An Update on Value Investing in Korea

This article is excerpted from a letter by MOI Global instructors Chan Lee and Albert Yong, managing partners of Petra Capital Management. Chan and Albert are instructors at Asian Investing Summit 2018, the fully online conference featuring more than thirty expert instructors from the MOI Global membership community.

Investing is a marathon, and each year can be thought of as just one kilometer marker along the route. What really matters to us is whether or not our investors will see their capital grow manifold after a long period of time. In this respect, we are much more optimistic about our longer term performance going forward because the compelling valuation of our current portfolio holdings bodes well for strong investment results with limited risk. Equally important, in addition to being very cheaply valued, our holdings represent great businesses, which are very competitive, generate high returns on capital and carry little or no debt. Thus, we certainly expect to outperform over the benchmark over the long-term as the stock prices will eventually reflect the fundamentals and values of the underlying stocks.

Market Commentary

After moving sideways for the past several years, the Korean stock market finally roared during 2017. The KOSPI Index rose 37.2% in U.S. dollar terms and became one of the best performing equity markets in the world in 2017. Similar to the recent trends we have observed in many other markets, the Korean benchmark index was driven mostly by a few large-cap stocks. In particular, Samsung Electronics, which comprises over 22% of the index, rose 59.3% in U.S. dollar terms during the year and contributed more than 40% of the rise of the index. Other semiconductor stocks, including SK Hynix, Korea's second largest public company with a market cap of over $50 billion, rose significantly along with Samsung Electronics. Also, we would like to point out that biotechnology was one of the hottest market sectors in 2017. For example, Celltrion, once a darling of many short sellers, became the third largest public company in Korea (in terms of market capitalization) after a meteoric rise of more than 100% in a short period of time.

The main reason why we think the stock market is being dominated by a few companies in certain sectors is that investors are increasingly buying rising stocks instead of undervalued stocks. They seem to only look at price, not value. In fact, many market participants have shunned undervalued stocks and, therefore, cheap stocks have gotten cheaper while richly valued stocks continue to rise further. Such a market is indeed a very challenging market for long-term oriented value investors like us. Although we firmly believe that value will eventually win at the end, we have to admit that a time horizon for the value investing strategy to work is becoming longer.

We believe that Korean stock market is still undervalued even after a sharp rise in 2017 because the advance was mostly due to the earnings increase. As a matter of fact, in terms of valuation multiples, Korea is still one of the cheapest markets in the world. Corporate earnings are expected to increase more in 2018, albeit at a slower rate than the previous year, on the back of a swelling trade surplus due to strong demand for Korean products and services from all over the world. Furthermore, we think that the Korean market valuation may get rerated to higher multiples if the much anticipated corporate governance reform under President Moon Jae-in gets underway.

Given the Korean government's strong will and growing demand from investors seeking more shareholder return, many companies from large business conglomerates (i.e., chaebols) to smaller businesses will have no choice but to adapt to a new shareholder-friendly environment. In other words, many Korean companies are likely to focus more on shareholder value concept. Of course, the pace of improvement could be slower than many investors hope for. Nonetheless, we think that even small changes can possibly lead to a meaningful upgrade in terms of market valuation.

Since President Donald Trump took office in early 2017, the geopolitical risk on North Korea has risen to unprecedented levels. This heightened risk was escalated by the exchange of bellicose rhetoric between President Trump and North Korean leader Kim Jong Un. But the tension seems to have eased somewhat lately after North Korea suddenly began to engage in cooperative dialogue with South Korea regarding its participation in the PyeongChang Winter Olympics in February 2018. Despite saber rattling threats, it is obvious that North Korea is ultimately seeking direct dialogue with and recognition from the U.S. government. North Korea’s sudden change of attitude toward South Korea might have enhanced such possibilities.

That is probably why financial markets have been largely nonchalant to the seemingly high risk. After all, given the substantial size of the Northeast Asian region’s economy (about 24% of the global total), it is highly inconceivable that any relevant parties to the North Korean issue would actually desire to see a major military conflict in the Korean peninsula. Of course, finding a workable solution to North Korea’s aspiration for nuclear arms and long-range missiles is far from being certain. Nevertheless, we believe that any minor improvement on the North Korean situation is likely to bring a positive impact on the Korean stock market.

The Korean won, South Korea’s currency, was one of the best performing currencies in the world during 2017, climbing almost 13%, as its economy benefited from thriving exports and the Korean central bank raised interest rates for the first time since 2011. Amid the ongoing weakness of the U.S. dollar, the Korean won is likely to keep strengthening in 2018. Given Korea’s export oriented economy, the conventional wisdom is that the appreciation of Korea’s currency is interpreted as a negative factor for the Korean market. However, if you have some familiarity with Korean financial history, you might come to a contrasting conclusion that a strong currency has always coincided with a strong stock market in Korea. Perhaps this is the case because a strong currency is a mirror image of a strong economy.

After two late summits between the presidents of South Korea and China, many assumed that China would end its punitive economic measures against South Korea over the deployment of the U.S. Terminal High-Altitude Area Defense (THAAD). Of course, China resumed its economic sanctions shortly after the Korean president returned home. This was no surprise to us since we never really expected China to lift the sanctions this early and quickly (based on the history of similar sanctions in the past). Nevertheless, we think China will eventually lift the sanctions in the longer term because maintaining them for too long will be detrimental to its own economy. For example, China currently imports most intermediary goods from South Korea because they are vital to its economy. In any event, whenever we review Korean companies which have substantial business exposure in China, we will make sure to incorporate such a risk accordingly.

Amid the recovering economy, the U.S. is set to continue to raise interest rates. Other major countries, including Korea, are surely to follow suit. If inflation expectations turn out to be higher than initially foreseen, the Fed might tighten monetary policy even further and faster than the market’s current anticipation. If this were to happen, we think that it might lead to a sell-off in global markets. Also, the higher interest rate will certainly prompt a long-term effect of lowering multiples of the stock market. The fact that the global equity market is currently ignoring such a risk is indeed worrisome. In particular, the over-enthusiasm is quite evident in the valuation of the U.S. stock market. The average P/E ratio on the S&P 500 now stands somewhere around 23x, which is the highest since 2009. We will keep closely watching any early signs or signals. Luckily for us, we feel much safer in the Korean market where the valuation is still quite cheap.

Without deviating from our core value investing principle, we will try our best to adapt to a challenging environment at the same time. The strategy of value investing is based on the concept of the reversion to the mean. In an environment like now where stocks could easily move to extreme prices in both directions, cheap stocks we buy tend to get cheaper and it is likely to take longer for them to get back to fair value. This has an effect of making an annualized return figure smaller. Therefore, we must research more diligently to find even cheaper stocks compared to the ones we have bought before. While this is a difficult task, given our research capability and accumulated knowledge and insight on Korean companies and industries, we think we can continue to discover more undervalued stocks. If we can manage to find companies that fit our desired set of characteristics – solid, competitive businesses with strong balance sheets, which are selling at dramatic discount to their intrinsic values, we are well-poised to deliver satisfactory results in the long-run.

Portfolio Positions Discussion

Although we think most of our portfolio companies are still trading far below their intrinsic value, we made a few small changes to our portfolio. We will continue to replace some of the existing portfolio stocks whenever we find better opportunities.

Our investment approach is always focused on producing the best possible long-term results with limited risk. In that connection, we are always looking for an opportunity to buy a high quality business with sound long-term prospects with strong balance sheets, which is trading at a deep discount to its earning power. We believe we found such an opportunity in Com2uS.

Com2uS is a developer and publisher of mobile games. We have been adding to our position whenever the stock price dipped in 2017. The stock price has risen steadily throughout the year, but we think it is still undervalued. The company was established in 1998 and its current controlling shareholder is Gamevil, also a Korean mobile game developer and publisher. The global mobile game market, presently 42% of the total game industry, is the fastest growing segment. We believe that Com2uS is one of the few Korean mobile game companies that have fully grasped the operation know-how of servicing mobile games at the global level. Its sales are well-diversified geographically, generating over 80% revenue outside of Korea.

Its flagship game Summoners War is a fantasy-based free-to-play role-playing game launched in 2014 which is currently ranked among the top 15 games in the global market with 80 million downloads. The game generates strong recurring earnings from its active users while continuously gaining over 1 million downloads per month. The company also has a strong pipeline of new games over the next 12 months, which is likely to contribute to the company's long-term growth. However, the stock price has been languishing in the recent years for several reasons. First, its dependence on one mobile game is high as more than 80% of the company's sales are generated from Summoners War. Second, there has been some concern over the repeated delay in launching of its new games. Third, the company's large amount of cash (equivalent to 40% of its market cap) is not being used efficiently which decreases the ROE. That is why stock has been trading at less than 6 times its earnings, excluding its cash holdings.

Through our in-depth research, we came to the conclusion that the life span of a highly sophisticated mobile RPG game such as Summoners War is much longer than expected by the market participants. Also, despite the recent delay, the company is well positioned to develop and publish more commercially successful games in the months and years ahead. For example, the company is scheduled to launch 10 new mobile games in 2018. In addition, we have reason to believe that the company is likely to use its cash more wisely by returning more to shareholders and acquiring other smaller game developers. That is why we think Com2uS stock has tremendous upside potential.

The price of most of our portfolio stocks rose in 2017, which is not surprising in a rising market. In particular, the stock price of Kumho Petrochemical, a major manufacturer of synthetic rubber and fine chemicals, rose significantly during 2017 thanks to increasing global demand for synthetic rubber. Even after the price rise, we think the stock is still undervalued because the company has a “hidden” asset in its cogeneration plant whose value is not properly reflected in the current stock price.

The stock price of LG Chem also rose sharply during 2017 because of increasing profits in its core chemical business. Also, the value of the company’s electric vehicle battery business unit was rerated because growing global demand for electric vehicle batteries is projected to increase at a much faster pace than previously forecasted. We believe the stock price is likely to rise further considering the company’s competitiveness in the chemical business and position as one of the leading electric vehicle battery manufacturers in the world. As mentioned previously, we own preferred stocks because of the additional discount.

The stock price of Samsung Electronics continued to move up in 2017 thanks to record profits from booming demand of its memory chips as the company continues to enjoy its market dominance in the semiconductor industry. We also expect the company to return more cash to its shareholders in the form of dividends and share buybacks. We own preferred stocks for the same reason as in the case of LG Chem. The stock price of two major suppliers to Samsung Electronics, Soulbrain and Jahwa Electronics, also rose substantially in 2017. Soulbrain is a specialty chemical manufacturer for the semiconductor and display industry and Jahwa Electronics is a manufacturer of a camera module for smartphones. We think these companies are still undervalued because of growth potential.

The stock price of Hankook Tire, our largest position, declined in the second half of 2017. There were two main reasons for this slide, but we think both of them are temporary in nature. First, the company’s expected production from its new production facility in Tennessee was delayed. But the production is now underway and will eventually contribute to the company’s sales. Second, there is some concern by the market participants over increasing raw material cost. However, tire manufacturers are historically able to pass on the raw material cost to customers over the longer horizon. We believe that this time will not be much different. We continue to believe that Hankook Tire is well positioned to record higher profits in the near future and this will likely to translate into higher stock price in the long-run.

We initiated a small position in two pharmaceutical companies. Both of them have tremendous growth potential, but the price has not been cheap enough for us to jump in. We bought a few shares during a short period of time when the price fell into undervalued territory. We plan to buy them more whenever the price dips.

Investment Philosophy

Our goal for investors is to preserve their capital and compound it at a satisfactory return with minimum risk for a long period of time. Investors often make the mistake of equating performance with skill. In some instances, a good investment strategy can produce poor performance and a bad investment strategy can produce good performance. Therefore, the real measure of successful investing is whether or not making investment decisions based on the same investment strategy can repeatedly produce satisfactory returns over the long term. We think investing is a matter of probabilities. As such, we would like to emphasize that we have achieved our investment returns without taking much risk. In other words, if we continue to do what we have done in the past, we are confident that we can generate superior returns over a long period of time. Of course, we may experience occasional underperformance from time to time. We are grateful to have patient, long-term minded investors as our investors as they have chosen to be in the same boat with us for a long journey.