South Korean Stocks Could Break Free From Bargain Hunters

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By Heejin Kim

(Bloomberg) -- South Korean equities,stuck near the lowest level versus the world since the 2008 global financial crisis, are ready to break free with the second-highest earnings growth prospects in Asia, according to Huh Nam-Kwon of Shinyoung Investment Management Co.

“The Kospi index is like a baby elephant, tied for years and never trying to set itself free,” said Huh, the chief investment officer who has worked as a value-stock fund manager in Seoul for 30 years and now runs a $5.2 billion fund. “But it can escape from the value trap when there is a trigger.

Conditions for the Kospi to break out from the trap are all ready.”

Profits in the benchmark Kospi are projected to jump 58 percent over the next 12 months, data compiled by Bloomberg show. Brokers upgraded Korea’s 2016 earnings estimates for a fourth month since April, according to Credit Suisse Group AG, and Yuanta Securities Korea Co. has predicted stocks to reach a record index of 2,250 this year. With shares priced at the cheapest relative to global peers in more than a decade, conditions are right for stocks to gain upward momentum, said Huh.

Value trap is a term used when stocks appear to be cheap and are trading at low earnings multiples for long periods, attracting investors looking for bargains. The trap springs when investors buying the companies don’t see any improvement in the stock.

Second quarter earnings surprises have spurred rallies at top Korean exporters such as Samsung Electronics Co. and materials producers like Posco, as a weaker won and a rebound in commodities helped bolster profits. Foreign investors -- who in

2015 pulled the most money in four years from equities and kept the Kospi stuck in a five-year range between 1,800 and 2,200 points -- have snapped up shares in July at the fastest pace in

15 months.

“Many people think that Kospi would continue to be stuck in the boring range,” said Hyun-Jun Park, Seoul-based Managing Director at Korea Investment Management Co. whose $2 billion fund is beating 94 percent of peers in one-year returns. “But some debt-ridden sectors such as shipbuilding or construction, which dragged down the overall earnings of Kospi so far, are trimming their losses.”

Samsung Rallies

The Kospi has risen 11 percent from a February low.

Samsung, the world's largest maker of phones and memory chips with the biggest weighting on the Kospi, is near a record high, having rallied 24 percent this year. On July 7, it posted its biggest operating profit in more than two years. LG Electronics Inc., the country's No. 2 mobile phone maker, reported last month its highest quarterly earnings in two years, while Hyundai Motor Co.'s earnings topped estimates.

Posco, South Korea's biggest steelmaker, trading near a three-month high, posted a 47 percent jump in quarterly profit in July. Hyundai Heavy Industries Co., the country's major shipbuilder striving for restructuring, up 45 percent in 2016, last week reported its biggest quarterly profit in three years.

The Kospi is valued at 0.96 net assets, lower than its 10- year average of 1.16 and more than 50 percent cheaper than the MSCI All Country World Index, which has a multiple of 2.1. The gap is near its widest since April 2005, data compiled by Bloomberg show.

Earnings will further improve as Korea bids to bring more transparency to the accounting methods of companies and boost investor confidence, said Huh. "Investors will be able to trust the accounting books of Korean companies," he said.

Daewoo Shipbuilding & Marine Engineering Co. is under investigation by prosecutors as the company restated its earnings from 2013 to better reflect the write-offs in its financials. The world's second-largest shipbuilder posted a net loss, excluding minority interest, of 3.19 trillion won ($2.8 billion) in 2015.

Not everyone is optimistic of Korean companies' earnings prospects.

Kee Ho Sam, a Seoul-based fund manager at Dongbu Asset Management who helps oversee 13 trillion won, said it's still too early to trust earnings estimates, as analysts could downgrade them for year-end annual earnings. For the Kospi index rebound, sales growth is necessary, he said.

Last month, South Korea's central bank held its benchmark interest rate at a record low and lowered its estimate for gross domestic product expansion this year to 2.7 percent, from an April projection of 2.8 percent. The government announced a 10 trillion won ($8.7 billion) supplementary budget in June, mainly to create jobs and aid regional economies that will be hurt by corporate restructurings.

Shinyoung's Huh remains optimistic.

The "extreme pessimism" that's plagued Korean equities for years was overdone, he said. "It will easily break free from the trap when there is market consensus that it can."

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