A STUDY ON CROSS-BORDER M&A AND FDI POLICY IN KOREA

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KWON, Ki-Yul

THESIS

Submitted to
School of Public Policy and Management, KDI
in partial fulfillment of the requirements
for the degree of

MASTER OF BUSINESS ADMINISTRATION

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ABSTRACT

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This paper examines the main drivers of cross-border M&A activities in Korea and suggests policy implications to promote them in the future. Due to the favorable policy environment of FDI and the removal of foreign ownership restrictions after the IMF crisis, cross-border M&A in Korea is expected to increase significantly. Cross-border M&A can contribute to the national economy by attracting foreign capital and management know-how, and enhance firm value by putting pressure on firms to be more responsive to shareholder value. This study also examines the strategic motivations for cross-border M&A and some of the key success factors by analyzing the case of Daesang's Lysine Business and Samsung Heavy Industries' Construction Equipment Business. Some policy implications derived from the case studies will be suggested in the conclusion.

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1. INTRODUCTION

The promotion of foreign investment has been one of the prime economic policies adopted by the Korean government since the IMF crisis. While foreign portfolio investors can suddenly withdraw large sums of capital and foreign commercial banks can refuse to roll over loans, multinational corporations (MNCs) can not quickly pack up their factories and go home. In the event of a crash, foreign direct investment (FDI) has become the only remaining private source of foreign investment. FDI has thus emerged as an important source of foreign exchange for crisis afflicted economies. In addition to the infusion of foreign capital, FDI can contribute to the transfer of technology and management skills, improve the financial and business structure, and increase employment and export.

The recent policy environment of FDI in Korea has changed significantly. Nearly all business sectors in Korea are open to foreign investment. Even the real estate market, which seemed to be the last target of the liberalization process due to Korean people's strong attachment to the land, has opened up. More incentives and more simplified procedures are made to attract FDI. There has been substantial progress on ownership issues. Most restrictions, such as foreign ownership limitations, requirement of target board approvals, mandatory tender offer rule, have been abolished. Foreigners are now able to retain shares of local companies without restrictions.[1] And most Koreans, who were known to be hostile toward foreigners in the past, have accepted foreign investments as an

[1] Actually limited industries remain closed (4) or partially opened (17) to foreign investors according to the laws.

inevitable option to rebuild the economy.

However, M&A form of FDI is not as prevalent yet. The Korean government has been aggressive in giving incentives toward green-field investment, but has not been active in inducing M&A types of FDI. The primary reason for this reluctance might be that cross border M&A does not always accompany the transfer of capital notwithstanding a change of ownership. In addition, the M&A process is thought to result in reduction in employment at least in the first round.

However, an efficient M&A market can contribute to the exit of inefficient management that neglects shareholder value. M&A strengthens market discipline and can enhance firm value. Because M&A has been a main engine of growth for MNCs, it is imperative to attract more FDI in the form of M&A.

The purpose of this paper is to examine the main factors in the recent cross-border M&A activities in Korea and to examine ways to promote them in the future.

The organization of the paper is as follows:

Chapter 1 introduces the background and the purpose of this paper.

Chapter 2 will examine the policy environment, the regulatory changes and the recent achievements of cross-border M&A in Korea. The strategic motivation for cross-border M&A and some of the key success factors in cross-border M&A will also be examined.

Chapter 3 analyzes two actual cases of cross-border M&A in Korea.

Chapter 4 summarizes the key findings derived from the case studies and concludes with some policy recommendations.

2. OVERVIEW OF CROSS-BORDER M&A IN KOREA

2-1. Historical Overview of Open Market Policy

Korea is well known for the outward-oriented, government-led economic development policies. But Korea's investment policy has failed to embrace an open market strategy during its development stages. President Park took great care not to jeopardize the goal of creating a "self-reliant" economy free from foreign control. Thus, government sought foreign loan capital, in which control could remain in Korean hands, as the means of financing growth and development in the 1960s and 1970s. During this period, FDI played a minor role in economic development.

Major changes occurred in the early 1980s. The Korean economy began to experience serious difficulties due to the negative effect of the Heavy and Chemical Industry Promotion Policy in the 1970s. Government intended to upgrade the industrial structure into technology and skill intensive sectors through liberalization of FDI. In 1984 by amending the "Foreign Capital Inducement Act", the Korean government replaced the positive list system with a negative list system in which all industries not listed were open for FDI approval.

In June 1994, the Korean government launched the Five-Year Foreign Investment Liberalization Plan that has been updated every year thereafter. Through several revisions of the plan, the government continuously widened the door for foreign investors. With the joining of OECD in December 1996, the government liberalized FDI further.

But, in spite of these efforts, government's overall position remained passive. Its basic concept did not change from that of President Park's era. On a Senate testimony in 1995, U.S. Trade Representative Mickey Kantor labeled Korea as "one of the most difficult country in the world." While the Korean market is gradually opening up, the further liberalization of the Korean market is still an arduous and unending task.[2] From the foreigner's viewpoint, once an investor or an exporter gets through Korea's external doors, there is a more formidable internal barrier to overcome.

A big step toward further liberalization was made after the IMF crisis. Policy regime changed drastically toward open market. Nearly all business sectors in Korea has been opened up now. Some business sectors (47 sectors) such as Postal Services, Central Banking, Legislative Administration, National Executive Offices are excluded from Foreign Investment at the outset. Out of 1,148 industrial sectors, only 21 sectors remain closed or partially opened to foreign investors. Only four business sectors like inshore fishing, coastal fishing, radio broadcasting, and television broadcasting are wholly closed. And some other sectors (17 sectors) are partly restricted. For example, in the case of public corporation (e.g. POSCO, KEPCO), the limit of stock acquisition by a foreign investor is three percent set by the article of incorporation concerned, and the total amount of stock acquisition by foreigners is limited to thirty percent of the total issued stocks. A foreign

[2] Congressional Research Service, "*South Korea: Perspective for Greater Market Openness*." CRS Report for Congress, Washington D.C.: Library of Congress, Mar. 26, 1996.

investor may hold stocks of banks within the limit of ten percent of its total issued voting stocks (Article 15 (2) of the Banking Act).[3]

2-2. Recent Regulatory Changes

- Foreign Ownership of a Corporation

Previously, foreign ownership was allowed only for acquisition of new equity issues or green-field investments in most business sectors. In Korea the acquisition of a controlling interest in an existing large local (i.e., stock exchange listed) enterprise was not permitted. Minority shareholders, inhabitants or foreigners, were prohibited from owning more shares than the principal shareholders in order to encourage the listing of the companies. But, since February 1997, foreigners were allowed to acquire more than ten percent or more of the outstanding shares of Korean companies through friendly M&As. Such friendly M&As required the consent of the board of the target company.

Since the Foreign Capital Inducement Act was amended on May 25, 1998, foreign investors may own up to one-third of the outstanding shares without the prior board approval of the corporation. The share purchase limit, increased to one-third from 10 percent of the outstanding shares, was abolished later. Along with that amendment, the requirement of gaining prior approval from the Ministry of Finance and Economy for large scale M&As – its asset being two trillion won or more – was also abolished. As the requirement of gaining the board consent for foreign ownership was abolished, the

[3] For domestic residents, on the contrary, it allows four percent.

restriction on foreign ownership has been removed.

Moreover, under the mandatory tender offer system, shareholders wishing to hold 25 percent or more of the outstanding voting shares were obliged to acquire them through the tender offers. And the number of shares for tender offer needed to be more than 50 percent of outstanding voting shares. This mandatory tender offer system was abolished in February 1998, allowing hostile takeover activities in the market and promoting foreign investments in local corporations. Now, all forms of M&A, including hostile takeover by foreigners, are permitted.

- Foreign Investment Promotion Act

The Korean government has now launched a new paradigm of foreign investment policies symbolized in the new Foreign Investment Promotion Act.[4]

This new legislation focused on creating an investor-friendly policy environment by strengthening investment incentives such as tax incentives, FIZ (Foreign Investment Zone), by streamlining foreign investment procedures, and by establishing an institutional framework such as one-stop service, foreign investment ombudsman to provide further convenience for foreign investors. Examples of the one-stop service are "The Comprehensive Process System" and "The Automatic Authorization System" for approval or authorization, which minimize the time and procedures needed to receive various approvals from related administrative institutions. But most policy tools of this Act are mainly focused on green-field investments.

[4] The new Act was passed on Sept. 2, 1998, by National Assembly and came in force in November 17, 1998.

Foreigner's Land Acquisition

Traditionally Korean people have been intensely attached to the land. Therefore opening up the real estate market seemed to be the last target of government liberalization plan. Considerable progress was made in the real estate related market to improve foreigners' investment environment in 1998. The Ministry of Construction and Transportation abolished various regulations on foreigner's land acquisition. In the past, only a specific category of foreigner could buy a limited size of land.[5] Since July 26, 1998, however, the Act was amended to allow any foreigner whether he is resident or not to purchase as much land as he wants, without any restriction on the size of the land. The restriction which has obliged foreign companies to buy land only for factory use, office use and warehouse use within limited size was completely abolished with the enforcement of the amended Foreigner's Land Acquisition Act.

In this context, when foreign companies merge with and acquire Korean companies, they are allowed to hold any real estate owned by the Korean company regardless of business or non-business purpose. Also, the process of land acquisition was streamlined. Before the amendment, foreigner's land acquisition was to be approved by the Mayor or the Provincial Governor, before the signing of the contract. However, this approval system has changed into a reporting system.

- Recent Achievement of FDI and Cross-Border M&A

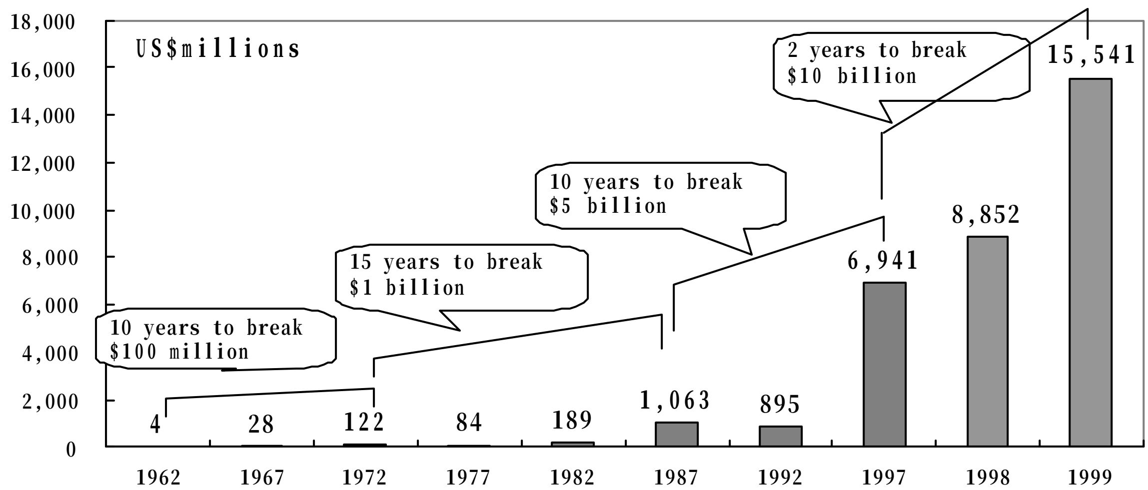
[5] It was limited to the housing site use within less than 790 square yards and to the business site use within less than 195.7 square yards.

To be classified as FDI in Korea, a foreign investor should acquire more than 10 percent of total issued voting stocks, and the amount involved must be more than 50 million won (US$45,000) per case. And the foreign investor is required to submit notification to the head of office of a local bank or any of its branch offices.

The value and cases of FDI has increased remarkably despite the overall decline in the value of FDI in Asian region after the financial crisis. In 1999, FDI reached $15.5 billion, which was the first time that FDI had exceeded $10 billion in a single year.

Since Korea's first effort to induce FDI, it took ten years to bring in the first $100 million in foreign investment in 1972. It then took another 15 years to break the $1 billion barrier in 1987 and another 10 years to bring in foreign investments totaling more than $5 billion – a goal the government achieved in 1997. However, it has taken only two years since then to surpass the $10 billion mark in foreign investments[6] <See Figure 1>.

<Figure 1> Inward FDI Trend in Korea



Source: *MOCIE*

6 *"Korea Sees Record Foreign Investments"*, Korea Herald, Nov. 3, 1999.

With the removal of restrictions on M&A and FDI, FDI in the form of M&A is expected to increase. Foreign investors are especially interested in the privatization of some state owned companies. However, M&A form of FDI is not so prevalent today. Korea recognizes three forms of FDI. First is the acquisition of newly issued stocks. Such stock may be acquired either by participating in the establishment of a new corporation or through capital increase in an existing domestic or foreign invested company. Second is the acquisition of existing stocks from Korean stockholders of a domestic or foreign invested company. Acquisition of stocks by means of M&A is included in this type of FDI. Third is an investment via a long-term loan of more than five year's maturity by an overseas parent company to an affiliated company in Korea.

The FDI volume in the form of acquisition of outstanding stock of domestic companies increased up to US$ 2,333 million in 1999 from US$ 1,244 million in 1998. But the acquisition of the outstanding stock from the existing domestic companies was still only 15 percent of all FDI in 1999 <See Table 1>.

<Table 1> FDI by Type

	Unit	1997	1998	1999
Total FDI(A)	US$ millions	6,971	8,852	15,541
Acquisition of Newly Issued Stock	US$ millions	6,208	6,525	12,571
Acquisition of Outstanding Stock(B)	US$ millions	699	1,244	2,333
Long-term Loan	US$ Millions	64	1,083	637
B/A	%	10	14	15

Source: *MOCIE*

M&A transactions take the form of a share acquisition, asset purchase, merger or a combination of these. Not all assets of the target need to be purchased in the asset acquisition. Nor do liabilities. Employees do not automatically become the employees of the acquiring company in an asset purchase, although they will do so in a share acquisition or a merger.[7] That's one of the reasons why many foreigners have preferred the form of asset purchase in Korea. Another reason for the preference of asset acquisition is the lack of transparency in financial statement. For foreigners, asset acquisition might be thought to be safer than share acquisition under the complexity of mutual guarantee among subsidiaries.

The volume of asset acquisition is not included in the figure of "the acquisition of outstanding stocks". Rather it is composed in the "the newly issued stock" in the table. So the real volume of M&As would be larger than the figure in this table. Unfortunately the official data on real volume of M&As including asset acquisition is not available so far.

Recent trends also show that the acquisition of newly issued stock is increasing, whereas the amount and share of outstanding stock is diminishing<See Table 2>.

<Table 2> Recent FDI by Type of Acquisitions

(Unit: U.S. million dollar, %)

Type of Acquisition	Jan-Aug in 1998		Jan-Aug in 1999		Jan-Aug in 2000		
	Amount	Portion	Amount	Portion	Amount	Portion	Rate v. 1999
Newly issued stock	2,847	69.4	6,023	77.5	8,819	94.2	46.4
Outstanding stock	930	22.7	1,213	14.6	398	4.2	– 67.2
Long term loan	325	7.9	538	6.9	149	1.6	– 72.3

Source: *MOCIE*

Korea still does not rank among the top FDI recipients worldwide today. Even though the

[7] BenDaniel, David J., and Arthur H.Rosenbloom. *International M&A, Joint Ventures, and Beyond: Doing the Deal*. New York: John Wiley & Sons, Inc., 1998: 46-47.

total amount of FDI has increased rapidly, the relative level of FDI stock to GDP remains far below that of many other developing and advanced countries <See Table 3>. To increase the level of FDI, we should keep in mind the fact that the majority of large FDI is in the form of M&A.

Inward FDI <Table 3> **FDI Stock as a Percentage of GDP** (%)

	1980	1985	1990	1995	1997
Korea	**1.8**	**2.3**	**2.3**	**2.3**	**3.5**
Thailand	3	5.1	9.6	10.5	8.5
Philippine	3.8	8.5	7.4	8.2	10.2
Malaysia	21.1	12.7	24.1	31.8	38.1
Indonesia	14.2	28.6	36.6	25.6	28.6
Mexico	4.2	10.2	9.2	14.3	12.5
Brazil	7.4	11.5	7.8	14.4	15.9
Argentina	6.9	7.4	5.3	9.9	12.3
developing countries	**5.9**	**9.8**	**10.5**	**1401**	**16.6**
U.K	11.7	14	22.4	19.4	21.5
Germany	4.5	6	6.8	6.9	9.9
U.S.	3.1	4.6	7.2	7.7	8.4
Western Europe	**5.7**	**8.7**	**11.1**	**12.9**	**15.4**
World	**5**	**6.9**	**8.7**	**9.9**	**11.7**

Source: *UNCTAD. World Investment Report 1999.*

2-3. The Motivation of Cross-Border M&A

2-3.1 The Motivation from the Seller's Viewpoint

Why does a firm need to sell off? The question is why does a firm need to be acquired or merged with. The restructuring of business firms stems from a number of forces. First is the need to survive in the global competition. Other factors are, theoretically, to transfer assets to owners who can utilize them more effectively or who can create higher value, to align better the incentives between managers and shareholders. *Divestiture* represents the sale of a segment of a company to another party. Assets, product lines, subsidiaries, or divisions are sold for cash or securities or some combination thereof.

When a target or bidder is located outside the national border, it will be a cross-border M&A. In the international context, additional obstacles and considerations will arise, some because of rules imposed by foreign jurisdiction and others that are inherent in any international transaction. The acquisition of one firm by another or merger of two firms is basically an investment made under uncertainty.

The motivation of M&A, especially cross border M&A, from the selling firm's point of view can be summarized as follows.

First, divestiture might be motivated by a desire to increase and maximize the market value of a firm. There should be a concrete reason to believe that the firm value will be worth more in the predator's hand than it is now, or that a firm can create value in other sector. M&A can contribute to replace management who neglects shareholders' wealth with management who can create value for the shareholders.

Second, divestiture may be motivated by a desire to close down some unpromising peripheral businesses in order to focus on the core business. With the cash by the disposal of non-core business assets, re-capitalization and focusing on core business can be possible.

The blind focus on capacity expansion with indebted weak financial structure of Korean conglomerates looked successful. But, such a diversified non-synergic expansion of the businesses is no longer tenable. The conglomerates do not have the capacity to manage all of their businesses, nor is the domestic market big enough to support them. The businesses are also too small to compete internationally. Few can reap the economies of scale that overseas competitors enjoy. Korean conglomerates need to focus on core businesses that have a chance of becoming internationally competitive, and sell, spin off, or close down other businesses.

Third, the divestiture in the form of cross-border M&A is generally motivated by various objectives: i.e. to attract foreign capital without any burden of interest payment, to improve financial structure, to access advanced technology and management skills, to reduce unemployment likely to occur by a possible shutdown of troubled business, and to improve corporate governance. This approach is known to be the principal way to attract international investors, to improve debt to equity ratios, and to provide a platform for the future growth and prosperity. [8]

Up until now maximization of shareholder value or improvement of corporate governance has not been an urgent motive for Korean companies. However, shareholder value has become increasingly an important objective for the firms. It is widely understood that firms belong to shareholders, not the family or society.

Shareholders of target firm prefer being acquired when the wealth of the target firm's shareholders can be increased as a result of acquisition. Empirical evidence suggests that the shareholders of successful target firms achieve substantial gains as a result of a takeover.

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[8] Akaba, Yuji, Florian Budde, and Jungkiu Choi. "*A Cure for Sick Chaebol*." Wall Street Journal, Nov. 19, 1998.

The gains appear to be larger in tender offers (30%) and in mergers (20%) whereas the shareholder of bidding firms earn comparatively little from takeovers. They earn only 4% on average from tender offers, nearly breaking even from mergers.[9]

But, frequently *managers* of the target firm resist takeover attempts. Managers stand up against takeovers so long as the manager's utility (salary, non-monetary rewards, job security) depend upon the firm's size rather than the firm's value. How can a manager's utility be a function of firm size? First, large firms pay higher salaries to their managers. There is empirical evidence showing a positive relation between the level of manager remuneration and changes in firm sales, whereas no relationship exists between the level of manager remuneration and the changes in firm market value. Second, the reason manager's utility is not directly related to firm value is that non-monetary rewards (such as power, prestige, and perquisites) are usually easier to obtain in larger firms. Finally, larger firms may provide managers with a greater degree of job security.

Of course, management resistance reflects pursuit of self-interest at the expense of shareholders. The resistance includes the amendment of the corporate charter, repurchases, standstill agreements, poison pills, share rights plans, going private, Crown jewel, etc.[10]

- 'Corporate charter' establishes the condition for allowing takeover. Firms frequently amend the corporate charter in order to make acquisition more difficult. For example,

[9] Ross, Stephen A., Randorph W. Westfield, and Bradford D. Jordan. *Fundamentals of Corporate Finance*. Boston: Irwin McGraw-Hill, 1998: 732-33.
[10] Ross, Stephen A., et al. Ibid.: 728-32.

changing the required percentage of the shareholders to approve a merger or staggering the election of the board members.

- In a targeted 'repurchase', a firm buys a certain amount of its own stock from an individual investor, usually at a substantial premium, to eliminate an unfriendly takeover attempt.
- Unless the buyer is willing to commit financial suicide, 'poison pill' is a financial device designed to make it impossible for firms to be acquired without management's consent.
- 'Share rights plan' (SRP) allows shareholders to buy shares of stock at some fixed price. The rights issued with SRP include higher exercise prices, can't be bought and sold separately from the stock, and can't be exercised immediately. Therefore, it is difficult for the bidder to acquire shares of the target stock without negotiation with management.
- When publicly owned stock in a firm is replaced with complete equity ownership by a private group, 'going private' happens. A result of 'going private' is that takeover via tender offer can no longer occur since there are no publicly held shares.
- 'Crown jewel' is to threaten to sell major assets, referred to as the 'scorched earth' strategy.
- As a defense strategy from hostile takeover, 'white knight' is an arrangement to be acquired by a different, friendly firm, rather than by a hostile takeover. The intention of these strategies is to force a bidder to negotiate with the management and to defend takeovers.

Nevertheless, the great virtue of M&A is to keep managers on their toes, enabling the improvement of the market discipline. M&A has intensified the pressure on firms to be more responsive to shareholders and to seek a higher rate of return.

2-3.2 The Motivation from the Bidder's Viewpoint

In order to formulate a strategic plan to attract cross-border M&A, it is helpful to understand the reason why bidders, mostly MNCs, want to acquire or merge with other firms. In the broadest sense, acquiring another firm makes sense only if there is some concrete reason to believe that the target will somehow be worth more in the bidder's hand than it is worth now. The acquisition will make sense only if the combined firm will have value that is greater than the sum of the value of the separate firms. A successful merger requires that the value of the whole exceed the sum of the parts.

Several hypotheses have been advanced to explain why firms engage in merger activities. The decision to acquire another firm, like any other investment decision, should be primarily motivated by the desire to increase the market value of the acquiring firm's shareholders. This is called a wealth maximization behavior. Acquisition may also be motivated by a non-wealth maximization behavior. For example, acquisitions may be motivated by the desire to increase firm's size regardless of whether the acquisition is a wealth-creating activity.[11]

[11] This part is largely based on Hawawini, Gabriel A., and Itzhak Swary's book, *Mergers and Acquisition in the U.S. Banking Industry*. New York: Elsevier Science Publishers B.V., 1990.

(1) Wealth Maximization Behavior

By wealth maximization behavior, wealth of the acquiring firm's shareholders can be maximized as a result of acquisition only if the future cash flow stream generated by the combination exceeds the sum of the future cash flow streams of the two individual firms, and/or if the risk to the merged firms is reduced.

- The Market Power Hypothesis

One important reason for an acquisition is that the combined firm may generate greater revenues than two separate firms. Increases in revenue may come from increase in market power. According to the market power hypothesis, horizontal mergers create monopolistic power by reducing the number of competing firms in an industry. In such mergers profits can be enhanced through raising product prices and reduced cost of monitoring rival firms in the industry. Of course, mergers that reduce competition substantially in the market may be challenged by the Competition Law on antitrust grounds.

- The Synergy Hypothesis

One of the basic reasons to merge is that a combined firm may operate more efficiently than two firms. If the production, administrative and marketing costs of the merged firms are smaller than the sum of these costs for the two individual firms before the merger, mergers create synergetic gains. Everything else being the same, lower aggregate costs mean increased profits and higher stock prices to bidder, unless competitors among bidders pushes the price of the target to the extent reflecting the present value of the expected value of synergetic gains.

A firm can achieve greater operating efficiency through M&A via economies of scale and scope, economies of vertical integration, complementary resources or distribution network. Empirical evidence indicates that "the smaller the target firm relative to the bidder firm, the higher the potential synergetic gains."

- The Tax Hypothesis

Tax gains are a powerful incentive for some acquisitions. A merger will create wealth to stockholders whenever the tax liability of the combination is smaller than the sum of the tax liabilities of the two individual firms. This situation may occur if one firm has generated net operating losses and the other significant tax liabilities. Another situation will happen if there is an increasing borrowing power for the combined firm. Since debt is a tax-deductible expense, increase in borrowing can lead to a decrease in tax liability.

- The Inefficient Management Hypothesis

This hypothesis suggests that mergers provide a mechanism to remove poor management from the target firm. Particularly during times of technological change or other period when innovations in business practice are occurring, some management team might be better to run a business. In that sense, corporate "raiders" provide a valuable service to target firm shareholders and society in general. However, improving the performance of a firm through better management does not always require M&A. Poor management can be removed by another alternatives.

- The Information Hypothesis

According to the information hypothesis, the share of some firms is incorrectly valued by the market because relevant information about those firms is not available to the public. Suppose that a potential bidder has information indicating that a potential target is undervalued. Clearly, the target becomes a desirable acquisition for the potential bidder.

- The Diversification Hypothesis

The merged firms may reduce their combined risk. This will be the case if the risk of the combined firms is less than the weighted average of the risks of the two individual firms prior to the merger. This acquisition motive is known as the diversification hypothesis. Moreover a merger may also be motivated by the need to reduce the combined investments in working capital or fixed assets to sustain an effective level of operating activity by the two firms.

(2) Non-Wealth Maximization Behavior

- The Manager Utility Maximization Hypothesis[12]

In manager utility maximization hypothesis, merger is motivated by a desire to increase

[12] Weston, J. Fred designated this as "agency problems." Weston, J. Fred, Kwang S.Chung, and Juan A. Siu. *Takeover, Restructuring and Corporate Governance.* 2nd ed. New Jersey: Prentice-Hall, Inc.,1998: 80-83.

manager's utility, not by the wealth of the shareholders of the acquiring firm. If manager's utility depends on firm size, risk or manager's compensation rather than the firm's value, then managers will maximize the firm's growth, reduce its risks or expropriate the firm rather than maximize shareholder wealth.

- The Hubris Hypothesis

The hubris hypothesis is another behavioral hypothesis of firm mergers. In Roll's hubris hypothesis, managers systematically overpay to acquire target firms. Managers of bidding firms believe that they are capable of uncovering "bargains". Consequently, bidders constantly end up *paying too much* for the firms they acquire. Nevertheless, managers of the bidding firm persist in taking over the target firm.

Despite objective information that the target's true economic value is lower, Roll believes that the individual decision makers in the bidding firms are infected by pride and arrogance(hubris), and thus persist in the belief that their own valuation of the target is correct.

Another reason for bidder's paying too much for target firms is the so called "winner's curse". In bidding contests involving only a few bidders, the winner usually ends up paying too much for the object being auctioned.

According to these two hypotheses (i.e. the Manager Utility Maximization Hypothesis and the Hubris Hypothesis), merger should *not create any net aggregate wealth* to shareholders, but actually only wealth transfer from bidding firm shareholders to the target firm shareholders: the gains realized by the target firm shareholders should be equal to the losses incurred by the bidding firm shareholders. More precisely, we should observe a *net reduction* in aggregate wealth because of the wealth transferred to third parties (advisers, lawyers, brokers) in the form of fees and commissions as well as any indirect costs that result from the time and effort devoted both by the managers of the bidding firm to acquire the target and by the managers of the target firm to fend off an unfriendly takeover.

2-4. Key Success Factors in Cross-Border M&A

M&A is one form of external growth alternatives. But, external growth is extremely competitive and the probability of increasing shareholder's wealth via M&A is very low. The probability of success for the average bid is 45 percent at best, according to an ex-post analysis of 116 acquisition programs in U.S. and U.K. between 1972 and 1983[13]. Usually foreign investment contains more risk and challenge than domestic one due to its foreign location. Accordingly, the probability of success for cross-border M&A is much lower. How can these odds be improved?

In terms of key success factors of M&A, most theories and articles are mainly interested in the bidder's viewpoint. In fact, it is not clear what 'success' is from a target company's point of view, but success should be evaluated by the eventual objective of the M&A: to improve competitiveness of the company, and to enhance firm value for shareholders.

[13] The analysis, done by McKinsey & Company's Corporate Leadership Center, indicates that the probability of success was only 23% on average, 45% at best, 14% at worst. Copeland, Tom, et al. *Valuation: Measuring and Managing the Value of Companies.* 2nd ed. New York: John Wiley & Sons, Inc., 1996: 416-18.

M&A from the seller's viewpoint is also the process of external growth to create value potential.

Then how can we succeed in cross-border M&A?

- Formulate Strategic Planning of M&A

First of all, it is essential to examine your own company carefully. Figure out the changing structure of your industry, the strengths and weaknesses of your company: the threat of potential entrants and substitutes, the bargaining power of suppliers and customers, the changes in the industrial structural. And then seek the approach that will work best for your company's value adding. This process of strategic planning is one of the most important factor of success or failure in the battlefield of M&A.

A firm must seek to exploit a set of capabilities and opportunities effectively in relation to its changing environments. The dynamics of competition and economic change will require continuous reassessment of its position and realignment to its new challenges and opportunities. Firms are required to make strategic decisions in the face of much uncertainty and considerable risk, especially with respect to M&A. In that sense, divestitures represent a form of a strategic planning process, not necessarily management failures.

- Find out Core Business and Decide Which Business to Spin Off

Divestitures are not necessarily management mistakes, representing effective efforts to adjust to the changing economic environment[14]. For the successful divestiture it is crucial to find out the core business on which a company will concentrate its limited resources, and to make timely decision about which business to spin off. Disposal is necessary to save other businesses. The sale of one business can be used to finance another.

- Make the Deal with the Right Partner

Closing a deal itself is sometimes the key to success. Selling off the non-core business is necessary for the next step of the restructuring process. To do so, discussion of the deal with the right partner and the right objectives is essential. Thus screening candidates to a handful of realistic possibilities mainly with the assistance of consulting firms, law firms and investment firms is important. Hiring the best deal maker is also suggested as a key element of successful M&A. Of course, the best and highly skilled professionals with credentials don't come cheap. However, a firm should set up the criteria of the right partner.

Chance of success are higher when companies acquire smaller companies in a related business. In a related business, the chances of achieving real economic synergy are higher and smaller businesses can easily be integrated during the post acquisition phase of the

[14] The motives for divestiture activity are many and diverse. They involve dismantling conglomerates, abandoning the core business, changing strategies or restructuring, adding value by selling into a better fit, large additional investment required, harvesting past successes, discarding unwanted business from prior acquisitions, financing prior acquisitions, warding off takeovers, meeting government requirements, selling businesses to their managers, taking a position in another firm, reserving mistakes, etc. Weston, J. Fred, Kwang S.Chung, and Juan A.Siu. *Takeover, Restructuring, and Corporate Governance.* 2nd ed. New Jersey: Prentice-Hall, Inc., 1998: 232-34.

program.[15] Accordingly, a larger company in a related industry would have a better chance to close a deal at the right price.

Success will depend on the merged company's ability to create value. Combined value of selling company is the value of selling company "as is" plus the value of the synergies less transaction costs of the deal. Here the value of synergy is different depending on the type of synergy, who holds it and how long it will take to seize synergy. If the synergy is unique and held by the seller, then the buyer has little hope of capturing any value in the bidding process. Different bidders can capture different synergies from acquiring a firm. The problem is how much synergy a potential bidder can create by acquiring a firm. If the synergy of firm A is less than that of firm B, firm A is not willing to offer higher premium.

In that sense, it is important to know what your company is worth to potential bidders. So it is advisable to seek a partner who can capture the highest synergies by means of M&A with your company. In negotiation, the estimated value of synergy to the bidder can be a yardstick of the utmost price that the bidder is willing to pay. In order to develop a successful M&A strategy, it is a prerequisite to evaluate and grasp the financial condition, motivation, and regional and global strategy of the bidder prior to the negotiation.

- Narrow the Price Gap with Value Creation Potential

There is bound to be a big price gap between the bidders and the sellers. Price disparity

15 Copeland, Tom, et al. *Valuation.* 2nd ed. New York: John Wiley & Sons, Inc., 1996: 404-18.

often occurs at the start of many negotiations. The reason why such a good looking deal of Seoul Bank with HSBC fell through was the disagreement about how to value assets, particularly bad loans.[16]

The money already invested, whether public fund or not, is meaningless to determine the value of the company because the value depends on the future cash flow, not on the past cash stock invested. Most Korean businessmen know that the value is decided by the discounted future cash flow theoretically. However, in practice, they often appear to be fixed on a price, usually high, which is derived from a peculiar mix of land value, personal contributions to a business and other un-measurable factors.

Potential bidders are waiting for a company to be in trouble with liquidation defaults, conflicts on the control of management, short-term poor performance, bad public opinion on the major shareholders and the managers, in order to take over cheaply.

The selling company could narrow the price gap by identifying value creation potential through operational improvements. There is still plenty of room for domestic companies to improve performance via internal operational reform, such as flatter organization, cutting jobs, and performance-based incentives. Pay and promotion are determined by seniority, not merit. Value is placed not on individual contribution to a company, but on solidarity within peer groups among employees. Successful deals begin profit improvement efforts a couple of months before the deal begins, tightly managing the market share and sales volume during negotiation. Ironically the best way to sell a company at the right price is to

[16] "*Lost Seoul*." Economist, Sept. 4-10, 1999.

create value potential for the shareholders and to defend the company well.

- Assurance of Transparency

Establishing the confidence and conviction in the transparency of financial information to potential acquirers is of foremost importance. Most acquirers are alert to the hidden cost that could be a crucial cause of over-payment. Transparency is a process by which information is made accessible, visible and understandable. The reason why transparency is so important is that it contributes to more efficient decisions, the efficient allocation of resources, improvement of performance, and the stabilizing of the market during period of uncertainty.

Korean companies were notorious for their opaque accounts. Even though all listed firms have produced financial statements audited by independent accountants so far, Korean practices still fall far short of international standards. The owner-managers of Korean companies tend to be rather secretive in their approaches to management. Only a few trusted executives of long service may know all of the details concerning the strategies and financial matters related to the operations of their companies. In some cases, no one outside the owner-manager's family really knows the crucial circumstances regarding the operation of the company. Some liabilities were not even mentioned at all in the unconsolidated accounts.[17]

[17] "*South Korean Accounting: The Open Society.*" Economist, May 20-26, 2000: 101.

It is recommended that acquirers should not proceed a deal if a detailed information gathering cannot be carried out.[18] And then the purchaser must be aware of any "hidden" post acquisition costs which are likely to arise. In spite of audited financial statement there are difficulties and inevitable reluctance to proceed transaction in cases where information is incomplete or doubtful. Therefore disclosing real financial statement at the very early stage helps to generate goodwill between the partners.[19]

3. CASE STUDY OF CROSS-BORDER M&A IN KOREA

3-1. Case 1: Daesang Corp.'s Lysine Business

On March 1998, Daesang Corp. said it agreed to sell its lysine business, a division specializing in the animal feed additive, to German chemical giant BASF AG for U.S.$600 million. It was the largest single sell-off between a domestic firm and a foreign buyer since the nation came under the IMF bailout program last December. Under the contract, Daesang would hand over the business rights, technology, production facilities, and employees (234 employees were engaged in) in its lysine business to BASF.

Daesang Corp. and Lysine

Daesang Corp., the flagship affiliate of Daesang Group, is the leading local condiment

[18] Walker, Ian E. *Buying a Company in Trouble.* Brookfield: Gower Publishing Co., Ltd., 1992: 39.
[19] McKinsey & Co., Inc. *"Perspectives on Attracting Foreign Direct Investment."* May 1999.

and food manufacturer. It formerly was known as the Miwon Company. Daesang ranked as the country's 29th largest conglomerate in 1997 with annual sales of 1,200 billion won or about U.S.$1 billion.

Looking briefly at the company history, Dong A Whasung Industrial Co., Ltd. was established in Jan. 31, 1956 and was renamed Miwon Co., Ltd. in 1962. Miwon Co. grew as a seasoning and general foodstuff manufacturer. It diversified its business lines to heavy industry, trade, and petro-chemicals in 1970s. It started to produce lysine since 1973. It further diversified its business lines to include food processing, frozen food, coffee, and construction in 1980s and moved into new business areas such as distribution, information technology, health and advertising in 1990s. The Miwon Group changed its name to "the Daesang Group" in 1997. Daesang's core businesses were fermentation, food materials (e.g. starch and sweetener), processed foods, and their strategic businesses were in pharmaceuticals, health, trade, and construction.

Lysine, one of several essential amino acids added to animal food to help swine and poultry gain weights faster, is produced by only five companies in three countries[20].

Daesang supplied about 21 percent of the world market, and had sales of U.S.$ 250 million (DM 450 million) in 1997. 90 percent of the turnover in lysine was outside Korea. The principal markets were in Asia, Western Europe, and North America. Lysine business was one of most profitable business that required high fermentation technology, consequently making a high entrance barrier. "This is a beginning of a positive trend where

[20] These involve ADM (Archer Daniel & Midland) in U.S., and Ajinomodo in Japan.

companies are selling attractive businesses." said Harry van Dyke, a managing director at Morgan Stanley Asia Ltd. in Hong Kong, who brokered the deal. Lysine sales accounted for about one-fifth of Daesang Corp.'s total sales of U.S.$2 billion in 1997.[21]

The feed additives business is a cyclically resilient market segment; the price level of lysine is correlated with the price of the corn. If the harvest of the corn is poor, the demand for feed additives increases. Because of the poor corn crop with the El Nino phenomenon and increased demand for swine and poultry, the strong growth in demand for lysine was expected. The plant site was located at the seaport of Kunsan, which made it ideal for cost-effective supplier to the strongly growing market in China. Because the demand was rapidly increasing, expansion of the Kunsan capacity was already underway.

As market interest rates surged over 25 percent level following the eruption of financial turmoil in late 1997, many companies have had difficulties in getting bank loans and issuing corporate bonds. Many Korean companies decided to sell assets to meet debt payments. Daesang Group was not an exception, with an accumulated debt of 1.2 trillion won or above four times its equity in 1997.

Through the sales of the lysine business, Daesang could invest more money into the future-oriented, high value-added businesses such as bulk pharmaceutical ingredients, health food, and environment. Daesang might select and develop such business as general

[21] "*BASF Buys Korean Lysine Operation*." Asian Wall Street Journal, Mar.19, 1998.

foodstuffs, fermentation, and food materials as core business. Actually Daesang Corp. will pour U.S.$ 177 million over the next three year in biotech fields including biological medical and environment to develop new technologies. The company will also make efforts to develop pharmaceutical products such as interferon, vaccines and growth hormones.

After the deal, Daesang Group's sales of 1,130 billion won increased by 116 percent, and net profit of 183.5 billion won increased by 370 percent in 1998 compared with the previous year. In addition debt-to-equity ratio was reduced from 436 percent in December 1997 to 322 percent in December 1998, up to less than 200 percent in December 1999. Cross guarantee dropped to 47.2 billion won in 1998 from 507 billion won in December 1997.[22]

An analyst said that the extent to which the company would benefit from the sale is uncertain, as it will lose its most profitable business. The sale of the lysine business would help lower Daesang Group's debt-to-equity ratio to below 200 percent. However, it is uncertain how much profit the company will make in the future.

BASF AG and Lysine

BASF[23], established in 1865, is Germany's leading global chemical company producing a comprehensive range of chemical products, operating production sites in 38 countries. The products of BASF are used in a wide range of industries and can be divided into 4

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[22] See Appendix A and Appendix B.

[23] BASF ranked 93rd in 1998 Fortune Global 500 in terms of revenue, involving the sales volume of U.S.$ 30,731 millions and the profit of U.S.$1,889.3 millions.

major categories: health and nutrition, colorants and finishing products, chemicals, plastics and fibers.

BASF is expanding its worldwide business with animal nutrition products. The purchase of Daesang Corp.'s lysine business gave BASF an Asian production base and would make it the world's third largest producer of lysine. Prior to that, BASF had agreed to buy up its partner's share in its two joint ventures in Korea. BASF decided to buy back shares from Korean partner Hyosung T&C Co. of 50-50 joint venture in May 1997 for U.S.$ 43 million, and to buy back shares from another Korean partner Hanwha Chemical Corp. of 50-50 joint venture in December 1997 for U.S.$ 85 million.

"We wanted to strengthen our position in these core businesses and increase efficiency." said Kurt Leider, BASF spokesman in Hong Kong. He added that Daesang's lysine operations had a "very advanced process, state-of-the-art production and skilled workers" that would complement BASF's existing animal-nutrition business[24].

In the feed additives business, BASF was already strongly represented around the world with vitamins, carotenoids[25], organic acids and enzymes. By acquiring and producing lysine, the essential amino acid to poultry and pig fattening rations, BASF could round off its animal nutrition product line. BASF could look forward to synergetic effects, because the customers for amino acids such as lysine and other feed additives are virtually identical, and the customers could find convenience in buying animal nutrition products. BASF's

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[24] "*BASF Acquires Division from Daesang of Korea*." Wall Street Journal Europe, Mar.19, 1998.

[25] Carotenoid are any of groups of non-nitrogenous yellow, orange, or red pigments that are almost universally distributed in living things.

sales of animal nutrition products were about DM 1.25 billion in 1997.[26]

The acquisition also helps BASF to expand its expertise in biotechnology. Lysine is produced in Kunsan by a modern fermentation process from sugar and molasses. Biotechnological processes can offer distinct cost advantage in selected vitamins or other additives such as enzymes. BASF has also been using biotechnological fermentation processes at Ludwigshafen in Germany and is to convert its production of Vitamin B2 completely to that process. BASF's sales, Euro$29,471 million in 1999, increased on average 6.6 percent compared with the previous year. However, sales in Asia rose 24.3 percent in all segments.

3-2. Case 2: Samsung Heavy Industries' Construction Equipment Business

On May 7, 1998, Samsung Heavy Industries (SHI) signed the agreement to sell SHI's Construction Equipment Division to AB Volvo, the Swedish automotive group, for U.S.$572 million[27]. It was known that it was paying U.S.$107 million for goodwill and U.S.$465 million for the net assets of the SHI business[28]. Samsung and Volvo signed the letter of intent for the sale last February. According to the contract, SHI would hand over to

[26] "*BASF: Significant Growth in the Health & Nutrition Segment: BASF purchases lysine business from Daesang*" M2 PRESSWIRE, Mar.18, 1998.
[27] Under the contract, Volvo will collect about $150 million receivable on behalf of Samsung, which does not include in the amount of $572 million.
[28] "*Volvo Pays Dollars 572m for Samsung Arm.*" Financial Times, May 8, 1998.

Volvo the production facilities, employees, overseas branches and subsidiaries and intangible assets of technology and patents. The division produced four items: excavators, loader trucks, cranes, and concrete pump trucks. Samsung kept control of its forklift truck business, which was not included in the transaction but afterwards sold to Clark of the U.S. for U.S.$ 30 million on July 15, 1998.

The transaction was not in the form of share acquisitions but in the form of asset acquisitions, in which not all the assets of the target company need be purchased and not all liabilities of the target need be acquired. SHI was expected to maintain a relationship with Volvo by retaining a minority stake (10 percent) of the Construction Equipment Business following the deal.

SHI and Construction Equipment Division

Samsung Heavy Industries established in August 1974, grew as a key member of the Samsung Group with the government's promotion policy for heavy and chemical industries (HCIs). It acquired the construction equipment division of Korea Heavy Industries & Construction in August 1983 and developed its own model of excavator in 1987. Its major businesses were shipbuilding, construction, platform and steel structures, and industrial machinery.

Construction equipment division had sales of U.S.$ 700 million (780 billion won) in 1997 with over 2,000 employees. Export to Europe had focused on crawler excavators, wheeled excavators and wheeled loaders.

Until 1997, Samsung had been one of the leading excavator manufacturers in the region. Its Changwon plant had the capacity to make 10,000 machines a year. But, in the wake of the region's financial turmoil, sales fell from nearly 8,000 machines in 1997, to less than half the following year, when the operation made a loss of U.S.$ 50 million.[29]

SHI had been losing money from its construction equipment business because of heavy investment in capacity expansion, and because of economic recession in the construction industry. Some people attributed it to the lack of a global distribution network despite excellent production facilities of SHI. Anyhow it was difficult for SHI to give up the construction equipment business, but Korea's financial crisis put pressure on SHI to sell the unprofitable asset to meet debt payments.

Sales of SHI's construction equipment division was seen as a test case of the new government's commitment to attract foreign investors and was regarded as a success story that helped boost confidence among foreign companies. However, some skeptical analysts said that such restructuring plans were in response to government pressure to reduce large debts and were designed to appease the government. Indeed, the head of the Financial Supervisory Commission warned that the government was prepared to stop propping up marginal businesses through emergency loans which would trigger a wave of corporate bankruptcies.

The transaction was expected to allow SHI to improve the financial status of the company considerably with the reduction in total debt, resulting in lowering debt-to-equity

[29] "*Volvo Digs Deep in Korea: Management Foreign Ventures.*" Financial Times, May 8, 1998.

ratio to below 300 percent in 1998 from 759 percent in the previous year<See Appendix D>.

AB Volvo and Construction Equipment Business

AB Volvo is a multinational corporation involved in a wide range of areas, including cars, trucks, buses, construction equipment, marine and industrial engines, and aircraft components. Volvo's Construction Equipment (VCE) operation achieved sales of U.S.$ 2.1 billion (SKr. 16.8 billion) and operating profit of U.S.$ 177 million (SKr. 1.44 billion) during 1997.

The deal would give VCE its first manufacturing base in this kind of equipment and a new hub to expand in Southeast Asia. Volvo's plant in Changwon is to become the center of Volvo's worldwide excavator manufacturing and marketing operations. To the surprise of many, Volvo transferred the head office of its heavy excavator operation to Seoul and closed its main excavator plant in Sweden.

Behind this was a desire to challenge the dominance of Caterpillar of the U.S. and Komatsu of Japan. For Volvo it was good opportunity to penetrate the Korean market through Samsung's well-established dealer network. Another background for Volvo's investment includes the price competitiveness thanks to the weakness of the Korean won and well developed business and social infrastructure in Changwon area.

After Volvo changed its strategic direction to concentrate on transport vehicles in 1994, Volvo's core business has been strengthened through purchase of stock and acquisition of companies while operations outside the vehicle and transport-equipment business were divested. Volvo has been actively expanding production capacity of construction equipment machine division through acquisitions in Germany, France, and Canada during the 1990s.

In January 1999 AB Volvo decided to sell its car division to Ford Motor for $6 billion. The background to the sale was that a thorough analysis showed that Volvo car would benefit from being integrated in a larger automotive entity, where it could enjoy subsequent economies of scale.[30] As a result of this decision Volvo could become a Group focused entirely on trucks, buses, construction equipment and marine and industrial engine business areas.

The takeover was viewed skeptically by those outside Volvo. Many believed the Swedish company had overpaid for the Samsung division.[31] However, Volvo asserted that the takeover would give it a strategic position in the construction machine market. Leif Johansson, CEO of Volvo, predicted that it would reach the break-even point in the fourth quarter of 1998 and then see increasing profits.[32] Volvo Construction Equipment Korea (VCEK) suspended its plant in Changwon for approximately one month in December 1998 and January 1999. Although the demand for construction equipment in Asia continued to weaken due to the still depressed construction equipment market, there were some signs of promising prospects.

[30] Volvo. *Annual Report 1998.* Volvo car faced with a risk of not being able to supply competitive products and generate satisfactory profitability due to its relatively small volume. Annual production of Volvo car was less than 400,000.
[31] "*Volvo Digs Deep in Korea: Management Foreign Ventures*." Financial Times, May 8, 2000.
[32] Actually, VCEK resulted in loss of 67 billion won in 1998 after acquisition, which was nearly breaking even. Korea Times, Feb 22, 2000.

As a strategy for managing global network, the company has developed a highly decentralized structure. Of the six business units in the division which are based on product type, only three are in Sweden: the large excavator division is run from Korea, the grader operations from Canada and the small machinery business from France.[33]

To overcome the huge management challenges, Volvo quickly introduced a series of tough measures at the company. Volvo succeeded in cutting the workforce by 10 percent through early retirement packages after initial worker resistance[34]. It also introduced a range of new factory procedures, including more rigorous quality checks and a 'benchmarking' to compare its own operations with those in factories around the world. The new management group has transformed the excavator division by introducing new production method based on teamwork.

Giving more responsibility to employees boosted productivity. Volvo's flat management concept was introduced into the company that was accustomed to a rigid hierarchy. Another key step was to introduce a range of initiatives, including western style scales of remuneration that pay people according to their capabilities rather than how long they have been at the company.

[33] "*Devoted to Dumptrucks: Management Volvo*." Financial Times, May 3, 1999.
[34] There was a resistance of the employees in the Changwon plant for fear of dismissal in the midst of negotiation in February 1998, despite lack of trade union in Samsung.

4. CONCLUSION: Key Findings and Policy Implications

4-1. Summary of Key Findings

The primary reason for the recent increase of inward FDI in the form of M&A is the favorable investment environment, through the removal of government restrictions. Removed restrictions on foreign ownership of corporations, abolishment of the prior board consent, increased share purchase limit was timely and effective to attract foreign investment.

Another major reason is the under-priced assets of troubled companies driven by the capital need to meet debt payments.

In addition, government's relentless drive to attract foreign investment has been a key factor of the recent massive inflow of foreign funds. As the government imposed a deadline in disposing of assets and meeting the recapitalization target on companies, foreign investors have been able to wait and see asset prices fall further.

The M&A activities of MNCs are basically motivated by the corporate strategy to strengthen competitive position, confronted with the limit to growth by internal operation improvement. In today's rapidly changing marketplace, sustainable growth for a business is dependent on the accessibility to proprietary technologies, distribution outlets, and production strengths. BASF and Volvo secured an Asian production base, and could benefit from the economies of scale and synergetic effects.

From the seller's viewpoint, cash was urgent to cover debt payments or to escape from bankruptcy. The desire to maximize market value of firm for shareholders was not a major motivation for selling off.

In fact the weak financial structure has been improved markedly in the case of Daesang up to 322.3 percent in 1998 from 436.3 percent in the previous year, and in the case of SHI to 293 percent from 759.9 percent in the previous year.

Through the divestiture process, companies could concentrate their resources and capabilities on the core businesses. Daesang selected and developed such businesses as general foodstuffs, fermentation, and food materials as key businesses after disposal of lysine business. And Daesang invested more money into the future oriented, high value added businesses such as pharmaceutical ingredients, health foods, and environment. Subsidiaries at home were reduced to 14 from 20 in early 1998. Ko Doo-mo, chairman of the Daesang Group, said that Daesang Group would focus investments on the development of next-generation medical ferment products as its new key business.

On the other hand, as a result of restructuring, SHI could concentrate its resources on shipbuilding and plant business. In the Shipbuilding & Plant Division, SHI concentrated on the production of a variety of products: commercial and value-added ships, offshore vessels and structures, as well as cargo and material handling facilities. SHI announced that shipbuilding would remain as a core business for SHI and Samsung Group.

Through the restructuring process, management structure was innovated and competitiveness has been increased. In the case of Daesang Group and VCEK, the seniority system was changed to the merit system. Decision making line was shortened and RPMS(R&D, Production, Marketing, and Staff) meetings were facilitated to encourage better communications among employees, sections, and divisions.

4-2. Policy Implications

Korea has taken nearly every step necessary to attract foreign capital. Nearly all business lines are opened. The restrictions on foreigner's acquiring outstanding stocks of Korean companies are removed. Procedures are simplified and favorable incentives are given.

However, all these changes came all at once by external pressure and by the strong intervention of the government rather than by internal corporate needs.

Government's main concern has been to promote FDI in the form of green-field investment. Most developing countries prefer green-field FDI to M&A. The primary reason for this preference is that M&As merely involve a change of ownership, and there is no new addition to the capital stock or production capacity of the host country, at least in the first round. Since capital formation is a key prerequisite for development, green-field investments that establish new production facilities are preferred.

The negative economic impact of M&As is that the consolidation and rationalization process result in *employment reduction* at least in the short run. In the United States for example, as many as 73,000 persons were laid off in 1998 from companies involved in

M&As, accounting for 11 percent of total job losses in that year.[35] Increased market power through M&A can lead to *reduced competition* such as oligopoly, consequently lowering consumer benefit. With the maturity of M&As activities, managers are inclined to stick to *short-term performance target*, ignoring long term objective.

Notwithstanding these defects, the existence and activation of M&A market can contribute to the efficient allocation of management resources, strengthen market discipline, and increase shareholder wealth.

In order to attract more foreign investment in the open economy, it is basically required to ensure political and economic stability, to enhance the transparency in the private and public sector, and to try to soften the strong economic nationalism and cultural clash. Moreover, it needs to strive to increase buying and selling incentives by generating more flexible labor market, and by allowing easier disposal of collateral assets.

- Political and Economic Stability

When analyzing a foreign investment opportunity, the company must consider the risks that stem from its foreign location. These risks include, most importantly, political risk and economic risk. So political and macroeconomic stability is a basic factor of promising foreign investment. For example, a depreciation of a currency's value will be attractive for the foreign investors who are looking for cheap price assets. In the long run, however, since the value of the cash flows it receives from those assets will fall as the country's currency

[35] UNCTAD. *World Investment Report 1999.* New York: United Nations, 1999: 103.

depreciates, it reduces the attractiveness of foreign investment in that country.[36]

- Transparency and Accountability

In the public sector, transparency and accountability is essential for macro economic stability and economic growth. Both will be helpful for better information about the design and objectives of fiscal and monetary policy, and for strengthening the credibility and public understanding of economic policies.

- Soften Economic Nationalism

Koreans were very sensitive to any hint of foreign domination of their economy. This sentiment results from a long history of foreign invasions and strong sense of nationalism. This deep-rooted concept of a creating self-reliant economy continues to be manifested today in policies and strategies despite the recent changes in FDI and M&As regime.

We cannot say that economic nationalism itself is obsolescence or symbol of failure in market openness. But, in order to enhance market discipline, it is more desirable that this strong economic nationalism and xenophobic corporate culture need to be more soft and flexible. Cultural crashes in mergers become more overriding concern and become harder to manage with increased number of the cross-border M&A. More attention should be paid to the post-merger integration rather than the pre-bid skills such as negotiation in the process of M&A.

- Making Easy the Disposal of Collateral Assets

Because banks have preferred to lend against collateral, most of Korean companies' assets might be already occupied as collateral by some financial institution. It is difficult to

[36] Hill,Charles W. L. *International Business*. Boston: Irwine McGraw-Hill, 1998: 567.

sell off collateral assets without prior approval of creditors. Thus it is a prerequisite to ensure the creditor's consent prior to the negotiation with bidder on the terms of the deal. But it is a time-consuming process to acquire individual assent from so many creditors. Therefore, it needs to establish an institution which can buy and sell the contingent claims on collateral assets, resulting in allowance of the disposal of assets. When a company is really willing to sell off peripheral business sectors, procedural problems should not be an obstacle to proceed a deal.

- Ensuring Flexibility in the Labor Market

This might be one of the tough issues of cross-border M&As. To revive an ailing company with accrued loss and high debt, the reduction of capacity is necessary. The buyer will usually want to have the initiative of renegotiating the terms of employment, while the seller will often insist that the buyer agree to employ its existing workforce and may want to specify the terms and conditions of the employment. Theoretically it might be desirable that these matters, as with other economic issues, will be negotiated between the buyers and sellers, rather than be compelled to do so by legislation. The burden of laying off the workforce of the troubled company is transferred to the acquirer. This burden needs to be mitigated through the development of a more flexible labor market. **II**

APPENDICES

APPENDIX A

Five-year Financial Summary of Daesang Group

Income Statement Data *Unit: billion won*

	1995	1996	1997	1998	1999
1. Sales	218.6	286.7	523.9	1,129.9	1,094.0
2. Cost of goods sold	180.9	235.1	345.3	843.3	829.5
3. Gross profit	37.7	51.6	178.6	286.6	264.5
5. Selling, general and Administrative expenses	18.9	21.8	56.4	272.1	193.3
5. Operating profit	18.8	29.9	122.2	14.5	71.2
6. Non-operating income	8.2	7.9	22.8	174.0	169.3
7. Non-operating expenses	13.1	16.6	97.3	345.9	179.7
8. Ordinary profit(loss)	13.9	21.2	47.7	157.4	60.7
9. Extra-ordinary income	0.04	0.1	0.0	725.6	
10. Extra-ordinary loss	0.1	2.4	1.2	299.5	-9.1
11. Pre-tax net income	13.8	18.9	46.5	268.6	
12. Income tax	2.4	2.8	7.5	85.2	
13. Net income(loss)	11.4	16.1	39.0	183.5	36.4

Source: Maeil Daily News Annual Report

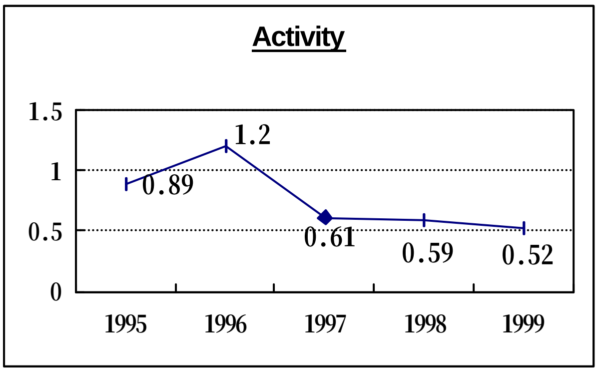
Balance Sheet Data *Unit: billion won*

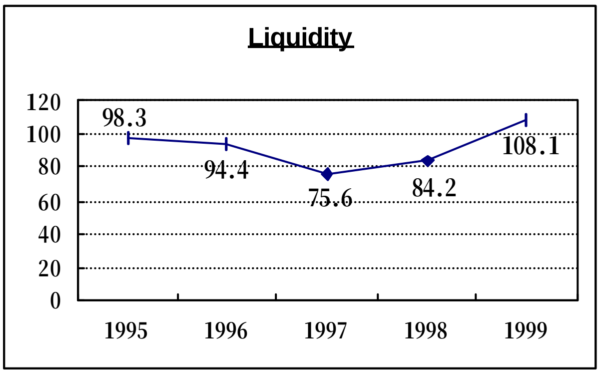
	1995	1996	1997	1998	1,999.0
1. Current Assets	109.3	97.0	644.7	1,222.1	886.3
2. Other Assets	137.1	133.9	835.5	1,085.6	985.2
Total Assets	246.4	230.9	1,480.2	2,307.7	1,871.5
1.Liabilities	180.5	147.9	1,204.2	1,761.2	1,203.2
1-1 current liabilities	111.2	102.8	852.4	1,452.2	819.6
1-2 other liabilities	69.3	45.1	351.8	309.0	383.6
2. Shareholder's equity	65.9	83.0	276.0	546.5	668.2
Total liabilities and Shareholder's equity	246.4	230.9	1,480.2	2,307.7	1,871.5

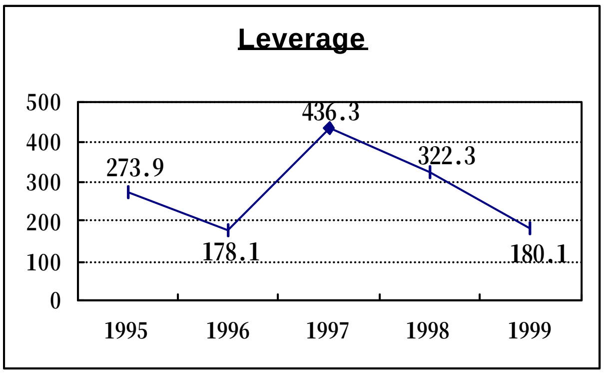
Source: Maeil Daily News Annual Report

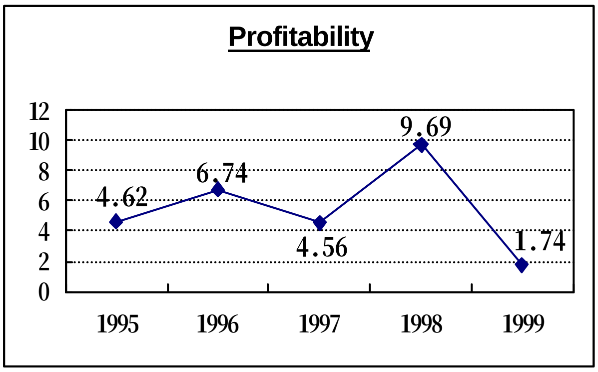
APPENDIX B

Ratio Analysis of Financial Statement in Daesang Group









APPENDIX C

Five-year Financial Summary of Samsung Heavy Industries

Income Statement Data

Unit: billion won

	1995	1996	1997	1998	1999
1. Sales	2,920.7	3,255.7	3,953.2	3,853.2	3,703.1
2. Cost of goods sold	2,454.2	2,861.1	3,042.0	2,972.9	2,907.1
3. Gross profit	466.5	394.6	911.2	780.3	796.0
4. SG&A expenses	245.5	272.4	367.2	246.9	213.7
5. Operating profit	221.0	122.2	544.0	533.4	582.3
6. Non-operating income	126.4	149.5	396.7	436.8	239.5
7. Non-operating expenses	294.8	516.7	4,031.1	924.5	690.9
8. Ordinary profit(loss)	52.5	-244.9	-90.5	45.7	130.9
9. Extra-ordinary income	0.7	1.6	1.5	49.4	2.6
10. Extra-ordinary loss	7.6	54.9	6.5	24.5	117.9
11. Pre-tax net income	45.6	-298.2	-95.5	70.6	15.6
12. Income tax	7.2	0	0	0	7.1
13. Net income(loss)	38.4	-298.2	-95.5	70.6	8.5

Source: Maeil Daily News Annual Report

Balance Sheet Data

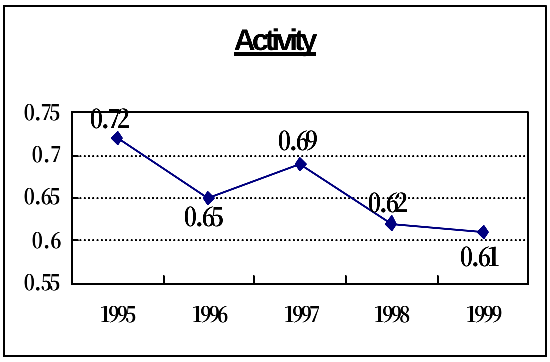
Unit: billion won

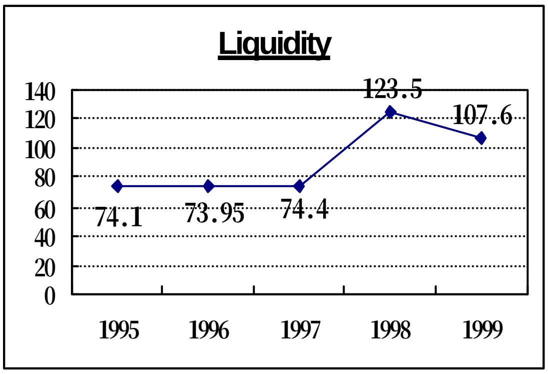
	1995	1996	1997	1998	1999
1. Current Assets	1,964.3	2,254.9	2,910.4	2,901.8	2,935.8
2. Other Assets	2,651.4	3,087.8	3,183.2	3,191.7	3,020.5
Total Assets	4,615.7	5,342.7	6,093.6	6,093.6	5,956.3
1.Liabilities	3,588.6	4,529.1	5,385.0	4,544.0	4,053.2
1-1 current liabilities	2,351.7	3,049.2	3,909.9	2,350.4	2,728.6
1-2 other liabilities	1,236.9	1,479.9	1,475.1	2,193.6	1,324.5
2. Shareholder's equity	1,027.9	813.6	708.6	1,549.6	1,903.2
Total liabilities and shareholder's equity	4,615.7	5,342.7	6,093.6	6,093.6	5,956.3

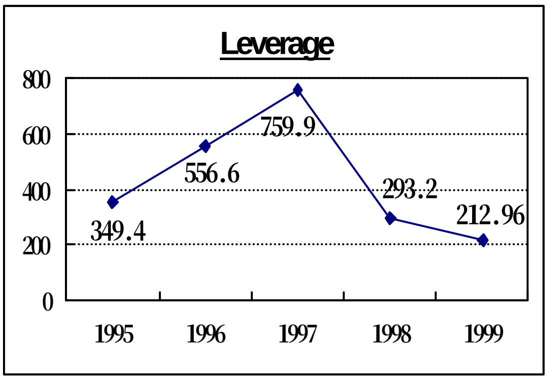
Source: Maeil Daily News Annual Report

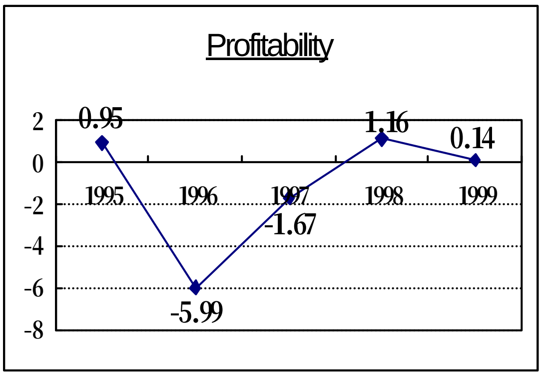
APPENDIX D

Ratio Analysis of Financial Statement in Samsung Heavy Industries









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