

Muck and murk in the pan-peninsula; successions and acquisitions - Korea's got talent... if not minority shareholder interests

...Chungdai E&C or Hyun Engineering & Construction?

December 2010, Adrian Cowell, Director and Fund Manager



Cuckoo, "Food inflation" and the Middle Kimburger with some of his impressive line-up of whoppers

Source: www.kimjongilllookingatthings.tumblr.com

The "show me the money" artillery outrage shelling of Yeonpyong-do in South Korea following the equally resonant air bubble torpedoing of the RoK naval vessel, the Cheonan, make for good TV and have ensured that dynastic succession in the middle Kim-dom, the northern half of the divided peninsula, has dominated the headlines for the last year and a bit... since the reported stroke suffered by the middle Kim himself, Kim Jong-II. Regime change or regime call for cash, or both? International high dudgeon and outrage is expressed! But the middle Kim carries on... just... together with his genius of artillery son, Kim Jung-Eun...stein.

In the international media there has been plenty of speculation on the transfer of power to the third generation in the Democratic People's Republic of Korea (DPRK) and the associated risks thereof for involved parties – indexed performance against the benchmark, volatility and information ratio notwithstanding. And these risks should not be underestimated.

In the Republic of Korea (RoK), the immediate physical response, or the absolute return, is behind benchmark, inadequate or even bungled;

- I. 3 out of 6 artillery pieces on Yeonpyeong-do primed to retaliate on the eye-for-eye rules of engagement malfunctioned;
- II. However, some Lance Bombardier or some such *ajoshi* outside of Seoul accidentally loosed off a live shell towards the Demilitarised Zone (DMZ) requiring a quick "hot line" call to the middle Kim-dom to explain that actually this shot was unintentional, and;
- III. The Minister of Defence has gone as a result of fiddling in a room in the National Assembly when it was raining shells in Yeonpyeong-do, hillside ablaze.

These southern or sub-prime responses have probably split a couple of DPRK Kim-sides with laughter, but in the south life goes on...

KSE listed successions and acquisitions....

...prime time viewing; *Chungdai E&C or Hyun Engineering & Construction*

...and south of the DMZ murky dynastic transfers of power and changes of ownership amongst generations of the business elite are also underway, as are privatizations as part of the “sole term” agenda of the pro-business President Lee Myung-Bak (aka 2MB, or Bulldozer)... an emerging new order, and life goes on.

The transfer processes and associated baggage, whether nuclear fuel rods on northern A-frames or southern truck full of bid documents and asset shuffling, are an essential ingredient of the Korea discount, and part of the assurance that Korean listed equities will remain “cheap” to their perceived developed peer group, and that the currency, the Korean won, will remain volatile and weaker than economic fundamentals would suggest. The more heavy-handed the RoK government and the more opaque the shove ha’penny corporate governance, the longer the status quo of said discount endures.

To reuse a phrase coined in this column – emergence as usual ... this time for added spice with a ‘y’ on the end for a touch of emergency!

Chungdai E&C or Hyun Engineering & Construction...

This board room soap opera could barely be scripted better in one of the hugely popular *hallyu* (Korean Wave) multi-episode *durama* (soap operas) with which RoK television grips the nation and which are so successfully exported to the rest of significant Asia. Will it be Chungdai E&C or Hyun Engineering & Construction? This is a corporate reality show; “Listed Korea’s got Talent!” Chung’s tails, the veritable cantabrian epic. With over W5.0tr at stake for 34.9% of Hyundai Engineering & Construction (HEC), tears will as usual flow.

The internecine campaign over ownership of HEC, the corporate core and spiritual heart of the old Hyundai Group founded by Chung Ju-Yong, has absolutely everything. We are only in the second generation of Chungs (as opposed to preparing for the third of Lees at Samsung), but there are lots of them despite some filial fall out, and they are being messed with by Ms Hyun who is a Chung widow. But Chung is in the blood! Being a widow is not the same as being a Chung original masterpiece, and this sibling rivalry is civil war, bitter, protracted and twisted (please refer to “Chung’s Tails” published on 8th September for more background).

HEC, after a spectacular Iraq-propelled-Asian-financial-crisis-compounded bankruptcy, went into work out in 2000 and is in the hands of its creditors, a blendlessly toxic cocktail of conflicted and compromised government-owned and private sector banks and institutions. These consist of private sector banks with a notional interest in shareholder return and a foreign-owned bank as well as the government; the passive Korea Finance Corp 11.1%, the active Korea Exchange Bank (KEB) 8.7%, Woori Bank 7.5%, Kookmin 3.6%, Shinhan 2.9% etc. This equity stake is being sold; it confers management rights and ownership of some key affiliates, principally a potential swing controlling stake of 7.2% in Hyundai Merchant Marine (HMM) ordinary shares (plus 1.1% in the prefs), itself the subject of an unseemly sibling scramble and a riveting sub-plot as the ownership is almost in balance between Ms Hyun, a nose ahead on one tack, and various Chungs collectively a nose behind on the other.

We will not go into the saga that is the “IMF-crisis dictat” that two banks in Korea had to be sold to foreigners, or the choice of private equity and Lonestar as the most appropriate owner for KEB (and the years of court wranglings and prosecutions that paralysed Lonestar’s efforts to restructure and effect an exit until just now). But this very same KEB was the main bank to the historic old Hyundai Group financing chips to ships. It was bankrupt elements of this old group, including HEC, which forced KEB to be sold at a price and with a buyer put back option for rotten assets. KEB was thus the key creditor of HEC and, post debt-equity swap, its key institutional shareholder after the government...

The HEC sale process is part of a privatisation platform integral to the agenda of President Lee Myung-Bak... who in his pre-political incarnation just happened to have been... errr... the CEO of HEC, and a protégé of patriarch Chung Ju-Yong! It is sometimes overlooked now that Chung Ju-Yong actually ran for president in the 1992 RoK Presidential election, “unbelievably” coming in third by a wide margin. Then his son Chung Mong-Joon took a tilt at the Presidency in 2003 and failed lamentably. The Bulldozer is third time lucky for Hyundai!

So HEC... cornerstone of the original Hyundai Group and builder of much of modern Korea. Chung Ju-Yong, the Hyundai Group founder, proliferated companies and off-spring with almost equal abandon. In the ‘90’s towards the end of his life and in the run up to the Asian financial crisis, the patriarch became increasingly pre-occupied with the DPRK and carved up his *chaebol* (business empire) between a rash of incompatible sons.

The favoured if hapless son, married to Ms Hyun, received what the patriarch considered to be the spiritual core of the group, debt laden entities hopefully representing its most exciting future including Hyundai Electronics (now Hynix) and HEC. The logic was flawed. However, this spiritual core was also to continue to develop the patriarch’s key initiatives with the DRRK, the Kaesong Special Economic Zone and the Mount Kumgang tourism project, through Hyundai Asan, thereby exorcising patriarchal guilt at having run away from home in what is now the DPRK. These have proved very expensive initiatives.

The ground breaking pan-Korea summit in June 2000 was “bought” for a give-or-take US\$500m payment by the RoK to the DPRK and this payment needed to find a way in to the DPRK. After the summit there was the gong of a Nobel Peace Prize for RoK President Kim Dae-Jung.

There is a change in President and vigorous opposition attempts to understand better the origins and channels of the lubrication for the historic Korean Summit that won the prize. Piping hot *kamja tang* (a favourite hot potato soup). The spotlight falls on the hapless son and his business interests through Hyundai Asan with the DPRK. After hours of interrogation the favoured Chung son defenestrates taking his life in August 2003 leaving behind widow Hyun in charge of the patriarchally designated, but financially challenged, core of the Hyundai Group. This core is financially weak, burdened with debt and lacking in cashflow, and lacking in scale. Crucially it lacks also its heart, the creditor controlled construction company, which in the interim has prospered and holds a key swing stake in another “core company”, Hyundai Merchant Marine, the key to ownership of much of any worth that is left under Ms Hyun’s control.

Events further conspired to continue the financial emasculation of the widow-Hyun-led core Hyundai Group, and increased the pressure on Ms Hyun to acquire HEC. In this game of Korean roulette, years ago all the chips had been put on “DPRK” black, and it had come up red... ink all over the balance sheet and income statement. Beg, borrow and issue equity from every possible listed entity, smoke and mirrors... and place that bet once again, this time on HEC. The problem is the competition; they never much liked her husband and by extension never liked her.

Several of the Chung brothers and one uncle have had a crack and been eliminated from the race. Stacked up against her representing the blood line is the Hyundai Motor Group (HMG) led by Chung Mong-Koo. HMG has had a very good global crisis and is flush with cash, W8tr or so, selling cars like nobody’s business fuelled by government stimulus packages and competitor bankruptcies and recalls.

Both bidders are required to submit sealed bids that are meant to reveal purity of source of funds and their future plans for HEC. Consensus is that it is a done deal with HMG the winner as Ms Hyun just can not afford it... having only W1.5tr in cash and equivalents versus HMG with its W8tr... the chattering analysts think the stake is worth W3-4tr... but Ms Hyun has a few rabbits in her *hanbok* (traditional Korean dress).

First though conflict. KEB is managing the sale and is Ms Hyun’s main bank, and was making negative noises on her bid so they had to go; already strapped for cash, she sacks KEB! Desperate defiance of financial gravity. She then lines up bid support from Natixis Bank (a bridge loan of W1.2tr), TongYang Investment Securities (W800bn terms and conditions to be discussed later) and others sufficient to table, at

least on paper, a whopper of a knock out bid of W5.5tr, W141,465/share or a mammoth 100% premium for management control. The funding plan is an enormous amount of everything except enough cash (the others being inter alia W1.2tr cash, W950bn rights issue, W550bn corporate bonds, W580bn commercial paper), and it is very light on essential detail. HMG meanwhile bids a still impressive W5.1tr with funding basically from cash. Which is the risky bid? Should be obvious, shouldn't it...?

The bid review process is murky, but against all expectations price and risk carries the day on 16th November, and Ms Hyun is awarded preferred bidder status signing an MoU on 29th November, one of the conditions precedent being that funding is by way of cash and equity, not debt... at which point all hell breaks loose. KEB, freshly sold by Lonestar to Hana Financial has just gone for price, and as it is no longer Ms Hyun's main bank, it has little future risk associated with the financing arrangements should the tower of cards collapse.

However, the other creditors claim to have had little to no consultation in the decision making process and very much do have a future risk should all collapse; a re-run of the Kumho fiasco acquiring Daewoo E&C is a strong prospect – the Korea Development Bank now owns Daewoo E&C!

Knees and share prices jerking all around. HMG and its group companies immediately withdraw W2tr of deposits from KEB... and scream about the lack of essential detail in Ms Hyun's financing structure. Related share prices are yo-yoing all over the place... and the threat of law suits start flying around.

The other creditors realise what a mess the whole thing is, and on 30th November the creditors demand more detail from Ms Hyun. Two separate submissions are made on 3rd December and 14th December, both deemed conspicuously inadequate in terms of demonstrating that it is cash and not debt with or without security that is financing her bid... she finally claims that the French subsidiary of HMM will raise W2tr through issuing equity to "interested investors" ... difficult to imagine uninterested investors taking equity. This is a French subsidiary of a shipping company that suddenly becomes a Special Purpose Vehicle (SPV) to facilitate a huge acquisition...

...and there you have it. On 20th December the MoU is revoked by the creditors with HMG still notionally in reserve. Threats of law suits from Ms Hyun meet the creditor suggestion of her possibly losing her 5% deposit of W275.5bn... and the creditors as a possible Hyun sop suggest that HEC may separately sell its 7.22% in HMM to a third party... she in the meantime has announced that she will proceed with a rights issue by HMM in the hope that the various Chungs will not take up their rights, and she will at least shore up her management control of HMM.

Muck and murk. Watch the space if you can. Greed and glory on Kye-dong with a quite staggering dose of incompetence.



The US\$500m embrace

Sources: www.bbc.co.uk, www.japanfocus.org

There remains no space and time to comment upon the dynastic transfer that may or may not be underway at Samsung; that will have to be an article for 2011! Appropriately next year is the Year of the Rabbit, perfect for what might be listed Korea's greatest ever game of corporate shove ha'penny!

Maybe Ms Hyun was a year ahead of her time?