Letter to investors

South Korea – enough is enough

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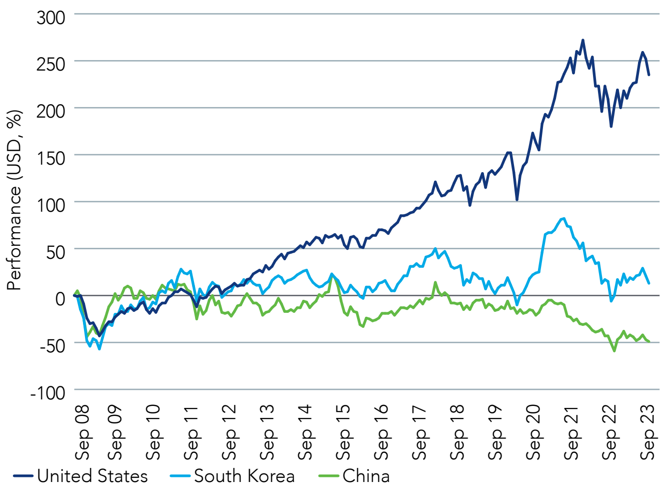
While many listed companies in South Korea have volatile earnings tied to economic cycles, which can depress valuations, most investors (ourselves included) believe that the main cause of the well-known 'Korea Discount' phenomenon is the endemic mistreatment of minority shareholders.

In this Letter to Investors, Jonathan Pines, Lead Portfolio Manager, Asia ex-Japan Equity, identifies what he believes are the two chief causes of poor corporate governance in South Korea. He also examines the specific methods controlling shareholders use to benefit at the expense of minority shareholders.

He details the results of a consequential review of the Asia ex-Japan team's voting policy for South Korean directors, which now includes a recommendation for the Asia-ex-Japan team to presume to vote against all directors up for re-election in the majority of companies trading persistently below book value.

Of the ten countries that comprise the MSCI Asia ex-Japan Index, the poor performance of two of the larger countries over the last decade and a half is notable.

Figure 1: Global laggards (South Korea and China vs. the US)



Past performance is not a reliable indicator of future performance.

Source: Bloomberg as at 30 September 2023. Returns in US dollars. For South Korea, the KOSPI was used, for China the Hang Seng China Enterprises Index. The US benchmark (S&P 500) was included for comparison purposes. Past performance is no guarantee of future performance.

One can understand China's poor performance. Over the relevant period there has been a deterioration in its relationship with the West. Investors are increasingly questioning whether China is entering a period of lower growth as structural imbalances, such as its outsized and overheated property sector, depress related sectors and spread negative sentiment to others. The limits of state growth planning has also become an area of concern[1].

But what explains South Korea's poor performance? The country's stocks have also derated, with the average price-to-book multiple now below one[2].

Besides cheap valuations, other anomalies abound. South Korean preferred shares – essentially non-voting common stock – trade at discounts to voting stocks of as much as 50%. Holding company discounts to the sum of their parts often exceed 65%. Stocks bought back by companies, uncancelled and held in treasury, can be as high as 40% of shares outstanding[3]. And pay-out ratios for even cash-rich profitable companies are often below 15%[4].

Many listed companies in South Korea are highly cyclical – with performance tied to economic cycles – which can attract lower valuations. In our view, however, the persistence of cheap valuations on offer in the country, coupled with the anomalies referred to above, are primarily a consequence of poor corporate governance.

Substandard laws and regulations empower controlling shareholders in South Korea, allowing them to generate substantial returns for themselves, while mistreating minority shareholders.

In the 14 years since our Asia ex-Japan Strategy was launched, we have witnessed (often through painful first-hand experience) how irresistible the temptation can be for controlling shareholders to employ creative methods to achieve their own objectives.

When we have been directly affected by this behaviour, we have tried hard to fight back. We have proposed multiple resolutions in shareholders' meetings. We have written to (or held discussions with) shareholder proxy providers, directors, controlling shareholders, and even a judge. Almost all of our efforts to influence corporate behaviour to date have been in vain.

[1] We view China as sufficiently cheap to be attractive despite the risks. For this reason, we are moderately overweight China in our Asia ex Japan fund and have recently launched a China Fund.

[2] As at 4 October 2023, per Bloomberg, the Kospi index traded at a price-to-book multiple of 0.89 times.

[3] Bloomberg as at 30 September 2023.

[4] As at 4 October 2023. A dividend pay-out ratio is the proportion of earnings paid out as a dividend.

The root cause of poor governance

Many investors are aware, in general terms, of South Korea's reputation for poor governance; and the so-called 'Korea discount', where local companies persistently trade at lower valuations than their global peers.

Perhaps less well known are the reasons *why* corporate governance is so poor, or the specific tools that controlling shareholders routinely employ in pursuit of their own objectives.

There are, in our opinion, two main causes of poor corporate governance in the country:

1) The outsized political power of a tiny number of powerful families that control companies. These families benefit from unusual laws that serve their interests, and disregard the interests of other investors, which has the effect of sharply raising the cost of capital for South Korean enterprise[5].

   The laws that help these families are technical and not top of mind for most citizens. As a result, it's difficult to develop a rallying cry to counter them. The streets of Seoul do not ring out with cries of "Down with Forced Share Swaps!", "Mandatory Offers for the Masses!" or "What do We Want? Treasury Share Cancellation! When do We Want it? Now!"[6].

2) The high effective inheritance tax that applies in South Korea to large estates, which (after surcharges) can be as high as 60%.

We believe that all of the governance weaknesses that we outline below stem from these two primary causes.

How controlling shareholders help themselves

Low dividends keep cash receipts and stock prices down – just the way many controlling shareholders like it

The high inheritance tax means that controlling families are incentivised to keep the stock price of the companies that they control low, as the tax is based on market value on the date of death. A low pay-out ratio, from the perspective of a controlling family seeking to minimise inheritance taxes, both reduces the cash directly held by the taxpayer and helpfully suppresses the stock price (because fewer investors are attracted to lower yielding stocks)[7]. As a result, the pay-out ratios of even cash-rich consistently profitable companies in South Korea are often tiny[8].

The creative methods some controlling shareholders use to extract cash

The low dividends, in turn, mean that controlling families need to seek other ways to extract cash from the companies they control. Lax laws allow them to do this easily. Many controlling families enter into related party transactions, such as selling property to the companies they control, often at eye-catching prices.

In addition, transfer pricing arrangements are common in South Korea – recurring transactions (such as royalty, information technology or advertising services) between one less fully-owned and one more fully-owned company[9].

Related party transactions do not need minority shareholder approval, and are often only disclosed long after the fact in a footnote in the annual financial results[10]. Not only do such transactions extract cash for controlling shareholders, but when unfairly priced, also transfer wealth from minority shareholders to controlling shareholders.

Cheap stock prices can still prove tempting for controlling shareholders

If such behaviour was not bad enough, some controlling shareholders then take advantage of the low levels at which their stocks are trading (because of the low pay-out ratio and minority shareholder upset about related party transactions). Safe in the knowledge that, because they control the company, they will ultimately get their hands on its cumulative net earnings, they often find the temptation to buy more stock cheaply impossible to resist. A lack of personal resources (because dividends have been intentionally kept low) is not a hinderance in this regard – they can direct the companies that they control (via their board representatives) to use company cash to buy stock on the market.

While such buybacks at cheap valuations theoretically benefit all shareholders (including minority shareholders), the shares bought back are not cancelled (which would reduce the share count, increasing earnings and net assets per share). Instead, the stock bought back remains uncancelled, preventing other shareholders from building meaningful positions, and remain available – if necessary – to be on-sold by directors to friendly parties if control ever needs to be more fully secured. General company resources are therefore used to further hinder any challenge to controlling shareholders.

[5] The relationship between government and business is complex. The top 10 conglomerates account for 80% of GDP. Conglomerates were heavily supported by the government after the Korean war (1950-1953) and received extremely favourable treatment during certain periods. There is a real desire to tackle corruption, but this is mingled with pride in the conglomerates and a belief among many politicians and citizens that conglomerates and leading executives need "support" for South Korea to do well.

[6] The controlling families have in the past been able to portray minority investor objections to technical laws that favour controlling shareholders as the musings and rantings of "greedy foreign hedge funds". As a local South Korean activist investor class continues to emerge, this stance might become more difficult to sustain.

[7] This dynamic particularly holds true for companies designated as "holding" companies i.e., the company through which the controlling shareholders typically exercise control of other companies, and explains the steep discounts at which holding companies trade to the sum of their parts, which can exceed 70%.

[8] Of course, when questioned, directors of companies with inappropriately low payout ratios seldom admit to a desire to reduce inheritance taxes. The normal response is to promise that cash accumulating on the balance sheet will be used for "future M&A opportunities".

[9] There have, in more recent times, been regulatory restrictions of some recurring ("captive company") transfer pricing practices.

[10] There is no requirement for Korean financial statements to be published in English, reducing the degree of scrutiny to which they are subjected. While transactions need to be at market value, many transactions (negotiated privately between related parties) lend themselves to a high degree of subjectivity.

Indeed, it is rare to find a company trading below book value that does *not* have a significant percentage of outstanding shares held, uncancelled, in treasury. The percentage of outstanding stock bought back and uncancelled for a family-controlled company can be as high as 40%, or more.

The fact that many cheaply-priced companies buy back stock is a sign that the directors (and controlling shareholders that appointed them) *know* that the stocks trade below intrinsic value. The fact that the stocks remain uncancelled thereafter shows that the controlling shareholders seek to take advantage of the low price – but in a way that only benefits them.

Controlling shareholders can make the stock price fall and *then* make minority shareholders sell to them

For more insatiable controlling shareholders, still further temptations present. Unsatisfied with using company resources to buy stock on the market, some employ one of two legal mechanisms to force minority shareholders into selling their stock to controlling shareholders cheaply[11].

Minority shareholders can be forced to swap their stock for stock in the controlling family's (perhaps) more fully-owned, larger, more expensive, debt-laden other company that subsumes the company in which minorities initially invested; or massively dilutionary new stock can be issued to holders of the family's (perhaps) more fully-owned, larger, more expensive, debt-laden other company in exchange for shares in that other company.

Both methods effectively end an investor's interest in the stock in which they initially invested, exchanging it for another investment that the controlling shareholders select (which may be less attractively priced and in which the controlling shareholders may have a larger interest).

The law requires the swap or buy to be at 'stock market value' but the outcome is nevertheless rarely fair for minority shareholders. This is because relative stock prices can be influenced by directors – both over a long period (for example by suppression using a low dividend policy), or immediately prior to swaps or new issues occurring[12]. In addition, even if the relative market prices *were* approximately fair, an investor is nonetheless being forced to sell at a time not of their choosing, such as when the stock price is particularly undervalued relative to intrinsic value.

Warren Buffett famously claimed the stock market is a device for transferring money from the impatient to the patient. Benjamin Graham, the father of value investing, said that in the short run, the market is a voting machine, but in the long run, it is a finely-calibrated weighing machine[13].

Such comments hold true in most jurisdictions – but not South Korea. When you buy South Korean stocks it is by no means guaranteed that you can remain invested for the long term. The decision as to when that stock is sold might be made by the controlling shareholders rather than the stock market investor.

Indeed, the controlling shareholders can first make the stock go down and *then* make the minority shareholder sell to them.

The irony is as follows: the worse the stock price is doing, the cheaper the price is, the greater the 'Ben Graham' margin of safety[14], the less stock market investors want to sell, the more likely are the controlling shareholders to *make the minority shareholders* sell.

We have twice been forced to effectively sell stock trading on cash-adjusted P/E multiples of below three times by being forced to exchange our stock for that of unattractively-priced entities chosen by the controlling shareholders in which they had a larger interest[15].

Of all the weaknesses described in this note, we believe the forced effective sale of stock is the most damaging to South Korea's capital markets because it undermines the very purpose of capital markets. If an investor can be forced out at a time of the controlling shareholders' choosing (especially if the controlling shareholder is able to first depress the price of the stock) then what is the value to a minority shareholders of a stock that has a controlling shareholder? What price is too low? Stock selection in South Korea therefore requires the additional, extraordinary step for minority shareholders of seeking to carefully weigh the integrity of the controlling shareholders and how resistant they are to the temptation of benefiting at the expense of minority investors[16].

If control changes, only the controlling shareholders get the premium

Some investors might imagine that one day the controlling shareholders of a cheap stock will sell their controlling interest, at a fair value, with minority shareholders enjoying

[11] The Korean Commercial Act (section 360-2 or 522) and the Financial Investment Services and Capital Markets Act (section 165-4) allow for an 'all stock' transaction in terms of which the stock of a target company is exchanged at market price for the stock of an acquiring company. Korean laws do not allow for a separate minority vote on share issues to related parties or compulsory share swaps with related parties. Thus if stock held by minorities is undervalued (relative to the asset being acquired or stock swapped for) prior to a new issue or swap, minorities are not only forced sellers but might suffer a destruction of value as the stock they hold is exchanged for a pricier asset.

[12] Directors of both the larger and smaller merging companies may be the same or both be appointed by the same controlling shareholders of both companies. Directors have the power to affect stock prices by among other things, dividend policy, conservative or aggressive accounting policies or estimates, positive or negative earnings or revenue forecasts, capital expenditure and investment programs, buybacks (with or without cancellation) or announcements about any of the aforementioned. They can also affect stock prices by creating anxiety about a possible delisting intention or refusing to engage with investors.

[13] Benjamin Graham has been heralded as the father of value investing, and advocated buying cheap stocks, particularly those cheap relative to assets and current assets.

[14] Margin of safety is a principle of investing in which an investor only purchases securities when their market price is significantly below their intrinsic value.

[15] In both cases we were forced to effectively swap our attractively priced stock for far more expensively priced stock, benefiting the owners of the more expensively priced stock, and hurting us. In at least one of the two instances, in our opinion, prior to the establishment of the swap ratio, the directors (appointed by the common controlling shareholders) sought to influence relative stock prices to move in ways that were advantageous to the controlling shareholder. Appeals by us to the judge in a court challenge in that case failed.

[16] Another key consideration is the age of the controlling shareholders. The older they are, the greater the incentive to suppress the stock price.

a 'tag along' mandatory offer. However, in South Korea, there is no tag along. Minority shareholders can only watch as stock is transferred from the old to the new controlling shareholders, often at a multiple of the stock market price. Indeed the lack of requirement for an incoming controlling shareholder to make a similar offer to minority investors means that the former controlling shareholder is able to attract an even higher premium than they otherwise would get (because control can be secured without the need to fairly compensate minority shareholders, leaving more cash available for a control premium). In the past we have watched our stock trade unchanged on the market as control changed hands at more than double the stock market value[17]. (Indeed, subsequently the stock price *fell* as it became clear to minority investors that the new controlling shareholders wanted 100% of the company, and had the power to cause a fall in the stock price and *then* force minority shareholders to sell – a cynical tactic that we have previously termed 'drop and swap').

Directors' loyalty is to the company, not shareholders

Investors might imagine that some of the actions outlined might be prevented if challenged in court, and that judges would hold directors to account for not fulfilling their fiduciary duty to shareholders. However, in South Korea, directors don't have a fiduciary duty to shareholders – the only requirement is that they are 'loyal' to the company[18]. Such a concept is, of course, subject to varying interpretations. It can even be argued that a director who acts in a way that prejudices minority shareholders is nevertheless loyal to the company.

Pardon?

Group pardons of top white-collar executives are frequent in South Korea, typically occurring more than once a year[19]. Indeed, purported changes in the law might allow pardoned individuals to return to running the very companies they have, in some instances, been convicted of stealing from[20]. The positive response of leading industry groups to these pardons is telling[21]. While the public's attitude is more equivocal, the country's political and business leaders have a remarkably forgiving attitude towards poor governance, even if criminality is involved.

In August 2023, President Yoon Suk Yeol pardoned 2,176 people, including the former chiefs of Kumho Petrochemical, Booyoung and Lotte Foundation, who were all convicted of breach of duty and embezzlement; Rhee Jang-han, chairman of Chong Kun Dang, a pharmaceutical company; Lee Ho-jin, former chairman of Taekwang Group, an apparel giant; and Kang Jeong-seok, former chairman of Dong-A Socio Holdings. Prime Minister Han Duck-soo said he "listened carefully to many different voices… for economic recovery, businesspeople were included in the list".

"We welcome the fact that major businessmen were pardoned and reinstated through the special pardon for Liberation Day," Kang Seok-koo, head of the research division at the Korea Chamber of Commerce and Industry, said. "[The latest decision] will stimulate the struggling economy and is perceived as a request to businesspeople to play an active role in their positions moving forward."

The Federation of Korean Industries said the pardons will be an opportunity for South Korean businesspeople to re-acknowledge their role in "paying back to the country via their businesses… The business circle will pioneer its way out of the slow economy amid a fast-changing environment and will look for new growth engines while welcoming challenges and innovation"[22].

Just 'cause it's true don't mean it ain't defamatory

Astute readers may have noticed that despite our 14 years of experience of dealing with specific South Korean governance failures, we have not named names in this note. This is because, under South Korean law, even a true statement can be defamatory. (In most jurisdictions, defamation requires the communication of a false statement. If what is alleged to be defamatory is in fact true, then this would constitute an absolute defence against defamation).

The legal ambiguity in South Korea stifles criticism from those who, though civic minded or financially interested, might not want to risk spending years in a *Kafkaesque* legal setting defending statements that everyone acknowledges are true but are nonetheless claimed to be defamatory.

Our South Korean performance and overweight explained

It might come as a surprise to some readers (although probably not our long-term investors) that South Korea is not only an overweight position but has also been (together with that other laggard, China), the *largest* contributor to our historic outperformance[23].

How do we explain South Korea's positive historic contribution and our current overweight in the context of the above corporate governance critique?

First, some South Korean companies are not controlled by families, and not every South Korean company controlled by a family is run solely to benefit that family. The country's poor

[17] We understand that some form of watered-down mandatory offer rule is apparently being contemplated by regulators.

[18] Article 382-3 of the Commercial Act.

[19] Admittedly this implies at least a reasonably high level of prosecutorial motivation and success in prosecuting high-profile white-collar workers too.

[20] "Business Tycoons given Liberation Day special pardons", Korean Times, 11 September 2023.

[21] "Business leaders, 2,100 others pardoned ahead of Liberation Day", The Korea Times", 14 August 2023. https://www.koreatimes.co.kr/www/nation/2023/08/113_357017.html.

[22] https:/koreajoongangdaily.joins.com/news/2023-08-14/business/industry/Biz-circle-welcomes-Liberation-Day-pardons-for-business-figures/184631.

[23] Korea and China stock selection have each contributed two fifths of the Federated Hermes Asia ex Japan strategy's since inception outperformance.

corporate governance reputation has meant that even some relatively well-run companies attract the 'Korea discount' and are therefore potential bargains.

Second, in some cases, companies that have corporate governance weaknesses are so cheap that the payoff profile is positively asymmetric despite those weaknesses. Governance has always been weak in South Korea, but stock prices are near trough valuations[24].

Finally, there is some evidence of improvement – albeit glacial – in the South Korean corporate governance environment because of a rising number of domestic activists. (South Korean activists have the advantage of a local media profile and being able to vote for politicians).

As is often the case when investing in stocks, it's unexpected changes that can be the most important driver of price performance. South Korean corporate governance is more likely than not to improve from its current low level – and might do so quicker than the average investor expects.

The significance of a price-to-book multiple below one

About one in three South Korean stocks trade below a price-to-book[25] multiple of one. When a company trades this cheaply, even on a persistent basis, it might be because of circumstances that are outside the control of management.

In the case of banks, for example, it might be because returns on equity are depressed by a high equity capital buffer demanded by regulators. In the case of more cyclical companies it might be because of a protracted industry downturn. For companies operating in industries facing significant long-term structural challenges, it might be because of the intensity of these ongoing challenges despite the best efforts of a competent management team. For utility companies it might be because regulations limit returns to below the company's cost of capital. Of course, it may also imply that the book value is overstated and needs to be written down[26].

But absent these mitigating factors, for a company's stock price to be trading *persistently* below book value per share is normally an indictment. It is a sign that the company is being assessed as being potentially worth more dead (liquidated) than alive[27]. It suggests that investors have little confidence that management will generate a decent return on equity; and that directors cannot be fully trusted to distribute future or past earnings to shareholders. It may signal a market verdict that management is poor, or controlling shareholders are prejudicing minority shareholders, or are expected to do so; and suggest that the directors, rather than creating value, are destroying it.

In our experience, particularly in South Korea, it is almost inevitable that such companies will exhibit poor corporate governance.

Indeed, as discussed in this note, when companies trade below book value in South Korea, it is often because that is exactly what the directors (and controlling shareholders that appointed them) *want* for inheritance tax reasons.

Lessons from Japan...

After he was appointed president of the Tokyo Stock Exchange in April, Hiromi Yamaji wrote to the chairman of every listed company. He encouraged companies to take a close look at their price-to-book ratios and engage in constructive dialogue with investors[28].

"We want companies to focus not only on revenue, profit and market share, but also on indicators that investors consider important, like capital cost and share price," Mr Yamaji, who has a Wharton MBA, wrote.

He expressed concern that too many Tokyo Stock Exchange-listed companies traded at a price-to-book multiple below one – more than 50% at the time versus less than 10% in the US[29]. He urged companies to update plans for improving return on equity at least once a year. "It's worth listening to shareholders," he said.

Progressive changes were underway in Japan's corporate governance culture before Mr Yamaji's letter. But the letter, coming when it did, nonetheless had a profound impact on the stock prices of many Japanese companies. His intervention injected an urgency into the progress already then underway.

The impact is already being felt: A more efficiently allocated and lower cost of capital has raised stock prices of many Japanese companies, benefiting the companies and investors.

[24] At a cheap enough price we would consider buying companies that have poorer corporate governance. However, this willingness would not extend to companies that we suspect have "crossed the line" to fraud, no matter how cheap the valuation, because in such cases the numbers upon which the valuation is based can quickly become meaningless.

[25] Book value is another term for net asset value. A price-to-book (or price-to-net asset) value below one means the company's market capitalization is below the value of its net assets, or assets less liabilities.

[26] We would tend to regard an overstated book value as a forgivable "misdemeanour" unless it is persistent or deliberate.

[27] Book value is not meant to reflect liquidation value. It is meant to show the value of assets (at the lower of depreciated cost or present value to the business) assuming the business will continue as a going concern. However, book value, particularly tangible book value, can often serve as a rough (and sometimes conservative) indicator of liquidation value.

[28] "New JPX CEO tells companies to seek 'dialogue' with Investors", April 11, 2023. https://asia.nikkei.com/cms/Editor-s-Picks/Interview/New-JPX-CEO-tells-companies-to-seek-dialogue-with-investors.

[29] The reasons for stocks trading below book in Japan are complex, but unlike in the case of some companies in South Korea, generally do not result from a desire among controlling shareholders to keep stock prices low, and might be better explained by a survivorship-biased conservative mindset that followed the bursting of that country's asset bubble in 1999, and low return on assets resulting from an extended period of low inflation. Relative to Korea, Japan has few family-controlled companies. Since 2000, the Horizon Kinetics Japan Founders Index actually shows that owner operated businesses have outperformed the MSCI Japan benchmark by approximately 4% per annum.

The easiest way for companies with surplus cash to increase returns on equity and stock prices is to return some of that cash to shareholders via buybacks or higher dividends. And that is exactly what is happening in Japan. Barely a day goes by without another Japanese company announcing an increase in dividend pay-out ratio or significant stock buyback (and cancellation).

…have encouraged the Asia ex-Japan team to review our voting policy in South Korea

We expect that South Korean investors (some of whom can vote for politicians) will observe the positive developments in Japan and start to put pressure on regulators to improve the corporate governance environment in South Korea. Any such pressures will act as a counterbalance to the powerful but tiny number of controlling families that have until now managed to so successfully sustain laws that suit their own interests but at the expense of all other South Korean investors and savers, and the country's capital markets.

The Federated Hermes Asia ex-Japan team looks east from South Korea towards its neighbour across the Sea of Japan with envious eyes. Japan and South Korea have for the longest time been twinned as Asia's corporate governance laggards – particularly so far as inefficient capital management is concerned. Now we witness Japan improving while South Korea lags as that country's powerful controlling families continue to win support for the retention of regulations that, in our opinion, are not fit for purpose.

We have decided to respond to poor South Korean governance by taking some lessons from recent developments in Japan.

Henceforth, for South Korean companies that have traded persistently below book which cannot be explained by an overstated book value, regulatory constraints on returns, a protracted cyclical downturn or industry-wide persistent structural challenges, the Asia ex Japan team will have a presumption to vote against the re-election of all directors up for re-election.

It is, of course, not our intention to vote against those directors valiantly doing their best under difficult circumstances, or to penalise directors of companies that are doing well but simply have not yet had their success recognised by the market in the company's stock price. Before voting, we will offer affected companies the opportunity to explain why a vote against the re-election of directors would not be appropriate.

However, in our experience, in South Korea there is a high correlation between companies trading below book value and those with poor governance (save for the exceptions discussed above), and we believe the voting presumption outlined above is an excellent starting point in developing our rebuttable stance. In particular, we will be on the lookout for companies that we assess as *preferring* a lower stock price – especially those acting to intentionally supress it, or directors who exhibit "concerted indifference" to a low stock price relative to value.

Furthermore, in South Korea, even for companies that are trading above book, henceforth we will also vote against *all directors (who do not explicitly dissent)* in circumstances where the company has proposed, enacted or supported within the previous three years any of the following:

1. A significant related party transaction (or continuation of a recurring related-party transaction arrangement) that *prima facie* appears to be unfair to the company and which minority shareholders were not given the opportunity (and continuing opportunities if relevant) to *separately* vote on;

2. A change of control where minorities are excluded from fairly participating;

3. A significant share swap transaction (including a new share issue in exchange for shares in another company) that we assess as being unfair to company shareholders (particularly where there have been prior adverse relative share price movements, whether or not such adverse movements were caused intentionally), unless minority shareholders have had a *separate* vote on the transaction;

4. The readmission or retention of a director previously convicted of a crime involving dishonesty or victimising the company, even if such a director has subsequently been pardoned;

5. A stock buyback program that we assess is being done to use general company resources to enhance or secure control for a large shareholder, rather than to enhance returns by cancellation;

6. Any other transaction or company policy (including a low dividend policy) that in our opinion evidences substantial poor corporate governance.

At the end of this note we have drafted a template letter that we intend sending to affected companies.

During our voting policy review, one consideration was that if we were to win a vote against all directors, we would potentially be left with a rudderless company, and it therefore might be a better policy to vote only against the chairman, rather than all directors up for re-election. We rejected this approach, preferring instead to make as forceful a statement as we can. By limiting our disapproval to only the chairman we would be sending a weak signal when we are already weak, because of our small shareholding.

So weak in fact that, we do not expect to win any votes against the re-election of any directors because, first, in the vast majority of cases the companies we are voting against will be family controlled. Second, given the staggered way in which South Korean directors are typically offered up for re-election, we will virtually never (in any event) have the ability to vote out most of the board in any one year, even theoretically[30].

Our main (and realistic) goal, rather than the removal of all directors, is that, by formally expressing our *strongest possible* disapproval of conduct that we believe is value destructive for the company, over time we will begin to exert pressure on companies to improve.

If other investors, particularly South Korean individuals and institutions, arrive – on their own – at similar conclusions and adopt a similar approach, further attention might be drawn to the 'Korea discount' from South Korean voters, the press and regulators. Were a majority of minority shareholders to express such unambiguous dissatisfaction, year after year, it would serve to highlight the extent of the mistreatment routinely occurring and the inadequacies in South Korean company and securities laws that allow it to continue. Indeed of the seven possible reasons we provide for voting against the re-election of directors, five could be directly addressed and prevented by legislation[31] (as they have been in other markets).

We therefore believe that the review of our voting policy for South Korean directors can help provide an impetus for positive change.

Jonathan Pines
Portfolio Manager
Federated Hermes Asia ex-Japan Equity

[30] This staggered re-election requirement is yet another corporate governance weakness.

[31] Only the first and last reasons we list (trading below book and poor governance policies) would be challenging for lawmakers to directly address or prevent by regulation.

[Example Letter following review of the Asia-ex Japan team's voting policy for directors of South Korean companies]

The Board of Directors
South Korean Company
Address

Date

Dear Board of Directors

Revised Asia ex-Japan Equity Voting Policy and Preliminary Intention to Vote Against all Directors of ________________ ______________ ("the company") up for re-election

On behalf of our investors, we hold and are authorised to vote on ________ shares in the company.

It is our current intention to vote against all directors put up for re-election for one or more of the seven possible reasons listed on the following page, specifically reason(s) ___________________.

If you believe that such a vote would not be appropriate in the circumstances, please advise us why not.

Because of stock purchases and sales we might make between now and the date of your annual general meeting (or changes in the vote authorisation instructions of our clients), it is possible that by then we will not hold and be authorised to vote on the same number (or any) shares in the company.

We are writing to you now to give you sufficient time, should you decide to do so, either to respond to our concerns, or to begin to address the factors that are causing us to vote in the way in which we intend.

Yours faithfully,

Portfolio Manager
Federated Hermes Asia ex-Japan Equity

Voting policy relating to re-election of directors in South Korean companies

The Asia ex-Japan team have a presumption to vote against **all directors up for re-election** in respect of companies:

1. That have a stock price that has traded below book value per share for over three years, unless:
   - Book value is overstated (in error rather than deliberately) such that if it were correctly stated the stock price would be trading above book value per share;
   - There are regulatory constraints on returns, including minimum equity requirements;
   - Relative performance has been acceptable in the context of a protracted cyclical downturn; or
   - Relative performance has been acceptable in the context of industry-wide persistent structural challenges.
2. That have entered into a significant related party transaction (or continuation of a recurring related-party transaction arrangement) that appears to be unfair to the company and which minority shareholders were not given the opportunity (and continuing opportunities, if relevant) to separately vote on;
3. Where a change of control has occurred or been announced, in which minority shareholders were not or will not be able to fairly participate on the same terms as controlling shareholders;
4. That have completed or announced a significant share swap transaction (including a new share issue in exchange for shares in another company) that we assess as being unfair to minorities (particularly where there have been prior adverse relative share price movements, whether or not such adverse movements were caused intentionally), and in respect of which minorities were not given the opportunity to separately vote on;
5. That have readmitted or retained a director previously convicted of a crime involving dishonesty or victimising the company, even if such a director has subsequently been pardoned;
6. With a stock buyback program that we assess is being done to use general company resources to enhance or secure control for a large shareholder, rather than to enhance returns by cancellation; or
7. That have entered into or announced any other transaction, or retained or adopted a company policy (including a low dividend policy) that in our opinion evidences substantial poor corporate governance.

Exceptions will be considered in the case of directors who have explicitly dissented to an objectional transaction or policy, or that contribute to the diversity of the board.

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