

Korea

Engineering & construction deals will result in a stand-out year for M&A

Current Environment

After a strong start, Korea's first half real GDP growth of 5.2% was slightly behind estimates of 5.5% but still ahead of the full year expectation of 5%. Nevertheless, this first half growth was greater than any of the previous six semi-annual periods (dating as far back as 2002). Initial growth predictions had taken into account the effect of high oil prices and the strengthening of the Korean won against the US dollar but increased private consumption and resiliency in exports countered the negative impacts of these factors.

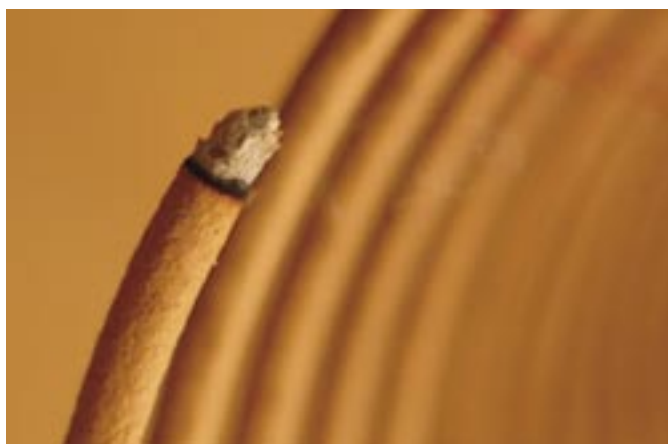
Increased private consumption in the first half was also supported by improved consumer confidence compared to prior periods. In fact, during the nine months ending June 2006 the consumer confidence index exceeded 100 for seven straight months, the longest 100-plus rally since 2002. Additionally, the nation's improved consumption was buoyed by better household income conditions and employment rates.

Exports continued their solid growth in the first half on the back of a robust global economy. Performance by export category (estimated by the Ministry of Commerce, Industry and Energy) was: automotive, up 14.5%; petroleum goods, up 45.7%; shipping, up 27.9%; and other items including wireless telecommunications equipment, up 5%.

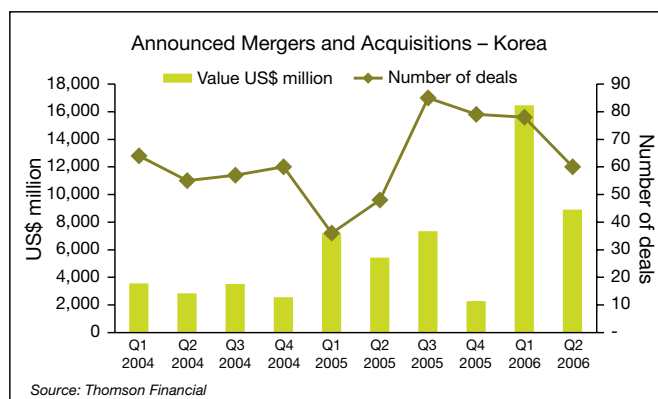
Imports increased resulting from recovering domestic demand, imports of oil, service account deficits, and other seasonal factors such as overseas dividend payments.

Amid increasing security concerns, after North Korea fired several missiles over the East Sea in early July 2006, the Bank of Korea (BOK) left the benchmark interest rate for July at 4.25% (the rate had been increased to a three-year high in June 2006; a total combined 1% increase since October 2005).

The BOK recently revised its second half growth forecast down from 4.6% to 4.4%. However, the initial full-year 2006 GDP growth estimate of 5% remained the same due to the higher than expected growth in the first half, expectations of steady growth in exports and the stabilisation of oil prices and the Korean Won.



Deal Activity

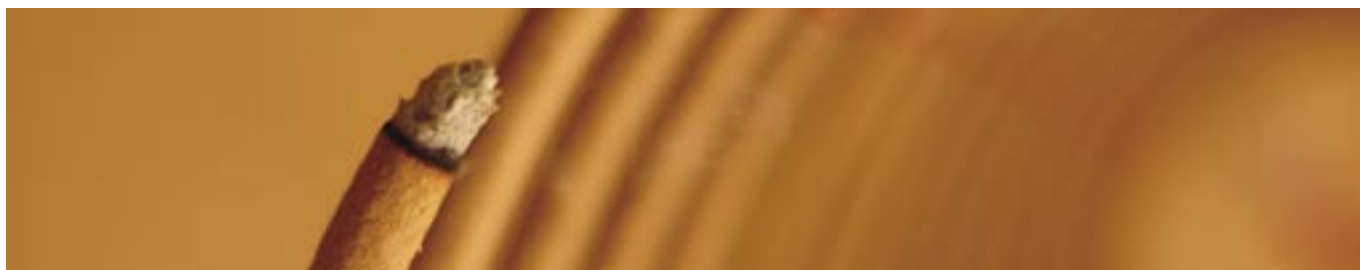


The 135 announced deals in the first half of 2006, is the highest level in recent years. The corresponding deal values were US\$25.2 billion (greater than deal values for all of 2005, as well as the sum of deal values in 2003 and 2004 combined).

The primary driver of these increases is the switch from distressed asset sales toward auctions of formerly bankrupt companies (by their creditors and/or financial sponsors) that have been restructured and are now performing well. Additionally, values have increased due to improved company performance, the economy and capital markets. Furthermore, fierce competition in the M&A market by buyers has created a seller's market and a valuation bubble. In particular, this is being fuelled by the willingness of domestic strategic investors who are willing to pay more to expand (with the expectation of realising cost savings via synergies).

Some of the more significant announced transactions include:

- In March, Korea's largest lender Kookmin Bank executed an agreement to acquire a 71% stake in Korea Exchange Bank from a consortium led by Lone Star for KRW7 trillion (US\$7.4 billion). Kookmin Bank is hopeful to close the deal quickly as it will significantly increase its assets and global presence; however, the sales process has been riddled with numerous investigations and political accusations that could delay the actual handover until next year
- In June, Kumho Asiana Group (Kumho), the 11th largest chaebol, was selected as the preferred bidder when it offered to pay KRW6.6 trillion (US\$6.9 billion) for a 72.1% stake in Korea's second largest builder Daewoo Engineering & Construction (Daewoo E&C). By acquiring Daewoo E&C, the No. 2 domestic builder by both market value and annual sales after Hyundai Engineering and Construction, Kumho's construction business will become the No. 1 builder in the country. Additionally, Kumho will see immediate benefits from Daewoo E&C's recognised brand and strong overseas business



- In April, Carrefour SA signed a contract with a Korean fashion retailer, Eland, to sell its 32 outlets in Korea for KRW1.75 trillion (US\$1.8 billion), effectively exiting the market it first entered 10 years ago
- Similarly, in May, Wal-Mart Stores agreed to sell all sixteen of its Korean outlets to Shinsegae, a leading domestic department store and hypermarket chain, for KRW825 billion (US\$872 million). Shinsegae is expected to fold the acquired stores into its E-Mart brand, the largest department store chain in Korea. Prior to the acquisition, the E-Mart chain was reported to account for 30% of the local market, followed by Samsung Tesco Homeplus (a venture between Samsung and the UK's Tesco) with 17%, and Lotte Mart with 12%
- In June, S&T Dynamics (S&T) announced that it had made a capital injection of KRW60.2 billion (US\$57 million) representing a 38.6% stake into Daewoo Precision Industries

Outlook

Although, Korea's consumer confidence index exceeded 100 for seven out of the last nine months, this strength looks to be easing as the recent trendline of the index is negative – it dropped for the fifth straight month falling to a 10-month low in June (index = 97.4). As such, domestic experts have warned that consumer spending has not yet fully recovered. Moreover, slowing global demand is expected to decrease exports, whilst steady growth in domestic demand will increase the level of imports in the second half. This non-historical pattern is expected to result in decreased trade surpluses in future periods. Trade imbalances are heightened further by record high oil prices (e.g., Dubai crude increased 28% in the first half), although this was mitigated partially by the appreciation of the Korean won versus the US dollar (6% in the first half).

In light of the above, a poll of researchers noted key risks, such as, i) decreases in private consumption and consumer sentiment, ii) higher oil pricing, and iii) downward trends in the construction sector (i.e., decreasing housing prices). These risks could potentially keep the economy from achieving its 2006 growth targets. It appears the BOK concurred with the poll when a representative stated: "Reviving domestic consumption and resilient exports will be the main driving forces of economic growth for the remainder of the year, but regrettably there are growing signs showing the pace of recovery is losing steam."

Lastly, while the BOK froze rates in July 2006, inflationary pressures in the coming months are possible, if not expected. Additionally, whilst the effect of recent inflationary pressures have been offset by the Korean Won's steep appreciation against the US dollar, statistics show that both consumer

prices and core inflation have risen consistently over the past nine months. As such, the BOK is expected to revisit its tightening policy in the coming months. However, given growing concerns regarding the effect of that policy on the economy's growth and the precarious geopolitical risk resulting from North Korea, it appears that the BOK could halt after one additional rate increase in the second half of the year.

Deal activity is expected to increase with sales of companies owned by creditor banks and financial sponsors. Activity in the remainder of 2006 and into 2007 is likely to be dominated by the financial services and construction sectors.

Some of the more significant deals to expect are:

- In April, the auction for a controlling stake in Daewoo Electronics drew bids from 19 companies. The intent is to finalise the sale in September 2006
- In June, a reported fourteen companies submitted preliminary offers to acquire Dong Ah Construction Industrial (Dong Ah), a builder under court receivership. Dong Ah has been under a debt workout program since September 1998 and was officially declared bankrupt in March 2001. Goldman Sachs, which owns the largest stake in Dong Ah with 29.1%, hopes to pick a possible buyer early in the second half
- Creditors, led by state-run Korea Development Bank, are planning to sell at least 51% of their controlling stake in LG Card. Although, bids were received on June 12, 2006, the process was delayed when the Financial Supervisory Service ruled in late June that the sale was subject to the "public open tender" rule, which obligates the buyer to purchase minority interests
- Finally, it is expected that the creditors of Hyundai Engineering and Construction (HEC, the nation's top construction company) which graduated from a five-year debt restructuring program in May, will begin the sales process in the 2nd half of 2006, now that Daewoo E&C creditors/shareholders have selected Kumho as its preferred bidder. The process will probably begin with the selection of a sell-side advisor, and then follow with the determination of a preferred bidder by early 2007. Estimates of HEC's corporate value go as high as KRW10 trillion (US\$ 10.6 billion), much higher than that of Daewoo E&C

These transactions should combine to make this a stand-out year for Korean M&A.