"Are you thinking what I'm thinking?"

Mergers can be tricky.
Which deals should
you target and close?

Banking on mergers in Asian financial services

By Edmund Lin, Gary Turner, Chul-Joon Park and Prisana Ratanasuwanasri

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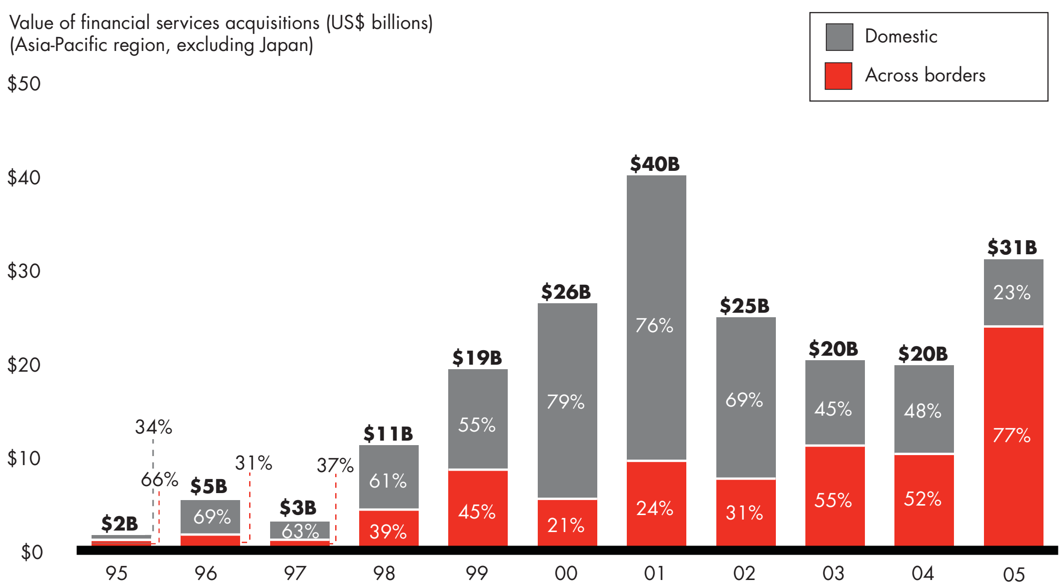
Mergers can be tricky. Which deals should you target and close?

From Beijing to Bangalore and Sydney to Seoul, deal fever is gripping Asia's financial services sector. The total value of mergers and acquisitions of banks, brokerages and insurers across Asian-Pacific markets topped $30 billion in 2005, making it the second-busiest year for M&A activity in the past decade. Notably, international investors have been staking out positions in the world's fastest-growing economies: Cross-border deals accounted for better than three-quarters of the value of all M&A activity last year. International private equity funds, with more than $100 billion to deploy across the region, have been especially active, accounting for nearly a quarter of total recent deal value. (See figure 1.)

Growth in national markets

Changes are sweeping financial services in national markets as varied as South Korea and Australia—and they are quickening the pulses of potential acquirers. (See sidebar, "A buyer's market in Asia,"on next page.) No market has exerted a more powerful draw than China, where the value of cross-border financial services acquisitions jumped 67% in 2005, to more than $15 billion. The upsurge is powered in large part by investors scrambling to forge alliances with local banks, insurance companies and fund managers before China opens its financial services sector to international competition under World Trade Organization rules in 2007. Also feeding the M&A appetite, the China Banking Regulatory Commission recently lifted the cap on foreign ownership stakes, from 15% to 20%. That move will enable international investors to exert increased control over their equity partners.

Figure 1: Cross-border deal activity is increasing

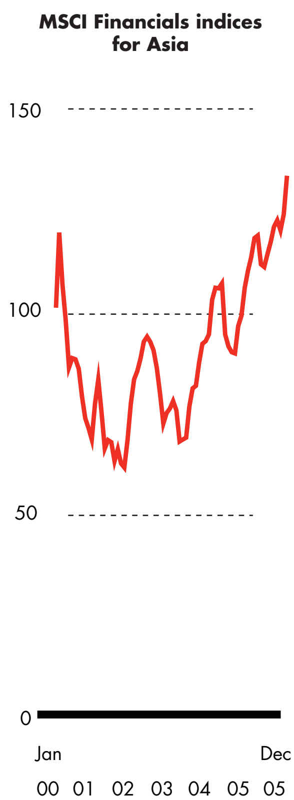


Sources: *Mergers & Acquisitions Asia Journal*, Bloomberg

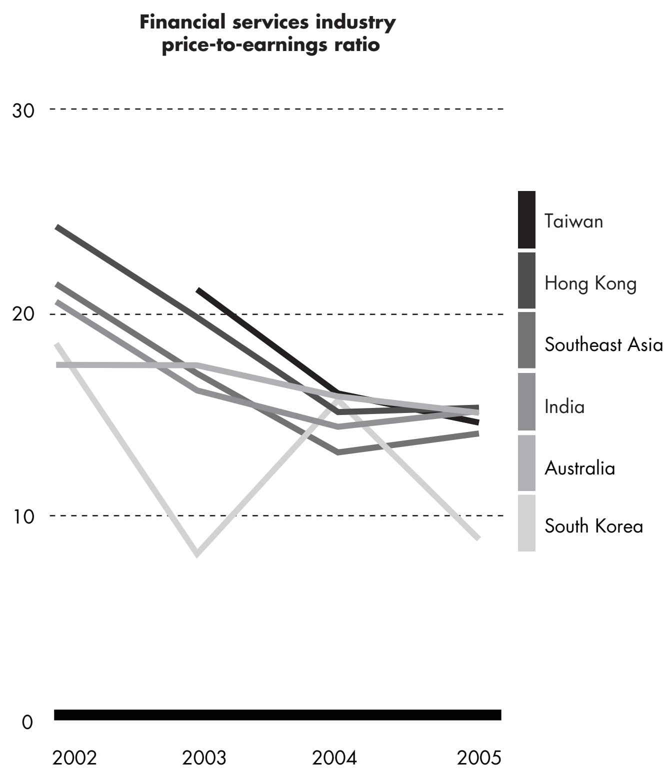
A buyer's market in Asia

The lure of Asian financial services companies is hard to resist—and buoyant economic growth is by no means their sole appeal. Attractive valuations have acquirers feeling the pressure to act while conditions are ripe. Shares of Asian financial companies, as measured by the Morgan Stanley Capital International (MSCI) Index, have rebounded sharply from their nadir in late 2001. Over the four years ending in late 2005, the MSCI-Asia index of financial services companies has doubled. Meanwhile, the financial sector's price-to-earnings ratios dropped across all major regional economies over the same period, making acquisitions a relative bargain.

Figure 2: Financial sector stocks are rising...



...but declining valuations may spur more deal activity



Note: Morgan Stanley Capital International performance indexed to 100 in January 2000; Southeast Asia price-to-earnings ratio is the weighted average for 27 banks and financial institutions across Indonesia, Malaysia, Philippines, Singapore, and Thailand

Sources: Bloomberg; JPMorgan Asia Pacific Equity Research

The merger trend is likely to remain strong as China taps foreign capital and looks for ways to strengthen its companies' capabilities as it pushes toward economic power.

In South Korea, deregulation and competitive pressures are also intensifying deal activity in financial services. Korean reforms put in place in the aftermath of the 1997 currency crisis have led to a fundamental restructuring of the banking sector. Financial institutions have shifted their focus from lending to the industrial chaebols to instead serving increasingly affluent savers and investors. In the past three years, Korean retail banks have seen rapid consolidation—the four largest institutions now control more than 75% of the market. But there's still plenty of room for additional merger-fueled growth in the insurance and brokerage sectors. South Korean institutions are just beginning to tap the market for managing the assets of the nation's savers and investors, and they will likely be eager to team up with seasoned partners.

China's burgeoning population of urban workers and energetic entrepreneurs are hungry for banking products, making financial services one of the hottest sectors of growth in the Chinese economy.

In Australia, regulatory changes, increasing penetration by foreign banks and a demographic tilt toward older, more affluent consumers are sparking merger interest Down Under. The competition for aging Aussies' business has driven down interest-rate spreads and narrowed profit margins, forcing banks to rein in costs. Although government policy currently prevents Australia's "Big Four" banks from merging, domestic institutions are collaborating in joint ventures to create new efficiencies for certain back-office functions such as check processing. Nevertheless, pressure to merge continues to build among Australia's remaining regional banks, and the bigger banks are expected to become more attractive to large overseas acquirers as competition heats up.

The M&A paradox

For all of the Asian financial sector's attractions, would-be acquirers face a stark reality: The M&A route may be the quick way to gain a foothold in the region's promising future, but in the end, most mergers fail to create value for shareholders. In fact, the stock price of the median acquirer is typically 12% below the index of its peers one year after the deal has been announced, according to data on financial industry mergers from an ongoing global analysis of M&A activity by Bain & Company. Mergers with Asian financial services companies in particular face even more daunting challenges. Many of them are undercapitalized, and they often suffer operational shortcomings, lack of transparency or nonperforming loans. Indeed, when Bain evaluated 105 domestic and cross-border deals completed between 1998 and 2003, we found that in nearly 60% of those transactions the acquirer's stock price underperformed the index benchmark both 12 months and then 24 months after the mergers were announced. In just 14 of those deals did the acquirer's stock outperform the broader index by 10% or more. Only private equity investors have consistently turned in market-beating results. Among them, the average realized internal rate of return for the private equity deals was 21%, versus just an 8.6% gain in the share price of public companies. (See figures 3 and 4.)

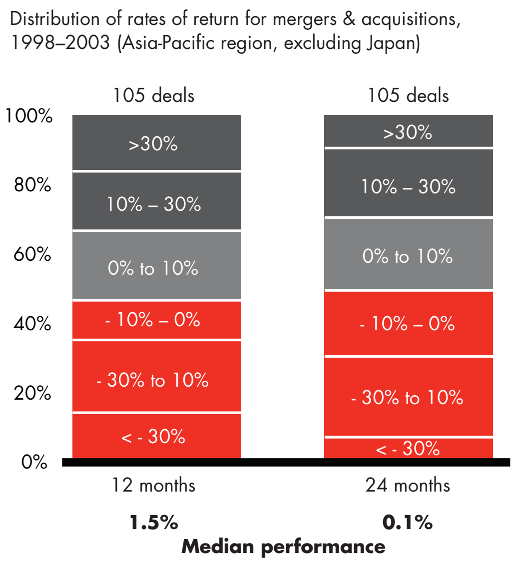
Why such bleak results? It's difficult to make the right calls consistently about acquisition targets. In fact, it is one of the biggest challenges executives face. When Bain surveyed 250 senior managers with M&A responsibilities, half said their due diligence process had failed to uncover major problems. Two-thirds said they routinely overestimated the synergies available from acquisitions. A third acknowledged that, despite nagging doubts, they hadn't walked away from problematic deals. Misgivings such as those are only magnified when acquirers target financial companies in markets—like many in Asia—that lack transparency or operate under regulatory and accounting rules only now beginning to conform to internationally accepted standards.

Our work with clients shows that successful merger deals follow a four-step process for identifying, vetting and integrating potential acquisitions that significantly improves their chances of success:

Pick the right targets

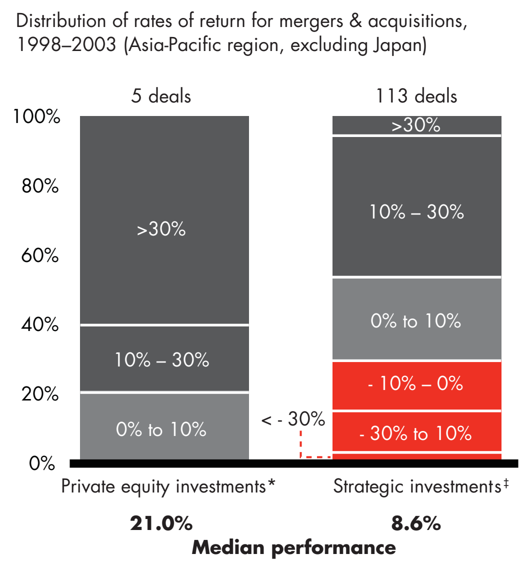
For would-be acquirers, Asia's financial services sector presents a target-rich environment. But for cross-border dealmakers especially, the sector proves to be a potentially perilous arena that needs careful evaluation to size up how companies compete. Successful deals begin with a sound investment thesis—a statement based on a clear growth strategy that describes how a particular merger will

Figure 3: Acquirer's total shareholder return vs. peer indices*



*Starting from one week before deal announcement
Source: Bain Asia FSI Deal Success Study (2005)

Figure 4: Private equity investments outperform strategic ones



Source: Bain Asia FSI Deal Success Study (2005)
*Realized internal rate of return
‡Cumulative annual change of acquirer's total shareholder return over 36 months

enhance the acquirer's core strengths and create value for the merged company. The sharpest acquirers cast a wide net, eyeing a range of possible candidates but pursuing only those they can get to know intimately. They focus on identifying the right-size deals, beginning with smaller transactions and building up to larger ones as they develop their expertise.

Commonwealth Bank of Australia (CBA) weighed its options carefully before placing three modest—but promising—bets on China's retail and small-business banking market. It found China's burgeoning population of urban workers and energetic entrepreneurs hungry for banking products, making financial services one of the hottest sectors of growth in the Chinese economy. The institutions now serving those markets—the 112 government-owned "city commercial banks"—enjoy privileged access to a major metropolis and its surrounding province. They are historically governed more by bureaucratic fiat than sound business principles, however, and find themselves saddled with bad debt and inefficient management systems. Finding the few potential stars in this opaque constellation requires a patient and comprehensive approach.

CBA quickly recognized that the brightest prospects would be in China's 29 tier-one cities—the country's largest commercial centers—and it concentrated on understanding those markets. After winnowing the long list of potential candidates over the course of two years, the Australian search committee found a receptive welcome in Jinan, a rapidly expanding industrial center in Shandong Province located south of Beijing on China's east coast.

Following months of building trust with their Chinese counterparts, CBA's international development team had gotten to know the Jinan market well enough to initiate an agreement with Jinan City Commercial Bank (CCB) in November 2004. Beginning with an investment of just $17 million for 11% of Jinan CCB, CBA secured a board seat and an option to raise its holding to 20% by mid-2008. The CBA investment lifted Jinan CCB's capital adequacy ratio a full percentage point, to a healthy 10.3%, which was well above the 8% minimum required under Bank for International Settlements guidelines and far outstripped the 6.1% average for all Chinese city commercial banks at that time.

Applying what was learned from its Jinan due diligence, CBA was ready to make a second and larger move in April 2005, buying a 19.9% stake in Hangzhou City Commercial Bank—one of China's top five—for $75.5 million. Again, strategic fit was key to the deal, and CBA took the time to build a relationship step-by-step over the course of 12 months. In a parallel move, CBA also purchased a Shanghai-based mortgage brokerage business from Australian rival, Macquarie Bank, in an effort to strengthen its position with both of its China banking deals and give it a leg up in China's nascent real estate–lending industry. Together, the investments gave CBA a solid, but low-cost, platform on which to build a profitable China future.

The M&A route may be the quick way to gain a foothold in Asia's promising future, but in the end, most mergers fail to create value for shareholders.

Know when to walk away

Successful dealmakers carefully test their investment thesis by building a bottom-up view of their target company to determine its stand-alone value. The due diligence process is no mere "check the box" formality for them. By understanding the target company's capabilities, competitors, customer base and cash flow, they evaluate whether—and when—true synergies can be achieved if the deal moves forward. But they also predetermine the criteria that would cause them to walk away if due diligence issues surface, and they actively look for potential problems before the deal is consummated. Among the warning signs: overestimating a deal's potential, being seduced by a target company dressed up to look more attractive than it really is and getting swept up in the bidding process. Without a thorough vetting and a readiness to pull the plug if trouble appears, overeager acquirers are especially prone to falling into one of those snares.

With $750 million to invest across the region, the veteran dealmakers at The Carlyle Group, a prominent US private equity firm, have been among the most active acquirers in Asia. In addition to financial services investments throughout the region, the list of companies in which Carlyle has bought stakes runs the gamut—from an artificial Christmas-tree manufacturer based in Hong Kong and a builder of industrial hoists in Japan to an electronic billing-services provider in India and an online travel agency headquartered in Shanghai. What do these disparate holdings have in common? For one thing, they all survived a painstaking due diligence process from a company renowned for its persnickety deal-vetting discipline.

Before the firm will commit investors' capital, Carlyle's partners limit any deal to an industry in which Carlyle can bring its expertise. That intimate familiarity with local market conditions and access to a network of global resources gives Carlyle a clear competitive edge. Because it is conservative in its use of debt and insists that its partners invest their personal funds alongside the firm's outside co-investors, Carlyle avoids getting swept up in competitive auctions. The company takes a pass on acquisitions that do not show potential for market leadership. Finally, it keeps an eye firmly fixed on its exit strategy from the outset. Identifying potential buyers at the end of a typical three- to five-year holding period is a core part of its due diligence process.

One recent acquisition that passed the firm's rigorous screening was the $410 million investment concluded last December that gave Carlyle a 25% share of China Pacific Life Insurance (CPLI). As the largest private equity transaction in China to date, the deal has all the earmarks of a Carlyle classic. The third-largest company in China's fast-growing life-insurance industry, Shanghai-based CPLI commands an 11% share in a market where the top-three insurers take in 80% of all premiums. In addition to naming a new management team, Carlyle further buffered its investment risk by enlisting China Pacific Insurance Group (CPIG)—CPLI's holding company parent—and US financial services giant Prudential Financial as co-investors and strategic partners. The matching investment by CPIG aligns the parent company's interests with Carlyle Group's, and the strategic involvement of Prudential makes the insurer a likely buyer for Carlyle's stake once the initial work of building CPLI's network is complete.

Integrate where it matters

Effective integration generally ranks as the single most important factor influencing the success of a deal. It can make or break a deal's trajectory. Although every integration project—like every merger—is different, a number of guiding principles apply across almost all integration efforts. They revolve around one central issue: Where do operations truly need to be integrated, and where can the merging businesses simply carry on separately? Leaders of merged companies put culture high on their leadership agenda, retooling their corporate environment in ways that are consistent with the deal's investment thesis. Whatever integration plan they choose, they use hard tactics—organizational structure, compensation incentives and the division of decision-making authority—to address cultural integration.

With plenty of previous merger experience under its belt, Singapore-based United Overseas Bank (UOB) knew a thing or two about successful post-merger integration by the time it announced its biggest acquisition: the $5.6 billion purchase of Overseas Union Bank in late 2001. UOB Chairman and CEO Wee Cho Yaw knew that the speedy integration of the two institutions' information technology systems would be crucial to making the merged institution a premier bank in the Asia-Pacific region. Few integration challenges are bigger than harmonizing often incompatible legacy systems that touch every critical aspect of a bank's operations. Success would depend on quickly developing an effective collaboration among teams of business and IT professionals. UOB estimated that integrating the two IT organizations serving 365 offices around the world would take a year and a half. In the end, the job was done in just eight months.

> Without a readiness to pull the plug if trouble appears, overeager acquirers are especially prone to problems.

How did UOB do it? From the outset, top management was involved in planning the integration. The IT organization worked hand-in-hand with their business unit colleagues, and a project management office was established to coordinate all merger-related activities. To ensure that the bank's post-merger IT infrastructure had the scale and capacity to support UOB's goals, the team sized up the capabilities of each bank's systems to determine which was better. Then, instead of cherry-picking from both systems, the team chose the better system—warts and all—with the goal of quickly unifying policies, processes and procedures. Using this "choose-and-move" approach, the integration team completed 30 concurrent projects and harmonized 100 major systems by June 2002, producing $140 million in annual operating cost savings.

Expect the unexpected

No deal goes exactly as planned. Most company leaders are blindsided by post-merger impediments; they've focused so hard on nailing down the terms of the deal and hashing out a broad integration plan that they've given short shrift to spotting specific problems.

But when execution of their post-merger program veers off course, alert acquirers let go of the past, admit errors and take tough, decisive action to put their deals back on track. Whether problems are manageable or cataclysmic, successful acquirers have strong early-warning systems in place to identify difficulties, and they respond to even the faintest distress signals without delay.

Opportunities for mishaps were rife when Newbridge Capital—the Asian private equity joint venture of Texas Pacific Group and Blum Capital Partners—acquired Korea First Bank from government receivership in January 2000. In their first major foray into North Asia, the new owners planned a major makeover for Korea First, converting the bankrupt commercial creditor into a retail bank and small-business lender. Working from a detailed blueprint, Newbridge and the new management team aimed to reengineer Korea First's branch network, consolidating back-office operations into two central customer service centers and refocusing the front-line personnel on boosting sales.

The plan was a tall order on all fronts, but the key to its successful execution was not the technological challenges, the asset redeployments or the operational reorientation. The surprising "x-factor" Newbridge faced was winning the confidence and support of a workforce demoralized by bankruptcy and bitter from successive rounds of layoffs.

Because the success of the bank's restructuring hinged on defusing employee anxiety, the new management team tapped key human resources staffers from the outset to help employees embrace change. They built credibility with branch-office workers by giving members of the change-management team visibility throughout Korea First. The team broadcast its commitment to retain employees made redundant by downsizing, and it helped steer displaced workers toward training programs to prepare them for new positions in customer service and sales. In all, 800 jobs were lost due to branch closings and streamlined work processes, but newly created positions offset the losses. In addition, the candor and support—reinforced by cash incentives for working smarter—helped First Korea cut its loan approval time by 75%.

Regaining employee confidence proved a winner. By 2005, the bank's front- and back-office infrastructure was considered best in class by Korean standards, and its balance sheet was the nation's strongest. The ultimate acknowledgment of this successful East-West collaboration came when Standard Chartered, the big British banking group, purchased Korea First for $3.25 billion, a nearly fourfold return on the private equity investors' cash investment.

Negotiating the perilous straits of mergers and acquisitions is becoming the new rite of passage to riches in Asian financial services, and as adventurers of the past have found, there are no shortcuts to reaching them. Only by embarking on a disciplined voyage of discovery, remaining vigilant to the risks of unfamiliar territory and carefully husbanding resources will the M&A journey yield its rewards.

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