
Capturing the private equity value creation opportunity among mid-cap SMEs

AVCJ KOREA 2016

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Practical assessment of Korean private equity and the mid-cap SME sector (work-in-progress)

Seoul, August 31, 2016

Key messages

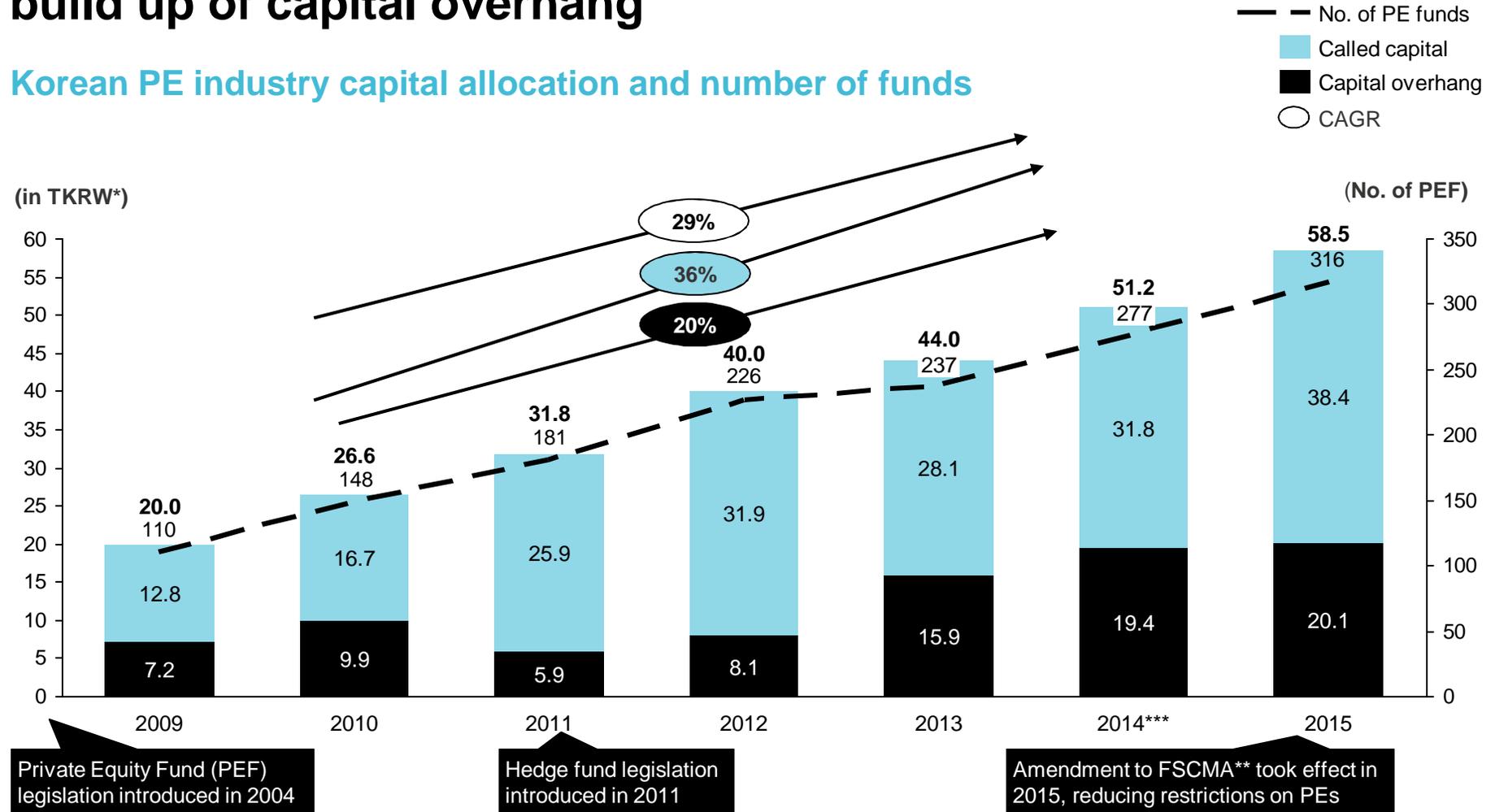
Korean private equity has grown rapidly into a polarized structure of a few dominant players and a long tail of smaller funds, with frequent regulative changes influencing firm operations and somewhat growing capital overhang

Issues related to challenges in allocation of funds, available targets (and capabilities) and exit paths affect smaller funds and mid-cap SMEs and prevent Korean private equity to reach its full potential

There is more potential but it takes decisive action; taking control and boosting SME operative capability, helping them to expand to new markets has value creation potential; there are also some interesting emerging sectors driven by technology and structural factors

The Korean PE industry has grown rapidly, with some recent build up of capital overhang

Korean PE industry capital allocation and number of funds



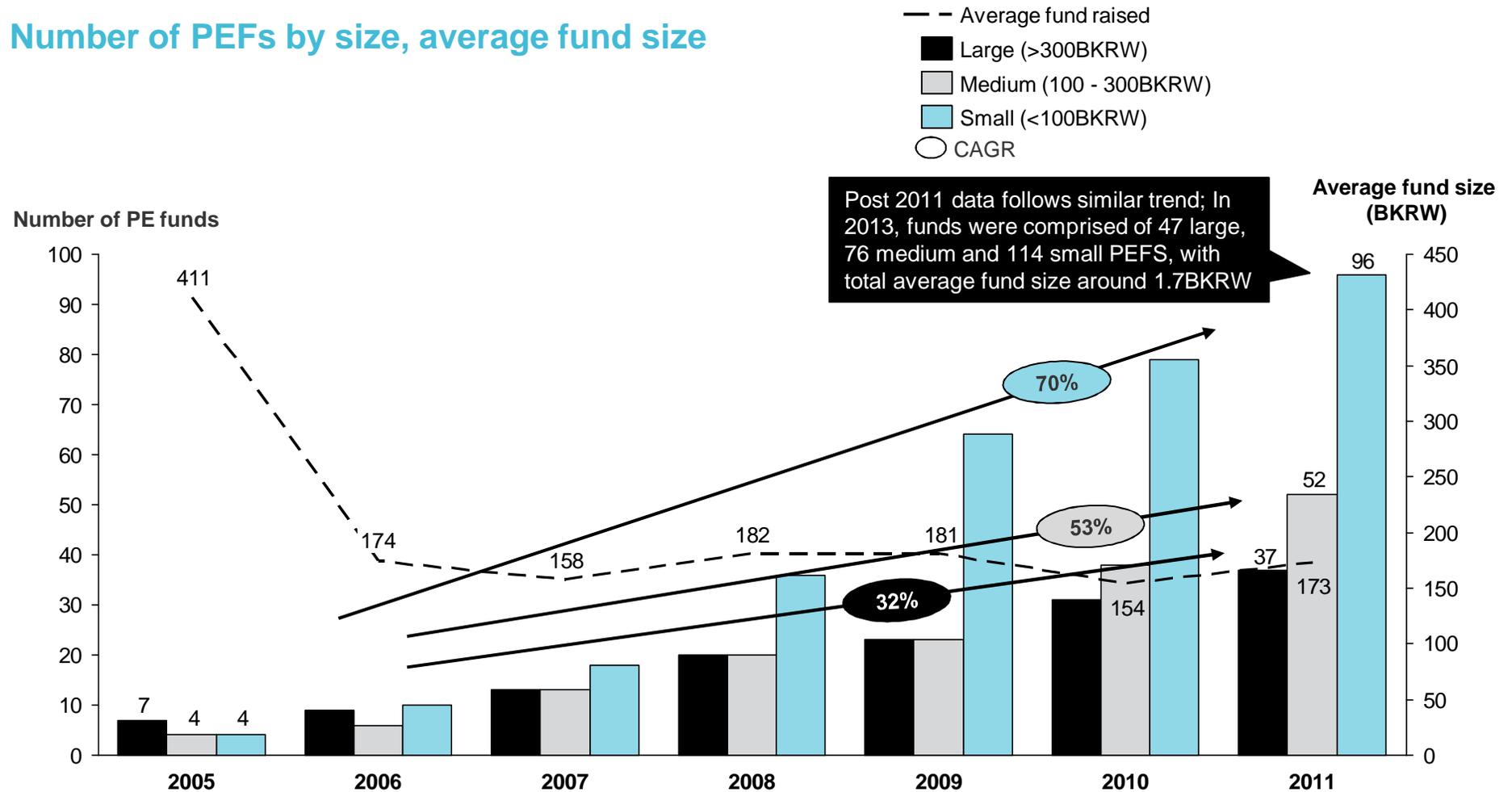
*1TKW is approximately 0.838USD using currency rate on 5/24/2016; **Financial Investment Services and Capital Markets Act (FSCMA);

***Figures adjusted based on modeling and Korean Capital Market Institute report

Source: Financial Supervisory Service, 5년 PEF 동향 및 시사점, 2016; Practical Law, Multi-jurisdictional Guide 2015/16

In particular small and medium funds have grown fast, creating a long tail of smaller players

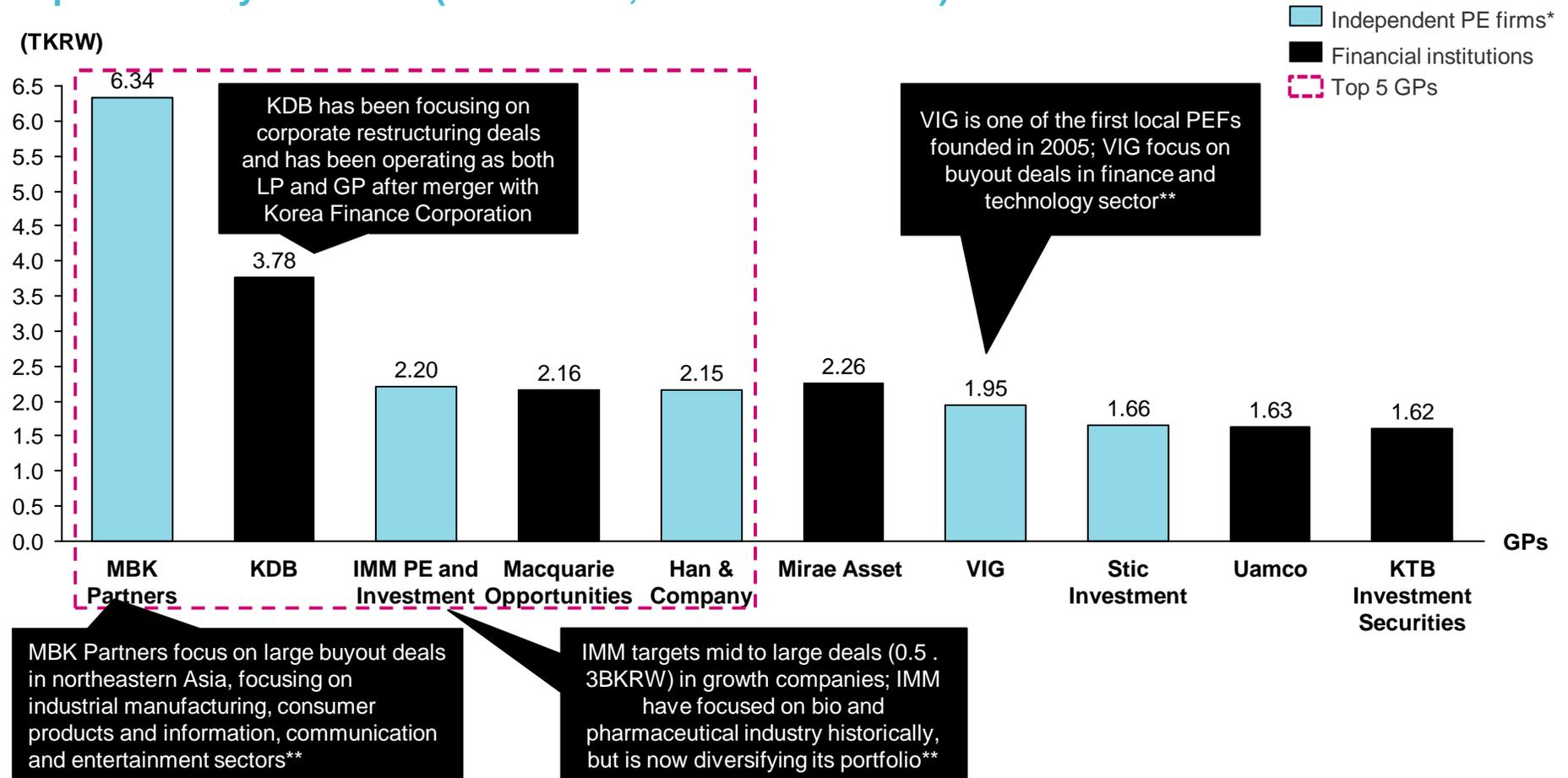
Number of PEFs by size, average fund size



Source: Financial Supervisory Service (2011)

Top 5 GPs out of 162 GPs accounted for more than 30% of total 51.2TKRW committed funds

Top 10 GPs by fund size (committed, as of end of 2014)

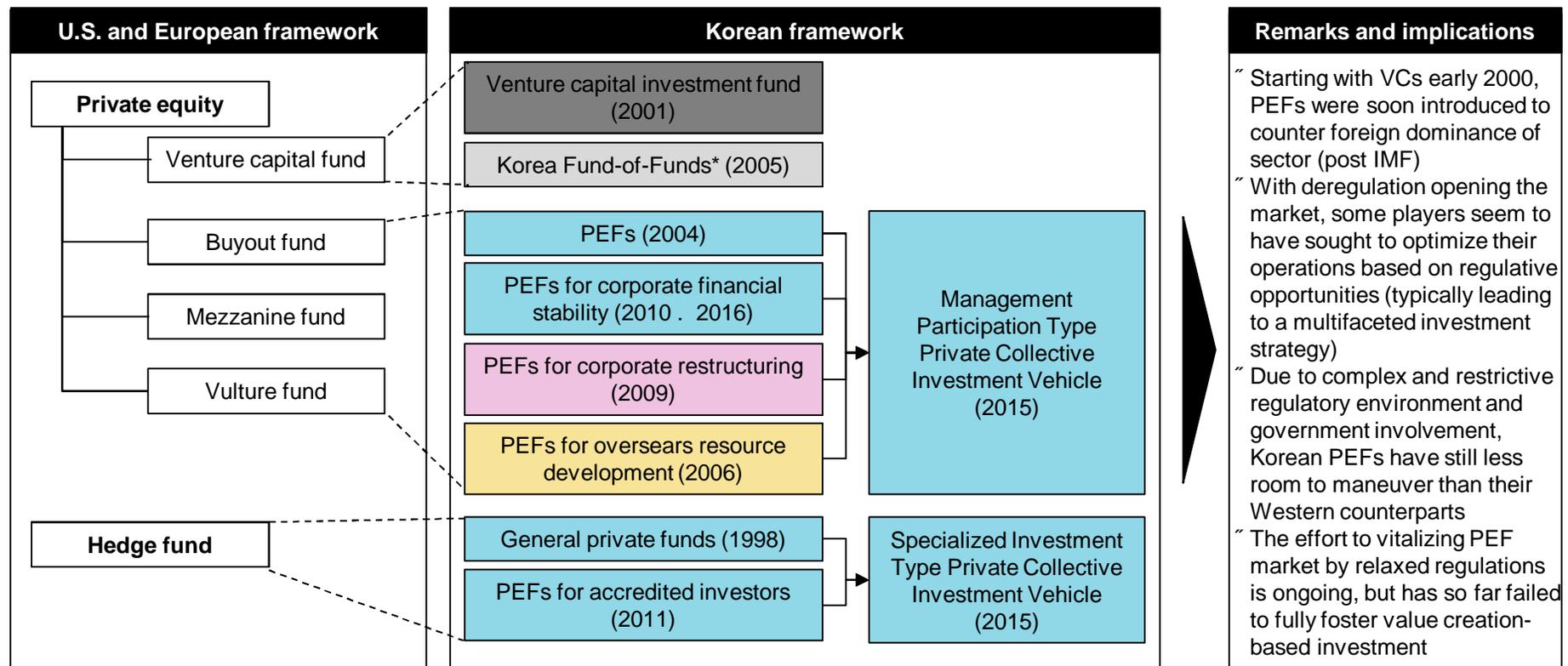


Source: Hankyung Stock ([www. stock.hankyung.com](http://www.stock.hankyung.com)); **KPMG Issue Monitor (2014)

During the 2000s, the Korean private equity legal framework has developed a lot, and left its mark on the industry structure

Regulatory framework comparison

- Financial Investment Services and Capital Market Act
- Industry Development Act
- Support for SME Establishment Act
- Special Measures for Promotion of Venture Businesses Act
- Overseas Resource Development Business Act



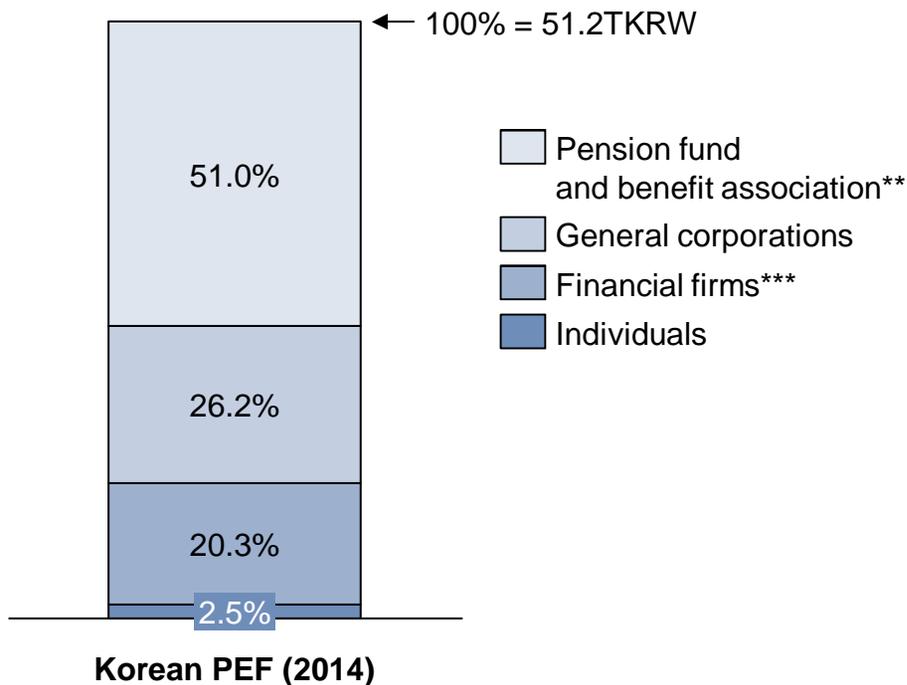
Source: Han, Sangjin (2015); Financial Services Commission; Lee and Han (2013)

*In Korea, PE Fund-of-Funds are only allowed under special cases to promote venture businesses; **Parts and material special investment fund, Korea venture investment fund

Government controlled/semi-government pension funds currently hold a large share of Korean private equity capital commitments

Korean PE source of funds

Korean* PEF committed capital by type of LPs



Remarks

- “ A majority of contribution to Korean PEF comes from (semi-)government organizations such as pension funds and benefit associations influenced strongly by public sector officials (in addition, many SMEs also depend on government funding and support)
- “ As semi-government organizations are risk-averse in nature, some GPs in Korea may have difficulties in developing their investment portfolio optimally
- “ However, financial firms and general corporations typically lead the investment due to strategic imperative to explore new value creation opportunities
- “ The market is still young; there is further capital growth potential with contribution from wealthy individuals, universities and foundations*

*Research by Korea Capital Market institute found that average contributions for foreign PEFs were 32% pension funds, 16% individuals, 15% institutions, and 9% universities, foundations and other (2014)

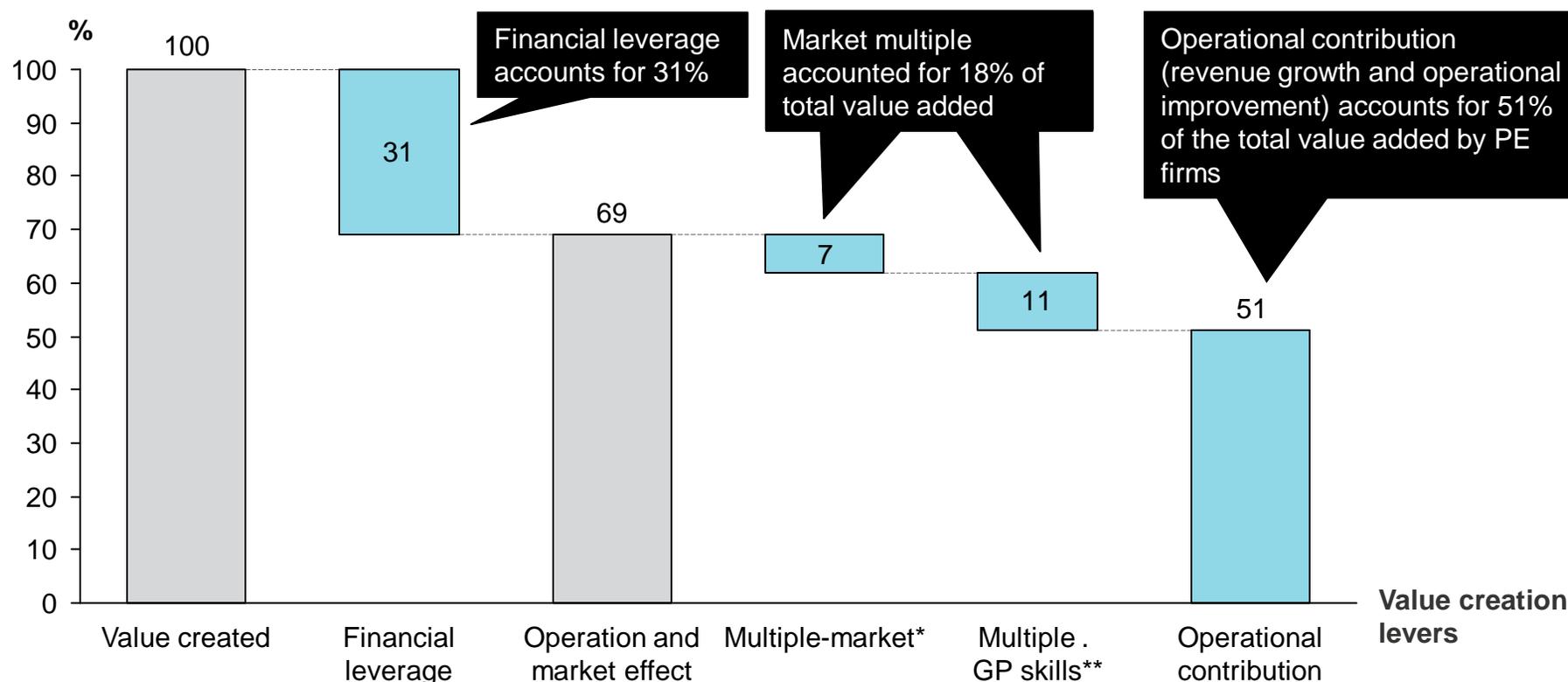
**National Pension, Teachers Pension, Government Employees Pension, Korea Post Insurance, and Military Mutual Aid Association, Korean Teachers Credit Union, Korean Finance Corporation, and others

***Financial firms refers to, but not limited to, commercial banks, insurance company, securities company, credit card company and savings bank

Source: Financial Supervisory Service, Preqin

Leverage and operational contribution (revenue growth and operational efficiency) are primary value creation levers for global PE funds

Value creation in PE (realized buyout deals, worldwide)



*Multiple effect due to an uplift in public market valuation; ** Multiple effect due to deal-specific multiple expansion, attributable to GP multiple expansion skills linked with qualitative operational improvements

Source: Analysis of 701 exits completed between 1990-2013 in North America, Europe and Asia-Pacific, Value Creation in Private Equity, Capital Dynamics and the Technische Universität München (June 2014)

There are several bottlenecks that need to be overcome to leverage the full value creation potential of Korean PE

Overarching factors affecting Korean private equity performance

Fragmented capital allocation

- ~ Due to short history, majority of local GPs lack concrete track record and reference cases, which may have limited their ability to raise anything more than fairly small project funds
- ~ Majority of contribution to Korean PEs comes from semi-government organizations such as pension services and benefit associations which are risk averse by nature and may be reluctant to allocate large investment amounts to a single fund
- ~ PE firms with small project funds may have difficulties in allocating enough capital to an individual deal to gain control

Lack of attractive targets with growth potential

- ~ Many SMEs are suffering from low profitability and growth due to being captured by domestic markets and customers (often large conglomerates with large purchasing power)
- ~ Cultural tendency to not differentiate clearly between ownership and management; control held in the hands of few individuals, in some cases with limited capabilities to lead company to international growth (this also makes it difficult for PEFs to make organizational changes for improved revenue and operational efficiency)
- ~ Some early attempts at creating value through taking operative control were not very successful, some PE firms lack staff members with in-depth operative experience (including global expansion)

Limited exit paths

- ~ There are only a limited number of domestic buyers with enough capital to purchase portfolio companies through trade sales
- ~ Secondary market is starting to develop recently but still is not as active as it is in mature markets
- ~ Albeit this is changing, there is still some negative public sentiment when Korean companies are sold off to foreign entities; an addition, acquiring Korean companies can be difficult for foreign companies lacking the language skills and cultural insight
- ~ Domestic M&A market (which has played a key role) getting more challenging due to economic situation

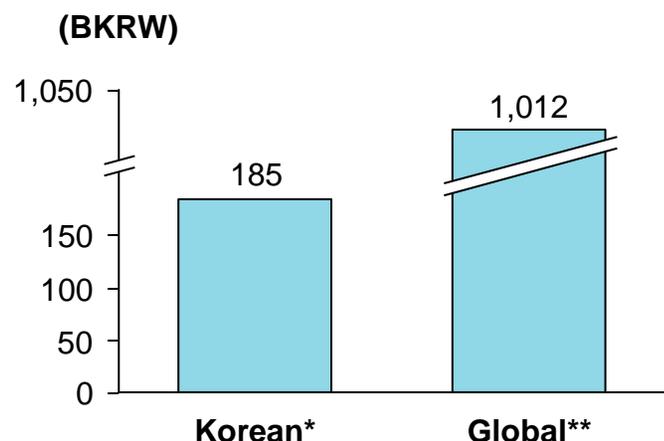
Source: Korea Development Institute Journal of Economic Policy (2016); Interview with market experts

Small fund size coupled with fairly low leverage affect investment strategies, with some players doing mainly minority share investments

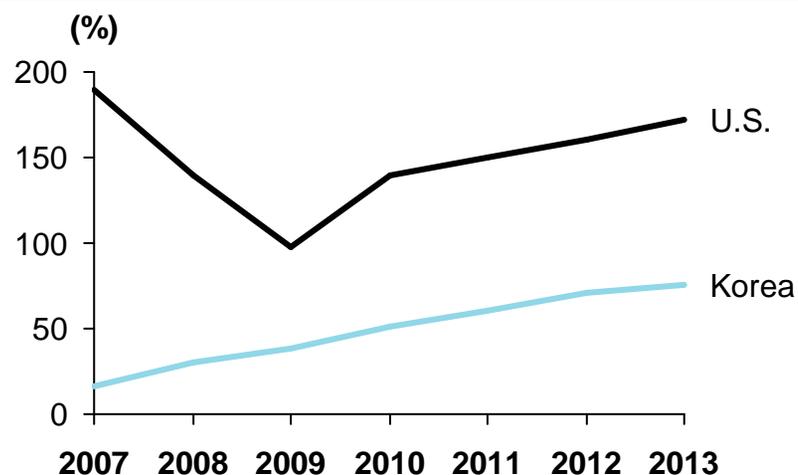
Fund size and leverage comparison

In Korea, up to 300% leverage is allowed for PEFs through use of SPC (special purpose company)

Average committed capital per PEF (2015)



PEF investment leverage***



~ With an exception of a few funds by leading GPs, many PEFs are small-sized project funds, where LPs have a visibility in investment targets prior to committing capital (and can put strict requirements on which deals are made)

~ Small fund size and restrictions on leverage may drive investment strategies to minority share investments, which does not give GPs sufficient control (there are also regulatory and cultural factors affecting this)

~ There is a cultural tendency not to differentiate between ownership and management. +

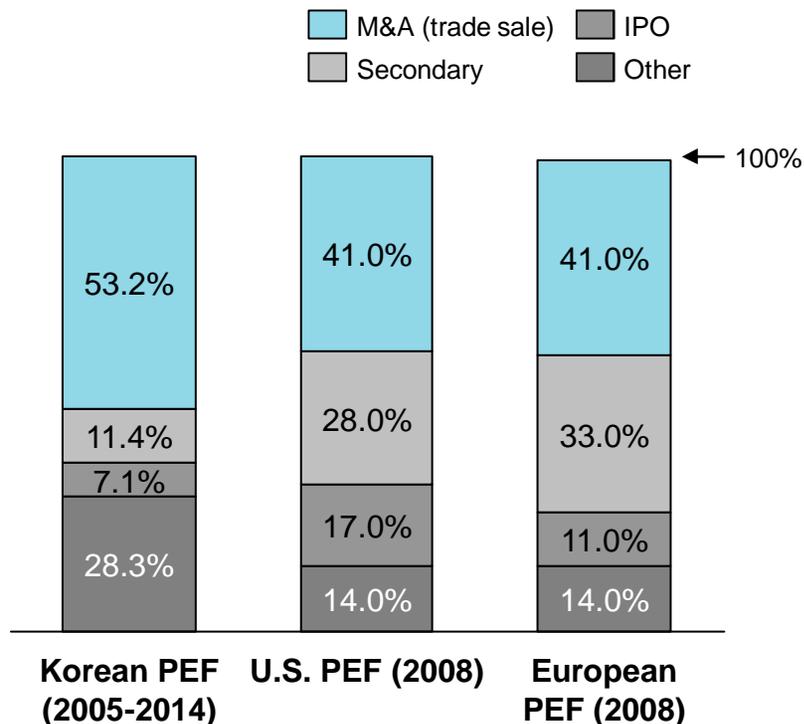
~ Most well-performing SMEs have strong owner-dependency; their performance drops if owner leaves. +

*FSS (2016); **Bain & Company, %Global Private Equity Report 2016+; ***Approximate figures based on Korea Capital market Institute report (2015)

M&A has accounted for primary exit strategy for Korean PEFs, but the economic downturn is putting brakes on this path

Exit strategies overview

PEF exit strategies (share of aggregate exit value)



Remarks

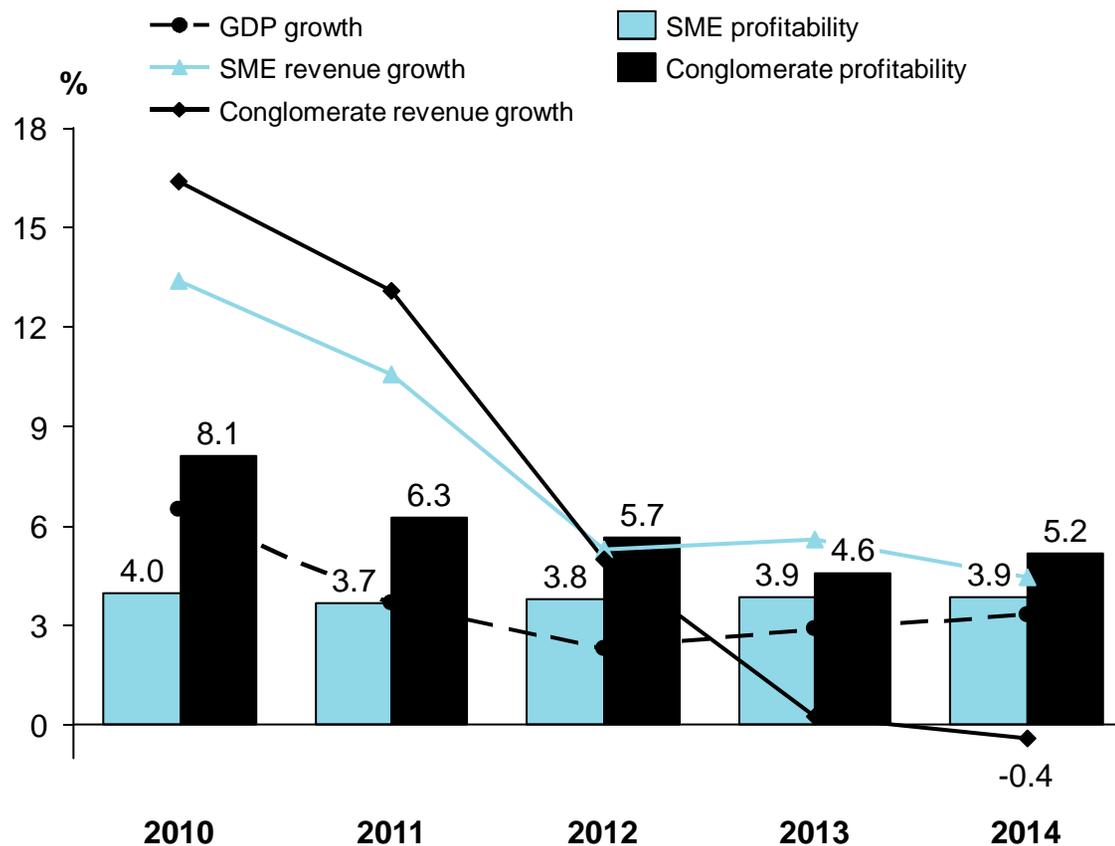
- ~ M&A market has been driven by largely by Korean conglomerates
- ~ IPO of companies with PEF as largest shareholder has been limited by KRX (main exchange)
- ~ Secondary market is still in an early stage compared to matured markets
- ~ Leveraged recapitalization has been increasing as a partial exit method due to difficulties to find a proper exit

Leveraged recapitalization substitutes some of the company's equity with additional debt, usually done by the company raising money by borrowing from a bank or issuing bonds, which amount is then used to repurchase the company's own shares from the investor

Source: Korea Capital Market Institute (2016); The Global Economic Impact of PE Report (2008)

Korean conglomerates are seeing lower growth and profit; this will trickle down the value chain to the SMEs supplying them

Growth and profitability of Korean SMEs and conglomerates compared to GDP

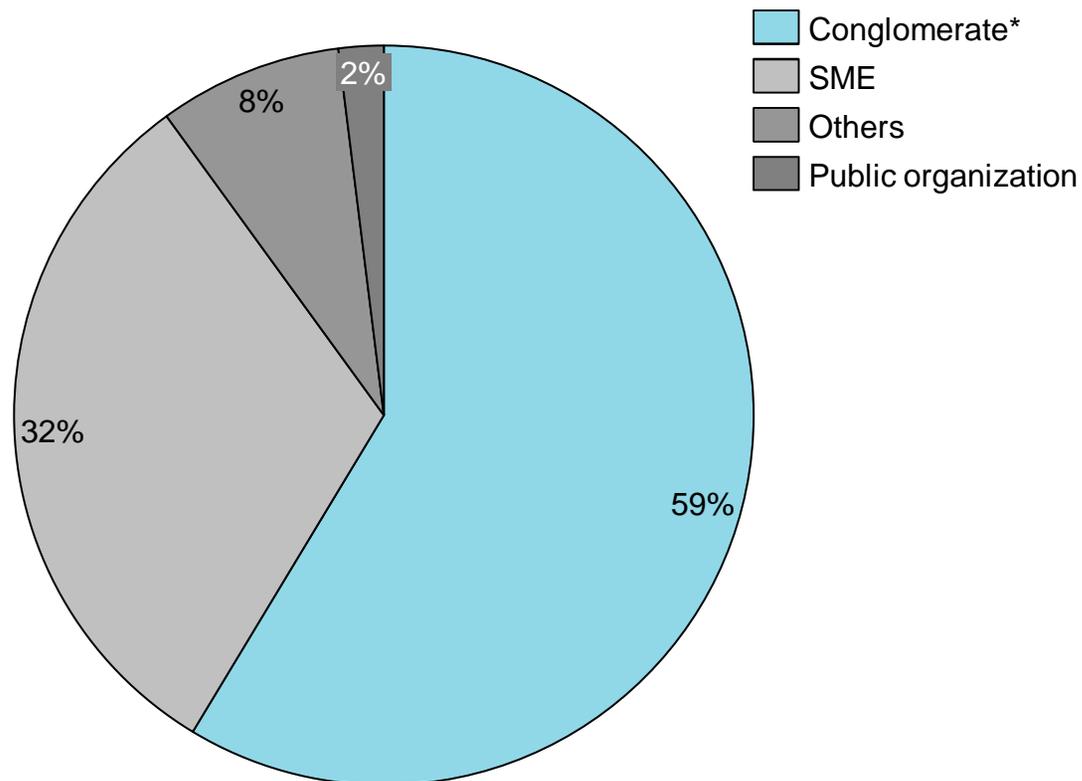


*Source: World Bank

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SMEs in Korea are highly dependent on domestic conglomerates

Korean SMEs (domestic) customer breakdown



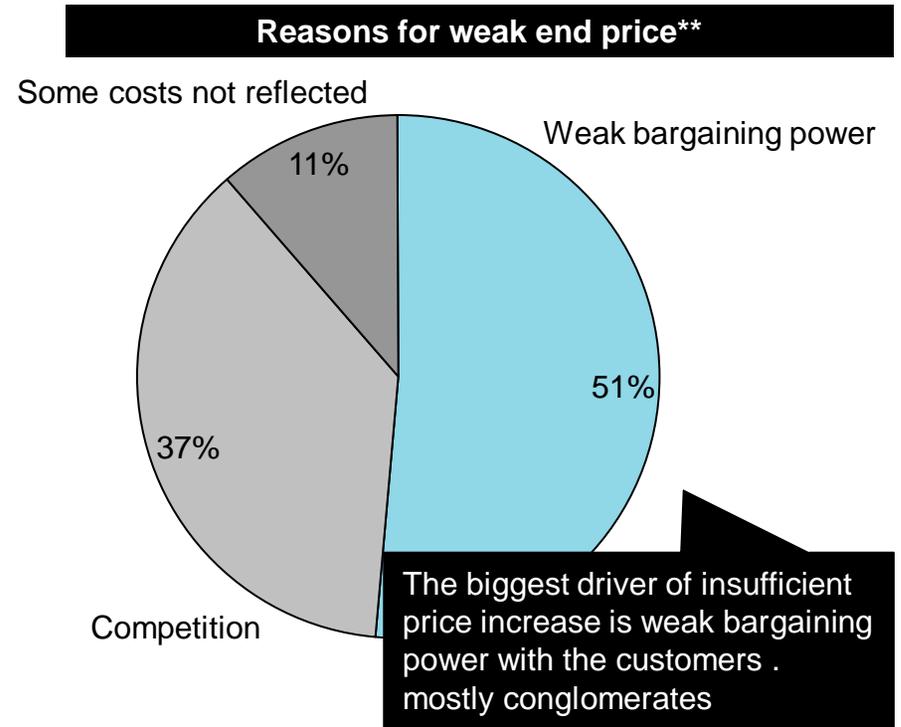
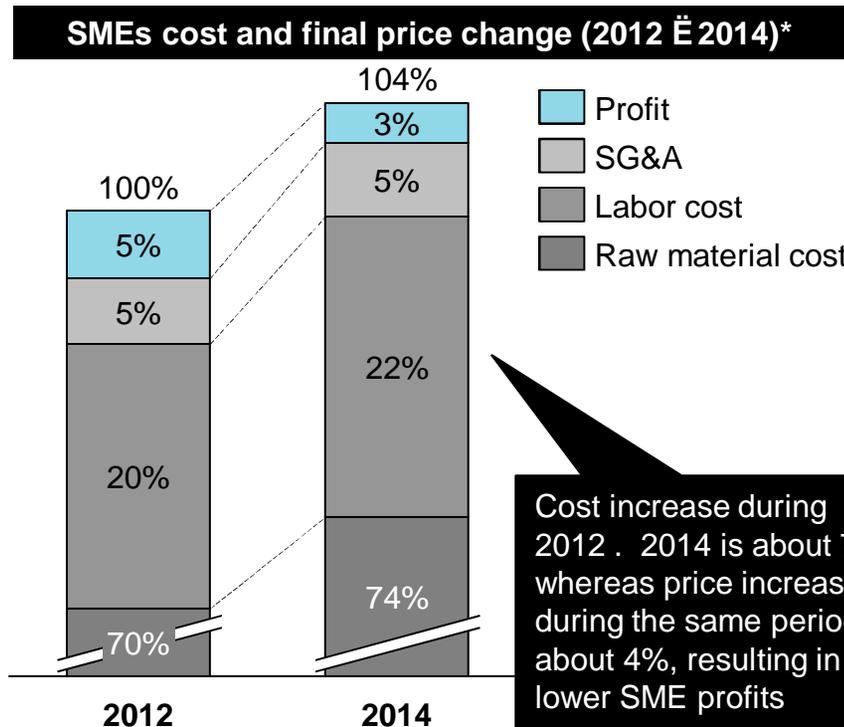
Remarks

- “Diversification of the customer base is key to successfully move to a virtuous cycle for SMEs, but often SMEs feel a sense of loyalty to the local conglomerates and do not actively pursue other customers
- “Although a cultural barrier exists, the attitudes are changing; some conglomerates view positively an SME that can sell its products also to Western competitors (in the hopes that this would develop their offering further, and thus in turn help the Korean conglomerate)

*Including conglomerates and mid-to-large sized firms
Source: Kbiz Korea Federation of SME report, 2014

Dependence on (local) conglomerates drives weak bargaining power of SMEs

Korean SME bargaining power



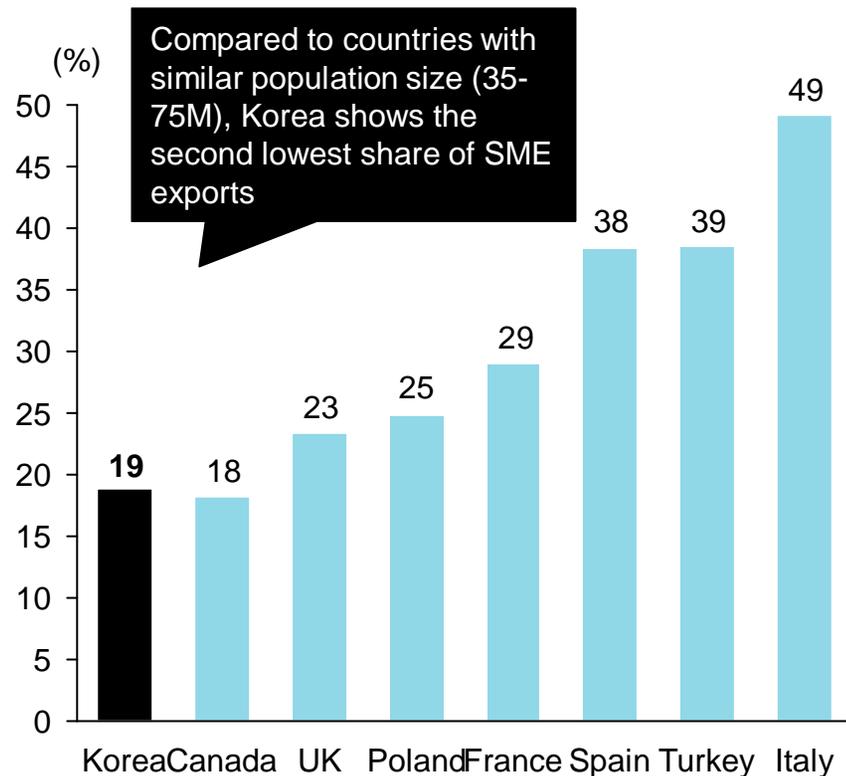
*Proportion of cost items are arbitrarily set for better understanding **Weak bargaining power includes customer refused to increase price, only partial increase agreed, price reduced uniformly without proper reason

Source: Kbiz Korea Federation of SME report, 2014

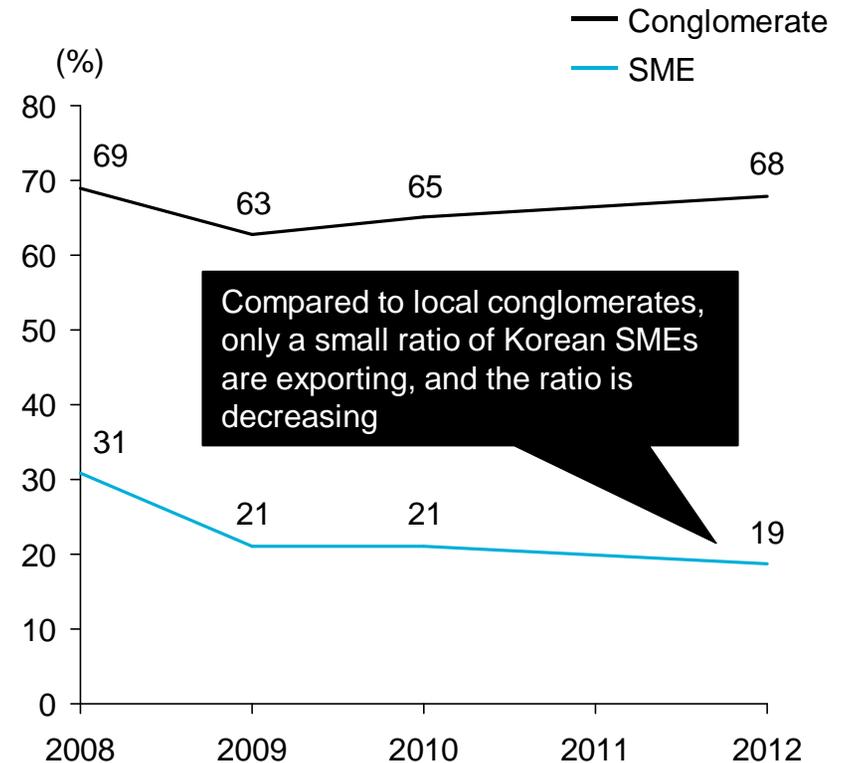
On an overall level Korean SMEs do not seem to actively drive global expansion

SMEs contribution to export

SME export share of total exports per country (2012)



Export by Korean SMEs vs. conglomerates, share of total exports (2008 - 2012)

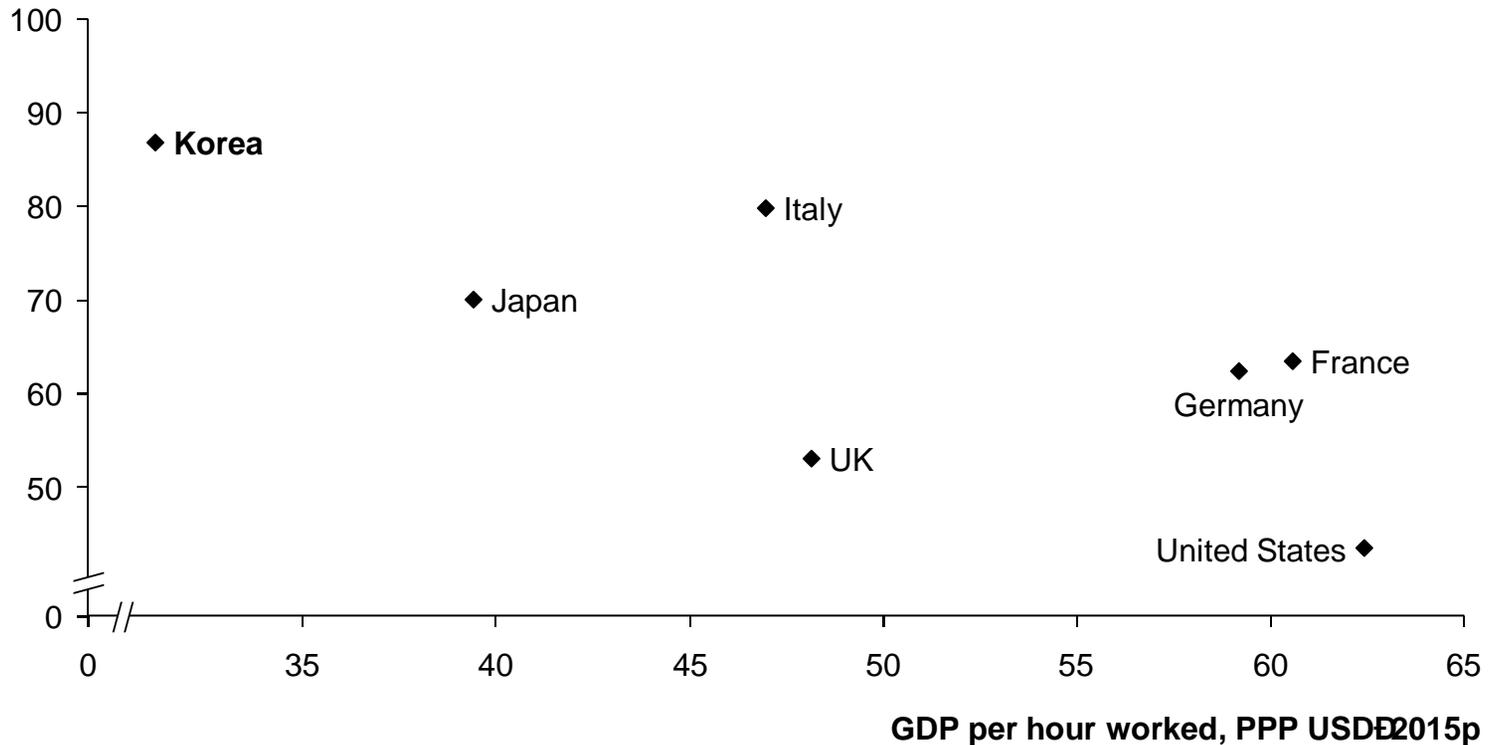


Source: Entrepreneurship at a Glance 2015, OECD, 2015; SMBA

The Korean SME sector is, compared other leading countries, still extremely inefficient

SMEs contribution to overall economy by country

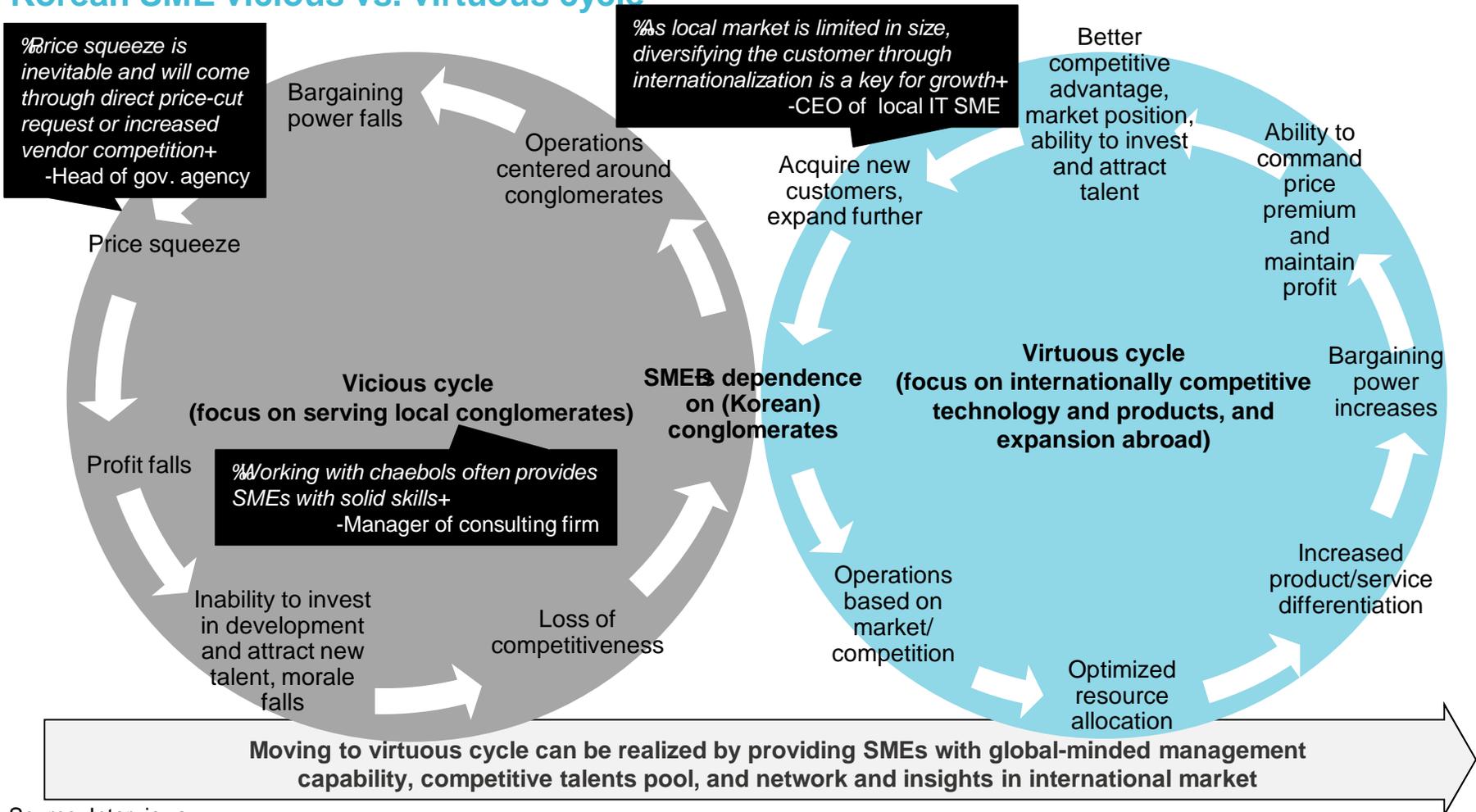
SMEs share of total employment



Source: OECD Compendium of Productivity Indicators 2016; OECD Entrepreneurship at a Glance 2015

High dependence on local conglomerates can trap SMEs into vicious cycle, but this can be broken by customer diversification

Korean SME vicious vs. virtuous cycle

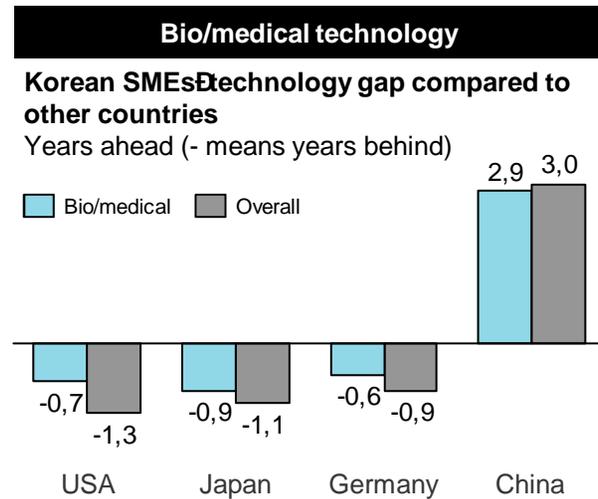


Source: Interviews

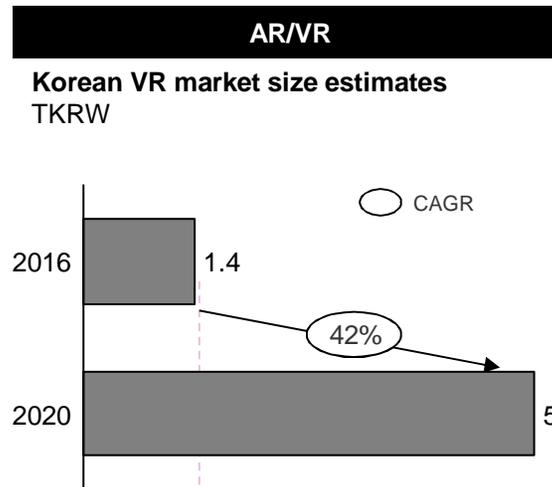


Bio-/medical technology, AR/VR and digital media are some of the sectors where strong Korean SMEs can emerge

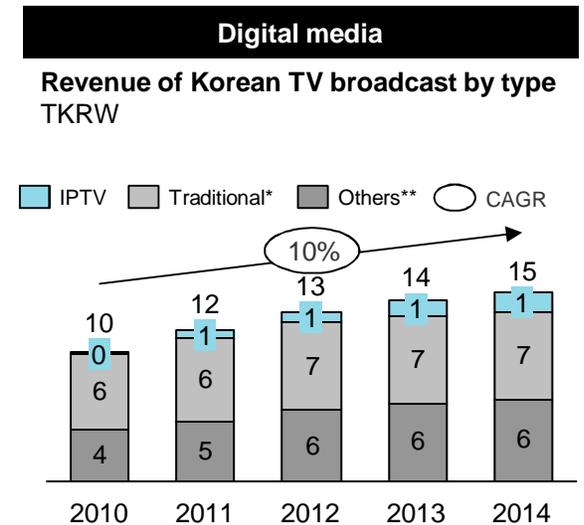
Potential emerging technology sectors



- “ The bio-/medical technologies of Korean SMEs have the least technology gap compared to most developed countries
- “ About 22% of Korean bio-/medical SMEs believe their technologies outrun US tech.
- “ Most developed technological abilities in Korea are manufacturing, operations and maintenance, reaching about 79% vs. world top class



- “ Revenue from sales of devices as well as contents is expected to grow to 5.7TKRW by 2020
- “ Korean companies have both H/W (Samsung Gear VR) and S/W (plenty of game developers) competency
- “ This year, Korean government vowed to invest 41BKRW in the VR industry through 2016, totalling 185BKRW by 2018



- “ The market size continues growing
- “ Opportunity to diversified offering and revenue model
- “ Also, new trend around transmedia is emerging; Korea is well positioned utilizing widespread mobile and broadband adoption, broad application base and high media consumption rate of Korea

*Traditional includes satellite, cable, ground wave TV broadcast. **Others include home shopping and diverse composition channels

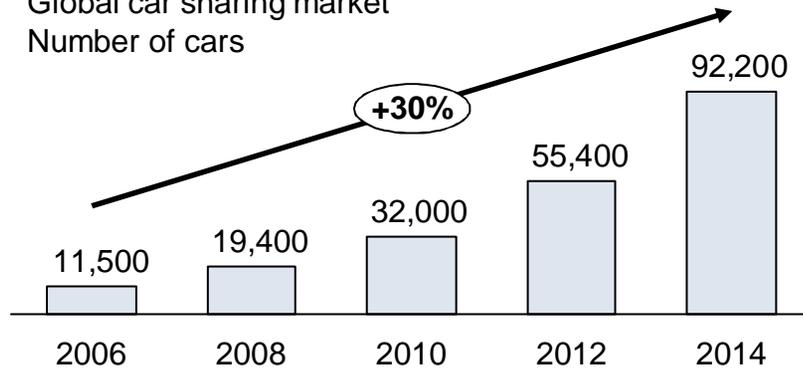
Source: 2015 SME Technology Report SMBA; Korean Virtual Reality Industry Association; Korean broadcasting market competitive status report, 2015, KCC

Benchmarking Japanese market, businesses promoting sharing economy may present attractive investment opportunities in Korea

Potential attractive SME sectors

Car sharing

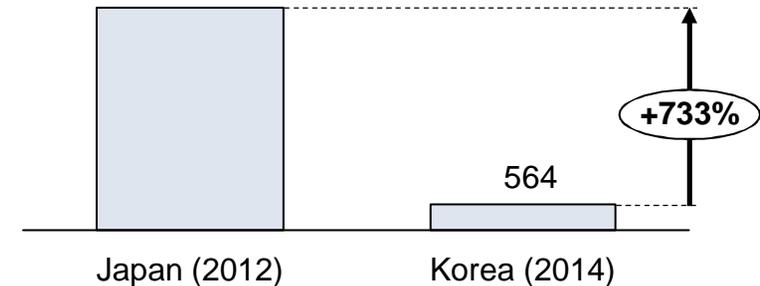
Global car sharing market
Number of cars



- ~ Car sharing market is growing fast globally
- ~ Japanese market has shown even more rapid growth at 100% CAGR during 2002-2016

Second hand trading

Market size in revenue
BKRW



- ~ Korean second hand trading market is still at initial stage with relatively small revenue
- ~ Second hand trading market in Japan has grown at 12% CAGR during 1997-2012

Korea may see similar growth as Japan in sharing industries as both countries experience similar social and economic trends (including long-term recession/low employment rate, increased polarization, deregulation, and increasing environmental concerns)

Source: Investor market report by leading financial institution

There are also other special segments that have shown strong growth in Japanese market which could expand in Korea

Potential growth sectors in Korea based on evolution in Japan

Industry	Growth rate in Japan	Korean market size estimate	Growth driver	Key players (Korea)
Nutrition supplement	6%	1.5TKRW (2014)	<ul style="list-style-type: none"> ~ Aging population ~ Interest growth for health/diet 	<ul style="list-style-type: none"> ~ KT&G ~ Natural EndoTech
Funeral prepayment	4%	3.7TKRW (2015)	<ul style="list-style-type: none"> ~ Low birth rate/super aging society ~ Growth of death rate 	<ul style="list-style-type: none"> ~ PreedLife ~ Boram Sangjo
Car tuning	12%	500BKRW (2013)	<ul style="list-style-type: none"> ~ Deregulation ~ Car market mature 	<ul style="list-style-type: none"> ~ Tuix ~ Tuon
Frozen food	5%	1.6TKRW (2014)	<ul style="list-style-type: none"> ~ 1-2 personsqfamily ~ Aged family ~ Convenience/storage 	<ul style="list-style-type: none"> ~ CJ Cheil Jedang ~ Dongwon F&B ~ Haetai food
DIY	7%	80BKRW (2010)	<ul style="list-style-type: none"> ~ Baby boomer retirement ~ Increased leisure time ~ Permanent low growth of economy 	<ul style="list-style-type: none"> ~ KCC ~ Hanhwa L&C ~ Hansaem
Pet care	4%	1.8TKRW (2015)	<ul style="list-style-type: none"> ~ Baby boomer retirement ~ Urbanization/nuclear family increase ~ Pet as a family member+concept 	<ul style="list-style-type: none"> ~ Daehan petfood ~ Daeju ~ Cheonhajaeil petfood
Parking lot management	8%	1.1TKRW (2015)	<ul style="list-style-type: none"> ~ Increased charge parking areas ~ Strict regulation/fee 	<ul style="list-style-type: none"> ~ Hi Inno Service ~ GS Park 24

Source: Investor market report by leading financial institution



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