Responsible Investment in Korea: Improving Corporate Governance

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Value Maximization and Sustainability

- Profit Maximization
  - Max \( \pi \)

- 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 Tobin’s Q (Black-Jang-Kim(2005, JCF))
Cumulative abnormal returns for top 50 and bottom 50 CGI firms (Park – Lee, 2005)
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

Case: SK Corp, the case of Parent Company Discount
Sovereign vs. SK: Stock Market Reaction

- Sovereign’s share of SK: Represented by blue line.
- KOSPI: Represented by dark blue line.
- Chem: Represented by red line.
- SK: Represented by green line.

Key Events:
- Sovereign announced purchase of SK shares (2003.4.3) \(9,050\)
- Sovereign demanded change of SK executives (2003.6.17) \(11,800\)
- Sovereign demanded CEO Choi to resign (2004.2.25) \(43,750\)
- SK won over Sovereign at the general meeting of shareholders (2004.3.12) \(37,750\)
- SK defended control at the general meeting of shareholders (2005.3.11) \(62,800\)
- Sovereign sold SK shares (2005.7.16) \(52,700\)

Note: The graph illustrates the stock market reaction to these events, with the x-axis representing time from 2002-04-03 to 2005-07-03.
Market model parameters are estimated from daily returns January thru December 2002: 
(a=0.064, b=1.06)
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 directors
  - 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
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

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<tr>
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<th>KT&amp;G</th>
<th>KOSPI</th>
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<tr>
<td>3 month:</td>
<td>(5.3%)</td>
<td>(6.9%)</td>
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<tr>
<td>6 month:</td>
<td>11.5%</td>
<td>(7.7%)</td>
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<tr>
<td>1 year:</td>
<td>28.6%</td>
<td>24.9%</td>
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<tr>
<td>2 year:</td>
<td>88.4%</td>
<td>60.6%</td>
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<tr>
<td>3 year:</td>
<td>160.0%</td>
<td>83.2%</td>
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Source: Bloomberg as on June 20, 2006

1 MSCI Asia ex-Japan
## Hidden Values in KT&G

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<th>Icahn’s key demands</th>
<th>KT&amp;G’s response</th>
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<tr>
<td>Selling down non-core assets</td>
<td>• To sell non-core assets such as Buy The Way, Youngjin Pharmaceuticals and news channel YTN which generated a collective loss in 2004</td>
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<td></td>
<td>• KT&amp;G has not formally responded to this request</td>
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<td>Listing Korean Ginseng Corp.</td>
<td>• To spin off and list Korean Ginseng Corp.</td>
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<td>• KT&amp;G denied near term plans of a sell-down or IPO</td>
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<td>Spinning off real estate portfolio</td>
<td>• To restructure KT&amp;G’s vast real estate portfolio so it can be spun out to KT&amp;G shareholders in a REIT or J-REIT type structure</td>
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<tr>
<td></td>
<td>• KT&amp;G has not formally responded to this request</td>
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<td>Increasing dividends</td>
<td>• To increase KT&amp;G’s dividend yield in line with other world class tobacco companies such as Altria Group Inc., Reynolds American Inc. and UST Inc.</td>
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<td>• On Jan 25, KT&amp;G announced a raise in dividend to 1,700 won per share, up from 1,600 a year earlier</td>
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<td>Buying back shares</td>
<td>• To cancel KT&amp;G’s treasury shares to the extent legally permissible</td>
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<td>• On Jan 25, KT&amp;G announced its plan of buying back 3 million shares, equivalent to a 1.8% stake in the company</td>
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<td>• To purchase additional treasury shares through a self-tender for the maximum amount permissible under applicable laws and cancel those shares</td>
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<td>• KT&amp;G management only allowed Icahn and partners to nominate candidates for only 2 seats</td>
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<td>Demanding for board seats</td>
<td>• Icahn and partners had nominated 3 of their candidates for the planned selection of 6 new directors in March 2006</td>
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<td>• Icahn subsequently filed a complaint in Daejeon District Court</td>
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Source: Bloomberg, Factiva news
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!!!