KEPCO PLANT SERVICE & ENGINEERING (Value Investors Club) – April 2020

						2020	2021
Price:		32,000.00		**EPS**		3455	3766
Shares Out. (in M):		45		**P/E**		9.3	8.5
Market Cap (in $M):		1,167		**P/FCF**		12	10.9
Net Debt (in $M):		-205		**EBIT**		160	175
TEV ($):		959		**TEV/EBIT**		6	5.5

Executive Summary

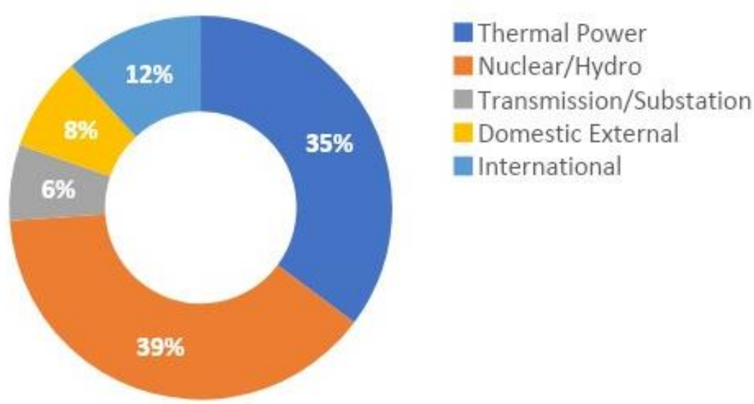
KPS KEPCO Plant Service & Engineering Co. (KPS, 051600.KS) is a listed subsidiary of Korea Electric Corporation (KEPCO, 015760.KS) for which it services its fleet of thermal and nuclear power plants. We estimate that at least 70% of revenues are recurring and that another 20% are essential to its customers and so very likely to be reconducted from one year to the next. Operating margins have gently fluctuated between 10% and 20% over the past ten years and have averaged 14% over the past five. We estimate that earnings in 2020 and 2021 will be in a +/-5% range, with some upside if KEPCO position improves. Valuation ratio expansion to more normalized levels could be the main performance driver.

KPS offers an attractive valuation of 6x EV/EBIT coupled with very strong earnings predictability. It has a current market capitalization of US$1.2B and a strong balance sheet with US$210M of net cash. The latest average daily volume is close to US$5M. Its payout ratio has averaged 50% historically which after a slide in its share price over the past five years, translates into a very secure 6% dividend yield.

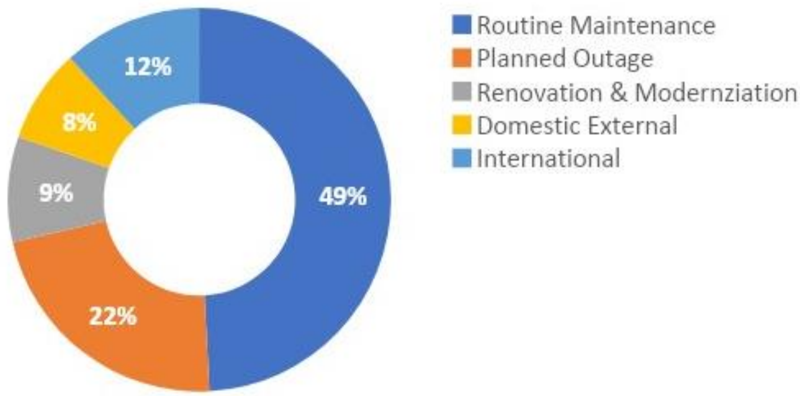
Like Sumitomo Densetsu (please see our August 2018 post), KPS is an asset-light business with high return on its team of highly skilled (and scarce) engineers. Its track record of maintaining mission-critical infrastructure and corporate pedigree provide a strong competitive moat around its business and explains its 60% overall market share and 80% share of planned outages maintenance.

Power Plants Maintenance and Services

KPS revenue contribution by facility type in 2019 were as follows:

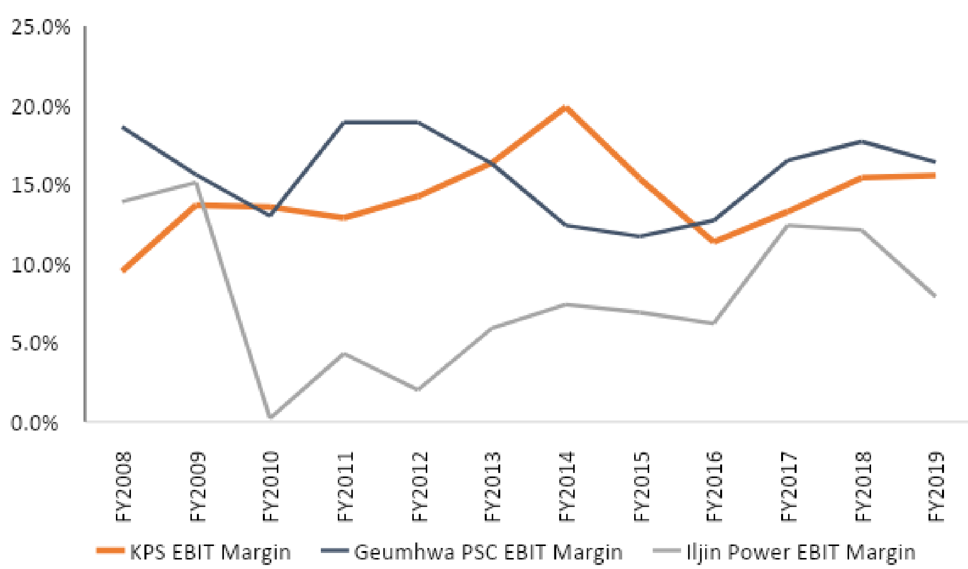


And its contribution by service type in 2019 was:



Source: Company Filings

Maintenance service for Thermal Power plants was opened up to competition in 2013, creating opportunities for new players such as Geumwha (036190.KS, written up by miser861 last August). This came to an abrupt stop in December 2018 when a temporary technician working for a private maintenance contractor was killed at a customer's site. This has led to a freeze of new contract awards while private competitors try to build up their in-house full-time employee capabilities. KPS exclusively recruits long-term employees, which have public service status, making them coveted positions attracting the best engineering talents.

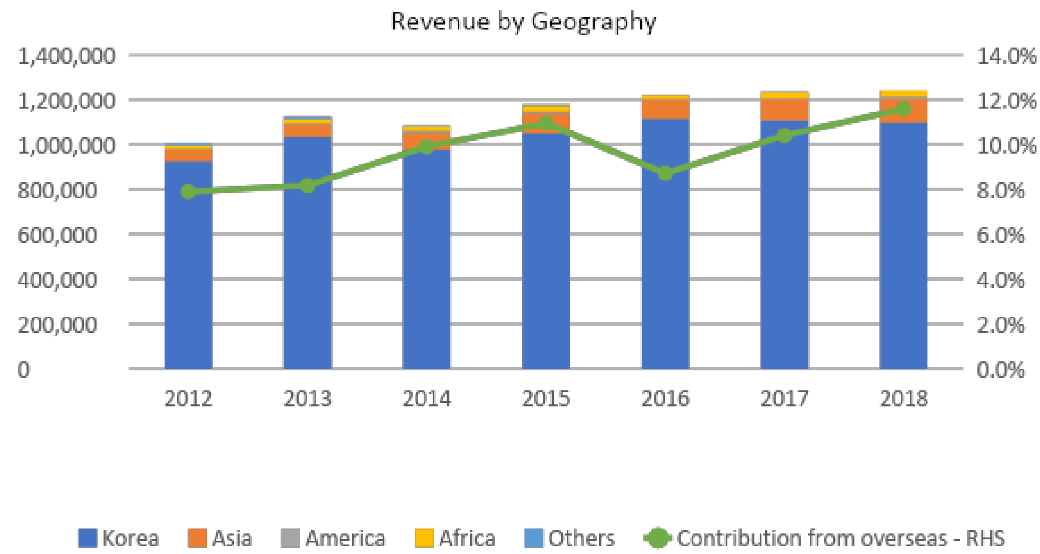


Source: Company Filings (KPS 2015/16 margins are one-off adjusted)

All along, KPS maintained exclusive rights for maintenance of the country's nuclear plants where its market share amount to72%.

International Markets

KPS has followed KEPCO's lead to offer maintenance planning and services in contracts around the world, mostly for nuclear plants. The largest international project is a nuclear plant in the UAE, which is close to completion and should start contributing revenues in 2020. Gross margins for this project should be higher than the 30% to 40% margins for domestic nuclear plants and should therefore be earningsaccretive.

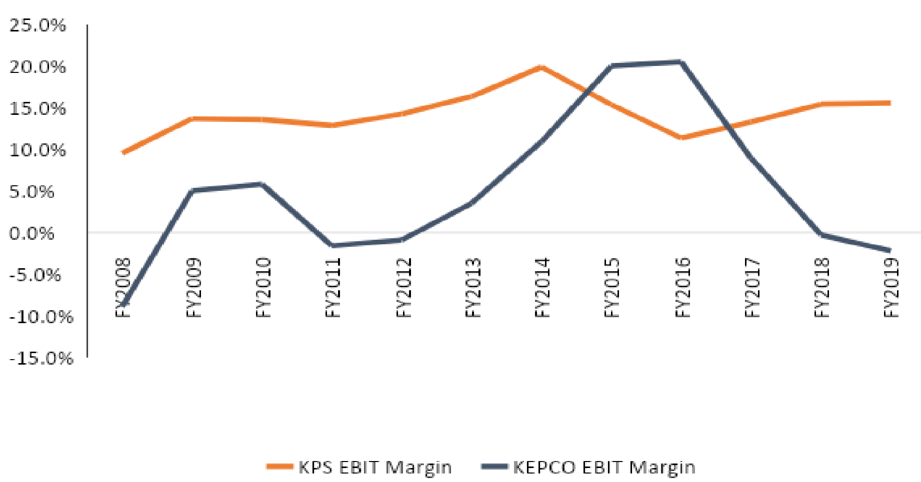


Source: Company Filings

The 75% slide in share price from its peak five years ago is probably due to an exuberance about international opportunities back in 2013, when valuation climbed to 24x EV/EBIT. At the current level, any future upside from the performance of the Korean nuclear industry abroad is heavily discounted.

Dependence on KEPCO

Our investment thesis' weakness is clearly going to be customer concentration, with~80% revenue generated from KEPCO. Although KPS has historically been shielded from industry cycles, its symbiotic relationship with its parent company could clearly become an issue if KEPCO's mounting troubles do not start toimprove.



Source: Company Filings (2015/16 margins are one-off adjusted)

KEPCO has been in the crosshairs of the newly elected Moon administration, which has piled pressure on it to increase its renewable energy mix and has led to problems increasing its electricity tariff back to levels enjoyed before the unprecedented tariff cut in 2016 by the prior administration. A moratorium on new nuclear plants construction in Korea and the fact that three units are currently under prolonged planned maintenance have also clearly not helped

KEPCO's poor performance since 2017 has slowly percolated to KPS level, with the addition earlier last year of a clause in its existing contracts linking its plants utilization rate with KPS maintenance revenues. We should note that although the conditions were clearly negative, there were no substantial impact in 2019.

An increase of 6GW in nuclear power from the installed 23GW capacity by 2023, a return to 85% nuclear utilization rate from the current 66% as well as a normalization of tariffs may revert some of this pressure. Again, not of this upside is priced in at this level.

Korean Equity Markets

We are not surprised to see five ideas based in Korea posted on VIC since the beginning of the year, versus only three for the whole of 2019. The Korean financial markets have gone nowhere for the past ten years with total returns in USD negative over that period. From its peak in early 2018 to its trough in mid-March 2020, the KOSDAQ was down 49%. A slowing Chinese import market in 2018 gave the economy a heavy blow just as the new administration was forcefully increasing the minimal salary rate. The current pandemic will also hit Korea's export-skewed economy hard but on the other hand, the government has responded very efficiently to the local healthcrisis.

Korea has many well-run, entrepreneurial and rapidly growing businesses. Its long-term poor market performance may be explained by poor corporate governance, especially when it comes to retaining family control by artificially lowering a company valuation in order to avoid high inheritance taxes. This is the only market in the region where management may not be outright fraudulent, but where its actions could still be diametrically misaligned with its minorityshareholders.

In this context, we take comfort from the fact that KPS is a public company owned 51% by KEPCO and 10% by the National Pension Service (NPS) with a high dividend payout ratio bearing proof of its good capital allocationskills.

KPS is at the very safe end of corporate governance quality in the country, in our opinion

Risks

- More pressure on KEPCO's nuclear plants utilization rates or tariffs
- Postponement of UAE nuclear project
- Opening of nuclear plants maintenance to private competition

Catalyst

- Pressure on KEPCO easing off leading to a valuation rerating to 10x EV/EBIT at KPS

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