The 10-second briefing

Demographics & real estate: don't overlook the mid-term positives

- While the long-term concerns are well known, Korea may be entering a 'Goldilocks period' for demographics...
- ...indicating positives for property prices until 2015, if not longer
- Opportunities for banks (KB FG), construction companies (Hyundai Development) and CVS operators (GS Retail)

SEOUL Searching

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▪ Summary

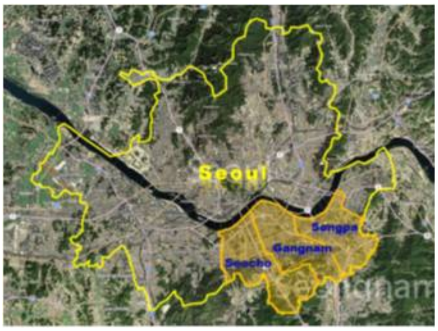
In this edition of Seoul Searching, we take a deep dive into the outlook for housing prices in Seoul and Korea, specifically with reference to demographics. Are housing prices set to drop sharply? Backed by our on-the-ground research, together with our assessment of interest rates, government policy, emerging household debt, and credit liquidity, we say not until 2015 at the earliest.

▪ What's inside?

As part of our assessment of conditions in the residential real estate market, we interviewed eight randomly selected realtors in the southeast of the city, known as the 'Gangnam Three Districts' — arguably the most important real estate market in Korea.

We learnt that: 1) recent deregulatory measures have had no impact on boosting transaction volumes, 2) even though volumes have been weak, sales of units offered at lower-than-usual prices have been steady, 3) realtors want more action from the government, while anticipating housing prices in the Gangnam Three Districts to rebound in the medium term on the back of future reconstruction work.

▪ **Location of the Gangnam Three Districts**



Source: Bing Maps, Daiwa

▪ Will Korea follow in the footsteps of Japan's real estate market?

We believe it is very unlikely that the Korean real estate market will follow Japan's on a three-year horizon. Korea differs from Japan in that: 1) the real estate bubble that has formed in Korea is much smaller than the bubble in Japan in the late 1980s, and 2) the housing supply ratio in Korea as of 2011 was far below that for Japan in 1990, when the bubble started to burst.

▪ Korea set for 'Goldilocks period' until 2015

By our reckoning, Korea's demographics will be favourable for the economy until 2015 because: 1) we expect the dependency ratio to bottom out around 2015, 2) the size of the home-buyer age groups is expected to peak in 2018 before entering a secular downtrend, 3) Korea's housing supply ratio and home ownership level are still lower than in the US and Japan, 4) we expect prolonged low interest rates and rising rents to spur demand for home purchases, and 5) we believe market concerns about rising household loans are overdone.

▪ Short-term weakness, but mid-term opportunity looks attractive

The real estate market has been weak in recent months, and the government's recent deregulatory measures have not been enough to stoke transaction volumes. We expect further deregulation related to transaction-related taxes, valuation gains tax on properties and reconstruction to revitalise the real estate market going forward.

▪ Stocks to watch

Under a scenario of further deregulation, we believe the construction companies and banks would be front-line beneficiaries.

Across our coverage universe, we like retail banking giant **KB FG (105560 KS, W36,800, Buy [1])**, which we think has the potential to capitalise on the M&A buyers' market, and **Hana FG (086790 KS, W35,300, Buy [1])**, as the positives from its recent acquisition do not seem fully priced in. Among regional banks, we see **BS FG (138930 KS, W12,050, Buy [1])** as a lateral play through its exposure to Busan's housing market.

Within the home-builders space, we like **Hyundai Development (012630 KS, W23,150, Outperform [2]).** Meanwhile, the rapid increase in single-person households favours **GS Retail (007070 KS, W24,400, Outperform [2]).**

Demographics: golden mid-term opportunity

Don't allow long-term risks caused by demographic changes to overshadow the medium-term opportunities

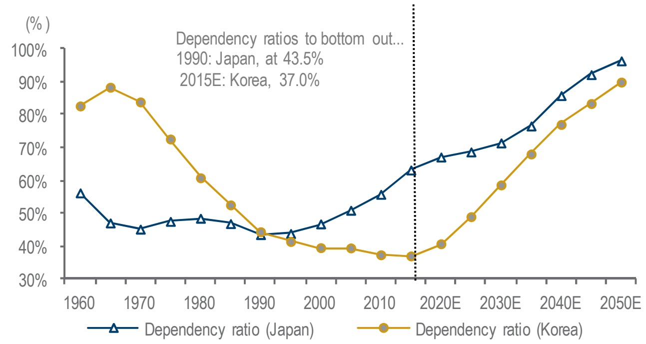
Goldilocks period expected for demographics at least until 2015

Many market participants are, rightly in our view, concerned about the long-term outlook for the Korean economy, due mainly to the rapid acceleration in the ageing population. (See our Seoul Searching report of 10 May 2012, *What women want*.)

Economic "vigour" generally dwindles and real estate prices tend to deteriorate as a society ages and population growth slows or even starts to decline, as we have seen in the case of Japan. From that perspective, demographic changes are inevitable forces of nature, and we believe Korea needs to start preparing if it is to avoid what has happened to Japan since that country saw its massive asset bubble, including the real estate bubble, burst in the 1990s.

But, in our view, these are long-term concerns. As we see it, there are medium-term opportunities stemming from the more favourable demographic composition of Korea that should last until at least 2015.

Dependency ratio of Korea versus Japan



Source: Statistics Korea, UN, Daiwa

Our view that medium-term investment opportunities are in store flows from the forecast trend in the dependency ratio, a measure of the burden of supporting the aged population. As the preceding chart shows, the dependency ratio in Korea is expected to bottom around 2015.

Low dependency ratio in Japan's case

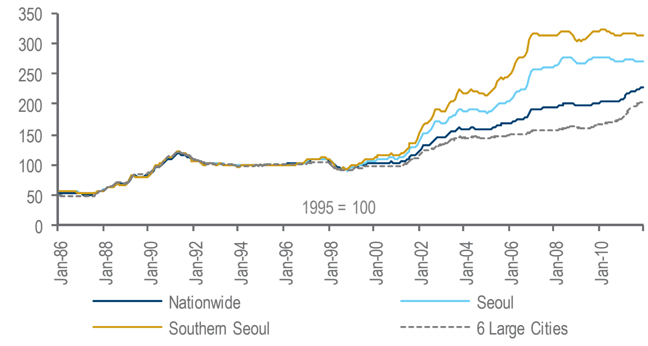
Take Japan as an example. Until around 1990, on the back of strong economic growth and asset price appreciation (which were subsequently defined as bubbles), Japan's dependency ratio was at its lowest. In our opinion, the massive formation of the asset bubble that developed during the latter half of the 1980s was closely related to the Plaza Accord, which forced a marked appreciation of the Yen against the US dollar from 1985. Had it not been for the excessive bubble that formed due to the Plaza Accord after 1985, the Japanese economy and asset prices could have shown much milder asset price appreciation from 1985 until 1990 (when the dependency ratio was at its lowest), and the post-1990 bursting of the bubble could have been a lot milder than it actually was.

What is different about Korea compared with Japan?

Despite the formation of the domestic real estate market bubble, in conjunction with global asset price appreciation up until the Lehman's crisis, we think the magnitude of the bubble in Korea is not sufficient to lead to a bubble bursting in the Korean economy. The reason for this view is that the country's previous government (the Roh Government) imposed highly restrictive measures to counter rising housing prices by squeezing the availability of credit in the real estate market via imposing strict loan-to-value (LTV) and debt-to-income (DTI) requirements for mortgage loans.

When an excessive bubble is formed in one asset class, there is a strong tendency for all sub-markets within one asset class to move together in the same direction, in our opinion. From this perspective, we do not believe the current real estate market in Korea falls into the category of excessive bubble formation — real estate prices (measured by the trend in nationwide apartment prices) are still showing upward movement but prices in Seoul, particularly in the blue-chip Seoul area, have been weak since February 2010.

▪ Apartment Purchase Price Index trend



Source: KB Kookmin Bank, Daiwa

With the bubble being small in the first place and the current global crisis compelling all economic units, be they the government, corporations, or households, to be conservative in using excessive leverage, we think the risk of asset prices (eg, equities and real estate) crumbling is not high. Unless there is another Lehman's-like global meltdown, we see a very low probability of real estate prices in Korea falling significantly from their current level.

Unlike Japan in the latter half of the 1980s, Korea has not experienced a massive bubble as of now, because it was not pinpointed as the source of the global imbalance, or the main culprit for the US trade deficit. Thus, currency appreciation was not mandated by any agreement between relevant countries, and efforts to alleviate currency appreciation by implementing unusually low and prolonged interest rates and the accompanying loose credit supply were not experienced in Korea. Therefore, we believe Korea is in a position to reap the benefits from improving fundamentals in terms of improving demographics until around 2015 without causing an excessive bubble.

Demographics in Korea could remain favourable for the economy until 2015

Based on the above line of reasoning, we believe the declining burden of supporting an aged population in Korea from now until 2015 could work in the country's favour, in terms of economic vigour and thereby strong asset prices.

We believe that investors who concentrate on the negative long-term outlook for the Korean economy and asset prices, based on the long-term effects of its rapidly greying population and slowdown in population growth, risk missing out on the potential short-to-mid-term investment opportunities arising from favourable changes in Korea's dependency ratio.

Demographics and the housing market

Home-buyer age groups

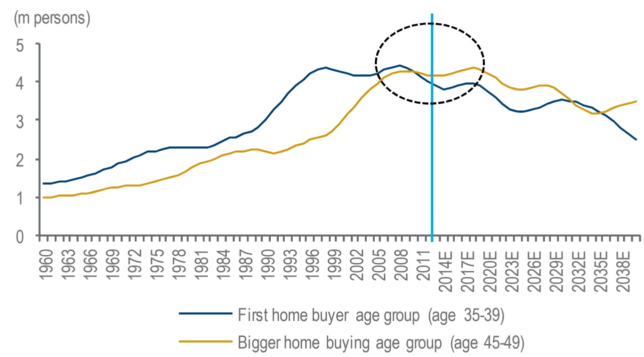
While housing market conditions are affected by factors such as government policy, credit availability, interest rates, the housing supply level, the home ownership level, and households' capability to take on debt, we believe demographics are a core factor.

Thus, we have looked first at the different groups of home buyers, as defined in the industry: 1) first home buyers (age group: 35-39), 2) bigger home buyers (age group: 45-49), and 3) the total home-buying age group (ages 35-39 and 45-49).

As shown in the following charts, the total population of first home buyers peaked in 2008, and is projected by Statistics Korea to decline until 2014 and then increase again to peak in 2018, before resuming a downward trend. However, the number of people in the first home buyer group in 2018 is projected to be lower than in 2008.

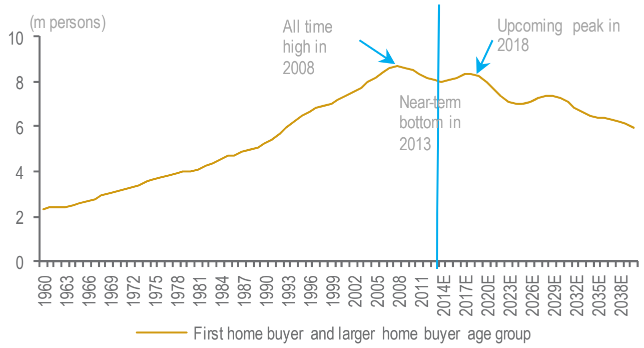
According to Statistics Korea, the number of people in the bigger home buyer age group reached an all-time high in 2009 and is expected to decline marginally until 2013, then resume growth until 2018. Statistics Korea expects the level to be reached in 2018 to be similar to the all-time-high attained in 2009, before showing a secular decline.

First-home and bigger-home-buyer age group population trend



Source: Statistics Korea, Daiwa

■ First-home and bigger home buyer age group combined



Source: Statistics Korea, Daiwa

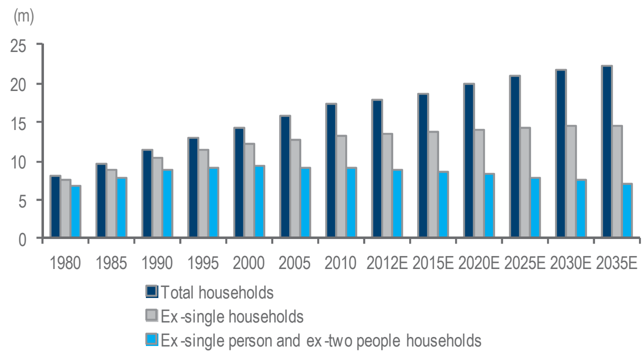
To assess the population trend of the overall home-buyer age group, we have added the first-home-buyer age group population and bigger home buyer age group population together. As the preceding chart shows, the overall home buyer age group population reached an all-time high in 2008, and is projected to reach a near-term bottom in 2013, before resuming an upward trend to reach its next peak in 2018, according to Statistics Korea. However, the overall home buyer age group population is expected to remain high until 2018, albeit smaller than in 2008. Therefore, based on the population trend of the home buyer age group, we believe housing market conditions are likely to remain resilient until 2018.

Rise in the number of single households

The total number of households in Korea is projected to continue to rise, according to Statistics Korea, implying a potential increase in the demand for homes.

On closer inspection, however, we can see that growth in the number of total households is likely to be driven mainly by a rapid increase in single-person households and two-people households (shown in the following chart).

■ Trend in the number of households in Korea



Source: Statistics Korea, Daiwa

For 2012, Statistics Korea projects single-person households to comprise 25.3% of total households, and two-people households 25.2%. Some 50.5% of total households are expected to be either single-person or two-person households in 2012, with the percentage rising to 54% in 2015, 59% in 2020, and 62% in 2025.

As we think single-person and two-person households are unlikely to opt for bigger houses, we believe long-term demand for bigger homes could see a secular decline, boding ill for the outlook for prices of larger houses going forward but also implying that smaller-sized homes would become more popular in the future.

Other factors affecting the housing market outlook

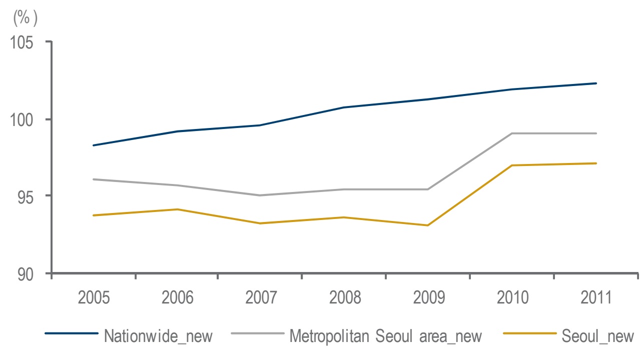
Given that housing market conditions are subject to many factors (listed earlier in this report), we have delved into each of these factors below.

Housing supply ratio

Housing supply data from the Korean Statistical Information Service (KOSIS) shows that the nationwide housing supply ratio as of 2011 was just 102.3%; for the metropolitan Seoul area it was 99%, and for Seoul it was 97.1%.

Considering that the housing supply ratios of developed countries such as Japan and the US exceeded 110% before their housing prices became sensitive to macroeconomic fluctuations, the seemingly low housing supply ratio in Korea in 2011 supports the view that Korea needs more houses. By extension, concerns in the market about a sharp drop in home prices in the near term strike us as overdone.

■ New housing supply ratio (incl. single-person households)

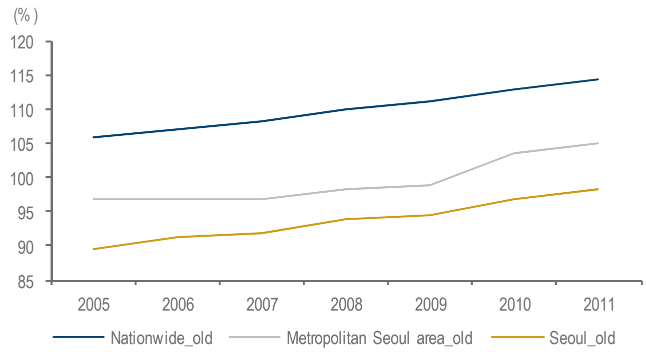


Source: Statistics Korea, Daiwa

However, the above observation is based on KOSIS's data for the new housing supply ratio, which recently started to include single-person households in its calculation of the total number of households. KOSIS also started to classify multi-family homes as multi-homes instead of just one house.

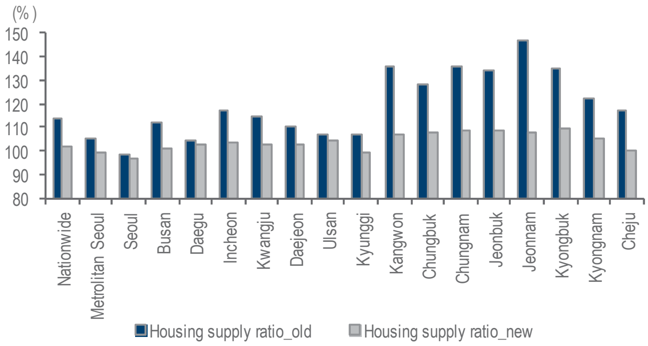
The previous data for the housing supply ratio painted a less optimistic picture of nationwide home price trends in 2011: 114.2% (nationwide), 104.9% (metropolitan Seoul area), and 98.4% (Seoul). There is only a 3pp difference between the new housing supply ratio numbers and the old ones for Seoul (98.4% vs. 97.1%), but an 11.9pp difference for the nationwide housing supply ratio (114.2% vs. 102.3%).

■ **Old housing supply ratio trend (excl. single-person households)**



Source: Statistics Korea, Daiwa

■ **Comparison between new and old housing supply ratio data**



Source: Statistics Korea, Daiwa

Regardless of whether we refer to the new or old housing supply ratio data, we conclude that housing supply ratios for Seoul and the metropolitan Seoul area do not seem high and are still lower than 110% – the level reached in Japan and the US prior to a substantial drop in housing prices in both countries.

Given the relatively low housing supply in Korea – in Seoul and the metropolitan Seoul area in particular – we believe the likelihood of a substantial drop in housing prices in the near future is low. Based on the nationwide housing supply ratio, which increased by 4pp from 2005 to 2011, we think it will take a decade or more for the housing supply ratio in Korea to exceed 110%, assuming that the ratio increases going forward at the same pace as it did over 2005-11.

Even if we incorporate an adjustment to the loophole in the new calculation for the housing supply ratio, which includes single-person households but excludes ‘officetels’ that are used for residential purposes, we still conclude that Korea needs more houses.

What is an officetel? Coming from the combination of ‘office’ and ‘hotel’, and unique to Korea, an officetel is essentially a multi-purpose building with residential and commercial units offering basic amenities like sports centres and shopping facilities. The floor plan looks similar to that of the studio apartment in western countries. Officetels are located mainly in the downtown or major transportation hubs, as tenants of officetels are most likely to be working-class single-person households or two-people household families. Other occupants that lease officetels for commercial use are typically travel agencies, trading companies, and small to medium-sized business owners/professionals including lawyers, accountants, tax accountants, professors, and artists. The officetel is designed to be a partially self-contained building, meaning that occupants can live and work in the same building, minimising commuting time. Since the Asian financial crisis, demand for officetels has increased rapidly due to deregulation, and they now take up a substantial portion of housing market in the metropolitan Seoul area.

Based on estimates from an industry source, the housing supply ratio in Seoul including officetels that are used for residential purposes is 4pp higher than the government’s number of 97.1%. Therefore, even including officetels, the housing supply ratio in the Seoul area would only have been 101.1% in 2011 — still substantially short of 110%.

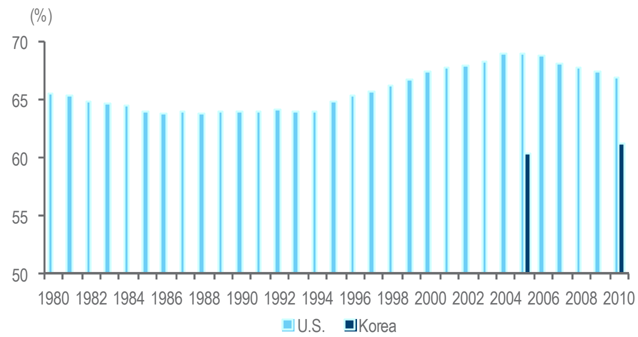
In addition, the number of houses per 1,000 people in Korea in 2010 was 302, 275 houses in the metropolitan Seoul area and 258 houses in Seoul. These figures are substantially lower compared with Japan (450 houses in 2005), the UK (439 houses in 2009) and the US (410 houses in 2010).

Looking at the housing supply ratio and the number of houses per 1,000 people in Korea compared with other countries, we can conclude that Korea will still need more houses going forward. Thus, in our view, concerns in the market that Korea may go through the same experience as Japan with its bubble bursting since 1990, or what the US experienced with the sub-prime mortgage crisis since 2007, look premature.

Home ownership

Home ownership data on Korea only goes back to 2005. According to Statistics Korea, nationwide home ownership in 2005 and 2010 was 60.3% and 61.3%, respectively. When we compare the home ownership trend in the US with that in Korea in 2005 and 2010 (as seen in chart below), we can see that Korea's home ownership level has remained low and we assume this to be the case currently.

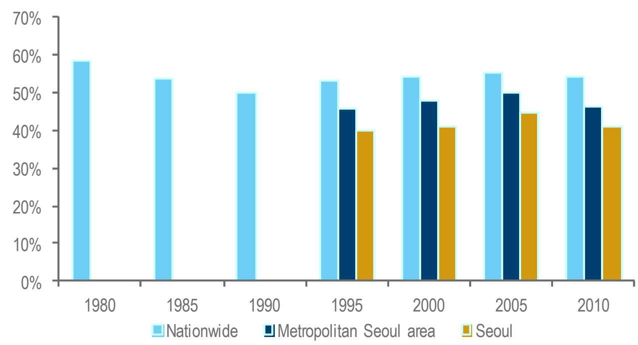
■ **Home ownership trend in the US and Korea**



Source: US Census Bureau, Statistics Korea, Daiwa

While the historical data for home ownership in Korea is limited, data on the percentage of owner occupancy of homes in the country goes back to 1980 (as seen in the following chart).

■ **Percentage of owner occupancy of homes in Korea**



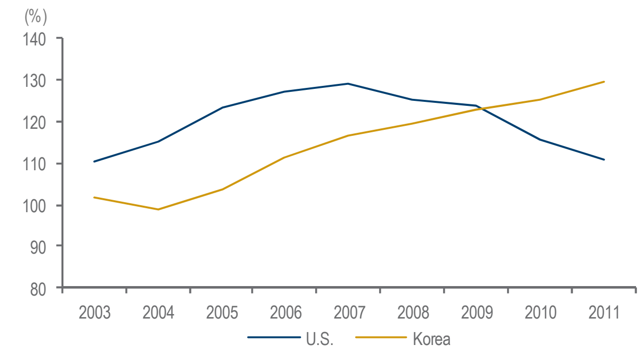
Source: Statistics Korea, Daiwa

The nationwide owner-occupancy ratio in 2010 was 54.2%, or 7.1pp lower than the nationwide home ownership ratio that year. If we assume that the 7.1pp difference could be applied to the metropolitan Seoul area and Seoul, we estimate that home ownership for the metropolitan Seoul area and Seoul would be 53.5% and 48.2%, respectively. In our view, these home ownership ratios are still low enough that high home ownership and potentially mounting downward pressure on home prices should not be a concern.

Growing concerns over household debt leading to a potential credit squeeze

Korea's household debt level expressed as a percentage of household disposable income started to exceed that of the US from 2010, and in 2011 reached the peak level recorded in the US in 2007, as shown below. Such a level is of increasing concern to policymakers and the market.

■ **Household debt/disposable income of households in the US and Korea**

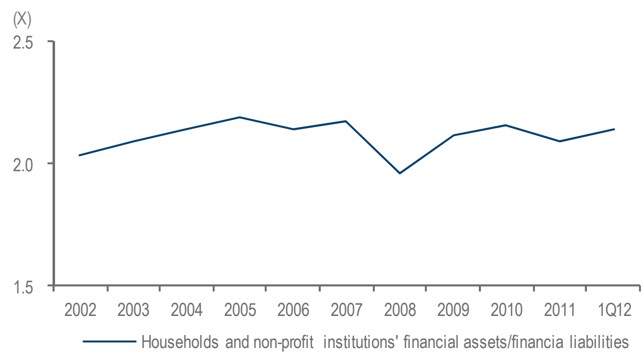


Source: Statistics Korea, BoK, US Federal Reserve, Daiwa

Concerns about individual household debt have led us to investigate further the debt payment capability of households, by assessing the overall assets and liabilities of households in addition to their disposable income.

We have looked at the flow of funds data provided by the Bank of Korea (BoK), and have obtained numbers on financial assets and liabilities of households (to be exact, households including small unincorporated business owned by households) and non-profit institutions serving households. The data shows that the financial assets of households and non-profit institutions serving households as of 1Q12 were 2.14x greater than their financial liabilities.

■ **Financial assets/financial liabilities of households and non-profit institutions servicing households**



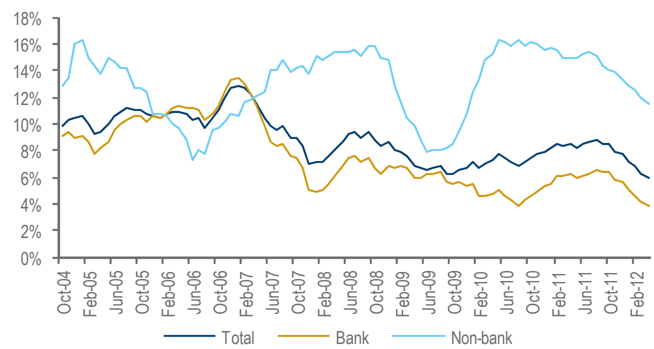
Source: BoK, Daiwa

Cash and deposits accounted for 46% of households' and non-profit institutions servicing households' financial assets as of 1Q12, meaning the amount of cash and deposits was almost on a par with the total amount of financial liabilities. Therefore, with financial liabilities able to be paid off through households' and non-profit institutions' cash and deposit holdings, we believe the existing debt level is not a serious problem per se when we look at the households as an aggregate.

Above, we have only counted aggregate households and non-profit institutions' financial assets compared with financial liabilities. When we factor in households' real asset holdings including real estate to assess the size of household financial liabilities compared with total household assets by incorporating the survey data from Korea Statistics, which is 73.6% on average, we estimate that the financial liabilities of households and non-profit institutions represent 12.3% of total assets of households and non-profit institutions.

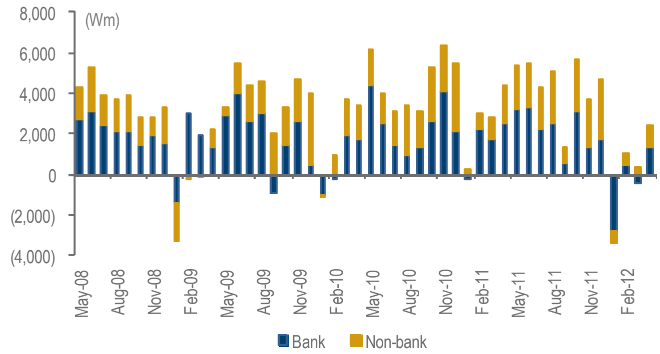
Since we have looked at the debt burden of households by looking at households in aggregate (and not focusing just on households with debt), we have referred to other data, based on a survey of 10,000 households conducted by Korea Statistics in conjunction with the BoK and the Financial Supervisory Service conducted in 1Q12. Based on the data, 63% of households surveyed had debt and their financial assets amounted to 1.08x their financial liabilities. Though this number is much lower than that of 2.14x for total households shown above, we believe household debt is not a problem for many of the liability-holding households at all, particularly when considering their real estate holdings as well.

■ Household loan growth of banks and non-banks



Source: BoK, Daiwa

■ Increase in household loan amount with banks and non-banks



Source: BoK, Daiwa

From a regulator's perspective, rising household debt, despite healthy balance sheets generally for individual households, is still a concern. The Financial Supervisory Service (FSS) has been keen to contain the increase in household debt in Korea and believes the current high level will present challenges for policymakers in the future.

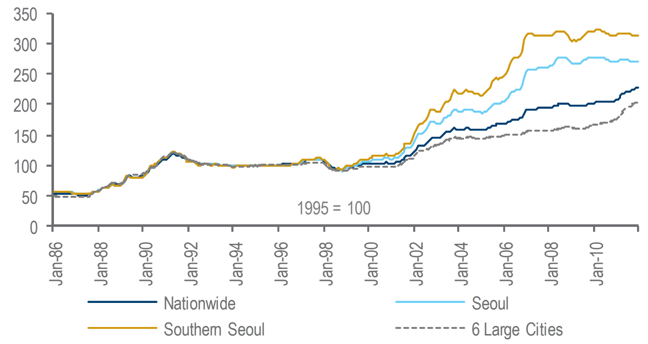
To this end, the government came up with its 'Comprehensive Measures for the Soft Landing of Household Debt' in June 2011, which aims mainly to trim the increase in household loans extended by commercial banks. However, despite the government's efforts, household loans have continued to grow, this time from non-bank financial institutions. Hence, the government has shifted to focus more closely on curbing the increase in loans extended by non-bank financial institutions to households from February 2012.

We acknowledge the market's concerns that the government might suppress completely any increases in household loans through its recent move of guiding both banks and non-banks to lower down household loan increase. But, we would not see a move by the government as an immediate threat to credit availability in the household loan market (which would lead to an overall credit contraction), because in our view the government's target is to control the pace of increase in household loans – which to us seems a prudent policy of stabilising the financial system, instead of eliminating household credit availability and inviting a credit crunch.

Low interest rates, strong Jeonse and the burden of monthly rents

Apartment prices in Korea have appreciated substantially since the early 2000s, as shown in the following chart. Nationwide apartment prices have continued to appreciate despite sluggish price movements in Seoul, due to strong price increases in regional cities.

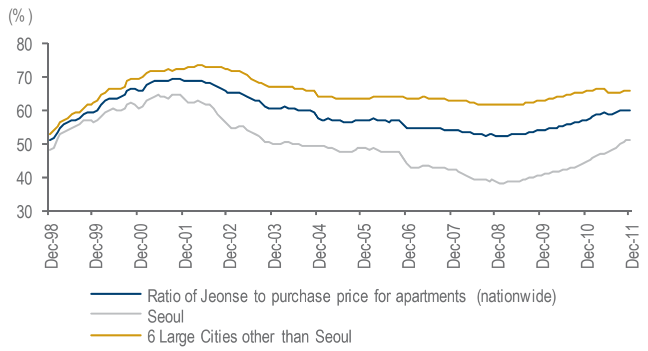
■ **Apartment Purchase Price Index trend**



Source: KB Kookmin Bank, Daiwa

The Jeonse price index has been on an upward trend following its trough reached in January and February 2009.

■ **Jeonse price to Purchase Price Index for apartments**



Source: KB Kookmin Bank, Daiwa

Jeonse is a real-estate term unique to Korea. It refers to a leasing contract (usually two years) whereby the tenant pays a lump-sum deposit, which is usually a percentage of the market value of the apartment to the landlord on the day that the tenant moves in. The homeowner is then free to invest the deposit amount within the Jeonse period, as long as the same Jeonse amount is returned to the tenant at the end of the lease.

The nationwide Jeonse price index bottomed out in January 2009 (at 52.3%), and has since recovered to 61.3% as of June 2012. In Seoul, it has risen from 41% to 52.1% over the same period. We believe the major reasons for the high Jeonse price index currently are the market's reduced expectations about strong home price appreciation in the future, along with prolonged low interest rates. This is because landlords' lowered expectations of future home price appreciation have prompted some of them to compensate partially by raising the Jeonse amount that the tenants have to pay. Prolonged low interest rates have also led to this effect.

■ **Trend of real interest rates and apartment Jeonse price index**

Source: Statistics Korea, the BoK, KB Kookmin Bank, Daiwa

The real interest rate, which we derive by subtracting the CPI growth rate from the weighted-average savings deposit interest rate from the banks (as Jeonse money is typically deposited into bank saving deposits by landlords), has remained low since 2009, while the Jeonse price index has increased steeply since then.

Another phenomenon in Korea's rental market amid the current low interest-rate environment is the rising number of home owners seeking alternative ways to receive compensation for the opportunity cost of owning a house, either through asking tenants for a higher Jeonse amount or switching from a Jeonse to a 'partial' Jeonse by lowering the Jeonse amount and requesting a monthly rent in addition to the lowered amount. The combination of a partial Jeonse with a monthly rent enables the landlord to obtain a higher yield than from a pure Jeonse, since the portion of the Jeonse that is converted into a monthly rent payment generates a yield of about 6-7% for the landlord.

If the current low interest rate environment continues, then more home owners will probably continue to rent their houses on a partial Jeonse with monthly payments instead of on a pure Jeonse. If this persists, tenants facing the rising cost of rents would be better off taking out loans to buy homes rather than accepting a partial Jeonse with monthly rents.

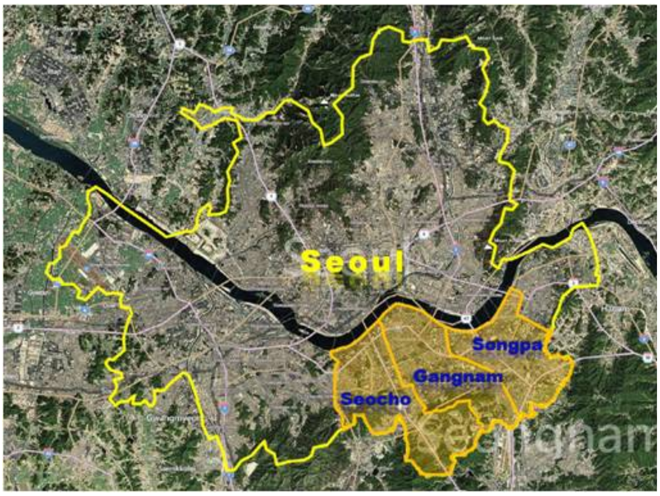
On the ground: interviews with realtors in the Gangnam Three Districts

Restrictive measures recently rolled back. What's next?

On 10 May 2012, the government rolled back almost all of the restrictive measures imposed on the real estate market by the previous Roh Government, ostensibly to normalise unduly depressed transaction volumes.

As the core of Korea's residential property market comprises the districts located in the southeast of the city, the so-called Gangnam Three Districts, we visited eight realtors at random in the area (Seocho-Ku, Gangnam-Ku, and Songpa-Ku) to get a feel for the market there.

■ Location of the Gangnam Three Districts



Source: Bingmaps, Daiwa

Q1: Have apartment prices and transaction volume risen following the rollback of the previous measures?

Almost all of the realtors said there had not been any meaningful rise in transaction volume since 10 May. Some said they had seen a marginal pick-up in transaction volume right before the roll-back based on the expectation of a rise in prices, but those people had been disappointed and now believed they had acted hastily.

Q2: What measures do you think would increase transaction volume?

Most of the realtors said the removal of debt-to-income (DTI) restrictions would be needed to help apartment transaction volumes recover to normal levels. This is because, in many cases, the income levels reported to the tax authority by professionals and self-employed people are much lower than their actual income. This means these people are unable to obtain a loan from a bank that truly reflects their repayment ability. One realtor said that elderly home owners with homes worth over W2bn found it difficult to secure home-equity loans as they did not have sufficient income. As a result, such home owners sought loans from non-bank institutions at much higher interest rates.

Some realtors said DTI was not an important issue, because they had potential buyers who were cash-rich and for whom the DTI restrictions were irrelevant. The key factor for them in buying a house in Gangnam Three Districts was a good outlook for the property market. Another factor preventing them from buying was uncertainty about the global economic outlook, which they expected to last for a long time. As a result, these people would only buy houses that were for sale at a discount.

Many of the realtors also suggested that applying exemptions or reducing the acquisition tax and registration tax associated with home purchases would also help boost transaction volume. In addition, they said the government should be more aggressive in liberalising the market, through measures such as lifting the cap on the pre-sale prices of apartments, and lifting the requirement for the inclusion of too many small-sized houses in the reconstruction of old apartment complexes. Some said that taxes on the valuation gains of houses should be reduced further for those who own more than one property.

Q3: How would you characterise transactions over the past 3-6 months?

Surprisingly for us, one realtor admitted that he had not had any transactions over the past three months. He said he had thought seriously about relocating his office to a place where the rent was less expensive.

Most of the other realtors said there were potential buyers in the market, but that these were only interested in buying at a discount of 5-10% on the asking price. They were buying in the expectation that prices would eventually pick up. However, prices are not rising; according to realtors, this is because there is a continuous supply of houses at discounted prices coming on to the market. Asked who was making these urgent sales, the realtors said it was owners of small businesses, suggesting to us that the domestic economy is in a fragile state.

Q4: How do you cope with a prolonged period of low transaction volume?

It was clear that the low level of transactions was making it a tough time for realtors. Some said it would have been difficult to continue if they had depended solely on the residential property business. Thus, many had started to offer services covering 5-10 storey commercial buildings, land, and consulting services.

Given this change, we learned from the realtors that an increasing number of affluent people are buying commercial buildings to secure a stable income stream. We think this trend is related to the prolonged period of low interest rates and people's expectation that this environment will continue for some time yet.

Q5: What is the outlook for prices?

Most of the realtors said they had no firm view on the nationwide home price trend. However, they did not believe the long-term outlook was bright given the demographic changes in the country. Nonetheless, almost all the realtors we met with in the area said that house prices in Gangnam had weakened considerably since the peaks reached in 2008 and 2010. They believe that the current the price level itself is an attractive price level, since it reflects at least about two years of price corrections. Therefore, they expect house prices in what is considered the core of Seoul (and thus of Korea) to rise over a time span of 5-7 years, given that many old apartment buildings in the area are likely to be redeveloped in the near future.

Reshaping of Seoul to continue through 'reconstruction'

Run-down parts of the city still ripe for reconstruction

One of the major drivers of house prices in Seoul, particularly in Gangnam Three Districts, from the early 2000s until 2006-08 was the redevelopment of run-down apartments in prime locations into high-rise blocks.

When an old five-storey apartment complex in Gangnam Three Districts was allowed by the district and the city government to be developed into a 20-30-storey high rise, windfalls were all but guaranteed for the home owners.

For the owners of run-down apartments, reconstruction can lead to an improved quality of life since the owners can live in a brand new home with spacious parking space located underground; also, some dwellings have high-tech features locating the spot where you have parked your car and even providing information such as weather forecasts, etc.

In addition, such reconstruction in the past has brought about sharp appreciation of home prices (300-400% capital appreciation in some cases). For owners of old run-down apartments, much of the cost of reconstruction is recouped, with a profit made from the sale of the additional units built, as living in a new, large apartment in Gangnam Three Districts is a dream for many people in Korea. Also, construction companies could fill their order books with construction projects and generate gross-profit margins of about 10-15% on these projects.

■ Old apartments suitable for redevelopment in Gangnam

Source: Daiwa

■ New apartments in Gangnam following redevelopment

Source: Daiwa

Due to the high level of property investment activity and the reconstruction bubble, the Roh Government introduced measures to restrict the profitability of reconstruction by reducing plot ratios, and imposing a levy on the gains from reconstruction. Thus, many owners' associations for old, run-down apartments decided not to seek redevelopment, resulting in the high level of redevelopment activity abating.

The city of Seoul cannot leave old, run-down apartments in its prime areas forever. If the government comes up with strong incentives to put as much as much profit as possible into the hands of home owners with old apartments, then we think reconstruction activity will resume, with the demolition of the old apartments likely to have a spill-over effect on rents and/or demand for homes for several years thereafter.

Interestingly, residents of a large apartment complex that is being redeveloped may cause rents in the surrounding area to increase temporarily, as the residents have to move out for a while when the work gets under way.

Should the government decide to boost the housing market in this way, it is likely to be controversial in a society where the bi-polarisation of wealth is a hot topic (See our Seoul Searching report of 9 April 2012, *On-the-ground in today's Korea*.) However, as the housing market is unlikely to receive a boost from the rollback of restrictive measures on 10 May, we expect the government to seek to introduce stronger measures. Thus, we think it is too early to conclude that Seoul's property market is on a long-term downtrend.

Conclusion: opportunities over the medium term

Expecting weakness in property market to abate or even reverse

We expect the current weakness in the property market to abate and even reverse to display some strength over the medium term (ie, on a three-year horizon).

The government is likely to continue to control the mortgage loan market due to the high level of household debt as a proportion of household disposable income. However, as we discussed in the previous section, we believe that what the government wants is to see is a smaller increase in the overall level of household debt over time (0.6% growth on a monthly basis). Therefore, investor concerns about an abrupt contraction by the financial companies in their outstanding household debt balances, which could cause a collapse in the country's housing market and financial system, should be mitigated, in our view. Obviously, that is not what the government would like to see. If short-term housing market weakness continues, then we believe the government would bring in measures to revive the property market, just as it has attempted to do so on 10 May.

Given this, we see a reasonably high probability of further deregulation of the property market in Korea, such as granting more incentives to make reconstructions profitable enough to be carried out based on profit motives by home owners and construction companies, as a way of bolstering the Korean economy.

Under such a scenario, financial companies would probably extend credit, as large-scale redevelopment projects, particularly in prime areas in Korea, would not be viewed as excessively risky. Thus, as in the past, collective mortgage loans, which are extended to all the old run-down home owners as one group, would be readily available for the projects from financial companies, and these collective mortgage loans would probably be guaranteed either by the financially healthy major home builders and/or the Korea Housing Guarantee Company, which is owned by the government (55.05%), financial companies (17.88%), and construction companies (12.21%). The financial companies would take the land owned by old run-down house owners' as collateral in addition to the aforementioned guarantees.

So-called collective mortgage loans, particularly for reconstructions of old apartments, are very low-risk projects and the continuation of such projects is much needed for the reshaping of Seoul, in our view. Therefore, we believe that the credit supply for such projects will be available and that these reconstruction projects could be one of the major factors that could strengthen the property market over the medium term, particularly in Seoul.

Implications for banks, construction companies, and convenience stores

Despite Korea's currently weak real estate market environment, we are positive about the outlook for the real estate market over the medium term, ie out to at least 2015 if not longer. Therefore, we do not expect the banks and construction companies to face serious headwinds from the household-debt problem over the near term. We would only expect there to be formidable yet fundamental downward pressure on home prices if a number of demographic changes were to converge, such as: 1) a secular decline in the number of individuals of home-buying age, 2) baby boomers retiring and potentially downsizing or selling their properties, 3) a larger proportion of elderly people with low incomes exiting the property market, and 4) a rapid increase in the number of single-person households resulting in reduced demand for large units.

While it is impossible to pinpoint when these factors might converge, we think it will be by about 2018 at the latest, because: 1) the number of those in the first-home-buyer and buyers-of-large-homes age groups combined is expected to decline from 2018 based on the demographic projections made by Korea Statistics, and 2) baby boomers' retirement should be completed by 2019, assuming a retirement age of 55.

Korea's relatively low housing-supply ratio and home ownership level, and the number of houses per thousand people currently, suggest to us that structural weaknesses in the housing market are unlikely to materialise in the next couple of years. In addition, the government's ability to influence the property market, including the residential segment, through policy measures, such as capital-gains tax, property tax and floor-space controls, remains strong.

Therefore, we believe it is much too early to be concerned about a negative scenario in housing prices having a massive impact on the banks and construction companies.

While investment sentiment towards banks and construction companies over the short term is likely to be affected by developments in the Eurozone economies and other global issues, we believe that attractiveness of banks and constructions companies would increase given our positive medium-term outlook for the property market.

Among the banks, we like retail giant **KB FG (105560 KS, W36,800, Buy [1])**, as in our view it has the greatest potential to use its large amount of capital to take advantage of the favourable conditions for buyers in the M&A market going forward. On fundamental grounds, we like **Hana FG (086790 KS, W35,300, Buy [1])**, because it acquired its major competitor at a time when the M&A market was favourable for buyers, and we believe the positives of the acquisition are not yet fully priced in. While we believe all the banks we cover would reap the benefits of our positive medium-term outlook for the property market, the two names highlighted above offer additional appeal with the structural factor of inorganic growth through M&As.

In addition, among Korea's regional banks we see **BS FG (138930 KS, W12,050, Buy [1])** as a lateral play through its exposure to Busan's housing market.

Among the home builders, we like **Hyundai Development (012630 KS, W23,150, Outperform [2])**, a domestic housing-market play. It recorded a 1H12 pre-sales ratio of more than 80%, demonstrating that it has been successful in finding niche demand in the pre-sales market. We expect the company's pre-sales units to rise YoY in 2012 and forecast more than 10,000 units this year (compared with pre-sales of 6,500 units in 2011).

In addition, management's efforts to expand the company's landbank look set to continue, supported by an inflow of cash from recently completed in-house projects. We believe this will sustain its highly profitable in-house business in the years ahead.

In the retail space, we like **GS Retail (007070 KS, W24,400, Outperform [2])**, the second-largest player in the Convenience Store Sector in terms of the number of stores, because it is benefitting from the rapidly increasing number of single-person households.

GS Retail is the main beneficiary of Korea's current demographic trend, in our view. The rapid growth in the number of single-person households should see more people opt to shop at convenience stores located close to their home rather than at large super supermarkets that are kilometres away. Also, as baby boomers reach retirement age, the number of convenience-store franchisees is likely to increase, as the retirees will probably seek convenience stores as a steady income generator. This is because the earnings generated from a convenience store franchise are more stable compared with earnings produced from managing an SME business given that minimum levels of income are guaranteed by the companies owning the franchises during the initial two years of opening. This should lead to more new store openings. In addition, a rise in the number of traditional mom-and-pop stores being converted into convenience stores should contribute to new store openings.

Risks to our view

If interest rates globally were to be raised sharply despite the massive monetary-easing policies of the major central banks, and if this were to lead to interest rate increases in Korea, then households' debt payment capability would most probably deteriorate. Financial companies, on concerns about such deterioration, would probably start to adopt conservative credit policies, which could in turn trigger a contraction of credit supply to households and lead to falls in property prices.

Another risk would be an unexpectedly sharp drop in economic activity in Europe or China resulting in the US dollar becoming substantially stronger against the Won, with the subsequent outflow of money by foreign investors leading to a sharp fall in property prices.

Korea Banks Sector: valuation summary

	Code	Mkt Cap (Wtn)	Price (W)	Rating	PER (x) FY11	PER (x) FY12E	PER (x) FY13E	PBR (x) FY11	PBR (x) FY12E	PBR (x) FY13E	Div. yield (%) FY11	Div. yield (%) FY12E	Div. yield (%) FY13E	ROE (%) FY11	ROE (%) FY12E	ROE (%) FY13E	EPS growth (%) FY11	EPS growth (%) FY12E	EPS growth (%) FY13E
Banking																			
KB Financial Group	105560 KS	14.2	36,800	Buy (1)	5.7	5.7	5.1	0.6	0.6	0.5	2.0	3.5	3.9	11.6	10.5	10.6	2427.3	(0.0)	11.2
Shinhan Financial Group	055550 KS	18.0	38,000	Outperform (2)	6.2	7.0	5.7	0.7	0.7	0.6	3.4	2.9	3.4	12.7	9.8	11.1	39.3	(11.4)	23.4
Woori Finance Holdings	053000 KS	9.4	11,700	Outperform (2)	4.4	5.6	4.5	0.5	0.5	0.5	2.3	1.8	2.2	13.6	9.5	10.8	80.4	(21.6)	22.9
Hana Financial Group	086790 KS	8.6	35,300	Buy (1)	6.8	3.7	4.9	0.6	0.5	0.5	2.2	4.1	3.1	10.0	15.6	10.4	7.8	82.7	(25.1)
Korea Exchange Bank	004940 KS	5.2	8,030	Outperform (2)	3.1	4.8	4.6	0.6	0.5	0.5	18.8	2.6	2.7	19.7	12.0	11.2	62.0	(35.3)	4.7
Industrial Bank of Korea	024110 KS	6.7	12,300	Underperform (4)	5.4	5.9	5.8	0.6	0.6	0.5	4.7	3.8	3.9	10.5	8.7	9.8	12.8	(8.5)	2.2
DGB Financial Group	139130 KS	1.8	13,600	Outperform (2)	5.9	5.3	4.7	0.8	0.7	0.6	2.6	3.9	4.3	14.3	14.2	14.0	34.0	12.0	11.5
BS Financial Group	138930 KS	2.3	12,050	Buy (1)	6.0	5.2	4.6	0.8	0.7	0.6	3.4	4.0	4.5	14.4	14.3	14.3	13.1	13.9	13.0

*Source: Bloomberg, *Daiwa forecasts* *Note: Prices are as at 10 July 2012*

Korea Construction Sector: valuation summary

	Code	Mkt Cap (Wtn)	Price (W)	Rating	PER (x) FY11	PER (x) FY12E	PER (x) FY13E	PBR (x) FY11	PBR (x) FY12E	PBR (x) FY13E	EV/EBITDA (x) FY11	EV/EBITDA (x) FY12E	EV/EBITDA (x) FY13E	ROE (%) FY11	ROE (%) FY12E	ROE (%) FY13E	EPS growth (%) FY11	EPS growth (%) FY12E	EPS growth (%) FY13E
Construction																			
Samsung Engineering	028050 KS	7.1	178,000	Outperform (2)	13.8	12.6	10.8	5.4	3.9	3.0	8.5	8.0	6.4	44.5	35.9	31.7	39.2	9.7	17.2
Daelim Industrial	000210 KS	3.2	90,900	Buy (1)	8.7	5.7	5.3	0.7	0.7	0.6	5.7	4.3	3.6	8.6	12.1	11.7	3.3	51.9	7.3
Daewoo E&C	047040 KS	3.6	8,780	Hold (3)	10.5	12.1	9.9	1.0	0.9	0.8	8.8	7.8	6.0	9.9	7.8	8.9	n.m.	(13.0)	22.6
Hyundai E&C	000720 KS	7.0	62,500	Outperform (2)	10.2	9.8	7.9	1.7	1.4	1.2	7.8	7.0	5.7	17.9	15.8	16.9	29.6	3.2	24.9
GS E&C	006360 KS	3.9	75,800	Outperform (2)	9.1	10.4	9.2	1.0	1.1	1.0	5.5	8.1	7.1	11.6	10.3	11.5	4.0	(12.1)	13.4
Hyundai Development	012630 KS	1.7	23,150	Outperform (2)	7.9	7.4	6.2	0.7	0.7	0.6	8.9	6.9	5.8	9.2	9.4	10.2	107.6	6.2	18.7
Samsung C&T	000830 KS	9.8	62,500	Outperform (2)	24.3	16.7	15.0	1.0	1.0	0.9	16.4	14.4	12.5	4.5	6.0	6.4.	(14.2)	45.6	10.9

*Source: Bloomberg, *Daiwa forecasts* *Note: Prices are as at 10 July 2012*

Korea Retail Sector: valuation summary

	Code	Mkt Cap (Wtn)	Price (W)	Rating	PER (x) FY11	PER (x) FY12E	PER (x) FY13E	PBR (x) FY11	PBR (x) FY12E	PBR (x) FY13E	EV/EBITDA (x) FY11	EV/EBITDA (x) FY12E	EV/EBITDA (x) FY13E	ROE (%) FY11	ROE (%) FY12E	ROE (%) FY13E	EPS growth (%) FY11	EPS growth (%) FY12E	EPS growth (%) FY13E
Retail																			
Lotte Shopping	023530 KS	9.1	314,000	Buy (1)	9.8	9.1	7.7	0.7	0.6	0.6	7.0	7.6	6.9	6.9	6.9	7.6	(7.4)	7.5	18.0
E-Mart	139480 KS	7.0	250,000	Hold (3)	12.9	12.9	12.2	1.2	1.1	1.0	9.2	8.5	7.9	0.0	9.2	8.9	0.0	(0.5)	6.2
Hyundai Dept Store	069960 KS	3.2	138,000	Buy (1)	7.9	7.8	7.2	1.1	1.0	0.8	6.8	6.1	5.5	11.7	13.0	12.5	(23.0)	1.2	9.5
Shinsegae	004170 KS	2.1	211,000	Hold (3)	12.4	11.5	10.4	0.9	0.9	0.8	9.0	8.8	8.6	3.5	7.9	8.1	(40.2)	7.6	11.0
GS Retail	007070 KS	1.9	24,400	Outperform (2)	20.1	15.2	12.3	1.3	1.2	1.1	9.5	7.4	6.1	6.6	8.4	9.6	30.6	32.2	23.8
Hyundai Home Shopping	057050 KS	1.3	107,000	Buy (1)	9.0	8.0	7.1	1.5	1.3	1.1	2.7	1.9	0.8	18.4	17.6	17.1	(7.0)	12.3	13.8
CJ O Shopping	035760 KS	1.2	189,000	Outperform (2)	9.8	9.1	8.0	3.4	2.5	2.0	9.6	8.6	7.8	34.4	31.7	27.6	25.8	7.3	13.9
GS Home Shopping	028150 KS	0.6	91,300	Hold (3)	2.7	5.9	5.5	1.0	0.8	0.7	1.4	0.7	0.0	42.5	15.0	14.5	191.1	(55.1)	8.4

*Source: Bloomberg, *Daiwa forecasts* *Note: Prices are as at 10 July 2012*

Please also see:

Seoul Searching: On-the-ground in today's Korea **9 April 2012**	**Seoul Searching: What women want** **10 May 2012**
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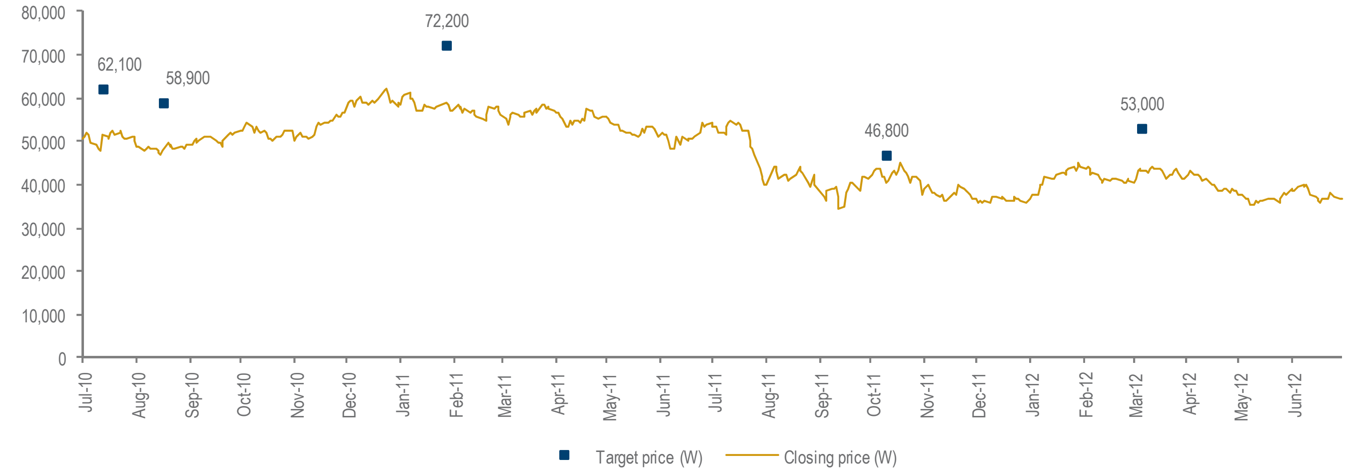
■ **KB FG: share price and Daiwa recommendation trend**

Date	03/16/2012	10/20/2011	2/7/2011	8/27/2010	7/23/2010
Target price	53,000	46,800	72,200	58,900	62,100
Rating	1	2	2	2	2

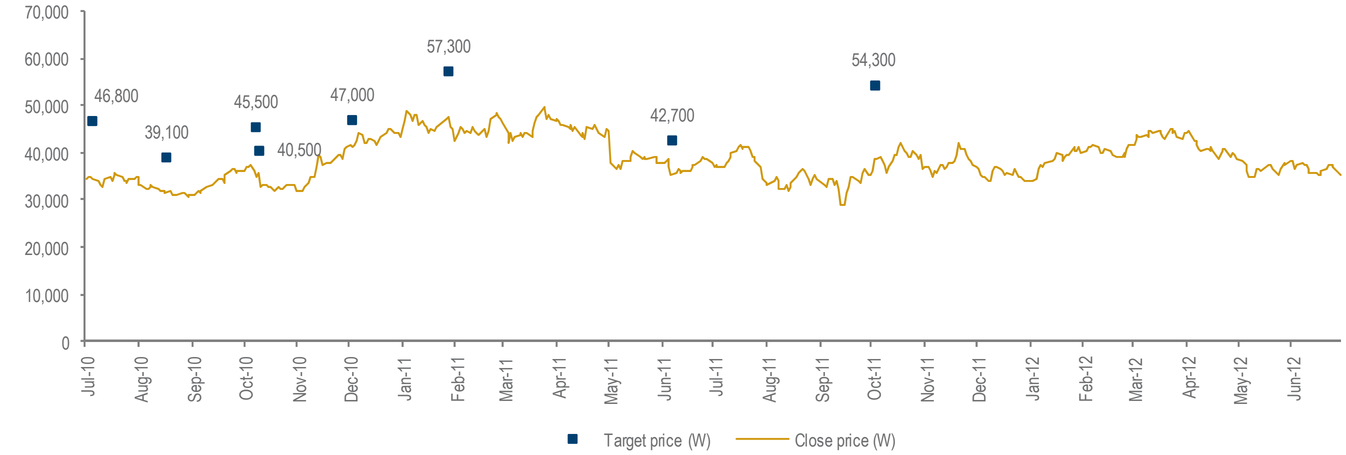


Source: Daiwa

■ **Hana FG: share price and Daiwa recommendation trend**

Date	10/13/2011	6/17/2011	2/7/2011	12/13/2010	10/20/2010	10/18/2010	8/27/2010
Target price	54,300	42,700	57,300	47,000	40,500	45,500	39,100
Rating	1	2	1	2	2	2	2

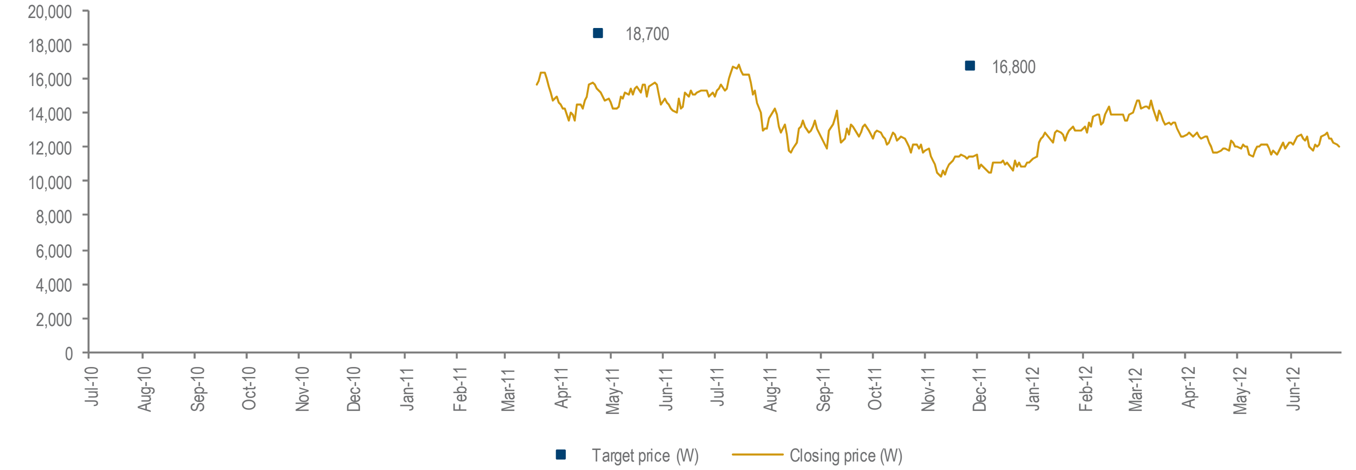
Date	7/15/2010
Target price	46,800
Rating	2



Source: Daiwa

■ BS FG: share price and Daiwa recommendation trend

Date	12/07/2011	4/5/2011
Target price	16,800	18,700
Rating	1	2



Source: Daiwa

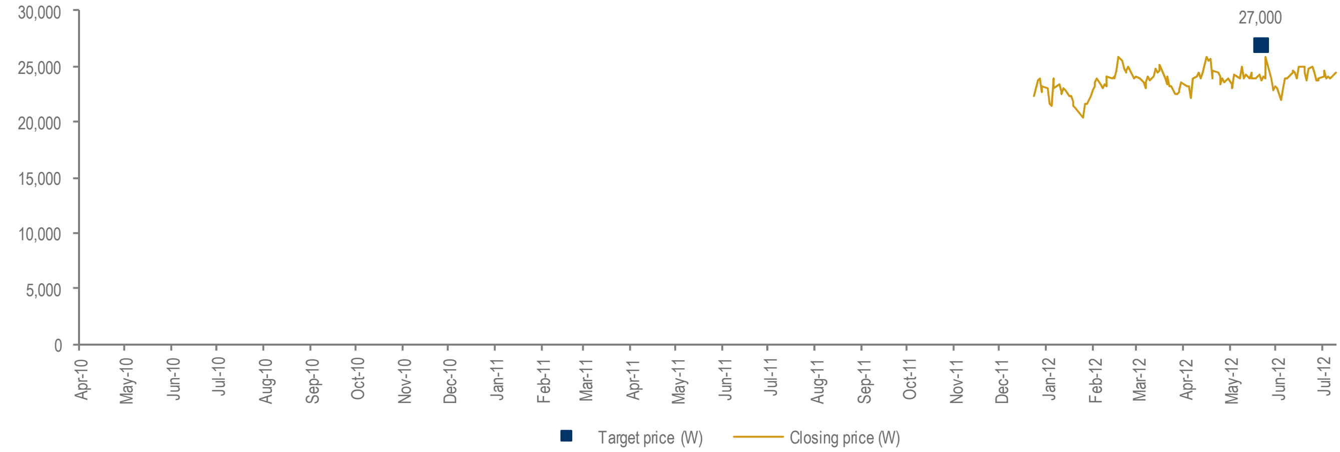
■ Hyundai Development: share price and Daiwa recommendation trend

Date	2/6/2012	10/21/2011	8/2/2011	5/4/2011	2/17/2011	2/9/2011	11/3/2010
Target price	28,000	25,000	36,000	41,000	38,000	36,000	32,000
Rating	2	2	2	2	2	3	3

Source: Daiwa

■ GS Retail: share price and Daiwa recommendation trend

Date	24/05/2012
Target price	27,000
Rating	2



Source: Daiwa

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