

PERSPECTIVE

Business and Politics in South Korea

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My recent travels took me to South Korea at an interesting time given mounting tensions with its neighbor to the north. My colleagues and I got a pulse check on some of the reforms taking place, including those related to the family-run conglomerate companies known as chaebols.

Political Influences

I first came to South Korea in the 1970s, and politics have been contentious there as long as I can remember. Over the years several Korean presidents have been jailed for corruption and one unfortunately committed suicide when his family came under investigation.

The most recent president to be jailed is former President Park Geun-hye, the daughter of Park Chung-hee, the previous strongman leader who ruled South Korea from 1963 until his assassination in 1979. As a teenager, she became de-facto “first lady” when a North Korean sympathizer assassinated her mother.

Perhaps not surprising given her traumatic past, she fell under the influences of a religious group in South Korea called the Church of Eternal Life. Its leader and later his daughter, Choi Soon-sil, were said to be Park’s confidantes.

When Park was elected president in 2013, Choi and her followers gained influence over a wide range of issues, including government budget proposals. Allegedly, Choi also used her position to pressure leading Korean chaebols to donate millions of dollars to her foundations, among other alleged illegal activities.

It’s important to note that US federal law and the Foreign Corrupt Practices Act could result in penalties on the embroiled chaebols and restriction of their business activities in the United States.

Corporate Governance and Reform

Park’s scandal and subsequent impeachment heightened awareness of corporate governance in South Korean companies. In May 2017, Moon Jae-in, a reform candidate from the opposition party, was elected president on a platform calling for a number of reforms and measures to weaken the chaebols’ power.

Scandal seems to be part and parcel to politics in South Korea. Some commentators say that it is very difficult for South Korea to break the tie between politics and business, but we have seen corporate governance undergoing substantial change as a result of recent scandals.

The National Pension Service (NPS) has been key in the effort to help clean things up. It is the third-largest pension fund in the world with more than US\$450 billion in assets. NPS has held substantial shares in companies listed in South Korea, so it has often had the deciding vote on various measures at shareholder meetings.

But alas, even the NPS has been subject to scandal. In 2016, Moon Hyung-pyo, a former South Korean minister of health and welfare and subsequent chairman of the NPS, was arrested for abusing his authority to pressure the NPS to cast a key vote in a corporate merger deal. The NPS held a substantial stake in both companies involved.

We were very interested in this case because approval of the merger would be disadvantageous to minority investors like us. We had hoped that the NPS would support minority investors. Instead, the NPS supported the merger at unfair prices that favored the vice chairman of one of the involved companies and his family. During the investigations, one of the NPS officials said he was pressured by a senior official of the South Korean Health and Welfare Ministry to back the deal. We were quite disappointed in the NPS action.

Nonetheless, we were starting to see signs the system was improving.

There has been a lot of debate regarding the proper organizational structure for the chaebols to achieve good corporate governance. One debate centers around the holding company structure, which some observers saw as a way to clarify the very complex ownership structures of the chaebol. These conglomerates often include a plethora of subsidiaries with multiple small holdings by the controlling family.

Since 1987, the government had prohibited the holding company structure, because it was thought that the chaebols could utilize the structure to strengthen their power. After the Asian Financial Crisis in 1999, the holding company structure was allowed again, regarded as a way to restructure the chaebols' ownership to make them more transparent.

At that time, the holding company structure was subject to many regulations. This was relaxed, so the end result was a holding company pyramid ownership structure.

Stewardship

After its scandal, the NPS mandated the Asian Institute of Corporate Governance (AICG), a research institute at Korea University, to develop standards. The AICG had been looking at the stewardship codes of the United Kingdom and Japan as models.

In Seoul, my colleagues and I visited a university professor who was leading a group to enhance minority shareholders' power and influence in listed company affairs. Another professor with whom we'd worked with in the past, Ha-Sung Jang, had been a strong supporter of corporate governance. President Moon recently appointed him to a key cabinet post. We view this as a positive step since it puts corporate governance issues in the heart of the Korean government.

There are many barriers to the application of a stewardship code. Up until recently, foreign investors have led shareholder activism. However, they have not been effective.

A great deal of antagonism is expressed in the local press, which is typically under chaebol influence. Chaebols are the largest advertisers, and some even control the newspapers directly. So, nationalist sentiment against foreign influence is a popular subject for the local press.

If you want a sense of the situation, the Korean film "Inside Men" is worth checking out. The film deals with corruption in the chaebols and the nexus between politicians, banks, the press, the underworld, the police, prosecutors and the powerful chaebol business groups.

Power of the Chaebols

In Korea, the power of the chaebols is evident by the number of small- and medium-sized companies dependent on them for business. The chaebols are well-known acquirers of businesses that look profitable. They also establish businesses against incumbent firms and then drive the incumbents out of business in order to take the lion's part of market shares.

One example being a supplier to a major chaebol electronics manufacturer we met. The smaller supply company made parts for the giant's smartphone business. The small firm's earnings were highly dependent on the chaebol's smartphone operations. So, a recent decline in the larger firm's smartphone sales caused the smaller company to also suffer. Some 60% of the smaller firm's sales were dependent on the larger chaebol. In order to gradually move out of this difficult situation, the management's plan was to start soliciting business from Chinese smartphone manufacturers. However, it was unclear whether the chaebol would allow it.

Despite an apparent weakening of chaebol power in recent days, the families controlling chaebols still prosper using their connections with affiliate companies and their financial power.

Given the various dynamics involved, it's quite complicated to reform the system. Chaebol reform is still a work in progress.

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