ARGO ASSOCIATES

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Can President Moon reform the chaebols?

Now that China has grown to be the dominant economy in Asia, analysts sometimes forget that South Korea's economic rise is perhaps the most impressive growth story of any country in Asia. In the 1950s, South Korea was one of the poorest countries in the world. It had suffered from both colonialism and a brutal and lengthy war that ended up splitting the country in two. The country's extraordinary economic growth from the 1960s onwards was driven by the large family-owned corporations - some of them now global brands such as Samsung, LG and Hyundai – that are known as *chaebols*. The *chaebols* still dominate the South Korean economy - the five largest (Samsung, Hyundai, SK, LG and Lotte) account for more than half of the country's benchmark Korea Composite Stock Price Index (KOSPI). This dominance is regarded by some economists as now detrimental to the Korean economy, however much the companies may have acted as drivers of growth in the past. The *chaebols* are criticized as overly cautious and hierarchical, suppressing the innovation that could come from smaller enterprises, and often seen as exercising corrupt influence over Korean politicians. In addition, as management is concentrated on the owner and the owner's family, the *chaebols* are inefficient; they also abuse their dominant position through '*gap-jil*', a South Korean term for the bullying of firms lower in the economic hierarchy.

The current centre-left administration of President Moon Jae-in came to power with a promise to reform the *chaebols* and restrain their influence both economically and politically. But the *chaebols* have proved to be more tenacious in holding on to power than many had expected. How much has Moon really achieved and should foreign investors be cheering him on or concerned about his *chaebol* reform programme?

Moon started off his campaign to rein in the *chaebols* in aggressive fashion by appointing Kim Sang-Jo, a former shareholder activist known as a "chaebol sniper", as South Korea's Fair Trade Commissioner in May 2017. Only 14 months after appointing Kim as the Fair Trade Commissioner, however, Lee Jae-yong of Samsung accompanied Moon on his state visit to India. This was particularly surprising as Lee had been initially imprisoned and then, after appeal, given a suspended sentence on corruption charges. To some liberal pundits this was a clear symbol that the Moon administration had given up on reforming the *chaebols*.

Moon's economic policy

In his campaign President Moon pledged to boost the economy through three main strategies: income-lead growth, innovation-lead growth, and a "fair economy". The first step in this policy was a bold experiment in raising the minimum wage. In addition, this year the finance ministry proposed an increased national budget of KRW 470 trillion for 2019, which included a 22% increase in funds allocated to create jobs. To address inequality the government also laid out plans to impose tougher taxes on property ownership to rein in a supposed real estate bubble.

With regard to innovation-lead growth, though, the government is showing little progress. Many economists believe that South Korea should fundamentally re-orient its industries towards "value-added" technologies or risk being hollowed out by competition from China and India. *Chaebol* reform, and other policies to address widening inequality, even if successfully completed, are merely half the goal.

Intragroup deals

On 27 September 2018 Kim Sang-jo, the Fair Trade Commissioner, targeted one issue in particular in dealing with the *chaebols* in an interview with *Joongang Daily*, a South Korean national newspaper: intragroup deals. These deals, which typically favour affiliates owned by family members at the expense of third-parties and minority shareholders, are often used to cement family control during periods of succession from one generation to another. Although such deals are already regulated, some listed affiliates of *chaebols* are called "blind-spot companies", because they do not fall under current regulations (the term refers to those affiliates where the shares owned by the family are between 20 and 30% of the total). So far, the Fair Trade Commission has identified more than ten South Korean conglomerates engaging in such potentially unfair intragroup deals. Another target is the family-run charity foundations allowing *chaebols* to retain control of their sprawling empires or carry out irregular family succession without paying inheritance taxes.

Chaebols' reaction

Some change is undoubtedly taking place. In June last year Kim asked the "big four" *chaebols* – Samsung, Hyundai, LG and SK – to get rid of their shares in unlisted affiliates and reform supply-chain pyramids, widely believed to be an example of *gap-jil* (i.e. bullying suppliers). Afterwards, SK group came up with a KRW 160 billion fund to pay second and third tier subcontractors directly if a first-tier supplier were to be temporarily cash-strapped. As of September 2018, Lee Jae-yong has also completely eliminated the circular shareholding structure within Samsung. Chung Eui-sun of Hyundai is also under pressure to do so.

The responses of the *chaebols* have been criticized as cosmetic, however; firms such as Samsung, Hyundai and Lotte are increasing their transparency and improving corporate governance, but some believe that the *chaebols* have overall yielded little ground to shareholders. Intragroup deals within companies actually increased last year, and reports suggest that they happen more often in companies where the second-generation family-owners hold shares.

Proponents of the reforms argue that new rules, currently under review in the National Assembly, on holding groups, intragroup deals, and charitable foundations, will produce more changes for the *chaebols* but there are reasons to be skeptical. Firstly, a number of organizations are against the proposed amendments. Financial organizations such as the Korea Chamber argue that such regulations are unnecessary while civil organizations debunk the amendments as "abandoning chaebol reform". Secondly, the amendments appear to have a number of potential loopholes that may allow the *chaebols* to evade their intended aims. Thirdly, the government lacks an absolute majority in the National Assembly, so it is unclear whether the amendments will make headway. The ongoing détente with North Korea has also shifted the focus from *chaebol* reform to security issues and has given the *chaebols* additional leverage as they would be required to rebuild North Korea's infrastructure if the policy of engagement leads to greater economic links (and if sanctions are at least partially lifted).

Foreign investors have been following the progress of reform with keen interest as the *chaebols* have previously been successful in preventing foreign shareholders from blocking what were perceived of as unfair intragroup deals. A notorious case during the previous administration of Park Geun-hye involved Samsung and the hedge fund Elliott Management. Elliott is now engaged in a dispute with Hyundai over a somewhat similar situation, in which the latter had proposed an intragroup deal in connection with a succession plan. In May of this year Hyundai was forced to abandon its restructuring plans due to pressure from investors including Elliott. This seems to suggest that pressure can now be brought against unfair deals; since the vote, however, the situation seems to have evolved into a form of stalemate as Hyundai has dropped its original plans but has not accepted Elliott's revised proposal. The eventual result of the Hyundai dispute will be one indication of whether the role of the *chaebols* has really changed under the Moon administration.

About Argo Associates

Argo Associates is structured around a single overriding purpose: providing our clients with the information and intelligence that will allow them to navigate acquisitions, investments, disputes, or frauds in a clear-sighted and rational way, minimizing risk and maximizing opportunities.

Information gathered may clarify the profile and background of key business people and managers; it could illuminate the operations of a company or demonstrate a history of fraud or mismanagement; or it could help our clients to assess the political situation in a given jurisdiction and how it may affect their investments or business operations.

Headquartered in Hong Kong, Argo Associates assists clients across Asia and – through international partners – globally.

Intelligence Gathering

"Intelligence" is central to making sense of the world and to decision-making. Argo Associates has developed a network of well-placed human sources across Asia and – through our partners outside Asia – globally. This network provides insights beyond what is available publicly – into leadership, operations, strategy, corruption, red flags, political connections and so on - and is supplemented by extensive research and analysis of publicly available sources – corporate filings, litigation filings, regulatory communications, media articles, social media postings and so on. In a world in which information is increasingly commoditized, high-level intelligence and analysis provides the insights that give our clients an edge over their competitors.

Fraud, Corruption and Disputes

Our intelligence-gathering techniques and in-depth research and analysis have also helped our clients uncover frauds within their operations or in those of a portfolio company or recent acquisition. Our professionals have provided numerous reports for arbitration or legal proceedings to recover the proceeds of fraud. We have also assisted clients in tracing assets globally when bringing a high-value claim against a company or individual. In high-profile disputes we have assisted a number of top law firms in gathering information, evidence and intelligence in support of their clients' cases.

Political Risk

Our political risk work has developed naturally out of our intelligence and investigative capabilities. We see political risk as an important part of the evaluation of many investments, mergers and acquisitions, as well as a key element of commercial disputes in many markets. We have helped our clients look at political risk in a new way, not just in terms of the broad outline of potential political developments in various countries, but with a focus on the impact on their businesses. For example, will growing frictions between two countries lead to tariffs that could impact the specific sector in which a portfolio company operates? Or, how will rising protectionism in a country alter the possibility of a fair result in an ongoing commercial dispute? Frequently, politics is local as much as national and we understand the importance of drilling beneath the widely-circulated opinions to a real understanding of what is happening.

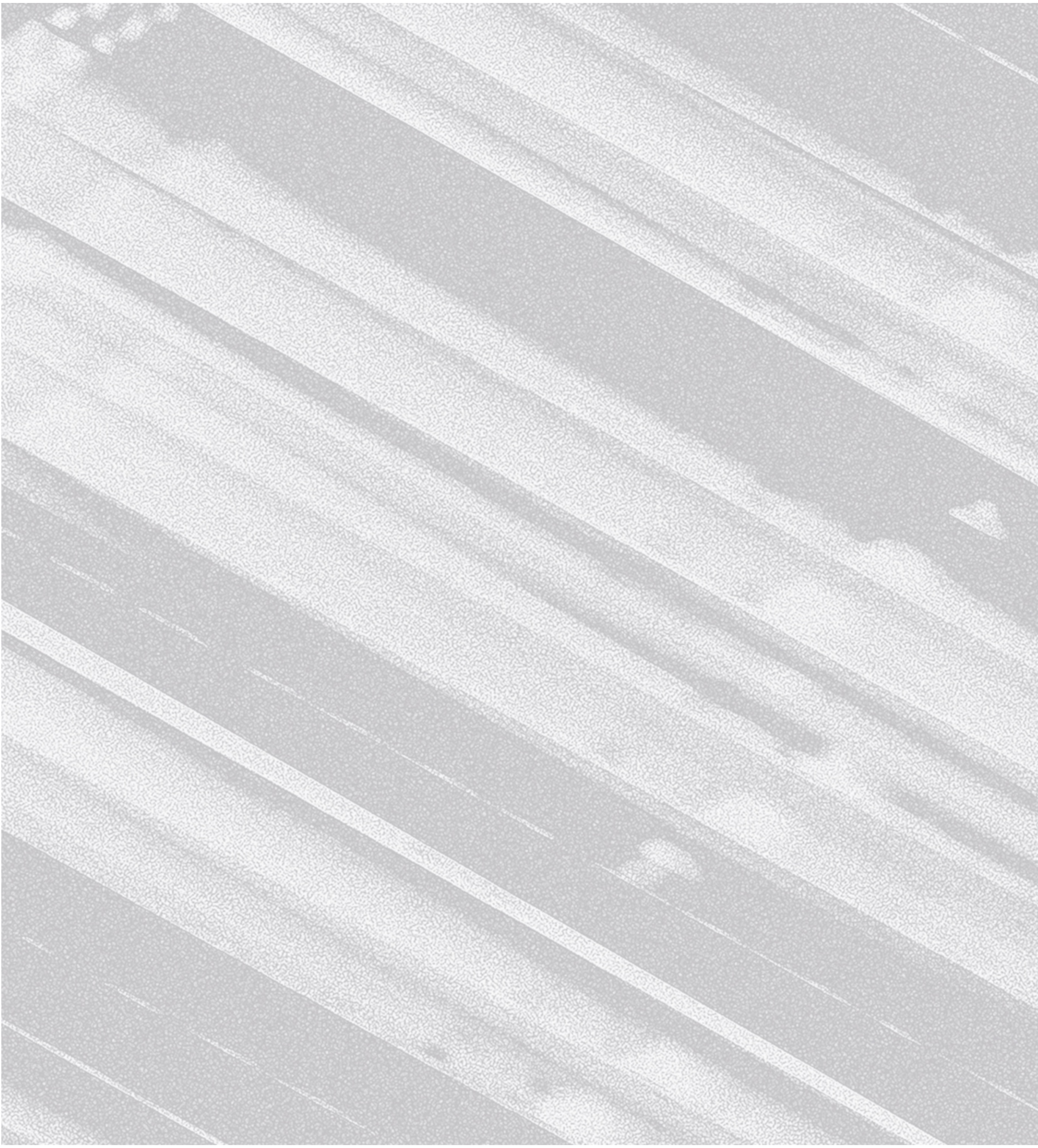
Our Founder – Jason Wright

Jason Wright is the founder and Managing Director of Argo Associates.

Prior to founding Argo, he was a Managing Director in Hong Kong for Kroll, the company that created the modern investigations and intelligence sector. Before moving to Asia seven years ago he worked for Kroll in Italy for five years and then briefly in London. While assisting clients on numerous transactions, investigations and disputes in Asia and Europe, particularly for private equity funds, banks, hedge funds and special situations investors, Jason has also specialized in the analysis of political risk, whether that has involved examining the role of local politicians, regulators and other stakeholders, or broader geopolitical concerns.

Although he has managed projects across the whole Asia- Pacific region he has been particularly focused on Korea, China, and Southeast Asia, especially Indonesia, Vietnam, Malaysia and Thailand.

Jason is a scholar of St. Catherine's College, Oxford, having been awarded a Master of Arts (Oxon) in English Language and Literature, as well as a Master in State Management and Humanitarian Studies from La Sapienza University in Rome, Italy.



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