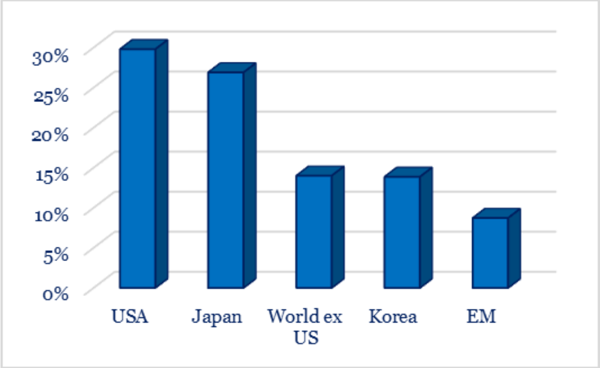
Creating Value from "Corporate Value-Up"

After more than 34 years, the Japanese equity market has made history by reaching an all-time high, finally surpassing the last peak reached in December of 1989. The reforms taken by the Japanese government, discussed in our November 2023 issue, seem to be working as the Japanese equity market has decoupled from the other international markets in the last year, besting most of the markets outside of the United States (Exhibit 1).

Exhibit 1. Trailing One Year Performance: Feb 29, 2024



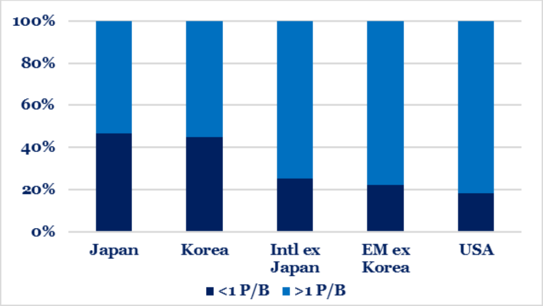
Source: Bloomberg

The outperformance of Japanese equities has not gone unnoticed. South Korea's Financial Services Commission (FSC) just announced a similar plan to the one in Japan called "Corporate Value-up Program". Like in Japan, the FSC wants listed companies trading at low valuations to improve their capital efficiency and generate higher shareholder returns. As part of this effort, companies will be required to provide an analysis of their market value and disclose an evaluation of whether that value is at an appropriate level. In addition, firms have to disclose mid- to long-term targets and an expected timeline to reach those targets as well as details on the implementation status.

Korean stocks are attractively valued.....

As presented in Exhibit 2, approximately 42% of the stocks in Korea are currently trading below book value. While this is lower than 46% in Japan, it is still higher than the 20% in International Developed Markets ex Japan and the 22% in Emerging Markets ex Korea that are trading below book value. Thus, it does make sense that the Korean government would want to encourage companies to boost shareholder value by improving capital efficiency and overall transparency.

Exhibit 2. Percentage of Stocks by Price to Book Value: Feb 29, 2024



Sources: Bloomberg, Topix, MSCI

This raises the question: will the Korean reform plan be effective in boosting equity market returns in the same way that the Japanese plan has helped Japanese stocks? In this report, we analyze some of the underlying idiosyncrasies of the Korean market and conclude that the Value-Up Program will take time to be impactful.

Low Valuation is Driven by Cash….

One of the reasons why Korean companies have low valuation and in particular, low price to book value, is because Korean companies have cash on their balance sheets. The uncertainties of the pandemic drove Korean companies to hoard cash, which pushed their book values higher. According to an analysis published by CEO Scor, a local business tracker, the top 20 companies have increased cash reserves by more than 30% since the end of 2019. Societe Generale Cross Asset Research estimates that 58% of Kospi companies are cash rich, versus 24% for Europe's Stoxx 600 and 32% for the S&P 500. Thus, more productive use of this cash sitting idly on balance sheets would lead Korean companies to improve their capital efficiency and generate higher Returns on Equity, which in turn, should mean better stock performance.

But Chaebols have also contributed to the "Korea Discount"…

But another reason why Korean stocks have low valuations is because about 50% of the stock market is owned by Chaebols, which are mostly family-owned industrial conglomerates made up of various affiliates. Samsung Group, SK Group, Hyundai Motor Company and LG Group together form the largest chaebol groups accounting for the majority ownership of the stock market value in South Korea.

The chaebols are a key part of the reason for the discount in Korean shares as these majority family-owned structures influence strategic decisions and minority stakeholders do not have much say. Thus, the presence of these strong controlling shareholders would make any change difficult to implement and thus the Value-Up program may not be effective unless there are further reforms that would incent the chaebols to create shareholder value.

And Tax Structure promotes low Valuation…

But chaebols exist because of the complicated tax structure in Korea. For example, dividends are taxed as regular income, which means the marginal tax rate could be as high as 49.5%. This may be why the payout ratio tends to be so low in Korea, another reason for a "Korea discount". There is a perception in Korea that dividends are for the ultra-rich and hence, any reform to lower taxes on dividend payments would be considered as helping the wealthy. By contrast, there is no capital gains tax, implying that stock trading gains are for the working class. Thus, it is not surprising that retail investors account for about 70% of the trading in the Korean stock market.

In addition, the inheritance tax in Korea can be as high as 60%, which is one of the highest amongst the member countries in the Organization for Economic Co-operation and Development, and almost double that of the average for these countries. Paradoxically, low stock prices are a way for chaebols to reduce inheritance taxes. And the reason behind sprawling conglomerates is partly to avoid the inheritance tax. In other words, Chaebols lower inheritance taxes through complex intercorporate structures as transactions between related parties are often overlooked in South Korea.

Value-Up Needs more Reform to work…

In summary, the reason behind the "Korea discount" goes beyond just the companies hoarding cash and thus incenting these companies to put their cash to productive use will likely be more complicated than it was in Japan. The reason for the "Korea discount" lies in the tax structure, a lack of minority rights and the prevalence of chaebols, all of which are interconnected and will take time to work out. However, the Value-Up program is a first step in the right direction to start thinking about necessary reforms needed to create value over the long term.