

Korea - market update

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Fund flows

With European woes playing out, KOSPI has declined c.10% from its recent peak with massive foreign selling. As one of the liquid markets in emerging markets, the Korean market seems to have been a main target for the foreign money pulling out of the region.

As you can see in the table below, foreigners sold W5.3tr MTD May, pushing down the index to 1600, while they had bought the similar amount in each of the previous two months. YTD, foreigners have net bought W6.2tr.

On the other hand, local ITCs, which saw major redemptions above the index level close to 1700 (where many retail investors had put their money into funds prior to the crisis), have turned to net buyers in May. YTD, net selling of W6.5tr though.

Pensions, among local institutions, has been solid and consistent net buyers throughout the year buying W2.2tr YTD. National Pension Fund is on the way to increasing exposure to equities as a mid to long term plan. According to Maeil Economic Daily (March 2010) quoting National Pension Service (NPS), NPS targets more than 20% weight in domestic equity out of expected asset size of W432tr in 2014 vs. 13.1% (36.3tr) of W277.2tr in 2009.

Net buying by investor type

Wbn	Foreigners	Retail	Local Institutions	Pension	ITC	Corporate	Foreign Ownership (%)	KOSPI
2001	8,711	-3,275	-4,091	737	-2,149	-1,346	32.22	693.70
2002	-2,711	2,678	-386	895	923	420	32.79	627.55
2003	14,655	-5,486	-9,825	899	-7,930	656	37.64	810.71
2004	11,770	-7,537	-5,843	2,043	-5,165	1,610	40.11	895.92
2005	-3,622	-8,277	8,314	-183	10,436	3,586	37.14	1379.37
2006	-12,004	-999	9,916	838	6,418	3,087	35.13	1434.46
2007	-27,083	7,261	10,135	3,872	4,599	9,687	30.96	1897.13
2008	-38,065	4,153	23,882	9,776	-2,133	10,030	27.22	1124.47
2009	30,124	299	-27,066	-8,187	-21,918	-3,358	30.44	1682.77
YTD 2010	6,178	1,636	-5,738	2,230	-6,491	-2,076	29.72	1600.18
Jan-10	679	1,194	-1,666	428	-1,431	-208	30.20	1602.43
Feb-10	-33	144	-67	433	-113	-43	29.76	1594.58
Mar-10	5,389	-3,829	-1,144	439	-1,312	-417	30.23	1692.85
Apr-10	5,451	-78	-3,616	501	-3,731	-1,756	30.81	1741.56
MTD May	-5,308	4,206	754	429	96	348	29.72	1600.18

As of 20 May, KOSPI and KOSDAQ combined. Foreign ownership and KOSPI index at the end of each period.
Source: KOSCOM

1Q10 Earnings

Earnings release for 1Q has been completed. For most major corporates, the results came out better than expected and also better than usual 1Q. Companies explained that 1Q results were good and probably abnormally good as the quarter was on the sharp recovery from the crisis (pent up demand). Thus, as some companies have suggested, 1H earnings could be larger than 2H.

Notably, Samsung Electronics recorded IFRS based consolidated revenues of W34.6tr with operating profit of W4.4tr (all time high quarterly op). The main contributor was semiconductors, which generated 24% margin with top line growth of 57% YoY due to ASP and volume recovery. The semiconductor segment accounted for 44% of total operating profits. They have been able to widen the gap with competitors during the crisis with advanced technology and ample cash balances. Also, solid profitability from handsets (12% opm) was another factor in highest profits. Sequential growth is expected in 2Q.

Hyundai Motor also beat the market's expectations. Despite concerns on strong KRW, their parent revenues for 1Q10 were up 40% YoY to W8.4tr, with 8.3% operating margin. Total global shipments came at 847K in 1Q10, up 36% YoY.

LG Chemical also showed strong results indicating sequential growth. 1Q is usually the second weakest quarter for the company with 4Q being the weakest, but their operating profit for 1Q10 came closer to their all time high quarterly results recorded in 3Q09. IFRS based consolidated revenue of W4.4tr (+32% YoY) and operating profit of W652bn (+50% YoY). Both petrochemical and information & electronic material divisions' margin came out higher than 14%.

You can see below MSCI Korea consensus earnings upward revisions and a jump in mid April after 1Q10 earnings release. EPS growth is estimated at 49% in 2010 and 6.5% in 2011. With current EPS, MSCI Korea is trading at 8.5x 2010 and 8x 2011 EPS, far below MSCI AC Asia ex Japan which is trading at 12x and 10.6x with EPS growth of 36.7% and 12.5%. Also, 1.2x 2010 book and 1.1x 2011 vs. ROE of 13.9% in 2011 - cheapest market in the region according to Morgan Stanley.

Consensus EPS revision



Source: Data from Morgan Stanley reports (weekly revision)

With a high base in 2H09, the growth on a YoY basis might look to be slowing down into 2H10, but overall demand is expected to be better than last year. Though the recent European sovereign debt crisis might dampen demand recovery. According to UBS, Samsung Electronics' end market exposure to Europe is c.27% of revenues. Credit Suisse estimates Hyundai Motor exposure to Europe is c. 20% of revenues. However within Europe, I believe the exposure to those troubled countries should be relatively small.

Economic data

Economic data shows signs of recovery and positive outlook.

- GDP for 1Q10 was better than expected, up 1.8% QoQ (seasonally adjusted), 7.8% YoY. Domestic components did well in 1Q including private consumption, government spending and facilities investment. High base in 2H would make growth slowdown though.
- Domestic consumption is quite solid. The consumer sentiment index has remained above 100 (threshold level for better sentiment) since May 2009, recording 111 in May this year, 1 point up from April. Also, April retail sales (same store sales growth for three major companies, source: Ministry of Knowledge Economy) for department stores grew 8.8% YoY. Discount stores SSS growth is rather slow though, up 0.3%.
- Business sentiment is also improving. The latest index came at 103 in April, 4 points up from March.

The Bank of Korea (BoK) revised up its GDP growth forecasts in early April reflecting improving macro conditions (including better consumption and corporate investments), though acknowledging risks in Europe. 5.2% growth in 2010 (previously 4.6%, forecasted in December 2009) and 4.8% in 2011 (same growth as previous forecast, but with high base in 2010, still better growth).

Local liquidity into equities?

Market interest rates remain low. Commercial banks' 1 year deposit rates are at a range of 3-3.5% and even those mutual savings which used to give much higher rates only provide c.4% rate products. The latest CPI is 2.6% in April, so not much gain in real terms from putting money into banks. I believe the rates should be rising in 2H when the market expects BoK to raise policy rates, which currently stands at 2%, but for the time being there is certainly attraction for money to be placed in the equity market.

Outlook on property, a major asset class held by Koreans, doesn't seem to be as bright as the past upturn, given increasing supply of housing, still high inventory of unsold apartments and on going government regulation on the property sector (borrowing, tax).

So local liquidity into the equity market? Recent volatility in the equity market might not look exciting, but at the same time the 10% fall could attract people looking at reasonable gains (more than deposit rates!).

In addition to the comments above, post the 'torpedoing' of the South Korean ship (see article Buddha's Birthday for further details) the KRW depreciated sharply recently on specific concerns about the relations with North Korea, so that should be an additional plus point for foreign investors assuming the rate should be normalized.

In my opinion, it seems that overall positives outweigh negatives in the Korean market.