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PRIVATE EQUITY

Private equity in Korea: A discussion with Scott Hahn

A pioneer investor explains why these are early days for buyouts in South Korea, the 11th-largest economy in the world.

Richard Lee and Vivek Pandit

Scott Hahn left Morgan Stanley five years ago to found a new private-equity (PE) firm based in Seoul. Hahn & Company now has $3 billion under management. McKinsey's Richard Lee and Vivek Pandit spoke with Mr. Hahn in November 2015.

McKinsey: *When you founded your firm a few years ago, what was the climate for private equity in Korea?*

Scott Hahn: We started in May 2010 and closed our first fund in July 2011. Our thesis was that there were opportunities for leveraged buyouts in Korea. That was a leap of faith, to some degree. Over the previous ten years at Morgan Stanley, we had done only seven buyouts. We had to persuade investors to join us. There had been some high-profile deals led by foreign PE firms that had perhaps performed well economically but left the public and other constituents with questions about the real value that PE was contributing to economic growth, jobs, and so on. Those are questions that PE faces in many countries, but particularly in Korea.

We have been fortunate in the past four years to do 12 buyouts. Other firms have also done well. Today, investors would agree that there is in fact a viable PE market in Korea, and it can generate good returns. And the public perception about PE's role in the economy has changed for the better over the past few years, especially with the rise of domestic private equity.

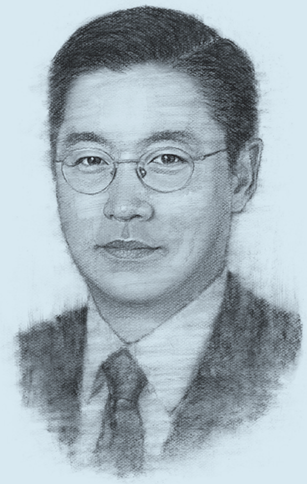
McKinsey: *Can you say more about how limited partners think about Korea today?*

Scott Hahn: Perceptions are evolving. For those investors seeking global exposure, a position in Korea is not a "must have" as it probably is for China or India. And the verdict is still out about whether Korea is a viable market for returns on private investment, compared with the rest of Asia, Europe, and the United States. Recent performance suggests that it is, but the record is spotty. It needs more time. I have always told our investors that I would not buy a Korea private-equity index, if there were one.

McKinsey: *What about the perspective of the companies you invest in?*

Scott Hahn: That's one place where we've seen a big change. Fifteen years ago, most employees and managers did not really know what private equity was. Ten years ago, people in privately owned companies felt disappointed and insecure; most were not proud to be working at their company. Today, domestic PE firms are now seen as an attractive place to work by the high-quality managers who formerly would only go to work at a large *chaebol*. They realize a PE firm whose sole focus is to benefit the company you work for is a good thing. That's different from the *chaebol*, or the family-owned conglomerate with multiple subsidiaries and central leadership, that often has to do what's best for the group, not just a single company, no matter how well it performs. That is a very important shift, and one that is just getting started.

Scott Sang-Won Hahn



Vital statistics

Born July 1971, in Seoul, Korea

Married, with 2 children

Education

Received an MBA from Harvard Business School in 2000

Received a BA in economics from Yale University in 1994

Graduated from Phillips Exeter Academy in 1990

Career highlights

Hahn & Company

(2010–present)

Founder and CEO

Morgan Stanley

(1994–98, 2000–10)

Global partner, Merchant Banking Division (2006–10)

Chief investment officer, Private Equity Asia (2005–10)

Managing director and chief investment officer, Private Equity Asia (2000–10)

Founder and head, Private Equity Korea (2000–10)

Investment Banking Division (1994–98)

McKinsey: *How do you see your industry's relationship with* chaebol *evolving? Are you partners? Or are you just another source of capital, like the banks? Or something else?*

Scott Hahn: Take a look at the last four big transactions in Korea. MBK Partners bought Homeplus, Tesco's retail chain in Korea. Our company bought Halla Visteon, an automotive-supply company, from Visteon. Carlyle Investment Management bought ADT Korea from Tyco. And MBK also bought ING's Korean life-insurance business. In every case, the seller was a multinational company. Multinationals appear to be leaving Korea, probably for different reasons. But the fact that the buyer in every case was a PE firm says something interesting about *chaebol*. I think many of the weaker *chaebol* are going through some internal restructuring. And the healthy ones simply do not need third-party capital—and at today's interest rates private equity is not a cheap source of capital. The two biggest recent deals involving *chaebol* were internal mergers, of two companies at SK Holding and two companies at Samsung. There isn't a meaningful relationship between *chaebol* and private equity as yet.

McKinsey: *What might change that? Would it be higher interest rates, slowing growth in the domestic economy, or a change in China, which is Korea's main export market?*

Scott Hahn: It would have to be a combination of factors. There probably won't be a massive move in interest rates. Mostly what we think about is the capacity in sectors we look at, and the potential for overcapacity. If Chinese demand for certain goods begins to fall, we may see overcapacity develop, which could prompt *chaebol* to become active. And as always in Korea, a big factor is the view the government takes on a given industry or company. More and more, the government is signaling its belief that the country needs strong businesses to compete and to have a functioning and efficient economy. What many people don't realize is that corporations are not the largest employers in Korea, far from it.

McKinsey: *What is?*

Scott Hahn: Self-employment. It goes unnoticed, but Korea has one of the highest rates of self-employment in the world among OECD[1] countries. And average job tenure is one of the lowest in the OECD. If you combine those two facts, you realize that the old notion of lifetime employment in a *chaebol* is not as important as it once was. In 1997, about half of the top 30 *chaebol* went bankrupt. We're now about 20 years removed from that, which is almost a generation, and people are realizing that this is not the most important form of employment and economic growth. It appears that the government may be realizing that certain structures associated with *chaebol* may not contribute to the level of competition and entrepreneurship that globally competitive countries aspire to.

McKinsey: *It sounds like the* chaebol *may be leaving the field to private equity, at least for the moment. Let's talk about what that means. Can you tell us about the opportunities or challenges associated with larger deals in Korea, and what kind of operational expertise or in-house capacity may be required?*

Scott Hahn: Transactions will continue to get larger because more firms, especially intermediate-size companies, have a pressing need to reform to remain competitive. Furthermore, while Koreans have always been emotionally attached to their companies, as businesses are handed down to the next generation, they are becoming less attached, which ultimately will mean more sales. Private equity will be tested in these large deals, not on its ability to raise funds—because good teams have access to capital—but on its ability to run and manage portfolio companies. As companies get larger and more global, their employees, unions, suppliers, and customers present more complex challenges to owners. Clearly, there are managers in this country who can manage complexity well; equally clearly, in my opinion, there are some who are out of their element. Private-equity owners will also be tested for their ability to successfully transition and exit these businesses, and then repeat that success across more companies.

McKinsey: *So we're talking at least in part about a shift in ownership styles. What decisions do you think private-equity owners will be able to make that previous owners were not able to?*

Scott Hahn: I see three kinds. At our portfolio companies, we place strong emphasis not only on their ability to execute the five or ten initiatives they have agreed to but also on their ability to do it while beating the clock. To us, execution is a function of time. There needs to be a sense of urgency to the process. There's a big difference between getting there in three months versus three years, a difference in the demands put on the organization. Private equity does act differently. The second is common globally but somewhat unfamiliar in Korea. We have a singular focus on improving the competitiveness and the value of the company we have acquired—not its subsidiary, and not its group. We tell our management that the only thing you need to worry about is improving your company. Our shipping guys have no need to concern themselves about our auto-parts guys, who don't need to be concerned about our consumer-beverage guys. A third kind of decision relates to capital. We tell our managers that two of their benchmarks are return on capital and return on equity, which are not common management benchmarks in Korea. Questions arise in *chaebol* companies when capital is directly and indirectly shared by many companies or guaranteed by affiliates: What is the actual return? We settle that by saying that if your business succeeds, you will have clear visibility with respect to incentives and performance.

McKinsey: *A lot of limited partners ask about the best way to invest in Korea. Could you describe the distinctive features of a Korean strategy, as opposed to a pan-Asian regional fund?*

Scott Hahn: Prior to starting Hahn & Company, our team ran a pan-Asia fund for a long time. Such funds are typically seen as offering a degree of diversification. But it's an open question. If the returns of pan-Asian funds come from two or maybe three countries, while losses pile up in a few other countries, how diversified is that? Investors need to ask if a general partner can really be good in every market in Asia.

Many of our investors have made that choice and look to us for a focus on Korea. Their view is that there is a big home-field advantage in this country, and they see us as positioned to use that. Korea has some macro characteristics that are challenging to businesses but make for an opportunity for private-equity owners. Korea is not growing as fast as China. It does not share the themes of urbanization and rising consumerism that we see elsewhere, particularly China and India. On the other hand, this is a very large economy. And it is extensively globalized: 50 to 60 percent of the revenues of all the companies we own are generated outside Korea, and most of their industrial capacity is outside the country. Managers need both local knowledge and global experience.

McKinsey: *Let me ask one of the tougher questions people sometimes raise about private equity in Korea. Why should investors choose private equity rather than public markets? Public markets function well here and are liquid.*

Scott Hahn: Since we started our first fund, the KOSPI[2] is down about 3 percent. I haven't fully digested what that means, though. Two companies, Samsung and Hyundai Motor, accounted for 58 percent of the net income of the entire KOSPI index last year. So while indexing in Korea has not worked, investing in some of the good public companies here is not a bad strategy to get Korean exposure.

On the other hand, active private owners who implement change successfully can produce a significantly higher return than public markets in Korea. Maybe more than elsewhere, private equity is a micro bet rather than a macro bet on the country. The macro bet on Korea is actually rather costly. We would be completely out of business if we had Korea's public-market-index returns. Active owners like us have greater capital efficiency, more investment in R&D, stronger customer development, global expansion in the factory footprint, and greater efficiency from a streamlined organization than the Korean public companies in the aggregate as an index.

McKinsey: *Are there new opportunities for the Korean PE industry?*

Scott Hahn: Recently, Samsung sold its plant-machinery, military-defense, and video-surveillance businesses to Hanwha Group. Neither company did it because of capital pressures or because of management skills. They simply decided that the businesses—the companies, their employees, their management, and their customers—would be better off under different ownership. I found that refreshing, and we hope it is a trend. But private equity is not going to drive this market. Rather, I think it is families that need to concentrate their portfolios. Businesses everywhere face challenges from new technologies and new, previously unseen competitors. Leaders will make their companies stronger through M&A and will make the economy stronger, too. It will be gradual. If you asked people in 1995 about whether foreign-ownership limits on securities would be relaxed within three years, no one would have agreed. But it happened. It's a gradual process, but one that might be set in motion by a shock to the system of some kind.

McKinsey: *Across the world, including Asia, most PE firms have grown by expanding asset classes as well as geographies. How will a Korea-focused firm like yours grow, and is there a limit to its size? At what point do you start thinking about moving into new asset classes?*

Scott Hahn: We talked a bit about operating in different geographies; in my mind, it is very difficult to be great in every market. The question then might be, can you be good in different asset classes in one market? I don't think we're there yet. I think it is still an early stage of buyouts in Korea. There is potential for further megadeals. And beyond that, most businesses are owned by *chaebol*. There is also a big group of midsize family-owned companies that need capital to expand. These are not typical growth-equity opportunities, however. Growth everywhere is slow; growth in Korea is quite cyclical. I'm not sure that cyclical growth is the right path for private-equity investment. Instead, we think about buying controlling stakes, consolidating businesses, providing new management know-how, providing customers, and adding new technologies. On that basis there are a lot of companies to choose from.

McKinsey: *What's your outlook on hedge funds, given the change in regulation this year?*

Scott Hahn: We're seeing activity, and we want to keep an eye on this sector. What does a Korea-focused long-short hedge fund do? One thing we see is that many funds are geared to other markets, so in some sense Korean hedge funds are simply Korea-based global macro investors. Our view is that for hedge funds to succeed, they must have access to timely information; they must be global, or at least active in certain geographies; and they must be at some scale to be sustainable businesses. While we think some funds can succeed on those criteria, we still have to wonder. Overall, markets are flat, and two companies generate nearly 60 percent of the available profit. Yes, some hedge funds can make improvements to their investments, and add some alpha, but for most the question is, what will you trade?

McKinsey: *Do you think investors want or need to be more activist oriented in Korea?*

Scott Hahn: Activism comes and goes; we don't see a particular trend like we do in the United States, where activism has caught on and is almost an asset class. Some people think Korea is not a great market for activism, and I agree. But there may be specific niches where investors with particular skills can succeed.

McKinsey: *What excites you about the future of your business in Korea?*

Scott Hahn: What excites me is coming to work and being with our people, and realizing that it is perfectly OK to think about our companies 24 hours a day. We are all excited here about the changes we are making to companies we own. We have an auto-parts business that used to have a single factory and a single customer. Now it has four new product lines and a global presence. Or take the cement business we bought in 2013. There were nine bidders, eight of them strategic. We were the only private-equity bidder. The employees went to the leading shareholder and said their preference was Hahn & Company—they believe we can best improve the business they have been a part of for almost their entire careers. I think they realize that they are going to get treated well and they are going to be on a winning team. We all want to be on a winning team. ■

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[1] Organisation for Economic Co-operation and Development.
[2] Korea Composite Stock Price Index.

Richard Lee is a director in McKinsey's Seoul office, and **Vivek Pandit** is a director in the Mumbai office.