CLSA ASIA-PACIFIC MARKETS

Korea

Market strategy

Shaun Cochran, CFA
shaun.cochran@clsa.com
(822) 3978427

Mike Greer
(822) 3978466

30 November 2009

Korea
Strategy

Dividend plays

Markets are likely to remain volatile and have looked stretched on both valuations and technicals. In this environment dividend farming is intuitively appealing because history suggests high yield stocks are highly likely to rally into year end while the inherent defensiveness of high yields means exceptional resilience to any potential selloff. Our preferred dividend plays are SK Telecom, micro cap Heerim and Samsung Card. We would SELL both S-Oil and GS Holdings despite the yields.

Roid rage?

- Like an athlete pumped up on steroids, the powerful cocktail of stimulus and exceptionally low rates has put markets into a state of amplified response.
- Heading into this weakness the market was showing two signs of extraordinary volatility and hence risk to investors: The first was that valuations had climbed from the bottom of the forward and trailing range to the top in only 10 months.
- The second indicator of excess volatility and potential risk was the market's premium to the 200 day moving average. By September Korea had reached 1 standard deviation above its mean, typically a sign of market reversal.

The parry of the dividend farmer

- In this environment dividend farming is intuitively appealing because history suggests high yield stocks are highly likely to rally into year end while the inherent defensiveness of high yields means exceptional resilience to any potential selloff.
- This year CLSA expects some traditional dividend stocks to fail to deliver to relatively consistent historical track records – this presents an opportunity for mispricing which we believe is reflected in consensus assumptions.

CLSA's dividend winners and losers

- The most attractive dividend plays that present the best balance of near term yields, 2010 growth and low market expectations are: SK Telecom (017670 KS - 170,500won - BUY) , microcap Heerim (037440 KQ - 10,000 won - BUY) and Samsung Card (029780 KS - 48,900 won - BUY).
- Other high dividend stocks are KT (030200 KS - 38,550won - O-PF), KT&G (033780 KS - 66,700won - O-PF), LG Telecom (032640 KS - 8,080won - O-PF), and LG Dacom (015940 KS - 17,550won - BUY) and Woongjin Coway (021240 KS - 37,550won - O-PF).
- The dividend plays most likely to disappoint are S-Oil (010950 KS - 54,500won - SELL) and GS Holdings (078930 KS - 30,850 won - SELL). Both stocks present downside across all our evaluation metrics (expected yield versus consensus, 2009 and 2010 earnings and most importantly our price targets). Of the two we prefer GS Holdings which has less downside on our evaluation criteria – long short investors could look to put on a pair trade into likely disappointment on S-Oil.

CLSA dividend plays ranked by attractiveness

#	Company	Ticker	Rec	Upside	CL - Cons. Yield (%)	CL/Cons. 2009 (%)	CL/Cons. 2010 (%)
1	SK Telecom	017670.KS	BUY	34.9	1.4	4.2	16.0
2	Heerim A&P	037440.KQ	BUY	57.0	0.6	-1.5	-3.9
3	Samsung Card	029780.KS	BUY	35.0	0.7	1.7	11.3
4	KT	030200.KS	OPF	16.7	1.5	11.6	3.2
5	KT&G	033780.KS	OPF	16.9	0.5	-2.3	10.7
6	LG Telecom	032640.KS	OPF	23.8	1.0	-5.3	-2.9
7	LG Dacom	015940.KS	BUY	23.6	0.4	-2.6	-6.5
8	Woongjin Coway	021240.KS	OPF	17.2	0.3	-4.3	-8.8
9	GS Holdings	078930.KS	SELL	-19.0	-0.8	-41.3	-25.2
10	S-Oil	010950.KS	SELL	-26.6	-2.8	-24.2	-63.2

Note: S-oil and SKT pay interim dividends. As such realised dividends are low than annual headlines (S-Oil's effective yield dops from 3.5% to 2.4% and SKT's yield drops from 5.5% to 4.9%.

Valuations still present risks

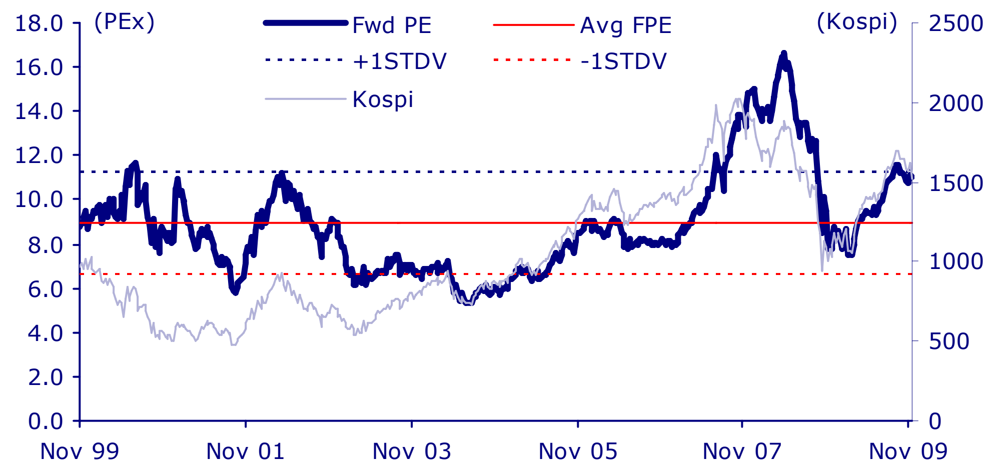
Roid rage?

Like an athlete pumped up on steroids, the powerful cocktail of stimulus and exceptionally low rates has put markets into a state of amplified responses. Heading into this weakness the market was showing two signs of extraordinary volatility and hence risk to investors. The first was that valuations had climbed from the bottom of the forward and trailing range on earnings and cash flows to the top in only 10 months (something that tooks 4 years in the previous cylce). The closet Korea came to that speed of recovery in a previous cylce was the post 2000 recovery when, fueled by unsustainable credit card stimulus, the same feat was achieved in 17 months only to reverse returning to the bottom of the range in 11 months.

Still close to one standard deviation above the decade trend

Figure 1

Kospi versus Forward PE



Source: CLSA Asia-Pacific Markets, Evaluator.

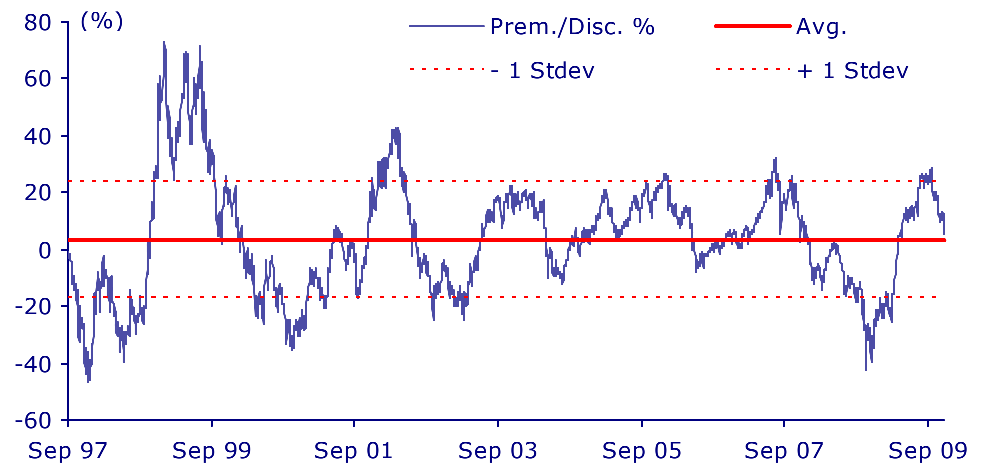
While the technical pressure is only just now beginning to subside

The second indicator of excess volatility and potential reversal risk was the market's premium to the 200 day moving average. By sepetmeber Korea had reached 1 standard deviation above its mean which typically suggests poor short-term performance lies ahead.

Still 5% above the mean premium to the 200DMA, though potentially near support

Figure 2

Forward PE multiple



Source: CLSA Asia-Pacific Markets, Quantiwise.

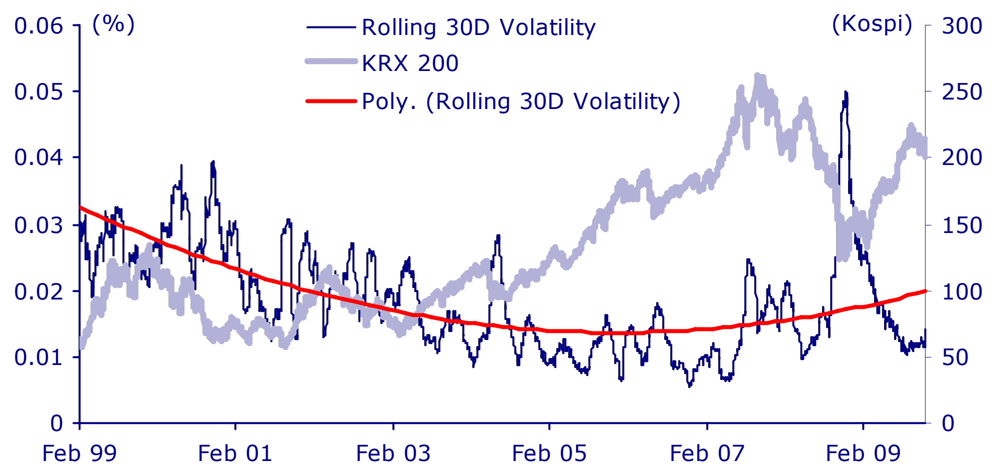
We are not convinced the period of accelerated volatility is over

Thus the globl reliance on debt funded stimulus and low interests rates has reversed what was a long-term trend of declining volatility for the Korean market. This is a process that we are not yet convinced is complete.

Having been rising since late 2007

Figure 3

KRX 200 versus rolling 30 day volatility (including a polynomial trend line)



Source: CLSA Asia-Pacific Markets, Quantiwise.

The parry of the dividend farmer

Dividend plays are an intuitively appealing hedge

One response investors can take to the volatility is to turn to dividend farming. This strategy is intuitively appealing because historical performance suggests these stocks are highly likely to rally in the last month of the year while the inherent defensiveness of high dividend yields means that they are exceptionally resilient to any potential selloff.

We see opportunities on both the long and short side around dividend expectations

Looking at the history of dividend performance on a stock by stock basis we have isolated Korea's historical top 10 dividend payers. To achieve this we have looked at dividend performance over the last five years (i.e. dividend and share price results from 2004 through to 2008). A number of conclusions can be drawn from this work:

(1) High dividend payers present marked absolute upside into the year end with a retracement that takes up to one month to reverse. This presents potential opportunities on both the long and short side.

(2) This year CLSA expects some traditional dividend stocks to fail to deliver to relatively consistent historical track records – this present an opportunity for mispricing which we believe is reflected in consensus assumptions.

Figure 4

Korea historical dividend leaders

#	Stock Name	BBG Code	Average 5-Yr Div Yield	Average Returns (%) from Ex-date ... 1 month	3 months	6 months
1	S-Oil Corp	010950 KS Equity	10.05	(3.30)	0.48	2.15
2	KT Corp	030200 KS Equity	5.19	(1.63)	(3.22)	(3.60)
3	SK Telecom Co Ltd	017670 KS Equity	4.41	(3.99)	(4.00)	(0.33)
4	KT&G Corp	033780 KS Equity	4.00	0.54	4.22	12.33
5	Korea Gas Corp	036460 KS Equity	3.57	(4.62)	(2.94)	3.01
6	Kangwon Land Inc	035250 KS Equity	3.25	(3.53)	(6.01)	(1.51)
7	POSCO	005490 KS Equity	3.04	2.52	12.42	12.99
8	Korea Exchange Bank	004940 KS Equity	2.92	(2.76)	3.22	18.33
9	LG Chem Ltd	051910 KS Equity	2.78	(2.66)	0.16	15.09
10	GS Holdings Corp	078930 KS Equity	2.68	(0.66)	6.24	10.69

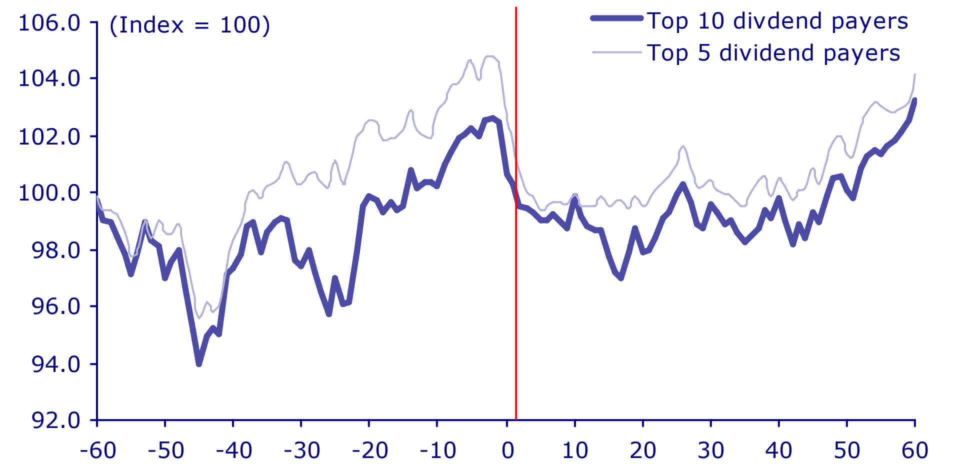
Source: CLSA Asia-Pacific Markets, Evaluator.

Historically high yield stocks produce a year end rally

Looking at the historical share price performance of our top ten dividend payers 60 days into and out of the ex-date, we can see a marked trend of absolute performance and then retracement around the ex-date. Supporting the view that it is indeed the yield driving this performance of the five highest yielding stocks and have traditionally offered the strongest year end rally.

Figure 5

Korea 10 dividend payers (performance in the 120 days around the ex-date)



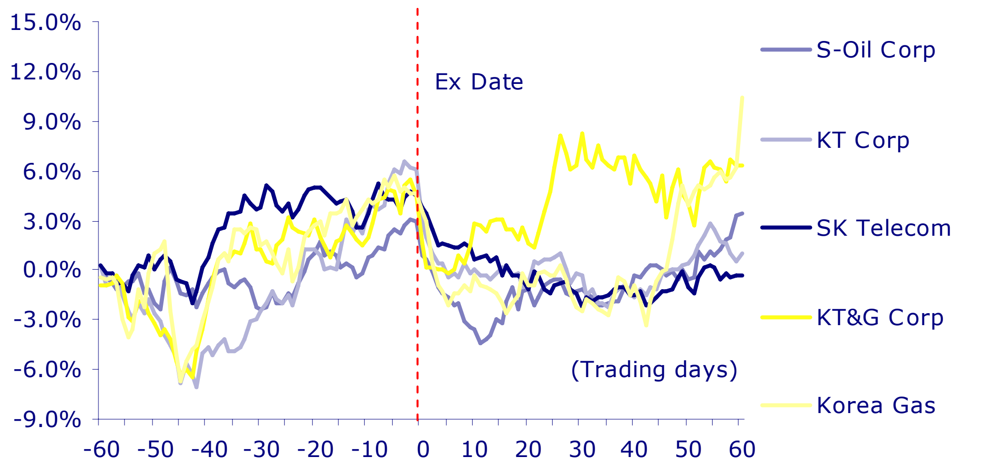
Source: CLSA Asia-Pacific Markets, Bloomberg.

The rally often starts about 40 trading days prior to going ex

Across each of the top five stocks there appears a clear pattern of absolute performance that typically begins about 40 days prior to the ex-date (i.e. early to November). Importantly the results do not appear to be driven by any one particular stock with all stocks exhibiting a similar pattern.

Figure 6

Cum. Avg. Daily Returns (Ex Dates June 2004 - June 2009): top 5 highest Yields



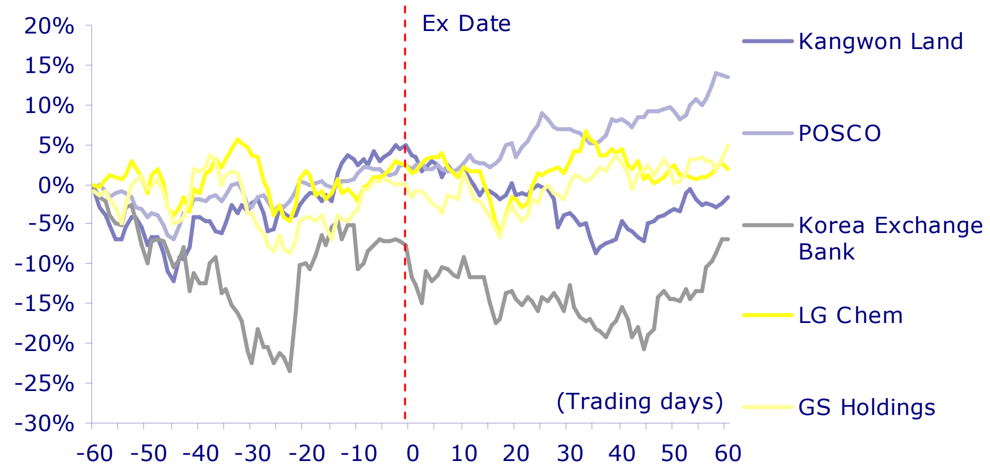
Source: CLSA Asia-Pacific Markets, Bloomberg.

Though the strength of the pattern appears correlated to yield levels

What is interesting is that while the same pattern exists for the five next highest dividend payers the trend is clearly not as marked for the dividend losers with the performance appearing to star later in the year. Roughly eye balling the chart would suggest that late November to early December would be the point at which the absolute performance tends to begin. On balance for both portfolios the most consistent performance appears to be from about the 20 trading day mark – the beginning of December.

Figure 7

Cum. Avg. Daily Returns (Ex Dates June 2004 - June 2009): nest 5 highest Yields



Source: CLSA Asia-Pacific Markets

Not all is as it seems with the usual suspects…

CLSA's dividend winners and losers

With year end performance in mind we have isolated the likely highest yielding stocks for the CLSA universe in 2009. All of these stocks go ex at the end of the year. What is interesting is that although we see a list of the usual suspects, this year CLSA is sufficiently below consensus on the refining stocks – traditional considered yield stocks, to foresee meaningful risk in consensus expectations. We also see our micro cap favourite – Heerim, just making the list with a projected 2.5% yield.

Figure 8

CLSA Korea's highest yielders

#	Company	Ticker	Rec	Target	Upside	Yield	PB09	ROAE 10	PE09	2010 EPS growth
1	KT	030200.KS	OPF	45,000	16.7	6.0	0.9	10.9	7.7	-1.5
2	SK Telecom*	017670.KS	BUY	230,000	34.9	5.5[1]	1.2	14.4	9.3	26.3
3	KT&G	033780.KS	OPF	78,000	16.9	4.3	2.2	21.7	10.4	8.1
4	LG Telecom	032640.KS	OPF	10,000	23.8	4.3	1.0	15.4	7.4	18.3
5	S-Oil*	010950.KS	SELL	40,000	-26.6	3.5[1]	1.8	7.1	18.3	-28.0
6	GS Holdings	078930.KS	SELL	25,000	-19.0	3.2	0.8	8.8	9.6	13.6
7	LG Dacom	015940.KS	BUY	21,700	23.6	3.1	0.9	12.6	8.4	18.8
8	Woongjin Coway	021240.KS	OPF	44,000	17.2	2.7	3.5	18.9	18.7	11.7
9	Samsung Card	029780.KS	BUY	66,000	35.0	2.7	1.4	9.8	10.4	-24.3
10	Heerim A&P	037440.KQ	BUY	15,700	57.0	2.5	1.6	22.2	11.0	23.0

Source: CLSA Asia-Pacific Markets, Evaluator. * Note 1: S-oil and SKT pay interim dividends. As such realised dividends are low than annual headlines (S-Oil's effective yield dops from 3.5% to 2.4% and SKT's yield drops from 5.5% to 4.9%.

In order to isolate the risks and opportunities we have looked at four factors:

(1) CLSA's yield expectations versus those implied by IBES median consensus DPS forecasts

(2) CLSA's 2009 EPS expectations versus those implied by IBES median 2009 consensus EPS forecasts

(3) CLSA's 2010 EPS expectations versus those implied by IBES median 2010 consensus EPS forecasts

(4) Upside to our price targets

On this basis we have ranked the dividend opportunities in Korea into three groups:

Preferred dividend plays are SKT, Samsung Card and Heerim

The most attractive dividend plays that present the best balance of near term yields, 2010 growth and low market expectations are: SK Telecom (017670 KS - 170,500won - BUY) , Heerim (037440 KQ - 10,000 won - BUY) and Samsung Card(029780 KS - 48,900 won - BUY).

KT the best of the rest

The stocks that offer attractive dividends, but less valuation upside and or high market expectations of future earnings are: KT (030200 KS - 38,550won - O-PF), KT&G (033780 KS - 66,700won - O-PF), LG Telecom (032640 KS - 8,080won - O-PF), and LG Dacom (015940 KS - 17,550won - BUY) and Woongjin Coway (021240 KS - 37,550won - O-PF).

Sell S-oil and GS Holdings

The dividend plays most likely to disappoint are S-Oil (010950 KS - 54,500won - SELL) and GS Holdings (078930 KS - 30,850 won - SELL). Both stocks present downside across all our evaluation metrics, expected yield versus consensus, 2009 and 2010 earnings and most importantly our price targets. Of the two we prefer GS Holdings which has less downside on our evaluation criteria – long short investors could looks to trade the pair.

S-Oil and SKT pay interim dividends

Note – both S-Oil and SKT pay interim dividends. S-Oil paid a 600 won dividend. This means the realised dividend yield for a buyer now will be 2.4%, not the 3.5% headline. Equally, SKT paid a 1000 won interim dividend such that the realised yield falls from 5.5% to 4.9% (still the second highest yield in our coverage).

Figure 9

CLSA dividend plays ranked by attractiveness

#	Company	Ticker	Rec	Upside	CL - Cons. Yield (%)	CL/Cons. 2009 (%)	CL/Cons. 2010 (%)
1	SK Telecom	017670.KS	BUY	34.9	1.4	4.2	16.0
2	Heerim A&P	037440.KQ	BUY	57.0	0.6	-1.5	-3.9
3	Samsung Card	029780.KS	BUY	35.0	0.7	1.7	11.3
4	KT	030200.KS	OPF	16.7	1.5	11.6	3.2
5	KT&G	033780.KS	OPF	16.9	0.5	-2.3	10.7
6	LG Telecom	032640.KS	OPF	23.8	1.0	-5.3	-2.9
7	LG Dacom	015940.KS	BUY	23.6	0.4	-2.6	-6.5
8	Woongjin Coway	021240.KS	OPF	17.2	0.3	-4.3	-8.8
9	GS Holdings	078930.KS	SELL	-19.0	-0.8	-41.3	-25.2
10	S-Oil	010950.KS	SELL	-26.6	-2.8	-24.2	-63.2

Source: CLSA Asia-Pacific Markets, Evaluator.

Key to CLSA investment rankings: BUY = Expected to outperform the local market by >10%; **O-PF** = Expected to outperform the local market by 0-10%; **U-PF** = Expected to underperform the local market by 0-10%; **SELL** = Expected to underperform the local market by >10%. Performance is defined as 12-month total return (including dividends).