
KOSPI 200 Reconstitution

Special reconstitution: Hanjin Shipping Holdings out, GKL in

KRX revised reconstitution rules related to spin-offs

On August 28th, the Korea Exchange (KRX) announced changes to the KOSPI 200 reconstitution rules related to corporate spin-offs. The exchange also announced that it was replacing Hanjin Shipping Holdings with GKL under the revised rules.

The revisions were aimed at ensuring that the KOSPI 200 remained representative of the market. Prior to the changes, splits by small-cap companies tended to make the index less representative, as surviving entities could not be quickly removed despite their reduced weights. Conversely, following spin-offs by large-cap companies, the inclusion of new entities has historically been delayed by KRX restrictions—even when their market cap and liquidity levels have been sufficient. Large caps that were slow to be added to the KOSPI 200 include Emart, Hankook Tire, and Dong-A ST.

Under the new rules, surviving entities will be excluded from the KOSPI 200 if they fail to meet certain requirements, while new, qualified entities will be added to the index. First, if a surviving entity does not meet certain requirements, it will be replaced with a new constituent. As mentioned above, under the old rules, surviving entities had been allowed to linger in the index regardless of their weights. Second, if a new entity meets certain requirements, it will be added. Accordingly, the number of KOSPI 200 constituents can now exceed 200 temporarily.

[Removal of surviving entities]

1. If the market cap of a surviving entity is lower than that of the smallest index constituent, it will be replaced.
 - Market cap will be calculated by applying the split ratio to the 30-day average market cap before the spin-off.
 - The stock market operation committee will make the final decision after considering the surviving entity's post-split market cap and KOSPI 200 weight as well as replacement candidates.
2. Deletion will take place on the day after the next futures expiry date. The replacement will be from the same industry.

[Addition of new entities]

1. If a new entity is a large-cap blue chip that meets certain requirements, it will be included in the KOSPI 200. As such, the number of constituents will be allowed to exceed 200 temporarily.
 - A new entity will be added to the index under two scenarios:
 - A) The combined market cap of the entity and larger same-industry players is equivalent to 70% or less of the industry's market cap; and its market cap surpasses that of the most promising other replacement candidate
 - B) Its market cap exceeds that of the 100th-largest constituent
2. Addition will take place on the day of relisting.

There have recently been many cases of companies executing spin-offs to facilitate holding structure conversions. As such, cases of holding companies (surviving entities) with small market caps remaining on the KOSPI 200 have increased, raising concerns over whether the index was truly representative of the market.

In addition, small-cap spin-offs have given rise to increased risk for index funds. When a spin-off takes place, index funds should sell pre-split shares on the day prior to the trading suspension and buy shares of surviving entities on the trading resumption date in order to minimize tracking errors. In the case of small-cap stocks, declines in market cap arising from spin-offs have created issues, including higher execution risk. On the trading resumption date, shares are typically volatile. There have been multiple cases of shares of surviving entities surging to their daily price limits on the resumption date, making it impossible for index funds to buy them. Cases in point are the Hanjin Shipping Holdings and Seoyeon examples.

As such, we believe that the revisions to the KOSPI 200 rules will go a long way toward ensuring: 1) the index's representative nature and 2) the stable management of index funds.

In particular, under the new rules, even if a surviving entity is deleted from the KOSPI 200, index funds will likely engage in trading not on the trading resumption date (amid high volatility) but on the futures expiry date.

However, the conditions for the removal of surviving entities and the addition of new entities are so exacting that spin-off-driven changes are unlikely to be commonplace.

From the perspective of index fund managers, there will be some uncertainties related to spin-off-driven changes to the KOSPI 200. As such, index funds are likely to adopt a variety of strategies based on the likelihood of a surviving entity's removal or a new entity's addition. The same can be said for other investors employing strategies driven by events (i.e., spin-offs and KOSPI 200 reconstitution).

The revisions to the rules could be seen as a preemptive move by the KRX ahead of the potential Samsung Electronics' (SEC) spin-off. Some analysts project that the Samsung Group will overhaul its corporate governance to address issues related to its cross-shareholding structure and ensure the smooth transfer of management control. The most likely method to achieve these ends is to split major group affiliates, including SEC, into holding companies and operating subsidiaries.

If SEC, which accounts for around 20% of the KOSPI 200's free float market cap, is split into a holding company and an operating subsidiary, the new entity would probably not be added under the previous rules, causing significant rebalancing by index funds (sharper than during regular scheduled KOSPI 200 reconstitution events). Under the revised rules, however, both SEC's holding company and operating subsidiary could be included in the KOSPI 200, limiting the impact of SEC's company split on the index.

Hanjin Shipping Holdings out, GKL in

The KRX also announced the exclusion of Hanjin Shipping Holdings from the KOSPI 200 and the inclusion of GKL based on the new rules. GKL's free float ratio stands at 50%.

The next round of KOSPI 200 reconstitution will take place on September 12th (the day after the September futures expiry date). As such, index funds' trading will likely be concentrated on September 11th.

Table 1. Hanjin Shipping Holdings out, GKL in

	Ticker	Company	Market cap (KRWtr)	Free float ratio (%)	Free float market cap (KRWtr)	Rank in K200	Weight in K200 (%)	Degree of shock (no. of days)
Removal	000700 KS	Hanjin Shipping Holdings	0.12	45	0.05	200	0.01	-0.31
Addition	114090 KS	GKL	2.78	50	1.39	90(E)	0.20(E)	+1.79

Notes: 1) As of August 28th

2) Degree of shock = potential demand from KOSPI 200 index funds/average trading value (20 days)

3) Total size of index funds (trusts only, including ETFs, KOSPI 200 leverage funds) is assumed at KRWtr 16.1

Source: KRX, QuantiWise, KDB Daewoo Securities Research

GKL: Demand from index funds to rise toward September 11th

GKL is estimated to rank 90th in the KOSPI 200 in terms of free float market cap (with an index weight of 0.20%) based on the August 28th closing price. Therefore, the stock will likely be a target for domestic index funds, ETFs, and foreign KOSPI 200 index funds.

The total size of index funds (trust only, including ETFs and KOSPI 200 leveraged funds) is assumed at KRW16.1tr. Potential demand from KOSPI 200 index funds, is 1.77 times higher than GKL's 20-day average trading value.

Pension funds, insurers (index funds), arbitrage traders (securities firms), and foreign investors (KOSPI 200 index funds) should further add to demand. But some large index funds may start to accumulate the stock one or two days earlier to reduce market impact costs.

Hanjin Shipping Holdings: Sell-off to pick up near September 11th, but extent is unclear

Hanjin Shipping Holdings is ranked last among KOSPI 200 constituents in terms of free float market cap (based on August 28th closing prices), and its weight in the index stands at just 0.01%. Few domestic index funds (including ETFs) hold the stock, but we believe most foreign K200 index funds have the stock in their portfolios.

Domestic investment trusts (index funds) are expected to sell off positions in Hanjin Shipping Holdings equivalent to 31% of the stock's 20-day average trading value. For foreign index funds, it is hard to forecast the level of the sell-off, but activity is expected to be concentrated around September 11th. We see no negative fundamental drags, and any near-term acceleration in the stock's decline is likely to be driven by speculative investors seeking to profit from its deletion, not by index fund sell-offs.

Long-short strategy to yield stronger returns

Typically, stocks added to an index are expected to rise (with the reverse being true for deleted stocks). When the composition of an index is changed, investors can choose between: 1) only buying the new addition, 2) only selling the deleted stock, or 3) doing both simultaneously.

For GKL and Hanjin Shipping Holdings, we believe that a long-short trading approach will be more profitable than buying or selling the stocks separately.

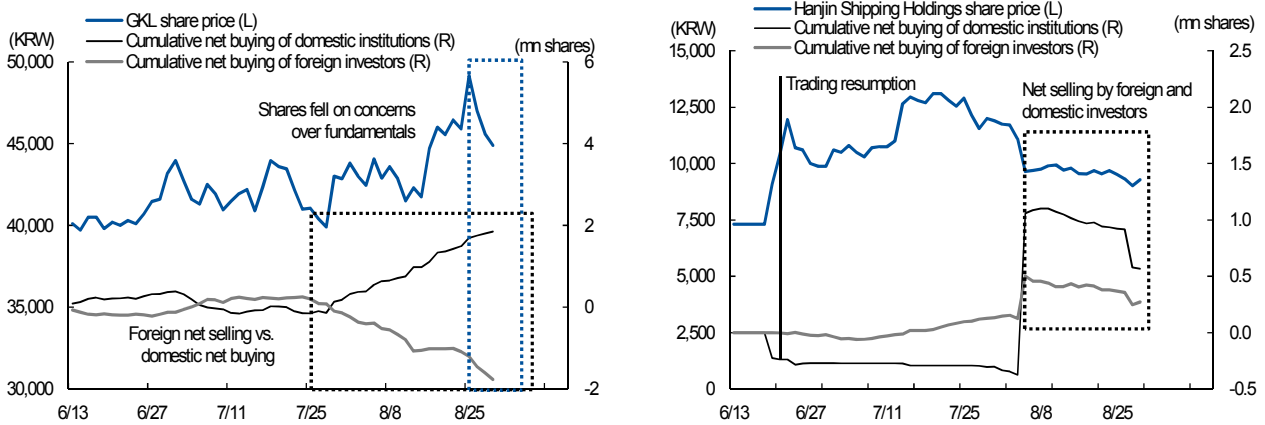
Previously, Chosun Refractories started to rally before it was added to the KOSPI 200, driven by index funds and investors seeking to profit from the stock's addition. Furthermore, it should be noticed that the stock's low trading volume also contributed to the price surge.

Meanwhile, we see growing uncertainties over GKL due to the government's decision to allow foreign casinos into Korea. Foreign investors are net-selling the stock as they forecast that the decision will weigh on the company's growth. However, domestic institutions are net-buying, as their focus is on the growth opportunities that could arise from the acquisition of new licenses (via participation in tenders for new concessions).

In light of the mixed views on the company's fundamentals, we believe it is risky to bet on upside to the stock based on expectations for an increase in buying by index funds and speculative demand. In addition, demand for GKL shares could be spread out over the time period between the announcement and actual replacement.

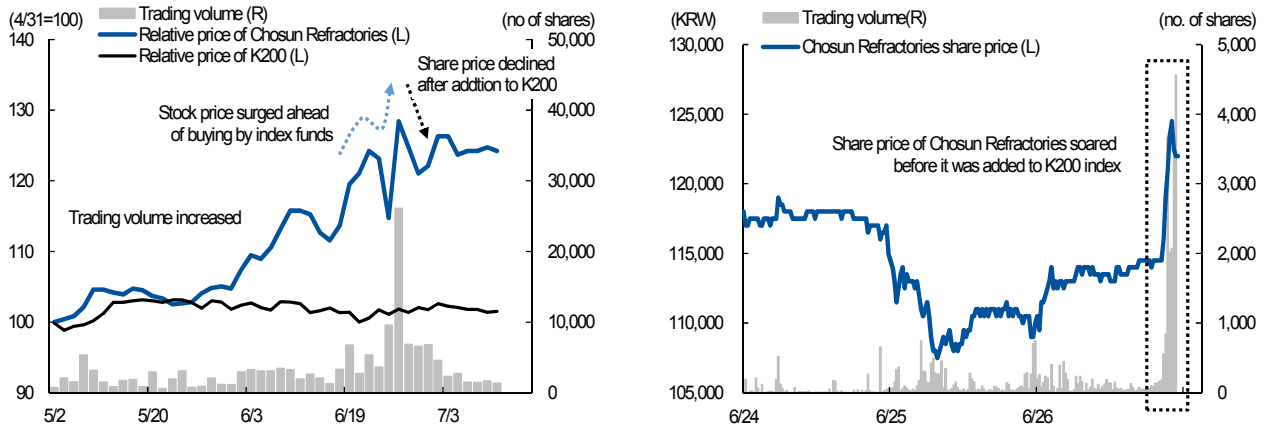
Accordingly, we believe that the strategy of going long on GKL and shorting Hanjin Shipping Holdings could reduce risks and deliver stable returns.

Figure 1. Long GKL/short Hanjin Shipping Holdings: More effective than just going long on GKL or shorting Hanjin Shipping Holdings



Note: Share performances and cumulative net buying since June expiry
 Source: KOSCOM, KDB Daewoo Securities Research

Figure 2. Case of Chosun Refractories: Stock price surged driven by speculation ahead of K200 addition and low supply



Note: Right chart is based on five-minute intraday data
 Source: KOSCOM, Bloomberg, KDB Daewoo Securities Research

Halla Holdings to remain; Mando unlikely to be included

Under the new regulations, Halla Holdings is expected to remain in the KOSPI 200, while Mando is unlikely to be included.

Even under the worst-case scenario, Halla Holdings (post-spin-off) is unlikely to fall below 170th in terms of free float market cap. (See the AI Analysis paper published on August 25th for more details.) However, we anticipate that Mando will not be added as the company does not meet the new requirements for addition. First, the combined market cap of Mando (post-split estimate) and larger same-industry stocks as a % of total industry market cap exceeds 70%. In addition, the post-split market cap of Mando is projected to be lower than that of LS industrial Systems (LSIS), which ranks 100th among KOSPI 200 constituents (based on the average market cap during the 30 days before Mando's spin-off).

Weights of current large-cap constituents to slightly decrease after addition of GKL

As the free float market cap of GKL is larger than that of Hanjin Shipping Holdings, we forecast the weights of current large-cap constituents to decrease after GKL is included in the KOSPI 200: SEC by 0.037%p, HMC by 0.010%p, SK Hynix by 0.007%p, and POSCO by 0.007%p. However, the market will likely see a limited impact from these changes, as the level of selling by index funds after the special reconstitution is expected to be much lower than the daily average trading value of KOSPI 200 constituents, and program trading tends to increase as futures expiry dates approach.

Table 2. Weights of large caps are likely to decrease after GKL's addition and Hanjin Shipping Holdings' removal

Rank	Ticker	Company	Closing price (KRW)	Free float ratio (%)	Market cap (KRWtr)	Free float market cap (KRWtr)	Weight in K200 (%,%p)			Potential demand of index funds (KRWbn)	20-day avg. trading value (KRWbn)	Degree of shock (no. of days)
							Before	After	Diff			
200	000700 KS	Hanjin Shipping Holdings	9,280	45	0.12	0.05	0.01	0.00	-0.0078	-1.25	4.00	-0.31
90(E)	114090 KS	GKL	44,900	50	2.78	0.00	0.00	0.20	0.1977	31.83	18.00	1.77
1	005930 KS	SEC	1,242,000	75	182.95	137.21	19.57	19.54	-0.0372	-5.99	338.50	-0.02
2	005380 KS	Hyundai Motor	231,000	70	50.88	35.62	5.08	5.07	-0.0097	-1.55	108.76	-0.01
3	000660 KS	SK Hynix	45,600	80	32.95	26.36	3.76	3.75	-0.0071	-1.15	200.76	-0.01
4	005490 KS	POSCO	336,000	85	29.29	24.90	3.55	3.55	-0.0067	-1.09	59.54	-0.02
5	035420 KS	NAVER	765,000	90	25.22	22.69	3.24	3.23	-0.0062	-0.99	84.95	-0.01
6	055550 KS	Shinhan Financial Group	52,000	90	24.66	22.19	3.17	3.16	-0.0060	-0.97	50.73	-0.02
7	012330 KS	Hyundai Mobis	287,500	70	27.99	19.59	2.79	2.79	-0.0053	-0.85	49.32	-0.02
8	017670 KS	SK Telecom	280,500	70	22.65	15.85	2.26	2.26	-0.0043	-0.69	38.35	-0.02
9	000270 KS	Kia Motors	59,600	65	24.16	15.70	2.24	2.24	-0.0043	-0.69	50.67	-0.01
10	105560 KS	KB Financial Group	41,450	95	16.01	15.21	2.17	2.17	-0.0041	-0.66	50.86	-0.01
11	015760 KS	KEPCO	42,000	50	26.96	13.48	1.92	1.92	-0.0037	-0.59	61.14	-0.01
12	051910 KS	LG Chem	274,000	70	18.16	12.71	1.81	1.81	-0.0034	-0.55	44.47	-0.01
13	086790 KS	Hana Financial Group	42,400	95	12.29	11.68	1.67	1.66	-0.0032	-0.51	33.17	-0.02
14	032830 KS	Samsung Life	108,000	50	21.60	10.80	1.54	1.54	-0.0029	-0.47	22.83	-0.02
15	033780 KS	KT&G	96,600	80	13.26	10.61	1.51	1.51	-0.0029	-0.46	28.98	-0.02
16	000810 KS	Samsung F&M	285,000	75	13.50	10.13	1.44	1.44	-0.0027	-0.44	27.03	-0.02
17	000830 KS	Samsung C&T	74,500	85	11.64	9.89	1.41	1.41	-0.0027	-0.43	45.04	-0.01
18	034220 KS	LG Display	34,950	65	12.51	8.13	1.16	1.16	-0.0022	-0.35	39.72	-0.01
19	066570 KS	LG Electronics.	74,200	65	12.14	7.89	1.13	1.12	-0.0021	-0.34	59.06	-0.01
20	006400 KS	Samsung SDI	151,500	75	10.42	7.81	1.11	1.11	-0.0021	-0.34	46.13	-0.01
21	030200 KS	KT	34,850	85	9.10	7.73	1.10	1.10	-0.0021	-0.34	44.07	-0.01
22	090430 KS	AmorePacific	2,156,000	55	12.60	6.93	0.99	0.99	-0.0019	-0.30	40.01	-0.01
23	003550 KS	LG Corp.	72,200	55	12.46	6.85	0.98	0.98	-0.0019	-0.30	18.12	-0.02
24	009540 KS	Hyundai Heavy	138,000	65	10.49	6.82	0.97	0.97	-0.0018	-0.30	41.27	-0.01
25	096770 KS	SK Innovation	95,100	75	8.79	6.60	0.94	0.94	-0.0018	-0.29	47.75	-0.01
26	004020 KS	Hyundai Steel	77,100	65	8.99	5.84	0.83	0.83	-0.0016	-0.25	25.74	-0.01
27	034730 KS	SK C&C	215,000	50	10.75	5.38	0.77	0.77	-0.0015	-0.23	26.69	-0.01
28	139480 KS	Emart	249,500	75	6.96	5.22	0.74	0.74	-0.0014	-0.23	17.34	-0.01
29	035250 KS	Kangwon Land	35,650	65	7.63	4.96	0.71	0.71	-0.0013	-0.22	20.57	-0.01
30	051900 KS	LG Household & Healthcare	523,000	60	8.17	4.90	0.70	0.70	-0.0013	-0.21	29.08	-0.01

Notes: 1) As of August 28th

2) Assuming that an index fund includes 200 stocks

3) Degree of shock = potential demand from KOSPI 200 index funds/average trading value (20 days)

4) Total size of index funds (trusts only, including ETFs, KOSPI 200 leverage funds) is assumed at KRW16.1tr

Source: KDB Daewoo Securities Research

APPENDIX 1

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