



Daum Kakao (035720 KS)

ACCUMMULATE RECOMMENDATION / COMPANY UPDATE

Rating:	OVERWEIGHT
Target Price (KRW):	157,295
Price (8 Oct 2015, KRW):	123,300
52-Week Price Range	99,000-162,000
Market Cap. (KRW B)	7,308.42
Enterprise Value (KRW B)	7,028.86

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Historical Price (3-Year)



Expected positives starting to materialize

Turnaround of Mobile Game sector along with business expansion expected to add momentum to Daum Kakao's growth

- Earning back the market share in the mobile game industry:** In the last quarter, 2Q15, Daum Kakao's earnings from game industry has been diminished to 53,984 million KRW. It has incurred some loss from its game business having some of its market share taken by its competitors. However, the numbers are improving due to "Friends Pop for Kakao", which is proven to be a big hit and ranks 1st in mobile app store for games in Korea. The earnings are projected to improve further as it launches "Anipang Matgo" and "Shanghai Anipang."
- Catalysts:** 1) O2O Business Expansion through Mobile Platform: Daum Kakao plans to launch new mobile services in the market after their huge success of KakaoTaxi, and their investment so far is now expected to turn into profits with 37.7 billion won of revenue. 2) Turnaround of Mobile Game Sector: Starting with their new game released in late August, "Friends Pop" just reaching more than 5 million downloads, company's game revenue is expected to recover in 4Q. 3) Monetization of newly launched businesses: in addition to commercial, which most of their profit is generated from, they will concentrate more on commerce and fintech, along with other services and make earnings. If they launch a new service for the Korean temporary driver service, it is expected to raise 83.4 billion won of new revenue in 2016.
- Valuation:** Our **157,295 KRW** target price is based on a DCF analysis with our long-term FCF projections, a discount rate of 8.92%, and a Terminal FCF growth rate of 4.0%. We are modelling a 3-year revenue growth rate of 33.4% CAGR, and EBIT margin stabilizing at 24.0% by FY18. Daum Kakao, as of its latest closing price, is trading at PER of 20.11x. The current stock price, even after the earnings shock in the 2nd quarter of 2015, has been stable but the share price of 123,300 KRW does not seem to fully reflect the firm's future growth opportunities or the earning capacity.

Financial and Valuation Metrics

Year	12/14A	12/15E	12/16E	12/17E	12/18E
EPS (KRW)	6,442	1,435	2,513	3,513	5,399
P / E (x)	19.2 x	88.8 x	50.5 x	36.3 x	22.1 x
Revenue (KRW B)	498.9	956.4	1161.2	1395.8	1543.1
EBITDA (KRW B)	199	152.7	233.2	309.7	472.1
EV / EBITDA (x)	32.5 x	45.9 x	29.4 x	21.5 x	17.5 x

Company Background

Overview

- Daum Kakao was created through the merger of a Korean Internet platform service provider Daum Communications and a mobile platform company Kakao in October 2014. Although Kakao’s market share heavily exceeded that of Daum, Kakao decided to buy and merge with Daum to be listed on KOSDAQ without having to go through an IPO. Daum was established in 1995 and had had a long history of providing searching, mailing, blogging, and communicating (café) services. Kakao, on the other hand, was established in 2006 and is known for its mobile messenger KakaoTalk, game services, and the emerging KakaoPay.

Figure 1 – Daum Kakao’s Businesses

PLATFORMS	DAUMKAKAO APPLICATIONS/SERVICES		
COMMUNICATIONS & COMMUNITY	 KakaoTalk	 KakaoStory	 Daum Café
ADVERTISING	 KakaoStory	 Daum	
RECOMMENDATION & SEARCH	 Daum Search	 Kakao(#) Search	
MEDIA & CONTENT	 Daum Media	 Kakao TV	 KakaoPage
GAMES	 Kakao Game	 Daum Game	
COMMERCE & FINTECH	 GiftShop	 KakaoPay	 BankWallet Kakao
TAXI & OTHERS	 KakaoTaxi	 Kimgisa Navigator	

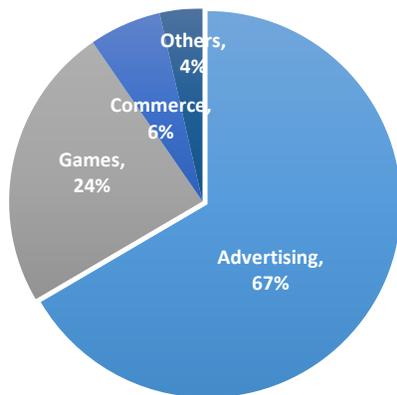
Source: Company data

- Kakao holds seven types of platforms, including communications & community, advertising, recommendation & search, media & content, games, commerce & Fintech, and taxi & others. KakaoTalk is mainly used as a communication method in Korea with over 97% of smartphone users being active KakaoTalk users. Moreover, KakaoTalk is currently serviced in 230 countries in 15 different languages and the number of users is bound to continue expanding. Kakao has also observed a significant growth in mobile advertising through KakaoStory as more people spend hours on their mobiles nowadays.
- For searching, Daum is continuously used as one of the top search engines in Korea and Kakao has recently added Kakao(#) search, which links a hashtag search in KakaoTalk chat rooms to Daum search. KakaoGame experienced a boom after its initial launch in July 2012 and it continues to develop and create new games to enhance its capabilities and grasp more users. Although communication, search, and game are the most commonly used platforms, Kakao has been diversifying its business to media & contents (music, TV, webtoon), e-commerce (KakaoPay, GiftShop), and taxi services (KakaoTaxi) to target different types of users.

Revenue Composition

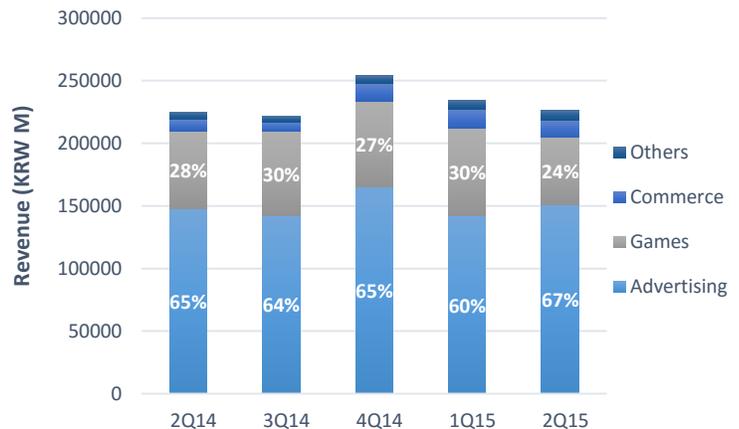
- The source of revenue for Kakao can be divided into four main sectors: advertising, game, commerce, and others. In general, advertising is the core revenue-generating business, followed by games. According to the quarterly financial data published by Kakao, total revenue is broken down as the following figures.

Figure 2 – Daum Kakao Revenue Mix (2Q15)



Source: Company data

Figure 3 – Daum Kakao Historical Revenue Mix



Source: Company data

- The figures show that there was a noticeable drop in the revenue generated from the game sector in 2Q15 compared to those generated in the past four quarters. This is due to a major shift in trend among game players. There used to be high concentration of people who play casual games, namely Anipang, but since last year, majority of people started to play role-playing games (RPG) like Raven and Blade. Casual games tend to earn higher revenue because it can draw small revenue from many people, while for RPG, revenue is only obtained from a small number of key players.
- Another significant change that occurred since the merger is the increase in the contributions of the commerce sector. From 3Q14 to 4Q14, there was an 84% rise from 7,756 million KRW to 18,584 million KRW due to increased product lines in the GiftShop and opening of Kakao character shops in various places around Korea. Ever since then, the commerce sector has been growing stronger, especially with the successful KakaoPay and KakaoTaxi services.

Investment Thesis

- **1) O2O Business Expansion through Mobile Platform** - Daum Kakao removed Daum and renamed as Kakao and appointed a new, young CEO, Ji Hoon Lim, to push its mobile business forward and grow into the global market. Kakao's strategic decision focuses on making some revenue from its mobile business, as the board of directors has agreed that Daum Kakao has been stabilized.
- Kakao already has the optimum foundation for expanding its mobile business, as Kakao Taxi made a big hit in 2Q 2015 with about 50 million users per month, along with KakaoPay, which made more than 10 million transactions with 5 million users. Moreover, the traditional Daum's map service, together with the sturdy messaging app, Kakaotalk, provided a smooth entry for Kakao into the O2O service industry.
- Kakao announced that it will launch new O2O services called 'Kakao Order' and 'Time Coupon' in the coming Q4. 'Kakao Order' is similar to the Starbucks Card app in a sense that it allows users to make orders through their phone and pay via KakaoPay. This is expected to reduce customer waiting time not only in line but also in pickup of food and drinks. Currently, there is a direct competitor in the national market called 'Syrup' operated by SK Planet. 'Time Coupon' is a service that will give out various discount coupons to the users who visit offline stores. In addition, Kakao is also planning to launch proxy driver services and a luxury version of Kakao Taxi, which will be charged, as an extension of the successful Kakao Taxi, and the company expects the revenue to be 83.4 billion KRW.
- Although Kakao's aggressive investment in its O2O services led to a 36% fall in its net profit last year, such O2O services are not only expected to attract more users, but also change their lifestyles in the long term. Therefore, its prospect remains positive and thus should buy Kakao's shares.

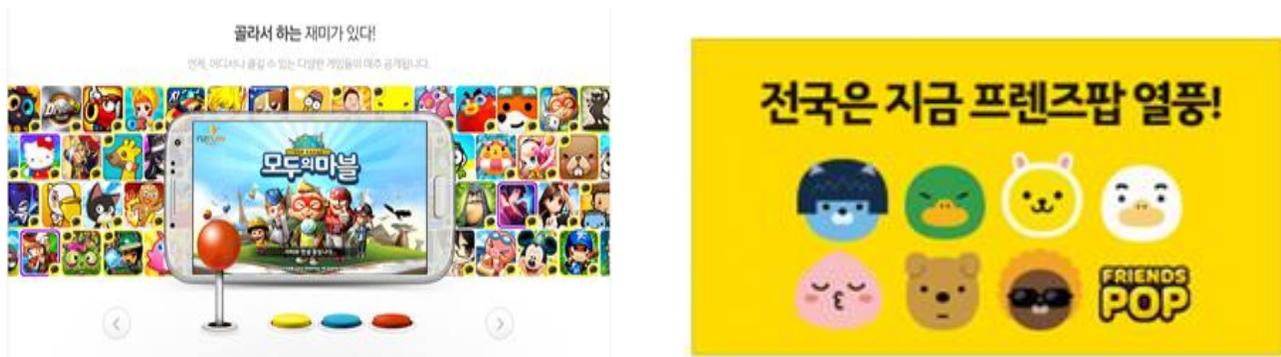
Figure 4 – Kakao Order and Time Coupon



Source: Daum Kakao

- **2) Turnaround of Mobile Game through Kakao's Platform** - It takes one popular game to generate the entire revenue in mobile game business of Kakao. The revenue generated from mobile game business is significant as it takes up 24% (2Q) of the company's total income. Kakao will continue to cooperate with national game companies and create a successful synergy. A recent success of "Friends Pop Kakao," which was launched in early 3Q, reached 52.3 million of downloads from Google Play and Apple Apps, even exceeding AniPang2 in terms of its sales.
- Both the game company and Kakao can benefit from launching a game together. Many national game companies are small in size and thus face difficulties in building their own platform to attract more ads; however, Kakao can help since it has the budget. From Kakao's perspective, it can naturally use the effects of advertising to attract global users and enter these markets. Therefore, a currently stagnant mobile game platform has the potential to rise again.

Figure 5 – Daum Kakao’s Top Performing Games



Source: Daum Kakao

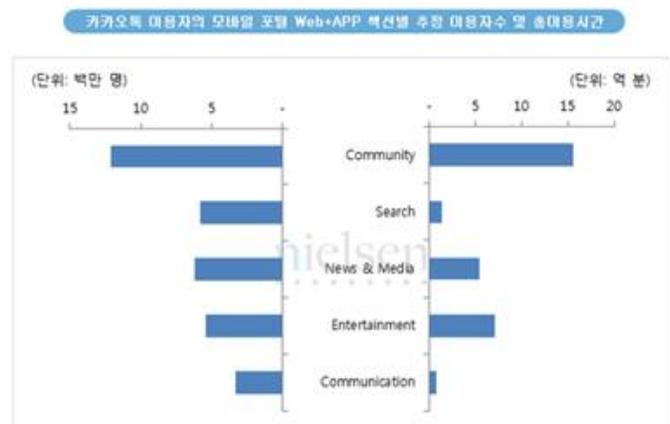
- 3) Daum traffic stabilization through Kakao mobile services** - In May 2015, Kakao introduced the ‘Hashtag (#) service’ in its updated KakaoTalk, which allow users to directly search keywords through the KakaoTalk app. This ‘Hashtag service’ connect users to use Daum search engine and it was created to surpass Naver in terms of mobile search engine market share. Not only that, all of Kakao services lead their users to naturally use Daum search engine instead of its direct competitors. Therefore, currently, according to Nielsen Koreanclick, Google ranks number 1 in terms of number of users for mobile search engine with 20.75 million people, followed by Naver (16.4 million) and Daum (13.6 million).

Figure 6 – Number of Expected Users of Mobile Kakao

Figure 7 – Number of Kakao Users by Platform



Source: Company data



Source: Company data

- Now with such increased Daum traffic, Kakao aims to solidify its user platform and make a community of its own. This is similar to the communities created by its peers, Apple and Xiaomi. This will allow current customer base to enlarge and draw more users to use Kakao instead of Naver or Google. By adding traditional Daum services like Daum News, Daum TV Pot, Daum Webtoon to Kakao, Kakao could definitely hope for a bigger user base and user loyalty.
- Although Kakao currently has low penetration in countries outside the nation, there is high potential for its expansion. Kakao merged with Daum to tackle the global market, specifically by focusing on O2O strategies that target beyond South Korea, which NHN started off with LINE. Kakao stated that it will solidify a platform for global customers and influence customers’ communication, information, and lifestyle, especially on their mobile devices and make a point of differentiation from other competitors in the global market. Hence, it is recommended to buy shares of Kakao, as it is anticipated to expand to a broader market and ultimately generate higher revenue.

Valuation

DCF Analysis

Our base case Discounted Cash Flow (DCF) analysis, which assumes a 33.4% annual growth and operating margin stabilizing at 24% by FY18 (average of 29.2%), with a Discount Rate of 8.92% based on WACC derived from CAPM and a Terminal FCF Growth Rate of 4.0%, produced an implied share price of **157,295 KRW**.

- **Current Share Price:** At 123,300 KRW, Daum Kakao appears substantially undervalued relative to its peer companies as well as to the implied intrinsic value from our discounted cash flow (DCF) analysis. As shown above, we believe a share price closer to 157,295 KRW would be more in-line with the P/E multiples from peers and the DCF output.
- **Other Cases:** If Daum Kakao can continue to have high revenue growth of 30%+, our target price is **182,200 KRW**; if the company delivers results that fall are close to market expectations, our target price is **144,000 KRW**. We focus on the “Base Case” numbers below, which imply a target price of **157,295 KRW**.

In summary, our targeted share prices are as follows:

- **Bull Case:** 182,200 KRW based on 33.4% annual revenue growth and 29.2% operating margin by FY18.
- **Base Case:** 157,295 KRW based on 33.4% annual revenue growth and 24.0% operating margin by FY18.
- **Bear Case:** 144,400 KRW based on 29% annual revenue growth and 24.0% operating margin by FY18.

To project Free Cash Flow and complete the Discounted Cash Flow analysis, we relied upon our “Base Case” financial projections:

Figure 8 – Daum Kakao Projected Income Statement

Revenue Assumptions:	Units					Projected			
		FY11	FY12	FY13	FY14	FY15(Q*4)	FY16	FY17	FY18
Total Revenue	\M	418,718	428,094	210,776	487,805	804,184	1,043,391	1,314,430	1,484,121
Growth Rate	%		2.2%	-50.8%	131.4%	64.9%	29.7%	26.0%	12.9%
Advertising	\M	402,505	411,163	28,771	207,501	219,951	296,934	386,014	443,916
YoY%	%		2.15%	-93.00%	621.21%	6.00%	35.0%	30.0%	15.0%
Game	\M	6,549	8,782	160,532	227,230	306,760	475,478	570,573	627,631
YoY%	%		34.10%	1727.90%	41.55%	35.0%	55.0%	20.0%	10.0%
Commerce	\M	9,663	8,149	12,014	36,664	59,396	130,671	189,472	227,367
YoY%	%		-15.67%	47.44%	205.17%	62.00%	120.0%	45.0%	20.0%
Others	\M	-	-	9,459	16,410	28,062	140,309	168,371	185,208
YoY%	%		0	0.00%	73.50%	71.0%	400.0%	20.0%	10.0%
Operating Income	\M	116,755	101,757	81,786	182,519	147,328	302,583	381,185	430,395
Operating Margin	%	27.9%	23.8%	38.8%	37.4%	18.3%	29.0%	29.0%	29.0%
Operating Income Growth Rate	%		-12.8%	-19.6%	123.2%	-19.3%	105.4%	26.0%	12.9%
Gains: others, financial, capital		18,539	7,541	3,161	8,469	7,213			
Loss: others, financial, capital		7,612	11,219	8,645	16,067	7,503			
EBT		127,682	98,079	76,302	174,921	156382	236,005.46	343,022.96	397,411.95
Loss: Discontinued Operating Income		8,342	4,485	3,028	-	3964	3964	3964	3964
Less: Taxes, Excluding Effect of Interest	\M	27,799	19,730	1,038	18,948	25,051	47,580	78,440	72,979
Net Income	\M	91,541	73,864	72,237	155,972	122,277	184,461	260,619	320,469
D&A			19,297.4	22,679.3	6,565.7	17,149.5			

Source: Company data, KEIC estimates

We then calculated Unlevered Free Cash Flow as follows:

Figure 9 – Daum Kakao Projection of Future Free Cash Flow

Unlevered FCF Projections:	Units					Projected			
		FY11	FY12	FY13	FY14	FY15(Q*4)	FY16	FY17	FY18
Total Revenue	\ M	251,065	330,371	210,776	898,386	842,591	1,151,821	1,574,540	2,152,396
Revenue Growth	%	-	31.6%	-36.2%	326.2%	-6.2%	36.7%	36.7%	36.7%
Operating Income (EBIT)	\ M	116,755	101,757	81,786	182,519	147,328	276,437	377,890	516,575
Operating margin	%	46.5%	30.8%	38.8%	20.3%	17.5%	24.0%	24.0%	24.0%
Less: Taxes	\ M	(27,799)	(19,730)	(1,038)	(18,948)	(25,051)	(47,580)	(78,440)	(72,979)
NOPAT	\ M	88,956	82,027	80,748	163,570	122,277	228,857	299,449	443,596
Total Adjustments for Non-Cash Charges	\ M	3	(273)	(12)	(505)	(389)	(389)	(389)	(389)
Total Inc(Dec) in Operating Capital:	\ M	2,958	(2,392)	7,914	(81,099)	(106,066)	(93,583)	(59,750)	(55,829)
Less: CapEx	\ M	(42,770)	(36,777)	(13,276)	(12,829)	(26,413)	(26,413)	(26,413)	(26,413)
Annual Unlevered Free Cash Flow	\ M	50,630	60,579	30,050	197,407	193,302	220,474	231,939	293,329
Present Value of Free Cash Flow:	\ M					190,256	199,265	192,495	223,549
EBITDA		143,775	137,736	72,588	199,483	138,700	200,884	277,042	336,892

Source: Company data, KEIC estimates

Assumptions:

- **Discount Rate:** 8.92% based on WACC derived from CAPM (Rf: 4.0%, Risk Premium: 6.0%, Beta: 1.10).
- **Terminal Value:** Long-term Free Cash Flow Growth Rate of 4.0%, with an implied terminal EBITDA multiple of 22.1x.

With these assumptions and the Free Cash Flow projections above, the DCF produced the following output:

Figure 10 – Daum Kakao DCF Analysis Output

		Operating Margin						
		28.0%	27.0%	26.0%	25.0%	22.0%	21.0%	20.0%
Revenue Growth	15.0%	₩ 120,463	₩ 117,419	₩ 114,375	₩ 111,331	₩ 111,331	₩ 108,287	₩ 105,243
	20.0%	133,856	130,393	126,929	123,466	123,466	120,003	116,539
	25.0%	148,563	144,640	140,718	136,795	136,795	132,873	128,950
	30.0%	164,666	160,242	155,818	151,394	151,394	146,970	142,546
	35.0%	182,252	177,281	172,311	167,341	167,341	162,370	157,400
	40.0%	201,408	195,844	190,280	184,716	184,716	179,152	173,588
		WACC						
		5.0%	6.0%	7.0%	8.0%	11.0%	12.0%	13.0%
Terminal Growth Rate	(1.0%)	₩ 165,166	₩ 142,731	₩ 125,781	₩ 112,499	₩ 85,553	₩ 79,236	₩ 73,781
	-	189,440	159,443	137,867	121,565	89,999	82,869	76,790
	1.0%	225,852	182,840	153,981	133,222	95,335	87,163	80,300
	2.0%	286,539	217,936	176,540	148,764	101,855	92,315	84,448
	3.0%	407,912	276,429	210,379	170,523	110,007	98,613	89,426
	4.0%	772,030	393,416	266,778	203,162	120,487	106,485	95,510

Source: KEIC estimates

Catalysts and Risks

We believe that Daum Kakao is undervalued and that a price correction could occur within the next 12 months for the following reasons:

- **1) Monetization of Newly Launched Businesses** – It is meaningful as there have been many newly launched services since April 2015 without clear profit models. Kakao Channel and Shop Search is expected to raise 37.7 billion won of revenue. Since there are other services recently launched and new services to be launched, the expectations of the company remains high.
- **2) Turnaround of the Mobile Game Platform Business** –The revenue from mobile game service takes up about 80% of the game platform business, and the company’s turnaround strategy is to diversify the game genres to support the growth of small and mid-size companies through entering the Chinese market. Fruitful results have been showing from “Kakao Friends Pop”, a new mobile game released on in August, which is considered another “hit” game after the famous Anipang. The new game has continued to rank the most downloaded game with 5.23 million downloads, making effectively a national game for the quarter. Likewise, the company’s revenue from the mobile game sector is expected to vitalize the company’s recovery.
- **3) O2O Business Expansion: Temporary Driver Service** – The new O2O business is expected to further diversify Daum Kakao’s business model, deviating from the existing advertising sector, which takes up about 91% of revenue as of 2Q15. The market size of the Korean temporary driver service industry is estimated at around 3,000 billion won. As the industry currently exists as a very complicated and inefficient model, if the company can serve as the major mobile O2O platform provider, the revenue is expected to amount 83.4 billion won calculated under the assumption of 50% of temporary drivers signing up for the service. However, we note that it may take some time for the company to properly plan and invest to launch and also make it profitable.

The followings represent the greatest risks to our investment thesis:

- **1) Underperformance in the O2O Market** –Despite the revenue increase for 1H15 reached 94.4% compared to that of 1H14, its net profit decreased by 36%, caused by the heavy expenditure in its new O2O business platforms. While Daum Kakao’s goal is to achieve of first-mover advantage in the domestic O2O market, uncertainty looms in future performance. The company’s ongoing conflict with temporary driver’s union is an example, which may bring more troubles than expected. However, even though the successes of Kakao Channel, Kakao TV, Kakao coupon, Kakao order and Kakao designated driving are yet to be determined, we believe the target price of 157,295 KRW is still conservative considering expected long-term future growth.
- **2) Brand Value Impairment from Future Release of New Mobile Games** – Mobile game sector contributes to 2nd largest source of income for Kakao. We note that the performances of Kakao’s future games, such as Anipang Mat-go and Shanghai Anipang, may be questionable. While these mobile gambling games seem marketable and can be expected to bring commercial success, the market may not view Daum Kakao’s revenues from gambling games as innovative. Such a perception can damage the company’s brand value, along with its long-term profitability. Thus, these game have double-edge swords and their respectively advantages and disadvantages must be considered thoroughly.