



The only way is up

Koreans have finally got bullish about their equity market. By *Steven Irvine*

It is one of those moments when you nearly drop your coffee cup. The moment takes place in the Yoido offices of Daewoo Securities. Kim Hee Joo, who is in charge of marketing equity instalment funds to the nation's other Mr and Mrs Kims, offers his own personal forecast on the Kospi. "In my personal view, the Kospi could rise to between 4,000-5,000 within the next three years," he says.

Could this be the most bullish man in Seoul? At the time of writing, the Kospi was trading just below the 1,100 mark – having broken through 1,000 for only the fourth time ever. However, it had also recently traded through the previous all-time high of 1,138 (set in 1994), and a mood of general bullishness was evident. But to quadruple in three years? On a more conservative note, Kim says that Daewoo Securities' own 'official' forecast is that the Kospi will breach 1,300 by year end.

Across the river in a meeting with the man who looks after Samsung Securities' private banking business, I share Kim's megabullish forecast and ask his opinion. Lim Il Soo considers it for a few seconds, and then says: "A forecast of 4,000 in three years. I don't think that is nonsense. There are some fundamental paradigm changes driving this market."

Lim adds that this paradigm change will drive an enormous amount of liquidity into what still remains one of the world's cheapest equity markets (on a price-to-earnings basis). He notes that Korea is entering its baby boomer phase, and that the paradigm shift is from a culture of saving to a culture of investing. The introduction of US-style 401k plans, he believes, will mirror the successes seen in the US stock market and drive a re-rating of the entire market.

Moreover, the National Pension

Fund has also indicated that it will put more money into the equity market. It finished 2004 with a 7.6% equity weighting. If you assume that weighting shifts to 15% (still well below global standards) and work on the basis that the National Pension Fund will grow to \$300 billion by 2008, that implies \$32 billion of net buying, according to CLSA. The broker quantifies the magnitude of this number by stating that it represents about 20% of the free float of Korea's top 50 companies.

Then there are the equity instalment funds, which, as of now, represent the best litmus test of the view ordinary Koreans have on the equity market. These are basically savings plans that see a fixed amount paid in each month – sometimes directly from salaries. Kookmin Bank began pushing the product in late 2003 as a way to offer its customers an alternative to low deposit rates, and to allow the



bank to boost its fee income. By early 2004 the strategy was proving a success and soon other financial institutions were copying Kookmin's lead. "We are the market leader in this area," says Kookmin's investment products team manager, Lee In Young. "We have a 25% market share in the equity instalment fund market. We now have 800,000 equity instalment fund accounts and that number is still growing every month by 50,000."

To date, almost \$9 billion has gone into equity instalment funds and each month that number grows by around \$500 million. That is a wall of new money going straight into the equity market every single month. And that money is being invested by all strata of Korean society. After one interview I asked the translator – a young person in his 20s – whether he had bought an equity instalment fund. He responded: "Yes, of course. I don't have a girlfriend and I am saving for my MBA. Buying an equity instalment fund is the best way for me to grow my assets."

The funny thing is that until a year ago, it would have been hard to find many ordinary Koreans who had any enthusiasm for their stock market. The market was dominated by foreign fund managers; indeed, foreigners had bought Korean equities to such an extent that they owned nearly half the market capitalization. Meanwhile ordinary Koreans – the vital ingredient in driving the market into a new bull phase – were signally absent.

So what, you might ask, has changed? And is it a permanent state of affairs?

Korean psychology

After having written about Korea for almost a decade, there is a trait about Korean psychology that has become evident to me again and again. And in researching this article I tested the theory on a number of Koreans I know well, and they concurred that it was a valid generalisation on the national psyche.

It is this: Koreans are a people that need a lot of persuading; but once persuaded they will act extremely quickly. This theory – persuasion then headlong rush – can be applied to the current boom in equity instalment funds.

Historically, the Koreans viewed their stock market as little better than a

casino, where rich *chaebol* families ritually ripped them off. To make matters worse, the Kospi had a disturbing habit of rising to 1,000 and then falling to 400. But in the wake of the Asian financial crisis, there was a move to clean up the stock market and clean up corporate Korea. The mantra of corporate governance was born, and many *chaebol* families saw their empires divided as non-core assets were sold off to pay down debts.

The period from 1999 to 2004 could be viewed as the era of "persuasion". In those five years Koreans watched in envy as foreign investors made large amounts of money from investing in their companies (particularly via the high-profile exits of private equity firms). And they watched the Kospi climb.

They also became aware of how little they got for putting their money in the bank. Meanwhile it became possible to own a lot of good stocks that had no *chaebol* connections, and were paying dividend yields of 6-9%, ie well in excess of local one-year time deposits (around 4.1%). Another catalyst was the arrival of Sovereign Asset Management in 2003 – which acquired almost 15% of SK Corp. Sovereign raised the profile of corporate governance and stirred debate within Korea inc.

Ironically, it was a wake-up call that most Korean companies had already embraced. According to a Goldman

scale. In the meantime, CLSA pointed out in the same February report that price-to-earning ratios had fallen from 24x in 1999 to around 9x. That is to say, the market looks like a bargain.

By the time Goldman Sachs came out with its high-profile prediction that the Kospi would reach 2000 (ie double) within three years, it was no longer falling on deaf ears in Seoul. The welter of data seems to have persuaded Koreans that the equity market was not the grim place it had once been.

Thus between 1999 and 2004 the Koreans were "persuaded" and changed their collective view of the equity market. Once persuaded, they pretty much started buying equity instalment funds with gusto. According to Daewoo Securities, the number of investment fund accounts is now three million. And according to Samsung Securities, the asset management industry is about to go through explosive growth. It currently has W200 trillion under management and Samsung Securities reckons that within 10 years that number will have doubled. Indeed, it expects its own asset under management to increase from W14 trillion to W20 trillion this year.

These forecasts are also a good indicator that the recent trends are not just a short-term blip but represent a longer term, sustainable state of affairs. That's because another key change has been

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Sachs report from March: "Value creators – companies whose ROEs exceeds their cost of equity – make up 71% of the market capitalization. The regulatory and corporate governance environment has clearly improved."

CLSA data also points to improvement in corporate management. Based on the universe of companies it follows it calculated that total revenues have increased from \$117 billion in 1999 to a forecast \$346 billion for 2005; net profit from \$8 billion to \$36 billion; dividends from \$0.8 billion to \$7.8 billion; ROE from 10% to 17%; and operating cashflow from \$27 billion to \$78 billion. And gearing had declined from 56% to 14%. That is what you call a corporate turnaround on a massive

the institutionalization of money management. Instead of individuals punting the market, there is now a greater share participation by fund managers, whose timeframes tend to be longer term.

This change has been driven by two things. Firstly, the clean-up of the banking sector helped Koreans to regain confidence in their financial system (indeed banks remain the key distributor of the equity instalment mutual funds). Secondly, the asset management industry has gone through a renaissance. The scandal-ridden investment trust companies of old have been taken over by reputable firms such as Prudential, and new Korean firms such as Mirae Asset Management have sprung up and demonstrated a consistent investment track



record. Indeed, Mirae's Independence Fund (bought by a lot of those who opened equity instalment fund accounts) was up over 40% in the past year. Mirae's marketing campaigns have also been highly effective.

"The local market used to be driven by irrational, individual punters with a short-term horizon," says Jason Shin, a managing partner of local private equity fund, Vogo. "But now Korea is following the US and European trend in the asset management industry. The market has shifted to indirect investment through mutual funds. This is only the early stage of this process and it is going to provide a lot of liquidity."

He adds: "The government's restructuring and sale of the three major investment trust companies also played a major role. They are now in the hands of very solid blue chip groups. That really instilled confidence."

Shin says he believes a liquidity-driven bull market is underway. "I am an ardent believer in this. I have been in Korea for 12 years and I have never thought the Korean stock market was solid until this year. The shift from individual investors to money managers is a significant event because it creates a virtuous cycle. Professional managers are going to stay in the equity market longer and be more patient and rational. And they are also going to demand better corporate governance from the companies they invest in. That makes the companies healthier and the whole just feeds off of each other. I happen to think this is a major watershed event."

The other aspect of this is government policy. It is now evident that the government has put a high priority on the equity market – possibly because it realizes that undervalued Korean stocks become vulnerable to foreign takeovers at cheap prices. It has therefore tried to direct ordinary Koreans to switch into the stock market, knowing there is a phenomenal amount of liquidity in the financial system looking for a home. The best evidence of just how much liquidity is lying on the sidelines occurred last year when a new luxury residential development called City Park organized a lottery to allocate apartments, and \$8 billion flooded in. If a real estate lottery can attract that type of sum in a week, it is evidence there is a lot of liquidity hibernating in the system.

Government policy moved on three fronts. The first two fronts involved upping the National Pension Fund's equity weightings and the creation of 401k-style corporate pension plans. The final front was real estate, since a key impediment to Koreans investing in equities was property. Koreans have a natural preference for property and since the real estate market was booming, the decision to invest in property rather than equity was not a tough one for them.

However, the government decided to make it a lot tougher. In October 2003 it changed property taxes so as to levy them on current market prices rather than construction cost; it also levied additional capital gains taxes on property sales and made it even more punitive to sell a second or third property if deemed to be in a "speculative zone". It leaned on banks to make fewer loans to people wishing to buy more than one property and reduced the loan to value ratio for mortgages from 50% to 40%. More recently, it imposed even tougher measures to end "property speculation". This included raising capital gains taxes on second properties sold to 50% and increasing the real estate holding tax on properties worth over \$580,000 to (up to) 3%, versus 0.5% for cheaper properties.

As one banker put it: "With bank

formed itself from a heavy-industry powerhouse to a modern society with renowned, trusted brand names. The new Korea has emerged as the best performing market in Asia this year, where the market has surged 284% since the Asian crisis."

Henry Seggerman, who runs US fund firm International Investment Advisors, has long been a bull on Korea, and now sees many of his rosy forecasts coming to fruition. "The story remains a liquidity story," he says. "Why can't the Kospi re-rate to the 2005 PE of the Philippines by year-end (1,275) and of Singapore one year from now (1,450)? Korea's listed companies offer a lot more growth than the Philippines' or Singapore's."

And with very little new equity issuance expected from Korea, the other key thing here is that all the new liquidity will go directly into the market – meaning more money will be chasing the same number of outstanding shares, and logically, driving up the price of those stocks.

Juxtaposed against the bull story are some risks. Rising oil prices and slowing exports to the US and China worry some Korean policymakers. Moreover, the domestic consumer has still not fully recovered from the credit card debacle and domestic demand is recovering only modestly. That is holding back GDP growth, which fin-

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deposits low, and the property market made less appetizing by the government, the only show left in town is the equity market."

Foreign fund managers have also noted as much. HSBC has just launched a new Korea Equity Fund. Its Korean specialist, Kang Mijung comments: "We believe that Korea's current market upturn will be sustainable as it is supported by positive structural shifts that have significantly improved the investment environment – both from a macro economic and earnings perspective. Government and corporate reforms have translated into better corporate earnings and governance, which has been well rewarded by domestic and foreign investor support. The country has successfully trans-

ished the first half at 3% versus 4.6% a year earlier. However, the second quarter saw an improvement over the first and July's industrial output report showed a 7% rise year-on-year, the largest gain in seven months. As Rob Subbaraman of Lehman Brothers says: "We have long argued that business capital expenditure is the missing ingredient in Korea's economic recovery and we have been optimistic it will regain traction. Indeed, the growth of machinery orders, a leading indicator of capex, rebounded to 25.5% year-on-year in July from -12.2% in June. Another positive indication is that the average factory operation rate rose to 80.5% in July, a four month high. We are forecasting Korea's GDP to grow 6% in 2006." **FA**