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# CORPORATE GOVERNANCE CHANGE AND MANAGEMENT PERFORMANCE: AN EXPLORATORY STUDY OF A KOREAN COMPANY - MANDO CORPORATION

## ABSTRACT

Triggered by the Asian financial crisis in 1997, corporate governance has become an important topic for many Korean companies. Particularly, Korea's large family-owned conglomerates, chaebols, went through significant changes in terms of corporate governance. There has been a widely held belief that the lack of proper corporate governance in Korean companies, notably chaebols, forces them to suffer from low performance. Changes in corporate governance, therefore, is expected to enhance company performance. This paper is an exploratory study to address this issue. Specifically, it has an in-depth look at the case of Mando Corporation to show how corporate governance improved management performance in terms of increasing shareholder value. The roles of the board of directors, large shareholders, and professional managers are explained and contrasted in the context of rapidly evolving dynamics of changes in the corporate governance of the company.

*Key words: corporate governance, Chaebol, Mando Corporation*

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# INTRODUCTION

The Asian financial crisis in 1997 offered an important watershed in the history of Korean companies. Among others, it is noteworthy that the external crisis triggered the introduction of corporate governance issues to the Korean business community. To many Korean companies until then, corporate governance remained as a rather conceptual topic and was not actively embraced as an explicit management concern. Diverse outside forces brought this topic to the attention of Korean companies. Most of all, it was the changing ownership structure that demanded changes in corporate governance. In a number of companies, traditional owners, many of whom were founders, had to yield their shares to outside investors. The new shareholders, many of whom were foreign investors, began introducing governance systems to the companies. Also, many institutional forces put explicit requirement that Korean companies adopt systematic corporate governance reforms. Following the recommendations of the International Monetary Fund, the Korean government introduced the outside director system in 1998, which demanded companies to have outside directors as a way of improving the governance structure. More concrete requirement was made by the Korean Stock Exchange. In 1998, it decided to install a mandatory requirement that all listed companies have at least 25 percent of the board of directors be filled with outside members. Going further, it later stipulated, in 1999, that large companies - those with total assets of more than 2 trillion won, or about 2 billion US dollars - should have at least 50% of the board of directors come from outside.

These moves hinged on the assumption that changes in corporate governance should lead to enhanced company performance. Many researchers as well as practitioners have indicated that one of the main reasons for Korea's 1997 crisis was failures in corporate governance of Korean companies (e.g., Mitton 2002, Baek et al. 2004). The main thesis of these studies is that the virtually non-existent corporate governance system in traditional Korean companies tended to lead to persistently low profitability. Simply put, the long-held owner-manager structures of many Korean companies, notably, chaebols, were the underlying reason for weak financial performance, thus for the near collapse situation of the Korean business sector followed by the Asian financial crisis. Other studies highlighted the agency problems of large shareholders of Koran companies, arguing that large shareholders tended to behave in their own favor, often at the expense of minority shareholders (e.g., Bae et al. 2002, Chang 2003, Joh 2003). Overall, while existing studies on this topic opened up discussion by providing early evidences, they await further theoretical and empirical investigation. The present paper attempts to add a piece of empirical evidence in line with the above discussion. Given the relatively short history of studies on Korean companies, the study aims to uncover some specific mechanisms that are related to corporate governance. To do this, the study relies on a case study rather than formal statistical testing (Yin 1994). It may give helpful notions for future studies by exploring the topic based on primary data rather than archives.

## CORPORATE GOVERNANCE AND PERFORMANCE: KOREAN COMPANIES

This paper defines corporate governance as a set of organizational arrangements that largely determines resource allocation and conflict resolution within the organizational boundary (Daily et al. 2003). With this broad and inclusive definition of governance, the paper draws on diverse lines of theoretical reasoning. Perhaps the most influential body of existing studies relies on perspectives of agency theory (Dalton et al. 2003). Since Jensen and Meckling (1976) published their seminal piece to explain how the separation of ownership and control can be sustained with the assumption of self-interested managers, agency perspectives form the theoretical basis to understand governance issues. Agency theory makes an explicit assumption that there is an inherent conflict between the owners of the firm and its hired managers (Fama and Jensen 1983). With their expertise and superior knowledge in running the company, professional managers tend to have incentives to pursue their own interests, often at the expense of the owners, i.e., company performance. A straightforward implication is that proper monitoring system should enhance company performance by moderating the self-interested behaviors of managers.

Agency theory perspectives addressed the board of directors as a key mechanism to monitor possible self-interested behaviors of managers. Monitoring by the board on behalf of shareholders may significantly reduce agency costs and improve company performance (Fama 1980, Zahra and Pearce 1989, Johnson et al. 1996). Since board members may be influenced by their own incentives in monitoring managers, specific board incentives are an important factor in the effectiveness of the board of directors. In this light, the independence of board members has been raised as a meaningful way to ensure proper incentives on the part of directors. The degree to which board members are dependent on the CEO or the organization is considered critical (Johnson et al. 1996). Empirical results of existing studies have been, however, not very definitive. For example, a number of studies investigated the relationship between the number of outside directors and company performance. While some studies found positive relationship between the outsider directors' ratios and performance (e.g., Pearce and Zahra 1992), others found opposite results (e.g., Beatty and Zajac 1994).

In dealing with corporate governance issues of Korean companies, one may need to have a careful look at the roles of large shareholders. After all, it is ownership that largely determines the governance system. The above discussion on the monitoring functions of the board of directors, particularly outside directors, may have limited impact if the ownership structure is dominated by a small number of people who have absolute power and influence on the managers. It was the case with many Korean companies before the Asian financial crisis in 1997. Most of those large shareholders were founders of the companies. They frequently served as CEOs of their own companies and appointed board members. In many cases, those owner-founders assumed Chairman of the board at the same time. Given this historical backdrop, corporate governance studies of Korean companies should keep track on the changes of the long-held founder-owner structures. It was this strong founder-owner structure that brought governance issues to Korean companies. That is, in the case of Korea, corporate governance issues have been largely the problems between large shareholders and minority shareholders (Cho and Kim 2007). It is therefore important to observe the changing ownership structures followed by the Asian financial crisis and the evolving dynamics between shareholders and board members.

Finally, there is another group of actors in the corporate governance dynamics - professional managers. While they have been treated as self-interested players who pursue their own goals, often conflicting against those of shareholders, managers perform critical functions in terms of enhancing corporate performance. In the case of Korean companies, the roles of professional managers have not been investigated at length. This relative lack of studies on managers reflect the traditional governance structure of Korean companies, where founder-owners exert absolute influences and managers serve as rather passive implementers of top-down orders. When we consider that many of CEOs were owner-founders, the roles of professional managers were supposed to be fairly limited. One can suspect that there should be meaningful roles of managers in explaining company performance. Recent stream of research addressing the limitations of agency theory investigates the active roles of professional managers (e.g., Johnson et al. 1996, Hendry 2002). Particularly, stewardship perspectives argue that managers are stewards with well aligned motives to the company performance and therefore will behave in the best interests of shareholders (Donaldson 1990). Viewed this way, managers should be seen as an important contributor to company performance. In the case of Korean companies, the deep-seated structural barriers have been keeping professional managers largely unseen in the landscape of corporate governance.

Several studies have shown that Korean firm performance has improved since 1997, and these authors tried to explain this improvement in terms of corporate governance reforms (Joh 2003, Joh and Kim 2003). Stronger stakeholder rights, improved transparency, and accountability, and other governance-related factors are attributed to be significant reasons why Korean firms are performing better today than the past (Lee 2003). Others indicate that the positive impact of corporate governance changes in Korea is too early to assess and that many Korean companies are still under owner-controlled structure with only limited governance changes made (Cho and Kim 2007). The present study attempts to extend this line of inquiries and to add empirical evidence to existing investigations. Specifically, this study approaches this topic through an exploratory study of Mando Corporation and Mando Machinery Corporation and shows that there seem to be fair amount of data to believe that better corporate governance has indeed improved management performance. Improved management performance is reflected in both operational and financial improvements in Mando's business. This case does not approach the benefits of corporate governance reforms as per changes in government regulations. Rather, it approaches the benefits of corporate governance in terms of the self-implemented by-laws and agreements made by the new stakeholders of Mando Corporation.

## THE CASE OF MANDO CORPORATION

### The Halla Group and Mando Machinery Corporation

Mando Machinery Corporation was established in 1962 by Chung Mong Won as a manufacturer of automobile components. It was listed on the Korea Stock Exchange in 1980. By 1997, Mando Machinery Corporation operated five separate factories across Korea; each was uniquely responsible for producing braking systems, steering columns, suspension systems, automotive electronics, or climate control systems. Mando Machinery Corporation was the cash cow for the Halla Group, the 12th largest chaebol in 1998 in terms of asset size. Of the eighteen Halla Group companies in 1997, Mando Machinery Corporation was the largest in terms of revenues, operating profits, and free cash flow.

Like many other chaebols, Madno Machinery Corporation was part of an intricate network of subsidiaries characterized by cross-shareholdings and other financial ties. Chung Mong Won held less than 10% of the company but was able to exert more control due to the cross-shareholding structure of the Halla Group. It is argued that the high disparity between ownership and control rights results in managerial entrenchment which in turn leads to possible expropriation (Shleifer and Vishny 1986). Halla Heavy was in a fairly chaotic situation in the late 1990s. Having never turned a profit for more than a decade and burdened with more than 2 trillion Korean Won in debt, Halla Heavy filed for bankruptcy in early 1998. The collapse triggered a chain of bankruptcies in the entire Halla Group. Mando Machinery Corporation, although an operationally sound and profitable company, could not sustain with the additional 2.1 trillion Korean Won in debt from the Halla Heavy guarantees and filed for court composition shortly thereafter.

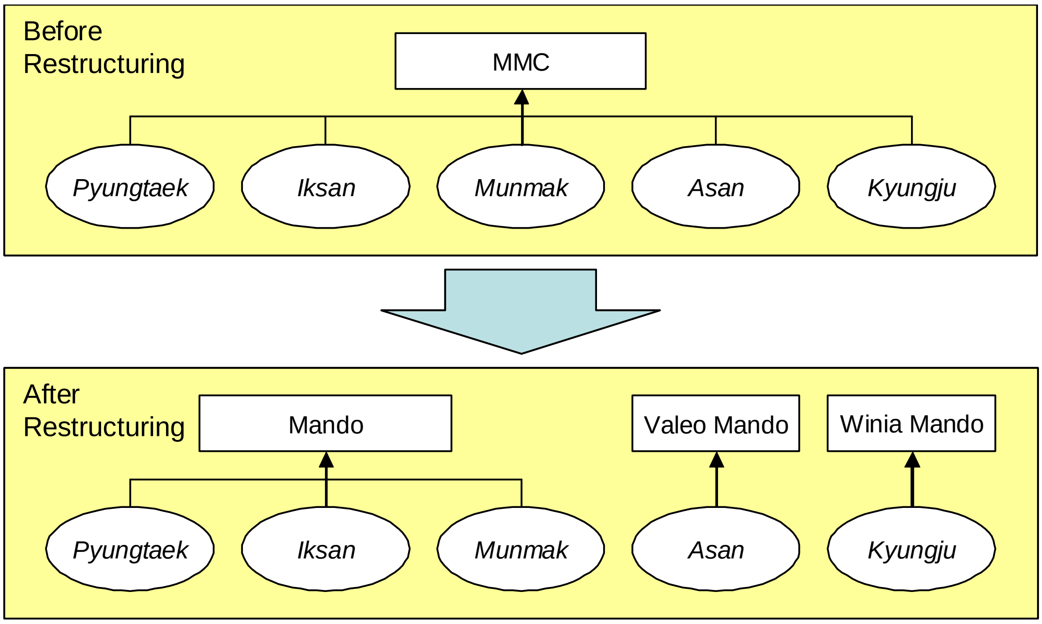
## The Breaking of Mando Machinery Corporation and Formation of Mando

Mando Corporation is the spin-off of the automotive chassis components business of Mando Machinery Corporation. As part of the composition plan, Mando Machinery Corporation sold off its business assets to foreign investors (see Figure 1). The electronic components factory in Kyungju was sold to Valeo of France and was newly incorporated as Valeo Mando Co., Ltd. The climate control business at Asan was sold to a consortium of private equity investors led by UBS Capital and was newly incorporated as Mando Climate Control Corporation (later changed to Winia Mando Co., Ltd.). The remaining three businesses, braking systems, steering columns, and suspension systems, located in Pyungtaek, Iksan, and Munmak, respectively, were sold to another private equity consortium led by Chase Asia Equity Partners (currently JPMorgan Chase Equity Partners) and was newly incorporated as Mando Corporation. Mando Machinery Corporation, reduced to a shell company with no more valuable assets, was de-listed from the Korea Stock Exchange in 2000.

## Corporate Governance Issues at Mando Machinery Corporation

Although the corporate governance problems within the Halla Group companies were shared with many other chaebols, it is useful at this point to discuss specifically how the various failures led to the subsequent collapse of Mando Machinery Corporation: issues of the board of directors, concerns regarding accounting procedures, and problems in the incentive structures for fiduciaries.

**Figure 1: The Breaking of MMC**




Source: Mando Machinery Corporation

## The shadow director and ineffective board of directors

The board of directors was comprised of close associates of Group Chairman Chung Mong Won. They included some of the senior management team and other executives from other Halla Group subsidiaries. Although Chung Mong Won retained the title, "Chairman," he was not an official director; he remained as what critics of the chaebol system called a "shadow director" (Ehrlich and Kang 2000). Despite his official absence from the board, Chung remained influential as the owner-founder. All the members of the board of directors were chosen by Chung. Challenges and dissension against Chung was rarely made. In their interviews, a senior executive and a former member of the board of directors at Mando Machinery Corporation said, "Mando Machinery was just a part of the whole. Although directors felt responsible for the company, loyalty was foremost to the Halla Group and Chairman Chung." In effect, this loyalty to both the Group and the Chairman compromised their roles as fiduciaries to the shareholders. It allowed the business to undertake dangerous levels of debt, undermining profitability, and worse yet, it gave Chairman Chung the power to use Mando Machinery Corporation as a guarantor to over 2 trillion Korean Won in loans taken out by Halla Heavy.

## Poor transparency in accounting and reporting

Mando Machinery Corporation's accounting and reporting practices were in line with the existing standards as laid out by Korean GAAP (Generally Accepted Accounting Principles) and the Korea Stock Exchange. The shortcomings of these standards in terms of extent of information and transparency have been well documented (Kim 2001, 2003). Mando Machinery Corporation's financial statements revealed similar weaknesses and limitations. In addition to the absence of requirements for consolidated financial statements between subsidiaries as well as accounting for contingent liabilities (that might arise from debt guarantees), the actual figures reported by the company were considered problematic.

One of such concerns involved artificial asset inflation. Inflating assets is a way to improve the appearance of a company's balance sheet. Higher assets must be necessarily accompanied by either increased liabilities or increased capital, which by itself is not a problem. However, if assets are artificially inflated, it means that the company did not account for the necessary losses in the asset value. Hence, shareholder equity is also artificially inflated. This increase in shareholder equity results in a lower debt to equity ratio, and therefore gives a healthier image of the company than one that actually is. A partner at one of the Big Four accounting firms in Korea who was responsible for performing the accounting due diligence on behalf of the Chase-led investment consortium, said that "account receivables and inventories were knowingly, yet "legally," inflated as to falsely increase asset value, lower debt to equity ratios, and make the company balance sheet look healthier."

## Incentive problems to act as proper fiduciaries

The fiduciary duty of company managers and directors is to make sure that the business is healthy and profitable such that the risks of being any stakeholder is commensurate with adequate returns (Kim 1999). This inherently means that they must always be wary of maximizing returns and minimizing risk in the future. Historical data shows that Mando Machinery Corporation was plagued by high leverage, low profitability, poor earnings, stagnant value-add, and risky business portfolio.

It is easy to dismiss these problems as the failures of an inept management; but to do so ignores the reality of the situation. Senior managers felt that they worked for the Halla Group and Chairman, not just Mando Machinery Corporation. They relied on Chairman Chung to get purchase orders from Hyundai as the largest automobile manufacturer in Korea and a related company by the fact that the chairmen of both Halla and Hyundai were family. In turn, they used Mando Machinery Corporation's resources to help other Halla Group subsidiaries. A former general manager of the Halla Restructuring Office in charge of divesting assets said, "Resources were often diverted to help sister companies. It was common practice for all chaebols, not just Halla, to do this. Managers from different subsidiaries worked to build the Group, not just a single company."

Given the situation of Group-rather-than-company, it is conceivable that they did not have the proper incentives to truly work for Mando Machinery Corporation. They were not bound by any fiduciary duty to Mando Machinery Corporation but rather by they loyalty to the Halla Group. In so doing, they did not act as proper fiduciaries and bore the possibilities to hurt both creditors and minority shareholders.

## Improved Corporate Governance at Mando Corporation

Before the Chase consortium acquired the new business, Mando Corporation (Mando hereafter), the investors were well aware of the corporate governance problems discussed above. They knew that Chairman Chung was the key to the complicated picture and they also knew that the management team contributed to the problems. During the management interview stage of the due diligence process, the investors realized that the core team of management was very knowledgeable and experienced in the auto parts business. They knew the value of good management and believed that most of the existing team would be necessary to run the business successfully. They also knew that Chairman Chung, despite potential risks, was still of significant value in terms of his family tie to Hyundai Motors, the biggest customer of Mando.

Given these opportunities and constraints found within the company, the investors, in conjunction with the new creditors, implemented through various agreements, contracts, and the articles of incorporation ways to work with senior managers and maximize their value. In essence, they made new corporate governance standards that allowed for the safe marginalization of Chung and for management to focus on Mando's auto parts business as proper fiduciaries without Chung's influence. A delicate balance between control and collaboration was put to work (Sundaramurthy and Lewis 2003). It is important to note that Mando is not a listed company. They are not bound by the same accounting and reporting standards as set forth by the Korean Stock Exchange. However, in some respects, Mando's self-imposed corporate governance standards exceed what the market requires (see Table 1). After a discussion on the corporate governance changes, we will then assess how effective they have been in transforming Mando Machinery Corporation into much healthier Mando Corporation.

**Table 1: Some Korean CG Reforms and Mando's CG Standards**

| Issue | Source of Problem | Korean CG Reform Standards | Mando Standards |
|---|---|---|---|
| Ineffective Board of Directors | Not independent from "chairman" or owner<br>Technically incompetent | At least half of BoD must be comprised of independent directors<br>At least one member of the audit committee must have some relevant experience in finance | Combination of management, shareholder representatives, and Chairman Chung<br>Chairman's directorship is "conditional" in that he cannot vote on some issues (as per shareholders' agreement)<br>BoD comprised of operational, technical, and financial experts |
| Transparency | Poor accounting standards<br>Long period between reports to shareholders | Revision of Korean GAAP<br>Requires combined financial statements<br>Quarterly reports | Accounting standards meet both revised Korean GAAP and US GAAP<br>Consolidated financials<br>In addition to standard quarterly reports, detailed monthly updates |
| Fiduciary Duty and Accountability | No fiduciary duty concept in Korean legal terminology prior to 1997<br>Loyalty to chairman, not shareholders in general<br>Concentrated decision-making at the top<br>Chairman held unaccountable | Revision of Commercial Code to reflect fiduciary duty<br>Prohibition of "shadow directorship" | According to management co-investment plan and subsequent stock option plans, fiduciary duty is linked to performance and increasing shareholder value.<br>Failure to meet business targets leads to loss of options and/or termination.<br>Marginalized role of chairman ("controlled voting") |

Source: Cho (2003), Ehrlich et al. (2000), and interviews with Mando management and shareholders

## Strong and effective board of directors

It has been investigated how board of directors can bring positive impact to the company performance (e.g., Hillman and Dalziel 2003). Through the changes, Mando has built a strong and effective board of directors. The current board of directors comprises of Andrew Liu, John Lewis, Ming Lu, Kok Yew Tang, David Lai, Sang Soo Oh, Se Pil Choi, Ki Won Kim, and Mong Won Chung. Chung is not the chairman. That title goes to Andrew Liu, the president of JPMorgan Chase Equity Partners (formerly Chase Asia Equity Partners). According to a member of Mando's board, Chung was brought on board not only because of his sizable shareholding or his connections to Hyundai, but "because even though we need him, we also want to keep a close watch on him."

Mando's board of directors is strong and effective because its members understand what it means by fiduciary duties. As partners in leading private equity firms, Liu, Lewis, Tang, and Lai are financial experts with significant experiences as directors of other companies across Asia. With direct management experience in international and domestic automotive components companies, Lu and Kim are operational experts. Choi is the de facto CFO with first hand knowledge of the company's finances, and President and CEO Oh with decades of experience working at Mando, complement other members with intimate knowledge of the company.

The board operates through both negative and positive controls on management (Baysinger and Hoskisson 1985, Johnson et al. 1996). Negative controls include requirement of board approval for expenses above a certain expenditure limit or for any expenses that arise after a certain quarterly allowance is reached. Borrowings are also controlled in a similar manner. New projects or investments that exceed a certain cost level are also subject to extensive board review and approval. Positive controls include benchmarking performance against yearly and semi-annually updated business plans and rewarding management with generous stock options.

Formal board meetings are held at least four times a year (quarterly meetings), and informal ones occur more frequently when various concerns arise or approvals are required. The frequency of meetings and the implemented control measures work to keep management focused, diligent, and accountable. A board member added that "[the investors] want management to have free hand to run the business as they see fit. At the end of the day, they know [Mando] best, and they know what works. The board operates just like that. We negotiate certain milestone targets in the business plan, and it is up to them to deliver as how they see fit. All we want is to make sure that we are aware of potential problems before they actually become problems."

### Transparent accounting and reporting

Because Mando is not a listed company, it is not required to publish quarterly, semi-annual, and annual reports to the public. However, this does not mean that the company's accounting and reporting standards are not transparent. The shareholders and the board not only require management to prepare four lengthy reports, but they also require monthly updates. As the new controlling shareholders are international investors, management prepares reports that conform to both the revised Korean GAAP and US GAAP. Although US and other international standards are not foolproof, they are much more strict in terms of reporting financial performance (Cho 2003). In addition, considering the fact that half of the board members have extensive experience in accounting, auditing, and corporate finance, the collective expectation and the level of requirement in terms of transparency has been raised notably. Internal reporting procedures have been changed as well. One board member said that directors turn hostile and management defensive during board meetings because "directors [use the meeting to] grill managers about potential discrepancies between previous reports and demand justifications for any numbers that exceed or fall short of [business plan] targets." In other words, management must explain not only the poor results but the good results as well.

Furthermore, this increased transparency extends to creditors as well. The new creditors trust the new shareholders' standards for transparency and rely on them to perform their own credit analyses of Mando. This is a strong endorsement of the company's transparency. The current creditors who helped debt-finance the Chase consortium's leverage buy-out of Mando did so with strong reservations; after all, many of them were the same creditors (although different business departments) that had lost a lot of money on Halla-related loans. Such endorsement of transparency is a clear indication that Mando's accounting and reporting standards are now significantly high.

### Incentives for fiduciary duty

The new Mando has introduced meaningful incentives to ensure fiduciary duties. Originally, twelve senior managers were included in a management co-investment plan; seven more were added later. The co-investment plan is similar to a management buy-out (MBO) plan in that investors back the management team in the acquisition and management of a business. Although this type of management buy-out arrangement was not required to complete the acquisition of Mando, the investors felt that it was a strong tool in having management shift loyalties to the new owners as well as to properly undertake fiduciary duties. These managers invested large amounts of their own individual assets at prices significantly lower than what the Chase consortium paid. Further incentives include generous stock option plans that are based on performance milestones. An investor of Mando said, "The MBO accomplishes two things: management's own assets are at stake, and they have the opportunity to approach business as owners."

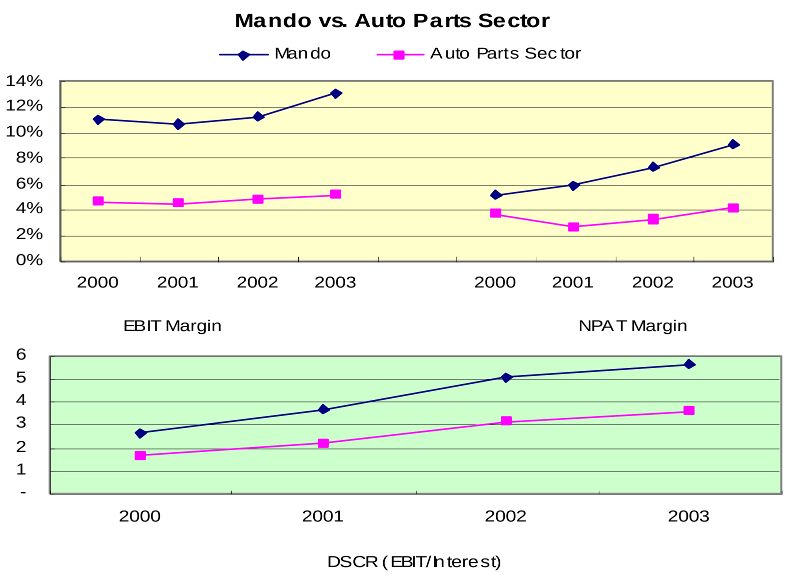
The investors needed the management to focus on profitability and mitigation of business risks, and they felt that management needed to stop working for Chung and to work for shareholders. If the co-investment plan and stock options are the incentives, then the business plans are the tools. Business plans serve as the benchmark for which performance is measured. They are not haphazardly prepared projections, but rather, very detailed plans that contain just about every type of quantitative and qualitative performance standards. To give but a few examples, these plans had targets for revenue, earnings, customer diversification, cost reductions, productivity increases, quality control standards, new market expansions, capital management, and new product developments. Each business plan is negotiated for several weeks before both the board and management 'sign off' on it. Once signed, the management is expected to deliver. A senior vice-president at Mando stated that the "business plan is extremely helpful" in that responsibilities are clear. He also added that contrary to what other people might think, "The detailed plan is not restrictive in the sense that managers are free to choose how they want to achieve these targets." Through share incentives and concrete targets, the new system has created an atmosphere where managers no longer think of loyalty to a larger "group" or chairman, but rather to their responsibilities of the business. Managers now work for shareholders, including themselves.

## Performance under Changing Corporate Governance

Did the changes in corporate governance help? Do a stronger and more independent board of directors, better transparency, and compliance with fiduciary duty actually increase performance? To assess performance in terms of changing corporate governance, it is necessary to remove regular business elements as possible contributors to increased performance, and then observe the residual or unaccountable reasons as justifications for the likely benefits of improved corporate governance. By comparing some of Mando's financial performance ratios to those of the auto parts industry, it is evident that certain changes have enabled the company's performances to exceed its peers. Figure 2 illustrates these differences. For Mando, the average operating profit margin and net profit margin between 2000 and 2003 were 11.5% and 6.9%, compared to the auto parts industry averages of 4.8% and 3.5%, respectively. Average debt service coverage ratio as defined by EBIT (earnings before interest and tax)/interest expense for Mando was also higher at 4.2 times, compared with 2.6 times for the industry.

Mando is essentially the same businesses as before and is run by the same management team. Yet, what these figures indicate is that the company is consistently outperforming its respective industry peers in all areas, and most of the time, the differences between them are increasing as well. Given that the only differences are the new controlling shareholders and the new corporate governance system, one can begin to see that improved corporate governance could have played an integral part in enhancing performance. In order to evaluate the benefits of the changed corporate governance, this paper focuses on business risk, debt management and earnings and profitability.

**Figure 2: Financial Ratios – Mando vs. Auto Parts Sector**




Source: Mando Annual Report (2003)

## Reduction of Business Risk

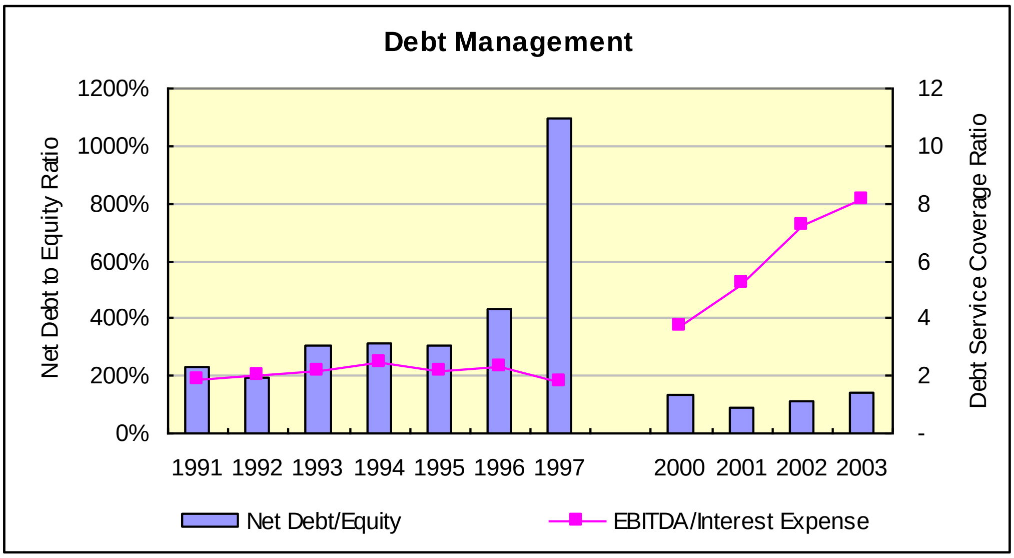
When the company is relying on a single source for its earnings, it is exposed to significant business risks. Over-reliance on one or two customers not only weakens a company's pricing power, but it also links the company's future to the fate of another company. As of 1999, nearly 85% of Mando's revenues came from Hyundai Motors or affiliates of Hyundai. The remaining 15% came from Ssangyong Motors (less than 3%) and from sales to several small and medium-sized domestic and international companies. The dominance of Hyundai was obvious. Family relations between Halla and Hyundai provided steady business to Mando Machinery Corporation. In order to counter the over-dependence on one customer, management had continuously attempted to break into the Big Three (GM, Ford, and Daimler Chrysler). Before 1999, there were some samples sent back and forth for testing and development purposes, but no major orders were placed. A senior Mando executive said that Mando Machinery Corporation did not have the financial resources to develop products demanded by the Big Three and that the Big Three rejected Mando Machinery Corporation because of its weak financial structure.

In 2001, less than two years in the transition, Mando received its first order for steering columns from Ford. Several months later, it received its first order for braking systems from Daimler Chrysler. Revenue breakdown by customer was not publicly available for 2003, but a senior manager at Mando and an associate director at UBS Capital mentioned that Hyundai's share had gone below 60%. Although the figure remains high, a drop from 85% to below 60% in four years and in a time of increasing orders from Hyundai is a meaningful accomplishment. It is clear that management is actively pursuing ways to reduce the risk of depending too much on one customer.

## Debt Management

Creditors and shareholders use different tools to measure a company's debt management. Shareholders or equity investors tend to look at debt to equity ratios as an indicator of financial strength, and creditors or loan officers tend to look more at debt service coverage ratios (DSCR) as a gauge for repayment capabilities. Debt to equity ratios are good proxies for assessing the financial health of a business. Although many of Korea's regulations focus on the ratio as defined by the percent of total liabilities to shareholders' equity, debt to equity ratio here uses net debt. Net debt is defined as all the interest bearing debt less cash and equivalents. Net debt to equity is a better measure for the financial health of a company because any last minute adjustments to debt levels for reporting purposes can be offset by observing the changes in cash balance. While there are also several ways to calculate DSCR, we use the simple ratio between EBITDA (earnings before interest, taxes, depreciation, and amortization) and interest expense. Those DSCR ratios that include principal repayments and capital expenditures are too extensive to display here and add no meaningful additional value to this discussion.

**Figure 3: Debt Management**




Source: Mando Annual Report (2003)

Figure 3 shows the changing patterns of debt management under the old and new corporate governance systems. Net debt to equity ratio moved from the 200% level in the early 1990s to over 400% in 1998 and almost 1100% in 1997. Net debt to equity levels around 200% are sustainable in the long run, but once levels exceed 300%, the company faces serious problems. During the turbulent years of 1998 and 1999, which are not shown here , net debt to equity exceeded 1200% and DSCR fell below 1x.

Under the simple DSCR calculation method as set out above, a 1x DSCR means that all the operational income (EBITDA) is spent on interest payments. A 2x DSCR means that half of operational income is spent on interest payments, etc. For seven years, DSCR hovered near 2x. This is not enough to repay principal amounts. As such, it is clear why debt levels kept rising. Mando Machinery Corporation needed to rollover repay existing loans. Such practices are obviously very risky. If the credit market contracts, the company would not be able to meets its obligations. This is exactly what happened in 1998. Since 2000, there is a remarkable turnaround in the company's debt management. Net debt to equity remains below 180% and DSCR rises dramatically from a little under 4x to over 8x.

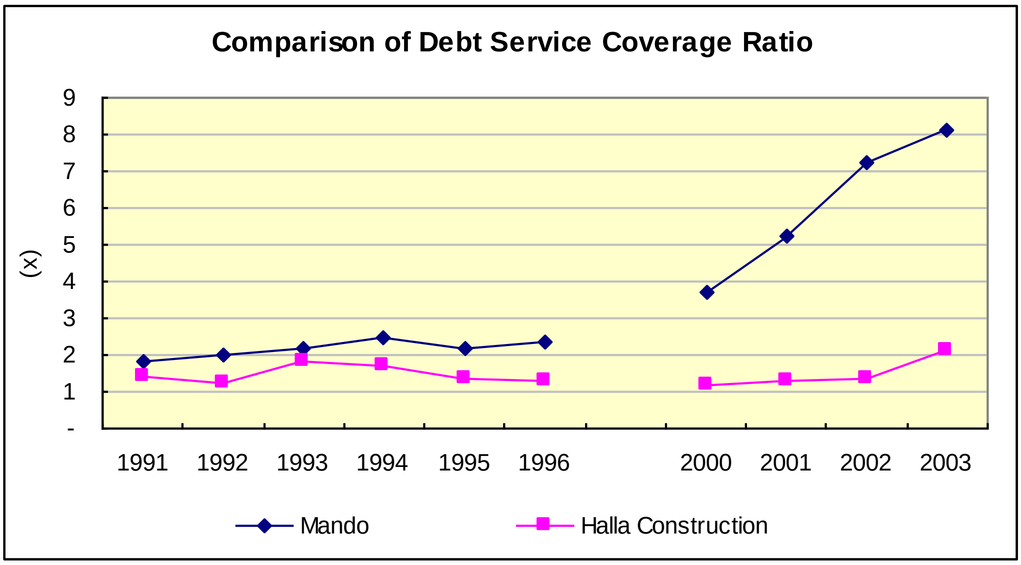
A number of non-corporate governance measures can explain the improved financial health. The original acquisition was favorably leveraged without the burdens of Halla Group debts. While this is true, the acquisition leverage ratio was at 200%. In addition, debt covenants undertaken by Mando with the new creditors only required a net debt to equity ratio less than 200% and a DSCR greater than 3x. With these creditors' demands as constraints, one could argue that management had no option but to simply follow. However, management did more than passively follow such constraints. In addition to the benefits received from lower market interest rates, management took further steps to re-finance the higher yield debts with low cost loans thereby reducing average interest rates by more than 15%. Furthermore, management continued to grow the business and increase EBITDA without undertaking debt-financed expansions.

So although market conditions and initial deal structuring helped, the management did actually become very pro-active in improving the company's financial health. Again, this paper does not argue that management was incapable of such performance before the business transfer, but rather, the changes in governance allowed management to focus solely on Mando and their fiduciary duties to both creditors and shareholders. The benefits of the changes to Mando's corporate governance becomes even more pronounced when comparing Mando's debt management performance to that of Halla Construction, a Halla Group company still under the control of Chung Mong Won. Figure 4 shows that while Mando's DSCR levels increase rapidly from 3.7x to 8.1x between 2000 and 2003, Halla Construction's DSCR only increases from 1.1x to 2.1x.

## Corporate Earnings

We now look at earnings. In fact, it is earnings (or profits) that essentially determine shareholder value. There are two factors that must be considered in earnings analysis: profitability (or earnings margins) and earnings growth. Furthermore, in terms of profits, we must consider at least two types of profits: operating profit and net profit. Operating profit (or EBIT – earnings before interest and taxes) measure performance at the operational level; it indicates how much the business makes in terms of its operations. EBIT does not include all those expenses related to financing, interest income and expenses and taxes. These items are subtracted from EBIT and results in net profit. In order to have good performance at the operating profit level, not only does management have to pay attention to revenues, but it also has to be concerned with costs like wages, raw materials, utilities, transports, office supplies, and advertising. Obviously, it must increase revenues and try to decrease costs or slow the rate of increase of such costs. If management is successful at increasing revenues and managing costs, operating margin, defined as operating profit as a percent of total revenues, will increase.

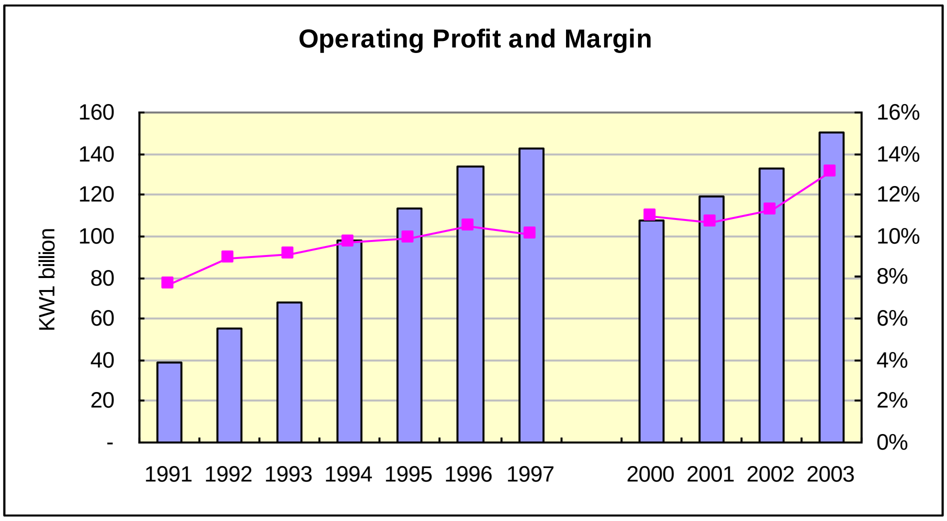
**Figure 4: Comparison of DSCR between Mando and Halla Construction**




Source: Mando and Halla Construction Annual Reports (2003)

Figure 5 illustrates operating profit and operating margins between 1991-1997 and 2000-2003. The figures represented between 1991 and 1997 reflect total operating profits of Mando Machinery Corporation. This includes profits from not only the three Mando businesses in Pyungtaek, Iksan, and Munmak, but also the climate control business in Asan and the highly profitable automobile electronics components in Kyungju. The 2000-2003 figures represent Mando's operating profits from only the automobile chassis businesses from the three plants in Pyungtaek, Iksan, and Munmak. Again, 1998 and 1999 figures represent the transitional period from Mando Machinery Corporation to Mando and were hence removed.

**Figure 5: Operating Profit and Margin for MMC and Mando**

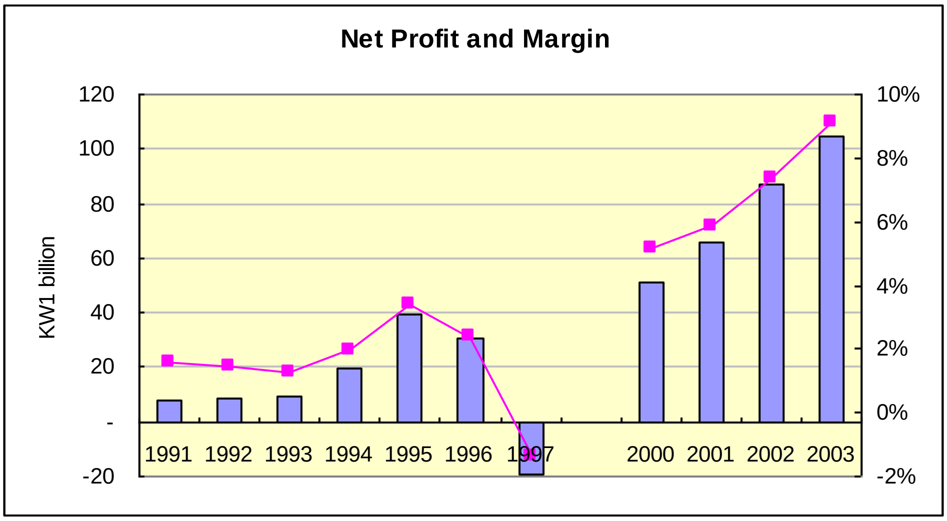



Source: Mando Annual Report (2003)

What is evident through this data is that management has focused on increasing profitability. Despite its smaller size, 2003 operating profit exceeds Mando Machinery Corporation's peak profit in 1997 of 142 billion Korean Won by 80 billion Korean Won, and it has improved operating margins from 10% in 1997 to 11% in 2000 and to 13% in 2003. As impressive as operating performance is, management's accomplishments at the net profit level are even higher. Figure 6 illustrates the dynamic shift in net profit between the Mando Machinery Corporation years and the new Mando years.

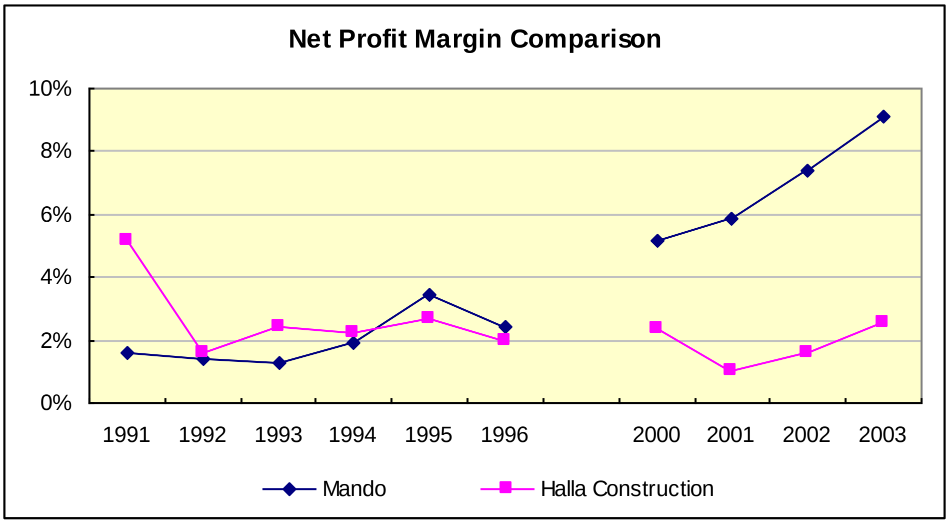
Mando Machinery Corporation management's commitment to the Halla Group is clearly evident by examining net profit trends during the 1990s. Net profit remained under 40 billion Korean Won, and its highest recorded net profit margin was 3.1%. A company that was earning between 40 billion Korean Won and 142 billion Korean Won in operating income was suffering because of huge interest expenses. By 1997, Mando Machinery Corporation was paying 147 billion Korean Won a year in interest payments alone. As with the discussion above on debt management, Mando was able to escape such burdensome leverage and report higher net profit margins. By 2000, Mando's three factories were turning higher net profit than all five factories combined did under Mando Machinery Corporation. Furthermore, the proactive debt and hence earnings management at the non-operating level allowed Mando to steadily increase its net profit from 50 billion Korean Won in 2000 to 105 billion Korean Won in 2003.

**Figure 6: Net Profit and Margin for MMC and Mando**




Source: Mando Annual Report (2003)

**Figure 7: Comparison of net profit margins between Mando and Halla Construction**




Source: Mando and Halla Construction Annual Reports (2003)

Over the course of three years between 2000 and 2003, shareholder value, if measured as a multiple of net profit (i.e., price to earnings ratio), increased more than two-fold. That translates to a compounded annual growth rate of 27%. Figure 7 shows the net profit margins of Mando and Halla Construction. Although margins were similar in the past under the Halla Group structure, Mando's new governance measures seem to have been instrumental in motivating management to deliver higher levels of net profit.

## DISCUSSION AND CONCLUSION

Corporate governance has become an important topic for the Korean business community. While there remain questions regarding which specific types of corporate governance work better in the context of Korea, people agree that the topic should be addressed as a strategic concern. Given the relatively short history of corporate governance studies about Korean companies, one may need to be careful in approaching to this topic. While there could be other factors than governance explaining the improved performance of Mando Corporation, the case illustrates that changes in corporate governance can bring impact. Three players interact in a traditional Korean company concerning governance - owner-founders or large shareholders, the board of directors, and professional managers. The present study highlighted the roles of the board of directors and professional managers in the transition processes from a traditional ownership structure of large shareholders to a more dispersed corporate ownership.

As seen in the case analysis, board members with expertise and knowledge about proper corporate governance should bring positive changes in the transition. They can introduce appropriate rules of how to run the company by clarifying roles and responsibilities of shareholders, board members, and senior managers. Stronger and more competent boards of directors independent of founder-owners may also motivate management to act on behalf of shareholders and creditors. In fact, it was not the management but the system, in the case of Mando, that led to poor performance in the past. It is fairly compelling to observe that the same management team performed very differently under different governance systems. Significantly increased earnings during the post-Halla years seem to reflect management's renewed attention to increasing shareholder value. Given strong incentives to properly undertake and fulfill fiduciary duty, management can be realigned with shareholder interests.

Our findings suggest that the success formula is a combination of 'system' and 'people.' In many cases, particularly in recent corporate governance-related change efforts made by many Korean organizations, companies introduced new governance systems fairly successfully, only to see not much of meaningful changes actually happened. The findings from the case of Mando Corporation imply that people as well as system should be in place. For example, transparency requirements under improved accounting and reporting standards help directors, shareholders, and creditors in properly monitoring the managers. Yet, transparency per se may not be sufficient. A board of directors who are knowledgeable about both the operations and finance should be working with the system.

Much of the corporate governance improvements at Mando were driven more by the new shareholders and creditors than by the sweeping reforms in the whole economy. However, these measures are not asynchronous to Korea's overall corporate governance reforms. Recent corporate governance reforms that address board efficacy, transparency, accountability, monitoring, shareholder and creditor rights, and fiduciary duty are all reflected in the Mando case. Although one case is clearly not enough to prove the benefits of good corporate governance on management performance, it does serve as a strong example of how good corporate governance increases shareholder value.

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