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Preferred by more

Just how inclusive is the global stock-market rally? Inclusive enough to levitate South Korean preferreds. Now unfolding is an update to our bullish analysis of this value-laden, hard-to-buy and chronically underachieving asset class (*Grant's*, Sept. 21, 2012).

No foreign investor just saunters into the Republic of Korea on a government-issued welcome mat. To accumulate shares in Hyundai Motor or Samsung Electronics or LG Household & Health-care, the would-be bull must obtain an IRC number, as in "investment registration certificate." It isn't easy, especially for retail investors. Kyung Suk Choi of Daewoo Securities, the broker we mentioned in our story last year, stands ready to help American individuals; his e-mail is kyungsuk.choi@dwsec.com. Institutional readers may write to Ju Kim of Samsung Securities, ju.kim@samsungfn.com.

New since the *Grant's* analysis two autumns ago is the flotation of the Weiss Korea Opportunity Fund on the London Stock Exchange's Alternative Investment Market (the Bloomberg ticker is WKOF LN). First and foremost, an administrative note: Americans may have to shop around for a broker to execute an order. Schwab won't; Interactive Brokers will. It seems as though UBS, Morgan Stanley and Bank of America Merrill Lynch might. Some broker-dealers will, others won't.

The Weiss fund buys and holds Korean preferreds. The preferreds in its portfolio trade at a 50%-odd discount to the common shares of the same issuing company; the Weiss shares trade at a 10.4% premium to the net asset value of the fund. Are your eyes already tearing? Bear with us, please.

Obscure and exotic, Korean preferreds may be. As if in compensation, the associated investment proposition is ripe with value, both relative and absolute. Korea's preferred shares, like those of Germany, Russia or Italy, confer on their holders no right to elect candidates for the issuing company's board of directors. And Korea's preferreds, again like those of other countries, are otherwise economically identical to the corresponding common. What sets the Korean species apart from the world genus is how much cheaper it trades than the corresponding common. The discount since 1995 has averaged in the neighborhood of 54%. It plumbed 70% during the Asian financial crisis in the fall of 1998. And it revisited 70% in the fall of 2012, when this publication, prompted by its friends, publicized the fact. The discount has lately narrowed to the vicinity of the long-run average. The risk-reward calculus may, therefore, be not so sweet as it was 15 months ago, but we judge it still appealing.

The phrase "Korean preferred" loses something in translation. One may think of these securities, of which the equivalent of $30 billion is outstanding, as a senior class of common, but one without the typical appurtenances of a certain kind of American preferred stock. Thus, a Korean preferred has no fixed coupon and no maturity date. "As investors research these securities," Andrew Weiss, founder of the eponymous Weiss Korea Opportunity Fund (and progenitor of the Boston-based Weiss Asset Management), advises colleague David Peligal, "they are becoming comfortable with their legal protections and dividend rights; and realizing that, while these stocks have limited voting rights, preferred shareholders can vote on issues that directly affect their interests. And as other markets have become overpriced, investors are migrating toward one of the few remaining value plays."

Still cheap to the common

source: The Bloomberg

Could the belated discovery of a heretofore unrecognized oasis of value be yet another sign that the great stock market rally is ending? One may so suspect. What one may positively observe is a continuing bullish reappraisal of an orphaned class of security.

"Interestingly," reports Peligal, "since our 2012 story, Hyundai Motor's second preferred series (the Bloomberg ticker is 005387 KS) is up by 55%, while Hyundai Motor's common (005380 KS) is down by about 8%. Thus, not quite 15 months ago, the Hyundai preferreds traded at just 32% of the price of the common. Now they trade at 54% of the price of the common. Expressed another way, the discount between the two classes of Hyundai shares has narrowed to 46% from 68%. Even so, the Hyundai preferreds are quoted at under two times the consensus 2013 EV/EBITDA estimate (the common at 3.4 times the 2013 EV/EBITDA estimate). There's another way of looking at this situation. Strip out excess cash, the market value of Hyundai's portfolio of listed public equities and other assets on the balance sheet. After which, an investor could, for the price of the preferred stock, effectively create Hyundai, on the aforementioned adjusted basis, for under one times the 2013 EV/EBITDA estimate."

Another augury for what may or may not prove to be a boost in the status of Korean preferred shares was a recent tender offer by the parts-and-service subsidiary of Hyundai Motor. "Just $4 million of preferred is all we're talking about," Peligal relates. "Owing to its tiny size and commensurate illiquidity, the stock was on the verge of being delisted. Hyundai Mobis, the issuer, was under no obligation to do anything. Management could have declined to tender, or it could have tendered at no premium to the quoted market price. Instead, it tendered at a 17.8% premium. Granted, Hyundai Mobis is a small company, and its tender offer can be seen as an isolated event. Then, again, it may prove to be a value-enhancing precedent for the population of preferred holders."

Which brings us back to the Weiss Korea Opportunity Fund. A bantamweight with net assets of £111.0 million, the fund is quoted at 116.75 pence per share, representing the previously cited 10.4% premium to the latest calculated NAV. Given that the preferreds in the fund's portfolio change hands at a 53.3% discount to the relevant common, one can see that the net premium to NAV must be something on the order of 42.9%. "On the order of" is a necessary qualifier, as 10% of the fund is temporarily parked in the iShares MSCI South Korea Capped ETF, which owns common stock. (The fund bought the ETF as a placeholder; as it finds preferreds to buy, it peels off the corresponding dollar value of common.)

Spot the outline
median premium (discount) of preferred shares

	2000*	2013 ytd.**
Germany	-8.0%	-4.0%
Russia	-56.0	-11.0
Italy	-20.0	9.0
Korea	-45.0	-55.0

*as of Dec. 31, 2000
**as of Nov. 30, 2013
source: The Bloomberg

As of Oct. 31, the preferreds in the Weiss portfolio yielded 1.6%, compared to a dividend yield for the overall Korean market of 1.18%; they traded at a 12-month trailing price-earnings ratio of 5.2 times, compared to an estimated 2013 P/E ratio for the overall market of 10.5 times. (Korea's stock market is now, as it often has been, one of Asia's cheapest). Samsung Electronics preferred, at 14% of NAV, is the top holding in the Weiss fund; runners-up are a trio of Hyundai issues in the aggregate sum of 27% of NAV.

"To date," Peligal observes, "investors have piled into the largest and most liquid preferred issues. And it's those issues in which discounts to the associated common have narrowed most. For example, the Samsung issue is trading at *only* a 30% discount to its common."

The Korea preferred awakening story has yet to reach the smaller preferred issues—"like, for instance, the ones we own, e.g., Amorepacific and LG Household and Healthcare," Boris Zhilin, cofounder and principal of Armor Capital, tells Peligal. "If you look at LG Household as an example, its current discount to common is about 60%, which, while lower than the 70% mark prevalent at the beginning of the year, is still quite substantial. We've been holders of both of the above issues for over seven years now, as we think that both companies are well run and have a bright future over the next five, 10 years. The management teams here actually care about things like return on capital and maximizing value, and generally think in a fashion that we find much more rati-onal than would be the case for a typical Korean company.

"More broadly, though," Zhilin goes on, "our investment thesis is not about the magnitude of the preferred-to-common discount per se. What's most important to us is the ability to own an economic claim on these companies' earnings and dividends at low absolute valuations, coupled with the fact that we think their intrinsic value is compounding at an attractive rate—say, north of 10%. If you look at LG Household preferreds, based on our estimate, they are trading at about 9.5 times 2014 estimated earnings, while those of Amorepacific, if you give them credit for some of their excess cash, are trading at roughly 8.5 times the '14 estimate."

Maybe the discount of the preferred to the common isn't the point, but that disparity has narrowed in countries that don't border on North Korea. You can see it over the sweep of the past 13 years. Thus, according to Bloomberg, at Dec. 31, 2000, median discounts of preferred shares (or, in Italy's case, "savings shares") to the associated common shares amounted to 8% in Germany, 20% in Italy, 56% in Russia and 45% in South Korea. Jump ahead now to Nov. 30, 2013. Italy trades at a 9% premium. Discounts still prevail in Germany (4%), Russia (11%)—and, of course, South Korea (55%). The problem isn't Kim Jong-un and his starving communist cadres so much as it is the legacy of South Korean corporate self-dealing, the bulls reasonably contend. As governance improves, they and we expect, so will the Korean discounts close.

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