COMGEST

Oct
31
2017
South Korea

A Postcard From

Comgest's Global Emerging Markets team

South Korea – the emerged emerging market

In recent weeks, the Comgest investment team travelled to South Korea, an "emerging country, largely emerged". With a population of 50 million people, World Bank statistics show Korea's GDP per capita of $25,000 in 2016 ($36,000 on PPP), not far below Spain at $31,000 and above other EU members including Greece, Portugal, the Czech Republic and Poland. In absolute terms, at $ 1.4 trillion, this is the world's 11th largest economy – no mean feat for a place that was completely devastated after the horrific civil war that ended in an armistice in July 1953 following an estimated 6 million casualties. At this time, South Korea was amongst the poorest countries in the world with GDP per capita of $67 and an average life expectancy of just 50 years (today it's 82).

A programme of rapid industrialisation centred on exports of manufactured goods was launched in 1961 by the regime of General (and eventually President) Park Chung-hee. This programme used 5-year central development plans and favoured private national corporate champions that could obtain cheap credit from banks – private in name but heavily subject to policy influence – that channelled the population's rising savings. This saw South Korea improve its economic standing in record speed not least due to the remarkable work ethic and dedication of its well-educated, Confucian (and highly aspirational) population which after the short, but devastating war, was willing to make general sacrifices for a greater common good. After a string of strong-men led the country under effective dictatorship, the first freely elected president - Roh Tae-woo - took his seat in 1987 and the country hosted the Seoul Olympic Games in 1988. In 1996 OECD membership was obtained by which time GDP per Capita exceeded $10,000, a remarkable achievement by any standards.

However by 1997, the rather unbalanced development model had reached its limits and Korea had to invite the IMF to help it draw up an economic reorganisation on 24th December. The country saw queues of normal people lining up to donate their jewellery and other personal savings to "save the country" as a crisis unfolded from the sprawling growth fuelled by excessive leverage and led by the aforementioned corporate champions which, by now, were unwieldy conglomerates known as chaebols.

(As an aside, but relevant to today's social mood, while normal people were donating their "gold teeth", the ruling class had handily moved their liquid assets into hard currencies before the Korean won devalued by 50%). Out of the top 30 chaebols, 16 went bankrupt: Those who had thoughtlessly diversified their businesses collapsed and brought down the entire banking system with them in the process.

The involvement of the IMF came with strict requirements for deregulation and broad economic reform, and the country again showed itself able to adapt and improve through rapid structural change bringing along a substantial improvement in competitiveness, better solidity of the financial system and a step-up change in focus on product quality by corporates. The result was that Korea managed to recover almost all of the 44% USD decline recorded in the economy during the 4th quarter of 1997 over just 11 subsequent quarters, a noteworthy achievement by any comparison (Spain's economy today remains ~20% below where it was in USD-terms in 2008, for example). The reforms put in place after the Asian crisis (referred to in Korea as the IMF crisis), equally helped the country continuously grow in the subsequent decade and ensured relatively less disruption from the global financial crisis of 2008.

However, after many quite good years perhaps a degree of complacency and hubris set in, gnawing away in the background and culminating by 2016 in what we consider one of the most remarkable and extensive episodes of institutional manipulation and constitutional scandal. President Park (daughter of the aforementioned "father of modern-day Korea", General Park) was impeached and eventually arrested and charged with bribery, coercion to avoid justice and embezzlement. This denotes a general revolt against a system where the relationship between business and politics, which had always been close, had become corrupt and unacceptable to a society under increasing strain due to rising inequality. Along with Ms Park - whose case is still pending - several ministers, the head of the national pension system and leaders of some of the largest chaebols have also been implicated, the highest profile suspect being the head of Samsung, Lee Jae-yong, for whom the prosecutor has demanded a 12-year jail sentence. [Note: the Samsung heir was found guilty and sentenced to 5 years in jail. He is held in jail while an appeal is pending].

As implied, the above-mentioned events were the culmination of a broader populist movement by a middle class squeezed by big business and their small group of beneficiaries and an increasingly mature economy threatened by a rapidly rising China. In fact today, in line with many developed countries, Korea also has an ageing population, high household indebtedness and record low interest rates. Youth unemployment is high despite the country regularly topping the OECD education rankings as the best in the world. On the bright side it has some of the world's fastest data speed and levels of internet connectivity in the world, while the ownership of cars (many of which are increasingly of a flash German variety) and apartments is comparable to the rest of the OECD. At the same time, we are conscious that Korea remains more cyclical and vulnerable

Traditional temple and modern radio communication on top of Namsan Mountain in Seoul

What a bus-stop looks like in a "hip" and not so emerging economy…

than many developed economies due to the large proportion of exports (still >100% of GDP), a highly concentrated corporate sector (revenue of the top 5 chaebols in 2015 were equivalent to 47% of GDP) and its location in an "uncertain neighbourhood".

All that being said, recent events suggest that the country, having undergone several remarkable transformations over the past 60 years, is now again attempting significant change to improve the level of governance.

In the general election subsequent to Ms Park's impeachment, the population handed Moon Jae-in a decisive mandate for change. Mr Moon, a previous elite soldier and labour rights lawyer, had run on a ticket promising a "cleaner, more transparent and fairer society". He has kicked off his term with a commitment to continue the anti-corruption drive but also with a host of new policies designed to follow-through on his promises including an increase in minimum wages and corporate taxes. This will have both positive and negative implications on the Korean economy and financial markets. Broadly speaking, the strategic intention is to defuse social tension over inequality and ensure Korea makes the full leap towards developed market status by de-emphasising the power of big business and the top 1% earners while encouraging a "human-focused economy" that is "income-led".

In our view, this will have a mixed impact on aggregate corporate performance in the short run (there will be winners and losers) but should be net-net beneficial to Korea's long-term economic prospects as it will widen out the wealth-creation base and create the social environment to support and encourage intellectual progress –desperately needed if Korea is to stay ahead of an ambitious China (it can only compete with China on efficiency and innovation; scale and costs are not plausible factors).

Initiatives by the Moon administration include:

- Introduction of a new Commercial law, Fair Trade act and an Insurance Business Act to reinforce the legal framework for better governance
- Structural reform of chaebols: limiting cross-ownership, enhancing the right of minorities through a cumulative voting system, limiting the use of treasury shares for control purposes and reducing the ability to form links between financial and non-financial entities.
- A new stewardship code: Based on the UK equivalent and in discussion for some time, the Moon administration is pushing for a faster and stricter implementation with clear implications for domestic fund managers including the National Pension System (NPS) and Korea Investment Corporation (the sovereign wealth fund).
- National Pension System reform; the NPS is Korea's largest investor in equities and has been a rather timid/passive entity in the past despite often owning more than 10% of many companies, including leading chaebol entities. The previous head was indicted for abuse of power and perjury and was sentenced to 2 years in prison.
- Raising minimum wages (2017 increase +16% yoy, current inflation level is 2.2%). A short-term negative for big employers which will obviously face higher costs, the quid pro quo is that this move could help to support consumption which has been relatively depressed in recent years.
- Rising corporate tax rate for big corporates; effectively rolling back cuts under the previous 2 governments which took the rate from 25% to 22%. The suggestion is to take it back to 25% for companies with revenues above KRW 200bn.
- Rising income tax for high earners with the top marginal rate going up by 2% to a maximum of 46.2%.

Beyond these points however, we consider that the net effect on Korean asset valuations from a more transparent governance system, including higher requirements of its corporate citizens, should be positive.

Taking a step back, it is fair to say that the Korean stock market – despite the good depth and breadth of different industries and business models – has long been a challenging destination for the Comgest Quality Growth stock picking philosophy, mostly on account of low returns and poor corporate governance. At the same time, the country has been the (coincidental) home to some of our most successful individual picks over time including Shinsegae, the retailer (held from December 2000 to November 2011), Naver – Korea's Google (previously NHN, from July 2010 to July 2014), Medytox – a leading producer of Botox (July 2014 to June 2015) and more recently, NCSoft – a computer games developer – whose shares we bought in 2016. These companies shared a strong innovative spirit, strong balance sheets and efficient operational management while also treating all stakeholders equally.

Today, given the above-mentioned social and political changes, there is stronger evidence than at any other time in the past three decades that corporate governance standards are improving and wrong-doers are held responsible. The impact on returns is predictively positive – improving (sometimes from a low base) due to healthier capital structures and more selective corporate investment actions – and as stock pickers, we are excited by the opportunities that Korea can now offer.

Operationally, Korea has long offered some fairly strong signs of excellence; companies such as Hyundai, Samsung and others have managed to substantially improve their product quality since the 1997 Asian crisis resulting in their rise to global brand status sitting at the top of their respective industries. Moreover, the Bloomberg Innovation index has ranked the country '1st' for 5 straight years based on a balanced assessment of 6 aspects: R&D, Manufacturing, Hi-Tech Companies, Education, Research personnel and Patents.

The results are evident in the highly visible brands in technology and automobiles but also increasingly in the medical and biopharma industries as well as fast moving consumer goods and popular culture.

It is also noteworthy that a "Korean wave" of popular culture – K-pop, cosmetic brands, computer games and dramas – has swept through Asia and beyond in recent years.

The breadth and depth of the Korean stock market make it highly interesting. Although building conviction in individual stocks has often proven challenging for us due to Korea's economic structure that results from a dramatic history and a typically less-than-friendly attitude towards minority shareholders, this seems to be changing fast as the Koreans once again set out to adapt.

Notes from the road: South Korea

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Bloomberg 2017 innovation index

2017 rank	2016 rank	YoY change	Economy	Total score	R&D intensity	Manufacturing value-added	Productivity	High-tech density	Tertiary efficiency	Researcher concentration	Patent activity
1	1	0	S. Korea	89.00	1	1	32	4	2	4	1
2	3	+1	Sweden	83.98	5	11	15	7	18	5	6
3	2	-1	Germany	83.92	9	3	16	5	12	16	9
4	5	+1	Switzerland	83.64	8	6	2	11	16	14	4
5	7	+2	Finland	83.26	4	13	20	15	5	3	5
6	6	0	Singapore	83.22	14	5	12	17	1	6	12
7	4	-3	Japan	82.64	3	9	28	8	27	9	3
8	9	+1	Denmark	81.93	6	17	5	13	22	2	11
9	8	-1	U.S.	81.44	10	22	10	1	34	20	2
10	11	+1	Israel	81.23	2	30	30	3	20	1	18
11	10	-1	France	80.99	12	34	18	2	10	18	10
12	13	+1	Austria	80.46	7	7	11	23	6	10	17
13	16	+3	Belgium	77.18	11	21	9	10	19	19	25
14	14	0	Norway	76.89	19	36	3	12	25	8	15
15	18	+3	Netherlands	75.23	17	24	19	6	44	15	19
16	15	-1	Ireland	74.94	22	2	6	16	13	22	31
17	17	0	U.K.	74.52	20	38	21	14	7	17	14
18	20	+2	Australia	73.33	13	44	1	20	21	12	21

Source: Bloomberg

Company comments

Our company visits during this trip covered a wide range of sectors, notably Korea's Spotify (a music streaming business), life insurance companies, a multinational snack manufacturer, several computer games developers, different retailers, an advertisement agency, pharmaceutical businesses and even a low-cost carrier. It was, in other words, a *tour de force* displaying the above-mentioned breadth and depth of this market. Below, we discuss a few of these companies in light detail to give a taste of the intensive research effort undertaken here at Comgest.

Being a highly connected country, where online sales already represent more than 20% of total retail sales, it is no surprise that Korea has many sophisticated internet-based companies. Amongst these is **Loen Entertainment**, that we see as a way to invest in the strong popularity of Korean popular culture. The company provides an online music service – Melon – and is differentiated from global peers such as Apple Music and Spotify by being vertically integrated; it has a label and artist management. Amongst these artists are names such IU, A Pink and SISTAR, all of which have sold millions of records. It differs also, of course, by virtue of being profitable. Today Melon has close to a third of the Korean online music market and continues to build on this thanks to its high quality local content and unique algorithms that tailor the music to user taste.

Loen Entertainment
www.iloen.com

Notes from the road: South Korea

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HANSSEM

As Koreans grew wealthier, home ownership rose. This was principally based upon the building of new apartment blocks in the major cities, especially Seoul. **Hanssem** supplied the kitchens to these apartments, from a domestic manufacturing base and of a quality that created a strong brand recognition and customer loyalty in a market where little formal competition existed. Consequently, it today has 85% market share in the segment. However, with less need for new homes market dynamics are changing and the company has adapted. In the past decade it expanded into more product lines including bathrooms and furniture. The next phase of growth will be fuelled by a two-pronged plan: Firstly, they seek to disrupt the fragmented (and cowboy-like) market for home improvements typically handled by "man in a van" individual contractors by introducing guaranteed, corporatised all-in-one home redecoration services. The market potential is large and the ability to leverage off its current contractor network and product supply obvious. Secondly, Hanssem is dipping a toe cautiously into China which is deemed to be 10-20 years behind Korea as far as market evolution is concerned. Of course the dynamics there are very different and the risks greater, but equally the potential rewards could be very large. For now, a distribution centre and a flagship store has been opened in Shanghai.

A company displaying the benefits of getting China right is **Orion**, the snack producer. The company first entered China more than 15 years ago and discovered that Chinese consumers liked their core offering, the choco pie (a Korean household stable equivalent to Hershey in the US, Cadburys in the UK and maybe LU biscuits in France). They gradually localised and grew the business focusing on the modern retail channel, which was in contrast to its biggest local competitors such as Want Want or Tingyi. Tremendous growth followed and today it is the second largest player in its segment, enjoying revenue of more than $1bn in 2016. In the short term it faces two principle challenges; firstly, the political spat between South Korea and China around the installation of the THADD anti-missile defensive systems have been targeting Korean businesses in China and Orion is amongst these. This is expected to pass but timing is uncertain. Secondly, Chinese taste is evolving. The need for product innovation and evolution has taken a significant step up; Orion had an unchanged product offering for the first 14 years it operated in China and still experienced fast growth. That all changed in the last few years with demand for things that are of better quality and different becoming very clear. Fortunately, the company can draw on its large arsenal of experience and products from Korea (which went through the same phase) and it will be introducing a large wave of new, premium products over the coming 12-24 months.

The life insurance industry in Korea is really a case of "haves" and "have-nots". Being a business where capital and scale are key barriers to entry, a large number of players are constrained by their undercapitalisation – particularly in light of tightening regulations which will be gradually implemented over the coming 4 years. Against this backdrop, **Samsung Life** stands out due to its dominant market share (of approximately 22-25% overall, but closer to 30% in high-value added protection products) and its well above industry-level of capital. Of course, the penetration of life insurance in Korea isn't as low as in other poorer emerging markets, yet there is still room to grow by providing products tailored for an aging population and in Samsung Life's case, from taking market share. The company is also interesting because it appears centrally positioned amidst the torrent of improving governance trends discussed earlier in this letter. With 10% of shares held in treasury, the potential for a capital reduction exercise seems greater than ever. As the largest direct holder of Samsung Electronics, its ownership in that company amounts to almost its own entire market capitalisation. As scrutiny around cross-ownership, equal treatment of all shareholders and transparency intensify, it would not be surprising to see Samsung Life, which is already a strongly communicating company with a defined sustainability policy, take further steps to create long-term value to all stakeholders.

Finally a word on the computer gaming industry, one where Korea has for some time held a unique competitive position. Gaming forms another tangent of the Korean wave of popular culture which has gained increasing recognition across Asia as well as incrementally in the west. Our interest here is concrete through the investment we have in **NCSoft** but extends to other names in the industry also. Our research efforts started with company meetings revealing a dynamic, fast growing but also highly competitive market place where barriers to entry are rising around the need to have scale in terms of development resource and marketing reach but also due to greater regulatory scrutiny. It is increasingly turning into a two-tier market with only **Netmarble** (of which NCSoft owns a part), Nexon and NCsoft occupying the tier one versus a second tier occupied by a host of medium- and smaller-sized companies, including names such as Com2Us and Gamevil. The former can take a portfolio approach to developing new products and leverage off brand recognition and marketing strength to support existing and promote new products. They also have the financial strength to more consistently pursue bolt-on acquisitions all of which mean the revenue and profit distribution is much less "accidental" or lumpy than the smaller players who will effectively live or die depending on their ability to make any individual game a hit. The market is expanding, partly thanks to the development of high-powered, large screen mobiles enabling better games "on the go" (i.e. freeing up more time to play) but also due to changing social and cultural acceptability of gaming as a mainstream past time. Increasingly people of both sexes and all ages are playing games, watching other people play games (via platforms such as YouTube or Twitch) and competing in games (e-sports). The Korean companies are enjoying the benefit of this at home with two recent games that have pulverised previous grossing records easily but they are also looking to improve their profile abroad where success was historically more mixed (although for NCSoft, this was an area of particular strength). Here the emphasis is naturally on the large existing markets of China, US, Japan and Europe with their high quality content and the general trend towards mobile providing a welcome opportunity to grow.

NCSoft Headquarters in Seoul

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Sources: Factset (index data, Comgest portfolio data and stock financial ratios), Bloomberg (company and market data) and Comgest calculations (e.g. long-term EPS growth) – portfolio data as of 31 August 2017. Company data based on latest available company reports (FY2016 when available) and company publications.

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