

Strategy Note

Preferred stock analysis

Overview

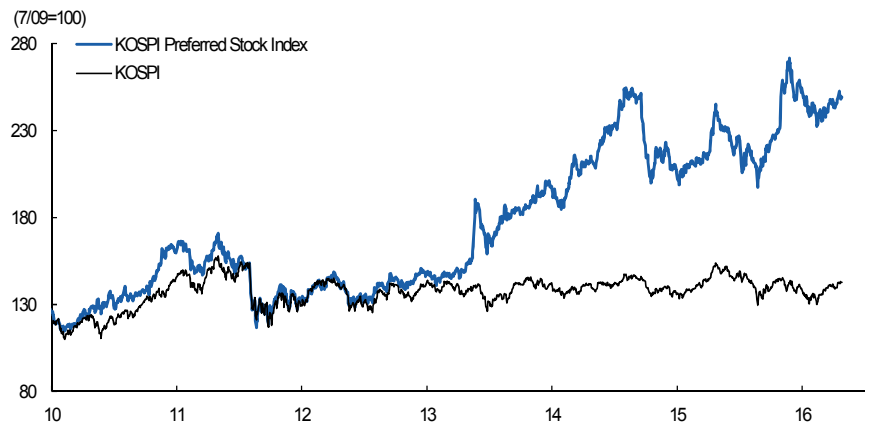
Preferred stock index outperforming the KOSPI

Since 2012, KOSPI preferred shares have been showing steady advancement, while the broader index has been largely range-bound. Notably, the preferred stock index has climbed by 149.2% since its establishment in July 2009, sharply outperforming the KOSPI (+42.7%).

As of April 28th, preferred shares accounted for 3.2% (KRW40.5tr) of the KOSPI by market cap. The weight of preferred shares, which initially surged after the 1995 revision to the Commercial Act, has been rising steadily since bottoming at 1.8% in December 2008.

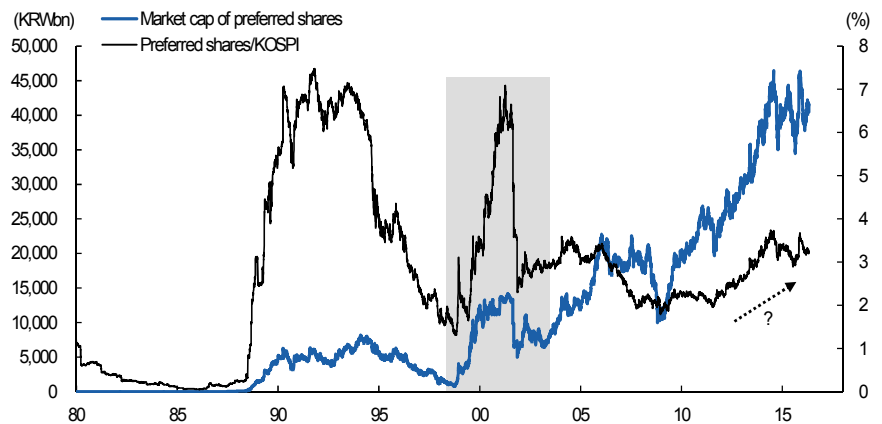
Of note, the merits of preferred shares are mounting amid muted growth and low interest rates. In this report, we analyze the variables affecting preferred shares to determine whether they will continue to display robust performance.

Figure 1. Preferred stock index continuing to rise



Source: WISEfn, Daewoo Securities Research

Figure 2. Preferred shares' weight in KOSPI continuing to increase



Source: WISEfn, Daewoo Securities Research

Common stock vs. preferred stock

After massive issuance of preferred shares in the late 1980s, the preferred-to-common share price ratio hovered around 90% through 1993. However, the ratio started to fall sharply, reaching 50% in mid-1994.

The decline was driven by 1) a rise in the premium for voting rights due to concerns over hostile takeovers, 2) an extremely narrow dividend yield gap, and 3) higher transaction costs for preferred shares stemming from their low volume.

Until the Commercial Act was revised in December 1995, preferred shares typically paid 1%p higher dividends than common shares (based on par value), and all shareholders were entitled to dividends at the same time. As such, the dividend merits of Korean preferred shares were not particularly high, and prices and investor interest fell accordingly. As a result, the transaction volume of preferred shares shrank sharply.

However, preferred shares issued after the aforementioned revision to the Commercial Act were different from their predecessors in significant ways. Specifically, the “new” preferred shares can be converted into common shares after a certain period and bear minimum dividend yield requirements.

With the dividend yields of preferred stocks recently surpassing corporate bond yields, preferred stocks are emerging as an attractive investment option in the current low-growth, low-interest rate environment. Recent trends—a move toward shareholder-friendly policies and equity stake increases to support holding company conversion—have eased hostile takeover concerns, increased dividend premiums, and dragged down voting right premiums.

Table 1. Common shares vs. preferred shares

	Common shares	Preferred shares (old)	Preferred shares (new)
Voting rights	O	X	X
Dividend yield	-	+1%p higher than common shares	Minimum dividend yield
Accumulated dividend	X	X	O
Redemption	X	X	O

Source: Daewoo Securities Research

Diverging performances

Returns on preferred stocks are inversely related to the price discrepancy between common stocks and preferred stocks. Preferred stocks started to outperform the KOSPI in early 2010 as the price discrepancy between common stocks and preferred stocks started to narrow from a record-high level.

The price discrepancy between the common and preferred shares of Samsung Electronics (SEC) plunged from 35.5% in January 2010 to 17.4% now. During the same period, the discrepancy of Hyundai Motor Company (HMC) shares plummeted from 63.6% to 31.0%. And both preferred stocks delivered impressive returns (304.3% for SEC, and +654.6% for HMC (2PB)), far outperforming corresponding common stocks (+180.5% and +274.7%, respectively).

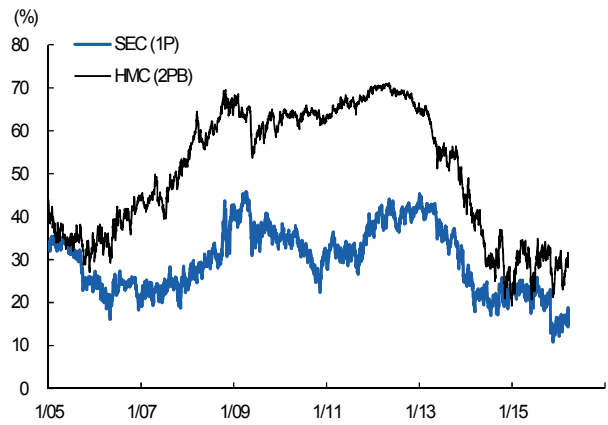
Currently, the price discrepancy between common shares and preferred shares averages 37.2%. In this report, we analyze key variables to determine whether the discrepancy will continue to narrow.

Figure 3. Average price discrepancy between common and preferred shares of top 20 players



Source: WISEfn, Daewoo Securities Research

Figure 4. Price discrepancies between common and preferred shares of SEC and HMC



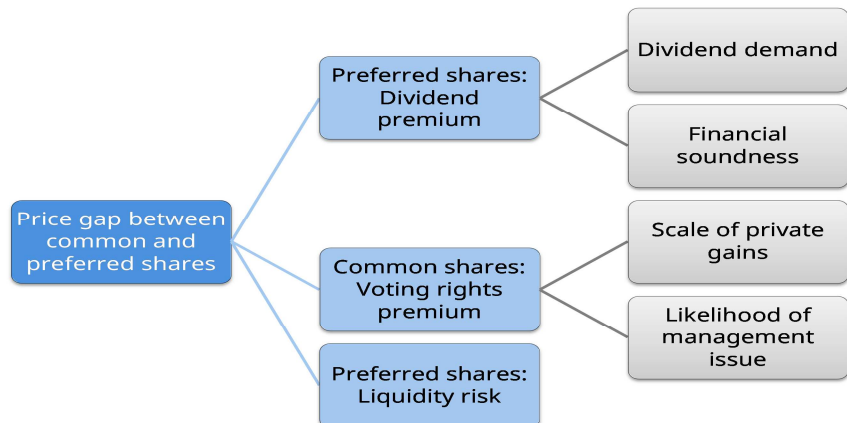
Source: WISEfn, Daewoo Securities Research

Key variables

Price discrepancy = voting rights premium - dividend premium

The price discrepancy between common and preferred stock primarily stems from the gap between the dividend premium of preferred shares and the voting rights premium of common shares. In other words, price differences will be determined by 1) how much higher dividends are for preferred shares, as well as 2) the importance of voting rights.

Figure 5. Factors behind price discrepancy



Source: Daewoo Securities Research

Dividend premium

One of the key reasons for investing in preferred shares is their high dividend yields relative to common shares. Notably, calls for higher dividend payments are intensifying these days. Indeed, the National Pension Service (NPS) has even announced a plan to designate certain low-dividend stocks as “businesses requiring attention,” with their names being disclosed to the public (starting in April 2017). Given the importance of the NPS as a stock market investor, few firms will be able to ignore the institution’s calls for higher dividend payouts.

Dividend demand from retail investors is also likely to rise. Currently, there are 225 dividend funds (worth KRW5.5tr), up by 116 (or KRW2.9tr) from the January 2011 level.

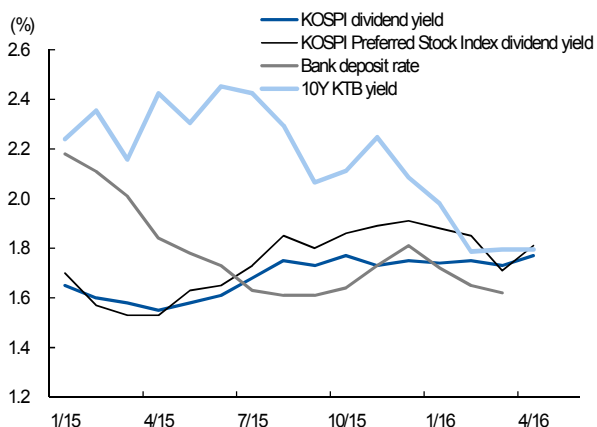
Amid continuously low interest rates, stocks with high dividend yields are increasingly gaining traction. In particular, demand for preferred stocks with high dividend payout ratios is anticipated to expand.

We believe that population aging should also boost demand for preferred stocks. If population aging progresses, the retirement money market will expand, leading to greater demand for low-risk assets. And demand for preferred stocks could be strong relative to that of low-return bank deposits and bonds.

At present, the dividend yield of the preferred stock index is 1.81%, higher than the broader KOSPI’s dividend yield (1.77%), bank deposit rates (1.62%), and the 10-year KTB yield (1.79%). Also, it should be noted that the dividend yield of the preferred stock index has been on the upswing, while yields of other assets have declined.

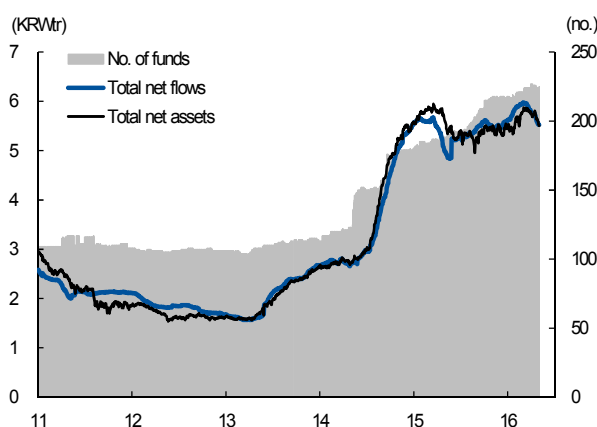
In conclusion, amid growing dividend calls from the NPS, the government, and retail investors, dividend payout ratios are likely to expand. As such the price gap between common and preferred shares is anticipated to narrow.

Figure 6. Dividend yields of preferred shares on the rise



Source: BOK, WISEfn, Daewoo Securities Research

Figure 7. Interest in dividend stock funds rising



Source: Fund Square, Daewoo Securities Research

Financial soundness

Expansion of the market for preferred shares will require financial soundness from corporates. In short, companies need to have the ability to pay out dividends even during tough times in order for their preferred shares to be attractive.

In particular, firms boasting a robust level of retained earnings (plus capital surplus) relative to paid-in capital are likely to be well-equipped to handle tough times. Thus, preferred shares of such firms should see expanding premiums going forward. In addition, preferred shares of companies with low debt ratios should receive premiums,

Voting rights

While dividends are a premium factor for preferred stocks, voting rights are a premium factor for common shares.

However, improvement in corporate transparency should lead to a steady decrease in the premium for voting rights awarded to common shares. Indeed, a higher level of corporate transparency leads to lower private gains for controlling shareholders and greater gains for minority shareholders. Transparent governance enables fairer distribution of gains between shareholders, and reduces shareholders' need for voting rights to secure a higher share of earnings.

Accordingly, government efforts to improve transparency, including revisions to the Commercial Act, the imposition of a gift tax on companies engaging in related-party transactions, the introduction of multiple derivative action, and the implementation of cumulative and electronic voting, will depress the voting rights premium.

Major shareholders' ownership of common shares is also an important determinant of the value of voting rights. The greater the number of major shareholders, the higher the likelihood of management disputes. On the other hand, if only a few major shareholders hold a large proportion of common shares, the likelihood of management disruptions will be lowered, narrowing the price discrepancy between common and preferred shares.

Liquidity risks

Liquidity risks could also contribute to discounts on preferred shares. Traditionally, the issuance of preferred shares has increased more slowly than that of common shares. And the liquidity of preferred shares has been poorer than that of common shares, pushing up transaction costs for preferred shares.

However, the turnover ratio of preferred shares has been improving recently in line with growth in demand. This should bring down transaction costs as well as discounts on preferred stocks.

In particular, preferred stocks generating higher daily average trading volume should see steeper narrowing of their price discrepancies with common shares thanks to lower liquidity risks.

Preferred stocks to watch

We expect the price gap between preferred and common stocks to steadily narrow on the back of 1) growing demand for higher dividends amid low interest rates, 2) the improving financial soundness of companies, 3) a decreasing premium for voting rights, and 4) the increasing liquidity of preferred stocks.

<Table 2> shows preferred shares that appear attractive based on key variables, including: 1) price discrepancy, 2) dividend yield, 3) retained earnings levels, 4) three-year dividend payouts, 4) controlling shareholders' ownership of common shares, and 5) daily average trading volume.

Table 2. Preferred shares with upside potential

(%, '000 shares, KRWbn)

Ticker	Name	Dividend yield	(Retained earnings + capital surplus)/paid-in capital	Daily avg. trading volume	Dividend payout (2015)	Dividend payout (2014)	Dividend payout (2013)	Major shareholders' stake	Price discrepancy
005945	NH Investment & Securities (1P)	3.9	198.5	27.0	3.2	22.7	11.8	49.1	32.5
010955	S-Oil (1P)	3.2	1,740.8	12.0	3.8	308.6	120.2	63.5	37.7
005385	HMC (1P)	3.2	4,268.4	37.0	3.2	632.5	586.9	27.4	32.1
005387	HMC (2PB)	3.2	4,268.4	82.0	3.1	632.5	586.9	27.4	31.0
019685	Daekyo (1PB)	2.7	1,161.6	12.0	4.1	19.7	18.7	62.9	40.8
005935	SEC (1P)	2.0	21,117.9	40.0	1.6	1249.7	2233.9	17.6	16.2
051915	LG Chem (1P)	1.6	3,434.4	16.0	3.4	308.4	299.9	30.1	33.5

Source: WISEfn, Daewoo Securities Research

APPENDIX 1

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