

Overweight (Maintain)

Industry Report
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[Holding Companies/IT Services]

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Holding Companies

Right now, wrong then: (7) Requirements for holding company establishment/conversion

Ownership restructuring has been an overriding theme of 2016. We anticipate that large conglomerates, including Samsung, will continue to pursue ownership restructuring in 2017 in efforts to secure competitiveness and solidify control over their groups. In this report, we continue examining the areas where current standards regarding ownership restructuring—which were once considered adequate—need revision, and forecast changes to come.

Q1. Requirements for holding company establishment/conversion

In order to establish or convert to a holding company, the company must meet the following requirements: First, a domestic holding company must possess assets worth more than W100bn. Second, the sum of stakes in subsidiaries owned by a holding company must exceed 50% of the holding company's asset value. Starting from July 1st, 2017, however, the asset threshold will be raised to W500bn, following a September revision to the enforcement decree of the Monopoly Regulation and Fair Trade Act (MRFTA). Existing holding companies with asset values between W100bn and W500bn will be granted a grace period of 10 years, and thus will have until June 30th, 2027 to satisfy the strengthened requirement (W500bn).

Q2. Requirements to legally qualify as a holding company

A holding company must meet the following requirements within a two-year grace period after the establishment/conversion date.

- ① Debt ratio: The debt ratio must be less than or equal to 2x asset value.
- ② Stake holdings in first-tier and second-tier subsidiaries must be at least 20% for listed firms and 40% for unlisted firms.
- ③ Holding a third-tier subsidiary is permitted only when it is 100% owned by a second-tier subsidiary.
- ④ Holding stakes in a financial subsidiary is barred (separation of industrial and financial capital).
- ⑤ Stakes in domestic non-affiliates must be 5% or smaller.

Q3. Method of holding company establishment/conversion

Several companies that underwent transitions into holding companies opted for tender offers/rights offerings after spinning off their subsidiaries. That is, once a company is separated into a holding company and a subsidiary, the holding company acquires a stake in the subsidiary via a tender offer, and then shareholders receive new shares of the holding company via a rights offering in return for their shares in the subsidiary. This method of transition is the most popular among companies switching to a holding company structure, as it allows controlling shareholders to increase their stakes in the holding company and allows holding companies to raise their stakes in subsidiaries.

Q4. Tax benefits to boost holding company conversion

Under the Special Tax Treatment Control Act (Article 38-2), shareholders that receive shares in the holding company in return for their shares in the subsidiary are not subject to capital gains/income taxes until they dispose of the holding company shares. Given that such disposals rarely occur (because such stakes are directly tied to management control), the tax burden is rather limited. These tax benefits will be effective only until December 31st, 2018.

Q5. Conditions for tax deferral at rights offering

Deferral of taxation requires a holding company to meet regulatory qualifications (20% stake in listed subsidiaries and 40% stake in unlisted subsidiaries) through rights offerings/share swaps within two years from the establishment/conversion date. The Special Tax Treatment Control Act is intended to facilitate conversion to a holding company by giving tax benefits to companies seeking to increase their subsidiary ownership to meet the regulatory threshold; this means that tax deferral at rights offering is not available if a holding company already satisfies the qualifications.

Q6. Transfer of holding company shares as inheritance or gift

Shareholders who acquire shares in the holding company through a rights offering can enjoy the benefit of tax deferral only until they dispose of the holding company shares. In cases where holding company shares are transferred to children (inheritance) or to non-profit foundations in the form of a gift, it is deemed a disposal and the deferred capital gains/income taxes must be paid immediately.

Q7. Average time taken until rights offering

It takes eight months (roughly 247 days) on average from the announcement of holding structure establishment/conversion until a rights offering to meet subsidiary stake requirements (four months for a BOD meeting, a shareholders' meeting, and re-listing, and another four months for a rights offering, share exchange, and listing of new shares).

Q&A on requirements for holding company establishment/conversion

Q1. Requirements for holding company establishment/conversion

- ① Assets worth more than W100bn (W500bn starting from July 1st, 2017)
- ② Sum of subsidiary stakes exceeds 50% of holding company's asset value

The MRFTA prescribes that a company seeking to establish or convert to holding company must meet the following requirements: First, a domestic holding company must possess assets worth more than W100bn. Second, the sum of stakes in subsidiaries owned by a holding company must exceed 50% of the holding company's asset value (Article 2, Paragraph 1 of the enforcement decree). In calculating the stake value, the shares of affiliates (where the parent company is not the largest stakeholder) are not taken into account.

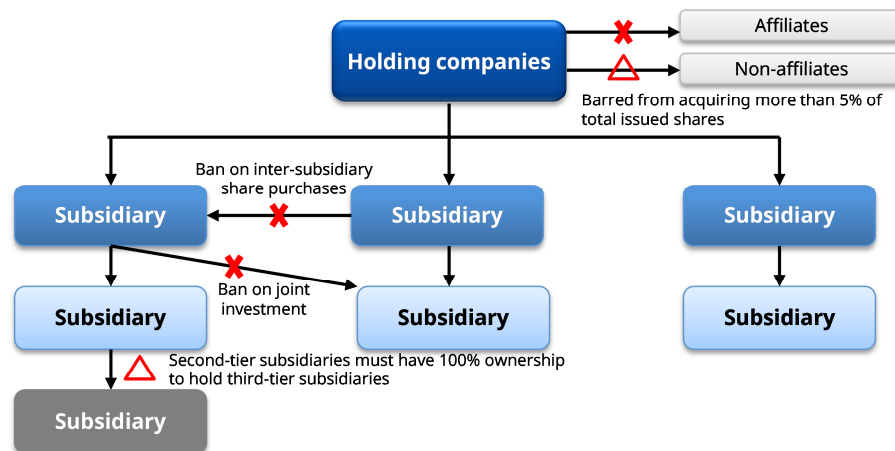
In September, the enforcement decree of the MRFTA was revised to raise the asset threshold to W500bn (from W100bn), starting from July 1st, 2017. Existing holding companies with asset values between W100bn and W500bn will have until June 30th, 2027 (including a grace period of 10 years) to satisfy the strengthened requirement. Meanwhile, the government plans to enact new clauses to make holding company requirements subject to a review and update every three years, in view of changes over time (e.g., in the size of the national economy and holding company asset values) and variation across holding companies in terms of asset value.

Q2. Requirements to legally qualify as a holding company

- ① Debt ratio: The debt ratio must be less than or equal to 2x asset value;
- ② Stake holdings in first-tier and second-tier subsidiaries must be at least 20% for listed firms and 40% for unlisted firms;
- ③ Holding a third-tier subsidiary is permitted only when it is 100% owned by a second-tier subsidiary;
- ④ Holding stakes in a financial subsidiary is barred (separation of industrial and financial capital);
- ⑤ Stakes in domestic non-affiliates must be 5% or smaller.

A holding company must meet the above shareholding requirements within two years (grace period) of the date of establishment/conversion. In the event a company is unable to satisfy the requirements within two years, the grace period can be extended by another two years upon approval from the Korea Fair Trade Commission.

Figure 1. Holding company requirements



Source: Mirae Asset Daewoo Research

Q3. Method of holding company establishment/conversion

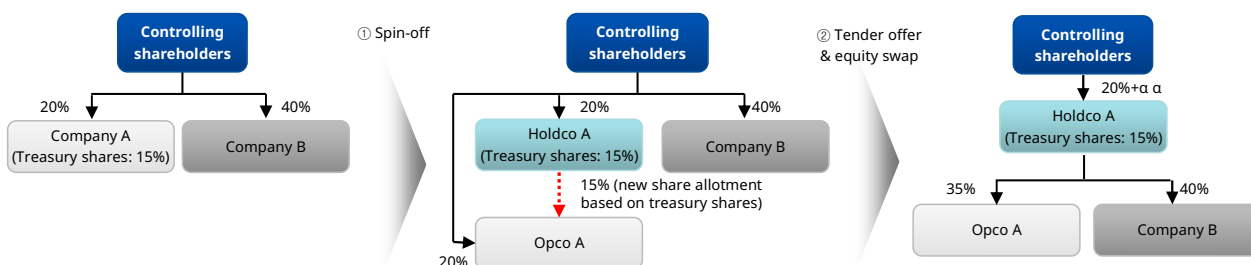
Spin-off → tender offer → rights offering → compliance with holding company requirements

One common method for transitioning into a holding company is a spin-off followed by a tender offer. That is, once a company is separated into a holding company and a subsidiary, the holding company acquires additional shares in the subsidiary via a tender offer to meet regulatory requirements (20% stake in listed subsidiaries and 40% stake in unlisted subsidiaries). Then, shareholders receive new shares of the holding company via a rights offering in return for their shares in the subsidiary.

This is the most popular method among companies switching to a holding company structure, as it allows 1) controlling shareholders to increase ownership in the holding company, and 2) holding companies to raise their stakes in subsidiaries. Acquiring shares of an affiliate in the open market would require a substantial amount of funds, whereas a tender offer followed by a rights offering/equity swap enables a holding company to easily raise stakes in subsidiaries without having to invest sizable funds. Simply put, controlling shareholders can assert their ownership in holding companies at minimal cost, and holding companies can meet their regulatory requirements for ownership in subsidiaries.

Controlling shareholders typically make efforts to raise the value of their subsidiary until the tender offer. The reason behind this is that, as shares of the subsidiary rise, controlling shareholders can secure more newly issued shares of the holding company in exchange for their stake in the subsidiary. Thus, after a corporate group announces its decision to convert to a holding company and subsequently splits off into a holding company and one or more subsidiaries, we advise investors to accumulate shares in subsidiaries during the conversion process until the holding company acquires subsidiary shares via a tender offer. Following the tender offer, we recommend investors increase their exposure to the holding company, as the stock's perceived undervaluation could trigger a sharp narrowing of its discount to NAV.

Figure 2. Conversion process: Spin-off (utilizing treasury shares)→Tender offer→Equity swap→Transition to holdco



Source: Mirae Asset Daewoo Research

Table 1. Controlling shareholders' ownership before & after the conversion process

Holdco	Before tender offer	After tender offer	Growth	Holdco	Before tender offer	After tender offer	Growth
Woongjin Holdings	36.4	87.2	+50.8	Daewoong	55	76.9	+21.9
LGEI (currently LG)	33.8	78.3	+44.5	Choongwae Holdings	33.5	54.4	+20.9
Daesang Holdings	33.5	67.4	+33.9	Neowiz	41.5	60.7	+19.2
Hanjin Heavy I&C Holdings	16.9	50.1	+33.2	KEC Holdings	29.6	48	+18.4
Pacific (currently Amore G)	31.7	62.6	+30.9	SK	15.7	29.6	+13.9
CJ	20.2	50.1	+29.9	DPI Holdings	33	45.5	+12.5
LGCI (currently LG)	12.7	41.6	+28.9	KPC holdings	48.5	56.7	+8.2
Nongshim Holdings	36.4	61.3	+24.9	Pyung Hwa Holdings	33.6	39.1	+5.5

Source: Economic Reform Research Institute, Mirae Asset Daewoo Research

Q4. Tax benefits to boost holding company conversion

Deferral of capital gains tax

Conversion to a holding company inevitably entails equity swaps and tax burdens. And the biggest tax burden is the capital gains tax (or corporate tax). In order to facilitate conversion to a holding company, the Korean government temporarily provides holding companies with a deferral of taxation on capital gains arising from tender offers/share swaps until the disposal of holding companies' shares.

Specifically, under the Special Tax Treatment Control Act (Article 38-2), shareholders that receive shares in the holding company in return for their shares in the subsidiary are not subject to capital gains/income taxes until they dispose of the holding company shares. Given that such disposal rarely occurs, the tax burden is rather limited.

Notably, these tax benefits will be effective only until December 31, 2018. Since its introduction in 2000, the deferral clause has been renewed five times—once every three years. Right now, we cannot say with certainty whether it will be extended again at end-2018. In our view, the tax benefits may serve as a strong incentive for corporate groups to adopt a holding structure.

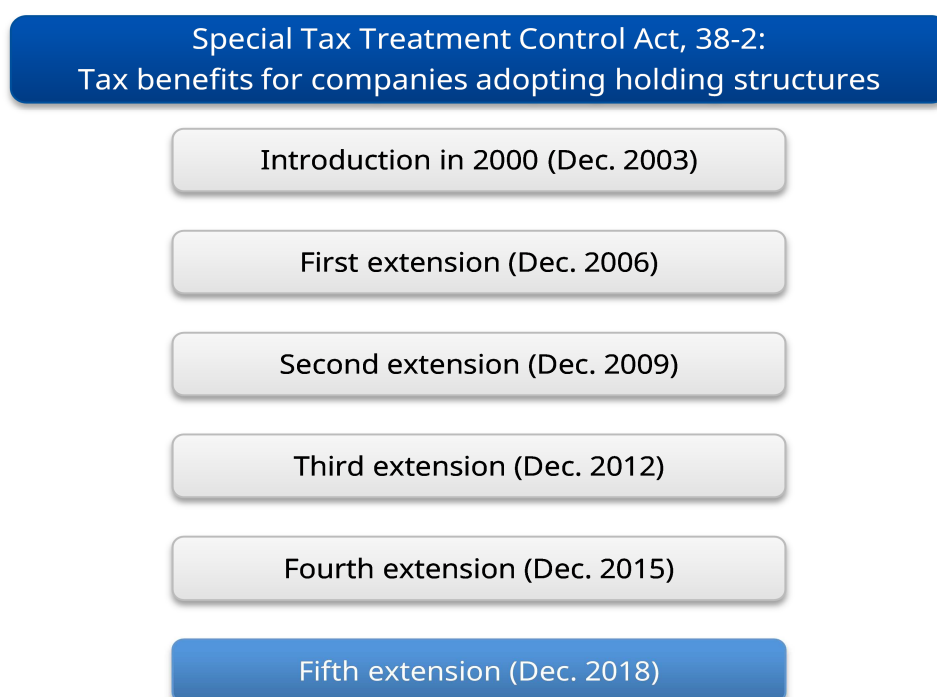
Q5. Conditions for tax deferral at rights offering

Only for companies that have yet to reach the subsidiary ownership threshold

Deferral of taxation requires a holding company to meet regulatory qualifications (20% stake in listed subsidiaries and 40% stake in unlisted subsidiaries) through rights offering/share swaps within two years from the establishment/conversion date. (As for the exchange of existing shares, all shareholders of subsidiaries for which the holding company has yet to satisfy stake requirements must be informed to participate in the share swap.)

The Special Tax Treatment Control Act is intended to facilitate conversion to a holding company by giving tax benefits to companies seeking to increase their subsidiary ownership to meet the regulatory threshold set forth under the MRFTA. This means that tax deferral at rights offering is not available if a holding company already satisfies the qualifications.

Figure 3. Details of extension of Special Tax Treatment Control Act



Source: Mirae Asset Daewoo Research

Q6. Transfer of holding company shares as gift

Taxation upon disposal of shares

Shareholders who acquire shares in the holding company through rights offering can enjoy the benefit of tax deferral only until they dispose of the holding company shares. Shares deemed to be disposed of—and thus subject to taxation—include those acquired for free, as inheritance or a gift. As such, in cases where holding company shares (for which taxation was deferred) are transferred to children as inheritance or to non-profit foundations as a gift, it is deemed a disposal and the deferred capital gains/income taxes must be paid immediately.

Q7. Average time taken until rights offering

Eight months, on average, between announcement and tender offer

A company establishing/converting to a holding company must complete spin-off and tender offer/rights offering within two years after the date of establishment/conversion.

It takes eight months on average from the announcement of holding structure establishment/conversion until rights offering to meet subsidiary stake requirements (four months for a BOD meeting, a shareholders' meeting, and re-listing, and another four months for a rights offering, share exchange, and listing of new shares). In cases where subsidiary earnings were weak, it has sometimes taken more than 12 months to ensure more favorable share exchange ratios for controlling shareholders.

Table 2. Announcement of conversion → Tender offer/rights offering: Average of eight months

Holding company	Announcement date	Split date	Relisting date	Tender offer/ rights offering	Announcement→ Tender offer/rights offering
Halla Holdings	Apr. 7, 2014	Sep. 1, 2014	Oct. 6, 2014	Nov. 6, 2014	213 days
Hanjin KAL	Mar. 22, 2013	Aug. 1, 2013	Sep. 16, 2013	Sep. 23, 2014	550 days
Korea Kolmar Holdings	Jun. 4, 2012	Oct. 1, 2012	Oct. 19, 2012	Dec. 11, 2012	190 days
Hankook Tire Worldwide	Apr. 25, 2012	Sep. 1, 2012	Oct. 4, 2012	May 20, 2013	390 days
AK Holdings	Apr. 24, 2012	Sep. 1, 2012	Sep. 17, 2012	Nov. 14, 2012	204 days
Samyang Holdings	Aug. 10, 2011	Nov. 1, 2011	Dec. 05, 2011	Jun. 1, 2012	296 days
Kolon	Oct. 15, 2009	Dec. 31, 2009	Feb. 01, 2010	May 24, 2010	221 days
KC Green Holdings	Sep. 28, 2009	Jan. 1, 2010	Jan. 29, 2010	May 14, 2010	228 days
Youngone Holdings	Apr. 14, 2009	Jul. 1, 2009	Jul. 30, 2009	Aug. 31, 2009	139 days
Iljin Holdings	Apr. 16, 2008	Jul. 1, 2008	Aug. 01, 2008	Sep. 8, 2008	145 days
Hitejinro Holdings	Apr. 16, 2008	Jul. 1, 2008	Jul. 30, 2008	Jul. 22, 2009	462 days
HHIC Holdings	May 15, 2007	Aug. 1, 2007	Aug. 31, 2007	Oct. 8, 2007	146 days
SK Holdings	Apr. 11, 2007	Jul. 1, 2007	Jul. 25, 2007	Aug. 29, 2007	140 days
Woongjin	Feb. 15, 2007	May 1, 2007	May 31, 2007	Aug. 2, 2007	168 days
CJ Corp.	Jun. 12, 2007	Sep. 1, 2007	Oct. 04, 2007	Nov. 8, 2007	149 days
AmorePacific Group	Mar. 15, 2006	Jun. 1, 2006	Jun. 29, 2006	Oct. 9, 2006	208 days
LG Corp.	Nov. 15, 2000	Apr. 1, 2001	May 2, 2001	Nov. 08, 2001	358 days
Average time until tender offer/rights offering					247 days

Notes: Tender offer/rights offering date is based on date of public announcement

Source: Mirae Asset Daewoo Research

Stricter requirements for holding companies and potential impact

Fair Trade Act revision on requirements and actions for holding companies proposed

On October 21st, 20 lawmakers, including Chae Yi-bae, proposed a revision to the Fair Trade Act that would change and toughen the requirements (i.e., minimum stake holdings) for establishing and converting to a holding company. As the current system has been viewed as making it easier for controlling shareholders to reinforce their control and succeed management rights, the revision aims to prevent controlling shareholders from amassing too much control.

Like other bills on economic democratization, we are not sure if the proposed bill will be passed. Nonetheless, discussions should heat up ahead of next year's presidential election. The revision goes against the grain of the government's stated goal to facilitate establishing and converting into holding companies. It is evident that the bill's enactment would increase the burden for groups considering conversion to a holding company structure, as well as for groups that have been undergoing such conversions and wish to maintain holding company status. It is possible that under the tougher requirements, some companies might even have to convert into holding companies unwillingly.

Key content and impact of proposed amendments

Amendment 1. Stricter standards for becoming a holding company → Issues may arise due to potential for unwanted conversion into a holding company

[Content] When evaluating the standards of becoming a holding company, the amendment would make the whole equity ownership of affiliates (not just the equity ownership of a subsidiary as the largest shareholder) a determining factor. Furthermore, this affiliate ownership would be calculated on the basis of market value (not the book value of equity). To qualify as a holding company, a company's ownership of affiliates would have to exceed 50% of its asset value. The amendment would minimize the regulatory loophole allowing actual control over a business through equity ownership (thus acting as a holding company), while not technically being defined as a holding company.

[Impact] If enacted, the amendment might force some companies to transform into a holding company unwillingly. In other words, de-facto holding companies that did not meet the current requirements may be forced to convert into holding companies as the definition of total equity ownership expands from subsidiaries to affiliates, and the valuation of such equity ownership changes from traditional book value to market value methodology. As such, companies may opt to either reduce their shares, increase unnecessary debt issuance to expand the asset value of affiliates, or merge in an attempt to avoid compulsory conversion into a holding company.

Amendment 2. Stricter regulations to qualify as a holding company → Higher financial burden to register as, transform into, and maintain holding company status

[Content] The proposed amendment would impose regulations as strict as those that were initially in place, before current revisions were enacted.

- 1) Debt ratio: The amendment would reduce the debt ratio to 1x asset value (less than or equal to 100%) from the current 2x asset value (less than or equal to 200%).
- 2) Minimum equity ownership of first- and second-tier subsidiaries: The amendment would raise the minimum equity ownership to 30% in first-tier and second-tier listed subsidiaries (50% in unlisted subsidiaries) from 20% (40% in unlisted companies).
- 3) Controlling a second-tier subsidiary: The amendment would ban two first-tier subsidiaries from owning and/or controlling the same second-tier subsidiary and require first-tier subsidiaries to have business relations with second-tier subsidiaries.

[Impact] The groups currently converting to holding companies would face additional financial burden. For holding companies, satisfying both the lower debt-to-equity ratio and the higher minimum equity ownership of subsidiaries would be challenging.

For any group that has already begun the process of converting to a holding company structure, a two-year grace period would be granted to satisfy the amendment related to acting as a holding company. As the debt ratio requirement (less than or equal to 100% of asset value) appears to have been satisfied by most holding companies, the impact would be limited. However, the minimum equity ownership requirement of first- and second-tier subsidiaries may impact certain companies; for example, SK Group would need to raise an additional W4.0tr to increase its ownership in subsidiaries such as SK Telecom (in which it currently has a 25.2% stake) and SK Hynix (in which it currently has a 20.1% stake). The proposal to ban joint control by first-tier subsidiaries of second-tier subsidiaries and require a business relationship with such subsidiaries will likely have limited impact on existing holding companies, as the amendment does not apply to them.

Table 3. Proposed amendments to Fair Trade Act related to holding companies (Oct. 21)

Bill	Revisions
Revision to the monopoly regulation and fair trade (20 lawmakers, including Chae Yi-bae)	[Stricter standards of becoming a holding company] When evaluating the standards of becoming a holding company, not only is the equity ownership of a subsidiary (as the largest shareholder) a determining factor, but also the whole equity ownership of its affiliates, calculated on the basis of market value, not the book value of equity
	[Stricter regulation to act as a holding company] 1) Debt ratio: Reduce the debt ratio to 1x asset value (less than or equal to 100%) from the current 2x asset value (less than or equal to 200%); 2) Minimum equity ownership of first- and second-tier subsidiaries: Raises the minimum equity ownership to 30% in first-tier and second-tier public companies (50% in private companies) from 20% (40% in private companies); 3) Controlling a second-tier subsidiary: Bans two first-tier subsidiaries from owning and/or controlling the same second-tier subsidiary and requires them to have business relations with their subsidiary

Source: Bill Information System, Mirae Asset Daewoo Research

Table 4. Standards and regulations on becoming a holding company

	Initial	Current	Proposed revision
Holdco standard	Equity ownership of a subsidiary (as the largest shareholder) Book value		Whole equity ownership of affiliates Fair value
Required ownership	Listed company 30%, Unlisted company 50%	Listed company 20%, Unlisted company 40%	Listed company 30%, Unlisted company 50%
Holdco's debt ratio	100%	200%	100%
Business relation between subsidiary and second-tier subsidiary	Necessary	Unnecessary	Necessary
Joint investment in second-tier subsidiary	Possible	Possible	Impossible

Source: Mirae Asset Daewoo Research

Table 5. Value of SK Group's additional ownership to meet revised minimum equity ownership

(shares, %, Wbn)

SK Group	Affiliate	Total shares	Shares held	Ownership (%)	Value (Wbn)	Additional ownership required (%)	Amount (Wbn)
SK	SK Telecom	80,745,711	20,363,452	25.2	4,612	4.8	874
	SK E&C	35,297,293	15,698,853	44.5	235	5.5	29
	Total						904
SK Telecom	SK Hynix	728,002,365	146,100,000	20.1	6,231	9.9	3,084
	Total						3,084
SK Innovation	Daehan Oil Pipeline Corp.	22,495,560	9,223,552	41.0	193	9.0	42
	Total						42
SKC	SK Bioland	15,000,000	4,190,841	27.9	68	2.1	5
	Total						5
Total							4,035

Notes: Based on Nov. 24 closing price

Source: Mirae Asset Daewoo Research

Case Analysis: Samsung Group may be forced to convert Samsung C&T into a holding company

According to the Fair Trade Act, to qualify as a holding company, a company must have 1) assets of W100bn or more (W500bn or more starting from July 1st, 2017), and 2) more than 50% of the assets should be in shares of its subsidiaries. However, as the definition of total equity ownership expands from subsidiaries to affiliates, and the valuation of such equity ownership changes from traditional book value to market value methodology, a company may be forced to transform into a holding company unwillingly.

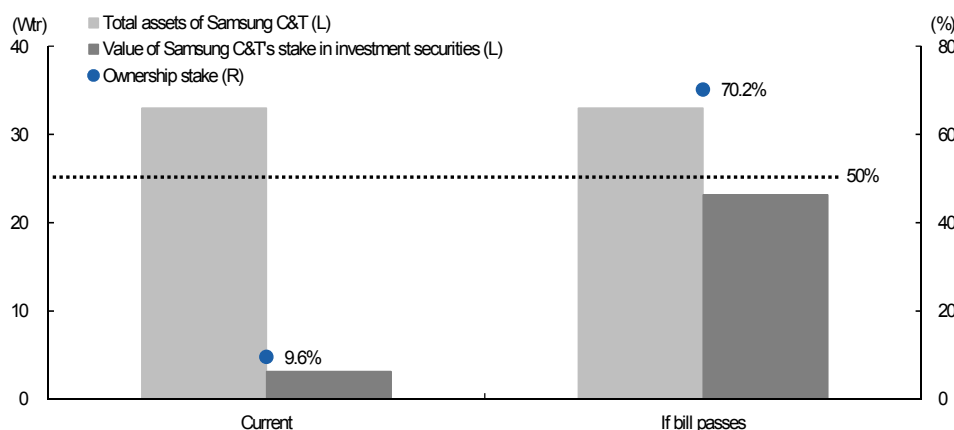
For practical purposes, Samsung C&T serves as a de facto holding company within Samsung Group, but under the current Fair Trade Act, it does not meet the requirement for establishment of or conversion into a holding company structure. If the proposed amendment is passed, Samsung C&T may have to convert into a holding company unwillingly.

Samsung C&T's total assets are W33tr (according to the balance sheet as of end-September 2016), and its total market value of equity in its affiliates exceeds W23.2tr from its public affiliates, such as Samsung Electronics (4.3%), Samsung Life Insurance (19.3%), Samsung SDS (17.1%), etc. and its private affiliates including Samsung Biologics (43.4%). Its equity ownership (calculated as equity ownership in affiliates divided by asset value) translates into 70.2%, triggering the compulsory switchover to a holding company and possibly requiring restrictions on its actions. (Note that even when carving out its 19.3% stake in its financial institution, Samsung Life Insurance, Samsung C&T's total equity ownership still comes out to 56.5%.)

Under the proposed revision to the Fair Trade Act, Samsung C&T would convert into a regular holding company that owns Samsung Electronics and Samsung SDS as its subsidiaries. However, this conflicts with the existing Fair Trade Act, which bans any equity ownership in financial institutions under a regular ownership structure, which will lead Samsung C&T to get rid of its 19.3% stake in Samsung Life Insurance within a certain period of time. (If the bill on intermediary financial holding companies—which the government has pushed to allow a regular holding company to own shares in its financial subsidiary—is passed, Samsung C&T, as a holding company, would be able to have shares in Samsung Life Insurance.) Moreover, Samsung C&T would have to increase its ownership in non-financial subsidiaries, such as Samsung Electronics and Samsung SDS (30% for listed, 50% for unlisted).

We believe Samsung Group will closely monitor the latest developments on the proposed bill and preemptively review a variety of measures related to its corporate governance structure to prepare for any changes that may emerge if Samsung C&T is obligated to switch to a holding company.

Figure 4. Samsung C&T may be forced to change to a holding company structure if amendments are enacted



Source: Mirae Asset Daewoo Research

Table 6. Value of Samsung C&T's investment securities

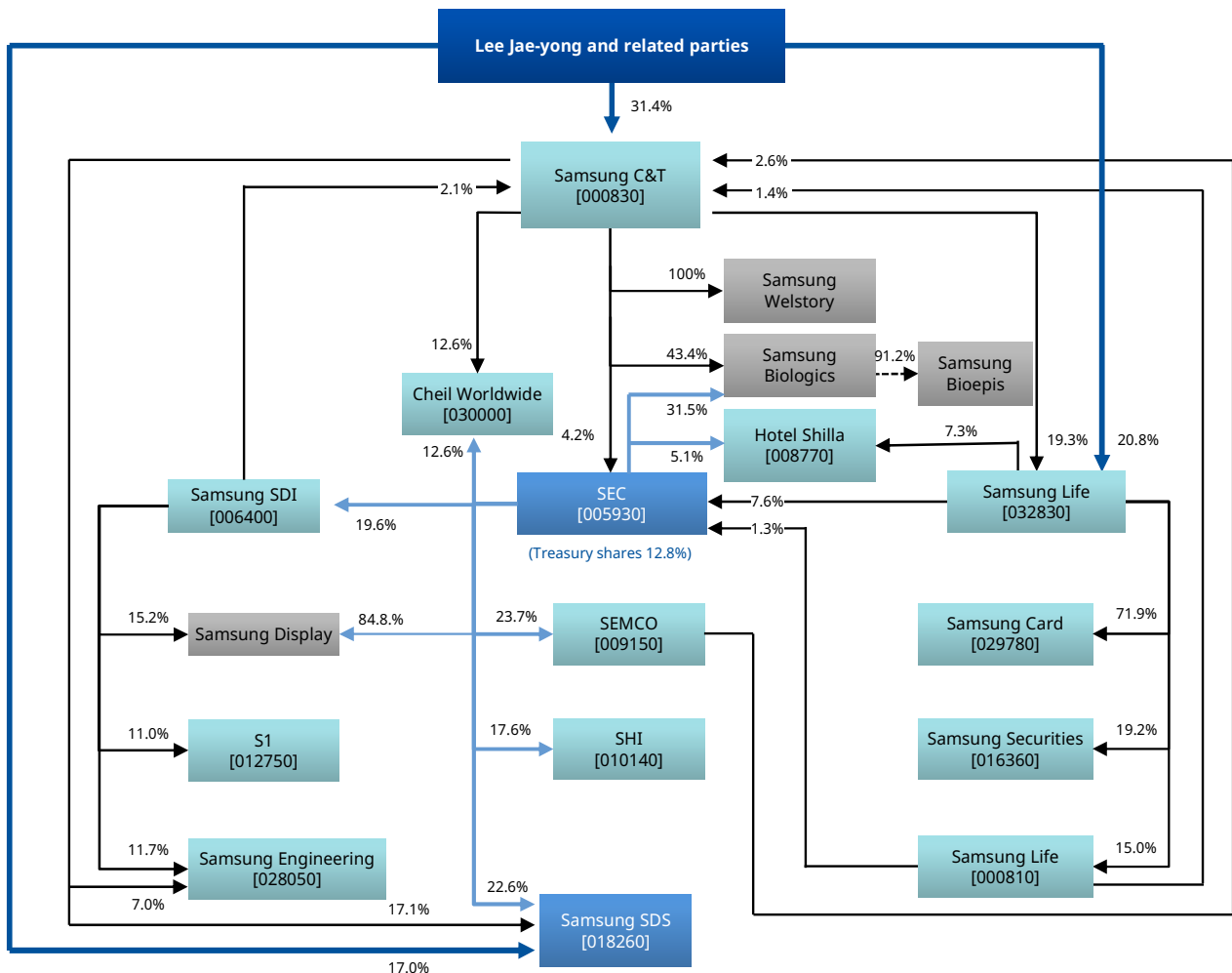
(W, Wbn)

	No. of shares	Ownership	Current price	Book value	Value
Total (1)+(2)				17,724	23,170
Listed companies (1)				15,543	20,989
SEC	5,976,362	4.2	1,650,000	8,516	9,861
Samsung Life	38,688,000	19.3	116,500	3,888	4,507
Samsung SDS	13,215,822	17.1	136,500	1,896	1,804
Cheil Worldwide	14,539,350	12.6	14,850	246	216
Samsung Engineering	13,668,989	7.0	9,430	140	129
Samsung Heavy Industries	300,265	0.1	8,530	3	3
Samsung Biologics	28,742,466	43.4	155,500	853	4,469
Unlisted companies (2)				2,181	2,181
Seoul Lake Side	117,600	100.0		350	350
Samsung Welstory	2,000,000	100.0		302	302
Other	-	-		1,529	1,529

Notes: Based on Nov. 24 closing price

Source: Dart, Mirae Asset Daewoo Research

Figure 5. Samsung Group's corporate governance



Source: Mirae Asset Daewoo Research

APPENDIX 1

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