

2018 KT&G REPORT

SUSTAINABLE SEED FOR SOCIETY



About this Report

Overview

KT&G integrated its annual report and sustainability report in 2017 to effectively share our progress, activities and vision for sustainable growth and development with diverse stakeholders. The integrated report has been published every year to transparently disclose our performances in and plans for sustainable value creation. The 2018 Integrated Report contains both financial information and non-financial information including the ESG performances.

Reporting Period

This report covers KT&G's sustainability activities and performances from January 1 through December 31, 2018. To provide a better understanding of our quantitative results, data for the last three fiscal years were applied. And some crucial results which were considered to be significant spanned the period up to the first quarter of 2019.

Reporting Boundary

The data for this report was collected from domestic business facilities including KT&G Head Office, R&D Center, Sintanjin Plant, Gwangju Plant, Yeongju Plant, Cheonan Plant, and Gimcheon Plant.

Reporting Standards

This report was prepared in accordance with the GRI (Global Reporting Initiatives) Standard's Core Option. The IIRC (International Integrated Reporting Council) Integrated Reporting Framework was also used for the integration with Annual Report.

Assurance

The contents of this report were verified by an independent assurance agency to ensure quality and reliability.

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Upright Company



Enhancement of the Soundness of Governance Structure
Internalization of Ethical Management
Compliance Program | Risk Management
Stakeholder Communication

A Company That Is Awake



Product Innovation | Enhancement of R&D Capability
Response to Climate Change

A Company That Shares with Customers



Shared Value Creation | Great Workplace
Social Contribution | Product Responsibility

MESSAGE FROM THE BOD CHAIRMAN



66

We will live up to our reputation as a company with excellent governance structure by strengthening the expertise and independence of the Board of Directors.

99

Song, Op-kyo
Chairman of the KT&G BOD

A handwritten signature in black ink, appearing to be 'Song Op-kyo'.

Dear Valued KT&G Stakeholders,

I am Song, Op-kyo who was appointed as the chairman of the KT&G Board of Directors at the BOD meeting in April 2019.

Despite challenging and tough business environment, KT&G managed to strengthen its competitiveness of the flagship business and foundation for sustainable growth in 2018. Particularly, we focused on advancing our management system at the Group level to further drive the expansion of our global presence. As a result, our tobacco business demonstrated stable growth of market share with successful entrance into the HNB (heat-not-burn) tobacco market in Korea. Health functional food, pharmaceuticals, and cosmetics sectors also sustained growth momentum.

Nevertheless, we are facing diverse challenges due to tightening regulations, fierce competition, and increasing uncertainties in the global economy. In response, as the BOD Chairman, I am committed to working with the management to create higher economic value for our shareholders and fulfilling our social responsibility as a corporate citizen in the areas of environment, governance, and human rights. Furthermore, I promise to ensure that our stakeholders' opinions are valued and reflected in our operation by maintaining close communication with them and sharing feedbacks with our board members.

The KT&G BOD will be thorough in examining management goals, strategies, progress and outlook of new growth engine development, while ensuring healthy and transparent supervision on the management. We will also live up to our reputation as a company with excellent governance structure by strengthening the expertise and independence of the BOD. Because healthy governance structure is the cornerstone of KT&G's sustainability management.

The 136-year corporate history of KT&G has presented overcoming numerous challenges and attaining growth. Despite challenging business environments, we will continue to put our passion and energy into driving sustainable growth.

We appreciate your continued interest and support.

Thank you

MESSAGE FROM THE CEO



“

By taking a proactive approach to change, we will maximize our corporate value and meet your expectations.

”

Baek, Bok-In
President and CEO of KT&G

A handwritten signature in black ink, appearing to read 'Baek', positioned to the right of the printed name.



Dear Valued Stakeholders,

In 2018, KT&G took a great step toward sustainable growth thanks to your interest and support as well as the dedication of our employees. Despite unfavorable business environments such as uncertainties in the global economy, prolonged sluggish domestic economy, tightening regulation, and fierce competition, we attained valuable performances in both financial and non-financial areas.

Our domestic market share in the tobacco business reached 62% in 2018, sustaining growth for four consecutive years. Particularly, our next-generation tobacco products born through efforts for product innovation satisfied consumers who wanted new trend and needs on the strength of faster-than-expected development, high quality, and differentiation strategy. Overseas tobacco business expanded the number of exporting countries to more than 60 by focusing on exploring new markets. Health functional food business also achieved KRW 1.3 trillion in sales with around 10% growth by increasing export to Great China region and new markets. Pharmaceuticals and cosmetics sectors concentrated on license-in and OEM strategies, respectively, to create new sales. Real estate business promoted the re-development of the Suwon Plant site.

On top of that, KT&G strived to fulfill its social responsibility based on corporate philosophy - “upright company,” “a company that is awake,” and “a company that shares with customers.” We were recognized as the best in governance structure by pursuing transparent and efficient corporate governance and internalized ethical management in the aspect of “upright company.” Proactive response to climate change and energy efficiency were conducted in the aspect of “a company that is awake.” In addition, as “a company that shares with customers,” we focused on creating share value through improvement of employee welfare and mutual growth with local communities and suppliers.

Business conditions are still unfavorable in 2019 due to increasing uncertainties in the global economy caused mainly by trade conflict and prolonged recession of the domestic economy. We are also facing not only tightening regulations and advent of competitive products in the next-generation tobacco business, but also fierce competition in non-tobacco sectors. However, without being complacent about what we have achieved, KT&G will make a concerted effort to create higher economic value and fulfill social

responsibility as a global player and a corporate citizen. To this end, we will be proactive in conducting the following two tasks for sustainable growth.

First, we will focus on building balanced business portfolio and securing new growth engines.

The company is committed to increasing market share in the domestic business and improving profitability to ensure stable growth foundation. Our next-generation tobacco business, as the first mover, will work on securing independent technologies and new growth engines by continuing innovation. As for overseas tobacco business, we will devote ourselves to exploring new markets in Africa and Latin America and significantly expanding R&D investment to secure core technologies. Health functional food business will pursue cultivating leading ginseng brands and creating new successful models in non-ginseng sectors. Developing new business opportunities and enhancing product development pipeline will be promoted for real estate and pharmaceuticals businesses, respectively. As for cosmetics business, we will expand marketing activities to ensure growth potential and profitability in a balanced manner.

Second, we will fulfill our social responsibility to ensure sustainability.

A company cannot succeed in a failed society as unstable and unsustainable society becomes fatal to corporate survival. In this regard, fulfilling social responsibility contributes to stable growth of society and market and eventually may be the most efficient way for mutual growth with local communities. This is why we strive to contribute to the development of society and pursue sustainability management beyond just economic value creation. KT&G will spare no effort to create both economic and social values as the “upright company,” “a company that is awake,” and “a company that shares with customers.”

In 2019, we will continue to make improvements in areas of our weakness while maximizing our strengths. By taking a proactive approach to change, we will maximize our corporate value and meet your expectations. Based on achievements we made last year, we will take another leap towards a leading global company. Your continued interest and support will be greatly appreciated.

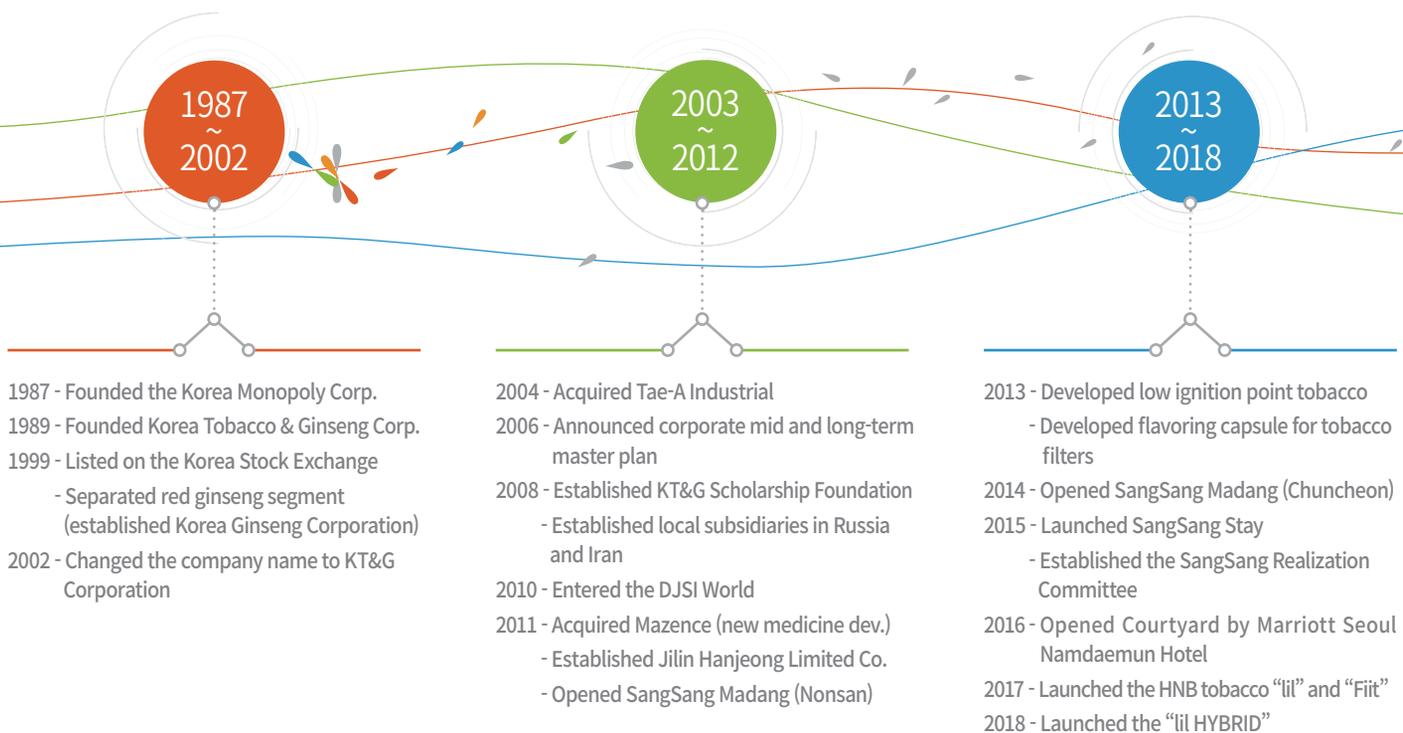
KT&G AT A GLANCE

Company Overview

With the corporate philosophy of “upright company,” “a company that is awake,” and “a company that shares with customers,” KT&G is committed to improving the quality of lives and making the world a better place to live. We are taking a leap forward to becoming a leading global company with competitive advantage by driving change, innovation, and sustainability management. Our business portfolio has been diversified into next-generation tobacco, health functional foods, bio & pharmaceuticals, and real estate sectors beyond just strengthening the flagship tobacco business.

| | | | |
|----------------------|----------------------------------------------------------|----------------------------|------------------------------------------------------------------------------------------------------------|
| Company name | KT&G Corporation | President & CEO | Baek, Bok-in |
| Foundation | April 1, 1987 | Number of employees | 4,215 persons |
| Head office | 71, Beotkkot-gil, Daedeok-gu, Daejeon, Republic of Korea | Subsidiaries | KT&G, Tae-A Industrial, Korea Ginseng Corporation, COSMOCOS, KGC Life & Gin, Yungjin Pharm., SangSang Stay |
| Main business | Manufacturing and distribution of tobacco products | Homepage | http://www.ktng.com |

Milestones





KT&G Seed



Meaning of Company Name

KT&G stands for “Korea Tomorrow & Global” and embodies our spirit in gaining competitive advantages in the global market through change and innovation.

KT&G “Seed”

Our CI, “Seed” is suggestive of infinity symbol and represents KT&G Group’s commitment to creating and expanding values.

Creativity Rational Aspect

Blue and green colors representing innovation, rationality, trust, and future symbolize our creativity from a rational aspect.

- In order to create unique value, we need to possess a rational aspect in an innovative and strategic manner.
- Creativity is the part of the rational aspect we focus on. This represents our corporate stewardship for social and ethical value.
- From a rational standpoint, KT&G Group has technological expertise, quality excellence, leadership, and ability to innovate and grow.

Passion Emotional Aspect

Orange and red colors representing pioneering spirit, passion, warmth, and joy symbolize passion from an emotional aspect.

- To turn possibility into value, we need to explore new opportunities based on emotional abilities.
- Our emotional aspect represents the passion to grow with our society.
- Our priority in emotional aspects includes pioneering spirit, corporate culture, exploration, confidence, respect for nature, and human rights.

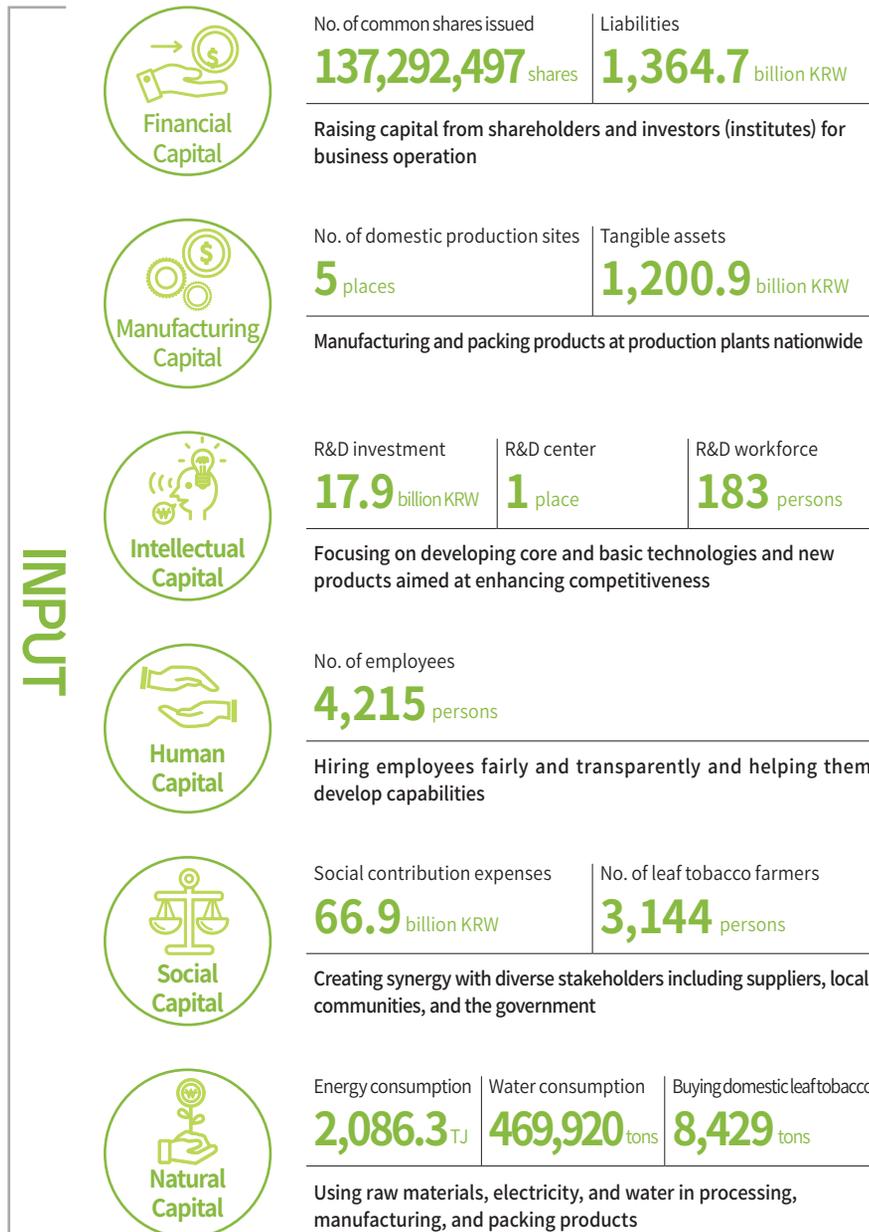
Wise Insight Balance

Gray color representing wisdom and diligence symbolizes the balance between rationality and emotion.

- To create customer value, it is important to maintain a balance between rationality and emotion.
- Our balance is maintained based on rationality and emotion, which is expressed through our progressive and vigilant mindset.
- From the balance aspect, KT&G Group places a priority on trust, love, quality, devotion, sincerity, and value and future-oriented practice.

KT&G VALUE CREATION MODEL

External Environment



Supply Chain Management



BUSINESS

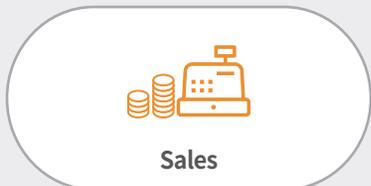
Manufacture



KT&G Value Creation

KT&G consistently pursues change and innovation. We make a concerted effort to create differentiated values with the aim of growing into a leading global player beyond Korea's representative company. Moreover, we faithfully fulfill responsibility and role as a corporate citizen.

External Environment



ACTIVITIES



| | | |
|---------------------|--------------------------|-------------------------------------------------------------------------------------------------|
| Sales (Billion KRW) | Net profit (Billion KRW) | Domestic consumers: 5.15Mn Tobacco tax: KRW 5.6 trillion Corporate tax: KRW 303.0 billion |
| 2,624.6 | 840.9 | |

We increase sales by enhancing core business, entering new markets, and developing new growth engines, thereby creating shareholder value and realizing sustainable growth.



| | | |
|----------------------|------------------------|---------------------------------------------------------------------------------------------|
| Total production | retail stores in Korea | Sintanjin: 2.45 billion packs Yeongju: 1.16 billion packs Gwangju: 0.22 billion packs |
| 3.82 bn packs | 110 thousand | |

We improve production efficiency by creating synergy between technology and competence and build stable product supply infrastructure.



| | | |
|--------------------|---------------------|----------------------------------------------------------------------------------------------|
| Ownership of IPs | R&D results in 2018 | Patents in 2018: 222 items Best brand in 2018 NBCI (National Brand Competitiveness Index) |
| 4,324 items | 54 items | |

Customer value and competitive edge is elevated by improving the quality of existing products and developing innovative new products.



| | | |
|---------------------------|-----------------------------|------------------------------------------------------------------|
| Training hours per capita | Training expense per capita | Rate of loss days : 0.0154 2018 Family-friendly Company Award |
| 115 hours | 1,050 thousand KRW | |

We strive to create more jobs and healthy working environment for employees. Fair evaluation and compensation motivate them.



| | |
|------------------------------------------------------------------------|------------------------------------------------------------|
| Grand Prize in social contribution (excellence in job creation) | Grand Prize in complex cultural space sector (KCSE) |
|------------------------------------------------------------------------|------------------------------------------------------------|

We promote shared growth and co-prosperity with stakeholders and fulfill responsibility and role as a corporate citizen.



| | |
|---------------------------------------|---------------------|
| GHG emissions | Waste discharge |
| 103,776.35 tCO ₂ eg | 3,571,691 kg |

We minimize environmental impacts from business operation and strive to create environmental values.

OUTPUT & IMPACT

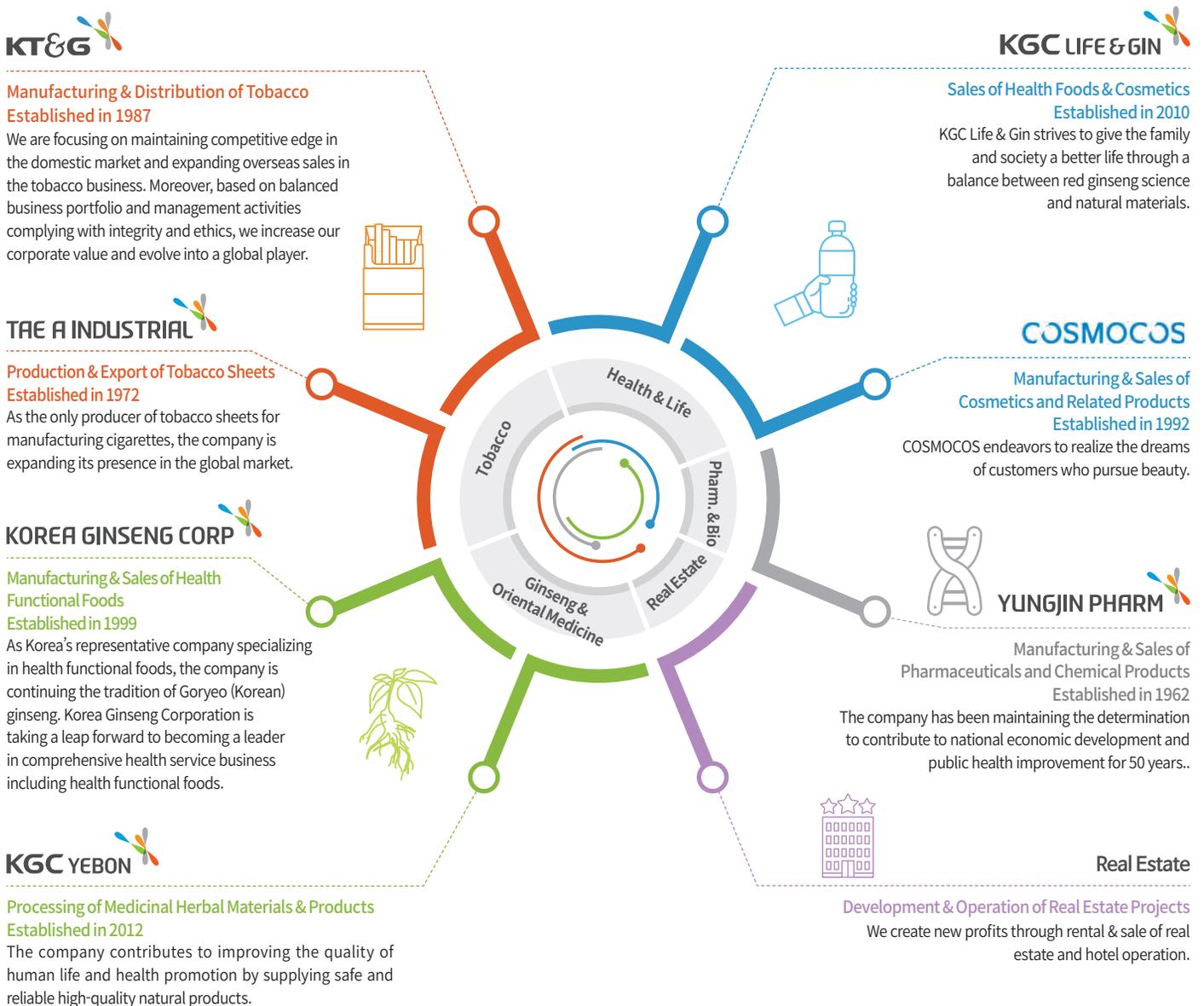
Corporate Governance

BUSINESS PORTFOLIO

Business Domain

In addition to its flagship tobacco business, KT&G takes the lead in developing the domestic pharmaceuticals technologies and improving people's health and the quality of their lives by engaging in the bio and health & beauty businesses. Moreover, our business portfolio has been diversified to diverse areas including real estate. We are committed to vitalizing the ecosystem of related businesses to fulfill our responsibility as Korea's representative company.

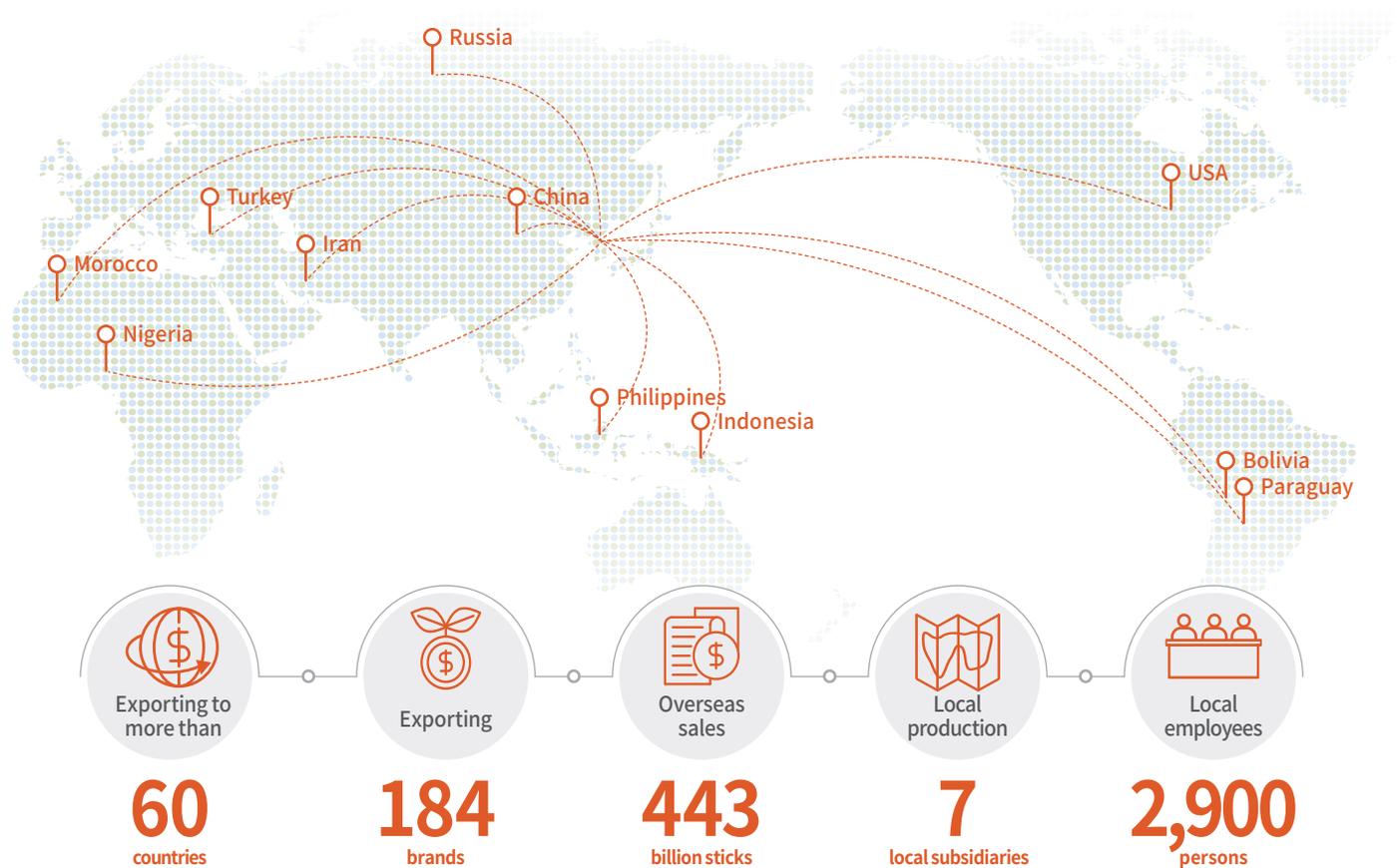
Business Portfolio & Affiliates



GLOBAL NETWORK

Global Operation

KT&G puts efforts into overseas sales as well as stable growth in the domestic market. The company produces major brands such as ESSE and BOHEM at overseas local plants to ensure better distribution in the global market. Our plants are proactive in employing local people, thereby maximizing operational efficiency and contributing to the development of local economy.



Overseas Organization

| Country | Annual Production (100M sticks) | No. of Employees | | | Major Brands |
|-----------|---------------------------------|--------------------|-----------------|-------|----------------------|
| | | Resident Employees | Local Employees | Total | |
| Turkey | 26 | 3 | 74 | 77 | ESSE, THIS |
| Iran | - | 2 | 14 | 16 | ESSE |
| Russia | 40 | 4 | 126 | 130 | ESSE |
| Indonesia | 60 | 13 | 2,556 | 2,569 | ESSE, BOHEM, KRETEK |
| USA | - | 8 | 109 | 117 | Carnival, TIME, THIS |
| China | - | 3 | 49 | 52 | ESSE |

BUSINESS REVIEW

Financial Highlights

Operating Performance

(Unit: KRW in billions)

| Classification | 2018 | 2017 | 2016 |
|-----------------------------------|-------|-------|-------|
| Sales | 2,624 | 3,000 | 2,968 |
| Cost of sales | 977 | 1,099 | 1,048 |
| Gross profit | 1,647 | 1,901 | 1,920 |
| Sales and administrative expenses | 643 | 656 | 615 |
| Operating profit | 1,004 | 1,245 | 1,305 |
| Net profit | 841 | 975 | 1,087 |
| Assets | 8,730 | 8,680 | 8,469 |
| Liabilities | 1,365 | 1,536 | 1,890 |
| Equity | 7,365 | 7,144 | 6,579 |

Financial Ratio

(Unit: %)

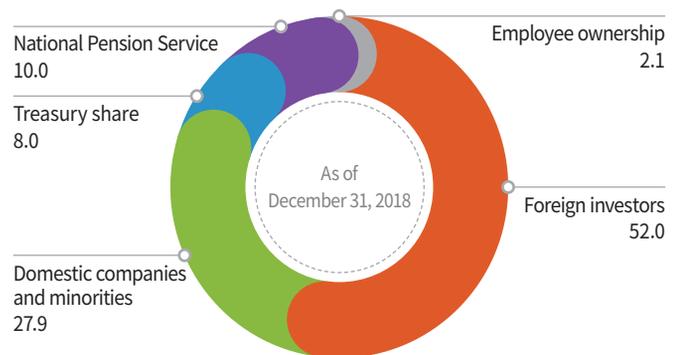
| Classification | 2018 | 2017 | 2016 |
|--------------------------|-------|-------|-------|
| ROA | 9.6 | 11.2 | 12.8 |
| ROE | 11.4 | 13.6 | 16.5 |
| Operating profit margin | 38.3 | 41.5 | 44.0 |
| Net profit margin | 32.1 | 32.5 | 36.6 |
| Earnings per share (KRW) | 6,660 | 7,721 | 8,618 |
| Payout ratio | 60.1 | 51.8 | 41.9 |
| Dividend per share (KRW) | 4,000 | 4,000 | 3,600 |
| Debt-to-equity | 18.5 | 21.5 | 28.7 |



Investment Information

Shareholder Structure

(Unit: %)



Stock Price

| Classification | 2018 | 2017 | 2016 |
|------------------------------------|-------------|-------------|-------------|
| Face value (KRW) | 5,000 | 5,000 | 5,000 |
| No. of common shares issued | 137,292,497 | 137,292,497 | 137,292,497 |
| Weighted average stock price (KRW) | 102,591 | 107,503 | 115,208 |

Dividend Payment

| Classification | 2018 | 2017 | 2016 |
|----------------------------------|---------|---------|---------|
| Total dividend (KRW in millions) | 505,061 | 505,061 | 454,554 |
| Method of dividend payment | Cash | Cash | Cash |
| Payout ratio (% , consolidated) | 56.0 | 43.4 | 36.9 |
| Dividend yield ratio (%) | 3.73 | 3.32 | 3.42 |
| Dividend per share (KRW) | 4,000 | 4,000 | 3,600 |

Voting Rights

| Classification | Kind | No. of shares |
|--------------------------------------------------------------------------|--------|---------------|
| No. of shares issued (A) | Common | 137,292,497 |
| No. of non-voting shares (B) | Common | 11,027,370 |
| No. of shares excluding voting rights by the articles of association (C) | Common | - |
| No. of shares excluding voting rights by other laws (D) | Common | - |
| No. of shares with recovered voting rights (E) | Common | - |
| No. of shares with voting rights (F=A-B-C-D+E) | Common | 126,265,127 |

Domestic Tobacco Business



Market Trend

The consumption of tobacco, which is an item of personal preference, tends to be changed in accordance with economic and seasonal conditions. Smokers are inclined to stick to the brand they favor. The tobacco market is generally monopolized by a few companies both at home and abroad as it has high barriers to entry such as bulk purchase of raw materials, long period of ripening raw materials, mass production facilities, and nationwide distribution channels. It is also sensitive to economic conditions and regulations. The introduction of graphic health warning in 2016 and advent of HNB (heat-not-burn) tobacco in 2017 have increased market fluctuation. In response, KT&G launched diverse new HNB tobacco products meeting consumer needs and focused on improving profitability and product competitiveness.



2018 Business Performance

KT&G launched a variety of differentiated new products including “ESSE CHANGE BING,” “BOHEM PIPE SCOTTIE,” and “RAISON FRENCH LINE” that satisfied the needs of consumers. Our market share rose by 1.4% year-on-year to 62% in Korea, continuing growth for four consecutive years. Particularly, “ESSE CHANGE” consisting of six SKU stood out as a strategic brand with 1.4%p increase in market share. Moreover, we successfully released an HNB tobacco brand “lil” in November 2017, despite late entry into the market, followed by the expansion of lineup to “lil Plus” and “lil Mini.” In November 2018, the “lil Hybrid,” a new platform that combined stick and liquid cartridge, was launched and recorded sales of more than 200 thousand units just in 80 days.



Outlook

The domestic tobacco market is facing tightening non-price regulations. When it comes to the next-generation tobacco business, the market paradigm is shifting dramatically with the release of new competing products and tightening regulatory demands. Therefore, it is hard to predict demand trend and consumers’ buying patterns. Despite these challenges, we are committed to solidifying our leading position in the domestic market and securing global competitiveness. We will also focus on increasing market share and cultivating high-value-added products and duty-free/corporate channels to maximize our profitability.

Overseas Tobacco Business



Market Trend

The global tobacco market environment is not favorable due to tightening regulations, fierce competition, and political issues in the Middle East. Especially in 2018, sales in the Middle East decreased due to volatile exchange rate and increase of tobacco excise tax caused by economic sanction, which was fortunately offset by double-digit growth of sales from new markets and local subsidiaries. Export to new markets in Africa, South and Central America, and Asia-Pacific regions sharply increased on the strength of launch of new brands and proactive marketing activities. Local subsidiaries in the U.S. and Indonesia also achieved sales growth by enhancing sales competitiveness.



2018 Business Performance

To ensure sustainable sale growth in the global market, KT&G has endeavored to enter new local markets, enhance sales competitiveness, expand brand portfolio, and stabilize business environment in the Middle East. Our overseas sales soared more than 20 times in 18 years compared with 2.6 billion sticks in 1999. We exported 184 brands to over 60 countries and recorded sales of 44.3 billion sticks in 2018. Overseas sales revenue reached KRW 536.6 billion. This remarkable performance was mainly attributable to our strong commitment to quality and localized production while dealing with aggressive marketing campaigns against multinational corporations. In addition, we implemented the controller system to manage overseas business more efficiently and ensured transparency in accounting based on the advanced internal control system.



Outlook

It is anticipated that aggressive entrance of global tobacco companies into emerging markets and M&A of local players will accelerate oligopoly situation. In response, we will continue to expand our overseas tobacco business to strengthen our position in the global market. Major strategies are as follows: minimizing potential risks in the mainstream market including the Middle East and normalizing local business operation; enhancing management infrastructure for stable business operation of local subsidiaries; and increasing R&D investment in securing core technologies for Virginia and Cretec types to dominate local markets. We also plan to focus our resources on developing new markets in such regions as Africa, South and Central America, and Southeast Asia.

Health Functional Food Business



Market Trend

In the health functional food business, Korea Ginseng Corporation (KGC) is committed to building trust and long-term relationships with consumers with a focus on manufacturing and sales of health functional food products as it is closely related to public health. This business is expected to realize stable growth due to continuously growing interest in health, prolonged average life span, and stress on well-being and environmental lifestyle. Meanwhile, competition is cutthroat and non-red ginseng products are leading the growth of health functional food market. KGC aims to become a global company that supplies diverse health functional foods as well as ginseng products based on knowhow and experiences accumulated for more than 110 years.



2018 Business Performance

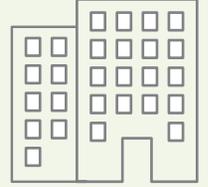
Despite tough business environment, KGC achieved KRW 1.3 trillion in sales in 2018 on the strength of product competitiveness. Domestic and overseas sales accounted for 91.5% and 8.5%, respectively. KGC purchases clean raw materials through 6-year contract cultivation program and operates facilities in Buyeo and Wonju with an annual production capacity of more than 8,000 tons, thereby supplying high-quality products. This supply chain ensures launching new products meeting needs and lifestyle of each age group and allows KGC to take a proactive approach in response to changing consumer trends. For example, the KGC Shop known as Jeong Mall sells more than 5,000 products including vitamins, omega 3, and probiotics in addition to red ginseng products. Sales from the shop surpassed KRW 10 billion July 2018 on a cumulative basis. The newly launched “Best Red Ginseng Collection” of the Good Base brand also received positive response from consumers.



Outlook

With an aim to expand the business into entire health functional foods market, KGC will focus on cultivating leading red ginseng products and creating successful models in the non-red ginseng market. Furthermore, the company will strengthen its position in the existing market to secure export competitiveness and devise strategies tailored to each market to drive exports to emerging markets.

Real Estate Business



Market Trend

In the real estate business, it is not easy to control supply and demand due to the characteristics of immobility. Its public and social nature faces a lot of legal restrictions. The market is also segmented by region, usage, and type of rights. Non-standardized product feature makes business complex and diversified. Our real estate business is broken down into rental, development, financial investment, and infrastructure for our target businesses. We established three strategies of “internalizing rental business and securing operation capability,” “laying a foundation for fostering development projects,” and “enhancing financial business portfolio” to ensure stable and sustainable growth.



2018 Business Performance

In the rental sector, KT&G attained sales of KRW 57.3 billion, operating profit of KRW 19.1 billion, and a vacancy rate of 3.8%, despite worsening market conditions in 2018. We acquired the Bundang Tower to expand the rental business and achieved an occupancy rate of 96.4% thanks to aggressive marketing activities. The property development business created KRW 122.5 billion in sales and KRW 56.7 billion in operating profit from the Suwon Development Project. We also invested in two valuable office buildings in Korea and three overseas tangible assets, through which KRW 15.4 billion dividend income was created. Moreover, this business has supported the Group’s purpose projects including the development of Youth Start-up Support Center and SangSang Madang Busan.



Outlook

The domestic real estate market is anticipated to face fiercer competition. However, KT&G will maintain growth trend by exploring profitable projects in the fields of office building rental, direct property development, and financial investment. Moreover, we will build a well-balanced business portfolio in the long run.

Cosmetics Business



Market Trend

The cosmetics market is sensitive to consumers' preference, habits, and trend. Short product lifecycle requires continuous launch of new products. The domestic cosmetics market has been enjoying stable growth on the strength of worldwide brand recognition. Since initiating the cosmetics business through the acquisition of COSMOCOS in 2011, we have made continuous investment to cultivate this business as a new growth engine. In 2018, the domestic cosmetics market laid a groundwork for taking a new leap even though there was a pessimistic view.



2018 Business Performance

To drive innovation and change, COSMOCOS recruited a new CEO and focused on enhancing brand power and competitiveness. The company also strived to expand customer contact for main brands - Danahan, A Man with Flowers, and VPROVE. In December 2018, we opened a multi-brand shop called "Beauty Credit" in the U.S. to make our first inroad into the market. Starting with the first shop in New York, we plan to open the shop in Jericho, Central Park, and Maryland to build foundation for business expansion into the U.S. and South and Central America. Moreover, our outdoor derma-cosmetic brand "VPROVE" successfully entered the Amazon, the largest online retail store in the U.S. The Skin Science R&D Center and efficient production facilities contributed to further enhancing the competitiveness of our own brands and cultivating technological prowess and product quality. We have also been highly recognized as a key OEM partner of major global distributors such as QVC in Japan and Watsons in Hong Kong.



Outlook

To stand out as a market leader, COSMOCOS will continue to develop new sales channels including OEM partners and cultivate Donginbi, VPROVE, and Danahan as its flagship brands by capitalizing on accumulated manufacturing knowhow and expertise. Particularly, we will provide optimized solutions meeting consumers' needs for skincare by positioning Donginbi as a premium brand with unrivaled competitiveness. Another strategy is to accelerate entrance into both online and offline markets in the U.S. The proven competitiveness of our products will captivate global consumers and stimulate our global expansion.

Pharmaceuticals Business



Market Trend

Contributing to the improvement of the people's health and quality of life, the pharmaceuticals business is critical to national health. As the development of new drugs requires sophisticated expertise, complex technologies, and enormous capital and time investment, it is significant to secure R&D pipeline and infrastructure. This business is also affected by the government's policy, relevant regulations, and supervision to ensure safe production, quality control, and transparent distribution. The domestic pharmaceuticals market is facing rapid changes in the government's policy and business environment as well as tightening competition. To overcome these challenges, domestic pharmaceutical companies are turning their eyes to the global market.



2018 Business Performance

Our pharmaceuticals realized KRW 186.4 billion in sales, a decrease of 4.4% year-on-year, in 2018. Meanwhile, the domestic sales grew 13.3% on the strength of soaring 93% in sales of new licensed-in products. We have focused on sales activities and the introduction of licensed-in products for five major diseases (including chronic circulatory disease) in the domestic market, while strengthening export of antibiotics to Japan and developing Chinese and Southeast Asian markets by expanding CMO and CDMO projects. In the R&D sector, we are promoting the Phase 2b clinical demonstration of YPL-001, a treatment for COPD (Chronic Obstructive Pulmonary Disease), and technology transfer, while carrying out the development of targeted and Immunotherapeutic drugs YPN-005 and YPN-006. In the non-financial aspect, the ISO37001 (anti-bribery management system) was introduced to ensure transparent and fair business operation and company-wide ethical management. It will allow us to eliminate risks related to rebate issues which have been recognized as a persistent problem in the industry and fortify the foundation of sustainable growth.



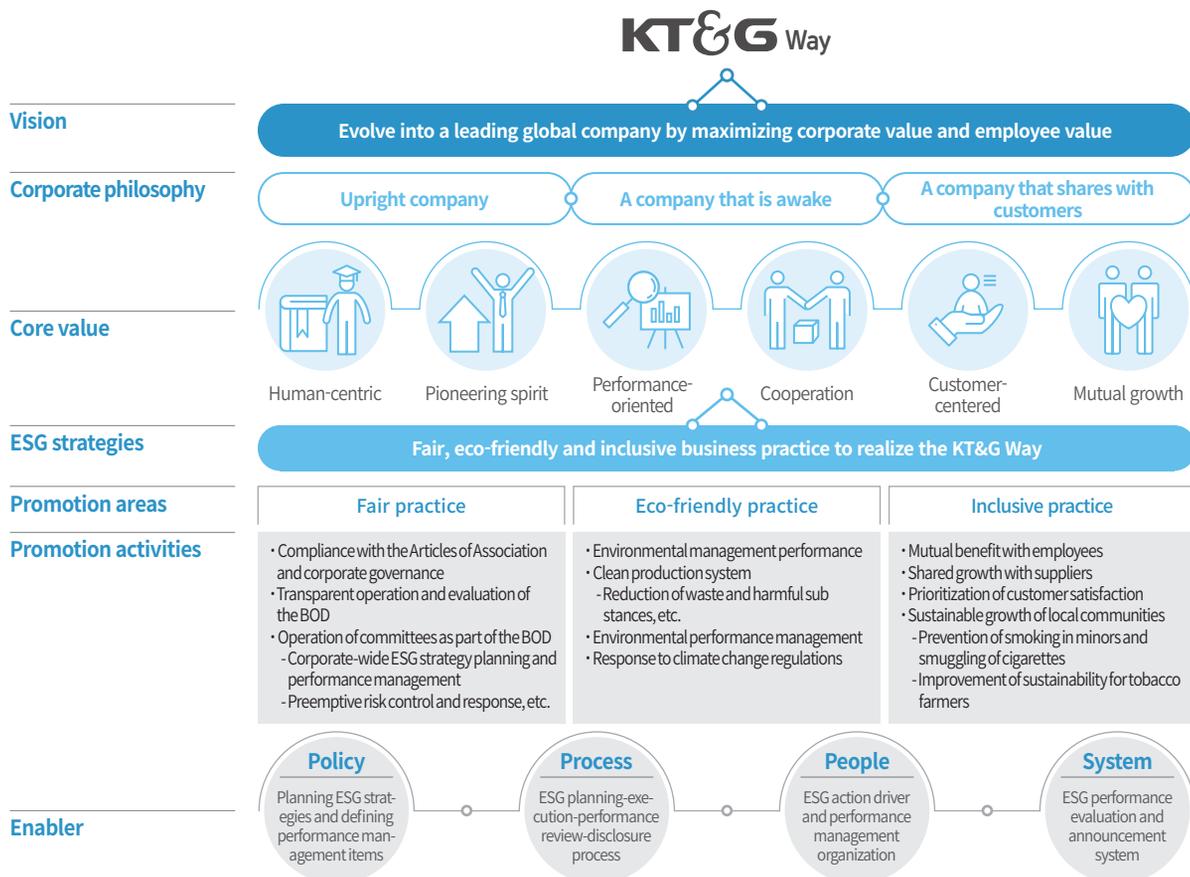
Outlook

In the pharmaceuticals business, we plan to strengthen our product pipeline and develop new overseas markets including the U.S. and China by activating large-scale license-in (acquiring license for the technologies, materials, patents and products from other companies) and license-out (providing licenses for producing and selling products containing technologies, expertise, and intellectual property rights) projects. Another focus will be on cultivating products for three major diseases (enteral nutrition, antipyretic analgesic, and antibiotic kit) with growing demand.

ESG PERFORMANCE REVIEW

ESG Strategy

In pursuit of becoming a sustainable leading global player and realizing corporate philosophy, KT&G established a strategy aimed at maximizing both financial value and non-financial values in the aspects of environment, society, and governance.



ESG Scope and Activities

At KT&G, all employees practice the KT&G Way, build fair governance to maximize corporate value, operate businesses in an eco-friendly way, and embrace various stakeholders to achieve sustainable growth.

Fair business practice

We will put emphasis on stakeholder interest by establishing responsible management system centered on the BOD consisting of independent non-executive directors. The BOD will serve as the top decision-making body for the company's environmental and social agendas included in the Rules of the Board of Directors in accordance with the applicable laws and Articles of Association.

Eco-friendly business practice

Recognizing environmental management as an important social responsibility, we will meet the increasing demands for environmental protection and improve our corporate value in the long run. In order to take a more integrated and systematic approach in environmental management, we will develop and apply various eco-friendly technologies and manage environmental impact throughout our business practice to support sustainable growth of our society.

Inclusive business practice

Serving roles as a corporate citizen, we are committed to making our society a better place to live in. In addition to maximizing the values for our customers and employees, we plan to build a system for shared growth with stakeholders including sustainability management, social contribution activities, and compliance with domestic and overseas regulatory requirements.

Value System - KT&G Way

KT&G aims to become a leading global company that ensures growth, profitability, and stability by maximizing corporate and employee values. This vision is promoted on the basis of our corporate philosophy pursuing “upright company,” “a company that is awake,” and “a company that shares with customers.” KT&G’s value system takes root in entire business strategies and corporate culture, which serves as a foundation of sustainable value creation.

Vision

Evolve into a leading global company by maximizing corporate value and employee value

Corporate philosophy

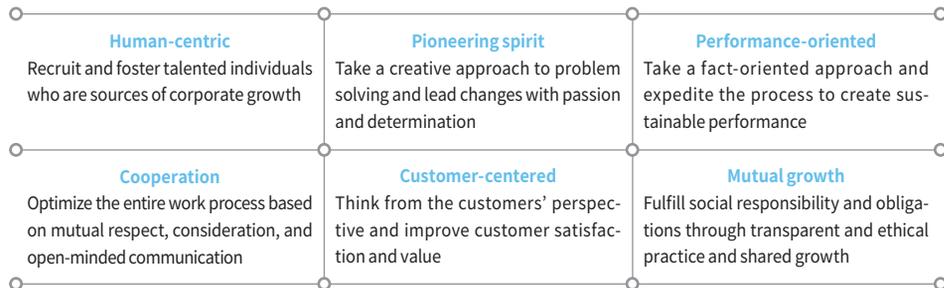
| Upright company | A company that is awake | A company that shares with customers |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| KT&G will comply with social regulations and norms. We will establish responsible management system that fosters creativity and freedom and pursue future-oriented management activities. | We will fundamentally pursue “Change & Innovation” beyond just utilizing it as a slogan for achieving goals, through which we will develop creative and progressive corporate culture. | We will not only create values for customers, shareholders, and employees, but become a company that contributes to public interest and fulfill social responsibility to build a better society. |

Business philosophy

Creating a better life for all

The value of our products and services pursue better feeling, better emotion, and better life.

Core Values



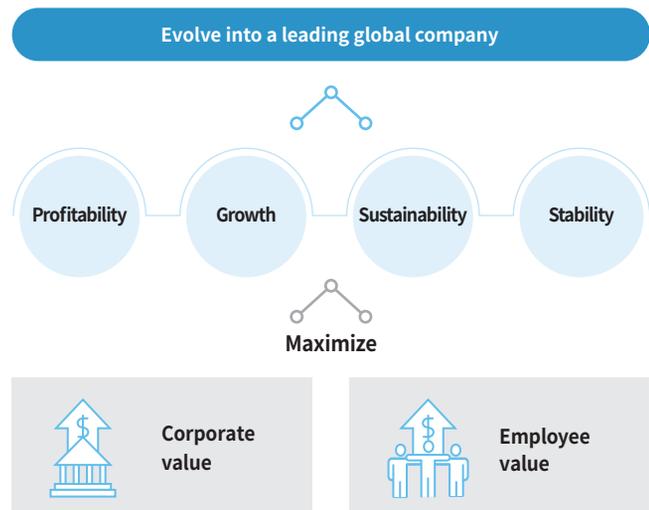
Corporate Value

The company pursues becoming a global player by maximizing corporate value. To this end, in the tobacco business, we will focus on proactive investments in developing differentiated new products, enhancing quality, and exploring overseas markets as well as promoting qualitative and quantitative innovation, which will help us solidify the foundation for value creation. Ginseng and health food businesses will promote portfolio diversification to become future growth engines. In the pharmaceuticals and cosmetics sectors, we will secure differentiated competitiveness by reinforcing business efficiency and synergy and be proactive in seeking for new business opportunities.

Employee Value

Employee value can be maximized when individual efforts for demonstrating their ability and intra-company systems are well integrated. To this end, we are pursuing human-centric management philosophy which is in line with the global trend. We will also build a culture of trust where the creativity of employees can be maximized based on open-minded communication and self-responsibility approach.

Realizing Corporate Vision



01

Upright Company

KT&G is committed to conforming to social norms and value. We will promote responsible management that lays stress on autonomy and creativity and continue to pursue future-oriented management.



Enhancement of the Soundness of Governance Structure

Corporate governance includes rules and procedures for coordinating interest conflict among stakeholders, making decisions on resource procurement, operation, and profit distribution, and supervising management activities. Thus, transparent and healthy corporate governance is indispensable to the “Upright Company.” KT&G strives to ensure transparency, professionalism, and fair procedure in corporate governance.

Material
Issue in
2018



Transparency in
organizing and
operating the BOD



Professionalism
and independency
of the Audit
Committee



Securing
professionalism in
decision-making

Board of Directors

The Board of Directors (BOD) makes deliberation and decisions on critical management issues in an effective and precise manner by capitalizing on professionalism of directors and subcommittees. Non-executive directors have an absolute majority of the BOD and the separation of the CEO and the BOD Chairman positions ensures efficient checks on the management.

BOD Composition

The BOD consists of two executive directors including the CEO and six non-executive directors.

(As of Dec. 31, 2018)

| Category | Name | Gender | Date of Birth | Residency | Major Careers | Position & Term |
|-------------------------|-----------------|-----------|---------------|-------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------|
| Executive Directors | Baek, Bok-in | Male | Sep. 1965 | Standing | Director of Strategy and Planning, KT&G Director of Marketing Headquarters, KT&G | CEO, Chairman of the Investment & Development Committee Mar. 17, 2018-2021, General Shareholders' Meeting |
| | Kim, Heung-ryul | Male | Mar. 1961 | Standing | Director of Management Support HQ, KT&G Chief of Global Market Focus Headquarters, KT&G | Head of General Management Mar. 17, 2018-2021, General Shareholders' Meeting |
| Non-executive Directors | Youn, Hai-su | Male | Feb. 1952 | Non-standing | President, Seoul Univ. of Foreign Studies Assistant Member of the Presidential 21st Century Committee | Chairman of the BOD and the Strategy Committee Mar. 19, 2016-2019, General Shareholders' Meeting |
| | Song, Op-kyo | Male | May 1941 | Non-standing | Advisor, National Assembly Committee for Constitutional Revision Member of the 15th National Assembly | Chairman of the Evaluation Committee Mar. 18, 2017-2020, General Shareholders' Meeting |
| | Lee, JuneQ | Male | Dec. 1957 | Non-standing | Professor, Kyunghee Univ. Director/Chairman, Korea Academic Society of Taxation | Mar. 18, 2017-2020, General Shareholders' Meeting |
| | Lee, Eun-kyung | Female | May 1963 | Non-standing | Managing Director of Finance, PVH Calvin Klein Corp. Korea Director of Finance, Reebok Korea | Mar. 19, 2016-2019, General Shareholders' Meeting |
| | Rho, Joon-hwa | Male | Jan. 1969 | Non-standing | Professor, Dept. of Business Administration, Chungnam Univ. Chair, Accounting Audit Div., Korean Accounting Association | Chairman of the Audit Committee Mar. 18, 2017-2020, General Shareholders' Meeting |
| Baek, Jong-soo | Male | Nov. 1960 | Non-standing | Lawyer, Dongin Law Firm Director, Busan District Prosecutor's Office | Mar. 17, 2018-2021, General Shareholders' Meeting | |

* Executive directors (Baek, Bok-in and Kim, Heung-ryul) were reappointed and a non-executive director (Baek, Jong-soo) was newly appointed at the 31st general shareholders' meeting on Mar. 16, 2018.



17 times

No. of the BOD
meetings held

BOD Participation Rate in 2018

97.1%

Participation
rate of non-execu-
tive directors



Major Discussions and Resolutions

In 2018, the BOD meeting convened 17 times, where 25 agenda items were voted for and 11 agenda items were reported.

| Key resolutions in 2018 | | Reports |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"> • Organization of the CEO Candidate Recommendation Committee and delegation of authority • 31st (2017) financial statements • 31st (2017) statement of appropriations of retained earnings • 31st business report • Organization of the Non-executive Director Candidate Recommendation Committee • Organization of the Executive Director Qualification Screening Committee • Establishment of annual remuneration limit of directors • Agreement on executive director candidates • Revision of the 31st financial statements • Recommendation of the Audit Committee Member Candidates • 31st general shareholders' meeting • Appointment of the BOD Chairman • Appointment of subcommittee members and Chairman | <ul style="list-style-type: none"> • Appointment of the Compliance Officer • Participation in bidding on a multipurpose building complex in Incheon • Establishment of a joint venture and capital investment • Selling some of commercial property within the Suwon Plant • Signing a contract for selling some of commercial property within the Suwon Plant • Joint guarantee on middle payment loans for the Hwaseo Station Park Purgio apartment • Extension of the KT&G Mutual Growth Loan Fund operation period • Budget plans for 2019 • Evaluation plan on the BOD activities in 2018 • Amendment of the Audit Committee operation rule • Amendment of the internal accounting management rule • Participation in capital increase of Tae-A Industrial • Transfer of slurry tobacco sheet manufacturing facilities | <ul style="list-style-type: none"> • Pending issues (Audits on local subsidiaries, examination status by the Financial Supervisory Service, etc.) • Operation status of the internal accounting management system • Results of the evaluation on operation status of the internal accounting management system • Result of selecting the CEO candidates • Proposals by shareholders • Results of 1Q 2018 settlement results • Pending issues (results of audits on local subsidiaries, etc.) • Results of 1H 2018 settlement results • Results of 3Q 2018 settlement results • Results of outsourcing the corporate governance advancement project • Mid and long-term management strategy and business plan in 2019 |

Subcommittees

KT&G operates four standing subcommittees - Strategy Committee, Investment & Development Committee, Evaluation Committee, and Audit Committee - and non-standing subcommittees including the CEO Candidates Recommendation Committee and Independent Non-Executive Director Candidates Recommendation Committee.

| Classification | Strategy Committee | Investment & Development Committee | Evaluation Committee | Audit Committee |
|--------------------------|--------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------|--------------------------------------------------------|------------------------------------------------------------------------------------------|
| Purpose of Establishment | Review of corporate management strategies | Control of investment, social contribution, risk management, and other obligations under the Commercial Act | Performance evaluation and compensation | Review of financial and accounting feasibility and evaluation of internal control system |
| Composition | 3 non-executive directors, 2 executive directors | 3 non-executive directors, 2 executive directors | 4 non-executive directors | 3 non-executive directors |
| Member | Youn, Hai-su, Song, Op-kyo, Rho, Joon-hwa, Baek, Bok-in, Kim, Heung-ryul | Lee, Eun-kyung, Rho, Joon-hwa, Baek, Jong-soo, Baek, Bok-in, Kim, Heung-ryul | Song, Op-kyo, Lee, JuneQ, Youn, Hai-su, Baek, Jong-soo | Rho, Joon-hwa, Lee, JuneQ, Lee, Eun-kyung |

Audit System for Transparent and Healthy Governance

We operate the Audit Committee to strengthen the independence and roles of our internal audit body and ensure transparency and reliability of our financial information while supervising and supporting the management.

Audit Committee

The Audit Committee is held at least once a quarter to make sure that the company fulfills its responsibilities and obligations to the stakeholders by auditing the legality of executives and directors and reviewing the financial health and accuracy of financial reporting.

Audit Committee Members (as of the end of December 2018)

The Audit Committee consists of three non-executive directors (Rho Joon-hwa, Lee JuneQ, Lee Eun-kyung). Rho Joon-hwa was appointed as the Audit Committee Chairman by the resolution of the committee.

Audit Committee Activities in 2018

The Audit Committee was held 15 times in total in 2018 and major agendas included resolving internal accounting control system and monitoring system, approving the audit report, and reviewing major items of the general shareholders' meeting.

Audit Committee Resolutions in 2018

| Date | Agenda Items | Resolution | Remarks (Attendee) |
|---------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------|---------------------------------|--------------------|
| Jan. 31 | Review #1: 31st (2017) financial statements | Resolved (Submitted to the BOD) | Non-executive: 3 |
| | Review #2: 31st (2017) statement of appropriation of retained earnings | Resolved (Submitted to the BOD) | |
| | Review #3: 31st (2017) business report | Resolved (Submitted to the BOD) | |
| | Report #1: Operating status of internal accounting control system | Received | |
| | Resolution #1: Assessment of operating status of internal accounting control system | Resolved | |
| | Resolution #2: Audit Committee review on internal accounting control system | Resolved | |
| | Report #2: Internal audit results for 4Q, 2017 | Received | |
| | Report #3: Audit plan for 2018 | Received | |
| Resolution #3: Ethical Management Audit Evaluation | Resolved | | |
| Feb. 8 | Resolution #1: Criteria for appointing independent auditors | Resolved | Non-executive:3 |
| Feb. 27 | Review #1: Revision of the 31st (2017) financial statements | Resolved after revision | Non-executive:2 |
| Feb. 28 | Resolution #1: Review of agenda items for the 31st general shareholders' meeting | Resolved | Non-executive 3 |
| | Resolution #2: 2017 audit report | Resolved | |
| | Resolution #3: Appointment of independent auditors | Resolved | |
| Mar. 29 | Resolution #1: Appointment of the Audit Committee Chairman | Resolved | Non-executive: 3 |
| | Resolution #2: Agreement on nominating an internal audit department manager | Resolved | |
| | Discussion #1: Discussion on compensation for independent auditors and audit hours | Discussed | |
| | Resolution #3: Proposal for upgrading audit function for internal audit advancement | Resolved | |
| Apr. 27 | Resolution #1: Submission of the pending issue (local subsidiaries) to the BOD | Resolved | |
| | Resolution #2: Plan for outsourcing the internal accounting system upgrade project | Resolved | |
| | Report #1: Promotion of the advancement of KT&G's internal control system | Received | |
| May 8 | Report #1: Settlement of accounts for 1Q 2018 | Received | Non-executive: 3 |
| | Report #2: Internal audit results for 1Q 2018 | Received | |
| | Report #3: Proceeding of internal audit monitoring | Received | |
| | Report #4: Proceeding of internal control enhancement in procurement sector | Received | |
| May 10 | Report #1: Settlement of accounts for 1Q 2018 | Received | Non-executive: 3 |
| May 23 | Resolution #1: Appointment of outsourcing partner for internal accounting management system upgrade | Resolved | Non-executive: 3 |
| Aug. 8 | Report #1: Settlement of accounts for 1H 2018 | Received | Non-executive: 3 |
| | Report #2: Internal audit results for 2Q 2018 | Received | |
| | Report #3: Proceeding of information protection improvement tasks | Received | |
| | Report #4: Result of inspections on internal control improvement tasks in procurement sector | Received | |
| Aug. 30 | Report #1: Review of plans for streamlining audit organization operation | Received | Non-executive: 3 |
| | Report #2: Review of laws and regulations for streamlining audit organization operation | Received | |
| Sep. 20 | Resolution #1: Improvement of audit organization operation | Resolved | Non-executive: 3 |
| Nov. 6 | Report #1: Settlement of accounts for 3Q 2018 | Received | Non-executive: 3 |
| Nov. 8 | Report #1: Audit plans for 2019 | Received | Non-executive: 3 |
| | Report #2: Internal audit results for 3Q 2018 | Received | |
| Dec. 18 | Review #1: Amendment of the Audit Committee regulations | Resolved (Submitted to the BOD) | Non-executive: 3 |
| | Report #1: Amendment of the internal audit regulation | Received | |
| | Report #2: Formulation of a guideline to protect unethical behavior reporters | Received | |
| | Review #2: Amendment of the internal accounting management regulation | Resolved (Submitted to the BOD) | |
| | Report #3: Review of necessary time for audit by independent auditors | Received | |
| Report #4: Results of outsourcing the internal accounting management system upgrade project | Received | | |
| Report #5: Pending issues from independent audits | Received | | |

Reasonable Evaluation and Compensation System

The Evaluation Committee consisting of non-executive directors under the BOD conducts annual management performance evaluation to ensure proper compensation for the CEO and executive directors.

Evaluation Committee

The Evaluation Committee not only resolves regulations on executive director remuneration and retirement allowance but also decides the evaluation criteria of the presidential candidates and their contract terms including business goals. Moreover, the committee deliberates remuneration and retirement allowance of the CEO and executive directors in advance and has the right to evaluate and compensate for management performances of the CEO.

Evaluation Committee Members (as of the end of December 2018)

The Evaluation Committee consists of four non-executive directors (Song Op-kyo, Lee JuneQ, Youn Hai-su , Baek Jong-soo). Song, Op-kyo was appointed as the chairman by the resolution of the committee.

Evaluation Committee Activities in 2018

The Evaluation Committee was held five times in 2018 and decided the CEO's short and long-term business goals and performance evaluation of the previous year.

| Date | Agenda items | Resolution | Members' vote | | | | |
|---------|--------------------------------------------------------------------------------------|------------|---------------|-----------------|-----------|-------------|---------------|
| | | | Song Op-Kyo | Choi, Kyung-won | Lee JuneQ | Youn Hai-Su | Baek Jong-soo |
| Jan. 25 | Resolution #1: CEO candidate examination criteria | Resolved | Approved | Approved | Approved | Approved | N/A |
| Feb. 8 | Resolution #1: Evaluation on the CEO's short-term performances in 2017 | Resolved | Approved | Approved | Approved | Approved | N/A |
| | Resolution #2: Evaluation on the CEO's long-term performances from 2016 through 2017 | Resolved | Approved | Approved | Approved | Approved | N/A |
| Mar. 13 | Resolution #1: CEO's management contract | Resolved | Approved | Approved | Approved | Approved | N/A |
| Mar. 29 | Resolution #1: Establishment of the CEO's short and long-term management goals | Resolved | Approved | N/A | Approved | Approved | N/A |
| Nov. 22 | Resolution #1: Decision on basic annual salary of executives | Resolved | Approved | N/A | Approved | Approved | Approved |

* A non-executive director Choi, Kyung-won retired due to the termination of his office and Baek, Jong-soo was newly appointed as a non-executive director at the 31st general shareholders' meeting on March 16, 2018.

BOD Member Remuneration Regulations & Payment Status in 2018

The remuneration of the BOD members is appropriated on the basis of the following criteria.

| Remuneration criteria for registered directors (executive director) | | |
|---------------------------------------------------------------------|---------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| | Basic salary | One-twelfth of annual salary is paid each month under the Executive Director Remuneration Policy. |
| Earned income | Bonus | Bonuses are paid depending on the resolution of the Evaluation Committee, and are based on quantitative indicators (sales and operating profits) and non-quantitative indicators (new growth engine value creation and group infrastructure innovation). Bonuses can be paid up to 255% of the base salary amount. |
| | Stock option income | N/A |
| | Other earned income | Including benefits such as medical check-up expenses for spouses |
| | Retirement income | N/A |
| | Other income | N/A |

Total amount of remuneration paid to the BOD members in 2018



KRW **4,099** million

Total amount of remuneration

Independence of the BOD

KT&G strives to ensure stable governance structure where check and balance function is performed in an efficient manner. The separation of the role of the CEO and BOD Chairman, a super majority (75%) of non-executive directors in the BOD, and a majority of non-executive directors in each subcommittee ensure the independence of the BOD. Particularly, all members of the Audit Committee and Evaluation Committee are non-executive directors.

Professionalism and Expertise of Directors

All members of the BOD demonstrate expertise and practical experiences in the fields of business administration, finance, accounting, and laws. KT&G operates an organization dedicated to helping non-executive directors perform professional works as members of the BOD and subcommittees. Agenda items are provided to them before meetings to help fully review relevant information and preceding explanation is executed when necessary. We also offer information on pending issues through roundtable meetings and invite them to our worksites at home and abroad to give onsite presentations on business status. On top of that, educational opportunities are provided to help them gain knowledge and skills needed for professional works.

Protection of Shareholders' Rights

In accordance with the Article 542-7 of the Commercial Act and Article 12 of its Enforcement Ordinance, we amended our Articles of Incorporation and introduced a cumulative voting system on March 23, 2001 at the general shareholders' meeting. As a result, shareholders holding at least 1% of the total shares with voting rights were given the right to appoint directors and those who intend to exercise the right must notify the company in writing at least 6 weeks prior to the date of the general shareholders' meeting (for a regular general meeting, the date of the general shareholders' meeting of the previous year).



Case Study

Selected as the “Best Governance Company” at the corporate governance evaluation in 2018

KT&G has been recognized as the company with the best corporate governance.

We obtained A+ rating, the highest level among evaluation targets, at the corporate governance evaluation conducted by the KCGS (Korea Corporate Governance Service). The evaluation targeted listed companies and financial firms.

Moreover, KT&G ranked top in the corporate governance evaluation performed by Hankyung Business. The evaluation targeted large-sized listed companies mandatory to disclosure in 2018 accommodated data of the Fair Trade Commission. Major evaluation items included the ratio of non-executive directors in the BOD, subcommittee operation, and guarantee for the right of minority shareholders. We gained high grade in the ratio of non-executive directors and ranked the highest in other categories as well.

Going forward, KT&G will further enhance not only transparency in corporate management but also independency and professionalism of the BOD, thereby ensuring healthier corporate governance.



Internalization of Ethical Management

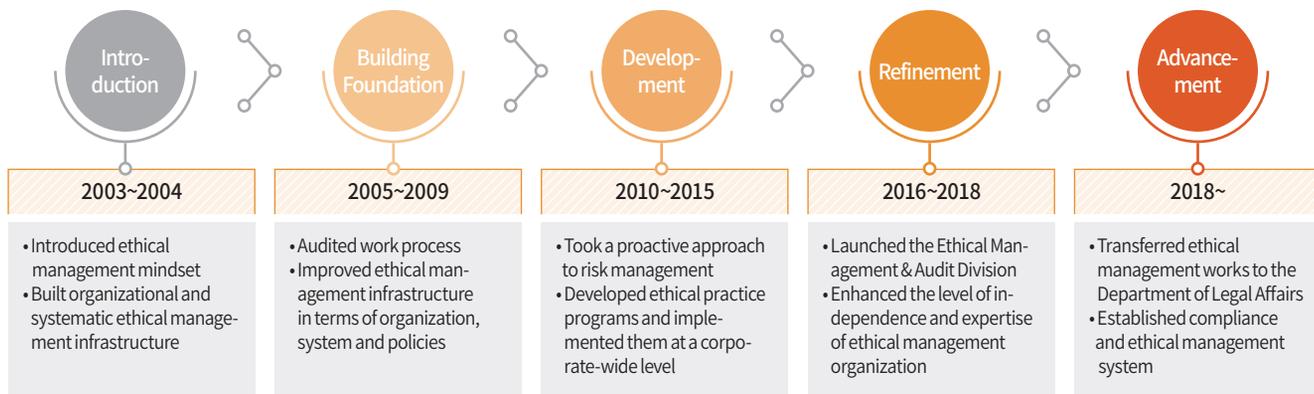
KT&G is committed to internalizing ethical management to meet the needs of shareholders for corporate transparency, integrity, and social responsibility and ensure sustainable growth. At KT&G, ethical management system was introduced in 2003 to help all employees' practice our corporate philosophy based on criteria for right behaviors and value judgment and has been continuously upgraded. In 2018, ethical management works transferred to the Legal Affairs Department to further foster employees' mindset toward compliance and ethics.

Material Issue in 2018



Internalization of anti-corruption and ethical management

History of KT&G's Ethical Management



Ethical Management System

At KT&G, ethical management is promoted on the basis of criteria for ethical behaviors and value judgment regulated by the Carter of Ethics and Code of Ethics. And, an organization dedicated to ethical management plays a key role in encouraging all employees to implement business ethics and advancing our ethical management system.

Ethical Management Organization

The Legal Affairs Department under the Sustainability Management Division is in charge of compliance and ethical management works to respond to ethics and compliance issues in a prompt and efficient manner. Serving as a control tower of ethical management, the department engages in business ethics training, campaign, internal & external reporting system, and response to public complaints.



Ethical Management Promotion System

KT&G operates the Charter of Ethics and Code of Ethics as standards for upright behaviors and value judgement with which all employees should comply. The Legal Affairs Department plays a pivotal role in helping employees practice ethical management activities through diverse programs.



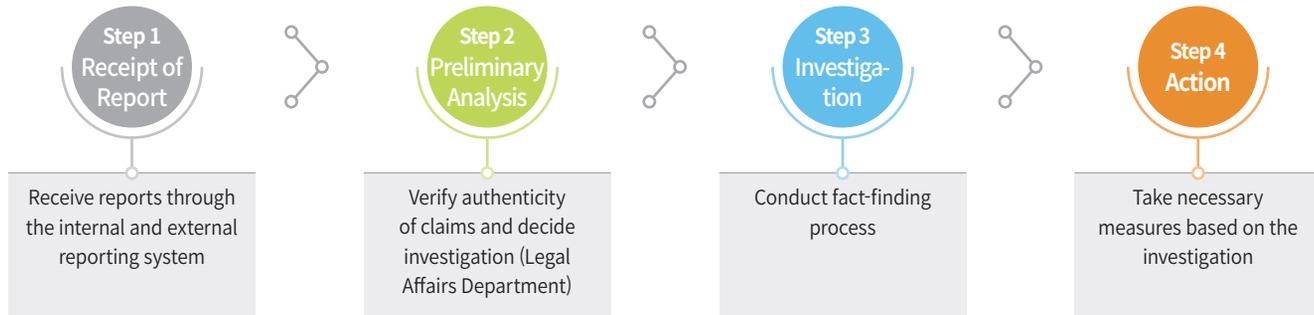
Ethical Management Practice Program

KT&G runs a variety of ethical management practice programs to respond to changes in business fields and further internalize ethical management throughout the company beyond just a slogan.

| | |
|----------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>Pledge on Ethical Conduct</p> | <p>We make sure that our employees are familiar with the Code of Ethics and ethical practice guidelines and sign the pledge on ethical conduct for full compliance at the beginning of each year.</p> |
| <p>Sexual Harassment Prevention Program</p> | <p>Sexual harassment prevention program is offered to improve conventional awareness and practices of gender discrimination and create sound working environment. Particularly, we establish sexual harassment prevention measures based on related regulations, case studies, and results of internal analysis, and offer online training once a year to raise employees' awareness of ethics.</p> |
| <p>Think Twice Campaign</p> | <p>The company holds ethical management campaign frequently and publishes casebook annually to internalize ethical management and prevent relevant accidents in advance.</p> |
| <p>Training on ethical management</p> | <p>We conduct online training on compliance and ethical management for all employees and offline training on business ethics for new employees and executives/managers, thereby raising the awareness of ethical mindset.</p> |
| <p>Ethics for external stakeholders</p> | <p>A survey is carried out to check external stakeholders' satisfaction on transactions and unethical behaviors. We also add special clauses on business ethics practice when signing contracts with them to encourage ethical management.</p> |

Internal & External Reporting Process

KT&G operates a reporting system through which any misconduct and violation of the Code of Ethics can be reported (“report on unethical behaviors” menu in the corporate website, both Korean and English version). The protection of whistleblowers is stipulated in the relevant guidelines.

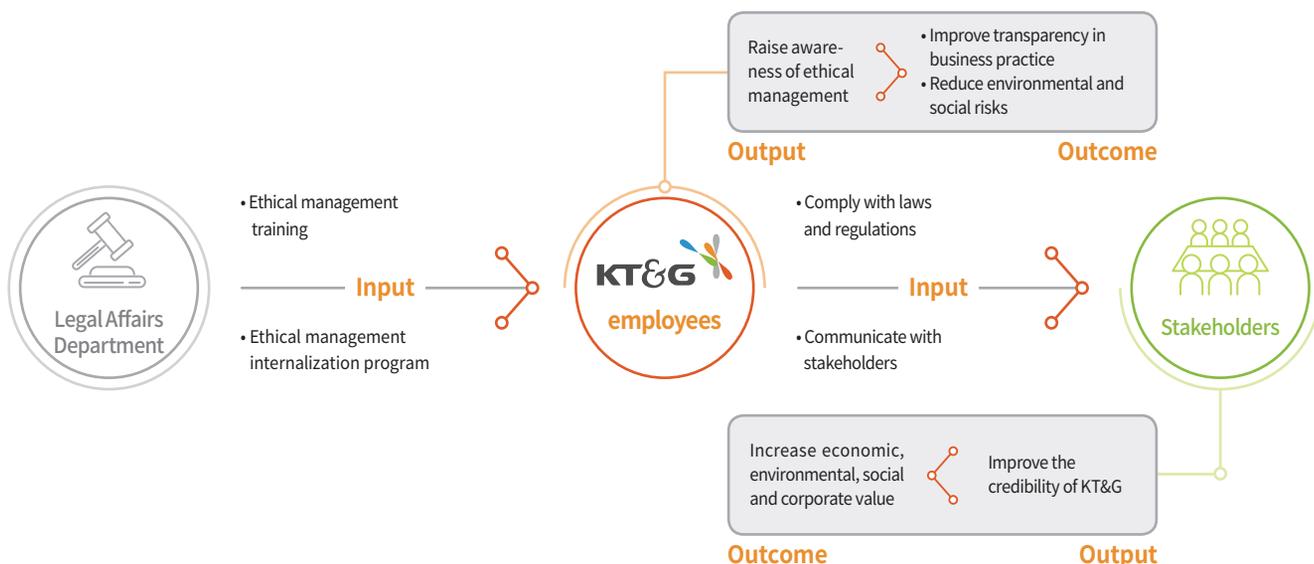


Dissemination of Ethical Management

KT&G is committed to preventing any unethical conduct in the course of our business activities and disseminating the culture of ethical management. This effort is made by all subsidiaries and suppliers at home and abroad. We ensure full compliance with safety and health standards and working hours recommended by the ILO (International Labor Organization) as well as applicable laws and regulations while promoting the fair and transparent business practice in all countries and regions in which we do business. In addition, our subsidiaries, suppliers, and partners are encouraged to join our ethical management activities to prevent unethical labor practices such as child labor and forced labor. KT&G will continue to disseminate ethical management by developing a variety of training and compliance programs going forward.

Effect of Ethical Management

Annual practice programs and frequent diagnosis programs are operated to raise employees’ awareness of ethical management and the effectiveness of those programs are checked through regular surveys. This process allows us to evaluate the efficiency of current ethical management system and programs and to devise better methods beyond just building and operating a system. Especially, we are thorough in managing problems, improvement items, execution results, and reasons for non-performance after diagnosis. Unexercised items are repromoted through consultation and coordination with relevant departments.





Case Study Operation of an Integrated Purchase System

In relations with suppliers, it is essential to provide production facilities, manpower, and technology to help them develop their competency and build a fair and transparent business relationship as part of ethical practice. In order to ensure transparency and efficiency in procurement process, we operate an integrated purchase system that allows us to share information with suppliers. The integrated purchase system was designed to enable sharing of a web-based production information system that supports real-time identification of inventories and production plans. It allows suppliers to keep track of our production plans and inventories, thereby helping them improve productivity and reduce inventories. This system ultimately contributes to enhancing our product quality and price competitiveness. It is our responsibility to promote ethical practice and shared growth with suppliers.

Improving transparency and efficiency in transaction through an integrated procurement system



Building an integrated procurement system

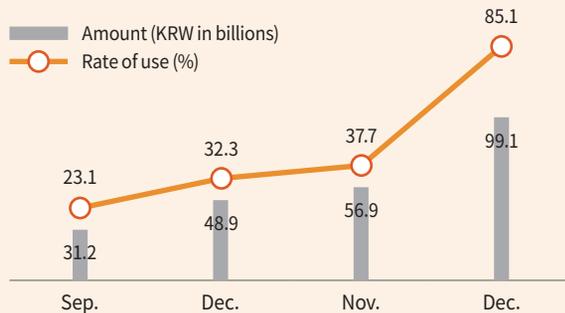


Enhancing transparency, standardization, and efficiency



Innovating procurement procedure

Transaction through the integrated procurement system



Transaction targets of the integrated procurement system

- Domestic and overseas materials (including leaf tobacco), construction, service
- Exemption to application
 1. Transaction through MRO contract, credit card, and electric billing system (Giro)
 2. Contract with individuals such as leaf tobacco farms and lecturers
 3. Transactions which asked for prior approval
- Monitoring the use of integrated procurement system by analyzing sales statements

Compliance Program

The entire process of tobacco business from production and licensing to manufacturing, distribution, and sales is strictly regulated by the government. Advertising for consumers is also subject to restrictions. In this respect, as compliance is crucial for our business practice, we take a systematic approach to compliance management based on strict standards and procedures.



Compliance Operation System

For more efficient compliance practices, we operate the Legal Affairs Department and Compliance Officer system. In addition, we align our legal information system to the internal portal to keep our employees updated on the subject while providing preliminary review service on legal matters.

Main Responsibilities of the Legal Affairs Department

1. Legal consultation: Review legal risks in advance and propose necessary response measures to minimize risks
2. Contract review: Review contracts before signing to reduce the risks in legal matters
3. Litigation: Collect and establish response plans and strategies in a timely manner in case of litigation against KT&G
4. Intellectual property rights: Protect intangible assets by securing legal rights to our research results

Compliance Activities & Performances

Employees' Voluntary Compliance Check System

At KT&G, a total of 33 persons are designated as the staff in charge of compliance and they establish compliance check plans of sales-related departments and evaluate operation status on a regular basis. Moreover, to build an autonomous compliance check system by department, the company is defining legal risks, reviewing relevant laws and regulations, and preparing guidelines specified for each business process.

Inspection of Compliance Practices

In order to raise the awareness of fair business practice and compliance, we regularly perform onsite inspection and training on related regulations.

Fair Trade and Competition

KT&G operates two online training courses in terms of compliance management and fair-trade related laws. In 2018, trainings on laws closely related to our business (five times) and the Commercial Act (once) were offered to new and experienced employees. We also published a handbook containing fair-trade guidelines and Improper Solicitation and Graft Act (Jan. 2018) and a leaflet for easy understanding of business-related laws (Nov. 2018). The "legal Issue & News Report" is published every quarter. On top of that, we are conducting diverse activities aimed at enhancing compliance with fair trade and internalize compliance management including anti-corruption management system (ISO37001).

Compliance Training

Diverse training programs tailored to each position and responsibility are provided to raise employees’ awareness of compliance. The fair-trade guideline handbook, leaflet, and quarterly report mentioned above also contribute to employees better understanding our business-related laws.

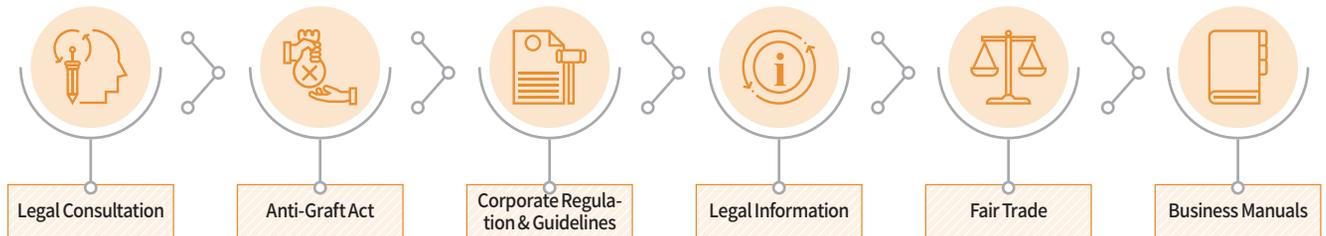
Compliance Training Programs

| Tobacco Business Act | | | | Fair Trade Act | Commercial Act | Compliance |
|----------------------|---------------|-------------------------------------------|------------------|-----------------------------------|----------------|-----------------------------------|
| January | April | May | November | December | July | December |
| New employees | New employees | Contract workers Experienced employees | Contract workers | All employees (Cyber training) | All employees | All employees (Cyber training) |

Legal Information System

KT&G operates an online system where legal affairs and information are treated, which contributes to preventing legal risk and improving work efficiency in our business practice. It is linked to the internal portal to offer easy access to our employees and creates additional benefits of reducing the cost of publication and document management. In 2018, we conducted legal reviews on 4,523 business-related contracts and 442 consultations through the system.

KT&G Legal Information System Composition



Plans for Compliance Enhancement

Regulatory requirements on fair competition, anti-corruption, and environmental impact as well as tobacco products have become increasingly more complex and stringent. In response, we are going to identify legal risks in advance and cope with them in an effective and consistent manner.



Won the Presidential Prize at the 2018 Law Order Awards

Risk Management

KT&G has established a systematic risk management system to effectively respond to wide range of risks such as political, economic, and social changes at home and abroad and increasing requirements from stakeholders. By rapidly and efficiently control potential risks in advance, we will continue to ensure sustainable growth.

Material
Issue in
2018



Company-wide risk
management

Risk Management Organization

The Strategy Committee and Investment & Development Committee under the BOD are the top-level organizations that inspect financial and non-financial risks and make decisions on countermeasures to mitigate major risks.

Strategy Committee

The Strategy Committee reviews our corporate identity, vision, and philosophy as well as mid- to long-term business plans. It is also in charge of improving the BOD operation standards and reviewing amendments to the Articles of Incorporation or the BOD Operation Regulations. In addition, it reviews our legal and institutional risks and develops countermeasures against major risks.

Strategy Committee Members (as of the end of December 2018)

The Strategy Committee consists of three non-executive directors (Youn, Hai-su, Song, Op-kyo, Rho, Joon-hwa) and two executive directors (President & CEO Baek, Bok-in, Vice President Kim, Heung-ryul). The Chairman of the BOD (Youn, Hai-su) served as the chairman of the committee for one year in accordance with the Rules of the Board of Directors.

Activities of the Strategy Committee in 2018

The Strategy Committee meeting was held on December 6, 2018 to review and decide on the mid- and long-term management strategy and business plans and budgets for 2019.

Major Resolutions of the Strategy Committee in 2018

| Date | Agenda | Resolution | Committee Members' Vote | | | | |
|-----------------|-----------------------------------------------------------------------------------|-------------------------------------------|-------------------------|-----------------|------------------|-----------------|--------------------|
| | | | Youn, Hai-su | Song, Op-kyo | Rho, Joon-hwa | Baek, Bok-in | Kim, Heung-ryul |
| Dec. 6, 2018 | Deliberation #1: Mid- to long-term management strategy and business plan for 2019 | Passed as proposed (submitted to the BOD) | Agreed | Agreed | Agreed | Agreed | Agreed |
| | Deliberation #2: Budget plan for 2019 | Passed as proposed (submitted to the BOD) | Agreed | Agreed | Agreed | Agreed | Agreed |

Investment & Development Committee

The Investment & Development Committee is responsible for checking financial and non-financial risks related to our management activities and establishing countermeasures against them. The committee also executes preliminary review on acquisition and disposal of properties, investment in new and additional facilities, overseas investment, and guarantee issue. Other roles include developing major projects with growth potential, checking and managing risks of investment projects, and deciding social contribution projects. Furthermore, it manages obligations under the Commercial Act such as the establishment, relocation, and retirement of branches.

Investment & Development Committee Members (as of the end of December 2018)

The Investment & Development Committee consists of three non-executive directors (Lee, Eun-kyung, Rho, Joon-hwa, Baek, Jong-soo) and two executive directors (President & CEO Baek, Bok-in, Vice President Kim, Heung-ryul). The CEO was appointed as the chairman of the committee.

Activities of the Investment & Development Committee in 2018

In 2018, the Investment & Development Committee was held twice and decided the installation and relocation of the branch office and loans to employees for the investment in ESOP.

Major Resolutions of the Investment & Development Committee in 2018

| Date | Agenda | Resolution | Committee Members' Vote | | | | |
|--------------|--------------------------------------------------------------|--------------------|-------------------------|----------------|---------------|----------------|-----------------|
| | | | Baek, Bok-in | Lee, Eun-kyung | Rho, Joon-hwa | Baek, Jong-soo | Kim, Heung-ryul |
| May 10, 2018 | Resolution #1: Installation and relocation of branch office | Passed as proposed | Agreed | Agreed | Agreed | Agreed | Agreed |
| Nov. 8, 2018 | Resolution #2: Loans to employees for the investment in ESOP | Passed as proposed | Agreed | Agreed | Agreed | Agreed | Agreed |

Risk Management Plan

KT&G will further enhance financial and non-financial risk management system. As for financial risk control, we will continuously monitor the status of financial transactions, and strive to reduce capital operation risk and improve transparency in transactions through the Finance Staff Committee. We will also identify potential risks from changes in exchange rate, price of raw materials, credit rating, and liquidity and working on eliminating or reducing them to an acceptable level. Non-financial risk will be categorized by type (corruption, legal proceeding, government regulation, etc.) to prepare tailored countermeasures. We will also check the compliance of risk management policies and procedures and the risk exposure limit through internal auditors.

Countermeasures to Risk Factors

| Classification | Major Risk | Risk Factor | Response to Risk |
|--------------------|---------------------------|-------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Financial risk | Tax risk | Managing national and local taxes | <ul style="list-style-type: none"> Analyzing tax-related works through tax review and consultation and rationalize tax affair report Carrying out tax review in advance through tax consultation service |
| | F/X risk | Compliance with Foreign Exchange Transaction Act | <ul style="list-style-type: none"> Improving accessibility and utilization of exchange rate management menu and enhancing F/X risk management system Conduct training on the Foreign Exchange Transaction Act by inviting outside experts Analyzing weekly and monthly in/outflow performance and currency market trend |
| Non-financial risk | Corruption risk | Prevention of corruptive practices | <ul style="list-style-type: none"> Monitoring risk factors related to corruption and managing audit data through the E-Audit system |
| | Human risk | HR management, employee health care | <ul style="list-style-type: none"> Managing personal information, compensation history, and benefits through the E-HRM system Conducting employee health check-up (once/year, including spouse) |
| | Information security risk | Cybercrime, information leakage | <ul style="list-style-type: none"> Establishing security policies, training operation guidelines, and monitoring security status Operating information protection system to prevent security breaches |
| | Legal risk | Domestic/overseas tobacco business, new projects, M&A, etc. | <ul style="list-style-type: none"> Managing legal documents and intellectual properties through database Categorizing incidents/accidents, identifying applicable laws, and analyzing risk factors by business unit |
| | Regulatory risk | Implementing FCTC | <ul style="list-style-type: none"> Complying with applicable laws for compliance with the FCTC (Framework Convention on Tobacco Control) |

Stakeholder Communication

KT&G defines customer, shareholder & investor, the government, local community, employee, and supplier as its stakeholder groups in consideration of their impacts and importance in our management activities. It is important for sustainability management to identify their expectations and demands and incorporate them in business practices. To this end, KT&G listens to their voices through communication channels tailored to each stakeholder group. By doing so, we identify material sustainability issues and disclose our activities and performances through the integrated report in an effective and transparent manner.



Material Issue in 2018



Cooperation and co-prosperity with local communities



Brand reputation management

Communication with Stakeholder Groups

| Stakeholder | Definition |
|-----------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|  <p>Shareholder & investor</p> | Stakeholders and investors provide capital needed for business operation and want to invest in companies with sustainable growth potential. |
|  <p>Government</p> | The government encourages companies to make comply with legal and social responsibilities and controls legal and regulatory environment, which affects corporate activities. |
|  <p>Local community</p> | Local community includes people who are living around our worksites and interested in our business. Their supports and cooperation are considered important assets to our operation. |
|  <p>Employee</p> | Employees desire to communicate with the company about stable and fair employment. They also want to have safe and healthy work environment and be evaluated on their performances in a fair and transparent manner. |
|  <p>Supplier</p> | Suppliers provide production facilities, manpower, and technological expertise. It is important to build fair and transparent business relationship with them and develop their competence to ensure our growth. |
|  <p>Customer</p> | Customers purchase and use our products and services and give feedbacks. It is essential to consistently communicate with them to supply better products and services satisfying them. |

Communication with Stakeholder Groups

We are proactive in communicating with each stakeholder group through diverse channels to listen to their voices and opinions..

Stakeholder Communication Plan

Our stakeholder communication channel covers general shareholders' meeting, seminar, workshop, plant tour, and volunteer service as well as business report, disclosure, and integrated report. It extends to grievance handling system, complaints handling process, Imagination Fulfillment Division, and prosumer activities to better identify even stakeholders' needs and potential complaints.

We also strive to improve our brand recognition. Going forward, we will continue not only to expand stakeholder communication channel specified for the characteristics of each stakeholder group with the aim of reflecting their opinions in our management activities, but also to disclose the results in a transparent manner to help stakeholders better understand KT&G.

| Communication Channel | KT&G's Activities |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"> • General shareholders' meeting • Performance evaluation • Business report • Website | We share information about sustainability management activities with shareholders and investors through the IR Department under the Strategy & Planning Division and collect feedback for improvement. |
| <ul style="list-style-type: none"> • Conference and seminar about industrial policies • Sales report • Public hearing • Advisory council meeting | With the participation in the government's decision-making process, we comply with the laws throughout our business operation and sustainability activities. |
| <ul style="list-style-type: none"> • SangSang Fund • Employee volunteer activities • SangSang Madang • Welfare Foundation & Scholarship Foundation • Supports for farmers | The Social Contribution Office under the Sustainability Management division takes the initiative in fulfilling social responsibility and contributing to solving social issues by operating volunteer groups and SangSang Fund. |
| <ul style="list-style-type: none"> • Labor-Management Council • Grievance handling system • CSR training • Intranet • Imagination Fulfillment Division | The Human Resources Management Office under the Management Support Division leads to create safe working environment and raise employees' awareness of sustainability management with the aim of encouraging their voluntary participation. |
| <ul style="list-style-type: none"> • KT&G Advanced Procurement System (KAPS) • EDI • Complaint handling process • Supplier workshop • Supplier support program | We help suppliers develop technologies and enhance their competence by offering consultation through the Leaf Tobacco & Procurement Division and provide farmers with a variety of benefits for their stabilization of living. |
| <ul style="list-style-type: none"> • Public disclosure • Reporting center • SNS • Satisfaction survey on new products • Sales report • Plant tour • Prosumer activities | KT&G communicates with customers through the Marketing Division faithfully implements CSR activities meeting customer expectations and strives to develop high-quality products. |

02

A Company That Is Awake

We will fundamentally pursue “Change & Innovation” beyond just utilizing it as a slogan for achieving goals, through which we will develop creative and progressive corporate culture.



Product Innovation

Product innovation is an essential part of creating new growth engines and driving sustainable growth. To promote innovation, it is important to develop a mindset of responding to constant changes and meeting expectations. KT&G is committed to continuous product innovation in order to enhance our technological competitiveness and profitability.

Material
Issue in
2018



Product
innovation



Creation of new
growth engines

Development of New Products Meeting Market Trend and Consumer Needs

As tobacco is an item of personal preference that is closely related to our lives, it is important to satisfy customer needs and expectations and to supply safe and user-friendly products. To this end, KT&G is proactive in monitoring market trends through regular survey and reflecting feedbacks from consumers in products. Particularly in the HNB tobacco market, a next-generation business, we are focusing on product innovation in response to rapidly-changing trends.

Performance in Product Innovation

The demand for HNB and liquid tobacco has been on a rise. In 2018, the HNB and liquid tobacco market grew around five times compared to the previous year. With a growing customer demand for less tobacco smells and well-being trends, the next-generation tobacco market is expected to grow further.

Despite being a latecomer in the market, KT&G is highly recognized for fast-paced product development, differentiated strategy, and high quality. Successfully launching our first HNB tobacco “lil” in November 2017, we have expanded the lineup of exclusive stick models. Launching new models “lil Plus” that reflected the needs of consumers and “lil mini” with compact size triggered faster-than-expected growth. In November 2018, we launched the “lil HYBRID,” KT&G’s unique platform with liquid cartridge, which laid a foundation for securing competitive edge in the tobacco market.

Product Portfolio

lil Plus



With a built-in battery and internal heat system, the “lil Plus” is a tobacco device that directly heats the stick to 320 degrees. It doesn’t produce smell due to burning instead of heating. It ensures continuous smoking without intervals, easy cleaning, simple insertion and removal of stick, and consistent flavor.

lil mini



It has the same format and function as the “lil Plus” model, but with smaller battery. It lasts up to 10 sticks.

lil HYBRID



Developed exclusively by KT&G, the “lil HYBRID” is an external heating-type device with a built-in battery, which heats the stick and liquid cartridge at the same time. It is characterized by plenty of smoke and unique stick construction as well as easy-to-clean battery. It does not produce smells and has a mild flavor.

Performances in 2017 and 2018

| Classification | | 2017 | 2018 | Change |
|----------------|-----------------------------|------|-------|--------|
| Sales revenue | Device (KRW in 100 million) | 43.7 | 979.5 | 935.8 |
| | Stick (KRW in 100 million) | 34.9 | 783.4 | 748.5 |
| Sales volume | Device (10,000 units) | 8.0 | 148.6 | 140.6 |
| | Stick (100 million units) | 0.4 | 12.0 | 11.6 |

Our product innovation pursues reducing risk and ensuring customer safety by developing responsible products beyond just improving technological expertise and profitability. The “lil” products ensures the safety declaration process (KC Certification) in accordance with the Electrical Appliances and Consumer Products Safety Control Act. Those are also equipped with safety device that prevents over-voltage, over-charge, and over-discharge. Like this, KT&G has become a “First Mover” beyond a fast follower in the next-generation tobacco market and endeavors to provide consumers with more choices and new experiences.

Our Plans

It is predicted that the next-generation tobacco business will enjoy growth trend while facing fierce competition due to launch of diverse products. In response, KT&G intends to build and expand the strategic platform for the next-generation tobacco products to secure market leadership. To this end, we will focus on developing upgraded version of HNB tobacco products and entering the liquid HNB tobacco market.



Case Study
New Platform ‘lil HYBRID’

On November 28, 2018, KT&G launched the “lil HYBRID” which was developed by our independent technology. This product is operated by putting liquid cartridge in device and then inserting an exclusive stick. If a user presses the button, steam generated from heated liquid is passed through the heated stick. This process ensures distinctive cigarette flavor. Particularly, KT&G contemplated how to satisfy HNB tobacco users’ unmet needs for vapor and how to dramatically improve cleaning method.

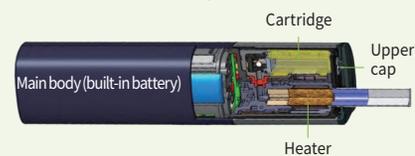
We expected that the vapor shortage issue would be solved by combing liquid cartridge with device. However, this idea met unexpected technological difficulties, which required fundamental changes in device and stick structure. Through countless trial and errors, we succeeded in designing optimal cartridge structure and liquid creation, developing new tobacco materials, and identifying suitable temperature.

Moreover, we designed the end of exclusive stick in Y-typed structure to pass vapor from cartridge and cut off the leakage of residue, thereby minimizing pollution of the device and dramatically improving inconvenience in product cleaning. The device equipped with a sensor is operated only when exclusive sticks are inserted, which prevents improper use.

Going forward, KT&G will be immersed in R&D activities to develop trend-leading products that meet consumer needs.



“lil HYBRID” Device Diagram



Structure of Exclusive Stick “MIIX”



Enhancement of R&D Capability

Product innovation originates from strong R&D capability. Our continuous efforts for enhancing R&D capability have resulted in successfully launching the next-generation tobacco products and satisfying the needs of consumers. KT&G will spare no efforts for R&D activities by leveraging the expertise of our R&D workforce and dedicated teams.

R&D Organization

At KT&G, the R&D Headquarters has been leading the development of core technologies for tobacco production. We operate three research centers (Product Research Lab, Technology Research Lab, and Analysis Lab) and R&D Planning Team.

R&D Organization and Activities

| R&D Lab | Research Areas |
|-------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Product Research Lab | <ul style="list-style-type: none"> Develop new products meeting customer needs and improve existing ones Develop NGP products (e.g. lil, lil HYBRID) and improve existing ones |
| Technology Research Lab | <ul style="list-style-type: none"> Research core technologies for developing innovative products Research tobacco cultivation, ingredients, aroma ingredients, and aroma capsules Develop next-platform technologies |
| Analysis Lab | <ul style="list-style-type: none"> Research analysis technology, response to technological environment, and content analysis (certified by KOLAS). |
| R&D Planning Team | <ul style="list-style-type: none"> Establish R&D strategies and goals Manage R&D projects to achieve goals |

Various technologies are integrated in a cigarette. Our researchers have been developing high-quality differentiated products by integrating diverse ideas and technologies. Launching a product goes through multiple steps such as identifying market needs, deciding brand concept, manufacturing trial products, verifying quality, and doing mass production test. As these stages require close internal and external cooperation, we strive to activate communication.



Research on core technologies

Domestic Research

The domestic research focuses on innovating traditional tobacco and developing next-generation tobacco. Major activities include researching core technologies, developing distinctive items meeting customer needs, establishing analysis methods, analyzing contents, certifying the KOLS to enhance product reliability, and so on.

Overseas Research

KT&G is committed to a range of overseas R&D activities. Since the acquisition of Trisakti Purwosari Makmur PT, an Indonesian tobacco company, in 2011, we have been working on joint R&D projects by dispatching our researchers to the company. This joint R&D allows us to acquire technical skills and expertise toward local markets and Trisakti to establish R&D systems and infrastructure.

Furthermore, the KT&G R&D labs conduct technological exchange with research center under the CNTC (China Tobacco) on a regular basis to enhance R&D capabilities. Other overseas R&D activities include establishing new analysis methods and proposing global standards in accordance with global regulation trends as a board member of the CORESTA. We also share information on export and import control guides in Asia through conferences such as the ACS (Asia Collaborative Study) and improve the reliability of measure by objectifying analysis methods of each country and organization.

R&D Performances for Three Years

| R&D Performance (case) | R&D Project | Expected Effect |
|---------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 2018  54 | <ul style="list-style-type: none"> • Research on the commercialization of next-generation platform and products • Development of differentiated ingredients and materials in response to the traditional market • Development and diversification of localized products | <ul style="list-style-type: none"> • Enhance next-generation product portfolio • Maintain competitive edge in the traditional tobacco market • Improve product competitiveness in the new global markets |
| 2017  63 | <ul style="list-style-type: none"> • Development of differentiated ingredients and materials • Development of products to expand overseas market • Establishment of an R&D base for next-generation products and innovative products | <ul style="list-style-type: none"> • Meet consumer needs and improve product competitiveness • Create new markets (unconventional) |
| 2016  45 | <ul style="list-style-type: none"> • Development of unique leaf tobacco • Development of differentiated ingredients and technology to enhance flavor • Development of special and functional filters | <ul style="list-style-type: none"> • Create new markets • Improve product competitiveness • Develop new products and enhance quality |

Our Plans

In 2018, we undertook 54 R&D projects, including the development of products for new global markets, special ingredients, materials, and next-generation product technologies. With an aim to improve the competitiveness of our products, the KT&G R&D Center will focus on the development of core and base technologies and new products for export as well as products and technologies in the next-generation sector that is growing at a fast pace. Furthermore, research on analysis methods such as the KS standardization of methodologies will continue.



Analysis Lab



Case Study

Tobacco Capsule Developed by Independent Technology

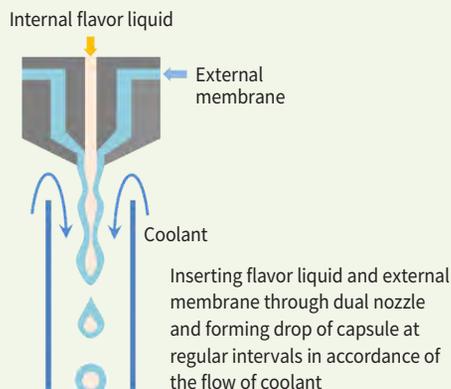
A researcher of the R&D Center proposed flavor capsule cigarettes as a new idea. Japanese flavor capsule was mainly used in the early stage of development. However, we succeeded in developing independent flavor capsule technology through cooperation with a domestic venture firm specialized in manufacturing capsules for cosmetics. Even though there were difficulties in identifying proper strength, we successfully completed the development of flavor capsules for cigarette with independent technology.

Currently, raw materials of capsule are entirely produced at the Sintanjin Plant #2, which allows us to reduce costs to less than half of imported price and to secure capsules quickly. Despite difficulties in the development of capsule technologies, our employees' consistent efforts and passion resulted in localizing flavor capsules and realizing dramatic cost reduction.

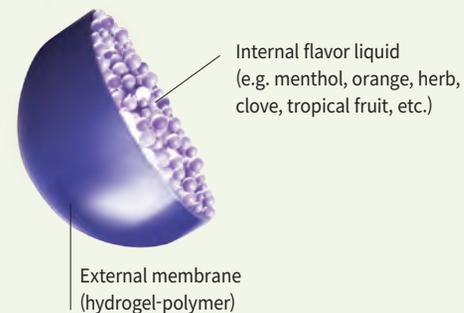
Capsule Manufacturing Process



Capsule Formation



Capsule Structure



Response to Climate Change

Recognizing climate change as a serious threat to mankind, we are committed to our roles and responsibilities as a global corporate citizen. This is not only fulfilling our corporate social responsibility but also integral part of sustainable practice. Based on these values, we are reducing environmental impact and taking initiatives in response to climate change while minimizing GHG emissions, improving energy efficiency, developing eco-friendly products, and promoting environmental communication on an ongoing basis.



Climate Change Response Strategy

Direction for the Response to Climate Change

KT&G makes a proactive response to the government’s policies and regulatory and global initiatives with regard to climate change. As part of these efforts, we are working on reducing GHG emissions, improving energy efficiency, and developing products with minimum environmental impact.

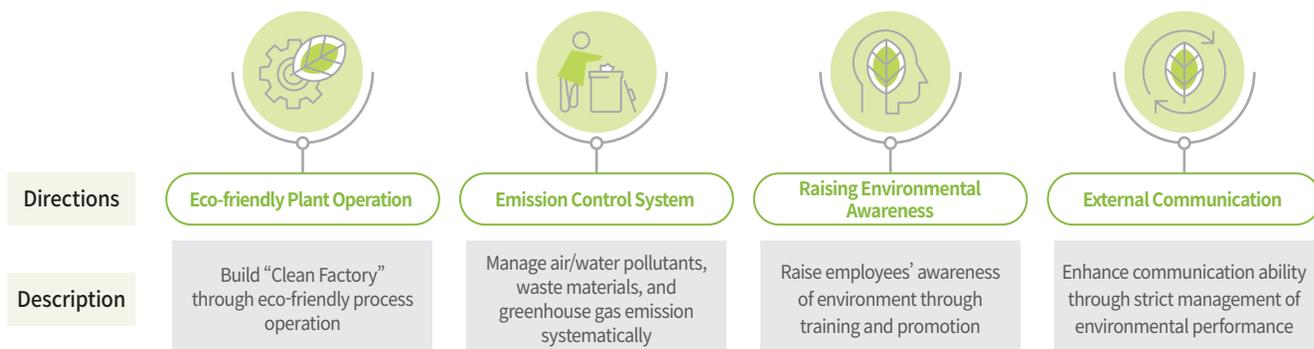
Dedicated Organization

With the Green Management Division as our dedicated organization for energy and environmental management, we manage our environmental practice at a corporate-wide level. The division is in charge of planning and managing energy efficiency and GHG emissions reduction initiatives at our production facilities around the country while responding to the government policies and regulatory requirements on climate change, energy consumption, GHG emissions and chemical substance control.

Promotion System

KT&G strengthens its corporate-wide environment management based on a well-organized system. We engage in eco-friendly plant operation, emission control, awareness improvement, and external communication from a mid- to long-term perspective. These activities contribute to minimizing environmental impact throughout our management activities.

Environmental Management System



Climate Change Response Activities and Performance

KT&G strives to minimize environmental impacts through developing eco-friendly products, participating in emission trading, managing energy consumption and GHG emissions, and operating low carbon production lines. These efforts contribute not only to the government's response to climate change and the environment of the global society, where we operate business, but also to cost-saving, thereby leading to the enhancement of our corporate value eventually.

Minimizing Environmental Impact through Eco-friendly Product Development

In order to promote eco-friendly quality management, we have developed eco-friendly products throughout the value chain covering production, packaging, and disposal. The eco-friendly packaging paper for our products contributes to reducing the use of pulp and GHG emissions. We also replaced plastic bags made from petroleum-based packaging materials with paper to improve the eco-friendliness of our products. The biodegradable film which is adopted to our products shortens the degradation process from 100 years to less than 10 years.

Efforts for and Effect of Eco-friendly Product Development

| Classification | Areas of Improvement | Effect |
|-----------------------------------------------------|----------------------------------------------------------------------|------------------------------------------------------------|
| Improvement of packaging material | Replaced vinyl cases with paper cases with low pulp consumption | Saved 1,500 tons of pulp per year |
| Improvement of wrapping paper inside cigarette pack | Developed recyclable eco-friendly paper to replace aluminum material | Saved 850 tons of aluminum per year |
| Usage of recyclable pulp | Recycled paper to produce softened paper and cardboard | Saved 400 tons of pulp per year |
| Oxidative biodegradable OPP film | Developed eco-friendly film with short decomposition period | Reduced environmental impact by the burial of wasted vinyl |



Solar power generation facility in the Sintanjin Plant

Building GHG Inventory

When the Emission Trading Scheme was implemented in 2015, KT&G was also registered as a target company. To support the scheme, we built the GHG inventory and identified the sources of emissions to calculate the emission volume while systemizing the process of managing the source and volume.

Environmental Communication

The information on energy and water consumption and GHG and waste emissions in business operation are disclosed through our website and sustainability report. In addition, we organize tour programs for the Sintanjin and Yeongju Plants, which have the largest production facilities in the world, to raise environmental awareness of the public. Through these communication channels, we bring stakeholders' attention to climate change issues and promote our efforts while seeking cooperation and support for the cause.

Participation in the CDP (Carbon Disclosure Project)

The CDP (Carbon Disclosure Project) is a climate-change response program undertaken in more than 60 countries worldwide. Since 2010, we have disclosed our GHG emissions data and strategy through the CDP and promote active communication on our commitment to climate change action with various stakeholders.

Our Plans

KT&G will continue to enhance environmental management and response to climate change to promote sustainable growth of our society and company. To this end, we will identify the areas of improvement in our operation and strengthen our competitiveness through comprehensive analysis of our environmental management activities.



Low-Carbon Green Lines that use waste steam from neighboring plants



Case Study

Improving Energy Efficiency and Reducing GHG Emissions

Improving Energy Efficiency at Production Plants

Improving energy efficiency is an integral part of the response to climate change. As part of our eco-friendly business practice, we have expanded high-efficiency facilities and built 2MWh solar power systems to reduce GHG emissions. Our five production plants have built peak power monitoring systems with the aim of maximizing energy efficiency and saving costs. Other activities include replacement of turbo freezers, operation of low-carbon green production lines, and installation of LED lights. These efforts have resulted in reducing environmental impacts as well as saving costs.

Energy Efficiency Practices

Replacement of Turbo Freezers



- Changed the energy source for freezers (LNG → electricity) to improve energy efficiency

- ※ Annual operation cost (estimated)
 - Absorption type freezer: KRW 120.6 million
 - Turbo freezer: KRW 95.3 million
 - Saved KRW 25.3 million a year

Replacement of LED Lights



- Installed LED lights to save energy

- ※ 1,874 lighting units, save 27W in average, when used 13 hours a day, 240 days a year
 - 1,874 units * 0.027kWh/unit * 13h/day * 240 days * KRW 130/kWh
 - Saved KRW 20.5 million a year

Energy Efficiency Improvement Activities and Performance by Plant

(Unit: KRW in 100 millions)

| Classification | Activities | 2018 | |
|----------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------|--------|
| | | Cases | Saving |
| Yeongju Plant | Operation of the low-carbon green line, collection of condensed water from air conditioners, participation in the demand response system, maintenance of air conditioners using dry ice, replacement of cold water pump (2 units), maintenance of high temperature water drainpipe, installation of ESS (Energy Storage System) | 8 | 6.3 |
| Gwangju Plant | Replacement of lighting facilities (fluorescent lights → LED) and one turbo freezer | 1 | 0.6 |

Operation of Low-Carbon Green Line

Our Yeongju Plant built the “Low-Carbon Green Lines” with a length of 804m to use waste steam from neighboring Novelis Korea Co., Ltd. during its aluminum coating process for the manufacturing of products. Instead of producing LNG through boilers and supplying it to the freezer to supply energy for cooling, we are now able to use the steam from local production facilities at a low cost. By doing so, we received 4,113 tons of steam from the company and saved KRW 130 million in 2018.

03

A Company That Shares with Customers

We will not only create values for customers, shareholders, and employees, but become a company that contributes to public interest and fulfill social responsibility to build a better society.



Shared Value Creation

As part of our efforts to create both social and economic values, we are working on the strategic shared value creation. To this end, we are committed to creating shared value through social responsibility programs in line with our business operation.

Material
Issue in
2018



Shared growth
with suppliers



Promotion of
farmers' safety
& health



Cooperation & co-
prosperity with
local communities

Shared Value Creation through Co-prosperity

By promoting shared growth with local communities, we make a positive impact on our society and maximize our business performance. When it comes to shared growth with our supply chain, in particular, we contribute to the increase in their income and financial stability. At the same time, we enhance the competitiveness of our products by purchasing high-quality leaf tobacco from them.

Major Activities

Financial Support

To relieve financial difficulties of our suppliers, we make full payment in cash within 5 business days of the following month and encourage our first-tier suppliers to settle their payments by the 25th of the following month. In addition, we make payments in advanced to suppliers during periods such as the Lunar New Year and Chuseok holidays. This is to alleviate financial difficulties of suppliers as they have a temporary shortage of funds during such periods due to various payment commitments. At the same time, we adjust the contract amount to help suppliers mitigate financial burdens due to increases in the price of materials and fluctuations as part of the commitment to shared growth. Our financial support programs promote sustainable growth of our suppliers and consequently contribute to our sustainability as well.

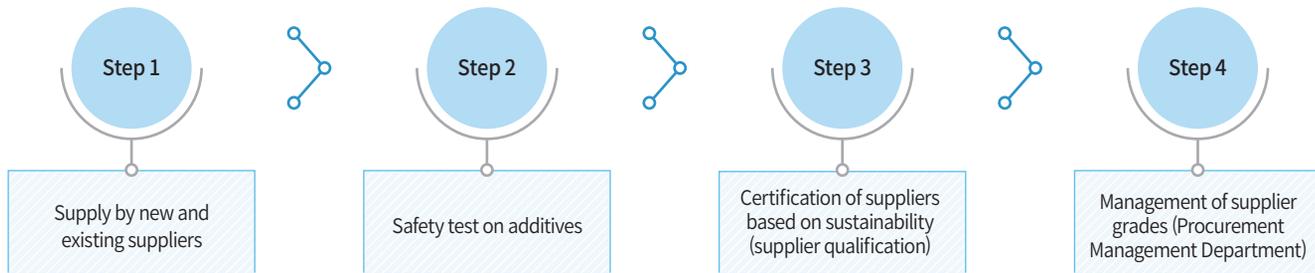
Advanced Payment to Suppliers

| Classification | Lunar New Year in 2018 | Chuseok in 2018 | End of 2018 |
|---------------------------|------------------------|-----------------|-------------|
| Amount (KRW in millions) | 7,879 | 8,665 | 13,930 |
| Scheduled date of payment | 2018-03-08 | 2018-10-05 | 2019-01-05 |
| Actual date of payment | 2018-02-13 | 2018-09-14 | 2018-12-31 |

Building Strategic Partnership through the Raw Material Supplier Certification System

KT&G has been operating a supplier certification system for the selection of new suppliers and establishment of long-term partnerships with existing suppliers. Our strategic partnership lasts for 3 years if there are no other qualified suppliers during that period. However, assessment is conducted after one year to identify areas of improvement and they are addressed by the suppliers. Since 2011, 74 of 75 companies in total have been certified. The system allows our suppliers to focus on production and technology development while we secure suppliers with high-quality and excellent business standards to promote shared growth and create shared value.

Supplier Certification Process



Shared Growth with Local Communities through Low Interest Loans

As part of our contribution to the economic development and job creation in Chungcheong-do where our headquarters are located, we signed an agreement on shared growth promotion with the IBK (Industrial Bank of Korea). In accordance with the agreement, KT&G invested KRW 100 billion in the shared growth fund and IBK raised a total of KRW 200 billion based on our deposit. The fund has been used for low interest loans to SMEs engaging in five business areas including start-up, small business, and medical care in Daejeon-si, Sejong-si, and Chungcheong-do.

Shared Value Creation by Conducting CSR Specified for Our Business

By leveraging our core competency and expertise, we are fulfilling our social responsibilities to support local communities. As part of this commitment, diverse projects have been undertaken for both smokers and non-smokers such as printing smoking etiquette pictogram on cigarette pack and improving smoking environment in public facilities. Particularly, in order to resolve the social conflicts caused by a lack of smoking areas, we have built more than 260 smoking areas in multi-purpose facilities based on consultation with local governments and public offices.

These activities contribute to creating social culture and value where smokers and non-smokers can ensure mutual respect and consideration. We also expect our business-specific CSR activities will receive a friendly and positive corporate reputation from the public.

Our Plans

We will continue to focus on creating shared value for suppliers and local communities by pursuing social and economic values simultaneously. To this end, we will actively identify what our suppliers need and what KT&G should conduct to gain competitive advantage. In addition to shared growth with our suppliers, we plan to create values that we can share with local communities around the world and actively engage in activities.



Improvement of smoking environment



Case Study Support Programs for Leaf Tobacco Farmers

KT&G is proactive in supporting domestic leaf tobacco farms by purchasing entire crops and promoting shared growth with them.

Even though we are not obliged to purchase domestic raw materials after the abolition of the manufacturing monopoly, we have purchased the entire tobacco leaf crops from domestic farms worth approximately KRW 80 billion a year. In 2018, we purchased 8,429 tons of leaf tobacco (KRW 79.98 billion) from 3,144 domestic farmers.

Meanwhile, we make the biggest contribution to raising the “Tobacco Production Stabilization Foundation” fund to help stabilize leaf tobacco production. From 2002 to 2018, a total of KRW 387.6 billion has been invested the fund, which takes up 82% of the total fund (KRW 472.5 billion) raised by manufacturers including KT&G, PM and BAT. KT&G, as a director of the foundation, actively participates in the fund operation for supports for leaf tobacco farms.

To support leaf tobacco farmers, diverse co-prosperity programs are operating. For example, we pay 30% of planned purchase amount in advance without any interest in April and May and provide them with expenses for medical checkup and scholarships for their children. From 2013 to 2018, 4,762 farmers were provided with the benefit at an amount of KRW 1.65 billion.

Through active communication with our farmers, we listen to their needs and grievances on an ongoing basis. For example, we made advanced purchase from those who have poor storage facilities. In 2018, 251 farmers benefited from this program, which represents 8% of the farmers in the same year.

KT&G will continue to listen to the voice of leaf tobacco farmers and provide them suffering from lack of workforce and aging trend with proper solutions such as volunteer works to ensure stable farming.



Volunteer work for leaf tobacco farms

Great Workplace

Employees' value creation and competency enhancement are directly connected to corporate competitiveness. This is why we should create great workplace. When employees are satisfied and respected, and able to develop their competency, the company can reach its full potential. To this end, KT&G focuses on building employee-oriented HR system, activating communication channels between the management and employees, cultivating talents, ensuring fair evaluation and compensation, and providing valuable welfare benefits.



HR Culture

KT&G People

Employees are one of the most valuable assets for our future. Placing a higher value on their future possibilities beyond current performances, KT&G strives to recruit and cultivate talented individuals who meet our core value of "I am C.E.O."



HR Management Philosophy

KT&G operates the HR management system based on a job-oriented performance evaluation. Our HR management system is operated in accordance with the CDP (Career Development Program), which contributes to enhancing individual competency and improving employees' satisfaction on their jobs. Our recruitment policy does not discriminate based on gender, academic background, region or disabilities. The diversification of recruitment methods and channels ensures diversity in our HR culture and expansion of hiring social minorities such as women, disabled, and high school graduates.

HR Philosophy



Reducing Working Hours

The company already prepared for the introduction of the 52-hour work week system in 2017 before its mandatory implementation in 2018, through which we have strived to create jobs and promote a healthy work-life balance in accordance with changes in business environment.

Distinctive programs were establishing new vacation and layoff system, using substitute workers for vacation season at sales fields, and cultivating multifunctional workforce at plants. Those have contributed to reducing working hours, stabilizing jobs, and building a job-sharing model unique to KT&G. As for the head office, the 40-hour work week system is encouraged by blocking out network in June 2018 and starting the PC shutdown system in September. Moreover, flexible work system tailored to each job was introduced to systematically manage working hours, perform reasonable rewards, and improve work efficiency through the collective bargaining in 2018.

Beyond just introducing systems, we are endeavoring to improve employees' awareness of work-life balance by running special programs such as the 1×3×5 Campaign (five things we can do to maintain a healthy work-life balance) with the aim of changing the way of working. These programs enable us to build a new working environment distinguished from traditional methods.



Work-life balance campaign poster

Employee Communication Channels

Identifying employees' complaints, demands, and expectations is an integral part of improving their job satisfaction. Active communication between the management and employees is essential for this.

KT&G has been establishing the culture of trust and stimulating in-house communication by launching the Communication and Empathy Office in 2015. We are also making our workplace more respectful and enjoyable to work by operating the Imagination Realization Committee which aims to turn imagination into reality and strengthen our corporate culture. The "Idea of KT&G" sector on the intranet plays a role as an online communication channel where employees can express their opinions.

KT&G's labor union was established in compliance with the organizing criteria of the Korea Tobacco & Ginseng Workers' Union in 1958, and 3,515 employees joined as of the end of 2018. In case of significant changes in business and organization influences on employment, both the labor and management make decisions through consultation.

Sustainable Cultivation of Talents

KT&G provides resources and support to help our employees achieve their dreams through continuous and systemic training programs. The core value internalization training is included as a mandatory module at the HR Development Center. Our regular training program consists of 10 value-based common competence training courses, 35 job training courses, and 18 leadership skill training courses. In addition, we provide various types of training programs such as online training, reading management, and mobile courses throughout the year to promote self-directed learning by standardizing our training program for each job function. We also support global talent development through internal application and selection process for graduate schools, E-MBA and overseas MBA programs.



Job training for employees' families

Transparent and Fair Evaluation and Compensation

Through the evaluation process standardized by the HR Management Policies, we evaluate the performance of our employees in an objective and transparent manner and provide compensation based on this. The results of performance and competence evaluation are used for various HR systems, and coaching and mentoring programs are also available. The evaluation results are shared with employees and used for interviews to ensure fair HR practice. To motivate our employees, we make sure that they are paid based on their performance identified through fair and transparent evaluation process. New employees are paid without discrimination based on gender and position. In 2018, the base salary of new college graduates was set to 202% of the statutory minimum wage in Korea.

Employee Welfare Benefit

We strive to provide employees with better welfare benefits to ensure their satisfaction on working environment. Our employee welfare benefit programs have been designed in view of their age, employment period, and lifecycle, and the scope of benefits covers even their family members.



Case Study

KT&G's Signature Program: C&C Leave

As part of our family-friendly initiative, we provide the C&C (Challenge & Change) leave system to motivate them to develop talents and inspire a pioneering spirit. During the leave that lasts from 6 months to 1 year, they are paid 75% to 110% of their base salary. Thanks to the C&C leave system, our employees are given opportunities to participate in overseas training and volunteer programs and develop their talents and global mindset. KT&G's unique leave system helps employees feel satisfaction on their jobs and enhance individual capability, thereby creating opportunities for mutual growth between the company and employees.



Self-development opportunities through the C&C leave program

Our Plans

At KT&G, we will continue to help our employees develop their talent and maintain a healthy work-life balance while diversifying our communication channels and building a respectful workplace culture. We will also increase the portion of remuneration based on organizational performance and individual achievement and make necessary improvements to the system in order to maximize their performance and establish a fair evaluation and compensation strategy.

Welfare Benefit Programs

| Support Area | Details |
|--------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|  Livelihood Support | <ul style="list-style-type: none"> • Housing for employees working remotely • Loan through internal welfare fund • Childcare allowance, financial support for children starting elementary/middle school, tuition for middle/high school and university • Special education fee for the disabled • Allowance for congratulations and condolences • Employee stock ownership system |
|  Medical Expense | <ul style="list-style-type: none"> • Medical check-up: for employees and their spouses on an annual basis • Medical expenses: for employees, spouses and children |
|  Leisure Activities | <ul style="list-style-type: none"> • Welfare cards: used for fitness clubs, restaurants, movies and education based on individual needs • Resort facilities: condominium and resorts facilities nationwide (e.g. Jeju, Gangwon) • Cultural activities: sporting events, SangSang Art Hall, SangSang Madang Concert • Summer vacation bonus |
|  Education & Work Life | <ul style="list-style-type: none"> • Self-development support through various internal training and education systems • 4 Social Insurance coverage • Refresh leave: 3 weeks for every 5 years of employment (vacation allowance) • Corporate club activities/sporting competition support • Operation of workplace childcare facility in Daejeon Head Office and Sintanjin Plant • The Culture Day at the Head Office • Overseas training for prospective retirees • Financial supports for competence development |
|  Childcare Assistance | <ul style="list-style-type: none"> • Educational support for children: childcare support up to 6 years of age, tuition of middle/high school student and university students • Maternity leave: KRW 1 million per month from pregnancy to birth for preventing miscarriage and premature birth • Childcare leave: up to 2 years after birth (KRW 1 million on the first year, KRW 2 million on the second year) • Leave of absence for in-house venture activities • Leave of absence for long tenured employees who want to change job |

Social Contribution

KT&G promotes social contribution based on the SangSang platform and our corporate philosophy that pursues public value. We are committed to fulfilling social responsibility as a corporate citizen to realize a society where different people live in harmony, thereby pursuing sustainable growth.



Introduction to KT&G's Social Contribution

Under the slogan "Imagine a Better Tomorrow," we carry out various social responsibility programs with a focus on our core values: "hope," "mutual growth," and "creativity." The scope of those programs extends to donation by employees, social welfare service, scholarship, culture & arts, and social responsibility projects related to our business. We will continue to focus on creative and differentiated social contribution activities.

KT&G's Social Contribution Framework

CSR Vision

Sustainable Development of the Company and Society

Slogan

Imagine a Better Tomorrow

Core Value



We work towards providing more opportunities and resources for members of society in need to promote harmony and prosperity.

We conduct our business in a responsible manner in pursuit of mutual growth with our society.

We support new artists and help university students develop skills to build a more creative, diverse cultural eco-system.

Platform



Major Projects

- Welfare Foundation:**
 - Low-income family support
 - Welfare institute support
 - Emotional support
 - Volunteer activities
- Scholarship Foundation:**
 - General scholarship
 - Specialized scholarship
 - SangSang Restart scholarship
 - Global scholarship
- SangSang Fund:**
 - Donation Market
 - Donation Petition Program
 - SangSang Together (Employee volunteer group)
- Social Responsibility:**
 - Global CSR activities
 - Improvement of smoking environment
 - Business-specific CSR
- Youth Start-up:**
 - SangSang Start-up Camp
 - SangSang Summit
 - Start-up sponsorship
- SangSang Univ.:**
 - Culture/arts program
 - Job support program
 - University students board
- SangSang Madang:**
 - New artist development
 - Supports for performance and exhibition
 - Culture/arts training

Major Beneficiaries





We established the KT&G Welfare Foundation in 2003 and KT&G Scholarship Foundation in 2008 to disseminate the culture of sharing and offer equal education opportunities to economically challenged adolescents. The KT&G Welfare Foundation provides both financial and emotional supports to socially alienated groups while the KT&G Scholarship Foundation operates a total care system covering entire courses from middle school to high school and university to help low-income students continue their study.

Welfare Foundation

With the aim of realizing an advanced welfare society, the KT&G Welfare Foundation engages in diverse contribution activities such as financial and emotional supports for low-income children, people with disabilities, and senior citizens who need social consideration and participation in addressing global social issues.

Major Programs of the KT&G Welfare Foundation

| Classification | Description | Major Programs |
|------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Low-Income Family Support | Carrying out various low-income family support programs through 8 welfare centers in Seoul and metropolitan areas. | <ul style="list-style-type: none"> • Educational support (music, art) • Nutrition improvement • Living environment improvement, etc. |
| Welfare Institution Support | Donating compact cars and facilities to social welfare institutes to help them better engage in welfare services | <ul style="list-style-type: none"> • Donation of compact car • Improvement of childcare center facilities |
| Emotional Support | Conducting various emotional support projects to improve the quality of lives for those in need | <ul style="list-style-type: none"> • SangSang Dream Picnic • Table tennis tournament for senior citizens • Senior Literature Award |
| Volunteer Works at Home and Abroad | Implementing volunteer works at home and abroad in collaboration with university volunteer clubs and our volunteer service center “& Ter” and participating in addressing global social issues | <ul style="list-style-type: none"> • Domestic: Wall painting, environmental protection for Bukhan Mt. • Overseas: Educational and healthcare center construction in Vietnam, volunteer works in Cambodia, Myanmar, and Vietnam |



Volunteer works in Cambodia

Scholarship Foundation

The KT&G Scholarship Foundation, established in 2008, has been promoting a variety of scholarship programs aimed at helping youth in need grow into healthy members of our society and become creative talents. Our scholarship programs encourage them not to abandon learning in spite of economic difficulties by offering stable educational opportunities.

Major Programs of the KT&G Scholarship Foundation

| Classification | Description | Major Programs |
|---------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| SangSang Scholarship Program | Operating a total-care scholarship program that provides tuition and financial support for middle and high school and university education to help low-income students further their educational aspirations | <ul style="list-style-type: none"> • SangSang Scholarship for middle school students • SangSang Scholarship for high school students • SangSang Scholarship for university students |
| Specialized Scholarship Program | Fostering talents in the field of culture and art, providing support for education, employment, and start-up for social independence of at-risk youth, and granting scholarships to global students in need | <ul style="list-style-type: none"> • Culture and Arts Scholarship Program • SangSang Restart Scholarship Program • Global Scholarship Program |
| Scholarship Camp | Operating the SangSang Scholarship Camp where students can gain cultural experience, listen to prestigious speakers, and get instructions for education. | <ul style="list-style-type: none"> • SangSang Scholarship Camp for high school students • SangSang Scholarship Camp for university students |



Delivery of Scholarship Certificate to Talents in Culture and Arts



KT&G is committed to promoting mutual growth with local communities. The “Youth Start-up Support,” “SangSang Fund,” and “Business-related Social Responsibility” have an intention of cooperation and co-prosperity with all members of local communities as well as direct stakeholders. The global CSR program was designed to fulfill our responsibility as a global corporate citizen.

SangSang Start-up Camp

The SangSang Start-up Camp is a full-time social innovation start-up support program offered to the youth who dream of creative entrepreneurs. This program aims to identify and cultivate start-ups who want to solve diverse social problems through innovative business solutions, thereby contributing to addressing the youth unemployment issue and creating positive impacts on our society. It provides a 14-week real start-up promotion course, consisting of 8-week introductory track and 6-week growth track, in which a coaching staff consisting of real start-up operators participate to give mentoring services. High performing teams receive financial support for commercialization, opportunities for overseas tours, office rental costs, and follow-up investment support. Moreover, KT&G plans to build a platform for start-ups in Seongsu-dong, Seoul, by 2020.



SangSang Start-up Camp

SangSang Fund

The SangSang Fund, launched in 2011, is raised by employees’ voluntary donation and the company’s 1:1 matching grant system. It is used for both supporting less fortunate class at home and abroad and solving urgent social problems. The SangSang Fund Operation Committee consisting of employees resolves the use of this fund and ensures transparent operation.

| Donation Petition | Donation Market | Other Public Services |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>We started the donation petition program in 2013 where our employees choose recipients for donation and financial supports for living and medical expenses are given to those with at least 200 likes. Over six years, approximately KRW 490 million was delivered to 49 cases.</p> | <p>The Donation Market, introduced in 2015, is a participatory donation system in which our employees choose recipients recommended by Happy Bean Foundation and KT&G Welfare Foundation. So far, we have donated KRW 2.5 billion to 454 cases with social vulnerability and overseas relief programs.</p> | <p>In 2018, the SangSang Fund was used for supports for earthquake damage recovery in Indonesia and educational facility construction in Laos. Like this, the use of this fund extends to diverse community-oriented donation activities at home and abroad.</p> |



Briquette donation

Global CSR

We have been proactive in global CSR activities to fulfill our responsibility as a global corporate citizen. Particularly, support and participate in the UN SDGs (Sustainable Development Goals) to address global issues such as poverty, environment, and housing problems in developing countries.

SangSang univ. in Indonesia

KT&G operates the SangSang univ. programs for local university students in Indonesia. Those include “SangSang Class” for sharing learning and exchange opportunities, “SangSang Volunteer” for encouraging local students to conduct volunteer works, and “SangSang Festival” for cultural exchange.

Dispatching Volunteer Group

As part of our global CSR program, we send volunteer groups to impoverished areas of developing countries including Indonesia. They work on improving living environment of local marginalized people and helping their self-reliance through educational support.

Operating Korean Language Institute

Since 2014, KT&G has been operating Korean language institutes in Indonesia in collaboration with NGOs to help local people learn Korean language and enjoy Korean culture.



Volunteer works in Indonesia



In a bid to build a more creative and diverse cultural eco-system, KT&G provides artists and university students with a place (KT&G SangSang Madang) where they can realize their imagination into reality. It has been built around Hongik University in 2007, Nonsan in 2011, and Chuncheon in 2014. The KT&G SangSang Madang offers new artists opportunities for communication with the public through performance, film, and exhibition. In addition, we operate the SangSang Univ. to help university students grow and fulfill their dreams.

SangSang Madang

Started as part of our Mecenat program in 2007, the SangSang Madang is Korea's leading multi-cultural arts venue with annual visitors of 1.8 million. The SangSang Madang Hongdae, Nonsan, Chuncheon, and Daechi Art Hall have been places of communication and exchange with unique values and characteristics. The SangSang Madang Busan is scheduled to open in 2020.

History of the SangSang Madang



SangSang Realization Festival

Flagship Programs of the SangSang Madang Project



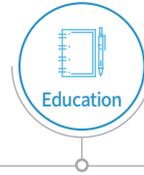
We are committed to building a music distribution platform by developing planning performance and supporting new musicians while creating a positive culture and environment for the performance industry.



By supporting the production of full-length and short films, SangSang Madang discovers promising filmmakers and hidden gems. It contributes to the development of the Korean movie industry as a whole by supporting the post-production and exhibition of films.



Serving as a contents market in the culture and art community to reflect the era of our young generations, we introduce works of new artists and designers.



SangSang Madang is a space for communication for imaginative creators, providing a variety of educational programs in culture and arts categorized into talent cultivation project, cultural and art program, and community arts program.



SangSang Madang runs a multi-brand store offering independent designer brand products and communicating their new ideas with diverse consumers.



| Musician Career Support | Indie Film Distribution Support | Photography Art Support | Indie Designers' Product Distribution Support | Original Play/Musical Performance Support | Culture Art Talent Cultivation |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------|
| We help musicians to further their career with such programs as "Surround" and "Band Discovery" where we provide support for producing music and opportunities to perform for bands. | We provide support for indie films and filmmakers with their distribution and marketing with the aim to stimulate the development of the indie filmmaking industry. | Through SKOPF (Korean Photographer's Fellowship), we support young photographers with their publication and exhibition. | Through the Korea Design Challenge for commercialization of ideas and overseas market entry, we support product development and distribution. | We support original musicals and plays with great potential through SangSang Stage Challenge. | We support culture planners and help them further their career through our culture art talent development programs. |

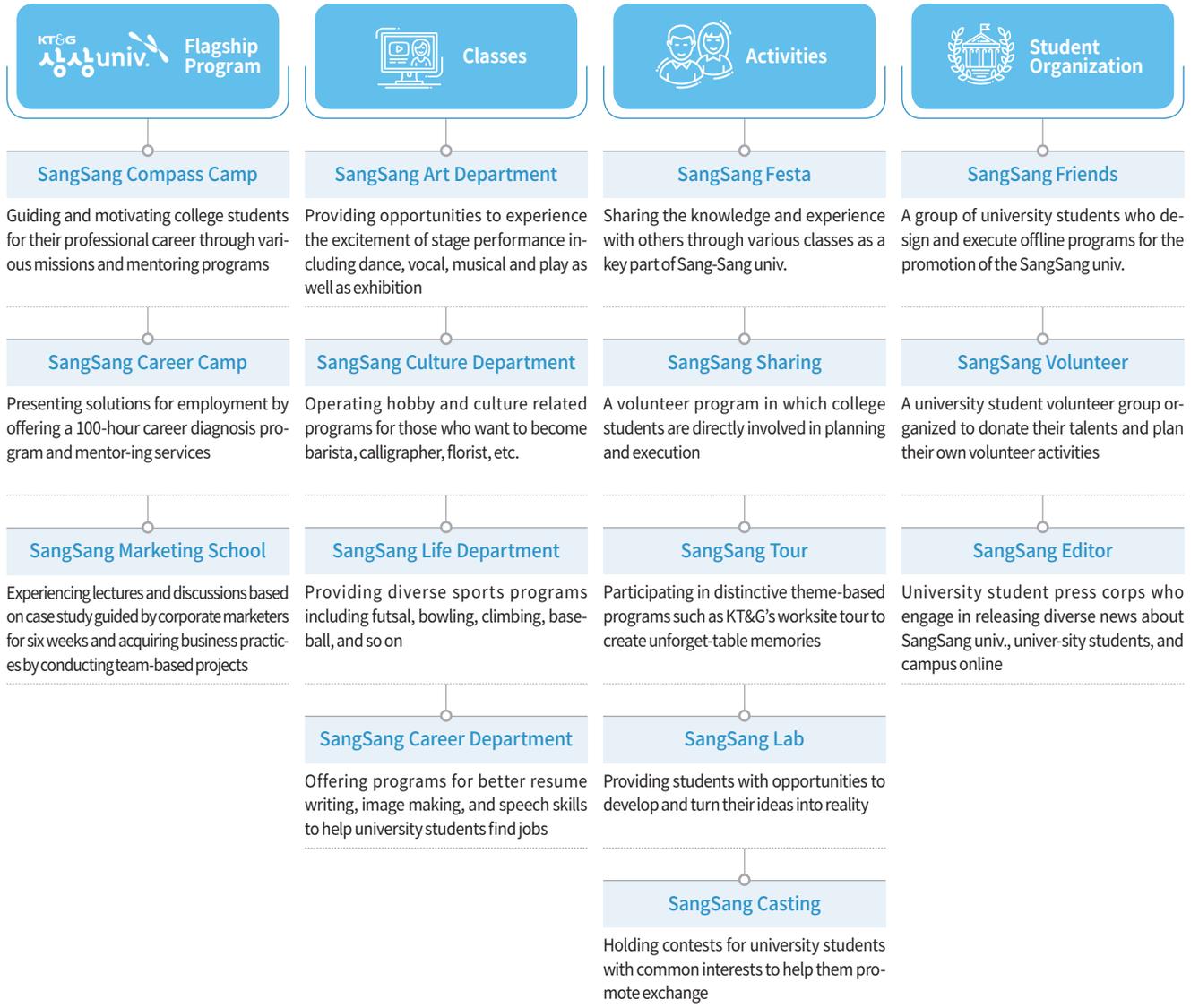


2018 SangSang Fashion Runway

SangSang univ.

The SangSang univ., one of our creative social contribution programs, started from the idea what university students need the most. It was launched as a culture and arts community for university students in 2010. The SangSang univ. provides university students with opportunities for learning, exchange, and sharing in the fields of lifestyle and career as well as culture and arts. It is growing into a valuable community where they can explore career paths and participate in volunteer works.

Major Classes and Activities of SangSang univ. and Student Organization



Our Plans

KT&G has been seeking for ways to sustain our creative social contribution activities in addition to improving existing ones. In 2020, a platform for upgrading our youth start-up support project will be completed in Seongsu-dong, which will pave the way for stimulating the "SangSang Start-up Camp" and related projects more actively and stably. Moreover, the SangSang Madang Busan, which will be completed in 2020, will play a role as a platform where local creators can demonstrate their capabilities and communicate with the public. Going forward, KT&G will make a concerted effort to build an effective and well-balanced social contribution portfolio based on sincere communication sympathy with all stakeholders.

Product Responsibility

KT&G is committed to fulfilling its product responsibilities by ensuring the safety and health of customers and ethical marketing practice and minimizing environmental impact.

Material
Issue in
2018



Enhancement of
consumer protection and
product responsibility



Customer information
protection and corporate
information security

Commitment to Products and Customers' Safety and Health

Improving Product Safety for Customers

KT&G is dedicated to improving product safety for customers. To this end, the company selects only high-quality leaf tobacco meeting the safety requirements (118 items) set by the CORESTA (Cooperation Centre for Scientific Research Relative to Tobacco) through analysis of the ingredients. We also make sure that our suppliers should pass the quality system conformity test (71 items in total) and the US FDA's safety standards. When it comes to new ingredients, we only use those that pass the safety test to put the safety of consumers as top priority. Our "lil" brands passed the KC Certification in accordance with the Electrical Appliances and Consumer Products Safety Control Act, ensuring product safety. Those are also equipped with safety devices that prevent over-voltage, over-charging, and over-discharging as well as automatic temperature controller.

Enhancing Customers' Health through Medical Research Support

KT&G supports medical research projects to offset the health hazards of its products and to improve the health of customers. As part of these efforts, we have supported public organizations that work on identifying the cause of cancers and new diagnosis and treatment since 2007.



Responsible Marketing and Labelling

Protecting Minors

As part of our business-specific social responsibility, we keep minors from using our products. To this end, age verification is required throughout our marketing channels including the brand introduction page on our website.

Other programs aimed at preventing adolescent smoking include distributing anti-smoking education materials to mental health promotion centers across the nation, supporting diverse research programs, and delivering stickers that provide information on the “Fake ID Verification ARS (1382 without area code)” to shut down the distribution channels that sell tobacco to youth.

Providing Responsible Product Information

All our products contain warnings and comply with international standards when it comes to messages that may cause confusion to consumers. All the tobacco packages and advertisements for domestic sales are labelled with warnings in accordance with the Enforcement Decree of the Tobacco Business Act and the National Health Promotion Act. For products sold overseas, we use warning labels according to local laws and regulations. We also protect the rights of consumers by indicating warning signs and disclosing the content of tar and nicotine even in the countries where it is not mandatory.

Minimizing Environmental Impact

In order to minimize environmental impact of our products, we have used paper for all product packaging since 2014. Replacing vinyl with paper is part of our initiative for eco-friendly product development. We also use recycled pulp for 20% of the materials, reducing annual consumption by 1,500 tons.

Our Plans

To ensure the safety and health of our customers, we plan to analyze the impact of our products and take necessary measures based on the results. In addition to raising awareness of health hazards, we will stop minors from accessing our products and fulfill our responsibilities in marketing practices. We will also expand our environmental responsibilities throughout the value chain, from production and packaging through to disposal.



Check on labelling warnings on cigarette packs

FINANCIAL & NON-FINANCIAL STATEMENT

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ESG Performance | Diagnosis and Analysis of ESG Performances

Separate Statements of Financial Position

(Unit: KRW in millions)

| | 2018 | 2017 | 2016 |
|-------------------------------------------------------|-----------|-----------|-----------|
| Assets | | | |
| Current assets | 4,418,632 | 4,688,299 | 4,782,329 |
| Cash and cash equivalents | 748,123 | 589,766 | 528,372 |
| Current other financial assets | 570,000 | 2,047,686 | 1,787,569 |
| Current fair value through profit or loss | 1,139,705 | - | - |
| Financial derivatives | 1,239 | - | - |
| Trade and other receivables | 730,895 | 898,211 | 1,086,301 |
| Current available-for-sale financial assets | - | - | 1,500 |
| Inventories | 954,678 | 872,391 | 911,169 |
| Refund asset | 422 | - | - |
| Accrued tobacco excise and other taxes | 218,210 | 255,822 | 439,413 |
| Advance payments | 18,377 | 20,259 | 22,272 |
| Prepaid expenses | 9,190 | 4,163 | 5,732 |
| Assets held for sale | 27,794 | - | - |
| Non-current assets | 4,311,284 | 3,992,119 | 3,686,484 |
| Other long-term financial assets | 6,937 | 6,340 | - |
| Long-term deposits in MSA Escrow Fund | 615,528 | 510,223 | 503,592 |
| Fair value through profit or loss | 210,655 | - | - |
| Long-term trade and other receivables | 119,288 | 131,132 | 115,109 |
| Fair value through other comprehensive income or loss | 230,545 | - | - |
| Available-for-sale financial assets | - | 454,051 | 364,305 |
| Investments in associates and joint ventures | 77,430 | 51,930 | 58,230 |
| Investments in subsidiaries | 1,185,361 | 1,208,228 | 1,154,925 |
| Property, plant and equipment | 1,200,907 | 1,171,775 | 1,039,955 |
| Intangible assets | 31,329 | 27,235 | 28,928 |
| Investment property | 606,679 | 426,621 | 416,043 |
| Long-term advance payments | 9,511 | - | - |
| Long-term prepaid expenses | 7,267 | 4,582 | 5,397 |
| Deferred income tax assets | 9,846 | - | - |
| Total assets | 8,729,916 | 8,680,418 | 8,468,812 |
| Liabilities | | | |
| Current liabilities | 1,289,018 | 1,456,484 | 1,762,299 |
| Short-term borrowings | 1,246 | 1,959 | 3,851 |
| Trade and other payables | 398,083 | 392,042 | 436,270 |
| Derivative liabilities | 461 | - | - |
| Advance receipts | 161,629 | 1,801 | 972 |
| Current provision | 6,455 | - | - |
| Income tax payable | 169,266 | 145,929 | 174,192 |
| Tobacco excise and other taxes payable | 551,878 | 914,754 | 1,147,015 |
| Non-current liabilities | 75,676 | 80,377 | 127,616 |
| Long-term trade and other payable | 39,152 | 21,655 | 6,848 |
| Long-term advance receipts | 702 | 582 | 319 |
| Net defined benefit liability | 34,837 | 19,084 | 47,121 |
| Provision | 985 | 3,086 | - |
| Deferred income tax liabilities | - | 35,969 | 73,328 |
| Total liabilities | 1,364,694 | 1,536,861 | 1,889,915 |
| Equity | | | |
| Ordinary shares | 954,959 | 954,959 | 954,959 |
| Other capital surplus | 3,582 | 3,582 | 3,582 |
| Treasury shares | -328,157 | -328,157 | -328,157 |
| Gain on sale of treasury shares | 513,776 | 513,776 | 513,776 |
| Reserve | 5,430,034 | 5,009,301 | 4,366,268 |
| Retained earnings | 791,027 | 990,096 | 1,068,469 |
| Total equity | 7,365,221 | 7,143,557 | 6,578,898 |
| Total liabilities and equity | 8,729,916 | 8,680,418 | 8,468,812 |

Separate Statements of Comprehensive Income

(Unit: KRW in millions)

| | 2018 | 2017 | 2016 |
|------------------------------------------------------------------------------------|-----------|-----------|-----------|
| Sales | 2,624,616 | 3,000,088 | 2,968,175 |
| Manufacture of tobacco | 2,374,432 | 2,672,324 | 2,670,305 |
| Real estate | 175,953 | 190,003 | 184,734 |
| Exports of leaf tobacco and others | 74,231 | 137,761 | 113,136 |
| Cost of sales | 977,356 | 1,098,562 | 1,048,119 |
| Manufacture of tobacco | 860,210 | 883,887 | 861,301 |
| Real estate | 59,829 | 123,051 | 118,427 |
| Exports of leaf tobacco and others | 57,317 | 91,625 | 68,390 |
| Gross profit | 1,647,260 | 1,901,525 | 1,920,056 |
| Selling, general and administrative expenses | 642,828 | 656,678 | 614,979 |
| Operating profit | 1,004,431 | 1,244,848 | 1,305,077 |
| Other income | 132,579 | 118,401 | 126,578 |
| Other expense | 140,273 | 241,886 | 91,848 |
| Finance income | 148,423 | 137,000 | 69,493 |
| Cost of finance | 1,233 | 19,465 | 8,936 |
| Profit before income tax | 1,143,927 | 1,238,897 | 1,400,365 |
| Income tax expense | 302,981 | 264,001 | 313,017 |
| Profit for the year | 840,947 | 974,896 | 1,087,347 |
| Other comprehensive income (loss) after income tax | -47,063 | 44,317 | -4,679 |
| Items that will not be reclassified to profit or loss | -47,063 | 15,200 | -18,878 |
| Remeasurements of net defined benefit liability | -19,379 | 15,200 | -18,878 |
| Gain or loss on valuation of fair value through other comprehensive income or loss | -27,684 | - | - |
| Items that are or may be reclassified subsequently to profit or loss | - | 29,118 | 14,199 |
| Gain or loss on valuation of available-for-sale financial assets | - | 29,118 | 14,199 |
| Total comprehensive income for the year | 793,884 | 1,019,214 | 1,082,668 |
| Earnings per share | | | |
| Basic and diluted | 6,660 | 7,721 | 8,618 |

Separate Statements of Changes in Equity

(Unit: KRW in millions)

| | Ordinary shares | Other capital surplus (deficit) | Treasury shares | Gains on sale of treasury shares | Reserve | Retained earnings | Total equity |
|---------------------------------------------------------|-----------------|---------------------------------|-----------------|----------------------------------|-----------|-------------------|--------------|
| Balance at January 1, 2016 | 954,959 | 3,582 | -337,062 | 494,648 | 3,784,467 | 995,887 | 5,896,481 |
| Effect of change in accounting policy | - | - | - | - | - | - | - |
| Profit for the year | - | - | - | - | - | 1,087,347 | 1,087,347 |
| Other comprehensive income (loss) for the year | - | - | - | - | 14,199 | -18,878 | -4,679 |
| Dividends | - | - | - | - | - | -428,284 | -428,284 |
| Increase (decrease) from transaction of treasury shares | - | - | 8,905 | 19,128 | - | - | 28,032 |
| Increase (decrease) from disposal of retained earnings | - | - | - | - | 567,602 | -567,602 | - |
| Balance at December 31, 2016 | 954,959 | 3,582 | -328,157 | 513,776 | 4,366,268 | 1,068,469 | 6,578,898 |
| Balance at January 1, 2017 | 954,959 | 3,582 | -328,157 | 513,776 | 4,366,268 | 1,068,469 | 6,578,898 |
| Effect of change in accounting policy | - | - | - | - | - | - | - |
| Profit for the year | - | - | - | - | - | 974,896 | 974,896 |
| Other comprehensive income (loss) for the year | - | - | - | - | 29,118 | 15,200 | 44,317 |
| Dividends | - | - | - | - | - | -454,554 | -454,554 |
| Increase (decrease) from transaction of treasury shares | - | - | - | - | - | - | - |
| Increase (decrease) from disposal of retained earnings | - | - | - | - | 613,915 | 613,915 | - |
| Balance at December 31, 2017 | 954,959 | 3,582 | -328,157 | 513,776 | 5,009,301 | 990,096 | 7,143,557 |
| Balance at January 1, 2018 | 954,959 | 3,582 | -328,157 | 513,776 | 5,009,301 | 990,096 | 7,143,557 |
| Effect of change in accounting policy | - | - | - | - | -36,766 | -30,393 | -67,159 |
| Profit for the year | - | - | - | - | - | 840,947 | 840,947 |
| Other comprehensive income (loss) for the year | - | - | - | - | -27,536 | -19,527 | -47,063 |
| Dividends | - | - | - | - | - | -505,061 | -505,061 |
| Increase (decrease) from transaction of treasury shares | - | - | - | - | - | - | - |
| Increase (decrease) from disposal of retained earnings | - | - | - | - | 485,036 | -485,036 | - |
| Balance at December 31, 2018 | 954,959 | 3,582 | -328,157 | 513,776 | 5,430,034 | 791,027 | 7,365,221 |

Separate Statements of Cash Flows

(Unit: KRW in millions)

| | 2018 | 2017 | 2016 |
|-------------------------------------------------------------------|----------|-----------|-----------|
| Cash flows from operating activities | 658,309 | 1,105,185 | 1,352,145 |
| Cash generated from operations | 942,379 | 1,444,909 | 1,694,203 |
| Income tax paid | -284,070 | -339,724 | -342,058 |
| Cash flows from investing activities | 5,526 | -588,918 | -603,818 |
| Interest received | 10,113 | 44,984 | 34,270 |
| Dividends received | 79,498 | 90,252 | 18,395 |
| Proceeds from sale of property, plant and equipment | 30,355 | 4,288 | 15,360 |
| Proceeds from sales of intangible assets | 551 | 1,350 | 476 |
| Disposal of fair value through profit or loss | 817,327 | - | - |
| Disposal of fair value through other comprehensive income or loss | 1,153 | - | - |
| Proceeds from sale of non-current assets held for sale | - | - | 5,800 |
| Disposal of available-for-sale financial assets | - | 22,600 | 33,988 |
| Disposal of investment in associated company | 5,025 | 7,319 | 13,095 |
| Disposal of investment in subsidiary | - | 17,724 | - |
| Collection of loans | 18,924 | 13,245 | 13,167 |
| Withdrawal of guarantee deposits | 108 | 4,889 | 12,083 |
| Acquisition of property, plant and equipment | -344,250 | -247,395 | -118,665 |
| Acquisition of intangible assets | -4,919 | -2,000 | -6,910 |
| Acquisition of subsidiary | -44,570 | -97,202 | -3,065 |
| Acquisition of associated company | -30,500 | -1,000 | -19,000 |
| Acquisition of available-for-sale financial assets | - | -89,613 | -31,000 |
| Acquisition of fair value through profit or loss | -62,500 | - | - |
| Increase in loans | -5,791 | -9,809 | - |
| Increase in guarantee deposits | -2,000 | -5,474 | -18,014 |
| Increase in long-term deposits in MSA Escrow Fund | -72,399 | -72,040 | -89,663 |
| Increase in other financial assets, net | -390,597 | -271,036 | -464,134 |
| Cash flows from financing activities: | -505,061 | -454,554 | -428,284 |
| Payments of dividends | -505,061 | -454,554 | -428,284 |
| Effect of exchange rate fluctuation on cash held | -417 | -318 | 182 |
| Net increase in cash and cash equivalents | 158,357 | 61,394 | 320,225 |
| Cash and cash equivalents at January 1 | 589,766 | 528,372 | 208,147 |
| Cash and cash equivalents at December 31 | 748,123 | 589,766 | 528,372 |

Management's Discussion & Analysis

Principle

The MD&A (Management's Discussion & Analysis) was prepared to easily compare financial position and operating performance in 2018 with those of the previous year in accordance with the Korean International Financial Reporting Standards (K-IFRS). It should be construed in comparison to the financial statements approved at the general shareholders' meeting on March 29, 2019 after being audited by the independent auditors. All amount was expressed in Korean won. In this section, KT&G does not include consolidated subsidiaries.

Operating Performance

Sales

Our sales in 2018 stood at KRW 2.62 trillion.

Sales breakdown

(KRW in billions)

| Classification | 2018 | 2017 | Change | % change |
|----------------------------|---------|---------|--------|----------|
| Sales | 2,624.6 | 3,000.1 | -375.5 | -12.5 |
| Domestic | 1,837.8 | 1,793.8 | 39.6 | 2.2 |
| Export | 536.6 | 878.5 | -341.9 | -38.9 |
| Others (real estate, etc.) | 250.2 | 323.3 | -73.1 | -22.6 |

Profit

Sales decreased 12.5% from the previous year to KRW 2.62 trillion in 2018. Operating profit and net profit also decreased 19.3% and 13.7% year-on-year to KRW 1.00 trillion and KRW 840.9 billion, respectively.

Summarized income statements

(KRW in billions)

| Classification | 2018 | 2017 | Change | % change |
|-----------------------------------|---------|---------|--------|----------|
| Sales | 2,624.6 | 3,000.1 | -375.5 | -12.5 |
| Cost of sales | 977.4 | 1,098.6 | -121.2 | -11.0 |
| Gross profit | 1,647.2 | 1,901.5 | -254.3 | -13.4 |
| Sales and administrative expenses | 642.8 | 656.7 | -13.9 | -2.1 |
| Operating profit | 1,004.4 | 1,244.8 | -240.4 | -19.3 |
| Net profit | 840.9 | 974.9 | -134.0 | -13.7 |

Sales and administrative expenses

Sales and administrative expenses fell by KRW 13.9 billion from the previous year to KRW 642.8 billion in 2018 due to the decrease of transportation and storage costs despite the increase of wage.

Breakdown of sales and administrative expenses

(KRW in billions)

| Classification | 2018 | 2017 | Change | % change |
|-----------------------------------|-------|-------|--------|----------|
| Wage | 244.6 | 232.6 | 12.0 | 5.2% |
| Retirement and dismissal benefits | 23.9 | 24.1 | -0.2 | -0.8% |
| Welfare benefits | 37.0 | 42.7 | -5.7 | -13.3% |
| Advertising costs | 100.6 | 104.7 | -4.1 | -3.9% |
| Commissions | 90.5 | 94.5 | -4.0 | -4.2% |
| Depreciation costs | 32.5 | 33.4 | -0.9 | -2.7% |
| Other expenses | 113.7 | 124.7 | -11.0 | -8.8% |
| Total | 642.8 | 656.7 | -13.9 | -2.1% |

Financial Position

Assets

Total assets at the end of 2018 grew 0.6% from the previous year to KRW 8.73 trillion. Current assets decreased 5.8% to KRW 4.42 trillion. Cash and cash equivalents and inventory rose by 26.8% and 9.4%, respectively, while trade and other receivables, tobacco excise tax, and others decreased 18.6% and 14.7%, respectively. Non-current assets grew 8.0% year-on-year to KRW 4.31 trillion due to the increase of 2.5% and 42.2% in property, plant and equipment and investment property in spite of decrease of 9.0% and 1.9% in long-term trade receivables and investment in subsidiaries, respectively.

Liabilities

Total liabilities in 2018 were KRW 1.36 trillion, down 11.2% from the previous year. Current liabilities decreased 11.5% to KRW 1.29 trillion due mainly to the decreases of 39.7% in tobacco excise payable. Provision and deferred income tax liabilities decreased 68.1% and 100%, respectively, which mainly affected 5.8% decrease of non-current liabilities to KRW 75.7 billion in 2018.

Summarized financial position

(KRW in billions)

| Classification | 2018 | 2017 | Change | % change |
|-----------------------------|---------|---------|--------|----------|
| Total assets | 8,729.9 | 8,680.4 | 49.5 | 0.6 |
| Current assets | 4,418.6 | 4,688.3 | -269.7 | -5.8 |
| Cash and cash equivalents | 748.1 | 589.8 | 158.3 | 26.8 |
| Trade and other receivables | 730.9 | 898.2 | -167.3 | -18.6 |
| Others | 2,939.6 | 3,200.3 | -260.7 | -8.1 |
| Non-current assets | 4,311.3 | 3,992.1 | 319.2 | 8.0 |
| Total liabilities | 1,364.7 | 1,536.9 | -172.2 | -11.2 |
| Current liabilities | 1,289.0 | 1,456.5 | -167.5 | -11.5 |
| Non-current liabilities | 75.7 | 80.4 | -4.7 | -5.8 |
| Total equity | 7,365.2 | 7,143.5 | 221.7 | 3.1 |
| Debt-to-equity (%) | 18.5 | 21.5 | - | -3.0%p |
| ROA (%) | 9.6 | 11.2 | - | -1.6%p |
| ROE (%) | 11.4 | 13.6 | - | -2.2%p |

Cash Flows

Cash and cash equivalents at the end of 2018 rose 26.8% from the previous year to KRW 748.1 billion. Cash flows from operating activities fell by 40.4% year-on-year to KRW 658.3 billion due mainly to the decreases of KRW 133.9 billion in net profit, increase of inventory, and decrease of tobacco excise tax. Cash flows from investing activities were KRW 5.5 billion due to the increase of disposal of fair value through profit or loss and decrease of investments in subsidiaries. Cash flows from financing activities were minus KRW 505.1 billion due mainly to dividend payment.

Summarized cash flows

(KRW in billions)

| Classification | 2018 | 2017 | Change | % change |
|----------------------------------------------------|--------|---------|--------|----------|
| Cash flows from operating activities | 658.3 | 1,105.2 | -446.9 | -40.4 |
| Cash flows from investing activities | 5.5 | -588.9 | 594.4 | 100.9 |
| Cash flows from financing activities | -505.1 | -454.6 | -50.5 | 11.1 |
| Effect of exchange rate fluctuation on cash held | -0.4 | -0.3 | -0.1 | -33.3 |
| Cash and cash equivalents at the beginning of year | 589.8 | 528.4 | 61.4 | 11.6 |
| Cash and cash equivalents at the end of year | 748.1 | 589.8 | 158.3 | 26.8 |

Dividend

Dividend per share was KRW 4,000 in 2018 and a total of KRW 505.1 billion was paid.

Dividend payment

| Classification | Unit | 2018 | 2017 |
|--------------------|-----------------|-------|-------|
| Net profit | KRW in billions | 840.9 | 974.9 |
| Total dividends | | 505.1 | 505.1 |
| Dividend per share | KRW | 4,000 | 4,000 |

ESG Performance

Environment

| Classification | Unit | 2016 | 2017 | 2018 | |
|--------------------|---------------------|-----------------|-----------|------------|---------|
| Raw material | Purchase | KRW in millions | 324,910 | 312,329 | 282,812 |
| | Consumption | Ton | 43,273 | 43,361 | 37,405 |
| Water consumption | Ton | 384,605 | 464,573 | 469,920 | |
| Energy consumption | TJ | 1,893.15 | 1,977.34 | 2,086.28 | |
| GHG emissions | tCO ₂ eg | 94,828.92 | 99,195.84 | 103,776.35 | |
| Waste discharge | Ton | 2,368 | 2,960 | 3,571 | |

Society

| Classification | Unit | 2016 | 2017 | 2018 | |
|---------------------------------|----------------------------------------------------------------|------------------|-----------|-----------|-----------|
| Employees | No. of employees | | 4,193 | 4,183 | 4,215 |
| | Recruitment of minorities | | 138 | 136 | 137 |
| Employment and retirement | Employment | Persons | 68 | 100 | 128 |
| | Retirement | | 50 | 127 | 164 |
| Childbirth and childcare leave | No. of childbirth leave users | | 103 | 113 | 84 |
| | No. of childcare leave users | | 43 | 56 | 55 |
| Labor practice | No. of employees eligible for labor union | Persons | 4,023 | 3,981 | 4,000 |
| | No. of labor union members | | 3,552 | 3,577 | 3,515 |
| | Rate of unionization | | % | 88.3 | 90 |
| Training | Annual training costs per employee | KRW in thousands | 949 | 1,070 | 1,050 |
| | Annual training hours per employee | Hours | 104.6 | 117 | 115 |
| Performance evaluation | Ratio of performance evaluatees | % | 95.4 | 95.3 | 97.5 |
| Human rights | Employees who completed sexual harassment prevention trainings | Persons | 4,034 | 3,933 | 3,945 |
| Social contribution | Investments in social contribution | KRW in billions | 73 | 114 | 67 |
| Customer information protection | No. of customer information leakages | Cases | - | - | - |
| Ethical management | No. of disciplinary actions | Cases | 18 | 15 | 17 |
| R&D | R&D expenses | KRW in millions | 12,249 | 16,081 | 17,898 |
| | R&D performance | Cases | 45 | 63 | 54 |
| | Patents | | 106 | 156 | 222 |
| Safety | Industrial accident rate | % | 0.05% | 0.02% | 0.05% |
| | Accident frequency rate | % | 0.2366 | 0.1178 | 0.2372 |
| | Total working hours | Hours | 8,453,088 | 8,491,302 | 8,430,912 |
| | Loss days | Days | 291 | 272 | 130 |
| | Rate of loss days | % | 0.0344 | 0.0322 | 0.0154 |

Governance

| Classification | Unit | 2016 | 2017 | 2018 | |
|--------------------------------------|--------------------------------------------|-------|-------|-------|------|
| BOD | No. of the BOD meetings | Times | 21 | 13 | 17 |
| | Attendance rate of non-executive directors | % | 97.7 | 92.2 | 97.1 |
| Governance evaluation level (by CGS) | - | A+ | A | A+ | |
| Remuneration of directors | KRW in millions | 2,179 | 2,333 | 4,099 | |

Diagnosis and Analysis of ESG Performances

1. Principles

The diagnosis and analysis of ESG performances was prepared to share KT&G's performances in the fields of environment, society, and governance with both the management and stakeholders including shareholders and institutional investors. We used the following criteria for the diagnosis and analysis.

GRI (Global Reporting Initiatives) Guideline

GRI Guideline provides principles for reporting strategies, activities, performances, and plans with regard to economic, environmental, and social responsibility of a company. It helps stakeholders understand sustainability activities and performances based on aspects and indicators.

<Integrated Reporting> Framework of IIRC

This principle offers a framework how a company's corporate governance, business model, strategy, and outlook are connected with operating performances. It requires an integrated reporting of all critical financial and non-financial factors which affect a company's long-term value creation ability beyond conventional financial reporting.

UNGC (United Nations Global Compact) 10 Principles

This guideline consists of 10 principles in terms of human rights, labor, environment, and anti-corruption which should be complied for the improvement of sustainable development, ethics, and environment in the global society when a company operates businesses.

ISO 26000

The ISO 26000 is a global standard to check the compliance of corporate social responsibility. It consists of seven principles of environment, human rights, labor, corporate governance, fair business practice, consumer issue, and engagement in local communities, serving as a yardstick for CSR evaluation.

UN SDGs

The Sustainable Development Goals (SDGs) are a collection of 17 global goals set by the United Nations General Assembly in 2015 for the year 2030. We report our material sustainability issues in connection with the UN SDGs.

2. Environment

Raw materials

Leaf tobacco is core material for KT&G's products. Procured leaf tobacco goes through a process to separate stems and leaves. The next processes are producing and treating leaf tobacco and by-products and then reshaping materials for the manufacturing of cigarettes.

Purchase and consumption of raw materials

| Classification | Unit | 2016 | 2017 | 2018 |
|--------------------------------------------------------------------------|-----------------|---------|---------|---------|
| Purchase of raw materials (leaf tobacco, tobacco sheet, and by products) | KRW in millions | 324,910 | 312,329 | 282,812 |
| Consumption of raw materials | Ton | 43,273 | 43,361 | 37,405 |

Water resource

Water consumption is calculated on the basis of water charges at Sintanjin, Yeongju, Gwangju, Gimcheon, and Cheonan plants. We endeavor to reduce the emission of effluent with the principle of making wastewater discharge with little influence on ecosystem around worksites a rule. Water consumption in 2018 was 469,920 tons.

Water consumption

| Classification | Unit | 2016 | 2017 | 2018 |
|-------------------|------|---------|---------|---------|
| Water supply | | 289,115 | 365,873 | 376,274 |
| Underground water | Ton | 95,490 | 98,700 | 93,646 |
| Total | | 384,605 | 464,573 | 469,920 |

Energy consumption and GHG emissions

In order to respond to tightening regulations on energy use and GHG emissions due to climate change and global warming, KT&G is proactive in increasing energy efficiency and reducing GHG emissions. Energy sources used at five plants are classified into fuel (LNG) and electricity.

Energy consumption and GHG emissions

| Classification | | 2016 | 2017 | 2018 |
|-------------------------|-----------------------------|-----------|-----------|------------|
| Energy (TJ) | Fuel (LNG) | 571.13 | 577.76 | 616.30 |
| | Electricity | 1,322.02 | 1,399.58 | 1,457.12 |
| | Steam | - | - | 12.86 |
| | Total | 1,893.15 | 1,977.34 | 2,086.28 |
| GHG (tCO ₂) | Direct emission (Scope 1) | 30,621.32 | 31,221.58 | 33,021.69 |
| | Indirect emission (Scope 2) | 64,207.60 | 67,974.26 | 70,821.66 |
| | Total | 94,828.92 | 99,195.84 | 103,776.35 |

Waste

We strive to reduce waste emissions from business activities. As part of this, consumption of raw materials has been decreased by developing and applying technologies that reduce byproducts in the manufacturing process. We also increase the recycling rate of byproducts by securing technologies to reuse raw materials separated in the process. We identify waste emissions at five plants.

Waste emissions

| Classification | Unit | 2016 | 2017 | 2018 |
|-----------------|------|-----------|-----------|-----------|
| Waste emissions | Kg | 2,367,998 | 2,959,844 | 3,571,691 |

3. Society

Employees

As of 2018, there are a total of 4,215 employees working for KT&G (4,215 regular and 218 non-regular workers). We also continue to hire people with disabilities.

Employment of minorities

| Classification | Unit | 2016 | 2017 | 2018 |
|----------------------------|---------|------|------|------|
| Employment of the disabled | Persons | 138 | 136 | 137 |

Employment and retirement

A total of 128 new employees were recruited in 2018, which was an increase of 28% from the previous year. KT&G's recruitment process does not discriminate against nationality, gender or religion and our employment policy ensures equal treatment of all our employees.

Employment and retirement

| Classification | Unit | 2016 | 2017 | 2018 |
|---------------------|---------|------|------|------|
| No. of new recruits | Persons | 68 | 100 | 128 |
| No. of retirees | | 50 | 127 | 164 |

Childbirth and childcare leave

Childcare leave is used for helping employees cultivate their children under the age of eight or second grader at elementary school. KT&G encourages employees to use childcare leave in accordance with the Equal Employment Opportunity and Work Family Balance Assistance Act. Moreover, KT&G is committed to mitigating employees' burdens on childbirth and childcare. To this end, we operate the one-year maternity leave system, childbirth support system to celebrate their childbirth, supports for school expenses, and childcare leave program.

Childbirth and childcare leave

| Classification | Unit | 2016 | 2017 | 2018 |
|--------------------------------------------------------------|---------|------|------|------|
| No. of childbirth leave users (male) | Persons | 89 | 97 | 69 |
| No. of childbirth leave users (female) | | 14 | 16 | 15 |
| Rate of return to work after childbirth leave | % | 100 | 100 | 100 |
| No. of childcare leave users (male) | Persons | 21 | 34 | 30 |
| No. of childcare leave users (female) | | 22 | 22 | 25 |
| Rate of return to work after childcare leave (male) | % | 100 | 100 | 100 |
| Rate of return to work after childcare leave (female) | | 100 | 100 | 100 |
| Turnover rate within 12 months after return to work (male) | | 2 | 2 | 2 |
| Turnover rate within 12 months after return to work (female) | | 2 | 3 | - |

Labor practice

The freedom of association stipulated in the ILO Convention and domestic labor law is respected at KT&G. And the company strives to build a desirable labor-management culture based on trust and respect. We conduct collective bargaining every year and hold the Labor-Management Council quarterly to discuss diverse agendas including HR affairs, wage negotiation, welfare benefit, industrial safety, and social contribution.

Unionization status

| Classification | Unit | 2016 | 2017 | 2018 |
|----------------------------------------------------|---------|-------|-------|-------|
| Employees who are eligible to join the labor union | Persons | 4,023 | 3,981 | 4,000 |
| No. of labor union members | Persons | 3,552 | 3,577 | 3,515 |
| Unionization rate | % | 88.3 | 90 | 88 |

Employee training

Employees are critical assets and the base of competitiveness at KT&G. The company makes a concerted effort to create better working conditions and provides them with systematic training programs aimed at supporting career development.

Employee training

| Classification | Unit | 2016 | 2017 | 2018 |
|---------------------------------------------|------------------|--------|--------|--------|
| No. of participants (cumulative) | Persons | 22,636 | 22,138 | 25,375 |
| Annual average training expenses per capita | KRW in thousands | 949 | 1,070 | 1,050 |
| Annual average training hours per capita | Hours | 104.6 | 117 | 115 |

Performance evaluation

Employee evaluation is fairly conducted in accordance with the HR management rule. The company evaluates employees in two categories – performance and capability – and accumulated evaluation results are reflected to their promotion and incentives.

Performance evaluation results

| Classification | Unit | 2016 | 2017 | 2018 |
|--------------------------------------------------------|---------|-------|-------|-------|
| No. of employees eligible for performance evaluation | Persons | 3,778 | 3,699 | 3,707 |
| Rate of employees who completed performance evaluation | % | 95.4 | 95.3 | 97.5 |

Human rights protection

KT&G continuously monitors potential risks related to human rights at all worksite at home and abroad. In addition, to preemptively prevent disgraceful incidents and cases within the company, all employees are encouraged to obligatorily complete sexual harassment prevention programs.

Sexual harassment prevention program

| Classification | Unit | 2016 | 2017 | 2018 |
|----------------------------------------------|---------|-------|-------|-------|
| No. of trainings conducted | Times | 1 | 1 | 2 |
| No. of employees who completed the trainings | Persons | 4,034 | 3,933 | 3,945 |

Social contribution

To fulfill the role and responsibility as a corporate citizen, KT&G conducts social contribution activities based on core values of “hope”, “creativity”, and “mutual growth”. We have also established a mid to long-term social contribution plan aimed at contributing to solving social issues beyond just short-term and temporary volunteer services. Our efforts are focused on creative social contribution activities unique to KT&G.

Social contribution activities

| Classification | Unit | 2016 | 2017 | 2018 |
|-----------------------------------------------|-----------------|------|-------|------|
| Classification | | 36.9 | 174 . | 28.5 |
| Social responsibility activities ¹ | KRW in billions | 20.6 | 81.3 | 22.7 |
| Culture & art activities ² | | 15.3 | 15.2 | 15.7 |
| Scholarship and welfare foundation | | 72.8 | 113.9 | 66.9 |
| Total investments in social contribution | % | 2.5 | 3.8 | 2.5 |

¹ Social contribution activities such as SangSang Fund, sponsorships, SangSang univ., etc.

² Cultural contribution activities centered on SangSang Madang

Customer information protection

KT&G complies with personal information regulations guided by the Act on Promotion of Information and Communications Network Utilization and Information Protection, etc. and personal in-formation protection guidelines of the Ministry of the Interior and Safety. Since the setup of personal information handling principles in March 2016, we have disclosed how we use personal information and what we act to protect it. Company-wide efforts to protect personal information have resulted in zero leakage for the past five years.

Leakage of customer information

| Classification | Unit | 2016 | 2017 | 2018 |
|--------------------------------------|-------|------|------|------|
| No. of customer information leakages | Cases | - | - | - |

Ethical management

We established the Charter of Ethics, ethics regulations, and whistleblower protection guides to disseminate ethical management throughout the company. We are also proactive in monitoring ethical risks and responding to reports on unethical behaviors. Stringent measures of dismissal, suspension, wage cut, and caution are taken to prevent unethical behaviors.

Anti-corruption policy and training

| Classification | Details |
|----------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Training | Cyber training on KT&G's ethical management practice guides (Jan. 2018), Implementation of the ThinkTwice campaign and sharing of unethical cases and prevention guides (twice a year), Training for new employees about our ethical management (Apr. 2018) |

Disciplinary actions

| Classification | Unit | 2016 | 2017 | 2018 |
|----------------|-------|------|------|------|
| Dismissal | | 1 | 4 | 1 |
| Suspension | Cases | 6 | 5 | 5 |
| Wage cut | | 5 | 1 | 4 |
| Reprimand | | 6 | 5 | 5 |
| Total | | 18 | 15 | 17 |

Supply chain

KT&G pursues fair trade with suppliers to contribute to forming a healthy industrial ecosystem and improve sustainability in the supply chain. As part of that, we make early payments to our suppliers before the national holidays to help them alleviate their difficulties in capital operation. We also purchase the entire crop of leaf tobacco produced from domestic farms even though their prices are usually two to four times higher than overseas raw materials.

Early payment of purchasing costs

| Classification | Unit | 2016 | 2017 | 2018 |
|-----------------------------------|-----------------|------|------|------|
| Early payment of purchasing costs | KRW in billions | 49.8 | 46.7 | 30.5 |
| Purchase of domestic lead tobacco | KRW in billions | 88.4 | 79.7 | 80.0 |

Transaction with suppliers

| Classification | Unit | 2016 | 2017 | 2018 |
|------------------------------------|-----------------|-------|-------|-------|
| No. of domestic suppliers | Companies | 64 | 65 | 65 |
| No. of overseas suppliers | | 6 | 9 | 8 |
| Purchasing from domestic suppliers | KRW in billions | 315.4 | 325.8 | 296.1 |
| Purchasing from overseas suppliers | | 29.1 | 23.7 | 20.3 |

R&D

The company has been devoting itself to developing core and basic technologies for enhancing product competitiveness, launching new products, and improving the quality of existing products. R&D investments increased 11% from the previous year.

R&D investment

| Classification | Unit | 2016 | 2017 | 2018 |
|----------------|------------------|------------|------------|------------|
| R&D investment | KRW in thousands | 12,248,509 | 16,081,000 | 17,898,338 |
| R&D projects | Items | 45 | 63 | 54 |
| Patents | Items | 106 | 156 | 222 |

4. Corporate governance

BOD composition

KT&G's BOD is composed of eight directors, six (75%) of whom are non-executive directors. The percentage satisfies the recommendations of the KCGS's Corporate Governance Code (The majority of the BOD members should be non-executive directors) and is higher than the average of large companies in Korea (50.1% according to conglomerates' corporate governance structure data released by the Fair Trade Commission in December 2018). Moreover, KT&G stipulates that there should be a separate CEO and BOD Chairman in order to create favorable conditions where directors can freely express their opinions.

Compliance with recommendations of Corporate Governance Code

| Recommendations | Adoption | Remark |
|---------------------------------------------------------------------------------------------------|----------|-----------------------------------------------------|
| Introduction of the Charter of Corporate Governance | 0 | - |
| BOD composition (majority of non-executive directors) | 0 | 2 executive directors and 6 non-executive directors |
| Separation of the CEO and BOD Chairman, or appointment of a senior non-executive director | 0 | Separation of the CEO and BOD Chairman |
| Disclosure on BOD activities, attendance rate, and agreement on major agendas | 0 | - |
| Establishment of regulations about the roles and operational process of the BOD and subcommittees | 0 | - |
| Evaluation on the BOD activities | 0 | - |

BOD operation

In 2018, the BOD was held 17 times and the attendance rate of non-executive directors was 97.1%, an increase of 5%p from the previous year.

BOD operation status

| Classification | Unit | 2016 | 2017 | 2018 |
|--------------------------------------------|-------|------|------|------|
| No. of the BOD meetings | Times | 21 | 13 | 17 |
| Attendance rate of non-executive directors | % | 97.7 | 92.2 | 97.1 |

Evaluation on corporate governance

KT&G has received A+ ratings in the area of Corporate Governance in the ESG (Environment, Social, Governance) evaluations conducted by KCGS for eight consecutive years since 2011.

Corporate governance rating

| Classification | 2016 | 2017 | 2018 |
|---------------------------------------|------|------|------|
| Corporate governance evaluation level | A+ | A | A+ |

Performance evaluation and remuneration

The BOD remuneration is set up annually by evaluating quantitative indices consisting of sales, operating profit, domestic M/S, etc. and qualitative ones in terms of new growth engines, infrastructure innovation of the Group, and transparent and ethical management. Remuneration limit is decided at the general shareholders' meeting and payment is fairly conducted in accordance with regulations. Individual remuneration over KRW 500 million is disclosed on the business report according to the revised law since 2014.

Payment of the BOD remuneration

| Classification | Unit | 2016 | 2017 | 2018 |
|------------------------------|-----------------|-------|-------|-------|
| Total amount of remuneration | KRW in millions | 2,179 | 2,333 | 4,099 |

APPENDIX

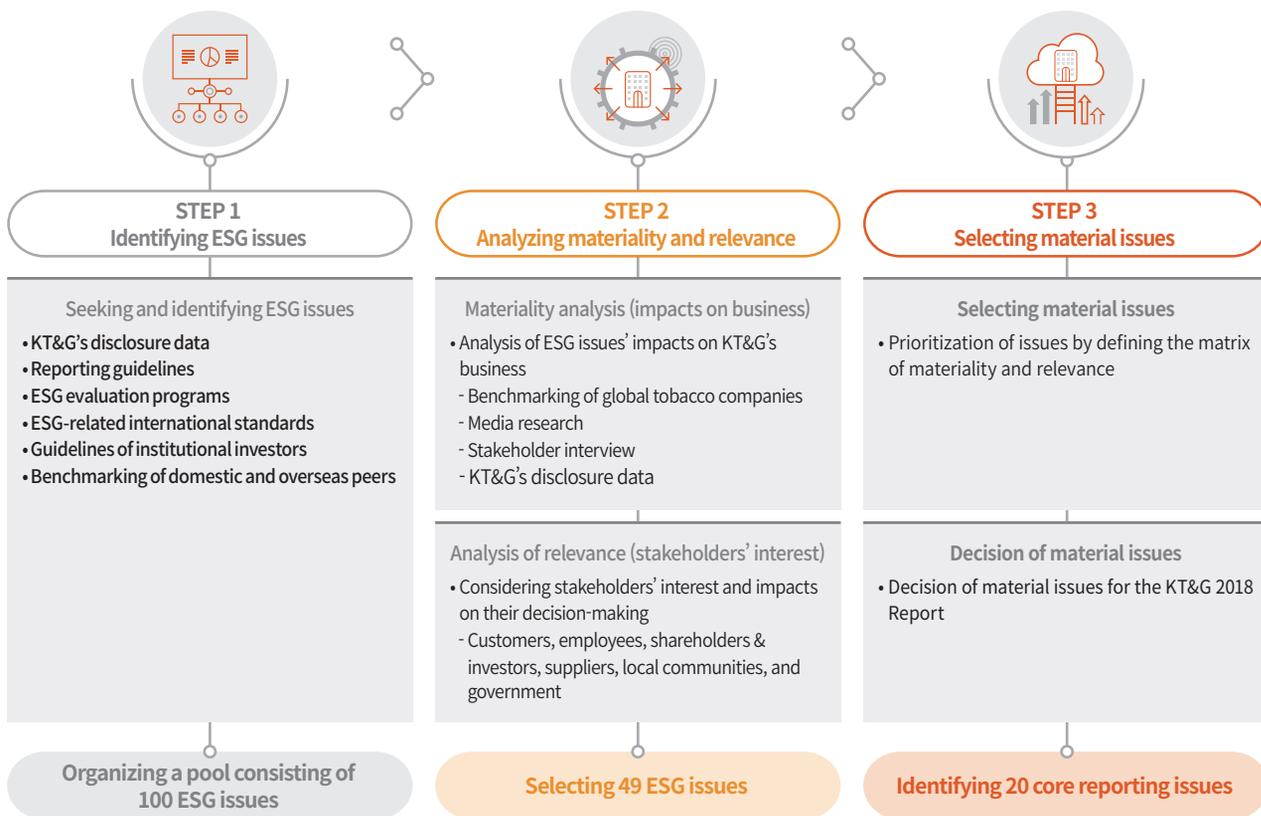
- 82 Identification of Reporting Contents
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- 91 Independent Assurance Statement

Identification of Reporting Contents

Identification of ESG issues

KT&G reports material issues which affect the company's value creation and long-term performances through materiality analysis. This process helps us identify our sustainability management activities' impacts on stakeholders and establish guides for systematic control of those issues. To identify ESG issues, we have analyzed the GRI (Global Reporting Initiative) Standards, domestic and foreign ESC disclosure guidelines, ESG evaluation items, investment criteria of institutional investors, international standards for corporate social responsibility, and disclosures of KT&G and peers. The identified issues were prioritized by the impacts on KT&G's business and impacts on stakeholders' decision-making and evaluation, through which a total of 20 material issues were selected for reporting.

ESG issue identification process



Material issues were selected by considering the magnitude of each issue's impact on our value creation. We also applied importance and relevance to the judgment of the magnitude of each issue.

- Importance: Comprehensively considering characteristics, degree, and frequency of each issue which affects KT&G's management activities
- Relevance: Comprehensively considering characteristics, degree, and sustainability of each issue which affects stakeholders' decision-making

2018 Materiality Analysis

The identified ESG issues were reported by matching with our management principles of “Upright Company,” “A Company That Is Awake,” and “A Company That Shares with Customers.” As a result of materiality analysis, “Healthy Corporate Governance” and “Internalization of Ethical Management” were selected as the most material issues in the aspects of “Upright Company” and “Product Innovation,” “Reduction of GHG Emissions,” and “Improvement of Energy Efficiency” were selected as the most material issues in the aspects of “A Company That Is Awake.” “Work-Life Balance” was the most material issues in the aspects of “A Company That Shares with Customers.”



GRI Standards Index

| Aspect | GRI No. | Core | Index Description | Page | Comments |
|----------------------------|---------|------|-------------------------------------------------------------------------------|-------------------|----------|
| Universal Standards | | | | | |
| | 102-01 | Core | Name of the organization | 6 | |
| | 102-02 | Core | Activities, brands, products, and services | 10, 14-19 | |
| | 102-03 | Core | Location of headquarters | 6 | |
| | 102-04 | Core | Location of operations | 6, 11 | |
| | 102-05 | Core | Ownership and legal form | 6 | |
| | 102-06 | Core | Markets served | 11, 14-19 | |
| Organizational Profile | 102-07 | Core | Scale of the organization | 6, 11 | |
| | 102-08 | Core | Information on employees and other workers | 74 | |
| | 102-09 | Core | Supply chain | 49, 79 | |
| | 102-10 | Core | Significant changes to the organization and its supply chain | 14-19, 83 | |
| | 102-11 | Core | Precautionary Principle or approach | 34-35 | |
| | 102-12 | Core | External initiatives | 86, 87 | |
| | 102-13 | Core | Membership of associations | 86 | |
| Strategy | 102-14 | Core | Statement from senior decision-maker | 4-5 | |
| | 102-15 | Core | Key impacts, risks, and opportunities | 8-9, 14-19 | |
| Ethics and integrity | 102-16 | Core | Values, principles, standards, and norms of behavior | 7, 20-21 | |
| | 102-17 | | Mechanisms for advice and concerns about ethics | 28-30 | |
| | 102-18 | Core | Governance structure | 23-27 | |
| | 102-19 | | Delegating authority | 23-27 | |
| | 102-20 | | Executive-level responsibility for economic, environmental, and social topics | 4-5, 23-27 | |
| | 102-21 | | Consulting stakeholders on economic, environmental, and social topics | 36-37 | |
| | 102-22 | | Composition of the highest governance body and its committees | 23-27 | |
| | 102-23 | | Chair of the highest governance body | 23 | |
| | 102-24 | | Nominating and selecting the highest governance body | 23-24 | |
| | 102-26 | | Role of highest governance body in setting purpose, values, and strategy | 23-27 | |
| Governance | 102-27 | | Collective knowledge of highest governance body | 27 | |
| | 102-28 | | Evaluating the highest governance body's performance | 26 | |
| | 102-29 | | Identifying and managing economic, environmental, and social impacts | 82-83 | |
| | 102-30 | | Effectiveness of risk management processes | 34-35 | |
| | 102-31 | | Review of economic, environmental, and social topics | 82-83 | |
| | 102-33 | | Communicating critical concerns | 82-83 | |
| | 102-35 | | Remuneration policies | 26 | |
| | 102-36 | | Process for determining remuneration | 26 | |
| | 102-37 | | Stakeholders' involvement in remuneration | 26 | |
| | 102-40 | Core | List of stakeholder groups | 36-37 | |
| Stakeholder engagement | 102-41 | Core | Collective bargaining agreements | 74, 77 | |
| | 102-42 | Core | Identifying and selecting stakeholders | 36-37 | |
| | 102-43 | Core | Approach to stakeholder engagement | 36-37 | |
| | 102-44 | Core | Key topics and concerns raised | 82-83 | |
| | 102-45 | Core | Entities included in the consolidated financial statements | 10, 14-19 | |
| Reporting practice | 102-46 | Core | Defining report content and topic Boundaries | 82-83 | |
| | 102-47 | Core | List of material topics | 82-83 | |
| | 102-48 | Core | Restatements of information | N/A | |
| | 102-49 | Core | Changes in reporting | 82-83 | |
| | 102-50 | Core | Reporting period | About this report | |

| Aspect | GRI No. | Core | Index Description | Page | Comments |
|---------------------------------|---------|------|----------------------------------------------------------------------------------------------------|--------------------------|----------|
| Reporting practice | 102-51 | Core | Date of most recent report | About this report | |
| | 102-52 | Core | Reporting cycle | About this report | |
| | 102-53 | Core | Contact point for questions regarding the report | About this report | |
| | 102-54 | Core | Claims of reporting in accordance with the GRI Standards | 75 | |
| | 102-55 | Core | GRI content index | 84-85 | |
| | 102-56 | Core | External assurance | 91-92 | |
| Topic-specific Standards | | | | | |
| Economic | | | | | |
| Management Approach | 103-01 | | Explanation of the material topic and its Boundary | About this report, 82-83 | |
| | 103-02 | | The management approach and its components | 14-19 | |
| | 103-03 | | Evaluation of the management approach | 14-19 | |
| Economic Performance | 201-01 | | Direct economic value generated and distributed | 8-9, 14-19 | |
| Market Presence | 202-02 | | Proportion of senior management hired from the local community | 11 | |
| Indirect Economic Impacts | 203-02 | | Significant indirect economic impacts | 8-9, 14-19 | |
| Procurement Practices | 204-01 | | Proportion of spending on local suppliers | 79 | |
| Anti-corruption | 205-03 | | Confirmed incidents of corruption and actions taken | 79 | |
| Environmental | | | | | |
| Management Approach | 103-01 | | Explanation of the material topic and its Boundary | 8-9, 14-19 | |
| | 103-02 | | The management approach and its components | 44-47 | |
| | 103-03 | | Evaluation of the management approach | 44-47 | |
| Energy | 302-01 | | Energy consumption within the organization | 76 | |
| | 302-04 | | Reduction of energy consumption | 8-9 | |
| Water and Effluents | 303-01 | | Interactions with water as a shared resource | 76 | |
| | 305-01 | | Direct (Scope 1) GHG emissions | 76 | |
| Emissions | 305-02 | | Energy indirect (Scope 2) GHG emissions | 76 | |
| | 305-05 | | Reduction of GHG emissions | 76 | |
| Effluents and Waste | 306-02 | | Waste by type and disposal method | 76 | |
| Social | | | | | |
| Management Approach | 103-01 | | Explanation of the material topic and its Boundary | 49, 52, 82-83 | |
| | 103-02 | | The management approach and its components | 49, 52, 82-83 | |
| Employment | 401-01 | | New employee hires and employee turnover | 77 | |
| | 401-02 | | Benefits provided to full-time employees that are not provided to temporary or part-time employees | 55 | |
| | 401-03 | | Parental leave | 77 | |
| Occupational Health and Safety | 403-06 | | Promotion of worker health | 55 | |
| Training and Education | 404-01 | | Average hours of training per year per employee | 77 | |
| | 404-02 | | Programs for upgrading employee skills and transition assistance programs | 55, 77 | |
| Diversity and Equal Opportunity | 405-01 | | Diversity of governance bodies and employees | 23-27, 76 | |
| | 405-02 | | Ratio of basic salary and remuneration of women to men | 77 | |
| Human Rights Assessment | 412-01 | | Operations that have been subject to human rights reviews or impact assessments | 78 | |
| Local Communities | 413-01 | | Operations with local community engagement, impact assessments, and development programs | 56-63 | 100% |
| Customer Health and Safety | 416-01 | | Assessment of the health and safety impacts of product and service categories | 64-65 | 100% |
| Marketing and Labeling | 417-01 | | Requirements for product and service information and labeling | 64-65 | |
| Customer Privacy | 418-01 | | Substantiated complaints concerning breaches of customer privacy and losses of customer data | N/A | |

UN Global Compact

KT&G complies with the 10 principles of the UN Global Compact in terms of human rights, labor, environment, and anti-corruption. Our activities and performances were included in the ESG performance section.



Human rights

10 Principles

Page

- | | |
|-----------------------------------------------------------------------------------------------|--------|
| 1. Companies shall support and respect protection of internationally proclaimed human rights. | 75, 78 |
| 2. Companies shall make sure that they are not complicit in human rights abuses. | 75, 78 |



Labor

10 Principles

Page

- | | |
|--------------------------------------------------------------------------------------------------------------------------|-----------|
| 3. Companies shall uphold the freedom of association and the effective recognition of the right to collective bargaining | 77 |
| 4. Companies shall uphold the elimination of all forms of forced and compulsory labor | 30 |
| 5. Companies shall uphold the effective abolition of child labor. | 30 |
| 6. Companies shall uphold the elimination of discrimination in employment and occupation. | 29-30, 76 |



Environment

10 Principles

Page

- | | |
|--------------------------------------------------------------------------------------------------|-------|
| 7. Companies shall support a precautionary approach to environmental challenges. | 44-47 |
| 8. Companies shall undertake initiatives to promote environmental responsibility. | 44-47 |
| 9. Companies shall encourage development and diffusion of environmentally friendly technologies. | 44-47 |



Anti-corruption

10 Principles

Page

- | | |
|------------------------------------------------------------------------------------------------|-------|
| 10. Companies shall work against corruption in all its forms, including extortion and bribery. | 28-31 |
|------------------------------------------------------------------------------------------------|-------|

UN SDGs

| SDGs | Priority | Policy & Direction | Major Activities | Relevant Issues | Reporting Topics |
|----------------------------------------------------------------------------------------------------------------------------------|--------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|  2 ZERO HUNGER | Mid. → High (▲) | Promote farmers' safety and health and pursue sustainable agriculture for stable income | <ul style="list-style-type: none"> Leaf tobacco farm support program Financial support for leaf tobacco farms | <ul style="list-style-type: none"> Promote farmers' safety and health Create shared value Pursue cooperation and mutual growth with local communities | <ul style="list-style-type: none"> Topic 5. Shared Value Creation (p.49-51) |
|  4 QUALITY EDUCATION | High → High (=) | Operate the welfare foundation, scholarship foundation, and diverse talents cultivation programs | <ul style="list-style-type: none"> Operate the KT&G Welfare Foundation Provide educational opportunities to low-income adolescents Offer volunteer work opportunities to university students through the SangSang univ. | <ul style="list-style-type: none"> Pursue cooperation and co-prosperity with local communities Create shared value | <ul style="list-style-type: none"> Social Contribution (p.56-63) |
|  7 AFFORDABLE AND CLEAN ENERGY | High → High (=) | Improve energy efficiency | <ul style="list-style-type: none"> Improve energy efficiency through environmental management Encourage efficient energy consumption at plants | <ul style="list-style-type: none"> Improve energy efficiency Reduce GHG emissions | <ul style="list-style-type: none"> Topic 4. Response to Climate Change_ Improving Energy Efficient (p.44-47) |
|  8 DECENT WORK AND ECONOMIC GROWTH | High → High (=) | <ul style="list-style-type: none"> Build great workplace Pursue sustainable company by internalizing healthy governance structure and ethical management | <ul style="list-style-type: none"> Build fair and transparent HR system Reduce working hours Improve welfare programs (C&C, layoff system, etc.) Enhance transparency, professionalism, and fairness of governance structure Operate ethical management programs | <ul style="list-style-type: none"> Work-life balance Secure professionalism in decision-making Transparency in the BOD composition and operation Brand and reputation management Comply with laws related to corporate information disclosure Company-wide risk management Professionalism and independence of the audit organization | <ul style="list-style-type: none"> Topic 1. Enhancement of the Soundness of Governance Structure (p.23-27) Topic 6. Great Workplace (p.52-55) |
|  10 REDUCED INEQUALITIES | Mid. → Mid. (=) | Co-prosperity and mutual growth with suppliers | <ul style="list-style-type: none"> Help suppliers strengthen their competence by offering production facilities, workforce, and technologies and build fair and transparent relationship | <ul style="list-style-type: none"> Pursue cooperation and co-prosperity with local communities | <ul style="list-style-type: none"> Topic 2. Internalization of Ethical Management_ Operation of an Integrated Purchase System (p.31) |
|  12 RESPONSIBLE CONSUMPTION AND PRODUCTION | Mid. → High (▲) | Ensure sustainability in manufacturing process and build sustainable production patterns | <ul style="list-style-type: none"> Improve energy efficiency at plants Ensure safety and health of products and customers Promote responsible marketing and labeling Enhance sustainable production patterns by minimizing environmental impacts from products | <ul style="list-style-type: none"> Improve energy efficiency Enhance consumer protection and product responsibility | <ul style="list-style-type: none"> Topic 4. Response to Climate Change_ Improving Energy Efficient (p.44-47) Product Responsibility (p.64-65) |
|  13 CLIMATE ACTION | High → High (=) | Respond to climate change through environmental management | <ul style="list-style-type: none"> Develop environmental products Promote energy efficiency and reduce GHG emissions | <ul style="list-style-type: none"> Improve energy efficiency Reduce GHG emissions Activate environmental communication | <ul style="list-style-type: none"> Topic 4. Response to Climate Change_ Improving Energy Efficient (p.44-47) |
|  16 PEACE, JUSTICE AND STRONG INSTITUTIONS | Mid. → High (▲) | Build responsible business environment and systems by enhancing fair competition and trade | <ul style="list-style-type: none"> Comply with fair competition and trade and operate independent integrated procurement system | <ul style="list-style-type: none"> Fair competition and trade Company-wide risk management Internalization of anti-corruption and ethical management | <ul style="list-style-type: none"> Topic 2. Internalization of Ethical Management_ Operation of an Integrated Purchase System (p.31) Compliance Program_ Fair Trade and Competition (p.32) |
|  17 PARTNERSHIPS FOR THE GOALS | High → High (=) | Promote cooperation by activating stakeholder communication | <ul style="list-style-type: none"> Run communication channels tailored to the characteristics of each stakeholder group | <ul style="list-style-type: none"> Cooperation and co-prosperity with local communities Internalization of anti-corruption and ethical management | <ul style="list-style-type: none"> Stakeholder Communication (p.36-37) |

Awards and Association Memberships

Awards in 2018

| No | Award | Awarded by | Background |
|----|---------------------------------------------------------------------|-------------------------------------------------------------|---------------------------------------------------------------------------|
| 01 | Appreciation Plaque for Social Contribution | Jecheon Division of the Lovely Transportation Service Corps | Contribution to the development of local communities |
| 02 | Appreciation Plaque | Jeju National University | LINC + excellent cultivation project performance |
| 03 | Appreciation Plaque | Haguil Elementary School in Jeju | Supports from the SangSang Fund |
| 04 | Meritorious Citation | Cheonan City Hall | Social contribution activities for local people |
| 05 | Award Certificate | Korea Customs Service | Compliance with tax policy |
| 06 | Best Brand in 2018 NBCI | Korea Productivity Center | No.1 brand power (ESSE) |
| 07 | 2018 K-BPI | Korea Management Association Consulting | No.1 brand power (ESSE) |
| 08 | Hall of Fame Plaque | Korea Rehabilitation Agency | Excellent social contribution for recipients of legal protection |
| 09 | Social Contribution Award | Digital Chosun Ilbo | Excellent social contribution activities for job creation |
| 10 | Co-hosting Start-up Program | Start-up Support Division of Keimyung University | Leadership in youth start-up |
| 11 | Award Certificate | Dobong-gu Office | Excellent volunteer works for communities |
| 12 | Welfare Service for Local Children | Wonseong Social Welfare Center | Excellent volunteer works for local children |
| 13 | Certificate | Korea Occupational Safety and Health Agency | Achievement of the injury record target |
| 14 | Excellent Volunteer Work Institute Award | Daegu Council on Social Welfare | Active volunteer work |
| 15 | Appreciation Certificate | 5th Infantry Division Commander | Improvement of moral condition and fighting power of soldiers |
| 16 | Appreciation Certificate | Chief of Daejeon Jungbu Police Office | Crime prevention through wall-painting volunteer works |
| 17 | CSRI Award 2017 | KUDOS IR Research Center | Best company in 2017 IR Trust Index |
| 18 | Appreciation Plaque | 26th Mechanized Infantry Division Commander | Supports for soldiers |
| 19 | Appreciation Plaque | Mipyong Girls' School under the Ministry of Justice | Valuable partnership |
| 20 | Appreciation Certificate | H2O PUMASSI | Volunteer works for children held in the National Assembly |
| 21 | Excellent Volunteer Work Institute Award | Volunteer Work Center of Yeosu-si | Excellent volunteer works for communities |
| 22 | Citation for the 2018 Hope-Sharing Campaign | Chungcheongbuk-do | Contribution to the improvement of local people's welfare |
| 23 | Appreciation Certificate | 6th Artillery Brigade Commander | Supports for soldiers |
| 24 | Appreciation Certificate | Incheon Cheongseon School | Co-development with local communities |
| 25 | Appreciation Certificate | 30th Mechanized Infantry Division Commander | Moral condition improvement of soldiers and friendship promotion |
| 26 | Excellent Social Contribution Activities | Social Contribution Information Center of Ganwon-do | Excellent volunteer works for communities |
| 27 | Career and job-related programs | Handong Global University | Operation of a career development and job-placement camp |
| 28 | Certification | Korea Occupational Safety and Health Agency | Achievement of two times of injury record target |
| 29 | Excellent NCSI in 3Q 2018 | Korea Productivity Center | No.1 NCSI in the tobacco sector |
| 30 | Citation | Minister of the Interior and Safety | Operation of the civil defense at work |
| 31 | Citation | Jisan Athletic Association | Contribution to the development of physical culture |
| 32 | ISO27001 Certification | SGS | External Audit Pass |
| 33 | Excellent Family-friendly Company | Hallym University | Offering of valuable work experience for students |
| 34 | Appreciation Plaque | Chungbuk Welfare Union for the Visually Handi-capped | Contribution to self-reliance of the visually handicapped |
| 35 | 5th Korea's Reading Management | Chairperson of the Culture, Sports, and Tourism Committee | Contribution to disseminating the culture of reading books |
| 36 | Grand Prize | University News Network | No.1 brand loved by university students (RAISON) in 2018 |
| 37 | Certification | Ministry of Culture, Sports, and Tourism | Excellent workplace in reading management |
| 38 | Grand Prize at the 9th Gwangju-Jeonnam Social Contribution Festival | Gwangnam Ilbo | Contribution to disseminating the culture of sharing to local communities |
| 39 | Appreciation Certificate | 7th Artillery Brigade Commander | Training on building upright character of soldiers |
| 40 | Excellent Social Contribution Activities | Community Chest of Jeonbuk | Excellent volunteer works for communities |
| 41 | Competence Enhancement Program | Keimyung University | Operation of SangSang Wardrobe, etc. |
| 42 | Appreciation Certificate | Gwangju Sunmyung School | Talent donation to the Paralympics for special-education students |
| 43 | Appreciation Certificate | 5th Aircraft Wing of the Air Force | Enhancement of soldiers' job competence and military lives |

| No | Award | Awarded by | Background |
|----|----------------------------------------------|-----------------------------------------------------------------------|--------------------------------------------------------------------|
| 44 | ISMS Certification | Korea Internet & Security Agency | External Audit Pass |
| 45 | Appreciation Plaque | Woosuk University | Excellence in industrial-educational cooperation |
| 46 | Certification | Korea Occupational Safety and Health Agency | Achievement of four times of injury record target |
| 47 | Appreciation Plaque | President of Hanbat National University | Cooperation with the SangSang univ. |
| 48 | Citation | Governor of Gyeongsangbuk-do | Excellent organization in volunteer works |
| 49 | Appreciation Certificate | Commander of the 3105 Unit under the 112 Regi-ment | Improvement of welfare for soldiers |
| 50 | Grand Prize at the Maekyung Ad Competition | Maekyung Media Group | High-quality corporate advertisement |
| 51 | Grand Prize at the Kukmin Ad Competition | Kookmin Ilbo | High-quality corporate advertisement |
| 52 | Appreciation Certificate | Bukgu Volunteer Service Center | Excellent volunteer works in 2018 |
| 53 | Excellent Social Contribution | Jeonbuk Council on Social Welfare | Volunteer works for local children |
| 54 | Appreciation Certificate | Chungbuk Basketball Association | Contribution to the development of sports for all |
| 55 | Appreciation Certificate | Cheongju FC | Support for the development of Cheongju FC |
| 56 | Appreciation Plaque | Cheongju Football Center | Contribution to the development of sports for all |
| 57 | Appreciation Plaque | Gangdong University | Excellence in industrial-educational cooperation |
| 58 | Excellent Social Contribution | Mayor of Jeonju-si | Excellent volunteer works |
| 59 | Excellent Social Contribution | Peace Social Welfare Center | Excellent volunteer works |
| 60 | Appreciation Plaque | Cheongju Futsal Club | Contribution to the development of sports for all |
| 61 | Appreciation Plaque | Cheongju Youth Dream Cultivation Center under the Ministry of Justice | Excellent partnership |
| 62 | Appreciation Plaque | Chungbuk Association of Persons with Physical Disabilities | Contribution to self-reliance of the disabled |
| 63 | Appreciation Certificate | Dean of Students for Employment, Korea Nazarene University | Supports for seeking jobs through a festival |
| 64 | Grand Prize at the Joongang Ad Competition | Joongang Ilbo | High-quality corporate advertisement |
| 65 | Award Certificate | Daejeon HQ of the ChildFund Korea | Donation of proceeds from a busking |
| 66 | Grand Prize at the Kyunghyang Ad Competition | Kyunghyang Daily News | High-quality corporate advertisement |
| 67 | Excellent Company | Minister of Employment and Labor | Exemplary operation of the ESOP |
| 68 | Appreciation Plaque | Creating Happy Cambodia | Supports and volunteer works through the SangSang Fund |
| 69 | Citation | Chungbuk Council on Social Welfare | Contribution to improving welfare of local communities |
| 70 | Grand Prize at the 2018 Jeju Mecenat | Jeju Mecenat Association | Contribution to local culture and arts through Mecenat activities |
| 71 | Korea Consumer Satisfaction Award | Korea Consumer Appraisal | Contribution to development of cul-ture and arts (SangSang Madang) |
| 72 | 2018 Family-friendly Company Award | Ministry of Gender Equality and Family | Excellence in family-friendly management |
| 73 | Meritorious Law and Order Award | Ministry of Justice | Contribution to the compliance with law and order |
| 74 | 2018 Volunteer Work Award | Volunteer Service Center of the Jeju Special Self-Governing Province | Contribution to the growth and sharing of local communities |

Association Membership

| Institution | Year joined | Purpose of establishment |
|-----------------------------------------|-------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Korea International Trade Associa-tion | 1989 | Helping activate trade cooperation in the private sector and establishing trade infrastructure by proposing deregulation and ideas for solving difficulties to the government |
| Korean Mecenat Association | 1994 | Promoting balanced growth of economy and culture sectors by connecting companies who want to support culture and arts and cultural organizations specializing in creative works |
| Korea Tobacco Association | 1998 | A purely civilian organization consisting of four major cigarette makers. Promoting social understanding of the tobacco business by collecting and distributing fair and objective information on cigarette. Contributing to healthy growth of the domestic tobacco business and national economy by encouraging intra-industry cooperation and coping with changes in business environment. |
| Korea Fair Competition Federation | 1999 | Serving as a bridge between the government and the industry by helping the private sector better understand the fair trade system, promoting autonomous fair competition and making suggestions to the government regarding fair trade policies |
| Korea Trade-Investment Promotion Agency | 2001 | Contributing to the development of the national economy by promoting trade, supporting investments between local and overseas corporations and promoting industrial and technological cooperation |

Third Party's Verification Statement (GHG Emissions)

Introduction

Korean Foundation for Quality (hereinafter 'KFQ') has been engaged by KT&G Corporation (hereinafter the 'Company') to independently verify its 2018 Report on Quantity of emitted Greenhouse Gas from places of Korea (hereinafter 'Inventory Report').

It is the responsibility of the Company's management to compile the Inventory Report and the emission quantity report by 'Scheme on the trading of Greenhouse Gas Emission Permits' run by the government of Korea and KFQ's responsibility is provision of opinions on the Inventory Report after verification according to ISO 14064-3 and national scheme.

Independence of Verification

KFQ has no conflict of interest with KT&G Corporation in terms of profit generation-related activities except providing third party verification service on the report. And we do not have any biased opinion on KT&G Corporation's stakeholders.

Verification Scope

KFQ's verification was focused on all of the greenhouse gas emission sources controlled by the Company's places of Korea.

Consideration and Limitation

Accuracy and completeness of emission data reported in the Report are subject to inherent limitations due to their nature and the methodology used determining, calculating and estimating such data.

Conclusion/Opinion

Based on verification process according to the ISO 14064-3, KFQ obtained reasonable basis to express the following conclusion on the greenhouse gas emission data in the Inventory Report.

- 1) The Company's 2018 Report on Quantity of emitted Greenhouse Gas was documented in accordance with 'Scheme on the trading of Greenhouse Gas Emission Permits (Notification No. 2018-73 of the Ministry of Environment)' run by the government.
- 2) According to materiality assessment on quantity of greenhouse gas emitted from every Company's places of Korea in 2018, material discrepancy is less than the criteria of 5% for an organization that emits less than 500,000tCO₂-eq in accordance with 'Scheme on the trading of Greenhouse Gas Emission Permits'.

| Report Year | Total Annual Emissions (tCO ₂ -eq) | | |
|-----------------------|-----------------------------------------------|------------------------------|-----------------|
| | Direct Emissions (Scope 1) | Indirect Emissions (Scope 2) | Total Emissions |
| 2018.1.1 ~ 2018.12.31 | 32,981 | 70,795 | 103,776 |

April 1th, 2019



CEO Seokun Yoon
Korean Foundation for Quality (KFQ)

Independent Assurance Statement

Introduction

KT&G Corporation ("KT&G") commissioned DNV GL Business Assurance Korea Ltd. ("DNV GL"), part of DNV GL Group, to undertake independent assurance of the 2018 KT&G Report (the "Report"). The directors of KT&G have sole responsibility for the preparation of the Report. The responsibility of DNV GL in performing the assurance work is to the management of KT&G in accordance with the terms of reference. DNV GL's assurance engagements are based on the assumption that the data and information provided by the client to us as part of our review have been provided in good faith.

Scope and Basis of Assurance

Based on non-financial data and sustainability activities and performance data of 2018 generated from KT&G, we have evaluated the adherence to GRI (Global Reporting Initiative) Sustainability Reporting Standards 2016 and assessed the quality of sustainability performance information. We have reviewed that the Topic-specific disclosures of GRI Standards which are identified in the process for defining report content;

| No. | Material Topic | GRI Disclosure | No. | Material Topic | GRI Disclosure |
|-----|---------------------------------|----------------|-----|-----------------------------|------------------|
| 1 | Wholesome Corporate Governance | - | 4 | Response to Climate Change | 305-1, 2, 5 |
| 2 | Compliance with Business ethics | 205-3 / 418-1 | 5 | CSV (Creating Shared Value) | 203-2 / 413-1 |
| 3 | Product Innovation | 416-1 | 6 | Great Work Place | 401-2, 3 / 403-6 |

We performed our work using DNV GL's assurance methodology VeriSustainTM1, which is based on our professional experience, international assurance best practice including International Standard on Assurance Engagements 3000 (ISAE 3000). We applied the limited level of assurance. The verification was carried out in May and July 2019. The site visits were made to KT&G Seoul Office. We undertook the following activities as part of the assurance process:

- challenged the sustainability-related statements and claims made in the Report and assessed the robustness of the underlying data management system, information flow and controls;
- interviewed representatives from the various departments;
- conducted document reviews, data sampling and interrogation of supporting databases and associated reporting systems as they relate to selected content and performance data;
- reviewed the materiality assessment report.

Limitations

The engagement excludes the sustainability management, performance and reporting practices of KT&G's subsidiaries, associated companies, suppliers, contractors and any third-parties mentioned in the Report. We did not interview external stakeholders as part of this assurance engagement. Economic performance based on the financial data is cross-checked with internal documents, the audited consolidated financial statements and the announcement disclosed at the website of Korea Financial Supervisory Service (<http://dart.fss.or.kr>) as well as KT&G's website (www.ktng.com). These documents, financial statements and the announcements are not included in this assurance engagement. Limited depth of evidence gathering including inquiry and analytical procedures and limited sampling at lower levels in the organization were applied. The baseline data for environmental and social performance are not verified, while the aggregated data at the corporate level are used for the verification. DNV GL expressly disclaims any liability or co-responsibility for any decision a person or an entity may make based on this assurance statement.

Conclusion

On the basis of the work undertaken, nothing comes to our attention to suggest that the Report does not properly describe the adherence to the Principles in GRI Standards. The verification team has observed that there is general awareness of sustainability context across all different levels of the organization. Further opinions with regards to the adherence to the following principles are made below;

Stakeholder Inclusiveness

KT&G has identified internal and external stakeholder groups such as Shareholders/Investors, Government, Local community, Employees, Suppliers and Customers. KT&G engages with the stakeholders at the company and business unit levels through various channels. The examples of approaches to engagement with selected stakeholders are described in the Report. KT&G has various business portfolios, KT&G could find communication channels that characteristics of each business stakeholders to address the reasonable expectations and interests of stakeholders and report corresponding actions taken in the Report.

¹⁾ The VeriSustain protocol is available upon request at DNV GL website. (www.dnvgl.com/assurance/reporting/verification.html)

Sustainability Context

KT&G has established ESG strategies including environment, society and governance to achieve sustainable management performance. The Report presents the vision, policy, core values and ESG strategies to help readers understand the sustainability management system. In addition, we have reviewed that the KT&G's policy for sustainable management and its key activities are also linked to the UN SDGs (Sustainable Development Goals). In the future, KT&G could quantify its sustainability goals and report its achievement and action plans depending on the timing of the report.

Materiality

KT&G has conducted the materiality assessment to prepare the Report. 'Business impact' and 'stakeholder interest' are considered during the materiality assessment, issue pools were used on internal and external stakeholder survey to rate the material topics and 6 material topics are prioritized accordingly. DNV GL has reviewed material topics that could have a significant impact on the KT&G's economic, environmental and social impacts or affect the decision-making of stakeholders in assessing materiality.

Completeness

The Report has covered the sustainability strategy, management approach and sustainability performances of KT&G for the reporting period. The reporting boundary has been set to include five domestic factories (Sintanjin, Gwangju, Yeongju, Cheonan and Kimcheon) in KT&G. Some of performances which are out of boundary have been described to help stakeholders understand in the Report. DNV GL has reviewed that the materiality assessment process and confirms relevant material topics prioritized from the process are addressed completely in the Report. As the proportion of overseas production is increasing, KT&G could consider including sustainable management performance of overseas factories to enhance the completeness of the report.

Further opinions with the principles of report quality of GRI Standards as follows;

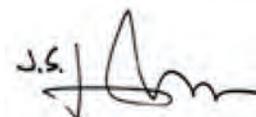
Report quality: Accuracy, Balance, Clarity, Comparability, Reliability and Timeliness

DNV GL has reviewed the quality of the report based on the 6 principles defined in the GRI Standards. We have interviewed the person-in-charge, reviewed the process of gathering and processing data and information, and the supporting documents and records. KT&G could improve the data collection process and present the sustainability performance for the last 3 years to allow for comparability over time. Any errors or misstatements identified during the assurance engagement were communicated and corrected prior to the Report being published. The information in the Report indicates the time period to which it relates.

Competence and Independence

DNV GL applies its own management standards and compliance policies for quality control, in accordance with ISO/IEC 17021:2011 - Conformity Assessment Requirements for bodies providing audit and certification of management systems, and accordingly maintains a comprehensive system of quality control, including documented policies and procedures regarding compliance with ethical requirements, professional standards and applicable legal and regulatory requirements. We have complied with the DNV GL Code of Conduct² during the assurance engagement and maintain independence where required by relevant ethical requirements. This engagement work was carried out by an independent team of sustainability assurance professionals. DNV GL was not involved in the preparation of statements or data included in the Report except for this Assurance Statement. DNV GL maintains complete impartiality toward stakeholders interviewed during the assurance process. DNV GL have no other contract with KT&G and did not provide any services to KT&G in 2019 that could compromise the independence or impartiality of our work.

July 2019
Seoul, Korea



Jang Sup Lee
Country Representative
DNV GL Business Assurance Korea Ltd.

² DNV GL Code of Conduct is available from DNV GL website (www.dnvgl.com)

