

**Philequity Corner (August 3, 2009)**  
**By Valentino Sy**

**Rise and Fall of Meralco: Your questions answered**

We have received many queries on the recent price action of Meralco. Many are still befuddled on the steep rise and the equally sharp fall of its stock price. Last week, market watchers have been asking why Meralco shares have gone up to a closing price of Php205 per share. They commented that at Php205 per share it was already overpriced.

However, after Meralco reached Php302.50 per share this week, the same people are questioning why it dropped when in fact it closed at Php229 per share, which is 12 percent higher than the previous week's close.

Because of the many queries of our readers and investors, we are changing the format of our column today to a question and answer (Q&A) type.

1) *Why did Meralco's share price zoom to astronomical levels these past few weeks?*

In our article *Turf Wars* (see July 13, 2009 issue of **The Philippine Star**), we said that Meralco's price action continues to defy gravity because the battle for control, given the limited free float circulating, is exerting upward pressure on the share price.

We mentioned the possible scenarios:

- a) That the PLDT Group or the SMC group may be buying in the market to get a majority stake,
- b) That fund managers sympathetic to either side may be accumulating
- c) That a risk arbitrageur may be gobbling up the free float with the intention of selling the shares to the highest bidder
- d) That maybe all of them are doing the buying at the same time.

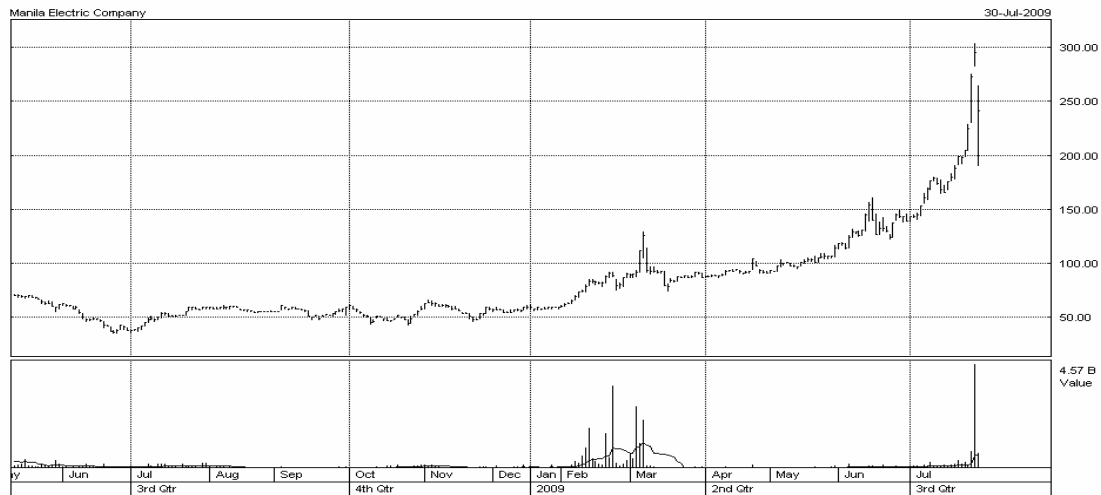
Note that buying in the market is less costly than for one party to buy the other out which would trigger a tender offer for all the shares.

2) *Why did it reach a staggering level of Php302.50 per share?*

It appeared that the race to own 50 percent stake + 1 share was decided by "photo finish". Therefore that last 1 or 2 percent - which matter the most - commanded a huge premium. Buying 2 percent of the company at Php300 per share to gain control is actually cheap.

Morover, many fail to realize that the bulk of the stakes of PLDT Group and SMC Group are priced at 90 pesos per share (in SMC's case it is even less because it is payable in 3 years). Thus, even if the winning bidder paid Php300 per share for the last 2 percent, the average cost would just be a little over Php90 per share.

**Daily Chart of Meralco**



Source: Technistock

3) Why did Meralco's share price drop sharply after reaching Php300 per share?

To the experienced eye or seasoned investors, the block of shares that was crossed at Php300 per share last Wednesday was a clear signal that the game was over. It was clear at that instance that one party sold and that the other party bought the deciding block.

It did not really matter which party won. It was apparent that when the fight for control was over, the demand for the shares and the buying frenzy would no longer continue.

4) Why is that block of shares traded on Wednesday a game-changer?

It was a game-changer because that block of shares represents nearly 2 percent of Meralco. Therefore it meant minus 2 percent for one side and plus 2 percent for the other side – a swing of around 4 percent.

5) So, who eventually got control of Meralco?

A quick look at the PSE quotation report last Wednesday showed a net foreign buying of Php2.03 billion. A foreign broker known to be used by the PLDT Group and foreign funds sympathetic to PLDT crossed 6.7 million shares last Wednesday. Meanwhile, a local broker which represented one of the local funds sympathetic to the SMC Group crossed 6 million shares.

Apparently the funds that are allies to SMC Group flipped and sold to the highest bidder. Obviously, the PLDT Group now owns the majority of Meralco.

6) Why is getting control of Meralco important for PLDT?

The PLDT group sees real synergies between Meralco and PLDT. The company mentioned eight specific areas where they can work together, namely: powerline broadband, fiber optic backbone network, electric power poles, easements and rights of way, prepaid electricity service, business offices, ICT or data center, bill statement printing & enveloping and access to subscriber base.

Moreover, losing Meralco at this point, when it has already invested billions of pesos, would be disastrous for PLDT. In fact, PLDT's share price has lagged the market during the battle

for control of Meralco but when it was clear that PLDT maintained control, the stock price went up.

7) *What do we do now with Meralco?*

For those who have a short-term perspective, especially the punters, the answer was clear. If the fight for control is over, they have no choice but to sell.

For those with a long-term view, PLDT Group's entry in Meralco brings many opportunities. Manny Pangilinan's track record of turning companies around, cost-cutting and creating synergies to optimise profits and enhance shareholder value is definitely a positive for the stock. MVP has proven this in PLDT with its shareholder value and stock price steadily increasing since he has taken over.

While Meralco's stock price has gone up too fast too soon, the company has a strong franchise, a good business model and sound fundamentals.

8) *Is the turf war over?*

As far as the fight for control of Meralco is concerned, the game is over. But in other battle turfs, the war would probably continue as both parties are involved in telecommunications, infrastructure and other businesses in the Philippines.

#### **Lessons learned**

The meteoric rise in the share price of Meralco and the sharp drop afterwards provide valuable lessons for investors.

1) One important lesson is that you should do your own research rather than following without thought what your brokers are doing. In Meralco's case, most brokerage houses had recommended a SELL on Meralco when it first reached Php90 per share. Their recommendation may have been based on fundamentals, not considering the battle for control.

But if you did your homework and realized that there was a battle for control and limited free float circulating, you would have known that the rich valuations were justified.

In the same manner, when the race to get majority is over, you should recognize that valuations will revert back to fundamentals.

2) Another lesson is that you should follow strictly your investment profile. If you are a short-term trader, you should be alert and nimble because while profit potential is high, volatility at the turn will be wild.

If you are a retail punter, it is important to do your homework rather than following blindly what bigger brokers or investors are doing. In this case, the block sale of Meralco may have triggered an immediate change in view from these investors. Instead of being buyers, they may have become sellers.

Finally, if you are a long-term investor, you should buy when the price is being offered at a bargain or as Warren Buffet and Benjamin Graham put it "*you should buy when the price of a stock offers a huge margin of safety.*"

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