its subsidiaries – Daehan Silo, Daehan Feed, and Korea Milk Product. These subsidiaries have maintained close relationship with each other, through which Daehan Flour Mills can improve their products in quality and stabilize overall profit.



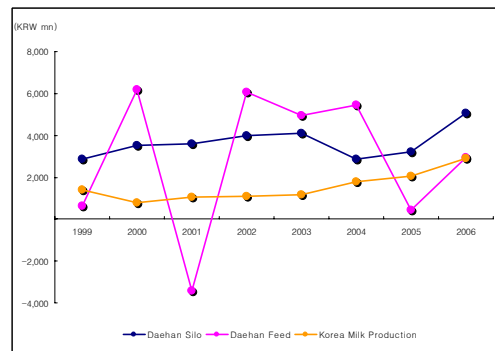
| Subsidiaries     | Share(%) | Major business                | Performance of 2006<br>(KRW mn)                      |
|------------------|----------|-------------------------------|--|
| Daehan Feed      | 98.21    | Manufacturing assorted feed   | Asset : 124,822<br>Sales : 149,777<br>Profit : 2,958 |
| Daehan Cyro      | 100      | Unloading & storing grain     | Asset : 98,855<br>Sales : 35,177<br>Profit : 5,050   |
| Hankook Dairying | 50.09    | Manufacturing substitute milk | Asset : 32,303<br>Sales : 57,172<br>Profit : 2,897   |

These subsidiaries, except for Daehan Feed, have been growing constantly, and consequently have contributed to stable increase in profit of Daehan Flour Mills. When it comes to Daehan Feed, the feed industry is sensitively influenced by livestock industry that is why its profit tends to be volatile. However, it has incurred a heavy loss just once and retrieved its loss promptly, so general tendency is stabilized.

Sales of subsidiaries



Profits of subsidiaries



## Part IV. Valuation

### ▶ DCF method with Free Cash Flow

We have made key assumptions deriving the target price of Daehan Flour Mills as follows:

- ✓ Market share of Daehan Flour Mills will be stable in the future. (25%)
- ✓ Sales of Daehan Flour Mills will increase in proportion to the market growth (+1.35%)
- ✓ Perpetual growth rate is the same as the above rate, to be conservative. (+1.35%)
- ✓ WACC is used as a discount rate, assuming that the firm maintains current financing structure (10.0%)

|                                 | 2007F  | 2008F  | 2009F  |
|---------------------------------|--------|--------|--------|
| Free Cash Flow                  | 19,050 | 19,877 | 20,111 |
| Present value of forecasted FCF | 17,978 | 17,058 | 15,696 |
| Continuing value (after 2010)   |        |        |        |

#### Continuing value calculation

|                                   |       |
|-----------------------------------|-------|
| FCF growth (2010 –normalized FCF) | 1.35% |
| Perpetual growth g (%)            | 1.35% |
| WACC                              | 10.0% |

|                                   |                |
|-----------------------------------|----------------|
| Present value of forecasted FCF   | 50,732         |
| Present value of continuing value | 184,614        |
| <b>Value of the stock</b>         | <b>235,346</b> |

We derived the target price of KRW 235,300 using DCF method by free cash flow.

### ▶ EV/EBITDA Method

We have made key assumptions deriving the target price of Daehan Flour Mills as

follows:

- ✓ In 2007, the sale will increase in proportion to the market growth. (+1.35%)
- ✓ In 2007, the average wheat price will be higher by 7.7% than that in 2006, which will lead to increase in COGS by 6.16%
- ✓ In 2007, the average won-dollar exchange rate will be around 950, which will affect the COGS in increase by 2.21%
- ✓ Other factors affecting EBITDA will be almost the same as in 2006.

In determining target EV/EBITDA ratio for Daehan Flour Mills, we used the industrial average of 8.5 x. 2007 EBITDA, which is expected to be KRW 26,783, multiplied by EV/EBITDA of 8.5 equals to KRW 227,700.

| Company               | Market Cap    | EV            | EBITDA      | EV/EBITDA |
|-----------------------|---------------|---------------|-------------|-----------|
| Daehan Flour Mills    | 344,760,000   | 410,534,323   | 56,288,000  | 7.3       |
| Youngnam Flour Mills  | 38,688,000    | 64,803,388    | 8,545,000   | 7.6       |
| Samyang               | 615,187,500   | 666,809,500   | 79,293,000  | 8.4       |
| CJ                    | 3,112,310,000 | 3,922,910,029 | 371,300,000 | 10.6      |
| Average of Industry = |               |               |             | 8.5       |

► **Maintain BUY, with TP of KRW 227,600**

We maintain our opinion BUY, with the target price of KRW 227,600. Recent plunge in share price seems to be largely attributed to the investors' concern about (1) increasing international grain price, (2) lawsuit result affecting the firm's pricing power, and (3) false rumour in the market that Warren Buffet sold his stake. We believe the company is still undervalued considering its stable performance and limited effect of negative factors.



| Income statement        | (Mn.won) |         |         | Cash flow statement           | (Mn.won) |         |         |
|-------------------------|----------|---------|---------|-------------------------------|----------|---------|---------|
|                         | 2004.06  | 2005.12 | 2006.12 |                               | 2004.06  | 2005.12 | 2006.12 |
| Sales                   | 248,542  | 127,465 | 251,559 | Operating cashflows           | 19,268   | 14,346  | 27,091  |
| Sales growth %          | 9.8      | -48.7   | 97.4    | Net profit                    | 31,167   | 6,610   | 37,103  |
| Cost of sales           | 187,387  | 93,553  | 190,656 | Depreciation                  | 6,082    | 4,133   | 10,327  |
| Gross profit            | 61,156   | 33,912  | 60,903  | Amortization                  | 0        | 0       | 0       |
| SG&A cost               | 29,733   | 14,915  | 31,269  | Chg in op assets/ liabilities | -12,583  | -6,284  | -12,097 |
| Operating profit        | 31,423   | 18,997  | 29,634  | Investing cashflows           | 13,334   | -9,534  | -11,464 |
| Operating margin %      | 12.6     | 14.9    | 11.8    | Chg in investment assets      | 20,338   | 5,569   | 6,838   |
| Non-operating income    | 19,969   | 8,946   | 25,406  | Change in tangible assets     | -7,071   | -8,354  | -18,472 |
| Interest income         | 6,797    | 2,693   | 5,874   | Change in intang. assets      | 0        | 0       | 0       |
| FX transact./transl.    | 3,518    | 1,502   | 6,551   | Financing cashflows           | -28,034  | -14,317 | -6,691  |
| Non-operating expense   | 8,425    | 14,984  | 6,921   | Chg in short-term debts       | -29,775  | -2,912  | -5,001  |
| Interest expense        | 5,197    | 1,637   | 3,716   | Change in bonds               | 0        | 0       | 0       |
| FX transact./transl.    | 963      | 951     | 1,556   | Change in long-term debts     | 1,091    | -6,952  | 0       |
| Recurring profit        | 42,966   | 12,959  | 48,120  | Change in CPLT.               | 0        | -1,388  | 0       |
| Net extraordinaries     | 0        | 0       | 0       | Change in paid-in capital     | 0        | 0       | 0       |
| Pre-tax profit          | 42,966   | 12,959  | 48,120  | Dividend                      | -2,535   | -3,380  | -1,690  |
| Income tax              | 11,800   | 6,349   | 11,017  | Net cashflows                 | 4,567    | -9,505  | 8,936   |
| Net profit              | 31,167   | 6,610   | 37,103  | Beginning cash                | 6,894    | 11,461  | 1,956   |
| EPS                     | 18,442   | 3,911   | 21,954  | Ending cash                   | 11,461   | 1,956   | 10,892  |
| Balance sheet           | (Mn.won) |         |         | Financial ratios              |          |         |         |
|                         | 2004.06  | 2005.12 | 2006.12 |                               | 2004.06  | 2005.12 | 2006.12 |
| Cash & cash equiv.      | 11,461   | 1,956   | 10,892  | Current ratio %               | 145.4    | 180.6   | 172.0   |
| Investment & securities | 131,413  | 114,262 | 101,475 | Quick ratio %                 | 126.7    | 159.8   | 141.1   |
| Accounts receivable     | 27,068   | 29,469  | 27,595  | Debt ratio %                  | 56.6     | 45.7    | 33.6    |
| Inventories             | 26,108   | 20,738  | 31,669  | Debt/Equity %                 | 39.3     | 18.9    | 17.2    |
| Current assets          | 203,122  | 179,684 | 176,214 | Debt/Total asset %            | 25.1     | 13.0    | 12.9    |
| Investment assets       | 218,445  | 281,582 | 283,354 | Net debt/Equity %             | -2.4     | -10.2   | -8.0    |
| Tangible assets         | 114,774  | 120,956 | 137,034 | Reserve ratio %               | 3,953.7  | 4,630.5 | 5,185.0 |
| Intangible assets       | 0        | 0       | 0       | Sales growth %                | 9.8      | -48.7   | 97.4    |
| Total assets            | 536,341  | 582,222 | 596,602 | EBITDA growth %               | 72.4     | -38.3   | 72.8    |
| Accounts payable        | 1,501    | 1,991   | 2,045   | Operating profit growth %     | 95.1     | -39.5   | 56.0    |

|                            |         |         |         |                           |      |       |       |
|----------------------------|---------|---------|---------|---------------------------|------|-------|-------|
| Short-term debts           | 110,889 | 64,591  | 70,517  | Recurring profit growth % | 38.3 | -69.8 | 271.3 |
| Curr. portion of Lt. debts | 1,287   | 0       | 6,150   | Net profit growth %       | 56.7 | -78.8 | 461.3 |
| Current liabilities        | 139,693 | 99,491  | 102,459 | EPS growth %              | 56.7 | -78.8 | 461.3 |
| Bonds                      | 0       | 0       | 0       | Total asset growth %      | -1.7 | 8.6   | 2.5   |
| Long-term debts            | 22,491  | 10,878  | 0       | Invested capital growth % | 6.8  | 1.4   | 17.1  |
| Long-term liabilities      | 54,108  | 83,004  | 47,561  | EBITDA margin %           | 15.1 | 18.1  | 15.9  |
| Total liabilities          | 193,802 | 182,495 | 150,021 | Operating profit margin % | 12.6 | 14.9  | 11.8  |
| Paid-in capital            | 8,450   | 8,450   | 8,450   | Recurring profit margin % | 17.3 | 10.2  | 19.1  |
| Capital surplus            | 48,849  | 48,849  | 48,849  | Pre-tax profit margin %   | 17.3 | 10.2  | 19.1  |
| Retained earnings          | 208,145 | 247,680 | 304,224 | Net profit margin %       | 12.5 | 5.2   | 14.7  |
| Total shareholders' equity | 342,540 | 399,727 | 446,581 | Interest coverage x       | 6.0  | 11.6  | 8.0   |

| Valuation guide |         |         |         | Per share data |         |         |         |
|-----------------|---------|---------|---------|----------------|---------|---------|---------|
|                 | 2004.06 | 2005.12 | 2006.12 |                | 2004.06 | 2005.12 | 2006.12 |
| ROE %           | 9.3     | 1.8     | 8.8     | EPS            | 18,442  | 3,911   | 21,954  |
| COE %           | 8.3     | 9.0     | 7.0     | PER x          | 2.2     | 33.1    | 9.2     |
| ROE-COE %       | 1.0     | -7.2    | 1.8     | CFPS           | 22,041  | 6,357   | 28,065  |
| ROE/COE x       | 1.1     | 0.2     | 1.3     | PCFR x         | 1.9     | 20.4    | 7.2     |
| EBIT            | 31,423  | 18,997  | 29,634  | BPS            | 202,686 | 236,525 | 264,249 |
| NOPLAT          | 22,793  | 9,690   | 22,849  | PBR x          | 0.2     | 0.5     | 0.8     |
| Pre-tax ROIC %  | 22.0    | 12.8    | 18.3    | SPS            | 147,067 | 75,423  | 148,851 |
| ROIC %          | 16.0    | 6.5     | 14.1    | PSR x          | 0.3     | 1.7     | 1.4     |
| ROIC-WACC %     | 10.8    | -0.3    | 7.7     | EBITDA/share   | 22,192  | 13,686  | 23,645  |
| ROIC/WACC x     | 3.1     | 0.9     | 2.2     | P/EBITDA x     | 1.9     | 9.5     | 8.5     |

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