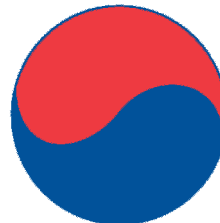


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# IMPACT OF PRIVATE EQUITY FUNDS ON THE KOREAN MERGER AND ACQUISITION MARKET

By Lee Ho-jin

## Introduction to Private Equities

The insatiable appetites of banks, insurance companies, pensions, endowments, and high-net-worth individuals make enormous capital possible for private equity funds. The private equity market has become an important source of funds for start-ups, firms in financial distress, and firms seeking buyout financing.

Private equity is a broad term that refers to any type of equity investment in an asset in which the equity is not freely tradable on a public stock market. Private equities are generally less liquid than publicly traded stocks and are thought of as long-term investments. Private equity has experienced substantial growth in the past two decades, in terms of both capital under management and the amounts invested, and the private equity industry is now considered a recognized asset class.

The private equity industry raised \$262 billion globally in 2005, surpassing the previous record high of \$254 billion set in 2000. Of the funds raised, \$134 billion poured into buyout funds, followed by \$40 billion into venture funds.<sup>1</sup> Armed with astronomical amounts of cash, buyout funds, corporate investors, and firms that are seeking buyout opportunities are vigorously engaged in both the domestic and cross-border merger and acquisition (M&A) market.

## The Merger and Acquisition Market Globally and Regionally

Starting in 2003, the worldwide M&A market has consistently been expanding, and the market size in

2006 reached \$4.0 trillion, posting a 48 percent year-on-year increase after marking a 27.2 percent increase with \$2.7 trillion in 2005.<sup>2</sup>

A regional breakdown of private equity activity shows that, in 2004, 66 percent of global private equity investments and 62 percent of funds raised were managed in North America. In North America, the stock of private equity investments at the end of 2005 was \$493 billion. In Europe, the stock was \$213 billion. Between 1998 and 2004, Europe increased its share of investments from 24 percent to 26 percent and increased funds raised from 18 percent to 31 percent.<sup>3</sup>

Although America and Europe still attract the lion's share of private equity investing, emerging markets—from Asia (\$122 billion at end 2005) and South Africa (\$6 billion at end 2005) to Latin America (\$15 billion at end 2005)—are growing rapidly. According to the Emerging Markets Private Equity Association (EMPEA), more than \$22 billion was raised for these markets in 2006, up from \$3.4 billion in 2003. The fastest growth last year was in Africa and the Middle East. An EMPEA survey of big investors found that 65 percent plan to increase their commitments to emerging markets in the next five years.<sup>4</sup>

Active participation from private equity funds in the cross-border M&A market, recovery of confidence among chief executives on the M&A environment, and low-cost cash financing have led to an unprecedented number of unsolicited takeovers with a total value of \$234 billion in the first three months of 2006. The rush of unsolicited bids helped to push up the value of global M&As to \$912 billion in the first quar-

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1. Data from Dealogic Holdings, PLC, [www.dealogic.com](http://www.dealogic.com).

2. Ibid.

3. Ibid.

4. "New Gates to Storm," *Economist*, 18 January 2007.

ter of 2006, up 35 percent from the same period in 2005.<sup>5</sup>

Among the top 10 M&As in the Asia region, three takeover deals worth a total of \$9.8 billion took place in the Korean market. M&As in the Asia-Pacific region, excluding Japan, reached \$91.4 billion in the first quarter of 2006, a 50 percent rise from the corresponding period of 2005.<sup>6</sup>

Texas Pacific Group, one of the best performers in the U.S. private equity industry, raised more than \$14 billion for a new buyout fund, the biggest single pool of capital raised in the global private equity industry in 2006. Another heavyweight, Blackstone, set up a new buyout fund worth \$13.5 billion.<sup>7</sup> On top of this, increasing amounts of oil dollars are flooding into Asia's private equity fund market. Funds from increasing amount of oil dollars can in no time make even blue-chip stocks a target.

In response, regulatory authorities in many countries are announcing that they will take a serious look at the private equity industry in relation to hostile M&A attacks in select industries by foreign capital. Experts in Korea are not the only ones who have expressed grave concerns regarding hostile M&A attempts in key local industries.

Measures to protect domestic industries from hostile takeover attempts have become global phenomena. Against a backdrop of global mergers in the steel industry, Nippon Steel Corporation has made provisions against unsolicited takeover attempts, while the world's most profitable steel company, POSCO, is contemplating ways to address its vulnerability to unsolicited takeover bids.

Even though about 42 percent of global M&A deals took place in the United States and 38 percent in Eu-

rope, anti-takeover devices in the United States have been under constant attack from shareholder activists. The so-called Exon-Florio provision of the U.S. Defense Production Act of 1988 empowered the U.S. president to either stall or thwart M&A proposals to U.S. industry for national security reasons. Oddly enough, it seems that the cross-border M&A market is on the verge of converging with the U.S. paradigm, which shows no reluctance and aversion to putting up protectionist market barriers.

### **The Mergers and Acquisitions Market in Korea**

While the global private equity industry has been abuzz over record fund-raising and M&A deals worldwide, Korean private equity funds have been quiet, even considering Korea's meager market size. As of March 2006, only 16 Korean private equity funds were in operation, raising a combined 3.11 trillion *won* and investing a total of 293 billion *won*.<sup>8</sup> However, the situation surrounding the Korean private equity market illustrates how fundamentally the Korean financial market has changed since the 1997–98 Asian financial crisis, when the power of U.S. private equity funds peaked in Korea. Korean corporations were in desperate need of fresh capital from abroad when they were hit by the financial crisis, and U.S. private equity funds were the main providers of the funds needed. The financial market situation in Korea has improved a bit since then.

When the American financier Carl Icahn and the hedge fund Steel Partners requested a change of corporate management to KT&G and the spin-off of the Korean tobacco maker's ginseng business operation along with movement of non-core assets such as idle real estate and other investments, a Korean private equity fund proposed embarking on a management buyout.

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5. Data from Dealogic Holdings, PLC, [www.dealogic.com](http://www.dealogic.com).

6. Ibid.

7. Ibid.

8. Asset Management Association of Korea, Trends and Statistics, [www.amak.or.kr/Eng/Main.aspx](http://www.amak.or.kr/Eng/Main.aspx).

Although the Korean government has recently altered its regulatory regime involving the private equity industry to combat hostile takeover attempts by foreign capital, Korea's private equity industry is at the very inception of being able to play a key role in helping local firms fend off what some see as foreign corporate raiders' attempts to prey on profitable Korean firms in key industries. Nevertheless, there were some benefits from the cross-border M&As that have taken place in recent years in Korea.

Improvements in corporate governance and efficiencies in the integrated entities are driving up the market value of the consolidated firms. Studies—one by Towers Perrin and another undertaken by Cass Business School, London, in 2006—have reported that shares in companies that were merged or acquired in 2004 outperformed the market by 7 percent on average, turning out to be beneficial to shareholders of those firms. Many foreign investors have argued that regulatory risk along with an antipathy toward foreign capital are important factors that prevent foreign capital from actively investing in Korea.

The Korean government is trying to put in place an agenda to further deregulate the local financial sector to assist foreign investors. To facilitate the efficiency of the economic system by strengthening the role of the private equity industry, rules that govern the market need to meet global standards, and legal interpretations must be transparent and consistent when disputes between nonresident investors and Korean corporations arise. Recently, M&As have been transforming Korea's industrial climate. Most of the notable examples can be found in the energy, media, and financial services industries.

Against this background, Korea needs to go beyond wasting its time debating the efficacy of foreign capital. What we need to debate is how to promote the growth of domestic buyout funds and learn from foreign funds. Despite the introduction of private equity funds in Korea last year, the market has not shown any growth. While there have been huge M&A booms

by private equity funds in the international financial markets, the market size of private equity funds, hedge funds, and real estate investment trusts is meager in Korea. After the revision of the Indirect Investment Asset Management Business Act in October 2004, domestic private equity funds were launched with a view to countering unsolicited takeovers by foreign capital. As of end 2006, six large private equity funds (worth 300 billion *won*), six medium-sized private equity funds (funds invested vary from 100 billion *won* to 300 billion *won*), and four small private equity funds (100 billion *won* and below) were active in the market, and they are managing approximately 730 billion *won*.<sup>9</sup> However, the investment styles of these private equity funds are similar to existing investment funds such as mutual funds.

Private equity funds are very important for the development of innovative industries. They serve as venture capital funds that finance small venture enterprises possessing valuable technology. In January 2007, the state-owned Korea Development Bank announced that it planned to create a venture-targeting private equity fund to help M&A deals between venture start-ups. The venture-targeting private equity fund is formed with the aim of helping small-sized companies with competitive edges in advanced technologies to overcome financial distress. Private equity funds are major players in venture capital in many developed countries where alternative investment vehicles are flourishing, but banks are reluctant to explore the opportunity because of high risks. In Korea, nurturing venture start-ups is crucial for economic development.

What is it that limits the development of the private equity funds industry in Korea? With record sums pouring into alternative investment vehicles in recent years—the biggest private equity funds have topped \$15 billion—steadily increasing amounts of funds are raised to compete with each other for the “prey” in the market. Some suggest inducing Korean conglomerates' idle cash-like assets into private equity funds, which would convert the assets into productive capital and stimulate the economy.<sup>10</sup>

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9. Ibid.

10. Bihn Ki-beom, “Private Equity Fund Market Taking Shape,” *Korea Times*, 29 August 2006.

To facilitate the role of private equity funds in the Korean M&A market, it is imperative for the private equity funds to accumulate a track record. The sole objective of private equity funds has to be the rate of return rather than any type of policy considerations. We should admit that the introduction of domestic private equity funds was the result of the political consideration that such funds should be able to fend off hostile takeover attempts of strategically important industries by foreign capital. However, because of Korea's lack of a global network, informational advantages of other countries, and insufficient compensation schemes for fund managers, Korea's domestic private equity funds still have a long way to go. So, for the time being, domestic private equity funds are in a position to cooperate with and learn from foreign private equity funds rather than compete with them.

If domestic private equity funds have a good track record in the future, they will attract enough interest from many institutional investors and will grow in size. To that end, regulatory authorities might consider regulatory provisions such as qualifications of investors, an obligatory ratio of investment to assets under management, the subject of the investment, and so on. In the long run, the subject of investment by private equity funds should be broadened to cover nonperforming loans, real estate, and hedge funds in addition to bonds and equities.

*Dr. Lee was a Research Fellow at the Center for Regional Economic Studies at the Korea Institute for International Economic Policy (KIEP) when he wrote this paper. He is now a Professor at Myung-Ji University.*



Korea Economic Institute  
1201 F Street, N.W., Suite 910  
Washington, D.C. 20004

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