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Emerging Markets Spotlight

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"KOSPI-listed Firms' Dividend Surpasses 3 Trillion Won in First Half"

Business Korea, 4 October 2017.

We have been overweight Korean equities since the end of 2012, finding the combination of strong corporate growth, attractive valuations and corporate governance reform an attractive proposition. The portfolio has benefited from this position, both through a modest positive performance contribution from the country allocation, and a very substantial contribution from stock selection in Korea.

Our view has been focused on Korean exporters (that also meet our valuation and corporate governance requirements), but that view is changing. At the end of 2016 Korea saw a major corruption scandal that led to mass protests, the impeachment of then President Park Geun-hye and an election in May 2017. That election returned a more liberal/left-wing administration under President Moon Jae-in, and is a significant contributor to our widened area of opportunity in the Korean equity market.

The stand-out feature of Korean equities is how cheap they are. On an industry-neutral basis, the cheapest markets (on a price/earnings basis) in the emerging world are Russia, Greece, Pakistan and Korea. Three of those face serious economic and/or political challenges; Korea does not. Korean equities are cheap because those earnings do not translate into dividends. Corporate Korea has the lowest payout ratio of any major market in the world, because a lack of effective oversight allows company managers to simply hold cash back from shareholders.

To put some numbers on this, in 2016 the non-financial companies in MSCI Korea paid out KRW 15.7trn (USD 13.5bn at 2016 exchange rate) in dividends on an earnings base of KRW 71.5trn, a 22% pay-out ratio. Those dividends look even less generous when one considers that those companies generated KRW 143.2trn in cash-flow from operations and had a capital expenditure of KRW 95.6trn. The resultant KRW 47.6trn in free cashflow is potentially entirely available to payout as dividends, which would increase the dividend yield on non-financial MSCI Korea from the current 1.4% to 5.0%. Five-year government bond yields in Korea are 2.0% for comparison.

Incredibly, there can and should be more. The net debt/equity of these companies is 10%, making Korea one of the least-levered markets in the world. The emerging market average for non-financial companies is 27.8%, implying that a further KRW 167.6trn of dividends (representing 17.8% of market capitalisation) could also be paid out through more efficient capital management.

The behaviour of corporate Korea and the related lack of dividends has become an increasing issue in Korean politics, as an ageing population needs income from its investments. We feel that both the Korean public's response to the corruption scandal, and the resulting election of a left-wing administration, will put huge pressure on Korean companies to reform, and that this will be the catalyst to unlock much of the hidden value in the Korean equity market.

Crucially, though, and in line with our investment process, we feel that this creates opportunities within Korea rather than making a case to own every stock in the market. Firstly, financial companies have been excluded from this calculation as this is not a useful analysis. Secondly, Korea does contain a few horribly over-leveraged businesses (Korean Air Lines, for example, has a debt/equity ratio of 780% and net debt/equity of 5.1x). As always in emerging markets, it pays to be selective.