

What do investors think of him?

These are pivotal times in Korea. With scandals and a new, not entirely predictable government, Steven Irvine asked some major investors for their views.

Mark Mobius

CIO
Templeton

Why do you think Korea trades at a discount on a PE basis versus other Asian markets such as Taiwan?

First of all there is the North Korean situation. A lot of people are pretty concerned about what is happening in North Korea and the US doing something about it, implying some kind of a war. That's at the back of investors' minds.

Also, there is the chaebol discount. There is concern that chaebols will disenfranchise the minority investors. That also creates concern, and leads to the discount.

What needs to happen to eliminate the discount?

There has to be some chaebol restructuring, which the government has not succeeded in doing. If you've been following the SK Corp situation with SK Global you see that these companies still insist on helping their little brothers and sisters.

And clearly there has to be some resolution of the North Korean situation. If those two things are taken care of, then Korea should do quite well.

Do you think the new holding company structure at LG is a good example of how chaebol can be reformed?

It's a step in the right direction, but a lot has to be done still.

Korean companies typically pay low dividends. Do dividends also need to improve?

It will help. There are some companies that pay dividends such as Posco and Korea Telecom, and they have been paying reasonable dividends. But I don't think that's too much of a problem, although it helps if they pay out more, particularly the big chaebols.

Should circular shareholdings be made illegal – ie company A owns company B which owns company C which owns company A.

Definitely. That's one of the reforms that's needed in order to break up the chaebol. Also, the mentality of the people. When you look at the ownership percentages of these families, it's not that great really. But there's a nexus between the government and these chaebols that still exists. So if a foreigner



Confidence man:
Korean President
Roh Moo-hyun

REUTERS / Issai Kato

wanted to come in and take over one of these big companies, theoretically they could do it, but because of Korean nationalism the government will put all sorts of barriers in there. A lot of it has to do with nationalism and the cultural structure of the society.

What's your view of the new president's first 100 days?

Not too good so far. He's succeeded in upsetting the economy and he hasn't really succeeded in making reforms.

Some people worry he is too pro-labour?

His election was won on that basis. The reality is he has to make structural reforms to make labour more efficient and that's the problem.

Do you worry that the Korean economy could become uncompetitive because of these labour issues?

Yes, it is a concern. For example, in the Hyundai Motor situation one of the concessions to labour unions was that they had to consult with the union before they established any facilities overseas. That's very bad.

In terms of Korea's technological advantages, how strong are they and how much of a barrier are they to Chinese competition?

Korea is between China and Japan in the sense they have been able to bring themselves close to Japan in technology – being a close equal – and yet the Chinese will move very quickly into that space. It behoves the Koreans to put more resources into China and utilise the Chinese workforce and the Chinese market, otherwise I think they'll be in trouble.

Will class action lawsuits have a transformational effect from a corporate governance perspective?

Yes, it would be great if they could implement it. I know they've been talking about it. It would help.

There's been a lot of bad news to come out of the banking sector. Do you think it is fundamentally undervalued now?



Mark Mobius

We're at the end of the bad news. We know what's there. We'll see continuing announcements but we've pretty much discounted that already.

Would the listing of Samsung Life be good for the Korean market?

Yes, it would be a very interesting listing. It's a very big company, and is an industry leader.

Do you think the Kospi will be higher at the end of 2004 than 2003?

I hope so!

Henry Seggerman

President
International Investment Advisors

You have spoken of the "embarrassing Korea discount". What do you mean by that?

Recently the Korean stock market was trading on a P/E ratio of 6.67 times, based on I/B/E/S estimated 2002 final earnings. It's the cheapest market in Asia and the cheapest market in the OECD. By contrast, the Taiwan market was trading on a 2002 PE ratio of 20.74 times. Why is Taiwan trading on a PE ratio more than three times higher than Korea? After all, Taiwan is a medium-size, mid-level GNI per-capita Asian nation with robust electronics exports, and a decades-old unresolved military confrontation – just like Korea. The "Korea discount" is an embarrassment. President Roh and his new administration should make it their mission to remove it as soon as possible.

The "Korea discount" should not be viewed as a foreign investor problem. The Korean stock market is bigger, and Korean stocks have a higher foreign ownership percentage, than most of the world's stock markets. The "Korea discount" is also the result of Korean individuals, whose equities exposure is 7% instead of 14% as in the US, and Korean pension funds, whose exposure is 2% instead of about 50% as in the US. Many Korean individuals and institutions harbour deep worries about Korea and deep suspicions of the Korean stock markets.

When Korea removes the discount holding the Kospi PE ratio below seven times, then its market should logically rise to the Taiwan level. An investor holding ₩1 million in the Korean stock market today will have more than ₩3 million when that happens.

As an investor, what recommendations do you have?

Our first, is to get the US troops out of Korea. Korea's decades-old unresolved military confrontation is more dangerous than Taiwan's because at all times, the North Koreans are poised to turn Seoul into a "sea of fire". Beijing certainly wants Taiwan to return to its rule, but it will accomplish this by means of diplomatic and financial pressure, not by raining missiles on Taipei. North Korea has 15,000 artillery tubes pointing at Seoul, plus hundreds of Scud missiles. It has an army more than twice the size of South Korea's. North Korea could kill one million residents of Seoul in twenty-four hours, without even one of its soldiers stepping across the DMZ.

Though extremely unlikely, this massive firepower trained on South Korea's capital results in a permanent risk to Korea, its economy, and its stock markets.

The 37,000 US troops now stationed in Korea would be utterly powerless against this onslaught. Parading them around in military exercises serves no purpose. In any case, wars are fought very differently today. In the extremely unlikely event of serious North Korean hostilities, within a few weeks, the US would counterattack with a powerful aerial bombardment. During this bombardment, it would assemble a large invasion force in the hundreds of thousands. As with Kuwait in 1991, whether the US has zero soldiers or 37,000 soldiers stationed in Korea, this counterattack strategy is guaranteed and will always be the same. The 37,000 US troops now stationed in Korea have no impact whatsoever on the US counterattack strategy, and are not needed.



Henry Seggerman

We do not subscribe to the Bush administration's argument regarding "weapons of mass destruction". It is believed that North Korea already has nuclear weapons, and even if it agrees to rigorous inspections, it can probably hide them going forward. The United Nations, the US, Russia, China, Japan and others will certainly continue applying diplomatic pressure on North Korea to discontinue its nuclear programme. At best, this will evolve into a stalemate as with Israel, with evidence – but no disclosure – of secret nuclear weapons. Likewise, the US will push to eliminate North Korea's conventional weapons export business. However, as these exports represent about 25% of North Korea's overall economic activity, they are likely to continue in secret despite these pressures. Moreover, in the event no chemical or biological weapons are found in Iraq, the US may be obliged to generally tone down its "mass destruction" rhetoric. In any case, no one should forget that the weapons used in the September 11, 2001 attacks were box-cutters.

Meanwhile, there are 15,000 artillery tubes pointed at Seoul. South Korean civilians are hostages in a dispute over, on one hand, what may be an unstoppable nuclear weapons programme and, on the other hand, a weapons export programme that does not affect them. South Korea has been very successful working out with North Korea agreements over family reunions, the Mount Keumkang tourist project, and the Gaeseong economic zone. Now, South Korea should ask for something from North Korea in return: moving the 15,000 artillery tubes away from Seoul. South Korea should voice its opposition to North Korea's nuclear weapons programme, but it should focus most of its efforts on moving this artillery away from Seoul, as this represents the most tangible day-to-day threat to its population. Obviously, this can be done more easily without US troops on Korean soil. We believe North Korea can be coaxed to move the artillery away from Seoul in gradual stages, perhaps linked to shipments of much-needed wheat and fuel oil.

What else?

Aggressive chaebol reform is extremely positive for Korea's stock market. If falsified financial statements or insider trading are exposed at a listed company, its share price will fall. If falsified financial statements and insider trading are investigated widely, the share price of companies demonstrated to be without falsified financial statements or insider trading, however, will rise.

Recently, Kookmin Bank's CEO, JT Kim, stated that more chaebol falsified financial statements and insider trading will be found. If the Korean government does not expose these companies guilty of falsified financial statements and insider trading, then the Korean economy and stock market will behave as if all Korean companies are guilty. It is utterly illogical and ridiculous to say that keeping these abuses swept under the carpet will help maintain economic or stock market stability. They should be eliminated without delay. Delay hurts the economy and stock market and perpetuates the embarrassing Korea discount.

What other reforms are required for corporate Korea?

Shareholders who control chaebol affiliates have used many deceitful methods in order to control them with minimal investment, often far below 10%. One of these numerous tricks is circular shareholding structures in which Affiliate A owns shares in Affiliate B, which owns shares in Affiliate C, which owns shares in Affiliate A. This type of circular shareholding structure is the same thing as cross shareholding, and should be prohibited in accordance with regulations banning cross shareholding.

Will class action lawsuits not help to remove some of these problems?

Company directors – whether inside or outside – have a fiduciary obligation to represent the interests of all the shareholders, not rubber-stamp the rulings of the controlling shareholders.

End socialism in South Korea

ers. One day in the near future, an independent outside shareholder who lost money investing in a badly managed company will be paid a large financial damage award that Korean courts have judged and collected from company directors personally. Company directors will lose large sums of money personally for breaching their fiduciary obligation to represent the interests of shareholders by allowing bad management. This will be a watershed moment in Korea, and will perhaps be the biggest factor in reducing the Korea discount.

Successful, non-“lip service” class action lawsuits will require honest judges who cannot be manipulated by controlling shareholders. We are concerned that within Korea’s court system there may be some of the same elderly chaebol buddies as in the Supreme Prosecutor’s Office. Efforts must be made to ensure class action lawsuits are handled by judges and courts which are 100% free from manipulation by chaebol-controlling shareholders. Class action lawsuits should not be limited to any type of company whatsoever, and should apply to small companies, large companies, chaebols, non-chaebols, 100% Korean companies, and joint ventures with foreigners. Simply put, if any shareholder has suffered financial damages as a result of bad management of any company, the company’s directors should be made accountable through the potential damages they could suffer personally in a Class Action lawsuit.

Do you have other recommendations for the government?

Yes, the government must stop keeping “zombie companies” alive. It comes as no surprise whatsoever that the US is imposing a whopping 57% tariff on Hynix imports. From the founding of Hyundai Electronics years ago, Korean taxpayers have indirectly kept this redundant, egotistical, inefficient, unprofitable enterprise alive. The procedure has changed little. In the bad old days, the government just ordered up a “policy loan.” Today, these have a new euphemism, “national service loans” – just a quiet telephone call from a mid-level minister to one of many banks still dependent on government business or stabilizing measures, and the loan is rolled over, the fresh capital injection approved. It’s time to stop wasting Korean taxpayer money in any more Dr. Frankenstein efforts keeping Hynix or any other “zombie companies” alive. We include with this any remaining so-called “workout companies”. If they haven’t

“worked out” their problems after all these years, they never will, and they should just be shut down. Keeping “zombie companies” and workout failures alive only serves to hurt the respective business sector, the overall Korean economy, and most importantly, real companies with a real business plans that don’t soak up taxpayer money.

The bankruptcy process in Korea is slow and constipated. Bankruptcy judges, whose job is to protect the interest of creditors who are already losing a fortune, often instead take up the cause of protecting controlling shareholders and employees deriving income from the bankrupt companies, with the result that NPLs continue rising at lending banks, with overcapacity continuing to squeeze profit margins throughout the sector. We urge President Roh and his

new administration to pursue bankruptcy reform, with the goal of shutting down redundant, unprofitable enterprises rapidly and selling off assets without delay, for the benefit of creditors. This is the only way to purge the banking system of perpetually bad loans.

What’s your view on the LG Corp holding company structure, and should it become a model for other chaebol? (eg Samsung)

In a misguided effort to control chaebols about 10 years ago, the Korean government in fact prohibited holding companies. This exacerbated the rats’ nest of cross-ownership, circular ownership, cross debt guarantees, etc., by which chaebols maintained control and borrowing power. Holding companies is a more honest approach to all this, and permits good businesses to detach themselves from worthless affiliates in unrelated businesses, ending value destruction. For investors, listed holding companies on occasion can also become leveraged stock market proxies for large affiliates they own.

What’s your view on the consumer finance issue?

For decades, banks focused most of their lending on chaebol affiliates. Five years ago, this began to change, as they were urged to extend more lending and services to Korean individuals. Today, due to rapid growth, there are rising credit card NPLs. This is largely due to aggressive marketing, little or no credit analysis, and a business plan stuck in the rut of 30-day terms and usurious cash advance charges. Instead, these banks should be encouraged to offer revolving credit lines to customers with reasonable credit histories. Some 98% of all Korean credit cards today are on 30-day terms, unlike much of the rest of the world, where revolving credit lines are the norm. The introduction of cheques would also help modernize Korean consumer finance. All too often, personal bills are paid in cash, through usurious cash advances, whose high interest rates reduce cardholder spending power and also make banks dependent on the most naïve customers for a sizable portion of their credit card income.

The mortgage loan-to-value ratio in Korea is still under 40%, far below the US and Europe. The government should encourage banks to lend against a greater portion of prudently-appraised home values. Other than in the Kangnam area of

Seoul, there is no “housing bubble” in Korea, and Korean homeowners with reasonable credit histories could have a greater degree of spending power if they were able to borrow 60 or 70% against their real estate holdings, rather than 35%.

Kookmin Bank is looking at buying into BII, an Indonesian bank. Should shareholders be excited at the prospect of Korean banks “going regional” over the next five years or worried?

Kookmin’s CEO, JT Kim, is one of the smartest, most forward-thinking executives in Korea. Kookmin has as much right to be in Indonesia as HSBC has to be in Korea. Samsung Electronics and Hyundai Motors have footprints around the globe, so why not Kookmin?

Any other recommendations?

End socialism in South Korea.

If there is a 100% monopoly, as in fixed-line telecom, power and gas distribution, Korean individuals should be protected via price controls. However, if there exists as little as two available competing providers, all controls should be completely removed. There are three competitors in wireless telecom. Let them set any rates they wish, give out as many free handsets as they can. If one of the three goes bankrupt, supply and demand will allow the two surviving companies to raise rates and reduce handset subsidies. As wireless is an open market with more than one service provider, free market principles should govern its behaviour. There is no need for any government regulation in this area whatsoever. Particularly nonsensical were last year’s forced capex demands made by MoIC on wireless providers to spend large sums of money on risky venture IT companies. The wireless providers were not even told which IT companies they had to invest in; the MoIC just issued a government decree requiring them to make the investments.

Korean brewers are required by law to pay four times market prices for Korean barley. They are legally prohibited from buying Chinese barley, which costs one fourth the Korean price. Korean barley growers clearly have an inefficient, unprofitable business plan, and are being kept in business by government-imposed price controls. Why continue this?

Wireless telecom and barley are just two examples of socialist price controls in Korea. Not a month goes by in which we don’t read about another example of nonsensical price controls which defy free-market principles. Although, please note that we have equally strong disagreement with steel import tariffs and farm subsidies in the US.

As an investor, what’s your view on Korean labour issues, which are often very difficult?

The Labor Reform Act in 1998 opened up the possibility of layoffs in Korea, but these were strictly limited to workout companies and bankrupt companies. It is still illegal for healthy companies to conduct layoffs in Korea. If a financially healthy company decides to discontinue any aspect of its operations, automate, or outsource, it is legally prohibited from laying off the employees from that area. How can any business hope to pursue and develop profitability with these strictures? Once again, the law of supply and demand should govern labour-management relations. If a workforce has unique skills much needed by management, it has the

leverage to negotiate higher wages and better terms. If a workforce does not possess any such unique skills and can easily be replaced, then the government should not step in to force any kind of job protection. There should be neither “illegal strikes” nor “illegal layoffs.” Where collective bargaining agreements have been negotiated, these should be enforced by law and violators on either side subject to civil prosecution.

True labour flexibility requires a complete and effective social safety net. Unemployment insurance needs to last a long time, perhaps as much as one year, and needs to be applicable to small, medium, and large companies alike. Korea has an excellent education system, with third grade math students recently ranked first in the world, and average families investing heavily in their children’s education. Why not put this system to work in retraining and re-educating laid-off workers in skills to work in faster-growing, higher margin business sectors? Instead of perpetuating redundant enterprises, overcapacity, and bad loans, through lifetime employment protected by law, why not migrate the workforce intelligently into areas far more stimulating to Korea’s economy on a long-term basis?

Sunhee Oh

Investment director
Standard Life Investments

Korea obviously trades at a very low PE multiple. Why does it trade at such a discount to other Asian markets?

It’s a legacy of the old perception about Korea. Korea used to trade at less than 0.5 times book, because people couldn’t be sure what the book was. That perception has lasted. And if you compare the return on equity of Korean companies versus Taiwanese companies, the Taiwanese are much superior.

But in terms of trends, Korean companies are improving quite fast. Beforehand their returns were structurally low



Sunhee Oh

Credit card growth was phenomenal, and in any period of phenomenal growth you then need to have a period of adjustment

because of their higher debt and higher interest costs. But after the financial crisis everything has changed and companies realized what they needed to do. One good thing about Koreans is that once they figure out what the problem is, they can fix it very quickly.

So is Korea fundamentally undervalued?

Yes. We have a positive view on Korea, and our investment philosophy is to focus on change. In that sense, Korea is a very good example in terms of shareholder value generation.

How would you judge President Roh's first 100 days?

It has been very difficult for investors to interpret what he has been doing and the reaction by the Korean corporates and people. This is a period of change and whenever change happens there is resistance at first. I wouldn't be surprised if the president himself is tired. The people in the street and in the corporates are not happy. But this is an adjustment period.

Some people think the President is too pro-labour?

It depends which segment of people you talk to. If you talk to the management side, they will insist on this point. But if you talk to the union side, their view will be different.

Does Korea face the danger that it might lose its competitive edge?

Korea will face problems if it can't add value. If you compare Korea today with 20 years ago, it was then just making cheap things. Now, the major products Korea produces are more value-added.

Costs are going up and Korea is set to become an OECD country in the true sense. So the focus should be on producing more value-added products, so companies can still make money even though they are paying higher wages. This will create a virtuous circle, with workers earning more money and having greater consumption power.

You seem quite bullish. What does worry you about Korea?

I may sound bullish, because I am confident that Korea will be successful in moving to more value-added products. The risk remains on the government policy side, as this is important to giving confidence to consumers and corporates.

Risks also remain with North Korea. Over the longer term I hope there will be no military action.

What's your view on the banks. Is the worst over and are they now quite undervalued?

Credit card delinquencies were triggered in my view thanks to the government tightening policies. They wanted to take a pre-emptive move, so as to have longer term consumer credit growth.

The credit card growth was phenomenal, and in any period of phenomenal growth you then need to have a period of

adjustment. The government began to tighten 12 months ago and we have seen that period of adjustment. I feel it is almost over. The government has announced an easing of its credit card policy, and it also seems to agree that the worst is over.

If the credit card situation improves, banks' earning cycles could be normalized next year. A normalized RoE would be 15% and currently Korean banks are trading at one times book. So in that sense I feel the banks are undervalued and we are overweight in financials.

Will Korea be upgraded from emerging market status by MSCI and would it be good for the Kospi?

Yes, eventually it will happen, but I have no idea about the timetable. If it happens it is good for the Kospi.

What do you think of the new holding company structure at LG and is it a model for other chaebol to follow?

It has been successful in segregating the operating and investment companies. One of the problems of the old Korea was that this was all mixed into one balance sheet. The founder families didn't care about minorities and were often confused about what was their wealth and the minority shareholders wealth. Often they were doing bad things.

That segregation has been successful at LG. But should all the chaebols follow it? If they are already doing well without a holding company structure, then why bother? The point is not the structure, but the philosophy of the management.

Vaughn Chang

Investment director
Prudential Asset Management

Why does Korea trade at a discount?

There are quite a few reasons in my view. One is that the market always tends to worry about the corporate governance issues, and that the chaebol business strategies never seem to be focused on returns and profitability, or good use of capital. Plus there are the low dividend payouts and the political factors.

Will Korean companies start to pay better dividends or is there no evidence of that?

We are seeing some incremental improvement in terms of dividend payouts. It is still low, compared to the other Asian markets. But corporations now tend to have more commitment in terms of dividend payout, which is good, and they are more aware of investor needs. Some corporations like KT&G or the new LG holding company are all moving towards higher dividend payouts.

If the companies in the Kospi had comparable dividend payouts to those in Hong Kong, would that have a direct impact on the PE ratio?

It would be a key factor, but the corporate governance issue remains, as do the political factors.

Will Korea be upgraded by MSCI from emerging market status to developed market?

I am not sure about the timing. The issue was talked about



Vaughn Chang

quite frequently during the World Cup, but now with the economic slowdown and the credit card bubble, no one seems to be talking about it. It's imminent and it's going to come but I don't know whether it will be next year. Some people also argue that once Korea graduates from emerging market status to developed market, the Korea market will look less attractive to those developed market investors. Whereas it looks more attractive compared to other developing markets.

Is the worst over for the banks and their consumer finance problems?

Overall the worst is over. It's not deteriorating and banks are aware of the risks and the trouble they have created in the consumer finance area. Mostly the problems are in credit cards. What concerns me a little is the property market, and the leverage that is being used. The government doesn't have a very effective measure to calm down the property market. But generally, we feel the worst is over.

Is the banking sector undervalued?

In the longer term I think the returns should be higher, and if you have a three-year time horizon they are undervalued.

Is Kookmin still your favourite bank pick?

Yes, from a transparency and management perspective, Kookmin is a favourite bank.

How do you rate Korea's manufacturing leadership?

The Koreans have a vertically integrated model, and have pricing power because they control their own brand names. That's positive. And because they have not been as quick as other to locate to China, they have focused more on productivity, which is long-term positive.

Which Korean sectors do you like to invest in?

I like the retail consumer space because higher wages lead to more consumption power. So Shinsegae, Hite Brewery and KT&G are plays on this.

Korea is gaining a competitive edge in autos too, so there you have Hyundai Motor and Mobis.

On the semi-conductor side, Samsung's position is very strong in memory and that is very positive. There is such a need for data storage today, that any manufacturer that is focused on memory devices has a very positive outlook.

What's your view on labour issues?

It's a legitimate concern as wages have risen over the past five years, and the power of the labour unions has risen. Another thing is Korea's immigration policy. It is still fairly restrictive compared to other Asian countries. That's a weakness as that would also make their labour force more competitive.

Is the new government more pro-labour than pro-investor?

The market perception is the president is pro-labour but he seems to be changing and moving towards more of an interest in business groups and their needs. It is a tough issue and it may still be too early to comment.

In spite of this, are you overweight?

Yes, we like Korea. We are overweight Korea.

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