

The background features a large, light gray dotted circle. Inside this circle is a white circle containing a faint world map. A thick, multi-colored ring (blue, green, yellow, orange, red, purple) encircles the globe. Several colorful, teardrop-shaped streaks in green, orange, blue, and purple are scattered around the globe, some appearing to trail off to the edges of the frame.

2016 ANNUAL REPORT

GLOBAL MOMENTUM

With the goal to achieve stronger and sustainable growth, KT&G has set itself an ambitious target – to grow into a ‘Leading Global Company’.

In order to realize the vision, we will build global momentum by adhering to our commitment to trust, success and truth.



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FORMATS

This annual report is available in the following formats:



Print



Interactive PDF



COMPASS

This annual report is also created in interactive PDF format:



Reference Page



Web link

CEO MESSAGE

DEAR SHAREHOLDERS,

Thanks to the interest and encouragement of our shareholders, all of our business areas at KT&G achieved balanced growth in 2016, enabling us to take another step towards becoming a 'Leading global company'. All our staff combined their passion and capabilities in order to maximize our corporate value and shareholder value, resulting in a strong performance that exceeded market expectations, despite difficulties in the business environment, including uncertainty in the global economy and the ongoing downturn in the Korean economy.

Our domestic tobacco business increased its market share thanks to our honest management and distinctive product competitiveness despite intense market competition resulting from stricter regulatory policies. Our overseas tobacco business maintained growth pace, in both sales and operating profits, by actively moving into overseas markets and achieving strong performance of customized products for local markets. Furthermore, we received the 'USD 700 Million Export Tower' from the Korea International Trade Association in December 2016. Our red ginseng business recorded sales of more than KRW 1 trillion for the first time, and also the first in the entire domestic health functional food industry. Our real estate business picked up as well, with the successful grand opening of a hotel in Namdaemun and the establishment of a new management infrastructure.

Tobacco and red ginseng company in Korea, and No. 5 globally

No.1

Year-on-year increase in sales

5.2%

We strived to create social values in order to fulfill our responsibilities, as well as generating economic values. We shared our corporate success with local communities by carrying out a wide range of social contribution activities both in Korea and abroad. We also worked on strengthening our ethical mindset, to grow in the right way. In addition, we have sought to drive shareholder value and increase management transparency by continually communicating with shareholders and investors.

In 2017, the downturn in the Korean tobacco market is likely to intensify due to the full launch of comprehensive regulations, and difficult economic conditions at home and abroad. It will not be easy in non-tobacco areas, either. Nevertheless, we will respond flexibly to the changes, and continue great effort to enhance corporate value by implementing active growth strategies and improving profitability. In particular, with an aim to continue our strong growth pace, we will focus on the following strategies:

First, we will further solidify our leading position in existing businesses, including domestic tobacco, domestic red ginseng, and real estate businesses.

We will strive to increase the market share of our domestic tobacco business, and improve profitability as well, so that it can serve as a reliable foundation for the Group's overall growth. In red ginseng business, we will strengthen our competitive edge, while undertaking a diversification strategy that covers non-red ginseng health functional foods and cosmetics, thus expanding our business. In the real estate business, we will further boost our competitiveness in development, operations and investment, in order to strengthen our business structure which generates sustainable value.

We will enhance our corporate value and maintain growth momentum by staying on tack in times of change and exploring new innovation and perspectives.



Second, we will continue to grow in the global market by implementing aggressive business expansion strategies.

In the overseas tobacco business, we will focus on emerging markets which we have already entered successfully, with the aim of becoming a truly global leading company. We will quickly acquire the key technologies needed to tap into overseas markets, and expedite our advance into new markets. In the overseas red ginseng business, we will build a product line-up and marketing strategies targeted at each individual country, thus once again taking a leap forward.

Third, we will accelerate growth in healthcare business, including pharmaceuticals and cosmetics, by actively expanding market presence.

We will make extraordinary efforts to build growth momentum in pharmaceutical business by strengthening our R&D pipeline. In cosmetics, we will establish our presence in the market with a focus on building competitive brands.

In addition, we will faithfully fulfill our social responsibilities as a corporate citizen.

We will enhance value for shareholders and fulfill responsibilities as a corporate citizen through an organizational culture of communication and compassion. We will also undertake more global CSR activities, in order to solidify KT&G's position as a global company.

In 2017, KT&G will continue with the innovations and challenges needed to become a 'Leading global company'. We will respond preemptively to change, making full use of the strengths that have enabled us to continue to grow even in difficult times. In doing so, we will enhance our corporate value, and do our very best to meet your expectations. I therefore ask for your continued support and encouragement.

Thank you.

President & CEO
BAEK, BOK-IN

CORPORATE GOVERNANCE

COMPOSITION AND ROLES OF THE BOD

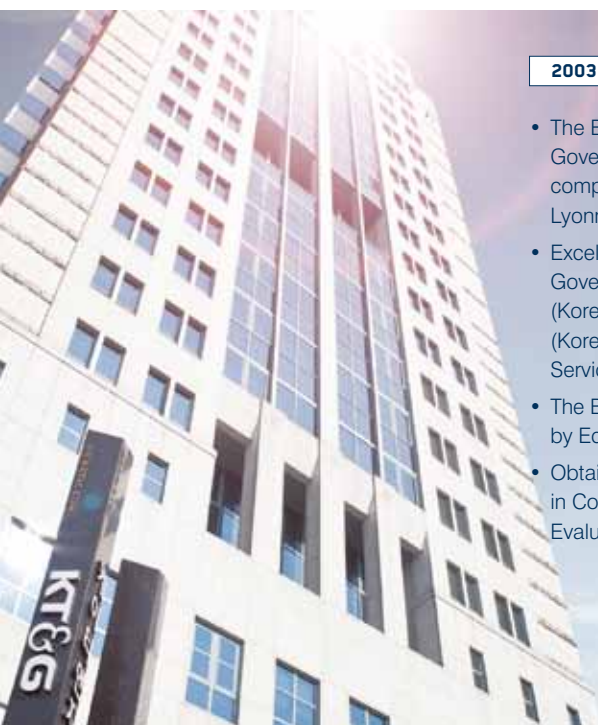
KT&G's advanced corporate governance is centered on its Board of Directors, ensuring professional, transparent management by separating ownership from management. As KT&G's top decision-making body, the BOD makes decisions on the company's financial and major management issues, as well as on matters that are delegated to the BOD by legislation and the company's articles of incorporation and regulations. The independent non-executive directors represent the interests of all shareholders and stakeholders in a balanced way through a responsible and professional management system. As of the end of March 2017, KT&G's BOD is composed of two executive directors and six independent non-executive directors. The BOD conducts a self-evaluation and individual evaluations on the year's performance at the end of each year, and analyzes and reports the results of those evaluations early the following year.

COMMITTEES UNDER THE BOD

The individual committees of the BOD are committed to stable corporate governance, and the strengthening of the BOD's expertise and transparency. In accordance with the Commercial Act, KT&G has established four standing committees: the Strategy Committee, the Investment Growth Committee, the Evaluation Committee, and the Audit Committee. There are also non-standing committees, including the Independent Non-executive Directors Candidate Recommendation Committee and the CEO Candidate Recommendation Committee. The Audit Committee and the Evaluation Committee are the BOD's internal auditors, and are therefore comprised only of independent non-executive directors, in order to ensure the transparency and credibility of the company's financial information, and to properly supervise and support management.

Strategy Committee This committee consists of two independent non-executive directors and two executive directors, and deliberates on company management strategies.

AWARDS IN CORPORATE GOVERNANCE



2003

- The Best Corporate Governance among Asian companies by CLSA (Credit Lyonnais Securities Asia)
- Excellent Corporate Governance in 2003 by KRX (Korea Exchange) and KCGS (Korea Corporate Governance Service)
- The Best Transparent Company by Economy21
- Obtained 'Strong' Rating in Corporate Governance Evaluation by S&P

2004

- The Best Corporate Governance in 2004 by KRX and KCGS
- Ranked the 4th among Respected Companies by Dong-a Daily Newspaper and IBM BCS Korea
- Grand Prize at the 5th Audit Award by KLCA (Korea Listed Companies Association) and KICPA (Korean Institute of Certified Public Accountants)

2005

- The Best Corporate Governance in 2005 by KRX and KCGS

2006

- The Best Corporate Governance in 2006 by KRX and KCGS

2007-2009

- Honorary Company in Corporate Governance for three consecutive years by KRX and KCGS

Investment Growth Committee Consisting of two independent non-executive directors and two executive directors, this committee manages investments, social contributions, and risk. It also manages corporate duties required by the Commercial Act, including the installation, transfer, and closing of branches, the appointment of proxies, and the closing of shareholder lists.

Audit Committee This committee consists of three independent non-executive directors. It reviews financial and accounting matters and evaluates internal control systems. All members of the committee are independent non-executive directors, in order to ensure the independence of the audit process, to enhance audit expertise and to strengthen internal audit functions.

Evaluation Committee This committee consists of four independent non-executive directors. It evaluates the management activities of employees and executives, and discusses compensation.

BOARD OF DIRECTORS

EXECUTIVE DIRECTORS

BAEK, BOK-IN

President & CEO

KIM, HEUNG-RYUL

Vice President

INDEPENDENT NON-EXECUTIVE DIRECTORS

CHOI, KYUNG-WON

- Lawyer, Kim & Chang Law Firm
- Minister, Ministry of Justice
- Chairman of the BOD

SONG, OP-KYO

- Director, Asia-Pacific Economics Research Institute
- Constitutional Amendment Advisor, National Assembly of Republic of Korea

LEE, JUNE-Q

- Professor, Kyung Hee University
- Head and Chairman of Korean Academic Society of Taxation

YOUN, HAI-SU

- President, Seoul University of Foreign Studies
- Board Chairman, Haegwang Institute

LEE, EUN-KYUNG

- Managing Director of Finance & Operation, PVH Korea
- Director of Finance, Reebok Korea

RHO, JOON-HWA

- Professor, Chungnam National University
- Chairperson of Auditing Subcommittee, Korean Accounting Association

2010

- The Best Corporate Governance in 2010 by KRX and KCGS

2014

- A+ in Corporate Governance Assessment by KCGS

2011

- The Best Corporate Governance in 2011 by KRX and KCGS

2015

- A+ in Corporate Governance Assessment by KCGS

2012

- A+ in Corporate Governance Assessment by KCGS

2016

- A+ in Corporate Governance Assessment by KCGS

2013

- A+ in Corporate Governance Assessment by KCGS

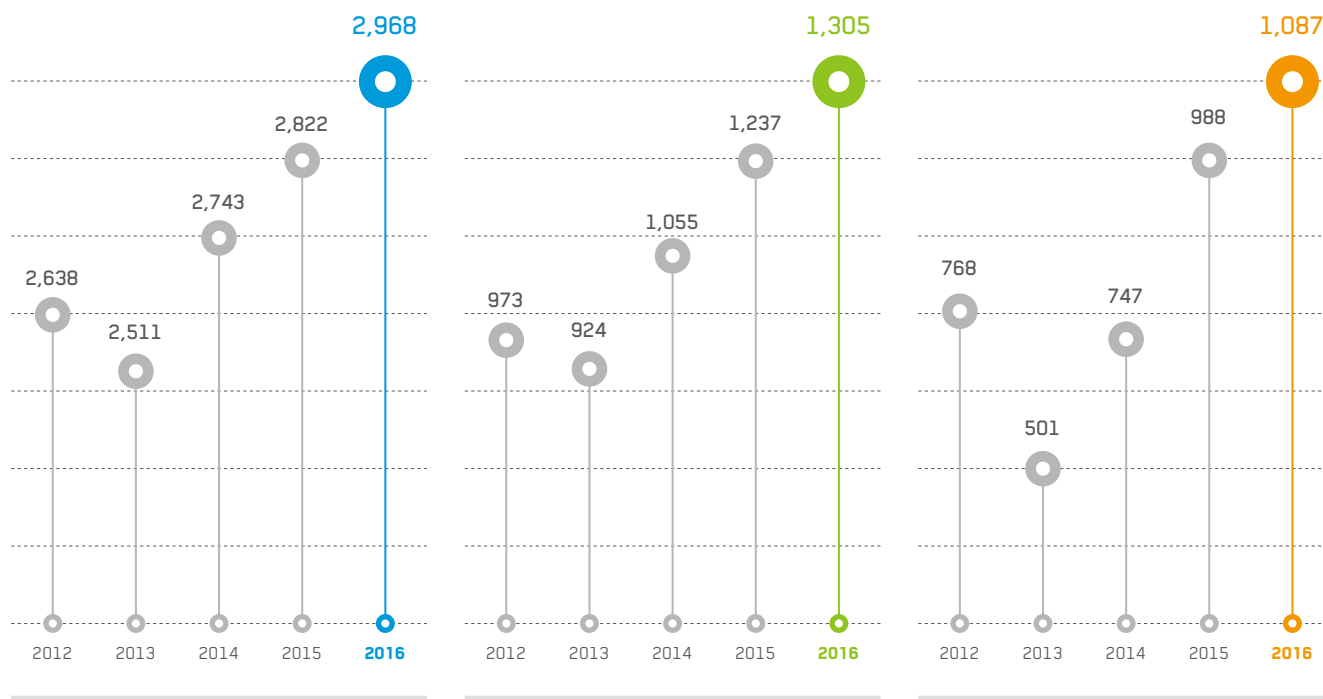
FINANCIAL HIGHLIGHTS

OPERATING RESULTS

(Unit: KRW billion)

	2016	2015	2014	2013	2012
Sales	2,968	2,822	2,743	2,511	2,638
Cost of sales	1,048	947	1,064	936	982
Gross profit	1,920	1,875	1,679	1,575	1,656
Selling and administrative expenses	615	638	624	651	683
Operating profit	1,305	1,237	1,055	924	973
Net profit	1,087	988	747	501	768
Total assets	8,469	7,449	6,295	6,082	5,918
Total liabilities	1,890	1,553	953	1,050	1,015
Total shareholders' equity	6,579	5,896	5,342	5,032	4,903

* Separate figures basis



SALES

(Unit: KRW billion)

OPERATING PROFIT

(Unit: KRW billion)

NET PROFIT

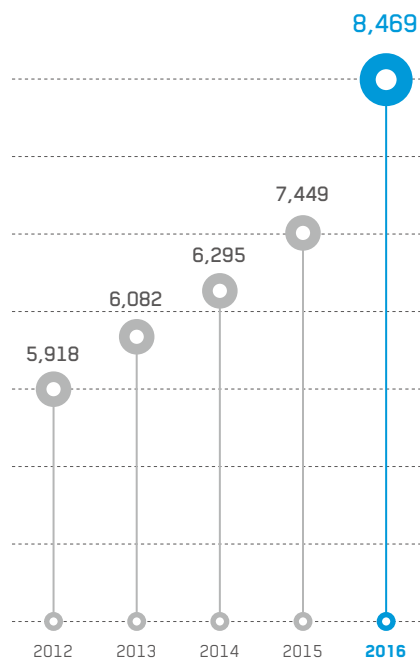
(Unit: KRW billion)

FINANCIAL INDICES

(Unit: %, KRW)

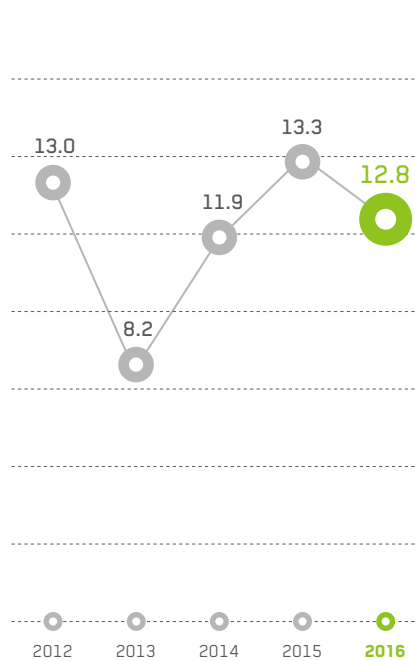
	2016	2015	2014	2013	2012
ROA	12.8	13.3	11.9	8.2	13.0
ROE	16.5	16.8	14.0	10.0	15.7
Operating profit margin	44.0	43.8	38.5	36.8	36.9
Net profit margin	36.6	35.0	27.2	20.0	29.1
EPS (KRW)	8,618	7,843	5,934	3,982	6,111
Payout ratio	41.8	43.4	57.3	80.4	52.4
DPS (KRW)	3,600	3,400	3,400	3,200	3,200
Liabilities-to-equity ratio	28.7	26.3	17.8	20.9	20.7

* Separate figures basis



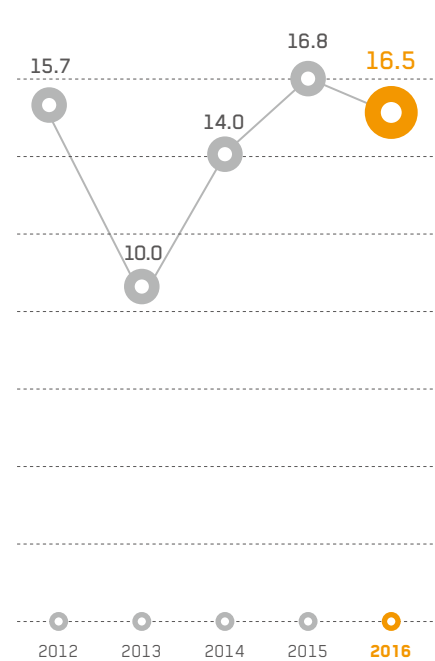
TOTAL ASSETS

(Unit: KRW billion)



ROA

(Unit: %)



ROE

(Unit: %)

NEWS HIGHLIGHTS

BUSINESS

OVERSEAS CIGARETTE SALES REACH A RECORD HIGH VOLUME

Overseas cigarette sales volume reached a record high of 48.7 billion sticks, an increase of 4.7% over 2015, and were also a record high in terms of sales, at USD 812.1 million. This is attributable to a strong performance by 'ESSE', our key export brand, as well as products that are customized to reflect different consumer tastes across different countries. We continued to perform well in emerging markets, including Asia, Africa, and Latin America, in addition to such existing key markets as the Middle East and Russia, thanks to an expansion of distribution networks in those markets.



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RECEIVED THE USD 700 MILLION EXPORT TOWER

KT&G was honored with the 'USD 700 Million Export Tower' at the 53rd Trade Day ceremony organized by the Korea International Trade Association, as our exports recorded approximately USD 764 million between July 1, 2015 and June 30, 2016. This is KT&G's sixth export tower – we won the USD 100 Million Export Tower in 2002, followed by the USD 200 Million in 2004, USD 300 Million in 2006, USD 400 Million in 2008, and USD 500 Million in 2011. We will continue to concentrate our company-wide capabilities on increasing exports, in order to become Korea's leading exporter.



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700

Awarded the 'USD 700 Million Export Tower' at the 53rd Trade Day ceremony



ESSE'S CUMULATIVE OVERSEAS SALES VOLUME SURPASSES 200 BILLION STICKS

The cumulative overseas sales volume of 'ESSE', an ultra-slim cigarette, has exceeded 200 billion sticks in July 2016 since 2001 when it was first exported to the Middle East and Russia. This achievement comes only four years after cumulative sales surpassed 100 billion sticks in 2012. Sold in approximately 50 countries across the globe, ESSE is now the world's No. 1 ultra-slim cigarette brand, and it accounts for more than one-third of the global ultra-slim cigarette sales volume.



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SALES IN THE RED GINSENG BUSINESS SURPASS KRW 1 TRILLION

Sales in KT&G's red ginseng business surpassed KRW 1 trillion, a first for the company and for the entire domestic health functional food industry. Our red ginseng business recorded sales of KRW 1,107.6 billion in 2016, a substantial increase of 20.7% over the previous year. This was mainly owing to our strategy of expanding and diversifying customer base by segmenting products in line with consumer trends and lifestyles, and by increasing the functionality and convenience of products. There was an increase in demand for red ginseng, a leading health functional food in Korea, supported by an increase in the number of overseas tourists in Korea, which also contributed to the improvement in sales.



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200

Cumulative exports of ESSE exceed 200 billion sticks in July 2016

PRODUCT

RELEASED 'TONINO LAMBORGHINI L6'

The 'Tonino Lamborghini L6' is a new product released in 2016, delivering a smooth taste by applying new blending to raw materials such as an orient leaf cultivated in Europe. It uses high-quality materials, including the "lip release filter", which does not stick to the lips. KT&G has signed a licensing agreement with Tonino Lamborghini, a lifestyle brand, and owns the copyright for 'Tonino Lamborghini' cigarettes around the world.

LAUNCHED A NEW PRODUCT – 'BOHEM CIGAR LIBRE'

KT&G launched 'BOHEM CIGAR LIBRE', in the style of a Cuban cigar. 'BOHEM CIGAR LIBRE' combines the 'BOHEM CIGAR' brand, which embodies the taste of Cuban cigars, with 'LIBRE', which means 'free' in Spanish. BOHEM CIGAR LIBRE delivers a taste that is stylish but not overwhelming, enhanced by using cigar wrapper technology, which wraps a cigarette in a special cigarette paper containing cigar leaves, rather than regular cigarette paper.



SANGSANG VOLUNTEER
A volunteer group of university
students operated by KT&G



900

Supported more than 900 university
students and employees for volunteer work
in Cambodia

VALUE

VOLUNTEER WORK IN CAMBODIA



KT&G supported a staff volunteer group and a university student volunteer group in Cambodia, which is still suffering from the effects of a long civil war and economic difficulties. The university student volunteer group comprised members of KT&G's 'Sangsang Volunteer', a group of volunteer university students, and the 'Correspondents Delivering Hope in Cambodia', whose members were chosen through open recruitment. The staff volunteer group consisted of employees chosen for demonstrating excellence in volunteer work. The volunteer groups visited Cambodia to improve daily life and to support education, including by building a library, repairing school and nursery facilities, and providing support for learning.



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RECEIVED A PRIME MINISTER COMMENDATION AT THE KOREA VOLUNTEER AWARDS

KT&G's Shintanjin Factory received a Prime Minister Commendation at the '2016 Korea Volunteer Awards' in recognition of its diverse activities in establishing win-win relationships with the local community. All employees at the Shintanjin Factory participate in at least one volunteer group, and undertake ongoing volunteer activities, rather than one-off events, including the 'House Repair of Love', launched in 2003 to support families in a poor residential environment. KT&G employees across the nation spend nearly 20,000 hours a year on volunteer work through the 'Sangsang Together Volunteer Group'.



Download our sustainability report



BUSINESS

MOMENTS OF SUCCESS

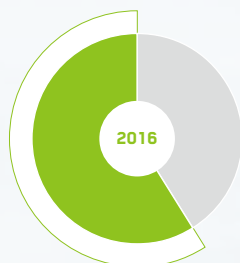
KT&G had an exceptional year in 2016, based on the groundwork for success laid over the past few years. We have established strong business foundations, invested strategically in our business, and expanded our global presence in order to generate strong, sustained and successful results.



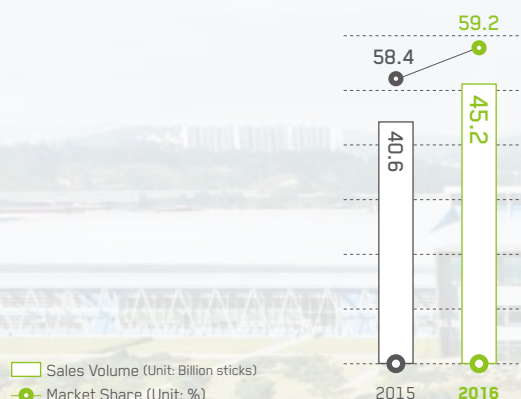
DOMESTIC BUSINESS

Domestic Market Share

59.2%



Sales Volume & Market Share



PERFORMANCE IN 2016

In 2016, the domestic tobacco market continued to see difficult business conditions, mainly due to intensified competition resulting from competitors' aggressive price strategies and frequent new product releases. Nevertheless, KT&G increased the market strength of its strategic brands, and responded preemptively to changes in the market by launching new products that reflect consumer requirements, including the 'RAISON French Yogo' and 'BOHEM CIGAR LIBRE'. As a result, KT&G recorded sales of KRW 1,839.4 billion and its market share rose 0.8%p year-on-year to reach 59.2%. The market share of the four types of 'ESSE Change', in particular, increased 1.2%p year-on-year, making the most significant contribution to the overall increase in market share.

We implemented a high-price portfolio strategy to strengthen profitability. As part of this strategy, we released the 'ESSE Special Gold 0.5 mg', an ultra-slim cigarette that is the outcome of blending carefully-selected top-quality leaf tobacco and applying a three-layer filter containing charcoal grains, as well as the 'ESSE Royal Palace', a top-class premium cigarette that was released to celebrate the 20th anniversary of the 'ESSE' brand. We also offered ultra-high-priced limited editions in duty-free stores.

We have focused on establishing an optimal sales organization that can respond effectively to market changes by increasing efficiency, reorganizing duties and relocating personnel to be market-centered, and diversifying our ordering and shipping methods. In addition, we improved our technological competitiveness and expanded capacity for key products, in order to ensure timely production and delivery of high-quality



We will expand our market share, improve profitability, and achieve stable growth by boosting the competitiveness of our strategic brands and releasing distinctive new products.

0.8%p

The market share of our domestic tobacco business rose 0.8%p year-on-year, thanks mainly to the launch of new products such as 'RAISON French Yogo' and 'BOHEM CIGAR LIBRE'.

RAISON



products. In response to rising demand for capsule products, we have worked on improving capsule productivity and quality, using in-house technologies. We also optimized production facilities and improved the efficiency of personnel operations with an aim to increase production of ultra-slim products. As a result of these efforts, KT&G produced 88.9 billion sticks in 2016, a year-on-year increase of 9.7 billion sticks. Domestic market sales recorded year-on-year growth of 11.3%, to reach 45.2 billion sticks.

CREATING SUSTAINABLE VALUE

In 2016, we continued with our eco-friendly green management, in line with the Korean government's environmental policies. We increased the use of highly efficient facilities, reduced electricity usage in summer, and also reduced greenhouse gas emissions by 2,078

tons compared to the legal standard set by the Ministry of Environment.

The low-ignition 'Blue Band' technology, the result of extensive in-house investment, has been applied to all our products, as part of our commitment to being a socially responsible company. In addition, all our product packages have a pictogram on smoking etiquette, thus helping promote proper etiquette for smoking.

FUTURE PLANS

KT&G will continue to expand our market share by further diversifying product portfolio to reflect rapidly-changing consumer requirements and by aggressively advancing into the market. In addition, we will strive to improve profitability, so that the domestic tobacco business can be the backbone of the Group's growth.

GLOBAL BUSINESS

PERFORMANCE IN 2016

In 2016, we exported 43.4 billion sticks, up 9% over the previous year. Sales grew by 22%, reaching a record-high KRW 830.9 billion. Operating profits saw year-on-year growth of 45% to reach KRW 419.3 billion. This was attributable to increased sales of our main product, 'ESSE MINI Slim', as well as the success of distinctive products, including capsule cigarettes, in such key markets as the Middle East and Central Asia. Expanded distribution networks in emerging markets, including Asia, Africa, and Latin America, also contributed to the improved performance.

KT&G is a truly global company, selling around half of its total production volume to approximately 50 countries around the globe, as of the end of 2016. Between 1988, when we began to export cigarettes, and September 2016, cumulative export volume has reached 540 billion sticks, and revenues from exports total USD 6.6 billion. In 2015, our overseas tobacco sales volume exceeded domestic tobacco sales volume for the first time. The overseas tobacco sales volume, including exports and sales from overseas factories, in 2016 totaled 48.7 billion sticks, considerably more than the domestic tobacco sales volume of 45.2 billion sticks. In December 2016, we received the 'USD 700 Million Export Tower' at the 53rd Trade Day ceremony organized by the Korea International Trade Association.

The strong performance of our overseas tobacco business comes from the active development of products that reflect the different tastes of local consumers around the world, as well as strengthening our overseas market presence by expanding local distribution networks. In particular, we reformed our global business organization in 2016, adopting an independent Company In Company (CIC) system, whereby finance, HR, and other areas are independent from Korean HQ. Our US subsidiary has been expanded and relocated to Dallas, which has in turn supported more active efforts to enter overseas markets.





KT&G maintained strong pace of growth and developed momentum for future growth by actively entering overseas markets with products of outstanding quality and the spirit of challenge.

50+

'ESSE', a key export brand of KT&G, is exported to more than 50 countries around the world as of the end of 2016.

ESSE

FUTURE PLANS

We will continue to expand aggressively, in order to reinforce our presence as a strong global player. We will increase exports by developing varied products, and make strategic products such as 'RAISON' and 'BOHEM' into global brands, following in the footsteps of 'ESSE', our key export brand. In order to continue our overseas growth, we will increase investments into markets with high growth potential, including Africa, and will actively acquire new space for our products in duty-free stores. Furthermore, we will focus company-wide capabilities on increasing exports, including exports of quality measurement equipment.

RED GINSENG BUSINESS

KT&G is reinforcing its leadership in the domestic red ginseng market and expanding in the global market through brand awareness, excellent product quality, and distinctive marketing strategies.



PERFORMANCE IN 2016

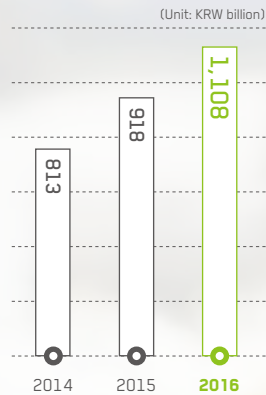
Our red ginseng business, represented by the 'Cheong-Kwan-Jang' brand, continued its strong growth in 2016, recording sales of KRW 1,107.6 billion, up 20.7% over the previous year. Domestic sales contributed to this improved performance, posting a year-on-year increase of 25.7%, at KRW 1,050.8 billion. Thanks to these strong sales, operating profits and net profit rose 31.1% and 22.9% year-on-year to reach KRW 174.9 billion and KRW 85.2 billion, respectively.

Difficulties were expected in improving financial performance last year due to several factors, including a crisis in the overall health functional food owing to the fake *Cynanchum wilfordii* incident, intense competition in the relatively limited domestic market, and an expected decrease in demand for red ginseng as a gift because of the enforcement of the

'Improper Solicitation and Graft Act', as well as the continued economic downturn. However, we were able to maintain growth thanks to a continuing societal emphasis on health, KT&G's outstanding product competitiveness, and a product diversification strategy that reflects consumer requirements, thus becoming the first company in the Korean health functional food industry to exceed KRW 1 trillion in sales.

Various strategic products that fulfill current consumer trends and lifestyles particularly generated strong results. There was a sharp rise in sales of 'Hongsamjeong Every Time', which is very popular with young people because of its convenience, and how it can be taken at any time, in any place. 'Hwa-Ae-Rak', our female health brand, has also been very successful as it has been segmented and its functions have been improved so that they can be enjoyed by women in different age groups, ranging from the young to the old. There was

Sales in Red Ginseng Business



also steady growth from 'Good Base', which is made by carefully selecting raw materials grown in their home countries, including red ginseng from Korea, aronia from Poland, and blueberries from the U.S. We also achieved stable sales in new businesses, including the red ginseng cosmetics 'Donginbi', the red ginseng spa 'Spa G', and the healthy pet food brand 'GINIPET'.

Major factors enabling steady growth in our red ginseng business include strict quality control, a nationwide distribution network, and franchise system. In order to ensure the best in quality, we purchase the raw materials for red ginseng products through a six-year contract farming system and systematically manage the cultivation. In 2012, we obtained Hazard Analysis Critical Control Point (HACCP) certification by satisfying global standards in food quality and safety.

FUTURE PLANS

KT&G will continue to strengthen our competitive edge in the domestic red ginseng market and further expand through diversification strategies based on unrivaled technology and product competitiveness. In overseas markets, we will improve export performance by formulating strategies that match the individual characteristics of different countries.

MARKETING & BRANDING

We have been recognized for our brand value through strategic brand management and distinctive marketing activities, thus also bringing about a sustained increase in our corporate value.

BRAND MANAGEMENT

Tobacco is an item of personal preference, which is why brand reputation and value are important factors in customer choice, as well as product quality. Brand management can therefore determine success or failure in the tobacco business, and, the importance of brand is becoming increasingly evident. KT&G therefore undertakes brand management activities based on in-depth analysis of markets and trends. We also conduct assessments of various attributes, including competitiveness, level of satisfaction, awareness, and image of our brands. Based on the outcome of these assessments, we determine brand management activities and formulate systematic strategies for new product development.

As part of brand management, KT&G has segmented management teams according to brand, and adopted a

brand manager system, assigning dedicated personnel to each brand, to manage product competitiveness and brand awareness. These strategies have helped to build such hit brands as ESSE, RAISON, THE ONE, and BOHEM. In order to continue to strengthen brand value, we analyze consumer requirements by region, age, and gender, and then launch new products that reflect lifestyle changes and trends.

We are also actively building alliances and collaborations with overseas companies. In 2011, we released 'Davidoff' through brand licensing from British Imperial Tobacco Group, and in 2012, we became first company to launch 'Tonino Lamborghini' cigarettes, through joint development with the Italian company Tonino Lamborghini. These luxury cigarettes earned excellent reviews from overseas buyers at Intertabac, one of the world's largest tobacco industry expos, and at the World Duty-Free Exhibition.

Thanks to continuous efforts to strengthen our brands, we have maintained our No. 1 position in the domestic tobacco market despite a difficult business environment, including intense competition from overseas tobacco companies and increased government regulation. Korea is the only country with an open tobacco market where a local company has remained in the No. 1 position. Our brand management has also led to KT&G winning awards. KT&G has ranked first for six consecutive years in the tobacco category of the National Customer Satisfaction Index (NCSI) survey carried out by the Korea Productivity Center, and 'ESSE' has been chosen as the best brand in the tobacco category for seven consecutive years in the National Brand Competitiveness Index (NBCI).

STAKEHOLDER COMMUNICATION

Customer Value KT&G makes extensive efforts to actively reflect customer opinions in our product development and marketing. We operate a customer satisfaction center 24 hours a day, and customer feedback is reflected in manufacturing processes, so that we can improve product quality. We also collect external opinions through various communications channels, such as an advisory committee consisting



of specialists in different areas of the tobacco industry, and our Sinmungo (complaint reporting) system. KT&G will strive to continuously improve our service and product offerings and to exceed customers' expectations.

Social Value KT&G strives to establish a smoking environment where the rights of both smokers and non-smokers are protected, and where smokers and non-smokers respect each other. This includes supporting the installation of smoking rooms and smoke control facilities, and the establishment and operation of smoking rooms at airports across the nation. We also supply portable ashtrays and public trash cans, place public advertisements and conduct campaigns to spread an appropriate smoking etiquette, and educate young people on smoking prevention, thus contributing to a mature civic society and the public interest.

Stakeholder Participation and Communication Channels



CUSTOMERS

Public announcements on business management, business reports, Sinmungo, factory visits, social media, prosumer activities, surveys on new product satisfaction



SHAREHOLDERS AND INVESTORS

Annual General Meeting (AGM), management evaluations, business reports, website



SUPPLIERS

Electronic Data Interchange (EDI) system, complaint-handling process, meetings among presidents of suppliers, supplier workshop, supplier support program



EMPLOYEES

Labor-Management Council, distress-handling system, CSR training, Intranet, employee volunteer work, Sangsang Realization Group



GOVERNMENT

Industrial policy meetings and seminars, business reports, public hearings, advisory meetings



LOCAL COMMUNITIES

Factory visits, KT&G Welfare Foundation, Scholarship Foundation

AFFILIATES

KOREA GINSENG CORPORATION

As Korea's best red ginseng producer, Korea Ginseng Corporation manufactures and sells red ginseng products that uphold the traditions of Korean ginseng, which is the best in the world. Korea Ginseng Corporation's products and technologies have a 118 year history, and their quality is fully recognized by the global market, resulting in exports to approximately 60 countries worldwide.

- **Business** Manufacture and distribution of red ginseng and red ginseng products
- **Ownership** 100%
- **Sales in 2016** KRW 1,107.6 billion
- **Major Product** Hongsamjeong (Red ginseng extracts)

 www.kgc.co.kr

KGC LIFE & GIN

KGC Life & Gin manufactures and distributes products that are made of red ginseng, including health functional foods, beverages, and beauty products. Its total health products are trusted by consumers thanks to Korea Ginseng Corporation's stringent selection of raw materials and quality management system.

- **Business** Distribution of red ginseng products and health functional foods, cosmetics
- **Ownership** 100%
- **Sales in 2016** KRW 51.8 billion
- **Major Product** Donginbi

 www.kgclifengin.com



COSMOCOS

In 2016, Somang Cosmetics signified a new beginning by changing its name to COSMOCOS, with an aim of becoming a 'Global leading beauty company'. The company has received recognition for quality and brand value, so that it has been chosen as Korea's Best Brand for seven consecutive years, and was also first in the Premium Brand Index, through such hit brands as 'Man with Flowers' and 'Danahan'.

- **Business** Manufacture of cosmetic products
- **Ownership** 98.6%
- **Sales in 2016** KRW 82.3 billion
- **Major Product** Man with Flowers, Danahan

 www.cosmocos.com

YUNGJIN PHARMACEUTICAL CO., LTD.


With a history of more than 50 years, Yungjin Pharmaceutical Co., Ltd. is trusted by medical personnel and citizens due to its distinctive pharmaceuticals and diverse health functional foods. It has been leading the Korean pharmaceutical industry, and now focuses its R&D on developing new drugs that ease the financial burden of medical expenses and improve people's quality of life.

- **Business** Manufacture and distribution of drugs, ingredients, and chemical products
- **Ownership** 52.5%
- **Sales in 2016** KRW 193.1 billion
- **Major Product** Harmonilan Solution

 www.yungjin.co.kr







VALUE

MOMENTS OF TRUTH

AT KT&G, our thoughts and actions are guided by the principle of sustainability – transparent and responsible management, fostering top talent, respect for the environment, and creating a better future. And we have stayed true to ethical and social values which have guided our sustainability.



ETHICAL MANAGEMENT MANUAL

Standards for ethical management which consists of a charter of ethics, a code of ethics, and guidelines on practicing ethics



ETHICAL MANAGEMENT & AUDIT DIVISION

Dedicated to ethical management, and in charge of an annual audit on ethical management



COMPLIANCE PROGRAM

Adopted in 2002 to ensure compliance with fair trade-related laws and all related regulations



ELECTRONIC DATA INTERCHANGE (EDI) SYSTEM

Increases suppliers' production efficiency, and improves our product quality and cost competitiveness



THE VALUE OF INTEGRITY

ETHICAL VALUE

ETHICAL MANAGEMENT

KT&G recognizes that transparent and honest management are core elements in our sustainable development, and so all our employees perform their duties to the highest standards of ethics and transparency. We comply with all relevant laws at home and abroad, and in addition we have created an ethical management manual and a dedicated ethics organization to spread a culture of ethical management. We abide strictly by the ethical standards expected of us, including fair transactions with business partners and the protection of the rights of our employees.

Ethical Management Manual KT&G's ethics charter enables the company to fulfill its social responsibilities, and serves as the basis for code of ethics and guidelines on practicing ethics. The code of ethics serves as a guide for employees when they make decisions in their actual work environment. It details their responsibilities toward stakeholders and sets out requirements on putting them into practice. The guidelines define detailed criteria and conduct for the implementation of the code of ethics. The Group's ethical management guidelines are also applied at all our subsidiaries – we regularly examine ethical management at the subsidiaries, and make improvements where necessary.

Organization Dedicated to Ethical Management The Ethical Management & Audit Division, which reports directly to the Audit Committee, performs a central role in our ethical management activities. The division responds quickly and efficiently to relevant issues, and, as the focus for transparent management, the division is responsible for spreading the culture of ethical management, monitoring business risk, examining the subsidiaries, undertaking regular ethics assessments, and investigating workplace accidents and incidents. This division also conducts an annual ethical management audit of each corporate division, regional headquarters, and branch.

Ethical Management Activities KT&G undertakes various activities to ensure that we are continually putting into practice our commitment to ethical management. All employees re-affirm their commitment to ethics on an annual basis, and receive ethical management training to

help them to prioritize human rights and ethics. We share information through our 'Think Twice Campaign' on negative incidents and accidents in order to prevent a recurrence, and we frequently assess whether ethical management is being properly executed in management and work processes, making improvements where necessary.

WIN-WIN PARTNERSHIPS

As a market leader in Korea, KT&G takes the lead in conducting fair trade, and seeks joint growth with business partners. We have set out our basic principles for purchasing in code of ethics, to ensure fair transactions, and we comply at all times with the guidelines for trading between large companies and SMEs established by the Fair Trade Commission. In addition, internal fair trade compliance guidelines improve employee understanding of the Fair Trade Act.

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

KT&G strives to establish cooperative relations based on mutual trust with our suppliers, thus building the foundations for joint growth. The Electronic Data Interchange (EDI) system, a web-based system to share production information, has enhanced the production efficiency of our suppliers and reduced their inventories. This in turn improves our product quality and cost competitiveness. We help suppliers with technology development, and provide funding to local tobacco farmers. We also offer support for research into improving the quality of locally-produced leaf tobacco, and give practical help to tobacco farmers during their busy seasons.



HOPE

A company that helps to create a bright future for children and teenagers

PLATFORM

KT&G Welfare Foundation, Scholarship Foundation



CREATIVITY

A company that provides young people with a place to realize their dreams

PLATFORM

Sangsang Madang, Sangsang University



WIN-WIN

A company that creates win-win social value for all

PLATFORM

Sangsang Fund, Global CSR,
Smoking environment improvement project

COMMITMENT TO OUR SOCIETY

SOCIAL VALUE

CSR DIRECTIONS

KT&G is carrying out social contribution activities under the CSR vision of 'Becoming a leading CSR company in Korea which contributes to culture through unique social contributions and active communication with society.' We re-established our mid- to long-term social contribution plan in 2016, and are committed to social contribution projects worth a total of KRW 330 billion by 2018. We plan to develop diverse CSR programs based on our core values of hope, creativity, and win-win. In particular, KT&G will contribute to solving social issues by offering ongoing, unique and sincere social contributions, rather than just one-time donations.

CSR HIGHLIGHTS

Sangsang Fund Launched in 2011, the Sangsang Fund has come to represent KT&G's unique donation culture. Donations are made voluntarily by our employees, and those donations are then matched by the company. The Sangsang Fund is used to support the underprivileged, by offering scholarships to students, providing winter supplies to people on low incomes, and through emergency relief activities abroad. In 2016, a total of KRW 4.1 billion was raised from 3,955 employees, 98% of total employees. A cumulative total of KRW 16 billion has been raised and donated through the Sangsang Fund.

Donation Petition System This system was created to ensure the most effective use of donations to the Sangsang Fund. Through the unique KT&G donation culture, donors make a range of choices about their donations, including the items to be donated as well as the locations and methods. Any employee can make a suggestion on the company's Intranet, and that suggestion is adopted if more than 200 staff members recommend it by posting a reply. An onsite assessment is then carried out to make a final decision concerning the donation.

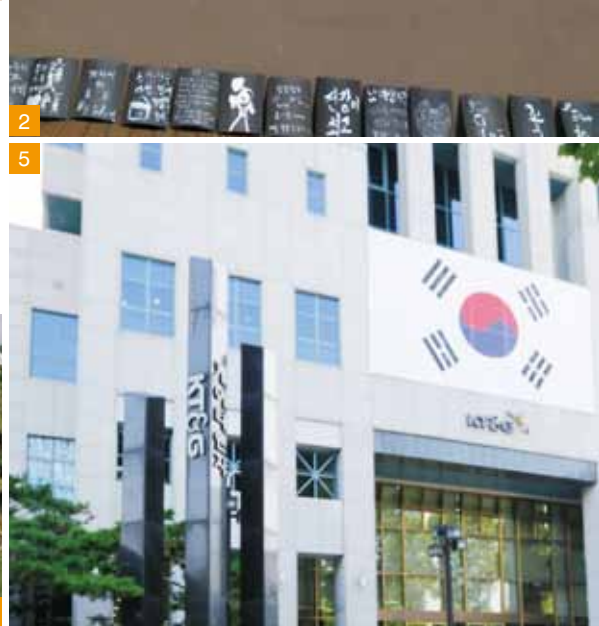
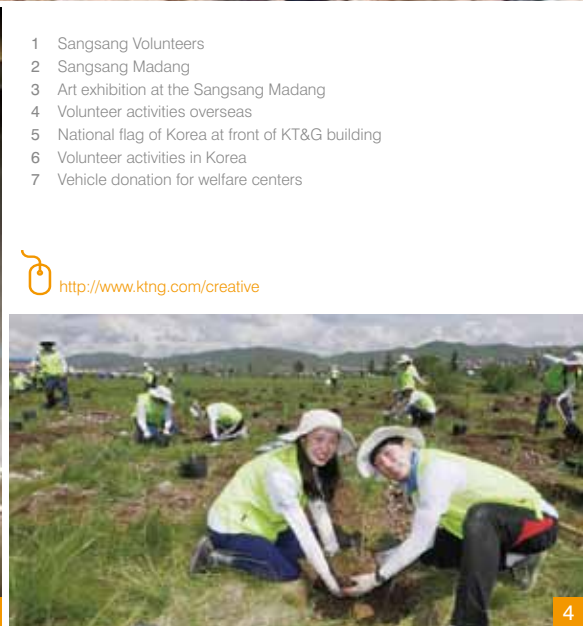
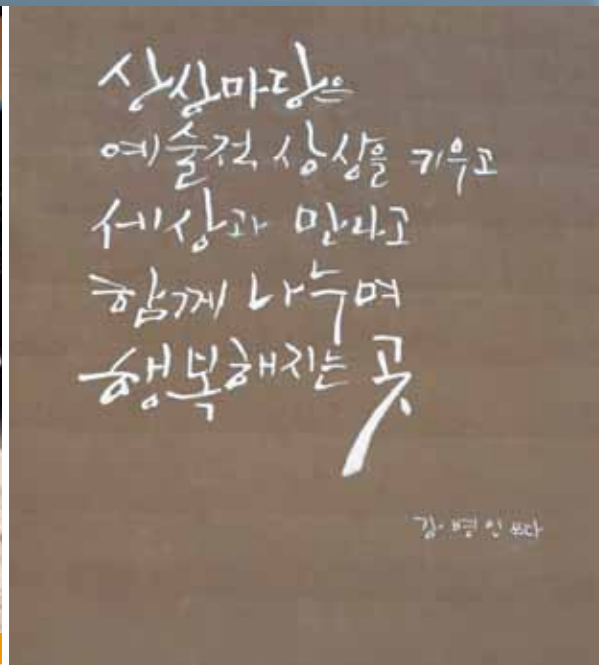
Sangsang Volunteer This volunteer group of university students plans and executes volunteer work, supported by KT&G. 12 volunteer groups have been formed from 2011 through 2016. In 2016, 639 Sangsang Volunteers worked in partnership with 10,489 other volunteers to help with volunteer work that included painting murals, hosting a track meet for the visually challenged, and holding the 'Share the Love Bazaar'.

Sangsang Together This volunteer group was created by KT&G employees wanting to take part in the resolution of local community issues. The group plans volunteer work to encourage employee participation, and it also selects the most outstanding volunteers, and rewards them with the opportunity to do volunteer work overseas. In 2016, 1,252 employees participated, performing an average of 17 hours of volunteer work per person. An overseas volunteer group consisting of 22 employees who had demonstrated excellence in volunteer work travelled to Cambodia for volunteer activities.

Sangsang Madang The Sangsang Madang is KT&G's flagship culture and art support program. It provides the public with a greater number of opportunities to enjoy culture and arts, and supports creative young artists. It has become Korea's leading multi-purpose art and cultural space, with visitors totaling 1.8 million annually. As of the end of 2016, KT&G operates the Sangsang Madang in three areas – Hongdae in Seoul, Nonsan, and Chuncheon. In 2006, KT&G opened the Sangsang Art Hall, a performance space in Samseong-dong, Seoul.


KT&G Welfare Foundation Established in 2003, the KT&G Welfare Foundation operates eight welfare centers in Seoul and the metropolitan area, with the mission of 'Sharing hope for a future of happiness'. Its welfare activities are categorized into sharing projects, hope projects, and professional projects. The Foundation has donated 100 vehicles every year since 2004, after learning about the need for compact cars that can be driven down small alleys to reach areas that would benefit from welfare projects. 1,300 vehicles have been donated to social welfare institutions across Korea, as of the end of 2016. The scale of projects totaled KRW 11.8 billion in 2016, benefitting 85,641 people.

Scholarship Foundation The Scholarship Foundation was established in 2008 with the aim of resolving imbalances in learning opportunities, and helping to support the education of students with limited opportunities, thus helping them to become the talented people that society needs. Students are chosen to receive the Sangsang Scholarship every year, and in 2016, scholarship programs totaling around KRW 3.5 billion were put in place. By staying in close contact with the students chosen, we are able to give them a helping hand with sincerity, and for the long-term.



- 1 Sangsang Volunteers
- 2 Sangsang Madang
- 3 Art exhibition at the Sangsang Madang
- 4 Volunteer activities overseas
- 5 National flag of Korea at front of KT&G building
- 6 Volunteer activities in Korea
- 7 Vehicle donation for welfare centers

 <http://www.ktng.com/creative>

A young girl with dark hair in a ponytail, wearing a white long-sleeved shirt, is smiling and looking up at several orange and yellow butterfly-shaped kites flying in a blue sky with white clouds. She is in a park with green trees in the background.

As we pursue sustainable corporate growth,
we will continue to follow the same set of deeply
held values that underpin our responsibilities as a
global corporate citizen, providing sustainable solutions
in the local communities where we live and work.

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FINANCIAL REVIEW

MANAGEMENT'S DISCUSSION & ANALYSIS

1. INTRODUCTION

KT&G Corporation was established on April 1st, 1987 as a manufacturer and seller of tobacco and tobacco products. The company has grown to be a global enterprise, exporting 100 brands to 50 countries around the world as of the end of 2016. KT&G has subsidiaries including Korea Ginseng Corp., KGC Yebon, Yungjin Pharmaceutical, KGC Lifeengine, and COSMOCOS. The company aims to accomplish balanced growth across a portfolio that has widened from tobacco and ginseng as our flagship businesses at home and abroad, to include bio businesses, and health & beauty.

KT&G's financial statements are reported according to Korean International Financial Reporting Standards (K-IFRS). They thus fulfill the requirements of the Korean government under the standards and guidelines released by the International Accounting Standards Board.

KT&G's financial statements for 2016 refer to the period from January 1st to December 31st, 2016, and this Management Discussion & Analysis (MD&A) is based on spate financial statements of the company. It covers not only KT&G's past performance but also a current financial and business evaluation, the economic and industrial outlook, future business performance and business goals. The forecasts in this material are based on internal business environment analyses and market forecasts, including a wide range of uncertainties that are subject to change. These uncertainties could generate a significant difference between the forecasts herein and actual performance. The company therefore does not give any guarantee as to the accuracy and completeness of any forward-looking information herein.

BUSINESS ENVIRONMENT In 2016, the global economy grew by 2.9%, a slight decrease from the 3.1% growth seen in 2015. This was the result of an economic slowdown in China, uncertainties resulting from the Brexit referendum, political and economic instability in Russia and the Middle East, low oil prices, and sluggish world trade, despite an economic recovery in the US and Western Europe. The Korean economy saw GDP growth of 2.7%, with continued stagnation in domestic demand and resulting difficulties in the business environment. The nation's GDP growth has now been below 3% for two consecutive years.

Tobacco markets in advanced economies have trended downwards recently, owing to increased regulation and a reduction in the smoking rate. In contrast, the consumption of tobacco continues to increase in emerging countries such as China, Russia, and Indonesia. In particular, countries in Africa, the Middle East, and Central Asia are continuing to grow in population, which in turn is leading to a rise in the smoking population. The smoking rate in Korea is on a downward trend and dropped slightly in 2016 as well, as a result of cigarette price hikes and the expansion of non-smoking areas.

2. OPERATING PERFORMANCE

SALES In 2016, KT&G recorded KRW 2,968 billion in sales, up 5.2% year-on-year. Exports rose substantially by 22.0% over the year, thereby driving the overall growth. Other sectors, including the real estate business, also grew significantly, by 39.2%.

The business environment of domestic tobacco business continued to be challenging owing to aggressive price strategies and frequent new product releases of competitors. Nevertheless, KT&G improved the competitiveness of its strategic brands, launched distinctive new products, and implemented a high-priced product portfolio strategy. As a result, sales in our domestic tobacco business in 2016 recorded KRW 1,839 billion.

In overseas tobacco business, there was an increase in sales of ESSE Mini Slim and capsule products in our major markets, including the Middle East and Central Asia. There was also an increase in exports to new markets such as Asia-Pacific and Latin America, supported by expanded distribution networks. Exports to the US reached a record high of 2.78 billion sticks, attributable to a strong performance of TIME brand, which satisfies the tastes of local consumers. Accordingly, exports grew 9.5% over the previous year to reach 43.4 billion sticks. Sales in overseas tobacco business also went up by 22.0% to KRW 831 billion.

In our real estate business and 'others' category, sales were KRW 298 billion thanks to active marketing, customer relationship management (CRM) for leaseholders and cost reductions, despite worsening conditions in the leasing market.

SALES BY BUSINESS

(Unit: KRW billion)

	2016	2015	Change (Amount)	Change (%)
Domestic Tobacco Business	1,839	1,927	(88)	(4.5)
Overseas Tobacco Business	831	681	150	22.0
Others (Real Estate, etc.)	298	214	84	39.2
Total	2,968	2,822	146	5.2

PROFIT AND LOSS Total sales rose 5.2% year-on-year, and the cost of sales ratio rose 1.7% points, from 33.6% in 2015 to 35.3% in 2016. Gross profits increased by 2.4% to reach KRW 1,920 billion. Operating profits increased 5.5% to KRW 1,305 billion. This was mainly attributable to increased gross profits as well as a 3.6% decrease in selling, general and

administrative (SG&A) expenses thanks to lower retirement and employee benefits and a reduction in advertising expenses. Net profits for the year increased by 10.1% year-on-year to KRW 1,087 billion, attributable to increased operating profits, reduced impairment losses and other profit/loss improvements.

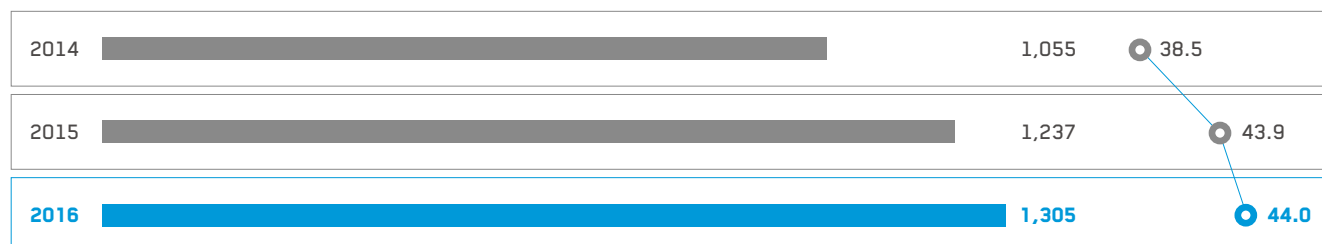
SUMMARIZED STATEMENTS OF INCOME

(Unit: KRW billion)

	2016	2015	Change (Amount)	Change (%)
Sales	2,968	2,822	146	5.2
Gross Profit	1,920	1,875	45	2.4
SG&A Expenses	615	638	(23)	(3.6)
SG&A Expenses Ratio	20.7%	22.6%		(1.9)%p
Operating Profit	1,305	1,237	68	5.5
Operating Profit Margin	44.0%	43.9%		0.1%p
Profit before Tax	1,400	1,319	81	6.1
Net Profit	1,087	988	99	10.1

OPERATING PROFIT & OPERATING PROFIT MARGIN

(Unit: KRW billion, %)



■ Operating Profit ● Operating Profit Margin

SG&A expenses went down by KRW 23 billion from the previous year to KRW 615 billion, mainly attributable to reduced retirement and employee benefits, despite a reduction in impairment losses (the reversal of an impairment loss) on trade receivables and an increase in service fees.

Salaries, advertising expenses, and service fees accounted for 38.0%, 18.0%, and 13.0% respectively of SG&A expenses. Salaries and service fees rose by 0.9% and 2.6% respectively to KRW 234 billion and KRW 80 billion, while advertising expenses fell by 7.5% to KRW 111 billion.

BREAKDOWN OF SELLING AND ADMINISTRATION EXPENSES

(Unit: KRW billion)

	2016	2015	Change (Amount)	Portion
Salaries	234	232	0.9	38.0
Severance Benefits	24	34	(29.4)	3.9
Employee Benefits	34	44	(22.7)	5.5
Advertising	111	120	(7.5)	18.0
Service Fees	80	78	2.6	13.0
Depreciation Expenses	32	33	(3.0)	5.2
Other Expenses	100	97	3.1	16.3
Total	615	638	(3.6)	100.0

3. FINANCIAL STATUS

ASSETS At the end of 2016, KT&G's total assets stood at KRW 8,469 billion, up 13.7% over the previous year-end. Current assets increased by 21.5% to KRW 4,833 billion. Prepaid tobacco excise and other taxes and advance payments fell by 1.9% and 15.9% respectively, but other financial assets, trade and other receivables, and cash and cash equivalents rose by 48.4%, 6.1%, and 55.0% respectively. Non-current assets stood at KRW 3,636 billion, up 4.8% year-on-year, mainly attributable to increases in invested real estate and long-term deposits in the MSA Escrow Fund of 145.0% and 24.7% respectively, despite decreases in tangible assets and long-term trade and other receivables of 14.7% and 13.5% respectively.

LIABILITIES As at end-2016, KT&G's total liabilities stood at KRW 1,890 billion, up 21.7% year-on-year, of which current liabilities were KRW 1,762 billion, up 23.2%. The increase in current liabilities was mainly attributable to rises in trade and other payables and tobacco excise and other taxes payable of 0.6% and 49.9% respectively, despite decreases in advances received and current income tax liabilities of 96.3% and 12.8% respectively. Non-current liabilities rose by 4.1% to KRW 128 billion. This was mainly attributable to increases in net defined benefit liability and deferred income tax liability of 11.7% and 1.6% respectively, despite a 15.9% fall in long-term trade and other payables.

SUMMARIZED STATEMENTS OF FINANCIAL POSITION

(Unit: KRW billion)

	2016	2015	Change (Amount)	Change (%)
Total Assets	8,469	7,449	1,020	13.7
Current Assets	4,833	3,979	854	21.5
Cash and Cash Equivalents	689	444	245	55.2
Receivables	931	819	112	13.7
Others	3,213	2,716	497	18.3
Non-current Assets	3,636	3,470	166	4.8
Total Liabilities	1,890	1,553	337	21.7
Current Liabilities	1,762	1,430	332	23.2
Non-current Liabilities	128	123	5	4.1
Total Shareholders' Equity	6,579	5,896	683	11.6
Debt-to-Equity Ratio (%)	28.7	26.3		2.4%p
ROA (%)	12.8	13.3		(0.5)%p
ROE (%)	16.5	16.8		(0.3)%p

4. CASH FLOWS

As at end-2016, KT&G's cash and cash equivalents reached KRW 689 billion, up 55.2% year-on-year. Cash flows generated by operating activities rose by 2.7% to KRW 1,352 billion. This was due to the increase in profits for the year, which contributed KRW 73 billion, and the cash inflows from reduced advanced payments of tobacco excise and other taxes, which contributed KRW 195 billion. Cash flows from

investing activities were minus KRW 680 billion, an 11.1% decrease year-on-year, as the result of increased disposals of available-for-sale financial assets and smaller increases in loans and investments in subsidiaries. Cash flows from financial activities recorded minus KRW 428 billion, with dividends paid being the most significant item.

SUMMARIZED STATEMENTS OF CASH FLOWS

(Unit: KRW billion)

	2016	2015	Change (Amount)	Change (%)
Cash Flows from Operating Activities	1,352	1,317	35	2.7
Cash Flows from Investing Activities	(680)	(765)	85	(11.1)
Cash Flows from Financing Activities	(428)	(429)	1	(0.2)
Cash and Cash Equivalents at the Beginning of the Year	444	322	122	37.9
Cash and Cash Equivalents at the End of the Year	689	444	245	55.2

5. DIVIDEND

The dividend per share for 2016 was KRW 3,600, and total dividend costs recorded KRW 455 billion.

	2016	2015	2014
Net Income (KRW billion)	1,087	988	747
Dividends (KRW billion)	455	428	428
Dividend per Share (KRW)	3,600	3,400	3,400

6. 2017 OUTLOOK

The low-growth trend in the global economy is forecast to worsen in 2017 due to the spread of protectionism, a weakened ties among EU countries, and slowing economic growth in China and emerging countries. In Korea, consumption is likely to remain low due to the prolonged stagnation in domestic demand. Korean GDP growth is forecast to remain between 2% and 3% for the third consecutive year, which would be a first in the nation's history. Against this difficult economic backdrop, the domestic tobacco market will likely come under further pressure from the full implementation of stricter regulations. Challenging conditions are also forecast for our non-tobacco businesses.

In this difficult business environment, KT&G will leverage its distinctive competitiveness and the strengths that have enabled us to overcome challenges in the past. We will respond flexibly to changes in the internal and external business environment, based on the systematic implementation of the right management strategies. We will

further strengthen our leading position in existing businesses, including domestic tobacco, domestic red ginseng, and real estate. In global business, we will continue to expand aggressively, and in life health business, which includes pharmaceuticals and cosmetics, we will build momentum for growth by actively tapping into new markets.

In 2016, everyone at KT&G worked together in order to achieve our goal of 'maximizing corporate value and shareholder value'. As a result, KT&G was able to achieve a record high performance. In 2017, we will put all our efforts towards improving profitability and developing engines for future growth, in order to exceed the expectations of all our shareholders.

INDEPENDENT AUDITORS' REPORT

The Board of Directors and Shareholders

KT&G Corporation:

We have audited the accompanying consolidated financial statements of KT&G Corporation (the "Parent Company") and its subsidiaries (collectively the "Group"), which comprise the consolidated statements of financial position as of December 31, 2016 and 2015, the consolidated statements of comprehensive income, changes in equity and cash flows for the years then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

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

Auditors' Responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the consolidated financial position of the Group as of December 31, 2016 and 2015 and its consolidated financial performance and its consolidated cash flows for the years then ended in accordance with Korea International Financial Reporting Standards.

Other Matters

The procedures and practices utilized in the Republic of Korea to audit such consolidated financial statements may differ from those generally accepted and applied in other countries.

The accompanying consolidated financial statements as of and for the year ended December 31, 2016 have been translated into United States dollars solely for the convenience of the reader and such translation does not comply with K-IFRS. We have audited the translation and, in our opinion, the consolidated financial statements expressed in Korean won have been translated into dollars on the basis set forth in note 4 to the consolidated financial statements.



KPMG Samjong Accounting Corp.
Seoul, Korea
February 24, 2017

This report is effective as of February 24, 2017, the audit report date. Certain subsequent events or circumstances, which may occur between the audit report date and the time of reading this report, could have a material impact on the accompanying financial statements and notes thereto. Accordingly, the readers of the audit report should understand that the above audit report has not been updated to reflect the impact of such subsequent events or circumstances, if any.

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

KT&G Corporation and Subsidiaries

As of December 31, 2016 and 2015

(In millions of won and thousands of U.S. dollars)

	2016 (Korean won)	2016 (U.S. dollars)	2015 (Korean won)
Assets			
Property, plant and equipment	₩ 1,601,877	\$ 1,325,508	₩ 1,789,779
Intangible assets	104,929	86,826	105,428
Investment property	341,580	282,648	164,489
Investments in associates and joint ventures	56,476	46,732	51,521
Available-for-sale financial assets	385,096	318,656	364,681
Other financial assets	11	9	12
Long-term deposits in MSA Escrow Fund	503,592	416,708	403,966
Long-term advance payments	86,592	71,652	107,723
Long-term prepaid expenses	6,091	5,042	7,128
Long-term trade and other receivables	69,942	57,875	75,071
Deferred income tax assets	35,757	29,588	32,696
Total non-current assets	3,191,943	2,641,244	3,102,494
Inventories	2,265,355	1,874,518	2,119,114
Current available-for-sale financial assets	1,500	1,241	-
Current other financial assets	1,657,338	1,371,401	1,136,906
Prepaid tobacco excise and other taxes	439,413	363,602	447,771
Trade and other receivables	1,283,647	1,062,182	1,217,938
Advance payments	69,364	57,397	75,710
Prepaid expenses	26,924	22,278	20,519
Cash and cash equivalents	850,786	704,002	546,213
Total current assets	6,594,327	5,456,621	5,564,171
Non-current assets held for sale	26,315	21,775	6,692
Total assets	₩ 9,812,585	\$ 8,119,640	₩ 8,673,357

KT&G Corporation and Subsidiaries

As of December 31, 2016 and 2015

(In millions of won and thousands of U.S. dollars)

	2016 (Korean won)	2016 (U.S. dollars)	2015 (Korean won)
Equity			
Ordinary shares	₩ 954,959	\$ 790,202	₩ 954,959
Other capital surplus	(3,430)	(2,838)	(9,928)
Treasury shares	(328,157)	(271,541)	(337,062)
Gain on reissuance of treasury shares	513,776	425,136	494,648
Reserve	4,296,523	3,555,253	3,704,315
Retained earnings	1,612,032	1,333,911	1,401,975
Equity attributable to owners of the parent	7,045,703	5,830,123	6,208,907
Non-controlling interests	72,554	60,035	66,592
Total equity	7,118,257	5,890,158	6,275,499
Liabilities			
Long-term borrowings	115,953	95,948	102,242
Long-term trade and other payables	14,700	12,164	13,647
Long-term advance receipts	9,877	8,173	10,390
Net defined benefit liability	123,610	102,284	120,648
Provision	4,703	3,892	2,765
Deferred income tax liabilities	272,106	225,160	276,472
Total non-current liabilities	540,949	447,621	526,164
Short-term borrowings	136,599	113,032	206,373
Current portion of long-term borrowings	9,597	7,941	27,659
Trade and other payables	622,208	514,859	606,355
Advance receipts	9,573	7,923	28,650
Income tax payable	210,213	173,945	224,836
Tobacco excise and other taxes payable	1,165,189	964,161	777,821
Total current liabilities	2,153,379	1,781,861	1,871,694
Total liabilities	2,694,328	2,229,482	2,397,858
Total equity and liabilities	₩ 9,812,585	\$ 8,119,640	₩ 8,673,357

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

KT&G Corporation and Subsidiaries

For the years ended December 31, 2016 and 2015

(In millions of won and thousands of U.S. dollars, except earnings per share)

	2016 (Korean won)	2016 (U.S. dollars)	2015 (Korean won)
Sales	₩ 4,503,280	\$ 3,726,338	₩ 4,169,839
Cost of sales	(1,796,725)	(1,486,740)	(1,630,601)
Gross profit	2,706,555	2,239,598	2,539,238
Selling, general and administrative expenses	(1,236,453)	(1,023,131)	(1,173,334)
Operating profit	1,470,102	1,216,467	1,365,904
Other income	165,270	136,757	118,752
Other expenses	(102,159)	(84,534)	(160,161)
Net finance income	52,551	43,485	74,762
Share of gain of associates and joint ventures	2,546	2,107	15,137
Share of loss of associates and joint ventures	(479)	(397)	-
Profit before income tax	1,587,831	1,313,885	1,414,394
Income tax expense	(361,801)	(299,380)	(382,174)
Profit for the year	₩ 1,226,030	\$ 1,014,505	₩ 1,032,220
Other comprehensive income (loss):			
Items that are or may be reclassified subsequently to profit or loss			
Unrealized net changes in fair value of available-for-sale financial assets, net of tax	₩ 11,436	\$ 9,463	₩ (16,076)
Exchange differences on translating foreign operations, net of tax	13,700	11,336	(14,770)
Items that will never be reclassified to profit or loss			
Remeasurements of net defined benefit liability, net of tax	(24,611)	(20,365)	38
Other comprehensive income (loss) for the year, net of tax	525	434	(30,808)
Total comprehensive income for the year	₩ 1,226,555	\$ 1,014,939	₩ 1,001,412
Profit attributable to:			
Owners of the Parent Company	₩ 1,231,274	\$ 1,018,845	₩ 1,035,717
Non-controlling interests	(5,244)	(4,340)	(3,497)
	₩ 1,226,030	\$ 1,014,505	₩ 1,032,220
Total comprehensive income attributable to:			
Owners of the Parent Company	₩ 1,230,549	\$ 1,018,245	₩ 1,007,103
Non-controlling interests	(3,994)	(3,306)	(5,691)
	₩ 1,226,555	\$ 1,014,939	₩ 1,001,412
Earnings per share in won and U.S. dollars:			
Basic and diluted	₩ 9,759	\$ 8.08	₩ 8,222

CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

KT&G Corporation and Subsidiaries

For the year ended December 31, 2016

(In millions of won)

	Ordinary shares	Other capital surplus	Treasury shares	Gain on reissuance of treasury shares	Reserve	Retained earnings	Owners of the parent	Non- controlling interests	Total equity
Balance at January 1, 2016	₩ 954,959	(9,928)	(337,062)	494,648	3,704,315	1,401,975	6,208,907	66,592	6,275,499
Total comprehensive income for the year:									
Profit (loss) for the year	-	-	-	-	-	1,231,274	1,231,274	(5,244)	1,226,030
Other comprehensive income (loss):									
Unrealized net changes in fair value of available-for-sale financial assets, net of tax	-	-	-	-	11,436	-	11,436	-	11,436
Exchange differences on translating foreign operations, net of tax	-	-	-	-	13,170	-	13,170	530	13,700
Remeasurements of net defined benefit liability, net of tax	-	-	-	-	-	(25,331)	(25,331)	720	(24,611)
Total other comprehensive income (loss)	-	-	-	-	24,606	(25,331)	(725)	1,250	525
Total comprehensive income (loss) for the year	-	-	-	-	24,606	1,205,943	1,230,549	(3,994)	1,226,555
Transactions with owners, recorded directly in equity:									
Dividends	-	-	-	-	-	(428,284)	(428,284)	-	(428,284)
In-kind donation of treasury shares	-	-	8,905	19,128	-	-	28,033	-	28,033
Transfer from reserve for research and human resource development	-	-	-	-	(10,000)	10,000	-	-	-
Transfer to unconditional reserve	-	-	-	-	577,602	(577,602)	-	-	-
Extinguishment of equity conversion option	-	7,780	-	-	-	-	7,780	10,220	18,000
Acquisition of non-controlling interests	-	(1,282)	-	-	-	-	(1,282)	(283)	(1,565)
Others	-	-	-	-	-	-	-	19	19
Total transactions with owners	-	6,498	8,905	19,128	567,602	(995,886)	(393,753)	9,956	(383,797)
Balance at December 31, 2016	₩ 954,959	(3,430)	(328,157)	513,776	4,296,523	1,612,032	7,045,703	72,554	7,118,257

KT&G Corporation and Subsidiaries

For the year ended December 31, 2016

(In thousands of U.S. dollars)

	Ordinary shares	Other capital surplus	Treasury shares	Gain on reissuance of treasury shares	Reserve	Retained earnings	Owners of the parent	Non- controlling interests	Total equity
Balance at January 1, 2016	\$ 790,202	(8,215)	(278,909)	409,308	3,065,217	1,160,095	5,137,698	55,103	5,192,801
Total comprehensive income for the year:									
Profit (loss) for the year	-	-	-	-	-	1,018,845	1,018,845	(4,340)	1,014,505
Other comprehensive income (loss):									
Unrealized net changes in fair value of available-for-sale financial assets, net of tax	-	-	-	-	9,463	-	9,463	-	9,463
Exchange differences on translating foreign operations, net of tax	-	-	-	-	10,898	-	10,898	438	11,336
Remeasurements of net defined benefit liability, net of tax	-	-	-	-	-	(20,961)	(20,961)	596	(20,365)
Total other comprehensive income (loss)	-	-	-	-	20,361	(20,961)	(600)	1,034	434
Total comprehensive income (loss) for the year	-	-	-	-	20,361	997,884	1,018,245	(3,306)	1,014,939
Transactions with owners, recorded directly in equity:									
Dividends	-	-	-	-	-	(354,393)	(354,393)	-	(354,393)
In-kind donation of treasury shares	-	-	7,368	15,828	-	-	23,196	-	23,196
Transfer from reserve for research and human resource development	-	-	-	-	(8,275)	8,275	-	-	-
Transfer to unconditional reserve	-	-	-	-	477,950	(477,950)	-	-	-
Extinguishment of equity conversion option	-	6,438	-	-	-	-	6,438	8,456	14,894
Acquisition of non-controlling interests	-	(1,061)	-	-	-	-	(1,061)	(234)	(1,295)
Others	-	-	-	-	-	-	-	16	16
Total transactions with owners	-	5,377	7,368	15,828	469,675	(824,068)	(325,820)	8,238	(317,582)
Balance at December 31, 2016	\$ 790,202	(2,838)	(271,541)	425,136	3,555,253	1,333,911	5,830,123	60,035	5,890,158

KT&G Corporation and Subsidiaries

For the year ended December 31, 2016

(In millions of won)

	Ordinary shares	Other capital surplus	Treasury shares	Gain on reissuance of treasury shares	Reserve	Retained earnings	Owners of the parent	Non- controlling interests	Total equity
Balance at January 1, 2015	₩ 954,959	(4,573)	(339,059)	492,032	3,426,367	1,100,876	5,630,602	77,478	5,708,080
Total comprehensive income for the year:									
Profit (loss) for the year	-	-	-	-	-	1,035,717	1,035,717	(3,497)	1,032,220
Other comprehensive income (loss):									
Unrealized net changes in fair value of available-for-sale financial assets, net of tax	-	-	-	-	(16,076)	-	(16,076)	-	(16,076)
Exchange differences on translating foreign operations, net of tax	-	-	-	-	(14,380)	-	(14,380)	(390)	(14,770)
Remeasurements of net defined benefit liability, net of tax	-	-	-	-	-	1,842	1,842	(1,804)	38
Total other comprehensive income (loss)	-	-	-	-	(30,456)	1,842	(28,614)	(2,194)	(30,808)
Total comprehensive income (loss) for the year	-	-	-	-	(30,456)	1,037,559	1,007,103	(5,691)	1,001,412
Transactions with owners, recorded directly in equity:									
Dividends	-	-	-	-	-	(428,056)	(428,056)	-	(428,056)
In-kind donation of treasury shares	-	-	1,997	2,616	-	-	4,613	-	4,613
Transfer from reserve for research and human resource development	-	-	-	-	(12,522)	12,522	-	-	-
Transfer to unconditional reserve	-	-	-	-	320,926	(320,926)	-	-	-
Extinguishment of equity conversion option	-	(5,483)	-	-	-	-	(5,483)	(5,390)	(10,873)
Acquisition of non-controlling interests	-	128	-	-	-	-	128	117	245
Others	-	-	-	-	-	-	-	78	78
Total transactions with owners	-	(5,355)	1,997	2,616	308,404	(736,460)	(428,798)	(5,195)	(433,993)
Balance at December 31, 2015	₩ 954,959	(9,928)	(337,062)	494,648	3,704,315	1,401,975	6,208,907	66,592	6,275,499

CONSOLIDATED STATEMENTS OF CASH FLOWS

KT&G Corporation and Subsidiaries

For the years ended December 31, 2016 and 2015

(In millions of won and thousands of U.S. dollars)

	2016 (Korean won)	2016 (U.S. dollars)	2015 (Korean won)
Cash flows from operating activities			
Cash generated from operations	₩ 1,882,242	\$ 1,557,503	₩ 1,585,600
Income tax paid	(384,480)	(318,147)	(326,365)
Net cash provided by operating activities	1,497,762	1,239,356	1,259,235
Cash flows from investing activities			
Interest received	35,885	29,694	31,659
Dividends received	18,395	15,222	19,196
Proceeds from sale of property, plant and equipment	11,980	9,913	10,314
Proceeds from sale of intangible assets	1,545	1,279	2,878
Proceeds from sale of non-current assets held for sale	7,945	6,574	4,260
Proceeds from sale of available-for-sale financial assets	34,099	28,216	233
Proceeds from sale of equity accounted investments	13,095	10,836	13,625
Collection of loans	15,328	12,683	11,866
Withdrawal of guarantee deposits	20,317	16,812	28,425
Settlement of derivatives, net	-	-	4
Acquisition of property, plant and equipment	(161,745)	(133,840)	(210,247)
Acquisition of intangible assets	(9,222)	(7,631)	(6,076)
Acquisition of investment property	-	-	(64)
Acquisition of available-for-sale financial assets	(31,000)	(25,652)	(34,200)
Acquisition of equity accounted investments	(19,000)	(15,722)	-
Increase in loans	(471)	(389)	(51,336)
Payments of guarantee deposits	(29,668)	(24,550)	(21,437)
Payments of long-term deposits in MSA Escrow Fund	(89,663)	(74,193)	(78,492)
Increase in other financial assets, net	(520,385)	(430,603)	(468,183)
Net cash used in investing activities	(702,565)	(581,351)	(747,575)

KT&G Corporation and Subsidiaries

For the years ended December 31, 2016 and 2015

(In millions of won and thousands of U.S. dollars)

	2016 (Korean won)	2016 (U.S. dollars)	2015 (Korean won)
Cash flows from financing activities			
Interest paid	(4,693)	(3,883)	(6,946)
Paid-in capital increase of subsidiaries	-	-	245
Payments of capital share issue cost	(128)	(106)	(249)
Dividends paid	(428,284)	(354,393)	(428,056)
Proceeds from borrowings	637,914	527,856	702,040
Increase in leasehold deposits received	3,803	3,146	3,191
Redemption of borrowings	(692,814)	(573,284)	(646,030)
Decrease in leasehold deposits received	(4,225)	(3,496)	(5,157)
Net cash used in financing activities	(488,427)	(404,160)	(380,962)
Effect of exchange rate fluctuation on cash held	(2,197)	(1,819)	(879)
Net increase in cash and cash equivalents	304,573	252,026	129,819
Cash and cash equivalents at January 1	546,213	451,976	416,394
Cash and cash equivalents at December 31	₩ 850,786	\$ 704,002	₩ 546,213

INDEPENDENT AUDITORS' REPORT

The Board of Directors and Shareholders

KT&G Corporation:

We have audited the accompanying separate financial statements of KT&G Corporation (the "Company"), expressed in Korean won, which comprise the separate statements of financial position as of December 31, 2016 and 2015, and the separate statements of comprehensive income, changes in equity and cash flows for the years then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Separate Financial Statements

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

Auditors' Responsibility

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

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

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

Opinion

In our opinion, the separate financial statements present fairly, in all material respects, the separate financial position of the Company as at December 31, 2016 and 2015 and of its separate financial performance and its separate cash flows for the years then ended in accordance with Korean International Financial Reporting Standards.

Other Matters

The procedures and practices utilized in the Republic of Korea to audit such separate financial statements may differ from those generally accepted and applied in other countries.

The accompanying separate financial statements as of and for the year ended December 31, 2016 have been translated into United States dollars solely for the convenience of the reader and such translation does not comply with K-IFRS. We have audited the translation and, in our opinion, the separate financial statements expressed in Korean won have been translated into dollars on the basis set forth in note 4 to the separate financial statements.



KPMG Samjong Accounting Corp.

Seoul, Korea

February 24, 2017

This report is effective as of February 24, 2017, the audit report date. Certain subsequent events or circumstances, which may occur between the audit report date and the time of reading this report, could have a material impact on the accompanying separate financial statements and notes thereto. Accordingly, the readers of the audit report should understand that the above audit report has not been updated to reflect the impact of such subsequent events or circumstances, if any.

SEPARATE STATEMENTS OF FINANCIAL POSITION

KT&G Corporation

As of December 31, 2016 and 2015

(In millions of won and thousands of U.S. dollars)

	2016 (Korean won)	2016 (U.S. dollars)	2015 (Korean won)
Assets			
Property, plant and equipment	₩ 1,117,268	\$ 924,508	₩ 1,309,632
Intangible assets	28,928	23,937	22,494
Investment property	335,196	277,366	136,801
Investments in associates and joint ventures	58,230	48,184	46,230
Investments in subsidiaries	1,154,925	955,669	1,124,446
Available-for-sale financial assets	364,305	301,453	340,149
Long-term deposits in MSA Escrow Fund	503,592	416,708	403,966
Long-term prepaid expenses	5,398	4,466	6,706
Long-term trade and other receivables	68,017	56,282	78,600
Total non-current assets	3,635,859	3,008,573	3,469,024
Inventories	914,702	756,890	889,035
Current available-for-sale financial assets	1,500	1,241	-
Other financial assets	1,620,000	1,340,505	1,091,976
Prepaid tobacco excise and other taxes	439,413	363,602	447,771
Trade and other receivables	1,140,598	943,813	1,074,862
Advance payments	22,272	18,429	26,489
Prepaid expenses	5,733	4,744	4,152
Cash and cash equivalents	688,735	569,909	444,376
Total current assets	4,832,953	3,999,133	3,978,661
Non-current assets held for sale	-	-	1,542
Total assets	₩ 8,468,812	\$ 7,007,706	₩ 7,449,227

KT&G Corporation

As of December 31, 2016 and 2015

(In millions of won and thousands of U.S. dollars)

	2016 (Korean won)	2016 (U.S. dollars)	2015 (Korean won)
Equity			
Ordinary shares	₩ 954,959	\$ 790,202	₩ 954,959
Other capital surplus	3,582	2,964	3,582
Treasury shares	(328,157)	(271,541)	(337,062)
Gain on reissuance of treasury shares	513,776	425,136	494,648
Reserves	4,366,268	3,612,965	3,784,467
Retained earnings	1,068,469	884,128	995,886
Total equity	6,578,897	5,443,854	5,896,480
Liabilities			
Long-term trade and other payables	6,848	5,666	8,147
Long-term advance receipts	319	264	491
Net defined benefit liability	47,121	38,992	42,174
Deferred income tax liabilities	73,328	60,677	72,179
Total non-current liabilities	127,616	105,599	122,991
Short-term borrowings	3,851	3,186	5,031
Trade and other payables	436,270	361,001	433,824
Advance receipts	972	804	26,024
Income tax payable	174,192	144,139	199,767
Tobacco excise and other taxes payable	1,147,014	949,123	765,110
Total current liabilities	1,762,299	1,458,253	1,429,756
Total liabilities	1,889,915	1,563,852	1,552,747
Total equity and liabilities	₩ 8,468,812	\$ 7,007,706	₩ 7,449,227

SEPARATE STATEMENTS OF COMPREHENSIVE INCOME

KT&G Corporation

For the years ended December 31, 2016 and 2015

(In millions of won and thousands of U.S. dollars, except earnings per share)

	2016 (Korean won)	2016 (U.S. dollars)	2015 (Korean won)
Sales:			
Manufacture of tobacco	₩ 2,670,305	\$ 2,209,603	₩ 2,607,650
Real estate	184,734	152,862	142,847
Exports of leaf tobacco and others	113,136	93,617	71,175
	2,968,175	2,456,082	2,821,672
Cost of sales:			
Manufacture of tobacco	(861,301)	(712,703)	(813,639)
Real estate	(118,427)	(97,995)	(84,915)
Exports of leaf tobacco and others	(68,391)	(56,591)	(48,091)
	(1,048,119)	(867,289)	(946,645)
Gross profit	1,920,056	1,588,793	1,875,027
Selling, general and administrative expenses	(614,979)	(508,878)	(637,709)
Operating profit	1,305,077	1,079,915	1,237,318
Other income	126,578	104,740	104,453
Other expenses	(91,848)	(76,002)	(103,360)
Finance income	69,493	57,503	81,917
Finance costs	(8,936)	(7,394)	(888)
Net finance income	60,557	50,109	81,029
Profit before income tax	1,400,364	1,158,762	1,319,440
Income tax expense	(313,017)	(259,013)	(331,516)
Profit for the year	₩ 1,087,347	\$ 899,749	₩ 987,924
Other comprehensive income (loss):			
Items that will not be reclassified to profit or loss			
Remeasurements of net defined benefit liability, net of tax	₩ (18,878)	\$ (15,621)	₩ 7,962
Items that are or may be reclassified subsequently to profit or loss			
Unrealized net changes in fair value of available-for-sale financial assets, net of tax	14,199	11,750	(17,695)
Other comprehensive loss for the year, net of tax	(4,679)	(3,871)	(9,733)
Total comprehensive income for the year	₩ 1,082,668	\$ 895,878	₩ 978,191
Earnings per share in won and U.S. dollars:			
Basic and diluted	₩ 8,618	\$ 7.13	₩ 7,843

SEPARATE STATEMENTS OF CHANGES IN EQUITY

KT&G Corporation

For the year ended December 31, 2016

(In millions of won)

	Ordinary shares	Other capital surplus	Treasury shares	Gain on reissuance of treasury shares	Reserves	Retained earnings	Total equity
Balance at January 1, 2016	₩ 954,959	3,582	(337,062)	494,648	3,784,467	995,886	5,896,480
Total comprehensive income for the year:							
Profit for the year	-	-	-	-	-	1,087,347	1,087,347
Other comprehensive income (loss):							
Remeasurements of net defined benefit liability, net of tax	-	-	-	-	-	(18,878)	(18,878)
Unrealized net changes in fair value of available-for-sale financial assets, net of tax	-	-	-	-	14,199	-	14,199
Total other comprehensive income (loss)	-	-	-	-	14,199	(18,878)	(4,679)
Total comprehensive income for the year	-	-	-	-	14,199	1,068,469	1,082,668
Transactions with owners, recorded directly in equity:							
Dividends	-	-	-	-	-	(428,284)	(428,284)
In-kind donation of treasury shares	-	-	8,905	19,128	-	-	28,033
Transfer from reserve for research and human resource development	-	-	-	-	(10,000)	10,000	-
Transfer to unconditional reserve	-	-	-	-	577,602	(577,602)	-
Total transactions with owners	-	-	8,905	19,128	567,602	(995,886)	(400,251)
Balance at December 31, 2016	₩ 954,959	3,582	(328,157)	513,776	4,366,268	1,068,469	6,578,897

KT&G Corporation

For the year ended December 31, 2016

(In thousands of U.S. dollars)

	Ordinary shares	Other capital surplus	Treasury shares	Gain on reissuance of treasury shares	Reserves	Retained earnings	Total equity
Balance at January 1, 2016	\$ 790,202	2,964	(278,909)	409,308	3,131,540	824,068	4,879,173
Total comprehensive income for the year:							
Profit for the year	-	-	-	-	-	899,749	899,749
Other comprehensive income (loss):							
Remeasurements of net defined benefit liability, net of tax	-	-	-	-	-	(15,621)	(15,621)
Unrealized net changes in fair value of available-for-sale financial assets, net of tax	-	-	-	-	11,750	-	11,750
Total other comprehensive income (loss)	-	-	-	-	11,750	(15,621)	(3,871)
Total comprehensive income for the year	-	-	-	-	11,750	884,128	895,878
Transactions with owners, recorded directly in equity:							
Dividends	-	-	-	-	-	(354,393)	(354,393)
In-kind donation of treasury shares	-	-	7,368	15,828	-	-	23,196
Transfer from reserve for research and human resource development	-	-	-	-	(8,275)	8,275	-
Transfer to unconditional reserve	-	-	-	-	477,950	(477,950)	-
Total transactions with owners	-	-	7,368	15,828	469,675	(824,068)	(331,197)
Balance at December 31, 2016	\$ 790,202	2,964	(271,541)	425,136	3,612,965	884,128	5,443,854

KT&G Corporation

For the year ended December 31, 2015

(In millions of won)

	Ordinary shares	Other capital surplus	Treasury shares	Gain on reissuance of treasury shares	Reserves	Retained earnings	Total equity
Balance at January 1, 2015	₩ 954,959	3,582	(339,059)	492,032	3,493,758	736,460	5,341,732
Total comprehensive income for the year:							
Profit for the year	-	-	-	-	-	987,924	987,924
Other comprehensive income (loss):							
Remeasurements of net defined benefit liability, net of tax	-	-	-	-	-	7,962	7,962
Unrealized net changes in fair value of available-for-sale financial assets, net of tax	-	-	-	-	(17,695)	-	(17,695)
Total other comprehensive income (loss)	-	-	-	-	(17,695)	7,962	(9,733)
Total comprehensive income for the year	-	-	-	-	(17,695)	995,886	978,191
Transactions with owners, recorded directly in equity:							
Dividends	-	-	-	-	-	(428,056)	(428,056)
In-kind donation of treasury shares	-	-	1,997	2,616	-	-	4,613
Transfer from reserve for research and human resource development	-	-	-	-	(12,522)	12,522	-
Transfer to unconditional reserve	-	-	-	-	320,926	(320,926)	-
Total transactions with owners	-	-	1,997	2,616	308,404	(736,460)	(423,443)
Balance at December 31, 2015	₩ 954,959	3,582	(337,062)	494,648	3,784,467	995,886	5,896,480

SEPARATE STATEMENTS OF CASH FLOWS

KT&G Corporation

For the years ended December 31, 2016 and 2015

(In millions of won and thousands of U.S. dollars)

	2016 (Korean won)	2016 (U.S. dollars)	2015 (Korean won)
Cash flows from operating activities			
Cash generated from operations	₩ 1,694,203	\$ 1,401,906	₩ 1,600,888
Income tax paid	(342,058)	(283,043)	(284,038)
Net cash provided by operating activities	1,352,145	1,118,863	1,316,850
Cash flows from investing activities			
Interest received	34,270	28,357	30,860
Dividends received	18,395	15,222	20,217
Proceeds from sale of property, plant and equipment	15,360	12,710	9,563
Proceeds from sale of intangible assets	476	394	1,593
Proceeds from sale of non-current assets held for sale	5,800	4,799	4,260
Proceeds from investments in associates and joint ventures	13,095	10,836	13,625
Proceeds from sale of available-for-sale financial assets	33,988	28,124	233
Collection of loans	13,167	10,896	11,220
Withdrawal of guarantee deposits	12,083	9,999	18,171
Acquisition of property, plant and equipment	(118,665)	(98,192)	(138,416)
Acquisition of intangible assets	(6,910)	(5,718)	(3,752)
Acquisition of investment property	-	-	(64)
Acquisition of investments in associates and joint ventures	(19,000)	(15,722)	-
Acquisition of investments in subsidiaries	(3,065)	(2,536)	(77,207)
Acquisition of available-for-sale financial assets	(31,000)	(25,652)	(34,200)
Increase in loans	-	-	(59,935)
Payments of guarantee deposits	(18,509)	(15,317)	(16,485)
Payments of long-term deposits in MSA Escrow Fund	(89,663)	(74,193)	(78,492)
Increase in other financial assets, net	(540,000)	(446,835)	(440,000)
Acquisition of redeemable convertible preference shares	-	-	(26,000)

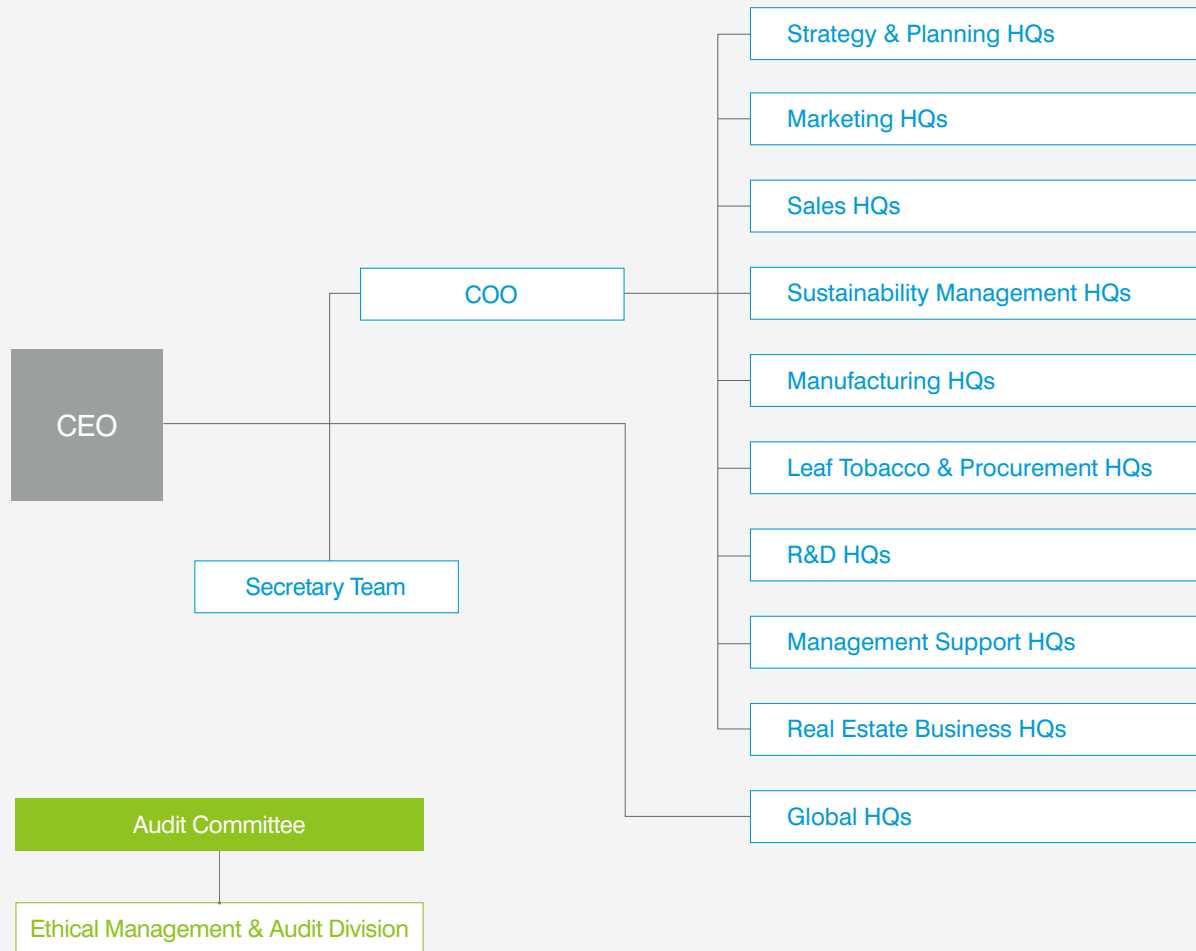
KT&G Corporation

For the years ended December 31, 2016 and 2015

(In millions of won and thousands of U.S. dollars)

	2016 (Korean won)	2016 (U.S. dollars)	2015 (Korean won)
Net cash used in investing activities	(680,178)	(562,828)	(764,809)
Cash flows from financing activities			
Dividends paid	(428,284)	(354,393)	(428,056)
Increase in leasehold deposits received	(3,704)	(3,066)	3,411
Decrease in leasehold deposits received	4,199	3,475	(4,605)
Net cash used in financing activities	(427,789)	(353,984)	(429,250)
Effect of exchange rate fluctuation on cash held	181	150	23
Net increase in cash and cash equivalents	244,359	202,201	122,814
Cash and cash equivalents at January 1	444,376	367,708	321,562
Cash and cash equivalents at December 31	₩ 688,735	\$ 569,909	₩ 444,376

ORGANIZATION CHART



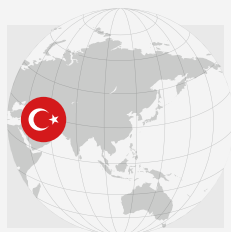
* As of March 2017

GLOBAL NETWORK

OVERSEAS BRANCHES



OVERSEAS PRODUCTION FACTORIES



Turkey Factories

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



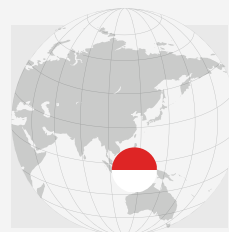
Iran Factories

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



Russia Factories

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



Indonesia Factories

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

* As of March 2017



INQUIRIES

INVESTOR RELATIONS DEPARTMENT

KT&G Tower, 416, Yeongdong-daero,
Gangnam-gu, Seoul 06176, Korea

Tel +82-2-3404-4522

Fax +82-2-3404-4278

HEAD OFFICE

KT&G CORPORATION

71, Beotkkot-gil, Daedeok-gu, Daejeon 34337, Korea

Tel +82-42-939-5000

Fax +82-42-939-5001

www.ktng.com