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Foreign capital as a means for globalization of Korean SMEs

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South Korea is facing economic challenges from declining population and saturated domestic markets. Globalizing SMEs is becoming increasingly vital, and strategically leveraging foreign capital offers a viable pathway. To attract investors and succeed globally, SMEs must pursue outreach efforts, carry out pre-deal turnarounds, and implement risk mitigation.

Executive Summary

Problem
Globalizing Korean SMEs is crucial for economic sustainability, especially with challenges like an aging population and saturated domestic markets. Despite accounting for over 89% of employment, SMEs struggle with low productivity and an overreliance on local markets. By leveraging foreign capital, these businesses can enhance their competitiveness and expand globally.

Why it happens?
Foreign investors face significant challenges when engaging with Korean SMEs such as limited transparency, misalignment with global business standards, and complex regulations. Profitability concerns, with many SMEs operating on thin margins, further reduce the appeal. These complications make it difficult for SMEs to attract foreign capital which can provide opportunities for global expansion and growth.

Why it happens?
To globalize through foreign capital, Korean SMEs must engage in active outreach and implement pre-deal turnarounds while mitigating key risks. By improving profitability, governance and transparency, SMEs can reduce barriers, align with global standards, and enhance their appeal to investors, thereby open door for international expansion.

South Korea is experiencing a major economic challenge stemming from aging and declining population, which in turn contributes to weak local consumption. Considering that population growth being a key component of GDP growth[1], the rapid demographic shift in Korea presents a grim outlook for the local economy.

Low productivity and limited capabilities of small and medium-sized enterprises (SMEs) further amplify the challenge. Overdependency on chaebols often limits the ability of SMEs to improve their efficiency and competitiveness, and as a result, most SMEs stay local and fail to reach their full potential as a contributor to the nation’s economy.

The concerning outlook is reflected in Korea's GDP growth forecasts. The Bank of Korea has lowered the GDP growth projections for 2024 to 2.2% and for 2025 1.9%[2]. Similarly, the International Monetary Fund (IMF) adjusted its forecast to 1.9% for 2024 and 1.8% for 2025[3]. The figures not only fall short on the global average GDP growth forecast (3.3%) but also lag behind many of its G20 peers[4].

With current circumstances, the globalization of Korean SMEs is becoming increasingly more critical. SMEs are the backbone of the Korean economy, being responsible for over 89%[5] of national employment, and in order to secure long-term economic success, Korea must empower its SMEs to expand internationally and globalize their businesses.

Foreign capital can provide a potential opportunity to accelerate SMEs efforts to globalize and break the chain of hierarchy

In Korea, inbound acquisitions and investments by foreign entities are much less robust than outbound activities. This is largely due to cautious and skeptical public sentiment about domestic companies being acquired by foreign capital based on historical experiences with IMF crisis. According to a report published by the Korea Economic Research Institute (KERI), South Korea's FDI-to-GDP ratio only stood at 0.3% in 2020 which is 25th out of 37 OECD countries[6]. Additionally, according to the Korea Employers Federation (KEF), South Korea experienced a net capital outflow of $310 billion between 2000 and 2021 as FDI was consistently lower than outbound direct investment (ODI)[7].

However, it is worthwhile noting that foreign direct investment can have a positive impact on economic growth at the macroeconomic level. Studies have consistently found a correlation between FDI and increased gross output levels[8]. For Korean companies, acquiring foreign capital can be beneficial in building up the foundation of global business capabilities. Foreign capital can provide access to international markets and enable companies to scale their products or services. It also can bring invaluable resources, such as foreign expertise, advanced technologies, and expanded distribution networks that can further support the growth of local SMEs.

The South Korean market presents challenges for global investors, driven by structural economic constraints, limited alignment with global business practices, and a complex regulatory environment

Korean companies face substantial profitability challenges, with an average operating margin of just 4.5%, which is significantly below the global average of 11%[9]. This issue is even more serious for SMEs, which face economic constraints that limit flexibility and growth. Tight supply agreements and limited pricing power often restrict SMEs’ ability to improve profit margins, reducing their competitiveness and attractiveness to investors.

Also, Korean SMEs often have a limited understanding of global business practices, which makes it difficult for foreign investors to explore investment opportunities in these companies effectively. Lack of understanding international standards, such as compliance, governance, transparency, and operational efficiency, creates hurdles for collaboration and integration into global markets. For investors, this gap presents increased risks and the need for additional resources to bridge cultural and operational differences, therefore making the opportunity less appealing compared to markets with more globally integrated SMEs.

Finally, addressing local regulations and domestic protectionism presents another hurdle for foreign companies. The complex interplay of laws, including the Commercial Law, the Capital Market Financial Investment Act, the Act on Monopoly Regulation and Fair Trade, and Tax Law, creates a regulatory landscape that can make investment or mergers and acquisitions particularly difficult for foreign investors[10]. Additionally, regulations that revolve around national security[11] further complicate the process, contributing to uncertainties and barriers for international businesses seeking to enter or expand within the Korean market.

Active outreach, supported by a comprehensive understanding of global practices, pre-deal turnaround initiatives, and risk mitigations significantly enhance the ability of Korean SMEs to attract foreign capital

SMEs can address and lower those potential barriers for foreign capital by following the methodology composed of four key steps as illustrated in figure 1 below.

Figure 1. Overview of methodology to attract foreign capital

The journey of any SMEs trying to acquire foreign capital can start with building deeper understanding of global M&A processes and practices. Comprehensive understanding of the standard end-to-end global M&A and investment process can equip SMEs with necessary context to align with investor expectations and serves as a basis for navigating complex negotiations. In addition, it can facilitate forward-looking planning and development of clear value creation strategies.

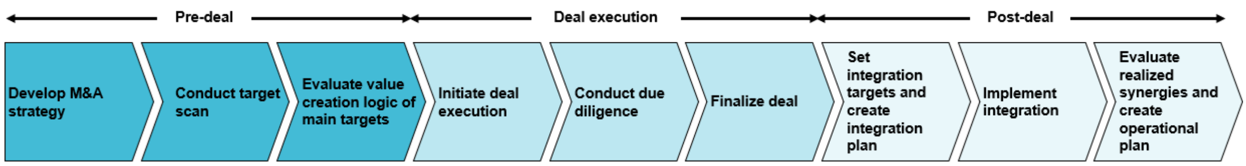

Figure 2. M&A process overview

From investor's perspective, the M&A process involves three key phases including pre-deal, deal execution, and post-merger integration (PMI), as shown in Figure 2. The complete M&A process, including detailed objectives, tasks, and deliverables, is available here. In pre-deal phase, strategic goals are set, acquisition targets are identified, and synergies and financial projections are assessed to create a clear roadmap. What should be highlighted is that investors are interested in evaluating the potential value creation opportunities from a very initial stage of the M&A process.

The second phase is deal execution, which involves due diligence, risk and legal assessments, and negotiations to finalize agreements. This is the stage where actual interactions between buyers and sellers take place with a substantial amount of information exchanged and transferred. As more information becomes available and is shared between parties, risks of the deal falling through always exist. In this phase, full discretion and sensitive communication play a critical role.

Lastly, the post-deal process, which is also referred to as post-merger-integration (PMI) phase focuses on integrating teams, streamlining operations, and achieving synergies that have been identified during pre-deal phase to ensure long-term success of the deal. As a post-deal process is usually the most critical stage for any deal to be successful, developing a clear integration plan, ensuring smooth integration, and monitoring the performance are required.

Once SMEs are equipped with solid knowledge on the general process of how global M&A works in practice, the process of active out-reach starts. It is essential to recognize that the foreign investment process is not one-directional, where investors solely seek out opportunities. Proactively pursuing and outreaching global opportunities can provide a strategic view on potential options therefore contributing to better decision making.

Type of acquirer	Company	Channels synergies	Cogs synergies	Sourcing synergies	Fixed cost synergies	M&A logic	Ability to finance
Industry	Company A					Market expansion	
Adjacent industry	Company B					Product expansion	
Private equity / venture capital	Company C					Investment / turnaround	
Industry	Company D					Technology acquisition	
Value chain	Company E					Vertical expansion	
Industry	Company F					Brand acquisition	

Instructions

1. Identify and list all the potential acquirers and their types.
2. Assess the different synergies the potential acquirers could realize. Quantify to the extent possible or use a high/medium/low scale.
3. Define the main logic the acquirer would have for the deal.
4. Assess ability to finance: look at cash in balance sheet and leverage ratios for ability to raise acquisition financing.

Figure 3. Potential acquirer and investor assessment framework

Figure 3 provides a useful framework for identifying and evaluating potential acquirers or investors by assessing key factors that can influence the success of such transactions. Reviewing and comparing the potential synergies that can be achieved via various dimensions of business can help SMEs quantifying the impact of choosing a certain partner. Also, proactively considering the strategic intent of potential acquirers and investors and aligning it with their needs can further support designing value creation logic and materials to be used to communicate with those parties.

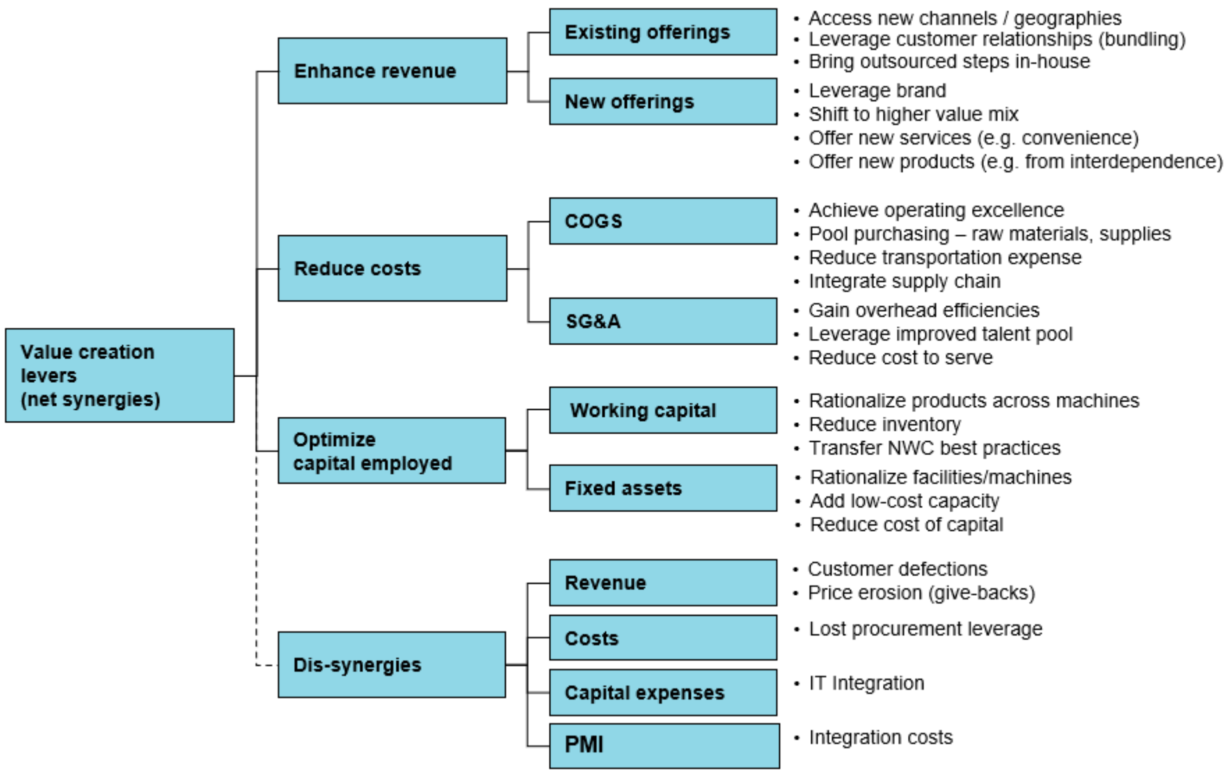

Figure 4. Value creation framework

With the strategic view on potential acquirers or investors in place, the SMEs can review and build value creation logic to demonstrate and quantify their business potential and upside for the partners. Figure 4 highlights the common levers of value creation, which include enhancing revenue through existing or new offerings, reducing costs by addressing COGS and SG&A, and optimizing capital by improving working capital and fixed asset utilization. While reviewing expected synergies, it is also important to take dis-synergies into consideration to get a more accurate view on the value creation potential. By breaking down each lever into detailed individual components, SMEs can gain a clearer and realistic perspective on how they can improve their businesses.

Once understanding of value creation logic is clearly established, the next step involves identifying specific value creation initiatives and assessing their potential impact on the overall value of the business.

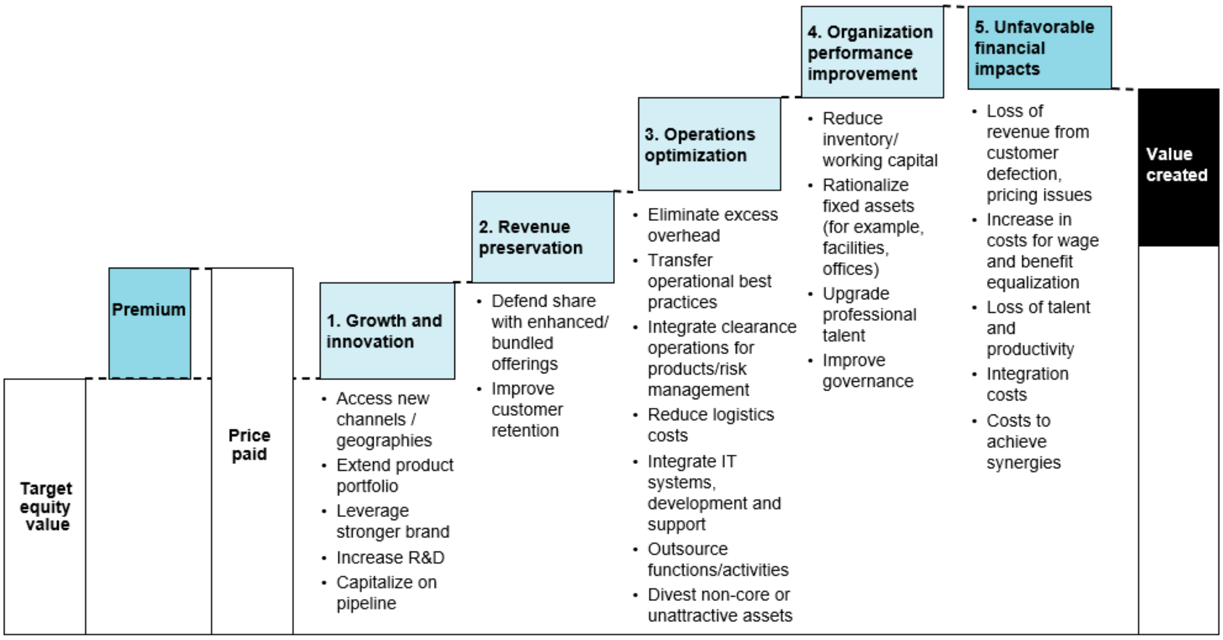

Figure 5. Value creation ladder

Assessing each lever and identifying opportunities for improvement provides a basis for a logical set of initiatives composing comprehensive value enhancement program. Figure 5 serves as a structured framework to visualize and track these initiatives. Visualizing and quantifying the impact of each initiative helps prioritize the required actions and ensures that individual actions are aligned with strategic goals. Additionally, it provides a basis for effectively monitoring progress while accounting for potential challenges.

With the value creation ladder in place, SMEs can consider pre-deal turnaround by implementing those initiatives in parallel with the outreach effort creating a more robust and investor-ready business. Each of the initiatives implemented results in an increased value of the firm, and therefore positioning the SMEs in more advantageous positions during the negotiation with potential partners. Additionally, even if SMEs are short on resources to carry out identified initiatives immediately, structuring value creation ladder can serve as a powerful tool to demonstrate its ambition and potential pathway forward with well-structured and transparent plans to foreign investors. This aligns with the expectations of foreign investors, who seek businesses capable of delivering long-term returns, and this usually can be reflected in higher valuation for SMEs.

One final note is that, throughout the process, it is important to keep in mind that SMEs should always pay attention to reducing risks perceived by foreign investors to improve their attractiveness. One key area to address is the nature of their relationships with chaebols, which can sometimes raise concerns for potential buyers or investors. For instance, while supply agreements with chaebols may provide stability, overreliance on such agreements or dependence on chaebols for R&D capabilities could be seen as vulnerabilities. To mitigate these risks, SMEs should work toward internalizing key capabilities, such as developing independent R&D functions or diversifying their client base.

Conclusion

In conclusion, the globalization of SMEs is imperative for fostering long-term economic growth and resilience for the Korean economy. Foreign capital can act as one of strategic avenues to support this globalization, offering SMEs access to resources, expertise, and international markets that can enhance their competitiveness. However, barriers for foreign capital inflow such as low productivity of Korean entities, limited alignment with global business practices, and regulatory complexities exist, and proactive efforts by SMEs implementing strategic measures – such as adapting to global standards, preparing clear and transparent value creation logic, and carrying out pre-turnaround initiatives – are needed to lower these barriers and attract foreign partners. These efforts will not only empower SMEs to expand globally but also contribute to a more diversified and sustainable economic future for Korea.

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