GRANT'S
INTEREST RATE OBSERVER®
Vol. 42, No. 4d 233 Broadway, New York, New York 10279 • www.grantspub.com MARCH 1, 2024

Discount to a discount

Evan Lorenz writes:

Last week's new post-bubble high in the Nikkei 225 was the fruit, not least, of a decade's worth of improvements in the governance and profitability of Japan's public companies.

Of course, there are few things more grating than watching a neighbor get rich. Not to be outdone by its neighbor and one-time overlord, South Korea is pushing forward its own equity-improvement program (*Grant's*, Sept. 29, 2023). In preview, we are bullish on Samsung C&T Corp. (028260 on the Korea Exchange), which comes with complexities and a gothic story line, and The Korea Fund, Inc. (KF on the New York Stock Exchange), which has neither.

On average, Korean stocks change hands at book value and 10.9 times estimated 2024 earnings. Compare Japan, at 1.6 times book and 22.9 times forward earnings, or the United States, at 4.6 times book and 20.9 times the 2024 guesstimate. Peer into the Korean Composite Stock Price Index, and you will find that 67% of its constituents trade below book value versus 37% of the Nikkei's and 3% of the S&P 500's.

Korea has its problems, and some of them are even more immediate than the perpetual irritation of sharing a border with the "little rocket man," Kim Jong Un. For one, Korean households are heavily in debt, with borrowings equal to 164% of income versus a ratio of debt to income of 97% for Americans. For another, so high is the average price of a condo in the capital city of Seoul—the equivalent of 15.2 times the average annual Korean household income—that few middle-class citizens can find a place on the wealth-building real estate escalator. For a third, Korea's National Pension Service, the world's third-largest retirement fund, faces insolvency by 2055.

Well aware of these facts, the government has surely listened to the local bean counters, who reckon that a 100 basis-point improvement in annual returns could extend the fund's life by a decade. To make that happen—and close the so-called Korean discount—the government on Monday fleshed out some of the details of its "Corporate Value Up Program."

There's been plenty of action along these lines already. Last fall, President Yoon Suk Yeol abolished an onerous foreign registration system, liberalized the foreign exchange market (with changes taking effect this year) and cajoled Korean companies to file their reports in English (with big companies required to comply in 2024 and smaller ones by 2026).

At the turn of the year, the threshold for the capital-gains tax was raised and a financial investment tax was designated for abolition. Rules were issued to improve the economic returns to shareholders from corporate stock repurchases.

On this last point: The problem is not that Korean companies refuse to repurchase their own cheap shares, but that, having bought them, they tend not to cancel them. So it often happens that, post-buyback, the share count, along with per share financial metrics, remain unchanged. Functionally, it's as if the buyback exercise had never happened.

The government says it wants better disclosure and an end to the use of stockpiled treasury shares to protect the control position of majority holders during a corporate spinoff.

It did not escape Korea's attention last year when the Tokyo Stock Exchange named and shamed the companies whose equities were quoted at prices below book value. Two-fifths of a portion of that stigmatized cohort (the companies listed on the TSE's prime section) duly submitted plans for improvement, and buyback announcements hit a record high, according to Bloomberg. Never mind that Japan's GDP contracted in both the third and fourth quarters of 2023; Japanese companies nonetheless reported a 46% jump in profits, measured year over year, in the fourth quarter. (For more on Japan's efforts on corporate reform, see the issues of *Grant's* dated Feb. 7, 2020, Jan. 22, 2021 and May 28, 2021.)

Monday brought new details on Corporate Value Up—not enough details, some investors complained, and not enough coercive teeth to enforce them, groused others. Still, there will be tax incentives for companies that prioritize shareholder returns and a new index of "best-practicing companies," Bloomberg reports, with new "exchange-traded funds to track the index."

Anyway, a boom in corporate activism is already under way. Gadfly funds demanded that 77 companies improve governance and shareholder returns last year, up from 10 such interventions in 2020; in 2023, Korea was the world's third-largest market for activism.

Meanwhile, a Korean ban on short-selling, imposed in November and slated to run through June 30, may not

What good governance gets you

source: The Bloomberg

be so serious (or incongruous) a blow to the cause of free and fair markets as it appears. It helps to recall that Koreans, not unlike other people in other countries, enjoy a punt on tech stocks. In 2022, the number of registered retail accounts rose to 14.2 million, or 27.6% of the population, not far from the 15.4 million Koreans who own their own home. Investors thus constitute a key voting constituency.

Last year, small traders led the charge that tripled, in seven short months, the share prices of a collection of electric-vehicle suppliers. Unfortunately, a worldwide overabundance of EVs led to a price war among auto manufacturers and an 82% collapse in the price of lithium carbonate since Dec. 31, 2022 (*Grant's*, April 7, 2023).

"The negative developments in the EV space since August," Daniel Perez, head of business development at Korea-focused ANDA Asset Management, Ltd., advised his investors at year end, "led hedge funds to build sizable short positions in several EV stocks and retail investors incurred significant losses as share prices underwent a seismic correction.... Many perceive the [ban] as political, an attempt to appease retail investors ahead of the upcoming midterm elections in April 2024."

MSCI, Inc., keeper of the developed-market equity indices that Korea yearns to enter, is another constituency to placate, and it's hard to imagine that the kibosh on short-selling will help Korea's drive for inclusion. Then, again, no imminent decision on Korea's status is likely. As Perez points out: "If Korea gets on the watchlist [for index inclusion], it usually takes two years for reclassification. As the government's timeline for policy changes occur mostly in late 2024, Korea could be placed on the watchlist in 2025 and then move from MSCI EM to DM in 2027." Meantime, the short-sale prohibition gives the government a boost ahead of the April 10 election.

There's much more room for market-friendly innovation. For example, the top marginal tax rate on inheritance, at 60%, is a standing invitation to drama and skullduggery in the contests to maintain family control when one generation of ownership makes way for the next. Nor does it help that, in Korea, directors have a fiduciary duty to a company but not its shareholders.

. . .

Samsung C&T, founded in 1938, is the entity that Lee Jae-yong and family use to control the larger Samsung group of companies. It has contributed more than any other publicly traded Korean company to the Korea discount.

While not so famous as Samsung Electronics Co., Ltd., the mobile-phone and semiconductor giant, C&T was the first company in what later became the Samsung chaebol. C&T, which stands for "construction and trading," started with a concentration in steel, chemicals, energy and other industrial commodities. The "C" portion of the nameplate was front and center on Jan. 17, 2009, the topping-out day for Burj Khalifa, the world's tallest building. Samsung C&T was the main contractor on the 2,722-foot colossus.

In 2014, Lee Kun-hee, former chairman of the Samsung group and father of Jae-yong, suffered a major heart attack and fell into a coma. This created two problems for the Lee clan. First, Kun-hee's death would trigger a monstrous tax liability ($10.78 billion, the largest inheritance tax in the world, was duly levied following his death in 2020). Second, with Kun-hee out of the picture, how would the Lee family, which owned a scant 4.7% of Samsung Electronics directly, maintain control of this most important company?

The answer was C&T, which held a 4% stake in Samsung Electronics. The rub was that the Lee family and various Samsung affiliates controlled only 19% of C&T's shares. To cement their ownership of C&T, the Lees decided to merge the company with Cheil Industries, Inc., which was 79.5% controlled by the family and its affiliates.

Elliott Associates, LP, which held 7.1% of the target company in 2015, protested that the proposed all-stock merger substantially undervalued C&T. The Lees won the ensuing acrimonious fight with a little help from the Korean government and hometown support from the Korean press, which painted Paul Singer, president of Elliott Management Corp., as a kind of foreign pirate. What sort of assistance the government tendered can be inferred from the 2016 impeachment and subsequent jailing of the then–sitting Korean president, Park Geun-hye (2013–17), on grounds of corruption and abuse of power.

Last year, Elliott won a $108.5 million settlement against the Korean government at the Permanent Court of Arbitration in the Hague, Netherlands, for the regime's connivance in forcing the merger. Meanwhile, last month in Seoul, Lee was cleared of accounting-fraud and stock-manipulation charges.

Which tortured history is preface to the C&T value proposition. At a glance, the company resembles a giant bowl of spaghetti. It holds a 5% stake in Samsung Electronics, 43.1% of Samsung Biologics Co., Ltd., 17.1% of Samsung SDS Co., Ltd., 21.5% of Samsung Life Insurance Co., Ltd. and 7% of Samsung Engineering Co., Ltd. For a sense of scale, the electronics holding is worth $16.3 billion and the biologics position $18.6 billion, against which might be noted C&T's current market capitalization of $20.5 billion.

There are five operating divisions: engineering and construction (58% of 2023 operating profit), trading and investment (20%), fashion (11%; brands like Beanpole and 8seconds), food and beverage (7%; a catering business) and leisure (4%; five golf courses and the Everland Resort theme parks).

It must be Korean history, rather than any known theory of capital allocation, that justifies the assembly of these oddly assorted parts under one corporate roof. Yet C&T has generated enviable results. Since 2019, operating profits in C&T's wholly owned businesses have grown by 117%. "This is a company that, since the 2015 merger closed, has doubled its net asset value," James Smith, founder of Palliser Capital Ltd. and an investor in C&T, tells me. "So the intrinsic value has been growing now at an approximately 11% compound annual growth rate."

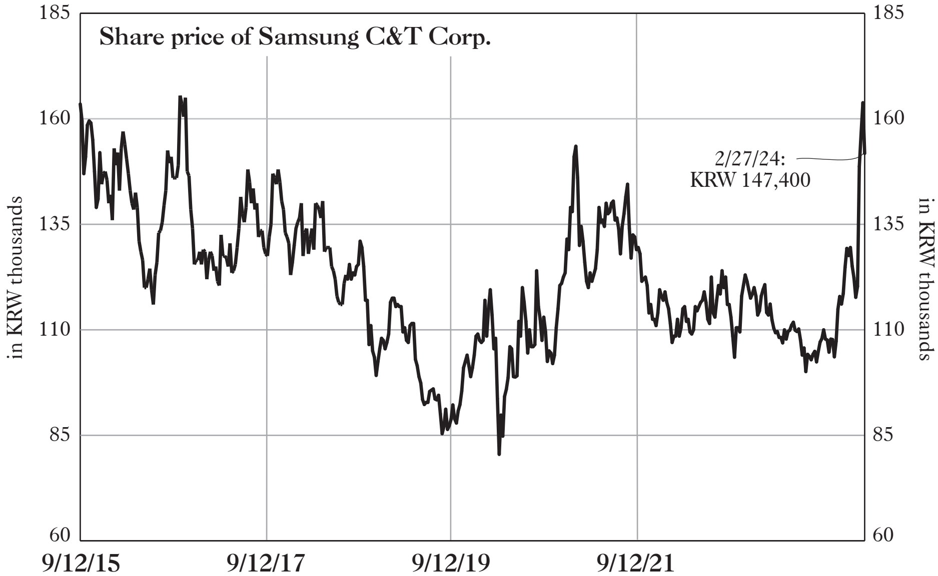
There's not much to complain about in C&T's balance sheet, which, as of Dec. 31, 2023, showed a net debt balance of 2 trillion won ($1.5 billion) versus trailing Ebitda of 3.6 trillion won. By the lights of the rating agencies, C&T is a solidly investment-grade A2/single-A-minus credit.

However, until a group of activists targeted the company late last year, C&T's public investors profited little from these many points of excellence. In fact, from Sept. 15, 2015, when the merger with Cheil closed, through Nov. 6, 2023, the share price, in dollar terms, dropped by 30% (including reinvested dividends), which translated into a 67% discount to net asset value. As the merger was completed, the share price represented a 10% premium to NAV.

What happened on Nov. 6 was the publication of a letter to the company by the activist investor City of London Investment Management Co., Ltd. (CLIM). The missive urged an increase in the annual dividend, to 4,500 won per share from 2,300 won in 2022, and the repurchase of 500 billion won's worth of stock ($376 million). Since CLIM said its piece, C&T's share price has rallied by 33.4% in dollar terms. Even so, the valuation languishes at a deep discount to NAV—56% as of Monday.

On Feb. 2, CLIM, joined by Whitebox Advisors, LLC and ANDA, submitted proposals for Samsung's annual general meeting on March 14. C&T, still fending off its constructive critics, has objected that "investing in long-term growth is more important than focusing on short-term share price boosts." Management says that it will begrudge a slight increase to its dividend, to 2,550 won per share, along with a substantial bump in capital expenditures. Perhaps the capex is intended to fund the exit of the discouraged activists; the company isn't saying.

Just the start?



source: The Bloomberg

Given the chaebol's immensity (the revenues of Samsung-affiliated companies make up over one-fifth of Korean GDP, and the conglomerate accounts for more than 30% of Korea's market cap), not many people are prepared to criticize it. Those close to CLIM and Whitebox tell *Grant's* that the activists expect to lose the March vote. The Lee family directly holds 36% of C&T's shares and, including affiliated companies and funds, controls around half of shares outstanding.

However, Samsung's reputation would take a hit if a large portion of its minority shareholders voted against the company, especially since what the foreign activists are asking for aligns with the Korean government's Value Up initiative. As a result, sources we spoke to expect C&T to announce an additional dividend hike, or buyback, later this year.

Recent precedent provides some reason for optimism. Three years ago, Whitebox had opposed an LG Corp. proposal to spin off certain corporate assets into a separately traded company. While the activist did not win that vote, LG later enacted a share-repurchase program to appease minority shareholders later in 2021.

According to CLSA Ltd. analyst Steve Chung, who rates C&T a buy, Korean conglomerates have traded at an average discount of 42% to the sum of their parts since 2015, a period that encompasses an era of premiums to NAV (2015–16) as well as one of discounts approaching 70% (2022–23).

Though the bulls to whom we spoke do not expect C&T to trade up to its net asset value, even a shrinkage in the discount to 42% from the current 56% would deliver a 32% increase in C&T's share price. Besides, prospective investors in C&T stand to benefit from continued value growth in the company's stakes in other Samsung entities as well as strong performance in its wholly owned businesses.

Buying a Korean conglomerate at less than its theoretical liquidation value is a way to get the Korean discount at a discount. Samsung Electronics, C&T's second-biggest portfolio holding by value, trades at 16.2 times estimated 2024 earnings versus Apple, Inc.'s 27.7 times forward multiple. "Samsung trades at 1.2 times book value," Simon Waxley, the head of equity arbitrage at Whitebox, reminds me. "Try and find a healthy and thriving semiconductor or consumer-electronics company in the U.S. that makes mobile phones and trades with a one-handle on their price-to-book value. I think you will struggle."

. . .

Or would you prefer a discount to the discount without the corporate governance intrigue? The Korea Fund is a U.S.-listed closed-end mutual fund with $136.9 million in assets under management. Top holdings, as of year end, included Samsung Electronics (19.5% of assets), SK hynix, Inc. (9.3%), Samsung Electronics preferreds (5.6%), LG Chem Ltd. (4.8%) and Naver Corp. (4.2%). By sector, the biggest exposures were to information technology (39.8% of assets), materials (13%), consumer discretionary (10.7%) and financials (10.4%).

The fund trades at book value and 9.2 times forward earnings, though investors in KF acquire those securities at even lower effective valuations as The Korea Fund itself trades at a 16.6% discount to net assets.

True, KF charges a high expense ratio (1.46% of assets), but the fund has beat its bogey, the MSCI Korea 25/50 Index, which tracks large- and mid-cap stocks, by 52 basis points per year over the past decade. Even so, such is Korea's long-term underperformance that the MSCI index has put up only a 2.7% compound annual return in dollar terms over the past 10 years.

Pay no attention to the long-term graph of the share price that's posted on Bloomberg and Google. The shocking 90%-plus plunge depicted from late 2007 through 2008 was no such thing, but rather the mirage of an overlooked 1-for-10 reverse stock split. It says something about the marginalization of Korean investments that nobody but *Grant's* has noticed.

•