BARRON'S ONLINE

Monday, April 30, 2007

INTERNATIONAL TRADER - ASIA

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For Korea, Free Trade and Fatter Multiples

Emerging Markets[1]

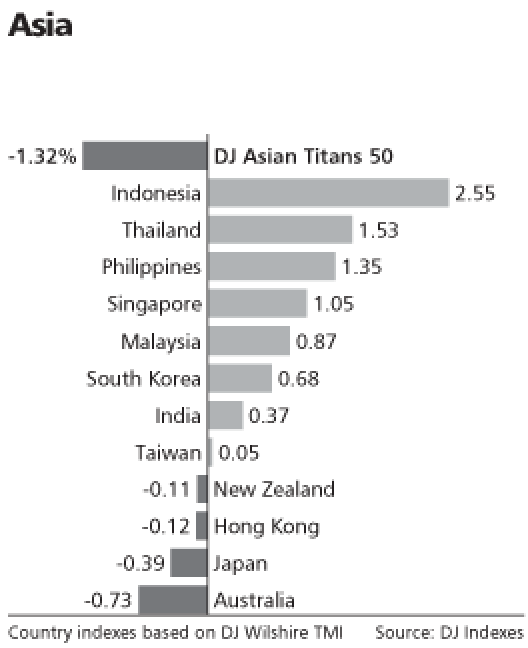
AMONG THE MYRIAD RIVALRIES that energize and bedevil Asia is the one between Japan and South Korea, which go head-to-head in global export markets. The perception for years was that Korea ate Japan's lunch, but lately Korean exporters have been tormented by the high won. Japan, in contrast, has kept its currency cheap, and its exports are surging, even though the rest of its economy is weak.

Korea's exports are about to get a lift, due to the recently concluded free-trade agreement between Korea and the U.S., which officials were busy shopping to Congress last week and whose final text will be published in coming weeks. That must be on the mind of Japanese Prime Minister Shinzo Abe, who was visiting President Bush last week. Japan has no free-trade agreement with the U.S., but is the fourth-largest exporter to this country (after Canada, China and Mexico). Korea is No. 6; its top exports include small cars, handsets, computer parts and LCD panels.

The free-trade agreement with Korea is expected to face a blistering fight in Congress, though Korea last week accepted its first shipment of U.S. beef in four months after turning back several, saying they contained bone fragments. (It blocked all U.S. beef imports nearly four years ago because of fear of mad-cow disease, and now allows only boneless beef.) Beef isn't covered by the proposed agreement, but it's a flashpoint with Congress.

What happens to the stock markets of would-be partners when a free-trade agreement is introduced? It's tough to judge in isolation. The Korea-U.S. deal is the largest since the North American Free Trade Agreement, which took effect in 1994. Samsung Securities credits Nafta with helping Canada's price-earnings multiple rise on increasing trade, while Mexico's discount to other emerging markets narrowed on overseas capital inflows and more stable financial markets. Singapore, whose free-trade agreement with the U.S. took effect in 2004, saw its P/E rise, partly alongside China's growth.

Samsung says the removal of tariffs alone will boost Korea's GDP by 0.42%, and that increased trade will hike overall GDP by 7.75%



Mixed Showing: Asia's big markets parted ways last week. Kapan sagged. Korea edged up. China jumped.

in seven to 10 months. Korean shares have marched to a new high this year, though their 7.5% increase trails that of many other markets in the region. Japan is up 1%.

"This will give a lift to the market," says Henry Seggerman, who runs Korea International Investment Fund. "Institutional investors who were underweight Korea will increase their Korea allocations, due to warming of discussions with North Korea and perceptions of a new playing field."

Seggerman likes builder Hyundai Heavy (009540.Korea), which he thinks will rise 20% from current levels, and NHN (035420.Korea), which could rise 25%. Hyundai Heavy's earnings are growing by 35%-plus a year, while profits at NHN, "the Google of Korea," are growing 40%.

A free-trade agreement wouldn't be great news for Hyundai Motor (005380.Korea) and Kia Motors (000270.Korea), two market stalwarts, even though the 2.5% tariff the U.S. imposes on passenger cars would vanish. Korea's whopping 8% tariff on U.S.-made passenger cars will go, too.

Nobody expects a U.S.-Japan free-trade pact anytime soon, largely because Japan's rice farmers and agricultural industry are so heavily protected. They are also major supporters of the ruling Liberal Democratic Party. Still, global trade is growing swiftly and now accounts for 31% of the world economy, up 10 percentage points from the mid-1990s.

The Korean market is cheap. According to CLSA, it trades at 10.6 times forward earnings, a discount of about 25% to the rest of the region, ex-Japan. But new accounting standards that take effect in 2011 could encourage investment. Investors long have criticized accounting and disclosure standards in South Korea, where companies don't have to report revenue from international businesses and other subsidiaries, leading to huge gaps between stated and actual figures. As of 2011, that will change for companies with assets of more than $2 billion.

LAST WEEK MARKED THE 80TH ANNIVERSARY of the American depositary receipt, which was invented by JPMorgan in 1927 and deemed an anachronism in recent years as investors gained more direct access to international markets, via **E*Trade** (ETFC) and the like.

Yet the ADR business is booming, says Claudine Cardillo-Rivot, global head of JPMorgan's Depositary Receipts Group. "It's still easier...in terms of settlement and custody to buy an ADR in markets where you would need a local custodian," she says, adding that ADRs will be around "until such a time that exchanges come to one platform and one set of securities regulations."

LAST WEEK'S COLUMN[2] mistakenly stated that the new AIG index for emerging markets has a low correlation with emerging-markets bonds. It has a high correlation.

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