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18:04 05Sep2008 ANALYSIS-Market turmoil adds hurdle to KDB-Lehman deal

By Michael Flaherty and Park Jung-youn

HONG KONG/SEOUL, Sept 5 (Reuters) - A wave of financial market turmoil that crashed into South Korea this week has made any deal between Korea Development Bank (KDB) and Lehman Brothers <LEH.N> all the more difficult to pull off.

Waning confidence in the country's worsening balance of payments has triggered concern about a potential flight of capital from Asia's fourth-largest economy.

The won currency <KRW=> sank as much as 6 percent this week before rising sharply on Friday on suspected intervention; the stock market <KS11> has dropped 12 percent in five weeks and a Merrill Lynch research report said the central bank may raise interest rates by 0.75 percent over the next three months.

All this comes as state-run KDB pores over a deal with Lehman, a 158-year-old New York brokerage that's seen its shares plunge 75 percent this year, hit by exposure to subprime mortgage securities.

With Lehman's market capitalisation at \$11.7 billion, any big investment by KDB would likely cost several billion dollars and involve loans and other banks. The timing does not look good.

"If you look at the Korea specific context in the current economic environment, there are uncertainties over Korea's external position," said Takahira Ogawa, director of sovereign ratings at Standard & Poor's. "If KDB needs funding, the cost of the funding would be very significant."

Wall Street has proved it can get deals done in good times, and bad. And, given that KDB's CEO is Lehman's former Korea head, a deal between the two cannot be ruled out.

(For profile of KDB chief, click [ID:nSEO141444])

But the economic backdrop, and other negative factors lurking, make a link-up look increasingly difficult.

The aversion to risk, of course, is not just a South Korean issue, but a global problem, fed by the credit crisis that sprang from Lehman's hometown just over a year ago.

"KDB will have to think real hard about whether Lehman is worth taking the risk," said Choi Doo-nam, an analyst at Prudential Investment & Securities, adding that the market's impact on the deal depends on price.

"If KDB is talking about 6 trillion won (\$5.3 billion) for a 25 percent stake," he said, referring to media reports, "I'm not so sure it's worth taking such tremendous market and financial risks."

STATE FACTOR

Government intervention is also a factor. Although KDB is in the process of privatising, state officials can still weigh in.

Like China, South Korea has seen its investments in Wall Street fall fast. Shares of Merrill Lynch <MER.N> have more than halved in value since Korea Investment Corp, a sovereign fund, agreed in January to buy \$2 billion worth of new preferred shares in the subprime-hit bank.

"In the middle of privatising, KDB proposes a major stake in a bank and the subject of the investment is having trouble?"

S&P's Ogawa pondered. "I don't think the government will be happy with this stake."

The chances of a deal have not been helped by several Korean banks denying reports they may join KDB in its investment. Sources told Reuters on Wednesday that HSBC <HSBA.L><0005.HK>, Europe's biggest bank, isn't likely to make a move either. And neither is China, sources say, given a deal it almost struck with Bear Stearns just before the U.S. bank collapsed.

That said, Lehman looks cheap.

"Will KDB have another opportunity to buy a significant stake in such a reputable global investment bank like Lehman?" Prudential's Choi asked.

And, some argue, the overall fundamentals of South Korea's economy are sound at the moment.

"Generally, the Korean economy is reasonably resilient, the fundamentals are still pretty strong," said Brayan Lai, a Calyon credit analyst. "A Korean deal is feasible. Obviously price will be the question here."

Lai said that while South Korea does face a mini currency crisis, its reserves should provide an adequate buffer.

A veteran banker based in Hong Kong, who did not want to be named due to the sensitivity of the issue, said KDB has eyed buying an investment bank with a global network. While Lehman's roots are in broking, it has a large investment banking franchise that has expanded rapidly in Asia in recent years.

Taken overall, however, a possible KDB-Lehman deal has fallen on brutally tough timing.

Just last week, South Korea's Doosan Infracore <042670.KS> said it and an affiliate would pump a combined \$1 billion into companies set up to buy the Ingersoll-Rand <IR.N> units it agreed to buy in the United States last year.

When Doosan announced that \$4.9 billion Bobcat deal, the buzz was that Korea was poised for more outbound acquisitions.

The \$1 billion Doosan just coughed up likely spooked Korean bankers and buyers looking abroad -- KDB included.

(Editing by Jonathan Hopfner & Ian Geoghegan)

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