

KG Inicis (035600.KQ)

As PG player, impact of card fee cuts to be limited

Company Comment | Dec 24, 2018

KG Inicis's share price is being weighed upon by fears that profitability at PG and value-added network (VAN) operators will deteriorate due to lower fees stemming from the government's new card commission policy. However, as a PG player, KG Inicis should be well able to defend its margins as: 1) PG firms' commissions are determined via negotiations with sellers; and 2) their fees are justified by being the guarantor that online transactions are secure.

PG players' fees are justified by being guarantor that online transactions are secure

With the Korean government's new card commission policy to be implemented from Jan 2019, KG Inicis's share price has slipped as of late on worries that payment system-linked earnings for payment gateway (PG) players will deteriorate.

We point out that PG fees are determined via negotiations with sellers (rather than credit card companies). For online shopping transactions, a PG generally charges a fee of about 3.5% per transaction to the seller, which is recorded in sales at the PG. After dividing this transaction fee between the credit card company (a fixed 2.2%) and the web hosting firm (a fixed 1.0%), 0.3~0.4% is left for the PG (commission income recognized in OP).

PG players are able to charge a 0.3~0.4% commission rate as they guarantee convenient and secure online transactions. In detail: 1) they must handle a variety of payment methods; 2) they must deal with payment-related servers; 3) they facilitate convenient settlement; and 4) they act as the guarantor of online transactions being secure (the most important factor in justifying their commission charges). Of note, in non-face-to-face online transactions, there are additional risk factors (vs offline transactions) such as wrongful use of the card by the buyer and 'dine and dash' behavior on the part of the seller. Accordingly, it is the PG players' role (not the credit card firms') to be the guarantor that transactions are secure for both online merchants and customers.

As PG player, impact of lower card fees on earnings to be limited

The electronic payment division is forecast to record 2019 sales of W708.5bn (+3.2% y-y), a level which represents a slowing in growth that is attributable to: 1) a lower commission rate due to the government's new card commission policy; and 2) a reduction in online/mobile transaction volume due to the exit of NAVER.

Not Rated

CP (2018/12/21) **W15,800**

| Sector | Software |
|-----------------------------|-------------------|
| Kospi/Kosdaq | 2,061.49 / 673.64 |
| Market cap (common) | US\$391.0mn |
| Outstanding shares (common) | 27.9mn |
| 52W high ('18/04/17) | W25,050 |
| low ('18/12/10) | W13,650 |
| Average trading value (60D) | US\$2.8mn |
| Dividend yield (2018E) | 1.90% |
| Foreign ownership | 17.3% |

Major shareholders
KG Chemical and 5 others 41.1%

| Share perf | 3M | 6M | 12M |
|--------------|-------|-------|-------|
| Absolute (%) | -13.7 | -26.9 | -11.7 |
| Relative (%) | 6.1 | -10.3 | -3.0 |

| | 2017 | 2018E | 2019F | 2020F |
|--------------------|-------|-------|---------|---------|
| Sales | 758.5 | 932.9 | 1,066.6 | 1,111.5 |
| Chg | 58.6 | 23.0 | 14.3 | 4.2 |
| OP | 54.7 | 76.4 | 89.6 | 108.2 |
| OPM | 7.2 | 8.2 | 8.4 | 9.7 |
| NP | -0.4 | 48.2 | 57.0 | 69.3 |
| EPS | -14 | 1,729 | 2,044 | 2,482 |
| Chg | TTL | TTP | 18.2 | 21.4 |
| P/E | N/A | 9.1 | 7.7 | 6.4 |
| P/B | 2.8 | 1.9 | 1.6 | 1.3 |
| EV/EBITDA | 8.4 | 5.0 | 3.8 | 2.9 |
| ROE | -0.2 | 23.3 | 22.7 | 22.6 |
| Debt/equity | 199.1 | 203.4 | 194.6 | 170.6 |
| Net debt | -11.8 | -87.4 | -161.6 | -225.3 |

Units: W/bn, %, won, x

Note 1: NP excludes minority interests

Note 2: EPS, P/E, P/B, and ROE based on NP (excl minority interests)

Source: NH I&S Research Center estimates



Hyundong Lee, Analyst

822)768-7423, hyundong.lee@nhqv.com

While card fee cuts threaten to hamper sales figures at PG companies, the impact on OP at KG Inicis should be limited thanks to the firm's well-secured commission structure. Affected by the client departure of NAVER (responsible for W2tn of annual transaction volume; established its own PG in 2H18), KG Inicis's transaction volume has been shrinking since 3Q18—a trend which is likely to sustain into 1H19. Despite NAVER's departure, however, the electronic payment division is continuing to expand through the acquisition of new franchise stores based on its competitiveness as the number-one domestic PG operator. In 2019, we expect KG Inicis to benefit from: 1) the acquisition of more than 30 new domestic customers and global clients; and 2) the entrance of global clients into Korea.

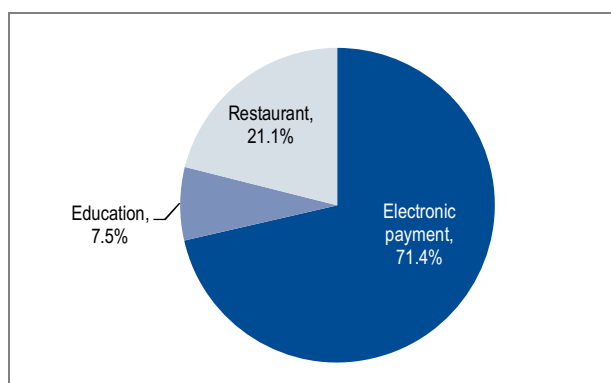
Having traded at an average P/E of 12.6x over the past five years (based on adjusted earnings after stripping out losses at the now-discontinued KG Logis), the firm's shares are presently trading at a 2019F P/E of 7.7x, affected by recent card fee cut-related concerns. With its shares currently trading at a significant discount compared to their historical levels, we believe that KG Inicis is undervalued in light of its growth potential.

Company overview

- A payment gateway is a merchant service provided by an e-commerce application service provider that authorizes credit card or direct payment processing for e-businesses, online retailers, bricks and clicks firms, or traditional brick-and-mortar companies. The payment gateway may be provided by a bank to its customers, but can also be provided by a specialized financial service provider (such as a payment service provider) as a separate service.
- KG Inicis was listed on the Kosdaq in 2002. The company is the number-one player in the domestic PG market, with 170,000 franchise stores.
- The firm has nine subsidiaries: KG Mobilians (stake: 47.81%), KG Allat (60.0%), Srook (68.6%), Mobile Fintech SPC #1, KG Eduone (69.49%), KG F&B (100%), KFC Korea (100%), KG RUS LLC (100%), and KG ICT (75.0%).
- Major shareholders include KG Chemical (29.37% stake) and KG Corp (10.21% stake).

Sales breakdown

- In 3Q18, the electronic payment business accounted for 71.4% of total sales, followed by the education business (7.5%: Internet program development, content supply, and private institute management), and the restaurant business (21.1.0%: franchise restaurant management)

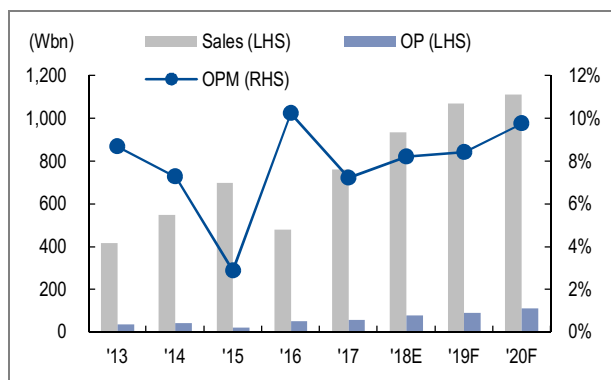


Note: As of 3Q18

Source: KG Inicis, NH I&S Research Center

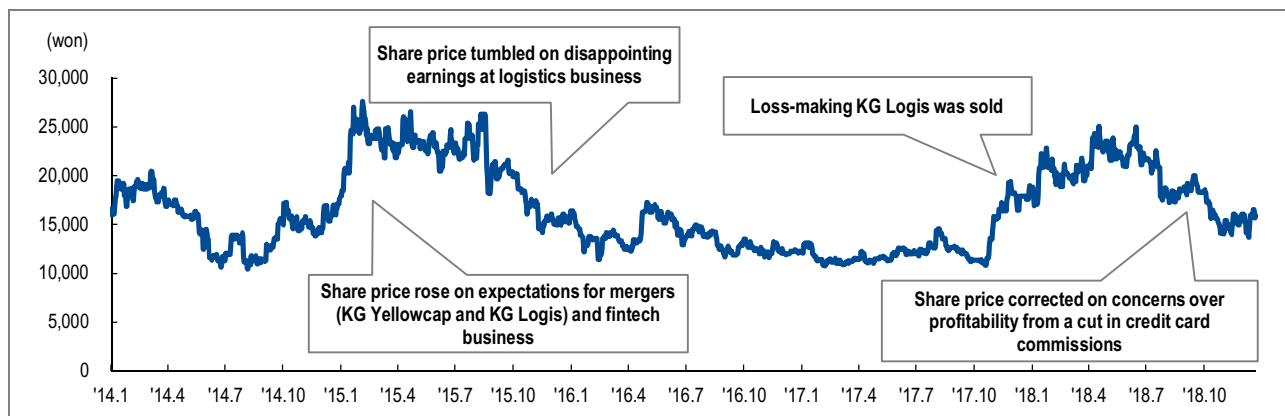
Earnings

- KG Inicis posted 3Q18 sales of W232.2bn (+6.0% y-y) and OP of W20.3bn (+34.3% y-y), driven by earnings growth at the electronic payment business and consolidated subsidiaries
- The company's 2017 NP reflects discontinued business losses of W36.5bn from the disposal of KG Logis



Source: KG Inicis, NH I&S Research Center estimates

Share performance and major events



Source: DataGuide, NH I&S Research Center

NH Investment & Securities stock ratings

1. Rating based on a stock's forecasted absolute return over a period of 12 months from the date of publication.

- Buy: Greater than +15%
- Hold: -15% to +15%
- Sell: Less than -15%

2. Regarding listed companies under NH I&S' coverage, our stock ratings break down as follows (as of Dec 21, 2018).

- NH I&S' stock rating distribution

| Buy | Hold | Sell |
|-------|-------|------|
| 81.4% | 18.6% | 0.0% |

- The stock rating on an individual company can change at irregular intervals. Our stock rating distribution is calculated on a weekly basis.

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