OPINION

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The Rise of Marginal Firms and the Implications of Stricter Delisting Criteria

The recent reform announced by financial authorities to tighten delisting requirements represents a meaningful step toward restoring market confidence while facilitating the timely exit of marginal firms. This initiative aims to enhance capital market integrity by reducing inefficiencies in the delisting system. Notably, restricting firms with non-clean audit opinions to a single improvement opportunity and expediting the delisting process are expected to strengthen market soundness. However, the persistence of marginal firms is a structural issue primarily driven by prolonged low interest rates and accommodative monetary policies, as well as industrial shifts and support practices of government and financial institutions. To maximize the effectiveness of this reform, a holistic approach is needed, encompassing measures such as increasing competitive pressures within the market, reassessing financial support programs, and ensuring full disclosure during the delisting review process. Additionally, efforts should be made to refine the application of market capitalization criteria and to strengthen investor protection, particularly for asset-rich firms that continue to trade below their liquidation value. While this reform lays the groundwork for addressing the issue of marginal firms, a consistent and sustained policy response is necessary to enhance corporate sector efficiency and further reinforce investor confidence in the Korean capital market.

Proliferation of marginal firms and weakening competitiveness of the stock market

Amid rising interest rates and deteriorating internal and external economic conditions, the proportion of financially vulnerable publicly listed firms has been increasing rapidly in Korea. As of the end of 2023, approximately 41% of all listed firms in Korea were unable to cover their

∗ All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

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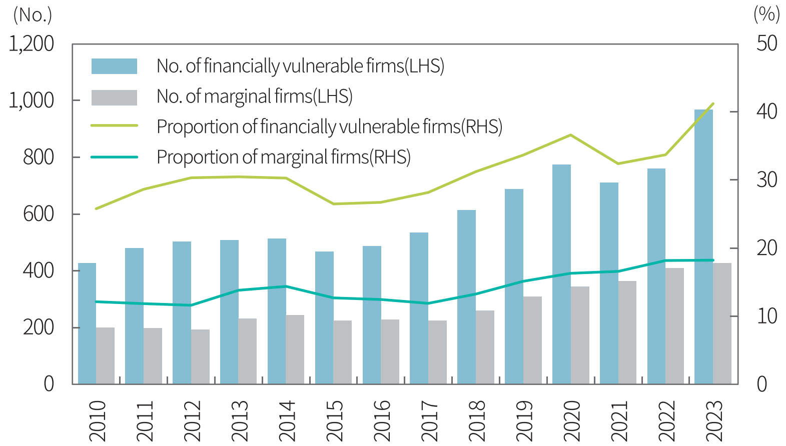
interest expenses with operating profits, with around 18% reporting an interest coverage ratio below 1 for three consecutive years (see Figure 1). The conditions of these marginal firms have worsened since 2017, fueled by the U.S.-China trade dispute and the COVID-19 pandemic. In particular, the prolonged existence of financially distressed firms, especially in the KOSDAQ market and among small-cap companies, has contributed to the rise of so-called "zombie firms."

Figure 1. Trends in financially vulnerable and marginal firms



Note: Financially vulnerable firms refer to the firms with an interest coverage ratio of below 1, and marginal firms represent those with the ratio of below 1 for three consecutive years.
Source: DataGuide, Korea Capital Market Institute (KCMI)

The surge in marginal firms is not merely a firm-specific issue but has broader implications on the stock market, lowering investment incentives and weakening market competitiveness. First, the management of struggling firms often resort to unfair trading practices, such as opaque fundraising activities and excessive M&A deals, to secure financing.[1)] More recently, cases of accounting fraud, including the fabrication of sales figures, have been reported as firms attempt to avoid delisting.[2)] These practices not only harm investors but also erode overall market confidence.

Furthermore, marginal firms inefficiently absorb scarce economic resources, undermining the productivity and growth potential of viable firms.[3)] Previous studies indicate that

1) Cressey, D.R., 1986, Why managers commit fraud, *Australian & New Zealand Journal of Criminology* 19(4), 195-209.

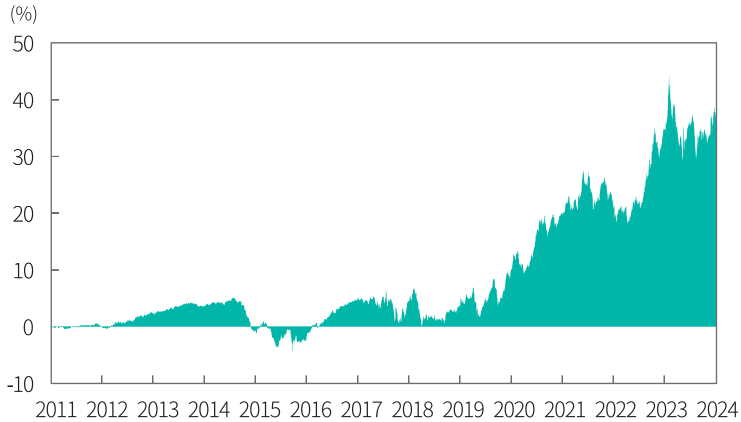
2) Financial Supervisory Service, "We will proactively conduct accounting audits to expedite the exit of marginal firms," Press Release, November 27, 2024.

3) Banerjee, R., Hofmann, B., 2022, Corporate zombies: Anatomy and life cycle, *Economic Policy* 37(112), 757-803.
Acharya, V.V., Crosignani, M., Eisert, T., Eufinger, C., 2024, Zombie credit and (dis-) inflation: Evidence from Europe, *The Journal of Finance* 79(3), 1883-1929.

a rising share of marginal firms negatively impacts employment, capital expenditures, and technological productivity of financially sound firms.[4)]

Empirical evidence also suggests that the prolonged presence of marginal firms adversely affects the stock market. The stock returns of marginal firms have persistently underperformed market averages, a trend particularly evident in the KOSDAQ market with a high proportion of marginal firms. For instance, if firms with an interest coverage ratio below 1 for three consecutive years had been excluded from the KOSDAQ index annually since June 2011, the index would have increased by an additional 37% as of June 2024 (see Figure 2).[5)]

Figure 2. Incremental return effect of marginal firm exits on the KOSDAQ market



Note: 1) Cumulative incremental returns under the assumption of the exit of marginal firms from the KOSDAQ market from July 2011 to June 2024.
2) Marginal firm exits assume the permanent removal of firms with an interest coverage ratio below 1 for three consecutive years at the end of June each year.

Source: DataGuide, KCMI

Ultimately, the timely delisting of marginal firms and the enforcement of stricter eligibility criteria for publicly listed companies are expected to accelerate the recovery of weak stock indices and contribute to more competitive and attractive capital markets in Korea. However, the existing delisting system has historically prioritized corporate rehabilitation, and delisting requirements have been continuously relaxed during economic downturns, delaying the exit of

4) Lee, S.H., 2021, "Need for Restructuring of Marginal Firms for Improved Business Dynamics," Korea Capital Market Institute, Opinion 2021-03.

5) In the KOSPI market, non-marginal firms account for a relatively high share of total market capitalization, limiting the impact of marginal firm exits on market returns. However, ensuring the timely delisting of marginal firms remains a critical issue for improving market confidence.

marginal firms from the market.[6] This highlights the need for a structural shift in the delisting system to strengthen market competitiveness and restore investor confidence.

Strengthening delisting requirements and enhancing procedural efficiency

In January 2025, financial authorities announced a reform plan for the delisting system to enhance capital market credibility and facilitate the effective exit of marginal firms.[7] This reform focuses on revising financial requirements to better reflect market realities, streamlining delisting procedures, and strengthening investor protection measures.

First, the financial criteria for delisting will be significantly tightened. The minimum market capitalization threshold for the KOSPI will be gradually raised from KRW 5 billion to KRW 50 billion by 2028, while the threshold for the KOSDAQ will rise from KRW 4 billion to KRW 30 billion. The revenue requirement will also be adjusted, with the KOSPI threshold increasing from KRW 5 billion to KRW 30 billion by 2029 and the KOSDAQ threshold rising from KRW 3 billion to KRW 10 billion. These adjustments reflect concerns that previous thresholds were too low to enforce effective delistings, aiming to promote a more rigorous assessment of firms' business continuity and financial health.

Additionally, the requirements related to audit opinions will be strengthened. Firms receiving a non-clean audit opinion for two consecutive years will be subject to immediate delisting. This measure is designed to prevent firms that fail to ensure financial statement reliability from remaining in the market for an extended period, thereby reducing investor risks and enhancing accounting transparency.

To expedite the delisting process, review procedures will be streamlined with shortened improvement periods. The maximum improvement period in the KOSPI market will be reduced from four years to two years, while the KOSDAQ market will transition from the existing three-stage review to a two-stage process, with the improvement period shortened from two years to one year and six months. Furthermore, formal delisting criteria will be evaluated in parallel with substantive review criteria to prevent unnecessary delays in the delisting process.

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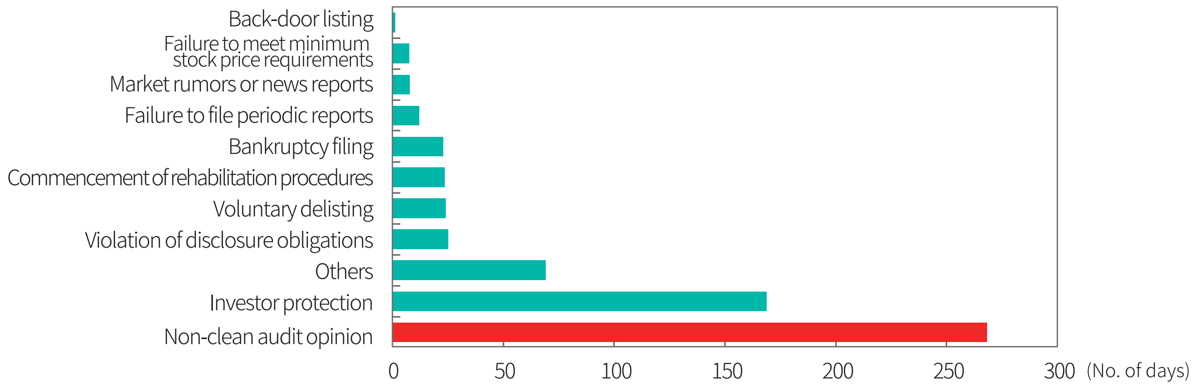
6) Specifically, the scope for appealing formal delisting reasons was expanded in 2014, and audit opinion requirements were relaxed in 2019, allowing firms receiving non-clean opinions to resolve delisting risks through subsequent audit opinions. In 2022, corporate performance requirements were eased, and the application of rehabilitation-focused substantive delisting reviews was expanded, further easing delisting requirements.

7) Financial Services Commission, January 21, 2025, "Improvement Measures for the Delisting System."

Additional supplementary measures will be introduced to mitigate market disruptions and enhance investor protection. To ensure trading continuity after delisting, the Korea Financial Investment Association (KOFIA) will establish a "Delisted Companies Division" within its K-OTC (Korea Over-the-Counter) platform, allowing delisted stocks to be traded for up to six months. On top of that, companies undergoing the delisting review will be required to publicly disclose key details of their submitted improvement plans, enabling investors to transparently access business continuity information of firms facing desilting risks.

Following the implementation of reform measures, a significant number of marginal firms that fail to meet the revised listing eligibility criteria are expected to face earlier delisting. Based on financial criteria alone, as of the end of 2024, approximately 8% of KOSPI-listed firms and 7% of KOSDAQ-listed firms fell short of the newly strengthened financial requirements. Furthermore, firms receiving non-clean audit opinions will be granted only one opportunity for improvement, potentially addressing a major source of procedural delays in the existing delisting review. This is expected to significantly enhance the efficiency of the delisting process (see Figure 3). Ultimately, this reform measure will help prevent prolonged trading suspensions, restore the price discovery function of the market, and improve investment liquidity, contributing to the recovery of market credibility.

Figure 3. Average trading suspension duration by reason for suspension



Note: 1) Average trading suspension days by reason for suspension from January 2010 to the end of June 2024.
2) Firms whose trading was suspended for multiple reasons were excluded from the sample, and cases where the cause of suspension was resolved on the same day were also excluded from the calculation.

Source: DataGuide, KCMI

Future challenges

The rise of marginal firms is a structural issue driven by a combination of factors, including accommodative monetary policies, industrial shifts, and support programs of the government and financial institutions programs. Academic research highlights that the prolonged low interest rate environment and monetary policy easing following the 2008 global financial crisis primarily contributed to the proliferation of marginal firms.[8)] Other contributing factors include the failure to adapt to technological innovation and industrial transformation, leading to firms falling behind in the competition,[9)] overly accommodative government subsidies and fiscal policies,[10)] and lenient lending practices of financial institutions.[11)]

To fundamentally improve the issue of marginal firms, tightening delisting requirements should be a starting point, but a holistic approach is needed, taking into account structural aspects of the market. To enhance the effectiveness of the recent reform and structurally mitigate the marginal firm problem, additional measures should be considered.

First, it is necessary to increase competitive pressure in the market. Although the strict removal of marginal firms can enhance overall stock market competitiveness, timely assessment of such firms remains a significant challenge, particularly given Korea's industry structure, which relies heavily on cyclical, intermediate-goods exporters. This inevitably entails the risk of erroneously classifying viable firms as marginal firms. Since uniformly strengthening delisting criteria alone is insufficient, a regulatory framework that fosters competition within the market is needed to ensure the swift exit of low-productivity firms through market discipline.

Second, support practices of the government and financial institutions warrant reexamination. Government policies aimed at mitigating an economic downturn can

8) Banerjee, R., Hofmann, B., 2022, Corporate zombies: Anatomy and life cycle, *Economic Policy* 37(112), 757-803.
Acharya, V.V., Crosignani, M., Eisert, T., Eufinger, C., 2024, Zombie credit and (dis-) inflation: Evidence from Europe, *The Journal of Finance* 79(3), 1883-1929.

9) McGowan, M.A., Andrews, D., Millot, V., 2018, The walking dead? Zombie firms and productivity performance in OECD countries, *Economic Policy* 33(96), 685736.

10) Andrews, D., McGowan, M.A., Millot, V., 2017, Confronting the zombies: Policies for productivity revival, OECD Economic Policy Papers No. 21.
Schivardi, F., Sette, E., Tabellini, G., 2020, Credit misallocation during the European financial crisis, *Review of Corporate Finance Studies* 9(3), 569597.

11) Caballero, R.J., Hoshi, T., Kashyap, A.K., 2008, Zombie lending and depressed restructuring in Japan, *American Economic Review* 98(5), 19431977.

inadvertently delay the exit of low-productivity firms and hinder the efficient allocation of scarce resources. Therefore, support programs for financially vulnerable firms should be implemented in a more selective and structured manner, considering corporate productivity and resource allocation efficiency within industries. Additionally, policy-based financing for firms undergoing the corporate rehabilitation process and lending practices for marginal firms must be thoroughly reviewed to prevent market inefficiencies.

Third, an incentive mechanism should be established to encourage companies to fully disclose delisting-related information. The recent reform mandates that key corporate improvement plans be disclosed during the delisting review process, which is a positive move as it allows investors to swiftly assess a firm's potential for improvement. However, it remains uncertain whether firms will transparently disclose adverse financial conditions without distortion. For this reason, complementary measures are needed to enhance the reliability and completeness of disclosures.

Fourth, specific measures should be reassessed to ensure the effective implementation of market capitalization criteria. Under current Korea Exchange regulations, a firm classified into a watchlist stock category for falling below the market capitalization threshold must remain under this threshold for a specified number of days within a 90-day period before being officially delisted. However, it must first remain below the threshold for 30 consecutive trading days to be initially placed on the watchlist. If the firm exceeds the threshold even for a single day within this period, it is exempt from watchlist designation.[12)] To address this issue, one potential improvement is to base delisting decisions on a firm's average market capitalization over a set period (e.g., quarterly or semi-annually), thereby reducing the risk of temporary fluctuations affecting watchlist and delisting decisions.

Finally, it is essential to refine regulatory frameworks to better protect investors. Concerns have been raised that when asset-rich stocks, which trade below liquidation value, are delisted, they may be liquidated at excessively low prices compared to their intrinsic value. To address the persistent undervaluation of such stocks, it is worth considering reinforcing market-driven M&A pressures while implementing regulatory measures to safeguard minority shareholder rights.

12) Refer to Article 47 (Designation of watchlist stocks) and Article 48 (Delisting) of the Securities Market Listing Regulations, as well as Article 53 (Watchlist stocks) and Article 54 (Formal delisting) of the KOSDAQ Market Listing Regulations.

Furthermore, an effective external monitoring system should be in place to assess the purpose and transparency of capital raising, preventing certain firms from engaging in reckless M&A deals or excessive paid-in capital increases merely to satisfy market capitalization thresholds. Additionally, it is crucial to enhance the trading infrastructure of the over-the-counter (OTC) market, ensuring continuity in transactions even after delisting from the main market. In this regard, adopting a system similar to the U.S. Pink Sheets platform, which minimizes entry requirements, could serve as an effective means to facilitate the trading of delisted firms. However, investors must fully bear the risks associated with speculative investments, a principle that should be firmly established as a fundamental market norm.

The recent reform of delisting criteria marks a meaningful step toward restoring market confidence by tightening delisting requirements and streamlining the process. However, stricter delisting regulations alone are insufficient to fundamentally resolve the issue of marginal firms. Therefore, this reform should be supplemented by additional policies that enhance market discipline and improve the broader environment. A more comprehensive and long-term approach will help structurally alleviate the issue of marginal firms while further reinforcing the competitiveness and credibility of the market.