On-the-ground in today's Korea

- Lowest-income households can't make ends meet - a long-running issue that isn't sustainable
- Amid high oil prices, and with 2012 being an election year, the mood on the street doesn't favour the oil refineries
- But there are sweet spots for investors. We highlight high-end retailer Hyundai Department Store (Buy) as a core holding

Introduction

Seoul Searching is a new series of Daiwa reports in which we take an on-the-ground look at socio-economic issues in Korea and their implications for investors.

What's in the first issue

We kick off Seoul Searching by examining the income disparity between the top 20% of Korean households and the remaining 80%. We focus on the issues facing the bottom 20% of households and the resulting investment implications in this election year.

In addition, we interview a group of Seoul taxi drivers to get their assessment of economic conditions today. We are particularly interested in their view of mounting inflationary pressures related to high oil prices, notwithstanding benign official CPI numbers. We note the taxi drivers' association has requested that the Seoul city government raise taxi fares by as much as 34%.

Tough times for the bottom 20%

The chart to the right shows the long-term trend of households' monthly surpluses as a percentage of income. But for the bottom 20% of Korean households, it's not a surplus but a deficit. The question here is whether long-running deficits of 20-40% of monthly income are sustainable. We don't think so.

In our view, the extent of the monthly deficit at the bottom 20% of households is a manifestation of some of the country's biggest socio-economic issues: its aging society, weak social safety net, rising rents, high home prices, high tuition fees for college education, increase in the number of non-permanent contract workers, and high unemployment rate among the younger generation.

Monthly household surplus/deficit as a percentage of income

Source: Statistics Korea
Note: Classifications I to V represent five income groups that are divided in terms of total household earnings; V represents the top 20% and I the bottom 20%.

Top 20% almost a mirror image of the bottom 20%

The bottom 20% of households are in an unsustainable position, and the bottom 60% have smaller monthly surpluses portion today than they did before the Asian financial crisis of 1997. But for the top 20% of households, the monthly surplus is hovering around its historical peak, reached before the Asian financial crisis. Simply put, this is the 80:20 rule in action.

Election year: chance for voices to be heard

Unlike economic power, election votes are distributed evenly. The remaining 80% of Korean households will have a chance to be heard in the forthcoming elections (parliamentary election on 11 April and presidential election on 19 December). Look for politicians to continue coming up with populist measures aimed at winning votes in the elections, regardless of which parties they belong to.

Public mood does not seem supportive of oil refineries

Frustrated by high LPG and food prices, the taxi drivers we spoke with were unanimous in saying: “Prices for everything have gone up — except taxi fares.” They said that, to date, they have borne the burden of high oil prices and it is time for other parties — the oil refineries and/or the government — to carry the load. Given the public mood, we think it is hard to rule out the possibility that the government will arm-twist the oil refineries, just as it did in 2Q11.

Focus on the sweet spot of bi-polarisation

Beneficiaries of consumption by the top 20% of households, such as Hyundai Department Store (069960 KS, W182,000, Buy [1]), deserve to be core holdings in Korean portfolios, in our view.
Clear-cut picture of bi-polarisation

Regardless of who wins the elections, we expect continued government intervention aimed at narrowing income disparities

Bottom 20% of Korean households facing perennial monthly deficits

Companies with sustainable growth outlooks generally offer a measure of comfort for long-term investors, since they look to have the right foundations in place. Not for nothing do leading companies push regular “sustainability reports”.

Let’s extend the concept to the country level. Determinants of sustainability in this case include demographics, political and economic systems, stage of development, labour-market conditions, and other socio-economic considerations. And specific to Korea is the question of North Korea risk.

“Income disparities”: haves and have-nots

In our first Seoul Searching we focus on income disparities and how these could play out during the elections. Korean households will have two opportunities to be heard this year: the parliamentary election on 11 April, and the more important presidential election on 19 December.

Looking at the monthly surpluses of Korean households as a percentage of income (single-person households excluded), one stand-out is the perennial deficits of the bottom 20% (group I). These deficits were relatively modest until the Asian financial crisis in 1997-98, after which they widened dramatically and now show little sign of narrowing. It seems the monthly deficit is “locked in” at between 20% and 40% of monthly income.

While no other group faces monthly deficits, for the three groups (II, III, IV) immediately above the bottom 20%, the monthly surplus has not returned to the pre-Asian financial crisis level. Only for the top 20% of Korean households has the surplus returned to the pre-Asian financial crisis level.

A closer look at the have-nots

The average age of the lowest-income quintile is 65.4, while for the other groups it ranges from 46.5 to 50.2. We can easily conclude that the lowest-income households are comprised mainly of retirees on modest incomes that don’t support their monthly expenditure. (Note that income transferred from the government and from their children is already included in the income statistics).

The net worth of the bottom 20% of households as of 2011 was down 5% to W94m compared with a year earlier. Given the long-running household deficits, the year-on-year decline is hardly surprising.

Real estate accounts for 80% of the group’s total assets and 92% of their net worth. Savings, at 11% of total assets, are similar to the amount of the group’s financial debt. Simply put, if we assume the financial debt cancels out the savings, the group has only real estate to its name.

If its real estate holdings do not generate sufficient cash to cover the monthly shortfall — either through additional debt taken against property or through liquidation of real estate — this group is likely to face even tougher times going forward. On this basis we believe that, from a long-term perspective, it is not sustainable for the bottom 20% of households to post perennial deficits.

Moreover, since Korea has a rapidly aging society, we think the problems facing the bottom 20% of
households could over time spread to more households. Indeed, Korea already tops old-aged income poverty rates among OECD countries (late 2000s data). Is Korea’s social safety net sufficient for the needs of the country’s senior citizens?

Old-aged income poverty rates

![Poverty among people of retirement age (late-2000s)](chart)

Source: OECD, Daiwa

Korea also tops the number of suicides per hundred thousand people among OECD countries (2009 data). Although the number of suicides may not be directly related to questions over the adequacy of the social safety net, and may not directly apply to senior citizens, we believe it could be one indicator of the general social mood, particularly in terms of economic hardship.

The elections represent an opportunity for many Korean households to make themselves heard more loudly. We believe that politicians, regardless of their affiliation, may seek to appeal to less-privileged households by coming up with “populist measures.”

Examples of such measures in the recent past include: 1) SSM (super supermarkets) were forced to close for two days per month, on either Sundays or holidays, upon a revision of related laws, 2) major department stores were forced to agree to a 3-7pp cut in commission rates for their small- and mid-sized vendors, with effect from November 2011, 3) oil refineries were requested to lower the retail price of oil by W100 per litre for a period of three months, and 4) major credit card companies were requested to reduce transaction fees levied on small merchants by 0.2%.

As part of its efforts to keep headline CPI numbers in check, we have also seen the government give strong guidance to food companies to refrain from passing cost pressure on to consumers. In our view, we could see similar measures in the coming months, particularly with 2012 being an election year. Moreover, we wouldn’t be surprised to hear a lot more about “welfare” over the course of this year.

On-the-ground: interviews with taxi drivers

Who better to talk to about high oil prices and their impact on the broader economy than Seoul’s taxi drivers? We think taxi drivers are a good proxy for the working populace. Besides, taxi drivers the world over like to chat.

To assess the situation, we interviewed more than 30 drivers from two groups: 1) those who drive cars owned by companies, and 2) those who own private taxis.

As well as high oil prices, we wanted to find out from drivers how they felt about economic conditions today as compared with three or six months ago. We were interested to hear not only the drivers’ own stories, but also their accounts of what passengers had told them (we found that on average the drivers carry 30-40 passengers per day).

We also wanted to get an idea of drivers’ income. In the process of the interviews, we learned of drivers’ average working hours and what they regard as a break-even fare. Since we now have a handle on drivers’ income, we have some insight into the outlook for consumption by at least one component group of the working class.

Where did we meet?

We hit the streets and met with 30-plus drivers in several parts of the city. We did so by: 1) taking taxis and travelling in them until the interviews were done, 2) frequenting a restaurant popular with taxi drivers, 3) speaking with drivers at gas stations, and 4) attending a soccer match between off-duty drivers (Seoul-based drivers vs non-Seoul-based drivers) near the capital.
The economy does not seem to be improving and oil prices are taking their toll

Following is a summary of the questions we put to drivers on a series of issues, including domestic economic conditions, political sentiment in an election year, and drivers’ own finances. In the interest of brevity we have summarised the drivers’ answers.

**Perception of economic conditions**

Q: Do you think economic conditions today are better, worse, or the same as they were three to six months ago?

A: Interestingly, not one driver said economic conditions today were better than they were three to six months ago. Just over 60% said economic conditions had deteriorated; the remainder felt that conditions were about the same.

Q: What’s the basis for your assessment?

A: First of all, the total number of passengers carried has declined, both during the day and during the night. In addition, some drivers remarked that the time when it starts to become difficult to find passengers is earlier than it used to be. They also said it seems as though there are fewer people than before staying out late while drinking. One reason for this, they said, could be that corporate expenses are tighter due to the weak economy.

Some drivers added that they believe major exporters are earning plenty of money but that most SMEs are in bad shape. In addition, they said a lot of self-employed business people had remarked that they face more challenges as time goes on in the face of weak domestic demand. For example, the drivers said they had frequently heard complaints by people running small restaurants that revenue was decreasing.

**High oil prices are drivers’ big concern…**

Q: How much do you make a month on average, and what is your main concern today?

A: It seems that private taxi drivers typically earn more than taxi drivers employed by taxi companies. Most of the private taxi drivers said that on average they take home W2.0-2.5m per month, excluding the depreciation cost of the taxis they drive. In the case of
taxi drivers employed by taxi companies, they said they work 12 hours a day, with 25-30 litres of gas provided by their company. They are required to bring in a minimum of W105,000-121,000, depending on when they drive the company car during the day or the night. Most of the company taxi drivers said that on average they take home W1.5-2.0m per month after handing in their daily payments to the taxi companies.

Most drivers said the rising price of gas had been weighing on their earnings because private taxi drivers need to fill up the tank with their own money and company drivers mostly fill up the gas in excess of 25-30 litres at their own expense.

Their major concerns were a decrease in the number of passengers against the backdrop of a weak domestic economy, as well as high gas prices.

Implications for the forthcoming elections

Q: With the caveat that what you hear from passengers may not be representative of the general public as a whole, could you share with us the typical view of your passengers? You’re likewise welcome to share your own opinions.

A: Many taxi drivers said they sensed that most passengers are no longer keen on talking politics, whereas previously they were happy to do so. The drivers took this as a sign of people’s cumulative disappointment in politicians, regardless of whether they belong to the ruling party or to opposition parties. The daily lives of average people are not improving but rather are deteriorating, despite the fact that many Korean exporters are doing well, taxi drivers said.

In Daiwa’s opinion, this view that bipolarisation in society is increasing is not positive for the incumbent party, regardless of whether the party is at fault or not.

Given ongoing complaints about high oil prices, and continuing perceptions that inflation is high despite benign official CPI figures, we believe the government may feel under pressure to alleviate such grievances, particularly with 2012 being an election year.

Therefore, we cannot rule out the possibility that the government will end up lowering taxes on oil and/or putting pressure on oil refining companies to make some concessions one way or another.

Veteran drivers highlight decline in real income

We would like to highlight one story we heard from a veteran driver who now drives his own private taxi. His story underlines the importance of being in a growing business rather than a dwindling one.

He told us that he purchased a private taxi, a Hyundai Pony, for about W2.3m at a time when the flag-fall fare was W600 in 1986. Back then, a bowl of black bean paste noodles and a pack of cigarettes were priced at about W240 and W150, respectively.

Today, the flag-fall fare is W2,400 while a bowl of black bean paste noodles and a pack of cigarettes go for at least W3,000 and W2,000, respectively.

This is a simple illustration of the extent to which general prices have gone up and taxi fares have failed to keep up — meaning a substantial drop in our veteran taxi driver’s real income over time.
In addition, alternative mass transport systems have come on in leaps and bounds. People can now go almost anywhere within Seoul by subway or bus, and the city government’s policy stance seems to favour the use of mass transit.

We heard a similar story from another driver. He recalls that, in the early 1990s, the flag-fall fare was W800, while a bowl of noodles was W300, a pack of cigarettes was W250, and a cup of coffee was W300. Today, the basic fare will barely stretch to a pack of cigarettes.

Now, it could be that taxi fares in previous years were simply too high. Maybe the supply of taxis back then was far too small compared with demand. But we note the current basic taxi fare in Seoul looks cheap compared with international levels.

- Taxi fare comparison in major cities around the world

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Source: World Taximeter, Naver, Daiwa
Note: No tipping is required in Seoul. Taxi fare calculations were conducted with reference to various Internet web-sites. No traffic jams and surcharges are reflected. The above taxi fares are based on about 10km covered.

Public mood is not on the side of the oil refineries, in our view

We think it is reasonable to presume that the general public will share taxi drivers’ view that it is time for other parties to bear the burden of high oil prices.

Currency appreciation may be part of the solution, in our view, but it won’t be the solution in itself. Moreover, we don’t think the current government, which has been focusing on economic growth by fostering exports and expecting a trickle-down effect into the domestic economy, would use currency appreciation as a major part of its solution. Considering the prevailing mood and the fact that it’s an election year, we cannot rule out the possibility that the oil refineries will be subject to arm-twisting again.

Back in 2Q11, political uncertainty concerning Libya drove gasoline retail prices in Korea up to W2,000/litre. At that time the government urged refineries to lower their retail prices for petroleum products (gasoline and diesel) by W100/litre for a period of three months.

As a result of the price cut, based on our oil-refinery sector analyst Jihye Choi’s estimates, SK Innovation (096770 KS, W160,000, Buy [1]), S-Oil (010950 KS, W108,000, Outperform [2]) and GS Caltex (Unlisted) incurred one-off losses of around W250bn, W100bn, and W170bn, respectively, for 2Q11.

As it stands, we believe the refineries may have strong grounds to say “no” if asked by the government to take similar measures, since they have already made concessions last year and the government has not made any concessions despite the fact that tax accounts for about 50% of prevailing gasoline prices.

Given our belief that the refineries may now be better placed to say “no”, set against lingering public sentiment regarding the refineries, we believe uncertainties may continue to weigh on investor sentiment toward the refinery stocks.

Focus on the sweet spot: top 20% of households

During our interviews, taxi drivers mentioned they see the rich getting richer and the poor getting poorer. By way of example they claimed there has been a rapid increase in the number of expensive foreign cars on the roads despite high oil prices.

In fact, they were delivering much the same message as our household monthly surplus/deficit data. When we look at the same data, it is clear that the top 20% of households’ wallets are substantially thicker than they were before the Asian financial crisis.

- Monthly household surplus amount trend

Source: Statistics Korea
Note: Classifications I to V represent five income groups that are divided in terms of total household earnings; V represents the top 20% and I represents the bottom 20%.

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Our take on the above chart is that the beneficiaries of consumption by the top 20% of households, such as Hyundai Department Store (069960 KS, W182,000, Buy [1]), ought to be core holdings in Korean portfolios — all the more so given our belief that the bi-polarisation trend is unlikely to come to an end any time soon.

Hyundai Department Store is one of our consumer sector analyst Sang Hee Park’s top picks. She expects its same-store sales growth to bottom out in April and a gradual recovery from 2Q12 onward. Luxury goods sales remain robust, while 2H12 earnings growth should be stronger than in 1H12, on the back of new store openings and completion of store-expansion work at its top-performing COEX branch. In our view, valuations appeal, with the stock currently trading at 10.4x PER on our 2012E earnings forecasts.

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<th>Korea consumer sector: valuation summary</th>
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Source: Bloomberg, Daiwa forecasts. Share prices are as of 6 April 2012.

Note: When a report covers six or more subject companies please access important disclosures for Daiwa Capital Markets Hong Kong Limited at http://www.daiwacm.com/hk/research_disclaimer.html or contact your investment representative or Daiwa Capital Markets Hong Kong Limited at Level 26, One Pacific Place, 88 Queensway, Hong Kong.

Please also see:

Korea Consumer Sector: Expect in-line 1Q12 results and a few to disappoint

3 April 2012

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S-Oil: share prices and Daiwa recommendation trends

- Date: 3/13/2012
- Target price: 143,000
- Rating: 2

SK Innovation: share prices and Daiwa recommendation trends

- Date: 1/25/2012
- Target price: 220,000
- Rating: 1
## Hyundai Department Store: share prices and Daiwa recommendation trends

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Source: Daiwa
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