



Responsible Investment in Korea: Improving Corporate Governance

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Value Maximization and Sustainability



❑ Profit Maximization

➤ Max π

❑ Value Maximization with Sustainability Constraints

➤ Max V , subject to sustainability constraints

❑ Value Maximization with Sustainability Objectives

➤ Max V , E-S-G objectives (multi-objective optimization)

❑ Sustainable Value Maximization

➤ Max V^* (where V^* reflects E-S-G compliance levels)

Oversight of E-S-G Compliance



□ Who oversees E-S-G compliance?

- Governments (legislation, regulation, rules, etc.)
 - Environment protection; anti-corruption; Sarbanes-Oxley
- NGOs (NGO activism)
 - Environmental NGOs' activism; consumer NGOs, etc.
 - Lacking enforcement abilities
- Financial Markets
 - Financial institutions such as lending banks, funds exert influence
 - Rating agencies
 - Activist investors
 - SRI funds

SRI Funds and E-S-G Disclosure



❑ SRI Funds in Korea

- SRI Fund by a religious NGO in 2003 – AUM of 4 billion KW
- As of February 2008, nearly 1.9 trillion AUM of SRI funds
 - 29 public SRI funds with AUM of 1,381.8 billion KW (11 domestic funds with AUM 423.8 billion KW; 18 overseas funds with AUM 9,580 billion KW)
 - A few private SRI funds (NPS, PSF) with AUM of 500 billion KW

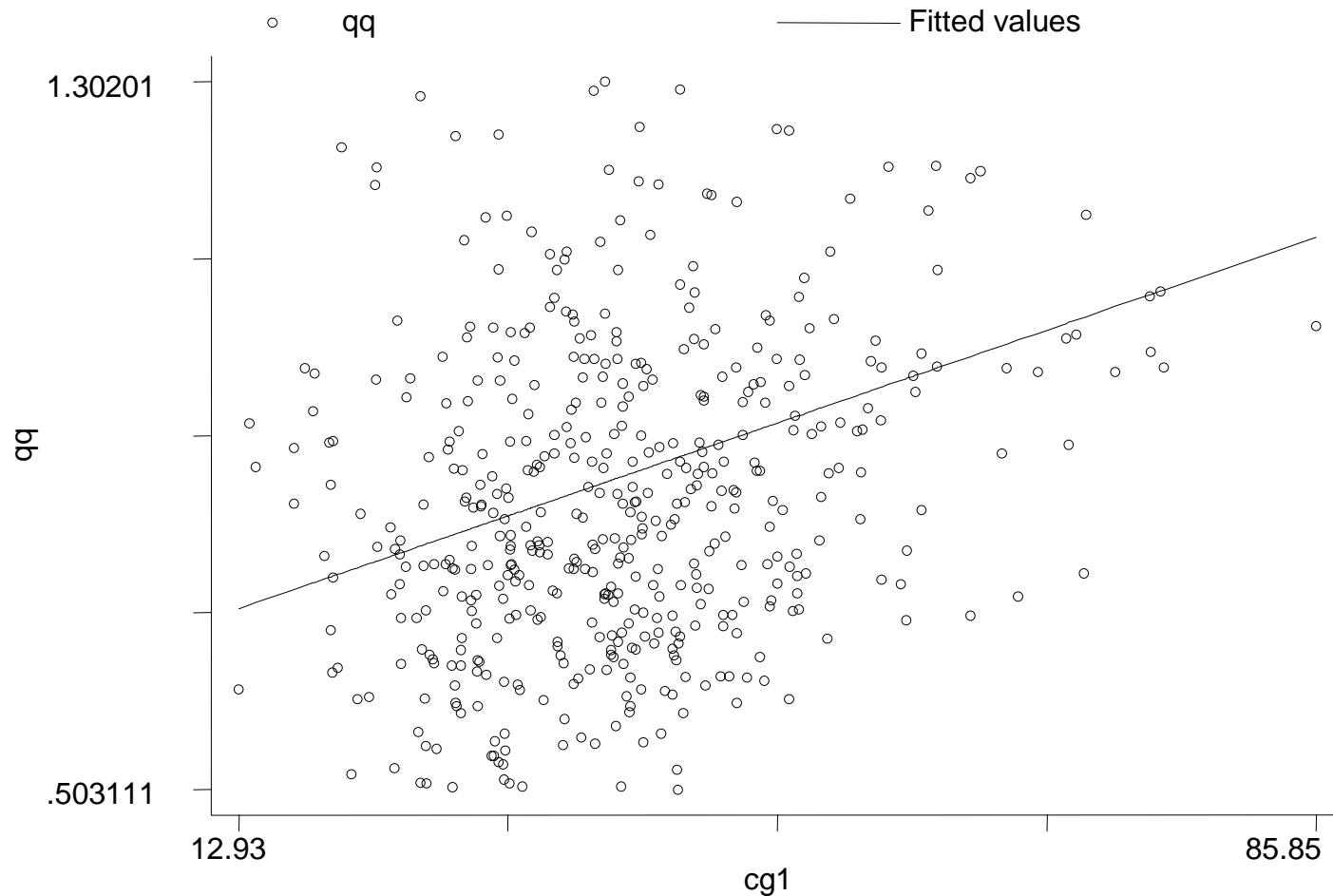
❑ E-S-G Disclosure

- 50 listed corporations (including financial institutions) produced sustainability reports as of February 2008.

Corporate Governance and Valuation (1)



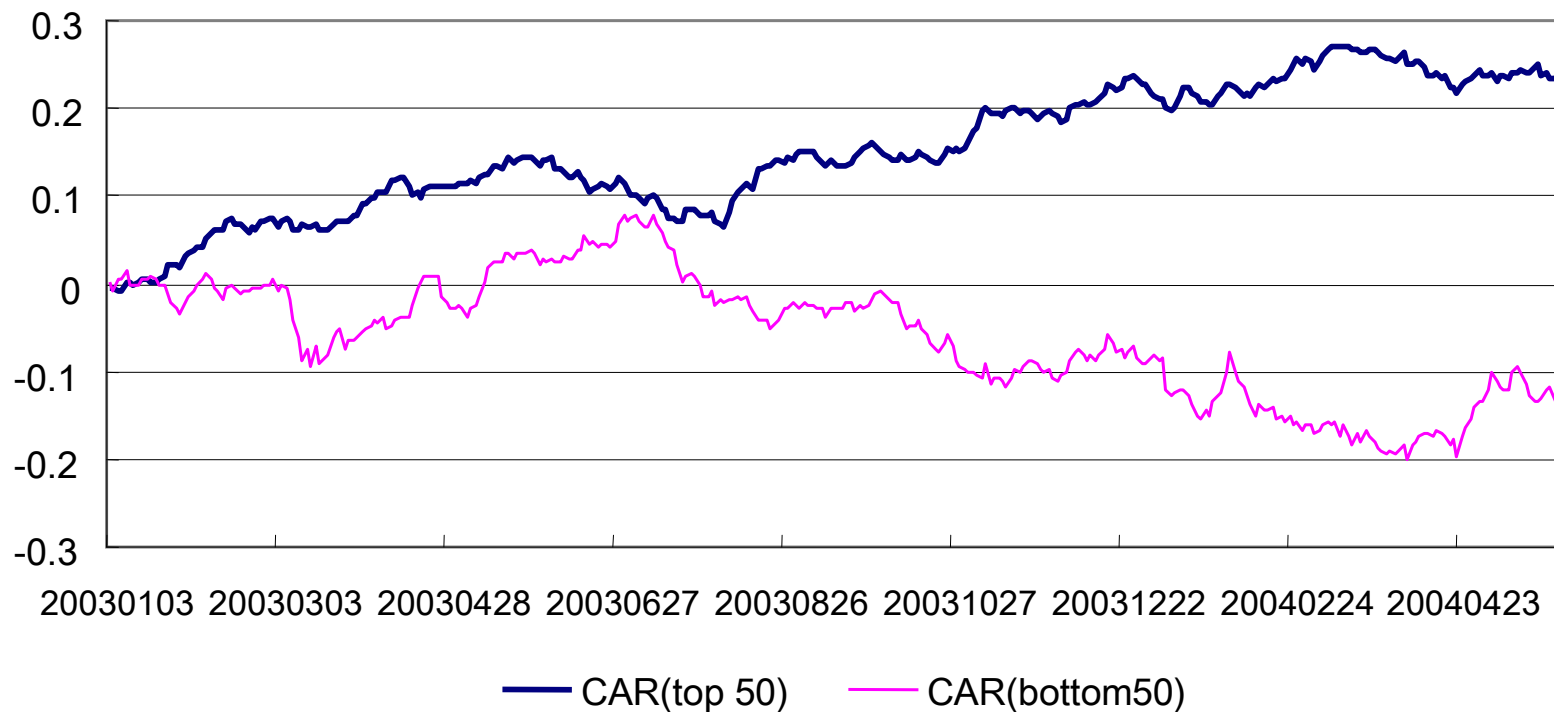
Corporate Governance and Tobin's Q (Black-Jang-Kim(2005, JCF))



Corporate Governance and Valuation (2)



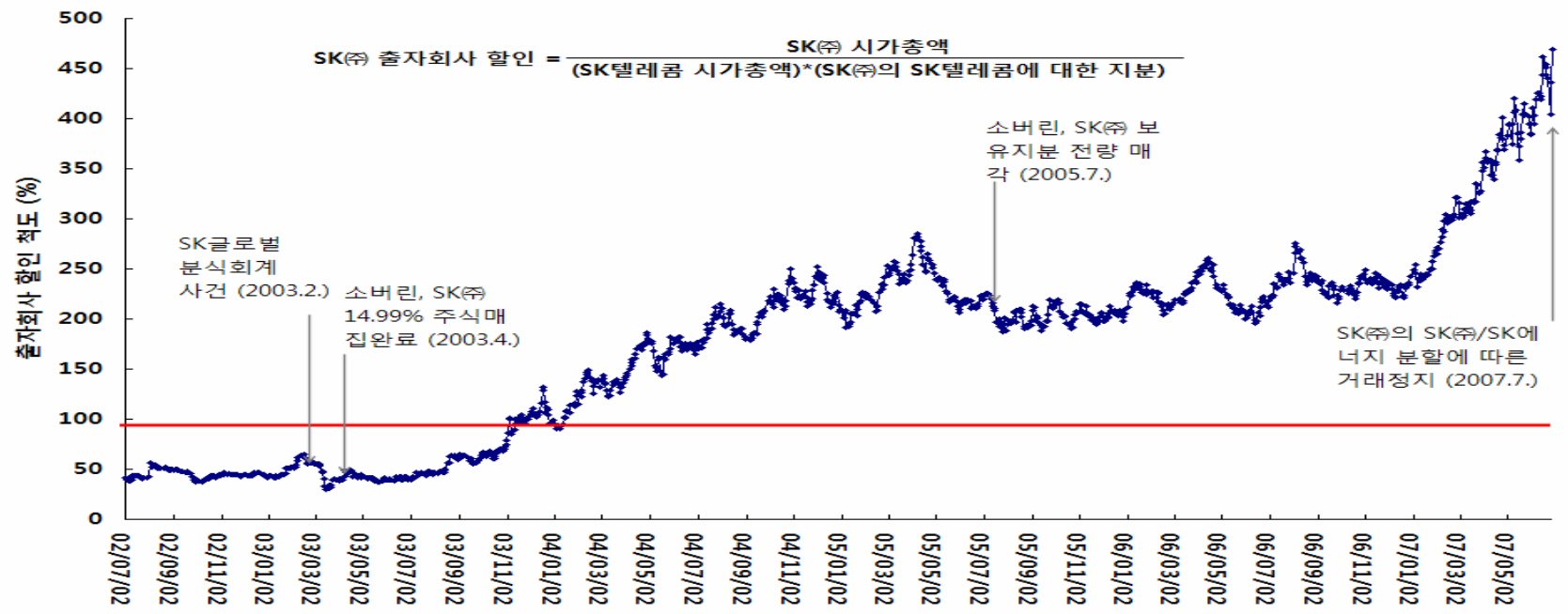
- ❑ Cumulative abnormal returns for top 50 and bottom 50 CGI firms (Park – Lee, 2005)



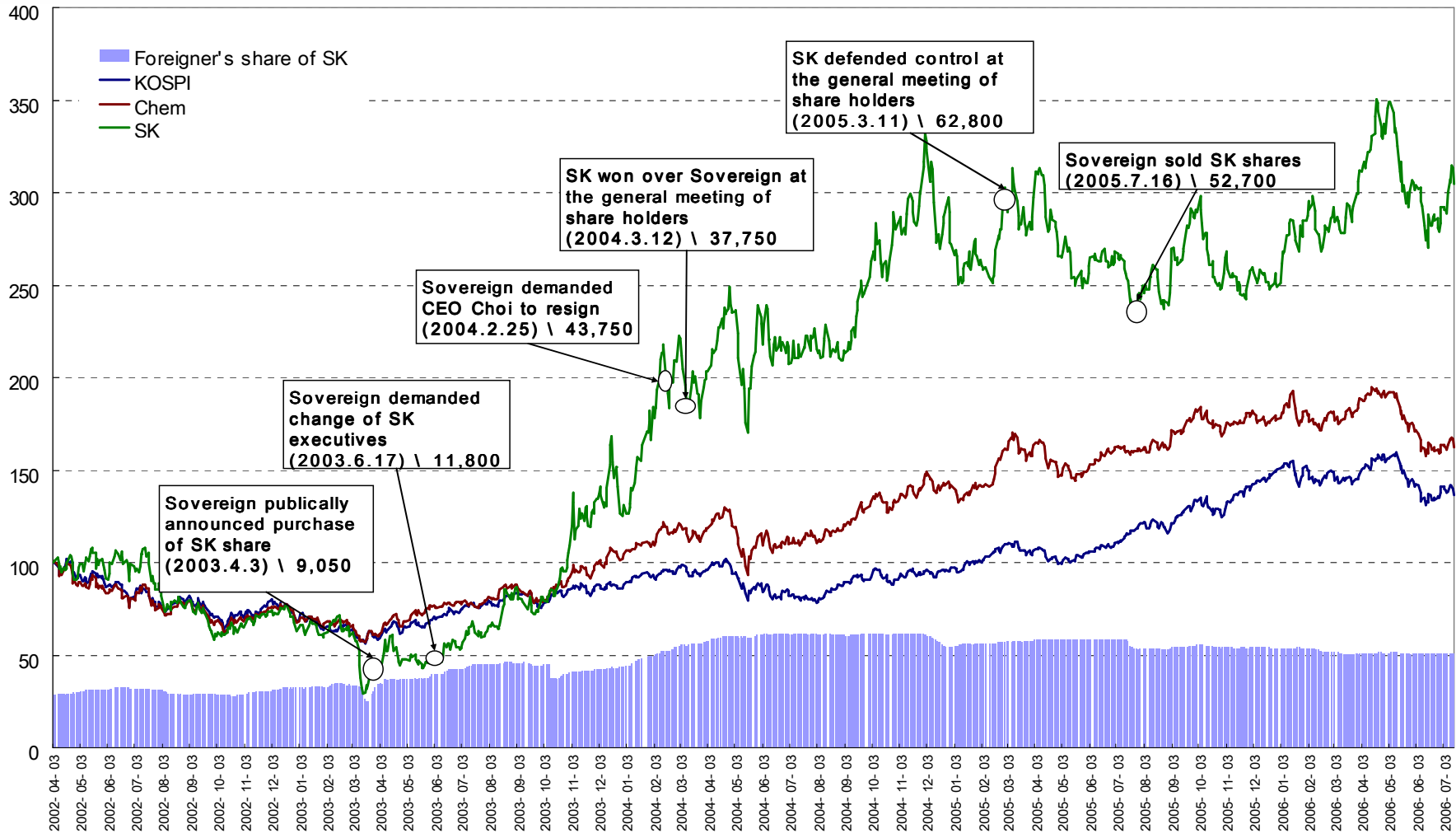


Case: SK Corp, the case of Parent Company Discount

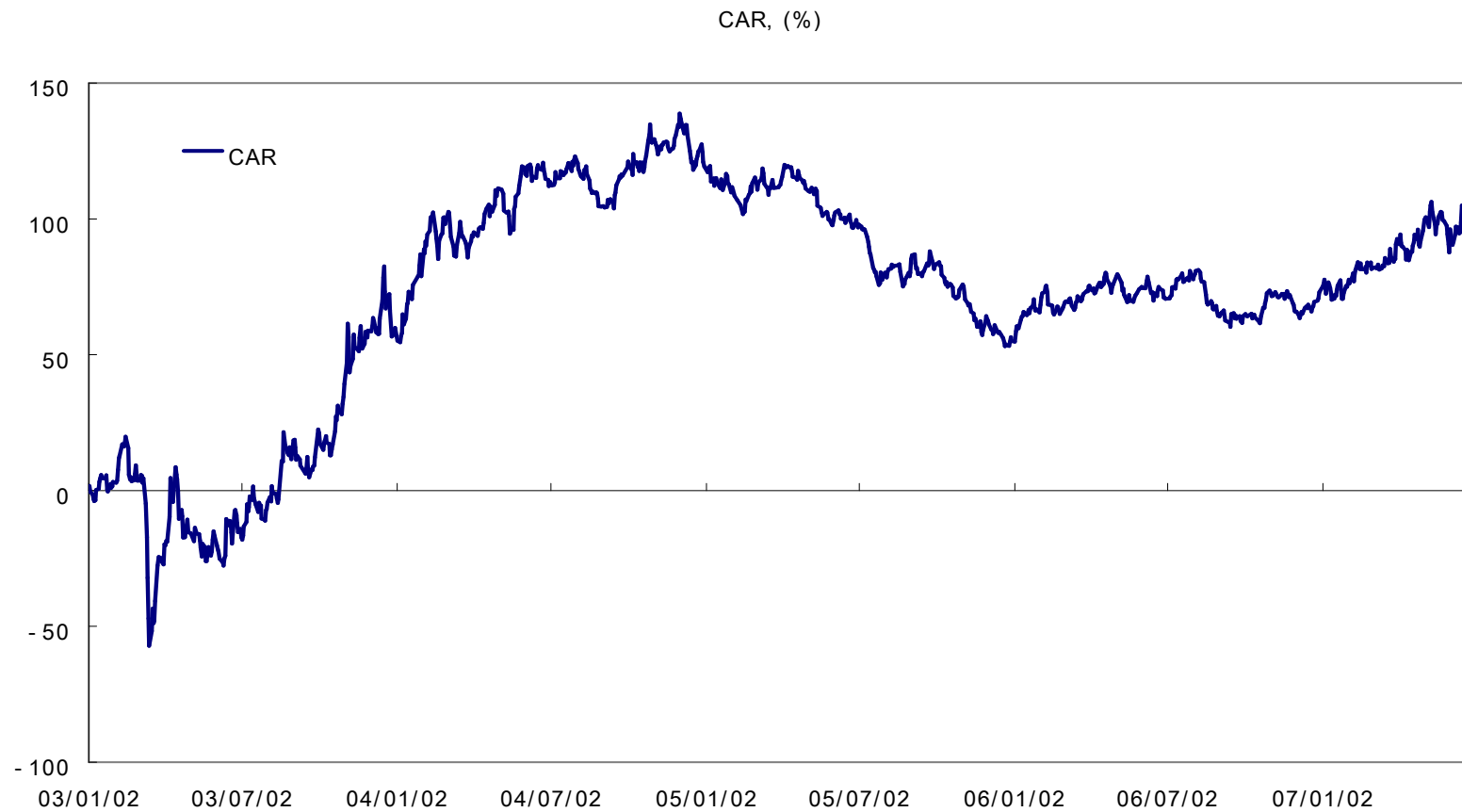
- ❑ The parent company puzzle (Cornell-Liu, 2001; Mitchell-Pulvino-Stafford, 2002) – why is the value of a parent smaller than the value of the subsidiaries' shares it holds?
 - $V_{stub} = MV_{parent} - MV_{subsidiary\ stake} - [MV_{assets} - MV_{liab}]$
 - PCD (parent company discount) = parent's MV / MV of subsidiaries' stakes



Sovereign vs. SK : Stock Market Reaction



Abnormal Returns of SK Corp



Market model parameters are estimated from daily returns January thru December 2002:
($a=0.064$, $b=1.06$)

Governance Reform of SK Group



□ Corporate governance reform initiative was announced in January 2004, in response to Sovereign Asset Management's proxy contest

- Independence of the Board of Directors

- More than 70% of the BOD are outside directors
- All the BOD committees are chaired by outside directors
- Audit Committee consists entirely of outside directors
- Outside directors declared the ethics code for outside director
- Advisory group, consisting of independent experts, was formed to recommend outside director candidates to the board

- Transparency of the Board's Decision Process

- Open debates and discussions during the BOD and committee meetings
- Several management motions were rejected and/or modified because of the objections by outside directors
- The role of the audit committee was strengthened (selecting outside auditors and outside consulting for internal control system development)
- The transparent management committee reviews all the self dealings and major inter-affiliate dealings

- More involvement of the Board

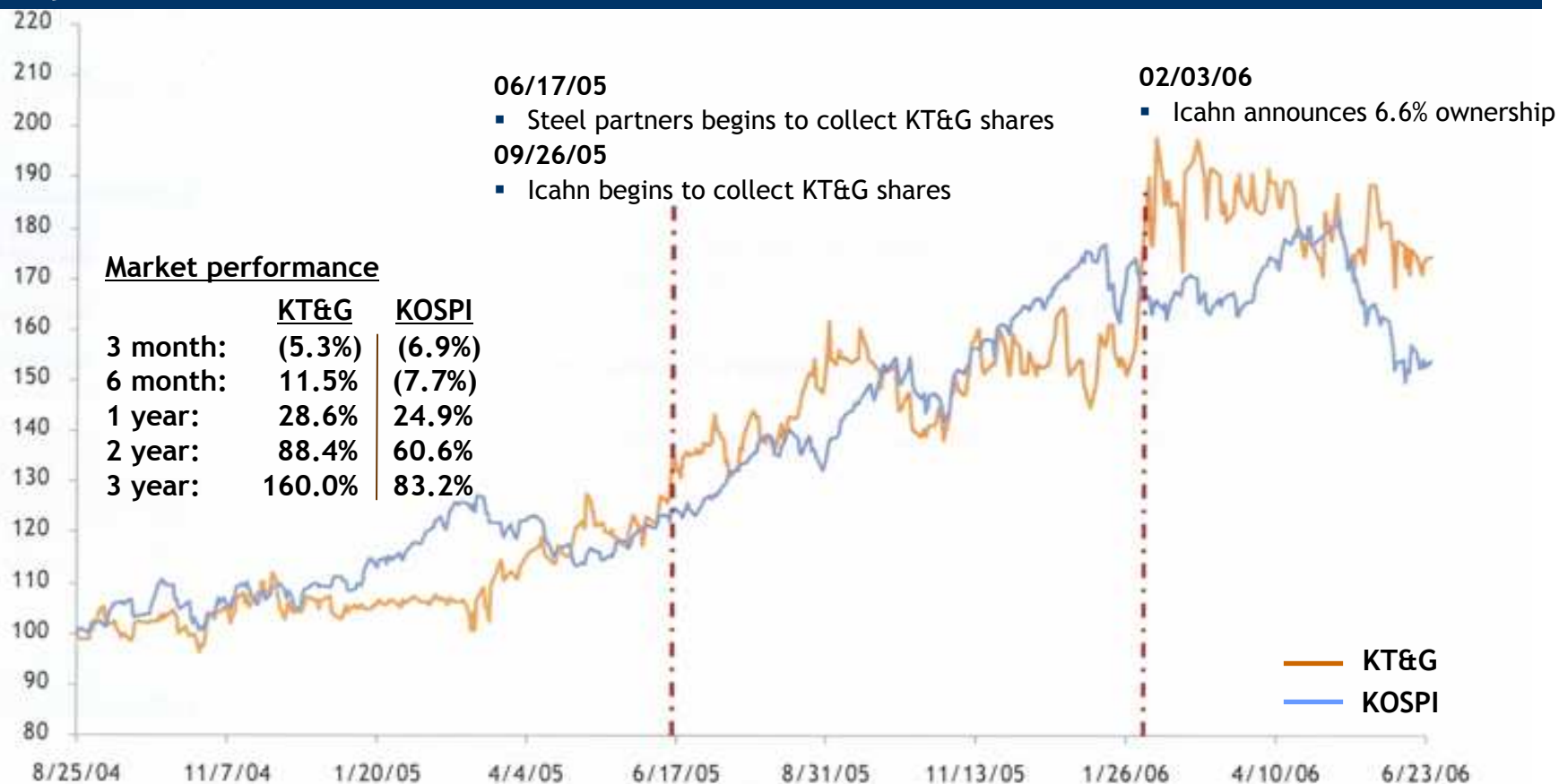
- Active engagement of the BOD
(14 board meetings, 29 committee meetings in a year)
- Directors become more engaged with the management decision processes
- BOD Secretariat was set up to assist outside directors and BOD/committee activities

KT&G Share Price Performance



- ❑ Despite share price delivering consistent stable appreciation, company became the target of hostile investors
- ❑ Icahn achieved its goal of boosting the stock price through proxy contest early 2006

Major Index Performance in the last 12 months



Source: Bloomberg as on June 20, 2006

¹ MSCI Asia ex-Japan

Hidden Values in KT&G



Icahn's key demands	KT&G's response
<i>Selling down non-core assets</i>	<ul style="list-style-type: none"> ▪ To sell non-core assets such as Buy The Way, Youngjin Pharmaceuticals and news channel YTN which generated a collective loss in 2004
<i>Listing Korean Ginseng Corp.</i>	<ul style="list-style-type: none"> ▪ To spin off and list Korean Ginseng Corp.
<i>Spinning off real estate portfolio</i>	<ul style="list-style-type: none"> ▪ To restructure KT&G's vast real estate portfolio so it can be spun out to KT&G shareholders in a REIT or J-REIT type structure
<i>Increasing dividends</i>	<ul style="list-style-type: none"> ▪ To increase KT&G's dividend yield in line with other world class tobacco companies such as Altria Group Inc., Reynolds American Inc. and UST Inc.
<i>Buying back shares</i>	<ul style="list-style-type: none"> ▪ To cancel KT&G's treasury shares to the extent legally permissible ▪ To purchase additional treasury shares through a self-tender for the maximum amount permissible under applicable laws and cancel those shares
<i>Demanding for board seats</i>	<ul style="list-style-type: none"> ▪ Icahn and partners had nominated 3 of their candidates for the planned selection of 6 new directors in March 2006
	<ul style="list-style-type: none"> ▪ KT&G has not formally responded to this request ▪ KT&G denied near term plans of a sell-down or IPO ▪ KT&G has not formally responded to this request ▪ On Jan 25, KT&G announced a raise in dividend to 1,700 won per share, up from 1,600 a year earlier ▪ On Jan 25, KT&G announced its plan of buying back 3 million shares, equivalent to a 1.8% stake in the company ▪ KT&G management only allowed Icahn and partners to nominate candidates for only 2 seats ▪ Icahn subsequently filed a complaint in Daejeon District Court

Corporate Governance Reform and SRI



- ❑ Corporate Governance Reform in Three Directions
 - Legal and regulatory reform
 - Self regulatory reform
 - Market discipline, including SRI funds

- ❑ SRI, especially SRI funds do have a significant role in enhancing corporate governance effectiveness



Thank you very much!!!