



Investment Insights

Korea's changing corporate landscape - leading to a healthier market

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The Korean corporate landscape is gradually changing, with the emergence of more independent businesses, on the back of the diminishing importance of the 'chaebols'. In our view, this is an important development for the Korean economy and market. The pace of change will not be overnight, but we are confident Korea is on the right course to a healthier market.

What are 'chaebols'?

'Chaebols' means 'business family' or 'monopoly' in Korean. The chaebol structure can be a single large company or several groups of companies that are owned, controlled or managed by the same family dynasty - generally being the group's founder. Chaebols have been the backbone of Korea's economy and their combined share in the economy is substantial. Today, Korea is largely driven by a few chaebols, of which the two giants, Samsung Group and HMC/KIA Motor Group, make up 30% -40% of Korea's GDP. In fact, in 2011, the five largest chaebols made up more than 55% of South Korea's GDP, while the top 20 accounted for an astonishing 85%¹.

Fundamentals and issues of chaebols

Many of the chaebols tend to have complicated 'cross-shareholding' structures, which often times lead to business areas being overly diversified in terms of scale and business fields, resulting in less efficient and unprofitable businesses. Samsung Group, as an example, is comprised of 74 domestic affiliates, where 17 are listed and 57 are unlisted. Samsung Electronics' consolidated subsidiaries totaled 153². Also, chaebols tend to have less awareness of shareholder interests and lack business transparency, given the controlling shareholder often has an excessive amount of control over the firm. Furthermore, due to the size of the empires, management and labor costs are normally high, with inefficient resource allocation stemming from the bureaucratic structure of the group. For example, the four big chaebols' labor cost per person (in KRW) was 95.1m, compared to independent businesses, such as Amorepacific and Hanmi Pharmaceuticals, which had labor costs of around 71.6m and 46.3m, respectively³. In addition, the debt ratio for the four big chaebols was 60.8%, while Amorepacific had a debt ratio of only 31.1%³.

Emergence of independent businesses

As earnings for chaebols have been affected more by slower global growth, what has been supporting overall earnings in Korea in recent years have been the more independent-minded companies. In fact, chaebol's dominance is gradually shrinking as the economy shifts to a more innovative economy, powered by independent companies that focus on their core businesses. Amorepacific, Hanmi Pharmaceuticals, and many food companies focus on domestic demand. We believe these companies will continue to gain ground in Korea, playing a larger role in the economy and market, which will be positive for the sustainability of growth in Korea, given their greater focus on profitability and corporate governance compared to most chaebols. The big four chaebols historically had operating margins of ~7.7%, compared to Amorepacific's operating margin of 13.0%³.

Implications for bottom-up investors

In our view, Korea's economic future is more dependent on the success of independent firms, rather than the chaebols. The strong growth provided by independent companies is gradually helping to reduce the discount placed on the overall Korean equity market by the long-standing dominance of Korea's chaebols. We expect the higher ROE and healthier balance sheet these businesses have to offer will be positive for Korean equities. This should also help lift foreign investor confidence as Korea's corporate landscape changes with the diminishing importance of chaebols. Against this backdrop, as bottom-up active investors, our strategy remains unchanged in that we continue to target core quality companies with a sustainable business models, free cash flow generation, market leadership, a competitive edge, branding power, quality management and industry growth.

Companies mentioned in this page do not represent Invesco's recommendation or holding.

¹ Source: Globe and Mail, 24 Apr 2015

² Based on Q1 2014 Samsung Group Business Report

³ Big four chaebols include Samsung Group, Hyundai Motor Group, SK Group and LG Group. Source: ERFI (Economic Reform Research Institute), data based on 2011-2013 averages.

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