



# PROXY PAPER

## KT&G

Korean Stock Exchange: 033780

Industry: Tobacco

Meeting Date: March 17, 2006

Record Date: December 31, 2005

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2006 Annual Meeting				
Proposal	Issue	Board	GL&Co.	
1.00	Accounts and Allocation of Profits/DividendsShare	For	For	
2.00	Election of Directors	Against	Split	
2.01	Elect Yong Chan An	For	Against	
2.02	Elect Byong Kyun Kim	For	Against	
2.03	Elect Steven Wolosky	Against	For	
2.04	Elect Howard Lorber	Against	Against	
2.05	Elect Warren G. Lichtenstein	Against	For	
3.00	Elect Audit Committee Members	For	For	
4.00	Directors' Fees	For	For	

### Note

Except as noted, W1.00 = \$0.0010 (exchange rate as of December 31, 2005)

# PROPOSAL 1.00: ACCOUNTS AND ALLOCATION OF PROFITS/DIVIDENDS SHARE

**FOR**

This proposal seeks shareholder approval of the Company's financial statements and the statement of appropriation of retained earnings for the fiscal year ended December 31, 2005.

The Company proposes to distribute a final dividend of W1,700 (\$1.70) per share to shareholders of record on December 31, 2005, representing a dividend payout ratio of approximately 48%.

## **Glass Lewis' Analysis**

We believe that all of the necessary financial statements and the statement of appropriation of retained earnings are present in the agenda for the Company's annual meeting of shareholders.

With limited exceptions, Glass Lewis will generally support the dividend policy proposed by a company. Here, we believe that the dividend payout is reasonable and we do not see any cause for concern in terms of the board's process in making this determination.

Accordingly, we recommend that shareholders vote **FOR** this proposal.

# PROPOSAL 2.00: ELECTION OF DIRECTORS

**SPLIT**

Board of Directors				
Name	Up	GLC Classification	Committees Audit	Term End
Yong Chan An	✓	Independent		-
Sun Gak Cha		Independent		-
Jin Hyun Kim	✓	Independent	✓	2006
Choong Sup Kim		Independent		2007
Byong Kyun Kim	✓	Independent		2006
Young Kyoon Kwak		Independent		2007
Kwang Youl Lee		Insider <sup>1</sup>		2007
Kyung Jae Lee		Independent		2007
Yoon Jae Lee	✓	Independent	✓	-
Chang Woo Lee	✓	Independent	✓	-
Warren G. Lichtenstein	✓	Independent <sup>2</sup>		-
Howard M. Lorber	✓	Independent <sup>3</sup>		-
Young Jin Min		Insider <sup>4</sup>		2007
Soon Moo Soh	✓	Independent	✓	2006
Steven Wolosky	✓	Independent <sup>5</sup>		-

C = Chair

1. Senior managing director.
2. Nonimated by Dissident.
3. Nonimated by Dissident.
4. Senior managing director.
5. Nonimated by Dissident.

Total of nine candidates are up for election to the board. Five candidates, Yong Chan An, Byong Kyun Kim, Steven Wolosky, Howard M. Lorber and Warren G. Lichtenstein, are being nominated for two seats to serve as independent directors of the Company. The remaining four candidates, Jin Hyun Kim, Yoon Jae Lee, Chang Woo Lee and Soon Moo Soh, are being nominated as members of the board's audit committee on a separate proposal.

## Summary

KT&G Corporation ("KT&G") is facing a contested proxy at its 2006 annual shareholder meeting. On February 7, 2006, The KT&G Full Value Committee (the "Committee" or "Dissident"), comprised of investment funds Icahn Partners LP, Icahn Partners Master Fund and High River LP (together the "Icahn Group") and Steel Partners II LP ("Steel Partners"), has filed to nominate three directors for election to the board of KT&G. The Dissident group collectively holds approximately 7.3% of the outstanding shares of the Company.

The Committee believes that the management of KT&G is not pursuing strategies which will maximize shareholder value and has proposed a number of restructurings which its believes would increase the value of the Company's shares.

## **Background**

Steel Partners and the Icahn Group first acquired shares of KT&G in June and August of 2005, respectively. In December 2005, the Icahn Group met privately with executive officers of KT&G to discuss potential alternative strategies to create value for the Company, including among other things, a spin-off of the KT&G's ginseng business and real estate assets as well as increased share buy backs. The board of KT&G opposed the advances of the Committee.

On January 26, 2006, the Committee nominated three directors for election to the board of directors of KT&G. On February 7, 2006, representatives of Steel Partners met with KT&G's CEO Young-Kyoon Kwak to discuss the Committee's proposals. The Committee indicates that KT&G management again rebuffed its proposals and suggested that the Company was already pursuing many of the suggested strategies. In addition, the Committee notes that in this meeting Mr. Kwak indicated he believed that KT&G's shares were worth approximately ₩80,000 (\$80.00). See KT&G Full Value Committee Presentation.

On February 9, 2006 KT&G announced that the election of director at the annual meeting would be divided into two proposals, the election of four audit committee directors and the election of two non-audit committee directors. However, KT&G only allowed the Committee's nominees to be nominated for the two non-audit committee board seats. In response to the Company's decision, the Committee has filed with the Daejeon District Court in South Korea seeking an injunction against the election of outside directors at the KT&G shareholder meeting. The Dissidents believe the current agenda violates shareholder's rights to request cumulative voting.

On February 23, 2006, the Committee sent a proposal to KT&G to enter into a negotiated acquisition agreement valued at ₩60,000 (\$60.00) per share. On February 26, 2006, KT&G rejected the Committee's proposal and indicated that the proposed restructurings are not in the best interest of the Company's shareholders.

## **Dissident Argument**

The Dissident's believe that KT&G's current strategy fails to maximize the value of the Company for shareholders. The Committee believes that there is substantial value to be realized if the Company were to effect a number of restructuring transactions, including the divestiture of certain non-core assets, the public listing of KT&G's ginseng business, a restructuring of the Company's real estate holdings and an increase in dividends and share buybacks.

Considering the Company's decision to separate the election of directors proposal, the Committee believes that the board of KT&G is effectively denying shareholders the right to cumulative voting the election of directors. The Dissident's believe that the board's actions serve as an anti-takeover provision for the board.

## **Management Response**

The board and management of KT&G believe that the Company is operating well as currently structured and that the proposals submitted by the Committee are without merit.

KT&G indicates that its current strategy has delivered substantial value for shareholders. Specifically, the Company notes that since its privatization at the end of 2002, its share price has outperformed

both its global tobacco peers and the Korea Composite Stock Price Index. In addition, management notes its dividend yield of 3.8% as of December 31, 2005 is within the comparable yield range of between 0.9% to 5.4% of its global tobacco company peers. KT&G notes that its total payout ratio of 121% during the period from 2002 to 2004, it is one of the highest among its peers.

KT&G notes that, after studying the Committee's proposed plan, it believes that the Dissident's proposals are not conducive to shareholder value. Specifically, KT&G believes that the Committee's proposals are highly conditional and lack certainty as to the structure, timing, financing or long term direction of the Company. Management believes that it can maximize shareholder value by continuing to implement its current strategic, operational and financial initiatives.

KT&G management has accepted the nomination of the Committee's three board representatives and has allowed cumulative voting with regard to the board election. However, the Company has structured its election of directors proposal such that the Committee's nominees are up for election for only two of the six available seats. KT&G indicates that the Dissidents have not properly submitted their nominations for the Company's audit committee directorships. Thus, the Committee's three nominees are being considered along with two Company proposed nominees for the two non-audit committee board of director seats.

KT&G states that Korean law distinguishes between ordinary and non-executive directors and non-executive directors which will serve on the audit committee of a company. In particular, the Company notes that given the differential voting rights for audit committee members, it believes that separate proposals should be passed for electing non-audit committee directors and audit committee directors. See KT&G Corporation Responds to Dissident Shareholder Letter (February 16, 2006).

## **Management Plan**

The board and management of KT&G believe that its current strategy is the most effective method to create value for shareholders. KT&G indicates that the financial alternatives proposed by the Dissident do not recognize the value enhancing opportunities available in its current plan and fail to recognize certain aspects of Korea's regulatory environment.

First, KT&G believes the suitability of its real estate portfolio for a REIT structure is uncertain given its current industrial zoning classification. In addition, management notes that it has a dedicated real estate team in place focused on the development of its current properties.

The Company also indicates that it is pursuing several initiatives for its ginseng business to increase its financial performance and strengthen its brand equity. Notably, it is exploring an expansion of its ginseng supply as well as potential synergies in co-marketing and co-distribution between its cigarette business and the ginseng business. Management indicates that a separation of the ginseng business would not maximize value at this time.

Ultimately, KT&G indicates that the Committee's proposal are not compelling value drivers for the Company. Management believes that, in general, a company generates value by executing on sound strategic plans and by meeting operational benchmarks. Though KT&G has, in general, acknowledged the potential benefits of divestitures and financial engineering transactions, it believes that the Committee has not demonstrated that it is the right time for such proposals. Further, management indicate that it believe that the Committee has failed to demonstrate that the Dissident nominees would add value to the KT&G board at this time.

## **Dissident Plan**

The Committee believes that there are substantial opportunities to create incremental value for KT&G shareholders. The Committee believes that the Company's shares trade at a discount to its intrinsic value and that its proposals are meant to minimize or eliminate this valuation gap. Though the board rebuffed its initial discussions and proposals, the Dissident's formally proposed the election of three independent directors to the board of KT&G to push its agenda with the board of directors.

The Committee's proposal includes a number of strategic transactions with the intention of unlocking the intrinsic value of KT&G. The plan includes the following proposals:

- Explore the sale of the non-core assets such as Buy The Way, Youngjin Pharmaceuticals and YTN;
- Restructure Korean Ginseng Co. to allow shareholders of the company to own the shares the division with the intention of listing the division on the Korea Exchange;
- Explore a restructuring of the company's real estate portfolio with the long term plan of divesting the assets to KT&G stockholders in a REIT or J-REIT structure;
- Increase the Company's dividend to a level such that the Company's yield is in-line with other global tobacco companies such as Altria Group Inc., Reynolds American Inc. and UST Inc.;
- Cancel the treasury shares which can be canceled; and
- Purchase additional treasury shares through a self-tender for the maximum amount permissible under applicable laws and cancel those shares.

In response to KT&G's continued opposition, the Committee has proposed an acquisition offer to KT&G for W60,000 (\$60) per share. Though the KT&G board of directors of KT&G has acknowledged the proposed bid, the filing of a formal take over bid ("TOB") has not been completed with the Korean regulatory offices.

## **Glass Lewis Recommendation**

We are reticent to recommend removal of directors in favor of a potential acquiror's nominees unless one of the following two things has occurred: (i) there are serious problems at the company and the newly proposed board has a clear and realistic plan to solve these problems; or (ii) the current board has undertaken an action clearly contrary to the interests of shareholders (or failed to undertake an action clearly to the benefit of shareholders).

In this instance, however, the Dissidents have proposed a so-called short slate, seeking to replace a minority of the board. In such instances, we believe the dissident must make a compelling showing of mismanagement on the part of the existing board members and a plan for improvement.

Here, we note that the KT&G is operating well. While the Company has experienced recent declines in its revenue and operating income, over the long-term, the Company has outperformed its peers. During the three year period ending January 26, 2006, KT&G shares outperformed its tobacco peers by approximately 47.0%. Nonetheless, we note that the Committee's complaints against KT&G are not grounded in poor management. Rather, the Dissident's believe that KT&G management is being complacent in its efforts to create incremental value for shareholders.

Considering KT&G's historical performance, it is not surprising that executives dismissed the Committee's initial advances. We also note that it is a common practice for Korean companies to hold separate elections for non-audit and audit committee members. In fact, this is how KT&G held its

election of directors in 2004. However, in our opinion, it is the Company's hasty dismissal of the Committee's acquisition proposal that is most troubling.

We note that the proposed agreement represents a substantial premium of approximately 33.0% and offers shareholders implied valuation multiples of approximately 3.8x revenue, 16.1x net income and 12.3x operating income based on the Company's December 31, 2005 results.

*KT&G Corporation (amounts in Won)*

	Market Value (1)	Dissident Offer	Implied Management Valuation
Shares Outstanding	148,300,000	148,300,000	148,300,000
Price per share	45,000	60,000	80,000
Implied Equity Value	6,673,500,000,000	8,898,000,000,000	11,864,000,000,000
Cash & Equivalents (2)	574,100,000,000	574,100,000,000	574,100,000,000
Total Debt (2)	-	-	-
Implied Enterprise Value	6,099,400,000,000	8,323,900,000,000	11,289,900,000,000

*KT&G, Fiscal Year End 2005 (amounts in Won)*

	December 31, 2005
Revenue	2,209,000,000,000
Net Income	516,000,000,000
Operating Income	677,000,000,000

(1) Unaffected share price as of January 27, 2006

(2) Cash & Equivalents and Total Debt as of fiscal year ended December 31, 2005

*KT&G Valuation (amounts in Won)*

Implied Multiples

	Market Value	Dissident Offer	Implied Management Valuation
Revenue	2.8	3.8	5.1
Net Income	11.8	16.1	21.9
Cash Flow	9.0	12.3	16.7

Equity Premium

	Market Value (3)	Dissident Offer (4)
Implied Equity Premium / Discount	-43.8%	33.3%

(3) Assumes KT&G management projected value per share

(4) Proposed bid relative to unaffected market value

We note that the unaffected value per share of W45,000 (\$45.00) implies a forward earnings multiple of approximately 12.2x the consensus mean 2006 earnings estimates for KT&G which falls near the low end of the comparable tobacco peer group multiple range. The Committee's proposal implies a 2006 earnings multiple of approximately 16.2x 2006 consensus estimates, near the high end of the comparable tobacco peer range and above the global tobacco average of approximately 14.7x 2006 estimates.

While the proposed valuation is not conclusive, such an approach should have at least brought KT&G executives to the table for further discussions. Instead, management announced its opposition to the proposed offering just three days later.

Having said this, we believe that the subject of hostile acquisitions and contested elections in Korea deserves further discussion. It has been historically difficult for foreign suitors to make advances toward Korean companies. Notably, there has never been a successful foreign hostile acquisition of a Korean company. Further, Sovereign Asset Management abandoned its two year proxy contest to remove the CEO of SK Corporation in 2005. The CEO had been convicted of accounting fraud during his tenure at the Company, and yet was reappointed after serving his jail sentence. It is well understood that Korean companies and Korean shareholders tend to band together in opposition of foreign advances. In fact, here, the Industrial Bank of Korea, a 5.9% shareholder of the Company has announced its support for management.

As such, it appears to be a long battle for the Committee. At Glass Lewis, we believe this is a close call as we see benefits and concerns associated with the arguments put forward by both management and the Dissidents. Shareholders now face the difficult decision of determining whether a well-performing company is really in need of corporate change. Here, we believe investors should be concerned when the board noting the company is worth substantially more than it is currently trading at but without putting forth concrete proposals to unlock that value, and at the same time summarily dismissing the counter proposal.

Thus, in our final analysis, we believe that given the inflexibility of the board and its perfunctory dismissal of a reasonable acquisition proposal, the Company could benefit from some new thinking in the board room by filling the two board seats with two of the nominees put forward by the Dissidents.

Reviewing the background and experience of the Dissident nominees, we believe the Messrs. Lichtenstein and Wolosky would provide the most benefit to the KT&G board. Mr. Lichtenstein is a long time corporate activist with a track record of long-term ownership and unlocking value in companies where he has obtained board representation. Mr. Wolosky is a corporate attorney with an extensive track record of representing Steel Partners. Though Mr. Lorber appears to have the most relevant tobacco industry experience (Vector), we note that he serves on a total of five public company boards. We believe that the time commitment required by this number of board memberships may preclude him from fulfilling his responsibilities to this Company.

Accordingly, we recommend that shareholders vote:

**FOR:** Lichtenstein and Wolosky

**AGAINST:** All other nominees

## PROPOSAL 3.00: ELECT AUDIT COMMITTEE MEMBERS

**FOR**

Nominees Jin Hyun Kim, Yoon Jae Lee , Chang Woo Lee and Soon Moo Soh are up for election to the audit committee.

As noted in Proposal 2, the Company elects its audit committee members on a separate proposal from the election of directors.

Pursuant to Article 409 of the Korean Commercial Code, shareholders who own more than 3% of voting rights are not entitled to voting rights greater than 3% when voting to elect members of the audit committee.

### **Glass Lewis' Analysis**

We find that all nominees are independent non-executive directors. We believe the audit committee, as proposed, will be sufficiently independent in accordance with the Korea Securities Exchange Listed Company Regulations and the Securities and Exchange Act. In addition, we have not found substantial issues for shareholder concern as to any of the nominees.

Accordingly, we recommend that shareholders vote **FOR** all nominees.

## PROPOSAL 4.00: DIRECTORS' FEES

**FOR**

This proposal seeks shareholder approval to fix the cap on the total annual compensation that may be granted to the Company's directors. If approved, the aggregate amount of director compensation will not exceed W3 billion (\$3 million) for fiscal year 2006.

### **Glass Lewis' Analysis**

In fiscal year 2005, the limit on director compensation was W3 billion (\$3 million), or W250 million (\$250,000) per director on average.

If Proposal 2 and 3 are approved, the board will consist of twelve directors, including three executive directors, after the annual meeting. If this proposal is approved, the annual compensation limit would remain at W250 million (\$250,000) per director on average, which we believe is reasonable given the size of the Company. A survey of Korea's top 20 companies by Corporate Governance Service, a state-run service, found that executive directors were paid approximately W1 billion (\$1 million) on average in 2003.

Accordingly, we recommend that shareholders vote **FOR** this proposal.

## DISCLOSURE

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