

Korean Equities Deserve a Closer Look

Conventional wisdom holds that Korea, as one of the strongest and fastest-growing of the “Asian Tigers,” affords investors little more than a convenient play on global growth, along with the attendant exposure to potential U.S., European, and global downturns. Deeper investigation, however, reveals that maintaining such a view could cause investors to overlook a market we believe is worthy of consideration in its own right.

Government and corporate reforms, changes in Korea's trading profile, and rapidly improving fundamentals have, in our view, created an equity market well positioned for continued regional expansion and one poised for impressive growth. As such, Korea's potential is now tied to factors beyond its links to the developed markets of the West.

While investors are wise to be cautious about some well-documented issues, such as the country's aging population and the political/cultural stagnation slowing additional reforms, we believe there are compelling reasons to be optimistic about the prospects for strong growth in the medium and long terms. Korea's increasing ties to economies within the region, including China and Japan, its compelling valuations, and its pending reclassification as a developed rather than emerging market, are just some of the reasons we feel investors should give this market a closer look.

The Asian Financial Crisis and Post-crisis Response

The years of 1997 and 1998 were not kind to the Asian economies, and South Korea was no exception. The country, which suffered along with its neighbors as currencies and stock markets tumbled across the region, emerged somewhat the worse for wear due to the unusually high leverage in the economy. As a result of long-standing traditions of a heavily regulated financial system and the dominance of the export-heavy, family-controlled conglomerates known as chaebols, Korea emerged with a corporate sector that was heavily leveraged after the crisis. At the end of 1997, the average debt-to-equity ratio in the manufacturing industry had reached approximately 400%, and, as a result, many companies collapsed or were on the verge of bankruptcy. The wave of corporate bankruptcies and rising non-performing loans led foreign banks to cut their credit lines to Korea, making it difficult for Korean banks to roll over their large stock of short-term external debt. This forced Korean banks to tighten up on their own domestic lending. Interest rates rose to punitive levels to defend the currency, which contributed to a severe recession.

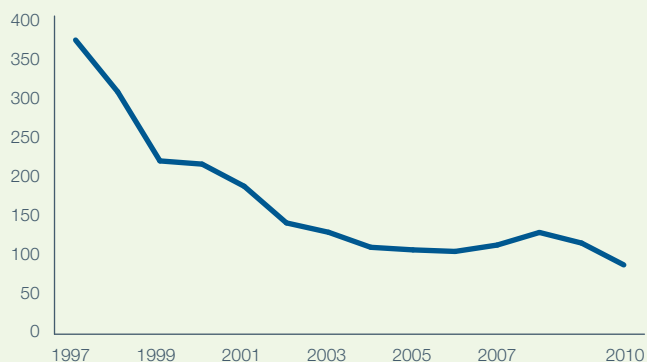
Government, corporate, and cultural adjustments after the crisis, however, have led to changes that have helped Korea transform itself into what we see as one of the world's strongest economies.

Government-imposed Reforms Result in Better Balance Sheets

After the crisis, corporations were required to restructure their balance sheets as the government imposed strict financial regulation on debt levels, credit arrangements, and inter-organizational loan guarantees. As a result, five of the top 20 commercial banks were closed and eight of the top 30 chaebols were bankrupted. Top manufacturing companies were able to halve debt-to-equity ratios to below 200% by the end of 1999, and they have continued to trend downward since (see Exhibit 1).

Exhibit 1 Better Balance Sheets

Debt-to-Equity Ratio of Korean Manufacturing Companies (%)



As of December 31, 2010

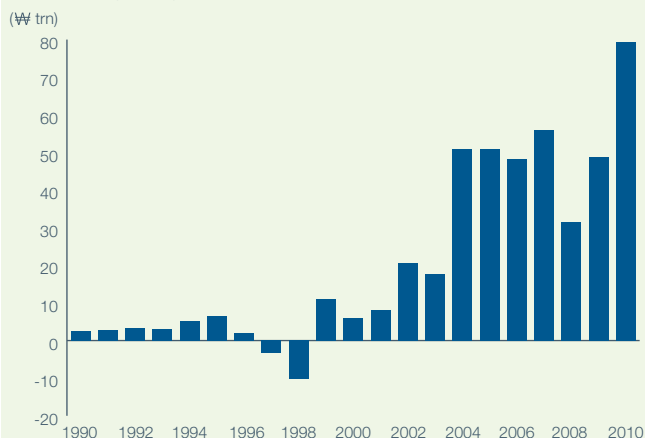
Source: National Statistics Office

Fast forward 14 years. Changes implemented after the crisis have helped deliver results never seen before. In the 20 years since 1990, major Korean companies have achieved an annual net profit growth of 20%, and their market capitalization has increased by 14% per annum, despite weathering the significant financial crisis of 1997 and the global financial downturn of 2008-09. Net profit more than doubled from 1990 to 2000 and swelled 15 times from 2000 to 2010. As for market capitalization, it has increased more than twentyfold in those two decades (see Exhibits 2 and 3).

Corporate Restructuring (Lower Debt, Higher ROE, and Diversified Exports): Corporate restructuring and changes in management strategies played a pivotal role in the Korean rebound. Altering their strategic focus from top-line expansion to profitability growth allowed companies to reduce debt and restructure non-per-

Exhibit 2 Higher Profits

Net Profit of Major Companies Listed on the KOSPI 200 Index



As of December 31, 2010

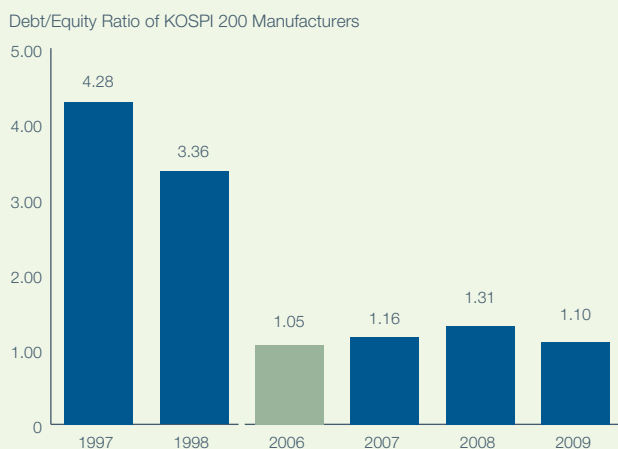
Source: Datastream

Exhibit 3
Market Capitalization Expansion



As of May 31, 2011
Source: Dataguide

Exhibit 4
Debt Ratio Contraction



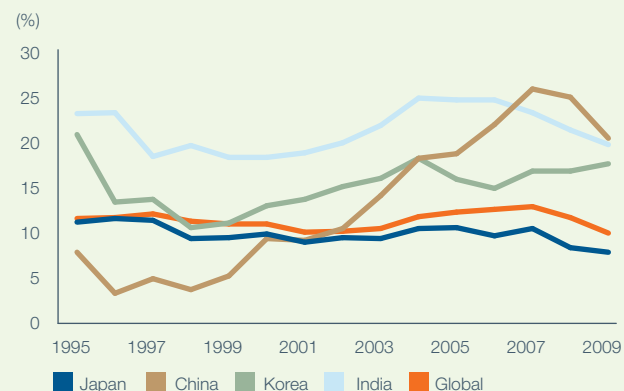
As of December 31, 2009
Source: Bank of Korea

forming assets as ways to improve profitability. The shifting nature of Korean exports, featuring increased inter-regional trading and more profitable trading with the E.U. and U.S., appears to have helped strengthen the economy and lessen the country's exposure to global slowdowns originating in the developed Western markets.

Debt: Debt-to-equity ratios plunged from 428% in 1997 to 110% in 2009 for the KOSPI 200 manufacturers (see Exhibit 4). Yields on bonds tumbled as well because excessive demand for capital evaporated. Lower borrowing costs have worked to generally bolster corporate profits.

Asset Efficiency: Restructuring non-earning assets, especially investments in affiliates, helped generate gains as businesses began to operate more efficiently. In our view, there is room for additional return-on-equity (ROE) expansion in Korea, especially

Exhibit 5
The Yield on Physical Capital



As of December 31, 2009
Source: Goldman Sachs Global ECS based on net accounts data

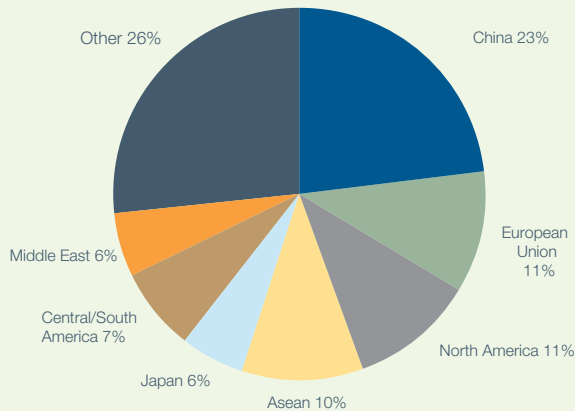
within small- to mid-cap companies with strong core businesses and that continue to hold abundant cash, cash equivalents, and idle assets. Generally, company managements are becoming more aware and sophisticated about shareholder value and better understand the need to utilize non-core assets. Accordingly, Korea's yield on capital has risen steadily since the 1997 Asian financial crisis and has shown an uptrend in the years following the 2008 global financial crisis, while in most of the developed countries and China, it has trended downwards (see Exhibit 5).

Exports: Korea has also been able to turn challenges into opportunities due to the changing global trade environment. The fast-charging Chinese economy, which has emerged to match the U.S. as an important economic power, has provided Korea with a regional partner with which to trade, thus lessening its reliance on the U.S. and European markets and its exposure to global slowdowns. Since 2003 China has overtaken the U.S. to become Korea's largest export destination. Of Korea's total exports, North American-bound exports shrank from 30% in 1990 to 22% in 2000 and to 11% in 2010, while China-bound exports surged from below 1% in 1990 to 11% in 2000, and to 23% in 2010 (see Exhibit 6). Additionally, as emerging economies in the region spent more and opened their markets to trading partners, they offered upside momentum for Korea's information technology, consumer goods, materials, and industrial players. In 2010, roughly 40% of the country's exports were within Asia. Korea's export-to-GDP ratio increased from 39% in 2000 to 45% in 2010 (see Exhibit 7).

Cultural and Structural Conditions

Korean companies have also benefited from specific cultural and structural conditions. A commitment to advanced technology, education, and research and development has helped create a business environment that can thrive in growing markets and hold its own in stagnant ones. Technological innovation, fueled in part by the country's disciplined and well-educated workforce (nearly 80%

Exhibit 6
Breakdown of Export Markets (2010)



As of December 31, 2010
Source: Woori Securities

Exhibit 8
Attractive Valuations (I)

Korea 12-month Forward P/E



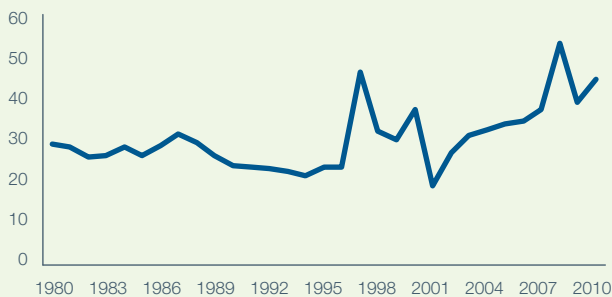
As of June 30, 2011

Source: Datastream, IBES

Forward-looking data is not a promise or guarantee of actual results and is subject to change.

Exhibit 7
Trend of Korean Exports

Korean Exports as Share of GDP (%)



As of December 31, 2010

Source: Bank of Korea

of the adult population is university-educated), has helped many small- and mid-cap Korean companies gain significantly in terms of global competitiveness. This presents diversified investment opportunities, as smaller, promising companies are joining the well-known large-cap names as companies to watch and consider in Korea.

Opportunities in Korean Equities

We believe there are several other compelling reasons for investors to consider a direct allocation to Korean equities: compelling valuations; stronger and better-quality earnings and growing global market share of Korean companies; a growing equity market culture among individual investors; expected corporate governance reforms; the impending reclassification from emerging to developed market status; and the enormous potential for growth that a possible reunification with North Korea represents.

Pricing Inefficiencies and Attractive Valuations: Despite the dramatic improvement in fundamentals, the Korean stock market appears undervalued. While great progress in both quantitative and qualitative aspects of the Korean economy have acted as catalysts for the recent stock price rise, we feel these enhancements have not been fully reflected in valuations. Korean companies have grown earnings 85% since FY07, but these companies are currently trading at only 10 times FY11 price-to-earnings (P/E). Compare this to a market that was trading at 14 times P/E in FY07. Despite the stock market's recent performance, valuations are still at a large discount to the FY07 peak (see Exhibit 8). Regionally and globally, Korea is also trading at low price-to-earnings and price-to-book ratios, relative to emerging markets, the rest of Asia (ex-Japan), and the world as a whole (see Exhibits 9 and 10), strongly suggesting there is currently upside potential for Korean stock prices.

Corporate Earnings and Market Share Gains: Korean companies have continued to generate higher and better-quality earnings since the financial crises of 1997 and 2008, a result of large gains in global market share and competitiveness. Earnings of listed companies in FY11 are expected to exceed those of FY10 by 19% reaching record high levels. In FY11, net profits are expected to be 85% higher than 2007 levels of 52 trillion won (see Exhibit 11).

The quality of earnings of Korean companies has also drastically improved. Since 2007, major Korean companies have shown impressive growth and large market share gains in the global market, accomplishments that have resulted in margin expansion and earnings growth. Korean companies took advantage of increased product quality, new product development, and a disciplined, well-educated work force to achieve such success. We believe we will see continued earnings improvement and market share growth

Exhibit 9 Attractive Valuations (II)

12-month Forward PER for MSCI Aggregate



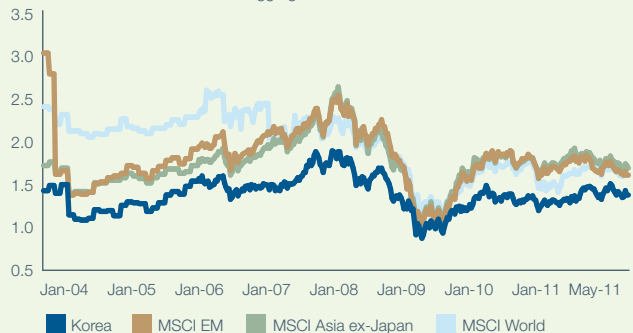
As of July 31, 2011

Source: Deutsche Bank and Datastream

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Exhibit 10 Attractive Valuations (III)

12-month Forward PBR for MSCI Aggregate



As of July 31, 2011

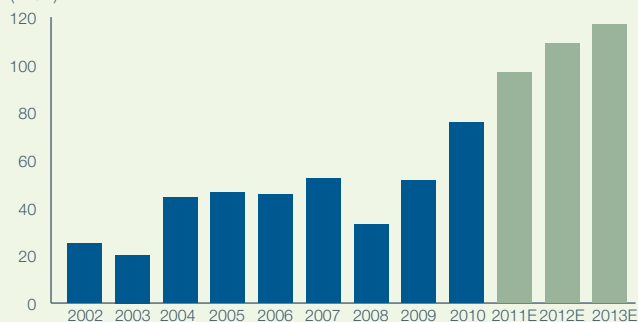
Source: Deutsche Bank and Datastream

Forward-looking data is not a promise or guarantee of actual results and is subject to change.

Exhibit 11 Significant Earnings Growth

MSCI Korea Aggregate Net Earnings

(₩ trn)



As of May 31, 2011

Source: Datastream

Estimated data does not represent a promise or guarantee of actual results and is subject to change.

across the board, but especially in the technology, auto, shipping, and materials sectors.

A Growing Taste for Equities: Koreans are increasing their equity ownership, through national and corporate pension plans and by increasing stock allocations in personal investment accounts, trends that suggest positive long-term catalysts for the Korean stock market.

Corporate Governance: In our view, Korea's corporate governance reforms remain incomplete despite some recent improvement. Consequently, Korean companies, which exhibit strong growth potential and sound fundamentals, still trade at a significant discount to their peers both regionally and globally, as we detailed earlier. However, recent government initiatives show signs of improvement in Korea's corporate governance landscape, which we believe should contribute to narrowing the gap over time.

Early this year President Lee Myung-bak convened a meeting of government agencies under the title of the "Fair Society." The goal was to curb improper wealth transfers and inheritance in chaebol families. After the meeting, even the pro-chaebol media outlets reported favorably on the proposals. In recent months, courts have also made moves against corporate crimes. Starting with chaebol families, the authorities' efforts to investigate and monitor inter-company transactions, improper wealth transfers, and inheritance will likely help change the corporate governance environment.

Reclassification: In September 2009, the Financial Times Security Exchange (FTSE) upgraded Korea to Developed Market (DM) status from Advanced Emerging Market (EM). The market is now awaiting Korea's upgrade to MSCI Developed Market status. The upgrades will likely be positive for foreign inflows, although the timing and magnitude are uncertain. Given the low allocation to Korean equities relative to historical ownership levels and Korea's MSCI Index weight, there is room for foreign investors to accumulate a higher percentage of Korean equities going forward. We believe the combination of EM-like growth potential and DM-like earnings quality make the market a compelling option for greater foreign inflows.

North Korea: Political Risk and Potential Opportunity

The uncertainty of the future of the North Korean regime has both posed a risk and presented an opportunity for the Korean market for many years. Despite the continued uncertainty, we feel investors can be cautiously optimistic that an eventual unification could provide numerous investment opportunities in North Korea and allow easier access to China. If the two nations were to unify, problems would likely present themselves in the short and immediate terms: a large number of refugees from the North may have to be absorbed and initial economic and political instability would need to be managed. Long-term problems, such as cultural differences

due to longstanding separation between two countries, contrasting political ideologies, and possible discrimination would also need to be resolved. South Korea would have to bear significant costs: North Korea's per capita GDP is less than 5% of the South's. Each year the dollar value of South Korea's GDP expansion equals the entire North Korean economy.

Collapse of the North Korean regime would have a massive social and economic impact on South Korea and neighboring countries. Reunification could allow for easier access to the Chinese market, already the most important trading partner with the North (other than South Korea). The North also possesses an excellent and inexpensive labor force with no language barrier for South Korean companies. The North's need for infrastructure could open significant opportunities for South Korean companies in sectors such as construction, telecommunications, and steel, while allowing the South to leverage the North's abundant natural resources. According to a Goldman Sachs estimate, the GDP of a unified Korea would surpass \$6 trillion within 30 to 40 years.

The Challenges to the Current Landscape

Despite the strides made in the last two decades, Korea still faces specific challenges to continued economic and financial growth. An aging population and shrinking middle class, increasing levels of household debt, the intractability of corporate and government leaders, and high dependency on exports all must be dealt with effectively for Korea to continue its transition into a solidly developed country. That said, as described in many cases below, steps are already being taken to mitigate these factors. As discussed, the uncertainties surrounding the political situation in North Korea, perhaps the most significant current challenge, could also be looked upon as a potential opportunity.

Demographic Challenges

Aging population: A decreasing birth rate (see Exhibit 12) and increasing life expectancy are combining to make Korea an aging society. As seen in Japan, an aging population leads to a smaller potential workforce to generate economic growth. In response, Korea has begun to attract foreign workers, mostly from within the region, and to encourage women to join the workforce. The number of foreign-born workers has quadrupled since the early 1990s, while the percentage of females working full time as opposed to part time has almost doubled since 2000 (see Exhibit 13).

Income Polarization: Despite the strong recovery from the global financial crisis, economic disparity in Korea remains an issue. According to the National Tax Service, income for the top 20% of self-employed earners rose 55% from 10 years earlier while the bottom 20% saw their income drop by 54%.

In order to prevent further widening of the economic gap, the government has endeavored to strengthen the social safety net, create jobs, and promote equal opportunities. Korea will have to continue

Exhibit 12
Decreasing Birth Rate

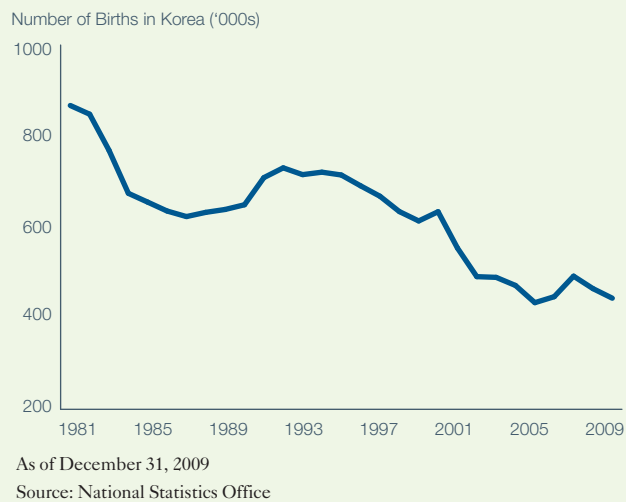
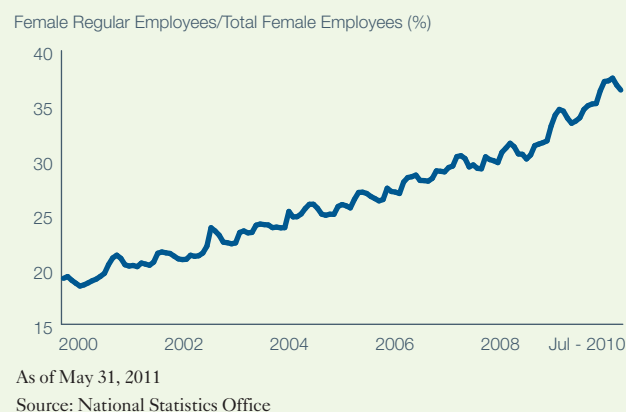


Exhibit 13
Increasing Female Participation in the Workforce



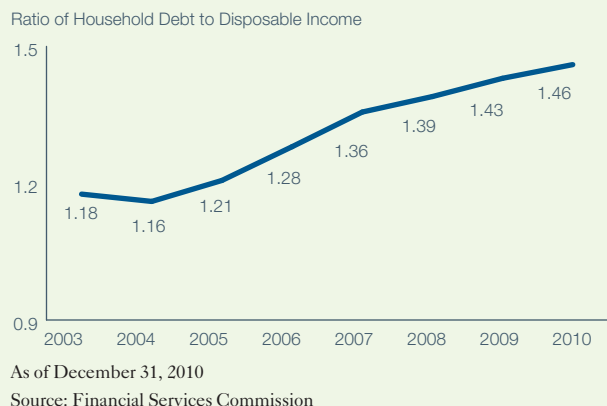
to address the restoration of the middle class by seeking more economic growth rather than by redistributing income. Similarly, more aggressive action may be needed to effectively stimulate domestic demand.

Household Debt: In contrast to corporate debt, as detailed earlier, household debt has been increasing between 6% and 12% per annum for the last five years, most recently increasing 8.2% in 2010, to 146% of disposal income (see Exhibit 14). This debt accumulation, mostly housing-related, may not decrease immediately as the ratio of floating-rate mortgage loans is relatively high. Given increased leverage and weakness in property and equity markets, Korean households are likely to undergo a de-leveraging process, much as corporations have done.

Structural Challenges

Government Regulation: Though government reforms played an important part in recovery after the 1997 crisis, the government

Exhibit 14
Increasing Household Debt in Korea



remains cautious about allowing market forces to play a greater role in driving the economy. Over-regulation and an opaque bureaucracy are part of Korea's historical legacy. From 1960 to the 1997 financial crisis the government took a very "hands on" approach in developing the economy. Also, from 1997 to 2002 it was heavily involved in the restructuring of private firms and commercial banks.

Corporate Culture: While the chaebols, with strong government backing, have contributed handily to Korea's rapid GDP growth, their generally inefficient and inflexible organizational structures limit further growth as the business environment matures and becomes more complex. Often managed for the private benefit of the controlling family rather than for overall shareholder value, we believe the chaebols present a challenge to fully free and transparent markets that investors have come to rely upon in developed markets.

Under Kim Dae-jung's administration from 1998 to 2003, the accountability, transparency, and financial health of the chaebols were drastically improved. An outside director system implemented in 1998—another positive sign—was the first time that Korea considered the implementation of a corporate governance system similar to that found in developed countries. However, we feel there remain many companies with cross-holding structures with poor transparency and, therefore, many opportunities to strengthen corporate governance.

This reluctance to adopt independent, transparent corporate governance extends beyond the chaebols to other corporate entities. There has undoubtedly been some improvement in corporate governance since the Asian financial crisis in terms of accountability, but, in our view, there is still room for improvement.

Exports: Korea has improved both the amount and composition of its export activities. However, exports remain in excess of 40% of GDP. Investors should consider that export-led growth, long the engine fueling Korea's economic growth, may not be sustainable in the future for a number of reasons: slower global economic growth, enhanced competition, high unemployment and stagnant consumption in the advanced economies, trade friction, and conflict over exchange rates. To achieve a more stable GDP growth, we believe Korea must closely watch domestic consumption trends and implement measures to boost domestic demand.

Conclusion

A generation of investors has looked upon Korean equities primarily as a stand-in for global growth or as a way to participate in the potential of Asia's emerging markets. As such, many investors have been unwilling or unable to separate the country's inherent potential from its perceived exposure to the economic fortunes of the U.S. and Europe.

Abundant evidence is available today to suggest that the Korean market should be looked at in terms of its significant growth potential, independent of its relationship with the developed markets of the West.

Government reforms, corporate restructuring, and shifting demographics since the Asian financial crisis of 1997 have transformed Korea from an emerging market in the "Asian Tiger" mode into a new developed market deserving consideration in its own right. It is poised to benefit as a key trading partner of both China and Japan, and it is capitalizing on opportunities to expand exports to its emerging market neighbors. All of which serve to lessen its exposure to global slowdowns originating in the West. At the same time, we believe strong fundamentals and consistent earnings growth have helped to make it one of the most attractively valued stock markets in the world.

To effectively capitalize on this opportunity, we believe investors should look beyond the traditionally-held views on Korean equities and embark on a dedicated approach to investing in this new developed market. Such an approach allows deeper participation in Korean equities by offering exposure to the high-growth potential of small- and mid-cap companies and beyond the household names. Companies such as Samsung, Hyundai, and LG are familiar to most global/international investors and are examples of the prime candidates to end up in the MSCI EAFE Index after the possible reclassification. These export-driven companies, highly correlated with Western markets, are subject to the effects of global capital flows in to and out of Korea. Just as owning Sony, Toyota, and Mitsubishi would not afford investors true exposure to the domestic Japanese market, solely investing in Korea through

a few marquee holdings would deny investors exposure to the full potential of the domestic Korean market.

Additionally, despite the many opportunities available in Korean equities, the remaining challenges also presented here underscore the need for experienced managers who understand the local marketplace and have the research capabilities to navigate it effectively.

As with any newly developed opportunity, investments in Korea will require careful management, monitoring, and some patience, but we believe the current potential for Korean equities will outweigh the challenges and risks. In the current global environment, we believe the Korean stock market presents an attractive investment opportunity.

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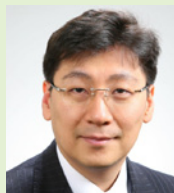
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