



# South Korea: prices still unfeasibly low



South Korea's equity market is still undervalued, which means opportunities are there for investors, argues **Eric Poh**

It has long been a well known fact that the valuation of the South Korean equity market is low: according to estimates by IBES, the price to forward earnings ratio is around 11. This is a significant discount whether we are comparing it to the region, which is trading at around 14 to 15, or global averages, which are around 15 to 17. Many investors have attributed this discount to the strong dominance of family owned conglomerates, called chaebols, which have wielded considerable power financially and politically.

For example, even today the Samsung Group, the biggest chaebol in South Korea, accounts for an estimated 20% of the total exports for South Korea; combined sales for the Samsung Group are also estimated to account for about 17% of South Korea's GDP. Furthermore these chaebols have nurtured a business culture where expansion is the top priority.

The focus was on sales growth, while profitability was of a secondary emphasis. As a result, a large number of companies were highly geared with low operating margins. This was fine when times were good, but when times turned bad, these companies suffered badly. Consequently, Korean companies have generally been viewed as highly cyclical. Corporate governance was also considered poor, since the aims of the group were more important than that of the individual subsidiary companies.

However, there was a sharp change following the Asian crisis in 1997. Many companies went bankrupt and were taken over by bank creditors. Among the bigger chaebols, the Daewoo Group totally collapsed and the chairman had to flee the country. A number of Hyundai companies were also taken over by creditor banks. Even the biggest – and widely regarded as the most well-managed – chaebol, the Samsung Group, had to sell their auto subsidiary to Renault. This led to a 180 degree change in the business culture of Korean corporates which initiated massive restructuring efforts. Non-core companies were sold off and debts drastically reduced. Cross hold-

ings among companies were also eliminated, thus improving corporate governance significantly.

The best example came from the LG Group, where a holding company was set up, and the group's stakes in all the companies under the LG Group were restructured so that they were only held by the holding company. At the same time, further change was implemented so that none of the subsidiary companies owned shares in the holding company.

Each of the subsidiary companies appointed professional management, while the owners now merely sit on the respective boards. As a result of this restructuring, profitability instead of sales became the main priority (see Chart 1). Balance sheets were also stronger which reduced the cyclical nature of Korean companies. With these changes, managements have been able to channel all their focus and financial resources into industries in which they deem they have competitive advantages.

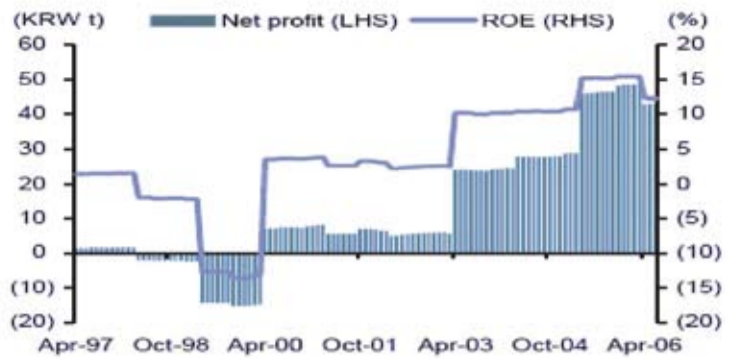
This has explained why Korean companies have brands that are global household names. Examples include Samsung mobile phones, LG refrigerators and Hyundai automobiles. With stronger brand names, Korean companies are not only gaining market share, but, more importantly, they are also gaining pricing power resulting in increased profitability.

Although the Korean equity market has performed well in the past three years, it has merely risen in line with the improved profitability of Korean companies. Investors have yet to discount the change in the risk profile. Valuations have only improved slightly from about 10x to 11x price to earnings. There is no reason why the valuation of the Korean equity market should still trade at such a significant discount to those in the region or global equity markets.

## Domestic liquidity flows

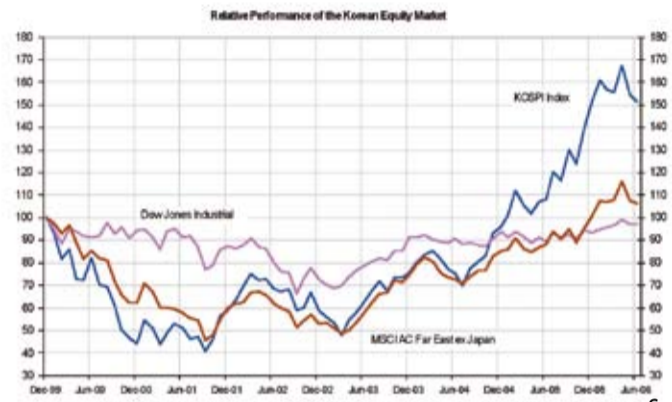
The drastic changes explained above are being appreciated by domestic retail investors. As shown by Chart 3 they are pouring significant

Chart 1: ROE and aggregate net profit of all listed companies



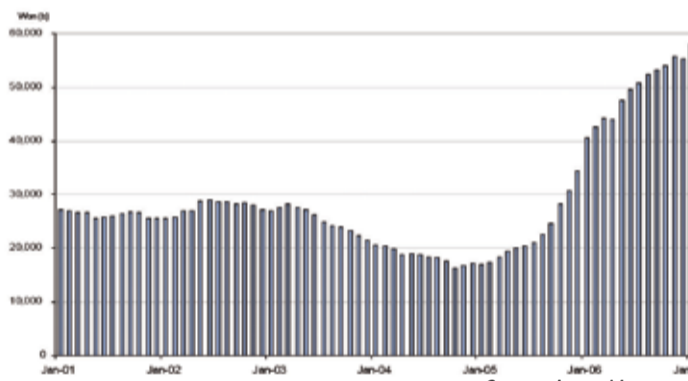
Source: KRX

Chart 2: Relative performance of Korean equity market



Source: Bloomberg

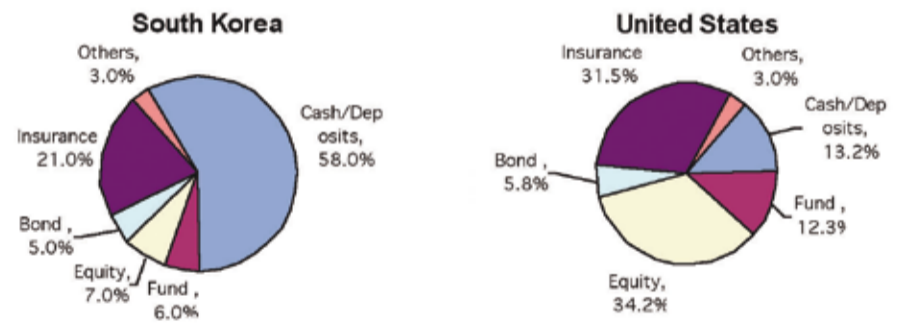
Chart 3: AuM of equity funds by domestic institutional investors



Note: that although the chart title refers to institutional assets, it is still reflective of the assets flowing into retail funds as the bulk of institutional assets are sourced from domestic retail investors.

Source: Asset Management Association of Korea

Chart 4: Comparison of South Korean and US equity markets



Source: Bank of Korea and Federal Reserve Bank

amounts of their assets into the Korean equity markets.

This is expected to continue in the near future as many of these retail investors have chosen to invest through regular saving/installment plans (in other words, funds are automatically deducted from the clients' bank accounts on a monthly basis).

At the same time, the low birth rate in the country, which will result in an ageing population, has highlighted the need for people to invest for their retirement. As a consequence, the profile of retail investors seems to be changing.

Whereas they tended in the past to invest in the equity market for short term gains, now, they are looking for the most sustainable long term gains.

Finally, the potential is also high; as shown in Chart 4 the bulk of the population's assets are still in cash or fixed deposits. Compared to the more mature US market, the

potential for inflows into the equity market is still substantial.

The biggest risk for the South Korean equity market remains the political uncertainty from North Korea. North Korea held both missile and nuclear testing in the second half of 2006. Although there was doubt that the tests were successful, the risk is still that North Korea may become a nuclear armed country in the next ten years. At the moment, the threat of war between North and South Korea is small.

At the same time, it is important to note that China (North Korea's biggest supplier of aid) is still very much preoccupied with its domestic affairs and therefore values regional peace and stability. This means that if North Korea went to war, it would get very little external support.

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