HOLD YOUR NERVE SAMSUNG

Op Ed by Dr Rory Knight

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Samsung is facing the massive challenge of a demand to deconstruct its corporate architecture. Its decisions, however, should not be taken lightly. They bring the danger of unintended consequences both for Samsung and the Korean economy. Samsung's development has been intimately linked to the Korean economy. It has been a driving force of the meteoric rise of modern Korea from the humble beginnings of 1953. Korea stands today as a highly educated well-endowed knowledge economy which has been served well by its unique approach to many aspects of business and in particular its market for corporate control - or corporate governance arrangements. The outcome could herald the unravelling of the Korean miracle, as Samsung has been a key force driving Korea's meteoric rise. As such, it presents a major existential threat to the nation.

The company is currently embroiled in a multiple maelstrom. The Galaxy 7 product fiasco has cost at least $5bn and dented its reputation. Accusations are swirling of corruption and manipulation in the consolidation of Cheil Industry. These difficulties have to be set against an inter-generational transfer of authority and control resulting in younger less experienced leaders at the helm. All these problems, moreover, are erupting amid a political earthquake the like of which has not been seen in Korea for several decades. Only last week the prosecutors investigating the links between Samsung and the controversy surrounding the president raided corporate headquarters.

In October a group of activist shareholders demanded the group be split and 75% of free cash flow distributed to shareholders. They point out the potential for improvement in the delivery of shareholder value, citing the cash pile of $60bn, the lack of transparency in the corporate structure and the slow payout rate. Their demand for a distribution of 75% of free cash flow and the break-up of the group is understandable but short-sighted.

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We need to ask: how far does the ownership structure of a firm matter? In the US where market capitalisation accounts for more than 50% of world market capitalisation it may not matter. In smaller countries with highly concentrated values where a small number of firms make up a significant part of stock market capitalisation it may well matter.

The *chaebol* structure and governance practices at Samsung and other Korean firms are all too easy to criticise from the perspective of the Anglo-American model of shareholder supremacy. Before rushing to judgement it would be wise to reflect on the genesis of the Korean system and the benefits it has delivered.

Lee Byung-chul, Samsung's founder received his education and formative influences in Japan and this was no doubt informed by aspects of Japanese industrial policy and practice. In particular, the *Keiretsu* structure which typified Japanese corporate organisations clearly was the template for Samsung. The development of Samsung since 1953 has been integral to the growth of the Korean economy.

The uniqueness of the Korean miracle is that in effectively one, albeit long, generation the country has gone from a standing start with a per capita GDP in 1953 lower than the average African nation to a fully formed knowledge-based economy with a per capita income slightly larger than the European average. This was achieved through several stages from developing through emerging to industrial and now knowledge-based. Samsung has experienced a similar metamorphosis and like many Korean firms is able to deal with all countries with much empathy. Regardless of the stage of a country's development Korea has had a similar experience in living memory. Whether dealing with a developing country or a sophisticated economy, Korea has the insight and humility of understanding their counterparts' context. This has proved to be a valuable attribute.

The Korean model is closer to the European 'Rhenish model' than to the Anglo-American model. In France not all shareholders are equal with respect to voting, dual class shares are common conferring different voting rights. In Germany corporate control is largely effected through bank ownership. Paradoxically, in the more liberal markets of the US and Britain corporate control is not the result of free markets but significant regulation. The rights of shareholders are enshrined in the regulatory framework there.

Shareholder supremacy is a central feature of the free market economy and it has delivered undeniable benefits to shareholders. Shareholder value has received much, largely unfair criticism since the financial crisis. Although the shareholder value approach is not a panacea for all corporate ills it is equally not the cause of financial myopia or short-termism. The shareholder value model is to be defended, however it is not a prescriptive model and would apply equally in any governance setting. The notion that management should set an overall corporate objective to maximize the economic value of the free cash flows to the residual risk-takers, the shareholders, is unassailable; provided the arrangement is not perceived as a zero-sum game with the other stakeholders. The argument goes that without an alignment of the long-term interests of all stakeholders – shareholder value will be diluted.

> "Longevity is not highly valued in the US markets. Only 12% of the companies making up the Fortune 500 in 1955 are still in existence today."

The Anglo-American governance model, however, is not without flaws. Longevity is not highly valued in the US markets. Only 12% of the companies making up the Fortune 500 in 1955 are still in existence today. In the US the expected life of a company fifty years ago was 75 years, today the expected life of a US corporation is only 15 years. The rapid turnover in companies is sometimes considered to be a sign of success reflecting the effective working of the Schumpeterian principle of 'creative destruction'. The argument goes that the early recognition of failure and the rapid re-deployment of capital through takeover or bankruptcy fuels efficiency. However it is not obvious that the Korean miracle would have been achieved without the corporate structures that obtain in Korea.

Furthermore, there are signs of exhaustion in the Anglo-American model. The disparities in wealth and education within the US are well documented and the underinvestment in infrastructure is receiving much attention. The recent unexpected political events of the Trump election and Brexit have been attributed to a general disaffection with the current model. It would be ironic if Korea embraced the dogma of shareholder value just as it was losing ground elsewhere.

Samsung and Korea might also reflect on the UK's experience during the Thatcher years. There was a strong movement to privatisation and opening the economy to international economic forces. The result was the sell-off of the British manufacturing base to international companies. Although the process generated much value for shareholders the loss of the ownership of the manufacturing base is now being lamented. Korea might well want to avoid the hollowing out of its own productive capacity. Loss of ownership implies loss of control. Whilst UK financial services have flourished the major beneficiaries have been foreign businesses. Currently much of the UK's productive capacity is controlled by boards of directors in other countries to a much greater extent than its European counterparts.

By contrast to the Anglo-American model, Korean corporate governance has been largely unregulated and has led to a unique set of rules not necessarily easily understood outside. These arrangements have permitted businesses to develop in clusters, charcterised by complex webs of cross-holdings within a constellation of *chaebols* that control and co-ordinate business. It is all too easy to criticise the potential inefficiencies that these apparently obscure structures spawn. However, the arrangements have undeniably resulted in an unprecedented alignment of interests among stakeholders including employees, suppliers, customers and society at large.

The Samsung constellation of companies constitutes around 20% of the market capitalisation of the KOSPI market, and its contribution to GDP is a similar proportion. It provides the single most important platform for the international diversification of the portfolios of Korean citizens through pension funds and insurance companies which benefit from the international nature of Samsung's business. Samsung has also attracted a significant amount of international investor interest augmented through its Global Depositary Receipts (GDR) programme in London and Luxembourg. The interest from international investors is enriched by the uniqueness of Samsung as a vehicle for further diversification and growth. It is clear that Samsung has shown commitment to all stakeholders over a long period. These are important linkages which may be disrupted if the group is deconstructed.

Globalisation has benefitted Samsung and Korea. The free flow of goods, capital and labour in the liberal world order since 1953 have fueled economic growth and prosperity. Although there has been a substantial increase in the internationalision of shareholding in the world, the market for corporate control has remained stubbornly domestic. The trend to increased internationalistion of corporate shareholding is observable in Korea, although foreign interest is skewed strongly to the larger Korean firms. The percentage of foreign holdings declines rapidly beyond the top 20 companies by size. The international investment interest in Korea has manifestly concentrated on the larger firms such as Samsung, which is understandable given the brand recognition for the larger firms. The average foreign holding in the top quartile of the KOSPI is around 50% in comparison to the overall average of only 6% for the whole KOSPI population. Despite the trend to international ownership in many countries the composition of boards and corporate control generally remain distinctly national.

Being responsive to the international constituency is of course important but acquiescing to every proposal is dangerous. The Korean economy avoids many of the drawbacks of the Anglo-American world. Generally speaking stakeholders interests are better aligned than in most countries. There is a better distribution of wealth, and education is uniformly good with the segment of those aged between 25-40 years old having the highest proportion of graduates anywhere in the world. There is a high level of social cohesion, notwithstanding the current political crisis. Although some reform is necessary, the *chaebol* structure despite its critics has served Korea well.

A lurch to allowing shareholders greater weight of the spoils may bring short term gains but could erode the long-term value of the business. Striking the proper balance is something Samsung should consider very carefully. Accepting shareholder value as an objective is correct. However, this should not be confused with giving current shareholders free rein. The stakes are much higher for Samsung than most other large companies and indeed for Korea overall given the prominence of Samsung in the local economy.

The alternatives to the short-term shareholder value model should be carefully weighed. Embracing a tired dogma could be a major mistake and start a process of unravelling hard to reverse. Management should not be daunted by the short term negative impact on share price, Oxford Metrica research shows that 80% of firms in the top 1,000 experience a dramatic reduction in value greater than 30% of their value in any given five year period. Reputation is a far more durable commodity.

Samsung indicates it intends to take time to review the costs and benefits of a restructuring. This is absolutely right. It would be a mistake, moreover, to take advice only from adherents of the value model. Samsung would do well to select their advisors carefully as there is a risk of appointing people who drink the same 'kool aid' as the activists.

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The company needs to stand its ground and have confidence in its past success – not acquiescing to the latest demands. It should complete its analysis on its own terms and have the courage to resist pressures and ensure the long-term value of the firm and of Samsung's reputation. If it does so it could well emerge from the current crisis even stronger than before.

The alternative is to see Samsung stripped down with a much shrunken financial capacity and a reduced set of strategic options. It would be in danger of becoming a bland multinational likely to disappear from the landscape within a decade.

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