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October 5, 1984

Mr. Peter Bird Martin, Director
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Dear Peter,

"No other people in the world work like Koreans. With so many people crowded in such a small space, we've got to be aggressive or we cannot live." These words came from Lee Seung Yeun, a former Minister of Finance who is now president of the Overseas Construction Association of Korea, trying to explain why Korean companies rushed to the Middle East in search of new contracts following the second oil price shock in 1979, and why now many of these same companies will face bankruptcy unless the Korean government steps into save them. "The present difficulties are of our own making," says Mr. Lee.

Korea's economic predicament in many ways resembles Japan. South Korea has few natural resources. (North Korea is far more richly endowed.) The nation has little arable land and a population density exceeding 400 persons per square kilometer. Korea imports 75% of its energy requirements and last year alone paid $5.77bn for imported oil.

Yet for the last decade Korea found that it could partially hedge against the price of oil by participating in Middle East construction projects worth billions of dollars annually. The value of overseas contracts rose from $2.5bn in 1976, to hit a peak of $13.7bn in 1981. (Of course, not all of those dollars were repatriated.) The overseas construction industry has provided Korea with 8% of its foreign exchange earnings over the decade, and has provided employment abroad in recent years for 160,000 Korean workers, or 1.5% of the nation's non-agricultural labor force.

The work abroad dovetailed neatly with Korea's domestic economic development. As a surge of domestic construction tapered off in the 1970s, Korean contractors were able to

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pick up the slack by looking abroad. They sometimes found themselves working jointly with engineering firms from Europe and the United States. They learned new technology, which they tried out at home and then in new projects in the Middle East which they were able to complete on their own.

The Korean companies gained their first experience abroad during the Vietnam War, working for the U.S. Army Corp of Engineering. They began bidding in Saudi Arabia in the early '70s, bringing to the Middle East a highly disciplined, inexpensive labor force well experienced in basic civil engineering and architectural projects. They moved earth, built highways, and constructed simple apartment and office complexes.

But like all contractors of that period, they found their profits severely squeezed by on-site logistical problems. Saudi harbors were so badly clogged that ships took over half a year to unload their cargoes, after which time food had spoiled and cement had become useless. But the Koreans stuck it out and began to put in higher bids to account for the higher on-site costs. When the Saudi government suddenly made a determined and successful effort to unclog the harbors in 1976, the Koreans found themselves earning fabulous profits on projects where they had anticipated much higher costs.

With such hefty profits to be won, though, competition heated up quickly and profit margins began to slip as early as 1978. Still there was plenty of business to go around. Contract volume to Korean companies more than doubled in 1978 to pass $8bn, and in 1981 and 1982, Korean companies won more than $13bn in new projects.

But, while the decline in world energy prices helped stimulate a 9.3% growth rate in Korea during 1983, it forced the oil-producing countries to scale back their construction plans. In Saudi Arabia alone, where Korea has won 62% of its projects, new contracts to Korean contractors declined last year to $4.467m from the previous year's total of $8.347m. A mammoth $3.4bn irrigation project in Libya kept the 1983 total overseas contract volume over $10bn, but industry specialists do not expect this year's total to exceed $8bn, 40% lower than two years ago. Some of the companies have not received new orders in over a year, and they have millions of dollars of construction machinery sitting idle on the ground while they must continue to pay interest on loans to cover their purchase.

Saudi Arabia has also been paying its bills more slowly. Hyundai Engineering and Construction, Korea's largest contractor and one of the largest in the world with assets over $2bn, is still waiting for a final $60m payment on the Al Khobar Housing project in Saudi Arabia, which it turned over to the

Saudi government over a year ago. Hyundai says the final payment has been tied up by disputes over the work, which to some extent is normal in any final settlement. But it is no secret that Saudi Arabia has less money than it used to, and the Saudi Ministry of Housing is nortorious for failing to pay its bills on time. As one industry executive put it, even within the terms of a contract, "There are many ways to delay payment." Hyundai, which is part of a huge business conglomerate can absorb the shock with help from other members of the group, but some smaller companies are as much as 240 days behind in their receivables accounts and have simply run out of money.

The slowdown from abroad coincided with an anti-inflationary, tight money policy at home, putting a severe squeeze on the contractors, which tend to be highly leveraged. The industry average debt-to-equity ratio was 4.81 in 1983, with three fourths of the debt in short term obligations. Keang Nam Enterprises, the fifth largest contractor with assets of almost $600m in 1983, had a net worth of only $45m, giving it an incredible debt ratio of 11.9, with hundreds of millions of dollars of short-term debt. Keang Nam has, in fact, gone broke. It has been placed under bank management and is likely to be merged with Daewoo Corporation, another of the industry giants, in order that its current projects can be completed.

For over a year now, the construction companies have been crying to the government to release more money through the banks and lend it to them. But the Finance Ministry has taken a hard line. It has first insisted that the companies sell their substantial holdings of real estate in Korea, which the companies began to purchase in the late '70s as a hedge against inflation and currency devaluation. Some companies have been forced to auction off their corporate headquarters and even the private mansions of company chairmen as a condition for obtaining more bank financing. Some companies have successfully resisted though. Bankers says that Hanyang Corporation, the fourth largest, threatened to sell the construction company itself rather than give up a prominent chain of supermarkets that provides an excellent cash flow and promises to be even more profitable as Korean life styles continue to change.

The experience of Kumho Construction and Engineering is typical of the smaller companies. It jumped on the bandwagon and won its first contracts in 1979, bidding on projects in the $20m to $50m range. After some initial profits in the early years, the company says it lost "heavily" on the Amman International Airport project, which was completed two years behind schedule. The company blames entirely the incompetency of the Jordanian government and has lodged claims against the Jordanian Ministry of Transportation. In Saudi Arabia, the company was forced to hire a European firm to solve unexpected technical problems, further eroding profit margins.

In the mean time, Kumho found its competitive edge in basic civil engineering projects reduced by the influx of contractors from Turkey, Pakistan, and India, with labor costs just a third of Korean workers, and it has not bid successfully on a contract since May 1983. The company's machinery now sits idle in Saudi Arabia, while the company awaits a Korean government decision on whether to allow it to import the foreign-manufactured machines for use on domestic projects. Korea generally prohibits such imports in order to protect its domestic industries.

Although Kumho is a relatively small contractor, it is still part of a diversified business group, and has been able to withstand the financial shocks with help from the other companies. It expects to finish its current projects in an orderly manner and will soon merge with another group company to improve its financial structure. It has not ruled out the possibility of bidding on another project, but is prepared to withdraw completely from overseas work and concentrate on the domestic market, which has been more profitable in recent years.

But the independent contractors are facing more severe difficulties. Some will be forced to halt work if they do not receive help soon. A handful have been taken over by their banks, and placed under the management of the larger, healthier companies. But the government has been running out of large companies willing to consider managing a troubled smaller one.

Slowly, though, the Korean government seems to be inching toward a bailout of the industry. It has released nearly $100m through the Korean Export-Import Bank and invited the companies to apply for loans. But bankers say that many times that amount will be needed if business conditions in the Middle East do not improve soon. There are reports that the government is considering plans to convert up to $500m of short term debt to long term loans with generous payback provisions, but government economists worry that a massive, indiscriminate bail out would upset their anti-inflation policies, which are a cornerstone of the current five year economic development plan.

Still no one thinks the government will let the industry go under. Says Mr. Lee of the OCAK, "The government will act to maintain Korea's image abroad and carry projects successfully to completion."

Mr. Lee says he does not expect a repeat of the boom in contracts that came in 1981 and 1982, since most of the basic infrastructure in the Middle East has been built. He is also pessimistic about Korean efforts to diversity on a large scale to non-Middle Eastern markets, which accounted for only 15% of new contracts last year. As Mr. Lee says, "There is no place in the world like the Middle East." There is no place with so much cash and such a poorly developed domestic labor force.

The market in the Middle East, in addition to shrinking, has also been getting more risky. Last year, Libya suddenly began to pay its bills in crude oil, and contractors initially took as much as a 15% loss, receiving the oil valued at the OPEC peg price, and selling it thirty to forty days later on the spot markets of Europe. Some of the Korean companies have also been trying to play both sides of the Iran-Iraq war, working on projects in both countries. One company executive practically threatened me if I made public his company's activities, even though it is a matter of public record and has been reported in international newspapers. The companies have just recently returned to Iran, a country that has an impeccable payment record, and they worry about reprisals from Iraq.

In fact the whole situation has become so dicey that the government and many companies involved are embarrassed and refuse to talk about it. If a government bailout ever materializes it is unlikely to be accompanied by any public pronouncements, but will show up in the year-end financial disclosure statements of companies as a massive reduction of short-term debt.

Of course no one like to air their dirty laundry, and for individual companies and their management, the past year has been painful. The construction companies' difficulties illustrate weaknesses that run through the Korean economy, especially in their poor financial structure due to a high level of debt. The plight of the companies also illustrates what sometimes seems to be a national characteristic: lack of foresight. As Mr. Lee of the OCAK says, "After the second oil shock in 1979, Korean companies rushed into the Middle East without a thorough knowledge of the market and they overextended themselves."

Yet from a broader perspective, the industry's experience is one illustration of why the Korean economy has grown so rapidly. The construction industry is notoriously cyclical throughout the world. The Korean companies rode the boom successfully, and it is hard to see how they could ride out the declines without a few bumps. More important, as a hedge against energy prices, the industry has worked perfectly. When asked which he would have preferred for Korea's economy, high oil prices and a booming construction industry, or cheap energy prices and a construction recession, one official from Korea's Economic Planning Board did not hesitate to choose the latter. The willingness to take risks and diversity is a basic strength of Korea's economy. Even some of the setbacks, such as having to accept payment in crude oil, may prove a long-term benefit. The companies now have developed in-house experts on the oil spot markets. The companies say they no longer lose money on the transactions, despite the higher risks, and these experts will be a great resource for Korea, which will continue to have to purchase oil on international markets.

Moreover, the industry is far from dead. some of the medium and small companies will be forced out of the overseas market, perhaps eventually bringing the number of companies working abroad down from over 50 to around 30. Yet those that remain will be the giants that have accounted for over 80% of the overseas business as it is. And those companies--Hyundai, Daelim, Daewoo--have the financial muscle and the technological capability to move higher and higher in the market, to bid on more sophisticated factory or power plant projects using more of their own in-house engineering. Michael Wood, of the National Commercial Bank of Saudi Arabia, says the Korean companies have a distinct advantage when operating in the Middle East because of their knowledge of the market, their experience, and their lower mobilization costs due to their sizeable presence in the area.

The future size of the Middle Eastern construction market depends on the health of the world economy and on the price of oil. But whatever the actual size, it will be substantial and Korean companies will be there to take a major portion of the business.

Best,

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Received in Hanover 10/15/84