

Korea

GDP growth is expected to remain positive but has decelerated sharply. M&A activity by value is also down but is likely to recover in 2009 on the back of distressed M&A opportunities and corporate divestitures



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Current Environment

The Korean economy is believed to have expanded 4.2% in 2008, nearly a percentage point below 2007. Based on preliminary figures, the economy maintained strong momentum in the first half, growing at 5.3% p.a., but economic growth appears to have sharply decelerated in the second half of 2008.

Overall, exports continued to be the economy's main driver of growth, expanding 13.7% year-on-year in 2008. While the diversification of exports to emerging markets helped South Korea maintain growth through most of the year, export growth noticeably decelerated in November and December as global demand stalled. However, the global economic slowdown also provided some benefits for Korea, as the declining price of oil reversed escalating import prices and relieved inflationary pressures that had contributed to a burgeoning trade deficit and sapped domestic demand. Korea ultimately posted a US\$13 billion trade deficit in 2008, and, more importantly, posted a current account deficit for the first time since 1997.

A current account deficit, combined with market concerns over domestic financial stability, contributed to the Korean won's 26% loss against the US Dollar in 2008.

Domestic demand remained weak because of poor consumer and corporate sentiment. Personal consumption expanded roughly 2% in 2008, while fixed investment grew by only 1%. Consumers scaled back purchases and firms cut capital expenditure as increased global financial

volatility spilled over into concerns about economic growth. In particular, investment in the construction sector, continued to contract in spite of government attempts to revive spending via numerous supply side initiatives. In addition, the unwillingness of banks to lend due to economic uncertainty severely hampered credit expansion, and initiated a painful deleveraging process towards the end of the year. While this economic scenario maybe similar to other countries, Korea faces additional challenges as total private sector debt (debt of non-financial firms and households), was approximately 176% of GDP at the end of the first quarter 2008.

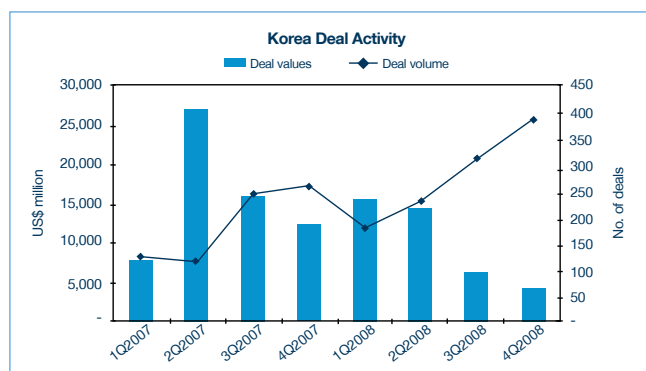
The weakening domestic economy overshadowed other important developments during 2008. The Korean government announced a three-round privatization process in September that pledged to merge or privatise government ownership in over 100 state-owned enterprises, including a number of large financial institutions. The government also committed to strengthen trade liberalisation efforts by continuing efforts to finalise the free trade agreement (FTA) with the US and negotiations with the EU to sign an FTA. Announcements were also made for a new initiative to sign FTAs with other key emerging markets in 2009. Finally, relations between North and South Korea worsened in December as the North cut off rail transport links between the two countries.

Future prospects of decelerating economic growth, combined with substantial outflows of capital, led to a downturn in equity markets. The KOSPI was down 38% at the end of the year, while the smaller KOSDAQ fell 53%. Investor risk aversion sparked a global sell off in equities, particularly in emerging markets, negatively impacting Korean stocks; foreign investors were net sellers of roughly US\$40 billion of Korean equities in 2008.

Two developments in 2008 will have long-term positive implications for the nation's capital markets. Firstly, the Korean government raised the ceiling for equity purchases by state-backed pension funds, potentially strengthening the role of institutional investors. Secondly, the FTSE's addition of Korea as a developed country to its index in September should lead to increased capital inflows over the long-term.



Deal Activity



Source: Thomson Reuters, based on total domestic, inbound and outbound deals announced as of 31 December 2008

Total deal value for the second half of 2008 fell 66% from the first half of the year to US\$10 billion. For the year as a whole total deal value was US\$40 billion, 37% lower than 2007 levels. A pronounced global economic slowdown and the unwillingness of domestic banks to fund large transactions contributed to the notable decline. Overall, domestic transactions totalled US\$28.3 billion in 2008; cross-border deals totalled US\$11.1 billion in 2008 only experiencing a marginal decline from 2007.

While the value of total deals declined noticeably, the number of transactions maintained an upward trajectory. Total deal volume increased 49% year-on-year to 1,095 transactions, and actually increased 72% in the second half of 2008 compared to the first half of the year. In particular, domestic transactions were up 51% in 2008, with cross-border deals up 42%.

As in other countries, deal value was depressed by the collapse of a number of high profile deals due to concerns over growth, funding, and valuation. Samsung made a bid for US NAND flash memory card and drive producer Sandisk in September 2008 which turned hostile before ultimately being dropped. After Sandisk's management initially rejected an offer from Samsung, Samsung made its offer public to Sandisk shareholders offering US\$26 per share (which represented an 80% premium at the time) to total US\$5.9 billion. Ultimately, Samsung withdrew the bid in October over concerns that Sandisk's risk profile had substantially increased given the slumping IT market.

Korean conglomerate LG entered into an agreement with German solar producer Coenergy Group in September to form a JV that would jointly produce solar batteries. LG planned to acquire a 75% interest in a solar module plant for roughly US\$168 million. After a breakdown in negotiations, however, LG stated that it would not go forward with the deal due to uncertainty in global markets.

Finally, HSBC abandoned a US\$6.3 billion bid to acquire 51% of Korean Exchange Bank (currently owned by Lone Star) in September. HSBC originally submitted the bid in September 2007, however, management dropped the bid when the initial price became untenable in the context of current banking valuations.

Domestic

Hite Brewery, one of South Korea's largest liquor producers and wholesalers, spun off its core manufacturing business unit to its shareholders in July. The transaction, which resulted in the formation of a new company named HB, was valued at approximately US\$1.8 billion. Hite hoped the transaction would provide greater focus for core operations and increase overall production efficiency.

Hanhwa, one of Korea's largest industrial chaebols, was selected as the preferred bidder for Daewoo Shipbuilding and Marine Engineering ("DSME") in October. DSME was initially put up for sale by Korea Development Bank and the Korea Asset Management, DSME's two biggest shareholders, which own 31.3% and 19.1%, respectively. The transaction is speculated to close in a range from 6.0 trillion won to 6.5 trillion won.

Doosan Corp, the flagship unit of the Doosan Group, chose Lotte Group as the preferred bidder to purchase its liquor business December 2008. The liquor unit, which boasts soju brands such as Cheoum Cheoroem and Green, and the wine brand Majuang, is scheduled to be purchased by Lotte for a price between US\$380 million and US\$480 million in the first quarter of 2009. The sale is part of Doosan's larger strategic plan to focus on heavy industry, selling off non-essential business units.

Private Equity

Morgan Stanley Private Equity Asia and Shinhan Private Equity acquired 100% of Norske Skog Korea, the leading global producer of newsprint, in September. The transaction was Korea's largest domestic private equity deal of the year closing at US\$830 million.

MBK Partners completed a cash tender offer for 30.8% of the shares of HK Mutual Savings Bank in November. MBK Partners, along with Hyundai Capital, had already purchased a 64.2% stake in the mutual savings bank in 2007. MBK plans to delist HK Mutual from the KOSDAQ, which if successful, would mark the first public to private transaction by a Korean private equity fund.

Doosan Group sold its packaging unit, Doosan Techpack GG, to Korean private equity firm MBK Partners for roughly US\$270 million in November 2008.



Outlook

Korea's economy is forecast to expand 1.5% in 2009 on the back of decelerating exports and a further deterioration in domestic demand. Korea, as one of the most trade dependent countries in Asia, will be particularly hard hit by a slowdown in global demand; exports are forecast to grow around 2% in 2009. In addition, the won is expected to gradually appreciate against the US dollar in 2009 as the nation's trade and current account deficits swing into surplus. A stronger won would hurt Korean goods' export competitiveness.

Domestic demand is expected to remain sluggish in 2009 as customers and firms retrench.

Personal consumption is forecast to expand 0.5% in 2009 due to a weak labor market and stagnant wage growth. Fixed investment is expected to contract 0.5% as firms slash capital expenditure budgets due to falling demand worldwide. This loss in demand may be partially compensated for by the Korean government's planned 33 trillion won (US\$22.7 billion) fiscal stimulus package and tax cuts to be implemented in 2009. The government also announced a 43 trillion won (US\$32.7 billion) "green" program to promote employment in environmentally friendly projects over the next four years. In light of this outlook, the Bank of Korea, which has already undertaken an aggressive monetary easing campaign at the end of 2008, is forecast to further reduce interest rates in 2009 cutting the base interest rate below 2.0%.

M&A activity will likely remain depressed in the first quarter of 2009. However, moving forward into the second and third quarters of 2009, corporate divestitures, especially amongst chaebols, may well increase as firms shed non-core businesses to boost liquidity and cut operational costs. Indeed, many chaebols such as Doosan and Hanhwa have announced sales or planned sales of subsidiaries to focus on core operations. Private equity deals will also likely pick up as distressed firms enter workouts and restructuring. Finally, mid and large sized Korean firms will continue to go abroad in order to diversify and find new sources of revenue.

Opportunities will likely exist in the financial services sector. The Korean government has pledged to implement

the Capital Market Consolidation Act (CMCA) in February 2009 even in the midst of continued volatility in domestic and global financial markets. The CMCA, originally passed in 2007, will promote a substantial diversification of financial products available to consumers and, in theory, break down barriers between financial services providers such as brokerages, insurance providers, and commercial banks. While there is a general consensus for implementing the CMCA, support for substantial deregulation in the financial sector, particularly to allow the integrated "investment bank" model, has clearly eroded after the collapse of several similarly structured institutions in the US. This perceived policy shift away from promoting financial liberalisation and towards strengthening risk management, will have implications for the government's planned privatisation of large domestic financial institutions. Indeed, the privatisation plan of Korea Development Bank ("KDB") was originally based on the notion of creating a domestic "investment" bank through a merger with Daewoo Securities. Currently, the privatisation of KDB is slated before 2012.

M&A in the financial sector, however, will still likely pick up in 2009. Firstly, industry consolidation will continue. While financial firms may hold back from diversifying operations, consolidation between commercial banks and mutual savings banks is expected to accelerate. Second, some chaebols are selling financial subsidiaries in order to raise cash and reduce their overall risk profile. The Kumho Asiana group is selling its 69.9% stake in the unlisted life insurer Kumho Life to boost overall liquidity after its purchase of Korea Express in 2007. The Eugene group, an industrial chaebol, is selling Eugene Securities in a bid to focus on its core operating activities.

Outside of the financial services sector, the government announced initial privatization plans for roughly 100 firms in September, although the timeline and structure of sale will likely be delayed due to the depressed market. According to the current government plan, there will be three different "rounds" of privatisation, many of which will include previously scheduled sales of domestic enterprises such as Hynix Semiconductor, as well as infrastructure including the Incheon Airport. ■