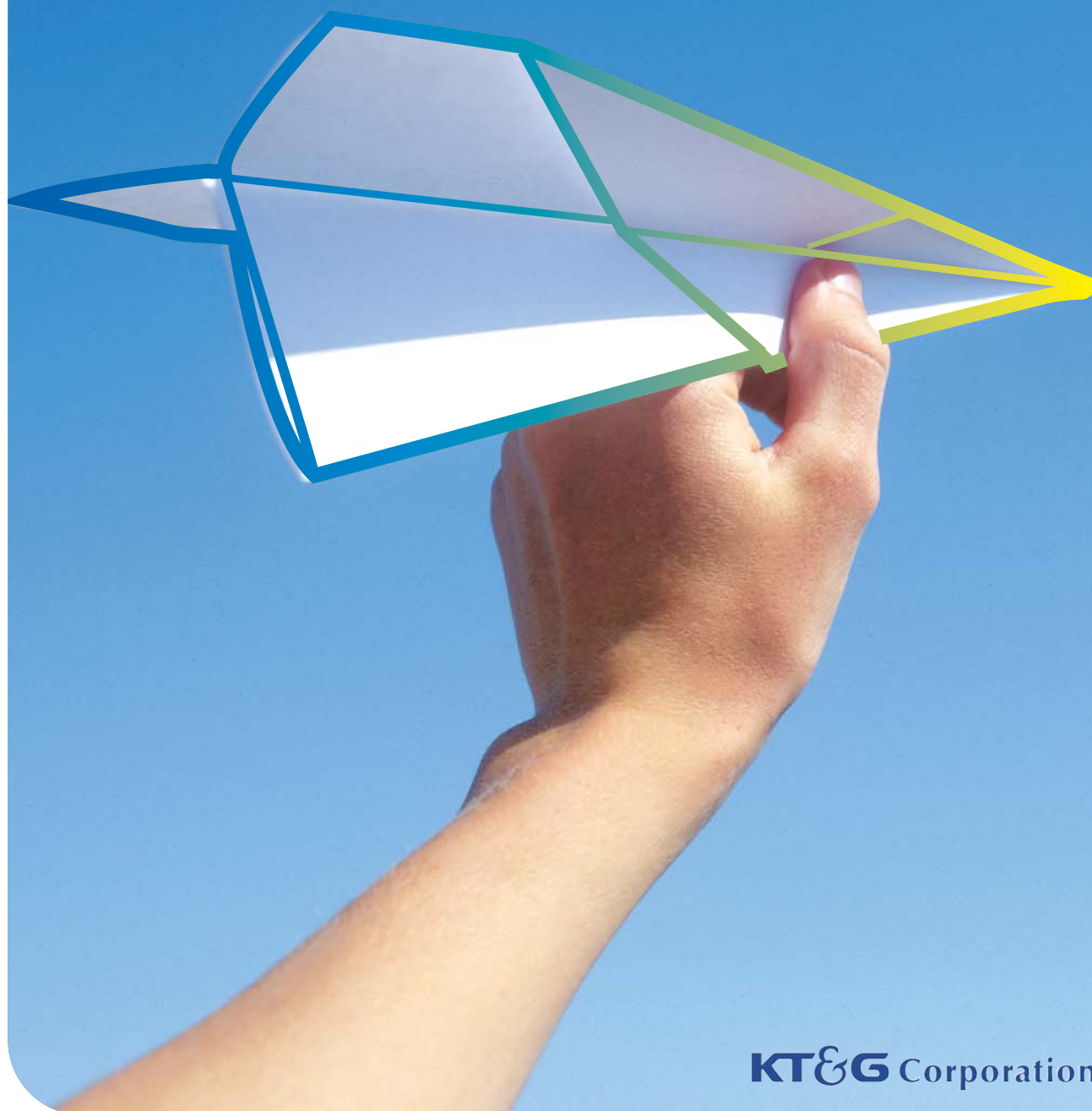


Annual Report 2006

# THINK NEXT



**KT&G** Corporation

## KT&G, Taking a Larger Step Toward Building a Leading Global Company through Sustainable Management

After successfully completing its privatization in 2002, KT&G has capitalized upon lessons of its experiences to take stronger initiatives to reform and innovate its businesses, thereby effectively executing its business model diversification strategies and achieving solid management performance results. As a consequence, KT&G has grown into a globally competitive business, facilitating enhanced communication among stakeholders and practicing a sustainable growth management.

By applying the three core beliefs of its management philosophy - "Righteousness," "Enlightenment," and "Companionship" - to every aspect of its business engagement, KT&G has continued to win commendations and respect for its business transparency and ethics such as corporate governance, ethical and transparent management practices, and business innovations, among others. KT&G has also shared created values with its clients, shareholders, and constituents, further with the society at large with a greater sense of balance.

Within its head office, KT&G maintains four groups for strategy, marketing, production, and R&D; two headquarters for growth business and management support; and three offices for finance, audit, and secretariat. Across the nation, KT&G also maintains 14 regional sales headquarters, 168 branch offices, and 46 sales offices, while operating 4 tobacco manufacturing plants, 2 leaf tobacco material processing factories, and a printing plant. As for its affiliates, KT&G has Korea Ginseng Corporation, Yungjin Pharmaceutical, Tae-a Industrial, KGC Sales, etc.

While improving superior product quality and manufacturing capabilities by competing with foreign cigarette manufacturers operating their production bases in Korea, KT&G has dominated domestic market over 70% by developing and releasing new products marked by ceaseless technological innovations. KT&G has also successfully developed over 40 export markets including Russia, CIS, Middle East, Central Asia, China, and Southeast Asia with its flagship product "Esse" spearheading its campaign.

In order to enhance its corporate value, KT&G will continue to reform and innovate its organization and businesses alike. By further strengthening its core businesses, developing growth drivers for the next generation, and achieving a better balanced business portfolio, KT&G will take a larger step toward building an exceptional global business of far stronger growth potential, profitability, stability, and sustainability.

2002



2003



2004



2005



2006



In order to enhance its corporate value, KT&G will continue to reform and innovate its organization and businesses alike.

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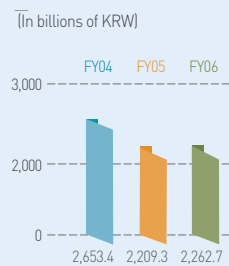
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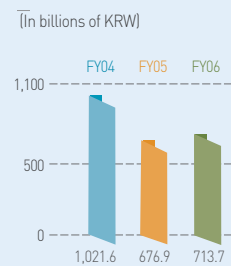
## FINANCIAL HIGHLIGHTS

|                             | 2004    | 2005    | 2006    |
|-----------------------------|---------|---------|---------|
| (In billions of Korean won) |         |         |         |
| Net sales                   | 2,653.4 | 2,209.3 | 2,262.7 |
| Gross profit                | 1,548.2 | 1,224.6 | 1,282.9 |
| Operating profit            | 1,021.6 | 676.9   | 713.7   |
| Net profit                  | 472.3   | 515.9   | 649.7   |
| (In billions of Korean won) |         |         |         |
| Total assets                | 3,885.0 | 3,964.4 | 3,668.4 |
| Current assets              | 2,002.0 | 2,032.9 | 1,602.7 |
| Fixed assets                | 1,883.0 | 1,931.2 | 2,065.6 |
| Total liabilities           | 670.8   | 516.4   | 622.6   |
| Current liabilities         | 535.3   | 301.1   | 345.8   |
| Long-term liabilities       | 135.5   | 215.3   | 276.8   |
| Total shareholders' equity  | 3,214.2 | 3,448.0 | 3,045.8 |
| (% YoY)                     |         |         |         |
| Net sales growth            | 21.8    | -16.7   | 2.4     |
| Gross profit growth         | 28.2    | -20.9   | 4.8     |
| Operating profit growth     | 43.6    | -33.7   | 5.4     |
| Net profit growth           | 2.7     | 9.2     | 25.9    |
| (%)                         |         |         |         |
| Gross profit margin         | 58.3    | 55.4    | 56.7    |
| Operating profit margin     | 38.5    | 30.6    | 31.5    |
| Net profit margin           | 17.8    | 23.4    | 28.7    |
| (Per share data)            |         |         |         |
| Diluted EPS (won)           | 2,981   | 3,491   | 4,608   |
| Diluted PER (x)             | 10.4    | 12.9    | 12.3    |
| Year-end stock price (won)  | 30,950  | 45,050  | 56,500  |

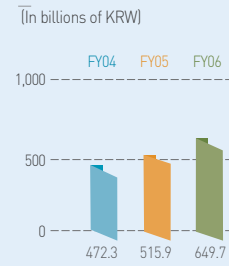
## • NET SALES



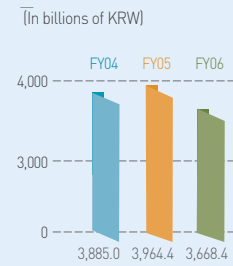
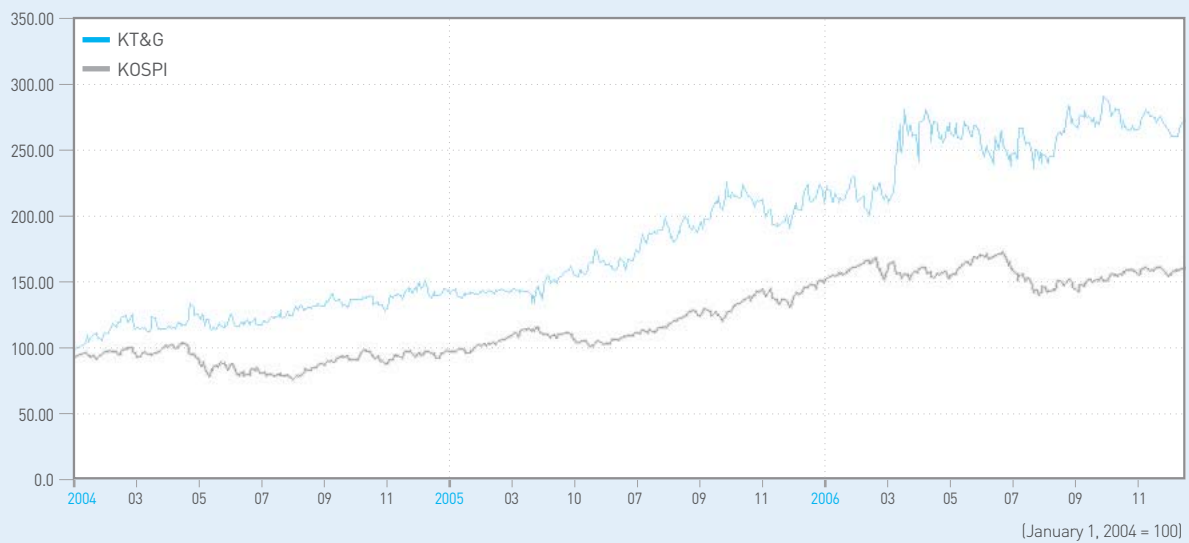
## • OPERATING PROFIT



## • NET PROFIT



## • TOTAL ASSETS

CHART OF KT&G STOCK PRICE IN RELATION TO KOSPI



## CEO MESSAGE



“

We will make an all-out effort to maximize the corporate value through corporate-wide reform and innovation.

”

## Dear Our Stakeholders,

In 2006, we were challenged by rising oil prices, destabilizing exchange rates, further tightening smoking regulations, and fiercer competition.

However, KT&G has continually managed to practice sustainable business by successfully projecting market behaviors and introducing management strategies and visions over the years. We have also rationalized manufacturing capacity and invested in modernization for enhanced product quality and competitiveness, while strengthening our marketing and research and development capabilities.



As a result of these endeavors, KT&G has achieved KRW 2,262.7 billion of net sales, which is a 2.4% increase year on year, and KRW 649.7 billion of net profits, a 25.9% increase year on year, respectively. Building upon these remarkable performance results, we have continued to successfully maintain our dominance by capturing 71.4% of the domestic cigarette market based on the number of sticks sold. KT&G has also expanded overseas markets and received 'USD300 Million Exports Award' presented by the Korean government.

The year 2006 was another opportunity amidst challenges for KT&G to reconstruct its future, as we timely completed a mid to long term masterplan last August for the corporate and shareholder value maximization with the assistance from a global strategy consulting firm based upon objectivity and credibility. This masterplan will serve to materialize a sustainable business management we consider to be of the most critical value, while enhancing our economic value by strengthening our business competencies.

The masterplan includes the strategies as follows. First, we will re-establish business portfolio to prepare for stagnant growth of the cigarette market, thereby effectively achieving continued growth in business and corporate value. Secondly, we will improve efficiency in asset management. Thirdly, we will try our best to maximize shareholder values.

In addition to executing the masterplan, KT&G will continue to practice transparency in management and strengthen corporate governance. To this end, we will pursue enhanced transparency and professionalism, so that we may reinforce ethical management practices within and throughout our organization. Meanwhile, corporate social responsibility will continue to play a vital role in our pursuit of "companionship" among the beliefs we adhere to in line with our management philosophy. KT&G, in this context, will actively continue to engage in social contribution through KT&G Social Welfare Foundation, focusing on the elderly, as well as underprivileged children and youth. Furthermore, we will practice sustainable business management by strengthening the effective communication with and among the stakeholders.

We will make an all-out effort to maximize the corporate value through corporate-wide reform and innovation. All KT&G employees including me will make no reservations in creating better values for the future by accepting challenges and capitalizing upon what we have, thus making a larger step forward. It is a corporate culture we intend to deliver dream and hope to the next generations, while keeping our promises to our shareholders and the community.

Thank you.

A handwritten signature in black ink, appearing to read 'Y. Kwak'.

Chairman & CEO \_ Young-kyoon Kwak

## SNAPSHOTS IN 2006



JANUARY 2006



MARCH 2006



MAY 2006



MAY 2006

### JANUARY 2006

#### [Steering Its Board of Directors Towards Greater Responsibility by Electing the Code of Conduct for Independent non-executive Directors](#)

At a recent Board meeting, KT&G has elected the Standard Code of Conduct for Independent non-executive Directors of Listed Companies provided by The Korea Listed Companies Association and affirmed its commitment to comply with the Code. To ensure that the independent non-executive director system elected and effectuated by each individual business organization will successfully perform, the Code provides a total of 11 articles that specify the roles and principles of independent non-executive directors.

### MARCH 2006

#### [Winning Grand Prize for Ethical Management](#)

KT&G was awarded Grand Prize at the Fourth Korea Ethical Management Award Ceremony for its highest performance achieved among all Korean corporations in each of the criteria including management transparency, social contribution and responsibility, environmental conservation, human resources management, welfare programs, and cultural management.

### MAY 2006

#### [Developing New Standards on Ginseng's Therapeutic Property for the First Time in the World](#)

KT&G has recently been certified by Korea Agency for Technology and Standards of The Ministry of Commerce, Industry and Energy for its development of the two variants of "Ginsenocide" as the major therapeutic property of Ginseng.

### MAY 2006

#### [Executing a Memorandum with The State Tobacco Monopoly Administration of China](#)

KT&G has executed a memorandum with The State Tobacco Monopoly Administration of China in Beijing to build a stronger relationship, covering the exchanges of human resources on sports and technology and other information including printed materials.



“We will practice sustainable business management by strengthening the effective communication with and among the stakeholders.”

## JUNE 2006

### Selected Number One for Corporate Governance for 3 Years Consecutively

KT&G was selected by The Korea Exchange and The Korea Corporate Governance Service as the winner of The 2006 Corporate Governance Award. Previously selected as one of the best Korean businesses for corporate governance in 2002 and 2003, KT&G has been selected number one for 3 consecutive years since 2004.

## JUNE 2006

### Selected One of the Best Companies for Shareholder Value

KT&G was selected as one of the recipients for The Second Annual Shareholder Value Award presented by Money Today. The Award recipients were selected based upon the survey performed on investor returns and comments by market specialists including analysts and fund managers.



JUNE 2006

## AUGUST 2006

### KT&G Declares Its Mid to Long Term Masterplan to Maximize Corporate Value by Innovations and Reforms

KT&G announced its “Mid to Long Term Masterplan” to maximize its corporate value by undertaking organization wide innovations and reforms. KT&G developed the masterplan based upon the management advisory services provided by the global Booz Allen Hamilton for approximately 3 months since April 2006.



JUNE 2006

## AUGUST 2006

### Achieving New KT&G 2010

KT&G held a ceremony to declare its mid to longer term vision to share with its constituents. The ceremony entitled “Achieving New KT&G 2010” was held in Lecture Hall at the KT&G’s Human Resources Development Center with the participation of over 300 individual staffs from KT&G, its subsidiaries, and unions.



AUGUST 2006



AUGUST 2006

## **KT&G Corporation**

KT&G has capitalized upon lessons of its experiences to take stronger initiatives to reform and innovate its businesses, thereby effectively executing its business model diversification strategies and achieving solid management performance results.

ECONOMY

SOCIETY

ENVIRONMENT

NET PROFIT GROWTH

25.9%yoy



**KT&G**  
*value oriented culture*

Molding a Corporate Culture  
to Share Growth and  
Happiness Together



ECONOMY

SOCIETY

ENVIRONMENT

HAPPINESS INDEX

99.9%+YOU



KT&G

*value oriented culture*

Communicating Love to Share  
Laughter and Joy Together



ECONOMY

SOCIETY

ENVIRONMENT

ANGEL

1004



KT&G

*value oriented culture*

Building a Good Company to  
Restore Environment and  
Sustain Future by Practicing  
Responsible Management





# Next Stage

■ Corporate Vision ..... 14

■ Corporate Governance ..... 16

As for reestablishing its business portfolio, KT&G will focus upon tobacco business, health functional food business, and pharmaceutical business.



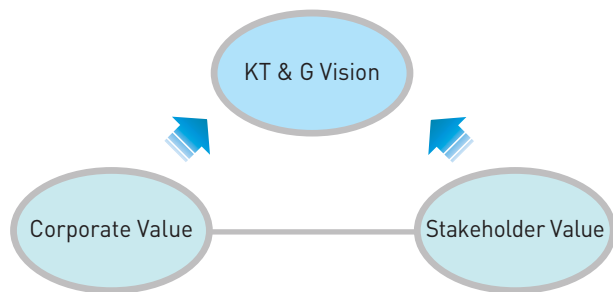
● Arirang: Arirang was reborn by upgrading in design and technology. The brand name and package design represent the very traditional Korean culture.





## CORPORATE VISION

### Vision: Emerge as a leading global company by maximizing the corporate and stakeholder value



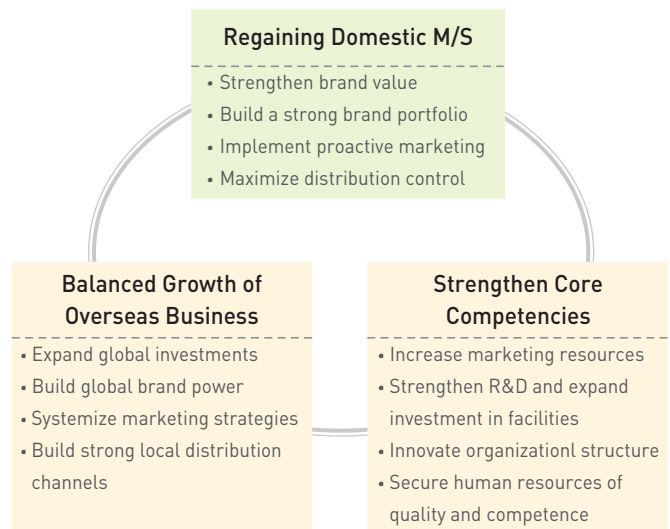
In order to build a globally competitive business, KT&G developed its mid to long term masterplan in August 2006 and created its core strategies for reestablishing business portfolio, maximizing value for each business, and delivering shareholder value with the view to further strengthen its management capabilities and performance.

As for reestablishing its business portfolio, KT&G will focus upon tobacco business, health functional food business, and pharmaceutical business. Of these, KT&G's tobacco business will play the role of a "value base" rendering both qualitative and quantitative growth in the export markets, while undergoing significant investments in brand value, marketing and research and development for the strengthened business competencies in domestic market. This in turn will reaffirm KT&G's exceptional leadership in the domestic tobacco market and high profitability within the global business arena.



KT&G plans to achieve KRW 3.2 trillion of net sales and KRW 970 billion of operating profit in 2010. Toward this end, KT&G will continue to carry out aggressive marketing, sales and investment strategies to ensure its dominance of the domestic market, while innovating performance results in the export markets for a better balanced growth and stronger business competencies.

### Implementation Strategy for the Cigarette Business Value Maximization



Ginseng business will actively seize opportunities in the fast growing health functional food market to assume its role as "value grower". In a fast growing health functional food market, KGC will seek to expand its business via, among others, creating newer products involving red ginseng and other ingredients and undertaking mergers and acquisitions, while paving its way to become a leading comprehensive health functional food provider. For this business alone, KGC targets to achieve KRW 1 trillion of net sales and KRW 260 billion of operating profit in 2010. Critical

“In order to build a globally competitive business, KT&G developed its mid to long term masterplan in August 2006 and created its core strategies for reestablishing business portfolio.”

to KT&G's value growth business strategy, ginseng will enable KGC to proactively develop businesses related and secure its unique market position in Korea's red ginseng market and beyond.

### Implementation Strategy for Maximizing the Health Functional Food Business



Pharmaceutical business, Yungjin Pharm., will be “value catalyst” for KT&G through enhancing corporate value by implementing intense restructuring and creating synergy with affiliated companies. We target KRW 230 billion of net sales and KRW 23 billion of operating profit for the pharmaceutical business in 2010, envisioning to enter the ranks of top 10 domestic pharmaceutical companies by securing core strategic products.

Meanwhile, KT&G has developed a number of principles and strategies to successfully deliver shareholder values. First, we will increase corporate value in the long-term and stable basis



by strengthening company's fundamentals to maximize economic value. As stipulated in the current laws and regulations in Korea, amount of the shareholder return will be implemented within the scope of profits available for dividend.

Whareholder return will be executed based on a resolution by BOD in order to maximize and sustain Total Shareholder Return (TSR = dividend yield + % change in share price) taking into consideration of mutually complementary role of dividend and share buyback to protect all shareholders' interests.

KT&G will arduously execute its mid to long term masterplan for maximized economic values of its businesses, while achieving greater asset management efficiency and far enhanced shareholder values through various policies of practicality. Alongside its continuing initiatives to develop future growth engines for the perennial procession of its businesses and creation of corporate value even against rising uncertainties of the operating environment, KT&G will carry out investor relations activities to reflect the values of its businesses including its affiliates' operations. Moreover, as KT&G Social Welfare Foundation together with other various programs will contribute about 2% level of its annual net sales to the society, KT&G will do justice to the “companionship” belief it upholds within its management philosophy by exercising a greatest sense of commitment to its corporate social responsibility.



## CORPORATE GOVERNANCE



[Young-kyoon Kwak](#)  
Chairman & CEO



[Kwang-youl Lee](#)  
Senior Managing Director



[Young-jin Min](#)  
Senior Managing Director



[Jin-hyun Kim](#)  
Independent non-executive  
Director



[Choong-sup Kim](#)  
Independent non-executive  
Director



[Kyung-jae Lee](#)  
Independent non-executive  
Director



[Sun-gak Cha](#)  
Independent non-executive  
Director



[Yoon-jae Lee](#)  
Independent non-executive  
Director



[Chang-woo Lee](#)  
Independent non-executive  
Director



[Yong-chan An](#)  
Independent non-executive  
Director



[Warren G. Lichtenstein](#)  
Independent non-executive  
Director



[Kiu-won Kim](#)  
Independent non-executive  
Director



“KT&G seeks highly qualified individuals of experiences professionalized in economics, business management, law and technology, among others.”

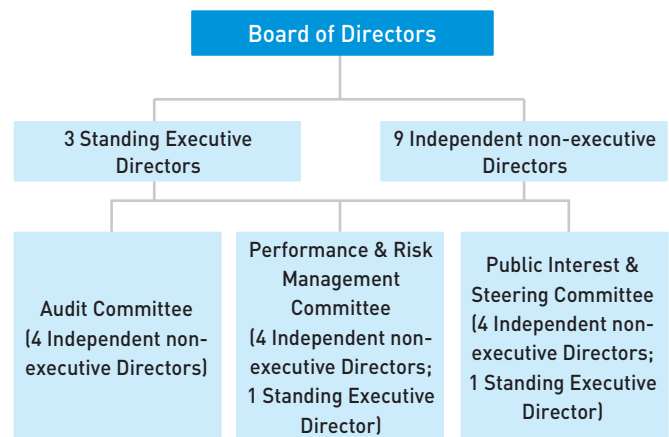
## BOD & MANAGEMENT

KT&G is fortunate to have its Board of Directors comprised of the specialists with unparalleled experiences, operating independently in making decisions with transparency in the best interests of its stakeholders. BOD consists of 3 executive directors and 9 independent non-executive directors. KT&G is also keenly aware of the important role its independent non-executive directors play and is proud of the level of their contribution as they far exceed any average number of independent non-executive directors sitting on the boards of major Korean businesses of prominence. Under the Board are 3 committees on Audit, Performance and Risk Management, and Public Interest and Steering, in addition to the Management Committee that provides direct support to the CEO for decision making, among others.

A foremost contribution by the Board is to review and decide on the issues of importance for KT&G such as management policies. Issues relating to KT&G's management activities are also within the scope of the Board's action, but the Board is better known for advising the senior management with objectivity and reasonability. For transparency and credibility purposes, the Audit Committee is managed by 4 independent non-executive directors only, while managing the agenda assigned by the Board as well as performing the accounting and business audits. The Performance and Risk Management Committee is consisted of 4 independent non-executive directors and 1 executive director, overseeing KT&G's budget, deciding standards of review on KT&G's CEO nomination, and determining contractual terms with KT&G's CEO nominee such as management objectives, among others. Comprised of 4

independent non-executive directors and 1 executive director, the Public Interest and Steering Committee performs advanced reviews of amendments to KT&G's articles of incorporation and Board regulations and decides on public interest projects, while undertaking advanced reviews of insider trading allegations subject to the statutes on anti-monopoly and fair trading practices.

### KT&G Board of Directors Chart



To continue its success with the Board, KT&G seeks highly qualified individuals of experiences professionalized in economics, business management, law and technology, among others.



# CORPORATE GOVERNANCE

## TRANSPARENCY

As the corporate social responsibility has become increasingly important, KT&G believes that ethical management will provide a long standing measure to decide businesses of global competitiveness and excellence. Having proclaimed its own Corporate Governance Charter encompassing shareholder rights and protection, Board of Directors, audit vehicles, stakeholders, and disclosure in July 2003 as the first Korean business to do so, KT&G has successfully carried out the three core beliefs - "Righteousness," "Enlightenment," and "Companionship" - of its ethical management philosophy by amending the Charter in 2005 and 2006 each, respectively.

Upholding its "Righteousness" belief, KT&G is committed to the basics by setting management principles respecting independence and creativity and pursuing future-oriented

management practices. At the same time, KT&G practices its "Enlightenment" belief by pursuing "changes and innovations" as the end, not as the means to achieve such ends. In this context, KT&G will continue its excellence in developing a conscious, creative corporate culture that will last for the generations to come. Its "Companionship" belief also enables KT&G to serve the society by large by exercising the greatest sense of its responsibility by accepting rules in the public interest and delivering satisfaction and values to its clients, shareholders and constituents all together.

KT&G also has fully complied with every recommendation and guideline on corporate governance formulated by The Korea Corporate Governance Service to avail the extent of its transparency for external review.

### \* KT&G's Performance on Corporate Governance Recommendation Compliance

| Recommendation  | KT&G's Action | Remark  |
|---|---------------|---|
| Adopt Corporate Governance Charter  | Completed     |   |
| Adopt Code of Ethics for Employees  | Completed     |   |
| Elect Cumulative Voting Practice  | Completed     |   |
| Compose Majority of Board of Directors with Independent non-executive Directors             | Completed     | 3 Standing Executive Directors; 9 Independent non-executive Directors |
| Separate CEO and Board Chairperson, or Appoint Principal Independent non-executive Director | Completed     | Appointed Principal Independent non-executive Director                |
| Disclose Board Activities, Attendance, and Decisions on Issues of Significance              | Completed     |   |
| Compose Independent Non-executive Director Nomination Committee                             | Completed     |   |
| Compose Compensation Committee  | Completed     |   |
| Compose Audit Committee Fully with Independent non-executive Directors Only                 | Completed     | 4 Independent non-executive Directors                                 |
| Adopt Rules on Roles and Operating Procedures for the Board and Its Committees              | Completed     |   |
| Subscribe to Liability Insurance for Directors at KT&G's Expenses                           | Completed     |   |
| Evaluate Board Activities   | Completed     |   |
| Preserve External Auditor's Independence  | Completed     |   |
| Certify Accuracy and Completeness of Financial Reports by CEO and CFO                       | Completed     |   |
| Explain Gaps from Standard Regulation   | Completed     | Posted on Homepage  |
| Disclose Audit Reports and Important Information in both English and Korean                 | Completed     |   |

“Championing such a corporate culture of transparency, KT&G won the Best Corporate Governance Award in 2006 again presented by The Korea Corporate Governance Service.”

Championing such a corporate culture of transparency, KT&G won the Best Corporate Governance Award in 2006 again presented by The Korea Corporate Governance Service. As a result, KT&G has been named a “Best Corporate Governance Business” for the three year in a row.

For enhanced transparency and shareholders’ right to know, KT&G carries out disclosure and investor relations activities proactively in order to maximize its business value and preserve shareholder centered management traditions. KT&G provides its information strictly in line with the guidelines and requirements of The Financial Supervisory Service, further to controlling relevant procedures on its own. Understanding the critical importance of its information for shareholders from abroad, KT&G provides English versions of its information alongside the Korean for disclosure purposes. KT&G endeavors to deliver its corporate information to existing and prospective investors with precision and promptness, anticipating to benefit from any advice or opinion they may have to offer for KT&G to reflect upon any aspect of its business and management practices.



## SHAREHOLDER RELATIONS

Practicing a well aligned shareholder return in the long term basis, KT&G retired 15 million treasury shares after making repurchases in 2006. KT&G also decided to pay out KRW 2,400 per share on dividend, which is approximately a 40% increase year on year. The mid to long term masterplan KT&G completed in 2006 will now facilitate more specific strategies to deliver shareholder values toward their maximization. Going forward, KT&G will continue to make larger progresses in delivering shareholder value in line with its completed masterplan.

In 2006 we have successfully carried out numerous investor relations activities to satisfy diverse needs and requirements of its shareholders and investors through non-deal roadshows, quarterly earnings conferences, conference calls, visitations on call, and the revelation of its mid to long term masterplan. To meet the expectations of its shareholders and investors, KT&G will unfold the more positive investor relations activities to stay well connected.



# Next Business

Business Structure ..... 22

Operations ..... 27

KT&G's business portfolio will be re-established to prepare for stagnant growth of the cigarette market, to sustain company growth and to continually create corporate value.



● Esse: Esse is the KT&G's best selling brand. The popularity of Esse is growing fast both in Korea and overseas.







## BUSINESS STRUCTURE

### BUSINESS STRATEGY

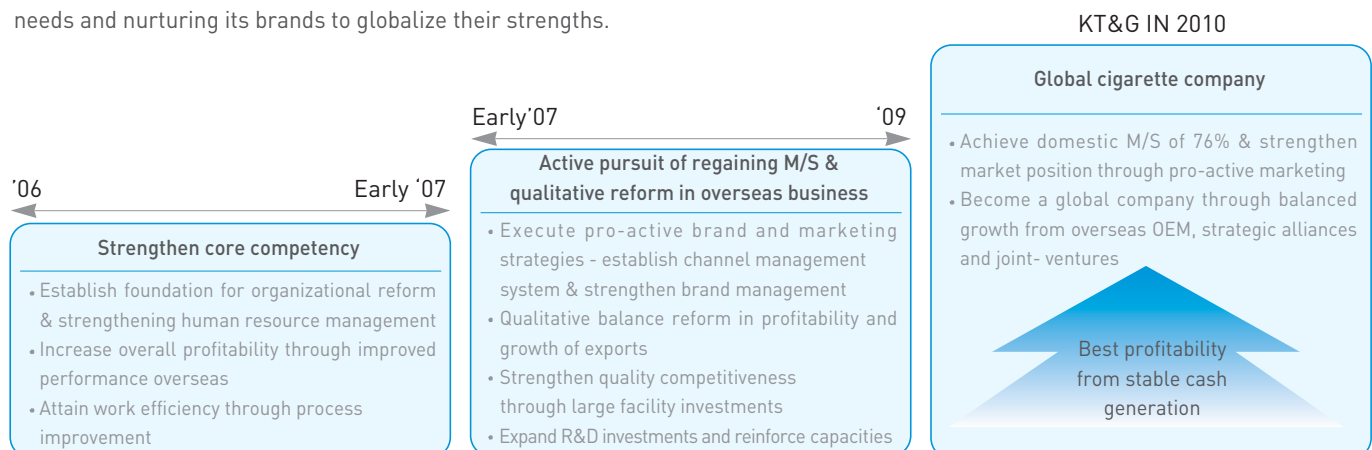
KT&G's business portfolio will be re-established to prepare for stagnant growth of the cigarette market, to sustain company growth and to continually create corporate value. Facing with market uncertainties and declining domestic demand for cigarettes due to stricter smoking regulation and well-being trend, KT&G has implemented a wide range of strategies to identify opportunities for future external growth, based on strengthened internal capabilities and enhanced performance of existing business etc..

#### Tobacco Business

Tobacco business will focus on its role as value base for KT&G. KT&G will increase investment in marketing, R&D, and production facilities for the stable profit generation domestically and abroad. As a core business providing the dynamics for KT&G's continuing growth, tobacco business will focus on regaining domestic market share. To this end, KT&G will develop high performance and risk reduced products, while differentiating its products to successfully meet consumer needs and nurturing its brands to globalize their strengths.

We also set growth strategies for overseas business, KT&G's core strategic business. KT&G will nurture "ESSE" into a genuinely global brand, which has been winning positive feedbacks from Russia, Southeast Asia, and Middle East and establish brand portfolio according to market characteristics and broaden sales portion of high profitable products. In this context, its Turkey plant will trigger KT&G's direct entries into the markets abroad. Since KT&G understands the invaluable marketing resources and strategic alliances play in its business strategies, KT&G will continue to seek stronger distribution channels and manage its relationships with local partners.

To achieve such a balanced growth in both domestic and overseas markets, KT&G will strengthen core competencies internally. While actively investing in marketing, KT&G will improve technological capabilities by making investments in research and development. KT&G will also continue to build a global network for advanced information and modernize its manufacturing capacities to ensure its competitiveness in product quality.



“KT&G will develop high performance and risk reduced products, while differentiating its products to successfully meet consumer needs and nurturing its brands to globalize their strengths.”

### Health Functional Food Business

KGC leads KT&G's growth as a comprehensive health functional food company, through active expansion of health functional food business domain and strengthening the market dominant position of the domestic & overseas red ginseng business. As this market will provide another value adding business, KGC will increasingly invest in strengthening marketing capabilities and defending its market leadership. KT&G will take a faster step forward to preempt this specialized market and operate a new research institute dedicated to expanding the scope of its research and development capabilities.

KGC will strengthen its distribution network by expanding franchise and department stores, developing new venues such as discount stores and home shopping channels, and setting up a franchise-type 'multi-purpose stores' in metropolitan areas starting 2008. Furthermore, KT&G will strive to enhance brand value for "Cheong-Kwan-Jang" overseas by utilizing every resource available, while taking customized marketing to suit each market consistently with each product demand.

### Pharmaceutical Business

As a value catalyst, Yungjin Pharm. will realign its pharmaceutical products focusing on profitability and rationalize its assets. Yungjin Pharm. will also enhance productivity of its pharmaceutical business by restructuring human resources and reinforcing research and development capacities. More importantly, Yungjin Pharm. will continue to cooperate with KGC to create the synergies intended.

### Real estate and investment asset management

In order to maximize the economic value of the real estate, each non-operating properties will be managed through comparative analysis in terms of sales value and development value. KT&G will also maximize the value of other investment assets including investment in bio venture companies. KT&G will continue to review commercialization potential and attainment of investment objectives, and then categorized as sell, hold, or new investment for create synergy.

#### KGC IN 2010



## BUSINESS STRUCTURE

### PRODUCT PORTFOLIO & NEWS

To reinforce its tobacco business as value base of KT&G, KT&G will introduce new products and improve quality to satisfy the changing consumer taste. While achieving the business competitiveness needed, KT&G understands that meeting consumer needs is not limited to improving the taste alone, but is more about inspiring consumers with the sophistication of product concepts and designs. KT&G will continue its commitment to improving its business competency by innovating product lines and quality alike, along with concepts and designs.

#### **“Arirang”, an Oxygen reinforced filter cigarette developed for the first time in the world released on March 1, 2006.**

KT&G’s reinforced oxygen filter was developed as the first in the world by KT&G’s research team. “Arirang” was designed in Korean in ways familiar to both middle aged and young aged groups with “Taeguk” shape softly brushed onto its face, thereby

communicating a genuinely Korean sense of aesthetics yet unseen in other brand products.

#### **“Raison 19+1”, Retransformed**

Having won good popularity due to unique characters and terminologies aboard one of the 20 sticks involving the theme of “Love”, the “Raison 19+1” series has now replaced the theme with “Dream”. Adhering to the scarcity principle by applying such themes to only 19% of the monthly production volume, KT&G has created a newly distinct culture within Raison.

#### **“Raison Black”, a New Product Offering 1mg Tar Released**

Reflecting the newer consumer trend towards low tar products, KT&G has developed and released “Raison Black”, a 1mg tar product in order to strengthen its brand power. While preserving the original “Raison” concept, “Raison Black” is made even softer by reducing the tar to 1mg. In addition, by applying the black hue gaining increased attention in fashion and other industries, KT&G has experimented with a new sense and style for “Raison Black”.

#### **“J”, a Brand Solely Localized in Jeju Island Released**

With its development initiated in May 2005, “J” carries the finest of all in brand concept, design, and taste. “J” is also the first local brand to emerge within the market. The official brand name is “Dive into J”, inviting its consumers to “Be fascinated by the Mysteries of Jeju Island.” By ingraining green tea native to Jeju, “J” tastes clean and clear consistently with the beauty of the Island. Every “J” is also equipped with a “Tube Triple Filter” that provides a 3 step smoke filtering process, rendering a better refined sense of product quality with softness.



“KT&G will continue its commitment to improving its business competency by innovating product lines and quality alike, along with concepts and designs.”

### “Indigo”, Designed Anew

Initially introduced in April 2005, “Indigo” was newly designed in July 2006. By applying light sensitivity to its package for the first time within the industry, “Indigo” changes its design instantaneously upon contact with ultraviolet rays. The new package satisfies a total of 3 different designs - one with the imaginative bird “Kisha” spreading its wings from side to side; a red sun rising from behind “Kisha”; and a tornado rising aside “Kisha”. By enhancing quality aspects of the product, “Indigo” delivers superior taste.

### “ESSE Soun”, the World’s First Bamboo Ash Processed Filter Cigarette

Carrying a bamboo charcoal processed filter, “ESSE Soun” was released in April 2006. As a family brand, “ESSE Soun” successfully meets the expectations of health conscious consumers, naming itself “Power of Our Nature”. The double phased filter is processed with bamboo charcoal that are known to prevent hazardous materials.

### “Arirang”, a Limited Edition Cheering for the Korean National Soccer Team Released

In commemoration of the 2006 World Cup Soccer Games in Germany, KT&G introduced a limited edition of “Arirang” last April. “Arirang” was marketed for only approximately two months until the start of the Games, bearing its official name “Arirang Soccer Edition (or Arirang SE)”. Each of the ten packs carries an illustration of a soccer player in action, rendering a panoramic view of the players taking diverse postures when placed together. This in sum instills an artistic value within its packaging wrap as well.

### “The One 0.5”, the Lowest Tar Product in Korea Released

On September 13, 2006, KT&G released “The One 0.5”, each stick of which carries 0.5mg tar for the first time in the Korean market. As a family brand of “The One” carrying 1mg tar and introduced in 2003, “The One 0.5” elected a regular 84mm stick and an octagonal packaging wrap. Despite its low tar retention, “The One 0.5” was designed to provide the taste and suction in par with existing 1mg products.

### “Season”, a Limited Edition Designed by a Film Director Released

KT&G released a limited edition “Season” in Pusan last September to coincide with The Pusan International Film Festival. As a “Season Cinema Version”, the limited edition was developed in conjunction with a film director as the first of its kind. As the sole artistic brand, this product allows consumers to appreciate different views of the world from an artistic perspective.

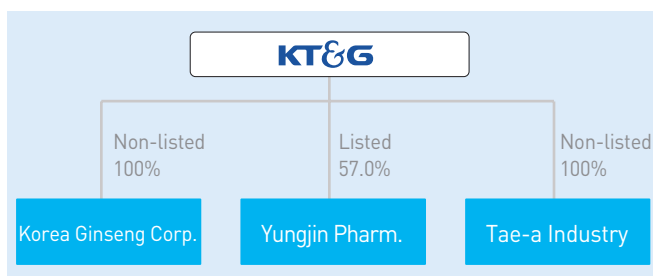
### KT&G’s New Products

-  \* “Arirang” Released in March 2006
-  \* “ESSE Soun” Released in April 2006
-  \* “Raison Black” Released in May 2006
-  \* “Dive Into J” Released in July 2006
-  \* “Time T-Collection” Released in August 2006
-  \* “Season Cinema Version” Released in September 2006
-  \* “The One 0.5mg” Released in September 2006

## BUSINESS STRUCTURE

### KT&G AND FAMILY

#### KT&G and Its Affiliates



#### Korea Ginseng Corporation

- Date established : January 1, 1999
- Main Businesses :
  - Manufacturing and sales of ginseng and ginseng products
  - Manufacturing and sales of food and beverages
  - Manufacturing and sales of pharmaceutical and supplementary health products
  - Related research and development; and trading
- Key Financials (as of end 2006) : KRW 64.9 billion of paid in capital; KRW 430.1 billion of sales; and KRW 508.3 billion of total assets

#### Yungjin Pharmaceutical

- Date established : July 16, 1962
- Main Businesses :
  - Manufacturing and sales of pharmaceutical and related materials, and chemically engineered products
- Manufacturing and sales of food and beverages, food additives, and cosmetic products

- Manufacturing and sales of supplementary medical products, medical equipments, and sanitation products
- Key Financials (as of end 2006) : KRW 46.6 billion of paid in capital; KRW 118.1 billion of sales; and KRW 154.2 billion of total assets

#### KGC Sales

- Date established : September 18, 2003
- Main Businesses :
  - Sales of ginseng and derivatives
  - Sales of food and beverage products
  - Sales of supplementary health products

#### Tae-a Industries

- Date established : December 20, 1972
- Main Businesses : Manufacturing of reconstituted leaf tobacco

#### Korea Islet Transplantation Research Institute

- Date established : January 30, 1998
- Main Businesses :
  - Bio technology research and development
  - Pharmaceutical products research and development
  - Exports





## OPERATIONS

### DOMESTIC SALES

The year 2006 proved to be meaningful for KT&G as it successfully maintained its strong market leadership and developed businesses overseas. At this juncture of strategic importance, KT&G placed each of its "ESSE", "Raison" and "The One" brand products in the forerunning positions with its superior product quality of distinction. Despite these achievements, however, KT&G anticipates intensifying competitions with its peers to continue, as they fiercely market their new products.

The total domestic market recorded 87.7 billion sticks in volume, 6.6% of increase year on year. In terms of sales amount, total sales in 2006 was KRW 9,283.5 billion, which is an 8.6% growth year on year as premium brand cigarettes as an emerging segment captured a larger portion of the total market.

The market expanded in 2006 most likely due to the declined sales volume in 2005, with the restoring demand in progress. KT&G sold 62.6 billion sticks domestically in 2006, reflecting a 4.2% increase year on year, with its net sales posting KRW 1,853 billion to reflect a 3.5% growth. KT&G achieved 71.4% of the total market share by the number of sticks sold, demonstrating a 1.6%p reduction year on year. Although its market share was affected by its peers' fierce marketing and promotions at the year end, KT&G continues to enjoy over 70% of the market share due to its strengths in achieving a balanced growth in profitability.

Over the past few years, the premium brand segment expanded because of the apparent growth in demand. This segment captured 73.8% of the total market in 2006, from 68.5% in 2005 demonstrating a 5.3%p increase. KT&G's premium brands alone captured 45.4% of the total market, increased by 3.2%p

year on year. Meanwhile, premium brands comprised 63.7% of KT&G's entire domestic cigarette product portfolio, reflecting a 5.8%p increase year on year and its strong leadership within this rapidly growing segment.

As in the premium brand segment, KT&G has been dominant within the low tar and slim cigarette market consistently with the rising health consciousness. The low tar market has been expanding fast, achieving 42.9% of growth in 2006 from 35.5% in 2005 as KT&G has successfully continued to introduce newer low tar products, conjoined by its peers' competitions. Even with their presence, KT&G still commands 73.8% of the low tar product market share, while its low tar products comprise 44.4% of its total domestic cigarette product portfolio. KT&G believes that the demand for low tar products is expected to grow.

KT&G's dominance in the low tar product market will be even more critically important to its profitability going forward. Because most low tar products are comprised of the premium brands, the rapidly growing demand for the low tar will lead to expanding the net sales and profitability. In 2006, KT&G's net sales per pack increased by 5.1% to KRW 592.1 from KRW 563.3 in 2005. KT&G achieved performance results well above its internal targets thanks to the well performing ESSE family and renewal products.



## OPERATIONS

### OVERSEAS SALES

To develop a global tobacco business of superior profitability, KT&G has aggressively developed markets overseas. As a result, KT&G now seeks to drive its overseas business beyond a mere growth in volume, but towards greater profitability. In 2006, KT&G exported USD350 million worth of 31.2 billion sticks to more than 40 countries including Russia, Uzbekistan, Iran, Iraq, and China, etc. This achievement reflects a 9.6% of growth in the number of sticks sold and a 33.5% of increase in the net sales year on year and a twelve fold growth in the sticks sold and a twenty five fold growth in the net sales since 1999 when KT&G started to export. In 2006, KT&G's exports contributed 14.8% to its total net sales, which is a 2.4%p increase from 12.4% in 2005.

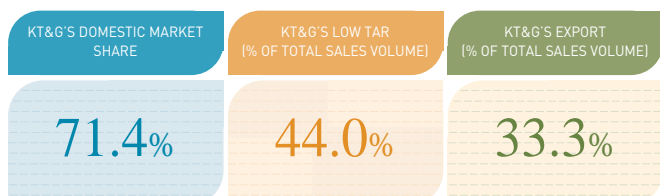
When KT&G started to export, its target markets were limited to Middle East and Central Asia. Today, however, the market expanded to China, Russia, CIS, Europe and the United States, among the 40 country markets exported. Most significant markets for KT&G to date have been Middle East and Central Asia including Russia. In 2006 alone, KT&G sold 28.2 billion sticks, which is a 13.1% increase from 24.9 billion sticks in 2005. Another rapidly growing export market for KT&G has been China as it consumed 1.1 billion sticks in 2006, demonstrating a 35.3% growth year on year.



In light of such a positive performance, KT&G was able to have its exports contribute 33.3% to the total products manufactured, thereby achieving a 1.2%p increase year on year. As KT&G shifted its focus from the lower net worth products to the premium brands, furthermore, its net sales per pack has grown every year.

Since it started to export "ESSE" in 2002, KT&G has dedicated significant resources to developing the global superslim brand, KT&G also believes that strong distribution channels in the local markets are needed to strengthen its export capabilities. In the same context, KT&G has pursued strategic alliances with local companies, while strengthening its relationships with importers to yield higher business performances.

KT&G was also participated in the Tax Free World Association (TFWA) conference in Cannes, France last October, where it introduced before European audiences its premium brands including "ESSE", "Cloud 9", "Raison", and "Zest". Additionally, KT&G will continue building its overseas manufacturing bases, beginning with its Turkey plant whose construction began in March 2007.

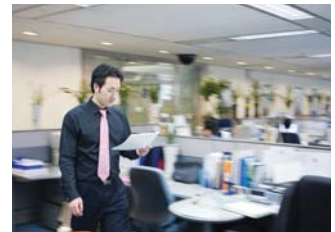


“Today, the market expanded to China, Russia, CIS, Europe and the United States, among the 40 country markets exported.”

## MANUFACTURING & PROCUREMENT

KT&G has strived to rationalize its raw materials procurement, while strengthening its product competitiveness. In rationalizing the procurement, KT&G has reduced its leaf tobacco purchase volume. Also the total cultivation area for leaf tobacco receded by 10% year on year to 10,800ha, with its leaf tobacco production volume declined by 18.6% to 22,237 tons in 2006 from the previous 27,322 tons. KT&G's use of domestic leaf has also incrementally declined, significantly contributing to its cost efficiency. KT&G intends to reduce the use of domestic leaf tobacco to 45% in 2007, from 54% in 2006 and 74% in 2005.

KT&G has also incorporated new product development technologies within its manufacturing processes to satisfy diverse needs of its consumers evidently marked by individuality. Even to the tiniest details such as filter materials and packaging methods, KT&G has been advancing its technologies and know hows.



Moving forward, KT&G will continue to invest its resources and energies to enhance profitability, while harnessing its competitive edge against its competitors by strengthening product quality, productivity, and manufacturing capabilities. KT&G will also continuously update its technologies to diversify brands to successfully meet consumer requirements both domestic and abroad in order to nurture its greater potential to further globalize its businesses.



# Next Generation

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The projects managed by the KT&G Social Welfare Foundation include “Happiness Network,” “Social Welfare Assistance,” and “Internet Welfare,” among others.



● **RAISON:** Raison, one of top quality premium brands, has gained popularity from urban youth for its clean and neat taste since 2002.







## ETHICAL MANAGEMENT

### CODE OF ETHICS

Subsequent to introducing the Code of Corporate Ethics, Code of Ethics for Directors, and the Guidelines on Ethical Conduct, among others, in December 2001, KT&G completed its ethical management system by formulating and effectuating the Regulations and Guidelines on Ethical Conduct based upon the four components - the Code of Corporate Ethics, Code of Ethics for Directors, Declaration of Compliance with Fair Trade Standards, and the Customer Service Code.

As every constituent of KT&G endorsed the Code of Corporate Ethics to practice ethical management, along with promotions including the Interpretations on Ethical Management published and distributed industry widely, KT&G has continued to improve and supplement its ethical management system by performing the ethical management evaluations necessary. As a result, KT&G was recognized in 2006 by New Industry Management Academy to win Grand Prize in the category of the "Ethical Management Performance in Korea."

Over time, KT&G has learned to value the significance of corporate ethics to enhance its business transparency and competitiveness because they measure the quality of corporate value. Its unyielding efforts to defend the transparency and responsibility involved in every aspect of its business strongly encourage the KT&G's board of directors to play a more transparent and responsible role than ever before.

Given this background, KT&G has elected the "Standard Code of Conduct for Independent non-executive Directors" provided by Korea Listed Companies Association to endorse the principles its Independent non-executive directors would need to accept last February with the view to continually practice ethical management based upon its highest ethical management performance record and spirit.



#### \* KT&G's Ethical Management System

Code of Corporate Ethics

Code of Ethics  
for Directors

Declaration of  
Compliance with  
Fair Trade Standards

Customer Service Code

**KT&G**

KT&G's Ethical  
Management System



## CORPORATE SOCIAL RESPONSIBILITY

### CORPORATE CITIZENSHIP

"KT&G Will Lead the Way for Everyone to Share in a Beautiful Caring Society."

Since 1994, KT&G has carried out diverse activities in social welfare, medical assistance, education and culture, environmental preservation, and youth protection, among others as part of its corporate social responsibility programs towards materializing a "Society Where Everyone Shares." Creating the KT&G Social Welfare Foundation in July 2003 allowed KT&G to streamline its corporate social responsibility projects in greater details with precision. Understanding that a corporate must coexist with society, KT&G has gone beyond mere donative and volunteering activities to resolve significant gaps existing in between the rich and the worldwidely, expand a sharing culture, and facilitate strategic changes to achieve greater solidarity for communities within the society. To continue these endeavors, KT&G will expand the scope of its corporate social responsibility activities by utilizing any and all human and material resources it has.

The projects managed by the KT&G Social Welfare Foundation include "Happiness Network," "Social Welfare Assistance," and "Internet Welfare," among others.

#### Happiness Network

The Happiness Network Project involves the Happiness Network Welfare Center and the Happiness Network Volunteer Center, the former of which extends professional services to the neighbors and communities in dire need of social welfare

services via various service systems and networks in line with the community protection ideals, while the latter provides opportunities for those desiring to help the neighbors in need but without the proper means to start doing so.

In June 2004, KT&G's Happiness Network Volunteer Center was the first private business affiliate to organize and provide social welfare services of diversity to the retired senior citizens. KT&G strongly encourages collaboration by and among the KT&G Senior Volunteer Group operating to promote fellowship among colleagues and in public interests and other active collegiate volunteer groups via the arrangements made through the KT&G Social Welfare Foundation.

#### Social Welfare Assistance

The Social Welfare Assistance Project encompasses youth services, medical assistance, education and culture, volunteer work, post disaster restoration work, refugee rescue and protection, youth smoking prevention, environmental work, and welfare programs for the elderly. Having successfully carried out various programs in 2005 including a national table tennis tournament for the elderly, a sign language contest, maintenance and repairs sessions for the welfare facilities for senior citizens, and light weight vehicle assistances, KT&G continued in 2006 to extend its services with college students to do volunteer work overseas, participate in forest fire restoration work in the greater Kangwon region, hold a national table tennis tournament for senior citizens, share new rice crops on Thanksgiving, provide 100 units of light weight automotive vehicles to social welfare institutions and organizations, and prepare Kimchi of love, among others.

## CORPORATE SOCIAL RESPONSIBILITY

### Internet Welfare

The Internet Welfare Project is comprised of the direct account transfer donation drive and the sign language game contest, the former of which is operated via the 1004 KT&G website run by the KT&G Social Welfare Foundation to help orphaned boys and girls heading their families, mentally and physically challenged individuals, and underprivileged children. This initiative allows KT&G to take part in forming a culture for donation meaningful and fun by inviting voluntary support from the mass on line. As of the end of 2006, the number of supporters for the 1004 KT&G increased to 20,113 from 13,745 in 2005, demonstrating a significant interest from the public including the Netizens contributing 58.6% of the total contributions.

In addition to these features, KT&G Social Welfare Foundation delivers "Gifts of the Happiness" to neglected children suffering from disabilities, those detained in facilities, and others from low income families, thus making their birthdays memorable with companionship. To help build a society compassionate and able to communicate by sign language, the Foundation also holds its on line sign language game contest every year, thereby creating a better foundation for people to relate to each other beyond existing barriers.



KT&G plans to invest approximately KRW 100 billion on its corporate social responsibility programs until 2007 in line with its ideal in building a "Beautiful World Where KT&G Is." Realizing that its business is deeply rooted within the public support, KT&G will continue to expand the scope and value of its corporate social responsibility in order to return a portion of its profits generated. In particular, main focus will be placed upon the senior citizens as they are most vulnerable to the lack of welfare support.



KT&G will collaborate with municipalities to construct and manage senior citizen centers, further to provide financial resources for researching and developing cures for fatal diseases, to operate volunteer centers, and to carry out welfare tasks including those on line. Last but not least, KT&G will channel its efforts to help preserve traditional Korean cultures largely neglected by society, build fora to discuss and resolve current social issues of importance, and continue functioning the post disaster restoration activities and donation drives in conjunction with local communities affected.

“KT&G encourages its constituents to participate in diverse training programs to properly understand and share its visions and management philosophy.”

## HUMAN RESOURCES MANAGEMENT

KT&G has a keen understanding of the critical significance of cultivating human resources to execute a new paradigm of reform and innovations in order to rank among the global businesses of exceptional quality and performance. To this end, KT&G continues to maximize the capacities of its constituents by successfully operating its system developed to check performance results and accountability.

A successfully completed group wide control system will soon ensure a fully optimized executive system satisfying the requirements of KT&G's mid to long term strategies. KT&G has continued to strengthen capacities of every constituent making meaningful contributions to materializing the corporate value, so that each will take advantage of the self development opportunities provided while enhancing the business value for the organization.

Moreover, KT&G encourages its constituents to participate in diverse training programs to properly understand and share its visions and management philosophy. In particular, KT&G trains them on their responsibilities and anticipated changes thereto, thereby providing creative and practical opportunities to achieve visions in line with its mid to long term masterplan. Communication in between manufacturing and sales business units has also been improved, while educational opportunities were provided for the constituents to reenergize and contemplate on the ways to collectively grow the organization.



Even aside from these efforts, KT&G has won positive responses from and by providing sales personnel with customer satisfaction training programs and other employees scheduled to retire with social adaptation programs. As it has, KT&G will continue to develop and offer diverse training opportunities to ensure that its constituents have the upperhand in improving their business capabilities and performance.

### Training Activities in 2006

- “Leadership Academy” for managers
- “Again Good Start! Great KT&G” training for the newly hired
- “New Start” training for the employees scheduled to retire
- Global-Technology Management Official (G-TMO) training for manufacturing managers and supervisors
- Head office staff visiting manufacturing facilities
- “Customer Satisfaction Training for Logistics Managers (LMs)”

# Financial Information

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KT&G was able to achieve 2.4% of growth in revenue in sales and 5.4% of growth in its operating profits, properly meeting shareholder expectations.



● The one 0.5 : The one 0.5 is a mild-tasting, ultra-low tar premium brand introduced to the domestic market in september 2006.



## MANAGEMENT'S DISCUSSION & ANALYSIS

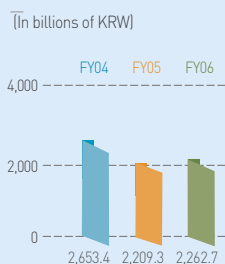
### Selected Financial Data

| (in billions of Korea Won) | 2004    | 2005    | 2006    |
|----------------------------|---------|---------|---------|
| Net sales                  | 2,653.4 | 2,209.3 | 2,262.7 |
| Gross profit               | 1,548.2 | 1,224.6 | 1,282.9 |
| Operating profit           | 1,021.6 | 676.9   | 713.7   |
| Net profit                 | 472.3   | 515.9   | 649.7   |
| (in billions of Korea Won) |         |         |         |
| Total assets               | 3,885.0 | 3,964.4 | 3,668.4 |
| Current assets             | 2,002.0 | 2,032.9 | 1,602.7 |
| Fixed assets               | 1,883.0 | 1,931.2 | 2,065.6 |
| Total liabilities          | 670.8   | 516.4   | 622.6   |
| Current liabilities        | 535.3   | 301.1   | 345.8   |
| Long-term liabilities      | 135.5   | 215.3   | 276.8   |
| Total shareholders' equity | 3,214.2 | 3,448.0 | 3,045.8 |
| (% YoY)                    |         |         |         |
| Net sales growth           | 21.8    | (16.7)  | 2.4     |
| Gross profit growth        | 28.2    | (20.9)  | 4.8     |
| Operating profit growth    | 43.6    | (33.7)  | 5.4     |
| Net profit growth          | 2.7     | 9.2     | 25.9    |
| (%)                        |         |         |         |
| Gross profit margin        | 58.3    | 55.4    | 56.7    |
| Operating profit margin    | 38.5    | 30.6    | 31.5    |
| Net profit margin          | 17.8    | 23.4    | 28.7    |
| (Per share data)           |         |         |         |
| Diluted EPS (won)          | 2,981   | 3,491   | 4,608   |
| Diluted PER (x)            | 10.4    | 12.9    | 12.3    |
| Year-end stock price (won) | 30,950  | 45,050  | 56,500  |

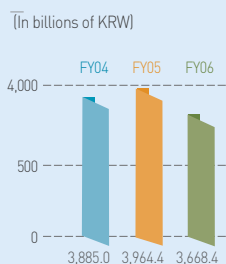
The following analyses and projections were prepared based upon each individual financial statement and the Korean GAAP, reflecting the KT&G management's plans and objectives including estimations and predictions regarding KT&G's financial conditions and business performance, among others. Any aspect of the information herein contained, whether expresses or implied, does not warrant security against any risk known or unknown and may vary from the actual figures or results, whose differences might be of vital importance.

KT&G does not warrant any assumption or assurance of the accuracy or completeness of any information directly or indirectly expressed herewithin, and does not make promises or suggestions regarding any statements both in the past and future. The management performance results discussed in the following only pertain to KT&G's plans, estimations, and expectations, subject to the future operating environment politically and economically. No undue reliance shall be placed upon any aspect of KT&G's estimations and expectations because they may change according to its operating environment. KT&G does not have obligations to provide any additional information regarding future events because its estimations, plans, and expectations are of the present only. Unless provided otherwise, "the Company" shall refer to "KT&G" for the purposes of the following discussions.

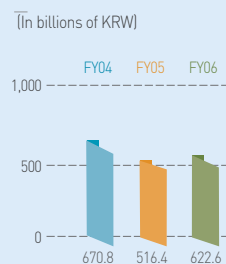
#### • NET SALES



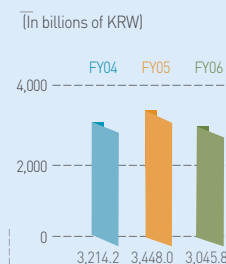
#### • TOTAL ASSETS



#### • TOTAL LIABILITIES



#### • TOTAL SHAREHOLDERS' EQUITY





## Executive Summary

The year 2006 was challenging enough for KT&G to overcome the intensifying competition, declining demand, and the strengthened regulation of the tobacco products. It also was encouraging on the other hand for KT&G to generate corporate values and maximize shareholder values with an even greater persistence and stability. Due to its firm commitment to excellence and passion to perform, KT&G was able to achieve 2.4% of growth in net sales and 5.4% of growth in its operating profits, properly meeting shareholder expectations.

### | Domestic Business |

KT&G continued to face a variety of challenges including the declining demands for tobacco products following the increasingly heightened health consciousness, strengthened non price regulations, and the ever more intensifying competitions with its peers. While nurturing big brands to effectively manage the situation, KT&G has undertaken aggressive product marketing and promotions within the marketplace and improved business efficiency by operating a better customer centered market control system. Most importantly, KT&G enhanced profitability by releasing premium brand products and realigning brand product portfolio.

New products KT&G introduced to strengthen its brand values included "Raison Black", "ESSE Soun", "The One 0.5", and "Arirang". Of these, "ESSE Soun" is equipped with KT&G's newly developed bamboo charcoal filter to highlight its health caring feature, "The One 0.5" is positioned to market the lowest tar craving consumers, and "Arirang" has won positive responses for advocating Korean values in consumer tradition. KT&G has also strengthened its distribution channel control and PRM with retailers to successfully manage and overcome

the prevailing adverse market conditions. Consequently, KT&G has achieved 4.2% of growth in domestic sales yoy and 5.1% of growth in Net ASP yoy thanks to its consistent efforts to shift its business toward the more profitable premium brand segment.

### | Overseas Business |

KT&G has achieved 9.6% of growth in sales volume and 22.3% of growth in revenue in sales, recording the sales of 31.2 sticks and KRW 333.8 billion in exports. Its operating profits reached KRW 55.5 billion reflecting KT&G's substantial progress in securing a strong platform to materialize a longer term growth in the overseas tobacco business. These achievements are attributable to KT&G's continuance of profitability focused business strategy executed by raising exporting prices, exporting premium products, and achieving greater cost efficiencies, among others. KT&G improved its overall exporting prices by 20.6% yoy by rallying in Middle East, Central Asia, and Russia with a 30% improvement. While benefiting from KT&G's global brand strategy, "ESSE" achieved 10.9 billion sticks in exports, which is a 106% increase year over year.

### | Manufacturing |

To deliver products of the best quality meeting client needs, KT&G has strengthened manufacturing infrastructures and improved quality control, thereby successfully getting ahead in satiating the consumers with sensational quality. KT&G has also reinforced its manufacturing competitiveness by redesigning business processes and reconstructing production system, while reforming e-production management and cost control systems.

## MANAGEMENT'S DISCUSSION & ANALYSIS

### | Raw Materials |

Based on agreement with leaf farmers cooperatives, 10% of its cultivation area decreased rationalize its tobacco leaves inventory. In addition, KT&G has also endeavored to improve the leaves' quality and utility by rolling out its plans to accomplish the so called "15 Principles on Standard Cultivation" to globalize its product competitiveness and client satisfaction.

### | Real Estates |

KT&G has achieved KRW 19 billion of revenue in lease by effectively managing its assets such as Kosmo Tower and KRW 26.8 billion of revenue in sales from developing properties such as Diot shopping mall in Dongdaemun. KT&G presently continues to develop diverse properties to maximize business values in real estate.

With its constituents fully committed to the value maximization, KT&G as a result has achieved KRW 36.8 billion of growth in operating profits to record KRW 713.7 billion and KRW 133.8 billion of growth in net income to record KRW 649.7 billion, respectively.

### Analysis of Operating Results

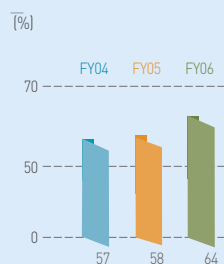
#### | Operating revenues |

##### Summary Income Statement

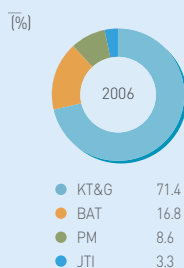
| (In billions of Korea Won) | 2004  | 2005  | 2006  |
|----------------------------|-------|-------|-------|
| Net sales                  | 2,653 | 2,209 | 2,263 |
| Operating income           | 1,022 | 677   | 714   |
| Net income                 | 472   | 516   | 650   |
| Earnings per share(won)    | 3,183 | 3,497 | 4,609 |

In spite of its peers' stockpiling and aggressive marketing competitions, KT&G has developed and delivered products the consumers wanted. KT&G also chose selectivity and effective marketing over other strategies to win the consumer confidence. By adopting market control systems to reinforce internal capacities, KT&G carried out sustainable management activities that mark distinctions only to its own. Thanks to such enduring efforts, KT&G achieved 2.4% of growth in net sales yoy to record KRW 2.263 trillion in 2006 reflecting stability in its performance, while achieving 5.4% of growth in operating profits yoy to record KRW 713.7 billion. In sum, KT&G has continued to achieve profitability in line with the increasing sales caused by the rising domestic consumption and exports, combined with the expanding taste for premium brands. In this background, KT&G

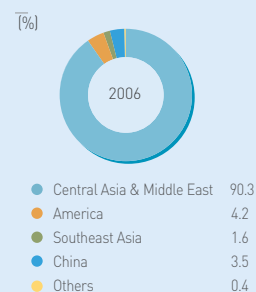
#### • BRAND MIX BY PREMIUM CIGARETTE



#### • DOMESTIC MARKET SHARE



#### • EXPORTS(VOLUME)BY REGION



has achieved 25.9% increase KRW 649.7 billion of net income due to the excelling business and expanding non operating income in 2006.

KT&G continues to maintain over 70% of the domestic market share as Korea's premier tobacco business. Despite a 1.6%p reduction in its market share compared to 2005, KT&G will be able to strengthen its market leadership by continuously introducing products of high quality and performance.

#### KT&G at the low-tar segment

| (Million sticks, %)                 | 2004   | 2005   | 2006   |
|-------------------------------------|--------|--------|--------|
| Domestic low-tar market             | 30,859 | 29,058 | 37,609 |
| KT&G's low-tar cigarette sales      | 24,515 | 21,203 | 27,737 |
| KT&G's low-tar sales growth         | 157%   | -14%   | 31%    |
| KT&G's low-tar sales to total sales | 30%    | 35%    | 44%    |

The domestic tobacco market has recovered by 6.6% yoy recording the sales of 87,718 million sticks. Of these, 37,609 million sticks comprise the low tar market capturing 42.9% of the entire tobacco market, demonstrating a 7.6%p increase yoy. These figures show that the taste for consumption is rapidly shifting towards the low tar market. KT&G was not an exception in experiencing this change as it offers Korea's 3 largest brands such as ESSE, Raison, and The One. In 2006, KT&G achieved 30.8% of growth in low tar product sales, thereby leading the shift in taste. Even within its own product portfolio, the low tar comprised 44.3% of the total revenue in sale to increase their profit contribution. KT&G understands that the low tar products' growth in sales will continue to strengthen its profitability because they primarily comprise the premium brand segment.

#### Brand Mix

| (%)     | 2004 | 2005 | 2006 |
|---------|------|------|------|
| Premium | 57   | 58   | 64   |

As the consumer preference for the low tar, premium brand products continues to increase, the premium brand segment has reached 64% of the total. As a result, the weighted net average selling price per pack has increased by 5.1% to record KRW 592.1 in 2006, which is well beyond 1.5% in 2005 by 3.6%p. For these reasons, KT&G will strive to develop newer products to excel in meeting consumer expectations, while introducing low tar, premium brand products.

#### Exports(volume)by Region

| (%)                        | 2004 | 2005 | 2006 |
|----------------------------|------|------|------|
| Central Asia & Middle East | 89.2 | 87.5 | 90.3 |
| America                    | 6.5  | 6.3  | 4.2  |
| Southeast Asia             | 1.9  | 2.6  | 1.6  |
| China                      | 2.0  | 2.9  | 3.5  |
| Others                     | 0.4  | 0.7  | 0.4  |

Since the overseas market was developed as a core strategy for KT&G to globalize its business, KT&G has undergone transformations both qualitatively and quantitatively. In 2006, KT&G achieved 22.3% of growth in exports yoy to record KRW 334 billion, while portion of exports to the total sales increased by 2.4%p yoy to record 14.8%. KT&G invested a wealth of resources to strengthen its product marketing and promotions in 2006, thereby achieving substantial, consistent growths in mid to premium brand product sales. While contributing to KT&G's improving profitability, ESSE Family as KT&G's flagship exporting products continued to increase in their share, recording 35% of the total exports in 2006.

Thanks to its market diversification strategy, KT&G was able to expand the number of export countries to over 40 covering Russia, CIS, Middle East, Central Asia, China, and Southeast Asia. KT&G will also continue to expand its global investments by pursuing strategic partnerships with local businesses and building local manufacturing plants. Among others, KT&G will nurture new brands to meet diverse local needs and strengthen local distribution channels in order to effectively develop the overseas markets.

## MANAGEMENT'S DISCUSSION & ANALYSIS

### | Cost of Sales |

In 2006, KT&G achieved 4.8% of growth in gross profits yoy to record KRW 1,283 billion due to increased sales including its premium brand products. This improvement is attributable to a 2.4% growth in net sales yoy and a 0.8% growth in the cost of sales.

While the domestic leaf tobacco usage ratio is linked to this performance, KT&G's usage ratio in 2006 was 54%, which is a 20%p reduction yoy. As previously discussed, KT&G reduced 10% of the cultivation area to rationalize its tobacco leaves inventory and globalize its competitiveness. In addition, these results were also due to KT&G's endeavors to improve manufacturing processes, cost control systems, and infrastructures as part of its campaign to enhance manufacturing capabilities.

### SG&A Expenses

| (In billions of Korean won) | 2004 | 2005 | 2006 |
|-----------------------------|------|------|------|
| Salaries                    | 164  | 172  | 170  |
| Employee welfare            | 28   | 13   | 19   |
| Advertising                 | 153  | 147  | 135  |
| Commissions                 | 37   | 47   | 62   |
| Depreciation                | 38   | 42   | 47   |
| Others                      | 107  | 127  | 136  |

Wages and salaries declined by 1.3% yoy, while advertising also declined by 8.3% due to KT&G's downsizing of its corporate advertising and overseas promotions. The welfares reflect

KRW 4.5 billion of ESOP, and commissions increased in part due to the payments made on real estate property developments and sales in part.

### Operating profit

| (In billions of Korean won, %) | 2004  | 2005 | 2006 |
|--------------------------------|-------|------|------|
| Operating profit               | 1,022 | 677  | 714  |
| Operating profit margin(%)     | 38.5  | 30.6 | 31.5 |

KT&G's operating profit increased by 5.4% yoy to record KRW 714 billion as a result of increased revenue in sales and premium brand sales, further to the effective SG&A expenses control. Its operating margin increased by 0.9%p yoy to record 31.5%, respectively.

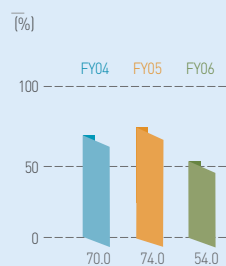
### | Non-operating items |

Non operating income increased by 92.5% yoy to record KRW 295 billion due to KRW 56 billion of tax refund, KRW 29 billion of escrow fund provision adjusted, and KRW 27 billion of valuation gains on equity method. KT&G's non operating expenses, on the other hand, increased by 26.6% yoy to record KRW 153 billion, primarily due to the increased donations. All in all, the net non operating income recorded KRW 141 billion reflecting a 340.6% increase yoy.

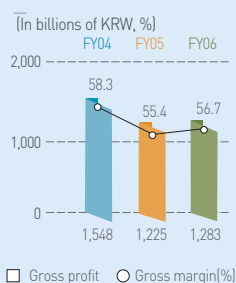
### | Earnings and dividends |

As the largest ever to renew, KT&G's net profit in 2006 increased by 25.9% yoy to record KRW 650 billion due to the

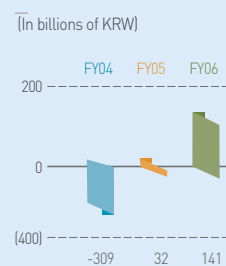
#### • DOMESTIC LEAF TOBACCO USAGE RATIO



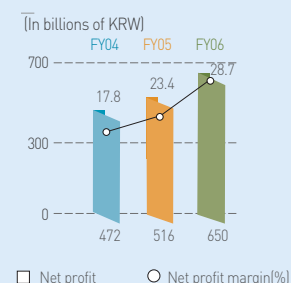
#### • GROSS PROFIT



#### • NON-OPERATING BALANCE



#### • NET PROFIT



significantly improved non operating income and increased revenue in sales. KT&G's net profit margin has also improved by 5.3%p to record 28.7%, respectively.

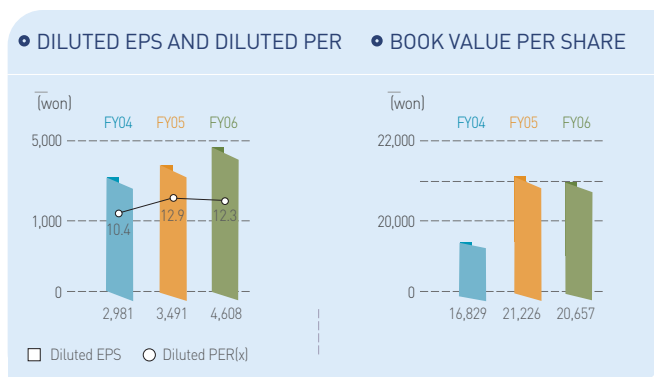
Since treasury stocks were cancelled and net profits increased, KT&G's Diluted EPS in 2006 increased by 31.9% to record KRW 4,608 from KRW 3,491 in 2005. KT&G's share price also increased by 25.4% to KRW 56,500 as of end 2006 from KRW 45,050 as of end 2005; however, the Diluted PER relatively fell to 12.3 from 12.9 due to the significant increases in the Diluted EPS.

In line with its shareholder value maximization policy, KT&G paid out KRW 2,400 of dividends per share in 2006. To successfully continue its policy moving forward, KT&G will faithfully carry out its mid to long term masterplan developed in 2006, while elastically managing policies on treasury stock repurchase and retirement, as well as high dividends payout policy in view of the market conditions and cash flows.

## Analysis of Financials

### Summary Balance Sheet

| (In billions of Korean won) | 2004   | 2005   | 2006   |
|-----------------------------|--------|--------|--------|
| Assets                      | 3,885  | 3,964  | 3,668  |
| Liabilities                 | 671    | 216    | 623    |
| Shareholders' equity        | 3,214  | 3,448  | 3,046  |
| Book Value Per Share(won)   | 16,829 | 21,226 | 20,657 |



Note) Share price is quoted as of the end of the year concerned

Based upon its healthy capital structures and financial strategies, KT&G has secured abilities and resources to steadily generate cash flows for business operation. KT&G has also continued to focus its core competencies on efficient decision making and operating capital management.

KT&G's total assets in 2006 declined by 7.5% to KRW 3,668 billion due to the decreased liquid assets as a result of repurchasing treasury stocks. Its total equity capital declined by 11.7% yoy to record KRW 3,046 billion, which resulted from the decreased retained earnings after the treasury stock retirement. On the other hand, KT&G's total liabilities increased by KRW 107 billion yoy to record KRW 623 billion due to KRW 48 billion of taxes payable and KRW 36 billion of tobacco excise taxes and dues payable.

### | Cash & marketable securities |

| (In billions of Korean won) | 2004 | 2005 | 2006 |
|-----------------------------|------|------|------|
| Cash & cash equivalents     | 465  | 574  | 167  |
| Marketable securities       | 0    | 0    | 0    |

Despite cash inflows, KT&G's cash and equivalents in 2006 declined by KRW 407 billion yoy to record KRW 167 billion due to KRW 858 billion of treasury stock repurchase and KRW 249 billion of dividends paid out.

KT&G's investment assets in 2006 increased by 2.5% to KRW 719 billion, with its tangible assets increased by 8.7% yoy to KRW 1,344 billion. Fixed assets recorded KRW 2,066 billion, reflecting a 6.9% increase yoy due to KT&G's investment in manufacturing facilities and machineries for enhanced manufacturing capabilities.

### Borrowings & debt-to-equity ratio

| (In billions of Korean won, %)        | 2004 | 2005 | 2006 |
|---------------------------------------|------|------|------|
| Short-term borrowings                 | 0    | 0    | 0    |
| Exchangeable bonds                    | 20   | 0    | 0    |
| Interest-bearing debt to equity ratio | 0.6  | 0.0  | 0.0  |

## MANAGEMENT'S DISCUSSION & ANALYSIS

After completing exchangeable bonds in 2004, there was no interest bearing debt.

KT&G's surplus capital increased by 11.8%, or KRW 35 billion, yoy to KRW 335 billion due to the gains realized on the treasury stock disposal. Its earnings retained declined by KRW 458 billion to KRW 2,061 billion due to its treasury stock retirement and increased dividends paid out in spite of the increased net profits. As a result, KT&G's total shareholders' equity declined by 11.7% yoy to record KRW 3,046 billion, while ROE improved by 6.3%p yoy.

### Analysis of Cash Flow

#### | Summary Cash Flow Statement |

##### Summary Cash Flow Statement

| (In billions of Korean won)          | 2004  | 2005  | 2006    |
|--------------------------------------|-------|-------|---------|
| Cash flows from operating activities | 749   | 498   | 844     |
| Cash flows from investing activities | 87    | (175) | 16      |
| Cash flows from financing activities | (619) | (329) | (1,027) |

KT&G does not reserve resources to make facilities investment for enhanced product competitiveness and nurture future growth engines. KT&G has also carried out management policies to ensure that values are in fact delivered to the shareholders through dividends payout and treasury stock repurchase for cancellation. By choosing selectivity as a core management principle, KT&G will continue to maximize its

corporate value by conducting efficient management activities and controlling cash flows on a steady basis.

##### Cash flows from operating activities

| (In billions of Korean won)                   | 2004  | 2005    | 2006  |
|---|-------|---------|-------|
| Net profit                                    | 472.3 | 515.9   | 649.7 |
| Depreciation and amortization                 | 103.4 | 110.9   | 121.2 |
| loss on redemption of exchangeable bonds, net | 157.2 | 15.1    | 0.0   |
| Others  | 15.7  | (143.7) | 72.9  |

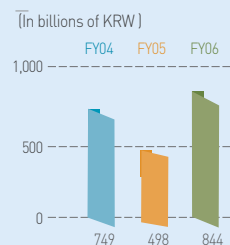
KT&G's cash flows generated from operating activities significantly increased by 69.5% yoy to KRW 844 billion due to the increased net profits and temporarily declined operating expenses including KRW 185 billion of taxes payable and KRW 60 billion of tobacco excise taxes and dues payable.

##### Cash flows from investing activities

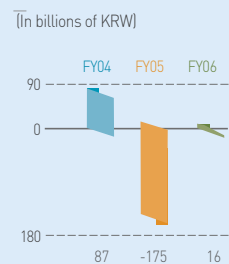
| (In billions of Korean won)               | 2004    | 2005    | 2006 |
|---|---------|---------|------|
| Net capital expenditure                   | (148.1) | 167.0   | 0.0  |
| Disposal of available-for sale securities | 316.1   | 10.0    | 9.7  |
| Others                                    | (80.6)  | (351.8) | 6.4  |

KT&G's cash flows generated from investing activities were KRW 16 billion in 2006. KRW 259 billion of cash outflows reflecting KRW 118 billion of increase yoy, mostly involved plant additions and facilities replacement to modernize KT&G's manufacturing capacities

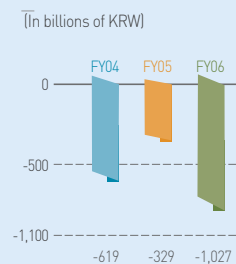
#### • CASH FLOWS FROM OPERATING ACTIVITIES



#### • CASH FLOWS FROM INVESTING ACTIVITIES



#### • CASH FLOWS FROM FINANCING ACTIVITIES





**Cash flows from financing activities**

| (In billions of Korean won)  | 2004    | 2005    | 2006      |
|------------------------------|---------|---------|-----------|
| Borrowings & debentures      | 3.4     | (1.5)   | 3.6       |
| Reissuance of treasury stock | 100.2   | 27.0    | 76.8      |
| Dividend                     | (221.5) | 237.3   | 249.7     |
| Others                       | (501.1) | (591.6) | (1,357.1) |

KT&G's cash outflows caused by financing activities significantly increased to KRW 1,027 billion in 2006 from KRW 329 billion in 2005. The outflows mostly involved increased repurchase of treasury stocks, reflecting KRW 742 billion of increase yoy to record KRW 858 billion in 2006. In addition, KT&G's dividends paid out increased by 5.2% yoy to KRW 249 billion in 2006.

### 2007 Business Outlook & Management Issues

KT&G's operating environment in 2007 is likely to involve even greater uncertainties triggered by the continuing foreign exchange rate fluctuations and the North Korean nuclear threat, further to the strengthening regulations against tobacco industry such as increasing taxes. With its mid to long term masterplan secured last August to cover up to the year 2010, however, KT&G will carry out its strategies to maximize its corporate value.

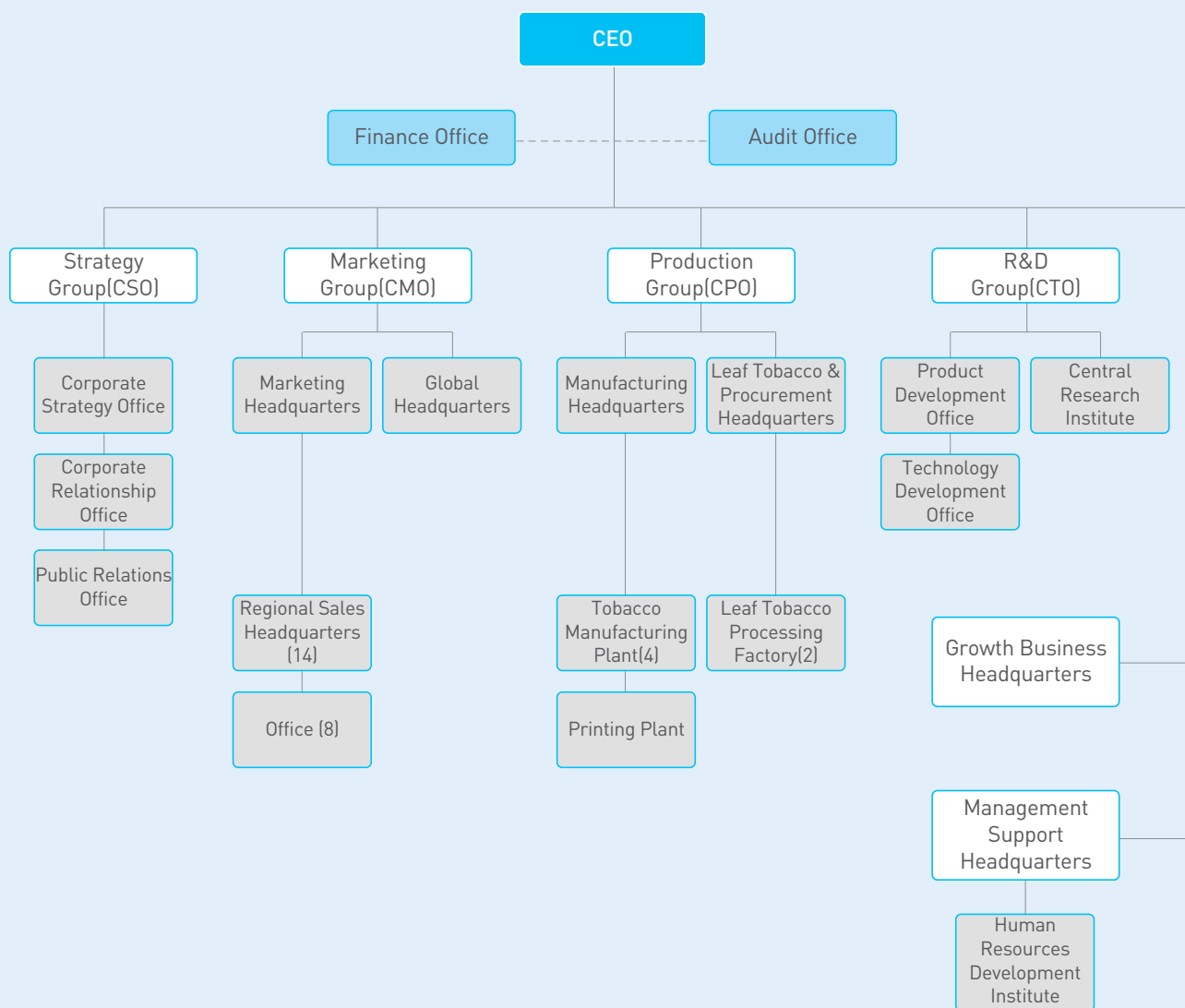
By declaring 2007 as the "Year to Achieve the New KT&G Vision," KT&G plans to roll out the following specifics by fully gearing up its organization wide competencies and resources on top of its strategies.

First, KT&G will focus on management performance and corporate value maximization by "strengthening fundamental investments for enhanced corporate value for the mid to longer

term." To expand its market share up to 73% as the domestic market is yet critical to its further growth, KT&G will continue to release new products and introduce renewal products. KT&G will also strengthen core competencies such as to include research and development, brand, business resources, and quality. KT&G will consolidate its local market positions in Russia, Turkey, and Iran, among the overseas markets signaling positively for KT&G's business prospects. To secure the frontier of the rapidly growing supplementary health food and products market, KT&G will increasingly invest in reinforcing its existing business platforms and securing new sources of income. As for the pharmaceutical business, Yungjin pharm. will implement restructuring to enable a mid to longer termed profitable growth by reinvesting resources made available through restructuring initiatives.

Second, KT&G will "build a management system optimized to achieve core strategic objectives" by transforming its organization wide paradigm. KT&G will continue to supplement and modify systems to enhance corporate transparency, ethics, and governance respected by many. KT&G will also improve systems for organization, human resources management, and compensation to allow its constituents to perform and excel. By completing an integrated strategy execution and performance control system, KT&G will ensure that its mid to longer term strategy is effectively phased out on a group wide basis. To this end, KT&G will continue to reinforce its communication with and invite its stakeholders for greater participation in encouraging KT&G to play its role of leadership going forward.

## ORGANIZATION CHART



## MANUFACTURING & SALES NETWORK

### TOBACCO MANUFACTURING

- Shintanjin Plant
- Wonju Plant
- Kwangju Plant
- Yeongju Plant

### PRINTING PLANT

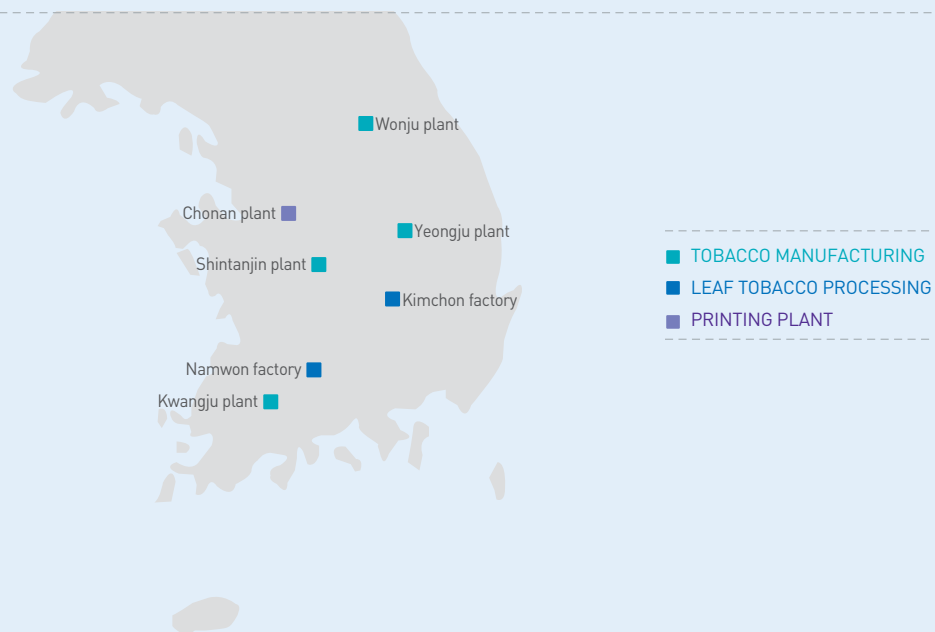
- Chonan Plant

### LEAF TOBACCO PROCESSING

- Kimchon Factory
- Namwon Factory

### SALES

- Regional Headquarters: 14
- Branch Offices: 168

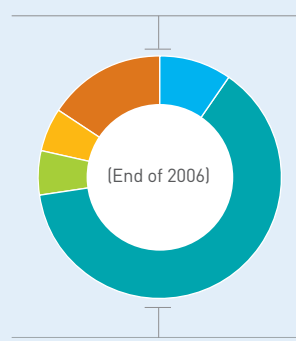


## INVESTOR INFORMATION

|                                     |                  |
|-------------------------------------|------------------|
| • Capital Stock .....               | KRW955 billion   |
| • Number of Authorized Shares ..... | 800,000,000      |
| • Number of Shares Issued .....     | 147,442,497      |
| • Shareholders' Equity .....        | KRW3,046 billion |
|                                     | (End of 2006)    |

### OWNERSHIP STRUCTURE (%)

|                            |       |
|----------------------------|-------|
| ■ Treasury Stocks          | 9.7%  |
| ■ Foreign Investors        | 55.9% |
| ■ Industrial Bank of Korea | 6.5%  |
| ■ ESOP                     | 5.9%  |
| ■ Others                   | 22.0% |



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## **FORWARD-LOOKING STATEMENTS**

KT&G Annual Report 2006 contains forward-looking statements about the Company, including descriptions of plans or objectives of its management for future operations, products or services, and forecasts of its revenues, earnings or other measures of economic performance.

Forward-looking statements, by their nature, are subject to risks and uncertainties. A number of factors-many of which are beyond the Company's control could cause actual conditions, events or results to differ significantly from those described in the forward-looking statements. Some of these factors include certain credit, market, operational, liquidity and interest rate risks associated with KT&G business and operations.

Forward-looking statements speak only as of the date they are made. KT&G does not undertake to update forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made or to reflect the occurrence of unanticipated events.



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