

Korea

Gradually emerging from the economic downturn but still faces numerous challenges. M&A activity likely to rebound as government workout and corporate restructuring efforts intensify in the second half of the year.



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Current Environment

After the Korean economy contracted by 5.1% quarter-on-quarter in the fourth quarter of 2008, the country narrowly avoided a technical recession in the first half of 2009 by registering positive quarter-on-quarter growth of 0.1% and 2.3% in the first and second quarters respectively. The growth was attributed to aggressive fiscal and monetary government measures, a relatively weaker Korean won, and a decline in oil prices. While sequential growth showed an improvement, year-on-year growth figures experienced a 4.3% contraction.

While exports have traditionally served as a key driver of Korea's economy, plummeting global demand severely dented volumes. To pick up the fall-off in exports, the Korean government had (and likely will continue) to play a more critical role in facilitating growth. Specifically, as of June 2009, the government had reportedly injected, or committed to, 67 trillion won (5% of GDP, US\$52.6 billion) in fiscal stimulus measures:

- On 3 November 2008, the Korean government announced a 14 trillion won (approximately 1% of GDP, US\$11 billion) fiscal stimulus package that included added government spending and tax cuts.
- On 13 December 2008, the National Assembly passed the 2009 budget, which featured fiscal stimulus and tax cuts amounting to 33 trillion won (approximately 3% of GDP, US\$25.9 billion). As indicated above, in November 2008 the government revised its original 2009 budget by increasing expenditures by 10 trillion won.
- On 24 March 2009, an extra budget of approximately 28.9 trillion won (approximately 2% of GDP, US\$22.7 billion) aimed at extra spending (social infrastructure investment, supporting small-to-mid sized enterprises and entrepreneurs, job creation efforts, welfare spending for low-income families) and to offset tax cuts was announced.

Also, the Korean government aggressively injected substantial funds into the economy including a 40 trillion won fund to buy corporate bonds and distressed assets, and established a 20 trillion won fund to buy non-performing loans (NPLs).

In January 2009, the Korean government released its "Green New Deal" package of 50 trillion won (roughly 4% of GDP, US\$38 billion), which it plans to invest in environmental restoration projects and development of domestic clean-tech firms over the next four years (2009 to 2012).

Finally, the Bank of Korea (BOK) supported the stimulus effort by keeping interest rates at a near-term low of 2% for most of the first half of 2009, aiding lending and spending in the domestic economy.

Exports fell 22.3% year-on-year through June 2009 due to a dramatic decrease in global demand. The reduction, although substantive, was comparatively less than that experienced by its manufacturing neighbours like Taiwan and Japan. Korea's export performance was largely driven by a diversified export product and customer base, and a weaker won which helped Korean firms gain market share abroad. In addition, the inventory restocking effect in 2009 (precipitated by significant inventory cuts at the end of 2008) helped mitigate downward price pressures on key IT exports. Despite a significant decline in export growth, imports fell at an even greater pace, 34.6% year-on-year through June, helping push Korea's trade and current account surpluses into the black after posting deficits in 2008. The drop in imports was on the back of a drastic fall in the price of energy and natural resources; offset somewhat by a weaker won which made imports more expensive. Due to a squeeze in US dollar funding, the won substantially weakened in late 2008 and deteriorated further in 2009 (the won traded at 1,597 won against the US dollar in early March 2009). Although the Korean won strengthened from the first quarter of 2009 lows, at the end of the second quarter of 2009, the won is still marginally weaker than its closing rate at the end of 2008.

Domestic demand remained weak in the first half of 2009 as consumers and companies retrenched in the face of economic uncertainty. Consumer spending was projected to decline 2% to 3% year-on-year in the first half of 2009, after private consumption dropped 4.4% year-on-year in the first quarter of 2009. A large reason for tepid consumption was the weak labour market. Korean unemployment rose to a near-time high of 3.9% (seasonally adjusted) in May 2009, when 219,000 jobs were lost, the worst in 10 years. Unemployment increased despite measures by a number of large Korean firms and the government to prevent job cuts via numerous schemes



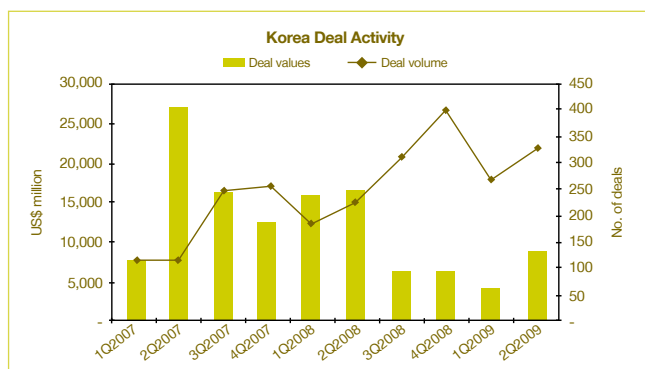
including lowering the wages of newly hired graduates and the mass hiring of 'interns'. Fixed investment fared slightly better as the government stimulus helped pump up spending, but fixed investment was to remain flat or marginally increase on a year-on-year basis largely due to construction spending, which rose 1.7% in the first quarter of 2009.

Korean equity markets benefitted from improved foreign and domestic investor sentiment in the first half of 2009. The KOSPI grew 23% in the first half of 2009, while KOSDAQ grew 46%; two of the best performing equity markets in the Asia-Pacific region. In addition, the Korean government announced two initiatives that served to increase confidence in capital market reforms: 1) The abolition of the tax paid by foreigners on bonds which will likely serve to boost sovereign bond sales; and 2) the removal of the short selling ban on stocks which was previously implemented to prevent excessive volatility. This will likely increase market activity.

The first half of 2009 also saw a number of other notable developments. First, the Korean government continued to push an aggressive trade liberalisation agenda that included trade deals with the European Union and US, and a focus on signing trade deals with emerging economies in order to boost exports. The Korean government's focus on trade issues was largely due to the need to secure future economic growth opportunities, as well as part of the country's larger platform of issues it will push as head of the G20 starting in 2010.

Finally, North Korean provocations notably increased as relations between the North and South deteriorated to a new post-war low. North Korea drew international censure after testing a satellite in April, and subsequently conducting a subterranean nuclear test and missile test in late May 2009.

Deal Activity



Source: Thomson Reuters, based on total domestic, inbound and outbound deals announced as of 30 June 2009

Overall, deal activity in Korea had somewhat mixed results in the first half of 2009 when compared on a quarter-on-quarter and year-on-year basis. Total deal value and volume in the first half of 2009 decreased by 1% and 16% respectively, when compared to the second half of 2008. On a year-on-year basis, total deal value in the first half of 2009 decreased by 60%, while total deal volume increased by 47.4%. An important point to note here is that while total deal value and volume in the first half of 2009 was sequentially down from the second half of 2008, there was a 122% and 25% increase in total deal value and volume in the second quarter of 2009 from the first quarter of 2009. The sequential decrease in total deal value in the first half of 2009 was the net effect of an increase in inbound and outbound deals, and a decrease in domestic deals. The decrease in total deal volume was reflected across the deal spectrum including cross-border, inbound and outbound.

Inbound

Private equity house KKR agreed to purchase Oriental Beer ("OB") for US\$1.8 billion in May. KKR outbid four other competitors to acquire OB which was being sold by AB InBev, the Dutch beverage giant. The deal marked the return of the LBO as KKR purchased OB with a large portion of the purchase price financed through senior syndicated loans (US\$760 million) and vendor financing (US\$300 million).

Outbound

An investment consortium, including Korea National Oil Corp (KNOC) and Columbia oil firm Empresa Columbia de Petroleos SA, acquired Petro-Tech Peruana SA, an oil E&P gas firm for US\$900 million in February. The transaction is expected to give KNOC increased access to oil deposits in the region.

In May, Korea Gas Corporation (Kogas) agreed to acquire a 10% stake in Blue Energy, an Australian oil and gas E&P firm. In addition, Kogas was granted an option to acquire an undisclosed minority stake in a number of existing LNG projects off the coast of Australia.

In July, KEPCO purchased 17% of Canadian uranium mining company Denison for US\$68 million. KEPCO has taken an aggressive stance in acquiring uranium contracts globally over the past six months in anticipation of increased demand for nuclear power. The transaction will give KEPCO access to 20% of Denison's uranium output per year between 2010 and 2015, and the ability to join the management team at Denison.



Outlook

After escaping a technical recession in the first quarter of 2009, and due to expectations of better-than-anticipated results in the second quarter of 2009, the Korean government raised their 2009 full year forecast from a contraction of 2.0% to 1.5%. Korea is expected to continue its gradual economic recovery by the end of 2009 or early 2010 on the back of improving global demand.

As a small open economy, Korea is likely to leverage its exports which are forecast to grow moderately in the second half of 2009. IT and other bellwether exports have picked up momentum with other industrial and durable exports expected to increase when global demand picks up. The won is expected to stay weak (on a relative basis) and this should also help to boost exports.

Domestic demand, on the other hand, is expected to remain tepid as consumers continue to decrease their spending in the face of relatively high unemployment and sluggish wage growth. Personal consumption is slated to contract 2% to 3% in the second half of 2009, while fixed investment will likely grow 1% to 2% with growth centered in the construction industry.

M&A activity will likely improve in the second half of 2009, particularly on the back of government efforts to restructure corporations. With some observers suggesting that the worst of the economic decline has past and corporate valuations steadily recovering, the Korean government will restart its corporate restructuring and privatisation programme that will result in increased activity of SMEs and divestments by chaebols (or large business conglomerates) of non-performing business units. Doosan and Kumho, two of Korea's largest chaebols, have announced the sale of business units to increase liquidity. There will also likely be a small uptick in outward bound acquisitions as cash-rich chaebols seek to purchase strategically compelling assets still well below valuations established during the previous business cycle.

Increased market volatility, lower valuations, and the economic crisis led the government to promote government restructuring initiatives as both SMEs and larger chaebols faced tighter liquidity and difficulty in raising funds. The main mechanism to catalyse restructuring will be the establishment of a group of private equity funds run by KDB that will restructure existing debts and inject capital into a selected group of firms over a three to five year investment period. While the current owners will have a call option to purchase assets at the end of the time period, assets will also be sold off. In addition to corporate restructuring efforts, the Korean government will also restart privatisation efforts for state-owned firms and take equity stakes in such firms as Hynix, Hyundai Engineering, and Daewoo Shipbuilding.

Energy and finance will be the sectors with the most opportunities. Korean energy and natural resource firms continued strong outbound activity during the global economic downturn as cash-strapped governments and firms sought capital investment. State-owned firms were the main focus of transactions, and are part of a larger Korean government initiative to promote national energy security. Korean Gas (Kogas) has sought to increase investment in LNG, taking a 10% stake in Australian LNG producer Blue Energy in May with a farm-in option to participate in two existing LNG projects off the coast of Australia. In addition, Korean Resources Corporation (KOREC) struck a deal with the Nigerian government in March to import 400 metric tons of uranium annually, as well as to take a 5% stake in a local uranium mine run by Chinese producer Trendfield. Private firms have also sought access to natural resources as a way to diversify revenues; the trading arm of the LG Group entered into a JV with Canada's Compliance Energy and Comox Joint Ventures to purchase 20% of the Raven Coal Project. Korean firms (both private and state-owned) are expected to continue their acquisition of natural resources with opportunities arising from a strengthening won and continued sales by distressed companies and governments looking to raise capital.

The financial sector will continue to offer opportunities as industry consolidation continues. The Korean government implemented the Capital Markets Consolidation Act (CMCA) in February which has already led to greater diversity in financial products and firms entering the market. While the implementation of the CMCA shows a potential trend toward deliberalisation, earlier plans to create a Western-style investment bank through the integration of different state-owned financial institutions have died. Instead, the Korean government has tentatively announced plans to privatise KDB by 2014 by splitting it into two parts: 1) A commercial unit that will essentially function as an investment bank, and 2) a government-sponsored policy bank that will take over the government-related functions of KDB. In the insurance and brokerage sectors, players continue to raise capital in anticipation of further consolidation. Finally, Korean banks continued their tentative moves abroad with Kookmin bank acquiring a majority stake in a Cambodian bank (Khmer Union Bank) and in February, Woori Securities acquired a 12.7% stake in Biet Viet Securities. ■