

Studio Dragon (253450 KQ)

HJ Kim

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Rating **MARKETPERFORM**

downgrade

6M TP (₩) **74,000**

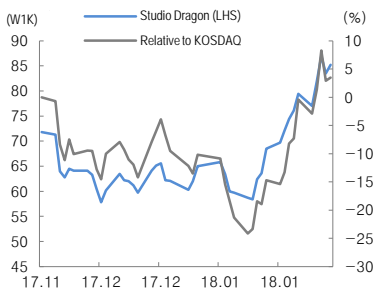
raise

CP (₩)
(18.01.26) **85,200**

Media

KOSDAQ	913.12
Market cap (₩bn)	2,389
Market cap portion (%)	0.80
Paid-in capital (common; ₩bn)	17
52w high/low (₩)	87,000 / 57,800
120d avg. trading volume (₩bn)	48.9
Foreign ownership (%)	0.96
Major shareholders	CJ E&M+3: 75.66%

(%)	1M	3M	6M	12M
Abs. return	41.3	N/A	N/A	N/A
Rel. return	17.9	N/A	N/A	N/A



On a Temporary Retreat

Rating Downgraded to MARKETPERFORM; but 6M TP Raised to ₩74,000

- We have arrived at the new target price of ₩74,000 for Studio Dragon from the residual income model (RIM). We assume that revenue will grow 35% annually until 2026 (more specifically, 58% until 2021 and 15% thereafter)
- Unlike our previous report in which the target price was derived from 2018E results, we have chosen RIM this time to reflect Studio Dragon's long-term growth as the company will not only produce TV dramas for tvN and OCN, but also will increase production of global contents (Netflix Original Contents, plus the CJ O Shopping and CJ E&M merger).
- We have raised our target price by 61% to ₩74,000 after revising up 2018E OP by ₩20bn (or 40%) in recognition of the increased probability of supplying contents to Netflix and China. However, we have downgraded the rating to MARKETPERFORM as the stock currently trades at 15% higher than our new target price.
- The new target price is equivalent to 36x 2018E EPS of ₩2,085 but the current P/E stands at about 41x.

Studio Dragon Exists for CJ E&M; Investors should wait to confirm China export

- In Korea, it costs about ₩500mn on average to produce a single episode for a TV drama series, which usually consists of 16 episodes. In other words, one TV drama series costs an average of ₩8bn.
- CJ E&M bears approximately 70% of the production cost, while the remaining 30% is funded by Studio Dragon (which books it as an intangible asset that is amortized over a 1.5-year period). Meanwhile, about 20% of the production cost is covered by revenue from indirect advertisements. Studio Dragon, which holds the intellectual property (IP) rights, recognizes an average of about 40% of the production cost as IP revenue, while paying about 15% of this to CJ E&M as commission. On balance, Studio Dragon's earnings amount to an average of about 30% of production cost (Fig. 2), with the number further rising to about 40% if revenue from China and Netflix is included.
- Supposing Studio Dragon produces 25 TV dramas in 2018, it will produce earnings of about ₩50bn, excluding commissions to be paid to CJ E&M. On top of this, if the company successfully exports two dramas to China, its earnings will further increase by ₩20bn (₩10bn per drama).
- The recent strong share price rise reflects the expectation that revenue in China will increase on the back of improving diplomatic ties. We also reflected this in our earnings forecast, assuming that Studio Dragon will export two dramas (₩10bn per drama). The unit price of ₩10bn per drama has been derived given a 30% premium Studio Dragon merits as the largest production company in Korea to the average price of Korean TV dramas exported to China so far (₩8bn) (Tab. 2). However, the share price is hovering above our target price even after assuming this earnings growth.
- Moreover, there are three hurdles to cross when exporting dramas to China at high prices: 1) The drama has to be produced in advance for simultaneous airing in Korea and China, and is subject to China's pre-emptive censorship; 2) the cast must comprise of Korean actors/ actresses popular among Chinese viewers; and 3) its genre should not negatively impact Chinese citizens' views or beliefs.
- It is possible for Studio Dragon to produce dramas, keeping in mind potential export to China, but its top priority is always CJ E&M. CJ E&M's success since 2014 owes to the fact that: 1) it avoided airing dramas at the same time with terrestrial TV broadcasters; 2) it explored unique genres such as time slip, ghost, and social criticism; and 3) it casted veteran actors and new actors rather than Korean Wave (Hallyu) stars. Investors should wait and confirm China exports before making investment decisions.

Operating results and major financial data (Wbn, W, x, %)

	2015A	2016A	2017F	2018F	2019F
Revenue	-	154	281	341	370
OP	-	17	32	72	85
Pretax profit	-	10	30	81	93
NP	-	8	22	58	68
NP (controlling int.)	-	8	22	58	68
EPS	-	5,691	985	2,085	2,414
PER	-	-	86.5	40.9	35.3
BPS	-	61,763	13,249	15,185	16,998
PBR	-	0.0	6.4	5.6	5.0
ROE	-	12.0	8.8	14.7	15.0

Note: EPS, BPS, and ROE are based only on the controlling interest.
Source: Studio Dragon, Daishin Securities Research Center

Yearly earnings forecast revision (Wbn, W, %, %p)

	Previous		Revised		Chg	
	2017F	2018F	2017F	2018F	2017F	2018F
Revenue	292	353	281	341	-4.0	-3.3
S&A expense	9	9	9	9	0.5	0.2
OP	39	52	32	72	-19.1	40.0
OP margin	13.5	14.6	11.4	21.2	-2.1	6.5
Non-operating profit	-2	8	-2	8	CL	0.0
Pretax profit	38	60	30	81	-19.9	34.4
NP (controlling int.)	28	45	22	58	-20.4	28.6
NP margin	9.6	12.9	8.0	17.1	-1.6	4.2
EPS (controlling int.)	1,240	1,622	985	2,085	-20.6	28.6

Source: Studio Dragon, Daishin Securities Research Center

Earnings Forecasts and Share Price Catalysts

- Positives: China and global business growth could outperform our forecast
 - 1) If the yearly China export volume posts three or four (vs. our assumed two) starting in 2018, the target price could be raised to W82,000 and W90,000, respectively.
 - 2) The purpose of the merger between CJ O Shopping and CJ E&M is to expand investments in global contents production. As such, Studio Dragon could continue rapid growth even after organic domestic growth has run its course in 2021. Currently, we assume that the company will grow 58% annually until 2021, and 15% annually starting in 2022. If it grows at 20% or 30% annually starting in 2022, the target price could be increased to W92,000 and W140,000, respectively.
- Negatives: Reduction in television money ratio; weak exports to China
 - 1) CJ E&M could cut its television money ratio: CJ E&M pays about 70% of production cost to Studio Dragon as "television money." CJ E&M's revenue is however greater than production cost as it additionally sells advertisements and collects 15% of IP revenue from Studio Dragon. CJ E&M's average OP margin is estimated at 5-10%.
 - 2) Studio Dragon's revenue is forecast at about 40% of production cost, and its OP margin at 20-25%. CJ E&M could lower its television money ratio or demand a greater share of IP revenue from Studio Dragon.
 - 3) China exports could contract: No export contracts to China have been signed yet. Neither continued improvements in bilateral diplomatic relations nor the increase of Studio Dragon's exports to China can be guaranteed. One of the reasons why China has to date imported Korean dramas at high prices is attributed to good quality, but it is unclear how much longer they will maintain good quality. If exports to China are excluded, the target price could fall to W60,000.

Don't hold your breath on Netflix

- Netflix needs Korean contents to lure Korean viewers and pursue growth in Southeast Asia where Korean pop culture is very popular. However, it will not be easy to settle in the Korean market where 150 real-time channels are available for a monthly average fee of W10,000.
- Some tend to regard Netflix as a big customer like China after it purchased *Man To Man* from JTBC for W6bn (about W400mn per episode). But there is a catch when Netflix buys dramas, which is simultaneous airing across the world, increasing the potential risk of cannibalization. We assume that Studio Dragon will supply an average of about three dramas a year to Netflix, grossing about W4bn per drama (even when accounting for the potential cannibalization).

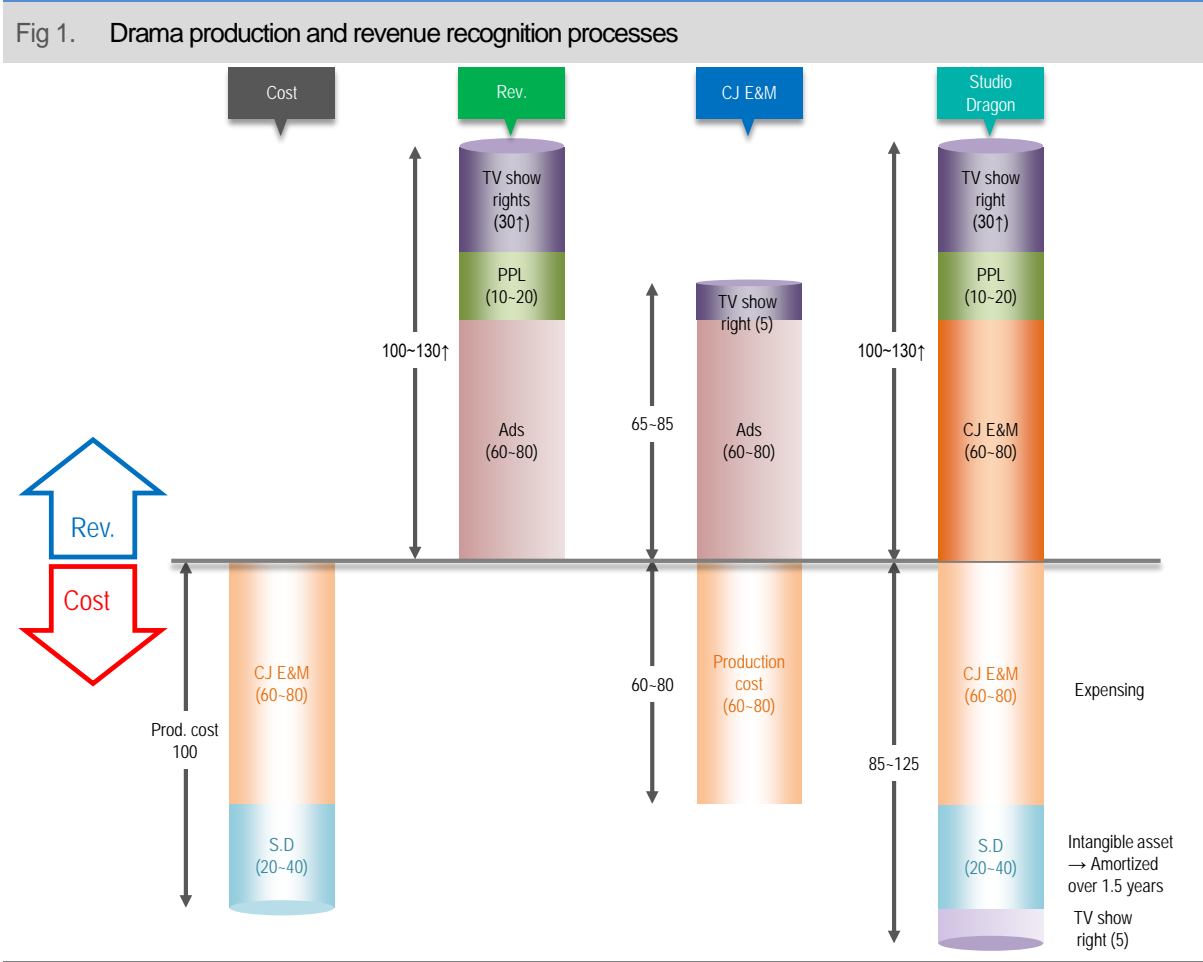
Tab 1. Studio Dragon earnings forecast

(W'00mn, %, episodes)

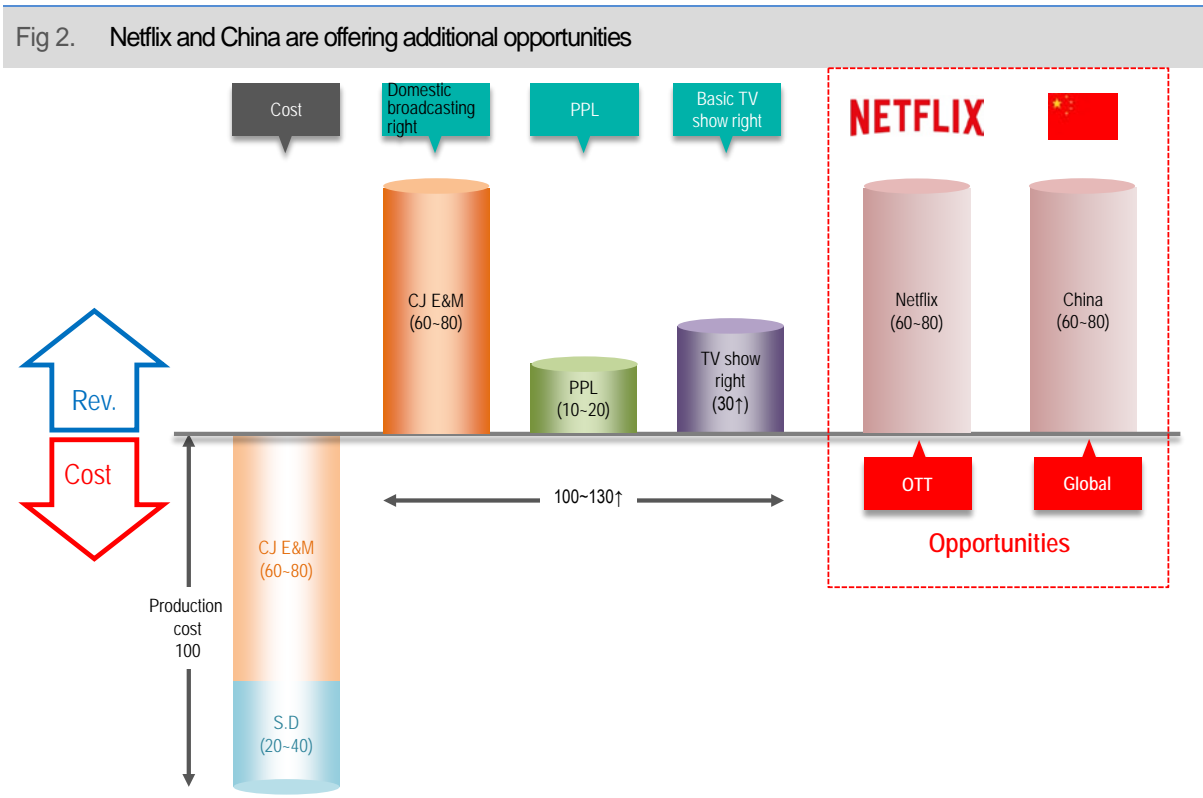
	2016	2017E	2018E	2019E	2020E	2021E
Revenue	1,544	2,807	3,415	3,700	3,936	4,196
1) Drama production	1,376	2,527	3,074	3,330	3,542	3,776
- CJ E&M recoup		1,001	1,449	1,509	1,585	1,610
- PPL		297	414	464	488	537
- TV show rights		1,229	1,211	1,357	1,470	1,630
2) Artist management	168	280	342	370	394	420
OP	166	319	723	848	921	1,028
NP	81	224	586	677	728	807
OP margin	9.0	11.4	21.2	22.9	23.4	24.5
EBITDA	657	817	1,329	1,545	1,741	1,972
No. of dramas produced	19	22	25	30	35	40
- Sales to China			2	2	2	2
Drama production cost	1,520	1,486	2,070	2,322	2,438	2,683
- Production margin		30	42	42	43	43

Note: 2016 earnings are based on the May 1-Dec.30 period (after the spinoff of Studio Dragon).

Source: Studio Dragon, Daishin Securities Research Center estimates



Source: Studio Dragon, Daishin Securities Research Center



Source: Studio Dragon, Daishin Securities Research Center

Tab 2. Exports of Korean TV dramas (W'00mn)

Drama title	Buyer	Airing period	# of ep.	Highest viewer rate	Broadcaster	Production company	Price
My Love from the Star	China	13.12.18~14.2.27	21	28.1	SBS	HB Entertainment	0.5 / 10.5
Descendants of the Sun	China	16.2.24~16.4.14	16	38.8	KBS2	Studio Dragon	5 / 80
Moon Lovers: Scarlet Heart	China	16.8.29~16.11.1	20	11.3	SBS	Wind Blows Co., Ltd.	4.6 / 91
While You Were Sleeping	China	17.9.27~17.11.16	16	10.0	SBS	IHQ	4.7 / 75
Man To Man	Netflix	17.4.21~17.6.10	16	4.1	JTBC	Drama House	3.8 / 60
A Korean Odyssey: Hwayuki	Netflix	17.12.23~	16	4.1	tvN	Studio Dragon	5 / 80

Source: news media reports, Daishin Securities Research Center estimates

Fig 3. Romantic comedies featuring ghosts



Source: Daishin Securities Research Center
Note: Oh My Ghost (top rating 7.3%) / Bring It On, Ghost (4.3%)

Fig 4. Historical dramas with modern elements



Source: Daishin Securities Research Center
Note: Three Musketeers (top rating 2.0%) / Deserving of the Name (6.9%)

Fig 5. Dramas dealing with social issues



Source: Daishin Securities Research Center
Note: "Incomplete Life" (top rating 8.2%) / Stranger (6.6%)

Fig 6. Fantasy dramas



Source: Daishin Securities Research Center
Note: Signal (top rating 12.5%) / The Legend of the Blue Sea (17.9%)

Fig 7. Fantasy drama



Source: Daishin Securities Research Center
Note: Guardian(top ratings) 20.5%

Fig 8. No more Cinderella story!



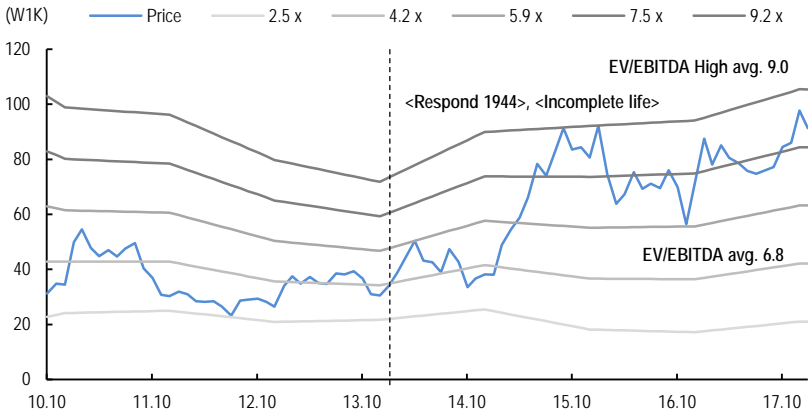
Source: Daishin Securities Research Center
Note: Avengers Social Club (top rating 6.3%)

Tab 3. Studio Dragon SOTP valuation (%)

	Enterprise value	Discount	Fair value	Per-share value
A Operating value	19,202	0%	19,202	68,107
OP	723			
Depreciation exp.	606			
EBITDA	1,329			
EV/EBITDA	14.5			
EV/EBITDA 14.5x = a 60% premium on the upper end of CJ E&M's EV/EBITDA band (9.0x).				
C Total enterprise value (A+B)	19,202		19,202	68,107
D Net borrowings	(2,152)		(2,152)	(7,633)
E Shareholder value (C-D)	21,354		21,354	75,739

Source: Daishin Securities Research Center

Fig 9. CJ E&M 12MF EV/EBITDA band rising sharply since 2014



Source: Wisefn, Daishin Securities Research Center

Per share intrinsic value

Residual Income Model		(Wbn, W, %)									
		2017F	2018F	2019F	2020F	2021F	2022F	2023F	2024F	2025F	2026F
I	NP (contr. int.) ^(Note 2)	22	58	68	73	81	93	107	123	141	162
II	Shareholders' equity (contr. int.) ^(Note 2)	371	426	477	477	527	589	658	733	819	910
	Estimated ROE	8.8	14.7	15.0	15.3	15.3	15.7	16.2	16.7	17.2	17.8
III	Required rate of return ^(Note 3)	5.2									
	Risk free rate of return ^(Note 4)	2.4									
	Market risk premium ^(Note 5)	4.0									
	Beta	0.70									
IV	Spread (estimated ROE – required rate of return)	3.6	9.5	9.8	10.1	10.1	10.5	11.0	11.5	12.0	12.6
V	Required income	7	19	22	25	25	27	31	34	38	43
VI	Residual income (I - V)	15	39	46	48	56	65	76	88	103	120
	Present value factor	1.00	0.95	0.90	0.86	0.82	0.78	0.74	0.70	0.67	0.63
	PV of residual income	15	37	41	41	46	51	56	62	69	76
VII	Sum of residual income	493									
VIII	PV of residual income following forecasting period	1,456									
	Terminal growth (g) ^(Note 6)	0.0%									
IX	Beginning shareholders' equity	136									
X	Fair market cap (VII+VIII+IX)	2,086									
	Total number of shares (thousands)	28,037									
XI	Per share value (W)	74,393									
	Current share price (W)	85,200									
	Potential (%)	-12.7%									

Note 1: Under the residual income model (RIM), we add the current shareholders' equity to the residual income based on the earnings forecast for the next ten years before adding the result to the residual income after the forecasting period to derive the value of shareholders' stakes. The RIM is considered less subjective than similar valuation models such as DDM, DCF, and EVA.

Note 2: The RIM reflects consolidated subsidiaries' earnings not in their entirety but only for the stake controlled by the company.

Note 3: The required rate of return (i.e., cost of equity) is the rate of return expected by the shareholders who take risks. It is derived by the capital asset price model: Cost of equity = Risk-free interest rate + Beta * Market risk premium.

Note 4: The yield on five-year government bonds was used as the proxy for the risk-free interest rate.

Note 5: Market risk premium refers to the gap between the expected return on the market portfolio and the risk-free interest rate. It has been lowered from 6-8% to 3-5% in reflection of the current low-growth environment.

Note 6: The terminal growth was assumed to be zero.

Financial statements

Income statement					(Wbn)
	2015A	2016A	2017F	2018F	2019F
Sales	0	154	281	341	370
Cost of goods sold	0	133	240	260	275
Gross profit	0	22	41	81	95
SG&A expenses	0	5	9	9	10
OP	0	17	32	72	85
OP margin	na	10.8	11.4	21.2	22.9
EBITDA	0	39	82	133	155
Non-OP	0	-6	-2	8	9
Income from affiliates	0	0	0	0	0
Financial revenue	0	1	1	8	8
FX related gains	0	0	0	0	0
Financial expense	0	-2	-3	-1	-1
FX related losses	0	1	0	0	0
Others	0	-5	0	1	1
Income before taxes	0	10	30	81	93
Income tax expense	0	-2	-8	-22	-26
Income from cont. op.	0	8	22	58	68
Income from discount. op.	0	0	0	0	0
NP	0	8	22	58	68
NP margin	na	5.3	8.0	17.1	18.3
NP for non-contr. interest	0	0	0	0	0
NP for contr. interest	0	8	22	58	68
Valuation of AFS fin. assets	0	0	0	0	0
Other compreh. income	0	0	0	0	0
Comprehensive income	0	8	23	59	68
Comp. income for non-contr. int.	0	0	0	0	0
Comp. income for contr. int.	0	8	23	59	68

Valuation metrics					(W, x, %)
	2015A	2016A	2017F	2018F	2019F
EPS	0	5,691	985	2,085	2,414
PER	#DIV/0!	0.0	86.5	40.9	35.3
BPS	0	61,763	13,249	15,185	16,998
PBR	0.0	0.0	6.4	5.6	5.0
EBITDAPS	#DIV/0!	27,127	3,598	4,737	5,511
EV/EBITDA	0.0	0.4	27.1	16.4	13.8
SPS	0	107,949	12,359	12,177	13,200
PSR	0.0	0.0	5.3	7.0	6.5
CFPS	0	24,684	3,599	4,827	5,609
DPS	0	0	150	600	800

Financial ratios					(W, x, %)
	2015A	2016A	2017F	2018F	2019F
Growth potential					
Sales growth	na	na	81.7	21.6	8.4
OP growth	na	na	91.7	126.7	17.3
NP growth	na	na	174.6	161.5	15.7
Profitability					
ROIC	0.0	19.7	15.4	28.8	31.1
ROA	0.0	13.7	8.6	14.3	15.8
ROE	0.0	12.0	8.8	14.7	15.0
Stability					
Debt ratio	0.0	77.8	35.1	19.9	18.0
Net borrowings ratio	0.0	12.1	-47.0	-50.5	-52.2
Interest coverage ratio	0.0	19.5	665.0	45,019.0	52,802.3

Source: Studio Dragon, Daishin Securities Research Center

Balance sheet					(Wbn)
	2015A	2016A	2017F	2018F	2019F
Current assets	0	81	323	330	370
Cash & cash equiv.	0	12	223	215	249
Trade & other receive.	0	39	70	84	91
Inventories	0	0	0	0	0
Other current assets	0	31	30	30	30
Long-term assets	0	161	179	181	192
Tangible assets	0	1	1	1	1
Investments in affiliates	0	0	0	0	0
Other long-term assets	0	159	178	180	192
Total assets	0	242	502	511	563
Current liabilities	0	84	109	83	84
Payables & other liab.	0	20	25	27	29
Borrowings	0	8	8	0	0
Current portion of LT debts	0	0	20	0	0
Other current liabilities	0	56	56	56	56
Long-term liabilities	0	21	21	2	2
Borrowings	0	20	20	0	0
Convertible securities	0	0	0	0	0
Other long-term liab.	0	2	2	2	2
Total liabilities	0	106	131	85	86
Controlling interest	0	136	371	426	477
Capital stock	0	11	17	17	17
Capital surplus	0	115	322	322	322
Retained earnings	0	8	31	85	136
Other capital changes	0	2	2	2	2
Non-controlling interest	0	0	0	0	0
Total shareholder's equity	0	136	371	426	477
Net borrowings	0	16	-175	-215	-249

Cash flow statement					(Wbn)
	2015A	2016A	2017F	2018F	2019F
Operating cash flows	0	-12	18	78	103
NP	0	8	22	58	68
Non-cash items	0	27	59	77	90
Depreciation	0	22	50	61	70
FX gains	0	0	0	0	0
Equity method gain	0	0	0	0	0
Others	0	5	10	16	20
Chg in assets & liab.	0	-46	-56	-42	-36
Other cash flows	0	-2	-8	-15	-18
Investing cash flow	0	-70	-136	-130	-149
Investment assets	0	0	0	0	0
Tangible assets	0	-1	0	0	0
Others	0	-68	-136	-130	-149
Financing cash flows	0	93	243	-42	-6
Short-term borrowings	0	7	0	-8	0
Bonds payable	0	20	0	-20	0
Long-term borrowings	0	0	0	0	0
Rights offering	0	56	213	0	0
Cash dividends	0	0	0	-4	-17
Others	0	10	30	-10	10
Net chg in cash	0	12	223	-7	33
Beginning cash balance	0	0	0	223	215
Ending cash balance	0	12	223	215	249
NOPLAT	0	13	24	52	61
FCF	0	34	5	51	50

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