



# **Responsible Investment in Korea: Improving Corporate Governance**

**June 17, 2008**

**Dosoung Choi**  
Monetary Policy Committee  
The Bank of Korea  
choids@bok.or.kr

# Contents



- Value Maximization and Sustainability
- E-S-G Compliance
- SRI Funds and E-S-G Disclosure in Korea
- Corporate Governance and Valuation
- Case: Corporate Governance Reform of SK Corp.
- Case: Corporate Governance and Hostile Takeovers
- Corporate Governance Reform and the Role of SRI

# 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

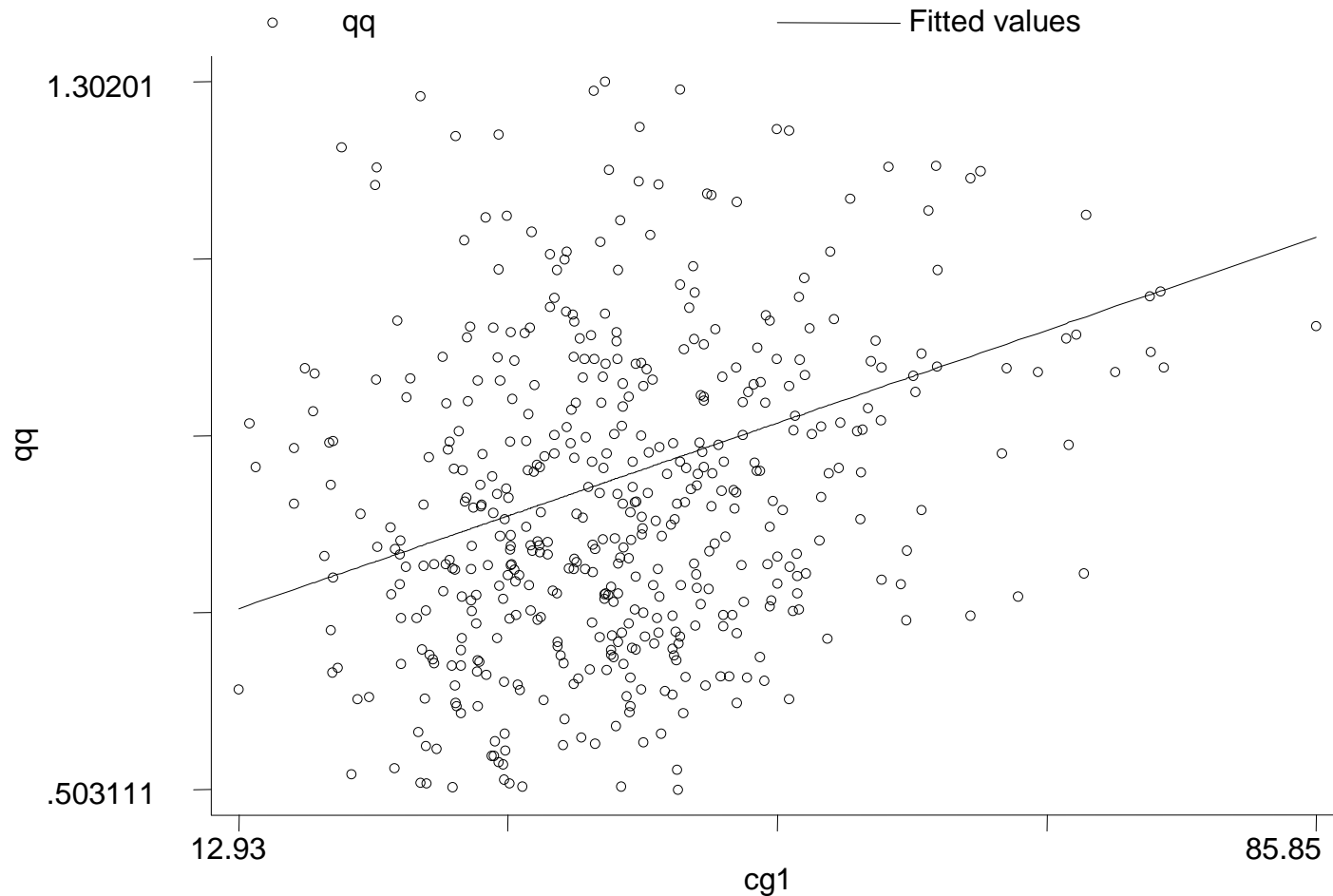
## ❑ E-S-G Disclosure

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

# Corporate Governance and Valuation (1)



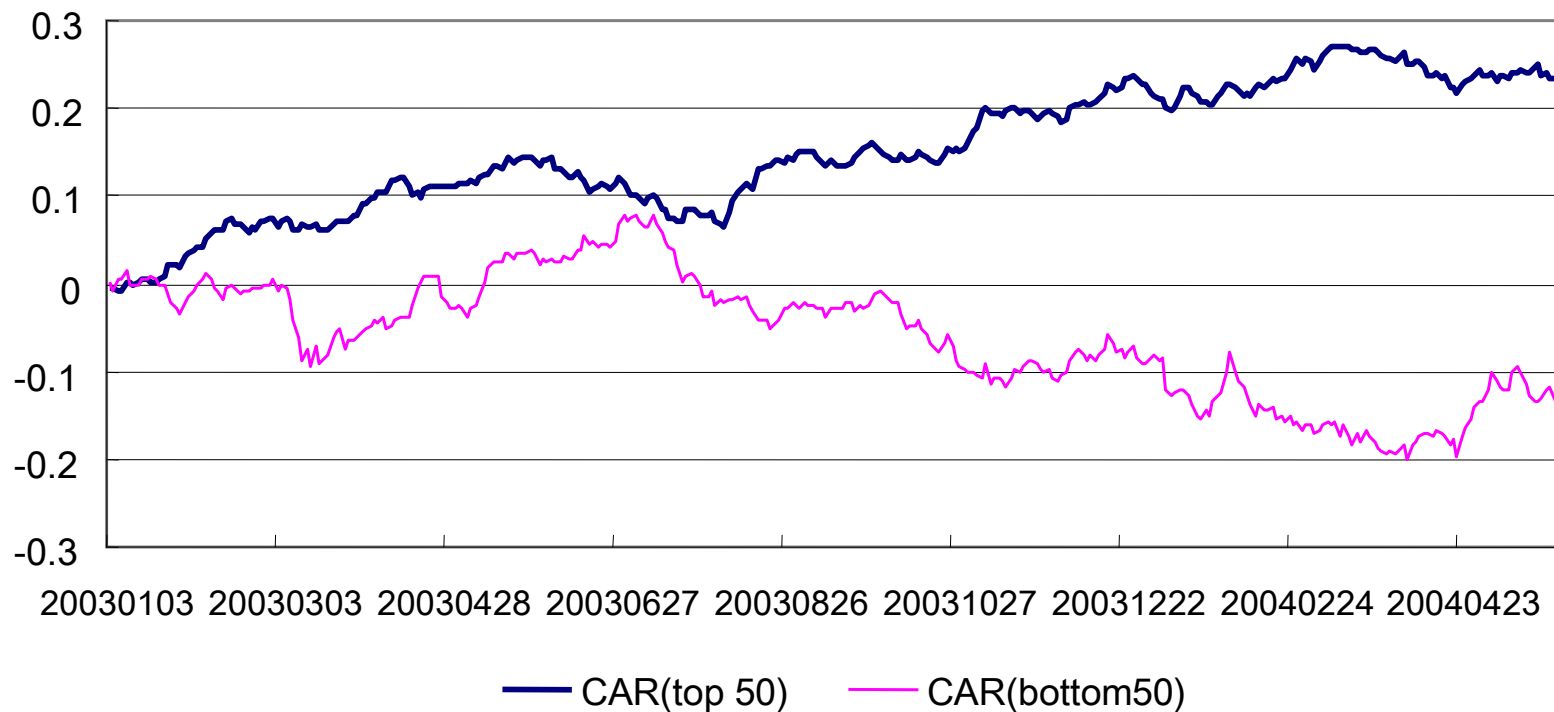
Corporate Governance and Tobin's Q (Black-Jang-Kim(2005, JCF))



## Corporate Governance and Valuation (2)



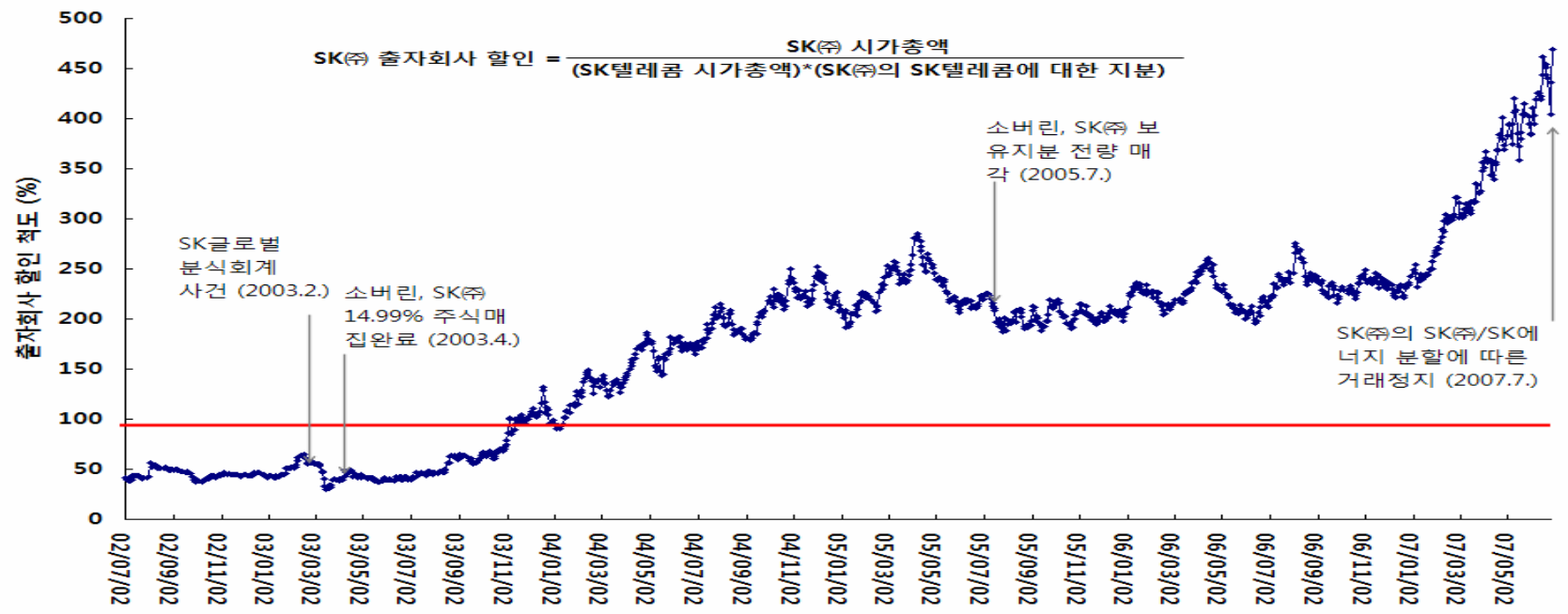
- ❑ Cumulative abnormal returns for top 50 and bottom 50 CGI firms (Park – Lee, 2005)





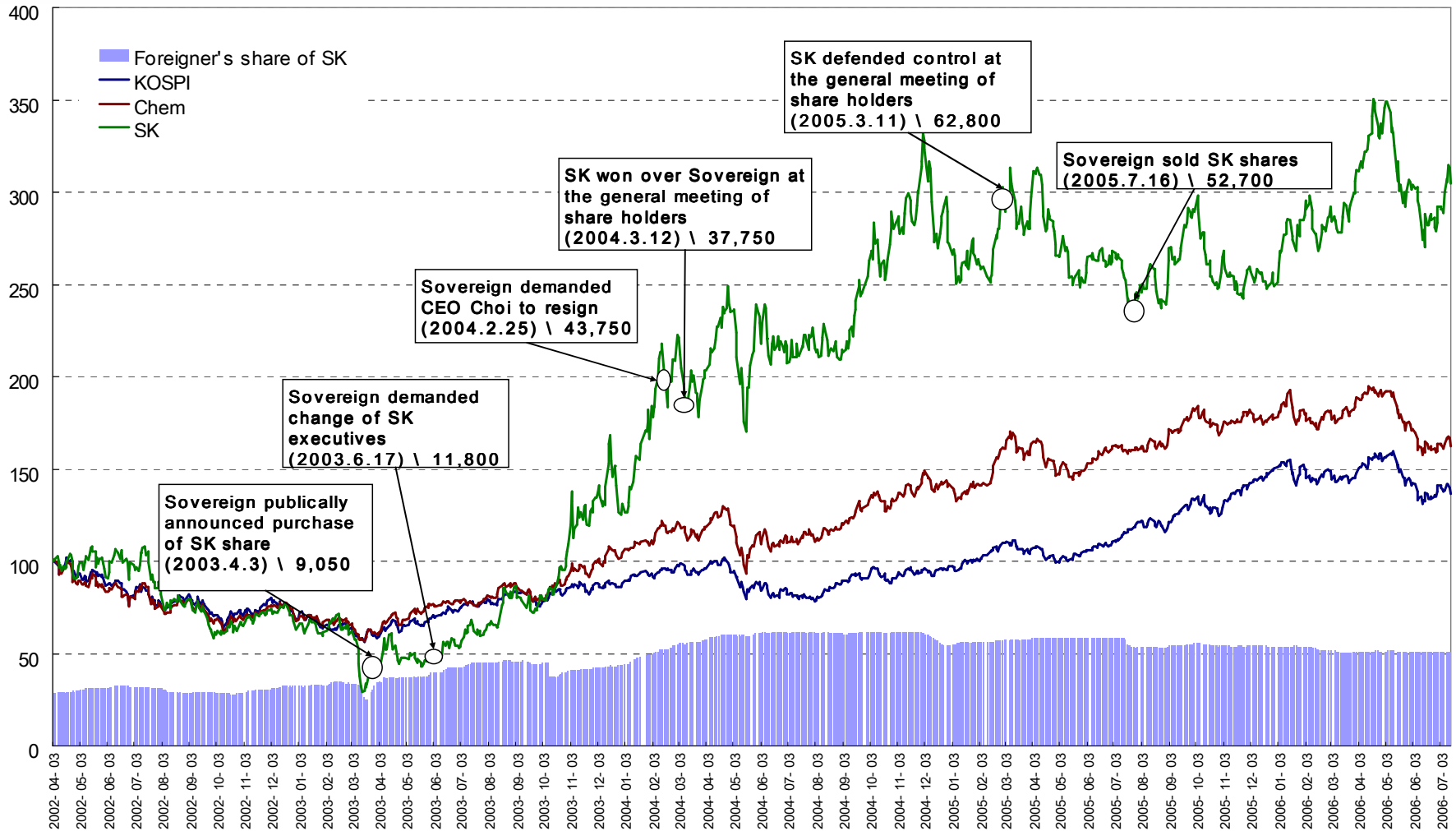
# Case: SK Corp, the case of Parent Company Discount

- ❑ 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

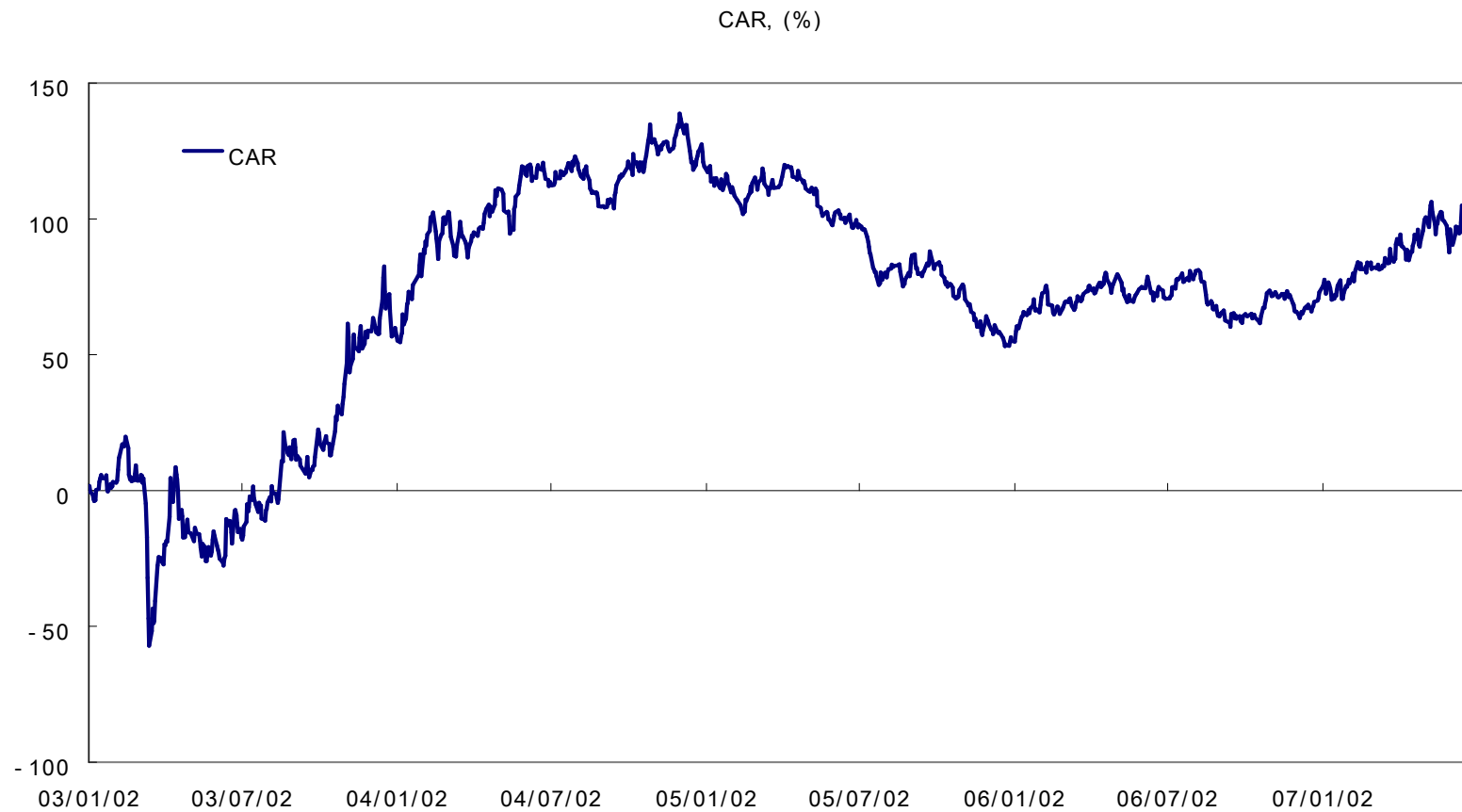




# Sovereign vs. SK : Stock Market Reaction



# 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

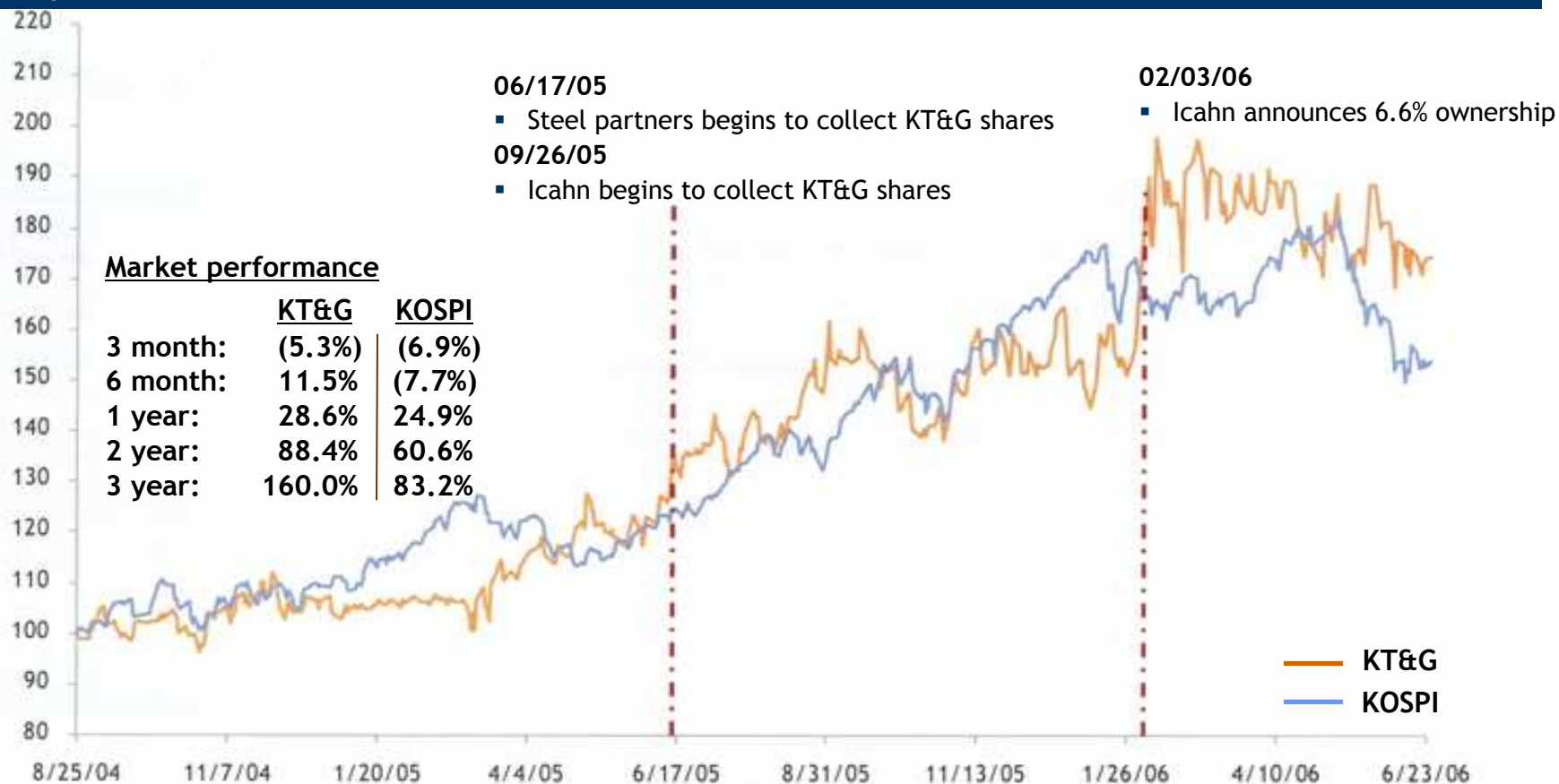
- Active engagement of the BOD  
(14 board meetings, 29 committee meetings in a year)
- Directors become more engaged with the management decision processes
- BOD Secretariat was set up to assist outside directors and BOD/committee activities

# 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

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

# 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!!!