

## Korean Preferred Stocks Basket - Investment Strategy

*“Citicorp sent a manual on Korean stocks. Within 5 or 6 hours, twenty stocks selling at 2 or 3x earnings with strong balance sheets were identified ... The strategy was to buy the securities of twenty companies ... \$100 million was quickly put to work.”*

-- Warren Buffett – 2005 talk to students at Harvard

*“When Warren said he’d put 100% of his fund in Korea, maybe he wouldn’t quite do that, but pretty much [he would].”*

-- Charlie Munger – 2006 Berkshire Hathaway Annual Meeting

### **Investment Summary:**

We suggest investing in a carefully selected basket of 20 Korean Preferred Stocks which trade at a 50% - 60% price discount to their respective common stocks. Korean preferred stocks are a form of equity and are roughly equivalent to Korean common stocks. They are entitled to a higher dividend and have a legal claim on assets, earnings, and cash flows. Their lack of voting rights justifies a small price discount of 15% - 25%, but cannot explain the huge price discount at which they trade.

Multiple catalysts over the next few years should reduce this huge price discount to a more reasonable 25% (or less). Adding 7% annual market appreciation and a 2% dividend yield results in about 150% return from current prices.

Importantly, the risk of permanent capital loss is minimized since we invest in a diversified portfolio of 20 cheap, profitable, dividend paying, preferred stocks. Therefore, we view this investment opportunity as compelling from a risk-reward standpoint.

### **Korean Preferred Stocks:**

South Korea, the world's 15th largest economy, has achieved impressive economic growth and development over the last 50 years. Today it is a developed capitalist democracy and home to leading global companies including Samsung, LG, Posco and Hyundai. Korean common stocks are cheap, trading for 10 X earnings and about 1.1 X book value.

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Over 100 public companies in South Korea have listed both common and preferred stocks. The Preferred stocks in Korea are very different than preferred stocks in the US and in most other countries. They are required to pay a higher dividend than the common stocks, have a claim on cash flows and profits, and are treated fairly whenever corporate events take place.

Most Korean preferred stocks were originally issued several decades ago when the Korean government pressured chaebols (Korean business conglomerates) to raise equity and delever their capital structures. The chaebols wanted the extra equity capital, but they also wanted to retain control of their companies — hence the new non-voting stock shares.

When first issued, Korean preferred stocks traded at only small price discounts to their respective common stocks. Over the years this price discount has fluctuated dramatically. Today, most preferred stocks in Korea trade at a 50% - 60% price discount to their respective common stocks. Since they must pay a higher absolute dividend amount, dividend yields for the preferred stocks are much higher and usually range between 2% to 4%.

After extensive research, we found that owners of Korean preferred stocks are almost always treated fairly with owners of Korean common stocks. Further supporting this viewpoint is the fact that many preferred stocks in the past (and a few today) traded at little or no price discount to their respective common stocks. Clearly investors in the past viewed Korean preferred stocks as roughly equivalent to Korean common stocks and they did not think that preferred stocks in Korea deserved a large price discount.

While the lack of voting rights of the preferred stocks is a small negative, it is not very significant since, in any case, most Korean companies are controlled by majority shareholders. In addition, Korean authorities have recently taken increased actions to protect the rights of minority shareholders and to improve corporate governance in Korea. These actions are favorable for investors in Korean preferred stocks since they protect our rights.

### **Why Invest in a Basket:**

While most of our investments are in individual companies, we do occasionally prefer to purchase a basket of related securities. This happens when we are confident that a certain sector or class of securities will, in aggregate, perform very well, but we are less certain about each individual member of the group. We think that Korean preferred stocks perfectly fit this definition. While not every company in our basket will be a winner, we expect that, on average, our basket will perform very well over the next few years.

An added benefit of the basket approach is that we are able to adjust our basket of preferred stocks as prices (and relative discounts) shift. For example, in 2013 we earned an 80% return on our investment in Hyundai Mobis preferred stock when the

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company announced a tender offer. We were able to take these profits and redeploy them into other preferred stocks in our basket.

### **Portfolio Strategy (Selecting Stocks for our Basket):**

We track over 100 preferred stocks in Korea and have invested in a basket of 20 carefully selected preferred stocks.

We look for 8 key criteria when selecting Korean preferred stocks for our basket:

- 50% - 60% (or higher) price discount between the preferred and common stock.
- High and sustainable dividend yield.
- Reasonable trading liquidity (average daily trading volume) for the preferred stock.
- Good business with competitive advantages.
- A history of profitability and positive free cash flows.
- Strong balance sheet.
- Trustworthy and capable management team.
- Extremely cheap market price relative to the intrinsic value of the business.

While clearly not all preferred stocks in Korea meet these criteria, we have found 20 preferred stocks that meet our high standards for investment. Across all the preferred stocks in our basket, the average price discount is above 55% and the average dividend yield is above 2%. We estimate that we are able to buy the businesses in our basket for about one third of their intrinsic business values.

	Preferred Tic	Common Price	Preferred Price	Price % of common	Market CAP (\$M)	Preferred Dividend Yield	Name	Industry
53	011785 KS	87600	35000	40.0%	2472	4.43%	KUMHO PETRO CHEMICAL CO LTD	Industrial
54	014285 KS	29700	15600	52.5%	134	2.56%	KUMKANG KIND CO LTD	Industrial
55	051915 KS	254000	148000	58.3%	15593	2.74%	LG CHEM LTD	Basic Materials
56	003555 KS	57000	32450	56.9%	9111	3.24%	LG CORP	Consumer, Cyclical
57	066575 KS	63800	27200	42.6%	9672	0.92%	LG ELECTRONICS INC	Industrial
58	108675 KS	154000	69500	45.1%	1279	2.66%	LG HAUSYS LTD	Basic Materials
59	051905 KS	484000	237500	49.1%	7003	1.60%	LG HOUSEHOLD & HEALTH CARE	Consumer, Non-cyclical
60	068875 KS	37700	21750	57.7%	579	0.00%	LG LIFE SCIENCES LTD	Consumer, Non-cyclical
61	005305 KS	1414000	600000	42.4%	1621	0.63%	LOTTE CHILSUNG BEVERAGE CO	Consumer, Non-cyclical
62	003925 KS	873000	360000	41.2%	582	0.29%	NAMYANG DAIRY PRODUCTS CO	Consumer, Non-cyclical
63	005725 KS	78900	32500	41.2%	372	1.69%	NEXEN CORP	Consumer, Cyclical
64	002355 KS	14100	5880	41.7%	1240	1.19%	NEXEN TIRE CORPORATION	Consumer, Cyclical
65	000325 KS	22000	12700	57.7%	269	3.19%	NOROO HOLDINGS CO LTD	Basic Materials
66	090355 KS	7150	5610	78.5%	132	3.65%	NOROO PAINT & COATINGS CO LT	Basic Materials
67	004255 KS	5500	2265	41.2%	187	3.31%	NPC	Industrial

**Part of our Korean preferred stock tracking system.**

**Source: Emerging Value Capital Management LLC**

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### **Selected Korean Preferred Stocks from our Basket:**

The following table shows ten out of the twenty Korean preferred stocks in our basket. Five of these preferred stocks are analyzed below in more detail.

Company Name	Bloomberg Ticker	Common Price (KRW)	Pref. Price (KRW)	Price Discount	Pref. Div Yield	Industry
AMOREPACIFIC CORP	090435 KS Equity	1235000	541000	56.2%	1.21%	Consumer, Non-cyclical
CJ CORP	001045 KS Equity	134500	61900	54.0%	1.62%	Diversified
DAELIM INDUSTRIAL CO LTD	000215 KS Equity	82200	33650	59.1%	0.45%	Industrial
DOOSAN CORP	000155 KS Equity	133500	67400	49.5%	5.27%	Industrial
KOLON INDUSTRIES INC	120115 KS Equity	50500	19450	61.5%	3.34%	Basic Materials
HYUNDAI MOTOR CO	005389 KS Equity	235500	116500	50.5%	1.72%	Consumer, Cyclical
KUMHO PETRO CHEMICAL CO LTD	011785 KS Equity	87300	34650	60.3%	4.47%	Industrial
LG ELECTRONICS INC	066575 KS Equity	63500	27100	57.3%	0.92%	Industrial
LG HOUSEHOLD & HEALTH CARE	051905 KS Equity	481500	235500	51.1%	1.61%	Consumer, Non-cyclical
SEBANG CO LTD	004365 KS Equity	18350	6920	62.3%	2.24%	Consumer, Non-cyclical

Ten out of the twenty Korean preferred stocks in our basket.

Source: Emerging Value Capital Management LLC

#### ***Sebang Co Preferred Stock (004365 KS)***

Sebang is a South Korean port operating company specializing in logistics, stevedoring, storage, and trucking services. They operate in major ports in Korea, including Busan, Gwangyang, Masan and Pohang. In addition, they own 38% of Global & Yuasa Battery – South Korea's leading manufacturer of vehicle and industrial batteries. Only a few companies in each port are licensed to perform stevedoring operations, thus limiting competition and providing Sebang with a competitive advantage.

The common stock of Sebang trades for about 7X Normalized earnings of 50B KRW (includes Sebang's portion of Global & Yuasa Battery earnings). While the common stock is cheap, the preferred stock of Sebang is extraordinarily cheap. It trades at a 62% price discount to the common stock. By investing in Sebang through its preferred stock we are paying 2.5X normalized earnings. The preferred stock also provides a 2.2% dividend yield.

#### ***Amorepacific Corp (090435 KS)***

Amorepacific is Korea's leading cosmetics company. It has a 34% market share, multiple leading brands, and a dominant position in all distribution channels (door-to-door, retail, duty-free and online). The company also produces household goods and some food products.

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Amorepacific enjoys excellent economics due to its strong brands and economies of scale in manufacturing, R&D, marketing, and distribution. Beyond its home market in Korea, Amorepacific is actively expanding into foreign markets with a focus on China, France, and the US.

The preferred stock of Amorepacific trades at a 56% price discount to the common stock. By investing in Amorepacific preferred stock we are paying about 10 times free cash flow, a cheap price for an excellent, well managed consumer brands business with significant growth prospects. The preferred stock also provides a 1.2% dividend yield.

### ***Doosan Preferred Stock (000155 KS)***

Doosan Corp is an industrial conglomerate operating in a number of disparate businesses, including electronic components for cell phones, heavy-duty excavators, machine tools, and building nuclear power plants. Doosan's management has been working to streamline the conglomerate structure. They are selling non-core assets, recapitalizing weak subsidiaries, and improving operational and financial performance. We expect these actions will unlock shareholder value over time.

We estimate Doosan's value to be about 3.7B KRW based on a 7X EBITDA multiple. The preferred stock of Doosan trades at a 50% price discount to the common stock. By investing in Doosan through its preferred stock we are paying 45% of estimated value. The preferred stock also provides a 5.3% dividend yield.

### ***Kolon Industries (120115 KS)***

Kolon Industries is a diversified chemicals and materials manufacturer with business lines in industrial materials, chemicals (petroleum resins), films and fashion materials. The company has significant market share in multiple niche markets including petroleum resins, polyester tire cord, airbags, and fashion item materials. Economies of scale, strong customer relationships, and intellectual property provide Kolon with a sustainable competitive advantage.

The common stock of Kolon trades for about 7X EV / EBITDA. While the common stock is cheap, the preferred stock of Kolon is extraordinarily cheap. It trades at a 61% price discount to the common stock. By investing in Kolon through its preferred stock we are paying just 2.7X EV / EBITDA. The preferred stock also pays a 3.3% dividend yield.

### ***LG Household & Healthcare Preferred Stock (051905 KS)***

LG Household & Health Care (LG H&H) manufactures and distributes cosmetics, household & personal goods and Coca-Cola beverages in South Korea. It has a leading market share in all 3 business segments. The company was spun off from LG Chemical (now LG Corp) in 2001 and has since been focused on western style brand management and shareholder value creation. LG H&H management is well regarded



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and shareholder friendly. Over the years the company has allocated capital wisely by investing in its core businesses, repurchasing stocks and completing multiple value creating acquisitions.

We view LG H&H as one of the best businesses in Korea. It enjoys strong consumer brands and significant growth drivers both domestically and internationally. We want to own it, but are unwilling to pay 26 times earnings for its common stock. Luckily, we can buy it at a much cheaper price via its preferred stock.

The preferred stock of LG H&H trades at a 51% price discount to the common stock. By investing in LG H&H's preferred stock we are paying about 10 times free cash flow, a cheap price for an excellent, well managed consumer brands business with significant growth prospects. The preferred stock also provides a 1.6% dividend yield.

### **Catalysts:**

The current price discount between common and preferred stocks in Korea is very high. In addition to simple mean reversion, we see four catalysts that will close this price discount over the next few years:

#### ***Capital inflow (both local and international):***

In recent years the price discount between Korean common and Korean preferred stocks has widened dramatically due, in part, to a negative feedback loop. As the price discount increased and preferred stocks underperformed, momentum chasing Korean investors fled from them, thus further reducing their price and their liquidity. Reduced prices and reduced liquidity led even more Korean investors to shun preferred stocks further pushing down prices, and so on and so on. This dynamic was further exacerbated by capital flight due to the 2008 global financial crisis.

This negative feedback loop has now started to reverse as bargain hunting foreign investors (like us) have started buying Korean preferred stocks, thus increasing their price and liquidity and reducing the price discount verses the common stocks.

One example is the listing in May 2013 of the Weiss Korea Opportunity closed end fund. This fund raised 100M British Pounds of permanent capital to be invested in Korean preferred stocks. We also know of multiple other international hedge-funds that have invested, or are starting to invest, in this space. This capital inflow has already started pushing up prices of Korean preferred stocks and we expect local Korean investors to soon follow.

#### ***Improved corporate governance and minority shareholder rights:***

In recent years, Korean authorities have taken multiple steps to protect the rights of minority shareholders and to improve corporate governance in Korea. These steps are very favorable for preferred shareholders since they ensure the protection of our rights.

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Corporate governance and transparency in Korea have improved significantly following the revisions to the Commercial Act, imposition of gift taxes on contracts to group affiliates, and aggressive legal action against abusive controlling shareholders. In addition, recent corporate law amendments in Korea now prohibit poison pills, require super majority board approval for related party transactions, and place strict independence and corporate governance burdens on directors.

### ***Buybacks and tender offers for preferred stocks:***

A handful of companies in Korea have repurchased some of their preferred stock. Given the cheapness of the preferred stocks, this is clearly a strong way to increase shareholder value. While we would like to see more and larger preferred stock buybacks, we are encouraged that in the past few years Korean companies including Doosan Corp, Samsung F&M, Samsung Electronics, and Hyundai Mobis have repurchased preferred stock. We expect this trend to accelerate over the next few years.

### ***High Dividend Yields:***

Korean preferred stocks are required to pay a higher absolute dividend amount than the respective common stocks. Therefore, dividend yields for the preferred stocks are often 2 to 3 times as high and mostly range between 2% to 4%. Many Korean companies have underleveraged balance sheets and could potentially increase their dividend yields even higher.

In an investment world hungry for yield, we think this market anomaly (much higher yield on mostly equivalent securities) will continue to attract investors to Korean preferred stocks.

### **Expected Returns:**

We make the following assumptions for our preferred stock basket:

- 5-year holding period.
- Price discount narrows from 55% to 25%.
- Stock market appreciates 7% per year.
- 2% annual dividend yield.
- Conservatively ignore profit from trading between the different preferred stocks.

These assumptions lead to the following expected returns:

- 66.7% from price discount narrowing.
- 40% from common stock price appreciation (7% per year for 5 years).
- 10% from dividends (2% X 5 years).
- Total Return = (167% X 140% ) + 10% – 1.0 = 144% (well over a double).

Importantly, the risk of permanent capital loss is minimized since we invest in a diversified portfolio of 20 cheap, dividend paying, preferred stocks. Rarely can we expect to earn multi-bagger returns with little risk of loss. As such we view this opportunity as compelling from a risk-reward standpoint.

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### **About the Author:**

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Ori Eyal has over 13 years experience in global value investing. Prior to launching Emerging Value Capital Management in 2008, he worked at Deutsche Bank Asset Management in New-York where he led multiple successful investments in South Korea and around the world. Ori also worked at Aquamarine Capital where he identified and researched global value investments.



Ori holds an MBA from the University of Chicago Booth School of Business, an MSc in Computer Science from the Open University of Israel and a BSc from the University of Maryland.

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