



MARKET INSIGHT

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NEW MOON ARISING IN KOREA

Soohorang, the white tiger, is the official mascot for the Winter Olympics to be held in PyeongChang, South Korea in February 2018. Considered Korea's guardian animal, the mascot symbolises protection, a much desired quality for athletes and spectators alike considering the current tensions with the North.

Meanwhile, animal spirits have taken over South Korea's stock market as it has surged 20% in local currency terms this year, making it one of the best performers in Asia in 2017. This price appreciation has been driven by earnings with Korean companies delivering the strongest earnings growth in Asia this year. As a result, the KOSPI remains one of the cheapest markets in the region, trading at a forward price-to-earnings (PE) ratio of just 9.6x.

Reasons for the Valuation Gap
Indeed, the chart illustrates the large valuation gap between Korean and other Asian stocks - MSCI Korea currently trades at a whopping 40% discount against MSCI Asia ex-Japan which has a PE of 14.4x. This discount can partly

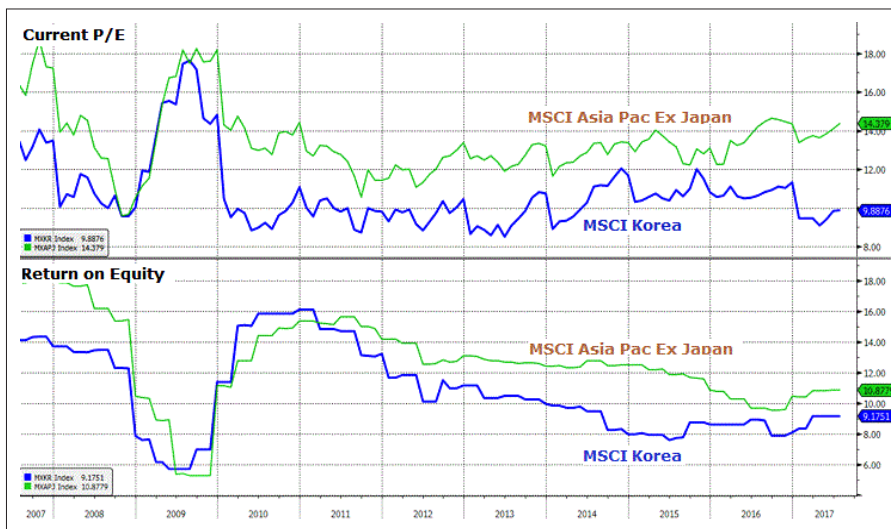
be explained by the return on equity (ROE) delivered by Korean companies, which is 15% lower compared to regional competitors. A geopolitical risk premium also needs to be factored in, with the threat of a military confrontation with North Korea a real and ever present danger.

There is however also a structural reason for the lower ROE and steep market discount, namely the presence of inefficient family owned conglomerates or "chaebols" in South Korea. These chaebols typically have complex and opaque cross-shareholdings, a poor culture of corporate governance leading to high profile corruption cases, and a poor track record of delivering value to shareholders evidenced by Korean companies having one of the lowest dividend pay-out ratios globally. While these chaebols have played a significant role in building up the country, these conglomerates may now be stifling small enterprises and inhibiting innovation.

Indeed, the sluggish economy may be another explanation for this valuation gap. As an open, export-

driven economy, South Korea suffered from the plunge in global trade since the 2008 Financial Crisis. The heady days clocking double-digit GDP growth as one of the four original Asian Tiger economies is long gone, and South Korea has since had to adapt to a much slower pace of growth - averaging between 2.5-3.5% in the last three years. Traditionally strong industries like shipbuilding and logistics have fallen on hard times epitomised by the bankruptcy of Hanjin in February. The poor economic conditions has resulted in a worrying rise in the youth unemployment rate which now stands at over 10%. Meanwhile, consumer indebtedness has also been trending higher with household debt-to-GDP close to 95%, an indication that South Koreans may be over bingeing on debt, which could be a potential risk when interest rates start heading higher.

Enter President Moon
Despite all these problems, there is growing optimism that South Korea could be turning the corner. A big reason for this is new President Moon Jae-in. Assuming office at a challenging time for the country, President Moon has quickly started to fulfil his campaign promises. On the economic front, he has already hiked the minimum wage by 16.4%, bringing it closer to the KRW10,000 target to be achieved by 2020, an initiative to reduce income inequality. Next steps include launching a KRW10 trillion (US\$9 billion) fiscal stimulus budget and to create over 800,000 more public sector jobs - an immediate strategy to tackle youth unemployment.



"PE Ratio & ROE Comparison"

A middle-to-long term strategy to recalibrate the economy entails the support of the fourth industrialisation of SMEs - recognising the need to involve SMEs, who are still the main source of job creation, as the country seeks to make the paradigm shift to a more digitalised economy.

President Moon has also taken steps to restructure corporate Korea. Reforming the chaebols is a key priority which has seen the appointment of Mr. Jang Ha-Sung, a long-time corporate governance activist to fill a newly created position chief of staff for policy. This comes on the back of "chaebol sniper" Mr. Kim Sang-jo, another vocal chaebol conglomerate critic, being tapped to run Korea's anti-trust regulator. These key appointments will likely continue to drive the reform process of large conglomerates and lead to fairer business practices between small and large organisations, potentially boosting SMEs.

Anecdotally, there are signs of progress in corporate Korea, with the Lotte group announcing corporate restructurings to reduce cross-holdings, and Samsung committing to share buybacks to boost shareholder returns. Also, Korea's National Pension Service, the world's third largest pension fund, is reportedly preparing to adopt the Stewardship Code, a set of guidelines promoting responsible investment practices that was launched in December 2016. Encouraging large institutional investors to demand good corporate governance practices will assist corporates to speed up the reform process. As a case in point, Japan, another country

previously tarnished with a poor corporate governance record, has seen a marked improvement in ROE since the launch of Japan's corporate governance and stewardship codes and pressure to be included in a new Nikkei400 index which rewards companies with strong ROE. A similar development in Korea, could easily close the ROE gap between Korean and Asian stocks, and trigger a re-rating for the market.

On the foreign policy front, President Moon has announced an ambitious 2020 goal for the complete denuclearisation of North Korea in return for a peace treaty between the countries. Negotiations with Pyongyang will undoubtedly be challenging and President Moon will likely pursue a dual track of pressure and dialogue. By taking the lead on North Korea, President Moon will help dampen down tensions in the region, balancing the conflicting interests of both the US and China. These discussions will test President Moon's diplomacy skills but he has thus far given us a glimpse of his qualities in how he deftly defused the tensions surrounding the controversial THAAD missile defence system by delaying its full deployment, pending an environmental review. Any progress with Pyongyang will reduce the geopolitical risk premium.

Various events could still derail President Moon's laudable initiatives, but at least he's off to an encouraging start after less than 100 days in office. We will have better visibility on South Korea's progress when the world descends onto PyeongChang in 200 days' time.



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“South Korea’s stock market has surged 20% in local currency terms this year, making it one of the best performers in Asia in 2017.”

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