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Unlocking the Korea Discount

Oliver McClure, CFA
Portfolio Manager

Alvin Lau, CFA
Equity Analyst

The South Korean equity market is an investing enigma. It is among the lowest-rated markets in the world and yet it boasts many companies in the upper echelons of global technological and manufacturing sophistication. For decades, equity securities in South Korea have traded at substantial valuation discounts to similar companies elsewhere. This has made it a popular hunting ground for stock pickers. Unfortunately, the persistence of the discount has led to frequently disappointing returns and many investors have retreated from the market upon concluding that the status quo is unlikely to change. But, as we will explore in this article, there are signs that we may be on the cusp of some exciting developments.

What Explains the 'Korea Discount'?

The Korean equity market is dominated by a group of large family-controlled conglomerates, referred to as 'Chaebol'. In our opinion, the discount can largely be attributed to a misalignment of interests between the controlling shareholders of the Chaebol and minority shareholders. We have observed that the controlling shareholders' primary focus often appears to be on maintaining control rather than maximising shareholder value. For example, to avoid high inheritance tax bills, the funding of which can reduce the family ownership stake, controlling shareholders may actively suppress the value of their companies. Controlling shareholders also have an incentive to retain cash within the business as it can be used to expand their empire while cash paid out as dividends is shared with both minority shareholders and the tax authorities. There have been too many examples of where this retained cash has not been deployed in an effective manner and destroyed shareholder value.

In addition to the issue of mis-aligned incentives, we also attribute a portion of the discount to a lack of minority shareholder protections. For example, Korea lacks mandatory takeover rules that are common in developed markets. Korean companies can buy controlling stakes in other firms, often at significant premiums to market value, and then later buy the minority stake for a much lower price. It is little wonder that minority shareholders demand a high risk premium.

Could 2024 Be the Year the Discount is Unlocked?

On 17 January 2024, Korea's President, Yoon Suk Yeol, announced a plan to resolve the 'Korea discount'. The announcement included various initiatives but most significant, from our perspective, is the 'corporate value-up program'. This program's objective is to boost the market value of Korean companies. While the details of the 'value-up' program are expected to be released late February, there appears to be a striking resemblance to the initiative introduced by the Tokyo Stock Exchange in Japan last year. That was a key driver of the 2023 outperformance by Japanese equities.

Since the announcement, Korea has been the one of the best performing equity markets in Asia with the KOSPI index up 11% (USD, up to 19th February). While the move so far has been significant, our assessment is that if the 'Korea discount' was to be resolved, there is further upside potential.

Can it be Different This Time?

There have been many attempts by the Korean authorities to address low equity market valuations and none have been successful. What makes this time different? We think there are three key differences that raise the probability of success:

1. The precedent set by Japan in 2023. Nearly half of the prime section companies on the Tokyo Stock Exchange have disclosed plans to enhance capital efficiency, sparking increasing investor interest and driving Japan's stock market to its highest point in 33 years.

2. The fact that a new generation of family members have or are due to take control of the Chaebol, with some committed to appointing professional management for the first time.

3. The massive increase in retail investor participation in the Korean equity market that took place during the COVID pandemic and remains at an elevated level today. This means there is a much higher percentage of the voting population that are affected by the issues we have described and will be supporting the 'value-up' program.

Risks to Continued Outperformance of Korean Stocks?

As fundamental investors we are naturally sceptical. While we are excited about the potential of our investments in Korea, we are also cognisant of the execution risks. In comparison to the developments in Japan, we recognise that the controlling shareholders in Korea are much more powerful. In fact, controlling shareholders are much less prevalent in Japan and therefore have not been a significant barrier to governance reform. The controlling shareholders of the Korean Chaebol will be disadvantaged if the issues we have described are resolved. Therefore, this period of reform will require both 'carrots' and 'sticks'. In terms of carrots, it would seem reasonable for the government to lower tax rates on dividends and inheritance to soften the blow for the controlling shareholders. In terms of 'sticks', legislation will likely be needed to address minority shareholder protections and corporate behaviour. We also understand that 2024 is an election year in Korea and the proposals by the incumbent government could be watered down post-election.

Or maybe there is more to the Korean discount than just the behaviour of the Chaebol. Perhaps a contributing factor is the extreme cyclicality of the Korean economy, or it could also be related to geopolitical risks posed by a nuclear-armed neighbour. Whatever the outcome, Korea is a market to keep a close eye on in 2024.

Stock Selection Remains Key

2024 is shaping up to be an exciting time for stock selection in Korea. No doubt there will be companies that respond positively to the value-up program and others that will fail to evolve. The Fundamental Equity team will be on the hunt for companies where we can have confidence that management will drive change and where the business is underpinned by both a strong market position and a robust financial condition.

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