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Korea consumer

Global Markets Research
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EQUITY: CONSUMER RELATED

DFS industry check-up with THQ

Quick Note

Research Analysts

South Korea Consumer Related

Cara Song - NFIK
cara.song@nomura.com
+822(3783)2328

We had an analyst call with THQ (192410 KS, Not rated) to understand: 1) the current market situation of the duty-free stores (DFS) sector; 2) the competitive landscape between Korean Duty-Free Stores (K-DFS) and Chinese Duty-Free Stores (C-DFS); and 3) prospects for K-DFS players operating on Hainan Island.

THQ (Gammanu): company profile

THQ, previously known as Gammanu, was established in 1997 and listed on KOSDAQ in 2014. The company has two business segments: 1) the antenna segment — the company is an antenna developer and producer of laptops and smartphones; and 2) the Inbound Platform (IP) segment — THQ creates traction for Chinese travellers visiting Korea to purchase duty-free products for fees received from K-DFS players. The company recently added a new business segment to supply C-DFS players in China with Korean products.

THQ has initiated a new business: supplying Korean brands to C-DFS

THQ announced on 14 July 2021 that it will open with 22 Korean brands including cosmetics (e.g., "Tony Moly", "It's Skin", and "Clio"), fashion accessories, electronic products, and alcoholic beverages at Haiyou Duty Free Shop in Hainan Province, China.

- Haiyou Duty Free store is 100%-owned by Hainan Tourism Investment and Development Co., Ltd., a state-owned company invested by the State Asset Supervision and Management Commission of China, and is a state-owned enterprise like the Korea Tourism Organization.

THQ is optimistic about its C-DFS prospects (Hainan DFS: USD43bn in FY25F)

THQ management diversifies its business portfolio from K-DFS only to K-DFS plus C-DFS, emphasising the importance of securing a presence in the C-DFS market. THQ cited that the provincial government aims to achieve a CNY290bn DFS market in FY25F (vs CNY32bn in FY20, +55% CAGR in FY20-25F, *link*) and the Hainan government relaxed regulation and increased the number of operators as well as the DFS store count. The number of DFS stores in Hainan island is 10 now vs 4 in early 2020. The travelers are allowed to purchase a maximum of CNY100,000 per year (USD15,450/person per year) worth of goods. An online delivery service after visiting the island for six months is available.

THQ partners with Haiyou DFS in Hainan, which signed a similar deal with Hotel Shilla

The C-DFS market looks likely to be ranked as the largest global DFS market in FY21F with a total market size of KRW21tn (vs K-DFS at KRW17.3bn, Nomura forecast) by growing more than 50% y-y. According to the company, CTG Duty-Free (601888 CH, Not rated) already has an 80% market share of the duty-free industry on Hainan Island. Of the remaining 20%, THQ believes that other DFS players will also enjoy strong growth opportunities. According to THQ, Haiyou DFS seeks to enter business agreements with THQ, as Haiyou DFS needs to strengthen its Korean brand portfolio. THQ anticipates KRW27.8bn in sales and KRW1.4bn in OP (OPM 5%) from supplying goods to Haiyou DFS in FY22.

Haiyou DFS recently signed a similar business contract with Hotel Shilla (008770 KS, Neutral), too. No details on the business contract between Haiyou DFS and Hotel Shilla have been disclosed, but we anticipate that Haiyou DFS would seek DFS operational know-how and merchandising capability from Hotel Shilla in return for allowing Hotel Shilla to gain commissions from supplying goods to the DFS store.

THQ management thinks that Chinese resellers will return to K-DFS post COVID-19

According to THQ, Chinese resellers prefer to visit K-DFS stores instead of C-DFS stores, because Korean brands' product pricing at C-DFS stores is still higher than at K-DFS. The company explained that Chinese consumers still want to purchase goods directly from K-DFS, as there still remain concerns about fake products in China, although the concern level is much less serious than before.

THQ expects IP segment recovery after COVID-19

The company's revenue model for the IP business is to provide Chinese travelers (mostly small resellers) promotional codes, which the travelers use to purchase duty-free products. The company receives some fees from K-DFS for products sold using the promotional codes. However, as the traveller traffic has reduced significantly due to the COVID-19 pandemic, the revenue from this segment, which was around KRW15bn in 2019, declined substantially to KRW3bn in 2020 (and will be KRW12.4bn in 2021, according to THQ guidance). Management believes that the IP business will turn around in FY22, when Chinese resellers return to Korea, and expects KRW18bn in sales revenue in FY22.

Here we summarize key takeaways and implications for K-DFS operators:

K-DFS operators' entry into C-DFS indicates strong prospects in the China market

Hotel Shilla and THQ are keen to expand in the C-DFS market, as managements believe China will remain the fastest-growing DFS market globally over the next four years. Hotel Shilla's entry into C-DFS could mean not only a larger growth opportunity, but also a higher probability of operating in Hainan. Korean DFS players could leverage their merchandising capabilities and purchasing power by expanding into C-DFS stores. We think a 5% profit margin (commission rate) for supplying goods to C-DFS operators looks solid, as 5% OPM is a level similar to the DFS OPM from operating many DFS stores in Korea with capital invested. If no capital is invested and an operator secures 5% profit margin from partnering with C-DFS, this could result in meaningful potential upside, in our view.

The 55% Hainan DFS market CAGR growth target set by the Hainan provincial government sounds surprisingly strong. Before COVID-19 outbreak, 70% of Chinese luxury goods spending was overseas, which looks structurally shifted to local consumption by government regulation. This trend appears unfavorable for K-DFS, as it will strengthen the power of C-DFS in terms of price/merchandising negotiation with global brands.

Chinese resellers appear already active in K-DFS thanks to lack of purchase limits and online delivery service

According to THQ's IP business sales data, Chinese reseller traffic has already recovered to c.90% level of pre-COVID-19 sales in FY21. Chinese reseller purchases via THQ codes in FY21 were at KRW1.357tn compared to KRW1.556tn in FY19, according to management. This is due to Korean government's temporarily relaxed regulation (e.g., purchase limit for reseller purchases) and allowed online delivery for resellers to purchase K-DFS goods without physical travelling. Having said that, we estimate that the recovery of Chinese reseller traffic after COVID-19 could be moderate, and not strong, as the market currently seems to anticipate, in our view. We maintain our current view that travel cost would make Chinese resellers travelling to K-DFS less attractive, even after the borders are opened, while there is a possibility that C-DFS will offer more attractive price discounts using its growing purchasing power.

Weakening popularity of K-Beauty remains a key concern

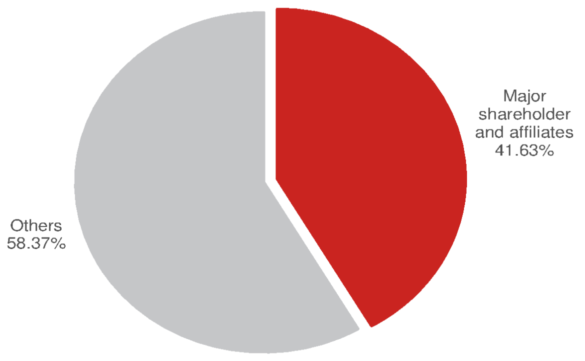
We believe that local Chinese cosmetics brands are growing rapidly in China and Korean cosmetics are losing market share. THQ management did agree that brand recognition of Korean 'basic cosmetics' is resulting in losing their market share to local cosmetics players in China. They think that most of the Korean cosmetics companies are well aware of such a trend and continue to develop innovative products to appeal to the Chinese consumers. But, THQ is also keen to diversify the product category from beauty products to apparels and other K-products, to be prepared for the declining popularity of Korean cosmetics brands.

We recently upgraded Hotel Shilla (008770 KS, Neutral); we see 35% upside potential for Shinsegae (004170 KS, Buy)

On 23 August, we upgraded Hotel Shilla from Reduce to Buy, after seeing some share price correction. We highlighted that: 1) rent charged by Incheon airport could reduce, and help reduce airport DFS losses; 2) new C-DFS business generating KRW250bn in sales and 5% operating profit in FY22F, and 3) downtown DFS OPM of 7% after full recovery in FY23F (vs 9% in FY19, before COVID-19 outbreak) remained unchanged.

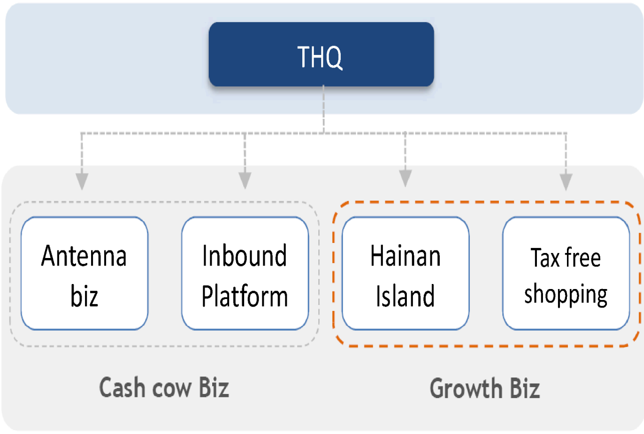
We reiterate our Buy rating on Shinsegae, as the stock looks undervalued to us compared to its domestic peer, Hotel Shilla. While Hotel Shilla trades at around 24x FY22F P/E, Shinsegae does at 9.2x FY22F P/E, despite: 1) a department store recovery after COVID-19, 2) its downtown DFS targeting KRW4tn of sales and 6% OPM in FY23F; and 3) the potential synergy with on-line cooperation with Naver (035420 KS, Buy).

Fig. 1: THQ - Shareholding Structure



Note: As of February 2021
Sources: Company data, Nomura estimates

Fig. 2: THQ - Business Segments



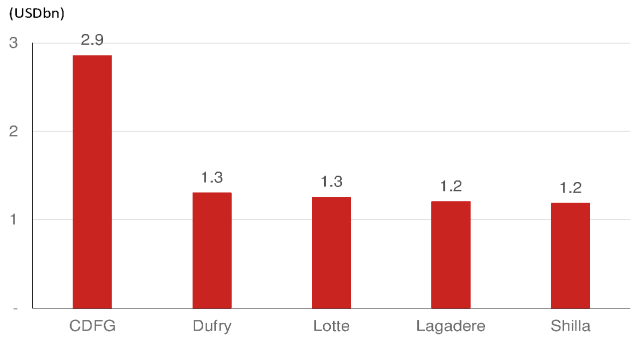
Sources: Company data, Nomura estimates

Fig. 3: THQ Earnings Guidance

Business type	(Wbn)	FY19	FY20	FY21E	FY22E
IP business (a)	DFS sales	1,560.0	620.0	1,907.7	2,117.6
	THQ commission sales	15.6	3.1	12.4	18.0
	Operating profit	4.9	1.1	2.4	9.0
	OPM (%)	31%	35%	19%	50%
C-DFS (b)	THQ sales			24.2	27.8
	Operating profit			1.2	1.4
(a) + (b)	THQ sales	15.6	3.1	36.6	45.8
	THQ OP	4.9	1.1	3.6	10.4

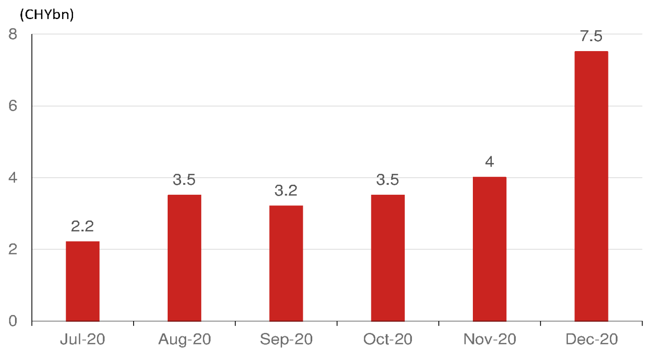
Sources: Company guidance

Fig. 4: Global DFS Ranking and Revenue Comparison



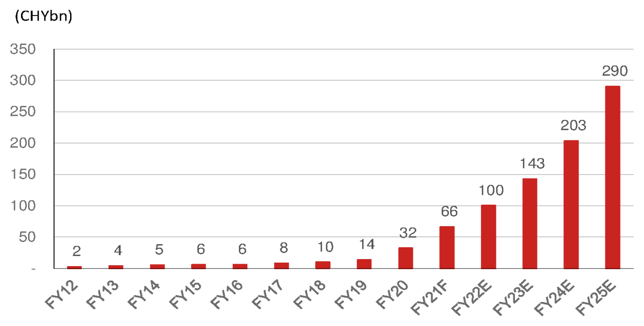
Note: As of 2020
Sources: Moodie Davitt, Nomura estimates

Fig. 5: Monthly Hainan Duty-free Revenue



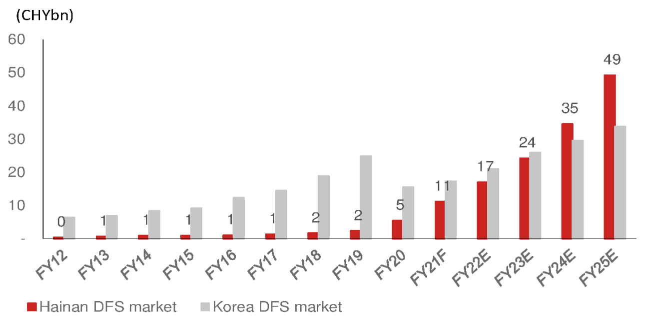
Sources: Company data, Nomura estimates

Fig. 6: Hainan Duty-free Annual Revenue Trend



Sources: Commerce of Hainan Province estimates, Nomura estimates

Fig. 7: Hainan DFS vs K-DFS Revenue Trend Comparison



Sources: Commerce of Hainan Province estimates, Nomura estimates for K-DFS

Appendix A-1

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Issuer	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Shinsegae	004170 KS	KRW 262,000	24-Aug-2021	Buy	N/A	
Hotel Shilla	008770 KS	KRW 88,600	24-Aug-2021	Neutral	N/A	
Naver Corporation	035420 KS	KRW 437,500	24-Aug-2021	Buy	N/A	A4,A6

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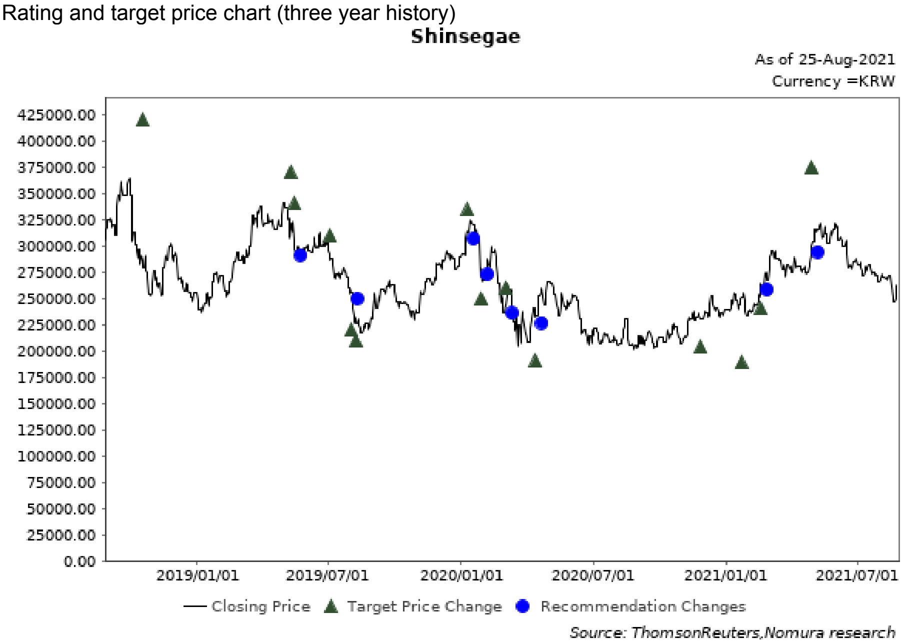
A6 The Nomura Group expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months.

Shinsegae (004170 KS) **KRW 262,000 (24-Aug-2021)** Buy (Sector rating: N/A)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
29-Apr-21	Buy		300,000.00
29-Apr-21		375,000.00	300,000.00
18-Feb-21	Neutral		264,000.00
18-Feb-21		240,000.00	264,000.00
22-Jan-21		189,000.00	251,000.00
27-Nov-20		204,000.00	230,500.00
13-Apr-20	Reduce		232,500.00
13-Apr-20		190,000.00	232,500.00
03-Mar-20	Neutral		241,500.00
03-Mar-20		260,000.00	241,500.00
29-Jan-20	Reduce		278,500.00
29-Jan-20		250,000.00	278,500.00
10-Jan-20	Neutral		312,500.00
10-Jan-20		334,000.00	312,500.00
09-Aug-19		210,000.00	226,500.00
02-Aug-19	Reduce		255,500.00
02-Aug-19		220,000.00	255,500.00
04-Jul-19		310,000.00	286,000.00
16-May-19	Neutral		297,000.00
16-May-19		340,000.00	297,000.00
10-May-19		370,000.00	321,000.00
18-Oct-18		420,000.00	286,000.00

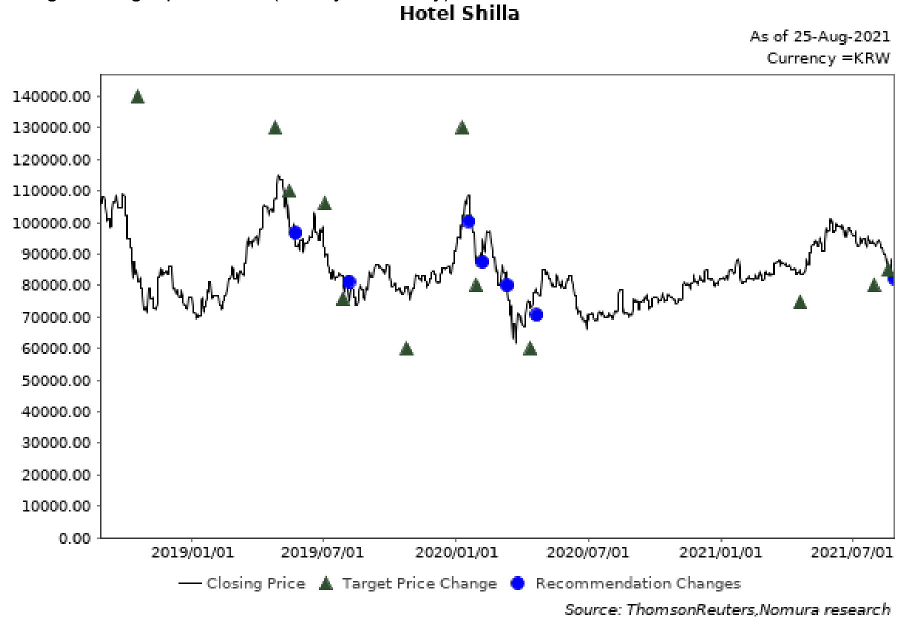
For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology Our TP of KRW375,000 is based on SOTP valuation, wherein: 1) 11x P/E is assigned to the department store business (historical average); and 2)19x P/E to the DFS business, using an earnings base of FY22F EPS (KRW28,507). Thebenchmark index for this stock is KOSPI.

Risks that may impede the achievement of the target price Downside risks to our target price: Any reimposition of purchase limits by the Korean government could hurt Chinese reseller traffic. Bigger price discounts by K-DFS to attract reseller traffic, impairing K-DFS margins, are another potential downside risk.

Hotel Shilla (008770 KS) **KRW 88,600 (24-Aug-2021)** Neutral (Sector rating: N/A)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
20-Aug-21	Neutral		84,300.00
20-Aug-21		85,000.00	84,300.00
31-Jul-21		80,000.00	93,500.00
20-Apr-21		75,000.00	85,000.00
13-Apr-20	Reduce		72,600.00
13-Apr-20		60,000.00	72,600.00
03-Mar-20	Neutral		82,000.00
29-Jan-20	Reduce		89,500.00
29-Jan-20		80,000.00	89,500.00
10-Jan-20	Buy		102,500.00
10-Jan-20		130,000.00	102,500.00
25-Oct-19		60,000.00	79,900.00
28-Jul-19	Reduce		83,300.00
28-Jul-19		76,000.00	83,300.00
04-Jul-19		106,000.00	89,000.00
16-May-19	Neutral		98,600.00
16-May-19		110,000.00	98,600.00
26-Apr-19		130,000.00	107,500.00
18-Oct-18		140,000.00	82,200.00

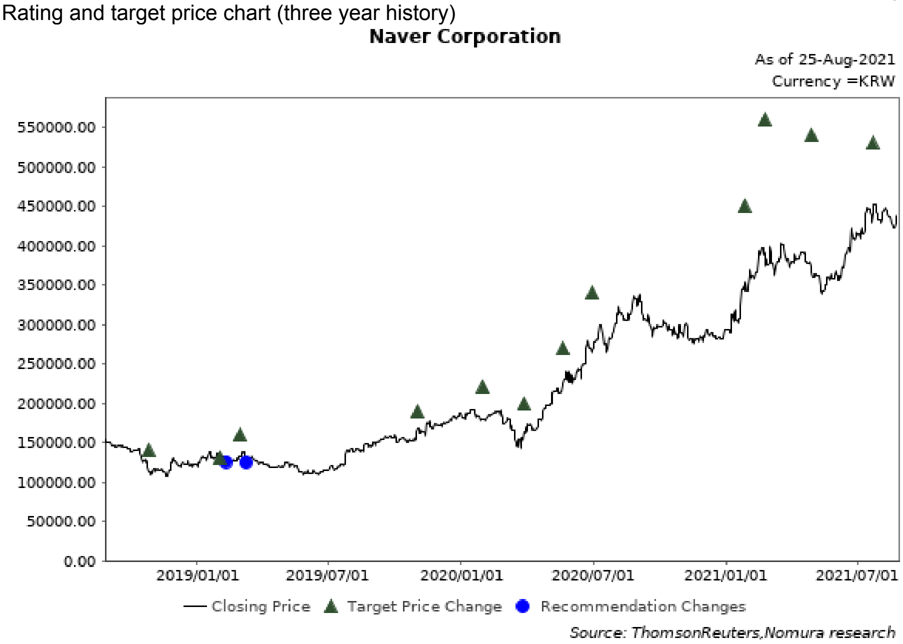
For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology We use the 19x fair P/E, FY23F EPS of KRW5,009 to derive a TP of KRW85,000. The benchmark index for this stock is KOSPI 200.

Risks that may impede the achievement of the target price Sooner-than-expected relaxation of travel regulations by the China government is an upside risk to our view. If COVID-19 is brought under control quicker than expected, favorable FX changes, and China's government's lift in travel ban to Korea are also upside risks. Downside risks include: 1) unfavorable FX; and 2) tougher competition with C-DFS.

Naver Corporation (035420 KS) **KRW 437,500 (24-Aug-2021)** Buy (Sector rating: N/A)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
22-Jul-21		530,000.00	440,000.00
29-Apr-21		540,000.00	366,500.00
23-Feb-21		560,000.00	390,500.00
26-Jan-21		450,000.00	342,000.00
30-Jun-20		340,000.00	267,000.00
21-May-20		270,000.00	225,000.00
27-Mar-20		200,000.00	164,000.00
31-Jan-20		220,000.00	179,500.00
01-Nov-19		190,000.00	167,000.00
01-Mar-19	Buy		133,000.00
01-Mar-19		160,000.00	133,000.00
01-Feb-19	Neutral		133,500.00
01-Feb-19		130,000.00	133,500.00
26-Oct-18		140,000.00	113,000.00

For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology Our SOTP-based fair value for Naver is KRW530,000, which includes fair value for its ecommerce business of KRW32tn with a target 2021F GMV multiple of 0.9x. The benchmark index for this stock is KOSPI 200.

Risks that may impede the achievement of the target price Key downside risk is regulatory pressure on platform business and/or heated competition in the ecommerce industry.

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