Korean Economy Series

KES 08-02, October 2008

Mergers and Acquisitions in Korea: The Leading Edge of Foreign Direct Investment

By Arthur J. Alexander

US·KOREA INSTITUTE AT SAIS

1740 Massachusetts Avenue, NW Washington, DC 20036

Tel: (202) 663-5830 Fax: (202) 663-5736 www.uskoreainstitute.org

Dr. Arthur Alexander is the Mitsui adjunct professor on Japan at Georgetown University and a professional lecturer at Johns Hopkins University's Paul H. Nitze School of Advanced International Studies. From 1990-2000, he served as the president of the Japan Economic Institute in Washington, D.C., where his research focused on Japanese economy, industry, technology, and innovation. Prior to that, he was a member of the research staff at the Rand Corporation and was the associate head of its economics department from 1977 to 1985. His experience also includes working as a research associate for the International Institute for Strategic Studies in London, and as an advisor and consultant to a wide range of industry and government clients. Dr. Alexander has been widely published in academic journals, magazines, and newspapers. His book on the Japanese economy, *In the Shadow of the Miracle*, was published by Lexington Books in 2002; and his most recent book, *The Arc of Japan's Economic Development*, was published by Routledge (London) in November 2007.

Note: This paper was prepared exclusively for the U.S.-Korea Institute's Korean Economy Working Paper Series.

The U.S.-Korea Institute at SAIS (USKI) is part of an extensive program which began in 2006 to make SAIS a hub of Korea-related activities in the Washington, D.C. area. USKI's mission is to increase information and understanding of Korea and Korean affairs in the United States through innovative research, educational and policy forums, and interaction with leading U.S. and Korean policymakers. USKI is generously funded by the Korea Institute for International Economic Policy, the Korea Foundation, and private Korean and American donors. To find out more about USKI, visit www.uskoreainstitute.org.

Mergers and Acquisitions in Korea: The Leading Edge of Foreign Direct Investment[1]

Three main trends characterize global foreign direct investment (FDI): it is reaching new highs, driven by increased cross-border mergers and acquisitions (M&A); there has been a growing importance of private equity and other collective investment funds; and services now account for the bulk of world inward FDI. (UNCTAD 2007, xv-xvi)

These observations about the global economy are directly applicable to Korea, where many of the main trends are occurring. The importance to Korea of these observations is that they signify new approaches to investment across a different mix of industries by different kinds of players. The shifting circumstances surrounding FDI means that government agencies are involved in oversight that are new to the issue and that competition is affecting domestic industries and companies in new ways. Consequently, public perceptions of foreign investment are being challenged by the new actors, many of which often are seen to lack legitimacy by private citizens as well as by many government officials.

The importance of FDI to Korea stems from two sets of circumstances. First, Korean economic development is now in a phase of deceleration, a common occurrence among successful developing economies. For the past 40 years of high-speed growth, the nation depended on rapid increases in the quantity and quality of capital, as well as on substantial improvements to human capital as evidenced by higher levels of education and training. However, future growth of the more mature economy will be decided by productivity gains coming from doing things better and more efficiently, rather than from simply expanding along the margins.

Second, by implication, anything that improves the incentives for higher productivity also enhances growth prospects. FDI has been associated with productivity gains in economies that possess a supportive infrastructure. Korea meets this requirement: a world-class educational establishment; an efficient transportation and communications infrastructure; and financial institutions learning to play in the international big leagues. However, FDI has been notably low in Korea, despite quite large increases of foreign presence that followed substantial opening since the mid-1990s. Therefore, investment by foreigners in Korea has the potential to make large contributions to the country's economic future.

This report reviews the principal source of Korea's FDI, its cross-border mergers and acquisitions. The major source of data is the same one used by UNCTAD, the SDC Platinum database compiled by Thomson Reuters Corp., which was acquired by The Paul H. Nitze School of Advanced International Studies (SAIS) at Johns Hopkins University for this research. The source covers approximately 672,000 M&A transactions from 1985 to the present; globally, since 1990. Each record includes transaction announcement and completion dates, names and nationalities of buyer and target firms, industries of participants, percent of outstanding shares that are acquired, and transaction value. Only about 60 percent of completed transactions list the deal's value; however, the missing information appears to be for smaller agreements, the absence of which does not seem to affect total dollar values significantly. The raw database includes many transactions that were never completed, mainly because the parties never reached agreement on the deal. To be included in the analysis, a transaction had to be completed and, following the definition of FDI, at least 10 percent of the target company's shares had to be owned by the buyer upon completion of the transaction. The date attributed to the transaction is the year the deal became effective, not the announcement date. Approximately 525 inward M&A deals met these criteria.

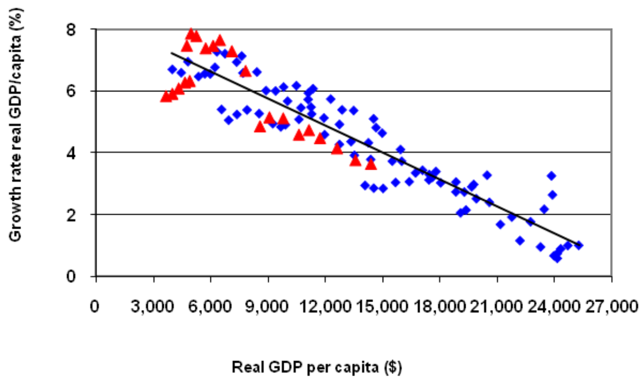
Growth Deceleration

A key rationale for examining FDI is that Korea's economy is slowing. The long-term norm for rich countries is GDP per capita growth of around 2 percent annually. Some countries do a bit better and others worse; however,

[1] This report is the second installment of a three-part series on FDI in Korea. The first was entitled: *Foreign Direct Investment in Korea:Trends, Implications, Obstacles* and is published at http://uskoreainstitute.org/research/special_studies#FDI.

none grow as fast as 3 percent over decade-long periods, and few sink below 1 percent. Figure 1 shows the growth experience of several of Korea's Asian high-growth neighbors – Singapore, Hong Kong, Taiwan, and Japan – as well as the trend for Korea itself.

Figure 1: Annualized 10-Year Growth Rate of Real GDP/Capita and Real GDP/Capita for Korea, Singapore, Hong Kong, Taiwan, and Japan (1980-2006, 2005 dollars at purchasing power parity)



Note: Korea denoted by triangles.
Source: World Bank 2007

The figure shows annualized 10-year growth rates from 1980 to 2006 on the vertical axis and real, per-capita GDP at the beginning of the 10-year period on the horizontal axis.[2] (World Bank, 2007) The triangles to the left show Korea's experience as it departs the ranks of developing economies. Its growth rate has been impressive, but is decelerating; national income per person tripled in just the past 15 years – to about half the level of its richest neighbors. Korea fits right into the pattern produced by the other countries; as their output per person increased, their growth rates slowed. Japan even fell below the one-percent lower bound for several years. If Korea follows the trend of its neighbors, its growth rate could hit 2 percent within 15 years or less.

The usual explanation for deceleration is that economies catch up with their potential; as they invest in more and more capital and technology and absorb the ideas and methods that others have already demonstrated, the benefits from being behind gradually vanish. The closer that countries approach the productivity frontier, the harder it is to maintain past rates of growth. New increments of output must come from squeezing more from the available resources. In other words, productivity becomes the key to future economic well being.

One method for absorbing technology, ideas, and methods from outside the country is through foreign direct investment. The economic benefits of FDI result from positive spillovers from foreign firms that provide technology, facilitate firm restructuring, promote international trade, strengthen competition, and support human capital formation.

M&A Trends

Foreign acquisition of existing domestic firms is one of the methods by which direct investment occurs. (See the appendix for discussion of the differences between FDI and M&A.) In general, host country characteristics that favor M&A over the establishment of new firms through so-called greenfield investments include the level of economic development, the absolute size of an economy, and the scale and sophistication of the domestic financial system (including the stock market). Other factors related to M&A are the price of local assets, determined, in part, by exchange rates and stock market prices. The reasoning behind these connections is that the larger and more developed a country, the more targets there are for M&A. Financial systems come into play because they help to facilitate deals and establish the value of enterprises. For the European Union, the ratio of M&A to total FDI is 80

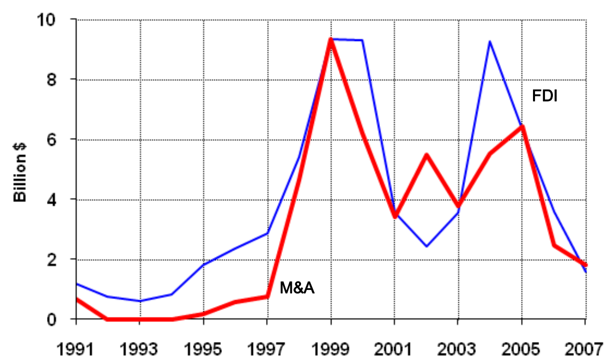
[2] The data for Taiwan are from the Penn World Table 6.2. (Heston et al 2006)

percent; the American and British values are close to 100 percent. In contrast, a country like China, with considerable FDI but still relatively undeveloped, has a share of M&A of only 10 percent. The Korean figure averaged over the four years from 2003-06 was 70 percent, midway between the highly developed and still evolving economies.

The 1997 financial and currency crisis that hit Korea and several of its East Asian neighbors created the conditions for a major turn-around in the role of FDI in Korea. The financial and corporate sectors, which required extensive restructuring in the wake of the crisis, created a demand for cross-border M&A.[3] Many of the large businesses and financial institutions that survived the crisis restructured through links with foreign investors. At the same time, the government removed many restrictions on FDI and vigorously promoted efforts to attract foreign investment. While the crisis provided the demand for foreign assistance, declines in the exchange rate as well as stock and land prices worked on the supply side by making Korea a more attractive place in which to invest.

Figure 2 shows the trends of FDI and M&A. Following initial liberalization in the early 1990s, FDI climbed from practically zero to $2 billion yearly by mid-decade. When the crisis hit, those numbers rose dramatically to more than $9 billion. An information technology investment boom coincided with the new opportunities in Korea at the end of the 1990s to reinforce the attractions of the country. When this surge subsided, FDI fell to pre-crisis levels. This decline was followed by another surge that peaked in 2005, partly stimulated by rising global liquidity. With the receding of that wave, FDI and M&A fell to 10-year lows.

Figure 2: Korea's Inward FDI and M&A (1991-2007, billion $)



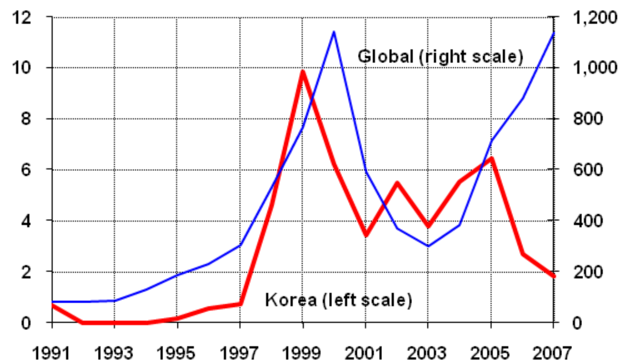
Sources: Thomson Reuters and Bank of Korea

As suggested above, investment into Korea is influenced by global forces, as well as by local conditions. Figure 3 illustrates this point by comparing global M&A with the Korean experience. Both trends rose throughout the 1990s, with Korea peaking a year before the global high. Following a collapse of international capital flows, recovery followed as investors with plenty of cash went hunting for targets. While cross-border M&A hit new worldwide records in 2006 and 2007, Korea's fell in both years. This divergence of trends suggests that something is weakening Korea's participation in the global M&A market.

Korea's relative attraction as a target for M&A is shown in Figure 4, where both FDI and M&A are graphed as a percentage of GDP. The differences between the two show up clearly; China, which has had substantial flows of total FDI into the country in recent years, attracts relatively low amounts of M&A. Mexico is pictured both prior to its entering the North American Free Trade Agreement (NAFTA), as well as in the latest data; NAFTA had a stronger effect on total FDI than on M&A. The richer euro area has a high amount of FDI, most of which is through M&A. Korea sits uncomfortably in the middle of these ranges. Its FDI is small compared to still developing China, but also compared to the euro area. However, its share of FDI coming from M&A looks more like the rich countries' experience. Only Japan seems to be in a similar situation. (Japan's FDI is smaller than its M&A because of

[3] These points are made by OECD analysts. (OECD 2007: 150)

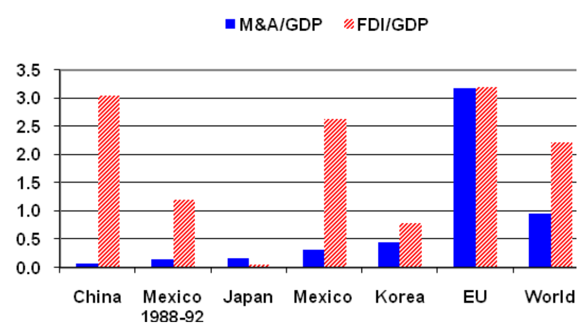
Figure 3: Korean and Global Cross-Border M&A (1991-2007, billion $)



Sources: Thomson Reuters, UNCTAD 2007

foreign withdrawals of capital that do not show up in the M&A data.) Korea has neither the volume of greenfield investments of China nor the M&A of richer countries. Its experience is more like pre-NAFTA Mexico, unlinked to the larger world of capital and business. However, unlike Mexico, Korea has world class technologies and businesses. Its potential for M&A appears to be high.

Figure 4: Ratios of Inward FDI and M&A to GDP, Selected Regions (2003-6, percent)



Source: UNCTAD 2007

The alert reader might note some caution in the last sentence: Korea's potential *appears* to be high. Economies differ enormously across important dimensions. How does the bundle of characteristics that describes Korea compare with that of other countries in denoting FDI or M&A attractiveness? One way to answer that question is to derive a relationship between a set of explanatory variables and FDI or M&A flows. UNCTAD has attempted to do this with its Inward FDI Potential Index. The index is based on 12 economic and structural variables converted to scores in the range of zero to one. The index is simply the unweighted average of the scores. (UNCTAD 2002: 34-6) Unfortunately, the FDI potential index is poorly correlated with UNCTAD's FDI performance index. (The correlation coefficient between the two indices is only 0.14 – omitting outlier Luxembourg.) Korea ranks in the top 20 in terms of potential, but is in 80th place when it comes to FDI performance. The United States is number one in potential, but does just a bit better than Korea in UNCTAD's performance index; this, despite the U.S. being the top target for foreign investors in most years.

Seeking to improve on this situation, I examined the economic literature on FDI and M&A potential. Most survey articles note that the explanatory factors used to clarify behavior differ across studies and also demonstrate highly variable effects from study to study. One research paper, though, attempted to place bounds on the wide range of results by examining the stability of the statistical estimates when various combinations of variables were used. Several variables were found to have stable influences: GDP, the ratio of exports to GDP, the number of telephone lines per capita, and a measure of country risk. (Moosa and Cardak 2006: 208) These variables also are included in the UNCTAD index. GDP measures absolute size of an economy; exports are an indicator of the economy's international linkages; telephone lines act as a proxy for infrastructure; and country risk provides a measure of political stability.

When I estimated equations based on these findings, Korea did turn out to be under-performing. Actual inward FDI flows in recent years have averaged around 0.8 percent of GDP. Predictions based on Korea's economic characteristics in a cross-section sample of 122 countries are in the range of 4.0-5.5 percent, depending on the exact specifications of the equations. Therefore, according to these results, Korean FDI potential is approximately five times its performance.

I suggested earlier that M&A might be influenced by different forces than those that affect greenfield investments. The contrasting cases of China and Europe illustrated this contention. Not surprisingly, academic attention has been devoted to this issue. Do the same explanatory variables that seem to help predict FDI do as well with M&A, or is there a different set? One study suggests that the same set of variables act on both aggregates of foreign investment, but with different weights. (Globerman and Shapiro 2004: 28) I estimated M&A equations using the UNCTAD set of variables, and, indeed, the same ones that were significant for FDI turned out to be important for M&A. Again, M&A into Korea is considerably less than predicted based on the country's characteristics; the actual value has been around 0.5 percent of GDP whereas the predicted values are in the range of 1.7-1.9 percent. The econometric results support the graphical conclusions that Korea's foreign M&A activity is lower than expected based on comparative statistical evidence.

Digging into the M&A Deals

The Thomson Reuters database of M&A transactions includes 523 completed foreign acquisitions of Korean companies in which more than 10 percent of the shares were owned by the buyer after the deal. (Spinoffs and divestitures with numerous, unknown buyers are excluded from this selection.)

Almost 60 percent of the records include the monetary value of the transaction.[4] Table 1 shows the total number of foreign acquisitions of domestic firms (these are often called "out-in" transactions as opposed to domestic deals, or "in-in") and the average value of those that include this information. The annual sums of these data are within a percent or two of UNCTAD's reported figures; for many years, the data are identical.

Table 1: Number and Value of Cross-Border M&A Transactions in Korea, 1995-2007

Year	Number of Transactions	Average value (million $)	Total value (million $)
1995	10	24	194
1996	14	81	564
1997	10	149	747
1998	59	136	4,620
1999	94	186	9,837
2000	56	201	6,230
2001	38	156	3,421
2002	31	288	5,473
2003	38	190	3,795
2004	60	158	5,530
2005	35	268	6,429
2006	36	128	2,691
2007	22	121	1,812

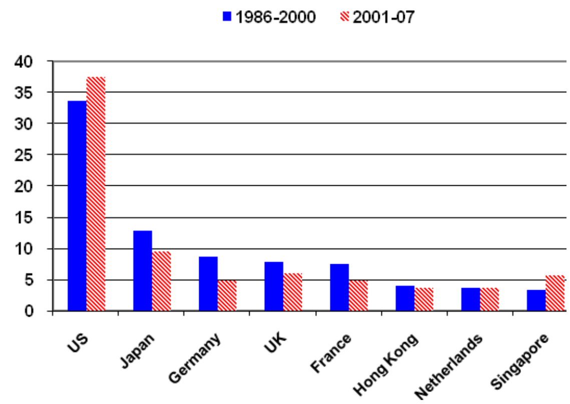
Note: Average transaction value calculated only for transactions with value data.
Source: Thomson Reuters

[4] Tests of possible differences between transactions with and without value information indicate that the samples are quite similar. Comparisons were made of target and buyer industries and buyer countries to test for possible differences; the sub-samples were almost identical in these dimensions. According to the data compilers, deals without value information typically are small ones and do not significantly influence the totals.

As noted previously, the number of deals peaked in 1999 with almost 100 completed that year. They declined subsequently; the most recent is less than one-quarter of the peak year. The average scale of the transactions, however, continued to climb until 2002 when it reached more than a quarter billion dollars. In 2006-7, the typical deal fell to less than half that amount. Thus, in the most recent figures, there were declines in the aggregate number of transactions, their average size, and total value.

What are the characteristics of foreign takeover deals, how may they have changed over time, and how do they compare with both domestic M&A and other international deals? Figure 5 shows the national origins of foreign buyers for two periods, 1986-2000 and 2001-7. The American share of all transactions has been somewhat greater in the recent period, whereas Japan and the other major players reduced their participation by small amounts. The top 10 countries accounted for 90 percent of the transactions in 1986-2000, but only 80 percent in 2001-7 as firms in more countries participated in international M&A. Overall, however, the picture remained much the same over the years.

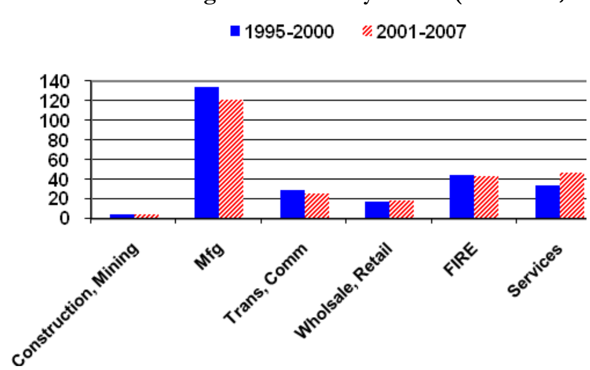
Figure 5: Country Origins of Korean Inward M&A (1986-2007, percent of each period's transactions)



Source: Thomson Reuters

As the Korean economy has developed and matured, we might expect a shift in the industries of target firms. Figure 6 shows the percentage of transactions by broad industry groups over the same periods as above – 1986-2000 and 2001-7. (Industries are classified at the so-called 1-digit sectoral level based on the four-digit Standard Industrial Classification.) Almost the same number of transactions occurred in both periods, 263 and 260. Manufacturing in the country grew steadily as a share of the total economy until the late 1980s, held steady for the next 20 years, and then trended slightly downward in the last few years. Domestic companies' strength in manufacturing provided an attractive target to foreign buyers as they were the single largest target industry in both periods. In the second period, manufacturing dropped a little and services rose, but overall the pattern did not shift markedly.

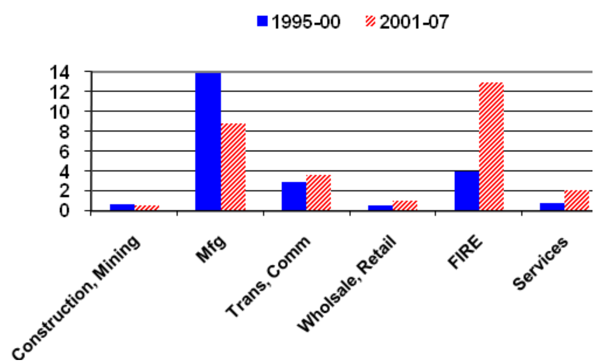
Figure 6: Inward M&A Target Industries by Period (1995-2007, number)



Note: Industries are defined at the "1-digit" level in the Standard Industrial Classification (SIC). FIRE: Finance, insurance, real estate.
Source: Thomson Reuters

If we look at the value of transactions, however, the picture is different. As seen in Figure 7, the value of manufacturing deals dropped by almost 40 percent while foreign investments in financial companies increased by more than three times. Several multi-billion dollar agreements led the list; one of the largest was the Standard Chartered 2005 acquisition of Korea First Bank from Newbridge Capital – an earlier rescuer of the Korean bank – and from the state-owned Korea Deposit Insurance Corp. for 3.4 trillion won ($3.3 billion). Other such deals included Citigroup's 2004 buyout of Koram Bank for $1.6 billion and Lone Star Funds' $1.2 billion investment in Korea Exchange Bank in 2004. Also included in this category were several large insurance company and real estate deals worth several hundred million dollars each. Lone Star subsequently encountered serious problems when trying to sell its shares.

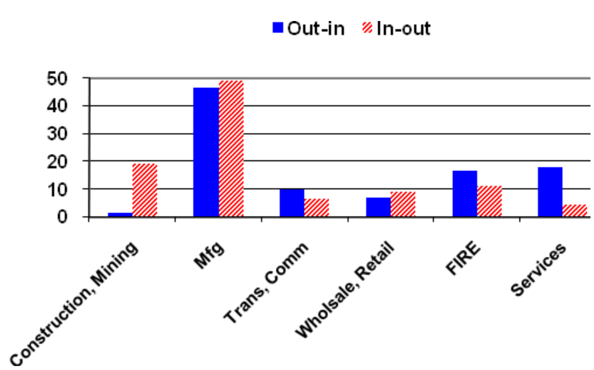
Figure 7: Inward M&A Value by Major Industry (1995-2007, billion $)



Note: Industries are defined at the "1-digit" level in the Standard Industrial Classification (SIC). FIRE: Finance, insurance, real estate.
Source: Thomson Reuters

How unique is the pattern of investment into Korea? One approach to answering this question is to compare out-in deals with in-out: Korean companies' investments in the rest of the world. Figure 8 shows the percentage of both types of deals in the period 2001-7. Two distinct features appear in the chart: First, close to 20 percent of all Korean outward M&A is in the construction industry, as domestic firms made strong gains around the world. Second, foreign service industry firms have picked up a larger share of domestic firms in the industry than is seen in the other direction. As the rich countries move out of manufacturing and into services, their products, technology, and efficiency improved. Korea remains a manufacturing power and its productivity in services remains well behind domestic manufacturing operations.

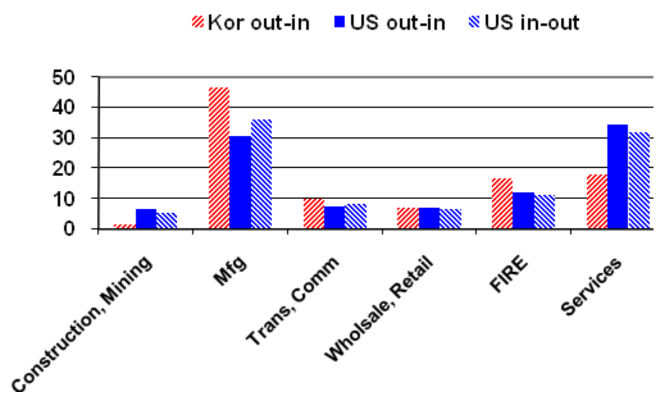
Figure 8: Korea's Inward and Outward M&A Target Industries (2001-7, percent of all transactions)



Note: Industries are defined at the "1-digit" level in the Standard Industrial Classification (SIC). FIRE: Finance, insurance, real estate.
Source: Thomson Reuters

Another revealing comparison is with investments into and out of the United States. The American economy is considerably less devoted to manufacturing than is the Korean, and more intensely oriented toward services. These differences show up in the M&A data (Figure 9). Manufacturing represents almost half of all Korean inward deals, but only about one-third of the American. The emphasis is reversed for services; fewer than one-fifth of the Korean transactions are in services, whereas they account for more than one-third of the American. Because of the Korean financial crisis, finance comprised a little greater share of the Korean deals than of the American.

Figure 9: Korean and US M&A by Target Industry (2001-7, percent of transactions by type)



Note: Industries are defined at the "1-digit" level in the Standard Industrial Classification (SIC). FIRE: Finance, insurance, real estate.
Source: Thomson Reuters

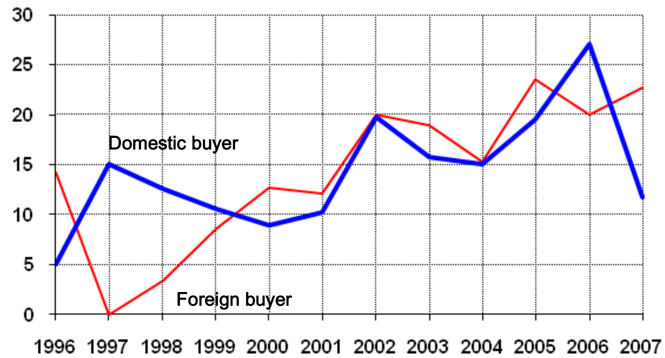
The relative low level of inactivity in Korean services industries' M&A requires additional comment. Note that Korean outward investment in services comprises only 4 percent of all such transactions whereas the sector accounts for 18 percent of incoming investments, but still only about half the American activity in this sector. These differences are telling indicators of the low productivity levels in Korean services. According to OECD estimates, value-added per worker in services is 65 percent of the manufacturing figure; wholesale and retail trade, hotels, and restaurants show productivity less than 30 percent of manufacturing. In stark contrast, service sector productivity in the OECD countries as a whole is almost equal to that in manufacturing. (OECD 2007: 153)

Low productivity in the service sector arises from earlier economic development policies that deliberately favored manufacturing; investment capital restrictions, for example, penalized services. Continued regulation of large parts of the service sector, medical care for example, creates barriers to both foreign and domestic investors. An additional explanation for low service sector productivity is that entry barriers are generally higher in the service sector, weakening competition and resulting in a large number of small firms. Also, a large inflow of older workers into services as they retire from large firms at a relatively young age of 55 has tended to drive down productivity levels. (OECD 2007: 154) Regulatory restrictions also are one of the explanations for Korea's low inward cross-border M&A—a subject that will be discussed in the conclusions.

UNCTAD has noted the growing importance of private equity and other investment funds in global M&A deals. Consistent with this trend, the number of foreign financial companies acquiring nonfinancial Korean firms has been growing steadily. However, this phenomenon is as much a domestic affair as it is a foreign one. Figure 10 shows the percentage of annual transactions accounted for by financial companies' acquisitions of nonfinancial firms. From barely a handful in the 1990s, both cross-border and domestic transactions climbed to more than 20 percent of all Korean M&A after 2004. The reason for the drop in the share of domestic financial buyers in 2007 was not that the actual number of such deals fell but that a large increase in the total number of transactions masked the smaller relative rise of financial buyers; the number of financial buyouts rose to 35 in 2007 from 10 the previous year, while the overall number of transactions increased from 37 to 300.

The size of many of the largest transactions has climbed steadily over the years. Since 1999, the biggest deals routinely have been more than a billion dollars and the largest three have averaged almost that size. (Table 2). So important have the large deals become that they add up to a large fraction of total inflows from M&A. In fact, the

Figure 10: M&A Transactions with Buyer a Financial Company and Target Not Financial (percent of annual transactions of each type)



Note: Financial companies identified as 2-digit SIC codes 60-64, 67
Source: Thomson Reuters

largest single transaction has accounted for about 40 percent of all transactions in recent years and the big three add up to a full 70 percent. In the United States, by contrast, the big deals are a much smaller share of the total.

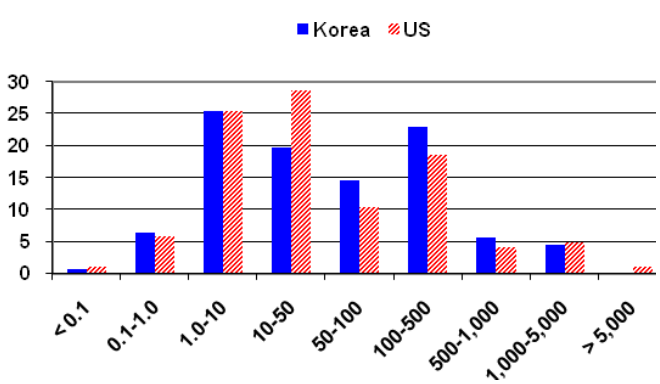
Table 2: Largest Cross Border M&A Deals in Korea and United States and Shares of Total (annual averages for 2001-7, million dollars and percent)

	Korea	U.S.
Largest transaction (million $)	1,696	14,808
Average top three transactions (million $)	965	9,898
Share of largest (percent)	41	14
Share of top three (percent)	70	28

Source: Thomson Reuters

One possible explanation for why the largest Korean inward M&A deals are such a high percent of the total is that there may not be many smaller deals; thus, the biggest ones represent larger shares of the total. However, if we compare distributions of transactions according to their size, Korea looks remarkably similar to the United States (Figure 11). The United States has a larger share in the $10-$50 million range and Korea in the two larger classes, but overall the distributions tell essentially the same story. The explanation for the differences in Table 2 showing larger shares for the biggest Korean transactions is that there are many more cross-border M&As in the U.S.: almost twenty times more. The effect is that any single one represents a smaller piece of the American pie. Therefore, even though the U.S. since 2001 experienced 32 inward takeovers worth more than $5 billion each and Korea had none

Figure 11: Distribution of Values of M&A Inward Transaction, Korea and U.S. (2001-7, million $, percent of country transactions)



Source: Thomson Reuters

that size, these megadeals accounted for just 1 percent of the of the almost 3,000 U.S. transactions that included value information.

Although the eye-catching share of foreign megadeals in Korea comes mainly from the statistical artifact produced by a relatively small number of foreign takeovers, their psychological impact is real. The multi-billion dollar acquisitions appear to represent a foreign invasion of the Korean economy simply because of their relative rarity. Another source of popular anxiety is that many of the substantial acquisitions are in industries that have been under tight government regulation and ownership. Table 3 shows the breakdown of transactions valued above $50 million. In the financial sector, three-quarters of the transactions fell into the top category, compared to only one-third of manufacturing deals.

Table 3: M&A Transactions by Major Industry with Value Greater than $50 Million (2001-7)

	Number of transactions	Percent greater than $50 million
Construction, Mining	3	100
Manufacturing	67	34
Transportation, Communications	20	55
Wholesale, Retail	10	40
Finance, Insurance, Real Estate	27	74
Services	27	48
Total	157	48

Note: Includes only transactions with value information.
Source: Thomson Reuters

The criterion for counting M&A transactions as a form of FDI is that at least 10 percent of the target's shares be owned by the foreign investor following completion of the transaction. However, that level of ownership does not normally grant much management control. Table 4 gives a breakdown of the shares held by the foreign investor in the M&A database. For comparison, Japan and the United States are included; Japan's FDI penetration is as low as Korea's, whereas the United States is the largest target for global takeovers.

Table 4: M&A Transactions by Shares Acquired by Foreign Investor (2001-7, percent of country transactions)

Shares acquired (%)	Korea	Japan	U.S.
10-19	7.7	19.1	1.8
20-29	8.8	9	1.6
30-39	6.5	7.1	0.9
40-49	5.4	4.8	1
50-59	10.4	5.7	2.3
60-69	2.7	5.9	0.8
70-79	3.1	3.2	1.1
80-89	5.8	3.6	1.6
90-99	3.8	3.6	0.8
100	45.8	38	88.3

Source: Thomson Reuters

The differences among the three countries in Table 4 is striking. Almost 90 percent of American deals involve all the target company's shares; less than half do so in Korea and only 38 percent in Japan. Indeed, 30-40 percent of the deals in Korea and Japan are for minority shares, whereas only 5 percent settle for minority status in the United States.

What could explain these findings? Corporate law in these countries is not much help. For most corporate decisions coming before shareholders as represented by the boards of directors, 50-percent majorities carry the day. However, some major changes in corporate strategy require super-majorities of 60 percent or two-thirds; in such cases, acquiring those shares can guarantee an outcome, or the complementary number of shares among opponents can block a decision. Those break-points, however, are not significant in the distributions of acquired shares.

Acquiring firms might prefer to join target firms as partners, each bringing different assets to the deal; for example, the local business group would have knowledge of domestic markets and relations with local suppliers, buyers, and finance whereas the foreigner may have unique technology, products, or other know-how. Possibly, the foreign investor desires a domestic partner to help in an unfamiliar locale. The problems with this hypothesis is that it is as likely to be true for American M&A.

Another possible explanation is that corporate groups in Japan and Korea (*keiretsu* and *chaebol*) own shares in a wide variety of companies, many of which are foreign M&A targets, and are unwilling to sell out completely to foreign investors. To test this proposition, I divided the sample of target companies into two sub-samples, depending on *chaebol* membership. A company was classified as a *chaebol* member if its name suggested that it belonged to one of the top 40 groups reported by the Korea Fair Trade Commission (KFTC 2003). Additionally, if the transaction description mentioned group membership, the company was so assigned. For example, this admittedly imperfect process assigned the *chaebol* label to any target company that included Hyundai in its name. Altogether, 44 target companies were given the *chaebol* label for the years 2001-7.

The *chaebol* distinction, however, had no power in explaining why so few Korean inward M&A deals ended up with a large chunk of the target companies. The share of deals in which 100 percent of the target firm was acquired was almost identical across group and non-group firms, as was the average number of shares owned following the transaction. The only significant difference was in the size of the transaction: $423 million for *chaebol*-labeled firms and $134 million for the others. Therefore, even though the scale of acquisitions was larger for group firms, the share of the company that was acquired was no different.

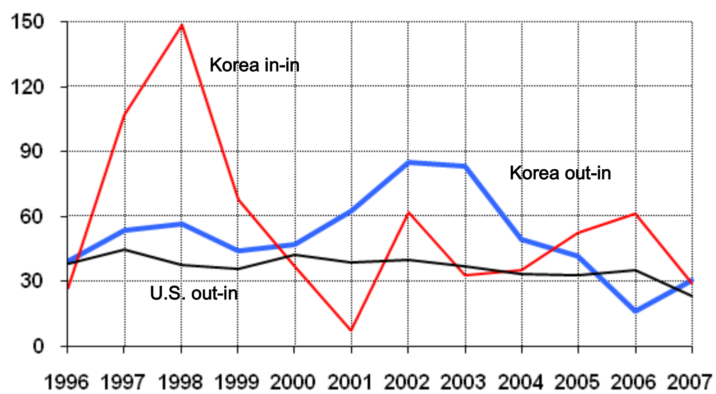
Another version of this story is that Korean minority shareholders, whether a *chaebol* or not, do not want to sell large or controlling interests in their companies to foreigners for possibly xenophobic reasons, an argument that could also apply to Japan. According to some findings, both Korea and Japan are unusually suspicious of foreigners.

To test the hypothesis about a link between xenophobic sentiments and inward M&A, I searched for international surveys that probed domestic qualms about foreign presence or influence. In May 2003, the Pew Research Center for the People and the Press asked the same question in 43 countries. "Do you completely agree, mostly agree, mostly disagree, or completely disagree with the statement: Our way of life needs to be protected against foreign influence." Among the Korean respondents, 82 percent agreed with these sentiments (30 percent completely agreed and another 52 percent mostly agreed); this response placed Korea in ninth position of most protective of domestic values among the 43 countries. American respondents agreed with the statement 64 percent of the time and Japanese 63 percent. These results do not clearly point to any conclusions. One potential confounder of a relationship is that other things influence FDI and M&A in addition to emotional feelings about foreign influence.

To further investigate the possible influence of sentiments, I inserted the survey results into the equations previously estimated to explain the ratio of M&A to GDP. The original variables were GDP, the ratio of exports to GDP, and the number of telephone lines per capita. The results were not as clear as I had hoped. The two agreement variables from the survey (completely and mostly agree) had negative effects as expected, but were statistically insignificant. That is, the more that people tended to answer that their way of life should be protected from foreign influence, the less inward M&A occurred. However, the disagreement variables also had negative coefficients, and verged on significance, contrary to what I had expected. Various combinations of these variables did not change the results. When all four survey responses were included in the equation, the predicted value of Korea's M&A to GDP fell from 1.8-1.9 percent to 1.6 percent; the actual value in recent years averaged 0.44 percent. We can conclude that, based on this one attempt at using survey data, sentiments do not have a very great influence on inward M&A.

What else could be explaining the low rate of foreign investment into Korea? A measure of the difficulty in acquiring companies might be seen in the length of time it takes to complete a deal. Regulatory, legal, or business barriers or other kinds of foot-dragging might deter potential foreign investors from even venturing into the country. The Thomson Reuters database includes the date on which a proposed deal is announced and the date on which it comes into effect. If there was an inordinate amount of time tied up in negotiating with government authorities or minority shareholders, or if there were other delays, it could be a signal of local reluctance to sell to foreigners. According to the information charted in Figure 12, the average amount of time it took to complete an inward transaction fell from 60 days in the early 2000s to under 30 days in 2006 and 2007. Domestic deal delays rose sharply in 1997 and 1998 during the Asian crisis when financial and business uncertainty became an overwhelming obstacle to deal-making. Since then, however, delays are similar for domestic and international transactions. Moreover, both types of Korean transactions are converging with the American times such that by 2007, they were all hovering around an average 30 days. Indeed, 55 percent of Korean and U.S. deals record no delays at all, and 67-70 percent become effective within 30 days. Consequently, we cannot look to obstructionist holdups for explanations of the relatively low rate of M&A in Korea.

Figure 12: Average Number of Days between Announcement and Effective Date, Korea and U.S., 1996-2007



Source: Thomson Reuters

Conclusions

The data tell two stories. Korea's rate of inward M&A is small for a country moving into the ranks of the rich economies. Indeed, along with its neighbor, Japan, it is near the bottom of the list of M&A recipients. Among middle income economies, only Brazil, Argentina, and Venezuela have even less M&A than Korea.

The second feature is that the detailed characteristics of Korea's M&A are not especially notable. The aggregate flow for the most part has traced the global M&A trend, except for the last two years when global deals grew rapidly while Korea's fell. The country origins of foreign investors has been stable over time, as has been the target industries. The money flow shifted into finance after Korea's financial crisis in the late 1990s, with less going into manufacturing; however, this change is to be expected, given that the crisis left many financial firms in distress. There is little difference in the industries between Koreans investing abroad and foreigners investing in Korea. However, M&A into Korea compared to the United States has tended to favor manufacturing over services, a difference partly explained by the post-industrial character of the American economy. The other explanation is the backwardness of much of the Korean service sector, plus regulations that act as barriers to inward investment. The rise of private equity has grown at the same rate in Korea as elsewhere, both across borders as well as domestically. The Korean size distribution of transactions values is surprisingly similar to the U.S., although the U.S. does have more very large deals.

What is different and remains unexplained is that most transactions in the United States are for 100 percent of a target firm's shares, whereas less than half of Korea's deals end up with the whole company; in fact, 30 percent of the deals settle for less than half compared to just 5 percent of the American deals. Neither *chaebol* membership nor popular sentiments against foreigners explains these differences.

We are left with the central questions: what accounts for the low rate of foreign investment, and what can be done to correct the situation? There are at least two leading explanations. The first one centers on foreign perceptions of Korea's receptiveness to outsiders. This possibility is illustrated by the management consultancy A.T. Kearney's annual FDI confidence index based on the likelihood of direct investment in a market over the next three years. Korea's ranking among 25 countries declined from the 15th position in 2000 to next to last in the most recent 2007 survey. (A.T. Kearney 2007) Despite the real changes occurring in Korea's openness to global business and the official wooing of foreign investors, other countries are trying even harder and perceptions remain that underlying emotions create barriers to foreigners.

One prominent example is that when U.S.-based Lone Star Funds announced that it intended to sell its majority shareholdings in the Korea Exchange Bank, it triggered at least four separate government agency investigations, none of which was initiated until after the announcement to sell at a $4.5 billion profit. The investigations generated accusations that the government was responding to domestic anger over excessive tax-free profits by foreign firms. The government's assertions that it was not targeting Lone Star failed to convince foreign observers when the finance ministry sought to apply new tax laws retroactively to eliminate similar tax havens. As described in a Heritage Foundation report, "regulatory agencies stepped up raids against foreign firms and levied fines to gain tax revenues, and the National Tax Service, in April 2006, announced a new campaign to investigate 4,889 firms in which foreign investors owned at least 10 percent share holdings to determine whether they profited from unwarranted tax benefits." (Klingner and Kim 2007: 6)

A second example was the attempted hostile takeover of Korea Tobacco and Ginseng in late 2005 by American corporate raider Carl Icahn, which set off renewed alarms. Regulators considered defensive measures to protect domestic companies from foreign hostile takeovers. The chairman of the Financial Supervisory Commission indicated that he was considering regulations to protect companies with state investment and firms regarded as strategically important against speculative foreign capital. The Federation of Korean Industries asserted that foreign takeover threats may jeopardize South Korea's economic recovery and long-term national competitiveness.

Although there has never been a successful unsolicited takeover bid for a Korean firm by foreign investors, three unsuccessful attempts prompted demands from Korean companies for increased protection. Business groups argued for the inclusion of poison pills, golden shares, and multiple voting rights to allow them to fight unsolicited take-overs. According to the OECD's annual report on Korea, "The Federation of Korean Industries also argued for an end to the 25 percent shareholding ceiling imposed on *chaebol*-affiliated companies as it makes them more vulnerable to unsolicited takeover bids. These demands were rejected on the grounds that they are inconsistent with global standards and violate the equal treatment of shareholders principle of the Commercial Code." (OECD 2007: 157)

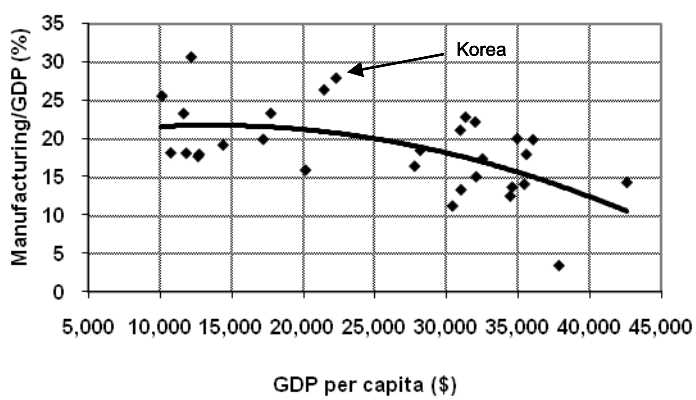
The Economist Intelligence Unit's report on Korea summarizes these sentiments: "The persistence of economic nationalism among government officials and the population at large means that foreign investors are often made to feel unwelcome in South Korea. … This has somewhat dented the government's efforts to become a business and economic hub for the north-east Asian region." (Economist Intelligence Unit 2008: 27) Even though Korea has removed most restrictions on foreign investment, promoted the idea from the top of government on down, and established an investment promotion agency and an FDI ombudsman, perceptions persist that Koreans are unwilling to accept outside investors.

The second major explanation for low FDI lies in Korea's domestic markets. Overall, formal restrictions on FDI are slightly weaker than the OECD average. However, investment in 26 sectors, primarily services, such as transport, telecommunications, and electricity remain restricted by limits on foreign ownership; the OECD index of FDI restrictions in these sectors is above the average of member countries.

A good deal of research performed under OECD auspices has shown that general product market regulations impose significant barriers to FDI. Product market regulations have become more significant obstacles to FDI as explicit restrictions have been eliminated. Korea's regulations were ranked as relatively restrictive in the "barriers to entrepreneurship" sub-category, which includes regulatory opacity, administrative burdens on start-ups, and barriers to competition. In services, Korea was ranked as the fifth most restrictive country. The OECD reports that restrictive product market regulations and regulations on foreign ownership in some sectors help to explain why the share of Korea's FDI stock in services is one of the lowest in the OECD area. In particular, regulations restricting new investment in the capital region, which are intended to promote balanced national growth, are frequently cited as a major obstacle to FDI. "The preference of foreign investors for the capital region, given its high quality infrastructure, the availability of skilled human resources, and access to a large market, conflicts with the government's objective of developing other parts of the country." (OECD 2007: 159)

The importance of non-manufacturing industries to Korea's economic future is shown in Figure 13. The figure plots the share of manufacturing in GDP for 30 medium-to-high income countries. Manufacturing share is plotted against GDP per capita. The data indicate that manufacturing declines in relative importance as countries become richer. The fit is not tight, though; at every income level there is a range of manufacturing shares, highlighted by Hong Kong whose 3-percent share demonstrates a growth path that favored services. Korea, at 28 percent manufacturing, is 7 percentage points more involved with industrial production than one might predict from this array of experiences.

Figure 13: Manufacturing Share of GDP (%) and GDP per Capita (2005 PPP $)



Note: 30 countries with GDP per capita greater than $10,000 and population greater than 5 million.; best-fit line shown.
Source: World Bank 2007

Because of Korea's low productivity in services as well as the small amount of foreign investment in the sector, the potential gains from greater foreign participation are large. However, improvements will require difficult and challenging political and policy moves to further open and deregulate telecommunications, healthcare, finance, transportation, and public media, such as television and publishing. Not only are these areas technically complex to open up, but the benefits currently enjoyed by incumbents represent potent political barriers to change. Nevertheless, Korea's economic future depends on such moves, hardly less challenging than those already undertaken by the nation. The policy issues dealing with increasing FDI will be explored in the final report of this series.

Appendix: Definitions of FDI and M&A

FDI is a balance-of-payments concept involving the cross-border transfer of funds.[5] The International Monetary Fund's balance of payments manual provides definitions and instructions to member countries for compiling FDI data. (IMF 1993) FDI is defined as an investment by a resident entity in one economy, in an enterprise that is resident in another economy, involving a long-term relationship; the long-term relationship is presumed to imply a lasting interest and significant degree of influence by the investor. Such investment involves both the initial transaction between the two entities and all subsequent transactions between them. For statistical purposes, the IMF defines a direct investment relationship to exist when the investor has acquired 10 percent or more of the ordinary shares or voting power of an enterprise abroad.

The lasting interest typically involves the establishment of manufacturing facilities, bank premises, warehouses, and other permanent or long-term organizations abroad, but it may also involve the operation of mobile equipment such as drilling rigs and construction activities, and expenditure on exploration for natural resources. It may involve the creation of a new establishment abroad in the form of so-called greenfield investments, joint ventures, or the acquisition of an existing enterprise abroad (M&A). The direct investment enterprises can be incorporated, unincorporated, or nonresident individuals.

Once established, additional FDI can involve injections of further equity capital, the reinvestment of earnings not distributed as dividends, and inter-company long- and short-term debt, including trade credits and loans. Reinvested earnings comprise the direct investor's share of earnings not distributed as dividends by affiliates, or earnings not remitted to the direct investor. The sale of foreign-owned FDI assets to a domestic buyer enters the FDI flows as a negative number.

Korea has improved its FDI reporting since 2000 to bring its information into consistency with IMF rules. However, these data depart from the guidelines in two main ways. First, Korean authorities look for signs of foreign control in addition to the 10-percent rule; foreign investors may be given FDI status with fewer shares, or may not be included in FDI if they possess more than 10 percent but do not exercise significant control. Nevertheless, the 10-percent guideline prevails in most cases. Second, data are not collected for reinvested earnings and intra-firm loans shorter than five years, both of which may result in underestimations of FDI flows.

Whereas FDI statistics are compiled by government agencies, cross-border M&A data typically are produced by private, commercial companies; in this report, the database was obtained from Thomson Reuters. The detailed information comes from news reports, stock market filings, law firms, and surveys by investment banks and other M&A advisors; additional information is from direct communications between the compilers and private companies. The compilers often have a cutoff for the minimum size of the transactions that they cover; in many cases, smaller deals fall beyond their scrutiny and do not appear in the compilations. For these reasons, M&A data often miss many smaller transactions, but tend to capture a high proportion of total M&A value.

In some cases, M&A transactions conform to the FDI definition as far as the equity share is concerned. However, the data also include purchases on domestic and international capital markets, which should not be considered as FDI flows. Although it is possible to distinguish types of financing used for M&As (for example, syndicated loans, corporate bonds, or venture capital), it is not always possible to trace the origin or country-sources of the funds used. Therefore, M&A data may include funds not categorized as FDI.

FDI flows are recorded on a net basis (capital account credits less debits between direct investors and their foreign affiliates) in a particular year. M&A data are expressed as the total transaction amount of particular deals, and not as differences between gross acquisitions and divestments. Transaction amounts recorded in the M&A statistics are those at the time of closure of the deals even though the actual funds are not necessarily paid out in a single year.

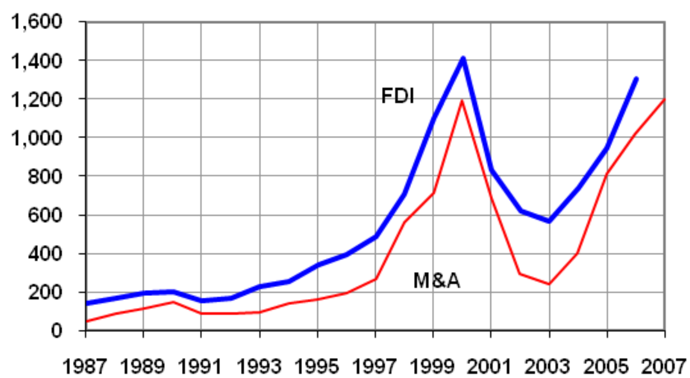
[5] This description is based on OECD and IMF definitions and descriptions.

Sales of M&A assets are not considered as negative amounts, but show up as a separate transaction, either domestic or cross-border.

While M&A activity is only one element in total FDI flows, it often accounts for a large share of the total in the more developed economies. This is especially true when overall investment activity is strong, as M&A tends to respond most directly to changes in the business climate, financial conditions, and macroeconomic developments. Such trends have been true for Korea where M&A value closely tracks total FDI.

Appendix Figure 1 compares the global trends of FDI and M&A. Clearly, FDI is closely associated with the abrupt ups and downs in M&A. FDI is larger because greenfield investments are not captured by M&A transactions and because reinvested earnings and other ongoing capital infusions often are missing in the M&A data. Because M&A deals tend to be governed by current conditions, they vary more than the more inclusive FDI, which incorporates the ongoing flow of reinvested profits. Because of the quicker-changing nature of M&A, the information embedded in such deals provides a picture of the current situation of particular economies relative to global conditions.

Appendix Figure 1: Global FDI and Cross-Border M&A (1987-2007, billion $)



Source: UNCTAD 2007

Bibliography

A.T. Kearney, Inc. (2007) New Concerns in an Uncertain World: The 2007 A.T. Kearney Foreign Direct Investment Confidence Index.

Economist Intelligence Unit (2008) *Country Profile: South Korea.*

Globerman, S. and D. Shapiro (2004) *Assessing International Mergers and Acquisitions as a Mode of Foreign Direct Investment*, Paper prepared for Conference on Multinationals, Growth and Governance, in Honor of A. Edward Safarian, Toronto.

Heston, Alan, Robert Summers and Bettina Aten (2006) *Penn World Table Version 6.2*, Center for International Comparisons of Production, Income and Prices at the University of Pennsylvania, Philadelphia.

International Monetary Fund (IMF) (1993) *Balance of Payments Manual*, fifth edition, Washington.

Korea Fair Trade Commission (KFTC) (2003) *Business Groups Under Regulations in 2003*.

Klingner, Bruce and Anthony Kim (2007) "Economic Lethargy: South Korea Needs a Second Wave of Reforms," *Backgrounder*, Heritage Foundation, December 7, 2007, No. 2090.

Moosa, I. A. and Cardak, B. A. (2006) "The Determinants of Foreign Direct Investment: An Extreme Bounds Analysis," *Journal of Multinational Financial Management* (16).

OECD (2005) *Economic Surveys Korea*.

OECD (2007) *Economic Surveys Korea*

World Bank (2007) *World Development Indicators - 2007*, Washington.

UNCTAD (2002) *World Investment Report 2002: Transnational Corporation and Export Competitiveness*, New York and Geneva: United Nations.

UNCTAD (2007) *World Investment Report 2007: Transnational Corporations, Extractive Industries and Development*, New York and Geneva: United Nations.

World Bank (2007) *World Development Indicators 2007*.