Letter From Korea

Part of the series from our GEM Equities team

Standard Life Investments

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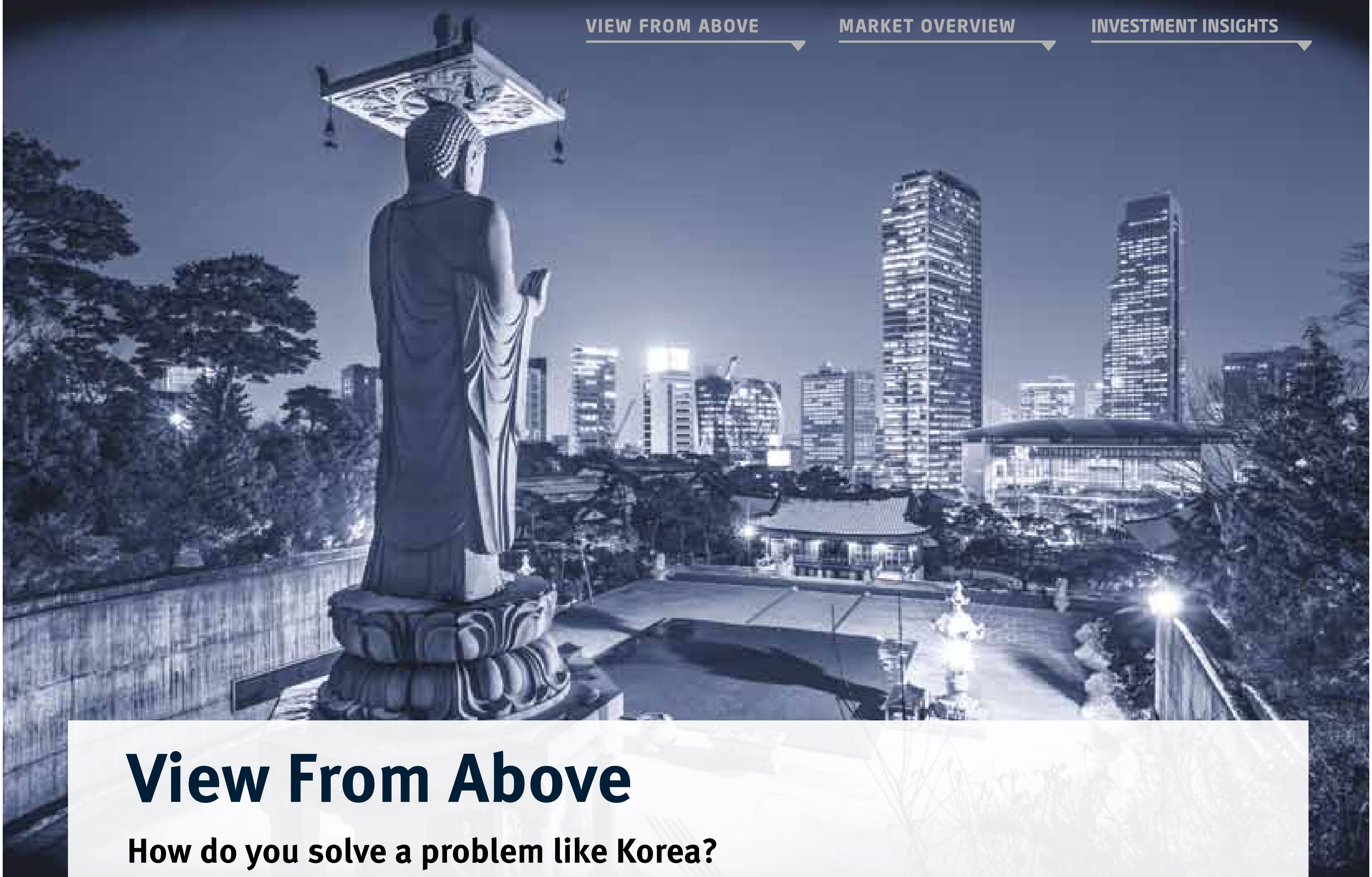


View From Above

How do you solve a problem like Korea?

At around 16% of the MSCI Emerging Markets Index, Korea is one of the largest markets in the emerging market universe, second only to China, in fact, and hard to ignore. The outward impression is of a vibrant, high-tech economy. However, the reality is more complex, as thriving export-led industries are counterbalanced by domestic sectors beset by onerous regulation and interference. Banks, for example, are prohibited from returning capital to shareholders, while price controls afflict many consumer industries - cinema ticket prices have been capped for four years despite being among the lowest around.

However, there is now recognition at least that change is required. The new government has stepped up its rhetoric against the chaebols, large family-controlled conglomerates often accused of hampering economic development, particularly new business formation. This has raised hopes that complex ownership structures could eventually be simplified to shareholders' benefit.

Hopes, could, eventually... these words highlight investors' problem: much of the reformist intent is currently just that - intent. While politicians talk the talk, the good news is that corporate South Korea at least is increasingly walking the walk, embracing better management practice and shareholder-friendly measures. There is undoubtedly further to go before this key market becomes more investable as a whole. However, the growing corporate reformist groundswell is a step in the right direction. Stock picking is how to solve an investment problem like Korea.

"There is now recognition...that change is required"

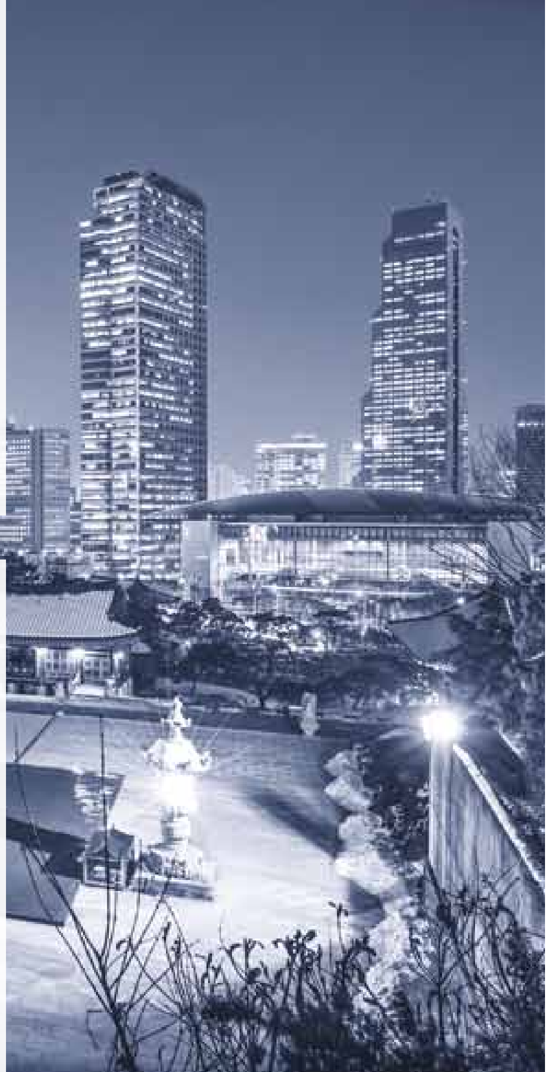
Market Overview

Cross currents

The mixed fortunes of South Korea's domestic and export sectors appear to have been reflected in the performance of the country's Kospi benchmark index. Returning only 5% or so over the past year, the index's performance pales in comparison to western markets. However, this actually amounts to respectable outperformance of the wider MSCI Emerging Market Index's decline of around 3%. Indeed, South Korea has been a relative rock amid emerging markets buffeted by the tapering of US monetary stimulus and the unwinding of the 'carry trade' it spawned. Many strategists consequently favour the country for its export-driven growth and stable currency.

For bottom-up stock pickers like us, such top-down 'attractions' are insufficient in themselves to warrant any investment. Until political reformist intent is backed by tangible action and more areas of the economy can generate more acceptable returns, it is difficult to see the Kospi as a whole make significant progress in absolute terms. Happily, while we wait for this higher-level change, corporate Korea's appetite for reform is growing, enlarging Korea's stock-picking opportunity set regardless of what may or may not be happening at the headline political, macroeconomic or market levels.

> **"Corporate Korea's appetite for reform is growing"**



Investment Insights

Lift the hood

Rather than asset allocate towards regions or countries, I seek fundamentally justified stock-level opportunities where change is underappreciated. This ensures that attractive individual opportunities of the type I am uncovering in Korea are not missed because of any negative top-down stance.

In particular, there is a growing trend that I increasingly see right across South Korea: management teams are reconsidering prior obsessions with sales growth in favour of improving profits and returns. Hyundai Motor Company is just one example of the many companies adopting more shareholder-friendly practices. In the initial stages of a new product cycle, it is enjoying strong fundamental demand for its new Genesis and Sonata models, making the company attractive for fundamental reasons alone.

However, this barely scratches the surface of an investment case that exemplifies the shift corporate Korea as a whole is making towards improving efficiency and capital discipline. Digging deeper, new management's intense focus on reducing costs becomes much clearer. Initiatives to expand production into lower-cost countries, to reduce the number of chassis variants and production platforms used, and even to share facilities and equipment with rival Kia, are emblematic of the culture change underway.

> **"Management teams are reconsidering prior obsessions with sales growth"**

While unit costs should therefore fall, the strategy is also yielding revenue benefits. Making fewer variants but better has boosted quality and consumers' brand perceptions. The company now boasts a total cost of ownership advantage over international peers of 10-15% over the life of the vehicle, meaning Hyundai's models should resonate more and more with increasingly value-conscious consumers.

This shareholder-friendly focus extends to its complex capital structure, a common feature in Korea. The company's preference shares trade at a near-40% discount to the ordinaries for example. Management also intends to address this anomaly, adding to Hyundai's appeal as a play on growing Korean corporate reform.

"The strategy is also yielding revenue benefits"

Taking DRAM out of a crisis

As an investor, I always compare the consensus view with what is actually happening on the ground: any misalignment can be a powerful source of returns. In my view, investors are overlooking significant change in the semiconductor sector in particular.

Difficult end markets for DRAM and NAND memory chips have encouraged extreme negative investor sentiment, pressurising companies such as Hynix. The consensus view is one of a pricing bloodbath given expectations of rising capacity amid high levels of funding and investment into the industry. However, conditions are improving. Poor returns have seen Japanese competitors dwindle to Elpida only, while Taiwanese peers have exited altogether. The memory market is at last becoming an oligopoly.

Shifting end-market trends are providing additional consolidation impetus. Weakening PC demand, growing mobile memory needs and the simultaneous emergence of numerous new technologies all create uncertainty over the longer-term product roadmap. Few are prepared to construct new plant, stabilising pricing.

What has been particularly transformational, though, is the huge shift in strategic thinking across the industry. Mobile device growth has seen battle lines redrawn. Samsung now views Apple as its main rival, not Hynix, enabling Hynix management to focus on improving returns. Indeed, with demand for Hynix's higher-margin mobile DRAM outstripping that of PCs, margins should expand. Top-line growth potential is also significant, as mobile memory capacity requirements increase.

Chinese smartphone makers will soon reach 30% market share, yet their models contain limited memory capacity compared with other players. Hynix looks particularly well placed to benefit from the improved competitive environment.

These companies are just a small sample of the stock-specific opportunities we see in Korea. We look forward to sharing more of our ideas from another part of our fascinating and diverse investment universe with you again in the not-so-distant future.

Alistair Way
Fund Manager

"What has been particularly transformational… is the huge shift in strategic thinking across the industry"

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