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INVESTMENT MANAGEMENT

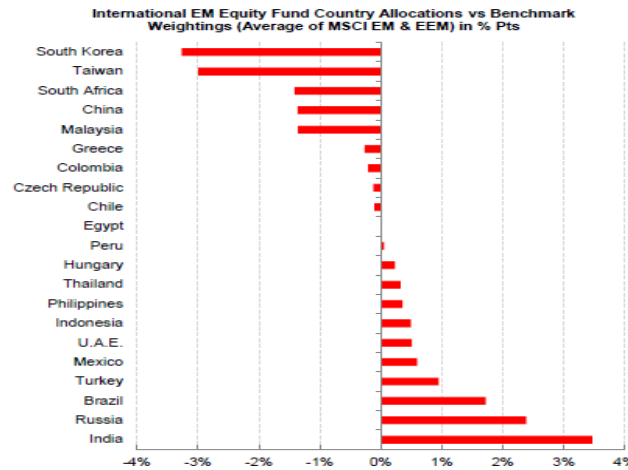
AFRICAN ROOTS | GLOBAL PERSPECTIVE

The Friday Filter

19 May 2017

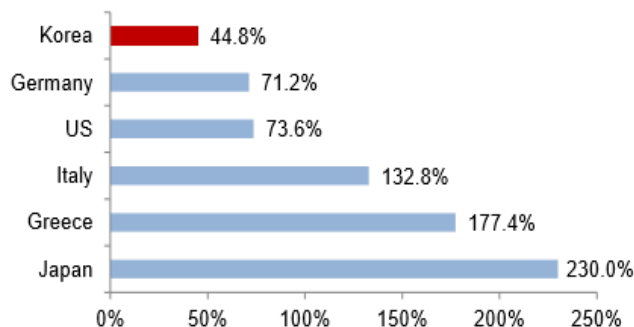
Korea – a long term value opportunity

Prior to last week’s election, South Korea had been grabbing headlines for all the wrong reasons. Not only do they have a very problematic neighbour, but there has been a widening corruption scandal that implicates both the ex-president and the Chairman of their largest company, Samsung Electronics. It is thus not surprising that South Korea is not the most popular investment destination for global investors. (Figure below source: Variant Perception)



Despite the poor news flow, Samsung Electronics has been one of the best performers in our global portfolios and has nearly doubled in the last twelve months. Our investment in Samsung Electronics had nothing to do with a view on South Korea. It was an investment in a good company trading at a very cheap price that just happened to have its main listing in Korea. Through holding and analysing Samsung we have built some knowledge about some of the challenges and opportunities within the region. While considered an Emerging Market, the economic reality is that South Korea is anything but and has solid financials that most developed markets can only dream about. (Figure below source: Petra Capital Management)

Sovereign Debt to GDP Ratio (2015)



Despite the sound country fundamentals, poor corporate governance and complicated legacy shareholding structures have resulted in poor returns from the Korean stock market (Kospi). The end result is a country that screens very well from a valuation perspective.

	P/E*	P/B
KOSPI	9.7x	0.9x
MSCI ACWI	16.4x	2.1x
S&P 500	18.3x	2.9x

* Based on 2017 Estimates
Source: Bloomberg (as of February 28, 2017)

On the face of it Korean equities look very cheap, but there is a group of shares within the market that are even cheaper. Korean preference shares participate in all the economic benefits of ordinary shares and are similar to non-voting ordinary shares in other parts of the world. Poor corporate governance and investor apathy has led them to trade at very large discounts to the ordinary shares of the same company. While Samsung Preference shares trade at a 20-25% discount, there are many that trade at 40%-50% discounts to ordinary shares, despite having the same economic interests.

Through our research we discovered a London listed vehicle that was set up in 2013 specifically to take advantage of this opportunity. An investment in the Weiss Korea Opportunity Fund has a few simple, yet attractive characteristics:

- Average PE ratio of preferred shares held - 8.3
- Weighted discount of preferred shares - 39%
- Management are significant owners in their personal capacity
- The fund is an active buyer of their own shares when the discount to NAV exceeds 5%

In our global portfolios we have recently added an investment in Weiss Korea, partially funded by some profit taking in Samsung Electronics (Samsung is the largest holding of Weiss Korea). We have also bought it for most local portfolios as part of our offshore allocation. In our view, it is a significantly better offshore investment than most of the expensive local rand hedge shares.

Weiss Korea is a good example of the sort of asymmetric opportunity we like to invest in. Our thesis is that corporate governance in Korea will improve in the years ahead, a view that is supported by recent shareholder friendly action by Samsung and a new President with a reform agenda. This should lead to a more shareholder friendly stance, simpler corporate structures and a narrowing of the preference share discount. When you add the potential rerating of the underlying company valuations, some moderate earnings growth and more generous dividend payments, the prospective returns are very good. Should our thesis be wrong, the valuation support is sufficient that we are unlikely to lose money.

In a world that broadly offers high risk and low potential return, we think Korean preference shares offer the opposite - low risk and high potential return. We have made our first investment in this area via a listed fund, but are doing further homework on one or two individual opportunities which may well feature on client portfolios in the months ahead.