Me Too! Small and Medium Businesses in Korea

At its core, venture capital is concerned with investments in pre-public, start-up technology companies. While the intersection of the two groups is not complete, such companies are also known as small and medium businesses in Korea. How is it that such companies are actually funded in Korea? Why is it that innovative technology companies have the hardest time getting funded in Korea? Today’s article is concerned with the gaps in funding for such companies, and how these gaps have resulted in companies that may be characterized as Me Too! Companies.

Korea wants to be known as a “Global Technology Center.” As a technology-driven economy, Korea is well, but there are significant deficiencies, particularly in the small and medium industry sectors. Most of us know that Korea has an extraordinarily vibrant economy. Korea’s business infrastructure and its well-educated, disciplined labor force make it an extremely effective location for high-tech R&D and manufacturing. Korea’s rapidly growing technological infrastructure and its technology-hungry consumers make it a very attractive market in the global economy. Korea’s reputation as a technology and style leader and its proximity to China, Hong Kong, Taiwan, Japan, Malaysia, and Singapore make it an excellent entry point for penetrating Asian markets.

Furthermore, Korea’s businesses and consumers are on the cutting edge of technology. With a population of 48 million, Korea has over 11 million broadband subscribers and millions more in broadband-equipped homes. Mobile phone usage is roughly 70%. The top two worldwide manufacturers of TFT LCD screens are Korean companies. According to DisplaySearch, Korea’s LG Electronics joint venture with Philips (LG Philips) boasts a 21.5% market share, while Samsung Electronics holds 21.2% of the market as of October of 2003. Korea is also recognized as a world leader in memory chips and other semiconductors.

Around the world, businesses, investors, and the media are recognizing Korea’s success. For example, Business Week featured a four-page story headlined “Korea is cool. This country of 48 million has become a model for developing nations everywhere." Consider Korea’s economic position: a budget surplus, $107 BN in foreign currency reserves, a rising credit rating, and a jobless rate of 3.1%. The Korean stock market is among the best-performing in the world. Some $52 BN worth of foreign direct investment has poured into the country during the past four years.”

In recent years, Korea has executed a remarkable transformation from the mid-90s Asian economic problems and an IMF bailout. Korea’s old, bureaucratic economy has been replaced by a new, entrepreneurial style.

Korea’s potential as a “hot market” is becoming recognized in both the venture community as well as the private equity sector in general. The presence and activity of foreign private equity groups in Korea testify to the latter, while the results in the venture capital segment are more mixed.

Domestically, the situation is quite different. Tech investment is down. Other sectors are set to slip into this vacuum. According to Samsung’s Economic Research Institute (SERI), the “hot” domestic consumption markets for the foreseeable future are the health and education sectors. It’s important to distinguish these sectors from those most often associated with the Korean economy: electronics, steel, ships, cars, etc. Health care and education are in fact the most local of industries. It’s only in the most developed of economies that a country exports its healthcare and education (the US and Germany of earlier years come to mind). Prior to this stage of economic maturity, however, it’s a necessary condition that a domestic market and capability be developed to the best possible state.
As an aside, the most serious constraint on the development of health care and education has been, and always will be, that financial investment in these sectors is often sacrificed in order for the country to maximize its material surplus through exports. Korea is now at a stage, in my opinion, where sustained growth in exports can be, notwithstanding the Chinese threat, a practical given; it must now invest in its health care and educational infrastructure.

The hesitation on the part of FOREIGN investors in Korean venture capital is due, in this author’s opinion, to distrust of the Korean legal regime as well as a perceived lack of global capability on the part of Korean entrepreneurs. At the risk of offending Korean readers, I’ve outlined the most common complaints here. My goal is not to entice argument here; I’m hoping that this feedback will be taken for what it is: information from potential sources of capital. It’s not a personal or cultural attack: just business as usual in a capitalistic world. I've hesitated to offer this feedback until recently, as my fellow Koreans did not react well to negative feedback in the past. It's my hope, however, that we are now ready to respond with other than knee-jerk defensiveness to constructive criticism.

The criticisms that I most often hear from potential foreign investors in Korean technology are that the Korean tech industry can be characterized as having: i. myopic and short-term oriented management; ii. a systematic refusal to accept individual responsibility at the management level; iii. a systematic aversion to risk (not attractive in the venture capital world); iv. a lack of understanding of global markets (an almost exclusive domestic orientation); and v. an almost academic approach to tech development (are the engineers in this for the money or not?).

There are those who argue that what Korea needs to reinvigorate its economy is yet another financial crisis. I tend to agree. Korea is a country that historically does not evolve endogenously; that is, exogenous forces are required as catalysts for change in Korea. I believe that this is a result of, and a mechanism to, maintain the status quo in a country that has increasing income differentials and a high degree of concentration of wealth. For those that have it, change is not particularly welcome, and for those that don't, it's difficult to affect change.

With respect to coming up with innovative technology, Koreans actually lag behind the world, particularly the United States. Specifically, if categorized into three tranches (research, development and production), Korea's technology sector is focused almost exclusively on production. Research and development investments, which require by definition a long horizon, are almost nil in Korea for the tech sector.

According to Samsung Venture Investments and other top Korean investment industry reports, Korea is most lacking in the development stage. One reason for this is the preference for short-term investments prevalent in Korea. Contrary to American analysts' view of Asian investors, this author's opinion is that Koreans are almost exclusively focused on the short-term. Long-term projects are almost impossible to fund in Korea, even with government money. The relatively high rate of turnover in the relevant ministerial ranks of government are one cause, and the short horizons of most Korean managers is another. In essence, we Koreans live very much with a “carpe diem” mentality: the levels of uncertainty regarding the long-term are such that a discount rate is difficult to derive.

Real tech investments involve large amounts of capital committed over long periods. This is diametrically opposed to the Korean sweet spot of small investments in very short-term projects. Furthermore, the resources available for research and development at universities, research institutes and governmental institutions are relatively scarce.

For example, from 120 potential venture capital funders, as of October of last year,
only ten or so are focused on biotechnology startups. This gap is typically taken up by large pharmaceutical concerns in other developed countries. In Korea, however, these entities are focused exclusively on production stage investments.

The situation is not quite as bleak as presented above, however. There are areas in which Korea can develop its biotechnical capabilities. Genomics, proteomics and cloning are viewed as potential sub-sectors in which Korea has both desire and capability because these are new sectors with relatively low barriers to entry. As a matter of policy, therefore, it is important that the nation's resources, to the extent that they can be devoted to biotechnology investments, be focused on these sub-sectors if significant returns are to be achieved. Breaking into the other sub-sectors of biotechnology would simply require an inordinate amount of capital, which Korea, despite its exports, simply cannot spare.

In exceptional instances, it can be done. LG Chemicals of the LG Group is the first Korean company to develop a new drug. This event, which occurred earlier last year, represents the first true biotechnology developed in Korea. If one actually considers previous claimed biotechnology developments in Korea, it's clear that they are in large part derivative works based on foreign technologies.

The current practice in bio or other technology funding in Korea is as follows: Angels seed bios with between $80,000 to $400,000. Most companies "burn" through this stage and never reach the level at which they can obtain institutional investment. For those that are able to attract institutional funds (about one of ten), these funds are most likely insufficient to carry the company through exit. Therefore, another crop of budding startups is lost (another nine of ten, in my experience). Finally, exit opportunities are few: even if the underlying technology is very broadly defined as tech, it is very difficult for real technology companies to get listed on the KOSDAQ. The other exit option, global M&A, is not viable and will remain so until the domestic M&A develops a depth and breadth sufficient to allow for sector amalgamations. Recently, the government has realized that this leads to the illiquidity currently seen in the Korean equity markets, and has responded with the designation of two rollup funds, managed by STIC and KTB. Whether this will act as a catalyst for Korean tech M&A remains to be seen.

As an aside, the Korean tech markets are rife with companies commonly known as the "walking dead" in the US: these are the companies not quite gone, which are viable over the short and medium-terms, but not quite able to make the hurdle over $1m to $5m in revenues. They are typically positive on a cash-accounting basis, and in no risk of immediate default on long-term obligations. They can't achieve exit through IPO or M&A, however, as either their customer or market base is too small, resulting in flat revenue growth. From the venture capitalist's perspective, these companies are as good as dead.

If you've read to this point, and still haven't "gotten the joke," I will make it explicit: the reason Korean venture companies are so similar, so Me Too!, is not because we don't have the capability or capacity to develop new technology, it is because such companies are in fact the ones that have the hardest time getting funded... which results in a plethora of funded companies that conduct remarkably similar businesses.

The companies that do get funded in Korea are essentially cut from the same cloth... they are Me Too! Companies that don't have anything new to offer... if they did, it's unlikely that they have the necessary working capital left, after R&D, to press the pedal for sales. Remember that countries other than Korea operate on credit terms. This funding gap, which I call the "Pal OK Problem" on innumerable occasions, is one reason that Korean small and medium-sized companies in the technology space are unlikely to succeed on a global scale. What's left? The Korean market, which, as we all know, regresses to the mean or to a consensus very quickly. Case in point? Xylitol!