

Fostering Entrepreneurship in a Conglomerate-dominated Economy

September 17, 2013

Yong Rin Park
Head of Financial Services Industry Department
Korea Capital Market Institute



Contents

I History of Economic Development and SME Policy in Korea

II Structural Problems of the Korean Corporate Ecosystem

III Korean Venture Ecosystem and Recent Development

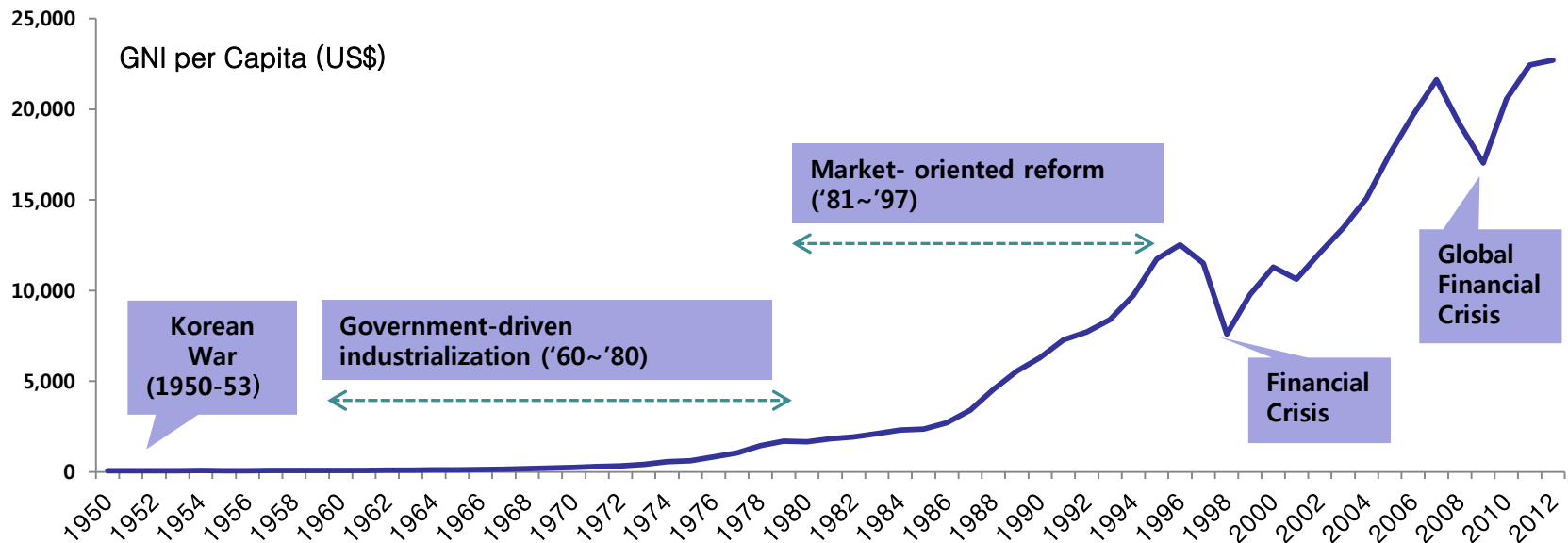
IV Conclusion and Key Lessons

I. History of Economic Development & SME Policy in Korea

Korea's Economic Performance

❖ **Despite poor initial conditions in the 1960s and intermittent economic and financial crises, Korea has emerged as one of the fastest growing economies over the last 50 years**

- Scarce natural resources and infrastructure damaged by the Korean War
- Government-driven industrialization ('60~'80) and market-oriented reform ('81~'97)
- Financial Crisis (1997) and Global Financial Crisis (2008)
- Now, Korea is the 7th largest exporter and has the 15th largest GDP



Source: Bank of Korea

Korea's Development Strategies, 1960s-1990s

- ❖ Korea had different development goals and policy directions across time depending on the given framework conditions

Korea's Development Strategies by Stage

	Development goals	Major policy directions	Macroeconomic policy framework	Science & technology	SME policy
1960s	<ul style="list-style-type: none"> • Build production base for exports 	<ul style="list-style-type: none"> • Expand light industries • Mobilize capital 	<ul style="list-style-type: none"> • Prepare institutional basis for industrialization 	<ul style="list-style-type: none"> • Build legal basis & administrative frameworks 	<ul style="list-style-type: none"> • Infrastructure for alienated SMEs in development policy
1970s	<ul style="list-style-type: none"> • Build self-reliant growth base 	<ul style="list-style-type: none"> • Promote HCI • Build SOC 	<ul style="list-style-type: none"> • Picking winners • Market intervention 	<ul style="list-style-type: none"> • Set up science & tech infrastructure (science town) 	<ul style="list-style-type: none"> • Conglomerate-SME business lineup and SME competitiveness
1980s	<ul style="list-style-type: none"> • Expand technology-intensive industries 	<ul style="list-style-type: none"> • Industrial rationalization • Trade liberalization 	<ul style="list-style-type: none"> • Macroeconomic stabilization • Private autonomy and competition 	<ul style="list-style-type: none"> • Promote business R&D • National R&D program 	<ul style="list-style-type: none"> • Balanced growth between SMEs and conglomerates
1990s	<ul style="list-style-type: none"> • Enhancing productivity through innovation 	<ul style="list-style-type: none"> • Nurture venture business • Build ICT infrastructure 	<ul style="list-style-type: none"> • Reform and restructuring • Regain growth potential 	<ul style="list-style-type: none"> • Frontier research and innovation clusters 	<ul style="list-style-type: none"> • Enhance productivity and technology, restructuring of SMEs

Source: Ministry of Strategy and Finance, KOSBI (2005)

Korea's History of SME Policy

- ❖ **The potential of SMEs as partners of large corporations and independent specialized growth engine was recognized in the mid-1980s**
 - A shift away from protection perspective to growth potential of SMEs
 - Since 1998, SMEs policy has focused on SMEs (esp. start-ups) as a major driver of the advanced economy as well as diversifying into female, self-employed, old market areas

1960s	1970s	1980s	1990s
<ul style="list-style-type: none">• Recognition and institutions for fostering alienated SMEs in the export-oriented development planning<ul style="list-style-type: none">- Minor Enterprise Basic Law (1966)- Small and Medium Business Cooperatives Act (1961)- Industrial Bank of Korea Law (1961)	<ul style="list-style-type: none">• Focus on conglomerate-SME business lineup and SME competitiveness<ul style="list-style-type: none">- SME Lineup Promotion Law (1975)- Korea Credit Guarantee Fund Act (1974)- SME Promotion Law (1978)	<ul style="list-style-type: none">• Balanced growth between SMEs and conglomerates through promotion of SME establishment<ul style="list-style-type: none">- Support for Small and Medium Enterprise Establishment Act (1986)	<ul style="list-style-type: none">• Balance enhanced productivity and technology, restructuring of SMEs<ul style="list-style-type: none">- SME Restructuring and Stabilization Support Law (1995)- Special Measures for the Promotion of Venture Businesses (1997)

II. Structural Problems of the Korean Corporate Ecosystem

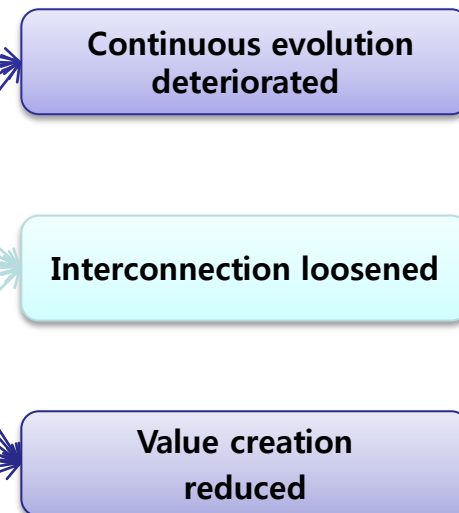
Characteristics of the Corporate Ecosystem in Korea

- ❖ To ensure sustainability, the corporate ecosystem should continuously evolve, be interconnected, and be creative in generating new value

Issues in the Korean Corporate Ecosystem



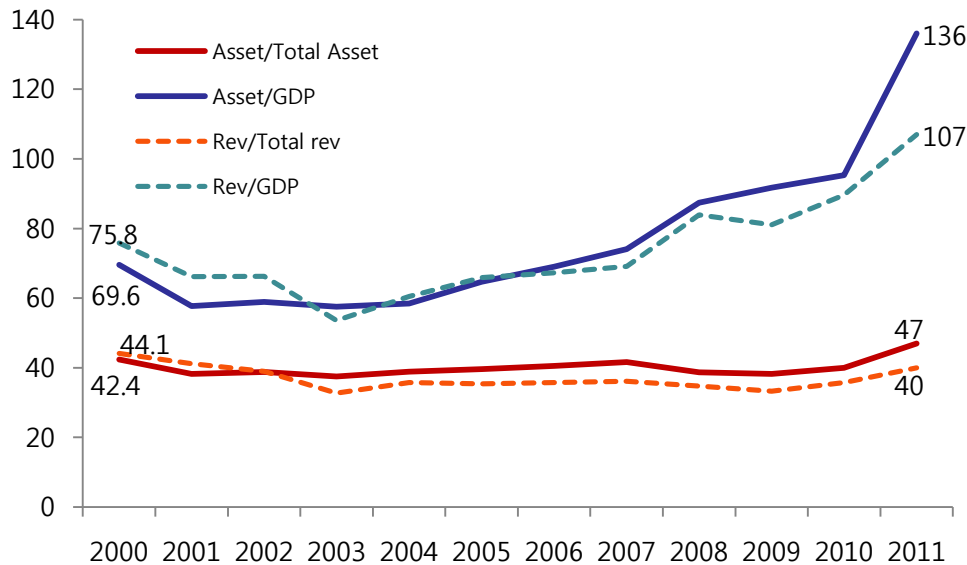
Sustainability of Corporate Ecosystem



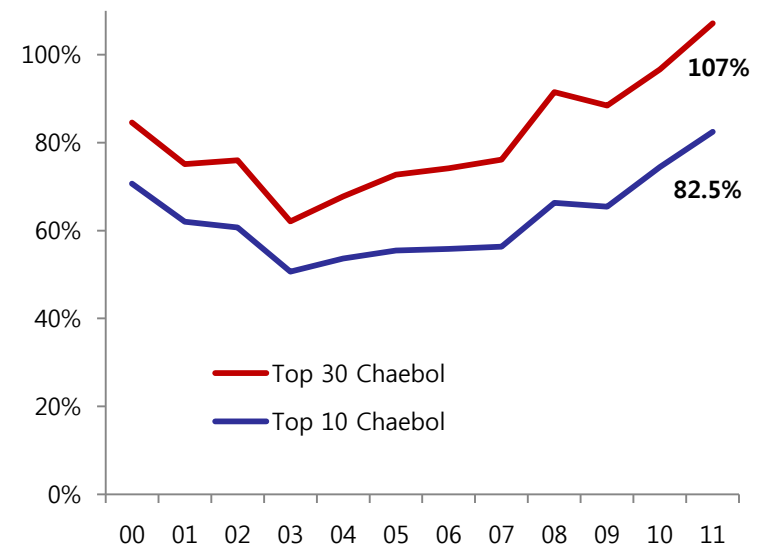
Concentration of Economic Power on Large Corporations

- ❖ **Concentration of 30 largest business groups has loosened to a certain extent, however, concentration of top 10 Family Chaebols has deepened**
 - Top 30 business groups may not represent true economic power due to downsizing of firms from inheritance
 - Economic concentration of top 10 Chaebols increased from 70.7% in 2000 to 82.5% in 2011, and top 30 business groups generally amount to top 10 Chaebols

Concentration of Top 30 Business Groups



Concentration of Top 10 Business Groups

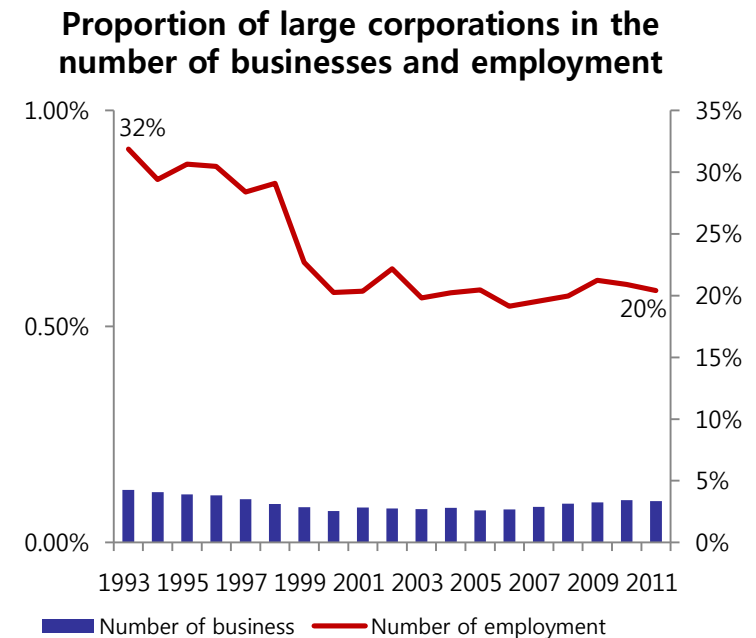
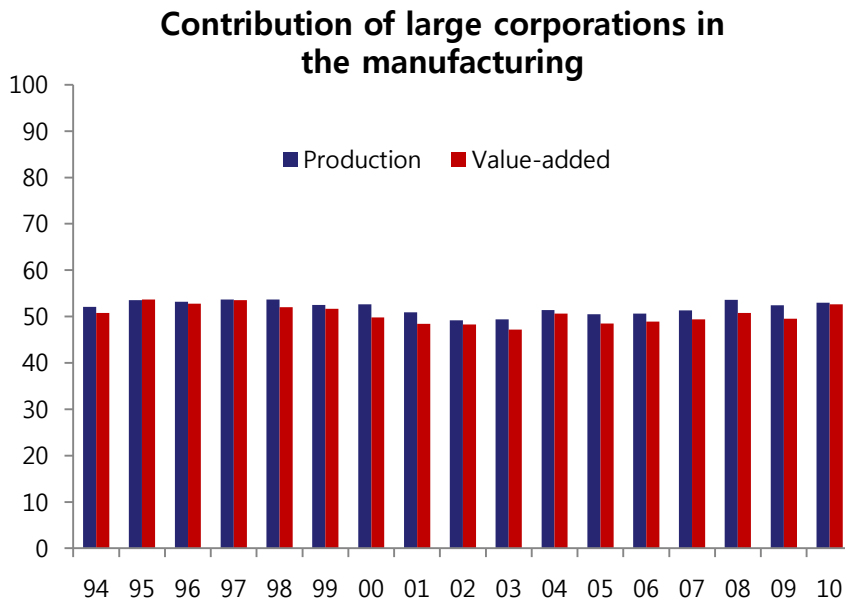


Source: Choi & Hwang (2012), KERI Database, Choi (2011)

Divergence between Large Corporations and SMEs - Employment

❖ Growth driven by large corporations resulted in the growth without employment

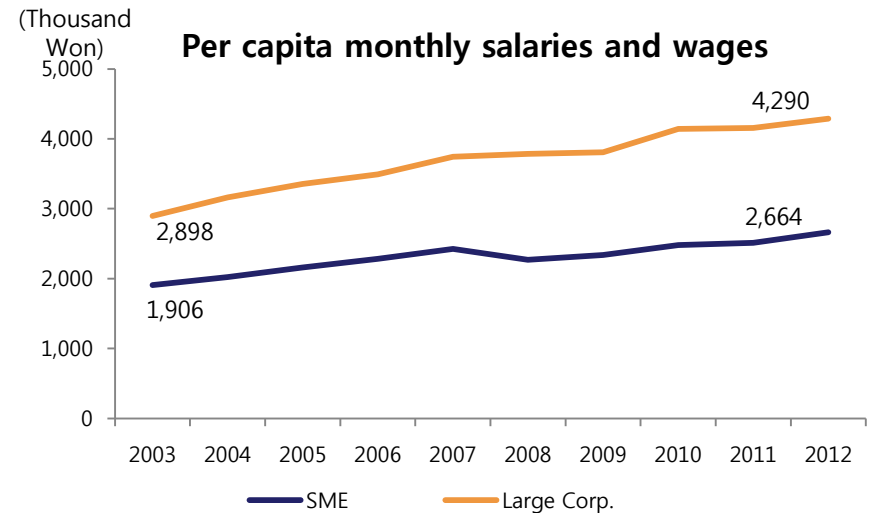
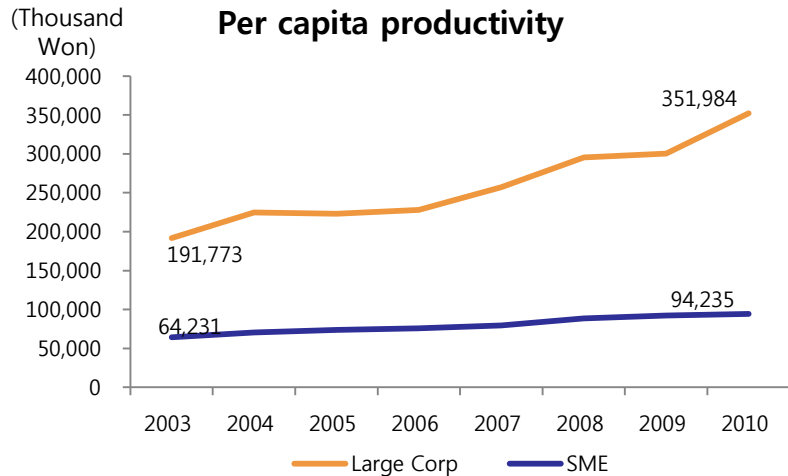
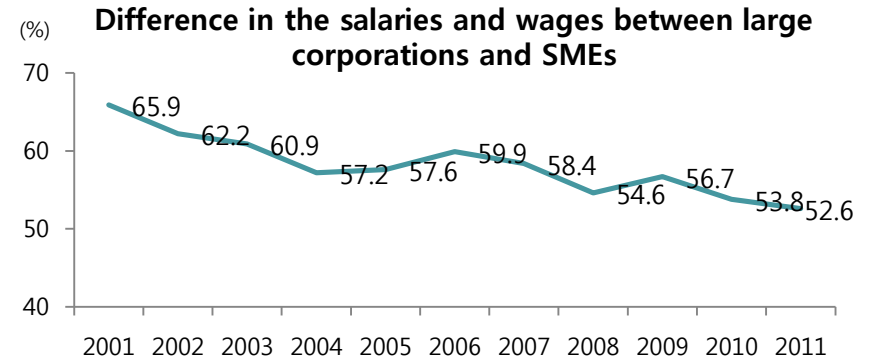
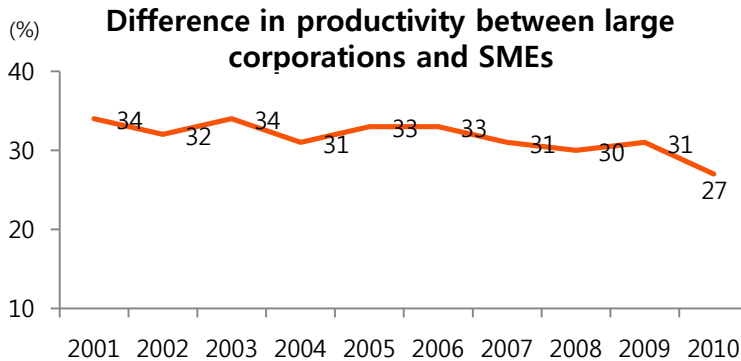
- Despite economic concentration, large corporations account for over 50% in total manufacturing and less than 50% in value added
- Large corporations account for only 0.1% in number, and the proportion accounted for by large corporations is on a downward trend



Source: Statistics Korea

Divergence between Large Corporations and SMEs - Productivity

❖ Growth driven by large corporations resulted in the divergence in employment



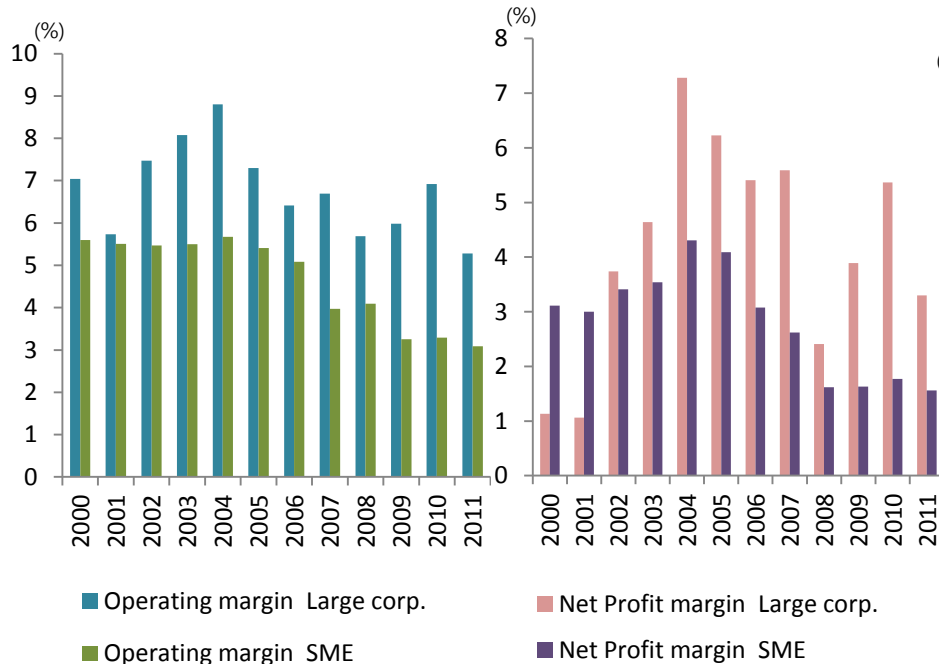
Source: Korea Federation of Small and Medium Businesses, Ministry of Knowledge Economy, Ministry of Labor

Divergence between Large Corporations and SMEs - Profitability

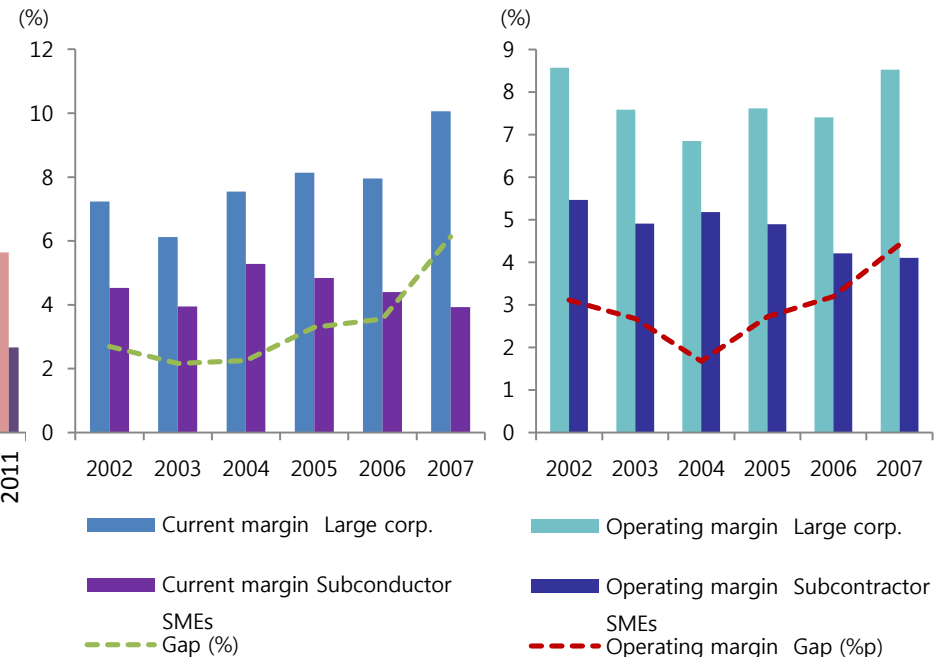
❖ Growth driven by large corporation led to divergence in profitability

- The gap in profitability between large corporations and SMEs has been widening
- The widening gap in profitability results from subcontracting

Profitability of large corporations and SMEs



Profitability of large corporations and subcontractor SMEs

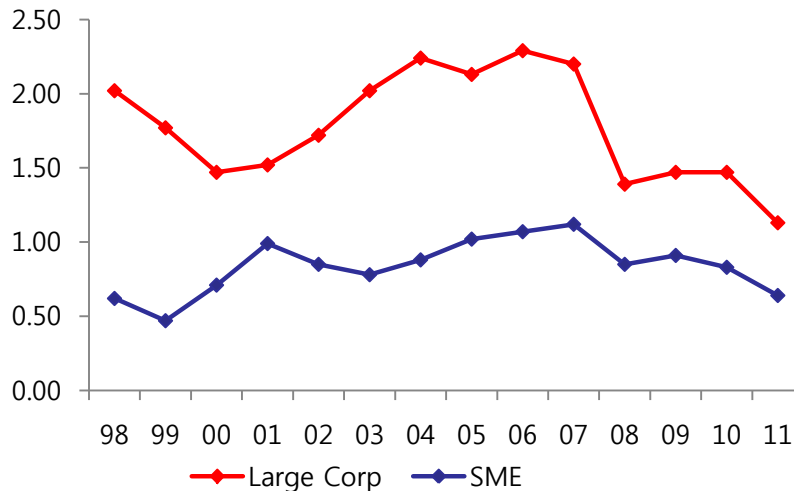


Divergence between Large Corporations and SMEs - Innovation

❖ Divergence in R&D between large corporations and SMEs

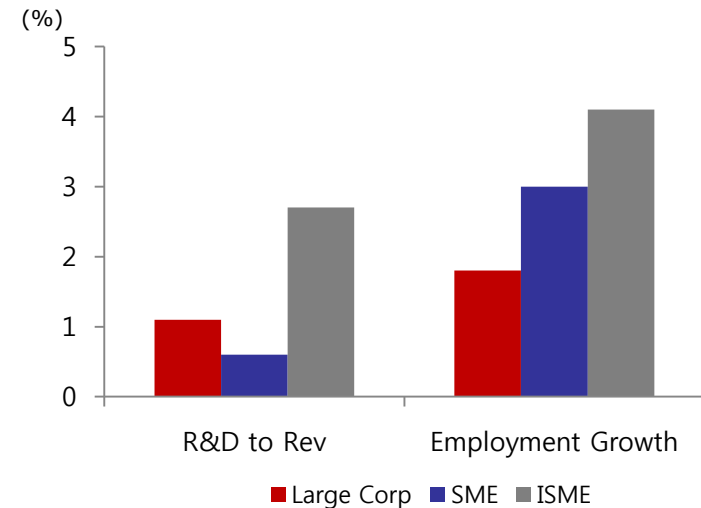
- Large corporations are mostly developing technologies and SMEs focus on production
- However, innovation activities of fast-growing Innovative SMEs (ISME or ventures) are stronger

R&D intensity of large corporations and SMEs



Source: Bank of Korea

Innovation and Employment of ISMEs



Source: SMBA, KOVA (2012)

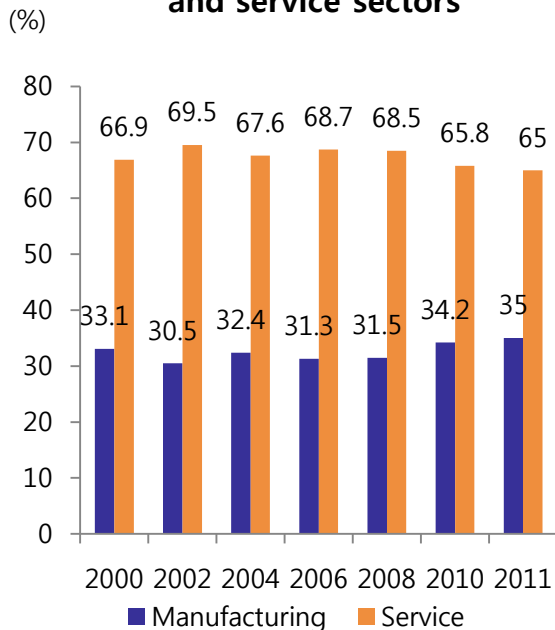
Divergence between Manufacturing and Service Sectors



❖ Growth driven by manufacturing-oriented export resulted in the negligence of high value added service sector

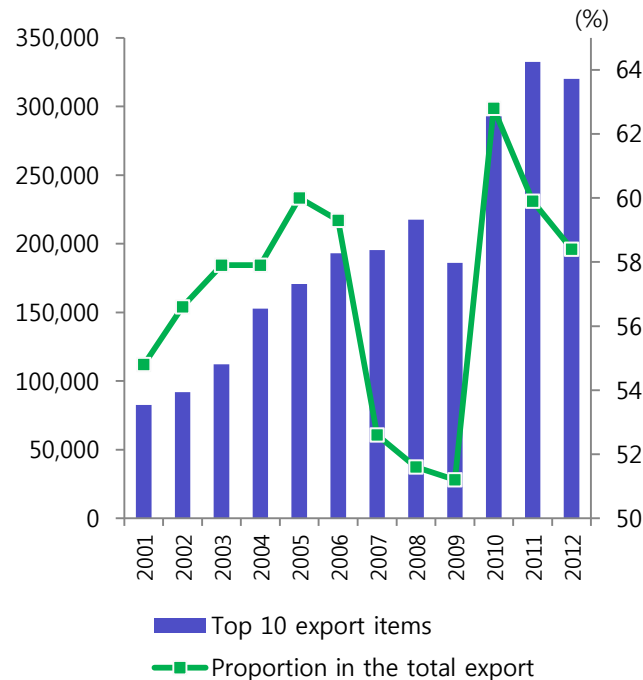
- Manufacturing does not tend to induce service production

Relative proportion of manufacturing and service sectors (%)



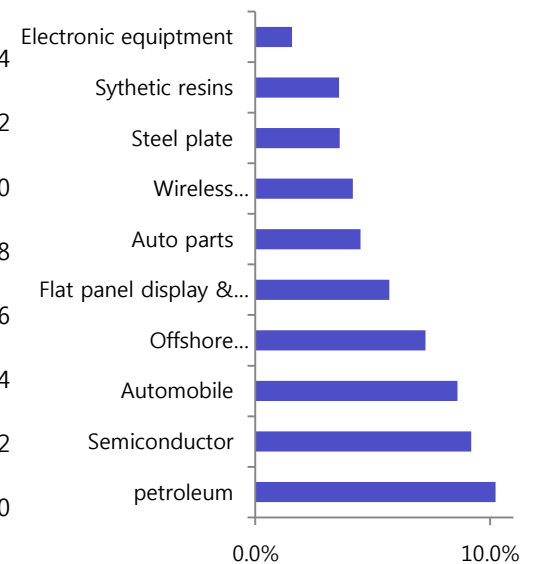
Source: Bank of Korea

Proportion of top 10 export items (%)



Source: Korea Customs Service

Share of top 10 export items (2012)



Source: Korea Customs Service

Lack of Corporate Growth Dynamism



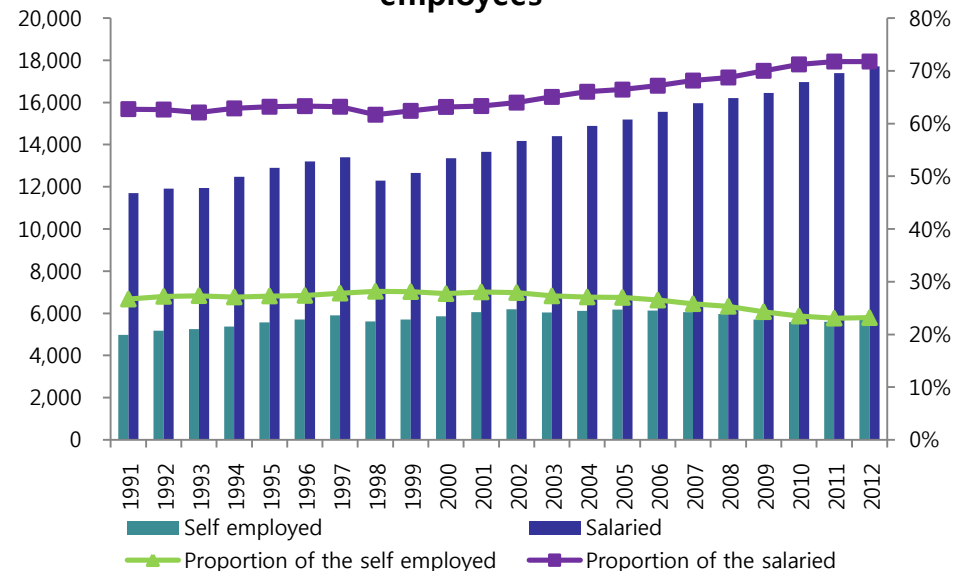
- ❖ **Only a few SMEs grow to middle-market and large corporations**
 - Over 2003-2008, 402 (41%) middle market corporations shrank to SME and 14 (0.14%) of them grew to become large corporations
- ❖ **Excessive proportion of establishments are small self-employed businesses**
 - 1 in 3 employed is self-employed (1 in 5 economically active population is self-employed), which is the highest among OECD countries

Growth of corporations from 2003 to 2008

		2008			
		SME	Middle-market	Large	Total
2003	SME	57,601	529	4	58,134
	Middle-market	402	568	14	984
	Large	2	7	17	26
	Total	58,005	1,104	35	59,114

Source: IBK Economic Research Institute

Percentage of self-employed and salaried employees



Retrospection of SME Policy in Korea



- ❖ **SME policy in Korea generally did not fully consider strategic goals of fostering innovative SMEs, improving SME competitiveness, and helping SME restructuring**
 - In 1980s, SME policy was ad-hoc, protective, short-term, financial support oriented
 - In late 1980s, characterized as 3-low economic boom (low oil price, low currency, low interest rates) resulted in overinvestment and an increase in labor cost, undermining SME competitiveness
 - Also, competition with emerging economies with cheap labor in the export market pressed SME profitability
 - All of these led to the divergence between large corporations and SMEs in 1990s
- ❖ **In retrospect, SME policy in Korea should have been more focused on improving SME productivity and efficiency**
 - SME policy was regarded only as a counter-measure to the economic concentration of large corporations
 - SME support measures were to alleviate SMEs' short-term financial bottleneck
 - And even financial support was given, not to emerging businesses with growth potential but was spread to SMEs on a non-discriminative basis

III. Korean Venture Ecosystem and Recent Development

Policies for SME vs. Innovative SME

Comparison between SME Policy and Innovative SME Policy

Dimension		SME Policy	Innovative SME Policy
Policy Goals	Goals relative to entrepreneurs	Entice <i>more</i> people to become entrepreneurs	Entice the <i>right</i> people to become entrepreneurs
	Goals relative to entrepreneurial firms	Increase the <i>number</i> of new entrepreneurial firms	Increase the <i>quality and growth</i> of both new and old entrepreneurial firms
	Goals relative to operational environment	Facilitate the environment for small business operation	Facilitate the environment for entrepreneurial firm growth
Resource Provision	Source	Mostly from public sources	Combination of public and private source
	Type of financial resources	Grants, subsidies, soft loans	R&D loans and innovation grants, business angel, VC, IPOs
	Dominant support service	Standard advice for firm creation, business planning, small business operation	Experience-based advice for VC, strategic planning, internationalization, organizational growth
	Resource distribution principle	Ensure equal access to small firms (resource spread)	Select promising recipient on the basis of growth potential (resource focus)
Regulatory focus	Life cycle focus	Remove bottlenecks to new business entry	Remove bottlenecks to entrepreneurial firm growth
	Attitude toward failure	Avoid failure, bankruptcy	Accept firm failure and bankruptcy, but reduce the economic and social cost of these

Source: European Commission (2008)

Evolution of Venture Capital in Korea



Background Condition (1974~1986)

Pre-emergence Phase (1987~1996)

Emergence Phase (1997~2000)

Crisis, Consolidation & Growth Phase (2001~Present)

- 1974: Korea Technology Advancing Corporation (KTAC) founded by Korea Institute Science and Technology (KIST)
- Three more New Technology Finance Companies established under Financial Support for New Technology Businesses Act (1986, Ministry of Finance and Economy)
 - 1981: Korea Technology Development Co. (KTDC)
 - 1982: Korea Development Investment Co. (KDIC)
 - 1984: Korea Technology Finance Co. (KTFC)
- Support for Small and Medium Enterprise Establishment Act enacted (1986, Ministry of Trade and Industry)

- Small and Medium Business Administration (SMBA) was established in 1996
- Act on Special Measures for the Promotion of Venture Businesses enacted in 1997
- Foundation of KOSDAQ in 1997
- 12 venture capital companies (VCs) were founded in 1986 and the number of VCs increased to 72 in 1998)

- VCs proliferated and the number of VCs peaked at 156 in 2000
- 325 VC funds were launched in 2000
- VCs invested \$2 billion in 2000

- After experiencing slowdown by the global economy downturn and plummeting technology-centered markets (NASDAQ, KOSDAQ, etc.) from 2001 to 2004, the venture capital industry starts to take off again (104 VCs in 2006)
- Dramatic changes in government policies to “revive the venture industry”
 - Government General Measures to revitalize the venture industry
- In 2005, Fund-of-funds (SMBA), whose role is to allocate funds among VCs, was built based on Act on Special Measures for the Promotion of Venture Businesses
- In 2009, VC fundraising reaches the prior peak level achieved in 2000

Success Factors

- Government policies for nurturing venture companies
- Equity investment is larger than loan contract
 - Growth of stock market (KOSDAQ)

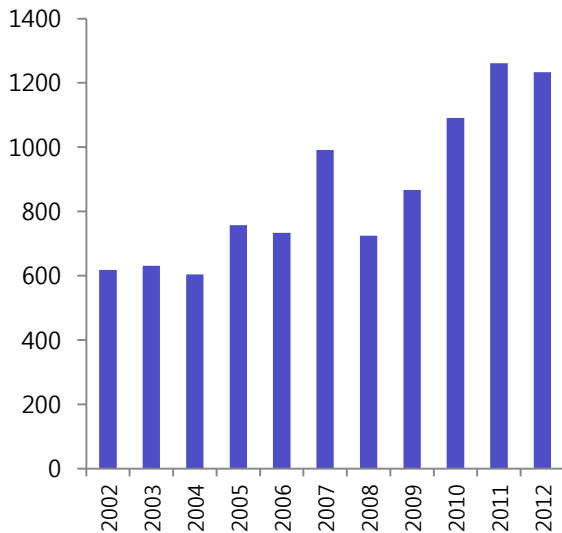
Venture Capital in Korea



❖ Venture capital in Korea has made significant achievements in boosting entrepreneurship in Korea

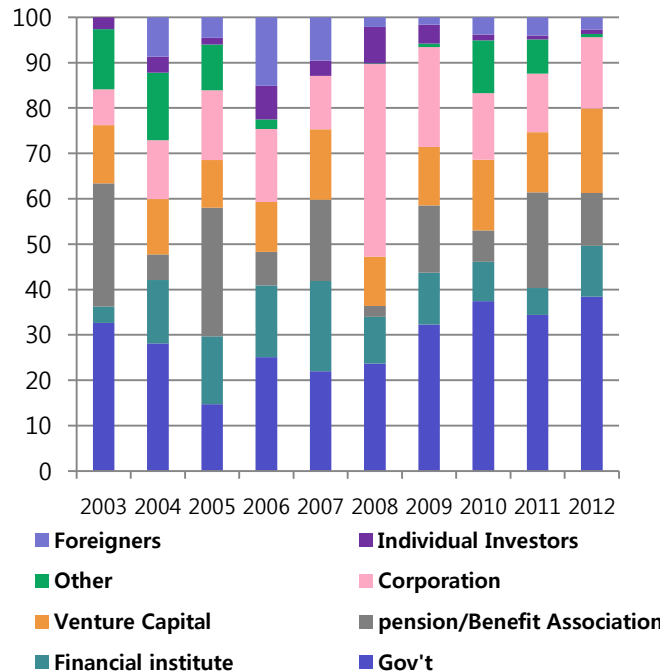
- Source of VC funding remain driven mostly by government and policy-based
 - Small & Medium Business Administration, The Ministry of Knowledge and Economy, The Ministry of Environment, The Ministry of Culture and Tourism, etc.

(bn won) VC Fundraising by Year in Korea

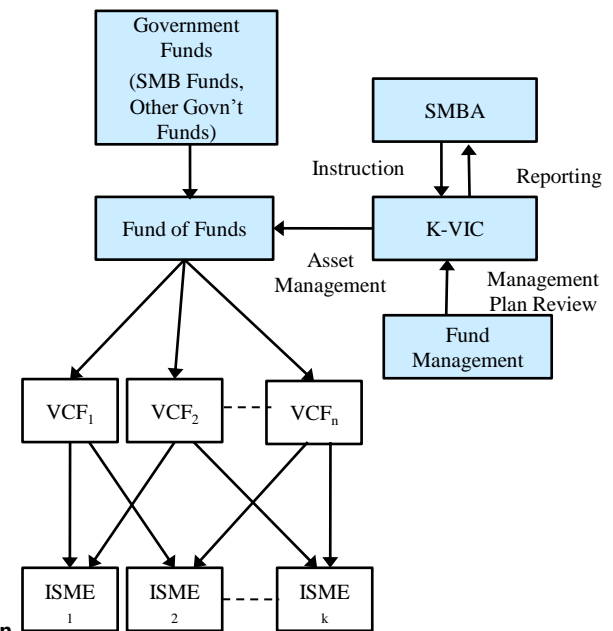


Source: KVCA

Sources of Fund Raised



Operation Structure of KVIC

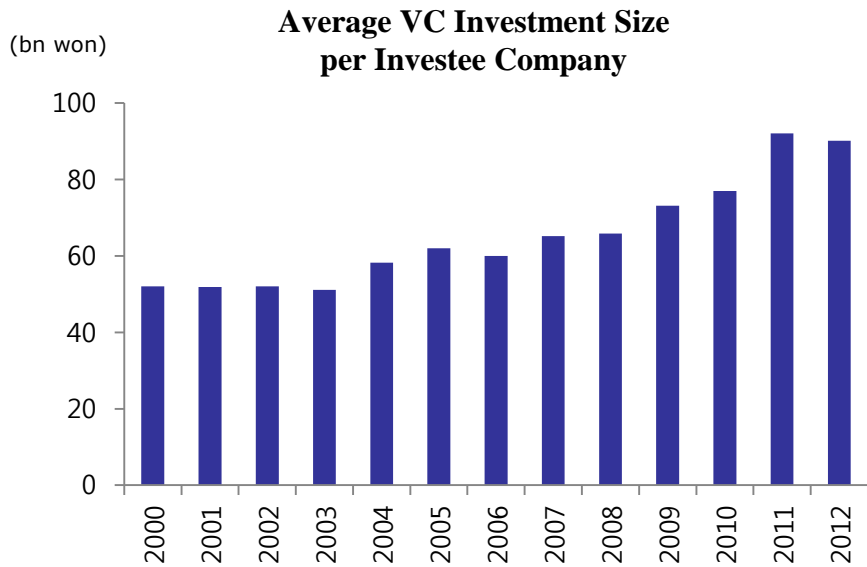


Issues in Venture Capital – Investment

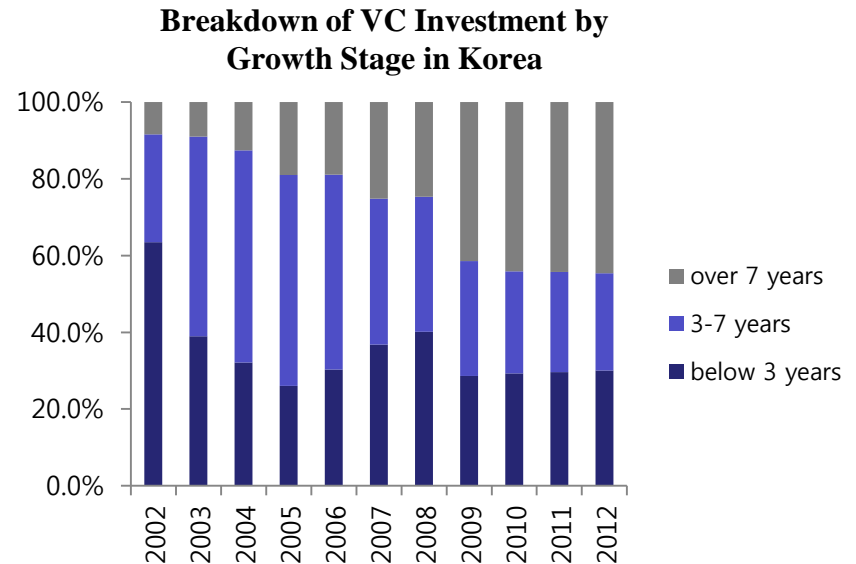


❖ Average size per investment has been steadily increasing, aggravating the equity gap problem

- Average investment size per investee company has increased from 52 bn won (2000) to about 90.2 bn won (2012)
- Leads to conservatism in VC investing preferring pre-IPO rather than early stage
- A critical issue considering primitive business angel market in Korea



Source: KVCA (2012)



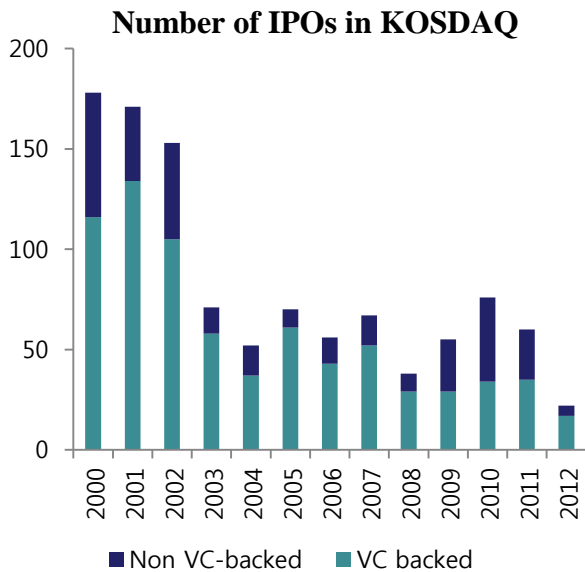
Source: KVCA (2012)

Issues in Venture Capital – Exit

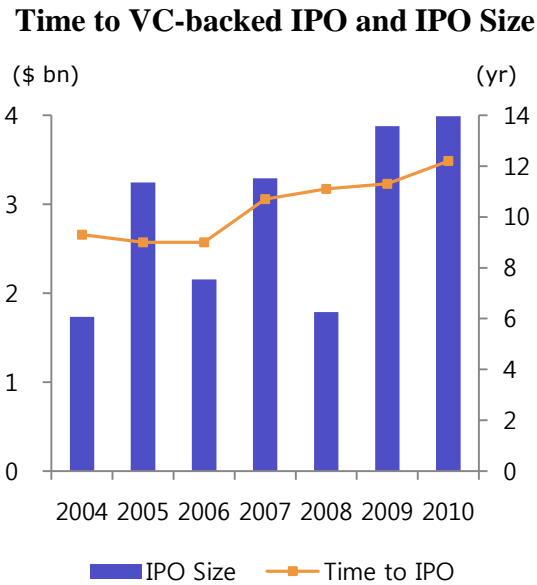


❖ **Despite its visibility, KOSDAQ has lost its vitality, and VC time to IPO and IPO size have been increasing with heavy reliance of exits on IPO**

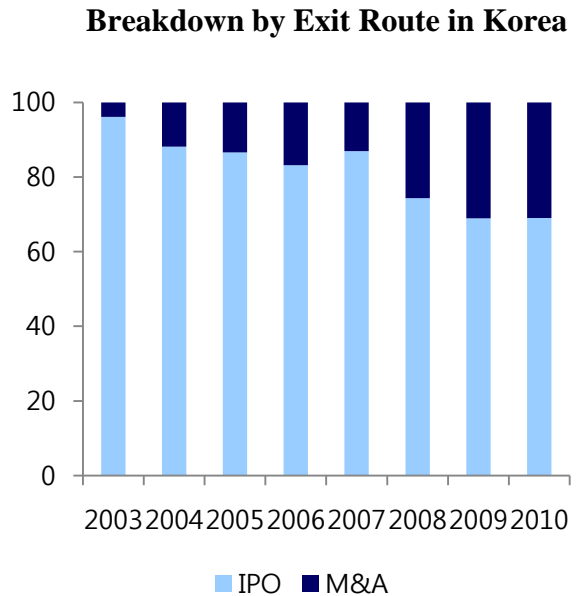
- KOSDAQ is the second largest growth stock market in the world by market cap.
- Due to relatively short life of VC funds in Korea (5~7 yrs), VC funds focus on later stage investees with over 7 years of operation history



Source: KVCA (2012)



Source: KVCA (2011)



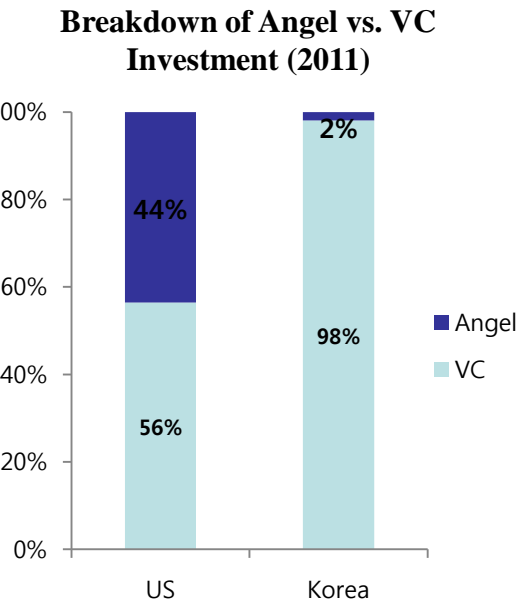
Source: KVCA (2012)

Angel Capital and Crowdfunding

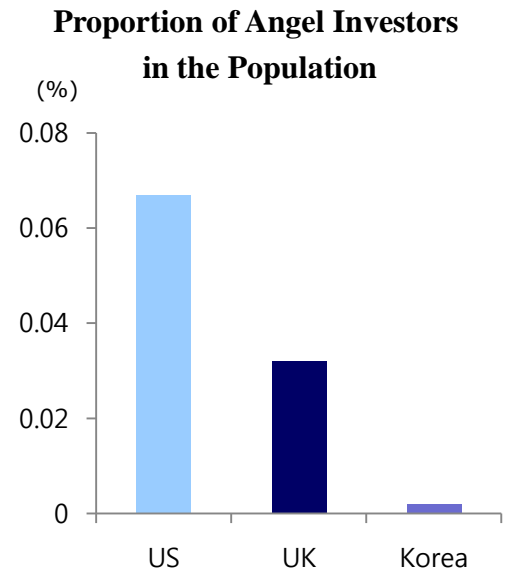
- ❖ **Although reviving recently, angel investment has played only a little role since the dot-com debacle, exacerbating the equity gap problem**
 - A serious threat to the ISME ecosystem in Korea
 - Recently, crowdfunding as an alternative source of finance is emerging in Korea as in other advanced countries



Source: Small & Medium Business Administration



Source: Small & Medium Business Administration



Source: Shane (2008), Mason & Harrison (2010), SMBA, KVCA

KONEX: Korea's New Growth Stock Market

❖ As a remedy to the restrictive KOSDAQ listing, KONEX was launched in July 2013

- Reasonably successful so far with 21 ventures listed, however, successful operation of a growth stock market remains tricky

Dimension	Characteristics of KONEX
Qualifying companies	– Only SMEs defined in the Minor Enterprise Basic Law
Listing and delisting requirement	– Minimal listing requirement – Audited financial report, engagement of Nominated Advisor, minimal capital, sales and profit requirement – Delisting conditions are simplified to default, disqualifying audit report, embezzlement, and discontinuation of the contract with
Trading	– Competitive auction of every 30 minutes
Investor mix	– Institutional investors (VC, collective investment vehicles, etc) and individual investors of more than KRW 0.3 bn trading account deposit
Sponsor (or advisor)	– Nominated Advisors source and evaluate qualifications of listing candidates on behalf of the Exchange under the contract with listing candidates
Graduation (or Migration) to KOSDAQ	– No explicit favor is given as of yet – However, the regulatory body expect the role of KONEX as the bridge to KOSDAQ listing

Korea's New Economic Policy: Creative Economy



- ❖ **President Park of Korea proposed the Creative Economy as the next step for Korea's economic growth**
 - Korea faces increasing competition from emerging economies such as China
 - Transformation of economic structure from follower economy to leader economy
- ❖ **Korean Creative Economy aims to create jobs and new markets through transformative and convergent technologies with an emphasis on fostering entrepreneurship and innovation**
 - The concept of the Creative Economy has been fostered in various advanced countries in an effort to create economic value and jobs through creativity, technology, and intellectual property
 - Creative Economy, in most cases, is defined as culture, art, and media based on creativity and talent of individuals
- ❖ **Korean government recently announced comprehensive policy measures for venture ecosystem as the first step to implement the Creative Economy**
 - Promoting start-ups and fostering entrepreneurship is the cornerstone of the Korean Creative Economy

Comprehensive Measures for Venture Ecosystem

	Start-up/Early stage (0~3 years)	Expansion stage (4~9 years)	Exit/Late stage (10~15 years)
Tax	<ul style="list-style-type: none"> • Promotion of angel investment - Income tax deduction 	<ul style="list-style-type: none"> • Promotion of technology innovation M&A - Buyer: corporate income tax deduction - Seller: donation tax deduction 	<ul style="list-style-type: none"> • Tax favor to exit proceeds
Private Sector			
Regulation	<ul style="list-style-type: none"> • Introduction of crowdfunding 	<ul style="list-style-type: none"> • Simplification of SME M&As 	<ul style="list-style-type: none"> • Establishment of KONEX • Enhancement of KOSDAQ
Policy Finance	<ul style="list-style-type: none"> • Future Creation Fund (early stage) • Angel Matching R&D Fund • Special Guarantee for to-be entrepreneurs 	<ul style="list-style-type: none"> • Future Creation Fund • Intellectual Property Protection Fund • M&A Guarantee Fund / Convergence Fund 	<ul style="list-style-type: none"> • Re-startup Angel Matching Fund • Growth Ladder Fund • Re-startup Support Loan
Enabling conditions	<ul style="list-style-type: none"> • Promotion of Startup Platform - Various startup projects - Incubation-investment-R&D technology startup 	<ul style="list-style-type: none"> • Protection of technology owned by ventures • M&A market infrastructure - M&A Info-market - Technology evaluation DB 	<ul style="list-style-type: none"> • Improvement on re-startup environment - Removal of joint and several liability on guarantee - Loosening of credit restriction of failed entrepreneurs
Human resources	<ul style="list-style-type: none"> • Promotion of startups by researchers 	<ul style="list-style-type: none"> • Improvement on venture stock option rules 	

IV. Conclusion and Key Lessons

Key Lessons from Korean SME Policy

- ❖ **SME policy should be understood from the perspective of enhancing core competence of SMEs**
 - Effective SME policy can be established by long-term vision and strategy about current and future industry structure
 - Current Korean SME policy includes both an element of economic policy for technology development and innovation and an element of social welfare policy for minor and declining businesses

- ❖ **General directions of desirable SME policy are as follows**
 - Orientation toward innovative SMEs, not just current SMEs
 - Inducement of private players in the capacity building of SMEs
 - Separation of competition policy from social welfare perspective
 - Recognition that current problems of SMEs are not the cause, but the symptom of the deficiencies of SMEs
 - Clear understanding and measurement of market failure and government failure