CHOI NOMICS: SOUTH KOREA FOCUSES ON HIGHER DIVIDEND PAYOUTS

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South Korea has generally been underperforming other emerging markets recently, but the KOSPI, a broad measure of South Korean equities, hit a three-year high in anticipation of higher dividend payments[1]. Newly appointed finance minister Choi Kyung-hwan announced tax measures that will incentivize corporations to unlock billions of dollars in cash reserves and redistribute them in the form of dividends and capital expenditure (capex). Choi stated "The goal of the plan is to help encourage companies' profits to be spent more in the form of investments and dividends."[2] Additionally a $40 billion stimulus package, which is close to 3% of gross domestic product (GDP), was rolled out to help stimulate a languishing economy that grew at its slowest pace in more than a year. **Why the Emphasis on Higher Dividends?** The South Korean equity market has one of the lowest dividend payout ratios in the world. Choi stated, "When a company makes a profit, the funds have to flow into households in the economy through investments, salaries or dividends for the economy to be functioning properly."[3] Below we detail the new economic team's proposals to facilitate higher dividend payouts. Raising dividend payouts potentially can be a stimulant for asset prices, attracting a new range of market participants looking for the cash flows from those equities. Growth in valuations can help boost domestic demand and subsequently improve economic growth. **The policies aiming to increase dividends: • New tax on undistributed earnings:** The government plans to introduce a 10% tax on undistributed net earnings to encourage investments, dividends and wage hikes in South Korea. This tax will be assessed on large companies if the combined impact of dividends, capex and wage increases is below 60% to 80% of the company's net profits. The tax is charged on the shortfall at 10%, and this is effective for earnings in 2015, 2016 and 2017. - One need not look far to understand the economic implications of these taxes. Taiwan introduced a similar tax on undistributed earnings in 1998, and today its equity market has an average dividend payout ratio of 48%. In contrast, South Korea's payout ratio is 14%[4]. These tax incentives clearly have an impact. - Michael Na, Nomura's Korean strategist, argues, "If Korean firms start paying out 50% of earnings, which would be 5.2% of dividend yield. That could spark a wave of buying and see the KOSPI rise to 3,000." The potential for a 5.2% dividend yield is highly alluring, given that current dividend yields in South Korea stand at 1.1%[5]. • **Lower tax on dividend income:** The government has also proposed lowering withholding tax rates for both large and minority shareholders who are currently subject to a dividend income tax of 38% and 15%, respectively. The proposal would allow large shareholders of qualified listed companies to pay a withholding tax of 25%, from a consolidated income tax of 38%. **Which Stocks Are More Likely to Raise Dividends?** The companies that are slated to increase dividend payments will most likely be the ones that are large and liquid in nature, have strong cash balances and have low current payout ratios. WisdomTree created an earnings-weighted index for Korea largely because the dividend payout ratios were some of the lowest in the world. The stocks with the most earnings and generally free cash flow outside of needs for capex are likely to be the ones increasing dividends—and we'd expect our earnings-weighted index to represent these opportunities well. Within our broad dividend-based emerging market strategies, Korea has always received relatively little weight given its historically low dividend payout percentages, while Taiwan has been a relatively high-weighted country. That gap may be set to close in the coming years. These bold moves by the South Korean government could be a game changer for the country's equity markets in the years ahead. We wrote about the currency warning the central bank and finance minister issued earlier this summer, and since then the Korean won has started backing off its extreme highs. The combination of a weaker won and higher dividends could be a good boost for Korean equity shares. We'd advocate for looking at currency-hedged equities given the currency warnings stemming from Korea, along with a recent cut in interest rates by the Bank of Korea. [1]Source: Bloomberg, as of 7/28/14. [2]Korea Daily, 7/23/14. [3]Frances Yoon, "Korea Plans Dividend Boost," IFR Asia, 8/2/14. [4]Source: WisdomTree, Bloomberg, : UBS Quant Research, MSCI, IBES as of 7/25/2014 [5]Source: Bloomberg on MSCI Korea trailing dividend yield as of 8/1/14.

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Capex : Funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment. This type of outlay is made by companies to maintain or increase the scope of their operations.

Dividend Payout Ratio : The percentage of earnings paid to shareholders in dividends. Calculated as yearly dividends per share over earnings per share.

Dividend yield : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.