

## **Shinsegae Food (031440)**

### **Key Investment Points**

1) Proven catering service business, which grew during the recent financial crisis, enjoys a 10% market share in the domestic catering service industry and 10% operating margin. Cash flow from the business is financing the growth in food distribution/manufacturing and restaurant businesses. We foresee continued mid-single digit growth in the catering business for years to come.

2) Strategic relationship with E-Mart allows the co. to expand into higher margin private label grocery items. We anticipate more exclusive agreements with foreign vendors entering the Korean market to spur growth within a few years.

3) No debt, strong free cash flow and a strong PP&E base provides ample safety margin for investors. Free cash flow is financing growth initiatives, which has kept leverage and risk at bay. Dividend paid annually with current yield at 0.9%.

### **Company Introduction**

Shinsegae Food is in the business of catering, distribution, processing of food. Shinsegae Food started off as a simple catering business to corporate clients in 1986, but has now diversified and grown into a 1) Catering Service, 2) Food Distribution and Food Manufacturing, 3) Restaurant and Banquet business.

#### **Catering Service (Rev. KRW 280BB; Op. Margin 10%; Growth 6% YoY)**

Cash cow. Creates a large number of pre-cooked, pre-packaged meals for schools, hospitals, companies, elderly communities and etc. They manage the onsite cafeteria facility with their own staff. Seems recession proof as sales grew during the recession since it is a cheaper alternative for the students, workers for lunch than eating at a sit down restaurant. Workers in Seoul have voiced their opinions on the rising cost of dining, so the catering service business can act as a hedge during economic downturns. Per the co.'s IR report, they have the highest margin in the industry and the catering market grew 7.6% during 2006-2009.

**Food Distribution (Rev. KRW 270BB; Op. Margin 3%; Growth 19% YoY)**

Growth driver of the company. Imports goods from overseas as exclusive distributors for Chiquita (bananas), Ocean Spray (cranberry juice), and other well known brands. Also, they import beef products, fruits and other high margin food items. The co. creates the Private Labeled goods on behalf of E-Mart, which the co. is pushing to increase margins and growth. 33% of revenues from food distribution/manufacturing is from E-Mart related sales.

**Manufacturing (Rev. KRW ~70BB; Op. Margin 2%; Growth 11% YoY)**

Meat processing, marine pre-processing, vegetable pre-processing, noodle/rice cake manufacturing, convenience food. The company sells the prepared food items to restaurants and catering businesses. Also, they are creating SKU items sold in convenience and grocery stores such as noodles, sandwiches, sauces, and kimbap.

**Restaurant Business (Rev. KRW 66BB; Margin 1.5%; Growth -6% YoY)**

Possible homerun or bust. Bono Bono (seafood buffet), Delia, Golf course club house, and provides banquet service. The business is still in the infant stages of development and needs time to grow revenue past the break-even point with fixed SG&A costs. Premium image and higher ASP will help margins improve over time. They could leverage their catering skills and food distribution logistics to lower costs, but restaurants operate on a completely different business model and time will prove whether the business was a sound investment. We think of this business as a call option piece.

**Ownership**

E-Mart is the largest shareholder with a 52.3% holding. Shinsegae Group was owned by Samsung, but split into a separate entity in the mid-90's. Shinsegae Group owned E-Mart, but E-Mart demerged into an independent co. on May 2011. As a result, the co. is officially, no longer tied to the Shinsegae Group, but cross shareholdings and previous ties may still play a part on their operations. E-Mart's major shareholders are Myung Hee Lee (17.3%; sister of current Samsung chairman), Aberdeen Asset Management (10.2%), First State Investment Management (9.5%), or an unconsolidated group of individuals and investment firms. KRW 113 BB in revenue with E-Mart, or 16% of company's total revenue. Roughly 130 E-Mart stores domestically are opened with room for expansion although government policy has been clamping down on chaebol growth for the mom

and pop stores. The relationship with E-Mart is a critical aspect of their business, especially with plans to grow merchandising to 50% of sales in the near future, from 35%. Also, the co. is an exclusive food supplier to the Chosun Hotel, another affiliate within E-Mart's holdings.

### **Competitors/Industry Trend**

As more individuals eat out for lunch, or drop by the market for a quick dinner, the consumption trend will lean toward the Home Meal Replacement (HMR) consumables produced by Shinsegae. A continually shrinking gross margin is indicative of pricing pressure and inflationary market as increasing commodity prices raise the cost of goods. The food industry is known for slim margins and a positive side to the co. is the recognition of the trend and action taken place to increase margins through private labels and premium goods development.

In the food catering business Hyundai Food System, Samsung Everland and LG Our Home dominate the industry, with a near 60% market share. The Co. has a 10% market share of the KRW 2.3 TT industry, 4<sup>th</sup> largest in the catering service business. The overall catering business is KRW 8 TT, so there is still ample room for continued growth.

For manufacturing/distributing, staple items such as noodles, rice cakes could be easily produced and replicated by the competitors. We believe the exclusive supplier agreement imported goods like Chiquita, Ocean Spray, Fiji Water will be successful in cross company sales to the likes of Home Plus. Food material business is a KRW 78 TT industry, which implies a market share less than 1%. The opportunities seem endless with a large market to exploit and the co. will need to invest much more capital.

### **Strategy**

Their near term goal is prioritized toward developing more private branded products to sell on grocery market shelves. Food catering is a cash cow, but the company could solidify a more pivotal role in the food space by selling branded goods like Nongshim. The co. will most likely grow along with E-Mart's expansion. Moody's cited E-Mart's "sizeable expansion plan" as a reason for their A3 rating since they will be leveraging their balance sheet to finance the new store openings, which could translate into more

sales venue for the co. Aside from store openings, the co. needs to increase the SKU count, by developing more in-house items or importing more foreign goods to the current stores. They have been reporting more SKU count development through their R&D, which is a marginal part of the company's expenditures.

Geographically, 3 distribution/warehouse centers are located near the South East, South West and near Seoul. Also, a central meat, seafood, vegetable processing plant and a convenience food production sites are within 30 minute proximity from Seoul.

The business is primarily a domestic firm. E-Mart's expansion to China, 100 stores by 2015, may create international opportunities for the co. Shinsegae doesn't have an international presence like the other conglomerates so it may prove to be difficult at first and will require external financing should they expand internationally. The co. may want to target Korean communities in the U.S., China initially since there are networks of grocery store within those K-town districts.

### **Performance/Financials**

On a consolidated basis, the businesses are realizing 20% growth rate over the past few years and they were profitable even through the economic crisis during 2007 to 2009. The co. reported KRW 698BB total revenue, 15% gross margin and 4% net margin on a consolidated basis in 2011. KRW 39BB net income over KRW 176BB is a 22% ROE, a fantastic net margin, slightly higher than the 20% ROE the co. averaged consistently in the recent few years.

KRW 40-50 BB in operating cash flow finances the roughly 15-20 BB KRW in annual cap ex. The company is essentially financing their expansion on an incremental basis without external financing, which allows co. to keep leverage low. The co. has grown the tangible asset base from KRW 34BB in 2005 to +100BB in 2011, the same nominal growth in the stockholder's equity. Cash from operations goes primarily into purchasing more land, building, equipment, not in costly, goodwill impairing acquisitions, thereby growing the underlying value for investors.

KRW 110BB in PP&E, KRW 188BB in Stockholder's equity, KRW 72BB in liabilities. Liability to equity is only 38.8%. 1,061 employees accounting for KRW 16.7BB in salary, wages

expenditures.

## **Opinion**

Co. enjoys a strategic relationship with E-Mart thanks to the history and ownership structure, although it is not a considerable part of overall revenue at 10% of total sales, but 33% of revenues from food distribution/manufacturing is from E-Mart related sales. We believe a fundamental question to ask is whether the company would be able to survive without ties to E-Mart, or Shinsegae? Food manufacturing/distribution, not so certain. We faced difficulty finding any insightful information into the business, so we are not sure of the inherent risk or growth prospects. We don't want to base our decision solely on the optimistic historic figures. A method we can apply to hedge our bets is to allocate the value of the underlying tangible assets to this business, since most of the activity from the factories and buildings would be for the distribution/manufacturing activities.

Catering services, yes. The diversified client base in the food catering service business provides a stable cash flow. For the long term, the co.'s growth will taper off, unless the co. does smaller sized deals or full service catering.

Restaurants, yes. There are so many restaurants in Korea, they will face heavy competition and may only be profitable with one or two restaurant chains. However, the business is a small part of the overall valuation, and acts essentially like a call option. If the business grows, then it is great, but too small to matter for our consideration at the moment.

Overall, the co. has a very low risk related to liquidity, solvency and going concern. Market price is KRW 90,000 and 3.43 MM shares outstanding for a market cap of KRW 308.5 BB. The co. holds roughly KRW 15BB in cash & equivalents, with zero interest bearing debt. Enterprise value comes out to roughly KRW 290BB with EBITDA of KRW 40BB, or a 7.4 x EV/EBITDA multiple. If we add 5 years of EBITDA, or roughly KRW 200BB to our current net tangible asset (tangible assets – total liabilities) of KRW 188BB, then in 5 years, the value should be KRW 388BB, or a 26% appreciation over the period relative to today's EV. Dividend is roughly KRW 2.5BB, or a 0.8% dividend yield.