Asia ex-Japan Equity

Korea discount: a dream deferred?

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June 2024

Federated Hermes Limited

www.hermes-investment.com
For professional investors only

South Korean authorities are looking at a number of measures to address the 'Korea discount'. Most won't work, says Jonathan Pines, Lead Portfolio Manager, Asia ex-Japan Equity.

- In our opinion, the 'Korea discount' has deprived investors of returns, in many cases leaving them impoverished relative to the growing value of the very companies into which they have invested. We believe it has also raised the cost of capital for South Korean enterprise, reduced risk-taking and economic activity, while undermining innovation. Were the Korea discount to be fully eliminated, we believe that the price at which the average South Korean company trades could double, with some tripling[1].
- Measures to address the discount will be effective only if they address its key cause: the tremendous power imbalance between controlling shareholders and minority shareholders. Indeed, a rule of thumb for assessing which measures are most likely to be effective is the following: *the greater the resistance of controlling shareholders to the implementation of a measure under consideration, the more effective is that measure likely to be in closing the Korea discount.* If controlling shareholders do not resist a (non-tax related) measure, it is unlikely to be effective.
- Without effective regulatory change, we expect South Korean companies to do the bare minimum, albeit with a friendlier veneer. In this circumstance we expect action to be limited to the buyback of discounted preferred stock (because they are a small part of capital), cancellation of treasury shares (when they are not needed to secure control – for this generation or the next), the sale of some non-core investments and a marginal improvement in dividend policies.

We have been investing in South Korea for more than two decades and continue to be deeply impressed by the professionalism and high quality of management in many companies in globally important sectors, particularly semiconductors, auto manufacturing and heavy industries. We celebrate the past and continuing positive contribution of South Korea's many leading global companies to progress in science, technology and business.

An area of frustration for us, that we know we share with many other investors – both foreign and domestic – is that the value that many companies have built over decades is not adequately reflected in stock prices.

We are encouraged by the recent interest lawmakers and regulators have shown in seeking to close the discount at which South Korean companies trade to similar companies listed on stock exchanges in other countries (the Korea discount).

In February, we published a paper, South Korea – enough is enough, detailing the ways that controlling shareholders in South Korea mistreat minority shareholders, and why they do so. In March, we published a follow-up note, The unpersuadables?, discussing challenges in applying Japan's approach to addressing cheap stock prices in South Korea and recommending six key (and four nice to have) measures that, if implemented, we believe would end the Korea discount. We have repeated these recommendations in Appendix A of this letter. Our recommendations prioritise regulatory change over voluntary action, because of the strong financial interest that controlling shareholders have in preserving the regulatory *status quo*, which in our opinion is not fit for purpose.

In our published papers, we took care not to recommend changes to taxes, because we did not feel that it was our place to opine on such matters, which go to the heart of the social contract among South Korean citizens. Of course, changes to tax rules can help to reduce the Korea discount. But we believe now, as we did then, that the discount can be significantly closed even without tax changes[2].

The South Korean government and regulators have not completed their deliberations. We would like to draw attention to measures that we understand are under consideration but that we do not believe will be effective in closing the discount. We do this in the hope that we can help encourage the focus to instead be on those measures that we believe *will* be effective.

In our view, measures under consideration that will not be effective, fall into two broad categories.

1) Measures that are both voluntary and are viewed by controlling shareholders as not being in their interests

In South Korea, unusually, families control more than 90% of listed companies[3]. Most companies are run by talented management teams, in turn, installed by astute controlling shareholders, and have thrived by successfully navigating complex and competitive international markets for their products. Given the high calibre leadership in South Korea's companies, we do not believe that stock prices are low because controlling shareholders are at a loss to understand how to address the far less challenging problem of low stock prices. Indeed, we believe that those who control companies know exactly what needs to be done to raise their respective stock prices but choose not to do so because the actions that will be effective in closing the Korean discount (as it may apply to the company that they control) runs contrary to their own interests.

1 This is based on our model and as such cannot be guaranteed.

2 Tax changes that we understand are being considered include reductions in inheritance and dividend tax, and a delay in the planned introduction of a capital gains tax. While reduction in taxes can have some impact on stock prices (as the perceived cost to the family of taxes resulting from high stock prices and high dividends will be reduced), unless there is a very substantial reduction in taxes (which to be clear we do not believe it is our place to argue for), the impact on the behaviour of controlling shareholders is likely to be small.

3 Source: Kospi, Kosdaq and Bloomberg

Controlling shareholders who prefer (or are indifferent about) lower stock prices will see no benefit in being part of a benchmark that could result in their company's stock price rising.

One measure that we understand is being considered by regulators, is the introduction of an index or exchange traded fund comprised of well-governed companies, the idea being that companies forming part of such a benchmark would attract additional capital, resulting in higher stock prices.

We do not believe that this measure will be effective because controlling shareholders who prefer (or are indifferent about) lower stock prices[4], will of course, see no benefit in being part of a benchmark that could result in their company's stock price rising. Even among those controlling shareholders who would not be particularly averse to a higher stock price, many will view the 'penalty' they must pay (resulting from the better treatment of minority shareholders) as being too high. After all, why would controlling shareholders want to voluntarily give up the benefits they can gain from (for example) compelling minority shareholders to sell stock cheaply to them, being able to enter into related party transactions with the companies they control without minority shareholder approval, using company resources to secure control for themselves by buying stock on the market which they can then retain in treasury or sell on to friendly third parties, or extracting artificially high control premiums for themselves alone in the event of a takeover[5]?

2) Measures that do not address the key causes of the Korea discount

Certain measures that we understand are being considered, while positive on the margins, will be little more than a distraction from the truly effective action that is required to help close the Korea discount.

While such efforts will enable regulators to claim that they are at least 'doing something', we fear that the energy spent passing these less effective measures will distract from implementing policies that will be far more effective. Measures which we understand are being considered that (although generally desirable) will not in our opinion meaningfully help close the Korea discount including strengthening laws against unfair trading, implementing further restrictions on short selling, tightening regulations on advisors, easing foreign investor registration requirements, enhancing accessibility to foreign exchange markets, establishing alternative trading systems, assisting investor relations department with their communications, holding awards ceremonies for companies with better governance, improving dividend payout procedures, promoting individual trading accounts, and mandating quarterly meetings between external and internal auditors.

A helpful rule of thumb for assessing which measures are most likely to be most effective is the following: *the greater the resistance of controlling shareholders to the implementation of a measure under consideration, the more effective is that measure likely to be in closing the Korea discount.* This is because we believe that at the heart of the Korea discount is the tremendous power imbalance between controlling shareholders and minority shareholders.

A helpful rule of thumb for assessing which measures are most likely to be most effective is the following: the greater the resistance of controlling shareholders to the implementation of a measure under consideration, the more effective is that measure likely to be in closing the Korea discount.

We doubt that any of the measures that we have listed in this subsection will be resisted by any controlling shareholder, which, although suggesting an easy passage, in and of itself hints that they are unlikely to be particularly helpful in closing the Korea discount.

Indeed, one measure that we understand is under consideration, in our opinion, will cause stock prices to *fall*. We understand that the Financial Supervisory Service is considering the forced delisting of companies that have "failed to grow"[6]. While well intentioned, we believe that the threat of delisting undervalued South Korean companies will only hurt minority shareholders, with the unintended consequence being an underserved (albeit gratefully received) windfall gain for uncooperative controlling shareholders. As the delisting date approaches, stock prices of affected companies will drop precipitously, presenting a wonderful opportunity for controlling shareholders, as allowed by the Commercial Act, to compel minority shareholders of the (by then very undervalued stock) to swap their shares for shares in another company in which the controlling shareholders have a greater interest[7]. Alternatively, the controlling shareholders, knowing that most investors will either be *required* to sell, or otherwise won't want to hold,

[4] Some controlling shareholders prefer lower stock prices to reduce inheritance tax and create continuing opportunities to force out minority shareholders (permitted in terms of the Commercial Act) at the low market price.

[5] South Korea's takeover laws do not provide minority stockholders tag along rights, allowing controlling shareholders to obtain for themselves alone, a control premium, which is likely higher than it would otherwise be because the incoming controlling shareholder does not need to fairly compensate minority shareholders.

[6] https://news.bloomberglaw.com/insurance/south-korea-warns-of-delisting-of-companies-that-fail-to-grow

[7] Indeed, we have in the past experienced a situation when a Korean company's directors used the threat of delisting to cause a drop in the stock price. They then compelled minority shareholders to swap their stock (at the depressed price) for shares in another company in which they had a greater interest. Appeals we made to the company, and later to a judge as part of a court challenge, were rejected.

unlisted stock, will be well positioned to make a low-ball cash offer to minority shareholders – perhaps with the backing of investment banks, which could generate large profits as they clamour to fund the cheap buyout.

Arguments against the implementation of our recommendations

We are aware of no recent persuasive arguments as to why the measures that we have recommended, included in Appendix A, will not be in the interests of South Korean companies or ordinary investors, or effective in closing the Korea discount. However, over the years, controlling shareholders have advanced arguments against some key points included in our recommendations. Below we repeat the main arguments against some of our recommendations (of which we have become aware and as we understand them), together with our response.

Low stock prices are more a consequence of the cyclical nature of the earnings of South Korean companies, and ongoing tensions with North Korea, rather than poor governance.

Most investors, us included, reject these alternative explanations for the Korea discount. There are other countries with companies that have similarly cyclical earnings and that face similar or greater geopolitical uncertainty, but which trade at far higher valuations. Taiwan is an example. Many of the companies listed in Taiwan, including its largest companies, face earnings cyclicality similar to that experienced by South Korean companies, with arguably greater geopolitical uncertainty, yet their stocks have consistently traded at higher valuations than those in South Korea. Currently the Taiwan Stock Exchange trades at a price-to-book multiple of 2.4 times, versus South Korea's 0.99 times[8].

Cash returned to shareholders means greater 'leakage', including to foreigners, with less cash left in the company, weakening it and reducing capacity for acquisition and innovation.

We believe that this argument misunderstands how markets value companies. If a company has a sub-optimal[9] balance sheet because of too much cash or too little debt, then higher cash returns to shareholders will enhance overall stockholder returns and will raise the stock price by more than the cash being returned. Shareholders stand to benefit from both the cash received and the higher stock price relative to cash returned. A higher stock price also lowers the company's cost of capital, reducing the equity capital required to fund new investment[10]. Should the new investment opportunity be adjudged by the market to be a high returning one[11], it will result in the stock price further appreciating – reducing the cost of required capital still further. It is not a zero-sum equation. Both optimising capital structure and pursuing profitable investment opportunities reduces the cost of capital for the company, and enhances shareholder returns, creating value for all shareholders in proportion to their shareholding.

That some controlling shareholders consider payouts to minority shareholders to be 'leakage' not only reveals the way that they view the companies they control (as fully owned by them); it also suggests a misunderstanding about how stock prices will react (they normally rise – certainly relative to the cash being returned), and how they view the purpose of the market (as a servant of controlling shareholders alone).

Regarding dividends flowing out of the country, this is true to the extent that foreigners receive dividends on their holdings. But the sole reason investors buy stock is because of the prospect of receiving dividends. South Korea's capital markets cannot thrive if dividends are supressed to prevent foreign 'leakage', and of course capital inflows from foreign investment exceed dividends paid out. Most countries welcome foreign investment. While attitude to foreign investment is a political and economic choice, in our view, it would harm South Korea's capital markets were companies to continue to keep dividends low to prevent dividends flowing to foreign investors. In addition, higher stock prices resulting from higher dividends means that a gain for foreigners is not a loss for South Korea.

Ironically, the biggest on-paper *beneficiaries* of higher stock prices resulting from enhanced shareholder return policies (and the other changes we recommended) will be the controlling shareholders themselves, who we believe will be the only ones arguing against them[12].

Cancellation of treasury stock and buy backs of 'high cost of capital' preferred stock will weaken the control structure of companies, meaning that control might fall into foreign hands or those who prioritise short term gains.

Large shareholders of South Korean companies often secure control by using general company resources to buy back shares. Although such stock cannot be used to exercise direct voting power, uncancelled, such stock is available to be sold on to friendly third parties if control ever needs to be more fully secured. Another way that controlling shareholders prevent challenge is by issuing preferred stock instead of common stock. In South Korea, preferred stock can more accurately be described as non-voting common stock

8 As at 2 April 2024.

9 The optimal amount of cash or debt to hold will differ depending on the specific circumstance of the company, which take into account factors such as tax relief on interest, stability of earnings and credible profitable growth opportunities.

10 In the case of dividend payouts, a lower cost of capital would apply even if stock prices fell in response to a dividend payment if the fall in stock price was less than the dividend paid.

11 In this context, a high returning investment means one where the expected return exceeds the company's cost of capital.

12 We believe that most controlling shareholders understand that they will be the biggest "on paper" beneficiaries of enhanced shareholder returns. However, most controlling shareholders are fully aware of the "true" (higher) value of their stock but have no interest in seeing that higher value reflected in a stock price quote if it means a potential higher inheritance tax liability, or reduced opportunity to force minorities out cheaply in terms of a compelled share swap.

because it is economically nearly identical to common stock but does not have voting privileges[13]. While non-voting stock is commonly used worldwide, in South Korea, over time, the discount at which such non-voting stock trades to voting stock has grown and for some companies exceeds 60%.

Consequently, the opportunity cost of continuing to use this form of capital for many companies has grown, because the dividend paid *relative* to preferred share capital can be more than double the dividend paid relative to common share capital. Our recommendations include the cancellation of excess treasury stock and an annual justification by directors for the continued use of expensive-to-service preferred stock (the implication being that if such stock is assessed as expensive to service, it should be bought back until the discount to common stock narrows, and replaced by common stock if capital is indeed required).

In the past, controlling shareholders have argued that requiring the cancellation of treasury stock and replacing expensive-to-service preferred stock with cheaper-to-service common stock would leave the companies they control vulnerable to takeovers by foreigners or short-term investors.

Our response is that the need for instruments of control often demonstrates a lack of confidence of the families that control companies that they are the best stewards of those companies. By frustrating the market for corporate control, controlling families undermine shareholder value and prevent companies from being managed by those most competent to do so and most likely to add value. Too many companies in South Korea (perhaps more than anywhere else worldwide) are controlled by families (many of whom make use of instruments of control) and given the poor performance of the South Korean Stock Exchange, this dynamic has demonstrably not served South Korea or its capital markets well. The best (and most honourable) defence against an unwanted takeover, and one that is in the interests of shareholders, is to sustain a consistently high stock price, which raises the cost of a takeover for an acquirer to a level at which it no longer makes economic sense for the acquirer to pursue the takeover. A sustainably high stock price, in turn, results from quality management, strong operating results, a long-term perspective, high-returning investment and an optimised capital structure.

In addition, even for controlling shareholders who prioritise the retention of control above all else, most no longer need to rely on either expensive preferred stock (because the amount of preferred stock in issue is typically small), or treasury stock, because even if they cancelled the lion's share of such stock, control is in most cases already secured by the high percentage of stock already owned by the families[14].

In this context, the signalling impact of directors' conduct cannot be overemphasised. For example, if directors of South Korean companies can easily cut their cost of capital by, for example, buying back preferred stock trading at a significant discount to common stock, and choose not to do so (particularly when the buyback of such stock does not threaten the control structure), it evidences that directors (and the controlling shareholders that appointed them) do not genuinely care about maximising shareholder value and suggests that they may *prefer* lower stock prices. In Appendix B we have provided an illustrative example showing how both common and preferred shareholders can gain, even with a zero net cash outlay, when companies replace discounted preferred stock with common stock.

Regarding control being relinquished to foreigners, the South Korean government already has legislation that can prevent foreign investors from buying or exercising control in companies operating in key industries such as aviation, communications and broadcasting. These powers can, of course, be further reasonably enhanced to include other sectors (or even specific companies) should the government decide to do so.

In this section, we have presented arguments that we understand have been advanced by others that seek to justify the use of uncancelled treasury stock and preferred stock to secure control, that are concerned about the potential adverse impact of higher cash returns to shareholders on South Korean companies' capacity to innovate and make acquisitions, and the possibility that were it not for certain tools of control, that key South Korean companies could fall into foreign hands, or those that prioritise short-term returns.

We have also explained why we disagree with each of these arguments.

It is noteworthy, however, that we have never heard any arguments against the other recommendations that we have made. (Nor are we able to think of any ourselves, no matter how flawed). For example, we have heard no arguments against establishing a fiduciary duty of care of directors to shareholders, requiring minority shareholder approval for related party transactions, ending compelled share swaps, introducing a 'tag along' rule for minority shareholders in the event of a takeover, and requiring an annual statement of directors (addressing optimal capital structure, cheap stock prices, and how holding companies will close the discount to the sum of their respective parts).

Nevertheless, we understand that despite the apparent absence of a logical rationale for opposing them, some controlling stockholders regard regulations, such as establishing a directors fiduciary duty to shareholders, and minority approval for related party transactions to be 'no go areas'.

To the extent that they continue to adopt this stance, they show that they do not believe their opposition requires a justification beyond self-interest.

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13 Most preferred stock in South Korea entitle holders to the same dividend per share that is paid to common stockholders plus a small premium.

14 Admittedly, this might not be the case for subsequent generations given that inheritance tax bills would need to be financed.

Appendix A: Regulatory changes that we believe would solve the Korea discount

'Must Haves'

1. End compelled share swaps (including dilutionary new issues in exchange for shares in other companies) by requiring *separate* minority shareholder approval for swaps or dilutionary share issues when issued in exchange for shares[15].

2. Introduce a mandatory offer 'tag along' rule for takeovers.

3. Require minority shareholder separate approval for related party transactions.

4. Require shares that have been bought back (including accumulated stock held in treasury) to be cancelled, save for a reasonable percentage of uncancelled outstanding treasury stock as is customarily permitted in other, well-regulated markets.

5. Codify into law a directors' fiduciary duty to the company and to shareholders (rather than simply a duty of 'loyalty' to the company, which is a more ambiguous concept and subject to widely varying interpretations).

6. Require an annual statement of directors (with measurable interim objectives) addressing balance sheet capital management, which should include, in particular:

   - in the case of stocks trading below book value, a plan to raise stock prices to at least book value (with exceptions granted to banks, utilities and other companies that have regulated returns or capital);
   - in the case of holding companies, a plan to eliminate the discount at which a stock trades to the sum of its parts;
   - justifying cash balances that are high (relative to equity, total assets or market capitalisation), taking into account the specific circumstance of the company; and
   - justifying the continuing use of expensive preferred stock (which can be up to twice as costly to service – relative to the cost of buying it back – as common stock).

'Nice to Haves'

7. Require the immediate disclosure of the outcome of Annual General Meeting (AGM) votes.

8. Ban directors convicted of crimes involving dishonesty from managing companies, even if subsequently pardoned.

9. Allow truth to be an absolute defence in defamation cases where views are publicised on shareholder/management/corporate governance issues.

10. Require notices and financial reports to also be published in English.

[15] Technically, a short-cut to implementing such a rule change could be to require minority shareholder approval for new share issues – either under any circumstance or when a merger, acquisition (both on the buy and sell side), restructuring or share swap is contemplated.

Appendix B: Illustrative example showing gains to preferred and common stockholders from a replacement of preferred stock with common stock

Most South Korean preferred stock pays the same dividend per share as common stock (plus a small premium), but trades at a significant discount.

Assume a company has the following capitalisation before any buy back of preferred stock

	Issued shares #	DPS (W)	Stock price (W)	Yield (%)	Total dividends (W)
Common stock	100	1,000	20,000	5.0%	100,000
Preferred stock	20	1,050	8,000	13.1%	21,000
	120				121,000

Assume further that the company has the optimal amount of net debt and doesn't want more. To benefit both common and preferred stockholders, it could do the following.

1. Make a tender offer to buy all the preferred shares back at (say) a 50% premium (i.e., W12,000 per preferred share), at a total cost of W240,000 (i.e., W12,000 x 20 shares).
2. To finance the W240,000 buyback cost, it could issue twelve new common shares (W240,000 /W20,000).
3. The company would, therefore, have eight fewer shares entitled to dividends for no net cash outlay, implying an annual dividend saving of W9,000 (W121,000 – W112,000).
4. Should the company reallocate the dividend saving to the common stockholders, each common stockholder would receive a dividend per share of W1,080 (i.e., W121,000/112), or an extra W80 per share (W1,080 – W,1000), equivalent to a total dividend yield of 5.4% (i.e., W1,080/ W20,000). Assuming the stock market price of the common rises to bring the dividend yield of the common stock to where it traded at before the restructuring, it implies an 8% stock price rise to W21,607 (i.e., W20,000 x 5.4%/5.0%).

Therefore, in the above scenario, **preferred shareholders will gain by 50% and common stockholders gain by at least 8%**, with the company's net debt position being unchanged. There would of course be a small replacement of non-voting stock with voting stock, but the increase in voting stock will likely be sufficiently small to not affect control. In reality, the price of the common stock would likely rise by more than 8% as stockholders would appreciate the attention being paid to capital structure and would likely view the management team more favourably than before.

In addition, given that most South Korean companies have more cash on their balance sheet than is optimal, most won't need to issue common stock to replace the preferred stock being bought back, and, therefore, the benefit to common stockholders will be still greater as a result of a more-optimally capitalised balance sheet following the buyback of preferred stock.

The opinions expressed this report represent the views of Jonathan Pines, Lead Portfolio Manager, Asia ex-Japan Equity and the Federated Hermes Asia-ex Japan Equity team.

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