The Korean Private Equity Market – Structural Considerations for Investors

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Growth of the Korean Private Equity Market

Over the past decade, the Korean private equity (“PE”) market has experienced rapid growth and transformed from a market dominated by offshore sponsors to a highly competitive one between both foreign (global and regional) and domestic players. Offshore PE firms (or sponsors) initially dominated the Korean PE market following the Asian financial crisis in 1997 as offshore sponsors made significant investments in distressed Korean assets and companies. This market dominance was due in part to a limited number of experienced onshore sponsors and the lack of local regulations to facilitate PE investments by onshore sponsors. However, legislation was introduced in 1999 allowing for the management and operation of special purpose vehicles such as corporate restructuring and asset-backed securities companies. This resulted in onshore fund managers forming “special situation” funds focused on the financial and operational restructuring of small financially distressed companies, which began to raise the level of competition in the domestic PE market.

Also fueling competition and the number of onshore sponsors in the Korean PE market was the introduction of the Indirect Investment Asset Management Business Act in 2004, which allowed onshore financial institutions to form Korean PE fund (“Korean PEF”) vehicles. Furthermore, in response to the global financial crisis in 2008, the Korean government implemented a “new growth engine” program as part of its economic stimulus package in June 2009. This program has resulted in 33 onshore PE firms raising approximately USD 3.5 billion over the past two years for investment in green technology, high-tech fusion and high value-added sectors. As of May 2011, there were a total of 167 Korean PEFs established and registered in Korea accounting for a total of KRW 28.9 trillion in capital committed.1

In addition to greater competition coming from new funds created by these government programs, global and

Number of Korean Private Equity Funds*

<table>
<thead>
<tr>
<th>Year</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>15</td>
</tr>
<tr>
<td>2006</td>
<td>25</td>
</tr>
<tr>
<td>2007</td>
<td>44</td>
</tr>
<tr>
<td>2008</td>
<td>76</td>
</tr>
<tr>
<td>2009</td>
<td>110</td>
</tr>
<tr>
<td>2010</td>
<td>148</td>
</tr>
</tbody>
</table>

(*) Cumulative at the end of the year


regional PE firms have also seen their share of the Korean PE market decrease as their core investment strategies—i.e., larger scale buyout transactions—have been more difficult to execute under current market conditions. Furthermore, offshore sponsors have generally had limited access to small and middle-market buyout opportunities due to the localized nature of the Korean market where local relationships are critical and language and other cultural barriers exist. The global financial crisis of 2008 resulted in many local PE professionals formerly employed by global PE firms and investment banks breaking off to join or establish local general partners (“GPs”), resulting in a significant increase in the number of onshore sponsors and fund raising (both onshore and offshore) for newly established Korea-focused funds. The chart below shows that local GPs have been involved in a disproportionate share of PE deals in Korea over the past few years.

While the Korean M&A market has seen steady growth during the past decade, climbing to a total value of $20.2 billion in 2010, the size of the Korean PE market by comparison suggests significant potential for expansion, as PE investment as a percentage of total M&A activity in Korea was only 7% in 2010 versus 11% in Australia and Japan. This may be due primarily to the comparatively smaller scale of the local funds operated by many onshore sponsors, many of which are focused on early-stage and growth capital investments that collectively do not represent a large portion of total investment value. Another factor may be the ability of Korean chaebols (i.e., business conglomerates) and other strategic investors to outbid their financial competitors. These statistics also do not account for proprietary deals which go unannounced to the public.

PE Fund Structuring for Investment into Korea

Offshore sponsors have historically invested offshore capital in Korea via an offshore fund structure due to certain advantages from both a tax and regulatory perspective. Such a structure generally involves an offshore fund investing in Korea indirectly via an offshore holding company, which generally mitigates double taxation for the fund investors. In addition, intermediate offshore holding companies which make direct investments in Korea are established for a variety of commercial reasons (e.g., facilitate acquisition financing and flexible exit strategies, satisfy regulatory compliance, structure effective management and corporate governance over the investments, manage local country legal risks, etc.). Finally, there are virtually no regulatory hurdles for an offshore fund to make direct investments in Korea due to certain austerity measures put in place during the Asian financial crisis and a number of open door policies and free trade arrangements implemented by the Korean government in recent years.

A parallel fund structure including a Korean PEF is generally required for offshore sponsors wishing to raise and invest onshore capital in Korea largely due to certain local regulatory or institutional restrictions that prohibit onshore investors from investing in an offshore fund. Similarly, onshore sponsors wishing to raise and invest offshore capital in Korea generally need to establish an offshore fund as the offshore investors may be unfamiliar and unwilling to invest in a Korean PEF vehicle (i.e., hapja hoesa, a local corporate entity) which operates pursuant to articles of incorporation drafted in Korean.

Share of Korean PE Deals Involving Local GPs (by value)

<table>
<thead>
<tr>
<th>Region</th>
<th>2007</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>South Korea</td>
<td>38%</td>
<td>85%</td>
</tr>
<tr>
<td>China</td>
<td>9%</td>
<td>20%</td>
</tr>
<tr>
<td>India</td>
<td>9%</td>
<td>8%</td>
</tr>
<tr>
<td>Australia / NZ</td>
<td>16%</td>
<td>21%</td>
</tr>
<tr>
<td>SE Asia</td>
<td>9%</td>
<td></td>
</tr>
</tbody>
</table>

Source: AVCJ; McKinsey, March 2011.

2 Capital IQ: AVCJ; Recof M&A; EIU; McKinsey analysis.
Beneficial Ownership

Historically, offshore sponsors utilized holding companies located in jurisdictions which had concluded a double tax treaty with Korea to minimize Korean tax leakage. In recent years, however, countries in the Asia-Pacific region (e.g., China, India, etc.) have increasingly scrutinized offshore investment structures under an anti-treaty shopping approach. The Korean tax authorities have taken a similar approach and have devoted significant resources to using a beneficial ownership argument to deny tax treaty benefits to foreign investors, particularly in the case of offshore PE firms and other financial investors. The Korean courts have upheld over a dozen beneficial ownership cases in which the Korean tax authorities denied treaty benefits to a conduit intermediary company due to the lack of beneficial ownership of the income in question (i.e., minimal substance in the holding company). The Supreme Court has yet to rule on any beneficial ownership cases although several cases are currently pending.

However, even if the Supreme Court upholds the lower courts’ beneficial ownership rulings, the impact to the offshore sponsor’s overall Korean tax cost may not be significant as the Korean tax authorities generally apply a “look-through” approach to intermediate holding companies. Thus, if the limited partners of the fund are resident in countries which have concluded favorable tax treaties with Korea, investment income (e.g., capital gains, dividends, etc.) should still be exempt from Korean taxation (or subject to a reduced rate) provided such limited partners are willing to disclose information to the Korean tax authority which establishes their tax residence (e.g., certificate of tax residency) and any other information that may be requested. Consequently, if the ultimate beneficial owners of the fund are located in both treaty and non-treaty jurisdictions, the Korean tax authority would likely take a “blended rate” approach in assessing tax on the fund’s investment income. In practice, however, this look-through approach may prove to be difficult for certain limited partners (e.g., pension fund, fund of funds, etc.) to comply with as the Korean tax authorities may only accept the tax residency of the ultimate income recipients.

Permanent Establishment

Offshore PE funds managed by offshore sponsors have historically been subject to limited permanent establishment risk provided the fund had neither a physical presence nor a dependent agent with the authority to conclude contracts on its behalf in Korea. Although Korean tax treaties generally adopt the permanent establishment principles of the Organization for Economic Cooperation and Development, the Korean tax authority has previously applied the rules under domestic tax law which contain a lower threshold for qualifying as a permanent establishment. Consequently, a dependent agent permanent establishment may be found if an offshore sponsor (i) has and habitually exercises the authority to conclude contracts on behalf of the fund/limited partners, or (ii) performs services primarily for the fund and such services represent an important part of the fund’s business. Therefore, the investment related activities (e.g., due diligence, deal negotiation, contract signing, etc.) conducted by the offshore sponsor in Korea should be carefully monitored and limited to the extent possible to minimize the risk that the Korean tax authority asserts that the portion of the offshore fund’s investment income attributable to activities conducted in Korea is subject to Korean taxation. Furthermore, Korean sponsors and offshore sponsors with a Korean presence are even more susceptible to permanent establishment risk as Korea does not have an exemption for Korea resident fund managers similar to those in other jurisdictions (e.g., Japan, United Kingdom, United States).

Although the Korean tax authorities in recent audits have been aggressive in asserting that certain fund managing activities conducted in Korea constitute a permanent establishment for the offshore funds investing in Korea, the higher courts have yet to rule on such a case, and the practical risk that a tax assessment would be formally imposed by the Korean tax authorities is arguably low.

Fund Raising in Korea

Offshore sponsors raising offshore PE funds investing in markets other than Korea are increasingly targeting Korean institutional investors (e.g., sovereign investors such as the National Pension Service and Korea Investment Corporation) as these institutions increase their allocations to PE. The fund raising process for offshore PE funds is relatively straightforward, provided that interests in such funds are not offered to the public.

Under the Financial Investment Services and Capital Markets Act (“FSCMA”), all offshore funds marketed and sold to Korean investors are required to be registered with the Financial Supervisory Service (“FSS”). In the limited cases where an offshore fund is offered to retail investors in Korea, the fund would be required to satisfy eligibility requirements and file with the FSS a fund and securities registration statement. Where the offshore fund is offered only to qualified professional investors (as defined under the FSCMA), the GP need only file a simplified fund registration statement to qualify for a private placement registration. In principle, an offshore fund must be registered with the FSS before it is offered to Korean investors. However, there are currently no clear regulatory guidelines as to what the term “offered” means. Therefore, in practice, offshore funds should be registered prior to the fund being actively marketed to Korean investors.
In addition to the above registration requirement, the marketing of offshore funds to Korean investors must be conducted through a locally licensed distributor (i.e., a domestic financial institution that is licensed to market and sell fund products). Therefore, in principle, representatives of the offshore funds must not be engaged in direct marketing activities vis-à-vis Korean investors unless they possess a local fund distribution license. However, in practice, offshore funds may be allowed to make pre-marketing contact with prospective Korean investors to survey their interest of such investors, provided that the pre-marketing activities are conducted on a low profile basis and limited to qualified professional investors. Currently there is no regulatory guidance as to what meets this threshold.

In other cases, individualized discretionary investment accounts managed by offshore fund managers are also offered to the Korean investors. An offshore fund manager with investment discretion over a fund with Korean investors must acquire a cross-border discretionary investment manager (“CBDIM”) license from the FSS prior to marketing the investment account unless (i) a Korean entity with a CBDIM license to manage the Korea investors’ funds delegates its investment discretion to the offshore manager or (ii) certain Korean investors (e.g., Korea Investment Corporation) contact the offshore fund manager on an unsolicited basis. Currently, there are over one hundred offshore fund managers which have acquired the CBDIM license from the FSS and manage separate investment accounts for Korean investors.

Conclusion

The Korean economy is fundamentally strong and resilient, illustrated by the strong recovery in GDP since the height of the financial crisis and the continued growth of Korean M&A. Korean chaebols’ historical dominance of the domestic market will be tested as competition increases, coming both from the growing number of onshore sponsors as well as global and regional PE firms seeking to establish footprints in Korea. In addition, the Korea government and relevant authorities continue to make efforts to facilitate the growth of the PE industry and to make tax and regulatory reforms to align Korean rules with international standards. Furthermore, Korean institutional investors continue to earmark more funds for both onshore and offshore PE investment. All of these factors combined should make Korea a more robust environment to invest in for both onshore and offshore sponsors.

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