

Sector **STEEL/MATERIALS** **Dung Quat in the spotlight**

Rating **NEUTRAL**

Investment points:

Table of contents

1. Profit margin to hit a rock bottom
2. Long steel segment: Dung Quat to change the game
3. And flat steel market as well
4. Risk factors
5. Stock coverage
6. Stock pick: HPG

Stock Picks

HPG: Overweight (VND28k/ 26%)

	2018	2019F	2020F
PER (x)	7.7	9.1	7.8
PBR (x)	0.9	1.0	0.9
EV/EBITDA (x)	5.2	6.2	4.3
DY (%)	0%	0%	4%
EPS (VND)	2,965	2,533	2,957
BPS (VND)	14,667	17,199	19,156

- 1st phase of Dung Quat to boost long steel segment. The outstanding margin is a key driver for long-term survival.
- Hoa Phat will deeply penetrate in flat steel segment with galvanized steel sheet factory and the 2nd phase of Dung Quat project.
- Profitability to improve thanks to more favorable input price.

- **Profit margin to hit a rock bottom.** Most of producers posted a poor performance in 2019 due to oversupply situation and opposite wild fluctuation of steel prices, in which iron ore price increased sharply but scrap and finished steel price slightly decreased. We see two positive points preventing margin from plunging further in 2020 are (1) production cut from China thanks to the final year of “Blue Sky” plan (2) more stable iron ore supply to lower input cost for BOF producers
- **Dung Quat to change the game of local long steel market.** The first phase of Dung Quat doubles the long steel capacity of Hoa Phat (HSX: HPG) to 4.35mn metric tons per year. Hoa Phat will fight for market share as Dung Quat complex comes into operation. We estimate that Hoa Phat will provide 3.88mn metric tons in 2020, resulting in 35% of total market share, compared to 25% in 2019. The short-term oversupply may hurt the profit margin of all local players
- **And flat steel one as well.** We estimate that severe export deterioration will keep worsening the domestic oversupply markedly. As Hoa Phat officially launches Hung Yen factory to enter galvanized steel sheet market and the second phase of Dung Quat complex to produce HRC in 2020, a stronger reshaping in this market is worth to watch closely.

Risk factors:

- **Tariff for HRC:** In our point of view, we see efforts from the government to develop domestic steel industry in general and HRC segment in particular. Therefore, a new kind of tariff like safeguard one may be brought to the table, which will reshape the domestic steel market faster and more significantly.

Recommendation:

- We believe that steel industry has a strong growth potential thanks to the inevitable industrialization and urbanization of Vietnam in the long term. However, the operation of Dung Quat and Formosa Ha Tinh factories will reshape the domestic market significantly in the short term. Local competition will be tougher which result in narrowing profitability despite of lower input risk. Therefore, we have a **NEUTRAL** outlook for steel industry in 2020.
- Stock pick: **HPG**

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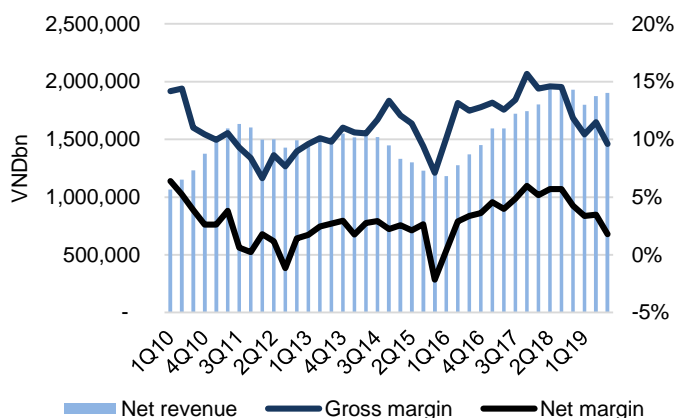
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1. Profit margin to hit a rock bottom

Steel industry experienced a poor performance in 2019 due to an excess supply and the wild fluctuation of input material price. Specifically, we estimate that gross margin of 16 Asian largest steel producers dropped to 9.6% in 3Q2019, which are the lowest points since 2016. It is noted that in the last 10 years, the corresponding margin recorded two bottoms at 6.6% and 7.1% in 1Q2012 and 4Q2015, respectively. Similarly, Vietnam steel producers also suffered a narrowing gross margin.

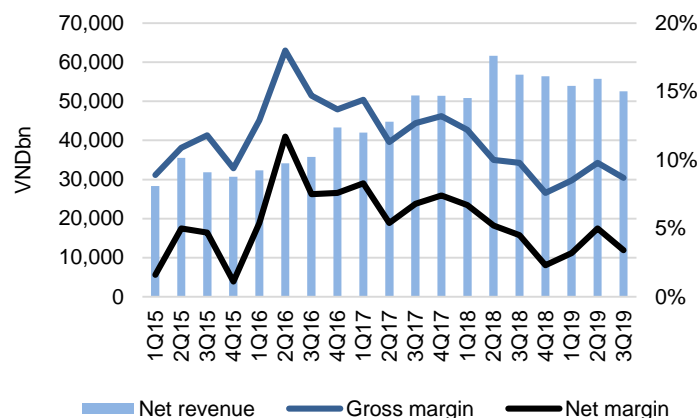
Despite the uncertainty of the next trough, we see two positive points preventing 2020 margin from plunging further that are production cut from China and more stable iron ore supply.

Fig 01. 16 Asian largest steel producers' performance



Source: Bloomberg, KIS

Fig 02. Vietnam steel producers' performance



Source: Finpro, KIS

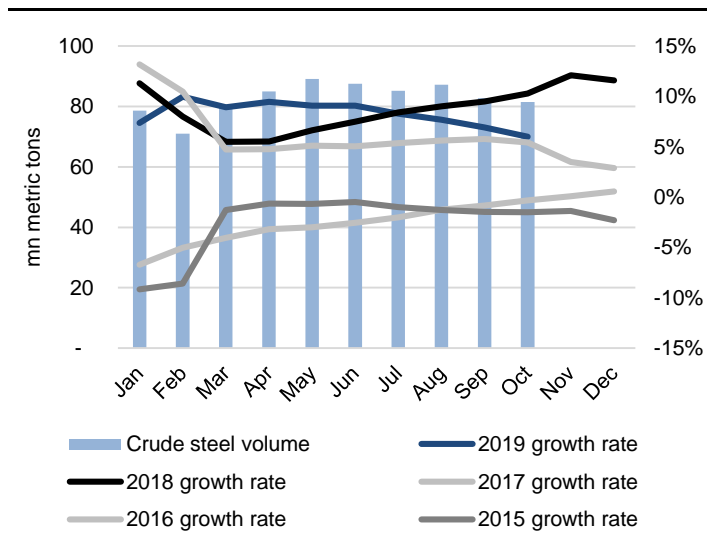
1.1. Chinese to cut production more aggressively

Excess supply has overshadowed the global steel market in the recent years. In 9M2019, we notice a steel consumption slowdown in developed markets, with a decrease of 3.8% YoY in Europe and 0.9% YoY in Japan. In the U.S., while consumption only increased by 0.4% YoY, production increased by 3.5% YoY.

Regarding to China (which accounts for 50% of the global steel production), strong Chinese steel production resulted in large inventories in 1Q19 and 3Q19, surpassing 2015 peak. However, after peaking at 12.1% YoY in Nov 2018, production growth rate has experienced a gradual fall to 9% YoY in the months of 1H2019 and only 6% YoY in Oct.

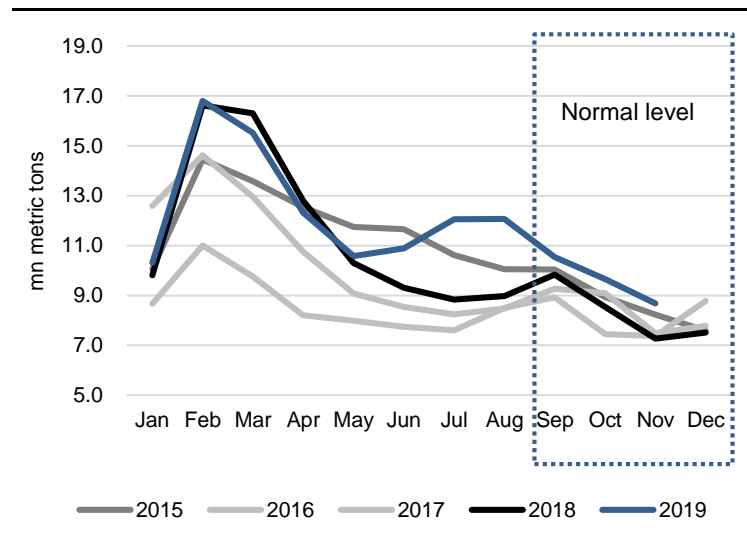
Back to 2013, China introduced environmental protection policies in a 5-year plan. During 2017, as the final year of the plan, production growth saw a remarkable slowdown. However, because the plan is considered as unsuccessful in reaching environmental objectives, Chinese government announced an extended 3-year plan called “Blue Sky” in 2018. As 2020 is the final year of the extended plan, we expect to see a similar pattern like 2017 as China is more aggressive with the environmental targets.

Fig 03. China production



Source: NBS, KIS

Fig 04. China rebar, wire rod, HRC and CRC inventory



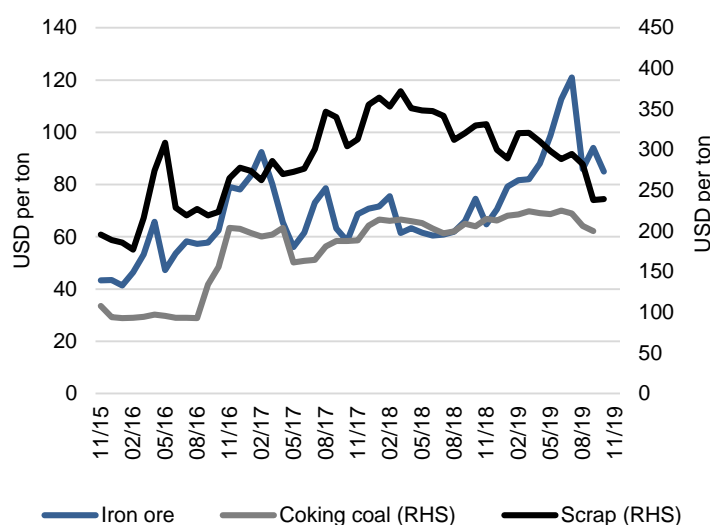
Source: SteelHome, Bloomberg, KIS

1.2. Stable iron ore supply to lower input cost of BOF producers

Another factor contributing to the poor performance of 2019 is the opposite movement of steel scrap price and iron ore one amid the global downtrend of output price. While EAF producers (which account for 30% of total crude steel in 2018) enjoyed the decrease of 13.7% YoY of scrap price, their BOF peers had to suffer the surge of iron ore because of the accident shortage of supply. The unexpected operation suspension of Vale in Brazil and Cyclone Veronica in Australia made iron ore price increased by 70% YoY to more than USD120 per ton (Bloomberg ticker: IOECAU62).

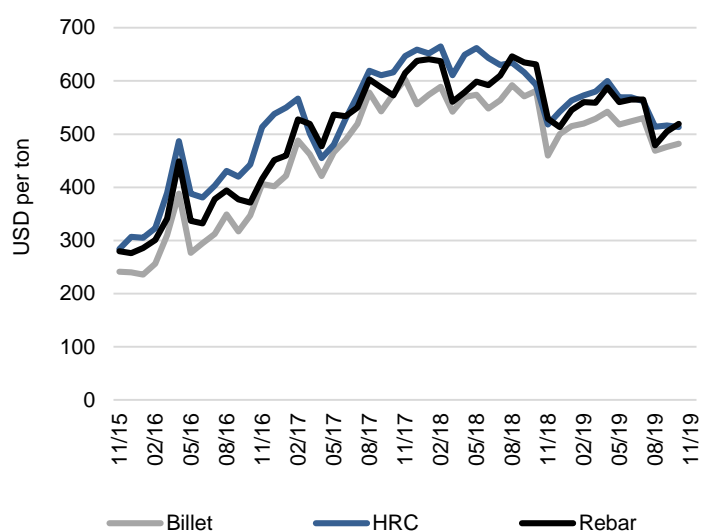
However, as Vale, Rio Tinto, BHP and Fortescue is getting back to normal, their iron ore production is improving and dropped only -5.8% YoY in 3Q2019 from the -10.6% of 2Q2019, making iron ore price correct to USD85 per ton at the end of Oct. Vale has also updated its iron ore production guidance for 1Q2020 at around 70-75 million tons, equivalent to 96%-103% of its 1Q2019 production, showing a full recovery. Therefore, we expect a more stable iron supply to lower input cost for BOF producers in 2020

Fig 05. 16 Input raw material fluctuation



Source: Bloomberg, KIS

Fig 06. Semi-finished and finished steel fluctuation



Source: Bloomberg, KIS

2. Long steel segment: Dung Quat to change the game

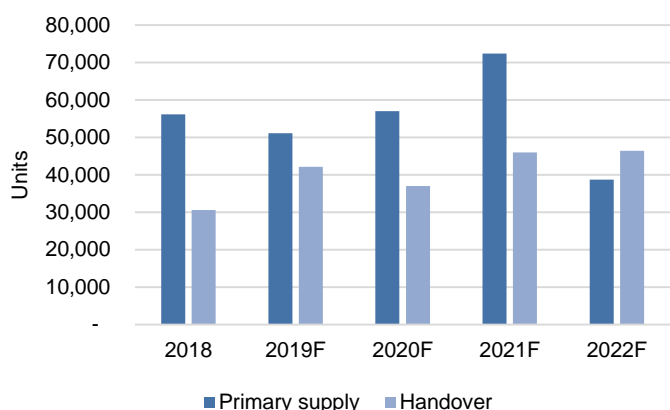
2.1. Weak consumption still intact

We estimate that Vietnam long steel consumption growth will decrease to only 5.5% YoY in 2019, compared with the stronger growth of 11.4% YoY and 10.2% YoY in 2017 and 2018. The weaker consumption come from both export and domestic markets.

For export markets, despite a strong growth in Cambodia, South Korea and Thailand markets saw decreasing demand so that total export grew only by 6.5% YoY in 10M2019, compared with 34.1% YoY of 2017.

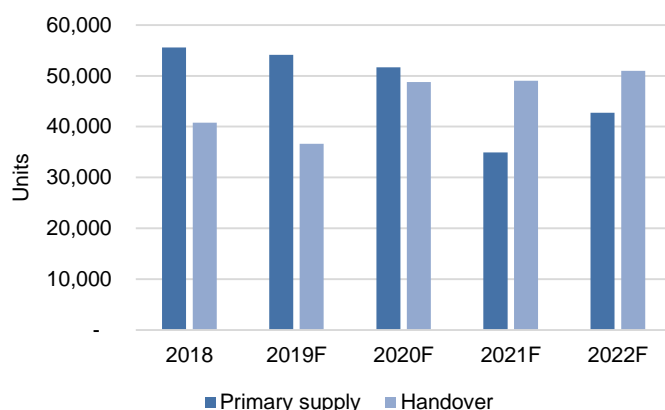
For domestic market which accounts for 90% of total demand, local authorities in some tier-1 cities have been overhauling the approval procedure of many real estate projects and caused a slowdown of steel consumption. In Hochiminh City, Savills estimates the primary supply of condominium to contract 9% YoY in 2019. Although this situation may be still intact until the end of 2020, we see that some developers have started seeking new opportunities in tier-2 cities, which will spur steel demand. Therefore, we estimate long steel consumption growth to be stable at 5.5 YoY in 2020.

Fig 07. HCMC condominium market



Source: Savills, KIS

Fig 08. Hanoi condominium market

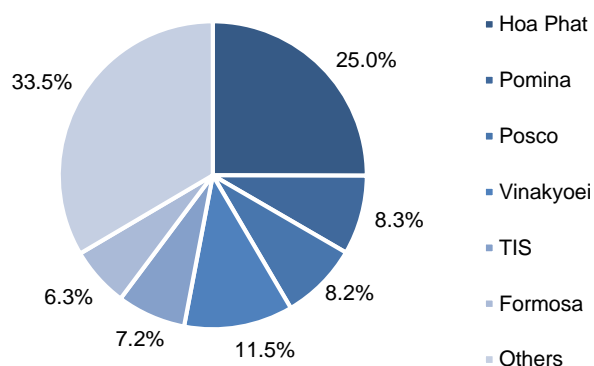


Source: Savills, KIS

2.2. Dung Quat - Hoa Phat fights for market share

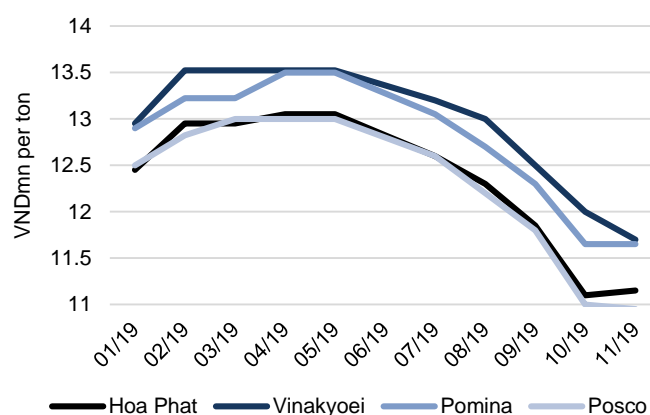
The first phase of Dung Quat steel factory, which is scheduled to operate fully from the beginning of 2020, doubling the long steel capacity of Hoa Phat (HSX: HPG) to 4.35mn metric tons per year. Given the current week market, the added capacity is equivalent to 18% of total market consumption, causing a short-term oversupply. Therefore, there will be a short-term fight for market share, which hurts the profitability of local producers. Year to date, steel price of Hoa Phat dropped 10.8%, faster than other local peers like Pomina and VinaKyoiei. We estimate that Hoa Phat will provide 3.88mn metric tons in 2020, up +1.13mn metric tons YoY, resulting in 35% of total market share from the current 25%.

Fig 09. Vietnam long steel market share of key players



Source: VSA, KIS

Fig 10. Steel price of key players



Source: VSA, Finpro, KIS

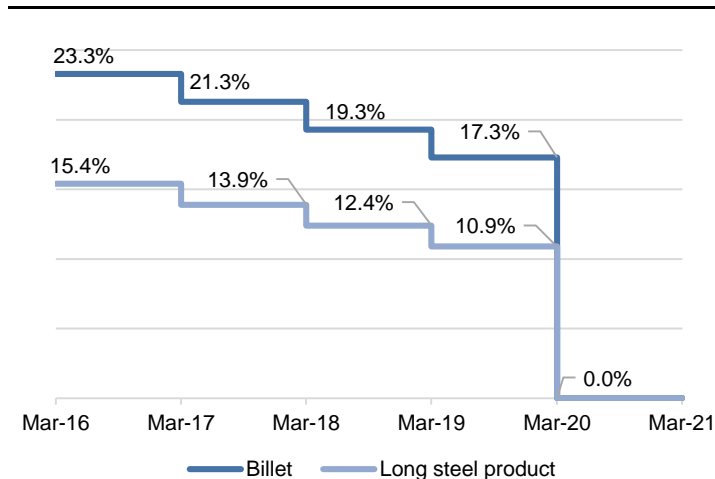
2.3. Safeguard tariff to be extended

Vietnam is imposing the safeguard tariff on imported billet and long steel from Mar 2016 to Mar 2020. Thanks to price disadvantage compared to local steel players, 2016, 2017, 2018 and even 10M2019 witnessed the remarkable decline of Chinese steel import.

After receiving requests from Hoa Phat and Vinasteel – 2 of 4 applicants in the previous safeguard tariff investigation, MoIT issued Decision 2605/QD-BCT to investigate whether to extend or not the current safeguard tariff on 22 Aug 2019. In the context of globally rising protectionism and the fact that MoIT aggressively promoted activities to protect local producers in 2019, there is a high probability that this tariff policy will be extended after Mar 2020.

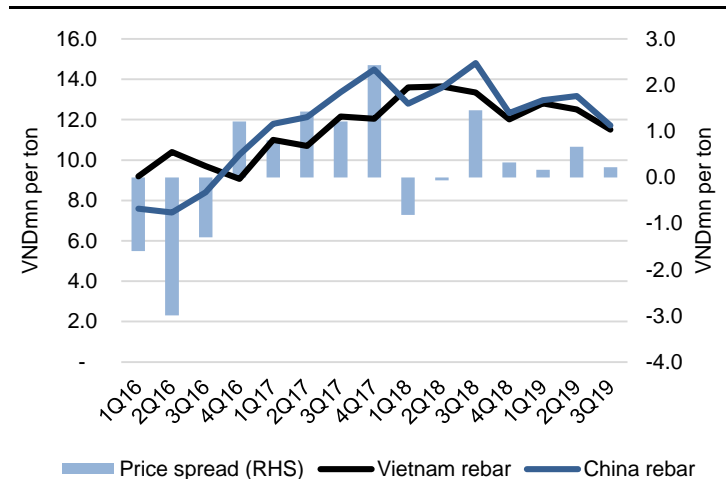
In the worst scenario, if the safeguard tariff is removed, we estimate that pressure from Chinese steel import will not be as high as before 2016. The abovementioned Chinese inventories contraction and narrowing price spread between Chinese and Vietnamese steel will not encourage Chinese players to dump their products to Vietnam.

Fig 11. Current safeguard tariff on long steel



Source: MoIT, KIS

Fig 12. China and Vietnam rebar price spread



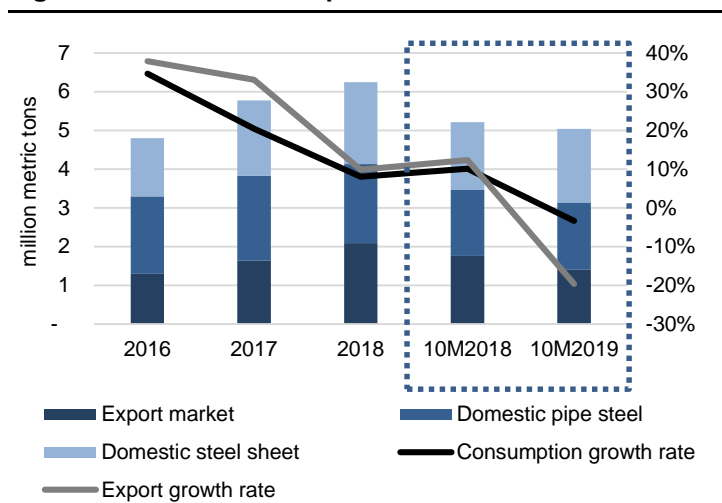
Source: Bloomberg, VSA, Finpro, KIS

3. And flat steel market as well

3.1. Tougher export markets put pressure on domestic one

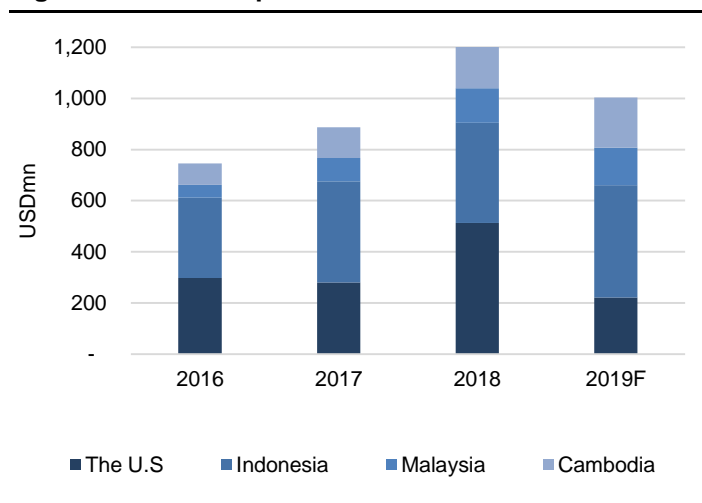
Because 2018 was the year of rising protectionism, tougher export was our main investment idea for our 2019 steel outlook. In fact, export was extremely damaged, leading to high pressure on local producers in Vietnam. Specifically, total flat steel export contracted by -19.6% YoY in 10M2019, compared with the growth of 9.8% YoY and 33.0% YoY in 2018 and 2017, respectively.

Fig 13. Flat steel consumption breakdown



Source: VSA, Fiinpro, KIS

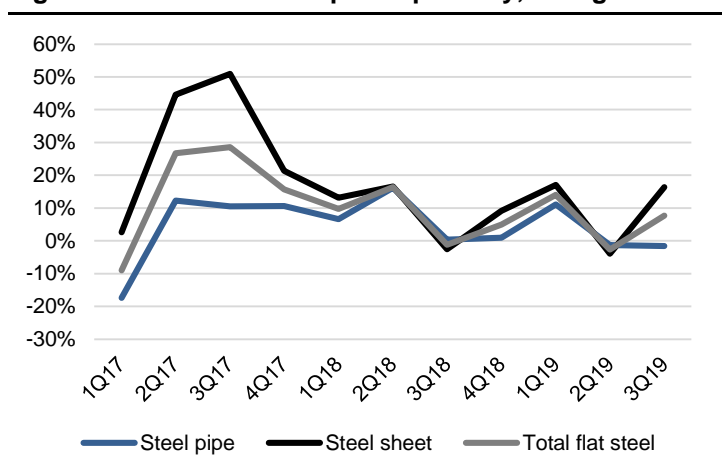
Fig 14. The main export markets of Vietnam steel sheet



Source: VN Customs, KIS

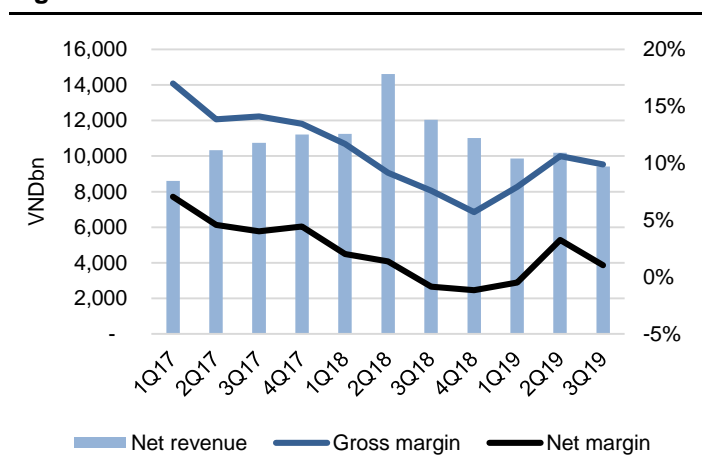
Severe export deterioration has worsened overall consumption markedly. Specifically, although the domestic consumption rose by 4.9% YoY in 10M2019, total flat steel consumption decreased by -3.3% YoY. Hoa Sen Group (HSX: HSG) and Nam Kim Group (HSX: NKG) saw their 3Q2019 revenue tumbling the lowest level in the past 3 years. Together with the 10% YoY decrease of HRC price, they also experienced the worst profitability in the last 5 years. In the context of global protectionism, we keep a negative view for the export markets of Vietnam, thus putting more pressure on domestic market in 2020.

Fig 15. Domestic consumption quarterly, YoY growth



Source: VSA, Fiinpro, KIS

Fig 16. Performance of HSG and NKG



Source: KIS

3.2. Different strategies to survive

To deal with this dark period, local producers have implemented different strategies. Hoa Sen Group (HSX: HSG) has restructured the operation and management of their distribution channel to reduce G&A expenses and interest expenses and shifted

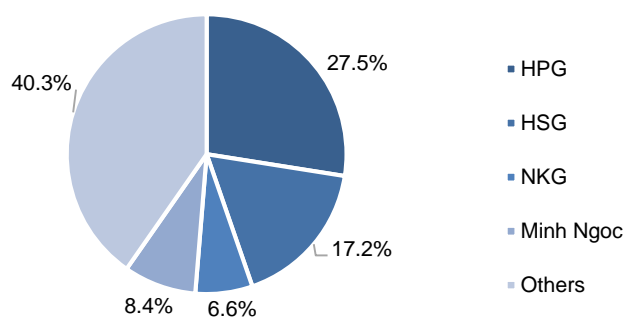
attention to profit target from market share. We see that market share of Hoa Sen Group in coated steel and pipe steel segments decreased to 29.5% and 15.6% in 10M2019 from 33.3% and 17.2% in 2018. BoD said that they would maintain their market share above 30% in the coming years.

On the contrary, despite current steel pipe market stagnation, Hoa Phat Group boosted its market share to 31.0% in 10M2019 from 27.5% of 2018.

Meanwhile, for Nam Kim Group (HSX: NKG), after old BoD was replaced by the representatives of SMC (HXS: SMC) in the AGM on 29 Jun 2019, the company started selling inefficient projects to reduce debt, quitting pipe steel market in July and paid more attention on steel sheet segment. However, in November, the company approved a plan to invest a new 150k-tons-p.a pipe steel factory in Quang Nam province to expand horizontally to the Central of Vietnam.

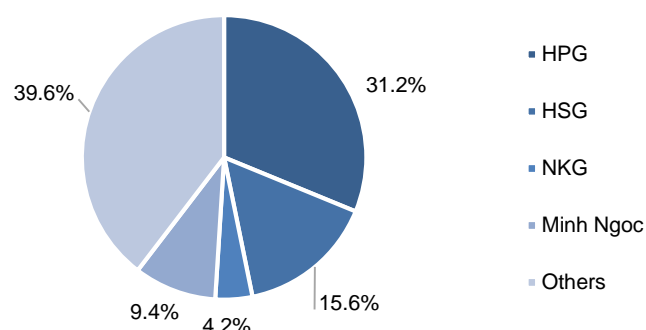
For Dong A Group (non-listed), they kept pushing sales volume and gain coated steel market share to 17.8% YoY in 10M2019 from 16.5% YoY in 2018.

Fig 17. Vietnam pipe steel market share, 2018



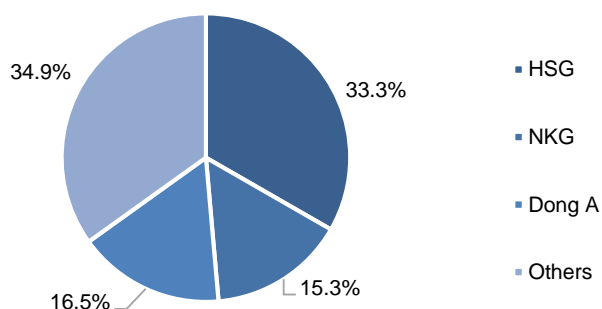
Source: VSA, Fiinpro, KIS

Fig 18. Vietnam pipe steel market share, 10M2019



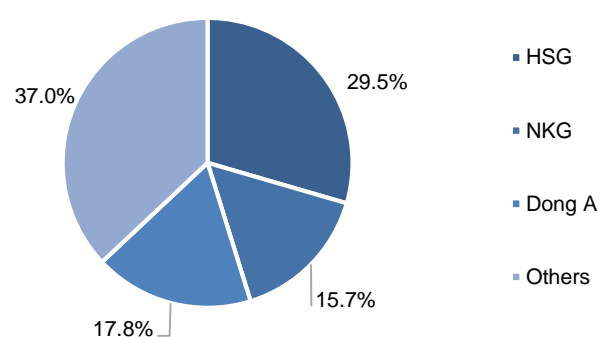
Source: VSA, Fiinpro, KIS

Fig 19. Vietnam coated steel market share, 2018



Source: VSA, Fiinpro, KIS

Fig 20. Vietnam coated steel market share, 10M2019



Source: VSA, Fiinpro, KIS

3.3. Strong new entrant

In 2020, Hoa Phat will start participating in the steel sheet market by putting a galvanized steel sheet factory in Hung Yen province into operation, worsening the current oversupply situation. The design capacity of this factory is 400,000 metric tons, equivalent 10% of galvanized steel sheet market consumption. Hoa Phat may pursue market share target instead of profit target for Hung Yen steel sheet project by the same way they planned for Dung Quat long steel project. The direct competitor of Hoa Phat is Hoa Sen Group, one of the few coil producers that have factories in the North.

The key advantage of Hoa Phat will appear only when the second phase of Dung Quat project is completed in 2H2020, capable of 2mn metric tons of HRC per year and complete the full value chain of its flat steel segment.

4. Risk factors

Tax for HRC

In Sept 2019, Ministry of Finance (MoF) proposed a plan of rising the Most-favored Nation (MFN) tariff on imported hot rolled steel coil (HRC) from 0% to 5% to increase the government revenue, improve trade balance and protect domestic steel industry. However, after collecting opinions from local steel players that insufficient HRC domestic supply will hurt local players rather than protect and HRC imported from China will keep increasing, MoF has canceled the plan.

In our point of view, we see efforts from the government to develop domestic steel industry in general and HRC segment in particular. Therefore, a new kind of tariff like safeguard tariff may be brought to the table, which will reshape the domestic steel market faster and more significantly.

5. Stock coverage

Recommendation & TP				Earnings & Valuation									
Company				Sales (VNDbn)	EBIT (VNDbn)	NPAT (VNDbn)	EPS (VND)	BPS (VND)	PER (x)	PBR (x)	ROE (%)	EV/EBITDA (x)	DY (%)
HPG	Recommendation	BUY	2016	33,283	7,856	6,606	1,799	5,856	12.7	0.6	38.6%	5.2	1.6%
(HOSE)	Target Price (VND)	28,000	2017	46,162	9,622	8,015	2,689	11,694	8.5	0.8	30.8%	4.1	0.0%
	Price (VND)	22,950	2018	55,836	10,550	8,601	2,965	14,667	7.7	0.9	23.6%	5.2	0.0%
	Market cap (VNDbn)	63,367	2019E	62,617	9,896	7,466	2,533	17,199	9.0	1.0	16.9%	6.1	0.0%
			2020E	76,062	12,735	8,901	2,957	19,156	7.7	0.9	17.7%	4.2	4.4%
HSG	Recommendation	NEUTRAL	2017	26,149	2,104	1,332	2,925	14,771	2.8	0.6	28.6%	5.3	10.1%
(HOSE)	Target Price (VND)	8,100	2018	34,441	1,266	409	937	13,381	8.7	0.6	7.9%	7.6	5.6%
	Price (VND)	7,850	2019U	28,035	970	361	828	12,913	9.8	0.6	6.8%	6.0	0.0%
	Market cap (VNDbn)	3,322	2020E	26,341	1,270	468	1,072	13,485	7.6	0.6	8.4%	4.8	6.1%
			2021E	27,326	1,128	359	808	13,293	10.1	0.6	6.3%	4.9	12.3%
NKG	Recommendation	NON RATED	2016	8,936	796	518	2,845	23,888	2.5	0.3	46.7%	5.7	0.0%
(HOSE)	Target Price (VND)		2017	12,619	1,024	708	3,887	22,619	1.8	0.3	31.3%	5.8	10.2%
	Price (VND)	6,100	2018	14,812	390	57	293	16,325	23.9	0.4	1.9%	7.1	0.0%
	Market cap (VNDbn)	1,110	2019E	12,013	132	195	998	17,323	7.0	0.4	6.4%	7.3	0.0%
			2020E	11,464	226	303	1,550	18,873	4.5	0.4	9.2%	5.1	0.0%

Source: Company data, KIS

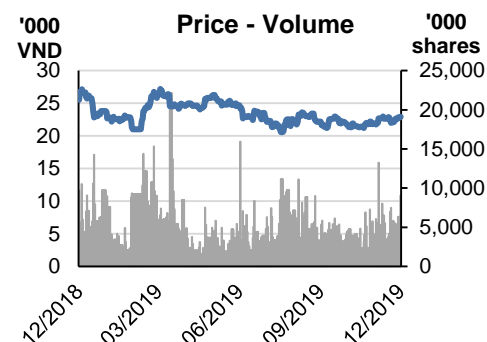
Data as of 2 Dec 2019

6. Stock pick: HPG

Stock Pick

HPG **Dung Quat, of course!**Rating **OVERWEIGHT**

Market price (VND)	22,950
1-Y target price (VND)	28,000
1-Y price return (%)	22.0%
1-Y dividend yield (%)	4.4%
1-Y total return (%)	26.4%



Stock performance (%)

	YTD	1T	3T	12T
Absolute	-4%	5%	3%	-10%
Relative	-13%	10%	5%	-16%

Source: Bloomberg, relate to VNIndex

Stock Statistics **02-Dec-19**

52-week range (VND)	20.6k-27.2k
Shares o/s (m)	2,761
Mkt cap (VND bn.)	63,367
Mkt cap (\$m)	2,734
Foreign % owned	37.7%
Est. free float (mn. shares)	1,439.5
3m avg. daily vol. (shares)	4,765,818
VND/USD	23,173
Index: VN-Index/HNX	959/101

Source: Bloomberg, KIS

Ownership **02-Dec-19**

Chairman & affiliates	32.4%
Dragon Capital	5.0%
Vinacapital	4.9%
CEO Tran Tuan Duong	2.7%

Source: Bloomberg, KIS

Investment points:

- **1st phase of Dung Quat project to boost long steel segment.** The 1st phase of Dung Quat will operate fully from the beginning of FY2020, doubling the long steel capacity to 4.35mn metric tons per year. We estimate that Hoa Phat will boost its market share to 35% in 2020 from 25% in 2019. However, short-term fight for market share will likely hurt profitability. We see outstanding financial performance is a key driver for long-term survival.
- **Hoa Phat will deeply penetrate in flat steel market** by a galvanized steel sheet factory in Hung Yen. The finish of the 2nd phase of Dung Quat project, which is capable of 2mn metric tons of HRC, will complete the full value chain of Hoa Phat in both long steel and flat steel segments. Dung Quat will help Hoa Phat become a top player in South East Asia
- **Profitability to improve thanks to more favorable price trend of input iron ore** as global production is back to normal in early 2020.
- In 2020, we estimate that the revenue and profit of Hoa Phat will reach VND76,062bn and VND8,901bn, up 21.5% YoY and 19.2% YoY. EPS will be VND3.0k

Risk:

- **Operating risk of the 2nd phase of Dung Quat project:** Because HRC is a totally new product of Hoa Phat, initial operation incident, if any, will make a test run longer than the plan of 3 months.

Recommendation:

- We expect the success of Dung Quat project to make Hoa Phat become a regional giant in the foreseeable future. Using PER of 10x, we evaluate the HPG share at VND28,000 by the end of 2020. Including VND1,000 cash dividend per share, total expected return is **26.4%**. Recommend **OVERWEIGHT**

FINANCIALS MODEL						BS & CF ITEMS (VNDbn)					
Unit: VNDbn.	2016	2017	2018	2019E	2020E	2016	2017	2018	2019E	2020E	
Net Revenue	33,283	46,162	55,836	62,617	76,062	Increase in WC	1,419	5,214	-5,447	5,549	2,436
Sales growth (%)	21%	39%	21%	12%	21%	Capex	3,445	8,882	27,659	16,463	4,895
Steel	28,855	39,738	46,424	50,631	62,516	Other cash flow items	-202	-1,452	7,946	-	-
Agriculture	1,464	2,895	4,596	7,213	8,645	Free cash flow	3,619	-2,624	-19,298	-11,697	6,465
Real estate	533	760	1,672	1,602	1,602	Share issues	-	5,057	11	-	-
Other	2,629	2,768	3,144	3,171	3,298	Dividends paid	1,102	-	-	-	2,761
COGS	24,533	35,536	44,166	51,231	61,517	Increase in net debt	-2,517	-2,430	19,287	11,697	-3,704
Gross margin (%)	26%	23%	21%	18.2%	19.1%	Net debt, end of year	1,208	-1,221	18,066	29,763	26,058
SG&A	895	1,004	1,121	1,490	1,810	Enterprise value	49,739	47,314	66,618	78,342	74,665
EBITDA	9,499	11,595	12,810	12,744	17,631	Total equity	19,850	32,398	40,623	47,643	53,073
EBITDA margin (%)	28%	25%	22.9%	20.4%	23.2%	Minority interests	106	111	127	155	182
Depr'n & Amort'n	1,643	1,974	2,260	2,848	4,895	Shareholder's equity	19,745	32,287	40,496	47,489	52,891
Operating profit	7,856	9,622	10,550	9,896	12,735	BVPS (VND, bonus-adjusted)	5,856	11,694	14,667	17,199	19,156
Operating margin (%)	24%	21%	19%	16%	17%	Net debt / equity (%)	6%	-4%	44%	62%	49%
Net interest expense	142	371	376	843	2,699	Net debt / EBITDA (x)	0.13	-0.11	1.41	2.34	1.48
As % of avg. net debt	6%	-5651%	4%	4%	10%	Total assets	33,227	53,022	78,223	97,386	99,823
Interest cover (x)	55.5	25.9	28.0	11.7	4.7	<i>Net debt = debts – cash & equivalent</i>					
Other profit/loss	-13	38	-103	-41	-	Key ratio & Valuation	2016	2017	2018	2019E	2020E
Tax	1,096	1,274	1,471	1,545	1,135	ROE (%) (excl minority interest)	38.6%	30.8%	23.6%	16.9%	17.7%
Effective tax rate (%)	14%	14%	15%	14%	11%	ROA (%)	19.9%	15.1%	11.0%	7.7%	8.9%
Net profit	6,606	8,015	8,601	7,466	8,901	ROIC (%)	34.2%	31.8%	19.8%	12.0%	14.1%
Net margin (%)	20%	18%	15%	12%	12%	WACC (%)	14.4%	15.0%	11.5%	10.3%	12.6%
Minorities	4	8	28	28	28	PER (x)	12.7	8.5	7.7	9.0	7.7
Net attributable profit	6,602	8,007	8,573	7,439	8,874	PBR (x)	0.6	0.8	0.9	1.0	0.9
Number of shares (m)	843	1,517	2,124	2,761	2,761	PSR (x)	1.5	1.0	0.9	0.8	0.6
EPS (VND,bonus-adjusted)	1,799	2,689	2,965	2,533	2,957	EV/EBITDA (x)	5.2	4.1	5.2	6.1	4.2
EPS growth (%)	83%	50%	10%	-15%	17%	EV/Sales (x)	1.5	1.0	1.2	1.3	1.0
DPS (VND)	375	-	-	-	1,000	Dividend yield (%) (bonus-adjusted)	1.6%	-	-	-	4.4%
Payout ratio (%)	21%	-	-	-	34%						

EBITDA = Net revenue – (COGs -Depr'n&Amort'n)– SG&A expenses

EBIT = EBITDA – Depr'n&Amort'n

Net interest expenses = interest expenses – interest income

Other profit/loss consists of other financial income/expenses, profit share from JVs/associates and other income/loss.

Payout ratio = Dividend paid / Net attributable profit.

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Recommendation System

OVERWEIGHT: where we believe prospective 12 months VND total return (including dividends) will be 15% or more.

NEUTRAL: where we believe it will be -5% to 15%.

UNDERWEIGHT: where we believe it will be -5% or less.

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