The curious case of Korea's preference stock

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What's the right discount for a low- or non-voting stock that is economically identical to its voting equivalent? Or what's the right price to pay for a vote?

We can glean much from the market prices of lower (or non) voting stocks and higher voting stocks in developed market stock exchanges. In the US, many stocks have dual voting classes. Although in most cases, the higher voting class is unlisted, some companies do have more than one listed class (each with different voting rights), allowing us to establish the value the market places on a vote in the US.

Figure 1: Little value in a vote - discounts available on US lower voting stock classes

	Stock price (US dollars)				
	Higher voting class	Lower voting class	Vote ratio	Discount (premium)	Liquidity note
Alphabet	173.17	174.42	1 to 0	-1%	
Berkshire Hathaway*	420.74	414.79	1 to 0.15	1%	
Lennar Corp	146.34	160.71	1 to 0.1	-10%	Higher voting stock is less liquid
Heico Corp	222.48	176.66	1 to 0.1	21%	
First Citizens BancShares	1549.93	1692.99	1 to 0.08	-9%	Higher voting stock is illiquid
Brown-Forman Corp	45.99	46.09	1 to 0	0%	
Mccormick & Co Inc	71.40	71.90	1 to 0	-1%	
Watsco Inc	445.15	471.74	1 to 0.1	-6%	Higher voting stock is illiquid
News Corp	28.04	27.29	1 to 0	3%	
Fox Corp	32.28	34.81	1 to 0	-8%	Higher voting stock is slightly less liquid
U-Haul Holding Co	64.21	61.70	1 to 0	4%	
Zillow Group Inc	40.89	41.71	1 to 0	-2%	Higher voting stock is less liquid
Paramount Global	22.14	12.80	1 to 0	42%	Subject to recent takeover interest
Bio-Rad Labs	288.40	288.96	1 to 0.1	0%	
Liberty Broadband	54.20	54.03	1 to 0	0%	
Liberty Global Ltd	16.50	16.74	1 to 0.1	-1%	
Clearway Energy	25.35	27.58	1 to 0.1	-9%	Higher voting stock is less liquid
Moog Inc	170.00	168.44	1 to 0.1	1%	
Rush Enterprises	40.81	43.61	1 to 0.05	-7%	Higher voting stock is illiquid
Greif Inc	64.74	64.59	1 to 0	0%	
Under Armour Inc	6.95	6.78	1 to 0	2%	
Central Garden Pet	42.71	36.78	1 to 0	14%	Higher voting stock is more liquid
Atlanta Braves	47.00	42.27	1 to 0.1	10%	Both stock classes illiquid
Tootsie Roll	30.00	29.35	1 to 0.1	2%	
Wiley (John) & Sons	36.13	36.24	1 to 0.1	0%	
Liberty Latin America	9.04	9.04	1 to 0	0%	
Lions Gate Ent	7.83	7.28	1 to 0	7%	
Average				**2%**	

Source: Bloomberg, as at 5 June 2024. *The price of Berkshire Hathaway's lower voting B Share class has been adjusted to reflect the lower earnings entitlement, which is 1/1,500 of the A share's.

The small extent and range of discounts (and, in some cases, liquidity-influenced slight premiums) that lower (or non) voting stock classes trade at, shows that US investors do not generally place a high value on more powerful voting ability. This assessment can, at times, prove costly. Consider Nasdaq-listed media production and distribution company, Paramount Global (included in Figure 1), for instance. That company, subject to recent takeover speculation that may have resulted in a takeover premium being paid only to holders of its voting share class, has seen strongly differentiated performance of its voting and non-voting share classes as the discount has grown. This year so far, the higher voting class has risen by 9%, while the lower voting class has fallen by 16%, widening the discount at which the non-voting stock trades at to 42%.[1]

Still, for most US-listed companies with dual voting classes and that are not the subject of takeover interest, the discount remains small and is often more the result of differing liquidity profiles than an appreciation of the potential for differential treatment in the event of a future takeover. Indeed, lower voting stock, when more liquid, frequently trades at a premium.

In Korea, preference stock is essentially equivalent to non-voting common stock. Preference stock does not enjoy voting rights, but is economically slightly *superior* to common stock, because, by construction, holders are entitled to the same dividend per share as common stock plus a small premium. In the event of bankruptcy, preference stock has a liquidation preference relative to common stock.

> **Unusually, in Korea neither common nor preference stockholders enjoy 'tag along' rights. One would therefore expect common stock to almost never attract any voting premium.**

Unusually, in Korea neither common nor preference stockholders enjoy 'tag along' rights in the event of a change of control, so, if control changes, neither minority common stockholders or preference stockholders will benefit. In addition, given that more than 90%[2] of Korean companies are already controlled, minority stockholders' voting power is inevitably inconsequential in a non-takeover context too. One would therefore expect common stock to almost never attract any voting premium relative to preference stock in Korea.

Our theoretical expectation for preference stock would thus be for it to trade somewhere between a slight premium (reflecting its slightly superior dividend entitlement per share) to a small discount in the case of preference stock that is particularly illiquid. Using the US as a guide, we would suggest that any illiquidity discount applicable to preference shares (especially when considering their slightly superior economics) should never be more than 10%.

However, this is not what we see when we analyse the discounts at which Korean preference stock trade at relative to the common stock.

Figure 2: Guaranteed better dividends per share for less - Discounts available on Korea's preference stock

	Price per share (Won)		Discount
	Common	Preference	
Amorepacific Corp	180,300	49,400	**73%**
Amorepacific Group	34,400	12,200	**65%**
LG H&H	414,500	169,400	**59%**
LG Electronics Inc	100,700	46,000	**54%**
Kumho Petrochemical	144,200	67,800	**53%**
Hyundai Motor Co	265,000	155,700	**41%**
S-Oil Corp	67,300	47,100	**30%**
Korea Investment Hold Co	67,700	47,400	**30%**
LG Corp	81,300	61,000	**25%**
Samsung Fire & Marine Ins	343,000	262,500	**23%**
Samsung C&T Corp	137,600	107,800	**22%**
Samsung Electronics	77,300	62,800	**19%**

Source: Bloomberg, as at 5 June 2024. Note: Hyundai Motor Co has three different classes of preference stock. We used the most liquid class in this table, the 'number 2' preference stock class. The Federated Hermes Asia ex-Japan Strategy may own all or any of the common or preference stocks in the above table, and may be active buyers or sellers of these stocks.

To us, these prices differentials make little sense. The discounts available on non-voting Korean preference stock are remarkable. They have also been persistent. Admittedly, the liquidity of some preference stocks are low. For example, in Figure 2 the preference share classes of Amorepacific Group, Kumho Petrochemical , S-Oil, Korea Investment Holdings and Samsung C&T each trade less than US$0.5m per day. However, when comparing discounts to equally illiquid share classes that trade in the US, the extent of the discount offered even for illiquid Korean preference stock cannot be explained by liquidity considerations alone.

> **Using the US as a guide, we would suggest that any illiquidity discount applicable to preference shares [...] should never be more than 10%.**

When we first started managing the Asia ex-Japan Strategy 15 years ago, we were immediately struck by the pricing anomaly. Indeed, we published a paper describing the phenomenon. We thought back then that, over time, the discount would almost certainly close for two reasons.

First, investors would be attracted to a cheaper way to access the same dividend flows. After all, a stock's value is (or, at least, should be) the present value of expected future dividends, and the future dividends of preference stock is guaranteed to be superior to that of common stock. If the cost to purchase (by construction) near-identical dividend flows is far cheaper on one share class than another, investors should bid up the cheaper share class.

[1] Year to date as at 5 June 2024.

[2] Source: Bloomberg, Federated Hermes Limited.

Second, we expected the company's own directors, noticing that the cost of servicing the dividend on the preference share class was far more expensive relative to the cost of buying it back (versus the common stock) would cause the companies that they control to buy back preference stock and replace it with far cheaper to service common stock – benefitting both common and preference shareholders. (In a previous note we provided calculations showing the benefit to both preference and common stockholders from the buyback of discounted preference shares. We repeat these illustrative calculations in an appendix to this note).

Over the last 15 years the discount at which preferred stock trades to the common has reduced a little in some cases, but in other cases it has widened.

What we didn't (but soon came to) fully appreciate was, first, in most cases Korean dividends on the common stock class are so low that it is not enough of a short term temptation for dividend-focused investors to buy the preference shares, even if the dividend yield is higher than the common stock. For example, if the dividend yield on the common stock were only (say) 1%, even a 50% discount on the preference stock would mean a preference dividend yield of a not particularly tempting 2%. Indeed, we believe that all stocks in Korea where the preference stock trades at a greater than 50% discount to the common stock have common stock dividend yields below 2%.[3]

> **Without exception, when preference shares trade at a more than 50% discount, common stock dividend yields are below 2% – establishing a link between these large discounts and overall poor corporate governance, often characterised by low payout ratios.**

In addition, the companies themselves appear uninterested in replacing expensive-to-service preference stock with cheaper to service common stock, because (1) many don't want either higher stock prices or to maximise after tax returns for common shareholders – preferring to instead prioritise the frequently opposing interests of the controlling families alone; and (2) were they to replace common stock with preference stock, they would dilute majority shareholders' control of companies. This second reason is more tenuous because, in most cases, the preference stock outstanding is low relative to the common stock outstanding, and were the preference stock to be replaced with common stock, control – in most instances – would not be threatened. In addition, most companies – having too much cash (or below optimal debt) – would not need to replace bought-back preference stock with common stock. They could simply buy back the preference stock without the need to issue new common stock.

> **Most companies would not need to replace bought back preference stock with common stock as they have sufficient balance sheet capacity to simply buy back the preference stock.**

Our strategy for investing in Korean preference stock has evolved. With rare exceptions, we will only consider buying preference stock when we find the common (more expensive) stock to be attractive in its own right. Once this determination is made, we would be more likely to elect to buy the preference rather than the common stock, in order of importance, when:

(1) The discount is high – both in absolute terms and relative to the discount that has applied in the past;

(2) The dividend yield offered by the preference stock is expected to be high in absolute terms; and

(3) We judge the potential disproportional buyback of preference stock by the company to be at least reasonably possible.

In considering the third factor, we would favourably assess situations where the number of preference stock outstanding is low relative to the number of common stock outstanding, if the company has surplus cash (increasing the ability of the company to buy back preference stock), and the extent to which control is already secured by a high shareholding by controlling shareholders in the common stock – reducing the 'control' disincentive to management of potentially replacing preference shares with common stock. We would also consider the extent of directors' commitment to improving corporate governance, in particular the communicated willingness of directors to buy back preference stock at a quicker rate than common stock in order to reduce the discount.

How Korea's 'value-up' programme might affect the discount on Korea's preference stock

We have previously expressed scepticism that controlling shareholders will be particularly co-operative with the government-supported 'value-up' initiative, and we expect controlling shareholders to continue to prioritise their own interests above those of ordinary shareholders. We believe that any 'value up' concessions they might reluctantly make will be as small as possible, albeit with a friendlier veneer.

[3] This observation establishes a link between the generally poor corporate governance in Korea and the wide discounts at which preference stock trades. This poor governance is often most starkly reflected in a low dividend payout ratio (in turn resulting from a frequent desire of controlling shareholders to keep common stock prices depressed).

The reason we remain reasonably optimistic that Korean preference share discounts will close, despite our pessimistic assessment on the extent of Korea Inc's commitment to improving governance, is that disproportionate buybacks of preferred stock will likely not be seen by controlling stockholders as a measure that will threaten their control or long-term financial interests, thus making it an easy 'concession' to make. This is because preferred stock is generally a low proportion of overall outstanding capital.

Figure 3: Replacing preference stock with common unlikely to threaten control.

Outstanding preference share capital relative to overall share capital

Amorepacific Corp	15%
Amorepacific Group	7%
LG H&H	12%
LG Electronics Inc	10%
Kumho Petrochemical Co	10%
Hyundai Motor Co	23%
S-Oil Corp	3%
Korea Investment Holdings	10%
LG Corp	2%
Samsung Fire & Marine Ins	6%
Samsung C&T Corp	1%
Samsung Electronics Co Ltd	12%

Source: Bloomberg as at 5 June 2024, with number of issued preference shares expressed as a percentage of the total number of shares issued. For Hyundai Motor Co we have summed all three classes of outstanding preference shares.

Consider S-Oil, for example. Here, the preference stock trades at a 30% discount to the common.[4] Only 3% by number of overall share capital is comprised of preference shares, but this company is already 63% controlled. Were the preference shares to be replaced with common stock (which would be in the economic interests of both classes of shareholders – see the Appendix at the end of this note), it would have no impact on control.

Similarly, in the case of Amorepacific Group and LG Corp, where the preference shares trade at 65% and 25% discounts respectively, a mere 7% and 2% by number of overall share capital are comprised of preference shares. Both companies have cash surpluses and could simply buy the preference stock back without the need to finance the buyback by issuing new common stock.

Indeed most companies listed in Figure 3 are able to buy back preference stock (with or without replacement with common stock) in ways that do not materially weaken the control structure.

Even absent buybacks, preference shares, in our opinion, would be disproportionate beneficiaries if companies improve dividend payout ratios. While we expect no sharp improvements here (as controlling shareholders often prefer depressed stock prices resulting from the low payout ratios that often cause them), we expect the pressure to raise payout ratios will increase over time.

Of course, in the event of directors being required to adopt a duty of care to shareholders (unlikely in the short term because this seems to be the measure most fiercely resisted by controlling shareholders), directors would be under far greater pressure to implement financial measures that would demonstrably benefit shareholders – particularly where it can be shown that no individual class of shareholder will be made worse off.

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[4] As at 5 June 2024.

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

Most 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 12 new common shares (W240,000 /W20,000).
3. The company would thus 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 pre 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 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 thus the benefit to common stock holders will be still greater as a result of a more-optimally capitalised balance sheet following the buyback of preferred stock.

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