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The Value-Up Recipe for Re-rating Korea

TALES FROM THE EMERGING WORLD | EMERGING MARKETS EQUITY TEAM | March 2024

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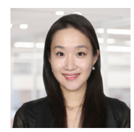

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In February 2024, the Korean government announced its "Value-Up" program, a series of market-friendly measures ahead of legislative elections in April. This follows corporate governance reforms led by the Tokyo Stock Exchange, which saw the Nikkei breach its previous peak after three and a half decades. The surge in Japan's stock market has revitalized interest in "value" markets in Emerging Markets (EM) as well, with Korea being the most proximate beneficiary. The key debate now is if this time will be different for Korea? We look back to trace Korea's de-rating over two decades to determine whether it is time to engage in the Korea "value trade."

Until recently, our investment strategy in Korea focused on a thematic selection process, targeting specific sectors we found promising, rather than following a broad country allocation model. We devoted our attention to dynamic sectors like memory chips, electric vehicles and battery supply chain experiencing structural growth, the Internet, gaming and China-related themes. The Value-Up program makes us take another look at our approach in Korea.

The Korea Discount

Between 2001-06, Korea had the largest weight in the MSCI EM Index. Seoul had navigated a strong recovery from the 1997 Asian Financial Crisis that hobbled indebted markets in Asia, including Malaysia, which had the highest concentration in the EM index in the 1990s. The rise of Korea was marked by its emergence as a technology and automotive powerhouse, challenging the Asian leadership mantle held by Japan. However, since 2007, coinciding with the of rise of China, Korea's share in the MSCI EM Index has been on a downward trend, almost halving from its peak of 24.2% in November 2002 *(Display 1)*.

Paradoxically, Korea's per capita GDP has steadily climbed to $33,000, doubling its 2004 level, with the potential to overtake Japan's. The country's rapid rise as a global hub for technology and automotive industries, including some of the most advanced companies, rivals Japan's long-held dominance. For example, Korean firms Samsung Electronics and SK Hynix control 70% global market share for DRAM memory chips and supply the vast majority of High Bandwidth Memory for advanced AI-related chips. Korea's three battery makers for electric vehicles control a combined global market share of 53%, excluding China.

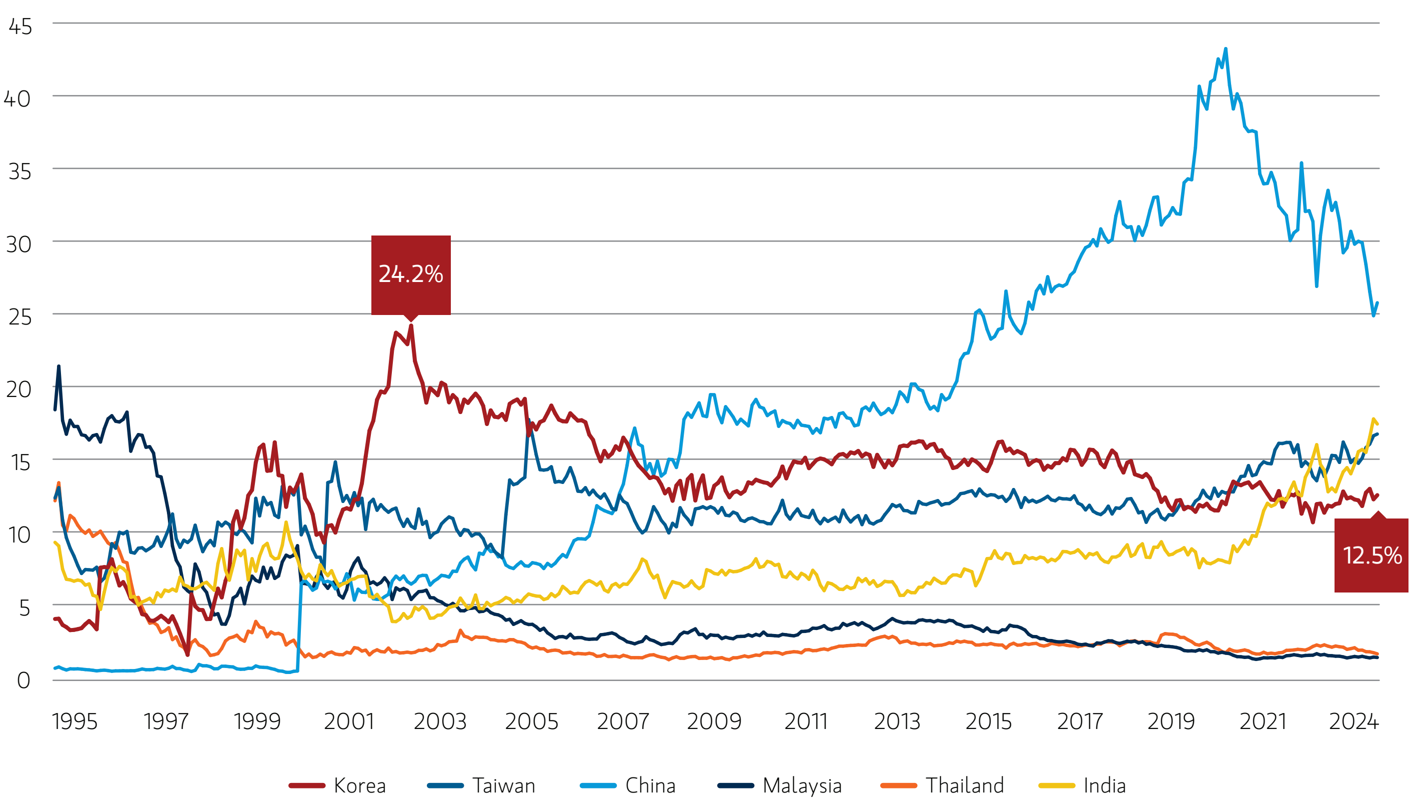
However, Korean equities have long been plagued by what is commonly referred to as the "Korea discount," where its stocks are assessed at a lower valuation than international peers *(Display 2 - see following page)*.

Samsung, for instance, a leader in electronics, memory chips and smartphone markets, is currently trading at approximately 1.3 times its price-to-book value, nearly a 50% discount compared to its U.S.-listed competitor, Micron. This persistent discount is rooted in several systemic issues. Among them are the prevalence of weak corporate governance, such as misalignment of interest between

DISPLAY 1

Korea's Index Weight Dropped From Nearly 25% to 12.5% Over the Past Two Decades

Country Share of MSCI EM Index (%)

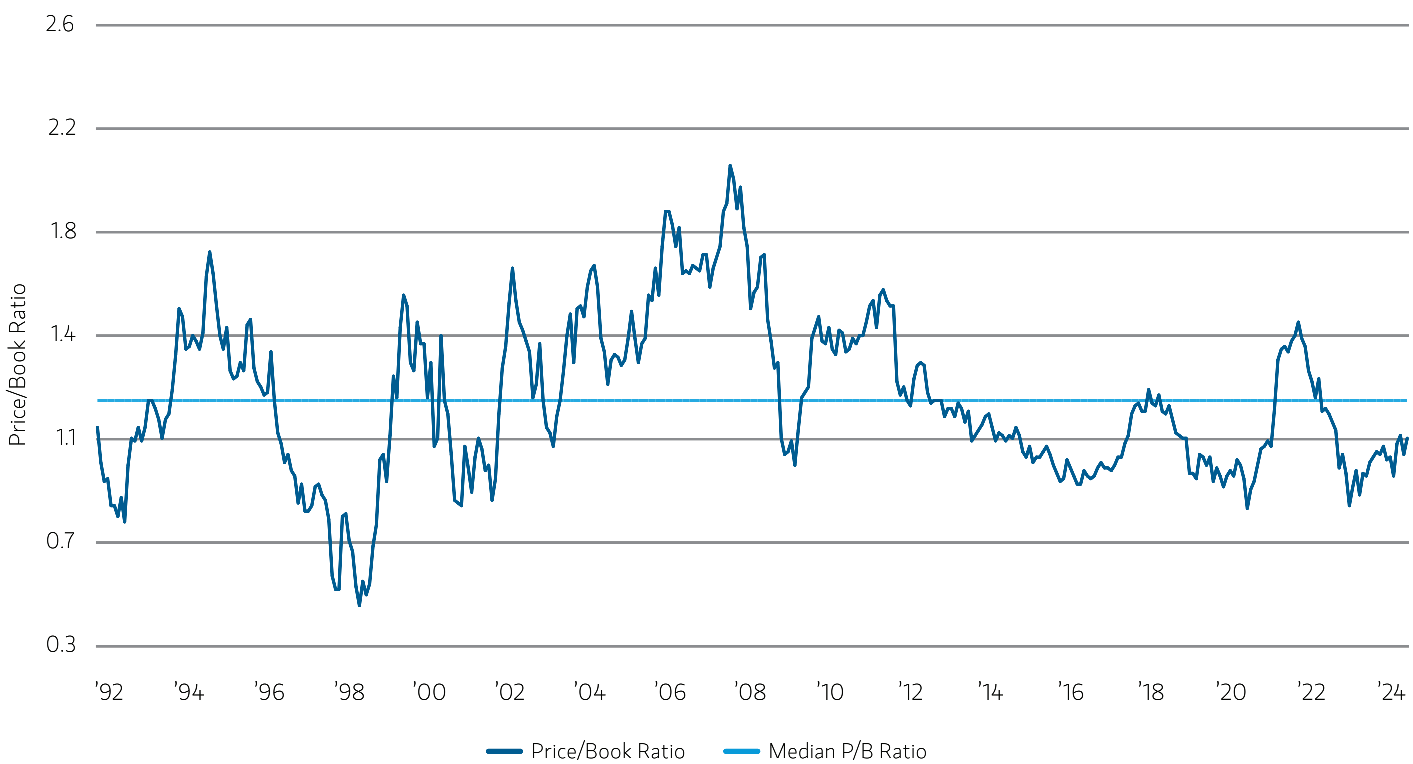


Source: Bloomberg, FactSet, Haver. As of January 31, 2024.

DISPLAY 2

Korea's Equity Market Is De-Rating

MSCI Korea Price/Book



Source: Bloomberg, FactSet, Haver, Global Insight. As of January 31, 2024.

chaebols (South Korean conglomerates usually owned by a single family) and institutional investors, and complex ownership structures that often undermine shareholder rights and transparency. In addition, the perception that chaebol heirs don't deserve their family's wealth has intensified political efforts to tackle income inequality.

As a result, Korea has the world's second-highest inheritance tax rates, only behind Japan, which along with the absence of controlling voting shares, discourages chaebol families from engaging in shareholder-friendly actions to boost share prices. Simply put, higher valuations don't align with the interests of chaebols, in light of substantial inheritance and dividend income tax considerations. At the beginning of this decade, Korea saw the emergence of new leaders in the internet and gaming sectors, who were unaffiliated with the chaebols. The rise of these companies fueled market excitement that a new era was born. But these companies were key beneficiaries of the COVID-19 lockdown and, with the opening of the economy, enthusiasm has since faded.

The Value-Up Program

In a move to tackle the "Korea discount," the much-anticipated Value-Up program was announced in February 2024 *(Display 3 - see following page)*. The initiative

The Korea Discount

- **Corporate Governance:** Korean equities are hurt by perceptions of misallocation of capital, convoluted cross-holding structures and misaligned actions against minority shareholders. Since 2010, the government has moved to address these, without much positive impact on valuations.
- **Over-Regulation:** Post the Asian Financial Crisis, our perception is that Korea remains heavily regulated. As the economy matures and growth inevitably slows, social issues such as income inequality are taking center stage. The government cracks down on companies that are deemed as "too big" – the definition of big being fluid – and calls on chaebols to act in the best interests of the "national service" in times of need, to help with the labor market or with investments, regardless of returns.

mandates financial regulators to establish guidelines that encourage corporations to adopt policies favorable to shareholders' interests, including the proposed launch of the Korea Value-Up Index in the third quarter of 2024. The index will be bolstered by new exchange-traded funds (ETFs), that will be rolled out by prominent asset managers, including the National Pension Service of Korea, in the latter half of 2024, aiming to foster market engagement.

Details on tax-related incentives, such as exemptions on dividends and obligatory share cancellations following buybacks, will be determined after legislative elections in April. Korea's proposed reforms follow on the heels of similar successful measures taken by Japan that helped rekindle investor interest in Japanese equities, along with a shift in country allocation by funds. While the Value-Up initiative is receiving more serious attention than previous efforts, some critics argue that there is too much "carrot" and not enough "stick" in the current proposals to encourage the chaebols to take transformative actions.

Balancing Policy and Growth

It is important to acknowledge that there are limitations to what government-led programs can accomplish. New indexes and ETFs may offer a temporary reprieve, but are expected to fall short of resolving entrenched issues related to taxes and incentives for the family-led chaebols.

Now, the key question revolves around whether the Korean market's current value proposition will solidify into a lasting investment theme, or if it will dissipate after the election having served as a transient phenomenon driven by short-term political considerations. Our conviction is that Korea offers a credible quality value opportunity for investors. We hope the chaebols are listening.

DISPLAY 3

Details of the Value-Up Program

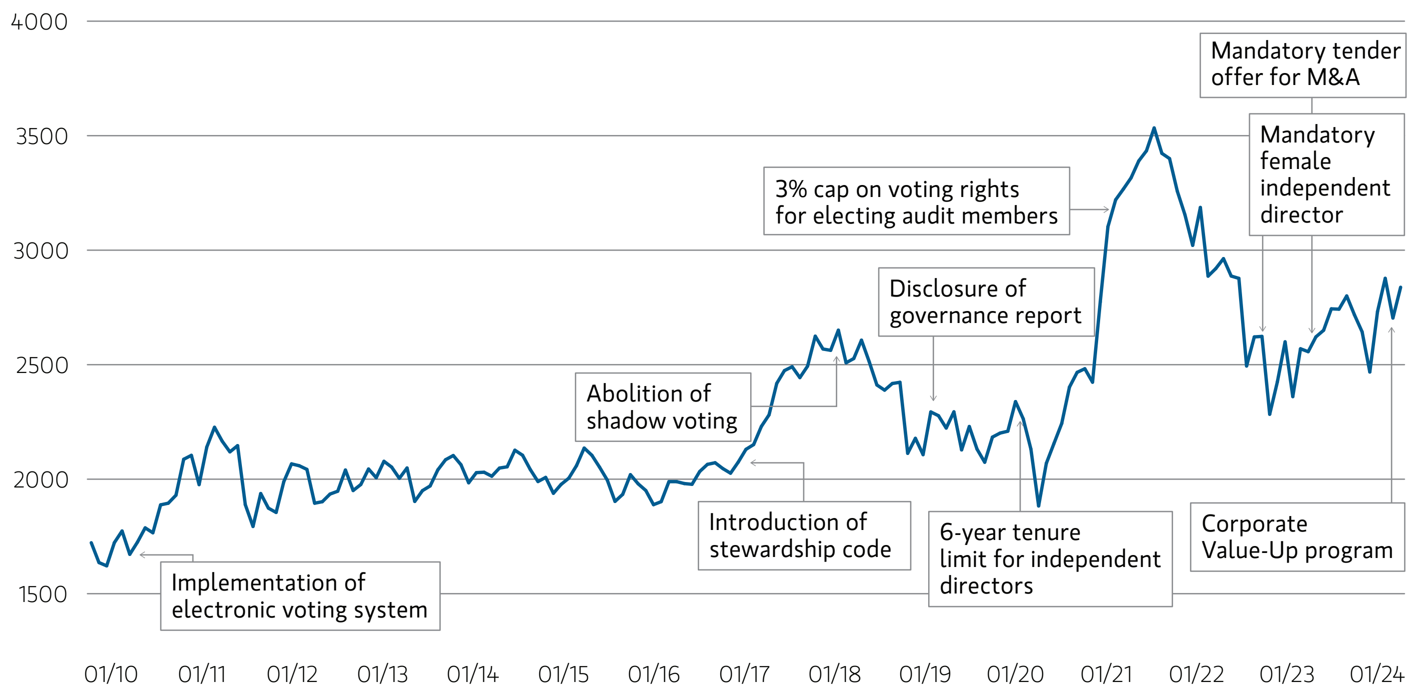
1. Support listed companies to communicate their corporate Value-Up plans	■ Provide guidelines and incentives to encourage corporate participation ■ Encourage corporations to provide annual medium-to-long term Value-Up plans ■ Advise companies to publish plans on their company website and make voluntary disclosures to the Korea Stock Exchange ■ Provide incentives such as tax support to promote corporate participation
2. Support shareholder value enhancement efforts	■ Develop Korea Value-Up Index and ETF (launch in 4Q24) ■ Revise stewardship code so that institutional investors take company initiatives into their investment considerations ■ Publish key indicators for comparison such as price-to-book ratio, price-to-earnings ratio and return on equity
3. Establish dedicated support network	■ Set up a dedicated team for the Value-Up program to support and monitor the process ■ Launch a web portal to publish disclosure by companies regarding their Value-Up plans ■ Provide training on disclosure, consulting and English translation services for small- and mid-size firms and online investor relations

Source: FSC, Macquarie Research, Feb 2024.

DISPLAY 4

The Regulator's Recipe for Re-Rating

The Korea Composite Stock Price Index (KOSPI)



Source: Nomura

Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. In general, **equities securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in **emerging market countries** are greater than the risks generally associated with investments in foreign developed countries. The risks associated with ownership of **real estate and the real estate industry** in general include fluctuations in the value of underlying property, defaults by borrowers or tenants, market saturation, decreases in market rents, interest rates, property taxes, increases in operating expenses and political or regulatory occurrences adversely affecting real estate.

INDEX DEFINITIONS

The **MSCI Emerging Markets Index (MSCI EM)** is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets.

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