

OPINION

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Strategic Direction for Korea's Value-up Program

Publicly traded companies that raise capital by issuing shares should, over the long term, achieve shareholders' required rate of returns by enhancing their stock prices. This approach aligns with the standard practice to fairly compensate shareholders who have invested in risk capital. However, in the Korean market, more than half of the companies have failed to achieve even a risk-free rate of return over an extended period. This phenomenon is often linked to the Korea Discount, characterized by a persistently low Price-to-Book Ratio (PBR). However, the underlying cause is more likely associated with diminished profitability and insufficient shareholder returns, which result in low but fair valuations. To be eligible for listing, companies should develop effective strategies to improve their capital efficiency. In the short term, expanding shareholder returns can be a valid approach, particularly for large companies with solid fundamentals. In the long term, structural improvements in corporate fundamentals are essential. Notably, efficient use and reallocation of capital employed, along with maintaining profitability and growth potential, are key factors for achieving superior valuation in major overseas markets. Additionally, it is worth considering legislative reforms to address the persistent issue of severe undervaluation.

Debate over the effectiveness of corporate value enhancement policies

The Korean stock market has long been characterized by a persistently low Price to Book-value Ratio (PBR). From 2010 to 2022, in the period following the global financial crisis, the average PBR of companies listed on the KOSPI and KOSDAQ was only 1.62. Since a significant portion of the book value of net assets is considered historical costs, the market prices of

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many Korean stocks have been hovering around liquidation value. Compared to other major economies, with the exception of Japan, the undervaluation of Korean stocks is particularly striking.¹⁾ This persistently low PBR has been referred to as the Korea Discount by market participants. Various studies have sought to uncover the underlying causes of this phenomenon and have proposed strategies for its mitigation (Kim & Kang, 2023). Despite these efforts, substantial skepticism persists regarding the potential for meaningful improvements, given the long-standing and entrenched nature of the Korea Discount.

Japan's recent implementation of value-up policies aimed at enhancing corporate value has had a remarkable impact on Korea's stock market. Both Korea and Japan have historically experienced low PBRs and shared a common need to invigorate the dynamics of their capital markets. Moreover, both countries face similar demographic challenges, such as low fertility rates and an aging population, which necessitate proactive measures to encourage household asset accumulation through a reasonable approach. In this context, Japan's value-up policies offer valuable insights for Korea in various aspects (Lee, 2024).

In response, financial authorities in Korea announced the Guidelines for Corporate Value Enhancement Plans on May 2, outlining measures to support the improvement of shareholder value. These guidelines encourage companies to establish strategies and objectives to ensure that returns on invested capital and shareholder returns meet the levels expected by shareholders over the mid- to long term. Additionally, companies are required to publicly disclose the outcomes of their implementation. In this respect, Korea's guidelines share core principles with Japan's value-up policies.

However, the introduction of the so-called Korean version of the value-up policy has been met with considerable negative responses. A primary concern is that without mandatory disclosure requirements for corporate value enhancement plans, it will be challenging to encourage corporate participation. This skepticism stems from the belief that expecting changes in management behavior is unrealistic without legislative reforms to address underlying corporate governance issues. The lack of enforceability is seen as a significant weakness, potentially rendering the policy ineffective. Further fueling these concerns is a recent merger between affiliated companies, where the expected synergies are unclear, resulting in

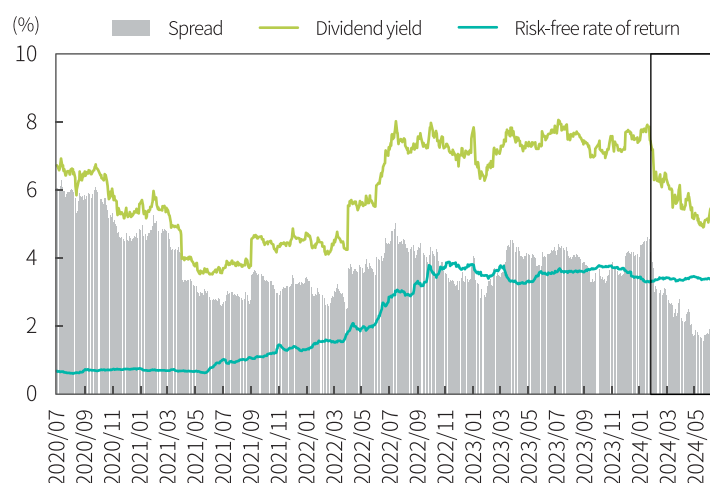
1) The average PBR of listed companies in major countries over the same period is as follows: 3.36 in the US, 2.86 in the UK, 2.64 in Germany, 2.01 in Taiwan, 1.62 in Korea, and 1.57 in Japan. In the most recent year, Japan's PBR slightly increased to 1.82, but Korea remained at the lowest level of 1.54 for an extended period.

conflicts of interest between controlling shareholders and minority shareholders. Additionally, doubts persist about whether boards of directors are independently performing their oversight and control functions. These controversies have reignited the debate over the effectiveness of Korea's value-up policy.

Resolving the undervaluation of bank stocks and drivers of value enhancement

It is necessary to maintain a neutral perspective when assessing whether efforts to boost shareholder value in Korea's capital market will extend beyond mere policy declarations. On January 24, 2024, the plan to introduce the Value-up Program was announced at a meeting involving the Financial Services Commission, the Financial Supervisory Service, and representatives from the securities industry. Immediately following this announcement, the dividend yield of Korea's bank stocks declined at an unprecedented rate (see Figure 1). In the month preceding the announcement, the expected annual dividend yield for a market capitalization-weighted portfolio of nine commercial banks, excluding internet banks, reached as high as 7.7%, which rapidly turned into a downward trend starting on January 24.²⁾ This shift suggests that bank stocks have been trading at a substantial discount, largely due to the remarkable uncertainty surrounding dividend payments. As the Value-up Program mitigated this uncertainty, stock prices were on a steady rise, bringing the dividend yield down to 5.3% by the end of June. Given that the benchmark interest rate stands at 3.5%, stock prices are considered to have aligned with their intrinsic value. Furthermore, when compared to the risk-free yield, a proxy for the 364-day Monetary Stabilization Bond yield, the dividend yield spread is now less than 2%, indicating that much of the Korea Discount on bank stocks has been alleviated over the past six months.

2) On February 26, the first seminar on "Support Measures for Enhancing Corporate Value to Advance the Korean Stock Market" revealed specific details of the value-up policy. On May 2, the "Guidelines for Corporate Value Enhancement Plans" were officially announced.

Figure 1. Dividend yields of listed commercial banks in Korea

Note: 1) Daily dividend yields of common shares issued by listed commercial banks in Korea are analyzed from July 2020 to June 2024.

2) The dividend yield is calculated as the value of cash dividends for common shares over the past 12 months divided by daily market capitalization. The calculation is weighted by the market capitalization of the previous day.

3) The spread is calculated as the dividend yield minus the risk-free rate, a proxy for the 364-day Monetary Stabilization Bond yield.

Source: Dataguide, Bank of Korea, Korea Capital Market Institute

It should be noted that the reduction in the undervaluation of bank stocks is likely not solely attributable to stock price increases driven by policy-induced expectations. The weighted average Return on Equity (ROE) of domestic commercial banks has steadily risen over the past decade, exceeding 8% as of the end of the first quarter of 2024. This demonstrates that these banks have secured sufficient capacity to deliver shareholder returns, even after accounting for loan-loss provisions on non-performing loans. On top of that, all nine commercial banks have proactively adopted regulatory improvements in dividend payment procedures, adjusting their dividend record dates to allow investors to make informed decisions with finalized dividend amounts. Notably, six of these banks have implemented shareholder return policies that surpass industry norms by combining cash dividends with the repurchase and cancellation of treasury shares.

The stock price movement in the first quarter of this year for commercial banks, particularly those affiliated with financial holding companies, demonstrates that effective shareholder return policies can be a major driver of corporate value enhancement. Established academic literature suggests that when a fundamentally strong company is undervalued in the market, factors such as uncertainty in future cash flow signaling (Denis et al., 1994) and the inefficient

investment or privileged consumption of free cash flows (Lang & Litzenberger, 1989) tend to increase the discount rate. Expanding shareholder returns not only alleviates these proxy issues but also shows that abstract shareholder rights can be realized as tangible cash flow rights, thereby serving as an effective mechanism for narrowing the gap between corporate value and stock prices.

This suggests that to rapidly address the Korea Discount, it is crucial for companies to establish solid fundamentals and reinforce corporate governance. A company's fundamentals serve as the primary driver of shareholder returns, while strong governance shows the company's commitment to implementing shareholder return policies. However, enhancing key elements of a company's fundamentals, such as profitability and growth potential, cannot be easily achieved through government intervention alone. In this regard, long-term structural improvements are needed since the impact of initiatives like the Value-up Program may be delayed, depending on the specific circumstances of each company. Therefore, discussions about the Value-up Program, particularly following the resolution of the undervaluation of bank stocks, should be based on a comprehensive understanding of the factors contributing to the undervaluation of non-financial companies in Korea.

Undervaluation trend of non-financial listed companies

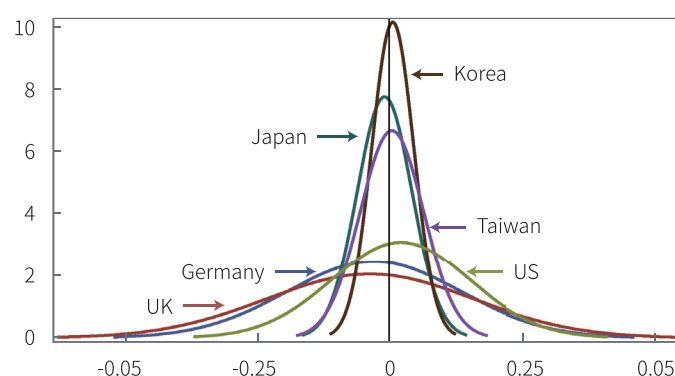
The Korea Discount has been frequently characterized by the persistently low PBR observed in Korea's stock market. A notable development occurred on March 23 when the Japan Exchange Group (JPX) announced its initiative for the Capital Cost and Stock Price-Conscious Management. This initiative recommends that companies with a PBR below 1 disclose plans to enhance corporate value, solidifying the notion that a PBR below 1 serves as a proxy for undervaluation relative to intrinsic value. Empirical evidence supports this, as regression analyses controlling various factors that could affect PBR reveal that non-financial Korean companies consistently exhibited the lowest PBR levels from 2010 to 2022, following the global financial crisis, when compared to their counterparts in Taiwan and Japan as well as the US, the UK and Germany.

However, assessing stock prices as overvalued or undervalued based solely on PBR levels can lead to a narrow and potentially misleading evaluation. PBR represents just one dimension—the difference between the market price (P) and the book value of net assets (B) as recorded in accounting (Penman et al., 2006). The relationship between P and B should be reassessed

as a polynomial function that takes into account multiple facets of corporate value. More specifically, when defining a company's intrinsic value as the sum of its net assets and profit value, it is necessary to measure profit value based on free cash flows—net income minus cash dividends—to capture the impact of shareholder returns on valuation. In this case, PBR can be redefined as the ratio of market value to intrinsic value, taking into account three elements of net assets, profitability, and shareholder returns, based on the clean surplus relationship described by Feltham-Ohlson (1995).

Using the model described above, a comparative analysis of non-financial listed companies in six major countries finds that Korea's non-financial listed companies are not undervalued relative to their intrinsic value (see Figure 2). On average, companies listed on US exchanges are valued the highest, followed by those listed on the Korean market, in descending order of the US, Korea, Taiwan, Japan, Germany, and the UK. When conducting a regression analysis while controlling various factors that can affect corporate value, Korean companies exhibit the highest market value relative to intrinsic value compared to their counterparts in the six major countries. This means that Korean companies are unlikely to achieve a higher PBR if listed on major overseas markets. On the contrary, they may face even more stringent evaluations in markets with robust regulatory frameworks for minority shareholder protection and stricter enforcement of laws.

Figure 2. Distribution of excess market value relative to intrinsic value for listed companies in major economies



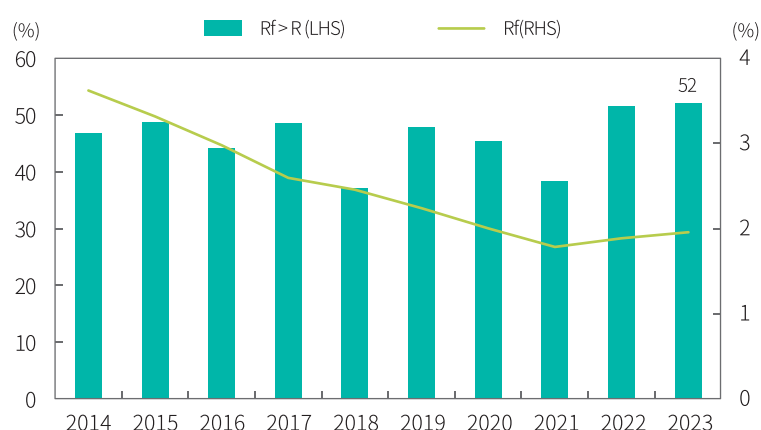
Note: 1) This figure represents the distribution of excess market value relative to intrinsic value for listed companies in six major economies from 2010 to 2022. Positive values (+) indicate high market value, while negative values (-) indicate low market value.

2) The intrinsic value is defined as the value of net assets and free cash flows, based on the clean surplus relationship suggested by Feltham-Ohlson (1995). The ratio of excess market value to intrinsic value for each company and year is measured through industry-specific (Fama-French 48 industry classification) and year-specific regression analyses conducted on a sample of listed companies in six major economies.

Source: Refinitiv, Bloomberg, Korea Capital Market Institute

Meanwhile, the Korean stock market has seen a significant proportion of companies whose stocks have underperformed over an extended period. In theory, the cost of raising equity capital is composed of the risk-free rate of return and a risk premium that reflects company-specific and market-specific factors and thus, the risk-free rate of return serves as the baseline and minimum threshold for the cost of capital. Notably, as of the end of 2023, over half of the companies listed on the Korean market (52%) had 10-year cumulative stock returns below the risk-free rate (see Figure 3). This proportion is even higher, at 58%, among large-cap companies representing the top 30% by market capitalization. While returns on risk assets are inherently volatile, a total shareholder return, including the reinvestment of cash dividends, that falls below the yields of short-term bonds issued by the Bank of Korea hardly constitutes an adequate level of compensation for risk capital.

Figure 3. Proportion of companies with long-term underperformance in stock returns



Note: 1) Among non-financial companies listed on the KOSPI and KOSDAQ with a December 31st fiscal year-end, the proportion of companies, whose 10-year stock returns (R) have long underperformed their risk-free rate (Rf) over the past decade, has been calculated.

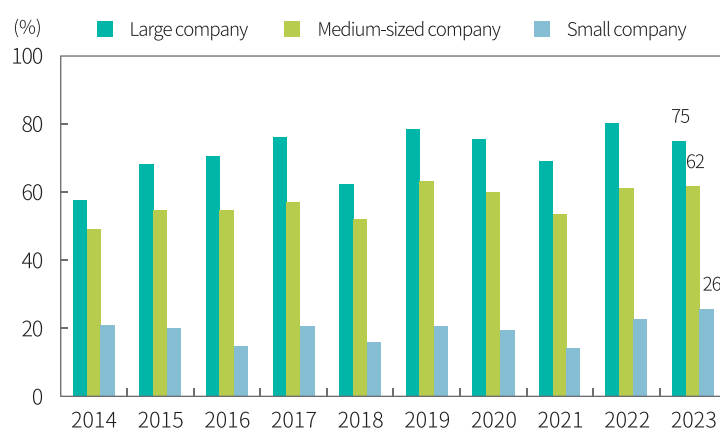
2) R represents the total return for shareholders, including both stock returns and cash dividend yields, while Rf is calculated using the yield on 364-day Monetary Stabilization Bonds.

Source: Dataguide, Bank of Korea, Korea Capital Market Institute

In cases where intrinsic value has declined due to low profitability, stock returns are typically low. However, as of 2023, 75% of large companies representing the top 30% by market capitalization achieved a higher ROE than their stock returns over the past decade (see Figure 4). These companies are generating sufficient profits to partially offset significantly low stock returns. Moreover, 24% of these large companies had a 10-year ROE that outperformed stock returns by 10% annually, while 15% had a 10-year average ROE that exceeded stock returns

by 20% per year. If these companies actively seek to compensate for low stock returns by increasing cash dividends or conducting the buyback and cancellation of treasury shares, this could not only enhance total shareholder returns but also significantly boost stock indices. This is particularly plausible since the top 30% of companies by market capitalization make up 94% of the KOSPI.

Figure 4. Proportion of companies with high ROE relative to long-term stock returns



Note: 1) Among non-financial companies listed on the KOSPI and KOSDAQ with a December 31st fiscal year-end, the proportion of the companies, whose 10-year annual ROE exceeded their stock returns (R) over the past decade has been calculated.

2) R represents the total return for shareholders, including both stock returns and cash dividend yields, while ROE is calculated as the net income of controlling shareholders divided by the total equity ownership of the controlling company.

3) Large (small) companies are those in the top (bottom) 30% by market capitalization of the year, while medium-size companies fall within the middle 40% of market capitalization for the year.

Source: Dataguide, Bank of Korea, Korea Capital Market Institute

Conclusion and challenges

Persistently low PBRs observed in the Korean stock market are well-documented. However, this phenomenon may reflect the low intrinsic value of companies rather than systematic undervaluation compared to other major global markets. When considering net assets, profitability, and shareholder returns as a whole for evaluating intrinsic value, non-financial companies listed in Korea have higher market valuations on average compared to their counterparts in other major economies. This suggests that the PBR may not be the single effective measure for judging whether the Korean stock market is experiencing a discount. A more comprehensive approach is necessary, focusing on three key aspects: the fair value of assets, the capacity to generate future cash flows, and the adequacy of shareholder return

policies. It is also important to acknowledge that a short-term upward movement in stock prices is unlikely without a significant improvement in poor corporate profitability.

However, there is no need to be skeptical of various policy efforts aimed at boosting corporate value. As evidenced by the revaluation of bank stocks in the first half of this year, companies with robust fundamentals and sound governance can quickly narrow the gap between the market price and intrinsic value through initiatives like the Value-up Program. It is crucial to conduct a thorough analysis of the factors behind the prolonged underperformance of many companies compared to the risk-free rate of return and to require these companies to disclose improvement plans. Despite this challenge, the good news is that larger companies generally remain profitable enough to counterbalance low stock returns. These companies are expected to immediately enhance corporate value by expanding shareholder returns, which could, in turn, drive an increase in stock indices. Given their significant weight in stock indices, such improvements would likely be noticeable to investors.

In the long term, structural measures to improve corporate fundamentals should be taken alongside the policies mentioned above. An analysis of factors driving excess market value for listed companies in six major countries highlights that high profitability, growth potential, and the efficient utilization and reallocation of capital employed are key to enhancing corporate value. The analysis also finds that companies underpinned by intangible assets, as opposed to those with labor-intensive business models, tend to achieve significantly higher market valuation. Shareholder returns through cash dividends and treasury share repurchases generally contribute to increasing corporate value, while reinvesting retained earnings has proven more effective in cases where the core business generates high margins. From a shareholder's perspective, the optimal shareholder return policy is to maximize after-tax returns.

Additionally, a legislative approach could effectively address the long-term undervaluation of stocks. For instance, many asset stocks have long traded at prices far below their liquidation value, which calls for regulatory intervention. Stricter regulations on mergers and acquisitions (M&A) are necessary to safeguard shareholder rights and ensure efficient resource allocation, and during the M&A process, the merger value and tender offer prices should be fairly assessed. On top of that, promoting shareholder activism is crucial to foster constructive and cohesive engagement that can drive meaningful changes in corporate management.

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