

# WHAT UNITES US?



By maintaining the highest standards and a commitment to global leadership, KT&G has grown into the No. 1 tobacco and red ginseng company in Korea. And now we are expanding our expertise to include biopharmaceuticals, cosmetics, and real estate, while increasing our global footprint for new growth.

We will continue to work together by sharing our expertise, experiences, and common values, in order to become a trusted partner for our stakeholders.

Leadership knows no boundaries

## LEADERSHIP

Partnership shapes long-term success

## PARTNERSHIP

Companionship is our shared value

## COMPANIONSHIP

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We will realize our vision of a ‘Leading global company’ by creating a brighter future, based on our principle management in the long-term perspective.

DEAR SHAREHOLDERS

I would like to thank you for your kind interest and support for KT&G over the last year. The year 2014 was with a continuum of uncertainties due to the slow recovery of the global economy and weak domestic consumer confidence. However, KT&G and all of our staff are working together under the slogan of ‘Restart KT&G’ to improve our corporate value and give the best in shareholder value.

In our flagship tobacco business, even in a difficult business environment, we achieved a market share of 62% through product differentiation that was driven by upgraded technology. In the overseas tobacco business, our exports to the Middle East and CIS improved, and we were also successful in new markets, recovering our growth momentum. Our red ginseng business was negatively affected by the slowdown in domestic demand for health functional products and weaker consumer confidence. However, new health functional products targeting consumer needs ended the decline in sales. We established the foundation for profitable growth of KGC Life & Gin and Somang Cosmetics as a result of structural innovation in production and distribution, and the land development at Daegu, following the successful development at Andong, suggests a promising future for our real estate business.

The end of quantitative easing in the U.S. and increasingly protectionist trade policies in several major trading partner countries are likely to cast a cloud over Korean exports in 2015, while concerns over structurally sluggish consumption and low growth are expected to hamper the recovery of the domestic economy. In our flagship domestic tobacco business, in particular, the hike in the tobacco tax and diversified consumer needs would result in fiercer competition in the market.

However, KT&G has overcome numerous challenges and remained successful throughout our 116 year history. We have been able to maintain the highest domestic market share of any tobacco company in countries with open tobacco markets. Based on these abilities, and backed by a spirit of challenge, we have been able to turn today’s obstacles into tomorrow’s opportunities. To this end, we will concentrate on three targets to drive increased growth.

**First, we will increase our market leadership in our flagship tobacco and red ginseng businesses in Korea.**

We will spearhead changes in the market to ensure we are No. 1 in the domestic tobacco and red ginseng markets, based on our comprehensive analysis of markets and customer requirements. In the tobacco business, we will focus on creative and differentiated marketing, and in the red ginseng business, we will leverage our outstanding technologies and brands.

**Second, we will expand the global business to establish a successful model for new growth.**

Under the goal of ‘Global KT&G in the World’, we will focus on making strong progress by working together across the Group to achieve synergies among businesses and sectors. We will put together the right structures and growth strategies to succeed in emerging markets that have high growth potential for the tobacco business. In the red ginseng business, we will focus on creating a success model by launching targeted products and localizing our integrated marketing strategies.

**Third, we will strengthen the growth driver of new businesses within the Group.**

We will expand our real estate business, so that it can help the Group to generate stable profits. In addition, any subsidiaries that had been struggling until last year will solidify the base for sustainable growth to participate in the Group’s new growth.

We are well aware that KT&G could take challenges to become a leading global company, thanks to unwavering trust and support of our customers and shareholders. Each and every one of us at KT&G is committed to making the company more performance-oriented, competitive, and sustainable for continued growth. We aim to deliver the best in shareholder value by generating strong profits and growth despite the challenges we face, based on our principle management in the long-term perspective.

Thank you.

President & CEO  
Min, Young-jin

Board of Directors

EXECUTIVE DIRECTOR



MIN, YOUNG-JIN  
President & CEO

INDEPENDENT NON-EXECUTIVE DIRECTORS



LEE, JUNE-O  
Chairman of the BOD



KIM, DUK-HWI



CHO, KYU-HA



SONG, OP-KYO



PARK, DONG-LYUL



CHOI, KYUNG-WON



SON, TAE-GYU

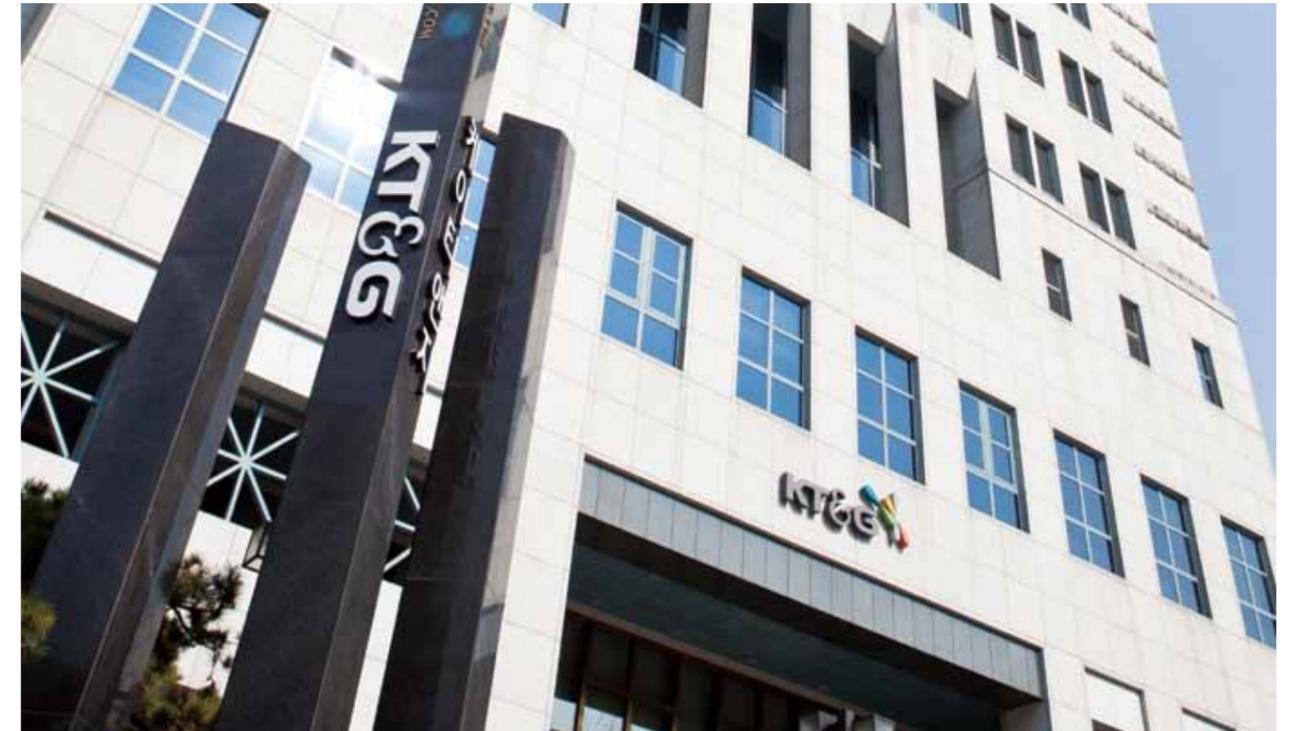
We will enhance our corporate value and strive to become a 'Leading global company' through transparent and responsible management, and the sharing of information with our stakeholders.

BOD Composition & Activities

COMPOSITION AND ROLES OF THE BOD

KT&G conducts its business based on decisions made by the Board of Directors (BOD) and through the accountability of the CEO. Our corporate governance aims at making profits for shareholders and doing the best for all stakeholders under the BOD-driven responsibility management system where the BOD is governed by independent non-executive directors.

As of the end of March 2015, KT&G's BOD is composed of one executive director and seven independent non-executive directors. The BOD is the top decision-making body on subjects which are authorized to the BOD by the legislation and articles of incorporation and company's key issues which are included in the BOD regulation. The BOD is recognized as one of the best in Korea in terms of its proactive functions and operational efficiency. All the independent non-executive directors are specialists with considerable amounts of expertise and relevant business experience. The BOD and each of its committees conduct detailed evaluations on individual performance at the end of each year, and analyze and report the evaluation results early next year.

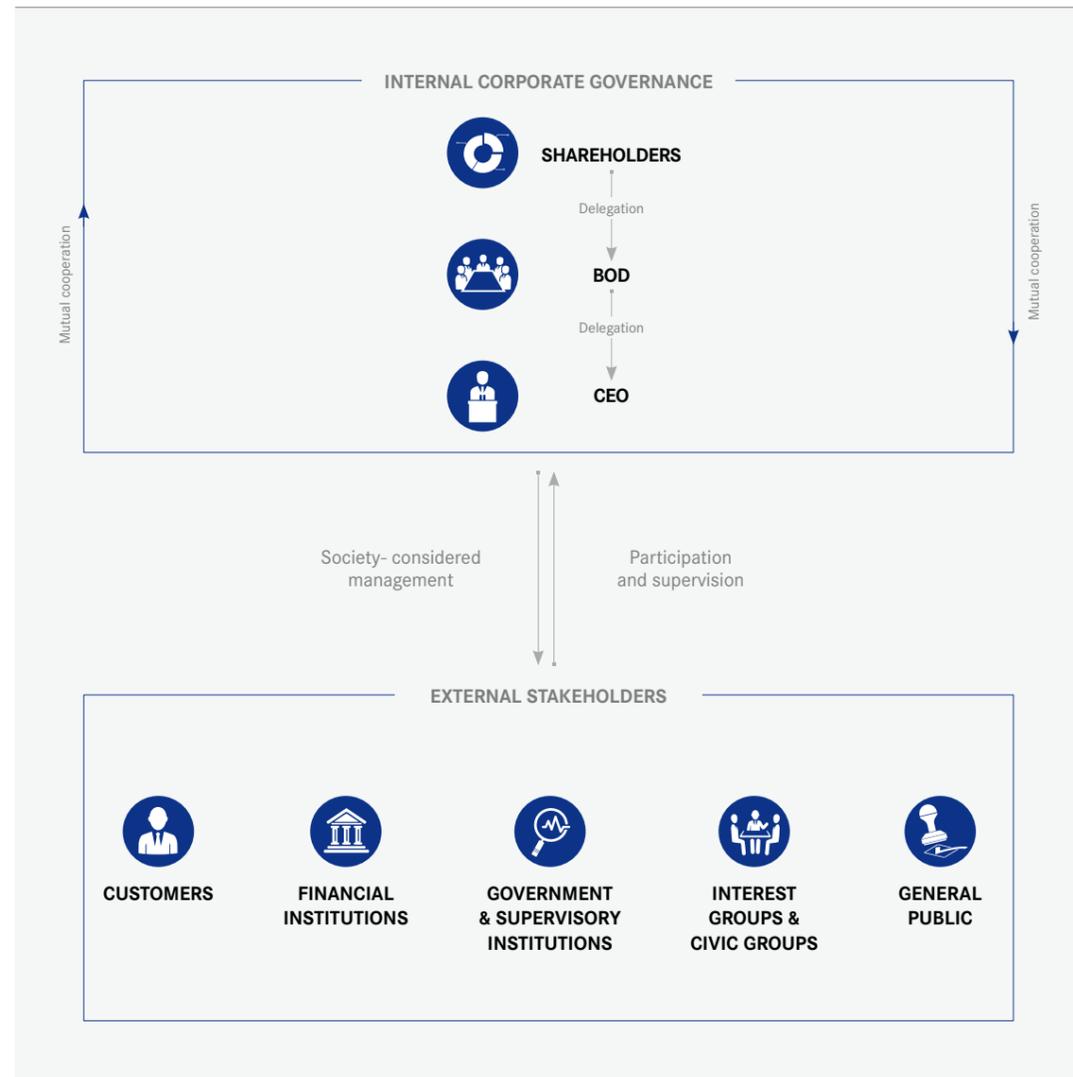


## INDEPENDENCE OF THE BOD

The role of the Chairman of the BOD is separate from that of the company CEO, and all members of the Audit Committee and the Evaluation Committee are independent non-executive directors. We have an Independent Non-executive Directors Candidate Recommendation Committee consisting of three or more members, all independent non-executive directors, to ensure transparency in the process of selecting the non-executive directors. An independent specialist search firm selects a pool of candidates, to prevent any possible controversies concerning the independence of the Independent Non-executive Directors Candidate Recommendation Committee in its selection of candidates. The Committee then examines the qualifications of those candidates and makes its recommendations, ensuring the whole process is transparent and fair.

## BOD-CENTERED MANAGEMENT

KT&G has improved its ownership structure to be more advanced BOD-centered corporate governance system, with ownership and management clearly separated, enabling the company to build a professional management system.



## COMMITTEES UNDER THE BOD

KT&G has established four standing committees to improve the quality and efficiency of the work done by the BOD: the Strategy Committee, the Investment Growth Committee, the Evaluation Committee, and the Audit Committee. There are also non-standing committees such as the Independent Non-executive Directors Candidate Recommendation Committee and the CEO Candidate Recommendation Committee. The Audit Committee and the Evaluation Committee are the BOD's internal watchdogs, and therefore are comprised only of independent non-executive directors, to ensure the transparency of financial information and to properly supervise and support our management.

### Strategy Committee:

This committee consists of four independent non-executive directors and one executive director, and deliberates on company management strategies.

### Investment Growth Committee

With four independent non-executive directors and one executive director, this committee manages corporate duties required by the Commercial Law, including the setting-up, installation, transfer, and closing of branches, the appointment of proxies and the closing of shareholder lists. It also manages investments, social contributions and risk.

### Audit Committee

This committee consists of four independent non-executive directors, and reviews financial and accounting matters and evaluates internal control systems.

### Evaluation Committee

This committee consists of five independent non-executive directors, and discusses and evaluates management activities and compensation.

## AWARDS IN CORPORATE GOVERNANCE

<b>2003</b>	<ul style="list-style-type: none"> <li>The Best Corporate Governance among Asian companies by CLSA (Credit Lyonnais Securities Asia)</li> <li>Excellent Corporate Governance in 2003 by KRX (Korea Exchange) and KCGS (Korea Corporate Governance Service)</li> <li>The Best Transparent Company by Economy21</li> <li>Obtained 'Strong' Rating in Corporate Governance Evaluation by S&amp;P</li> </ul>
<b>2004</b>	<ul style="list-style-type: none"> <li>The Best Corporate Governance in 2004 by KRX and KCGS</li> <li>Ranked the 4th among Respected Companies by Dong-a Daily Newspaper and IBM BCS Korea</li> <li>Grand Prize at the 5th Audit Award by KLCA (Korea Listed Companies Association) and KICPA (Korean Institute of Certified Public Accountants)</li> </ul>
<b>2005</b>	<ul style="list-style-type: none"> <li>The Best Corporate Governance in 2005 by KRX and KCGS</li> </ul>
<b>2006</b>	<ul style="list-style-type: none"> <li>The Best Corporate Governance in 2006 by KRX and KCGS</li> </ul>
<b>2007~2009</b>	<ul style="list-style-type: none"> <li>Honorary Company in Corporate Governance for three consecutive years by KRX and KCGS</li> </ul>
<b>2010</b>	<ul style="list-style-type: none"> <li>The Best Corporate Governance in 2010 by KRX and KCGS</li> </ul>
<b>2011</b>	<ul style="list-style-type: none"> <li>The Best Corporate Governance in 2011 by KRX and KCGS</li> </ul>
<b>2012</b>	<ul style="list-style-type: none"> <li>A+ in Corporate Governance Assessment by KCGS</li> </ul>
<b>2013</b>	<ul style="list-style-type: none"> <li>A+ in Corporate Governance Assessment by KCGS</li> </ul>
<b>2014</b>	<ul style="list-style-type: none"> <li>A+ in Corporate Governance Assessment by KCGS</li> </ul>

KT&G will grow into a 'Leading global company' through a commitment to growth, profitability and sustainability, and will maximize the value of the company and its employee.

Vision



Management Philosophy

KT&G aims to achieve mutual growth with customers by being an ethical company, a progressive company and a partner company, all based on its commitment to the principle management in the long-term perspective.



Strategies

Based on the growth foundation which has been built by our key business such as the domestic tobacco business, we will establish a more balanced business portfolio with global competitiveness by expanding the sales portion of our growth engines such as overseas tobacco business, red ginseng and other health products, and pharmaceutical/bio. We will also develop products that fully reflect changing consumer requirements, and will leverage the brand strength and distribution channels of our existing businesses, in order to remain competitive and lead target markets.

**Domestic Tobacco Business**

We will respond to increasing regulation by expanding our range of higher value-added products, and by applying our 'Blue Band' technology to all products with low ignition propensity (LIP).

**Overseas Tobacco Business**

We will develop new markets by localizing consumer marketing and differentiating our brands. We will also look to develop new markets through various strategies.

**Red Ginseng Business**

We will provide scientific explanations for the efficacy of our ginseng products, and increase our market share by developing highly functional products for the domestic market. We will form strategic alliances with local companies and utilize local production facilities to make an inroad into the Chinese market.

**Health Functional Food Business**

We will accelerate our growth by building a stable foundation in the domestic market and expanding our presence in the overseas market. To this end, KGC Life & Gin will concentrate on door-to-door sales, and will make investments in its core cosmetics business. Somang Cosmetics will strengthen its distribution channels and make a strong push into overseas markets.

**Pharmaceutical/Bio Business**

We will join with business partners in the early stage, in order to develop and commercialize new, first-in-class drugs. We will also expand overseas markets through the globally competitive products of Yungjin Pharm, and boost our R&D capabilities.

# FINANCIAL HIGHLIGHTS

## OPERATING RESULTS

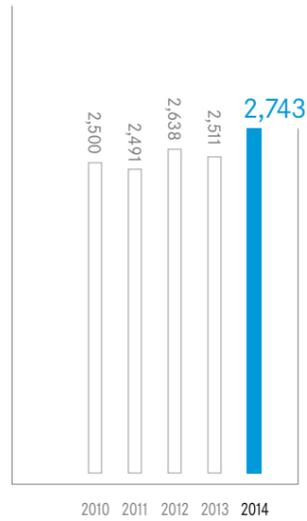
(Unit: KRW billion)

	2014	2013	2012	2011	2010
Sales	2,743	2,511	2,638	2,491	2,500
Cost of Sales	1,064	936	982	967	1,002
Gross Profit	1,679	1,575	1,656	1,524	1,498
Selling and Administrative Expenses	624	651	683	626	573
Operating Profit	1,055	924	973	898	925
Net Profit	747	501	768	776	931
Total Assets	6,295	6,082	5,918	5,418	5,254
Total Liabilities	953	1,050	1,015	874	916
Total Shareholders' Equity	5,342	5,032	4,903	4,544	4,338

\* Separate figures basis

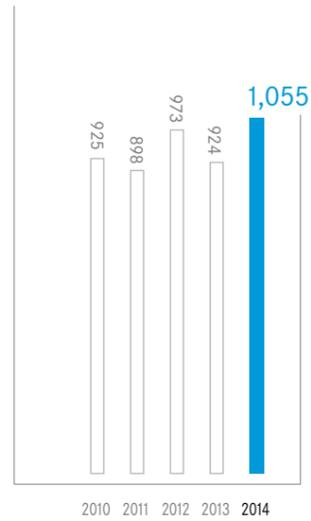
### Sales

(Unit: KRW billion)



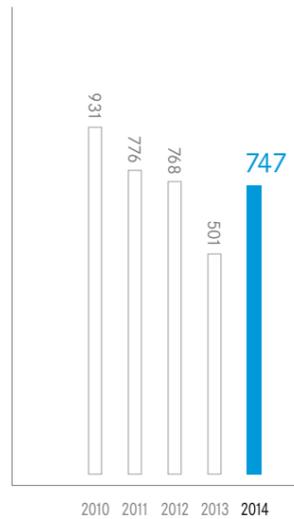
### Operating Profit

(Unit: KRW billion)



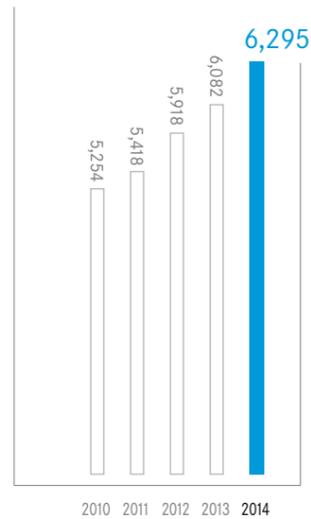
### Net Profit

(Unit: KRW billion)



### Total Assets

(Unit: KRW billion)



## FINANCIAL INDICES

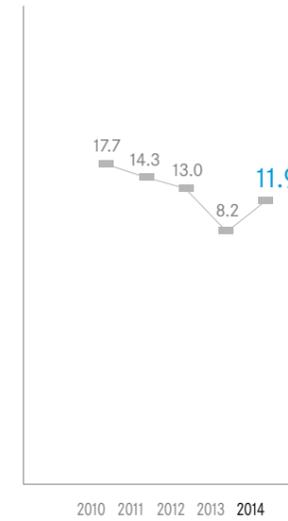
(Unit: %, KRW)

	2014	2013	2012	2011	2010
ROA	11.9	8.2	13.0	14.3	17.7
ROE	14.0	10.0	15.7	17.1	21.5
Operating Profit Margin	38.5	36.8	36.9	36.0	37.0
Net Profit Margin	27.2	20.0	29.1	31.2	37.2
EPS (KRW)	5,934	3,982	6,111	6,134	5,934
Payout Ratio	57.3	80.4	52.4	51.8	41.1
DPS (KRW)	3,400	3,200	3,200	3,200	3,000
Liabilities-to-Equity Ratio	17.8	20.9	20.7	19.2	21.1

\* Separate figures basis

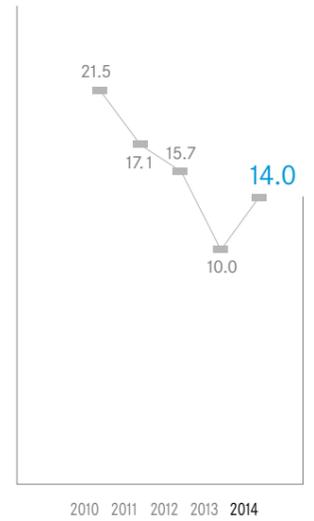
### ROA

(Unit: %)



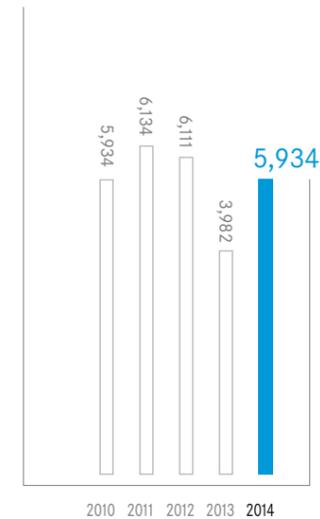
### ROE

(Unit: %)



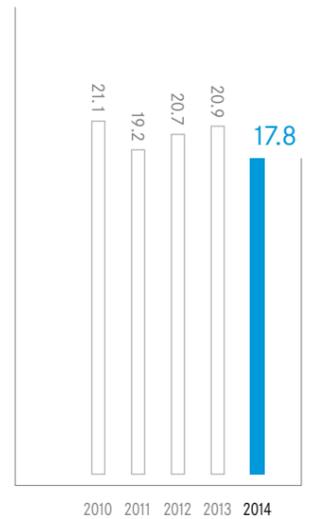
### EPS

(Unit: KRW)



### Liabilities-to-Equity Ratio

(Unit: %)



01-



**01- 'ESSE SOO Masterpiece', a Premium Cigarette**

KT&G launched 'ESSE SOO Masterpiece', a premium cigarette with Korea's first bamboo-activated fiber filter. The product has a cleaner flavor through the use of high-premium tobacco leaves and a high-tech filter. This bamboo-activated fiber filter is the result of two years of our exclusive research, and the patent registration has been completed.

**02- 'THE ONE Change', an Ultra-low Capsule Cigarette**

KT&G launched 'THE ONE Change', an ultra-low capsule cigarette offering two flavors. 'THE ONE' launched in 2003, and has ranked first in domestic sales for 11 years in a row for regular cigarettes of less than 1mg of tar. THE ONE Change is the first THE ONE product with a capsule, and has the coolest flavor of products of less-than-1mg in Korea.



**03- 'RAISON SUN Presso' with Two Special Flavors**

With the launch of 'RAISON SUN Presso', the RAISON Presso series now offers four products. 'RAISON Presso' was launched in 2012, and has been expanding its market share by offering consumers distinctive flavors. Through the launch of new products for the RAISON Presso series, customers have wider range of choice. RAISON SUN Presso gives two flavors in a single stick when the capsule changes the flavor of RAISON PRESSO into a burst of refreshment.

**04- 'THIS AFRICA Rula', a Capsule Cigarette**

In September 2014, KT&G launched 'THIS AFRICA Rula' with a unique Rula capsule, driven by customer feedback about the limited edition of the Rula capsule, introduced in May. When the capsule is crushed in a desired moment, the product's unique nutty and sweet flavor becomes a gentle, refreshing one. The recessed filter stays drier for longer, and ensures a good smoking experience.

05-



06-



**05- Shintanjin Factory Became the World's Biggest Factory for Ultra-slim Cigarettes**

In March 2014, KT&G completed 3 years and 5 months of construction to extend its Shintanjin Factory and install automation systems. The factory is now the world's largest ultra-slim tobacco factory; annual production capacity has risen from 35 billion to 85 billion sticks, which maximizes our production efficiency. In particular, the production facility for ultra-slim cigarettes has been extended so that it can now produce 59 billion sticks, which is about 50% of the world's ultra-slim cigarettes. We have put in place a flexible production system which will enable us to react to consumer needs more pro-actively, as the number of products that can be made at the same time has risen from 7 to 25. We also focused on a good working environment, and higher energy efficiency. The construction of this advanced factory has upgraded our product quality, which in turn will boost our competitiveness and customer value.

**06- The Opening of 'KT&G Sangsang Madang Chuncheon', a Multi-purpose Art and Cultural Space**

In April 2014, KT&G opened 'KT&G Sangsang Madang Chuncheon', to contribute to the development of culture and the arts, and to help in the revitalization of the local economy. This is a multi-purpose art and cultural space, offering cultural experiences to the public and supporting emerging artists in their creative activities. The opening of the KT&G Sangsang Madang Chuncheon follows the opening of similar spaces in Seoul and Chungnam Province in 2007 and 2011, respectively. This will open a wide array of cultural experiences to local residents, and help to revitalize the local economy in Chuncheon.

**07- Donating 500 Heating Tents to the Energy Poor**

KT&G donated 500 heating tents to the energy poor. This charity work was performed where each employee visited a single low-income household and installed a free heating tent, helping the impoverished to stay warm in the winter. The fees for buying heating tents were entirely sponsored by 'Sangsang Fund' voluntarily formed by the employees of KT&G. 'Sangsang Fund' is our exclusive social contribution fund and matching grant program participated by all the employees. Staff donate a certain amount from their monthly salaries, and the same amount is matched by the company.

07-



# LEADERSHIP knows no boundaries

Despite a challenging business environment at home and abroad in 2014, KT&G continued to grow, taking further steps towards realizing its vision of becoming a 'Leading global company'. We maintained our undisputed No. 1 position in the domestic market, and expanded our global footprint, exporting more than 100 brands to 50 countries around the world.

\* Consolidated figures basis

**KRW**  
**7,419** Billion



**TOTAL ASSETS**

As at end-2014, KT&G's total assets stood at KRW 7,419 billion, up 4.9% from the previous year-end.

**TOTAL LIABILITIES**

As at end-2014, the total liabilities of KT&G were KRW 1,711 billion, up 0.1% year-on-year.

**KRW**  
**1,711** Billion

**OPERATING INCOME**

In 2014, KT&G made KRW 1,172 billion in operating profit, up 15.6% year-on-year.

**KRW**  
**1,172** Billion

**KRW**  
**4,113** Billion



**SALES**

In 2014, KT&G recorded KRW 4,113 billion in sales, up 7.6% year-on-year.

**TOTAL EQUITY**

As at end-2014, KT&G's total equity stood at KRW 5,708 billion, up 6.4% from the previous year-end.

**KRW**  
**5,708** Billion

**KRW**  
**814** Billion



**NET PROFIT**

Net profit was up 45.5% year-on-year, to KRW 814 billion.

# ADVANCING THE WAY FORWARD

We have created momentum for growth by responding pro-actively to market changes through product differentiation that is based on upgraded technology.

Domestic Market Share  
(Unit: %)



## Performance in 2014

In 2014, KT&G focused its Korean business on differentiating its products and improving the competitiveness of strategic brands in order to respond to its competitors' aggressive launching of new products and price cutting policies. We launched products to reflect diversifying customer requirements, such as 'ESSE SOO Masterpiece', 'THE ONE Change', 'RAISON SUN Presso' and 'THIS AFRICA Rula'. These products enjoyed successful launches, helping us to spearhead changes in the market and drive corporate growth. In addition, our brand management has led to the renewal of our strategic brands; this, together with the launch of limited editions, has enabled us to enjoy a market share increase for strategic brands, the fourth year in a row. Our market share in 2014 recorded 62.3%, up 0.6%p year-on-year.

Sales in the domestic tobacco business in 2014 were KRW 1,966.9 billion, up 4.1% year-on-year, with sales volume of 55.7 billion sticks. The net average selling price was up 1.8% over the previous year; this is attributable to our endeavors to boost profits, for example by increasing marketing for existing high-end brands, launching the 'ESSE SOO Masterpiece' premium cigarette, and launching 'THIS AFRICA Rula' into the lower-tier market.

## Creating Sustainable Value

Despite the difficulties in the market in 2014, we sought to respond to consumer demands, and ensure quality throughout the distribution process. To this end, we expanded our sales unit, the key infrastructure in the tobacco industry, by branch, and reassigned their duties, in order to realign our organization to be more efficient and performance-based which could adapt to market changes promptly.

We applied our low-ignition 'Blue Band' technology, the result of extensive investment, to a wide range of products as part of our commitment to our social responsibilities. In addition, we attached a pictogram on smoking etiquette on product packaging, to contribute to the spreading of the proper smoking etiquettes.



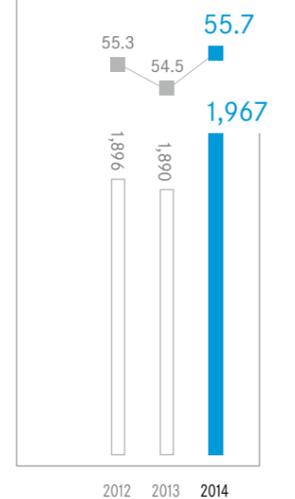
## Future Plans

The domestic tobacco market is expected to get smaller as a result of the dramatic increase in the tobacco tax. There will also be fiercer competition for market share from our competitors' price reduction policies. KT&G therefore plans to solidify its market position by launching products that meet changing consumer requirements, strengthen its strategic brands, improve profitability and undertake in-depth communications with its consumers.

We will realign the design identity for our strategic brands and improve their brand image. We will also strive to enhance our corporate image by developing stories about our high-quality products and strong technological capabilities, and launching communication programs that will encourage consumer participation. To ensure constant improvement in product quality, we will continue to research and develop new technologies for future market changes, improve our production facilities, and ensure stability in the supply process for our raw materials.

## Domestic Tobacco Sales

□ Sales  
(Unit: KRW billion)  
■ Sales Volume  
(Unit: Billion sticks)



# CHARTING NEW TERRITORIES

We have built a presence as one of the top five tobacco companies in the world, driven by quality products and pro-active commitment to new markets.

## Global Business Overview

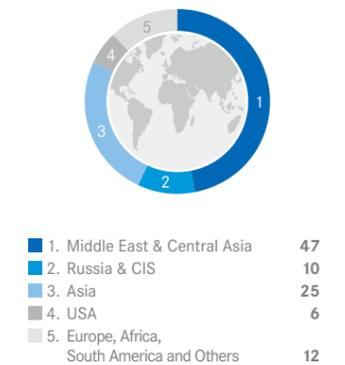
KT&G tapped into overseas markets in the 1990s as a reaction to sluggish growth in the domestic market. We have moved aggressively into new markets, based on the excellence of our products and differentiated brands, as well as localized strategies that focus on what local customers want. As a result, overseas sales of just 2.6 billion sticks in 1999 skyrocketed to 43.4 billion sticks, including sales of overseas subsidiaries, in 2014. We now have a presence well beyond our initial export destinations in the Middle East and Russia, to include Southeast Asia, the Americas, and Africa. We are now a truly global enterprise, selling about 44% of our total production volume overseas to about 50 countries around the globe.

KT&G's flagship export brand, 'ESSE', is an ultra-slim cigarette with the highest sales volume – one in three ultra-slim smokers around the world smoke ESSE. 6 million sticks were exported in 2001; that figure was 10 billion sticks in 2006, and 21 billion in 2011, making us the dominant player in the overseas ultra-slim tobacco market. ESSE is currently exported to about 50 countries including Russia, Europe, and the Middle East; as of end-2014, accumulated overseas sales exceeded 140 billion sticks.



As of end-2014, KT&G has overseas factories in Russia, Turkey, Indonesia and Iran, and overseas subsidiaries and branches in the U.S., China, the Philippines, Kazakhstan and Lebanon. Our market position in the global market continues to improve through the expansion of local distribution channels and premium products as well as brand strategies that suit local needs.

Overseas Sales by Region in 2014  
(Unit: %)



## Performance in 2014

Sales of our flagship export brand, 'ESSE', have risen steadily in our key markets, including the Middle East and Central Asia. New products such as 'ESSE MINI Slim' have also been successful, helping overseas sales to improve substantially, driven by new markets in Africa and Latin America. In 2014, 36.1 billion sticks were exported, up 30.2% year-on-year; sales were KRW 533.1 billion, up 17.8%, and operating profit was KRW 174.8 billion, up 38.0% over the previous year.

## Future Plans

We forecast steady growth in overseas sales volumes in 2015, helped by favorable export conditions in target markets and our thorough preparations for making forays into new markets. We will expand and improve local marketing by strengthening local units in key export destinations such as the Middle East and Central Asia. In addition, we will look to make long-term investments into destinations such as China, India and south east Asia. We will also focus on improving our marketing by undertaking differentiated brand management strategies for each region, and by releasing distinctive new products for niche markets.

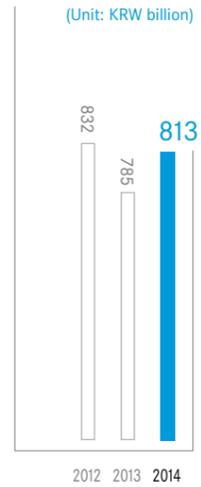


# LEADING BALANCED GROWTH

Our red ginseng business contributes to the stable growth of the company and the globalization of the Korean red ginseng through steady growth at home and abroad.



Sales in Red Ginseng Business  
(Unit: KRW billion)



## Performance in 2014

Our red ginseng business maintains steady growth through the development of new products, customer-focused marketing, increased production capacity and continuing R&D. In 2014, despite the difficult business environment caused by a slowdown in the domestic health functional product market and weaker consumer confidence, we released new functional products that meet customer needs, building a foundation for new growth.

In particular, 'Hongsam-jeong Every Time' saw positive feedback from consumers. This stick-type new product with red ginseng extract can be easily carried on the go, and has become popular with consumers, leading a new trend in the market.

As a result of these efforts, red ginseng sales in 2014 recorded KRW 812.8 billion, up 3.6% over the previous year. Operating profit was KRW 130.1 billion, up 4.1% year-on-year, suggesting definite growth momentum.

## Key Competitive Advantage

The red ginseng business is a vital part of KT&G, playing a role of cash cow along with tobacco business. Built on 116 years of tradition and know-how, we produce and sell 'Cheong-Kwan-Jang', our leading brand, and a diverse range of other health functional foods. We strive to contribute to the globalization of the Korean red ginseng, based on our strong brand power and customer trust in the domestic market, built upon our nationwide distribution networks and franchise systems.

We produce high-quality red ginseng through a systematic cultivation management process for 6 years in purchasing raw materials. Product safety is ensured through food traceability system and a strict quality control system. Our constant R&D efforts have continued to show results, producing the world's highest-quality red ginseng.

To support continued sales growth, we have invested about KRW 130 billion, since 2004, in improving our capacities to treat fresh red ginseng, and in expanding our facilities to produce extracts. KT&G was designated as a company with GMP (Good Manufacturing Practice) for health functional products in December 2006, while obtaining the certification of HACCP (Hazard Analysis Critical Control Point) in June 2012 which shows our commitment to the requirements of food quality and safety. We have also reduced costs and increased production by introducing automated production facilities.

## Future Plans

We will build on our dominance in the domestic red ginseng market, build the base for future growth, and create stable growth strategies for overseas markets. In line with this, we will develop new and different health functional products, expand distribution channels, strengthen consumer communications, and improve profitability by enhancing production efficiency. To expand globally, we will implement business strategies that are differentiated by region, and generate improved performance from the localization of Jilin Hanzheng Ginseng Co., Ltd.

## KEY PRODUCTS

KT&G's distinctive range of products is the result of our quality and brand management, and our global brands are now enjoyed by consumers in about 50 countries across the globe.

\*New Product

### ESSE Series

ESSE is the best-selling ultra-slim brand in the world, and the dominant brand in Korea.

### ESSE SOO Masterpiece\*

It is a premium cigarette, the first in Korea to use an active bamboo fiber filter.



### THE ONE Series

An activated oxygen filter with twice-oxygenated filter particles gives clean and smooth flavor to THE ONE series.



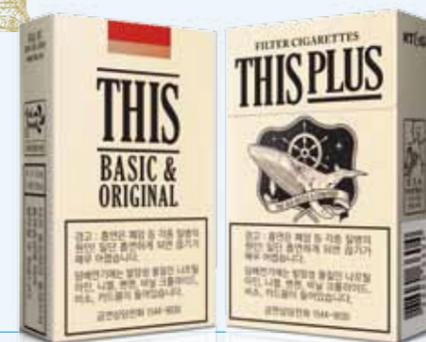
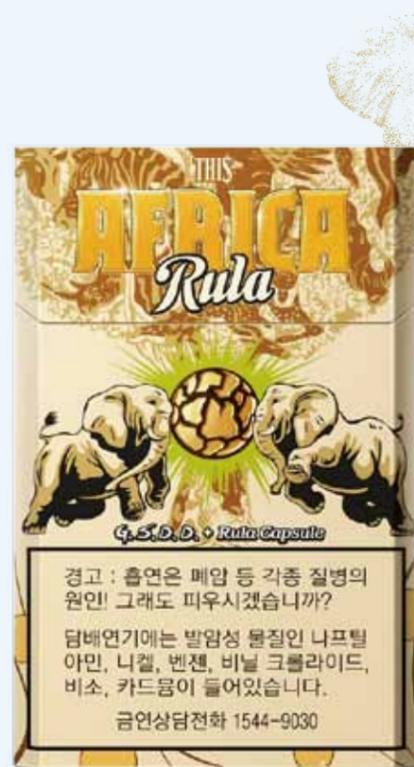
### THE ONE Change\*

This is a new product in which a capsule is added to THE ONE, to create an ultra-low tar capsule cigarette.



### BOHEM CIGAR Series

It is the only domestic cigarette made from cigar leaves, with an exotic and unique taste that consumers truly appreciate.



### THIS PLUS Series

THIS PLUS is one of our longest-established brands which has been expanding its market dominance through a dramatically improved design and an extended product line-up.

### THIS AFRICA Rula\*

This new product features a unique capsule and a recessed filter, to target relatively younger consumers.

### RAISON Series

RAISON is a highly popular brand among college students appealing to consumers' creative sensitivity.

### RAISON SUN Presso\*

It is a new product which delivers two special flavors by using a capsule.



# PARTNERSHIP shapes long-term success

Partnership is the cornerstone of our approach to business, and a vital part of what makes us strong. We think long-term, and we understand that stable and sustainable relationships are an essential part of long term strength. That is why KT&G always strives to stand alongside our stakeholders as a strong and reliable partner, recognizing their needs and generating higher value for them.



As of the end of 2014, we have 2,654 intellectual properties registered.



No. 1

ESSE has ranked first in the 2014 K-BPI for seven consecutive years.



KT&G ranked 27th in the 2014 'Best Korea Brand', as designated by Interbrand.

100%

The customer complaint handling rate of KT&G is 100%.



# INNOVATING FOR SUSTAINABLE GROWTH



We continually look to our industry-leading R&D to build greater customer satisfaction and sustainable company growth.



## R&D Organization

KT&G's R&D structure consists of the R&D Planning Office and three research centers. The R&D Planning Office devises R&D strategies and goals, and manages the R&D projects that are put in place to achieve those goals. The Product Research Center works on the development of new products and the improvement of existing lines, based on customer tastes. The Technology Research Center conducts research into core technologies, including for tobacco cultivation and products. The Analysis Research Center focuses on research into the analysis technologies needed to develop products and technologies.

## Blue Band

The Blue Band is a technology to produce cigarettes of low ignition propensity (LIP). It came about as the result of KT&G's advanced technology and outstanding R&D. Technological development was successfully completed in May 2014, after the investment of KRW 7 billion over three years of development. KT&G has completed the registration of five patents – two for coating materials, two for technologies for facility components, and one for the band structure. We will be able to use Blue Band to export to countries where cigarettes are mandated to be LIP. This will enable us to address issues of cost, technology and quality assurance, and underline our reputation as a company that fulfills its social responsibilities.

## Intellectual Property Rights

(As of the end of 2014)

# 2,654

# SETTING NEW STANDARDS



We are opening a new horizon in quality management based on systematic quality management and value innovation.

## Competitiveness in Quality

### DOUBLE-LAYER WRAPPING TECHNOLOGY

Wrapping tobacco in a double layer of cigarette paper helps cut off the smoke coming off the end of a smoldering cigarette, and reduces tobacco odor on clothes and fingers.

### AROMA PACKAGING

By rubbing a package after smoking, an aroma comes out of a micro capsule containing a special aroma mounted on the package, thus reducing the tobacco odor left on the hands.

### TASTE & QUALITY ASSURANCE SYSTEM

To maintain the best taste, KT&G has built a real-time monitoring system for the entire process, from the input of materials to production of finished products. If a problem occurs, the production line can immediately be halted and then resumed after the problem is fixed.

### DOUBLE VERIFICATION SYSTEM

Products are shipped only after being checked for quality, firstly by using an evaluation from the senses of skilled workers and then at the shipping stage by a quality measurement data review with the latest quality equipment.

## Disclosure of Information

### DISCLOSURE OF PRODUCT INFORMATION

KT&G is the world's first tobacco company to introduce the producer real name system, which is applied to all goods produced in Korea. This helps raise consumer confidence, and also encourages our employees to feel more responsible for quality. The company has printed production information and name of the team head responsible since August 2011. We have also built an internal process to assess and further improve the efficiency of the system.

### CONSUMERS' RIGHT TO KNOW

All cigarette packages and cigarette advertising in Korea carry health warnings in accordance with the Tobacco Business Act and the National Health Promotion Act. All export products are printed with warning messages that comply with the laws of the importing country. KT&G also prints warning messages on cigarette packages exported to countries where there is no such legal requirement. We follow international standards regulating messages that may be misleading to consumers, and disclose the tar and nicotine content of our products.

# REACHING NEW HEIGHTS

We enhance corporate value, as a company opening up a better tomorrow, by increasing the brand value of our high-quality product line-up.



## Stakeholder Communication

### CUSTOMER VALUE

KT&G always listens to its customers' opinions, and has in place policies and activities for total customer satisfaction. Our customer counseling system operates a 24-hour customer satisfaction center that always tries to handle claims promptly. Feedback on the process further improves product quality. In order to hear external independent opinions, we operate various communication channels such as an advisory committee of specialists in different areas, and the Sinmungo (complaint reporting) system.

### SOCIAL VALUE

KT&G fulfills its role as a corporate citizen by taking the lead in creating a good smoking environment. This includes supporting the installation of smoking rooms and smoke control facilities, supplying portable ashtrays and public trash cans, campaigning to spread smoking etiquette, educating teens on smoking prevention, and assisting cancer research.



## Increasing Brand Value

A brand enjoyed and trusted by consumers generates higher economic performance. Because cigarettes are chosen by consumers based not just on product quality but also on brand reputation and value, increasing our brand value is essential for the sustained growth of the company. We are therefore committed to comprehensive brand management.

Markets are categorized by region, age, gender, and other factors, and the trends in each market are analyzed, in order to strengthen our brand power. For our flagship brands, we conduct a biannual Brand Equity Index, to analyze brand competitiveness, satisfaction, recognition and image, which helps us to measure the performance of brand strategies and seek the most responsive strategies for each market.

In 2014, we concentrated on balanced growth of strategic brands, and sought to increase our dominance in premium markets. As a result, KT&G was ranked 27th in the '2014 Best Korea Brand' by Interbrand, the renowned brand consulting firm. In addition, ESSE, our flagship brand, has now been ranked first for seven consecutive years in the Korea Brand Power Index (K-BPI) organized by the Korean Management Association Consulting and also has also been ranked first in the National Brand Competitiveness Index (NBCI) from the Korea Productivity Center for five years in a row.

To engage in active marketing abroad through local supply channels and to promote our brands, we have participated in the World Duty-free Exhibition, the largest of its type in the world, since 2006, proving our commitment to expanding on existing sales channels, tapping into new markets and securing new customers.

## AFFILIATES

KT&G affiliates work together to grow into world-class companies in diverse businesses such as tobacco, ginseng, health food, cosmetics, and bio/pharmaceuticals.



### Korea Ginseng Corporation

Korea Ginseng Corporation (KGC) began its red ginseng business with the establishment of Sam-Jeong-Gwa (Ginseng Management Division) in 1899. KGC has grown into a major health-food company, and has inherited and developed the traditions of our premium brand, 'Cheong-Kwan-Jang'. As Korea's best ginseng producer, we are proud to share the tradition of Korea ginseng with the world.

<b>BUSINESS</b>	Manufacture and distribution of red ginseng and red ginseng products
<b>OWNERSHIP</b>	100%
<b>SALES IN 2014</b>	KRW 812.8 billion
<b>MAJOR PRODUCT</b>	Hongsamjeong (Red ginseng extracts)

### Somang Cosmetics

Somang Cosmetics is an advanced cosmetics company that helps its customers achieve the beauty they seek. The company is enjoying sustained growth through the development of reliable and high quality products and distinctive marketing strategies.

<b>BUSINESS</b>	Manufacture of cosmetic products
<b>OWNERSHIP</b>	50%
<b>SALES IN 2014</b>	KRW 71.7 billion
<b>MAJOR PRODUCT</b>	Man with Flowers, Danahan



### KGC Life & Gin

KGC Life & Gin is a health & beauty provider that offers a better life through the balance of science and the natural ingredients of red ginseng. KGC Life & Gin offers diverse total health products to consumers based on the stringent selection of raw materials and a detailed quality management system.

<b>BUSINESS</b>	Distribution of red ginseng products and health foods, cosmetics
<b>OWNERSHIP</b>	100%
<b>SALES IN 2014</b>	KRW 46.2 billion
<b>MAJOR PRODUCT</b>	Donginbi

### Yungjin Pharmaceutical Co., Ltd.

Yungjin Pharmaceutical Co., Ltd. is a pharmaceutical company, producing differentiated pharmaceutical products and diverse health functional foods and drinks. Its focus is on building R&D capabilities so that it can develop new medicines that fulfill its founding credo of contributing to the welfare of the mankind by curing diseases and easing suffering.

<b>BUSINESS</b>	Manufacture and distribution of drugs, ingredients, and chemical products
<b>OWNERSHIP</b>	53%
<b>SALES IN 2014</b>	KRW 167.6 billion
<b>MAJOR PRODUCT</b>	Harmonilan Solution



# COMPANIONSHIP

is our shared value

We know that long-term corporate success is not possible without sustainability. We also know that the enduring strength of our business depends on healthy and vibrant communities. That is why giving back to communities is a vital core value for KT&G, and why we invested 2.13% of sales in 2014 into corporate social responsibility (CSR) activities.



6.47

The average number of volunteer hours per staff member in 2014 was 6.47 hours.

## Global Frontier Award

KT&G won the 'Grand Prize for the Global Frontier'.



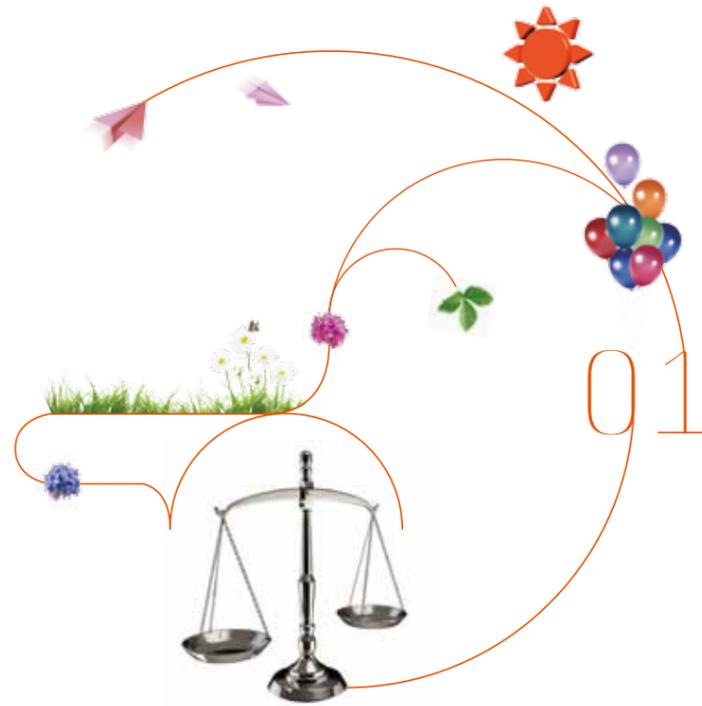
KT&G has been listed on the Dow Jones Sustainability Index (DJSI) World for five consecutive years.

KRW  
**58.4** Billion



KT&G invested KRW 58.4 billion into CSR activities in 2014.

# WORKING WITH INTEGRITY



KT&G will become a company that is respected and trusted by all stakeholders by practicing ethical and transparent management.

### Creating Value through Ethical Management

KT&G complies with all relevant laws at home and abroad as part of its commitment to being an ethical and transparent company. We abide by ethical standards including fair transactions with business partners and the protection of employees' rights, and we conduct various training programs and campaigns that aim at establishing and developing ethical management at the heart of our corporate culture.

#### CODE OF ETHICS

The code of ethics and guidelines for its implementation were established in 2003, so that all employees can establish a proper perspective on the values required and fulfill their duties with integrity. The code of ethics details our commitment to customers, respect for legal compliance and fair competition in the market, the ethics required from employees, the company's responsibilities towards its employees, the right way to build relationships with business partners, and our responsibilities towards shareholders and society. A code on how to put these into practice is also set out.

#### ETHICAL MANAGEMENT OFFICE

In order that KT&G always responds quickly and efficiently to ethical management issues, the Ethical Management Office reports directly to the CEO about all relevant activities. As a control tower for ethical management, the office shares policies on ethical management, monitors business risks, examines subsidiaries, and investigates and responds to accidents or other safety events. There is an annual audit on ethical management for each division, regional headquarters and branch.

#### SUPPORT FOR ETHICAL MANAGEMENT

We have diverse ethical training programs for all staff, and continue to update our ethics regulations and action systems. In addition, we diagnose the ethical management at major subsidiaries and makes corrections where necessary, thus ensuring they maintain the standards of ethical management required at the Group level.

### Fair Transactions and Win-Win Partnerships

KT&G has established basic principles for purchasing based on its code of ethics, to ensure fair transactions. We comply with guidelines set by the Fair Trade Commission for trading between large companies and SMEs. In addition, we have set up internal compliance guidelines so that our employees understand the Fair Trade Act.

Since the introduction of the Compliance Program in 2002, we have designated a compliance officer to ensure compliance with fair transaction laws. As a member of the Korea Tobacco Association, we also joined the Trade-related IPR Protection Association, to help eliminate the illegal distribution of tobacco.



We strive to establish win-win partnerships with our suppliers, recognizing them as business partners on equal footing. Activities to build win-win partnerships include discovering and supporting the best suppliers, supporting financial aid to local tobacco farmers, research to improve the quality of locally-produced leaf tobacco, and giving practical help to tobacco farmers during their busy season.



# FOSTERING GLOBAL TALENT



We aim to realize our vision of becoming a ‘Leading global company’ by fostering global talent, with all the necessary expertise, flexibility and leadership.



## HR Development Philosophy

KT&G strives to generate performance by recruiting people willing to be a part of win-win partnerships, based on the spirit of ‘I am C.E.O.’ Driven by a human resources (HR) philosophy centered on performance and duties, we do the

utmost to establish a proper HR culture and strengthen the expertise of our staff. We are also creating a corporate culture where the best employees are rewarded well, based on impartial assessment. Our HR mission, strategies and tasks are all set to align with our core values, and thus help all our staff to improve their ability to do their jobs.



## Principles for Recruitment

KT&G recruits people without prejudice and regardless of gender, academic background, region or disabilities, pursuant to the Labor Standards Act. We strengthen the diversity of our recruitment through multiple recruitment schemes and channels. We particularly emphasize opportunities for the socially disadvantaged, the disabled and high school graduates.

## HR Development

KT&G HR development program consists of training sessions on core values, job skills and leadership. Our staff are trained to embody the KT&G Way. We create specialists in relevant fields through job training, and our leadership training programs build leaders who will continue the onward journey of KT&G.

The KT&G Business Information Service, built in March 2011, offers web- and smart phone-based video content and thesis search services in economics, business administration, and leadership. The KISS (KT&G Innovative Supreme System), an education management system, helps staff track their education history, manage their career development, and share useful information with colleagues.



# CREATING A GREENER TOMORROW



03

We will open up a brighter and greener future by respecting the environment and valuing it as an integral part of our business.

## Strategies for Environmental Management

KT&G strives to strike a balance between business and the environment through the thorough environmental risk management and climate change responses. Because we treat environmental management as part of our corporate social responsibilities, we have a more integrated and systematic environment strategy, instead of one that merely responds to regulations. We therefore develop and apply various green technologies, and manage the environmental impact of all our business activities. We also pro-actively engage in activities that seek to ease climate change, in line with the government's low carbon green growth policies.

## Environmental Management System

KT&G has fewer environmental issues than many other manufacturing businesses, but we have nevertheless established company-wide environmental management systems. We conduct environmental activities from a mid-to-long-term perspective. These activities include eco-friendly factory management, establishment of emissions management systems, building environmental awareness among staff and suppliers, and undertaking external communications. Energy saving and environmental issues are monitored in each factory, and the Green Management Team, which was created to take charge of our environmental management, promotes environmental activities throughout the company, improves green management at each factory, and aims to reduce greenhouse gas emissions.



**ECO-FRIENDLY FACTORY MANAGEMENT**

Establishing clean factories through eco-friendly process management



**EMISSIONS MANAGEMENT SYSTEM**

Systematically managing air, waste, water polluting materials and greenhouse gases



**ENVIRONMENTAL AWARENESS FOR EMPLOYEES**

Improving environmental awareness through training and environmental education



**EXTERNAL COMMUNICATIONS**

Improving external environmental communications through detailed environmental performance management

## Efforts to Reduce the Environmental Impact

KT&G strictly controls its use of water resources, its waste-water discharge and its waste management so that it can minimize its environmental impact on local communities and the ecosystem, and can make its sites as environmentally friendly as possible. We have reduced our use of water by installing water-saving facilities, and by using recycled industrial water or underground water. All water pollutants are kept to levels below legal requirements, and waste-water is treated by specialist outside companies. Waste is also controlled in line with strict waste reduction plans.

## Strategic Response to Climate Change

Under the Korean government's 'Greenhouse Gas and Energy Target Management System', most domestic companies are required to address the issues of climate change. Although KT&G is not on the list of companies mandated to comply with greenhouse gas and energy target requirements, we undertake a range of activities to counter climate change. These include promoting the use of high energy-efficiency devices, installing energy-saving facilities, and sharing energy sources with nearby factories by participating in Energy Service Company projects. We also strive to lower our greenhouse gases by producing environmentally friendly products and integrating the logistics system within the Group.



# SOWING THE SEEDS OF HOPE



KT&G makes unwavering efforts for a better world and a more promising tomorrow, and will always strive to be closer to the community.

### Directions for Social Contributions

KT&G has developed unique CSR activities based on our CSR direction of 'KT&G Way, and carries out diverse range of social contribution programs including Mecenat activities. The KT&G Way is based on 'Sangsang' (imagination), and is comprised of five categories – 'Contributing to the Arts

and Culture' to support and create a new culture; 'Welfare Foundation' to help the disadvantaged; 'Scholarship Foundation' to offer financial assistance to young people in need; 'Volunteer Services' to share our staff's talent with others; and 'Social Responsibility Activities', to reflect the sense of responsibility that we have as a leading company in the tobacco industry.

### Major Contribution Activities

#### SANGSANG FUND

In March 2011, KT&G formed the 'Sangsang Fund', whereby all staff donations are matched by the company. In 2014, KRW 2.7 billion of the fund was used to support patients with limited income, to offer scholarships to low-income students and donations for the victims of the Sewol Ferry disaster, and to conduct other sharing and volunteering activities.

#### SANGSANG TOGETHER

'Sangsang Together' was formed in 2007 so that staff could directly participate in resolving problems in local communities, and share some of our corporate profits with wider society. As at the end of 2014, we have 167 volunteer groups in operation through 20 organizations.

**WELFARE**

**DONATION AND VOLUNTEERING**  
Establishing a creative donation and volunteer culture through the KT&G Way

**WELFARE FOUNDATION**  
Offering productive welfare to assist future generations via the KT&G Welfare Foundation

**VALUE CREATION**

**SANGSANG MADANG**  
Presenting a wider scope of cultural welfare to the general public, and supporting young artists

**SCHOLARSHIP FOUNDATION**  
Fostering next-generation leaders by providing education opportunities to underprivileged young people



#### SANGSANG VOLUNTEER

'Sangsang Volunteer' is a group of university student volunteers. This program was launched in 2010 with the purpose of increasing opportunities for students to undertake voluntary sharing activities. It currently operates in 14 regions throughout Korea. As a new concept of talent donation, university students organize and undertake volunteering activities on their own.

#### GOOD REPLY CAMPAIGN

An employee writes a positive reply on the company Intranet, KT&G donates money to help victims of on-line bullying – and the more positive comments there are, the more we donate. The funds raised are donated each quarter to the 'Sunfull (good reply) Movement Korea', an internet movement which counters on-line bullying.

#### ACTIVITIES ON SOCIAL RESPONSIBILITIES

KT&G implements public interest programs on smoking so that we can do our best to create a culture of mutual respect between smokers and non-smokers. Activities include distributing portable ashtrays, inserting smoking etiquette pictograms on tobacco cases, and improving the smoking environment in public facilities. We also make donations to the Korean Foundation for Cancer Research to support its R&D, and seek to promote ways to prevent under-age smoking.

#### SUPPORT FOR CULTURE AND THE ARTS

KT&G runs KT&G Sangsang Madang, a multipurpose social and cultural space to support young artists, and provide the public with opportunities to enjoy the arts and cultural experiences. It is located in three areas – Seoul, Nonsan in Chungnam Province, and Chuncheon in Gangwon Province, and it has helped to set cultural trends and contribute to local economic development in those areas.

#### WELFARE FOUNDATION

Established in July 2003, KT&G Welfare Foundation assists the elderly, children and others in need through social welfare, volunteering, and welfare projects on the Internet. The foundation assists eight local welfare centers in Seoul and its metropolitan areas, extending a helping hand to the under-privileged in the local community through a public-private co-operation network.

#### SCHOLARSHIP FOUNDATION

Scholarship Foundation was established in 2008 with the purpose of achieving its management philosophy 'Growing Together' and cultivating creative talents to contribute to enhancing the national competitiveness. Scholarships have been extended aiming to foster sound members of the society and outstanding talent.

# FINANCIAL REVIEW

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## MANAGEMENT'S DISCUSSION AND ANALYSIS

### Introduction

KT&G Corporation was established on April 1st, 1987 as a manufacturer and seller of tobacco and tobacco products. The company has now grown to become a global enterprise, exporting 100 brands to 50 countries around the world. KT&G has subsidiaries including Korea Ginseng Corp., Yungjin Pharmaceutical, KGC Life & Gin, and Somang Cosmetics. The company aims to accomplish balanced growth across a portfolio that has widened from tobacco and ginseng as our flagship businesses at home and abroad, to include bio businesses, and health & beauty.

KT&G's financial statements are made by applying the Korean International Financial Reporting Standards (K-IFRS). This means that they fulfill the requirements of the Korean government under the standards and guidelines released by the International Accounting Standards Board.

KT&G's financial statements for 2014 refer to the period from January 1st to December 31st, 2014, and this Management Discussion & Analysis (MD&A) is based on those and other financial figures. It covers not only KT&G's past performance but also a current financial and business evaluation, the economic and industrial outlook, future business performance and business goals. The forecasts in this material are based on internal business environment analyses and market forecasts, including a wide range of uncertainties that are subject to change. These uncertainties could generate a significant difference between the forecasts herein and actual performance. The company therefore does not give any guarantee as to the accuracy and completeness of any forwardlooking information herein.

### BUSINESS ENVIRONMENT

The global economy saw mixed results in 2014, with slowing growth in Japan and the Eurozone, sluggish investment in China, a rapid slowdown in Russia, but strong growth in the U.S. As a result, global economic growth was 3.1%, slightly better than in 2013. In the domestic market, the Gross Domestic Product (GDP) growth rate was 3.3%, which was up from the 3% recorded in 2013, but below the 4% expected at the beginning of the year. This was mostly attributable to sluggish growth in both exports and domestic demand.

The global tobacco industry continues to confront numerous challenges; however, as a result of increasing adult populations and other factors, it is still expected to grow. While growth is limited in major economies due to stricter regulations on tobacco marketing and sales, tobacco markets in developing countries have less stringent regulations. The domestic tobacco industry faces a challenging business environment, with a slow recovery in the economy, a major hike in tobacco prices, stronger regulation, and fierce competition from foreign brands.

### Operating Performance

#### SALES

In 2014, KT&G recorded KRW 2,743 billion of sales, up 9.2% year-on-year, despite a difficult business environment at home and abroad. This was thanks to stable growth in all our businesses, including tobacco and real estate.

In the domestic tobacco business, KT&G concentrated on differentiating its products and improving the competitiveness of its strategic brands, in order to respond to its competitors' aggressive launching of new products and price reductions. As a result, sales volumes and net average selling price both went up, enabling domestic tobacco sales to reach KRW 1,967 billion, a 4.1% increase over the previous year.

In the overseas tobacco business, export volumes rose driven by higher sales of differentiated products, such as ESSE Mini Slim in our major markets, including the Middle East and Central Asia, helped by improving geopolitical stability in those regions. Exports were also improved by our proactive entry into new markets, including Africa and Latin America. Sales overseas thus reached KRW 533 billion, 17.8% higher than in 2013.

In the 'others' category, sales were KRW 243 billion, up 44.0% year-on-year, mainly because revenues from real estate rose strongly due to the development of the site of the former Andong Raw Materials Factory.

#### SALES BY BUSINESS

	2014	2013	Change (Amount)	Change (%)
Domestic Tobacco Business	1,967	1,890	77	4.1
Overseas Tobacco Business	533	453	80	17.8
Others (Real Estate, etc.)	243	168	75	44.0
<b>Total</b>	<b>2,743</b>	<b>2,511</b>	<b>232</b>	<b>9.2</b>

#### PROFIT AND LOSS

Sales increased by 9.2% year-on-year, but the ratio of sales cost rose by 1.5%p from 37.3% in 2013 to 38.8% in 2014. Gross profits were therefore KRW 1,679 billion, up 6.6% over the previous year.

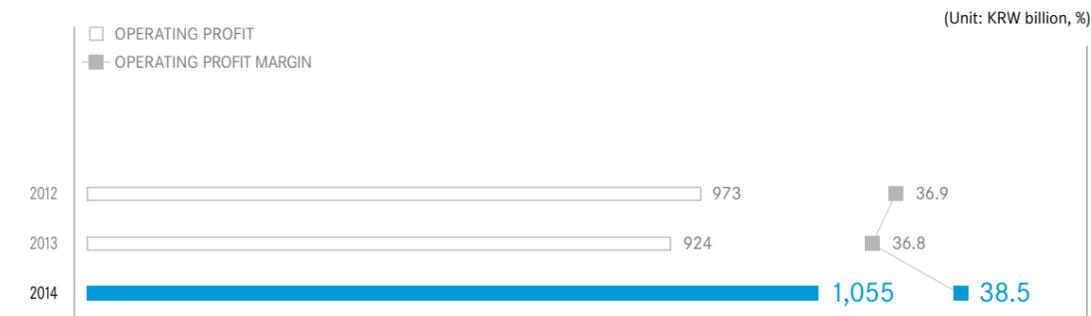
SG&A expenses decreased 4.1% year-on-year due to reductions in advertising and bad debt expenses. As a result, operating profits stood at KRW 1,055 billion, up 14.2% from 2013.

Net profits saw a gain of 49.0% year-on-year to KRW 747 billion due to marked improvements in currency gains, such as foreign currency transaction gains and foreign currency translation gains, and reduced miscellaneous losses.

#### SUMMARIZED STATEMENTS OF INCOME

	2014	2013	Change (Amount)	Change (%)
Sales	2,743	2,511	232	9.2
Gross Profit	1,679	1,575	104	6.6
SG&A Expenses	624	651	(27)	(4.1)
SG&A Expenses Ratio	22.7%	25.9%		(3.2)%p
Operating Profit	1,055	924	131	14.2
Operating Profit Margin	38.5%	36.8%		1.7%p
Profit before Tax	1,045	757	288	38.1
Net Profit	747	501	246	49.0

#### OPERATING PROFIT & OPERATING PROFIT MARGIN



SG&A expenses declined by 4.1% to KRW 624 billion due to lower advertisement expenses, etc. Salaries, advertising expenses and service fees accounted for 36.8%, 21.3% and 12.8% of SG&A expenses respectively. Salaries and service fees increased by 6.8% and 14.3% to stand at KRW 230 billion and KRW 80 billion, respectively, but advertising expenses fell to KRW 133 billion, down 13.9% year-on-year.

#### BREAKDOWN OF SELLING AND ADMINISTRATION EXPENSES

	2014	2013	Change (%)	Portion (%)
Salaries	230	215	6.8	36.8
Employee Benefits	29	29	-	4.7
Advertising	133	154	(13.9)	21.3
Service Fees	80	70	14.3	12.8
Depreciation Expenses	32	32	-	5.2
Bad Debt Expenses	(11)	27	(140.3)	(1.7)
Other Expenses	131	124	5.6	20.9
<b>Total</b>	<b>624</b>	<b>651</b>	<b>(4.1)</b>	

## Financial Status

#### ASSETS

As at end-2014, KT&G's total assets stood at KRW 6,295 billion, up 3.5% from the previous year-end.

Current assets were KRW 2,983 billion, up 4.7% year-on-year. While inventory and other financial assets dropped 3.1% and 3.0%, respectively, accounts receivable & other receivables, and cash and cash equivalents were up by 14.3% and 30.9%, respectively. Non-current assets stood at KRW 3,312 billion, up 2.5% year-on-year; decreases in investments in subsidiaries and long-term accounts receivable & other receivables, by 7.3% and 10.3%, respectively, were more than balanced by increases in tangible assets and long-term deposits, by 8.2% and 37.3%.

#### LIABILITIES

As at end-2014, the total liabilities of KT&G were KRW 953 billion, down 9.2% year-on-year.

Current liabilities stood at KRW 786 billion, down 13.1%. Income tax payable and unearned revenues increased by 15.6% and 52.32%, respectively, but trade and other payables, and accrued tobacco consumption taxes dropped 13.7% and 27.3%, respectively, which led to the fall in current liabilities. Non-current liabilities stood at KRW 167 billion, up 14.4% over the previous year. This was mainly due to increases in net defined benefit liabilities and deferred income tax liabilities of 11.6% and 28.6%, respectively, and despite a 36.2% fall in long-term advances.

SUMMARIZED STATEMENTS OF FINANCIAL POSITION

(Unit: KRW billion)

	2014	2013	Change (Amount)	Change (%)
<b>Total Assets</b>	<b>6,295</b>	<b>6,082</b>	<b>213</b>	<b>3.5</b>
Current Assets	2,983	2,850	133	4.7
Cash and Cash Equivalents	322	246	76	30.9
Receivables	728	623	105	16.9
Others	1,933	1,981	(48)	(2.4)
Non-current Assets	3,312	3,232	80	2.5
<b>Total Liabilities</b>	<b>953</b>	<b>1,050</b>	<b>(97)</b>	<b>(9.2)</b>
Current Liabilities	786	904	(118)	(13.1)
Non-current Liabilities	167	146	21	14.4
<b>Total Shareholders' Equity</b>	<b>5,342</b>	<b>5,032</b>	<b>310</b>	<b>6.2</b>
Debt-to-Equity Ratio (%)	17.8	20.9		(3.1)%p
ROA (%)	11.9	8.2		3.7%p
ROE (%)	14.0	10.0		4.0%p

Cash Flows

In 2014, cash and cash equivalents reached KRW 322 billion, up 30.9% year-on-year.

Cash flows generated by operating activities rose 19.2% to KRW 752 billion, mainly because of the 49.1% year-on-year increase in net income, to KRW 747 billion. Cash flows from investing activities were minus KRW 274 billion, a 10.0% year-on-year increase in the negative figure, due to increased acquisition of tangible assets and available-for-sale financial assets. Cash flows from financing activities were minus KRW 402 billion, mainly from dividend payments.

SUMMARIZED STATEMENTS OF CASH FLOWS

(Unit: KRW billion)

	2014	2013	Change (Amount)	Change (%)
Cash Flows from Operating Activities	752	631	121	19.2
Cash Flows from Investing Activities	(274)	(249)	(25)	10.0
Cash Flows from Financing Activities	(402)	(403)	1	(0.2)
Cash and Cash Equivalents at the Beginning of the Year	246	267	(21)	(7.9)
Cash and Cash Equivalents at the End of the Year	322	246	76	30.9

Dividend

The dividend per share for 2014 was KRW 3,400, up 6.3% over the figure for 2013. Total dividend costs were KRW 428 billion, up 6.3% from the previous year.

	2014	2013	2012
Net Income (KRW billion)	747	501	768
Dividends (KRW billion)	428	403	403
Dividend per Share (KRW)	3,400	3,200	3,200

2015 Outlook

The global economy is expected to continue its slow recovery in 2015, as quantitative easing in the U.S. comes to an end. There will be continuing difficulties in our export business due to trade protection policies in some countries. In the domestic market, concerns over a deep-seated and structural slowdown in consumption are leading to a prolonged period of low growth, and hampering the recovery of the Korean economy. Profound changes are expected in the domestic tobacco market due to substantial increases in the tobacco tax in Korea, fiercer competition, and more diversified consumer requirements.

KT&G will respond proactively to this challenging economic environment at home and abroad, and will continue its stable growth based on thorough analysis of its current and potential markets, as well as detailed strategies to meet customer needs. The company will build on its market leading position through distinctive marketing and technological innovation in its main businesses, such as tobacco and red ginseng. Synergies across businesses and sectors will be maximized to pave the way for new growth engines, thus expanding global businesses and generating success models.

KT&G will confront the rapidly changing business environment by spearheading innovation in the industry. The company will strive to build sales and increase profits by overcoming the challenges it faces, and by maintaining its principle management in the long-term perspective. In doing so, KT&G will both enhance shareholder value and make further progress in realizing its vision of becoming a 'Leading global company'.

## INDEPENDENT AUDITOR'S REPORT



To the Board of Directors and Shareholders of  
KT&G Corporation

We have audited the accompanying consolidated financial statements of KT&G Corporation (the "Parent Company") and its subsidiaries (collectively referred to "the Group"), which comprise the consolidated statements of financial position as of December 31, 2014 and 2013, and the consolidated statements of comprehensive income, changes in equity and cash flows for the years then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

**Management's responsibility for the financial statements**

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the International Financial Reporting Standards as adopted by the Republic of Korea (Korean IFRS) and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

**Auditor's responsibility**

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with the Korean Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

**Opinion**

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of KT&G Corporation and its subsidiaries as of December 31, 2014 and 2013, and their financial performance and cash flows for the years then ended in accordance with the Korean IFRS.

**Other matters**

The consolidated financial statements of the Group as of and for the year ended December 31, 2013 were audited in accordance with the previous Korean Standards on Auditing.

Auditing standards and their application in practice vary among countries. The procedures and practices used in the Republic of Korea to audit such financial statements may differ from those generally accepted and applied in other countries.

Seoul, Korea  
February 5, 2015

## CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

December 31, 2014 and 2013

(in millions of Korean won and thousands of U.S. dollars)

	2014 Korean won	2014 U.S. dollars	2013 Korean won
<b>Assets</b>			
<b>Non-current assets</b>			
Property, plant and equipment	₩ 1,753,412	\$ 1,595,171	₩ 1,622,289
Intangible assets	154,937	140,955	232,630
Investment property	167,968	152,810	173,975
Investments in associates	57,903	52,677	58,076
Available-for-sale financial assets	325,833	296,427	296,601
Other financial assets	259	235	1,740
Long-term deposits in MSA Escrow Fund	301,808	274,571	219,760
Long-term advance payments	127,855	116,317	140,692
Long-term prepaid expenses	4,625	4,207	5,966
Long-term trade and other receivables	86,735	78,908	108,898
Deferred income tax assets	28,725	26,133	25,731
	3,010,060	2,738,411	2,886,358
<b>Current assets</b>			
Inventories	1,982,503	1,803,587	1,893,853
Available-for-sale financial assets	1,000	910	-
Other financial assets	668,436	608,111	684,132
Prepaid tobacco excise and other taxes	260,773	237,239	262,770
Trade and other receivables	989,777	900,452	915,618
Advance payments	68,491	62,310	65,007
Prepaid expenses	20,801	18,924	19,134
Cash and cash equivalents	416,395	378,816	347,933
	4,408,176	4,010,349	4,188,447
Assets held for sale	426	387	153
<b>Total assets</b>	<b>₩ 7,418,662</b>	<b>\$ 6,749,147</b>	<b>₩ 7,074,958</b>

This report is effective as of February 5, 2015, the audit report date. Certain subsequent events or circumstances, which may occur between the audit report date and the time of reading this report, could have a material impact on the accompanying consolidated financial statements and notes thereto. Accordingly, the readers of the audit report should understand that there is a possibility that the above audit report may have to be revised to reflect the impact of such subsequent events or circumstances, if any.

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

Years Ended December 31, 2014 and 2013

(in millions of Korean won and thousands of U.S. dollars, except per share amounts)

	2014 Korean won	2014 U.S. dollars	2013 Korean won
<b>Sales</b>	<b>₩ 4,112,855</b>	<b>\$ 3,741,680</b>	<b>₩ 3,821,696</b>
<b>Cost of sales</b>	<b>(1,840,819)</b>	<b>(1,674,690)</b>	<b>(1,688,644)</b>
<b>Gross profit</b>	<b>2,272,036</b>	<b>2,066,991</b>	<b>2,133,052</b>
Selling and administrative expenses	(1,100,174)	(1,000,886)	(1,119,703)
<b>Operating income</b>	<b>1,171,862</b>	<b>1,066,105</b>	<b>1,013,349</b>
Other income	90,432	82,270	71,238
Other expenses	(151,767)	(138,070)	(219,906)
<b>Net other expenses</b>	<b>(61,335)</b>	<b>(55,800)</b>	<b>(148,668)</b>
Finance income	55,102	50,129	42,468
Finance costs	(10,963)	(9,974)	(26,792)
<b>Net finance income</b>	<b>44,139</b>	<b>40,155</b>	<b>15,676</b>
Income from jointly controlled entities and associates	3,245	2,952	3,225
Expense from jointly controlled entities and associates	-	-	(1,662)
<b>Profit before income tax</b>	<b>1,157,911</b>	<b>1,053,412</b>	<b>881,920</b>
Income tax expense	(344,110)	(313,055)	(322,616)
<b>Profit for the year</b>	<b>₩ 813,801</b>	<b>\$ 740,357</b>	<b>₩ 559,304</b>

December 31, 2014 and 2013

(in millions of Korean won and thousands of U.S. dollars)

	2014 Korean won	2014 U.S. dollars	2013 Korean won
<b>Equity</b>			
Capital stock	₩ 954,959	\$ 868,777	₩ 954,959
Other capital surplus	(4,573)	(4,160)	(4,573)
Treasury shares	(339,059)	(308,459)	(339,059)
Gain on reissuance of treasury shares	492,032	447,627	492,032
Reserve	3,426,367	3,117,146	3,368,835
Retained earnings	1,100,876	1,001,525	802,755
Equity attributable to equity holders of the Company	5,630,603	5,122,456	5,274,949
Non-controlling interests	77,478	70,485	90,531
<b>Total equity</b>	<b>5,708,081</b>	<b>5,192,941</b>	<b>5,365,480</b>
<b>Liabilities</b>			
<b>Non-current liabilities</b>			
Long-term borrowings	137,795	125,359	117,639
Long-term trade and other payables	32,244	29,334	29,597
Long-term advance receipts	14,587	13,271	18,836
Net defined benefit liability	132,247	120,312	111,137
Provisions for other liabilities and charges	2,871	2,612	2,981
Deferred income tax liabilities	266,282	242,251	247,043
	586,026	533,139	527,233
<b>Current liabilities</b>			
Borrowings	141,861	129,058	96,240
Current portion of long-term borrowings	1,218	1,108	4,424
Trade and other payables	503,853	458,382	542,908
Advance receipts	37,532	34,145	28,079
Income taxes payable	180,809	164,492	156,277
Tobacco excise and other taxes payable	259,282	235,882	354,317
	1,124,555	1,023,067	1,182,245
<b>Total liabilities</b>	<b>1,710,581</b>	<b>1,556,206</b>	<b>1,709,478</b>
<b>Total liabilities and equity</b>	<b>₩ 7,418,662</b>	<b>\$ 6,749,147</b>	<b>₩ 7,074,958</b>

The US dollar figures are provided for information purposes only and do not form part of the consolidated financial statements.

## CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

Years Ended December 31, 2014 and 2013

(in millions of Korean won and thousands of U.S. dollars, except per share amounts)

	2014 Korean won	2014 U.S. dollars	2013 Korean won
<b>Other comprehensive income(loss), net of tax</b>			
Items that will not be reclassified to profit or loss:			
Remeasurements of the net defined benefit liability	₩ (21,655)	\$ (19,700)	₩ 5,604
Items that will be reclassified subsequently to profit or loss:			
Change in value of available-for-sale financial assets	(8,732)	(7,945)	25,065
Loss on currency translation of foreign operations	(37,993)	(34,564)	(17,892)
<b>Other comprehensive income</b>			
<b>Other comprehensive income (loss) for the year, net of tax</b>	<b>(68,380)</b>	<b>(62,209)</b>	<b>12,777</b>
<b>Total comprehensive income for the year</b>	<b>₩ 745,421</b>	<b>\$ 678,148</b>	<b>₩ 572,081</b>
<b>Profit for the year attributable to:</b>			
Equity holders of the Parent Company	₩ 825,606	\$ 751,097	₩ 570,667
Non-controlling interests	(11,805)	(10,740)	(11,362)
	₩ 813,801	\$ 740,357	₩ 559,305
<b>Total comprehensive income for the year attributable to:</b>			
Equity holders of the Parent Company	₩ 758,529	\$ 690,074	₩ 586,934
Non-controlling interests	(13,109)	(11,926)	(14,852)
	₩ 745,420	\$ 678,148	₩ 572,082
<b>Earnings per share attributable to the equity holders of the Parent Company during the year (in won)</b>			
Basic and diluted earnings per share	₩ 6,558	\$ 6	₩ 4,533

Years Ended December 31, 2014 and 2013

(in millions of Korean won)

	Attributable to equity holders of the Parent Company								
	Capital stock	Other capital surplus	Treasury shares	Gain on reissuance of treasury shares	Reserve	Retained earnings	Total	Non-controlling interests	Total equity
<b>Balance at January 1, 2013</b>	₩ 954,959	₩ (4,573)	₩(339,059)	₩ 492,032	₩ 3,011,110	₩ 976,425	₩5,090,894	₩ 103,524	₩ 5,194,418
<b>Comprehensive income</b>									
Profit for the year	-	-	-	-	-	570,667	570,667	(11,363)	559,304
Change in value of available-for-sale financial assets	-	-	-	-	25,065	-	25,065	-	25,065
Loss on currency translation of foreign operations	-	-	-	-	(14,548)	-	(14,548)	(3,345)	(17,893)
Remeasurements of the net defined benefit liability	-	-	-	-	-	5,747	5,747	(144)	5,603
<b>Total comprehensive income (loss)</b>	-	-	-	-	<b>10,517</b>	<b>576,414</b>	<b>586,931</b>	<b>(14,852)</b>	<b>572,079</b>
<b>Transactions with equity holders of the Company</b>									
Cash dividends	-	-	-	-	-	(402,876)	(402,876)	-	(402,876)
Acquisition of investments in subsidiaries	-	-	-	-	-	-	-	1,859	1,859
Other reserve	-	-	-	-	317,000	(317,000)	-	-	-
Legal reserve	-	-	-	-	208	(208)	-	-	-
Reserve for research and human reseouce development	-	-	-	-	30,000	(30,000)	-	-	-
<b>Total transactions with equity holders of the Company</b>	-	-	-	-	<b>347,208</b>	<b>(750,084)</b>	<b>(402,876)</b>	<b>1,859</b>	<b>(401,017)</b>
<b>Balance at December 31, 2013</b>	<b>₩ 954,959</b>	<b>₩ (4,573)</b>	<b>₩(339,059)</b>	<b>₩ 492,032</b>	<b>₩3,368,835</b>	<b>₩ 802,755</b>	<b>₩5,274,949</b>	<b>₩ 90,531</b>	<b>₩5,365,480</b>

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Years Ended December 31, 2014 and 2013

(in millions of Korean won)

	Attributable to equity holders of the Parent Company								
	Capital stock	Other capital surplus	Treasury shares	Gain on reissuance of treasury shares	Reserve	Retained earnings	Total	Non-controlling interests	Total equity
<b>Balance at January 1, 2014</b>	<b>₩ 954,959</b>	<b>₩ (4,573)</b>	<b>₩(339,059)</b>	<b>₩ 492,032</b>	<b>₩ 3,368,835</b>	<b>₩ 802,755</b>	<b>₩ 5,274,949</b>	<b>₩ 90,531</b>	<b>₩ 5,365,480</b>
<b>Comprehensive income</b>									
Profit for the year	-	-	-	-	-	825,606	825,606	(11,805)	813,801
Change in value of available-for-sale financial assets	-	-	-	-	(8,732)	-	(8,732)	-	(8,732)
Loss (Gain) on currency translation of foreign operations	-	-	-	-	(38,257)	-	(38,257)	264	(37,993)
Remeasurements of the net defined benefit liability	-	-	-	-	-	(20,087)	(20,087)	(1,568)	(21,655)
<b>Total comprehensive income (loss)</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>(46,989)</b>	<b>805,519</b>	<b>758,530</b>	<b>(13,109)</b>	<b>745,421</b>
<b>Transactions with equity holders of the Parent Company</b>									
Cash dividends	-	-	-	-	-	(402,876)	(402,876)	-	(402,876)
Other reserve	-	-	-	-	152,000	(152,000)	-	-	-
Reserve for research and human reseouce development	-	-	-	-	(47,478)	47,478	-	-	-
Others	-	-	-	-	-	-	-	56	56
<b>Total transactions with equity holders of the Company</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>104,522</b>	<b>(507,398)</b>	<b>(402,876)</b>	<b>56</b>	<b>(402,820)</b>
<b>Balance at December 31, 2014</b>	<b>₩ 954,959</b>	<b>₩ (4,573)</b>	<b>₩(339,059)</b>	<b>₩ 492,032</b>	<b>₩ 3,426,368</b>	<b>₩ 1,100,876</b>	<b>₩ 5,630,603</b>	<b>₩ 77,478</b>	<b>₩ 5,708,081</b>

Year Ended December 31, 2014

(in thousands of U.S. dollars)

	Attributable to equity holders of the Parent Company								
	Capital stock	Other capital surplus	Treasury shares	Gain on reissuance of treasury shares	Reserve	Retained earnings	Total	Non-controlling interests	Total equity
<b>Balance at January 1, 2014</b>	<b>\$ 868,777</b>	<b>\$ (4,160)</b>	<b>\$ (308,459)</b>	<b>\$ 447,627</b>	<b>\$ 3,064,806</b>	<b>\$ 730,309</b>	<b>\$ 4,798,900</b>	<b>\$ 82,361</b>	<b>\$ 4,881,261</b>
<b>Comprehensive income</b>									
Profit for the year	-	-	-	-	-	751,097	751,097	(10,740)	740,357
Change in value of available-for-sale financial assets	-	-	-	-	(7,944)	-	(7,944)	-	(7,944)
Loss (Gain) on currency translation of foreign operations	-	-	-	-	(34,804)	-	(34,804)	240	(34,564)
Remeasurements of the net defined benefit liability	-	-	-	-	-	(18,274)	(18,274)	(1,426)	(19,700)
<b>Total comprehensive income (loss)</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>(42,748)</b>	<b>732,823</b>	<b>690,075</b>	<b>(11,926)</b>	<b>678,149</b>
<b>Transactions with equity holders of the Parent Company</b>									
Cash dividends	-	-	-	-	-	(366,518)	(366,518)	-	(366,518)
Other reserve	-	-	-	-	138,282	(138,282)	-	-	-
Reserve for research and human reseouce development	-	-	-	-	(43,194)	43,193	(1)	-	(1)
Others	-	-	-	-	-	-	-	50	50
<b>Total transactions with equity holders of the Company</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>95,088</b>	<b>(461,607)</b>	<b>(366,519)</b>	<b>50</b>	<b>(366,469)</b>
<b>Balance at December 31, 2014</b>	<b>\$ 868,777</b>	<b>\$ (4,160)</b>	<b>\$ (308,459)</b>	<b>\$ 447,627</b>	<b>\$ 3,117,146</b>	<b>\$ 1,001,525</b>	<b>\$ 5,122,456</b>	<b>\$ 70,485</b>	<b>\$ 5,192,941</b>

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## CONSOLIDATED STATEMENTS OF CASH FLOWS

Years Ended December 31, 2014 and 2013

(in millions of Korean won and thousands of U.S. dollars)

	2014 Korean won	2014 U.S. dollars	2013 Korean won
<b>Cash flows from operating activities</b>			
Cash generated from operations	₩ 1,059,122	\$ 963,539	₩ 906,834
Income tax paid	(293,934)	(267,407)	(323,454)
<b>Net cash generated from operating activities</b>	<b>765,188</b>	<b>696,132</b>	<b>583,380</b>
<b>Cash flows from investing activities</b>			
Interest received	32,087	29,191	38,489
Investment income received from long-term deposits in MSA Escrow Fund	1,346	1,224	845
Dividends received	20,259	18,431	10,213
Proceeds from sale of property, plant and equipment	11,480	10,444	15,173
Proceeds from sale of intangible assets	218	198	7,277
Proceeds from sale of non-current asset held for sale	63	57	7,601
Proceeds from sale of available-for-sale financial assets	14,515	13,205	-
Proceeds from sale of jointly controlled entities and associates	-	-	612
Decrease in loans	13,446	12,233	13,070
Decrease in guarantee deposits	27,392	24,920	24,894
Decrease in derivative instruments	-	-	244
Acquisition of property, plant and equipment	(330,395)	(300,577)	(162,603)
Acquisition of intangible assets	(2,094)	(1,905)	(4,015)
Acquisition of investment property	(248)	(226)	(1,736)
Acquisition of jointly controlled entities and associates	-	-	(5,000)
Acquisition of available-for-sale financial assets	(53,592)	(48,756)	(13,781)
Increase in loans	(360)	(328)	(24,663)
Increase in guarantee deposits	(24,185)	(22,002)	(25,575)
Increase in long-term deposits in MSA Escrow Fund	(70,094)	(63,768)	(56,067)
Decrease (Increase) in other financial assets	17,281	15,721	(42,731)
<b>Net cash used in investing activities</b>	<b>(342,881)</b>	<b>(311,938)</b>	<b>(217,753)</b>

Years Ended December 31, 2014 and 2013

(in millions of Korean won and thousands of U.S. dollars)

	2014 Korean won	2014 U.S. dollars	2013 Korean won
<b>Cash flows from financing activities</b>			
Interest paid	(3,221)	(2,930)	(3,747)
Issuance of common stock	-	-	2,097
Dividends paid	(402,876)	(366,518)	(402,876)
Proceeds from borrowings	302,078	274,816	222,033
Increase in deposits received	4,113	3,742	4,529
Repayments of borrowings	(251,296)	(228,617)	(207,945)
Decrease in deposits received	(2,559)	(2,328)	(4,030)
<b>Net cash used in financing activities</b>	<b>(353,761)</b>	<b>(321,835)</b>	<b>(389,939)</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>68,547</b>	<b>62,361</b>	<b>(24,312)</b>
<b>Cash and cash equivalents at the beginning of year</b>	<b>347,933</b>	<b>316,533</b>	<b>372,260</b>
<b>Exchange losses on cash and cash equivalents</b>	<b>(85)</b>	<b>(78)</b>	<b>(15)</b>
<b>Cash and cash equivalents at the end of year</b>	<b>₩ 416,395</b>	<b>\$ 378,816</b>	<b>₩ 347,933</b>

The US dollar figures are provided for information purposes only and do not form part of the consolidated financial statements.

## INDEPENDENT AUDITOR'S REPORT



To the Board of Directors and Shareholders of  
KT&G Corporation

We have audited the accompanying separate financial statements of KT&G Corporation, which comprise the separate statements of financial position as of December 31, 2014 and 2013, and the separate statements of comprehensive income, changes in equity and cash flows for the years then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

**Management's responsibility for the financial statements**

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the International Financial Reporting Standards as adopted by the Republic of Korea (Korean IFRS) and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

**Auditor's responsibility**

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with the Korean Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

**Opinion**

In our opinion, the separate financial statements present fairly, in all material respects, the financial position of KT&G Corporation as of December 31, 2014 and 2013, and its financial performance and cash flows for the years then ended in accordance with the Korean IFRS.

**Other matters**

The financial statements of the Company as of and for the year ended December 31, 2013 were audited in accordance with the previous Korean Standards on Auditing.

Auditing standards and their application in practice vary among countries. The procedures and practices used in the Republic of Korea to audit such financial statements may differ from those generally accepted and applied in other countries.

Seoul, Korea  
February 5, 2015

## SEPARATE STATEMENTS OF FINANCIAL POSITION

December 31, 2014 and 2013

(in millions of Korean won and thousands of U.S. dollars)

	2014 Korean won	2014 U.S. dollars	2013 Korean won
<b>Assets</b>			
<b>Non-current assets</b>			
Property, plant and equipment	₩ 1,279,660	\$ 1,164,174	₩ 1,182,763
Intangible assets	19,636	17,864	21,191
Investment property	140,141	127,493	146,034
Investments in associates	60,225	54,790	60,225
Investments in subsidiaries	1,081,840	984,207	1,166,478
Available-for-sale financial assets	303,439	276,054	296,391
Long-term deposits in MSA Escrow Fund	301,808	274,571	219,760
Long-term prepaid expenses	4,159	3,784	4,797
Long-term trade and other receivables	120,702	109,809	134,498
	3,311,610	3,012,746	3,232,137
<b>Current assets</b>			
Inventories	910,438	828,273	939,744
Available-for-sale financial assets	1,000	910	-
Other financial assets	640,000	582,242	660,000
Prepaid tobacco excise and other taxes	260,773	237,239	262,770
Trade and other receivables	824,948	750,498	721,468
Advance payments	20,233	18,407	16,474
Prepaid expenses	3,922	3,568	3,878
Cash and cash equivalents	321,562	292,542	245,838
	2,982,876	2,713,679	2,850,172
Assets held for sale	426	387	3
<b>Total assets</b>	<b>₩ 6,294,912</b>	<b>\$ 5,726,812</b>	<b>₩ 6,082,312</b>

This report is effective as of February 5, 2015, the audit report date. Certain subsequent events or circumstances, which may occur between the audit report date and the time of reading this report, could have a material impact on the accompanying separate financial statements and notes thereto. Accordingly, the readers of the audit report should understand that there is a possibility that the above audit report may have to be revised to reflect the impact of such subsequent events or circumstances, if any.

## SEPARATE STATEMENTS OF COMPREHENSIVE INCOME

December 31, 2014 and 2013

(in millions of Korean won and thousands of U.S. dollars)

	2014 Korean won	2014 U.S. dollars	2013 Korean won
<b>Equity</b>			
Capital stock	₩ 954,959	\$ 868,777	₩ 954,959
Other capital surplus	3,582	3,259	3,582
Treasury shares	(339,059)	(308,459)	(339,059)
Gain on reissuance of treasury shares	492,032	447,627	492,032
Reserve	3,493,758	3,178,455	3,411,099
Retained earnings	736,461	669,997	509,821
<b>Total equity</b>	<b>5,341,733</b>	<b>4,859,656</b>	<b>5,032,434</b>
<b>Liabilities</b>			
<b>Non-current liabilities</b>			
Long-term trade and other payables	28,310	25,755	28,269
Long-term advance receipts	2,344	2,132	3,676
Net defined benefit liability	67,260	61,190	60,273
Deferred income tax liabilities	69,195	62,951	53,823
	167,109	152,028	146,041
<b>Current liabilities</b>			
Borrowings	5,552	5,050	4,920
Trade and other payables	347,240	315,903	402,389
Advance receipts	26,245	23,876	17,230
Income taxes payable	157,545	143,327	136,285
Tobacco excise and other taxes payable	249,488	226,972	343,013
	786,070	715,128	903,837
<b>Total liabilities</b>	<b>953,179</b>	<b>867,156</b>	<b>1,049,878</b>
<b>Total liabilities and equity</b>	<b>₩ 6,294,912</b>	<b>\$ 5,726,812</b>	<b>₩ 6,082,312</b>

Years Ended December 31, 2014 and 2013

(in millions of Korean won and thousands of U.S. dollars, except per share amounts)

	2014 Korean won	2014 U.S. dollars	2013 Korean won
<b>Sales</b>			
Manufacture of tobacco	₩ 2,499,986	\$ 2,274,369	₩ 2,342,229
Real estate	160,342	145,871	109,201
Exports of leaf tobacco and others	82,233	74,812	59,202
	2,742,561	2,495,052	2,510,633
<b>Cost of sales</b>			
Manufacture of tobacco	(914,356)	(831,838)	(841,434)
Real estate	(96,076)	(87,405)	(57,285)
Exports of leaf tobacco and others	(53,362)	(48,546)	(37,336)
	(1,063,794)	(967,789)	(936,055)
<b>Gross profit</b>	<b>1,678,767</b>	<b>1,527,263</b>	<b>1,574,577</b>
Selling and administrative expenses	(624,212)	(567,878)	(651,073)
<b>Operating income</b>	<b>1,054,555</b>	<b>959,385</b>	<b>923,504</b>
Other income	71,897	65,408	47,914
Other expenses	(157,307)	(143,111)	(246,353)
<b>Net other expenses</b>	<b>(85,410)</b>	<b>(77,703)</b>	<b>(198,439)</b>
Finance income	77,139	70,177	47,490
Finance costs	(830)	(755)	(15,753)
<b>Net finance income</b>	<b>76,309</b>	<b>69,422</b>	<b>31,737</b>
<b>Profit before income tax</b>	<b>1,045,454</b>	<b>951,104</b>	<b>756,802</b>
Income tax expense	(298,400)	(271,470)	(255,488)
<b>Profit for the year</b>	<b>₩ 747,054</b>	<b>\$ 679,634</b>	<b>₩ 501,314</b>

The US dollar figures are provided for information purposes only and do not form part of the separate financial statements.

## SEPARATE STATEMENTS OF CHANGES IN EQUITY

Years Ended December 31, 2014 and 2013

(in millions of Korean won and thousands of U.S. dollars, except per share amounts)

	2014 Korean won	2014 U.S. dollars	2013 Korean won
<b>Other comprehensive income</b>			
Items that will not be reclassified subsequently to profit or loss: Remeasurements of the net defined benefit liability	₩ (13,016)	\$ (11,841)	₩ 5,616
Items that will be reclassified subsequently to profit or loss: Gain (loss) on valuation of available-for-sale financial assets	(21,863)	(19,890)	25,065
<b>Other comprehensive income (loss) for the year, net of tax</b>	<b>(34,879)</b>	<b>(31,731)</b>	<b>30,681</b>
<b>Total comprehensive income for the year</b>	<b>₩ 712,175</b>	<b>\$ 647,903</b>	<b>₩ 531,995</b>
<b>Earnings per share attributable to the equity holders of the Company during the year (in won)</b>			
Basic and diluted earnings per share	₩ 5,934	\$ 5	₩ 3,982

Years Ended December 31, 2014 and 2013

(in millions of Korean won)

	Capital stock	Other capital surplus	Treasury shares	Gain on reissuance of treasury shares	Reserve	Retained earnings	Total equity
<b>Balance at January 1, 2013</b>	₩ 954,959	₩ 3,582	₩ (339,059)	₩ 492,032	₩ 3,039,034	₩ 752,767	₩ 4,903,315
<b>Comprehensive income</b>							
Profit for the year	-	-	-	-	-	501,314	501,314
Other comprehensive income							
Gain on valuation of available-for-sale financial assets	-	-	-	-	25,065	-	25,065
Remeasurements of the net defined benefit liability	-	-	-	-	-	5,616	5,616
<b>Total other comprehensive income</b>	-	-	-	-	<b>25,065</b>	<b>5,616</b>	<b>30,681</b>
<b>Total comprehensive income</b>	-	-	-	-	<b>25,065</b>	<b>506,930</b>	<b>531,995</b>
<b>Transactions with equity holders of the Company</b>							
Cash dividends	-	-	-	-	-	(402,876)	(402,876)
Other reserve	-	-	-	-	317,000	(317,000)	-
Reserve for research and human resource development	-	-	-	-	30,000	(30,000)	-
<b>Total transactions with equity holders of the Company</b>	-	-	-	-	<b>347,000</b>	<b>(749,876)</b>	<b>(402,876)</b>
<b>Balance at December 31, 2013</b>	₩ 954,959	₩ 3,582	₩ (339,059)	₩ 492,032	₩ 3,411,099	₩ 509,821	₩ 5,032,434

The US dollar figures are provided for information purposes only and do not form part of the separate financial statements.

Years Ended December 31, 2014 and 2013

(in millions of Korean won)

	Capital stock	Other capital surplus	Treasury shares	Gain on reissuance of treasury shares	Reserve	Retained earnings	Total equity
<b>Balance at January 1, 2014</b>	₩ 954,959	₩ 3,582	₩ (339,059)	₩ 492,032	₩ 3,411,099	₩ 509,821	₩ 5,032,434
<b>Comprehensive income</b>							
Profit for the year	-	-	-	-	-	747,054	747,054
Other comprehensive income (loss)							
Loss on valuation of available-for-sale financial assets	-	-	-	-	(21,863)	-	(21,863)
Remeasurements of the net defined benefit liability	-	-	-	-	-	(13,016)	(13,016)
<b>Total other comprehensive loss</b>	-	-	-	-	<b>(21,863)</b>	<b>(13,016)</b>	<b>(34,879)</b>
<b>Total comprehensive income (loss)</b>	-	-	-	-	<b>(21,863)</b>	<b>734,038</b>	<b>712,175</b>
<b>Transactions with equity holders of the Company</b>							
Cash dividends	-	-	-	-	-	(402,876)	(402,876)
Reserve for research and human resource development	-	-	-	-	(47,478)	47,478	-
Other reserve	-	-	-	-	152,000	(152,000)	-
<b>Total transactions with equity holders of the Company</b>	-	-	-	-	<b>104,522</b>	<b>(507,398)</b>	<b>(402,876)</b>
<b>Balance at December 31, 2014</b>	₩ 954,959	₩ 3,582	₩ (339,059)	₩ 492,032	₩ 3,493,758	₩ 736,461	₩ 5,341,733

Year Ended December 31, 2014

(in thousands of U.S. dollars)

	Capital stock	Other capital surplus	Treasury shares	Gain on reissuance of treasury shares	Reserve	Retained earnings	Total equity
<b>Balance at January 1, 2014</b>	\$ 868,777	\$ 3,259	\$ (308,459)	\$ 447,627	\$ 3,103,256	\$ 463,810	\$ 4,578,270
<b>Comprehensive income</b>							
Profit for the year	-	-	-	-	-	679,634	679,634
Other comprehensive income (loss)							
Loss on valuation of available-for-sale financial assets	-	-	-	-	(19,890)	-	(19,890)
Remeasurements of the net defined benefit liability	-	-	-	-	-	(11,841)	(11,841)
<b>Total other comprehensive loss</b>	-	-	-	-	<b>(19,890)</b>	<b>(11,841)</b>	<b>(31,731)</b>
<b>Total comprehensive income (loss)</b>	-	-	-	-	<b>(19,890)</b>	<b>667,793</b>	<b>647,903</b>
<b>Transactions with equity holders of the Company</b>							
Cash dividends	-	-	-	-	-	(366,518)	(366,518)
Reserve for research and human resource development	-	-	-	-	(43,194)	43,194	-
Other reserve	-	-	-	-	138,282	(138,282)	-
<b>Total transactions with equity holders of the Company</b>	-	-	-	-	<b>95,088</b>	<b>(461,606)</b>	<b>(366,518)</b>
<b>Balance at December 31, 2014</b>	\$ 868,777	\$ 3,259	\$ (308,459)	\$ 447,627	\$ 3,178,454	\$ 669,997	\$ 4,859,655

The US dollar figures are provided for information purposes only and do not form part of the separate financial statements.

## SEPARATE STATEMENTS OF CASH FLOWS

Years Ended December 31, 2014 and 2013

(in millions of Korean won and thousands of U.S. dollars)

	2014 Korean won	2014 U.S. dollars	2013 Korean won
<b>Cash flows from operating activities</b>			
Cash generated from operations	₩ 1,002,253	\$ 911,803	₩ 925,216
Income tax paid	(250,630)	(228,012)	(293,951)
<b>Net cash generated from operating activities</b>	<b>751,623</b>	<b>683,791</b>	<b>631,265</b>
<b>Cash flows from investing activities</b>			
Interest received	30,139	27,419	32,469
Investment income received from long-term deposits in MSA Escrow Fund	1,346	1,224	845
Dividends received	20,525	18,673	12,216
Proceeds from sale of property, plant and equipment	8,787	7,994	8,647
Proceeds from sale of intangible assets	1	1	1
Proceeds from sale of assets held for sale	55	50	7,471
Proceeds from sale of available-for-sale financial assets	10,010	9,106	-
Proceeds from sale of investments in associates	-	-	612
Proceeds from sale of investments in subsidiaries	85	77	-
Decrease in loans	13,629	12,399	13,767
Decrease in guarantee deposits	19,842	18,052	18,430
Decrease in other financial assets	20,000	18,195	-
Acquisition of property, plant and equipment	(235,843)	(214,559)	(115,339)
Acquisition of intangible assets	(1,164)	(1,059)	(1,317)
Acquisition of investment property	(223)	(202)	(1,736)
Acquisition of investments in associates	-	-	(5,000)
Acquisition of investments in subsidiaries	(8,101)	(7,370)	(58,088)
Acquisition of available-for-sale financial assets	(51,992)	(47,300)	(13,781)
Increase in loans	(9,946)	(9,049)	(35,288)
Increase in guarantee deposits	(20,723)	(18,853)	(17,337)
Increase in long-term deposits in MSA Escrow Fund	(70,094)	(63,768)	(56,067)
Increase in other financial assets	-	-	(40,000)
<b>Net cash used in investing activities</b>	<b>(273,667)</b>	<b>(248,970)</b>	<b>(249,495)</b>

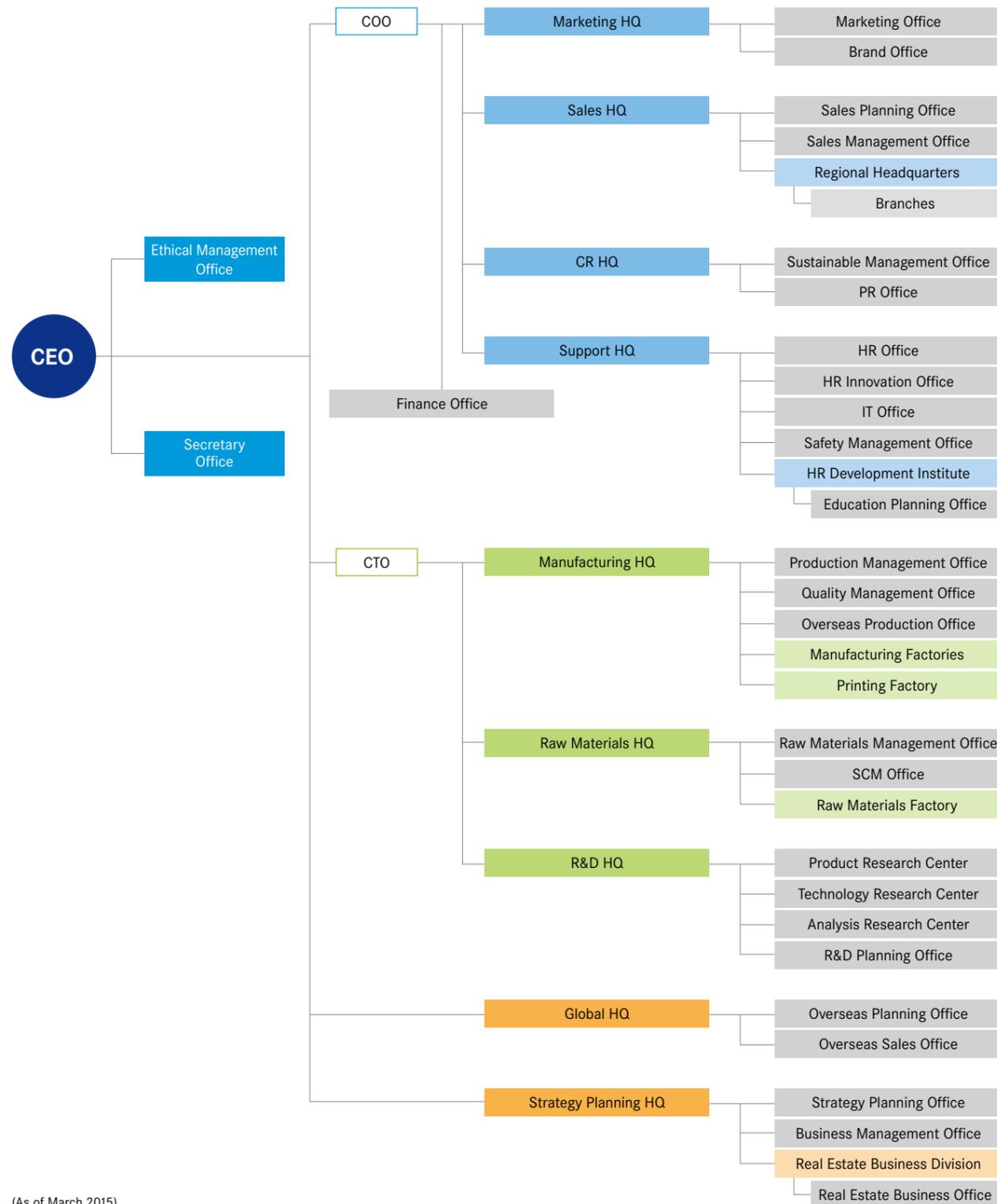
Years Ended December 31, 2014 and 2013

(in millions of Korean won and thousands of U.S. dollars)

	2014 Korean won	2014 U.S. dollars	2013 Korean won
<b>Cash flows from financing activities</b>			
Dividends paid	(402,876)	(366,518)	(402,876)
Increase in deposits received	3,466	3,153	4,182
Decrease in deposits received	(2,820)	(2,566)	(3,944)
<b>Net cash used in financing activities</b>	<b>(402,230)</b>	<b>(365,931)</b>	<b>(402,638)</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>75,725</b>	<b>68,890</b>	<b>(20,868)</b>
<b>Cash and cash equivalents at the beginning of year</b>	<b>245,838</b>	<b>223,652</b>	<b>266,720</b>
<b>Exchange losses on cash and cash equivalents</b>	<b>(1)</b>	<b>(1)</b>	<b>(14)</b>
<b>Cash and cash equivalents at the end of year</b>	<b>₩ 321,562</b>	<b>\$ 292,541</b>	<b>₩ 245,838</b>

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## ORGANIZATION CHART



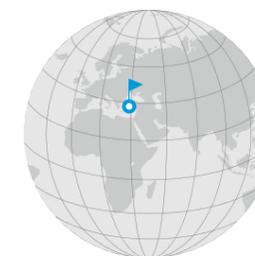
(As of March 2015)

## GLOBAL NETWORK

### Overseas Branches



### Overseas Production Factories and Subsidiaries



#### TURKEY FACTORY

- Completed in April 2008
- Annual production capacity: 2.6 billion sticks (as of double shift)



#### IRAN FACTORY

- Completed in April 2009
- Annual production capacity: 1.0 billion sticks (as of double shift)



#### RUSSIA FACTORY

- Completed in October 2010
- Annual production capacity: 4.0 billion sticks (as of double shift)



#### INDONESIA FACTORY

- Acquired in August 2011
- Annual production capacity: 6.4 billion sticks (as of double shift)



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