South Korea and Samsung: an Overview

South Korea macroeconomic overview: a tired tiger?

South Korea has been one of the fastest growing economies in the world: in little more than a generation its GDP per-capita went from about $1,778, in 1980, to more than $27,000 in 2015. This astonishing growth brought the country into the Next Eleven: the list of the 11 emerging economies with the potential of becoming the largest economies in this century besides BRICS countries. The country managed to grow at an average annual growth rate of 7.53% between 1961 and 2016, however in the last 5 years of the sample the growth decelerated to an average of about 2.5%. The forecast is that it will decrease to 1% within 2020. Markets fear that the recent political scandal regarding corruption that has brought to the impeachment of former President Park Geun-hye could even worsen the situation. The scandal brought also to the arrest of Samsung Vice-President Lee Jae-yong, the de facto leader of the conglomerate. President Park was elected in 2012 with the support of older conservative South Koreans but now her downfall is expected to push South Koreans towards more liberal political forces, who are willing to re-examine the country's position with respect to North Korea. This political shift could bring further instability to the region.

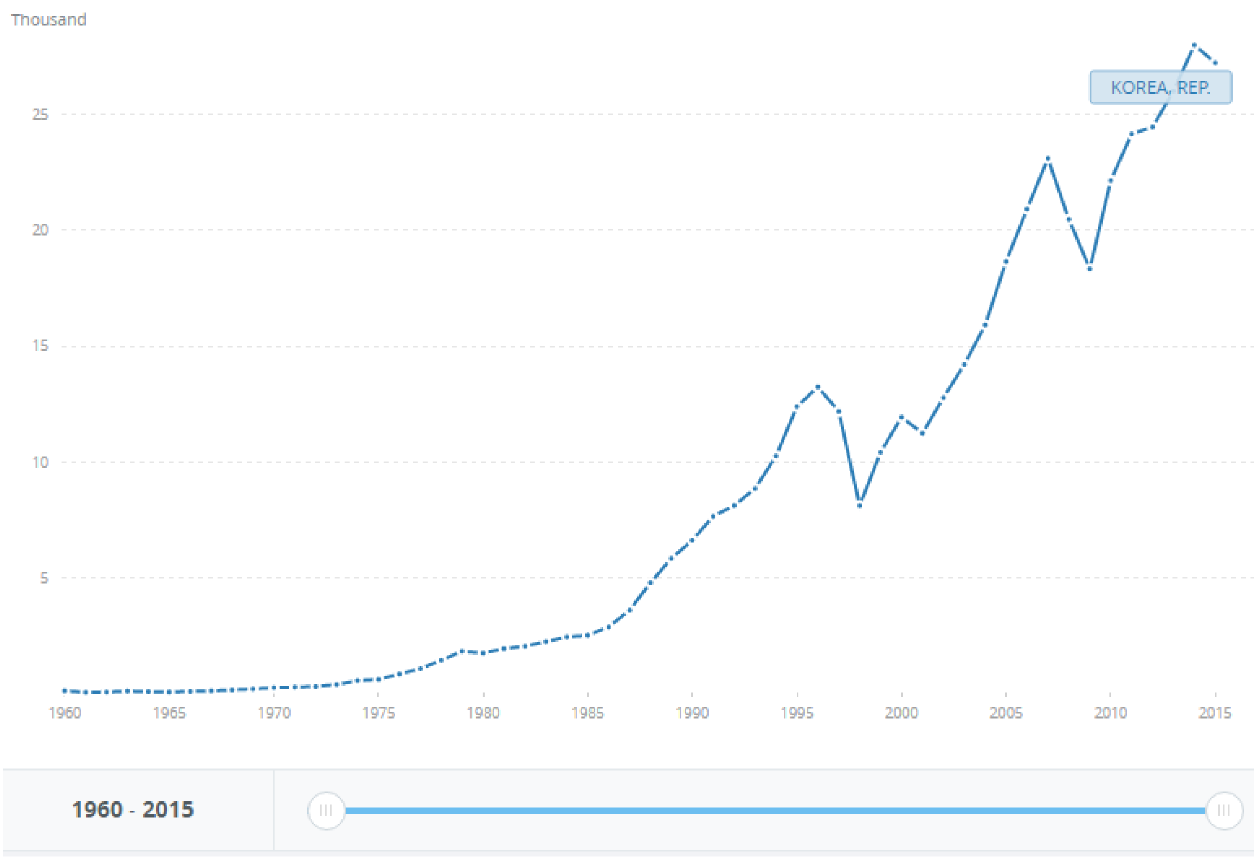

Chart 1: South Korea GDP per capita (source: World Bank)

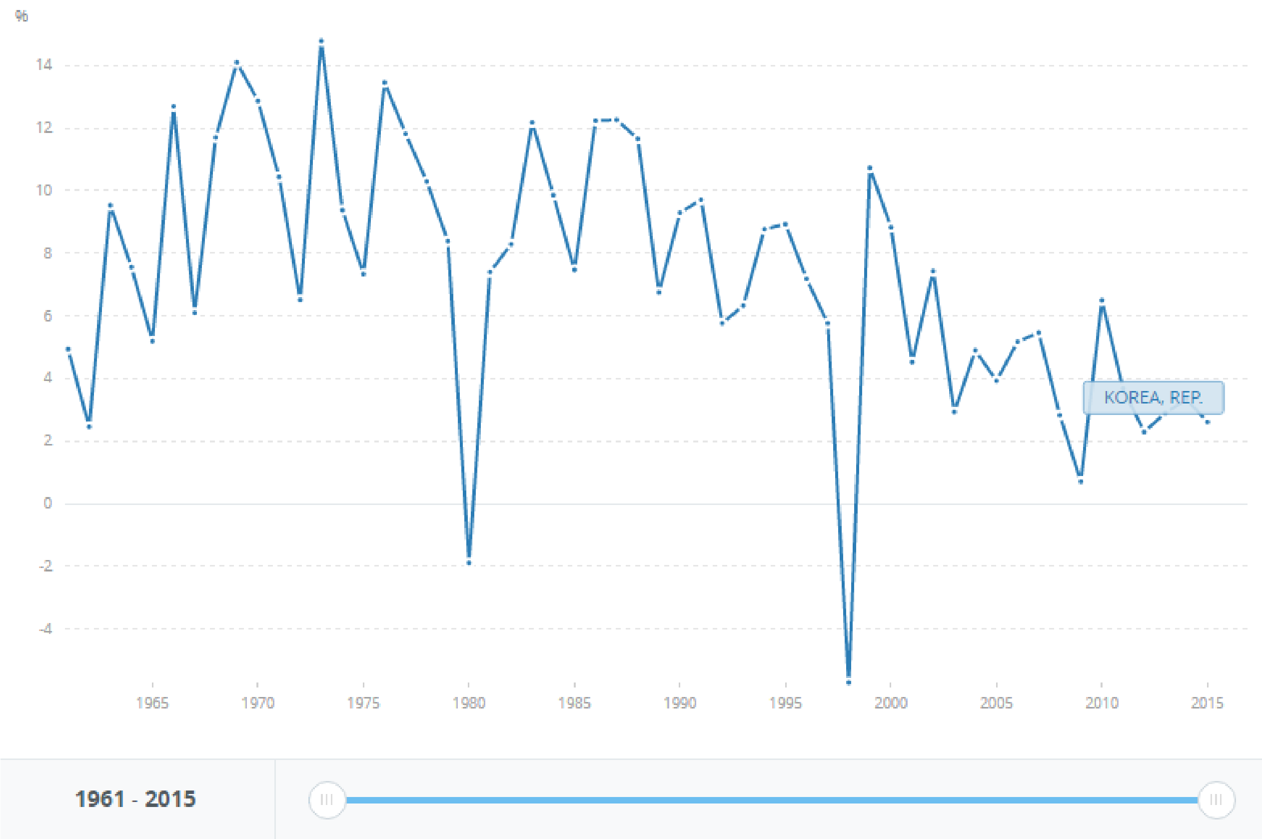

Chart 2: South Korea annual GDP growth rate (source: World Bank)

The South Korean economy is heavily dependent on exports: in 2012 the exports/GDP ratio touched an all-time high of 56.34% and although it slightly reduced in 2015 was still at 45.901% (World Bank estimates). Just to give a sense of the number, China's exports/GDP was 22.087% in 2015 and touched the peak in 2006 when the ratio was equal to 37.175%. This is clear evidence of the difficulty of the country in switching to a consumption economy and exposes the economy to a variety of risk from increasing competition to protectionist policies. Moreover, South Korean exports are very concentrated. Electrical equipment, vehicles and machinery including computers make up 51.5% of total exports. This lack of diversification is another potential problem for the country, which is heavily exposed to increasing competition in a sector that is characterized by a high rate of innovation. The case of Samsung is important and emblematic: Samsung revenues in 2015 were 14.56% of the national GDP. However, Samsung is facing increasing competition in its core businesses and in particular in the mobile phone manufacturing by both Apple and Huawei not to mention its involvement in the corruption scandal.

Another factor that casts concerns about the country's fundamentals is the current level of private debt. According to OECD, the private debt-to-GDP ratio has grown from 240.33% in 2010 to 255.78% in 2015. This number is high, especially when compared to the ratio of other countries such as U.S. and U.K whose ratios are respectively 198.49% and 224.96%. Why should this be a problem? In principle, as long as the country grows and the debt is sustainable none; however, this is not the case and during the last decade the number of marginal companies has increased dramatically. Marginal companies, also known as zombie companies, are those that have reported negative operating profits for 3 years in a row or even more and according to a survey of OECD in 2014 accounted for 11.1% of all the companies in South Korea. It is quite clear that the debt owed by these companies is very unlikely to be ever repaid. This contrasts with a very low unemployment rate, which is currently at 4%, up 0.4% with respect to January of this year but expected to decrease to 3.8% within May. Summarizing the situation, we can say that South Korea remains socially stable (with a very low unemployment rate and a good GDP per capita level) but its companies are beginning to feel the burden of competition and debt, posing a long-term threat to the sustainability of this export-driven economic model.

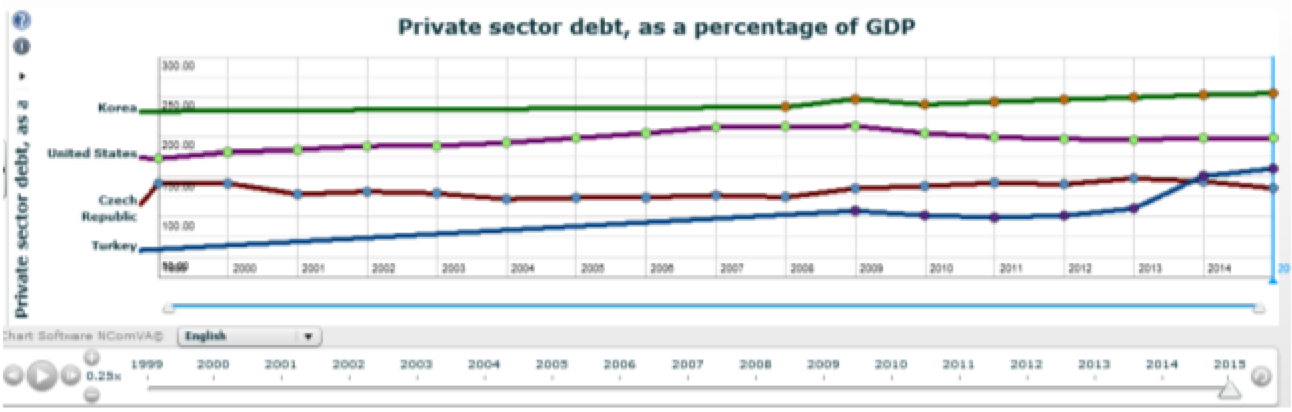

Chart 3: South Korea private sector debt as a percentage of GDP (source: OECD.stat)

Samsung: issues with the law but not with the markets

Exploring Samsung more closely, we can certainly say that it represents a driving force in the South Korean economy. Being the largest chaebol (business conglomerate) of the country, Samsung's thriving performance is essential for a growing domestic business cycle. Founded in 1938 by the magnate Lee Byung-chul as a trading company, Samsung Group has now exponentially diversified its core operations. Currently, it displays a leading position in many sectors and, particularly, in information technologies, heavy industries, and constructions. In addition, the group's complex corporate structure is divided into four main divisions: IT and Mobile Communications, Display, Semiconductors, and Consumer Electronics. Overall, the conglomerate's chief public listed subsidiary is Samsung Electronics, which just announced first quarter operating profits of $8.7bn (the highest level in three and a half years). This is a great result coming after the exploding Galaxy Note 7 debacle last year, which in the beginning of October momentarily caused a sizable dip in Samsung Electronics' share price. However, investors' enthusiasm, coupled with strong relationships with the South Korean Government, have allowed the company's share price to keep on rising to historic highs (2,080,000 KRW).

Even with the most recent political turmoil connecting Samsung's heir Lee Jae-yong with bribery and embezzlement with South Korea's president Park Geun-hye, the stock price seems to be unaffected. This counter-intuitive result appears to be mainly driven by very strong performances in the display and semiconductor divisions of the whole group, and due to vertical integration economies of scale in the widget manufacturing process. Nevertheless, such result has created uncertainty in the valuation of the company's share price. Looking at key ratios such as the P/E ratio, Samsung looks cheap, trading at single digit values (8.94 2017 forward P/E for Samsung Electronics).