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The continued rise of South Korean private equity

Solid returns and optimistic forecasts have made South Korea an increasingly attractive market for investors.

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Ever since South Korea reopened itself to private equity in 2005, the market has demonstrated robust growth as measured by total investment and returns. Over the past decade, private equity funds have allocated nearly $100 billion in capital. Further, acquisitions by both global and local private equity firms grew from 44 in 2005 to 342 in 2016. During that same period, the yearly capital committed to private equity funds increased to $57.1 billion, from $8.4 billion, raising private equity's share of total investment of M&A in South Korea to 25 percent in 2016. As impressive, private equity returns, holding steady at around 20 percent a year, have far outstripped the public equity markets.

By most measures, the country's private equity market, the third largest in Asia, is poised for continued growth. Yet to date South Korea private equity hasn't been high on the list of global investors. Its relative obscurity could be due to the concentrated nature of its market, a prevalence of large conglomerates that may have overshadowed promising investment opportunities, and a lack of knowledge about certain industries. To be sure, the market has a high level of capital in search of acquisition targets, a shortage of acquirers to ensure timely exits, and a lack of experienced management talent to spearhead turnarounds. Still, South Korea's private equity market is making progress despite such concerns.

Recent McKinsey research on South Korea's private equity market highlights factors that have been responsible for its steady returns and indicators of future growth. Our in-depth analysis includes fund performance, investment strategies, and economic contribution of the private equity investment nature of the performance. As global investors contemplate entering the market, they should educate themselves on where opportunities lie. Rising interest in South Korea will increase competition, meaning that private equity firms may need to evolve their investment strategies and models.

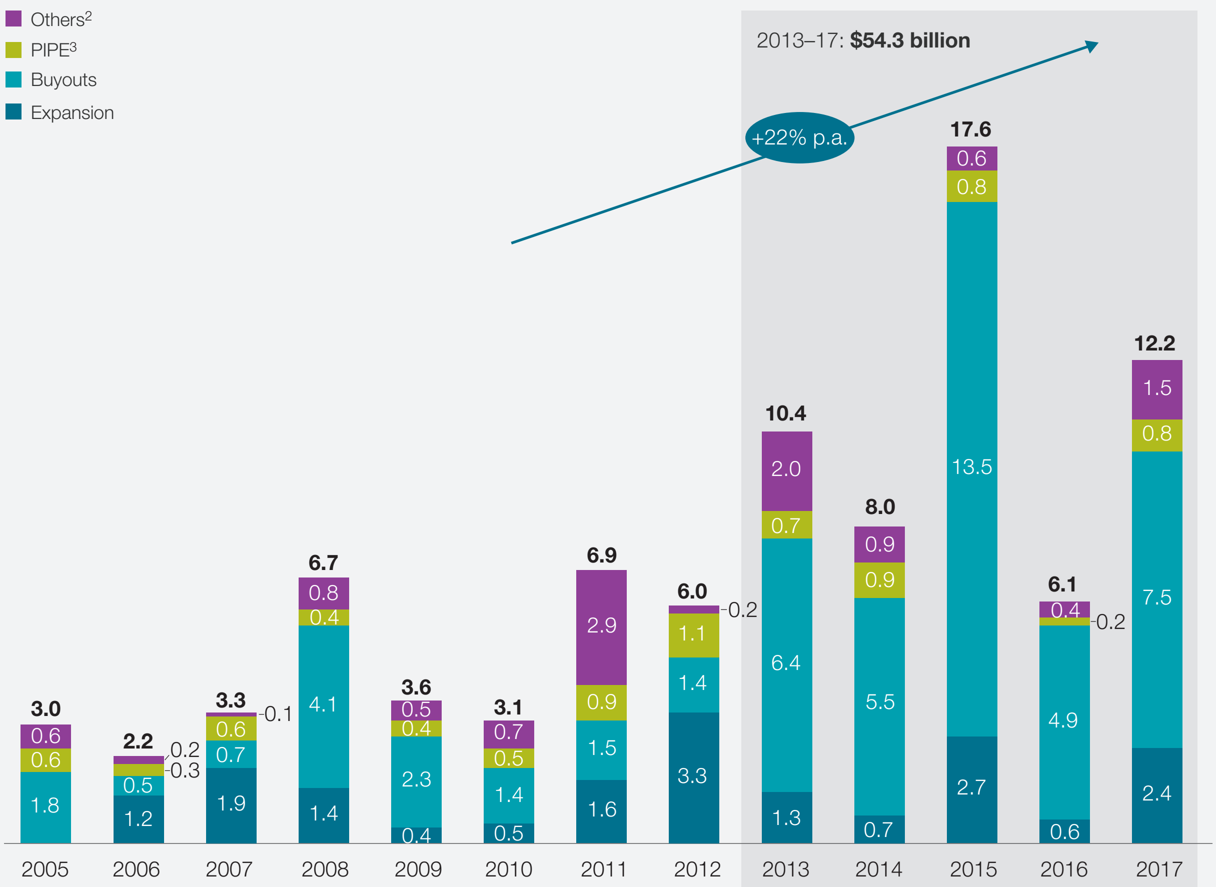
South Korean private equity on a tear

Since 2005, when South Korea's regulatory changes first allowed private equity fund setup, the market has been on a tear. From 2005 to 2017, private equity firms in South Korea invested in more than 870 companies. Private equity has represented a broad-based source of equity capital, across both sectors and company sizes. A temporary setback due to the global financial crisis has been followed by five years of rapid expansion: from 2013 to 2017, more than $54 billion in equity capital entered the market, equal to 62 percent of the accumulated total since 2005 (Exhibit 1). In 2015 alone, private equity investments totaled $17.6 billion, concentrated primarily in buyouts. Although total investments fell the following year, 2017 saw a rebound to $12.2 billion.

Exhibit 1

Private equity is a stable source of equity capital, contributing more than $89 billion since 2005.

Total private equity investments,[1] $ billion



Note: Figures may not sum because of rounding.

[1] Based on deal closing date.
[2] Includes Mezzanine/Pre-IPO, Turnaround.
[3] Private investment in public equity.

Source: AVCJ; McKinsey analysis

High returns across all asset sizes and types

In tracking results by investment periods, private equity firms have generated a return of 1.4 times invested capital. Of the $53 billion that has been invested from 2005 to 2014, $34 billion has exited so far—approximately 60 percent of the total—at a value of $47 billion (Exhibit 2). From 2005 to 2014, exit multiples of money[1] were consistent at 1.3 to 1.5 with a holding period of three to three and a half years.

Exhibit 2

Of the approximately $53 billion invested from 2005 to 2014, approximately $34 billion has exited at a value of approximately $47 billion.

Investment period	**PE Investment,**[1] $ billion	**Exits, cost basis,**[2] $ billion	**Exits, value basis,**[2] $ billion	**Exits to entry (value/cost),** multiples	**Holding period,** number of years
2005–08	15.1	7.4	10.3	1.4	3.0
2009–11	13.3	10.6	16.3	1.5	3.6
2012–14	24.4	15.8	20.3	1.3	3.5
Total, 2005–14	**52.8**	**33.8**	**46.9**	**1.4**	**3.4**

Note: Figures may not sum because of rounding.

[1] PE investment samples are based on 590 PE investments from FY05–14.
[2] PE exit samples are based on 460 PE investments exited from FY05–14.

Source: AVCJ Research; Kisvalue; McKinsey analysis

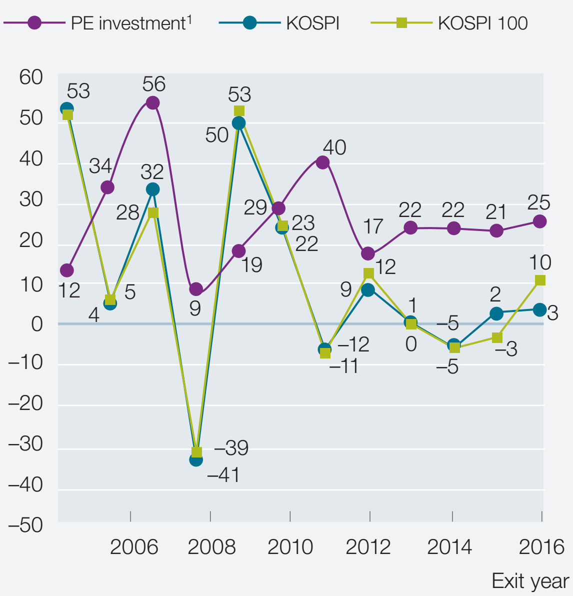
In tracking results by investment periods, private equity firms have generated a return of 1.4 times invested capital.

[1] Defined as the amount of money returned divided by the amount invested for that particular investment.

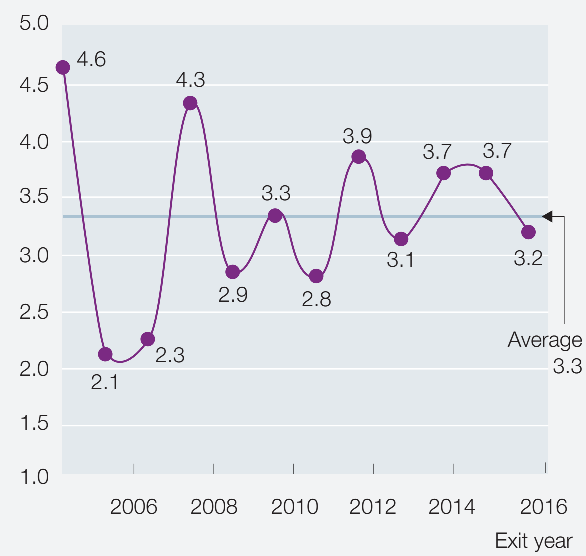
Since 2005, private equity firms in South Korea have achieved an average internal rate of return (IRR) in excess of 20 percent and healthy exits. Smaller investments and fewer exits caused some variation in private equity returns before 2010, but annualized returns have held steady for the past five years, at just above 20 percent. By contrast, the KOSPI Index achieved 1 to 3 percent annualized returns since 2013 (Exhibit 3).

Exhibit 3 **Annualized private equity returns have held steady since 2012.**

Annual return realized at exit, %



Holding period for PE investment,[1] years



[1] Average of 540 exited samples that disclose transaction amounts both in the year of acquisition and year of exit; excluded deal sizes of less than $5 million.

Source: AVCJ Research; McKinsey analysis

Returns and holding periods varied significantly by strategy. Buyout investments generated more attractive returns compared with nonbuyout deals across all deal sizes in excess of $50 million (Exhibit 4). The greatest gap was in deal sizes greater than $500 million, where buyouts generated twice the returns of nonbuyout deals—22 percent compared with 11 percent. These figures are heavily influenced by the large deal for South Korean beer company Oriental Brewery.

Exhibit 4

Buyouts produced the most attractive returns across most deal sizes, especially those in excess of $500 million.

Average of annual returns realized at exit[1]

x.x = Holding period, number of years

PE investment deal size, $ million	**Buyout returns,** 2005–17, %	Holding period	**Nonbuyout returns,** 2005–17, %	Holding period
501+	22	4.4	11	5.1
101–500	17	4.6	16	4.3
51–100	15	3.6	6	3.9
<50	27	2.9	38	2.9
Average		**3.7**		**3.3**

[1] Average of 310 exited samples that disclose transaction amount both in year of acquisition and year of exit between 2005 and 2017; excluded deal size of less than $5 million.

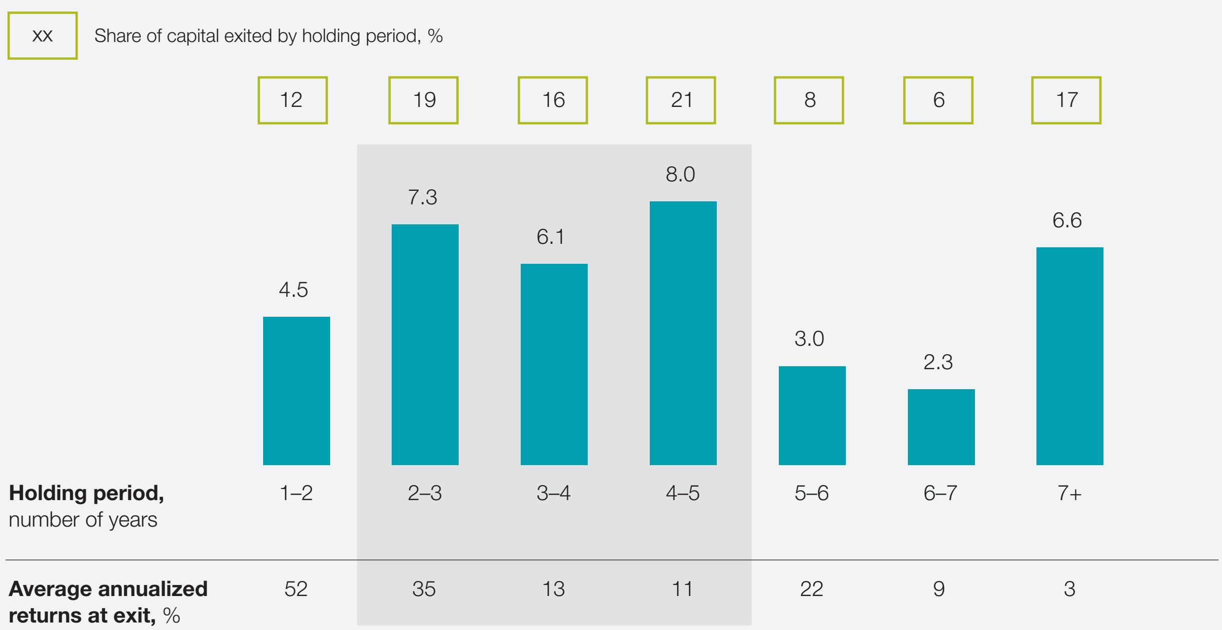
Source: AVCJ Research; McKinsey analysis

The preferred private equity strategy was to hold investments for two to five years; this category made up 56 percent of total capital exited (Exhibit 5). The average annual returns achieved at exit varied significantly within this group: exits after two to three years generated returns of 35 percent compared with 22 percent for exits of five to six years. At the opposite end of the spectrum, investments held for more than seven years expectedly produced returns of just 3 percent.

Exhibit 5

PE investments exited within two to five years of the holding period account for more than 50 percent of total investments exited.

PE investments and returns by holding period,[1] $ billion



[1] Three hundred ten exited samples that disclose transaction amount both in year of acquisition and year of exit between 2005 and 2017; excluded deal sizes of less than $5 million.

Source: AVCJ Research; McKinsey analysis

Strong returns across industries

Private equity investments were distributed across industries, with 75 percent of capital concentrated in consumer, industrials, financial services, and infrastructure (Exhibit 6). Consumer, industrials, and financial services had exits for 70 percent of invested capital, and the first two industries generated returns of around 25 percent. Private equity firms are interested in the consumer and financial services industries because of the steady cash flow, demographics, and domestic consumption. Industrials companies are attractive because they present private equity firms with ample opportunity for operational improvement and restructuring balance sheets to improve returns to equity.

Exhibit 6

Consumer and financial services industries are of interest to private equity firms.

	PE investments,[1] 2005–14, $ billion	**Exits, cost basis,**[2] 2008–17, $ billion	**Exit vs. investment,** %	**Returns where exited,**[3] 2008–17, %	**Holding period of deals exited** 2008–17, Number of years
Consumer	10.7	7.5	70	24	3.4
Industrials	9.8	7.2	73	25	3.1
Financial institutions	9.5	6.5	69	14	4.9
Infrastructure[4]	8.9	3.7	42	27	3.3
Tech, media, and telecommunications	4.5	2.0	44	16	4.0
Electronics	4.4	2.0	46	19	3.6
Global energy and materials	2.9	2.8	99	13	3.0
Healthcare	1.3	1.0	76	36	3.2

[1] PE investment samples are based on 590 PE investment.
[2] PE exit samples are based on 460 PE investments exited.
[3] Excluded outliers with higher than 200% realized return per annum.
[4] Including transportation, travel, and logistics.

Source: AVCJ Research; Kisvalue; McKinsey analysis

Industrials companies are attractive because they present private equity firms with ample opportunity for operational improvement and restructuring balance sheets to improve returns to equity.

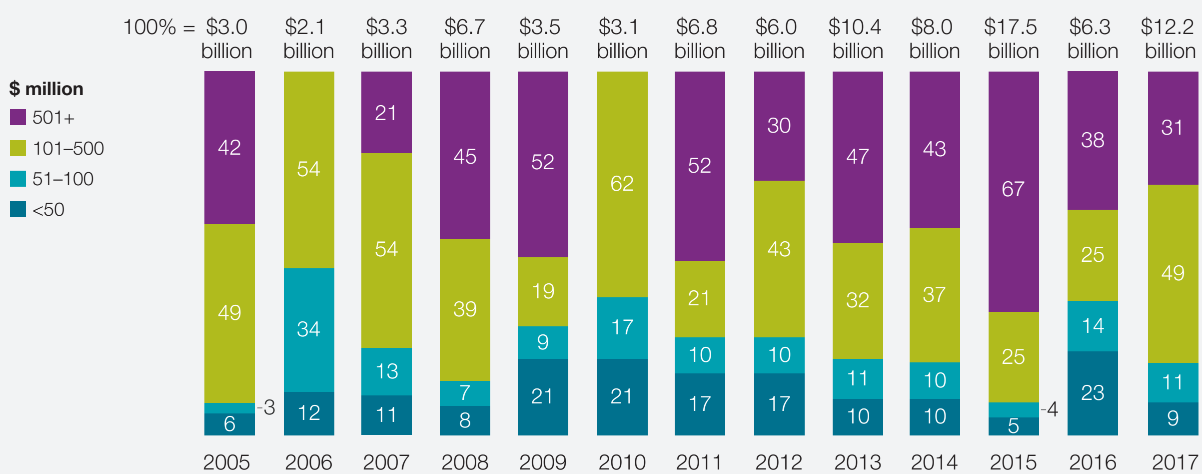
Increased deal sizes

To date, a sizable majority of private equity investments have gone to "big ticket investments"—defined as investments with more than $100 million in average deal size (Exhibit 7). Indeed, since 2013 this segment has attracted the bulk of capital, sometimes garnering more than 90 percent of total investment in a given year. The average deal size peaked at $214 million in 2015, when big-ticket transactions drew 92 percent of all private equity investment.

The increase in average deal size is also caused by the industry landscape in South Korea. Companies with more than $500 million in annual sales account for 57 percent of total

Exhibit 7 **Big-ticket transactions (more than $100 million) have consistently accounted for more than 50 percent of deals by value since 2011.**

Value of deals by deal size, %



	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Average deal size, $ million	144	71	77	143	78	58	89	64	105	103	214	76	131

Source: AVCJ; Capital IQ; McKinsey analysis investments by value since 2005 (Exhibit 8), a trend that has held fairly steady since 2005. This category of investment requires general partners to adopt an active ownership operating model. Private equity's ability to source and close private deals depends on strong relationships with conglomerates so that executives viewed these firms as the first choice of divestiture for noncore assets.

With investments in small and medium-size corporations, which made up 37 percent of all deals by value, private equity firms tended to adopt a lean operating model. In these deals, fund managers used their proven strength and ability to help these companies scale quickly, in part by installing a professional management team to implement the strategy and systems to enable operational excellence. Prior to being acquired by private equity firms, South Korean companies have often selected managers with whom they have close personal relationships. In contrast, private equity firms typically assemble experienced management teams and align talent to sources of value, performance management, IT systems, and governance.

Increased interest from government pension funds

South Korea's private equity market is forecast to continue its recent trajectory. In addition, institutional investors are seeking to diversify investments by placing an increasing share in private

Exhibit 8

PE contributes to the development of companies of all sizes, particularly early stage to midcorporate.

	Sales,[1] $ million	**Number of companies in the organized sector**[2]	**Value of PE investment,** 2005–17, %	**Volume of PE investment,** 2005–17, %
Very large corporate	6,001+	61	27	2
	1,001–6,000	234	20	5
Large corporate	501–1,000	266	10	4
Midcorporate	126–500	1,615	18	25
Small corporate	26–125	7,337	19	41
Small office and home office	<25	16,886	5	23

[1] Exchange rate of 1 USD = 1160 KRW used.
[2] Based on corporations audited by an independent external auditor as of 2016.

Source: AVCJ Research; McKinsey analysis

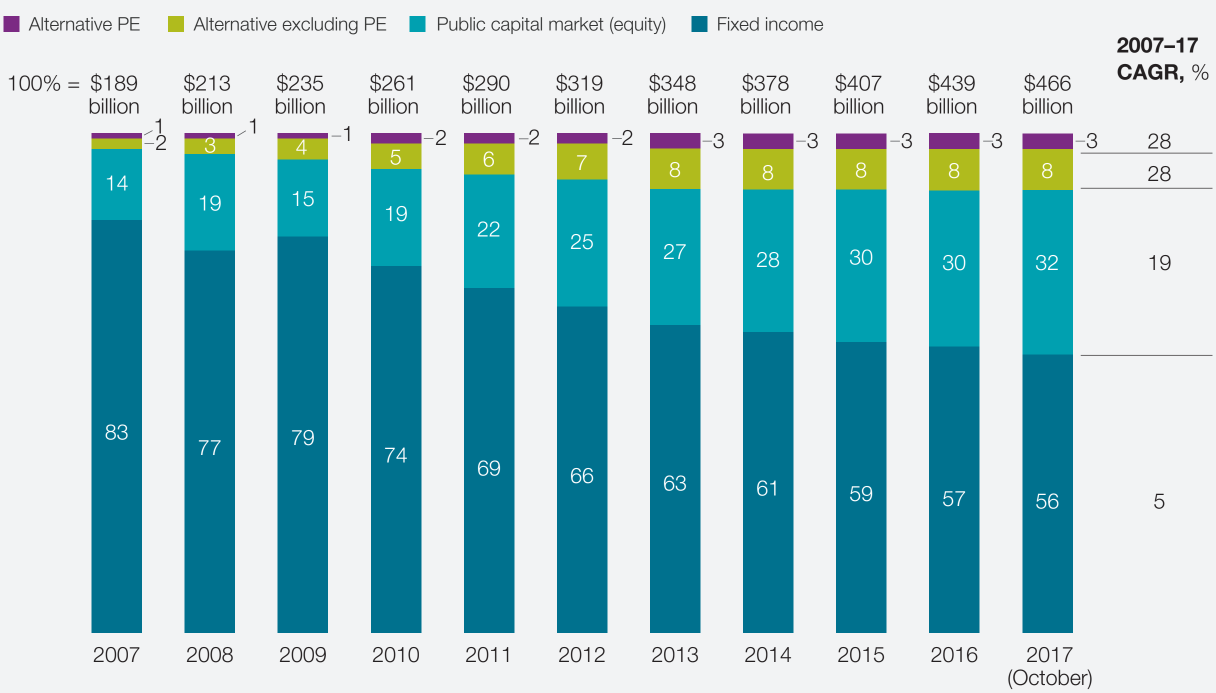
market alternatives. Public pension funds, the largest category of limited partners, have expressed a desire to meet increasing liability gaps with returns from private markets. Further, the continued interest of limited partners in private markets is fueled by the muted outlook for public markets. McKinsey research suggests that limited partners are facing the prospect of a sustained low-return environment in public markets over the next 20 years. With slow growth, US equity returns could decrease by up to 390 basis points and fixed-income returns by up to 590 basis points. In a growth recovery scenario, US equity returns and fixed-income returns could decline by up to 240 and 490 basis points, respectively.[2]

South Korea's National Pension Service, for example, has steadily diversified its holdings beyond fixed-income investments, with stock and alternative investments making up a growing share of its portfolio. From 2007 to 2017, alternative investments, including private equity funds, increased 28 percent (Exhibit 9).

Exhibit 9

South Korea's National Pension Service is diversifying its holdings into alternative investments.

NPS's asset under management portfolio trend,[1] %



NPS's PEF investment has increased by more than 10 times since 2007 ($1.3 billion in 2007 to $12.6 billion in 2017)

Note: Figures may not sum to 100%, because of rounding.

[1] Based on Book value.

Source: AVCJ; Capital IQ; McKinsey analysis

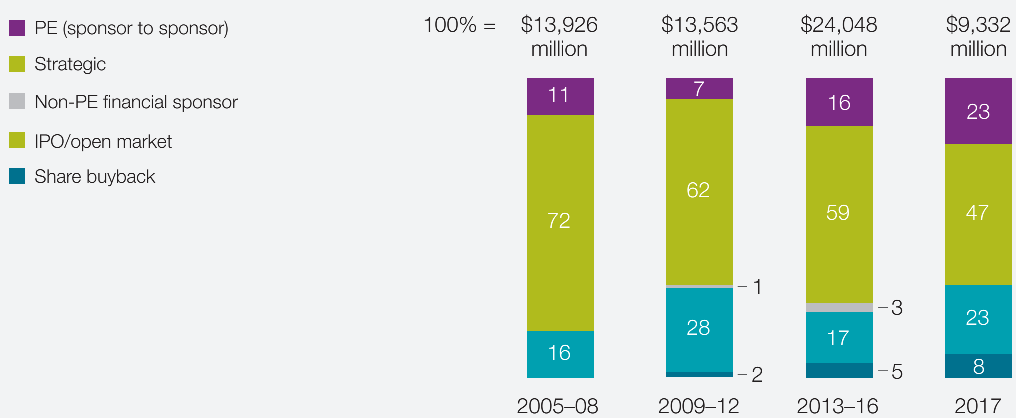
[2] *A routinely exceptional year: McKinsey global private markets review*, February 2017, McKinsey.com.

The rise of private equity as an exit route

Notably, as the private alternatives market grew over the past decade, private equity firms accounted for an increasing share of buyers in exits. In the 2005–08 period, nearly 75 percent of exits were sales to strategic investors, while private equity made up 11 percent. By 2017, strategic sales had dropped to less than 50 percent, as deals between private equity firms more than doubled, to 23 percent (Exhibit 10). This trend was emblematic of an active stance of private equity as investors, a more robust market, and quality of asset being sold.

Exhibit 10 **PE sponsor-to-sponsor exits have more than doubled in the past ten years.**

PE exits by exit value and type of exits, %



	2005–08	2009–12	2013–16	2017
Number of exits	85	239	285	51

Note: Figures may not sum to 100%, because of rounding.
Source: AVCJ Research; McKinsey analysis

Four factors fueling private equity's rise

The recent trajectory of the South Korea private equity market has been shaped by several factors.

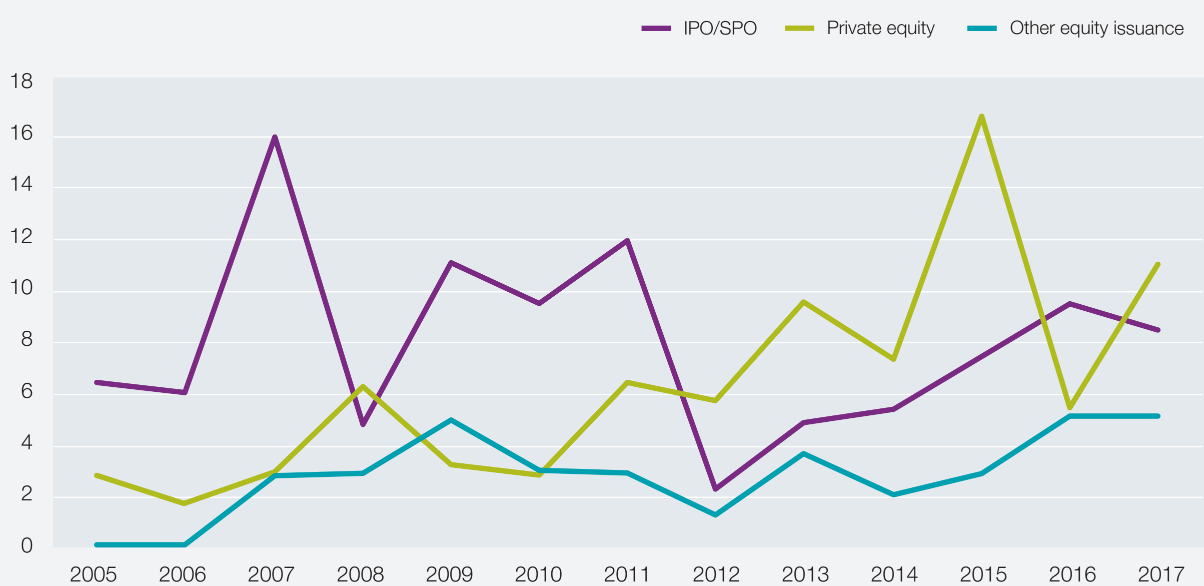
1 Public markets have underperformed significantly

While private equity funds in South Korea grew from 2005 to 2017, the country's public capital market took a different path. Prior to the financial recession, the public markets served as the largest sources of equity capital. Since 2012, initial public offerings and secondary public offerings have slowed considerably, allowing private equity investments to become the primary source of equity capital (Exhibit 11).

The KOSPI Index was highly dependent on the performance of Samsung Electronics, which accounted for 30 percent of its market cap. Samsung's incremental growth from 2012 to 2016 meant that the KOSPI achieved minimal growth until Samsung's share price rose more recently thanks to a huge demand for semiconductors in 2017. This market's reliance on large companies mirrors South Korea's economy as a whole. Currently, the top 50 conglomerates and other large companies account for more than 60 percent of the country's GDP.

Exhibit 11 **Private equity has outgrown the IPO/SPO market since 2012.**[1]

$ billion



[1] Secondary public offering.

Source: AVCJ Research; McKinsey analysis

2 First-generation owners are exiting via private equity

South Korea has one of the highest inheritance taxes in the world: an inheritance tax of 50 percent, and a progressive tax for the largest shareholders of 65 percent compared with an average of 26.3 percent for OECD countries. As the family owners of these businesses contemplate their succession options, private equity has emerged as a more attractive and lucrative alternative. In 2017, Affinity Equity Partners, for example, acquired a 63 percent stake in Lock & Lock for $561 million.[3]

3 Conglomerates divest assets due to regulatory shifts

Recent regulatory changes have forced conglomerates and chaebol to reduce their ownership of unlisted companies with significant intragroup business and divest affiliates that are outside their core business. For this reason, Hanwha Group sold Hanwha S&C, an IT solutions company, to STIC Investments in 2017. In addition, companies have been selling businesses to raise capital: Hyundai Heavy Industries dealt its entire stake in subsidiary Hotel Hyundai to South Korean private equity firm Hahn & Company in 2017.

4 Many MNCs have exited South Korea

Recent developments suggest that conglomerates (both locals and MNCs) and chaebol may provide investment opportunities via divesture or carve-outs in the coming years. A few MNCs decided to sell businesses in South Korea due to the deteriorating financial performance of the parent company. In 2015, after 16 years of business in the country, Tesco sold Homeplus for a record $6 billion buyout deal, the biggest single deal in Asia. In 2014, Tyco sold ADT caps, its security service business. Visteon Corporation (owned by Ford) also exited HVCC (Halla Visteon Climate Control) due to its flagging financial performance.

South Korea has one of the highest inheritance taxes in the world: an inheritance tax of 50 percent, and a progressive tax for the largest shareholders of 65 percent compared with an average of 26.3 percent for OECD countries.

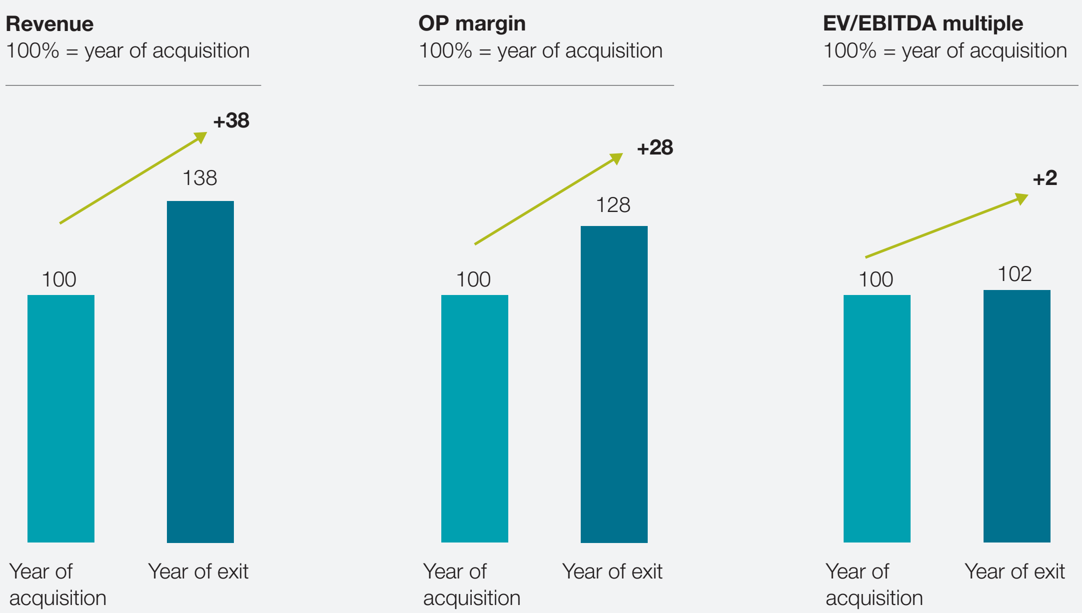
[3] Tomas S. Noda III, “Asia digest: Affinity Partners invests $561m in Lock & Lock; KKR buys Australian clinic,” *Deal Street Asia*, August 30, 2017, dealstreetasia.com.

Private equity firms are generating superior growth

Private equity investment portfolios have also achieved significant returns: on average, the top line of portfolio companies grew 38 percent in revenue from acquisition to exit, or annual growth of 11.2 percent over an average three-year holding period (Exhibit 12). Operating profit margins also grew 28 percent, meaning that most portfolio companies increased their enterprise value while maintaining the earnings before interest, taxes, depreciation, and amortization (EBITDA) multiples.

Exhibit 12 **PE's value creation mainly came from revenue increase and operational improvements.**

PE portfolio companies' financial comparison between the year of acquisition and the year of exit[1]



CAGR, %	11.2	9	1

[1] Fewer than 70 examples that disclose revenue and operating profit both in the year of acquisition and year of exit.

Source: AVCJ Research; Kisvalue; McKinsey analysis

In general, private equity firms' portfolio companies showed impressive growth in both revenues and operating profits. If we analyze each cohort's growth compared with non-PE-backed companies, portfolio companies outformed their peers in seven out of the ten years from 2005 to 2014 in revenue growth, and in eight out of the ten years in operating profit growth (Exhibit 13).

Exhibit 13

PE-backed companies demonstrate higher revenue and operating profit growth than non-PE-backed companies.

Comparison in growth two years after PE investment,[1] indexed to year of PE investment at 100

[1] PE-backed company samples are based on 320 PE investment in listed companies between FY05–16; excluded outliers with fewer than 50 or more than 200 revenue indexes; Sample of non-PE-backed companies consists of 11,000 comparable listed companies for FY 05–16; excluded outliers with fewer than 50 or more than 200 revenue indexes.

Source: AVCJ Research; Kisvalue; McKinsey analysis

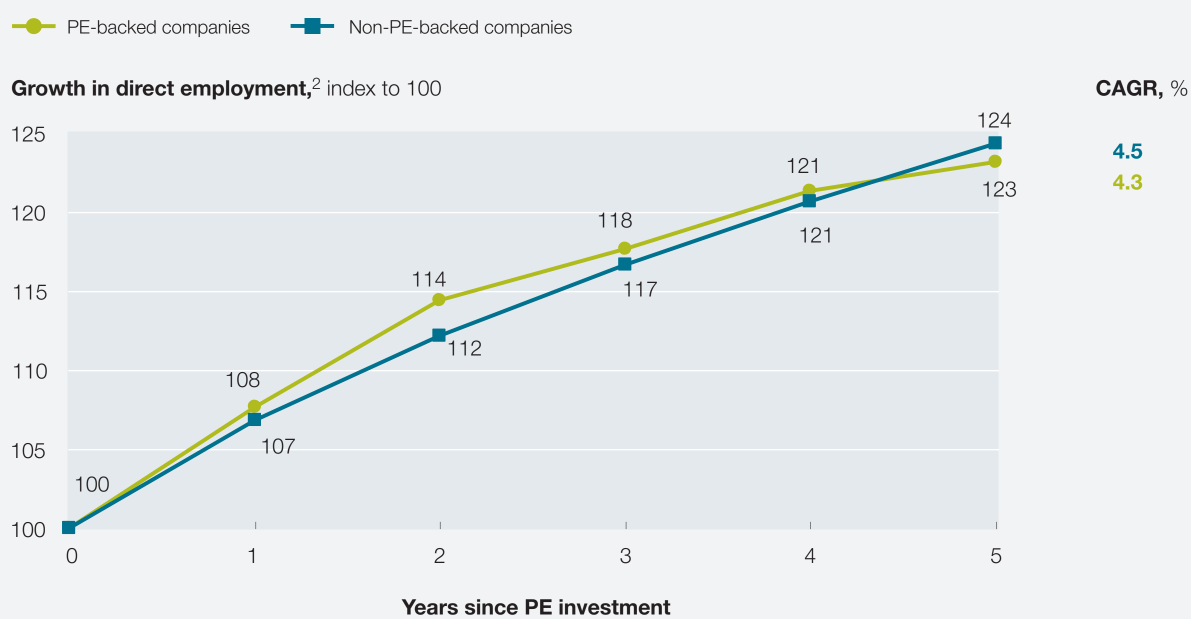
PE-backed companies have also made a significant contribution to the economy in the form of increased employment. McKinsey analyzed 430 portfolio companies and found an interesting pattern in their human resource planning. Since private equity funds in South Korea have focused on performance and growth, they have added employees on a similar trajectory to the that of non-PE-backed companies (Exhibit 14). This pattern contradicts the narrative that private equity firms in South Korea are interested primarily in reducing costs and selling off their portfolio companies rather than pursuing growth.

On profitability, private equity portfolio companies achieved an increase in profit margins similar to that of non-PE-backed companies. Two factors contributed to this trend.

Exhibit 14

PE-backed companies are contributing to employment growth.

Comparison of direct employment growth between PE backed and non-PE-backed companies[1]



[1] PE-backed company samples are based on 430 companies that saw PE investments; non-PE-backed company samples are based on 6,380 private sector companies.

[2] Use employment data from FY05 to FY15 to compare job growth in PE-backed companies and in non-PE-backed companies over the same period.

Source: AVCJ Research; Kisvalue; McKinsey analysis

The ability to attract superior talent

Private equity firms have the resources to hire and install more experienced executives and give them authority and autonomy. MBK Partners, for example, hired Samsung senior executives to helm Coway, one of its portfolio companies, and the Carlyle Group lured executive talent from LG to run ADT Caps. Private equity firms can also offer incentives for performance targets that help to align senior management with shareholder interests. These attributes are rare for professional executive positions in South Korea—and a major differentiator for private equity funds in their quest to attract the best executives.

A focus on operational expertise

Similar to KKR Capstone and TPG Capital, South Korea private equity firms have gained more expertise and experience in hands-on operational excellence. Larger firms such as Hahn & Company and MBK have established operating arms to assist the management teams of their portfolio companies in specific areas. This model offers private equity firms an additional lever to create value beyond financial leverage.

What's next for South Korean private equity firms

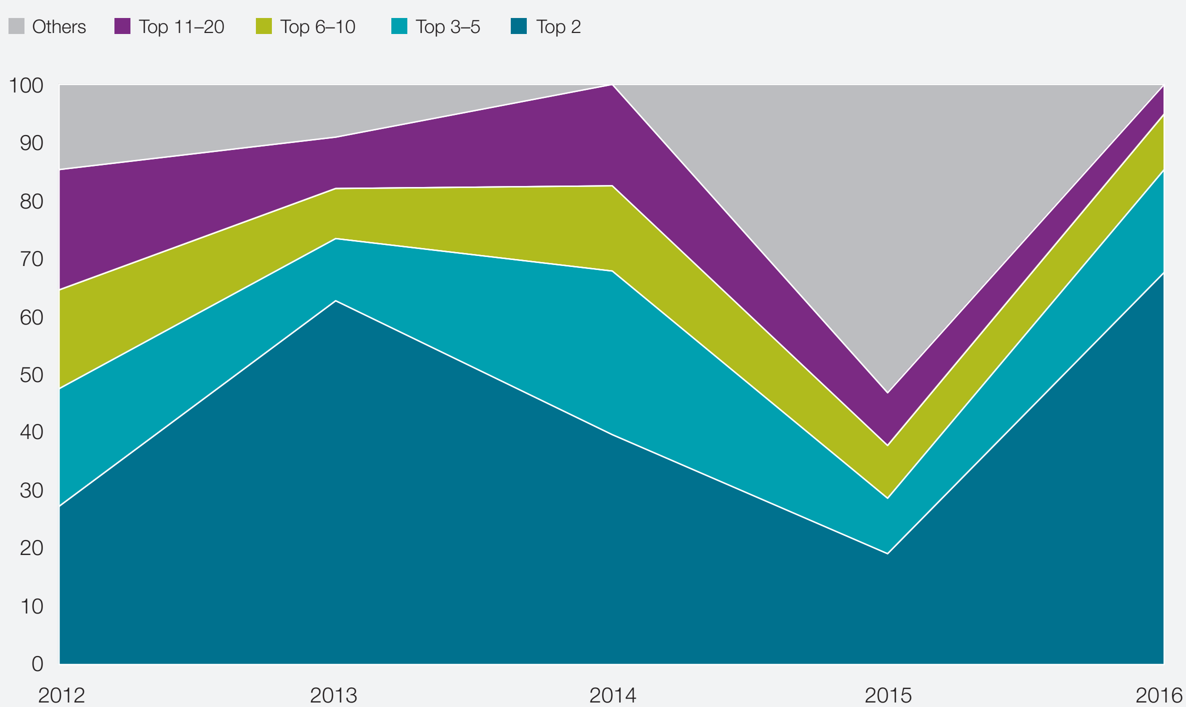
As global investors become more aware of opportunities in South Korea, the competition for attractive deals will likely increase significantly. Heightened interest from global megafunds—for example, KKR ($9 billion), Baring ($7 billion), and TPG ($5 billion)—are pushing EBITDA multiples higher, especially in auctions. Carlyle, KKR, and TPG have all established a dedicated presence in South Korea and are expanding their investment teams.

Thanks to South Korean private equity's robust return profile and healthy exit track record, the market represents a viable channel for limited partners looking to allocate their capital. The resulting influx of funds has fueled the growth of South Korea's two largest private equity firms—MBK and Hahn & Company. Since 2012, these firms have garnered a substantial share of fund-raising, approaching 60 percent of all private equity capital raised by South Korean funds in 2013 and 2016 (Exhibit 15).

As a result, private equity firms are starting to move beyond traditional leveraged buyouts into other strategies. MBK, for example, recently established a special situations investment fund. Since these new approaches require a different set of knowledge skills, a fund's success will be dictated by its ability to attract top talent to augment existing capabilities.

Exhibit 15 **Large local funds are gaining a significant share of fund-raising in South Korea.**

Share of South Korea private equity fund-raising, by size of fund, %



Source: Preqin

What it will take to succeed in South Korea

The spate of megadeals from 2015 to 2017 has further turned up the heat. Increased competition for acquisitions in South Korea, due in part to heightened interest from global megafunds, is pushing EBITDA multiples higher, especially in auctions. Private equity firms can respond by building capabilities in the following areas:

Ability to execute the real turnaround and add value

Private equity firms must find additional sources of growth to justify elevated prices. To remain competitive in leveraged buyouts, funds should consider building their expertise and know-how on executing business turnarounds and generating more value through growth.

Talent attraction in both operations team and network of local investment talent

Recently, private equity firms have begun to demonstrate their knowledge of a particular sector to notch multiple wins, both through managing portfolio companies and expanding into other parts of the value chain. Sector-specific expertise will become even more important in the coming years.

New deal sourcing beyond auctions

Increasingly, a private equity firm's network and ability to identify proprietary deals are critical. With South Korea private equity capital largely focused on traditional leveraged buyouts, firms can expand their network by creating enticing propositions for overlooked pockets of businesses or establishing lines of communication with conglomerates that don't want to pursue public auctions.

Expanding investment strategies beyond the buyout

Private equity firms are starting to extend past traditional leveraged buyouts into other strategies, such as special situations. Since these new approaches will require a different set of skills, a fund's success will be dictated by its ability to attract top talent to augment existing capabilities. In addition, a few other funds are rumored to be planning an expansion of its investment strategy in South Korea into credit and distressed funds, including special situations in Korea.

■ ■ ■

The impressive track record of private equity in South Korea over the past dozen years has created an attractive investment climate. That in turn has drawn more investors and funds to the market—developments that call for new strategies to identify promising deals. Private equity firms that can adapt their approach could be poised for continued success. ■

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