

**Fundamentals of Divestiture as Restructuring Method :
Case Study of LG Demergers in Terms of Shareholders Value and
Corporate Governance in the Context of Korean Practice**

by

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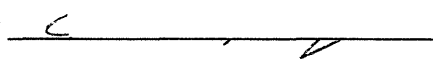
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In Partial Fulfillment of the Requirements for the Degree of

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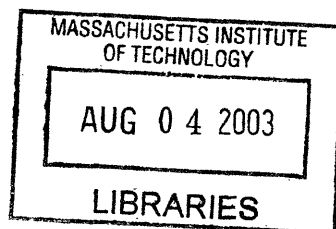
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ABSTRACT

This thesis is to generally review the practices and cases in the global capital market places in regard to the divestitures as one of the corporate restructuring instruments and to confirm the generally acceptable hypothesis that the most of breakup cases driven by the strategic purpose of “focus and concentration” would be justified by the enhancement of shareholders value. And the discussion expands to the divestitures in Korea introduced in late 1990s, which prevailed and practiced widely in the market ever since, but in some cases, it was combined with formation of the holding company structure in accordance to the Monopoly Regulation and Fair Trade Act making the issue complicated one in regard to the reform and restructuring of major conglomerates, the “Chaebol” in Korea. The LG demerger cases were right in the center of the discussions, and this thesis is to address four hypotheses in regard to the background, key components, aftermaths, and the implication of the LG’s transaction through which it would be assessed in terms of shareholders value and corporate governance in the context of Korean practice.

Thesis Supervisor : Arnoldo C. Hax
Title : Professor of Management

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1. Introduction

1.1 Current Global Divestiture Events

The financial news on the “mega-breakup” is quite popular these days, almost as many as the “mega mergers”, and the events seems to become a fashion in modern corporate practices. The announcement, on October 25, 2000, that AT&T would break itself into 4 different entities – Wireless, Broadband, Consumer, and Business – wasn’t an astonishing news at all because the market players already experienced the precedent breakups of AT&T twice in 1984 and 1995.

It seems many of merged companies of which deals were executed by the inflated market valuation in late 1990’s and early 2000’s are suffering from the wrong direction of diversification as well as the economic downturn and depreciation of share prices. AOL Time Warner, the world largest media monster created by the record breaking mega-merger, is not an exception now, and the management has floated the idea of breakup as a solution of troubled AOL division, prompting speculation that the company could demerge in 2003. ¹

Divestiture cases have been noticed as an instrument of corporate restructuring, such as for focus and concentration, enhancement of shareholders value, privatization of public sectors, and acquisition fallouts. The thing is that divestitures have been usually welcome by capital market and its investors in the US and Europe altogether. Therefore, we would generally uphold the hypothesis in the textbook, “Investors in U.S companies seem to reward focus, penalize diversification.” ²

¹ October 29, 2002, Owen Gibson, Media Guardian

² Richard A. Brealey / Stewart C. Myers : “Principles of Corporate Finance”, Page 971, 7th Edition, McGraw-Hill Companies, 2003

1.2 Current Korean Practice

Before the foreign currency crisis, Korean business conglomerates, “Chaebol”, had just one-way direction of corporate strategy towards diversification. In Chaebol’s practice, unlike the Anglo-Saxon corporate culture, it was quite unusual to scrap even money losing business out of the “family”, meaning that there was virtually no exit strategy once the Conglomerate got involved in certain business.

However, things changed remarkably in the midst of IMF bailout when they were asked to restructure themselves in ways to achieve their financial soundness and management efficiencies. Since it was a semi-revolutionary situation, the government strongly pushed private sectors to that direction through reform and deregulation of relevant laws and regulations while the foreign investors brought up with out quite demanding agendas to their investee companies.

As the divestiture was formally allowed in 1998 by the revision of Commercial Code together with the regarding tax relief, the breakups became a trend epidemic, starting as a measure to scrap the minor fallouts in the earlier stage, and spreading out to the public companies in pursuing various financial goals later on. In 2002, the breakups of publicly trading companies became a sort of fashion in capital market of Korea.

Among the breakup cases, the LG case was the largest, most complicated, and symbolic one which had comprehensive implication in regard to the Korean corporate finance practices. LG, the 2nd largest conglomerate in Korea, really made serious decision to break up its main business entities to cope with the business, market, and regulatory demands as well as the internal demands regarding the corporate control structure. Unique feature of the transaction was the formation of a holding company as a

controlling legal entity of post breakup, which was allowed by the controversial revision of the Fair Trade Act in 1999.

1.3 Key Issues on Discussion

Consequently, the basic direction of this thesis is to address the following themes, which would be properly explained, referred, and proved.

- Obtaining the updated insights of divestiture as global common practice
: its theoretical backgrounds and empirical aftermaths in modern corporate finance
- Identifying Korean divestiture practice in the context of IMF bailout and global trends
- Assessment of LG Divestiture Model : Shareholders Value, Corporate Control and Governance Aspects, and its implications in the long run

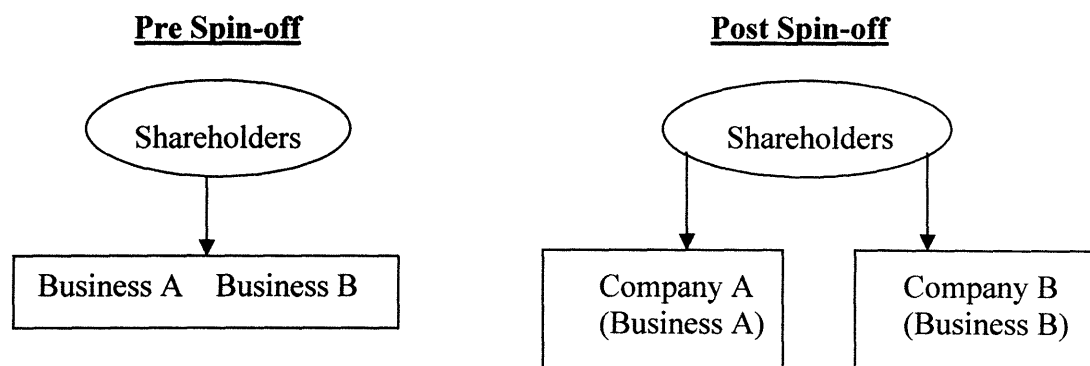
2. General Review on Divestitures

2.1 Structures of Divestiture and its Terminologies

“Divestiture” or “Breakup” has been used as general term referring any kind of corporate fissions, and often, it is mixed up with “spin-off”, and “split” in practice which is also called “demerger” in the British. However, the followings are generally defined as one of the sub-categories of “Divestiture” or “Breakup”.³

Most Common Form of Divestiture : Spin-offs (“Demerger” in the British term)

Spin-off is one of the divesting schemes to form a new company by splitting certain portion of assets or operations of existing company, and eventually the shares of new company will be distributed as dividend proportionally to the shareholders of divesting company.



Consequently, the shareholders will own the shares of new company – divested company – as well as the divesting company, which is the most common form of divestiture. In the

³ Countries adopting the Civil Law System, most continental European such as France and Germany define the specific schemes of divestiture in their Corporate Law, while United States doesn't have any specific regulation in regard to the divestitures other than the Internal Revenue Codes stating the boundaries of tax free breakup transactions. Jin Su Kim : “Taxation Policies in regard to the Corporate Divestitures”, KIPF (Korea Institute of Public Finance), December 1998

same process of breakup, the divested new shares can be unequally distributed reflecting the specific intention or preferences of shareholders, which they call “Split-off”.⁴

Regardless of the scheme of breakup – Spin-off or Split-off, the mother company, the divesting entity, will not have any shareholdings in its affiliate, the divested entity, so that both will be separated completely as a result of the breakup and managed autonomously.

Incomplete Form of Divestiture : Equity Carve-Out

It’s exactly same as Spin-off in a sense that the divesting entity sets up the new company as affiliate and transfer specific assets and operations. However, the difference is that the shares of new company will belong to the divesting company itself, not its shareholders. Also it is followed by the IPO(Initial Public Offering) of the affiliate so that the mother company cash out some or most of the portion of its investment in affiliate.

Carving-out company is to reduce risks of particular business in its portfolio by partial disposition of its carved-out shares, consequently monetizing some of its assets in operation. But, usually, the mother company remains as majority controlling party even after carve-out except the case that the mother company entirely sell off the carved-out shares to 3rd party.⁵ In that sense, carve-out is one of the incomplete schemes of divestiture.⁶

⁴ In case of the publicly listed company, mostly it is executed through the redemption of “class stock” in exchange of the new shares of divested company. Case: General Motors’ redemption of the class stock of EDS by issuing the new shares. Sang Su Park : “Win-Win Strategy of Business Restructuring I”, Economy Weekly 459, LG Research Institute, March 18, 1998

⁵ So-called “trade sale”

⁶ The parent company must retain an 80 percent interest to consolidate the subsidiary with the parent’s tax account. Richard A. Brealey / Stewart C. Myers : “Principles of Corporate Finance”, 7th Edition, Page 971, McGraw-Hill Companies, 2003

Internal Split without New Company : Tracking Stocks

Tracking stock is a class of parent company stock that tracks and claims the earnings or assets of certain business division within the company. Usually the newly issued shares are granted to the current shareholders as dividend, and accompanied with Initial Public Offering. It is most incomplete form of divestiture in a sense that it is not separated from the parent body, also remaining under the control of parent's board. So tracking stock is very unusual form of divestiture even in US, and is not allowed in most of the countries adopting the civil law system.⁷

Another Simple Form of Divestiture : Asset Sale

From the divesting company's point of view, the simplest form of divestiture is the "Asset Sale", which includes not only the sale of particular asset of certain business operation but the sale of affiliate shares, through so-called M&A.

Asset Sale is also the very direct and quick method of corporate restructuring and result in the most complete separation, however, unlike the spin-offs and carve-out, it's not usually tax free transaction, which can be critical issue in preservation of the fundamental value of the post divestiture.

⁷ Since the General Motors issued the first of them with its acquisition of EDS in 1984, a total of 23 have been listed in the US, Patricia Anslinger, Steven Klepper and Somu Subramanian : "Breaking up is good to do?", Mckinsey Quarterly, 1999, Number 1

2.2 General Background of Divestiture : Shift of Managerial Trends, “Economy of Scale → Focus & Concentration”

It has been believed that there are substantial advantages in diversification of such as mergers, acquisitions, and new entries, achieving synergies, cost efficiencies, financial accountability, and risk-mitigating portfolio effect mostly from the so-called “Economy of Scale”.

Many businesses of the United States pursued the growth through diversification in 1960’s, forming the “conglomerate” of which businesses consisted of various unrelated industries. Also the “conglomerate” has been the majority model of forming industrial capital in most Asian countries, especially in Korea by the name of “Chaebol”.

However, in the United States, it didn’t take so long time that the diversification of unrelated industries turned out to be inefficient, out of fashion, eventually most of the conglomerates divested themselves through spin-offs.⁸

Theoretically when the costs of being a well-diversified company such as conglomerate surpass the benefits from the economy of scale, the issues of divestiture emerge. In case of conglomerates, the key management members have to manage the variety of business divisions and also function as decision maker of internal capital market. So if they are to be justified, it must be assumed that the key management members are supposed to be equally efficient in managing all of divisions as they are managed independently, and their financial decisions on the allocation of financial assets must be as efficient as those of the market, all of which are hardly true historically.

⁸ Even though there were some exceptions such as GE, most of the conglomerates created in the 1960s were broken up in 1980s and early 1990s, including the symbolic case of ITT, which ranked 8th largest corporation as of 1979 with the operation in 38 different industries, sold and spun-off many different lines of business until 1995. Richard A. Brealey / Stewart C. Myers : “Principles of Corporate Finance”, 7th Edition, Page 974, McGraw-Hill Companies, 2003

Therefore, reflecting those underlying costs as conglomerates causing the distrust and undervaluation of the company in the market, the demands towards divestiture increase over time. Moreover, it is also true, in some cases, there are pressures even to breakup the homogenous core business into the smaller ones to achieve “Focus and Concentration” rather than “Economy of Scale”.

The textbook of Brealey and Myers estimates the average conglomerate discount at 12 to 15 percent, considering the potential overinvestment and misallocation of resources.⁹ Some author argues that the overall performance of a Multi-Business Company (“MBC” hereafter) is often less than the performance would be if the business units were independent, of which difference is not small. He estimates about 10~50 percent of value is destroyed, if all other things are equal, by the formation of a multi-business organization.¹⁰

In addition, the Mckinsey research on the Fortune 1000 companies illustrates that the business performances of smaller corporations in terms of shareholders value are much better than those of the bigger ones. It can be interpreted that the smaller companies are quite in good position to be swift in innovation to cope with the shortened cycle of the product life in the modern market together with, needless to say, the efficiencies in communication within the organization.

⁹ Generally, we can't believe that the key management members of conglomerates will make fair decisions about all the investments, often destroying the shareholders value by investing the negative NPV projects, even worse, transferring the resources between business divisions without considering the principle of arms-length transaction. Richard A. Brealey / Stewart C. Myers : “Principles of Corporate Finance”, 7th Edition, Page 975, McGraw-Hill Companies, 2003

¹⁰ David Sadtler / Andrew Campbell / Richard Koch : Executive Summary, “Breakup! – How Companies Use Spin-offs to Gain Focus and Growing Strong”, The Free Press of Simon & Schuster Inc., 1997

Table 1 : Business Size and Creation of Shareholders Value ¹¹

Period January 30, 1995 through September 30, 2000
 Companies American companies among Global Fortune 1000

	Sales	Shareholders Value
Amount	\$6.0 trillion	\$1.5 trillion
(% shares)		
Fortune 100	57%	16%
Fortune 101-500	33%	25%
Fortune 500-1000	10%	69%

In that context, many companies may suffer from the disease of value destruction, and spin-off has been the prevailing solution these days of which annual transaction value mounted to the level of \$100 billion, became an irreversible tide. ¹²

2.3 Immediate Causes of Divestitures : “Focus and Shareholders Value”

Table 2. Relative Importance of Immediate Causes of Breakup in the Landmark Cases ('82-'96) ¹³

Reason	Number of Occurrences			Comment
	US	UK	Total	
Focus	12	10	22	The Standard Answer
Fair Value	7	3	10	Everything to do with Stock Price
Reduce Debt	7	1	8	Little noted by commentator
Poor Performer	5	0	5	
Fear of Takeover	0	4	4	Mainly UK
Competitive Conflict	4	0	4	Unwinding vertical integration
Enhance Capital Raising	2	1	3	
Quarantine Problem	2	1	3	
Regulatory	2	0	2	Telecoms
Tax Efficiency	1	0	1	

¹¹ David Campbell, Ron Hulme : “The Winner-takes-all Economy”, Mckinsey Quarterly, 2001, Number 1

¹² Some analysis of the Fortune 100 and the FTSE 100 suggested that a large percentage of MBCs were over-diversified, more than half of the large companies in US and the UK. MBO, LBO and hostile takeovers were the traditional solutions to mitigate that kind of value destructions, however, the Breakup proved to be the fastest, easiest, most tax efficient, and least revolutionary method. David Sadtler / Andrew Campbell / Richard Koch : “Breakup! – How Companies Use Spin-offs to Gain Focus and Growing Strong”, The Free Press of Simon & Schuster Inc., Page 14, 1997

¹³ David Sadtler / Andrew Campbell / Richard Koch : “Breakup! – How Companies Use Spin-offs to Gain Focus and Growing Strong”, The Free Press of Simon & Schuster Inc., Page 42, 1997

As the repercussion of drawbacks from over-diversification, the divestitures were mainly driven by the momentum of pursuing “Focus and Concentration on the core business”, each of which cases were clearly the responses to the market pressure, so called “under-valuation” basically caused by two components,

Managerial Context. As discussed previously, the over-diversification of business implies various managerial issues such as subsidization to money losing operations as well as the cost of communication and misallocation of resources.

Investors’ Context. Most of cases, investors prefer simple business, easy to understand and analyze because they want to set the portfolio for their own purely based on the investors point of view. So it’s very natural they avoid the investments in the diversified companies which are hardly fit into their scopes of portfolio and also expensive due to the over-paid premiums for the acquisitions.

Market concerns those and reacts with the discount in share prices, and this strong signal of the market pushes management to initiate the divestitures. In that sense, the two main reasons of divestitures illustrated above are virtually identical; Market demands “focus” of the business, management responses it with divestitures to get the fair valuation of the market.

Other immediate causes of divestitures are mostly related with financial restructuring measures or regulatory compliance issues, however, regardless of the apparent reasons, most of them are closely related with the management efficiencies so that they are to achieve the fair market valuation as aftermaths. The details are as follows,

Table 3. Twenty Landmark US Breakups / Ten Landmark UK Breakups ('82-'96)¹⁴

Year	Company	New Entities	Reasons Stated	Additional Reasons
(USA)				
1982	AT&T	Baby Bells	Regulatory(Anti-Trust)	
1995	AT&T	NCR / Lucent	Focus	Reduce Debts
			Competitive Conflict	Poor Performer
1992	Baxter Int'l	Caremark (Home Health Care)	Competitive Conflict	
1995	Baxter Int'l	Allegiance (Hospital Distribution)	Focus / Fair Value	Competitive Conflict
1994	General Mills	Darden Restaurants	Focus	
1996	GM	EDS	Focus	Competitive Conflict
1995	Grace	National Medical Care	Focus / Fair Value	Reduce Debts
1995	ITT Corp.	ITT Hartford	Focus	Fair Value
		ITT Industries	Enhance Capital Raising	
		ITT Corp.(Hotels)		
1994	Lilly	Guidant (Medical Dev)	Focus / Fair Value	
1992	Marriott	Hotel Real Estate	Focus	Reduce Debts Quarantine Problem
1995	Marriott	Concession Business	Focus	
			Enhance Capital Raising	
1995	3M	Imation	Poor Performer	
1992	Pacific Telesis	Cellular	Regulatory / Fair Value	
1994	Sears	Allstate Insurance	Focus	Reduce Debts
1996	Tenneco	Newport News (Shipbuilder)	Focus	Reduce Debts
1996	PepsiCo	Restaurant Business	Focus	Reduce Debts
			Poor Performer	
1996	American Brands	Gallaher Tabacco	Fair Value	Quarantine Problems
			Poor Performer	
1996	Monsanto	Chemicals	Fair Value	
			Poor Performer	
1996	Rockwell Int'l	Automotive Comp.	Focus	Fair Value
(UK)				
1990	BAT	Argus (Catalog Retail) Arjo Wiggins (Paper)	Focus	Takeover Fear
1996	British Gas	British Gas Centrica	Focus	Quarantine Problems
1990	Courtaulds	Chemicals, Coatings	Focus	Takeover Fear
1994	ECC	Aggregates	Focus	
1995	Hanson	US Industries	Focus	Reduce Debts
1996	Hanson	Breakup	Focus	
1993	ICI	Zeneca	Focus / Fair Value	Takeover Fear
			Enhance Capital Raising	
1996	Lonrho	Hotel Business	Focus / Fair Value	
1990	Racal	Vodaphone	Focus	Takeover Fear
1995	Thorn EMI	EMI Music Thorn Retails	Focus / Fair Value	

¹⁴ David Sadtler / Andrew Campbell / Richard Koch : "Breakup! – How Companies Use Spin-offs to Gain Focus and Growing Strong", The Free Press of Simon & Schuster Inc., Page 41-42, 1997

2.4 Cost Aspects of Divestitures

The cost aspects of divestiture are often discussed, even though those were not so significant in the full context, to formulate the consequences and characteristics of divestitures. Those are the tax and cost of capital issues.

Cost 1 : Transaction Tax

In most cases, the divesting transactions are tax-free under certain conditions and circumstance. In the US, the Internal Revenue Code 355 grants the tax relief on the stock dividend and capital gain in transaction of spin-offs, implying that the government encourages the spin-offs as a corporate restructuring measure. The trend to support and protect the divestitures both by the Corporate Law and Tax Codes is very common practice in developed countries, so usually the divestiture doesn't incur any additional cost in terms of tax.

Cost 2 : Cost of Capital

Also, there can be a concern regarding post-divestiture cost structure of capital, which is very legitimate reasoning since the divestiture is usually accompanied with significant changes especially in the capital structure of the related entities. Many imagine that the cost of capital must be higher than that of before divestitures due to the reduced financial accountabilities of both the divesting and divested firms. However, many argues that the over-diversified business demands higher risk premium for its equity investors due to the uncertainty, so the divestiture will release the tension from the

investor, resulting in the stabilization of cost of capital.¹⁵ Generally it can be inferred that the overall average cost of capital of divesting and divested entities after divestiture will remain unchanged or at least won't change significantly upwards.

In general, it can be said that the divestitures are free from the additional cost, or at least, it won't be significant, if any.

2.5 Aftermath of Divestitures as Solution

While some studies stipulated that many mergers eventually destroyed the shareholders value, most of the divestitures were positively assessed in capital market in line with the discussions 2.2 -2.4.

Short Term View upon Disclosure

Unsurprisingly, many researches concluded that the market disclosures of divestitures were accompanied by the 'leaping' of share prices in very short term, which meant the divestitures were directly welcome by the market sentiment – perceived as friendly transactions to the market. The studies on reaction to the disclosure of divestitures are as follows,

* Schipper & Smith (1983) analyzed 93 spin-off cases in New York Stock Exchange between 1963 through 1981, and concluded the share prices of divesting companies gained 2.84% excessive returns

¹⁵ Richard J. Schmidt : “The divestiture Option – A guide for Financial and Corporate Planning Executives”, Quorum Books, Page 102, 1990. / Also there was a study about the cost of capital of AT&T upon the divestiture in 1982, arguing that the divestiture wouldn't change the cost of capital to the Bell system, David S. Evans : “Breaking Up Bell – Essays on Industrial Organization and Regulation”, A CERA research study, Elsevier Science Publishing Co, October 1, 1982

* Slovin, Sushka & Ferraro (1995) analyzed 37 spin-off cases in New York Stock Exchange between 1980 through 1991, and concluded the share prices of divesting companies gained average 1.32% excessive returns ¹⁶

Longer Term View

In the longer term, the share prices of divesting entities generally tended to outperform the market in spite of some deviations, meaning that the overall divestitures created the shareholders value at least in terms of market valuation.

* JP Morgan (1999) analyzed 231 spin-off and carve-out cases between 1985 and 1998, extracted the data that the spin-offs exceeded S&P Index by 11.3% while the carve-outs exceeded S&P Index by 10.1% during the 18 months periods after divestitures. ¹⁷

* Mckinsey Quarterly (2000) analyzed various cases of spin-offs and carve-outs between 1988 through 1996, and the data regarding stock returns during the two year periods after the divestitures were, ¹⁸

	Form of Div.	Stock Return	S&P 500	No. of Sample
Divesting Entities (Parent Co)	Spin-offs	18.2	17.5	79
	Carve-outs	22.1	16.5	46
	Tracking Stocks	21.4	21.5	16
Divested Entities (Subsidiary)	Spin-offs	27.1	16.3	78
	Carve-outs	23.8	11.0	67
	Tracking Stocks	19.2	21.0	23

¹⁶ Two cases from Jin Su Kim : “Taxation Policies in regard to the Holding Company System”, KIPF (Korea Institute of Public Finance), Page 11, December 1999

¹⁷ Donald Depamphilis : “Mergers, Acquisitions, and other Restructuring Activities : An Integral Approach to Process, Tools, Cases, and Solutions”, Academic Press, February 2001

¹⁸ Patricia Anslinger, Sheila Bonini and Michael Patsalos-Fox : “Doing the Spin-out”, Mckinsey Quarterly, 2000, Number 1

According to Mckinsey research, it was clear that stock returns of the spin-offs and carve-outs cases outperformed the market during the two years of post transaction, which were more obvious for the divested entities than those of the parents, implying that the independence from the parents enhanced the values of subsidiaries.¹⁹

2.6 Generally Acceptable Hypothesis and its Conditions

With all the discussions and argument of 2.2 through 2.5, we are possibly able to support the hypothesis suggested in 1.1 that “Most of divestiture cases driven by the momentum of ‘focus’ and ‘concentration’ tended to be justified by the positive market valuations in relatively short term period.”

However, the possible argument is that the benefits of divestitures must prove themselves through the enhancement of intrinsic value of the business in the long run, otherwise the possibly inflated market values have to be retrieved after all. This generic but purely theoretical assumption must be carefully tested in general. But, unfortunately, there are not many reliable research results on the correlation and relevance between divestitures cases and its long term financial performances, so the above hypothesis of relatively short term period would be paralleled with the reviews of long run financial results in the interpretation of individual cases.

¹⁹ In the same article are mentioned the aspects of improving operating performance ; if we examine the operating performance of newly traded subsidiaries during the two years from the time of issue, we see, on average, substantial increases in the return on invested capital (ROIC) both in the tracking stocks and the spin-offs, while the ROIC of carve-outs dips slightly. Carve-outs instead enjoy high revenue growth after they begin trading, with an average annual gain of 32 percent

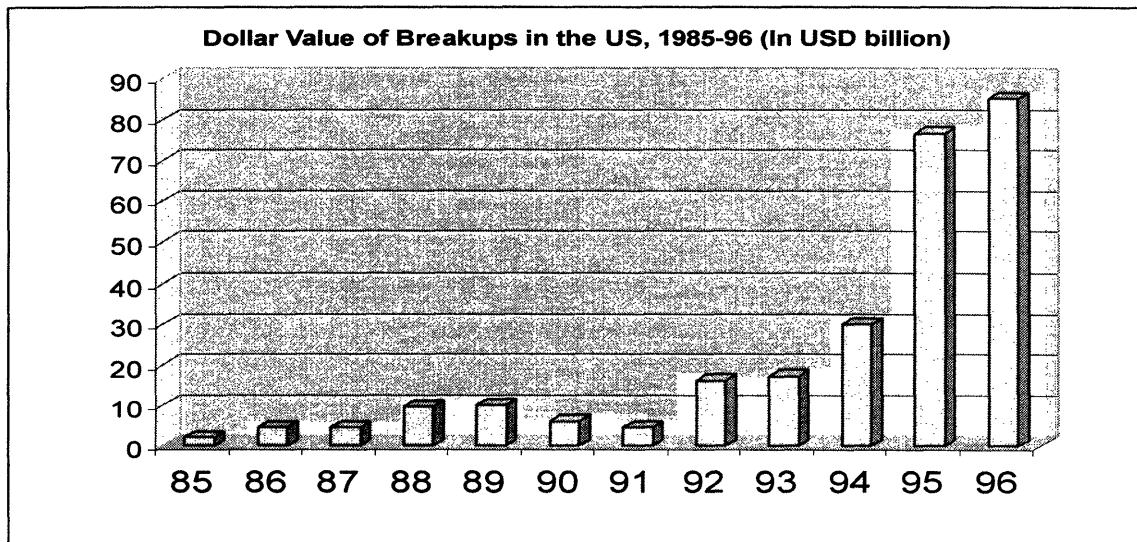
3. Global Trend, Practice of Divestitures / Case Review, ITT and AT&T

3.1 Trend Epidemic

The demands of divestitures emerge over time as one of the corporate restructuring tools and solutions in the United States and European countries, the government bodies have polished and updated the relevant laws and regulations to support and even boost the transactions, including tax relieves and revision of anti-trust provisions as well as the basic corporate law.

As a result, the total value of transactions divestitures mounted almost to the level of \$100 billion annually. It was merely annual average of \$1.1 billion in the early 1980s excluding the AT&T case, and this average jumped to \$6.1 billion for 1985-90, leaped further to \$14.8 for 1990-94, and it was phenomenal afterwards and now it seems like an irreversible tide as featured below.²⁰

Exhibit 1. Value of Breakups in the US, 1985-96 (In USD bn)



²⁰ David Sadtler / Andrew Campbell / Richard Koch : "Breakup! – How Companies Use Spin-offs to Gain Focus and Growing Strong", The Free Press of Simon & Schuster Inc., 1997

As illustrated in table 3, most of the landmark breakups were to aim the ‘focus’ of the main business usually triggered by the pressure from market, and started to rush in 1995 when the ITT and AT&T declared the symbolic mega breakups which were followed by the other renown breakups in 1996 – General Motors and EDS, PepsiCo and its Restaurant Business. Among the landmark divestitures, the ITT and AT&T cases bring the key relevant issues for the main topics in regard to the Chapter 5.

3.2 ITT – Breakup of Conglomerate

ITT (International Telephone and Telegraph) formed the very unique conglomerate in the United States throughout the 1960s and 70s, and became the largest one as of 1979.

Table 4. The largest conglomerates in 1979, ranked by sales compared to all US industrial corporations.²¹

Sales Rank	Company	Number of Industries
8	International Telephone & Telegraph (ITT)	38
15	Tenneco	28
42	Gulf & Western Industries	41
51	Litton Industries	19
66	LTV	18
73	Illinois Central Industries	26
103	Textron	16
104	Greyhound	19
128	Martin Marietta	14

ITT’s unrelated diversification was phenomenal, pursuing the safety of business portfolio and the higher margins within the territory, so the acquisitions were made in any industry under the tenure of Chairman Harold Green until 1977, and the financial results were, surprisingly, very successful so far.

²¹ Richard A. Brealey / Stewart C. Myers : “Principles of Corporate Finance”, 7th Edition, McGraw-Hill Companies, Page 974, 2003

However, expectedly, as the profitability of the entire business slowed in 1980s so that the market were getting skeptical about their legitimacy of that corporate model, it started to send strong signal of distrust – undervaluation, stipulating conglomerate discount. As time went on, it was getting clear that the unrelated diversification was quickly losing the competitiveness as a corporate organization model, the conglomerate went out of fashion rapidly.

The next Chairman Rand Araskog recognized the realities and sold some 200 companies, nonetheless, ITT remained a conglomerate of enormous range and it continued to grow, so they reached \$24 billion of sales in 1995²² when ITT announced the symbolic breakups into three bodies – Manufacturing (ITT Industries), Insurance (ITT Hartford), Leisure and Hotel (ITT Corporation).

It was obviously driven by the severe pressure of the market valuation and managerial issues together and was welcome by the market with 30% price jump, formulating the virtual end of conglomerate period in the US, triggering the follow-up divestitures in late 1990s. Also, needless to say, the most of the conglomerate in table 4 were broken up in 1980s-90s.

3.3 AT&T – Breakups of Horizontal and Vertical Integration

AT&T had been the ubiquitous monster as legally sanctioned, regulated monopoly until 1984 when it broke up into 7 Baby Bells. Even though it started practice the divestitures by the regulatory causes, it formed a model of swift corporate reorganization through divesting as well as the massive acquisitions to cope with the rapidly changing

²² David Sadtler / Andrew Campbell / Richard Koch : “Breakup! – How Companies Use Spin-offs to Gain Focus and Growing Strong”, The Free Press of Simon & Schuster Inc., Page 6, 1997

business and technological environment. The cases illustrate the comprehensive dimensions of divestitures in breaking up the horizontal and vertical integration of business over time.

3.3.1 1st Divestiture in 1984 : Regulation Driven

Background and Transaction

Up until early 1980s, AT&T, as the universal telephone service provider, formed the largest company in the world with assets of \$155 billion and one million employees, of which business operations included (1) the 22 BOCs(Bell Operating Companies) providing the local telephone service, installation and repairs (2) AT&T Long Lines, the interstate long-distance division, carrying all Bell System calls made between states. (3) Western Electrics, the AT&T's manufacturer of telephone equipment (4) Bell Labs, the AT&T's famous research and development arm.

Horizontal Integration: Even though there were other 1,450 Independent Telephone Companies competing BOCs, their share was only around 10% of US retail market. In case of Long Distance Competitors, the OCCs(*Other Common Carriers, MCI, GTE-Sprint, ITT and so on) occupied just about 20% of the market. So it was obvious that the level of concentration and horizontal integration of market by AT&T could be a concern for fair competition of the market.

Vertical Integration: The Bell System (*The BOCs and Long Lines) bought 80% of its equipments from Western Electric, its manufacturing arm, and this transaction accounted for 90% of Western's revenues. The level of vertical integration of

manufacturing and captive purchasing practices had been a long-run concern for the obstacle of technologic development.²³

So, as AT&T set up itself horizontal and vertical integration nationwide, there had been many speculations about Bell System's benefit and setbacks. Also technological innovation and the strong American tradition of competition had raised issues about the legitimacy of AT&T's monopoly rights.²⁴ The pressure toward reform persistently came to the attention of Antitrust Division, Justice Department who brought an antitrust suit against AT&T in 1974. Finally, after long litigation, the Justice Department and AT&T reached to the Modified Final Judgement (MFJ), dismantling AT&T to breakup into AT&T main body itself and 7 regional players, the Regional Bell Operating Companies (RBOCs), so called Baby Bells – NYNEX, Bell Atlantic, Bell South, Southwestern Bell, Ameritech, US West and Pacific Telesis.

Consequences

It was said that most aftermaths of AT&T's breakup were positive from the customers point of view. The long distance telephone rates dropped approximately 40% in five years, and there was "rash" of new innovative services introduced together with the explosion of new telecommunication equipment driven by the increased R&D investments. Also the main concerns on the breakup were addressed as follows,

²³ Samuel A. Simon : "After Divestiture : What the AT&T Settlement Means for Business and Residential Telephone Service", Knowledge Industry Publications, Chapter 1-2, 1985

²⁴ Mr. Michael Baudhuin described in the Communication Forum as : During the 1970s, AT&T "went through turmoil" regarding regulation at the Federal State levels. AT&T argued for "Integrated Network of Service from end to end". In contrast, regulators were "crying for competition in hopes of bringing down prices and increasing the pace of technological innovation. Gail Kosloff : "Divestiture: Five Years and Counting", Seminar Notes of Massachusetts Institute of Technology Communications Forum, May 4, 1989

- (1) Divestiture may impact negatively on the Universal Service in the US. However, telephone penetration increased from 91.5% to 92.8% in five years of post-divestiture.
- (2) Divestiture may cause the double or triple the cost of telephone service instantly. However, it didn't happen. The absolute average billing amount per customer barely increased for the following a few years.
- (3) Divestiture may decline the quality of service. There was an initial decline, but was back at pre-divestiture levels quickly.
- (4) Also many feared that AT&T might go back to monopoly dominating the other players even after divestitures, but it never happen, and the competition became increasingly vigorous and the market share of AT&T decreased at approximately 2% per year after divestiture.

As a whole, by removing the cross-subsidy granted within the integration and stimulating the competition, the significant productivity gains were materialized in the relatively short time period, which were attributable to improvement in technology and more well-managed companies. The first divestiture was an undoubted success even though it was involuntary one.²⁵

3.3.2 2nd Divestiture in 1995 : Business Restructuring towards Focusing

On September 20, 1995, AT&T announced another surprising mega-divestiture in history, the separation of its manufacturing arm and computer company, each of which became Lucent Technologies and NCR respectively afterwards. Those transactions were

²⁵ From 1-4, refer to, Gail Kosloff : "Divestiture: Five Years and Counting", Seminar Notes of Massachusetts Institute of Technology Communications Forum, May 4, 1989

based on the voluntary strategic decision of AT&T for the sake of business restructuring towards “Focus”.

Lucent Technology

Upon the 1st divestitures, the manufacturing operation recast as AT&T Network System had to experience the transition from monopoly to competition. Moreover, the predicament was the conflict of interests between its customers, the RBOCs and the AT&T’s main body itself. As the regulatory environments advanced over time, the drawbacks were getting more significant than the synergies, meaning that the two businesses became obstacles for each others growth.

Therefore, AT&T decided mainly to break it up in the “Trivestiture”, renamed it Lucent and legally spun-out through IPO and distribution of remaining shares to its shareholders, so it became independent on September 30, 1996. The table below shows clearly that the divestiture removed the bottleneck of business, achieving breakthrough in financial performance afterwards.

Table 5. Key figures of Income Statement Pre and Post Divestiture, Lucent Technologies²⁶

	1992	1993	1994	1995	1996	(Unit : USD million)		
						1997	1998	1999
Revenues	17,312	17,734	19,765	21,413	24,215	27,611	31,806	38,303
Operating Expenses	16,908	17,065	18,794	22,413	24,871	26,012	29,168	32,897
Operation Income	404	669	971	(1,000)	(656)	1,599	2,638	5,406

NCR

In 1991, AT&T acquired computer maker NCR, renamed it AT&T Global Information Solution (“GIS”), in a \$7.3 billion deal to pursue the combined service in the

²⁶ Hae Jin Je, FKI-International Management Institute : “Seminar : Strategy of Divestitures”, FKI (The Federation of Korean Industries), Page 125, November 27, 2002

convergence of communication and computing. However, it was an obvious failure in post acquisition management so that GIS suffered from the reversed-synergy resulting in the operating deficits three years in a row. So AT&T couldn't avoid the "acquisition fall-out", deciding to include it in the "Trivestiture".

The distribution of share dividend for spin-off was completed as of December 31, 1996, and NCR became independent. After divestiture, NCR came out of the big deficit by massive cutting of expenses.

Table 6. Key figures of Income Statement Pre and Post Divestiture, NCR ²⁷

	1991	1992	1993	1994	1995	1996	(Unit : USD million)		
							1997	1998	1999
Revenues	7,246	7,139	7,265	8,461	8,162	6,963	6,589	6,505	6,196
Operating Expenses	7,144	6,884	7,546	8,563	10,533	6,833	6,608	6,403	6,118
Operation Income	102	255	(281)	(102)	(2,371)	130	(19)	102	78

The 2nd divestiture of AT&T could be said to be another great success after all, because it created substantial shareholders value in terms of market valuation in post-divestiture periods as well as it turned around the financial performances of the divested entities in aftermath. ²⁸

²⁷ Hae Jin Je, FKI-International Management Institute : "Seminar : Strategy of Divestitures", FKI (The Federation of Korean Industries), Page 127, November 27, 2002

²⁸ The pre-divestiture valuation of AT&T was \$75 billion, however, little more than a year later, in January 1998, the separately trading AT&T, Lucent, and NCR had a combined market capitalization of \$159 billion. They explained it attributable not only to the improvements of financial performances but to some technical aspects; the divestitures increased the coverage of analysts. In fact, Lucent picked up coverage from 24 telecom equipment analysts, previously, only two of them had covered AT&T. The parents, whose remaining analysts could focus on it more closely, benefited as well. Also additionally they explained it attributable to the attraction of new investors who was little overlap between people who invested in a parent company and the improved management incentives and corporate governance as results of restructuring. Patricia Anslinger, Steven Klepper and Somu Subramanian : "Breaking up is good to do", Mckinsey Quarterly, 1999, Number 1

3.3.3 3rd Divestiture : Pressure from Market and Shareholders

As Michael Armstrong joined as Chairman and CEO of AT&T in November 1997, AT&T went on to another journey to be an “any-distance” company from long distance company. Since they think the long distance voice alone was likely to decline, he determined to transform the company focus from a voice call to any form which delivers the information comprehensively - voice, data, and video.

So over the next a few years, AT&T aggressively acquired businesses in the areas of the local telephone service (TCG), global data networking service (IBM Global Network), and many others (Teleport, MetroNet and so on), and also merged with large cable companies (TCI and MediaOne) by which AT&T broadband became the largest cable company in the US. Consequently, by mid-2000, AT&T had three rapidly evolving networks – data, broadband, and wireless which enabled the bundled package service of local, long distance, wireless telephone and internet access service. The strategy proved to be on the right track by the fact that the volume of data traffic exceeded that of voice traffic on AT&T network in year 2000.

However, due to the over-spent budget for mergers and acquisition²⁹ and slowdown of economy and IT industries, AT&T suffered from the massive losses in 2000, resulting in the strong pressure from market and shareholders to cope with the crisis.

In response to that demands, in October 2000, AT&T announced to go to the reversing direction of its strategy - horizontal integration of business line-up, breaking itself up into 4 independent entities over next two years – AT&T Wireless, AT&T Broadband, AT&T Business, and AT&T Consumer. Under the restructuring plan, the AT&T Wireless became an independent company on July 9, 2001, and the AT&T

²⁹ It was estimated that Michael Armstrong spent \$140 billion for M&A in the early stage of his tenure

Broadband was merged with Comcast upon spin-off on November 18, 2002. Also AT&T Consumer, the premiere consumer communications and marketing company, was separated through tracking stock from the main body of AT&T Business.

Upon divestiture, AT&T Chairman Michael Armstrong stipulated that the breakups were pivotal events in the transformation, so the separating entities would continue to collaborate under competitive, long-term commercial contracts and coverage of strong brand of AT&T. So he insisted that it was an event combining the power of common vision – comprehensive service with horizontal integration of business – together with meeting the demands of the focus and flexibility of separate companies.

It is too early to assess the benefit of transaction, but Michael Armstrong didn't really conceal the facts that the divestitures were basically triggered by the pressure of shareholders asking the enhancement in market value. It seemed he reached a compromise with market by breakup of AT&T while preserving the collaboration structure among the business families, which we have to watch and see what's the consequences of the transaction in the long run.

3.4 Implications from ITT / AT&T Cases

Most of breakup cases in the US suggested that the divestitures were driven by the ultimate goal of shareholders value, in other words, by the pure economic sense and criteria. So it was taken for granted that divestitures were generally practiced upon the demanding signals from the market, and the shareholders values in terms of market valuation were usually enhanced just by the implementation of divestitures.

Both ITT and AT&T divestiture cases illustrated that the largest companies – world largest or multi-diversified – were to practice healthy separations of existing business to cope with the rapidly changing strategic environment, implying how much difficult it is to sustain competitiveness in the business world over the time periods.

On the context of this thesis, ITT case would be the precedent model of the breakup of conglomerate diversified with unrelated businesses and industries, while AT&T would be the comprehensive textbook cases of breakups in regard to the dismissal of horizontal and vertical integration.

4. Korean Practices and Key Issues

Divestiture is still unusual practice in most Asian countries while that became epidemic in the US and European countries. In many Asian countries, the businesses believe that the size counts when it comes to the bargaining power with government to get licenses of business or to go to the new business area. It had been quite true in Korea until foreign currency crisis in 1997, the family controlled conglomerates, “Chaebol”, kept on diversifying into the unrelated industries with highly leveraged capital structure, so there was virtually no concept of divestitures, even there were no spin-off provisions in the Commercial Code. However, the crisis forced to change the practices drastically.

4.1 Foreign Currency Crisis and IMF Bailout in late 1990s

Asian Crisis Overall

Under the world economy system organized by OECD countries, there was structurally long-run trend of US dollar depreciation against other major currencies since 1980’s, which caused, consequently, weakness of Asian local currencies mostly pegged with US dollar. That currency trend fueled the Asian export-oriented economies to over-boom without proper adjustment in the long run, resulted in the highly leveraged corporate sectors and over-consuming households through the bank credit expansion and investment rushes into this region, all of which turned out to be rich background of proliferation of conglomerates together with the socio-cultural contexts. Such vulnerable economies with long-run accumulated deficits were easily led to insolvency of foreign

currencies at the end when they were faced with the increasing pressure of redemptions in matured debts and attacks of FX speculators.

Korean Crisis and Massive Restructuring – Introduction of Divestitures

At the end of 1997, overall debts to equity ratio of manufacturing sector in Korea was reportedly 396.3% while its capital productivity was in a very low level compared with that of international standard.³⁰ With \$8.2 billion annual deficit of current account by losing labor-intensive products market of export to China, Korean entities, business and banking sectors altogether, faced with a rush of demands asking redemptions of short term debts, which resulted in shortage of foreign currency, consequently Korean government ended up asking for IMF bailout packages in November 1997.

As results, Korean Won had to be significantly depreciated, interest rates skyrocketed, and all of the asset values went down sharply, securities and real estates altogether. On the other hand, there were series of corporate bankruptcies including the conglomerates such as big five Chaebol, Daewoo and Hyundai, which resulted in the devastation of banking sector with non performing loans.

To manage the crisis, the Korean government deployed emergency measures for the massive restructuring of finance and corporate sectors as well as the general policies to stabilize the macro-economic indicators. While shutting down the financial institutions

³⁰ It was said Korea invested in best practice technology, however, failed to adopt quality management. Consequently, the capital productivity of most of industry sectors were way lower than those of the US. For example, in 1995, assuming 100 for the capital productivity of the US, that of Auto was 48, semiconductors 54, confectionery 39, and telecom 58. Only that of steel surpassed the US, which was 115. Martin Baily, Chuong Do, Yong Sung Kim, William Lewis, Victoria Lee Nam, Vincent Palmade, and Eric Zitzewitz : “The Roots of Korea’s Crisis”, Mckinsey Quarterly, 1998, Number 2

and setting up the bad bank for NPLs, the government enforced the corporate players to comply with the rigid disciplines as follows,

Enhancement of Capital Structure : Each corporation, or each conglomerate had to lower their debt to equity ratio below 200%. They had either to sell their assets or to increase their equity capital to meet the requirement of leverage ratio. Also the invitation of foreign investors was strongly recommended.

Practice of Shareholders Capitalism : Corporate players were asked to implement the key principles of shareholders capitalism, such practices as management transparency, clear accounting rules and full disclosures, protection for the minority shareholders

Needless to say, those restructurings were accompanied with many changes and reforms in laws and regulations, including the discussions on the divestitures, in order to facilitate the possible spin-offs as one of the corporate restructuring instruments.

Afterwards

Fortunately, the large scale depreciation of FX helped the corporate sector to cash their excess capacities by pushing out the inventories to the export market, and the above mentioned government measures for the restructuring of corporate and financial sectors paid off in the earlier time than generally expected.

Table 7 : Key Macro Figures of Korean Economy, 1997-2001

	FY 97	FY 98	FY 99	FY 00	FY 01	FY 02(E)
Nominal GDP Growth	5.0%	-6.7%	10.9%	9.3%	3.0%	6.0%
Current Account (USD Billion)	(8.2)	40.4	24.5	12.5	8.6	10.0
Foreign Reserve (USD Billion)	20.4	52.0	74.0	96.2	102.8	117.0
Risk Free Rate	14.8%	7.2%	9.0%	6.8%	5.3%	5.0%
Debt to Equity Ratio (Manufacturing)	396.3%	303.0%	214.7%	210.6%	182.2%	135.0%

(Data: Ministry of Commerce, Industry and Energy)

Korean economy successfully escaped from the negative growth and the macro indicators got back to almost normal by the year 2000. One of the most drastic changes was the Leverage Ratio of Corporate Sector. The gearing currently came down to 1.3 from the almost 4.0 of 1997, which is now quite normal level of leverage level compared with those of other OECD countries.

4.2 Divestiture Trends after Foreign Currency Crisis

Regulatory Aspects

As one of the regulatory reform in 1998 to cope with the flooding demands of corporate restructuring, the new provisions of spin-off structure were introduced in Commercial Code.³¹ Also the revision of Tax Codes granted the relevant tax relief for the Spin-off structure to be tax-free transaction.

³¹ Until then, surprisingly, divestitures such as spin-off and carve-out structure with establishment of new corporation had not been stated, only simple sales of assets or business units and share transfer were feasible in line with the old Commercial Code

The 30 Largest Conglomerates - Chaebol

Based on the regulatory supports mentioned above, fueled by the severe pressure from the governmental window guidance asking financial soundness of corporate sectors, the businesses, especially the conglomerates, started to sell, scrap or spin-off their business units and its assets. They didn't have any other choice – it was a game of survival, which was exactly the other direction of pre-IMF regime's diversification. The conglomerate, so-called Chaebols, had to scrap or spin-off the money losing and unrelated business units, desperately selling the non-operating extra assets on the other hand. Those were to meet the financial leverage standard by repayment of debts, and regain the confidence of their creditors and investors.

The following tables from the survey done by Federation of Korean Industries in 2001 illustrated number of divestiture cases between 1997 through 1st half of 2001 in the 30 largest conglomerates, their key reasons, and the size of divestitures.³²

Table 8 : Divestitures, 30 largest Conglomerate (1997-2001.6)³³

Group	No. of Divesting	'97	'98	'99	'00	'01.6	Total
Samsung	16	0	115	29	5	12	161
Hyundai	12	36	27	18	8	9	98
LG	15	5	18	51	14	6	94
SK	11	3	11	11	13	7	45
Others	22	3	7	15	13	6	44
Total	76	47	178	124	53	40	442

³² In Korean practice, they frequently use the concept of “30 largest conglomerates”, so-called “Chaebol”, in accordance with the definition of “Monopoly Regulation and Fair Trade Act” which has regulated the business practices, financial structures, and M&A transactions of the top 30 largest Chaebol since 1980, so the “30 largest Chaebol or conglomerate” is very common combined-word in Korea

³³ Table 8-10, Keum Seung Yang : “Suggested Reform of Divestiture System for the Restructuring and Innovations”, CEO Report on Current Issue, FKI (The Federation of Korean Industries) CER 2001-20, Page 9, October, 2001

Table 9 : Key Reasons of Divestitures

<u>Driver</u>	<u>Case</u>	<u>Percentage</u>
Scrapping Money Losing Business	4	0.9%
Restructuring of Human Resources	85	19.2%
Divesting Unrelated Business	104	23.5%
Divesting Medium to Small Scale Business	181	41.0%
Others	68	15.4%
Total	442	100.0%

Table 10 : Size of Divestitures, (Number of Employees of Separated Companies)

<u>Number of Employees</u>	<u>Case</u>	<u>Percentage</u>
100 and below	345	78.1%
100 above ~ 300 below	63	14.3%
300 above ~ 1,000 below	17	3.8%
1,000 and above	17	3.8%
Total	442	100.0%

As above, unlike the conventional practice in Korea, the conglomerates unloaded many of their business units and operations especially in 1998-1999 when they are under the massive restructuring process. Also, noticeably, about two thirds of the entire cases, the key purpose of the divestiture were the “focus” stated such as divesting unrelated business and medium to small scale business.

However, 92.3% cases were small scale divestitures (the number of employees of separated company were 300 or below) while the relatively large scale divestitures (the number of employees of separated company were 1,000 or above) were only 17 cases, which accounted for just 3.8%. Even though there have been some rather large and symbolic cases, basically the divesting experiments of 30 largest Chaebol were mostly limited to relatively small scale separations, not applying to the restructuring of its main bodies. So, it was clear that conglomerates started to adopt divestitures as an option of corporate reorganization to focus and concentrate their management resources towards

key business operations, but still as a limited methodology passively applied to fix or adjust their business portfolio partially.

Listed Companies

Most of sizable divestitures were implemented among the listed companies in the stock market as the number of disclosures was stacked up over time, 11 cases in 2000, 18 cases in 2001, and 27 cases in 2002. It seemed the divestitures became fashion and epidemic among the listed companies currently.³⁴

Daewoo Securities analyzed the completed 24 divestiture cases in 2002, and classified the main purpose of divestitures into 4 categories as follows ;

Type 1. Separating business units to improve the efficiency of each business

Type 2. Divesting the non-core business to focus on the core business

Type 3. Divesting to sell off the unprofitable unit to improve capital structure

Type 4. Divesting business units from the investment functions to construct transparent corporate governance structure

Even though all of the divestitures were to achieve the enhancement of the shareholder value in the end, the consequences were not always positive. In 2002, only 45.8% of the share prices of divestiture cases outperformed the market index, which might imply that the divestitures were not necessarily accompanied with the enhancement of shareholders value in Korea, however, the research covered only the short periods of

³⁴ Interview comment : It was said that some of the demerger cases seemed to simply pursue just pricing effects and were suspicious of price manipulation and insider trading. Sukrin Hong, Sr. Associate, Disclosure Supervision, Financial Supervisory Board

time especially in the very bearish market in year 2002.³⁵ Therefore, it's too early to conclude the correlation between divestitures and the enhancement of shareholders value in general when considering the short history of introduction of divestitures in Korean market. But the research revealed as illustrated below that the aftermath of Type 2 and 3 divestitures were relatively strong in terms of shareholders value, which needs tracing to be proved in the future.

Table 11. Purposes of Divestitures, and Aftermath in 2002 ³⁶

Type	Divesting Company	No.of Outperform / No.of Co
Type 1	<u>Tong Yang Confectionary</u> , <u>Deco</u> , NSF Namhae Chem, Shin Cheon, Growell Metal Hyiundai Department Store	2 / 7
Type 2	<u>Plenus</u> , <u>Cecrop</u> , <u>LG International Corp.</u> <u>NC Soft</u> , <u>Finetec</u> , <u>Hyunjin Materials</u> HumanCom, Han Wha, NitGen Tech Eagon Ind, NetSecure Tech, Korea Computer	6 / 12
Type 3	Namsun Aluminum, Hunex Inc	2 / 2
Type 4	LGEI, LGCI, Daewoong	3 / 3
Total		11 / 24

* Underlined are the companies which outperformed the market index.

³⁵ The research compared the share performances of individual stocks with the market index for the period of between the board resolution date and November 29, 2002 respectively, and only 11 out of 24 cases turned out to outperform the market

³⁶ Research mentioned above, Ki Lim Choi : "Research : the Impacts of Divestitures on the Enterprise Value", Industry Analysis and Updates, Research Group, Daewoo Securities, December 6, 2002

4.3 Combining Holding Company Structure with Divestiture, and Controversies in the context of Corporate Governance

The regulatory reform to accelerate corporate restructuring after IMF crisis could be segmented into following three dimensions,

Deregulation to facilitate diverse demands of corporate restructuring needs. Introduction of the divestitures together with the enhancement of flexibilities in consolidation was adopted in Commercial Code, Securities and Exchange Act, and Bankruptcy Acts.

Reinforcement of Corporate Governance to implement Shareholders Capitalism. Rigid rules and disciplines to enforce management transparency and accountability, and protection of minority shareholders were adopted in Commercial Code, Securities and Exchange Act, and GAAP (Generally Accepted Accounting Rule).

Tax Relief or Cut to assist the restructuring. Taxes for most transactions in regard to the massive restructuring of corporations were relieved or exempted by the amendments of Corporate Tax Act, Income Tax Act, and Tax Cut Control Act.

In the midst of the regulatory reform, as a very complicated and controversial by-product, the “Monopoly Regulation and Fair Trade Act” (“FTA” hereafter) was amended in 1999 to allow the formation of “Holding Company”(“HC” hereafter) which had been completely prohibited until then.

Shown as Type 4, in 4.2 (Table 11), one of the top 5 Chaebol, LG, adopted HC structure combining with divestitures in its reorganization, which attracted great public attentions in capital market. Since HC's nature is very much new to the market and also extremely versatile as a framework of corporate reorganization, it was said that HC scheme may call for the shape of the future organizational structure of conglomerate in Korea, bringing controversial issues in regard to corporate governance of Chaebol.

4.3.1 HC Practices in Western Countries and Japan

Western Countries

Most of western countries do not control or prohibit the HC directly. In case of the US, they have controlled the banking and public utilities sectors in formation of HC.³⁷ Other than that, the possible problems under HC have been strictly regulated by the Anti-trust laws, such as Sherman Act and Clayton Act, prohibiting any HC related practices of horizontal and vertical restraints of trade, exclusive dealing, and tying arrangement. Same are the UK and Germany regulating the issue indirectly through Anti-trust laws.

Also, the common practice is that the HC holds 100% of its affiliates' shares. For example, General Electric's principal affiliates consolidated in the financial statement as of December 31, 2002 were 52 companies, not surprisingly, GE held 100% share of 51 companies out of those 52,³⁸ and only the HC has been listed on NYSE(New York Stock

³⁷ Banking Holding Company Act of 1956, Public Utilities Holding Company Act of 1935, Jun Ki Kim : "Holding Company System and its Practice in Foreign Countries", PSPD (People's Solidarity for Participatory Democracy) Conference, June 29, 1998

³⁸ Annual report, General Electrics, Year 2002

Exchange). In some countries, for example, Norway, they enforce HCs to hold 100% of their affiliates' shares.³⁹

Japan – Most Relevant but Different in Fundamentals

Until 1997, only Korea and Japan were the countries that prohibited HC including new formation and transformation altogether. After World War II, the US occupation not only disintegrated Japanese conglomerates traditionally controlled by the individual family groups, but prohibited the HC by the legislation of Monopoly Regulation Act in fear of the resurrection of the economic monster. Consequently, the family owned conglomerates disappeared, and cross holding of the shares among the allied companies and institutional investors had replaced the governance structure and been common practice for decades.

Faced with the significant capital market downturn in 1990s resulting in the book losses from the cross holdings, they resumed the discussion to activate the HC as one of the solutions to cope with the crisis. After long debates, Japanese legislature amended the Monopoly Regulation Act to allow the HC under the very rigid conditions in 1997. But the largest corporations with certain amount of assets or above were still prohibited to make or transform to HC, also so were the cases that may restrain the fair competitions or cause concentration of economic wealth. Therefore, allowing the HC in Japan was fundamentally to replace and restructure the prevailing cross holding schemes in the financial crisis of the corporation, not to go back to the regime of conglomerates in the World War II.

³⁹ Jun Ki Kim : “Holding Company System and its Practice in Foreign Countries”, PSPD (People’s Solidarity for Participatory Democracy) Conference, June 29, 1998

4.3.2 FTA and Government Practices in Korea

Since the legislation of FTA in 1981, Korean government body, Fair Trade Commission (“FTC” hereafter) has served for two key public missions, (1) Prevention of competition restraints and (2) Repression of the economic power concentration to Chaebol.

For prevention of competition restraints, the FTA stipulates the instruments – “restriction of combination of enterprises restraining competitions”, and “prohibition of inappropriate internal transactions”.

For the repression of the economic power concentration to Chaebol, the FTA designates “30 largest Chaebol” and their prohibited acts such practices “mutual capital contribution”⁴⁰, “gross amount of investment over certain criteria”⁴¹, and “formation of Holding Company”.⁴²

4.3.3 Controversy on the HC

Chaebol’s Arguments

Chaebols brought up the issue to allow the formation of HC in line with the regulatory reform. Their arguments were

(1) HC structure would accelerate corporate restructuring in the invitation of foreign investors. (*As a matter of fact, many of foreign investors asked Korean government to

⁴⁰ It actually means the cross holding between the affiliates

⁴¹ It has raised many complaints and petitions from Chaebol who tried to diversify their business through leverage. The limit has been moving around according to the economic situation in 25~40% range of the net asset of the individual Chaebol. Currently it is 25% with some waivers

⁴² According to FTA, the HC is defined as a company controlling any domestic company's business through the ownership of shares as its primary business, and whose total assets are above KRW 10 billion, and affiliates' shares constitute more than 50% of its total assets

allow the HC as prerequisite simply considering the convenience of the HC as investment vehicle)

(2) HC would replace the conventional “Chairman’s Staff Office” which had been informal but very prevailing organization controlling the entire group affiliates. As the realities and formalities match through HC, they argue that the structure of corporate governance will significantly be improved through “alignment of the power and its legal responsibility”.⁴³

Critics Arguments

The critics against Chaebol, mostly the activist leaders, explicitly objected to the agenda to allow the HC with the following arguments,

(1) The governance of the HC structure may deteriorate the minority shareholder rights because they can’t exercise the rights against the management of HC who actually governs the company. The Chaebol’s argument about the positive aspects of “alignment of Chairman’s power and responsibility” can be easily surpassed by the negative impacts of undermining minority shareholders rights.⁴⁴

(2) HC structure can be abused as an instrument of inheritance to the next generation of Chaebol family in taking advantage of its tax saving scheme.⁴⁵

(3) The adoption of HC will inevitably result in the concentration of wealth of Chaebol by the financial leverage of the HC.⁴⁶

⁴³ The above Chaebol’s stance was discussed in, Seung Ryong Park : “Functions of Fair Trade Act after Massive Corporate Restructuring”, Korea Research Institute, 1999

⁴⁴ Sang Hoon Lee : “Implications to Corporate Law in the introduction of Holding Company System”, PSPD (People’s Solidarity for Participatory Democracy) Conference, June 29, 1998

⁴⁵ It was said that the profitability of HC was very easy to manipulate so that the per share value in line with tax code could be lowered in time of inheritance to save the relevant tax, and this effect could be maximized by the financial leverage of the HC. Seung Su Ha : “Taxation Issues on Holding Company System”, PSPD (People’s Solidarity for Participatory Democracy) Conference, June 29, 1998

In the PSPD (People's Solidarity for Participatory Democracy) conference, held on June 1998, they presented strong objection to the HC with compelling rationale. Also about the arguments in regard to Japan as a precedent case allowing the HC in a similar circumstance, they counter-argued that it was not the case because (1) Japan didn't allow the HC for everyone, they prohibited largest corporations from doing it (2) Japan had totally different backgrounds from Korea in terms of corporate governance, which meant that there would be no chance that individual family owned conglomerate would emerge again in Japan.

So, they finally insisted that, even in case of allowing HC, at least the FTA should include the provisions of prohibition of HC for the 30 largest Chaebol, the prohibition of financial leverage of HC, and compulsory 100% shareholding for its affiliates, stating all of which were the minimal condition to prevent the excessive side effects of the HC.

Final Shape of FTA in Year 1999

Notwithstanding the controversies, the FTC finally drew the conclusion to allow the HC with some constraints, key of which were,

- (1) Debt-to-equity ratio must be below 100% following a one-year initial grace period,
- (2) 30% or more stake is required in listed affiliates, and 50% or more in non-listed
- (3) More than 50% of assets must be invested in subsidiaries with a two-year period

⁴⁶ It was said that HC would be allowed certain level of leverage and it didn't necessarily have to own 100% of shares of its affiliates, also the HC wouldn't be regulated by the provision of gross amount of investment limit, the concentration effect would be phenomenal in some cases. Ki Won Kim : "Problems in the introduction of Pure Holding Company, and its Prerequisites", PSPD (People's Solidarity for Participatory Democracy) Conference, June 29, 1998

With the above criteria to minimize the side-effects, the FTC's final conclusion was based on the rationales that the HC would drive the Chaebol to focus on their core competence by facilitating the spin-offs and foreign investment altogether, which also might help to reinforce the better transparency of corporate governance.⁴⁷

There have been not many cases afterwards, however, they have brought many issues into corporate finance practices in Korea for last a few years, and many of relevant issues have been on discussion over time since the reform on FTA allowing the HC was an experimental tryout. Needless to say, HC itself still remains in the prototype stage in Korea and will be reviewed further in Chapter 5 with the LG cases.

⁴⁷ Seung Ryong Park : "Functions of Fair Trade Act after Massive Corporate Restructuring", Korea Research Institute, 1999

5. Case Study : LG Group Demerger in Korea

5.1 LG Group

Founded by the Chairman's family and their partners in 1947, LG ventured its business in the chemical products, and diversified into the electronics in late 1950s. Both made a great success and LG became one of the leading business conglomerates in Korea. As of the year end of 2001, LG positioned itself as 3rd largest Chaebol in terms of asset size (2nd in terms of sales), whose affiliates accounted for 51 companies diversified into telecommunication, retail, media, energy, and financial service.⁴⁸

Table 12. Top 10 Conglomerates in Korea ⁴⁹
(As of the Year End of 2001, Unit: USD billion)

Name of Group	No. of Affiliates	Asset(a)	Asset(b)	Debts	Equity	Sales	Net Profit	D / E (%)
1 KEPCO	14	75.7	75.7	31.7	44.0	26.0	2.4	72.1
2 Samsung	63	60.3	125.7	88.8	36.9	107.3	4.4	240.6
3 LG	51	45.4	59.1	39.9	19.3	66.6	1.4	206.8
4 SK	62	39.0	41.1	25.1	16.0	41.9	1.0	156.4
5 Hyundai Motors	25	34.4	39.2	24.6	14.6	38.3	2.4	168.0
6 KT	9	27.2	27.2	13.7	13.5	13.8	1.3	101.7
7 Korea Highway Co	4	22.0	22.0	11.0	11.0	2.0	0.0	100.4
8 Hanjin	21	18.0	20.2	15.1	5.1	12.7	-0.6	294.4
9 POSCO	15	17.4	17.4	7.2	10.2	13.2	0.8	71.0
10 Lotte	32	15.0	15.6	6.8	8.8	12.8	0.6	77.8

Among more than 50 group affiliates, LG Chemical and LG Electronics have been the key business entities, maintaining the largest sales in the group, and carrying assets which include the controlling investment shares of the key affiliate firms. The total assets and sales of Chemical and Electronics accounted for 35% and 28% of group as table 13.

⁴⁸ In Korean practice, they call all of the LG affiliates as "LG group"

⁴⁹ Source : Press Release, Fair Trade Commission, April 1, 2002. Asset(a) excluded that of affiliate financial institutions, while asset(b) included. Sales included that of financial institutions. The foreign exchange rate of KRW/USD = 1,200

Table 13. The Weight of LG Chemical and Electronics in LG Group
(As of the Year End 2001, Unit : KRW Million)

Company	Assets(a)	Sales
LG Chemical ⁵⁰	7,477	6,016
LG Electronics	11,593	16,601
A : Sub Total	19,070	22,617
B : Group Total	54,484	79,966
A / B	35%	28%

In November 2000, LG Chemical astonished the capital market by the announcement of its plan of the massive reorganization to spin-off into 3 entities, which was followed by another spin-off of LG Electronics. Unlike the other divestitures after IMF, those were so-called mega-breakup dismantling the controlling structure of a big 3 Chaebol of Korea.

5.2 Hypothesis 1: Drivers of Demerger Decision (Scopes)

It is generally said that “the LG demergers were strategically designed to address the synthetic purpose of shareholders value and corporate control”, which can be discussed as follows separately,

Shareholders Value : Driver of Spin-off Decision

LG Chemical and LG Electronics couldn't be fairly valued due to the two key restraints, which were

(1) the business portfolio themselves were too much diversified to be simply understood by the outside investors. The LG Chemical and Electronics were running too many different business divisions vertically and horizontally integrated. As illustrated in Table

⁵⁰ LG Chemical is assumed to be before demerger, and the figures are the simple summation of the separated companies

14, LG Chemistry consisted of Petrochemicals, IB&M, EM, and variety of consumer product lines. LG Electronics ran roughly four divisions such as multimedia, appliances, display devices, and telecommunication equipment. So the covering analysts had to come up with different comparables for each business to get comprehensive valuation. However, market demands “focus”, prefers “pure player”, which mean that the investors like to diversify themselves through portfolio, so they don’t business to diversify on their own.

(2) Both company had substantial amount of investment assets in the affiliates by which they were faced with the concerns of investors on a daily basis regarding the “internal capital market” and management transparency issues, also those assets significantly deteriorated the financial performances of the firms in terms of such as ROIC and EVA.

Therefore, LG Chemical and LG Electronics shares had historically suffered from the undervaluation of the capital market which penalized the complexity of business and diversified investments. In that sense, LG had to spin-off themselves so that they could separately win higher valuation as pure players, more attention from analysts and investors, consequently unlock the intrinsic value of entire business portfolio.⁵¹

Corporate Control : Driver of HC Reorganization Decision

⁵¹ Interview comment : LG contemplated the divestitures from early 1990s with regard to the over-diversification of its two major companies, and there has been internal debates how to reorganize the businesses across the group affiliates to maximize the efficiencies. The demergers in last two years mostly focused on the HC structure, so further spin-offs and mergers among group businesses and affiliates will be actively considered to implement as the current HC structure settles down in the long run. Kisup Sung, Executive Vice president, LG Corp

As conventional business holding companies of LG group, it can be inferred that LG Chemical and Electronics had faced with two key constraints in the corporate control structure of the group, which were

(1) Dilution problem. As the companies grew over time, the controlling interests of majority shareholders, the Chairman's family, were badly diluted to 11.25% and 16.17% of total voting shares respectively as of the board resolution date of demerger. So, another big round of equity funding or simple inheritance to next generation might imply the disintegration of controlling stake of current majority.

(2) Compliance with FTA in gross amount of investment limit. It was announced that the suspended rule restricting the gross amount of investment in domestic affiliate would be applicable again in 2002, from which many Chaebol had suffered for decades in their ways to diversification. It was obvious that LG would have hard time to comply with the FTA, and highly likely would lose some of its controlling stakes of affiliates on the way.

So, it needed the solution to create the new corporate control structure to protect the majority shareholders from further dilution, as well as to meet the criteria of FTA. The breakthrough structure to make both issues clear was the HC solution which could enhance the corporate control of the majority shareholders through the reorganization and be waived from the enforcement of gross amount of investment limit.⁵²

⁵² In some references, the concept of "Corporate Control" is sometime mixed up with that of "Corporate Governance". HC may enhance the control of majority, however, it doesn't necessarily mean to enhance the corporate governance. It will be discussed further in 5.4.2 and 5.5.

*Also the limit of gross amount of investment is currently 25% of the Net Assets, and it is applied for the entire companies belonged to top 30 Chaebol, but the HC is exempted from the application. Instead, the HC is regulated by the mandatory limit of Debt-to-Equity ratio

*Fund managers and analyst perception on the LG cases whether to improve the Corporate Governance are pervasively neutral according to the interviews.

*Interview comment : Even though the internal discussion on demergers started from the simple separation, it encountered with the corporate control and FTA compliance issues after all. So entire transaction structure was designed to serve those purpose. Kisup Sung, Executive Vice president, LG Corp

5.3 Hypothesis 2 : Key “Smart Alchemy” Components of Transaction (Methodologies)

It is possibly said that “the LG demergers were strategically designed to leverage the regulatory structures and market price mechanism at maximum in their transactions”, which can be attributed to the key “smart alchemy” components in the formation of the HC with spin-offs.

5.3.1 Summary of the Transaction

Grand Picture : the Spin-offs and Merger

LG started restructuring with the breakup of LG Chemical into three separate entities in April 2001, which was followed by another small breakup from one of it in August 2002.

Table 14. The Separating Entities from LG Chemical

<u>Company</u>	<u>Divesting and Divested Business</u>
LG CI (Chemical Investment)	Investment Holdings for the group affiliates Life Science division
LG Chemical	Petrochemicals, Industrial and Building Materials (IB&M) Electronics Materials (EM)
LG H&H (Household & Health Care)	Dominant market player in consumer chemical products: Cosmetics, Toothpaste, Shampoo, Detergent, Soap
LG Life Science	Additional Breakup from LGCI

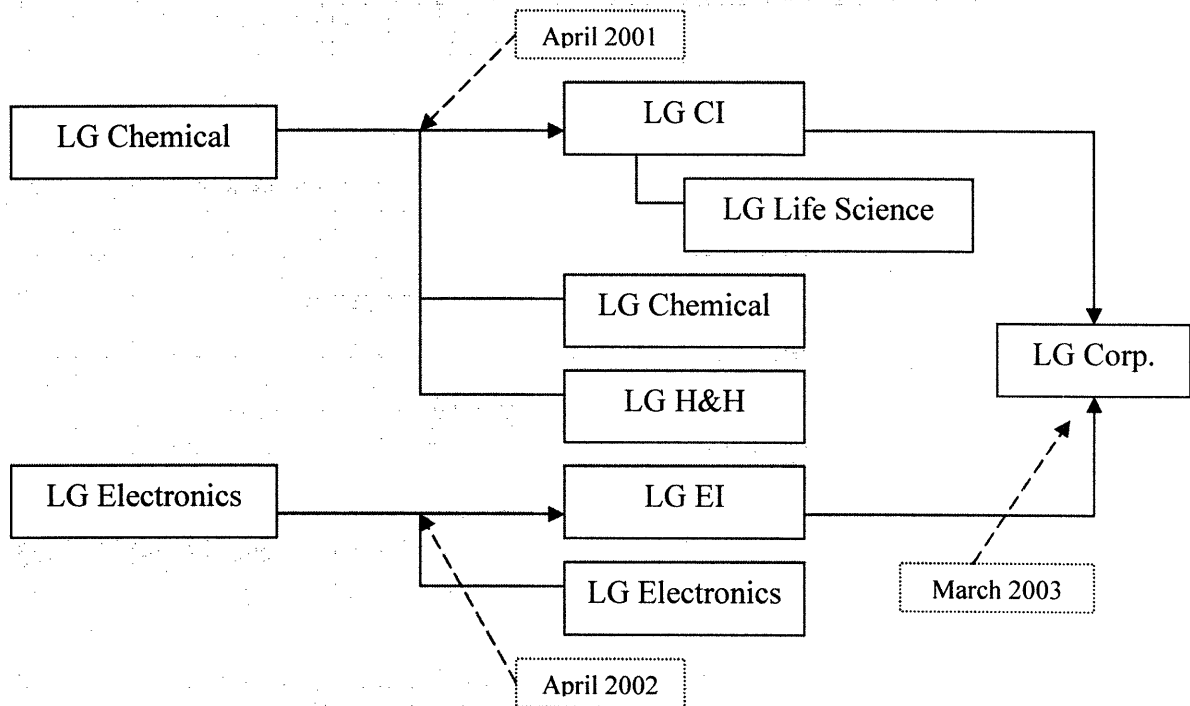
In April 2002, LG Electronics followed LG Chemical to break itself into two entities,

Table 15. The Separating Entities from LG Electronics

<u>Company</u>	<u>Divesting and Divested Business</u>
LG EI (Electronics Investment)	Investment Holdings for the group affiliates : LG Electronics and Telecom Affiliates (LGT, DACOM, Hanaro)
LG Electronics	Multimedia, Appliance, Telecom Equipment And Strategic Joint Venture Shares (LG IBM, LG Philips, LG Hitachi)

Finally, the HCs, LGCI and LGEI merged to form the grand HC of the LG group in March 2003.

Table 16. Spin-offs and Merger to LG Corp



1st Step : Split of Business/Financial Statement/Legal Entity, and Re-listing

Spin-offs were designed to serve the fundamental agenda of “focus and concentration” of the business together with the value maximization upon re-listing, so the most significant strategic aspect of the spin-offs was to break the investment management sectors⁵³ from the pure business sectors to let the business affiliates focus on their own core businesses. Under that principle, LG Chemical and Electronics spun-off their business operations as new corporations, consequently the left-over portions were to form themselves as pure Holding Companies.

⁵³ It refers to mostly controlling shareholdings of affiliates

Under those strategic designs how to divest the originals into multiple entities, the legal and formal split process was followed in line with the law and regulations. In those processes, the key structural issue was how to split the assets and liabilities. Under the current regulatory framework, there has been virtually no relevant restriction how to split the financial statement. Only some of the leverage ratio issues were carefully considered such as the FSB's (Financial Supervisory Board) window guidance that the bank would monitor the corporate sectors to keep the debt-to-equity ratio 200% or below, and the FTA's criteria that the HC would maintain the debt-to-equity ratio 100% or below.

Therefore, in split of financial statement, the divesting entities, the candidates of HC should obtain superior financial structure to the separating business entities considering the regulatory requirements of debt-to-equity ratio.⁵⁴

* Split of Assets and Liabilities

Table 17. The Split of Financial Statement, LG Chemical upon Demerger (In Wm)

	Divesting Entity	LG CI	LG Chem	LG H & H
Asset	6,171,067	2,153,023	3,474,532	543,512
	100.0%	34.9%	56.3%	8.8%
Debts	3,890,693	1,214,233	2,314,420	362,040
	100.0%	31.2%	59.5%	9.3%
Shr Equity	2,280,374	938,790	1,160,112	181,472
	100.0%	41.2%	50.9%	8.0%
Paid In Cap	553,684	99,663	365,432	88,589
No. of Common Shr	97,613,734	17,570,473	64,425,064	15,618,197
No. of Preferred Shr	13,123,108	2,362,160	8,661,251	2,099,697
(Demerger Ratio)		0.18	0.66	0.16
Equity Surplus	1,726,690	839,127	794,680	92,883
Debt to Equity Ratio	170.6%	129.3%	199.5%	199.5%

⁵⁴ Interview comment : Unlike the merger rule, there is no principle on the demerger in splitting the financial statement and valuation in regard to it. So FSB has contemplated to address this issue in the revision of relevant provisions of Securities and Exchange Act. Sukrin Hong, Senior Associate, Disclosure Supervision, Financial Supervisory Board

In case of LG Chemical Demerger, the HC candidate, LG CI, was assigned with 41% of the shareholders equity while receiving only 31% of the liability so that the debt-to-equity ratio of LG CI approached to the legal requirement of 100%,⁵⁵ and the assigned number of shares were merely 18% of the outstanding, which implied the LG CI would have quite high per share values in terms of BPS (Book Per Share). This arrangement seemed to be obviously based on the calculations to meet minimum requirements of debt-to-equity ratio of business affiliates, LG Chem and H&H, which were set to have that ratio almost exactly 200% as results.

Table 18. The Split of Financial Statement, LG Electronics upon Demerger (In Wm)

	Divesting Entity	LG EI	LG Electronics
Asset	12,297,215 100.0%	2,224,770 18.1%	10,072,445 81.9%
Debts	7,722,171 100.0%	715,777 9.3%	7,006,394 90.7%
Shr Equity	4,575,044 100.0%	1,508,993 33.0%	3,066,051 67.0%
Paid In Cap	1,031,068	247,107	783,961
No. of Common Shr	155,118,070	15,511,807	139,606,263
No. of Preferred Shr	19,095,547	1,909,555	17,185,992
(Demerger Ratio)		0.10	0.90
Equity Surplus	3,543,976	1,261,886	2,282,090
Debt to Equity Ratio	168.8%	47.4%	228.5%

In case of LG Electronics Demerger which followed the LG Chemical case year later, the split structuring was much more to the direction to meet the regulatory requirement as seen in the Table 18. The HC candidate, LG EI, took 33% of shareholders equity while receiving only 9.3% of the liability, resulting in only 47% of debt-to-equity

⁵⁵ In FTA, the company has one year grace period to meet the ratio

ratio, and the assigned number of shares were such a minimal level of 10%, which would increase the BPS at the possible maximum level.

* Setting Base Price for Re-listing

Upon the de-listing of the original divesting company, the base prices for re-listing of all the separated entities were calculated by the market capitalization of the last trading date proportionally to the BPS of each entities, and KSE (Korea Stock Exchange) announced that the separated entities would be re-listed on a certain day by the base price calculated accordingly.

Table 19 illustrates LG Chemical case how to calculate base price for re-listing. The last day market capitalization of the de-listing entity was spread out to three new entities according to the shareholders equity basis, and the per share prices were calculated by the outstanding shares allocated.

As already mentioned, the DE ratio and BPS were favorably designed for the HC, LG CI, so the re-listing base price was naturally the highest among the three. In regard to the fact that many institutional investors didn't have appetite to invest in the HC, it was intuitively foreseeable that the share price of the HC would be hovering way under the base price just set by per share NAV of the book. So, as in the Table 19, the post demerger share price in two months of LG CI, the HC, was only about 30% of the base price, while the share price of LG Chem and LG H&H rose to 177% and 466% respectively.

Table 19. The Base Price upon Re-listing, and Aftermath, LG Chemical (In Wm)

Divesting Company	Common	Preferred	(As of Mar 28, 2001)	
Last Market Price	12,700	5,760		
Market Capitalization	1,239,694	75,589		
Distributed Market Cap.	Divesting Entity	LG CI	LG Chem	LG H&H
Common	1,239,694	510,360	630,679	98,655
Preferred	75,589	31,119	38,455	6,015
(Market Capitalization)	1,315,284	541,479	669,134	104,670
Distributed Prices per Share upon Re-listing In line with BPS				
Common		29,046	9,789	6,317
Preferred		13,174	4,440	2,865
Relisted Price, as of April 25, 2001		21,326	13,000	13,000
Market Price, as of Jun 29, 2001 (Common)		8,571	17,300	29,450

As stipulated regarding the figures in Table 19, DE ratio of LG EI was more favorably designed than the LG Chemical case, therefore, the post demerger share price in two months was only 24% of the base price of demerger, while the share price of new LG Electronics rose to 143% of the base price in as illustrated in Table 20 below despite the paralleling bearish market.

Table 20. The Base Price upon Re-listing, and Aftermath, LG Electronics (In Wm)

Divesting Company	Common	Preferred	(As of Mar 27, 2001)	
Last Market Price	45,000	25,800		
Market Capitalization	6,980,313	492,665		
Distributed Market Cap.	Divesting Entity	LG EI	LG Electronics	
Common	6,980,313	2,302,326	4,677,987	
Preferred	492,665	162,496	330,169	
(Market Capitalization)	7,472,978	2,464,823	5,008,156	
Distributed Prices per Share upon Re-listing In line with the BPS				
Common		148,424	33,508	
Preferred		85,096	19,212	
Relisted Price, as of April 22, 2002		149,500	64,400	
Market Price, as of Jun 29, 2002		35,400	48,000	

2nd Step : Share SWAP to form the HC

The shapes of restructuring were completed by the formation of the Holding Companies, so the shareholding structures of the HC candidates, LG CI and LG EI, had to be restructured in line with the requirements set by FTA. (See Table 21, The Structure of SWAP)

* LG Chemical

The HC candidate, in case of LG CI, had to purchase its affiliates' shares to meet the FTA criteria of minimum 30% in case of listed ones. The basic solution was swapping shares with the majority shareholders, the Chairman's family, who owned the LG Chem and H&H as results of previous demerger. So, LG CI pulled out a tender offer to solicit of selling LG Chem, H&H, and Home Shopping shares in exchange of LG CI shares in capital increase, and the Chairman's family fully subscribed all shares to the tender.⁵⁶

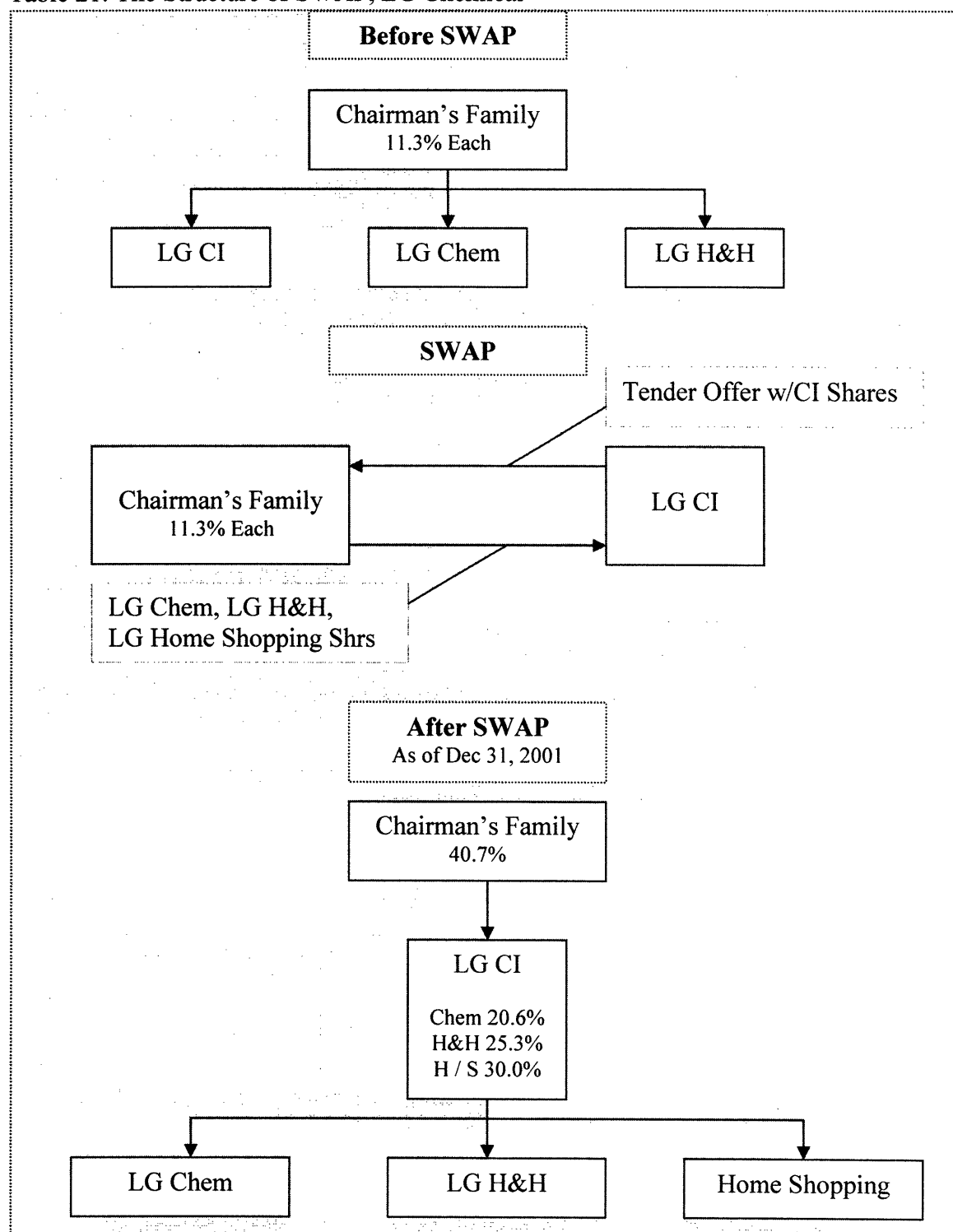
The entire SWAP process was that the Chairman's family materialized its majority control over the HC as the HC restructured itself as legitimate Holding Company according to FTA simultaneously. As results, the interest of Chairman's family reached 41% in LG CI as of Dec 31, 2001,⁵⁷ and the LG CI added significant stakes of its affiliates in addition to existing shares from the demerger.⁵⁸

⁵⁶ It was previously determined to do so before the implementation of demerger

⁵⁷ It would be more than 45% if considering the shares held by affiliates and treasury

⁵⁸ Since the old entity owned 6.7% of the treasury shares and those were not split upon demerger, the breakup transaction automatically created the 6.7% share position of LG CI into its affiliates. The detailed leverage structures regarding the treasury shares and pricing structure will be further analyzed in 5.3.2

Table 21. The Structure of SWAP, LG Chemical



* As illustrated, the final interest of Chairman's family over LG CI was not solely contributed by the swapped LG Chem and H&H shares. They additionally granted the LG Home Shopping shares in exchange of LG CI, also some of the cashes in the previous capital increase. In Aug 2002, LG CI spun-off the it small business operation, LG Life Science, which was too small to count it in the main contexts.

* LG Electronics

In the 2nd step of restructuring of LG Electronics, the process and structure of SWAP and the formation of the HC were identical to LG Chemical except the fact that it broke up into just two separate entities, which was virtually separating the controversial investment management sectors from the core businesses. As the consequences of the SWAP and formation of the Holding Company, the interest of Chairman's family reached 63% in LG EI as of Sep 30, 2002.⁵⁹ and the LG EI almost achieved the FTA requirement of minimum shareholding to LG Electronics.

5.3.2 Structural Analysis of Transaction : Two Key Components – “Smart Alchemy”

As reviewed in 5.3.1, the LG demergers were not simple breakups, but had to come up with the HC structure in line with FTA together with the enhancement of the controlling stake of majority shareholders. To implement those multiple purposes, LG designed and installed two key “smart alchemy” components into the transaction structure which LG took advantage of extensively – Treasury Shares and Leverage Scheme.

Treasury Shares : Framework of the HC

Both of the old divesting entities had substantial amount of treasury shares as of the board of resolution date for demerger as follows,

<u>Company</u>	<u>Stake</u>	<u>Reason of purchase</u>
LG Chemical	6.7%	Market Purchase to stabilize the market price
LG Electronics	9.8%	Market Purchase / Merger with subsidiary

⁵⁹ It would be more than 77% if considering the shares held by affiliates and treasury

In split of the financial statement, the treasury shares were not necessarily divided into the separating entities, so those were designed to entirely belong to the HC candidates. Also in demerger process, the treasury shares were split into the different shares in accordance with the demerger ratios. In that way, LG CI, the HC candidate, were able to automatically obtain 6.7% of stake in the separating entities, LG Chem and H&H. Same happened in LG EI, obtaining 9.8% of LG Electronics upon demerger itself. Since the HC were to meet the minimum 30% stake requirement of its affiliates, splitting the treasury shares were the very starting point to comply with it, and also very much reduced the HC's future purchase burden of affiliates.⁶⁰

Leverage Scheme : Alchemy of Creating Controlling Block in the HC

As reviewed in 5.3.1, the split of financial statement in demerger was intentionally designed to lower the DE ratio of the HC candidate while maximizing the per share net asset value, BPS. So the theoretical re-listing base price of the HC candidate was set to the abnormally high level while the business affiliates were way understated so that the share price of the HC candidate plunged from the base price significantly while the share price of the affiliates skyrocketed.

The thing was that this post demerger pricing was definitely reflected in the SWAP processes as the subscription price of the HC shares and the tender prices of the affiliate shares. The HCs, LG CI and LG EI's subscription prices in swapping were merely 23.9% and 12.1% of the base price upon the re-listing, and this pricing scheme created much leverage for the majority shareholders to extend their controlling stakes in the HCs. The

⁶⁰ Interview comment : It was obvious that the treasury shares substantially contributed to ease off the burden to cope with FTA, worked as framework of HC structure. Kisup Sung, Executive Vice president, LG Corp

Table 22 below is to estimate the leverage effect of the pricing scheme of swap, assuming the majority shareholders, mostly Chairman's Family, would have held the original shares in demerger and subscribed the tender fully to exchange their affiliates to the HCs by the given prices. The results were that theoretically they could have enhanced their controlling stake by 3.1x and 4.3x in LG CI and LG EI respectively compared with those in the original entities. ⁶¹

Table 22. The Leverage of Controlling Stake through the SWAP

LG Chemical		CI	Chemical	H&H	
<u>Upon Demerger</u>					
	Old Chemical				
Outstanding Shares	97,613,734	17,570,473	64,425,064	15,618,197	
Chairman Family	10,983,533	1,977,036	7,249,132	1,757,365	
% Holdings	11.3%	11.3%	11.3%	11.3%	
(Base Price upon Relisting)		29,046	9,789	6,317	As of 03/28/01
(Market Price in two months)		8,571	17,300	29,450	As of 06/29/01
<u>Upon Capital Increase, CI</u>					
Family Subscription		1,736,223	Shrs		
(Subscription)		8,681	Wm		
Outstanding after		37,570,473			
Chairman Family		3,713,259			
% Holdings		9.9%			
<u>Upon Tender SWAP</u>					
(Tender Pricing)		6,930	17,100	30,410	As of 11/08/01
Tender Value (Wm)			123,960	53,441	
No of CI Shares			17,887,468	7,711,613	
No of CI Shares of Family		29,312,340			
Outstanding after SWAP		94,770,135			
% Holdings		30.9%			
LEVERAGE		3.1			

⁶¹ Interview comment : The entire transaction structure was intentionally designed to take advantage of the "leverage" effect to improve the controlling stake of the Chairman's family in the HC. Kisup Sung, Executive Vice president, LG Corp

*Interview comment : The leverage effect was more than the simple calculation in senses that (1)the most of the quality assets were deliberately allocated to HC (2)the treasury shares were assigned to HC which eventually resulted in the understatement of the shareholders equity of HC. Stanley Jo, Sr. Fund Manager, Hyundai Investment Trust Management

LG Electronics			
<u>Upon Demerger</u>			
	Old Electronics	EI	Electronics
Outstanding Shares	155,118,070	15,511,807	139,606,263
Chairman Family	27,510,131	2,751,013	24,759,118
% Holdings	17.7%	17.7%	17.7%
(Base Price upon Relisting)		148,424	33,508
(Market Price in two months)		35,400	48,000
			As of 03/27/02
			As of 06/29/02
<u>Upon Tender SWAP</u>			
(Tender Pricing)		17,900	49,700
Tender Value (Wm)			1,230,528
No of EI Shares			68,744,590
No of EI Shares of Family		71,495,603	
Outstanding after SWAP		92,865,192	
% Holdings		77.0%	
LEVERAGE		4.3	

(*The real transactions basically followed identical courses as shown above, however, there were some deviations, for example, such as cash in and out in realities, so the real consequences of SWAP were somewhat different from the results of above table)

Mostly thanks to the leverage from the smart split of financial statement and the SWAP pricing scheme, the controlling stakes in the HCs reached the highest level of listed companies. In March 2003, the two HCs merged and virtually formed the group HC, named LG Corporation, and not surprisingly the controlling block of LG family accounted for 65.3% of total outstanding, including 17% treasury shares, and 10.4% owned by affiliates according to the current FSB filing.⁶²

On the other hand, the SWAP created the shareholding structure of the HC, in case of LG Chemical as shown the Table 23, purchasing the affiliates shares in the tender by the issuance of new shares. Based on the former interest which was from the treasury shares of the old company, the HC could extend its shareholdings into affiliates, LG

⁶² Interview comment : If includes the treasury shares purchased from the shareholders who objected to the merger transaction according to the Commercial Code, the total stake goes up to around 80%. Theoretically LG has to consider the “going private” of the HC in regard to the market valuation as well as the percentage of the shares, but doesn’t really have any intention to implement it considering the side effects. Kisup Sung, Executive Vice president, LG Corp

Chem, LG H&H, and LG Home Shopping, to 21%, 25%, and 30% respectively. Those level of interest approached the criteria of minimum 30% set by the FTA.

Table 23. The SWAP and Consequences in Formation of the HC, LG Chemical (In Wm)

Board Resolution	11/08/01			
Record Date	12/21/01			
Subscription	11/26/01 ~ 12/5/01	Identical to Tender Period		
Price per Share (W)	6,930	Offered Price of CI		
Paid In Capital after transaction		485,661		
Common		94,770,135	shrs	From "Treasury"
Preferred		2,362,160	shrs	
	Tender Price / Shr	No. Tendered	Subscribed	Sub. Amount
LG Chemistry	17,100	17,636,000	10,747,136	183,776
LG Household & Health	30,400	4,276,000	3,446,422	104,771
LG Home Shopping	54,800	1,968,000	1,968,000	107,846
(Total)				396,394
	No of SWAP-CI	CI's -Before	CI's -After	CI' Share %
LG Chemistry	26,518,907	4,290,000	15,037,136	20.6%
LG Household & Health	15,118,503	1,040,000	4,486,422	25.3%
LG Home Shopping	15,562,251	0	1,968,000	30.0%
(Total)	57,199,662			

5.4 Hypothesis 3 : Economic Consequences (Assessment)

It is said that “LG demergers enhanced shareholders value and improved the corporate governance”. The hypothesis must be tested or assessed separately.

5.4.1 Aspects of Shareholders Value

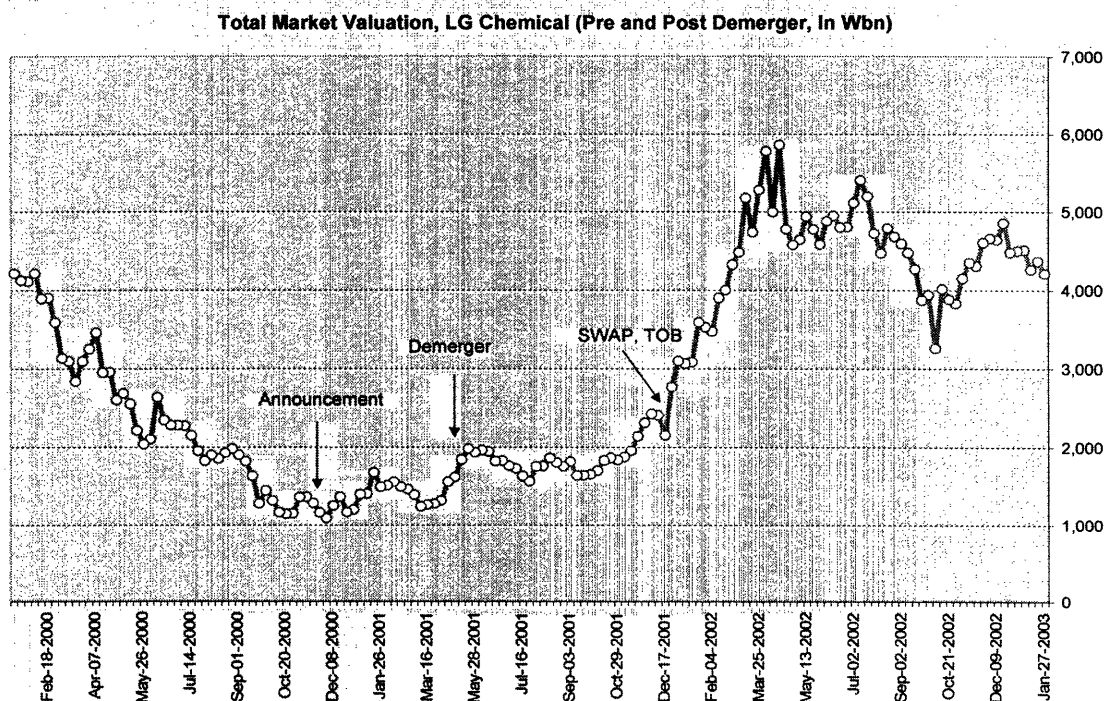
In terms of Market Capitalization

The simplest way of testing whether the demerger enhanced the shareholders value is to see if the total market capitalization has been increasing after the demerger. (Absolute Performance) More specific and scientific approach would be the comparison of the post demerger market price with the major market index. (Relative Performance)

* LG Chemical

As shown in exhibit 2, it looks intuitively obvious the market capitalization of LG Chemical was boosted by the demerger, however, there was some time lag.

Exhibit 2. The Trend of Market Capitalization upon Demerger, LG Chemical

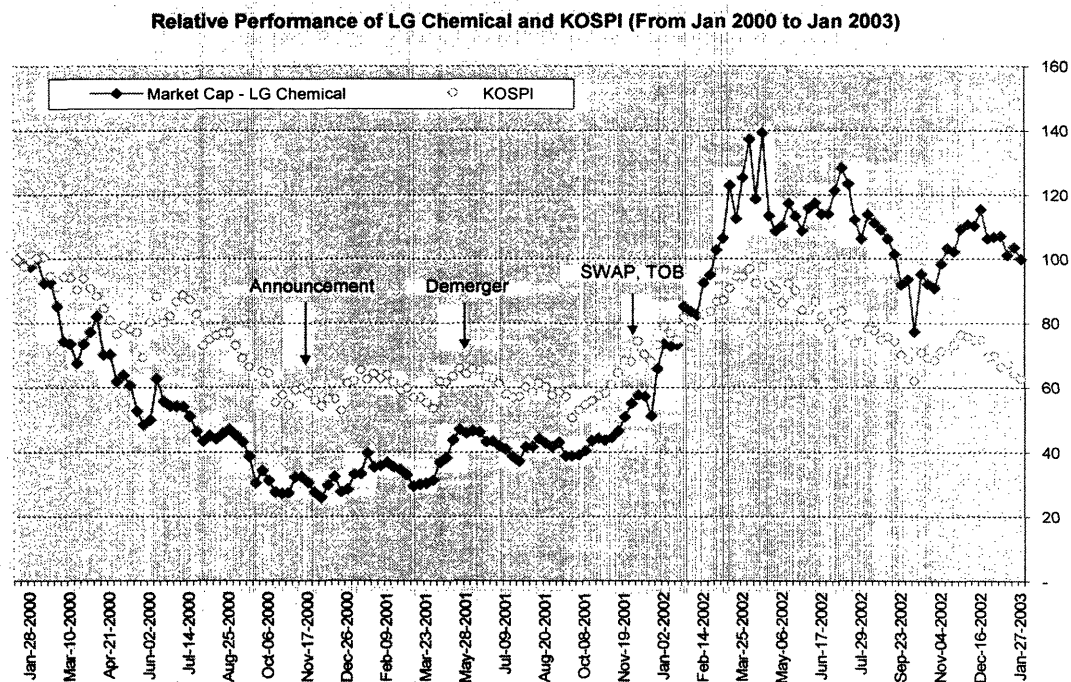


(*The post demerger Market Capitalization is the simple summation of those of the separating entities)

Upon the announcement of old LG Chemical on November 15, 2000, the stock market didn't react simultaneously and it took about almost 10 months for the share price to take off upwards. The market needed time to decipher the spin-off structures with the HC, which was definitely unfamiliar to most of the market players, and also to digest and overcome the controversies and skepticism.

But the big jump period of price, between October 2001 to March 2002, was exactly overlapped with the overall bullish market, so the relative price performance has to be reviewed.

Exhibit 3. Relative Performance of LG Chemical and KOSPI, Jan 2000 ~ Jan 2003



(*KOSPI : Korea Stock Price Index. Market Capitalization of LG Chemical and KOSPI on January 4, 2000 were assumed as at 100.0 respectively)

Exhibit illustrates that the share price had been underperformed the market Index in the year 2000-2001 period reflecting the complexity of diversified business portfolio and poor corporate governance. However, upon completion of the demerger, the share price of LG Chemical have clearly outperformed the market Index afterwards.

* LG Electronics

As shown Exhibit 4, it also quite obvious that demerger boosted share price of LG Electronics. But, unlike the LG Chemical case which was the precedent case year earlier, the share price started to move upon the announcement, not upon the completion of the transaction. It seemed simply because the “Study Effect by the precedent case” drove the market price under the assumption that the follow-up case would be on the same positive direction.

Exhibit 4. Trend of Market Capitalization upon Demerger, LG Electronics

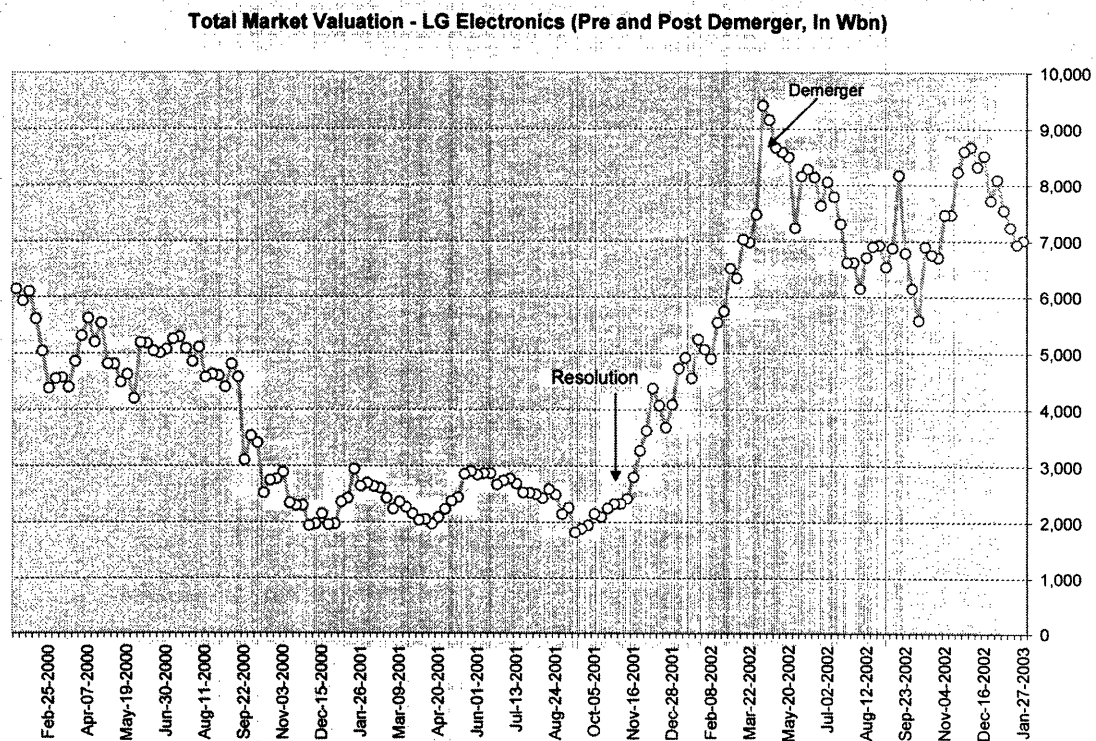
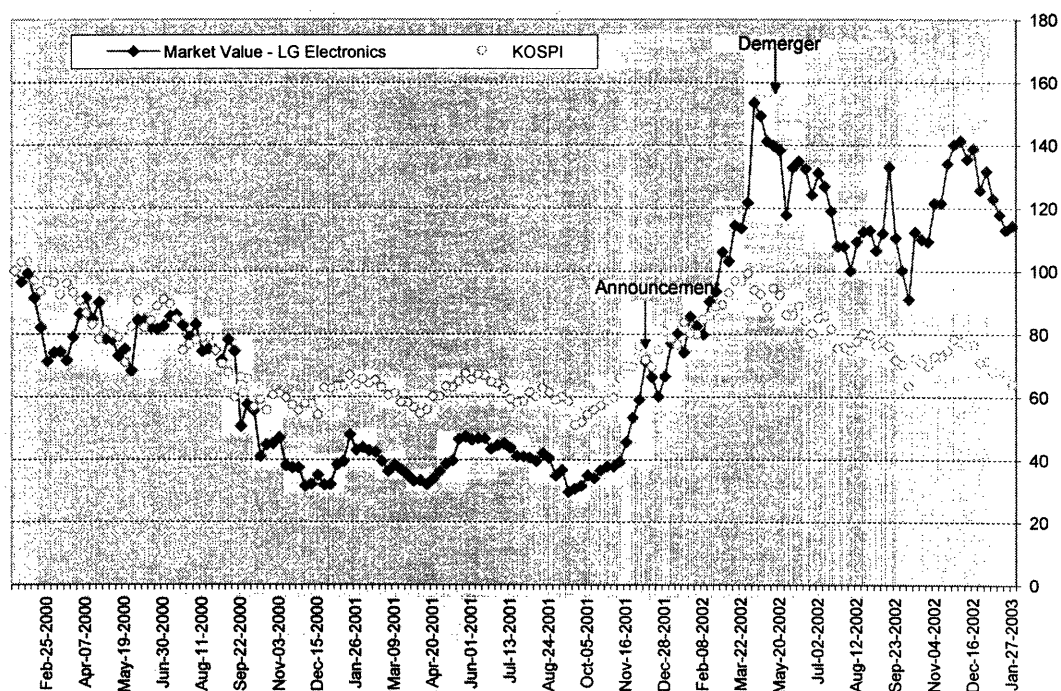


Exhibit 5. Relative Performance of LG Electronics and KOSPI, Jan 2000 ~ Jan 2003

Relative Performance of LG Electronics and KOSPI (From Jan 2000 to Jan 2003)



(*KOSPI : Korea Stock Price Index. Market Capitalization of LG Electronics and KOSPI on January 4, 2000 were assumed as at 100.0 respectively)

Same as LG Chemical case, LG Electronics demerger also made a material momentum change in market price, shifting underperformance to outperformance of the market Index.

So, it was quite clear that the LG demergers enhanced shareholders value in terms of market capitalization – both in absolute relative performance.

In terms of Financial Performance

As discussed in 2.6, the enhancement of market capitalization in demerger must be justified by the improvement of financial performance in the long run, otherwise the inflated value will be retrieved.

Table 24. below illustrates the financial performances of related LG entities since the year 1997 to date. (The shaded portion indicates the numbers of post-demerger, and the underlined are the simple summation of the numbers of affiliates, not the numbers from consolidation according to GAAP)

We can possibly say that the accounting profit, NPAT, has been improving through demergers, however, can't say how much it came from the demerger.⁶³ Looking at the EVA, it is more obvious that the demergers improved the profitability.⁶⁴

In terms of MVA, both LG Chemical and Electronics came out of the negative numbers after all in 2002, which could be interpreted as the direct result of the demergers.⁶⁵

Therefore, it is quite defensible argument that the LG demergers, in the relatively short run, enhanced shareholders value in terms of financial performances in such as NPAT, EVA, and MVA, yet, the long run consequences have to be monitored to firmly support the hypothesis.

⁶³ Interview comments : The strong performance of LG Chemical, however, can be partially attributed to the robust market situation of the industry, not only by demerger itself. Daeyong Park, Senior Analyst, Research Center, Hyundai Securities

⁶⁴ Most of EVA numbers are smaller than the NPAT numbers over time, implying that the companies have suffered from the over-diversified investments

⁶⁵ The aggregated MVA number of LG Chemical in 2002 is smaller than that of EVA number, since the LG CI destroyed MVA significantly while the business entities - LG Chem, H&H, and Life Science – created multiples in MVA/EVA. This implies the severe under-valuation of the HC and one of the main causes of so-called “Korean Discount” in the capital market

Table 24. The financial performance of LG Chemical and LG Electronics,
NPAT, EVA and MVA During the 1997~2002 (In Wbn)

NPAT (Net Profit After Tax)						
	97	98	99	00	01	02
LG Chemical (Divesting)	6.4	53.6	367.7	324.8	<u>308.8</u>	<u>516.1</u>
LG CI					120.7	132.0
LG Chem					132.5	345.3
LG H&H					55.6	44.1
LG Life Science						(5.3)
LG Electronics (Divesting)	9.2	112.0	2,005.0	502.0	507.0	<u>593.5</u>
LG EI						315.8
LG Electronics						277.7
EVA (Economic Value Added)						
	97	98	99	00	01	02
LG Chemical (Divesting)	(188.0)	(85.0)	122.2	86.5	<u>31.6</u>	<u>450.8</u>
LG CI					68.8	100.6
LG Chem					(57.1)	305.0
LG H&H					19.9	61.1
LG Life Science						(15.9)
LG Electronics (Divesting)	187.7	(138.3)	1,819.0	607.2	369.9	<u>488.5</u>
LG EI						235.1
LG Electronics						253.4
MVA (Market Value Added)						
	97	98	99	00	01	02
LG Chemical (Divesting)	(964.1)	(514.5)	1,671.8	(1,330.7)	<u>(648.4)</u>	<u>427.6</u>
LG CI					(1,167.4)	(1,336.0)
LG Chem					256.6	1,415.5
LG H&H					262.4	338.2
LG Life Science						9.9
LG Electronics (Divesting)	(655.2)	(406.1)	2,618.6	(1,728.6)	6,449.0	<u>1,598.1</u>
LG EI						(1,630.0)
LG Electronics						3,228.1

About Table 24.

* The EVA and MVA calculations followed the standard formula suggested by Professor Peter Joos, Sloan School of Management, MIT

* The EVA data provided by the research institutions in Korea implied that they used quite different formula and ingredients of Invested Capital to calculate EVA, which basically excluded the investments to their affiliate companies. The analysts had

legitimate arguments that most of large Korean companies were assuming holding company position (not the legal HC under FTA) while doing its conventional business. So the substantial amount of investments would significantly deteriorate the EVA numbers if those were simply included in the Invested Capital. They insisted that adoption of the US formula shouldn't be appropriate due to the differences of accounting rules and practices. In that sense, even though it wasn't compelling, there were some chances that the EVA and MVA numbers in Table 24 understated the real economic consequences.

* WACC numbers of the companies were imported from the "Annual Korean Company Handbook", which has been updated annually by co-working research institutes.

* Ke (Cost of Equity) : On the appropriate Market Premium, I had several conference calls to consult with the strategist and analysts in Seoul, and concluded to use the followings over the time period. Also on the Risk Free Rate, the fixed income specialist recommended the 1 year maturity MSB (Monetary Stabilization Rate, Bank of Korea) rate to cover the entire period cohesively. On the Beta, I found that market research institutes adopt 1 year volatility data for Beta, which seemed obviously had some limited statistical meanings, however, I imported the data of 3rd quarter 2002 from the same source of WACC and used it to cover the entire 5 year period. The Components for the Computation of Cost of Equity were,

	FY 97	FY 98	FY99	FY00	FY01	Remarks
Rf	14.8%	7.2%	9.0%	6.8%	5.3%	MSB rate, year end
Rm – Rf	15.0%	3.0%	13.0%	13.0%	12.0%	Analyst Opinion

5.4.2 Improvement of Corporate Governance

It is said that “LG demerger improved the corporate governance”, which has been on long discussions separately from the shareholders value point of view. In plain spin-offs, nothing would have to do with corporate governance, but the management efficiency would be the only concerns.

However, the LG demergers were further shaped with the HC structure of which featured phenomena were (1) dismantled ownership structure, creating indirect control through the HC (2) increased controlling block of the HC by Chairman’s Family (3) dual listing of the HC and affiliate.⁶⁶

Basically, it was obvious that those transactions enhanced the controlling of the majority shareholders, but it didn’t necessarily mean the improvement of corporate governance.⁶⁷ The following points were discussed in regard to corporate governance aspects of the LG demergers.

Positive Aspects of the Transaction Consequences

(1) The alignment between the realities and legal entity is said to be the most noticeable products of the transactions. Before that, it was truly at least a moral problem in that the Chairman’s staff office performed the HC functions without legal presence, so it had so-

⁶⁶ Dual listing refers to the situation that the HC and its affiliates are listed together in the stock market. It’s quite unusual in line with the global practice and theoretically a bit grey although it is allowed according to regulations in Korea.

*Interview comment : Korean government fully realizes the characteristics of dual listing and its uniqueness. Ingyoo Park, Deputy Director, Antitrust Bureau, Fair Trade Commission/Sukrin Hong, Senior Associate, Disclosure Supervision, Financial Supervisory Board

⁶⁷ Interview comment : About this point, most of the market players, the fund manager and analysts, agreed on the argument unanimously

*Moreover, basically the HC is not receptive to market players who are in support of shareholders capitalism, because they think the HC creates “corporate group” which is inevitably accompanied with “internal capital/resource market” issue. In that perspective, the HC is the regressive form of corporate governance. Seung Il Jung : “Industrial Policy, where is it supposed to go to”, Position 21, Progress Network, Conference, March 14, 2003

called superpower to make major managerial decisions but didn't have any liabilities. So the argument is that the transactions at least removed the discrepancy.⁶⁸

(2) Some argue that the autonomy of management in the affiliates companies was reinforced because the individual majority shareholders would control the affiliates only indirectly through the HC, and the management was set free from the non-core managerial issues regarding the "group".

(3) Since the dividends are almost the only revenue source of the HC, they are supposed to push the affiliates paying more dividends to the shareholders. Needless to say, it has become common to pay more dividend than ever among the affiliates that belonged to the HC, which used to be not the customary practice.

Some Deficiencies of the Structure

(1) The greatest concern is that the Chairman's Family and its affiliates finally holds too high percentage of shares in the HC, say way over than 50% in the end, which stipulates the clear control of the HC directly and the affiliates indirectly by the absolute majority voting power.⁶⁹

(2) At the same time, the HCs have suffered, and definitely will suffer from the severe under-valuation in the market, in that sense the majority shareholders had to and will give up some wealth in terms of share price in exchange of the corporate control

⁶⁸ Interview comments : It is mostly true. The relevant policymakers realize that it isn't best solution, however, they argue that it is still much better than the Chaebol's conventional complicated controlling structure since the transformation simplifies the shareholding structure of the affiliates disconnecting insolvency risks each other as well as the alignment issue. Ingyoo Park, Deputy Director, Antitrust Bureau, Fair Trade Commission.

*Exactly same argument as FTC. Kisup Sung, Executive Vice president, LG Corp

⁶⁹ Interview comment : The transaction was designed to maximize the controlling stakes over the HC to cope with the future dilution in regard to the limited financial capabilities of the Chairman's family. Kisup Sung, Executive Vice president, LG Corp

(3) There would be some constraints of minority shareholders' rights coming from the dual listing structure of HC and its affiliate, which is further discussed in 5.5

(4) Also there would be a strategic conflict between the controlling stakeholders and growth itself, which is further discussed in 5.5.

Set aside the positive aspects, the deficiencies themselves seemed to be not so serious issues, however, it can be a totally different story when they try to answer whether LG's HC model would be sustainable, and so could be the Chaebol's basic future structure of corporate control in Korea.

5.5 Hypothesis 4 : Future Model of Corporate Control

It can be said that "LG's HC model would be the typical and prevailing corporate control structure of Chaebols in Korea in the future", and the new Minister of FTC mentioned currently that he strongly recommend the Chaebols to restructure themselves into the HC system.

However, the uniqueness of the LG's HC model distinguishing itself from the common practice is holding back the conclusion. The LG's HC model can be possibly defined,

Incomplete Separation, Just Reorganization

In the transition to the HC system, the business entity has to go through the spin-off, but the separating entities must be consolidated under the controlling of the HC. In principle, it won't be a pure separation but just the reorganization of corporate control.

In summary, involving the HC structure makes Korean breakup cases totally different from the divestitures of the western world. As reviewed in 3.3, the series of the spin-offs of AT&T over the last two decades, regardless of its compelling drivers, were simple and complete separation in terms of corporate control despite some of the remaining relationship for the brand and marketing synergies. Even the breakup case of ITT in 3.2, the largest US conglomerate, was just a complete separation to fix the problems of over diversification resulting in the historical end of conglomerate in the US.

So under the incomplete form of separation, (1) the enhancement of managerial autonomy in the business affiliates is possibly uncertain as long as the majority shareholders maintain the absolute majority voting power over the HC. (2) Moreover, the chances for the minority shareholders of the affiliates to challenge the management of the HC is very slim due to the legal split, which implies deterioration of minority shareholders rights.⁷⁰

Incomplete Holding Company Structure

According to the current FTA, it is allowed for the HC to own other than 100% shares of its affiliates, as a matter of fact, just 50% shares of private affiliate and only 30% shares of listed affiliate. Also, the dual listing status, meaning that the HC and its affiliate are listed altogether, is not restricted by the relevant financial regulations.

The common practice in regard to the HCs in the western countries is well illustrated by the General Electric which is a pure HC holding 100% of its 51 affiliates.

⁷⁰ This issue comes from the dual listing situation. The concern is that the minority shareholders of affiliates can't not challenge the management of the HC even in the case that they pervasively influence the managerial decisions of the affiliate

Naturally only the HC, General Electronics, is listed in NYSE.⁷¹ There are totally different shapes of HC in Korea. However, unlike the LG's model, Shinhan Bank formed a pure financial holding company, Shinhan Financial Service, in September 2001, following the GE's holding company model.⁷²

So, LG's HC model can be identified as incomplete HC structure compared with the common practice. (1) This nature raises the problem of dual listing, implying certain conflict of interests between shareholders between the HC and affiliates. (2) Also relatively low % criteria of the HC's shareholding to the affiliates allow the majority shareholders to leverage their corporate control on a large scale.

Future Model of Chaebol's Corporate Control

Furthermore, strategically, under the current LG's HC model, the HC will face serious difficulties when it needs massive equity financing due to the affiliates' needs such as operating capital for consistent long-run growth or emergency funding to cope with certain contingencies. It comes down to the inevitable massive dilution of controlling stake or giving up the strategic growth and evolution. In that sense, affiliates' growth possibly conflicts with the corporate control structure of the HC so some are

⁷¹ As reviewed in 4.3.1, there is only one exception that GE owns 50% in a Joint Venture

⁷² The former listed companies in Shinhan financial group together with the privately owned companies tender-offered their shareholders to swap shares with newly formed HC, consequently the HC held 100% of most of its affiliates' shares, and the affiliates went private. The HC holds 100% of Shinhan bank which accounts for more than 80% of paid in capital of the HC, and holds 59.4% of its securities arm which was decreased from the 100% due to the acquisition of another securities firm in 2002. Also it holds 100% of its credit card service and installment service. So, although it holds some of the affiliates other than 100%, the basic strategy is holding 100% of the affiliates.

skeptical whether the LG's HC model is sustainable and generally applicable to the other cases.⁷³

So, considering the uncertain sustainability as well as the incomplete characteristics of LG's HC model, it must be still regarded just as one of the "prototype" of governance model of Korean Chaebols which have been consistently asked to restructure and reform themselves in line with the principles of shareholders capitalism. It's the remaining tasks for the policy makers, market players, and Chaebols themselves to improve the current model to cope with the market demands in regard to the reform and future role of Korean Chaebol.⁷⁴ The positive thing is that the discussions regarding this issue are getting robust these days including the perspective of critics on the generic shareholders capitalism.⁷⁵

⁷³ In the conventional ownership structure, it was technically allowed to make the "circulating investment" which forms investment connections among affiliates as "A→B→C→A" just avoiding the simple cross holdings. It was widely used to enhance the controlling stake as the dilution went on over time. But it is prohibited in the HC structure so that the conflict would be possibly very serious in case

*Interview comment : Overall results of the transaction in the short run was satisfactory so far internally, however, not sure about the consequences in the long run. Also they anticipate that the LG's HC model won't be simply applicable to other Chaebols considering the differences in the controlling structures and relevant cost factors under the current circumstances. Kisup Sung, Executive Vice president, LG Corp

⁷⁴ Interview comment : FTC haven't set any HC model to drive the Chaebols yet, and just reviewed the cases implemented whether they complied with the FTC. Ingyoo Park, Deputy Director, Antitrust Bureau, Fair Trade Commission. / Also the Minister of FTC mentioned many times these days in the press interview that the current form of HC is tentative corporate structure of Chaebol in transition to the independent individual companies like those in the US

⁷⁵ While the government, capital market players, and the citizen activist group altogether have supported the ideas of shareholders capitalism in Korea in order to reform the Chaebol, enhance the management transparency, and protect minority shareholders, some of the activist group, such as "Position 21", currently raised other perspective about the direction of Chaebol's role in the long run. It criticized the side-effects of shareholders capitalism, for examples, the short-sighted view of investment and its volatility due to the herd behavior of the investors in the market. It also argued the ultimate direction of reform of Chaebol, the disintegration, won't be necessarily positive result in light of the past experiences of the large independent companies in Korea. Therefore it presented unique agenda to perceive Chaebol as a form of "stable controller" of the large business in the future so that the government would strongly induce the Chaebols to restructure their corporate control into the HC structure in revision of HC criteria. It even insisted that banking sector's investment must be allowed in formation of the HC in support of Chaebol's effort if necessary. Seung Il Jung : "Industrial Policy, where is it supposed to go to", Position 21, Progress Network, Conference, March 14, 2003

6. Conclusions

In general, it would be considered as acceptable hypothesis that the most of divestiture cases driven by the strategic purpose of “focus and concentration” have been justified by the enhancement of shareholders value for last decades since the capital market increasingly asks the companies to be clean-cut pure players. From the shareholders capitalism points of view, any corporate formation creating corporate group or diversification is not desirable so that those cases are to be penalized by the conglomerate discounts. The AT&T and ITT breakup cases illustrated typical separation or disintegration of over-diversified businesses resulting in the creation of the American model of “independent” companies.

The divestitures were introduced in Korea as one of the restructuring instruments of the corporate sectors in late 1990s in order to overcome the foreign currency crisis, and it didn't take long until this unusual concept prevailed and practiced widely in the market. However, in some cases, the divestitures were combined with formation of the HC structure, which made the issue very complicated one in regard to the reform and restructuring of large Chaebols in Korea. The LG demerger cases were right in the center of the discussions.

LG launched the demerger transaction mainly as the corporate control solution which was to cope with the dilution issue of majority shareholders and compliance issue to FTA, also as unlocking measure of the fair market valuation. The implementation of

the HC structure and the Spin-offs were adopted to address the former and latter purposes respectively. (Hypothesis 1)

The key components that physically materialized the LG's transaction, the smart alchemy, were (1) the purchase of treasury shares which constituted the framework of the HC structure upon demerger and (2) the leverage scheme taking advantage of market price mechanism linked with the splitting of financial statements in demerger. Regulating principles in regard to the valuation of demerger were suggested. (Hypothesis 2)

From the thorough review of aftermaths, it was obvious that LG transactions enhanced shareholders value in terms of market valuation both in absolute and relative term. This shorter term perspective was reasonably justified by the fact that the financial performance of the related entities was quite positive in last two years when demergers took place. However, the long run consequences shall be monitored to confirm the arguments as generally acceptable one in Korea. Also it was believed that the LG transaction clearly enhanced the corporate control of the majority shareholders after all, but it didn't necessarily imply the overall improvement of corporate governance. (Hypothesis 3)

Finally, in regard to the characteristics of the final consequences, LG's model would be identified as incomplete separation with the HC structure compared with that of global practice so that it may incur the theoretical and strategic conflicts among the stakeholders. Therefore, it is not clear whether the LG model would be sustainable to be

the prevailing form of Chaebols' corporate control in the future, but it can be possibly defined as just "prototype" about which many controversies and discussions are underway in Korea. (Hypothesis 4)

Interviews

Period March 29 – April 1, 2003
 Location Respective offices, Seoul, Korea
 Interviewer Thesis Author
 List

<u>Institution</u>	<u>Name</u>	<u>Focus</u>
Fair Trade Commission Antitrust Bureau	Yunsoo Kim (Sr. Deputy Director) Ingyoo Park (Deputy Director)	General Policy on HC
Financial Supervisory Board Disclosure Supervision	Sukrin Hong (Senior Associate)	Financial Regulatory aspects on HC
LG Corp.	Kisup Sung (Executive Vice President)	Implementation of HC
Hyundai Inv. Trust	Stanley Jo (Sr. Fund Manager) Hyunwoo Lee (Fund Manager)	Market Perspective on HC
Tong Yang Securities Proprietary Trading	Taesun Jeon (Head Fund Manager)	
Hyundai Securities Research Center	Daeyong Park (Sr. Analyst)	Analyst Perspective on HC

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