

Korea - Pan-peninsula politics... and “significant other” dates!

...from the emerging market that continues ever so slowly to emerge into...

... Korea express!

July 2011 - Adrian Cowell, Director and Fund Manager

The MSCI Barra non-announcement...

The diaspora of the Korea chapter of the wider publicly listed equity investment world, indexed and otherwise, may have been eagerly hanging on the June 21st announcement from MSCI Barra on global and regional country index component changes – involved and detached chapter observers have been treated to an annual, protracted and stylised will-they won't-they promotion ritual for several yawning years now... A fully emerged groundhog, or one that is perceptibly emerging... but with a healthily reduced or even removed weighting to telcos in the index. Hark the Korea Herald! It is still emerging! Hold your index and the business page. Now that is news for you... isn't it?

But the rest of Korea has other significant dates on their minds.

And the “significant other” dates!

June 25th marked the 61st anniversary of the start of the Korean War, a bitter Cold War conflict, billed as a United Nations' police action that saw horrendous military and civilian casualties. Several thousand troops from United Nations' forces, almost half a million soldiers from South Korea, around 1 million soldiers from North Korea and China, and as many as 2 million civilians from both sides lost their lives. The absolute total will never be known, but the scale of slaughter is almost beyond comprehension. Peninsula population today is of the order of 70 million. A “forgotten war” that must not slip the memory; today the DPRK plays a full part in ensuring that it does not.

June was a month when average minds of *potom saram* (the voters) began to turn towards domestic politics. 2012 is an important year electorally speaking with National Assembly elections on 11th April, and the Presidential Election on 19th December. There are the first signs of potential candidates twitching and jostling for position or hinting at possible interest in running. How might the vote count? Korea is still a young democracy. More will be hinted at below.

June 28th was the deadline imposed by the Korea Development Bank (KDB) for bids to be received to acquire “the jewel” that is Korea Express, Korea's largest logistics company by sales, and, whilst listed, it is currently owned by Daewoo Engineering & Construction and Asiana Airlines, affiliates of the deeply troubled but formerly rapacious Kumho Group. Kumho finds itself largely in KDB hands (its main creditor bank) as a result of an ugly display of corporate binge acquisition. This little *bude chigae* (popular restaurant dish of army base left-overs) has all the ingredients of a classic *durama*, the ever popular Korean soap operas that are gaining a following amongst non-Korean audiences overseas. Synopsis provided below.

“Yes Pyeongchang!”; the International Olympic Committee meeting on July 6th in Durban in South Africa awarded the 2018 Winter Olympics to Pyeongchang (in a hilly/mountainous region towards Korea’s East coast, and two times loser for the right to host for ‘10 and ‘14) competing under the slogan “New Horizons” with strong if somewhat controversial backing from IOC member Lee Kun-Hee (also Chairman of Samsung). The bid was led by Cho Yang-Ho, Chairman of Hanjin Group, owners of Korean Air. They were up against Munich, Germany (“Festival of Friendship”) and Annecy, France (“Snow, Ice and You”). The 2010 Games held in Vancouver were immortalised in Korean eyes by the perfect figure skating display of Kim Yu-Na in winning the gold medal. President Lee Myung-Bak and coterie together with Kim Yu-Na has been on an African tour starting in South Africa taking in lobbying, the final bid presentation, trade promotion, etc, the Democratic Republic of Congo, and Ethiopia (Ethiopia contributed troops to the United Nations’ forces in the Korean War, as indeed did South Africa).

Irresistibly perfect... Winter Olympic bid ambassador Kim Yu-Na



Image sources: www.worldsportsstars.blogspot.com, www.time.com.

Pyeongchang is not Pyongyang, but be prepared for noises on the subject of a possible joint peninsula team and even a joint hosting.

MSCI Barra? Nothing changed. There was almost no coverage domestically of any possible promotion to developed market suggesting that there was little or no debate or indeed expectation (anyone interested please see a previous couple of submissions on this website dated June 2010 and June 2009 – this correspondent has little enthusiasm for reprinting the issues).

The national assembly and the presidency

The ruling party, the Grand National Party (*Hanaradang*), currently holds 170 seats in the 299 seat National Assembly, but is “reeling” after a very poor showing in a series of bye-elections in April. The opposition, the Democratic Party (*Minjudang*) trails with 87 seats, the Liberty Forward party (*Jayu Seonjindang*) a right wing split from *Hanaradang* has 16 seats, the Future Home Alliance (*Mirae Heemang Yeondae*) has 8 seats, and the Democratic Labour Party (*Minju Nodongdang*) has 6 seats. There are a number of other small parties.

Hanaradang has two major factions, a pro-President Lee Myung-Bak faction, and a pro-Park Geun-Hye faction with several elected members who “float”. Park Geun-Hye was Lee Myung-Bak’s losing opponent in the *Hanaradang* primary ahead of the 2007 Presidential election, and, if notoriously unreliable polls are to be believed (see a June poll from the Chosun Ilbo below), she currently commands near overwhelming popularity (42.1%) based largely on masterly compassionate nostalgia. She reveals little in terms of policy initiative. She is the daughter of former president and General, Park Chung-Hee and acted as a de facto first lady for five years following the 1974 assassination of her mother. Therein lies part of Park Geun-Hye’s appeal.

During his Presidency Lee Myung-Bak has pursued grandiose pro-big business policies and has not addressed the more populist concerns of a widening wealth gap and poor job opportunities. Despite the large *Hanaradang* majority in the National Assembly, Lee Myung-Bak has had problems pushing through his agenda. Whilst one of his nick names is the Bulldozer (a comment on his style and business background as a former President of Hyundai Engineering & Construction), he is also known as 2MB, an alternative rendition of his initials.

At its national convention on Monday 3rd July *Hanaradang* elected a new Chairman, Hong Joon-Pyo, and four other members of its Supreme Council. Hong is a populist not clearly aligned with either faction, but has been critical of Lee Myung-Bak’s policies, and received the tacit support of Park Geun-Hye. Yoo Seong-Min, her man, came a surprising strong second, underlining the swing within the party away from Lee towards Park. The Lee faction has not done well with only one, Won Hee-Ryong, coming fourth of five. Lee Myung-Bak may be entering the lame duck phase of his presidency.

Mr Hong’s first comments were somewhat cryptic and can be interpreted as supporting Park Geun-Hye. Alternatively they could be interpreted as a rallying call to other potential candidates to raise their profiles if they really wish to challenge her! Hong also has a National Assembly election to worry about.

“If a fair election is guaranteed without being disrupted (by other candidates), former Chairwoman Park would be the candidate for the presidential race at this time”

Park 42.1%, Sohn 10.2%, Yu 6.2% ...



Image sources: www.koreatimes.co.kr, www.inside.chosun.com.

The other *Hanaradang* (at least for the moment) hopefuls include Chung Mong-Joon, major shareholder of Hyundai Heavy Industries (he comes with significant political baggage, initial popularity based upon securing the joint hosting of the 2002 Soccer World Cup, running in 2002 initially as an independent but flipflopping to aligning himself in an unholy pact with Millennium Democratic Party and ultimately successful Presidential candidate Roh Moo-Hyun, only to fall out spectacularly on election eve, then join *Hanaradang*...2.4% in the poll), and two ambitious gubernatorial rivals in Oh Se-Hoon, Mayor of Seoul (5.8%), and Kim Moon-Soo, Governor of Kyonggido (3.0%).

The Millennium Democratic Party morphed through the Uri Party (*Uridang*) to today's *Minjudang*.

It is quite likely that the opportunistic Sohn Hak-Kyu, *Minjudang* leader, will run for the Presidency (10.2%), but it is noteworthy that he was a *Hanaradang* primary prospective just last time around trailing in third behind Lee and Park. We hope that we are spared serial right wing *Hanaradang* failure Lee Hoi-Chang (4.1%) running again under the *Jayu Seonjindang* banner but he probably will anyway and there will doubtless be a number of other candidates in the fray.

There is much time to elapse before clarity will emerge with regards to the presidential election. The results in the National Assembly election in April next year will be critical indicators of party and individual fortunes.

3 bidders - 2 bidders -1 preferred; we have Korea express version 2011!

Korea Express, the country's largest logistics company, has had something of a chequered couple of decades, and events these last few weeks suggest at the very least that the inflated cheques will continue to fly, if not the stock prices of companies too closely associated with this seminal trucker! In the words of C W McCall from the popular '70's song "Convoy" ...

"Breaker 1.9, this here's the Rubber Duck, You got a copy on me com'on, Uh 10-4, Pigpen for sure for sure ...
"Cause we got a little convoy, Rockin' through the night".

In 2010, Korea Express had sales of W2tr (US\$1.8bn), operating income of W99bn and made a net profit of W68bn (US\$63m) for an earnings per share of W3,927. The book value per share was W103,785. The company derives its revenues from inland transport (33.9%), freight forwarding (25.5%), parcel delivery (23.5%) and shipping and port operation (15.1%). In Korea there is a very limited number of manufacturers, i.e. the shippers, but a plethora of forwarders multiplied by a factor of ten for the transporters.

Chronic oversupply, and pathetic operating margins! Show us the growth!

Episode 1

Korea Express (Rubber Duck) was a member of the Dong-Ah Group, a group dominated by Dong-Ah Construction and Industrial Co., Ltd. (Breaker 1.9), a company that epitomised much of Korea of the '80's and early '90s. It was the builder of the 1979 Songsu Bridge across the Han River in Seoul that tragically collapsed during morning rush hour on 21st October 1994 with loss of life, and it was the builder of the Great Man Made River in Libya, a vast project to bring water from deep aquifers in the heart of the Sahara Desert to Libya's coastal strip, the Greening Revolution by sprinkler. The Chairman, Choi Won-Suk left his wife for a significantly younger former Miss Korea, and the wife, herself a former announcer, wrote a book about life with him.

Korea Express trucked huge sections of 7 metre diameter concrete pipes across the desert in a near endless round the clock convoy. Trucking hell! "cause we got a great big convoy rockin' thru the night, Yeah, we got a great big convoy, ain't she a beautiful sight, Come on and join our convoy, ain't nothin' gonna get in our way".... except ...

... that mass foreign currency miss matches under the construction contract took Dong-Ah down in all but name before the aftermath of the Asian Financial Crisis of '97-'98 finally put paid to the company. Its final demise came despite a most fanciful and imaginative claim, in 2000, to have located US\$125bn worth of sunken Tsarist Russian gold (at then prices the trove would have been 14,000 tonnes, or 13% of all the gold mined in the world...) off the south east of Korea sitting in the *Dmitri Donskoi*, a Russian cruiser scuttled by its crew after suffering extensive damage fighting off six Japanese cruisers in the Battle of Tsushima. The Russian Baltic Fleet, on its way the long way round from St Petersburg to relieve the blockade of Port Arthur, was completely destroyed at the battle of Tsushima on 27-28th May 1905 by the Japanese navy led by Admiral Togo. This engagement effectively ended the Russo-Japanese War (1904-5).

There was a share rush on the rumoured gold discovery; Dong-Ah's share price soared 10 fold, before settling back submerged in absolute and final dilution possibly somewhere alongside the *Dmitri Donskoi*.

Essentially viable affiliate Korea Express went into court receivership in mid-2001.

Episode 2

A few years later in 2006, enter the Kumho Group, a lesser *chaebol* (once got to 8th by assets, the owners' favoured measure) with typically entrenched and grandiose ambitions having started life modestly as Kwangju Taxi in 1946 with just two second hand American cabs. The man in the two cabs took on an industry a decade entering tires in 1960, petrochemicals in 1970, and airlines in 1980, and debts mounted. The group was subsequently blighted by the toxic combination of second and third generation offspring squabbling and competing.

In 2006, the Kumho-Asiana Group acquired 72.1% of Daewoo Engineering & Construction (DE&C) from KAMCO (the government agency that collected non-performing loans from banks and others – DE&C was part of the former disgraced Daewoo Group) for a total of W6.5tr, W2.9tr (32.5% of the total equity) sourced by Kumho companies largely off more gearing, and W3.5tr (nominally for the other 39.6% of the equity) from financial institutions provided in return for guarantees from Kumho of a 9% annual return over three years with a put back option.

At the anointed time Kumho Group's contingent liability to these financial institutions amounted to W4.2tr (US\$3.9bn) ... some straw on the camel's back ... as the financial investors exercised their put, and pouuuf! KDB now controls DE&C, but not before the Kumho Parks, utterly blind to recent history and the fate of the Daewoo Group and others, had tried to pull off the same trick again in 2008 ... "faites vos jeux" ... the ultimate double or quits!

In March 2008, the Kumho-Asiana Group through Asiana Airlines and DE&C with a band of others won a court led auction for 60% of Korea Express offering around W4.1tr (US\$3.8tr). Korea Express had been in court receivership since mid 2001. Kumho-Asiana was now not only mortgaged to the hilt, but firmly built upon leverage compounded by leverage propped up by external "investor" put options back to Kumho in the event of share prices not achieving 9% compounded targets.

Two contingent time bombs in "38th parallel" ticking away with the Park family, erstwhile "owners", having set the timers utterly oblivious to the lessons of recent history. A belated and monstrous ouch! But should they have seen it coming?

A case of "We can work it out" from the Beatles (corporate Korea's unofficial anthem and usual course of action when on the banana skin of excessive debt), or more likely the last line from C W McCall's Convoy; "This here's the Rubber Duck on the side, we gone bye bye".

For more about the Kumho-Asiana Group please see the earlier publication "Park and drive ... into the Wall" dated February 2010 by KR Min that chronicles the Group's rise propelled by debt and government favour and its most recent fall caused by a fatal combination of greed and over-extension compounded by contingent liabilities. Unjustifiable premia to underlying value and no-no-notional synergy (pardon the stammer).

Episode 3

Which brings us up to date to June 28th and the bid deadline set by the very same KDB (star of earlier episodes) for the acquisition of 37.6% of Korea Express. There were three bidders; Posco, widely assumed to be the favourite, top steel company with W61.5tr in sales, cash rich and acquisitive and with a justifiable and significant logistical need possibly double Korea Express's actual annual sales, the Lotte Group, a retailing powerhouse and serial over-payers for acquisitions, possibly(?) with a logistical need in addition to what they already have in-house, and finally the CJ Group (Pigpen), a staples food/animal feed, home shopping and entertainment group, grumpy cousins of Samsung, but arguably with tenuous logistical need above and beyond their existing CJ GLS (global logistics service if you are wondering) operation.

The rise in television home shopping has supported a highly fragmented and over supplied logistics industry. As mentioned earlier there is a limited number of major manufacturers such as Posco, Samsung, Hyundai and LG Groups, etc and there are over one hundred forwarders of which Korea Express is one, and times whatever for the number of transporters, again Korea Express is one. What synergy there is lies very firmly in captive demand!

Preliminary bids were submitted by all three on 28th March; final bids due 28th June. Shock horror, the serial over-payer Lotte Group withdraws at the last gasp! Drrrrinnng! Posco joins forces with Samsung SDS ... an almost logical if not logistical near win-win bid. The CJ Group which had been using Samsung Securities for advice truculently threatens a law suit against uncle and cousin alleging leakage of bid details to the rival Posco consortium ... bids in ...

... and ... the winner is the CJ Group with a whopping bid of W2.0tr trumping the Posco bid of W1.8tr. W2.0tr equates to W215,000/share or a 95% premium to the closing share price of W111,000 on the day (it fell 7.3% on the news). CJ Corp, the holding company, falls 9.8% on the day, CJ Cheil Jedang, an operating company, falls 7.6%, and the uncle and cousins' Samsung Life (the CJs own 5.5% between them and disposal of some or all may be the key to financing this) falls 2.8%!

The CJ bid is 2x historic book value per share of W103,785, and ... 54.7x historic earnings per share of W3,927. Need some long division to get that multiple down! There is not a lot of cash in the CJs, they do own their 5.5% stake in the uncle's life insurance company, and there will be some real estate that could be disposed of, but it will be a stretch. So leverage! And the obvious synergies to support the bid price? Time will tell.

The KDB organised the auction and price accounted for 75% of the bid evaluation ... could this in effect be an uncontingent guarantee that Korea Express may a few years hence come some put date or other be up for sale once again to be auctioned by the self same KDB?

Watch out for Episode 10-4 ...

... and 10-5 will be the SKT and Hynix *durama!* But we haven't the strength!