Trends and Developments

Contributed by:
Yun Seok Jang, Yong Hee Kim, Gajin Choi, Dae Kun Jang and Seung Hyun Dennis Cho
Shin & Kim

Shin & Kim is a leading Korean law firm providing comprehensive legal, accounting, tax, compliance and regulatory services and its clients include multinational companies, conglomerates, global financial institutions and government agencies. Shin & Kim's finance team regularly advises its clients on the most complex and significant M&A transactions and it has the expertise and experience to advise on loan financing, notes issuance, financing of leveraged buyouts and public takeovers, and asset-backed financing as well as customised financing structures. It has been dominant in the Korean acquisition financing market, which has recently become the most active sector because of its importance to high-profile M&A. In recent years, Shin & Kim's team members have been advisers to some of the largest acquisition financings in Korea, including the USD740 million (equivalent) financing transaction for the acquisition of Lotte Card, USD667 million (equivalent) financing transaction for the acquisition of Microworks and USD499 million (equivalent) financing transaction for the acquisition of KJ Environment.

Authors

Yun Seok Jang is a partner at Shin & Kim who leads Shin & Kim's corporate finance group. He has unparalleled experience in the securities and finance sector and has experience in advising landmark acquisition financing transactions, including Taylormade, Job Korea, SK Lubricants and CJ Olive Young. Mr Jang acted as lenders' counsel for the acquisition of Home Plus, Momentive, Linde Korea, Daesung Industrial Gas, Twosome Place and Burger King among others. His practice also focuses on a wide range of matters including alternative investments and private equity transactions.

Yong Hee Kim is a partner at Shin & Kim. He focuses his practice primarily on representing domestic and foreign financial institutions and corporate and sponsor borrowers in financing transactions, including acquisition finance, real estate project finance, structured finance and other financing transactions. Mr Kim also advises domestic and foreign clients on Korean banking and securities laws and other general matters. He is a member of the Korean Bar Association.

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Shin & Kim

Gajin Choi is a partner at Shin & Kim with extensive experience in various domestic and cross-border financial transactions, including acquisition financing, credit financing and corporate financing. She has advised clients on many landmark acquisition financing transactions and has extensive knowledge in related legal issues and trends. Ms Choi represents a broad range of domestic and international banks, securities companies and other financial institutions, and also provides advice for private equity firms in connection with financing. She is a member of the Korean Bar Association.

Dae Kun Jang is a partner at Shin & Kim and is active in providing legal advice in a wide range of financial transactions. His main areas of practice include acquisition financing, project financing, SOC and infrastructure financing, data privacy, and fintech. Mr Jang has also been involved in asset management, IPO, PEF, and a variety of mergers and acquisitions of financial institutions. He is a member of the Korean Bar Association.

Seung Hyun Dennis Cho is a senior foreign attorney at Shin & Kim and has extensive experience in advising investors, lenders and borrowers in a wide range of finance transactions. While his practice concentrates on corporate finance, acquisition finance and asset finance, he also regularly advises clients on general corporate matters. Mr Cho began his career as a credit analyst at the investment banking arm of a leading commercial bank in Korea and, more recently, served as an executive director at a global zinc smelter where he headed the risk and operation teams. He is a member of the New York Bar.

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Shin & Kim

Shin & Kim LLC

D-Tower (D2)
17 Jongno 3-gil
Jongno-gu
Seoul 03155
Korea

Tel: +82 2 316 4114
Fax: +82 2 756 6226
Email: shinkim@shinkim.com
Web: www.shinkim.com

Introduction

Korea's mergers and acquisitions (M&A) market saw a downturn in 2024 and the number of completed deals also declined sharply, marking the lowest activity level in recent years. Korea was not immune from being affected by high interest rates, economic uncertainty and geopolitical tensions. While a significant pick-up in M&A activities in Korea is currently not expected given the general economic outlook, it is noted that the M&A market is expected to slowly rebound in 2025, driven by various factors.

Korean conglomerates have been accelerating efforts to divest non-core assets – particularly in industries such as chemical, oil refining and energy, rechargeable batteries, semiconductors, biopharmaceuticals and shipbuilding, shipping and logistics – to enhance financial strength and focus on future growth sectors. Also anticipated are increased M&A activities driven by technological advancements and strategic realignments, which are reshaping the corporate landscape in Korea, prompting companies to pursue M&A as a means to boost competitiveness and achieve transformation objectives. Private equity firms, with significant cash reserves and growing influence in the M&A market, will continue to play a key role in corporate restructuring, capitalising on opportunities arising from conglomerate divestitures as increasingly seen from 2024 onwards.

In terms of market players, domestic private equity firms (PEFs) will continue to play a significant role as borrowers in the Korean M&A market, along with Korean conglomerates as strategic buyers of businesses. On the lenders' side, Korean domestic banks and securities houses are likely to remain as the most active lender group in the acquisition finance sector. However, overseas private equity firms and international banks are showing increased interest in filling the liquidity gap created by the domestic financial institutions taking a more conservative approach to underwriting new loans. The challenge for these institutions will be to find effective means to comply with and navigate through various regulatory requirements, including those found under the foreign exchange regulations, in order to provide credit to borrowers in Korea.

Financing Structure

For acquisition loans, generally a special purpose vehicle (SPV) is newly established by a sponsor as the borrower of the acquisition loan and the acquirer of the target. Upon consummation of the acquisition, the target will become the subsidiary of the borrower. The acquisition loan is usually repaid in one lump sum at maturity. The term of the acquisition loan is usually between two and five years. If the borrower elects to prepay the loan, a prepayment fee will usually apply if the loan is prepaid between 12 and 18 months from the drawdown.

In terms of security, an acquisition facility is generally secured by the target's shares and the borrower's bank accounts. The target assets may not be used as collateral to secure the acquisition loan due to breach of fiduciary duty concerns discussed in more detail below. For the same reason, the target may not provide a guarantee to support the payment obligation of the borrower, as such guarantee will constitute an upstream guarantee.

The acquisition loan agreement in Korea typically contains a robust set of representations and warranties and covenants. The most common financial covenants required by the lenders cover the ratio of net debt to EBITDA and the ratio of loan to value of the shares provided as a security (generally in respect of publicly traded target companies).

Lenders may consider a covenant-lite documentation, if the financing is provided for an acquisition of a minority equity interest in a target. In case of an acquisition of a minority interest in a listed company, the lenders may forego stringent documentation terms in place of a strict loan to value test (ratio of loan to value of the listed shares granted as a security).

Carve-Out Structure

In 2024, carve-out transactions emerged as a new trend. Amid high interest rates and uncertain macroeconomic conditions, major Korean conglomerates pursued strategies to concentrate on core businesses and divest non-core assets. PEFs have been actively participating as sponsors in these carve-out deals, leading to an expansion in overall acquisition financing demand.

This strategic shift reflects a broader trend where large corporations are opting to sell non-core companies, while PEFs are increasingly interested in acquiring such assets. This dynamic is anticipated to drive growth in the M&A market and related financing activities in the coming years. Some of the recent notable transactions include the sale of SK Enpulse's ceramic business, the sale of SK Pucore and the sale of LG Chem's diagnosis business.

Acquisition financing for carve-out transactions often exhibits distinct characteristics compared to traditional buyout deals. Structure typically involves the PEF establishing a new entity and acquiring the business through an asset transfer. In such arrangements, the PEF or its special purpose company (SPC) incurs debt financing for the acquisition and contributes them as equity investment to the newly formed entity. The PEF or SPC often pledges the shares of the newly established company as collateral for the loan.

Additional capital infusion after the carve-out transaction is completed is frequently considered by PEFs as follow-on investment. To facilitate this, specific conditions are often negotiated with the lenders group and are incorporated into the finance documents. These conditions may include placing covenants on cumulative investment amounts or restricting that investments can only be permitted if agreed-upon financial ratios are complied with. Such approach aligns with customary practices in carve-out financing, where the financing structure is tailored to the specific aspects of the transaction, including the incorporation of a new entity and the discussion of terms for follow-up investments.

Further, PEFs often consider strategies to enhance value through post-carve-out restructuring activities, such as mergers, spin-offs, or comprehensive share exchanges involving the newly established company and its subsidiaries, which are collectively referred to as *"permitted organisation"*. Additionally, PEFs may explore the option of divesting specific business units. To facilitate these plans, PEFs typically negotiate with the lenders to incorporate provisions into the loan agreement that permit such reorganisations, ensuring that these activities are aligned with the agreed-upon terms and conditions.

Syndicated Facilities and Interest Rates

A financing institution may choose to underwrite the entire acquisition loan facility and engage in multiple sell-downs after the closing or invite other lenders to form a syndicate in order to finance the acquisition. Although syndicated acquisition loans are common in the market, there has been an increasing trend towards a single leader or a small group of arrangers fully committing to the entire facility followed by post-closing sell-downs.

In order to facilitate sell-downs, the lead arranger may offer interest rate options in the financing terms that allow a loan transferee to select either a fixed rate or a floating rate of interest within a certain designated period of time after the initial utilisation of the loan.

Floor rate and market flex provisions were seldom included in acquisition financing terms prior to 2022. However, due to the recent interest hikes and liquidity crunch, more lenders prefer to have these interest rate protection options reflected in the financing terms to increase the chances of successful syndication.

Bridge Loan

A bridge loan is one of the popular ways to finance larger M&A. Bridge loans are generally put in place to bridge the gap between the initial funding of the acquisition and the borrower obtaining the longer-term funding of the acquisition. There are various types of bridge financing depending on the types or the value of the collateral provided by the borrower or the sponsor.

One of the most common bridge loan types is a short-term bridge loan where a private equity buyer acquires financing to bridge the gap between the acquisition closing and the buyer securing equity financing from its LP (limited partner) investors. These bridge loans are temporary loans with a maturity of one year or less.

Bridge loans are secured by the equity commitment issued by the general partner (GP) investor or the private equity (PE) sponsor, which provides that the GP or the PE is responsible for repayment of the loans should there be a default. Such equity commitment usually provides that at maturity or upon acceleration of the bridge loan due to an event of default:

- the PE sponsor is required to make an equity contribution to the borrower in an amount equal to or exceeding the respective bridge loan principal and interest amount; and
- the GP investor is required to make capital calls to its limited partner (LP) investors for the purpose of enabling the PE to repay the loan.

Prior to the amendment of the Financial Investment Services and Capital Markets Act in 2021, it was unclear whether a PEF could issue an equity commitment under the Act in connection with a financing. However, the amendment clarified that a PEF is able to issue an equity commitment in connection with a loan, so long as a certain leverage ratio limit is complied with.

Tender Offer

Obtaining acquisition financing to fund tender offers has become a trend in the Korean market. Tender offers made for Ostem Implants and Lutronic in 2023 are examples of this trend, where the sponsor contemplated using the acquisition loan proceeds to partially fund the tender offer.

Under the Financial Investment Services and Capital Markets Act (FSCMA), a tender offer report must be filed with the Financial Supervisory Service and the Korea Exchange before a tender offer is made. The filing must be accompanied by documents evidencing that the funds necessary for the tender purchase have been secured.

Until recently, Korean financial regulators required a potential tender offeror to deposit cash in a tender purchase account and submit documents relating to the account as evidence of secured funds. This cash deposit requirement meant that the mechanism for securing and releasing loan proceeds for the tender offer had to be carefully negotiated and documented in order to ensure that the transaction could proceed without any hiccups.

However, in recent years, regulators have been willing to take a more flexible approach to securing tender purchase funds before filing a tender offer report. More recently, financial regulators have announced that a letter of commitment issued by financial institutions may be recognised, under certain circumstances, as evidence that the tender offer funds have been secured. Given such an announcement, it is expected that, in future, potential offerors will more frequently use a letter of commitment to evidence that the funds needed for a tender purchase have been secured.

Fund Subscription Facilities

Fund subscription facilities are a type of financing arrangement commonly used by PEFs and other investment funds. These facilities enable funds to borrow capital from banks or other financial institutions, using the uncalled capital commitments of their investors as collateral. The primary purpose of these facilities is to provide liquidity to the fund, allowing the fund to make investments quickly without waiting for capital calls from investors. This is particularly useful in urgent transactions or for routine fund administrative payments, and domestic PEFs have been increasingly taking note of these benefits.

While fund facilities have become well-established in global transactions, their use in Korea has been somewhat limited until recently. However, there has been a noticeable increase in the adoption of these financing structures in Korea, particularly for corporate-type funds (private equity funds exclusive for institutional investors). The first cases have emerged in 2024 and their numbers have been gradually increasing over the years.

The growing interest can be attributed to several factors.

- Urgent transaction needs – the ability to quickly secure funding for urgent transactions without waiting for capital calls from investors is a significant advantage.

- Administrative payments – fund facilities provide a reliable source of liquidity for routine administrative payments, ensuring smooth fund operations.

Fund facilities, while beneficial, require careful consideration of various legal issues, especially in Korea. In Korea, fund facilities must comply with the FSCMA. This Act imposes various requirements and limitations on the creation and perfection of security interests over uncalled capital commitments, making it challenging for funds effectively to use these commitments as collateral. Addressing these regulatory issues is crucial for the successful implementation of fund facilities. In addition, obtaining investor consent for fund facilities (if any) can be a challenging process. In Korea, cultural business practices may further complicate this, as securing investor commitment faces practical challenges.

Despite such challenges, the demand for fund facilities in Korea is expected to grow. Funds are increasingly looking to establish fund facilities to secure urgent and confidential investment funding or to prepare for unforeseen liquidity needs. Although there are difficulties in creating collateral over uncalled commitments, financial institutions may sometimes prefer the reliability of investor commitments over other forms of collateral, such as portfolio company shares. By addressing the regulatory, legal and cultural issues, funds can effectively utilise fund facilities to enhance their investment strategies and achieve their financial objectives in Korea.