Alpha Investment Partners Limited

Commentary

Korea Choinomics: Minimal impact this year

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The new pro-growth Finance Minister Choi on 24 July 2014 announced a stimulus package following a slow 0.6% quarter-on-quarter growth in 2Q2014 due mainly to weak domestic consumption. The aim is to create a virtuous cycle of growing household and corporate income, encouraging private consumption and reviving the economy. The Bank of Korea (BOK) followed with an interest rate cut on 15 August. This commentary analyses the impact of these recent stimuli on the Korean economy and Seoul property market.

Highlights of measures

Size: KRW41trn (USD40bn), about 3% of GDP

Key measures to encourage corporate and consumer spending and normalise the housing market are:

1) Credit to support corporate investments in production facilities

2) Financial support for small- and medium-sized companies

3) Tax incentives to encourage wage increases, dividend income and corporate investments. The proposed new tax system will be imposed upon large corporations and conglomerates, whose wage growth, dividends and investments fall short of a 60–80% share of net profits.

4) Higher tax breaks to companies that create jobs

5) Wage support to companies to convert non-regular employees to regular workers

6) Increase in tax deductions for spending on credit and debit cards

7) Relaxation of loan-to-value ceiling to 70% and debt-to-income limit to 60%.

Our View

The real impact is minimal. Corporate spending and wages are expected to increase only from next year. However, the measures have boosted consumer sentiment and invigorated the housing market. The strong commitment of the government will see it continuing to stimulate the economy over the next few years and achieve results. In the medium-term, the property market can benefit from increased demand driven by free trade agreements (FTAs) and the stimulus, global recovery, growing tourism and e-commerce. The risks are slower growth in the US and China, a divided parliament and government policies that change the demand-supply dynamics. Longer term, major reforms are necessary to tackle structural problems.

Real impact limited: While the stimulus is the most aggressive since the global financial crisis, actual government spending will only be KRW11.7trn or 0.8% of GDP. It is estimated to lift GDP growth by only 0.1ppt each this year and next year.

Corporate spending only from next year: Over the past decade, corporate savings have risen at the expense of household income growth, resulting in weak private consumption. Samsung Electronics is reported to have USD60bn in its cash pile. The tax measures can thus potentially reallocate corporate savings to households and raise private consumption. The impact will however not be immediate, as the tax revisions need to be passed by the National Assembly and are slated to become effective only on 1 January 2015, followed by wage negotiations that can be protracted. In comparison to Japan which has also been encouraging companies to raise wages and capital investments since last year, the tax policies are clearer in Korea's package and more likely to succeed in persuading the corporate world to change their mindsets and spend their cash hoard. How much they will spend and on which component will depend on their cost-benefit analysis, and whether they will find ways to avoid the tax on retained earnings.

Sentiment lifted: Meanwhile, the stimulus has given a psychological boost in lifting sentiment. Consumer and non-manufacturing business confidence have risen in August, although manufacturing confidence level has fallen due to the weak global economy. The KOSPI hit a three-year high in anticipation of higher dividend payments. Consumption data showed some sales improvement in August with higher month-on-month department store sales and year-on-year Chuseok gift package presales. It is however too early to tell if the uplift in sentiment and consumption will be broad-based and sustained given that increased corporate spending will only be felt next year.

Housing market revived: The relaxed mortgage lending has invigorated the housing market, which is one of Choi's strategies to stimulate the economy. Besides new borrowers, the new policy also benefits existing borrowers who can save on interest repayments by shifting higher interest rate loans from non-banks to banks, now that the LTV is higher and interest rates are lower. Transactions surged 94% yoy in July, with Seoul seeing a spike of 133.1%[1]. With a low homeownership rate of 50% in Seoul and rising rents as potential buyers held back purchases in anticipation of further price fall, demand from first-timers will support the market recovery and eventually lead to price increase which lags transaction volume. The Realty Sector Recovery Plan announced on 1 September will further boost the market revival and curb oversupply. The plan reduces the age of existing buildings that can be redeveloped by 10 years and halts the development of New Towns.

Strong government commitment: Like Japan, a strong leadership drive is the critical factor to pushing through policies and overcoming the initial lack of faith and mindsets. While President Park is seen to have soften on some of her earlier election promises, she and Choi, a close confidante, are expected to work together to aggressively stimulate the economy in the next few years before her single-term expires in early 2018. Choi, nicknamed "the Bull" for his hard-charging manner, has said he will continue with the expansionary policy until the intended results are reached. He has promised an expansionary budget for 2015. The market expects speedier intervention from him.

Implications for real estate investors

What Choi is pre-empting with his stimulus is a dampened mood which can decelerate the economy to a standstill and risk following Japan's footsteps of two lost decades. We expect "Choinomics" to energise the economy in the near term given his strong commitment.

The South Korea has been actively pursuing FTAs with its key trading partners. FTAs in place include those with ASEAN, EU and US. It is currently in negotiations with a number of countries, including a trilateral agreement with China and Japan which could be finalised by year end. These will boost trading and demand for real estate, particularly office and industrial space, along with global recovery.

Office vacancy rates are expected to decline over the next few years with rental increase, given stronger demand and subdued new supply after a spate of redevelopments which raised vacancy to double-digits.

A rise in household incomes and domestic spending will benefit **retail** malls with residential catchment. However, too much consumption will drive up inflation and interest rates and curtail domestic consumption. Location, local supply-demand dynamics, mall design, tenant mix and ability to rise to the e-commerce challenge are thus important factors to stay resilient.

Tourism is a growing sector, with an increasing proportion from China which makes up for the decline in Japanese visitors as a result of the yen depreciation. Limited service hotels are springing up to cater to more budget-conscious travellers. The risks are over-supply as the government incentivises conversions, and over-reliance on Chinese travellers who are sensitive to geopolitical tensions and

[1] Ministry of Land, Infrastructure and Transport

government travel advisories. Their numbers can drop significantly overnight as witnessed in other countries this year. Similar to retail, resilient asset performance will depend significantly on design, concept, positioning, operator selection and distribution channels.

Demand for **logistics** space is increasing with rising online shopping and expanded trade activities resulting from the FTAs. Yields are higher than commercial assets but government deregulation has facilitated the supply of many logistics buildings, thus dampening potential rental increase particularly for older buildings competing against new buildings with improved specifications. Location dynamics, with good links to major expressways and ports are also critical considerations for end tenants.

However there are risks to the above medium-term outlook that tempers the optimism:

Political risks: Most of the measures require to be passed by the National Assembly before they can be implemented. A divided parliament will delay the implementation of the stimulus measures.

External risks: The main external risks to the medium-term outlook will be 1) the economic growth rates of China and US, Korea's top two export destinations and 2) geo-political risks that will raise the price of oil as Korea imports all its oil requirements.

Government risk: Government policies can easily change the demand and supply landscape as witnessed in the past when it incentivised redevelopment or curb supply and eased regulations.

Household debt risk: A healthy housing market recovery is one where income growth is more than household debt growth. The reverse is however expected to happen in the short-term. When the interest rate moves up in future, this could pose a higher risk of bad debts and defaulters as the expanded mortgage limit benefits lower-income and self-employed individuals who have had limited access to bank borrowing, and could weaken domestic demand structurally.

Conclusion

In the long term, bolder measures to reform structural weaknesses such as high household debt, aging population, heavily regulated service sector and dominance of giant conglomerates are needed to sustain a potential 4% growth rate.

Notwithstanding the structural problems, South Korea has the deep, well-regulated debt and equity markets of a developed economy, but with higher potential growth. It has low government debt and the country's manufacturers are competitive globally though they are beginning to have to contend with China competitors, while the service sector represents an emerging opportunity if deregulated.