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# What's a Chaebol to Do?

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# What's a Chaebol to Do?

The family-owned conglomerates made South Korea an industrial powerhouse, but can they transform themselves and their nation's economy again now that the rules have changed?

**by Tariq Hussain**

The recent news that Samsung Group's heir apparent, Jay Y. Lee, was named chief customer officer of Samsung Electronics has led some observers to suggest that the younger generation of Koreans is, as Newsweek put it, "abandoning their fathers' practices for contemporary Western management styles."

Lee's appointment to this new post was viewed as an indication that the huge, family-controlled, traditionally secretive Korean conglomerates known as chaebol were becoming more open and transparent. Not so fast. A closer look reveals that these international megaliths, including Samsung, Hyundai Motor, and SK — to name a few of the corporations that drove the rise of Korea Inc. — have not kept pace with the global competitive environment and are not much different than they were a decade ago, when overleveraged banks and companies collapsed in the wake of the East Asian financial crisis.

In fact, far from spearheading a new approach to business that might give the economy of the Republic of Korea (hereafter Korea) much needed buoyancy, the chaebol continue to resist modern corporate thinking, which is only perpetuating Korea's leaden economic performance. According to the World Economic Forum's *Global Competitiveness Report*, which assesses a country's business sector, policies, and institutions to measure productivity, Korea fell to 24th place in 2006, five slots lower than the year before.

The chaebol came into being in the early 1960s, when President Park Chung-hee catapulted Korea into the community of industrial nations by giving a number of business tycoons free rein to set up organizations designed to kick-start the economy. By the 1990s, the chaebol had become corporate juggernauts, too big to fail and too big for the government to control. The 1997 financial crisis exposed how debt-ridden these favored corporate behemoths had become: One-quarter of the manufacturers in Korea did not earn enough to meet the interest payments on their loans.

At first, it appeared that the chaebol would be chastened by the state of affairs, especially when they were forced, for example, to take on outsider directors to discipline and control the family owners. But any hope that the chaebol would lead the much-needed transformation of Korea's economy into an open, globally integrated, knowledge-based system was soon dashed. Consider corporate governance. The reforms of the late 1990s were mostly cosmetic, and chaebol continue to be run by proprietor families through a complex network of cross-shareholdings that give the owners inflated amounts of stock in all the subsidiaries and undue influence over the professionals and the board of directors.

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And although the chaebol have led Korea's rise as a manufacturing powerhouse, they have not been able to build successful service businesses, a distinct disadvantage for Korea because it will not be able to survive on its manufacturing alone — especially with hundreds of thousands of its best factory jobs moving to China. Yet even with the disappearance of factories, Korean companies continue to try to squeeze incremental improvements out of their manufacturing systems, rather than shift their focus to developing service operations. Indeed, labor productivity in Korean service companies is only 56 percent of that in manufacturing, the largest gap among members of the Organization for Economic Development and Cooperation (OECD).

Similarly, the share of foreign direct investment as a percentage of GDP is the lowest of any OECD country except Japan. Following the financial crisis, a number of chaebol subsidiaries were taken over by non-Korean companies. Noteworthy were Renault's acquisition of Samsung Motors and Otis's purchase of LG's elevator business. Yet these sales were driven more by chaebol cash-flow needs than by a fundamental conviction that teaming up with a foreign company could reveal the company's full potential, even if it meant losing control. And today, most chaebol owners are reluctant to part with their assets. In one recent case, a global leader in the industrial equipment sector was eager to acquire a chaebol subsidiary, a leader in the local market but a small player by international standards. After being courted with one highly attractive offer after another, the Korean owner declined, saying that he would build his business by himself. The response of the foreign company's chief negotiator was predictably terse: "We remain interested in a partnership, but, with China emerging fast as a global manufacturing and R&D center, the value and importance of this company to us is unlikely to increase going forward."

The existence of all-powerful chaebol also makes it difficult for startups and small or midsized businesses to flourish — a significant concern, because in most advanced economies such companies drive economic growth and employment. When interacting with small and medium-sized enterprises, chaebol seek total control, leaving the smaller companies with enough to survive but not enough to prosper. As Ahn Chul-soo, founder of AhnLab, an antivirus software startup, put it: "The chaebol are squeezing small companies for every penny. We have no room to breathe."

The chaebol are by no means the only barrier holding back Korea's economy. Hostile labor unions and an overactive government bureaucracy also hamper foreign direct investment and the emergence of a healthy small and midsized sector. And of course, the chaebol are not necessarily bad for Korea; a chaebol subsidiary that commands world-class leadership in its market, such as Samsung Electronics, often holds a competitive position that is not soon likely to be eroded by global rivals and emerging Chinese companies. In other words, Korea needs more Samsung Electronics, but less Samsung.

Yet, given their leadership role, the chaebol carry particular responsibility for Korea's success or failure. In August 2006, the Korean newspaper *JoongAng Ilbo* and the East Asia Institute, an independent thinktank, published research on Korea's most powerful organizations, based on the perceived level of influence and trust. Four of the top five organizations were chaebol, led by Hyundai Motor and Samsung, and they ranked above NGOs, government, and political parties.

For the chaebol to help unleash much of the Korean economy's hidden potential, they must seek partnerships with multinational companies, drastically reform their corporate governance practices, and eliminate their command and control management style. Some companies have demonstrated that these recommendations, although foreign to Korea, are not impossible to implement there. For example, LG's decision to institute transparent corporate governance through a holding structure that eliminates cross-shareholding, significantly improves transparency, and ensures board independence, and the privatized Korea Telecom's recent efforts to strengthen the role of outside directors and return excess cash to shareholders, prove that world-class corporate governance can work in Korea. Daewoo Motors, which collapsed under $16 billion of debt in 1999 and was subsequently taken over by General Motors, is selling more cars today than it did as part of the Daewoo Group. It may have been a major change for Daewoo managers to deal with Detroit supervisors, but their jobs are more secure and the Korean economy is clearly better off.

As Korea's largest, most successful, and most powerful chaebol, Samsung is the trendsetter for corporate Korea. The group accounts for 8 percent of Korea's tax revenues, 22 percent of exports, and almost one-quarter of stock market capitalization. The leadership position at Samsung is reserved for Jay Y. Lee, the newly appointed chief customer officer and son of chairman Lee Kun-hee. The father is making sure that his son receives more rigorous business training than the average chaebol "prince," and the younger Lee's new position puts him closer to the customers — and to understanding the type of openness that they require — than most Korean executives ever get. Perhaps all of this will drive him to eventually streamline Samsung's portfolio, transform its culture and management style, and establish a world-class corporate governance system. If that occurs, he may not only pave the way for Samsung's success, but also set a course for Korea's economy as a whole. As an LG executive acknowledged: "Samsung's future is Korea's future." +

## Resources

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East Asia Institute Web site: Research by *JoongAng Ilbo* and the East Asia Institute on Korea's "power organizations" ranks Korea's companies by perceived influence and level of trust. (In Korean.)

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