

HMG settles US class action lawsuits

Auto/Auto Parts/Tire

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Major issues and conclusions

- A US class action lawsuit against HMG over its Theta II engine vehicles was settled with the Group agreeing to pay compensation for 4.69mn cars produced between 2011 and 2019, apply knock sensor detection systems, and provide lifetime warranties as well as repairs and incentives.
- Hyundai will book a one-off cost of KRW600bn and Kia KRW300bn in 3Q19. The punitive award has yet to be decided but the scale should be limited. The Theta II engine issue is unlikely to spread outside Korea and the US, and the recent agreement signals the end of the engine quality issue that had been plaguing HMG for several years

Industry and stock outlook

- Temporary corrections are likely in the near term due to one-off cost hikes and the possibility of further punitive awards but the potential resolution of the lingering engine issue is positive
- Korean automakers' three major risks in 2019 are wage negotiations with the union, engine issues, and possible US auto tariffs and of these, two have disappeared or mitigated, brightening the earnings outlook in 2020 when the new model cycle begins.

Cost rises in 3Q19 on agreement in a US class action lawsuit against HMG

- 1.69mn vehicles with Theta II GDI and Theta II turbo GDI engines produced between 2011 and 2019 are the subjects of compensation (2.3mn Hyundai vehicles in the US, 363K Hyundai vehicles in Korea, 1.87mn Kia vehicles in the US, 157K Kia vehicles in Korea). The number of compensated vehicles has grown, to include 1.66mn vehicles produced between 2011 and 2014 that were previously recalled in the US and vehicles produced in 2019.
- To prevent engine accidents, Hyundai's knock sensor detection system (KSDS) will be applied more broadly. Also, the owners of vehicles equipped with the subjected engines will have a lifetime warranty for the connecting rod bearings problem, free inspections and repairs if the subjected cars stop or catch fire, and incentives when purchasing a new car or selling the currently owned car.
- The resulting cost increase is KRW600bn at Hyundai Motor Company (005380.KS, BUY) and KRW300bn at Kia Motors (000270.KS, BUY). This includes KRW66bn in customer compensation (KRW46bn for Hyundai, KRW20bn for Kia).
- These costs are fully booked in 3Q19 earnings. Of the 17 class action lawsuits raised in the US, five cases have been closed, and other similar cases are expected to be resolved too. HMG might have to pay a punitive award after the US court approval, but it is part of the process to resolve the engine quality issue.

Lingering engine issue resolved

- The Theta II engine issue that was raised in 2015 has caused Hyundai to spend KRW560bn in total and Kia KRW380bn, including the cost of KSDS application (KRW150bn). US prosecutors and the National Highway Traffic Safety Administration opened an investigation in 2018 into the recalled cars.
- The recent agreement will drive Hyundai to book approximately KRW600bn and Kia KRW300bn in 3Q19 for compensation and provisions. There could be an additional punitive award, which is a risk, but we believe the scale of the award will be limited thanks to HMG's preemptive actions to accommodate customer claims. The major markets where the Theta II engines have been deployed are Korea and the US, so the Theta engine issue is unlikely to spread to other regions, and because of this, we believe the recent agreement means the issue is resolved.

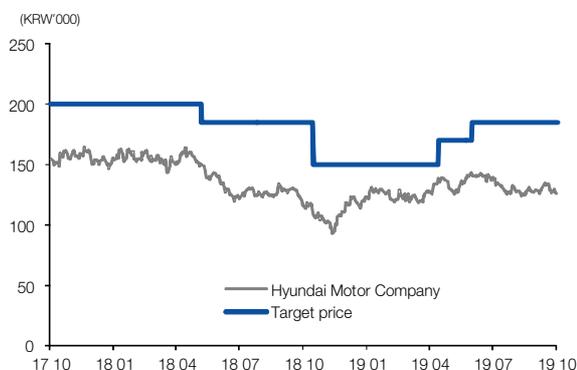
Auto shares' temporary pullback expected but recovery likely in mid/long term as risks ease

- In recognition of the one-off cost hike, we revise down the 3Q19 earnings of Hyundai and Kia. However, we keep our ratings and target prices intact.
- Shares may correct in the near term due to one-off cost hikes and the possibility of a further punitive award. However, we find it positive that the lingering engine issues at HMG are finally being resolved and with it the disappearance of uncertainties. It is notable that of the three major risks that Korean automakers face in 2019 (wage negotiations with the union, engine issues, and possible US auto tariffs), two have disappeared or mitigated. This brightens the earnings outlook in 2020 when the new model cycle begins.

Investment rating and target price history

Date	Rating	TP	Difference (%)	
			Average	High/low
19/07/02	BUY	185,000	-	-
19/07/03	BUY	185,000	-25.0	-23.5
19/07/08	BUY	185,000	-26.1	-23.5
19/07/23	BUY	185,000	-27.6	-23.5
19/08/02	BUY	185,000	-27.7	-23.5
19/08/05	BUY	185,000	-29.3	-23.5
19/09/03	BUY	185,000	-29.3	-23.5
19/09/04	BUY	185,000	-29.6	-23.5
19/09/20	BUY	185,000	-29.5	-23.5
19/09/25	BUY	185,000	-29.4	-23.5
19/10/02	BUY	185,000	-29.4	-23.5
19/10/04	BUY	185,000	-29.4	-23.5
19/10/07	BUY	185,000	-29.5	-23.5
19/10/14	BUY	185,000	-	-

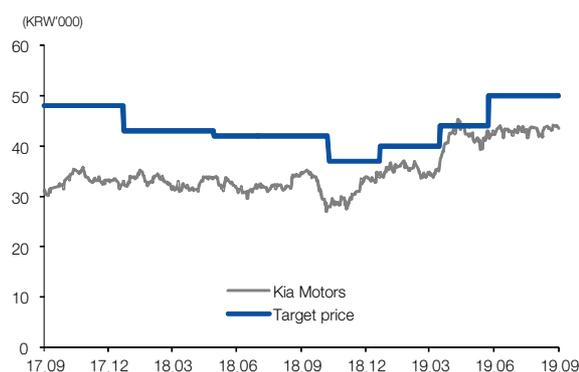
Two-year price chart: Hyundai Motor Company



Investment rating and target price history

Date	Rating	TP	Difference (%)	
			Average	High/low
19/07/03	BUY	50,000	-14.9	-13.2
19/07/08	BUY	50,000	-14.3	-13.2
19/07/24	BUY	50,000	-13.9	-12.2
19/08/02	BUY	50,000	-13.9	-12.2
19/08/05	BUY	50,000	-14.0	-12.2
19/09/03	BUY	50,000	-14.0	-12.1
19/09/04	BUY	50,000	-13.7	-11.8
19/09/20	BUY	50,000	-13.5	-7.2
19/09/25	BUY	50,000	-13.1	-7.2
19/10/02	BUY	50,000	-13.1	-7.2
19/10/04	BUY	50,000	-13.1	-7.2
19/10/07	BUY	50,000	-13.2	-7.2
19/10/14	BUY	50,000	-	-

Two-year price chart: Kia Motors



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Stock ratings distribution (July 1, 2018- June 30, 2019)

Rating	Count	% of rating category
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SELL	0	0.0

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