

# Advances in the corporate finance literature: a survey of recent studies on Korea

Advances in  
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## Abstract

**Purpose** – The purpose of this paper is to provide a survey of recent studies on Korean firms' financial policies and their interactions with financial markets, and suggest directions for future research.

**Design/methodology/approach** – The authors review the finance research on Korean firms and markets, focusing on the articles published in the last 20 years.

**Findings** – This survey of the recent Korean finance literature covers the research on the capital structure and the distinct financing behaviors of chaebol-affiliated firms and independent firms; the factors affecting the costs of capital and firms' preferences for capital budgeting methods; raising capital through public and private equity issuance; corporate governance and the market for corporate control; payout policies; and bank-firm relationship. The authors suggest a number of future research directions that may lead to significant contributions to the literature.

**Originality/value** – This paper provides the first comprehensive review of the post-crisis corporate finance literature in Korea.

**Keywords** Survey, Capital Structure, Capital budgeting, Equity issuance, Corporate governance, Payout policies

**Paper type** Literature review

## 1. Introduction

In recent years, a significant body of corporate finance research has focused on Korea, especially on the unique corporate business structure called the chaebol, or large business group. The nature of these large conglomerates or financial cliques and the role they played in the economy before and after the two financial crises of 1997 and 2007 have been of particular interest to financial economists. The growing body of corporate finance research on Korean corporate finance has created the need for a survey of the literature. Hence, in this paper, we review the research on Korean firms' financial policies and their interaction with the financial markets that has been published in the last 20 years.

We are interested in the financial research on the Korean markets for several reasons. First, in recent decades, Korea has undergone one of the most successful phases of economic development in history, and has grown at a speed that has been unmatched by other emerging economies. During the early development period in the 1960s-1980s, Korea condensed the century's worth of growth achieved by advanced economies into three decades (Cho, 1994). According to the 2016 World Bank data, Korea is currently ranked 11th in the world in terms of gross domestic product[1]. Commensurate with the size of the economy and its unique pattern of growth, the Korean market has provided ample financial data and been the focus of numerous studies that have made significant contributions to the finance literature.



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Second, during the Asian financial crisis, Korea was one of the hardest hit economies, along with Indonesia, Malaysia, the Philippines, and Thailand. The crisis period provides an excellent context in which to analyze the behavior of the firms and markets impacted by the exogenous shocks. Third, Korea underwent a process of financial market liberalization starting in the early 1990s. The Korean equity markets were officially opened to foreign investors in January 1992, with an initial limit on foreign ownership of 10 percent. The limit was raised to 20 percent in 1996 and 55 percent in 1997. Following the economic crisis of 1997-1998, Korea abolished the foreign ownership limits (except for a few national security related industries) in May 1998 (Jeon *et al.*, 2011; Hwang *et al.*, 2013). The Korean Government also made reforms to the board structure. In 1998, Korean corporate law required all public firms to have at least 25 percent outside directors. In 1999, the law was amended (and came fully in effect in 2001), and large firms (assets greater than 2 trillion won, around US\$2 billion) were required to have at least 50 percent outside directors, an audit committee, and an outside director nominating committee (Black and Kim, 2012). These reforms and legislative changes provide an ideal setting for studying the responses of Korean firms and markets to the changes in the legal environment.

For the abovementioned reasons, a substantial body of financial research has examined Korean firms and markets. In this paper, we review the recent studies on Korean firms and markets and suggest directions for future research. Although we are aware of the considerable amount of financial research published in Korean, we only examine studies published in English in this paper. The remainder of this paper is structured as follows. In Section 2, we survey the research on the capital structure of Korean firms. In Section 3, we focus on the research on firms' capital investments, cost of capital, and capital budgeting methods. Sections 4-6 focus on the literature on firms' capital raising, corporate governance, and payout policies, respectively. Section 7 examines the research on the bank-firm relationship. Section 8 concludes the paper and provides directions for future research.

## 2. Capital structure and internal and external capital markets

Recent studies on the capital structure of Korean firms focus on the determinants of leverage (Lee *et al.*, 2000, 2014; Booth *et al.*, 2001; De Jong *et al.*, 2008; Fan *et al.*, 2012), sources of funding for capital expenditure (Choi and Suh, 2017; Yoon *et al.*, 2017), and the different capital structure policies of chaebol-affiliated firms and independent firms (Shin and Park, 1999; Lee *et al.*, 2000, 2009; Almeida *et al.*, 2015; Choi and Suh, 2017).

Booth *et al.* (2001) investigate the determinants of the capital structures of the largest companies in ten developing economies including Korea during the 1980-1990 period. They report that both business risk (measured by the standard deviation of the return on assets) and profitability (return on assets) are significantly negatively associated with Korean firms' use of debt. Other factors, including the tax rate, size, asset tangibility, and market-to-book ratio, do not show a consistently significant relationship with Korean firms' leverage across the different models. In their analysis of the capital structures of firms in 42 countries including Korea over the 1997-2001 period, De Jong *et al.* (2008) show that the leverage ratio (book value of long-term debt/market value of total assets) of Korean firms is significantly positively related to firm size, the tax rate, and asset tangibility, but significantly negatively related to profitability and growth opportunities. Lee *et al.* (2000) and Fan *et al.* (2012) report qualitatively similar results to De Jong *et al.* (2008) for Korean firms. In their analysis of 39 countries during the 1991-2006 period, Fan *et al.* (2012) show that the leverage ratio of Korean firms is significantly positively affected by firm size and asset tangibility, but significantly negatively associated with profitability and the market-to-book ratio.

A number of studies use survey data to examine the factors affecting corporate financing policies. In a survey of the capital structure choices of Korean chief financial officers (CFOs), Lee *et al.* (2014) report that when firms make debt issuance decisions, Korean CFOs are

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primarily concerned about financial flexibility and earnings volatility. However, when Korean firms issue equity, maintenance of the target debt ratio and the recent stock price behavior are the two most important factors.

Another line of research considers the hierarchy of funding sources for capital expenditures. Choi and Suh (2017) investigate the relative contribution of different types of funds to Korean firms' investments over the 2001-2012 period. They document that on average, Korean firms mostly rely on long-term debt, followed by short-term debt, equity issuance, and cash in financing capital expenditure. In contrast, Yoon *et al.* (2017) examine Korean firms' cash flows during the 1996-2015 period, and find that the cash inflows from investing activities are the primary source of funding for capital expenditure, followed by cash flows from operations and cash inflows from financing activities including debt issuance. Overall, the most important source of financing for Korean firms' cash deficits is the cash inflows from investing activities followed by short-term debt, long-term debt, and equity. Moreover, Korean firms tend to use matching strategies to meet their cash needs, such that cash inflows from investing activities are the main source of funding for capital expenditure, and cash inflows from financing activities are the primarily source of funding the cash outflows from financing activities.

As pointed out earlier, chaebols play a prominent role in Korean corporate finance. Researchers study the differences in the capital structure policies of the two main Korean corporate entities, namely, chaebol-affiliated firms and independent firms. Lee *et al.* (2000) examine Korean firms' use of leverage over the 1981-1997 period, and report that chaebol-affiliated firms have higher leverage than non-chaebol firms, even after controlling for the typical leverage determinants. Choi and Suh (2017) report that chaebol-affiliated firms use more long-term debt and less equity issuance to fund capital expenditures than non-chaebol firms.

In studying the distinct behavior of chaebol firms vs independent firms, researchers show particular interest in the internal capital markets within chaebols. Shin and Park (1999) compare the sensitivity of investment decisions to cash flows for chaebol-affiliated firms and non-chaebol firms during 1994-1995. They find that non-chaebol firms' investment decisions depend on their internal cash flows, whereas chaebol firms' investment decisions are not affected by their own cash flows, but are significantly affected by the cash flows of other firms within the same chaebol group. Thus, they suggest that the internal capital markets allocate funds among the firms in the same chaebol. Almeida *et al.* (2015) find that chaebol firms were able to use their internal capital markets to mitigate the negative effects of the crisis on corporate investment. The chaebol firms used the internal capital markets to direct capital to firms with high growth opportunities and thereby supported investment in these firms during the crisis period.

There are studies documenting the evolution of corporate finance in Korea over time. Lee *et al.* (2009) show that the active internal capital markets within Korean business groups attenuated the financial constraints on the group-affiliated firms, thus allowing them to make efficient capital allocations during the early 1990s. However, these markets barely functioned after the financial crisis of 1997. In line with this, Lee *et al.* (2009) show that the public debt markets began to serve as a substitute for the internal capital markets after the crisis.

In sum, recent studies on capital structure show that firms' use of leverage is positively associated with firm size and asset tangibility, but negatively related with profitability and growth opportunities. Korean firms primarily fund their cash deficits by the cash inflows from investing activities, followed by short-term debt, long-term debt, and equity. Chaebol-affiliated firms use more leverage than non-chaebol firms. Chaebol firms also used their internal capital markets extensively before and during the Asian financial crisis. However, the external capital markets have become more active in recent years, which suggests that the healthier financial structure of chaebol firms in the wake of the crisis has come about at the expense of investment efficiency.

### 3. Capital investments, cost of capital, and capital budgeting methods

Recent studies of Korean firms' capital investments examine the relationship between the cost of debt (and equity) and corporate governance practices (Byun, 2007; Byun *et al.*, 2008), the relationship between the cost of private borrowing and the value of external audits (Kim *et al.*, 2011), the market reaction to the announcements of capital investment decisions (Kim, Lyn, Park and Zychowicz, 2005), the effects of financial liberalization on investments (Koo and Shin, 2004; Koo and Maeng, 2005), and evidence from the field on the practice of capital budgeting and estimation of the cost of capital (Lee, 2017).

A number of studies investigate the cost of debt and equity capital of Korean firms. Byun (2007) examines the relationship between the cost of debt capital and corporate governance practices of Korean firms using firm-specific corporate governance score data for the 2001-2004 period provided by the Korea Corporate Governance Service. The results show that corporate governance practices are negatively associated with the cost of debt capital and the relationship is more pronounced for larger firms with assets of approximately US\$2 billion or more. More specifically, firms with sound corporate governance practices have lower interest rates, lower industry-adjusted leverage ratios, and higher bond ratings. These findings are consistent with Anderson *et al.*'s (2004) finding that S&P 500 firms with fully independent audit committees have a significantly lower cost of debt financing. Using the same data set as Byun (2007), Byun *et al.* (2008) investigate the association between Korean firms' implied cost of equity capital and corporate governance practices. They find that Korean firms' corporate governance practices are negatively associated with the implied cost of equity capital. They also show that shareholder rights protection, boards of directors, and disclosure policies play particularly important roles in reducing the implied cost of equity capital.

Kim *et al.* (2011) examine the effect of external audits on the cost of private borrowing (such as bank loans) by privately held Korean firms during 1987-2002. They find that private companies with voluntary audits pay significantly lower interest rates on their debt than private firms with no audits. Moreover, a first-time audit status change from no audit to a voluntary audit results in a greater interest cost saving than a first-time status change from no audit to a mandatory audit triggered by the size threshold. Thus, they argue that external audits have information value for the pricing of private debt because external audits help lenders overcome the information problems related to borrower credit quality by enhancing the credibility of firms' financial documents.

Studies also consider announcement effects. Kim, Lyn, Park and Zychowicz (2005) examine the market reactions to the announcements of capital investment decisions among Korean firms using a sample of 697 cases of investment decisions over the 1992-1999 period. Consistent with previous studies on US industrial firms (McConnell and Muscarella, 1985) and UK joint ventures (Burton *et al.*, 1999), they find that capital spending announcements generate positive abnormal returns. They also report that a positive market reaction is associated with the investment decisions of independent firms, but not chaebol-affiliated firms.

As noted earlier, in the 1990s, Korea implemented a series of financial market reforms. Using a sample of 348 firms over the 1980-2000 period, Koo and Shin (2004) examine the effects of the financial reforms introduced in the early 1990s on Korean firms' investments. They report that the sensitivity of investments to cash flow declined significantly after the introduction of the reforms, which suggests that the liberalization of the Korean market helped reduce the financial constraints faced by Korean firms. Similar results are reported by Koo and Maeng (2005), who examine 371 Korean firms over the 1981-2002 period.

Another important line of research on capital investment considers the views of practitioners in the field. Lee (2017) examines the capital budgeting practices of Korean firms using survey data and compares the findings with survey results from the USA (Graham and Harvey, 2001) and the UK, the Netherlands, Germany, and France (Brounen *et al.*, 2004). He reports that Korean firms mostly use the net present value (NPV)

approach, followed by the internal rate of return and payback period, when they make decisions about potential projects or acquisitions. These three capital budgeting techniques are also the most frequently used methods by firms in the USA and the four European countries. The use of capital budgeting methods by Korean firms varies with the characteristics of the firm and whether the firm is affiliated with a business group. Firms with a larger size, higher leverage, and chaebol affiliation use NPV significantly more often than firms with a smaller size, lower leverage, and no affiliation with chaebols.

Lee (2017) also reports how Korean firms estimate the cost of equity capital and find that the capital asset pricing model (CAPM) (the  $\beta$  approach) is the most commonly used method, followed by average historical returns on common stock and CAPMs that include some extra risk factors. The CAPM is also the most favored approach among firms in the USA and the four European countries. Korean firms with a larger size and chaebol affiliation use the CAPM more frequently than firms with a smaller size and no affiliation with chaebols. Lee (2017) also provides Korean CFOs' responses to the risk factors used to adjust the discount rate or cash flows when valuing a project. The three most common risk factors considered include the interest rate risk, commodity price risk, and foreign exchange risk. More than half of the respondents reported that they adjust both the discount rates and cash flows for the interest rate risk.

Also reported in Lee (2017) is the use of a particular discount rate by Korean firms when evaluating new projects in overseas markets. The most commonly used discount rate is the discount rate for the entire company, followed by a risk-matched discount rate for a particular project (considering both the country and industry) and the discount rate for the overseas market (country discount rate). Firms in the USA and the four European countries also primarily use these three discount rates.

To summarize, research shows that Korean firms' costs of debt and equity are associated with their corporate governance practices. External audits are significantly related to the cost of private borrowing, and capital investment announcements lead to positive abnormal returns. The financial market reforms helped reduce the financial constraints faced by Korean firms. Korean firms mostly use the NPV method, followed by the internal rate of return and payback period, when making capital investment decisions. The CAPM is the most frequently used method for estimating the cost of equity capital, followed by historical stock returns and a CAPM with some extra risk factors. The most commonly used discount rate when evaluating a new project in an overseas market is the discount rate for the entire company, followed by a risk-matched discount rate for a particular project and the discount rate for the overseas market.

#### **4. Raising capital: public and private equity issuance**

Studies on the equity issuance in Korean markets examine the underpricing of initial public offerings (IPOs) (Kim *et al.*, 1993; Joh and Kim, 2017), the long-run stock performance of equity offering firms (Kim *et al.*, 1995a (IPOs); Mathew, 2002 (seasoned equity offerings or SEOs)), the role of the information in prospectuses in the pricing of IPOs (Kim *et al.*, 1995b), earnings management prior to equity issuance (Yoon and Miller, 2002), motives for equity offerings and the types of shares offered (Kim and Weisbach, 2008), and the private placement of equity-linked securities and tunneling (Baek *et al.*, 2006).

A number of studies investigate the IPOs of Korean firms. Using a sample of 177 IPOs listed on the Korea Stock Exchange (KSE) during the 1988-1990 period, Kim *et al.* (1993) find that the motives for going public are associated with significant differences in the degree of underpricing. Specifically, the underpricing is significantly higher when firms intend to use IPOs as a last resort for raising funds than when exiting equity holders want to diversify their holdings. Joh and Kim (2017) show that institutional investors' higher bidding prices predict lower IPO underpricing. In contrast, institutional investors' oversubscription ratios are not

significantly related to initial returns. Kim *et al.* (1995a) examine the long-run stock performance of Korean firms that implemented IPOs during the 1988-1989 period and their findings contradict those that have been documented for other countries. They find that Korean IPO firms do not underperform seasoned firms over the next two years after going public, which is in contrast to the long-run underperformance of IPO firms in the USA (Ritter, 1991), the UK (Levis, 1993), Finland (Keloharju, 1993), and Latin America (Aggarwal *et al.*, 1993).

Using a sample of 260 Korean IPOs from January 1985 to March 1990, Kim *et al.* (1995b) investigate the effects of the information disclosed in the prospectuses of issuing firms. They find that the after-market prices of the IPOs are significantly affected by the earnings per share, offer size, industry price index on the offering date, and offer type (issuing new shares vs the sale of old but not previously traded shares). The influence of these variables is more pronounced after the 1988 liberalization of Korean IPO pricing than it was before.

Researchers examine the SEOs of Korean firms. Using a sample of 415 SEOs by Korean firms during the 1979-1992 period, Mathew (2002) finds insignificant abnormal returns over the 36-month period following an SEO, which is in contrast to the findings for the USA (Spiess and Affleck-Graves, 1995) and Japan (Cai and Loughran, 1998). He suggests that the result is due to the Korean Government's intervention in the capital market during the sample period. Using a sample of 249 SEOs by Korean companies during the 1995-1997 period, Yoon and Miller (2002) investigate whether Korean firms engage in earnings management prior to equity issuance. They find that Korean SEO firms use income-increasing strategies during the year preceding a planned equity issue and that the degree of earnings management is more pronounced when the issuing firms' operating performance is poor.

Kim and Weisbach (2008) investigate firms' motives for conducting equity offerings and the types of shares offered: primary shares (new shares) vs secondary shares (existing shares held by insiders). Using 17,226 IPOs and 13,142 SEOs from 38 countries including Korea over the 1990-2003 period, they report that firms issue equity both to finance investment and to take advantage of overvaluation. Consistent with the investment financing motivation, they find significant increases in investments, including R&D and capital expenditure, following IPOs and SEOs. Consistent with the market timing motivation, they find that a higher abnormal valuation is associated with a higher fraction of secondary shares in the offering. This indicates that when equity values are high, managers are more likely to sell their own shares in a secondary offering so that they can benefit personally. Also consistent with the motivation to take advantage of potential mispricing, following an SEO, firms with a high market-to-book ratio tend to keep more of the cash raised than low valuation firms, whereas firms with a low market-to-book ratio spend more on inventory, capital expenditure, acquisitions, and long-term debt reduction than high valuation firms. Other studies on Korean firms' equity issuance include Kim and Lee (1990) on the process and the wealth effects of issuing stocks in the 1980s, Lim (1992) on the price mechanism and reform of the IPO market in the 1980s, Dhatt *et al.* (1996) on Korean firms' rights issues, and Yong's (2007) survey of research on IPOs in Asian markets including Korea.

A substantial body of literature observes private equity issuance in Korea. Baek *et al.* (2006) examine the misuse of private placements of equity-linked securities by non-financial firms listed on the KSE during the 1989-2000 period and find direct evidence of tunneling within business groups whereby the controlling shareholders of chaebols use offerings of equity-linked private securities to benefit themselves at the expense of other shareholders. Their results provide further evidence that owner-managers in business groups have strong incentives to expropriate member firms to maximize their welfare by tunneling funds among the group firms (Bae *et al.*, 2002; Bertrand *et al.*, 2002).

In summary, the research on Korean firms' equity offerings shows that firms issue equity both to finance investments and to take advantage of overvaluations. In contrast to the findings from the US markets, Korean firms' IPOs and SEOs do not underperform. Korean

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firms tend to use income-increasing strategies prior to a planned equity issuance and the degree of earnings management is more pronounced in firms with a poor operating performance. The controlling shareholders of Korean business groups use private placements of equity-linked securities to benefit themselves at the expense of other shareholders.

### 5. Corporate governance and the market for corporate control

There is a rich and diverse body of research on Korean corporate governance[2]. Recent studies investigate the effects of governance structure on firm profitability before the Asian financial crisis (Joh, 2003), the effects of corporate governance on stock performance during the Asian financial crisis (Mitton, 2002; Lemmon and Lins, 2003; Baek *et al.*, 2004), the effects of board composition and ownership structure on firm performance and foreign ownership after the crisis (Choi *et al.*, 2007; Kim *et al.*, 2010; Choi *et al.*, 2012), the liberalization of the equity markets and the effects of corporate governance on share prices, foreign ownership, and capital accumulation (Bae and Goyal, 2010), the value of board monitoring (Min and Verhoeven, 2013), the ownership structure of business groups (Lim and Kim, 2005), the effects of the quality and diversity of outside directors on firm value (Kim and Lim, 2010), changes in the regulatory environment of corporate governance and their effects on firm value (Black and Kim, 2012), and tunneling as a major motivation for acquisition activities of chaebol firms (Bae *et al.*, 2002).

The relationship between control rights and cash flow rights is a key proxy used in studies on corporate governance and its effect on firm performance in emerging economies. Using a sample of 5,829 Korean firms during 1993-1997, Joh (2003) examines how the corporate governance structure of Korean firms affected firm profitability (measured by accounting income) before the Asian financial crisis. He notes the existence of a “controlling-minority structure” where “a shareholder exercises control while retaining only a small fraction of the equity claims on a company’s cash flows” (Bebchuk *et al.*, 2000, p. 295). When control rights exceed cash flow rights, the benefits the controlling shareholder can gain from appropriating the firm resources exceed the costs, which provides the controlling shareholder with an incentive to pursue his/her private benefits at the expense of other shareholders. The controlling shareholder’s incentive to expropriate other shareholders increases when he/she owns less (Jensen and Meckling, 1976). Consistent with these findings, Joh (2003) reports that firms have lower profitability when the controlling family’s ownership is lower after controlling for firm, industry, and macro-economic effects. Firms with higher disparity between control rights and cash flow rights show lower profitability and the negative effect of control-ownership disparity is stronger in publicly traded firms than in privately held firms. The resources transferred from the firms in business groups to affiliated firms are often wasted and lower firm profitability, which suggest the presence of “tunneling.”

Lemmon and Lins (2003) investigate the effects of ownership structure on firm value in eight East Asian countries (including the five countries examined in Mitton (2002), namely, Indonesia, Korea, Malaysia, the Philippines, and Thailand) during the region’s financial crisis. They find that during the crisis period, the cumulative stock returns of firms with high levels of managerial control rights, but with the control separated from the cash flow ownership were significantly lower than those of other firms. When managers have low levels of control rights, the separation of control from the cash flow ownership has no effect on firm performance. Their findings are consistent with those of Claessens *et al.* (2002) and Lins (2003), who find that firm value is negatively associated with the separation of control from cash flow ownership. Using a sample of 644 non-financial firms from November 1997 to December 1998, Baek *et al.* (2004) provide additional evidence for Korean firms’ corporate governance structure affecting firm value during the Asian financial crisis. Overall, their findings are consistent with Mitton (2002) in that corporate governance has a significant impact on firm-level performance during a crisis, suggesting that the impact is greater when

controlling shareholders have stronger incentives and the means to expropriate resources. Specifically, they find that firms with larger equity ownership by foreign investors, firms with higher disclosure quality, and those with access to alternative sources of external financing show a smaller decline in share value between five days before and 32 days after November 18, 1997, which is the day the International Monetary Fund proposed the rescue package for Korea. In contrast, chaebol firms with concentrated ownership by owner-managers and those with concentrated ownership by affiliated firms experience a larger decrease in equity value. Firms in which the controlling shareholder's voting rights exceed their cash flow rights and those who borrow more from the main banks have significantly worse equity performance.

In line with earlier studies (La Porta *et al.*, 1997, 1998, 2000b, 2002), Mitton's (2002) findings highlight the importance of corporate governance for firm value across countries. Johnson *et al.* (2000) further argue that corporate governance measures are more important than macro-economic variables in explaining the stock performance of emerging markets during the Asian financial crisis. Mitton (2002) uses firm-level data to examine the impact of corporate governance on the stock market performance of the five East Asian economies (Indonesia, Korea, Malaysia, the Philippines, and Thailand) that were most affected by the financial crisis that began in July 1997 and ended in August 1998. He finds that corporate governance significantly affected stock performance during the crisis. More specifically, higher disclosure quality and higher outside ownership concentration are associated with significantly better stock performance during the crisis after controlling for size, leverage, country, and industry.

Board composition and ownership structure (especially ownership by foreigners) are other key variables used in corporate governance studies on Korea[3]. Choi *et al.* (2007) examine the value of outsiders (independent directors and foreign investors) in Korea after the Asian financial crisis using a sample of 464 firms over the 1999-2002 period. They find that board independence (measured by the proportion of outside directors) has a significantly positive effect on firm performance (Tobin's  $Q$ ), which contradicts the findings on the USA where no relationship is found between the proportion of outside directors and firm performance (Hermalin and Weisbach, 2003) and the findings on the international markets where no conclusive evidence is found (Denis and McConnell, 2003). Institutional equity ownership, especially by foreign investors, also has a positive effect on firm performance. Family holdings are significantly negatively associated with firm performance, which is consistent with the role of the founding families in Asia (Mitton, 2002; Lins, 2003), and in contrast with the findings for US firms (Anderson and Reeb, 2003).

Korea opened its equity markets to foreign investors in January 1992. Bae and Goyal (2010) investigate the extent to which the corporate governance of Korean firms affects the cross-firm variations in share price, foreign ownership, and capital accumulation after the liberalization of the equity markets. Using three measures of corporate governance (ownership by the largest shareholder, affiliation with business groups, and dividend payments), they find that firms with strong governance (i.e. firms with high equity ownership by the largest shareholder, non-chaebol firms, and dividend-paying firms) showed significantly higher abnormal returns in the month of liberalization. Moreover, foreign investors tended to invest more in firms with better governance after liberalization, and these firms realized higher growth rates of capital stocks relative to the pre-liberalization period.

Researchers also show interest in the value of the monitoring by the boards of Korean firms. Motivated by Duchin *et al.* (2010), who suggest a new approach to studying the relationship between independent directors and firm valuation, Min and Verhoeven (2013) examine the effects of board monitoring (proxied by outside directors' attendance of board meetings) on firm value and productivity using a sample of 3,437 non-financial Korean firms listed on the KSE for the 2002-2006 period. They find that outsider's attendance of board meetings increases both firm value (measured by Tobin's  $Q$ ) and firm productivity.



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Lim and Kim (2005) investigate the ownership structure of Korean business groups (chaebols) by examining the 30 largest chaebols as of December 1995. They find that pyramidal ownership (owning subsidiary firms indirectly through interfirm holdings) with a low family stake is a more common type of ownership structure among Korean business groups. Along with pyramidal ownership, Korean chaebols use non-voting shares as a supplementary device to separate control rights from cash flow rights. Pyramidal ownership is found to be more prevalent in larger chaebols and those with a larger proportion of non-voting shares, while direct (or horizontal) ownership is more favored by chaebols with higher leverage and a bigger proportion of non-manufacturing businesses.

Different from prior studies that focus on the quantity (such as the number and proportion) of independent outside directors and its effect on firm performance (Choi *et al.*, 2007), Kim and Lim (2010) focus on the quality (such as age, education, and previous job experience) and diversity of independent outside directors and their effects on firm value (measured by Tobin's *Q*). They examine 593 Korean companies over the 1999-2006 period, after the introduction of the corporate governance reform in 1998 that required all KSE listed companies to have at least 25 percent of their boards composed of outside directors. They find that independent outside directors with government experience have positive effects on firm value, but those who are accountants have negative effects. The diversity of independent outside directors' academic majors and age is positively associated with firm value. The effect of professor outside directors is insignificant.

A unique regulatory environment and a policy change can offer settings for natural experiments for corporate finance research on Korea. Black and Kim (2012) analyze the change in firm value due to the 1999 legislation requiring large Korean firms (with assets greater than 2 trillion won, around US\$2 billion) to have minimum of 50 percent outside directors, an audit committee with an outside chair and at least two-thirds outside members, and an outside director nominating committee. They report evidence for a causal connection between the board structure reforms and firm value (measured by stock returns and Tobin's *Q*). The market values of large firms increased relative to mid-sized firms when the reforms were adopted and large firm values jumped when the reforms were announced.

Financial economists study two competing views on the behavior of entrepreneurs who control publicly traded firms in relation to minority shareholders, namely, tunneling and propping (or negative tunneling) (Barclay and Holderness, 1989; Khanna and Palepu, 2000; Shleifer and Wolfenzon, 2002; Friedman *et al.*, 2003). Bae *et al.* (2002) examine 107 mergers in Korea between 1981 and 1997 and provide evidence of tunneling among business groups. They report that minority shareholders of chaebol firms that make acquisitions typically lose from the acquisitions, but the controlling shareholders of these firms benefit from them.

Other studies related to Korean firms' corporate governance include Solomon *et al.* (2002a) on the development of corporate governance reform in the early 2000s; Solomon *et al.* (2002b) on institutional investors' views on various corporate governance issues; Choi and Cho (2003) on shareholder activism; Ferris *et al.* (2003) on chaebol-affiliated firms suffering a value loss relative to non-affiliated firms; Kim (2005) on boards of directors' network characteristics and firm performance; Kim, Jung and Kim (2005) on the ownership structure and internal fund allocation in business groups; Chang and Shin (2006) on corporate governance effectiveness before and after the Asian financial crisis; Chang *et al.* (2007) on the change in information asymmetry around the 1997 financial crisis; Cho and Kim (2007) on outside directors, ownership structure, and firm profitability; Kim (2007) on the effects of outside directors and their social capital on firm value; Kim *et al.* (2008) on the effects of ownership structure on the relationship between financial slack and R&D investments; Rhee and Lee (2008) on outside directors' characteristics and foreign ownership; Chizema and Kim (2010) on the factors affecting outside director presence on the board; Oh *et al.* (2011) on the effect of ownership structure on corporate social responsibility; and Low *et al.* (2015) on board gender diversity and firm performance.

To summarize, the corporate governance structure affects the performance of Korean firms. The disparity between control rights and cash flow rights negatively affects firm performance. Firms with strong governance (high equity ownership by the largest shareholder, non-chaebol affiliated, dividend-paying) generated significantly higher abnormal returns in the month of equity market liberalization. Greater foreign ownership, higher disclosure quality, and the presence of alternative sources of external financing led to smaller declines in equity value during the crisis period in 1997. The quantity, monitoring, and characteristics of outside directors also influence firm performance. Board independence (measured by the proportion of outside directors) and outside directors' attendance of board meetings positively affect firm performance. Independent outside directors with government experience enhance firm value and the diversity (in terms of academic major or age) of independent outside directors is positively associated with firm value. The acquisition activities of chaebol-affiliated firms typically benefit the controlling shareholders at the expense of minority shareholders.

## 6. Payout policies

Studies on the payout policies of Korean firms investigate the firm-level factors affecting dividend payments (Gul and Kealey, 1999; Aivazian *et al.*, 2003; Abor and Bokpin, 2010), the effects of corporate governance, legal regimes, and investor protection on payout policies (La Porta *et al.*, 2000a; Mitton, 2004; Hwang *et al.*, 2013), the relationship between foreign ownership and payout policies (Jeon *et al.*, 2011), the factors affecting dividend smoothing (Jeong, 2013), and controlling shareholders' influence on payout policies (Kim *et al.*, 2013)[4].

Researchers are interested in the firm-level factors that affect dividend policies. Aivazian *et al.* (2003) examine the dividend behavior of firms in eight emerging economies including Korea and report that the same firm-level factors affect the dividend payments of both emerging market firms and US firms. They find that higher profitability, lower debt ratios, and a higher market-to-book ratio are associated with higher dividend payments. They also find that firms in emerging markets pay higher dividends than similar firms in the USA. Using a sample of 411 Korean firms during the 1982-1994 period, Gul and Kealey (1999) show that firms with more growth options pay lower dividends, which is consistent with the research on US firms (Smith and Watts, 1992; Gaver and Gaver, 1993). However, they find no differences between the dividend policies of chaebol and non-chaebol firms. In a study of 34 emerging markets including Korea over the 1990-2006 period, Abor and Bokpin (2010) also find a negative relationship between growth potential and dividend payouts.

Another important line of research on dividend policies is the analysis of the interaction among corporate governance, legal system, and payouts. Using a sample of 4,103 firms in 33 countries including Korea, La Porta *et al.* (2000a) test two agency models of dividends, namely, outcome vs substitute models, and provide evidence for the outcome agency model of dividends, which hypothesizes that dividends result from minority shareholders using their legal powers to force companies to disgorge cash. They find that dividend policies vary across legal regimes in ways consistent with the outcome agency model of dividends. Specifically, firms operating in countries that provide better protection of minority shareholders (common law countries) make higher dividend payouts than firms in civil law countries. In common law but not civil law countries, there is a negative relationship between growth opportunities and dividend payouts such that high growth firms pay lower dividends than low growth firms. Extending the work of La Porta *et al.* (2000a), Mitton (2004) uses a sample of 365 firms from 19 emerging markets including Korea to analyze the effects of firm-level corporate governance and country-level investor protection on dividend payouts. He finds that stronger corporate governance is associated with higher dividend payouts primarily in countries that offer strong investor protection, as measured by legal origin or anti-director rights. He also reports a negative relationship between growth and dividends, which is stronger among firms with stronger corporate governance.

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A few studies document the relationship between payout policies and corporate governance by focusing on the ownership structure. Using survey data on Korean firms' corporate governance practices from the Korea Corporate Governance Service over the 2003-2010 period, Hwang *et al.* (2013) examine the relationship between the corporate governance and payout policies paying particular attention to the two distinct business structures in Korea, chaebol vs independent firms. They report that chaebol firms have much weaker shareholder rights and lower dividend payout ratios than independent firms. They also show that improved corporate governance enhances payout policies over time but is statistically significant only for independent firms. They suggest that the entrenched control of chaebol firm owners who have much higher control rights than cash flow rights leads to less interest in protecting minority shareholders and lower dividend payout ratios. Using a sample of Korean firms over the 1994-2004 period, Jeon *et al.* (2011) investigate the relationship between foreign ownership and the payout policies of Korean firms. They report that foreign investors have a preference for firms that pay high dividends and that foreign investors with substantial ownership (more than 5 percent) lead firms to pay more dividends. They also find that foreign investors are not interested in share repurchases in that they neither increase their ownership in firms that buy back shares nor cause firms to increase repurchases when they have substantial ownership.

Another issue in dividend policies that has been of interest to financial economists for a long time is dividend smoothing (Lintner, 1956; Fama and Blahnik, 1968; Garrett and Priestley, 2000; Kumar and Lee, 2001; Brav *et al.*, 2005; Leary and Michaely, 2011). Using a sample of 279 Korean firms during the 1981-2012 period, Jeong (2013) investigates the well-documented corporate behavior of dividend smoothing. He finds that the majority of Korean firms engage in dividend smoothing, and that their dividend smoothing is affected by the firm characteristics (size, growth, risk, and ownership concentration) and macro-economic factors (tax and interest rates). Overall, larger firms, lower growth firms, and riskier firms tend to smooth their dividends more during the sample period, while safer firms smooth their dividends more after the liberalization of interest rates that was completed in 1995. The dividend smoothing behavior of Korean firms is also positively associated with tax and interest rates.

In addition to dividend payment, share repurchase is an important form of distributions to shareholders. Studies on the US firms' payouts report that firms have become less likely to pay dividends, but more likely to engage in share repurchases (Fama and French, 2001; Grullon and Michaely, 2002; Skinner, 2008). A similar observation is documented for Korean firms by Kim *et al.* (2013) in their analysis of controlling shareholders' influence on corporate payout policies. Using the gap between the voting rights and cash flow rights of the controlling shareholders, or the wedge[5], as a primary analysis tool, Kim *et al.* (2013) report that firms with higher wedge tend to repurchase more shares, while firms with lower wedge distribute more cash dividends to shareholders. They also find that operating performance (measured by the ratio of cash flow from operations to net sales) has no effect on share repurchases, but significantly positively affects cash dividends. For the firms that repurchase shares, the greater the wedge, the lower firm value (measured by the price to book value of equity).

In sum, Korean firms with greater growth opportunities pay lower dividends. Chaebol firms have weaker shareholder rights and pay lower dividends compared to independent firms. Foreign investors prefer to invest in Korean firms that pay high dividends. Foreign investors with substantial ownership tend to force firms to pay more dividends. The majority of Korean firms engage in dividend smoothing. In particular, larger firms, lower growth firms, and riskier firms tend to smooth their dividends more than other firms. As the disparity between the voting rights and cash flow rights gets greater, firms tend to repurchase more shares, but distribute less cash dividends.

## 7. Bank-firm relationship

Along with Germany and Japan, Korea is one of the most important bank-centered economies in the world. Hence, a number of studies examine the bank-firm relationship in Korea. Recent studies investigate the effects of the bank reforms and the 1997 financial crisis on banks' efficiency and productivity growth (Park and Weber, 2006a; Banker *et al.*, 2010), the relationship between banks' efficiency and profitability (Shin and Kim, 2011), the determinants of bank profitability (Park and Weber, 2006b), the value of durable bank relationships (Bae *et al.*, 2002), the probability of banking sector failure (Byström, 2004), the effects of foreign ownership and foreign directors on the returns and risk of banks (Choi and Hasan, 2005), and the performance of privately controlled banks vs banks subject to de facto government control before the Asian financial crisis (An *et al.*, 2007).

Park and Weber (2006a) investigate the effects of the Korean bank reforms and the Asian financial crisis on the efficiency and productivity growth of the Korean banking industry during the 1992-2002 period, and argue that the bank reforms of the 1990s and early 2000s were successful in generating productivity growth, primarily due to technical progress, which offset the declines in efficiency. Banker *et al.* (2010) re-examine the impact of the Korean banking system reforms on bank technical efficiency over the 1995-2005 period, and document that the average technical efficiency of Korean commercial banks declined during the financial crisis of 1997-1998, but improved during 1999-2001 when the Korean banking sector was being restructured, and continued to improve through 2005. They also report that the capital adequacy ratio is positively related to banks' technical efficiency and that the non-performing loans ratio is negatively related to technical efficiency. Both relationships are more pronounced during the financial crisis.

Shin and Kim (2011) examine the relationship between the efficiency and profitability of the Korean banking industry during the 1992-2005 period, and report that higher efficiency has positive effects on profitability, market share, and market concentration. Park and Weber (2006b) document the primary determinants of Korean bank profitability during the 1992-2002 period. Specifically, a greater net interest margin, lower operating costs per employee or branch, greater assets per employee or branch, less technical inefficiency, a higher equity capital ratio, and a smaller non-performing loan share lead to higher profitability.

Another important area in the banking literature is the analysis of relationship banking (Fama, 1985; Sharpe, 1990; Sloven *et al.*, 1993; Gibson, 1995; Kang and Stulz, 2000). Bae *et al.* (2002) examine the value of durable bank relationships in Korea using a sample of 113 news announcements that negatively affected 15 Korean banks from January 1997 to December 1998, a period during which banks experienced significant difficulties that forced them to contract credit. They find that the adverse exogenous events negatively affect both the value of the banks and the value of their client firms. Moreover, they find that the costs of bank distress are higher for firms that are bank-dependent and financially constrained. Firms with larger borrowings from banks and higher leverage experience bigger declines in their equity value, whereas firms with alternative means of financing and more liquid assets experience smaller falls in their share value.

Using an aggregated version of the model by Hall and Miles (1990), Byström (2004) assesses the probability of banking sector failure in the banking sectors of 34 countries including Korea between 1994 and 2002. Hall and Miles (1990) use stock market information to estimate the default probabilities of banks. Byström (2004) finds that higher government quality (measured by the degree of corruption, risk of expropriation by the government, and law and order) and lower state ownership are associated with a lower probability of failure before the Asian financial crisis. During the Asian financial crisis, the level of state ownership becomes insignificant, while the existence of explicit deposit insurance schemes seems to reduce the probability of default in the banking sector.

Researchers also examine the ownership, governance, and control of Korean banks, and their effects on the returns, risk, and efficiency of banks. Choi and Hasan (2005) analyze Korean commercial banks' performance during the 1998-2002 period by examining the effects of foreign ownership and foreign director presence on the returns and risk of banks. They report that the level of foreign ownership has significantly positive effects on bank returns and risk, and that higher returns and lower risk are associated with the presence of a foreign board member. An *et al.* (2007) examine the performance of two groups of Korean banks, namely, banks controlled privately and banks subject to de facto government control, during the 1987-1997 period before the Asian financial crisis. They report that government controlled banks are less efficient, have higher bad loan ratios, and generate lower profit compared to privately controlled banks.

Other studies on Korean banks investigate the changes in bank productivity in response to the privatization and deregulation of the sector during the 1980s and early 1990s (Gilbert and Wilson, 1998), the key determinants of the efficiency of Korean banks during the 1985-1995 period (Hao *et al.*, 2001), the role of the financial reforms and liberalization during the 1997 financial crisis (Oh and Park, 1999), the stock market response to the corporate governance reforms in the Korean banking sector after the Asian financial crisis (Choe and Lee, 2003), and the determinants of Korean banks' profitability (Sufian, 2010).

In summary, the bank reforms of the 1990s and early 2000s succeeded in increasing the productivity of Korean banks. However, the adverse exogenous events during the 1997-1998 period negatively affected not only the value of Korean banks themselves but also the value of their client firms, while bank-dependent and financially weak client firms suffered more from the distress of their main banks.

## 8. Conclusion and directions for future research

In this paper, we review the research on Korean firms and markets published in the last 20 years. A substantial body of finance research investigates various features of the Korean markets. We primarily review the research related to capital structure, cost of capital, capital budgeting, equity issuance, corporate governance, payout policies, and banking.

Recent studies on the capital structure of Korean firms examine their use of leverage and the distinct financing behaviors of chaebol-affiliated firms and non-chaebol firms. Firm size and asset tangibility positively affect Korean firms' use of leverage, while profitability and growth opportunities negatively affect the use of debt. Chaebol-affiliated firms use more leverage than non-chaebol firms, and the internal capital markets within chaebols have been replaced by public debt markets.

Research shows that Korean firms' costs of capital are significantly related to their corporate governance practices. When Korean firms make capital investment decisions, they mostly use the NPV, followed by the internal rate of return and payback period. When firms estimate the cost of equity capital, the CAPM is the most commonly used method, followed by historical stock returns and the CAPM with some extra risk factors. When evaluating a new project in an overseas market, the most frequently used discount rate is the discount rate for the entire company, followed by a risk-matched discount rate for a particular project and the discount rate for the overseas market.

Studies show that Korean firms' equity offerings are motivated by the firms' financing investments and desire to take advantage of overvaluation. Contrary to the findings on US firms, studies also find that Korean firms' IPOs and SEOs tend not to underperform. Korean firms also engage in income-increasing tactics prior to a planned equity issuance and the degree of earnings management is more noticeable in firms with poor operating performance.

Research shows that the corporate governance structure of Korean firms is significantly associated with firm performance. In particular, the disparity between control rights and cash flow rights negatively affects firm performance. Firms with strong governance

generated significantly higher abnormal returns during the time of the equity market reforms. Board independence and the characteristics and diversity of independent outside directors significantly affect firm value. Foreign block ownership and foreign board membership are positively related to firm value.

The studies on Korean firms' payout policies show that firms with greater growth opportunities pay lower dividends. Chaebol firms have weaker shareholder rights and pay lower dividends compared to independent firms. High dividend-paying Korean firms are favored by foreign investors. Moreover, foreign investors with substantial ownership squeeze more dividends from the firms. Dividend smoothing is also common among Korean firms. In particular, larger firms, lower growth firms, and riskier firms tend to engage in dividend smoothing more than other firms. Korean firms' payout policies are significantly affected by the gap between the voting rights and cash flow rights of the controlling shareholders, or the wedge. Korean firms with higher wedge tend to repurchase more shares, while firms with lower wedge distribute more cash dividends to shareholders.

Research on Korean banks shows that the net interest margin, operating costs per employee or branch, assets per employee or branch, technical efficiency, equity capital ratio, and non-performing loan share are determinants of bank profitability. Foreign ownership also has a significant positive effect on Korean banks' returns and risk. The presence of a foreign board member is associated with better returns and lower risk. Adverse exogenous events negatively affect the value of Korean banks and their client firms. For the client firms, the costs of bank distress are higher when the firms are more bank-dependent and financially constrained.

In looking for future research directions in corporate finance, authors could find a number of interesting research topics in the interdisciplinary area rooted from the conventional corporate finance. For example, it would be worth investigating the capital structure of Korean firms that exercise extreme conservatism in their use of leverage[6]. Moreover, research should examine how corporate culture factors, such as the characteristics of the CEO and the board, interact with corporate finance decisions, including investment and payout policies. Finally, corporate issues that are frequently discussed in the media and are the subject of vigorous policy debates, such as innovation, corporate social (environmental) responsibility, fraud, and taxes, are potentially fruitful topics for corporate finance studies on Korea[7].

## Notes

1. <https://data.worldbank.org/data-catalog/GDP-ranking-table>
2. Yang (2011) further documents a survey on the recent corporate governance issues in Korea.
3. A large number of papers document the role of foreign investors in Korea. Choi *et al.* (2012) note the dramatic increase in the foreign ownership of Korean firms after the equity market was opened to foreign investors, from 4.9 percent of market value in 1992 to 42 percent in 2004 and 33 percent in 2010. They use a sample of non-financial firms in the Korea Exchange's KOSPI 200 index during 2004-2007 to examine the impacts of foreign block ownership (more than 5 percent of an individual firm) and foreign board membership on firm value (proxied by Tobin's  $Q$ ). Consistent with Choi *et al.* (2007), who report the value of foreign institutional ownership, Choi *et al.* (2012) find that both foreign block ownership and foreign board membership are positively related to firm value, which indicates that foreign block shareholders and foreign outside directors both provide independent monitoring over controlling shareholders. Board independence reinforces the positive effect of foreign outside directors on firm value. However, when foreign outside directors represent foreign blockholders' private interests, the positive impact of foreign shareholders as independent monitors is mitigated. Kim *et al.* (2010) investigate whether corporate governance affects equity participation in Korean firms by foreign investors using a sample of 915 firms listed on the Korea

Stock Exchange (KSE) and Korea Securities Dealers Automated Quotations (KOSDAQ) over the 1992-2003 period. They find that foreign ownership is positively associated with the presence of foreign outside directors on the board during the post-financial crisis period, 1999-2003. They also report that firm size, Tobin's Q, and ROA are positively related to foreign ownership during the same period.

4. In a recent paper, Kim (2011) reviewed the literature on the payout policies of Korean firms.
5. Kim *et al.* (2013) use the wedge data from the Korea Fair Trade Commission. The wedge is computed as follows:

$$\text{Cash flow right} = A / (\text{Number of issued shares} - \text{Number of treasury shares});$$

$$\text{Voting right} = (A + B + C) / (\text{Number of issued shares} - \text{Number of treasury shares});$$

$$\text{Wedge} = \text{Voting right} - \text{Cash flow right},$$

where  $A$  is the number of shares owned by the controlling shareholders including family members;  $B$  the number of shares owned by the affiliates and not-for-profit organizations;  $C$  the number of shares owned by the directors and officers of the firm (p. 211).

6. Firms that stay debt-free or almost debt-free for an extended period in the Korean corporate setting where heavy reliance on debt is the norm raise many interesting research questions relating to the motives, characteristics, and performance of firms with (almost) zero leverage. Numerous recent studies examine the characteristics of debt-free firms, primarily in the USA (Lee and Moon, 2011; Devos *et al.*, 2012; Byoun and Xu, 2013; Strebulaev and Yang, 2013; Moon *et al.*, 2015).
7. For example, Jo *et al.* (2016) show that lower environmental costs increase firm value in OECD countries including Korea.

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