View Point

Why I like Korean equities

By Henry Seggerman 06 July 2004

The Korean equity market is cheap and set to rise dramatically says a leading fund manager who specializes in Korea.

Today, the Korean stock market is trading at a PE below 9 times, at the low end of its historical trading band. It is the cheapest market in Asia and the cheapest significant emerging market. By contrast, Hong Kong trades at a PE near 15 times.

Korea is growing much faster and its economy is far more diversified than Hong Kong's. Another plus is that Korea is an independent nation, and not a colony ringed by menacing PRC submarines. Before long, Korea is certain to re-rate upwards to Hong Kong's valuations, or higher.

After a blistering 82% rally capped by panic buying, the Korean market took a long-expected breather a few weeks ago. In typical Korean fashion, the fall was reflected almost immediately in share prices.

Now is the time to jump back in. Samsung Electronics is also trading at a PE below 9 times. Everybody knows $1 million invested in the Korean stock market might very well be worth $1.5 million in a matter or months.

Pundits have singled out Chinese cooling as culprit #1 for the recent correction. However, the Chinese government's plan to slow its rampant economy has been known for nearly a year, yet this was strangely not priced into any markets until April of this year, when the announcement was made.

The worldwide correction used the Chinese announcement as a convenient available excuse for profit-taking after a momentum-driven run-up over many months. Note that India and Thailand are not dependent on exports to China, yet their corrections after bigger run-ups were even more pronounced than Korea's. In our view, China will continue to grow in the 8% range, and its demand from Korea will expand into a wider range of wider-margin products, despite any government interventions.

Korea's overall economic picture remains encouraging. May exports were up 42% YoY - the fastest growth in sixteen years - having exceeded 30% annual growth for six months running. China has been important, but rising US facility investment is also a principal driver.

The current account has run a surplus consistently for thirteen months. Industrial production rose 11.3% in April, an improvement over 1Q04. GDP, capex, and capacity utilization are rising. Korean corporate operating margins have reached a new historical high. Consensus estimates for the next twelve months' earnings for the MSCI Korea constituents rose 12% in April and 15% in May, and BNP Paribas forecasts 33% earnings growth this year for its universe of Korean companies.

Pundits have singled out US tightening as culprit #2 for the recent correction. However, tightening in the US does not hurt the Korean stock market.

Quite the opposite. In the 1994 U.S. tightening cycle, the KOSPI experienced a roaring rally. Besides, the fear of tightening in the US is not due to concern that the corporate investment beneficial to Korea will wane, but rather because of the simultaneously high levels of mortgage refinancing and securitization.

Greenspan's hesitation, and the market jitters, stem from this unwieldy double-edged debt overhang in the US. Korean bank rates were never eased to US ZIRP-ish levels (They may even ease in the weeks ahead.), and Korea's financial institutions are essentially immune from any residential lending problems, given a super-low mortgage loan-to-value ratio and a market for asset-backed securities which is still in its infancy.

Meanwhile, a recent tenuous spike in retail sales suggests that Korea's credit card problem may be drawing to a close. The government is now moving from patching up credit card problems to patching up SME problems. Korea is a geared market, and this simply means that its extremely healthy fiscal surplus will need to be deployed for lending-related hull repairs on a regular basis.

The Saudis promise a production boost to drive oil prices down to the stated $30-31 goal, and the spot price has already fallen over 9%. Al Qaeda can affect sentiment, but cannot really disrupt production in any real way.

As prices reach the Saudi goal, it will be a relief for oil-dependent Korea. Even Hollywood celebrities are trading in their Hummers for low-mileage Priuses, indicating US petroleum binge appetites may get under control.

The Korea discount is an old story by now, and the most often mentioned reason is poor corporate governance. But improvements are plainly evident.

This month, Credit Lyonnais will publish its fourth annual Corporate Governance Survey of Asian countries. Between the inception of the survey and its most recent results, Korea posted the greatest improvement of any country in the survey.

Of course, there is more work ahead, but the Koreans have pursued corporate governance improvement with some of the same enthusiasm they pursued financial sector reform in the months following the Asian financial crisis.

On this note, very soon we will see the advent of class-action lawsuits in Korea - a first for many Asian countries. It is limited to companies with more than W2 trillion in assets, and we would be fools not to expect delays, red tape, regulations, and exceptions; but it is a start. It is a statistical fact that countries which permit class-action lawsuits, such as Great Britain and Australia, enjoy a significantly higher stock market capitalization to GDP than countries which do not, such as France and Germany.

Korea's crown jewel companies enjoy share price support, perversely due to a history of dilution and corporate governance abuse. Controlling shareholders have soaked the equity markets over and over again, based on a Monopoly-Money delusion that they could exercise control by manipulation, despite perilously anemic stakes, often below 5%.

They have also engaged in wanton, value-destroying malinvestment, damaging outside shareholders. Now, all that abuse is coming home to roost, as they discover malinvestment drives down the share price to bargain-basement levels, attracting international M&A predators like Sovereign Asset Management. (Speaking from experience, it's actually not that hard for portfolio managers to become the largest shareholder of Korean companies.)

The government offers no help, even salting the wounds, by sentencing offending Chaebol Lords like Chey, Tae-Won to three-year prison terms. So, going forward, dilutive rights issues will be impossible for typical chronic corporate governance abusers, and they will think twice before value destruction. Moreover, when share prices fall below the normal discount to international peers, we will see more and more share buybacks and other stake-boosting strategies, serving to stabilize prices.

Korea's stock market sports one of the world's highest levels of foreign ownership, 43% - a level unchanged in the recent correction. With these hefty positions and also long-term institutional holders, we could see a free-float squeeze on some key blue chips, which would drive up share prices dramatically.

Meanwhile, many domestic investors have remained on the sidelines for many months. The Minister of Health and Welfare just announced the government pension fund will boost its stock market allocation up to W5 trillion. If domestic investors finally decide to follow the government's lead and pile in, we all remember clearly the nitro-methane potential in a liquidity-driven rally from a few years ago.

In a few months, the World Bank will publish its 2003 final results, and it will be time for MSCI's Index Committee to stop stalling, unhook the velvet rope, and finally allow Korea into its EAFE private club. MSCI has really run out of excuses at this point.

Korea notched an $11,400 per-capita GNI last year, pushing it even deeper inside the World Bank's High Income territory for a third year running. According to MSCI's March, 2002, press release, High

Income status "is used as an initial trigger for further analysis" regarding EAFE admittance.

Then, "a developed country should be able to sustain its level of economic achievement." We have reason to believe that Korea's three years satisfy MSCI's High Income sustainability requirement. MSCI has to admit Korea to EAFE, and when this inevitability happens, the Korean market will surge, as $1.5 trillion follows the EAFE index, while only $180 billion follows the Emerging Markets index.

Finally, on North Korea, Kim Jong-Il is merely staging a revival of the play his father opened ten years ago. During Kim Il-Sung's initial performance in 1993-1994, the Korean stock market experienced an 82% surge. Tensions between North Korea the Bush regime did not decelerate last year's stock market rally, and we do not expect that this year, either.

In five or ten years, we expect the Korean people will finally have their "Korea is One" wish granted, resulting in a Korea loosely unified in a federation style, the North a vast, well-educated maquiladora hobbling labor unions in the South, boosting operating margins -- and the Dear Leader comfortably in exile, well stocked with Hennessy cognac. In all likelihood, it will be a country with its own humble nuclear deterrent, just like Pakistan or Israel. No doubt, Samsung will upgrade Taepodong missile avionics, which could benefit from some state-of-the-art technology.

Henry M. Seggerman (pictured) is President of International Investment Advisers (IIA - http://www.iiafunds.com), an investment management company, which has focused exclusively on the Korean market for twelve years. Last year, IIA's Korea International Investment Fund (KIIF) was the top-performing Korea equity fund tracked by Standard & Poors.

In its most recent edition, Barclay reported KIIF's three-year annualized return as 21%, and placed it in the top ten Emerging Markets Asia funds. From inception, KIIF has outperformed Korea's KOSPI index by 257%.