RBC BlueBay
Asset Management

Asian takeaways
Bibimbap bulletin

For Professional Investors Only | Marketing Communication

Selina Lu
Asian Equity
Portfolio Manager

Published March 2024

> "Scepticism is an easy default position, however my discussions with company management suggest that there is perhaps meat on this particular bone."

Following the recent buzz around corporate Japan's efforts to prioritise shareholder returns, my trip to South Korea came at a highly opportune moment. The country's Financial Services Commission ("FSC") has recently unveiled its corporate 'Value-up' programme, and the flurry of news surrounding it is piquing interest in the region.

Scepticism is an easy default position, however my discussions with company management suggest that there is perhaps meat on this particular bone, with investors taking the view that the programme could have a positive impact on Korea's historical discount.

What is the 'Value-up' programme?

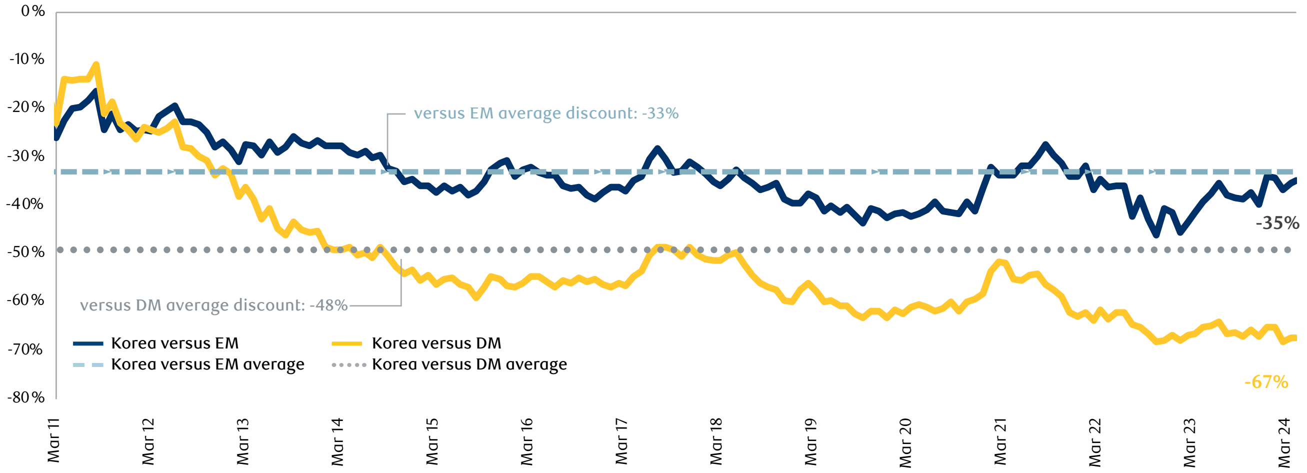
The 'Value-up' programme was announced on 26 February this year by the FSC. Its highlights include encouraging listed companies to increase disclosures (particularly with regard to plans to enhance corporate value), improve dividend payout ratios, and upgrade shareholder return policies, including share buybacks and retirements.

To provide some background, for the past decade, Korean equities have traded at a steep discount to both emerging and developed market indices, due to factors such as low dividend payouts, poor corporate governance, and, notably, weakness when it comes to corporate management and structure.

Family-run conglomerates, know as *chaebols*, accounted for close to 45% of Korea's GDP in 2022. They are often associated with complex corporate structures and founder-controlled boards[1]. These issues have often resulted in poor governance & shareholder rights and a lack of transparency, in turn dampening investor interest in the region and manifesting themselves in Korea's discount. This has simultaneously put a strain on economic growth, as companies have had difficulties when it comes to raising affordable capital.

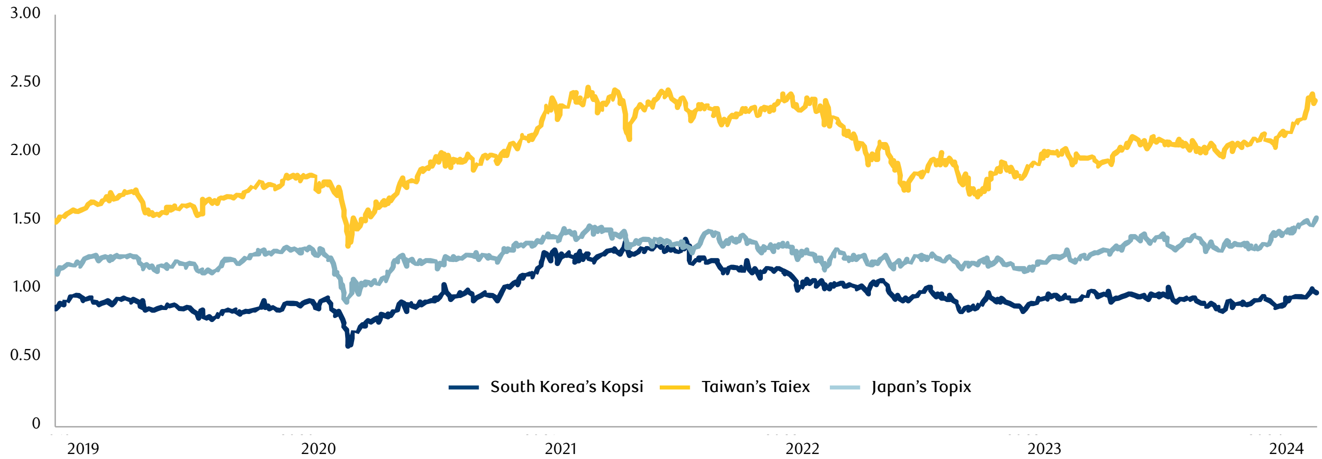
[1] Bloomberg, What is the 'Korea Discount' and why is it a problem?, 6 March 2024.

Figure 1: Korea's equity market is highly discounted relative to both EM and DM
MSCI Korea versus MSCI EM and MSCI World indices P/B discount



Source: Goldman Sachs, as at 20 March 2024.

P/B ratio versus peers



Source: Bloomberg, as at 20 March 2024.

Neighbourly competition

Elements of the programme echo recent governance reforms in Japan, which have already gained significant traction and helped drive the Nikkei 225 Index above historic highs. Our Asian Takeaways – Sushi Special piece gives further insight into these reforms.

With Japan being one of Korea's closest neighbours, there is natural competition the two countries, particularly in areas such as auto and electronics exports, foreign capital investment, and research and development, and it is not surprising that Korea feels the need to play 'catch-up' when it comes to boosting corporate value. In a similar vein to the Tokyo Stock Exchange's launch of its Prime Index, designed to highlight the top value-creating Japanese companies, the FSC has announced plans to roll out the Korea Premium Index, creating a similar pool of high quality, high value companies.

With Japan, and now Korea, paving the way in corporate governance reform, it will be interesting to see if this phenomenon spreads further afield.

Even in the current 'ABC' ('Anything But China') investment environment, the Chinese government is urging state-owned enterprises ("SOEs") to make efforts to improve shareholder returns and capital efficiency, with the intention of driving a re-rating of valuations. With SOEs representing 50% of the MSCI China Index, potential improvements here could have a significant impact on the country's valuation discount versus global peers.

Closer to home

From a political standpoint there are also implications, with a rising domestic market (driven by the 'Value-up' programme) likely to drive voter support. With legislative elections due to be held on 10 April, policymakers will be keenly aware of the need to gain traction from retail investors who account for more than a quarter of the country's 52 million population. The programme could also unite younger voters as this demographic continues to struggle to enter the housing market, despite falling property prices. It could instead encourage them to invest in equities, and a boost to share prices would undoubtedly also boost voter sentiment.

The programme's potential is clear, but it is early days. My discussions with both domestic and foreign investors added useful insight. Attending a conference held by the FSC, the consensus from foreign investors seemed to be that the initiative could indeed lead to increased interest in the market and help to narrow the Korea discount.

Domestic investors, on the other hand, are more cautious, focusing on the lack of detailed measures involved, and the fact that corporate participation is voluntary. The looming election also adds potential to sway the reform path, adding further uncertainty to the programme's potential success.

Company visits

During my visit, discussions with company management unsurprisingly turned to the 'Value-up' initiative, with responses varying depending on managements' place on the market cap spectrum. Smaller companies voiced concerns around the difficulties of improving shareholder returns in the near term, as a result of limited free cash flow and large capital expenditure plans over the coming years.

"In the more recent past, we have witnessed a slowdown in EV sales and overall weak consumption in Korea on the back of rising inflation. However, meetings with EV manufacturers suggested a more positive outlook moving forwards."

Larger firms, on the other hand, responded positively, and are already in the process of evaluating plans to increase shareholder returns through buybacks and dividend payouts, and cancelling treasury shares. For all companies, final guidelines from the FSC, due to be announced in June, will be important in solidifying plans.

Many companies are already under pressure from a high number of retail investors, notable National Pension Service ownership, and the government's stance on improving ordinary shareholder rights and value. Due to this, our overall view on the programme is constructive. It should provide management with the tools required to align minority and controlling interests, and more generally, it should help to address inefficiencies in the capital system, providing a welcome boost to Korea's slowing economic growth.

Korea's electric vision

While the 'Value-up' initiative wove a strong narrative throughout my visit, it was by no means the only theme of the trip, with Korea's electric vehicle ("EV") market also a strong focus.

Electric vehicle charging station, South Korea

In the more recent past, we have witnessed a slowdown in EV sales and overall weak consumption in Korea on the back of rising inflation. However, meetings with EV manufacturers suggested a more positive outlook moving forwards.

Plant tours with Hyundai Motors and Kia Motors, two of Korea's largest auto companies, indicated steady sales growth in the U.S. market, thanks to a focus on product quality and innovation. Management teams at both reiterated their vision for electrification, implementing net-zero targets of 2045 (five years ahead of Korea's overall target). New product launches, including more affordable models over the coming year, should bolster company sales and cater to a broader market.

Kia's management team also highlighted plans for capacity expansion, with an EV plant currently under construction in the U.S.. This will support its product offerings in North America and allow the company to enjoy new EV tax credits under the Inflation Reduction Act. However, there is a strong likelihood that supply chains will remain somewhat tied to China, due to its ability to compete on costs.

Further meetings with major EV battery manufacturers, cathode makers and separator companies supported more favourable outlooks, in spite of recent weakness in volume and price trends, with the launch of new models on the horizon and improving battery capacities. In addition, increased EU and U.S. legislative measures, to attempt to decouple original equipment manufacturers ("OEMs") from China's supply chain, could prove supportive to Korea's battery and EV materials market. Indeed, the country's three largest battery manufacturers control nearly half of the global market for EV batteries outside of China, and they would be clear beneficiaries should these measures come into play[2].

[2] Bloomberg, Korean battery makers ease driver anxiety with winter-proof cells, 11 March 2024.

Low foot traffic at Seoul's duty-free stores

Slow inbound tourism means slow sales

That said, we remain constructive on our outlook for China's EV market due to its product and cost competitiveness, and strong domestic supply chain, and we expect it to remain a major player in the global EV market. However, as global EV demand grows, it appears that there is ample room for Korea to take a piece of the pie.

Sluggish consumption remains a concern

There is evidently a lot to be positive about when it comes to Korea's prospects, however with domestic demand and inbound travel looking weak, there are pockets of economic concern that won't go away overnight.

Meetings with department store companies indicated a cautious outlook, as they are battling weak consumer purchasing power due to a high base from the pandemic, inflationary pressure, and falling property prices. Duty-free stores have also been suffering on the back of a slow recovery on inbound tourism from China, something that they would expect to improve towards the end of this year. In the meantime, high price discounts from Chinese duty-free companies have added to reduced sales, with my visits to duty-free shops reflecting this slow demand.

"Korea is increasingly characterised as a mature economy with slowing economic growth and, as they currently stand, unsupportive consumption trends."

These retail trips provided an interesting contrast to the rest of my trip and the numerous discussions that I had with companies on the 'Value-up' initiative. Korea is increasingly characterised as a mature economy with slowing economic growth and, as they currently stand, unsupportive consumption trends.

However, there is clearly room to breathe new life into corporate Korea and the economy as a whole. A broadly positive response for the FSC's initiative from management teams is a good sign, and as the programme is rolled out, we would expect investor interest in the region to grow – particularly with Japan's recent turnaround top of mind.

Published March 2024

RE/0067/03/24

RBC

RBC BlueBay
Asset Management