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Korea's Long-Awaited "Value-Up" Reforms

A Strategic Shift to Enhance Corporate Governance and Market Valuation

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The Foundation of Korea's Economic Miracle

South Korea's impressive economic growth can be traced back to the 1960s, when the country began exporting goods, starting with wigs. Since then, the success of South Korea's economy is a testament to the country's well-planned strategic and government-led industrial policies that continued until the 1980s.

During this period, South Korea established itself as a major player in global manufacturing, leading to an impressive ten-fold increase in its GDP. The government's role in facilitating this growth, through loans from foreign financial institutions and protective measures, laid the foundation for the rise of conglomerates such as Samsung, LG, and Hyundai. These conglomerates, also referred to as "chaebols", have now become the backbone of the South Korean economy, contributing to nearly 60% of the nation's GDP as of 2023.

The “Korean Discount”: A Barrier to True Valuation

While Korea has experienced a great period of prosperity, it has also led to the emergence of a few powerful family-run conglomerates. These conglomerates prioritised preserving their wealth over the interests of minority shareholders, which profoundly impacted the local equity market. This created the “Korean Discount” phenomenon, which refers to the lower valuation of Korean companies due to corporate governance issues. The intricate structure of preferred shares, holding companies, and practices surrounding share repurchases contribute to this pervasive discount, which disadvantages minority shareholders and benefits the controlling families’ wealth preservation strategies. These features, partly influenced by high inheritance and dividend taxes that encourage low stock prices and manipulative share buybacks, have historically prevented Korean companies from being fairly valued in the global market.

The Socio-Economic Imperative for Reform

This concentration of economic power within a few chaebols has exacerbated income inequality, leading to significant social and economic challenges with investors frustrated with corruption, tax evasion and questionable capital allocation. With the nation facing demographic shifts and a highly inflated housing market, the younger generation are struggling to gain financial stability. Moreover, the sustainability of pension funds is at risk in a market where equities are consistently undervalued, and market returns are sub-par, threatening the financial security of future retirees.

Learning from Japan’s Governance Reforms

Japan’s experience with “keiretsu” and “zaibatsu” (Chaebol equivalent) structures offers valuable lessons for Korea. Recognizing the detrimental impact of companies trading below their book value, Japan has initiated reforms to improve corporate governance and encourage a more investor-friendly dialogue. These measures, advocated by Hiromi Yamaji, president of the Tokyo Stock Exchange, aim at enhancing return on equity and transparency. The positive outcomes of these reforms in Japan, including improved stock valuations and a lower cost of capital, underscore the potential benefits of similar “Value-Up” reforms in Korea, as we see the Japanese equity market at current all-time highs.

In effect, Korean President Yoon Suk Yeol recently proposed significant reforms in response to the “Korea Discount” in order to improve shareholder returns, enhance governance and increase valuations. The proposed changes also include adjustments to dividend and inheritance taxes, which are expected to benefit the ordinary public and the powerful chaebol families.

Fiera Capital’s Approach

Over the years at Fiera Capital, we have focused on investing in the Korean equity market by navigating the obstacles created by the dominance of large conglomerates. We target opportunities where the interests of minority shareholders align more closely with those of company stakeholders and where governance has marginally improved. The upcoming “Value-Up” reforms could be a turning point for the Korean equity market. The valuation gap is particularly noteworthy, illustrated by banks generating an 11% return-on-equity (ROE) yet trading at a mere 0.3x price-to-book (P/B) ratio at the start of the year, even with the risk-free rate in the country. This contrasts with most global banks generating ROEs above their cost of equity trading, which is above 1x price-to-book. With idle excess capital on the books and treasury shares unlikely to be needed for M&A, ample scope exists to enhance shareholder returns, improve ROE, and deliver a potential 50% multiple re-rating.

Stock-Picking in Korea

In anticipation of the transformative impact these reforms could have, Fiera’s Magna Income & Growth Emerging Markets Strategy increased its Korean exposure by holding both strongly governed companies exhibiting high-earnings growth and those standing to benefit from a potential re-rating boost driven by the reforms, especially where management teams have already shown a willingness to respond to the government efforts. Such a strategic reallocation underscores the confidence in the “Value-Up” reforms to address systemic issues that have long plagued the Korean equity market, paving the way for a re-evaluation of Korean stocks. This recalibration could unlock tremendous value, making this an exciting time for investors with a keen eye on Korea’s fundamentally sound companies poised for growth and a significant valuation uplift.

The Strategy recently added to a global leader in the OEM (Original Equipment Manufacturer) automobile space, trading at an undeserved discount to global peers, with treasury shares to cancel, excess capital to return to shareholders and multiple other catalysts. Operationally, results in recent quarters have shown better than industry profitability. At the same time, non-core assets could be disposed of with proceeds returned to shareholders or used to close the further 40% discount on preference shares. Even if only some of these events are executed, the value unlock is considerable when trading at just 0.6x price-book.

An Outperforming Actively Managed Strategy

Fiera Capital takes a unique approach to Emerging and Frontier Markets by viewing the universe as a collection of separate and often uncorrelated investment opportunities, without worrying about index weighting. With rates and inflation rising after the COVID-19 pandemic, the days of ever-increasing valuations for growth companies are arguably over. The current scenario demands a more active approach to the asset class, with stock pickers able to identify mispricing and the necessary catalysts to unlock value.

This approach has proven effective with the Magna EM Income & Growth strategy, which has delivered 5.5% annualized net outperformance against the MSCI EM index over three years and is ranked in the first quartile compared to peers over 1, 3, and 5 years.[1] Recent events in Korea serve as an example of the distinctive investment thesis that populate Fiera Capital's Emerging Market portfolios.

1 As at 28 February 2024. Source: Fiera Capital, MSCI