Philequity Corner (August 30, 2010)
By: Valentino Sy

Ripe for the Picking

Banking stocks continued to reach fresh highs, even outperforming the gains made by the PSE Index. Since we wrote ***Size Matters*** (see 2 August 2010 issue of **Philstar**), bank stocks are up 6.1% on continued speculation of mergers and acquisitions (M&As). The impressive first half earnings results – up an average of 30% over the same period last year – likewise lent credibility that bank stocks are indeed ripe for the picking.

	Earnings Performance						Share Price Performance	
	1H09	1H10	YoY	2Q09	2Q10	YoY	From Jan 1	From Aug 2
Banco de Oro	2,100	4,100	95.2%	1,123	2,087	85.8%	33.6%	8.5%
Metrobank	3,090	4,200	35.9%	1,154	1,700	47.3%	42.0%	1.4%
BPI	5,333	5,600	5.0%	2,400	2,800	16.7%	1.9%	0.4%
PNB	1,521	1,800	18.3%	796	915	14.9%	69.1%	6.5%
UnionBank	2,196	2,220	1.1%	1,631	1,365	-16.3%	22.4%	6.6%
Security	1,406	1,800	28.0%	655	930	42.0%	37.2%	9.5%
RCBC	1,691	2,110	24.8%	911	1,133	24.4%	42.3%	10.1%

International M&A

M&A activities are much more in vogue in other countries. In North America for instance, BHP Billiton's (a global mining company domiciled in Australia) hostile all-cash takeover bid of Potash Corp (a Canadian fertilizer and feeds producer) sent the latter's share price to an all-time high. Also, Intel (global chipmaker) recently entered into definitive agreement to acquire McAfee (a computer software security company) for US$7.7 billion, representing a significant premium to its current value. Hewlett-Packard recently raised its bid on 3Par Inc (a data storage company) after Dell earlier reached a deal to acquire the storage firm. Takeovers really unleash the value of stocks. Indeed, M&As excite markets.

MVP vs. RSA

Last year, the battle for dominance between Manny Pangilinan (MVP) of the PLDT Group and Ramon Ang (RSA) of San Miguel ignited an M&A frenzy which helped lift the stock market.

Meralco was then a hostile takeover target of RSA's San Miguel. Its infrastructure attracted RSA since San Miguel had plans of entering the telecom sector. MVP, however, surprised the market as he ended up as the white knight of the Lopezes. At the height of the saga, Meralco's share price peaked at Php300. See ***White Knight***, ***Checkmate!***, ***Turf Wars***, ***Beneficiaries of Turf Wars***, and ***Rise and Fall of Meralco*** from March through August 2009 articles of **Philstar** for a more complete picture.

In Philex Mining, the board was in disarray as disagreements among directors arose. First Pacific, SSS, GSIS, DBP, and Roberto Ongpin were the prominent shareholders. Ownership, however, was very fragmented since not one shareholder had veto power. The boardroom war prompted MVP to pull the trigger and buy out the rest, except for SSS, at a hefty price of Php21/share (see also ***Return Bout*** 17 August 2009 and ***Manny "Pacman" Pangilinan*** 9 November 2009 articles of the **Philstar**).

Missing Winston

Do we need another Winston Garcia to cause another bout of M&A mania? His storied investments can be traced back to the Equitable-PCIBank saga. He was at the forefront in the battle for control of Equitable-PCIBank.

After a successful exit in Equitable-PCIBank, Winston Garcia next targeted Meralco, supporting RSA's takeover attempt. Despite the failed concerted effort to get control of Meralco's board, GSIS made a handsome profit. He then quickly moved to Philex Mining, forming ties with San Miguel ally Roberto Ongpin. Again, GSIS generated significant returns in its mining investment. With all the M&A actions triggered by Winston, market punters are most probably missing him now.

Genius Ramon Ang

Ramon Ang is no apprentice when it comes to M&A. He was the architect that led to San Miguel's transformation from a consumer-driven empire to a pure conglomerate with diverse interests in infrastructure, mining, and oil refinery, among others. Prior to its diversification plans, San Miguel sold off its international consumer brands such as National Foods, J. Boag, Del Monte, and Coca-Cola. After the sale of a 49% stake in San Miguel Brewery to Kirin, the company is now selling 49% of Pure Foods. Ginebra San Miguel and San Miguel Packaging are also in the selling block.

RSA's investments are spread all over. No one knows for sure what his next move will be. Like what we said in a past article, RSA is always ten steps ahead. Will RSA start the ball rolling this time around in the banking space? Is Bank of Commerce a potential acquirer given its intention to become a unibank? Or is it a potential seller eventually? The genius that he is, RSA can buy and sell anything at the right price.

Recipe for Bank M&A

From prospecting to actual bidding, there are many factors involved for an M&A deal to advance. While the reasons for acquisitions could vary depending on the buyer, we enumerate the factors a buyer will take into account before engaging into bank M&A.

1. **Management.** Our director, Washington SyCip, noted that management is one of the key criteria in a bank M&A. A well-managed bank adds value to a prospective buyer. It can then translate into a higher selling price once put on the auction block. The sale of International Exchange Bank (iBank), for example, exemplified a well-managed bank that commanded premium pricing. Shareholders of iBank made an exit at 2.4x P/BV.

2. **Branding / Niche.** Having a niche sets a bank apart from competition, which then translate into better valuation. iBank was known for its niche in branch banking. Its excellent customer service was unparalleled in the industry. PCIBank and Far East Bank, meanwhile, had very strong corporate accounts and trust businesses.

3. **Ownership structure.** The ownership base is said to be fragmented if there is no clear majority shareholder among the owners. A bank with a fragmented ownership base may be a good acquisition target. If one party is persuaded to sell, others may be forced to follow suit, thus creating a domino effect.

In Far East Bank, there were several groups in the board. The families of Gokongwei, Sy, Cacho, and Fernandez owned blocks in the bank. In the case of iBank, there were Razon, Lanuza, Tiu, and Vantage each owning around 20% of the bank post-IPO. In PCIBank's case, the Lopez clan and the Gokongwei family owned equal percentage in the bank. In all the cases we cited, the fragmented ownership was a key factor in the eventual sale of the banks.

4. **GFI participation.** Having GFIs on the board can both be a boon and a bane. Their mandate is to make reasonable rate of returns for their respective funds. If their investment has achieved substantial returns, they may decide to make an exit especially if an attractive offer is made to them. However, GFIs investments may entice predators that may lead to a change in control of the company.

   A case in point was the Equitable Bank and PCIBank merger. Equitable Bank used the government financial institutions (or GFIs), particularly SSS and GSIS, to buy into a much larger PCIBank. After the ouster of Estrada, the SM group entered the picture and bought out the shares of SSS and GSIS. Sensing eventual defeat, the Go family reluctantly sold their 25% stake for Php56.50/share after a heated battle for control. (See ***The Hunter becomes the Hunted*** 30 May 2005 and ***The Hunt is Over…*** 9 October 2006 articles of the **Philstar.**) BDO's purchase of the GFIs' shares led to the eventual sale of the bank. The same held true in the case of Meralco. MVP, however, thwarted the hostile takeover attempt. In both cases, the GFIs were used as a springboard for an M&A.

5. **Bangko Sentral (BSP).** The BSP has always envisioned a banking industry where there exist a few but strong banks. The M&A wave in late 90s to early 2000 was induced in large part by the BSP. Back then, the BSP instituted a mandatory increase in the minimum capitalization of banks. This forced bank owners who were unable to meet the requirements to sell out at low valuation multiples given their high non-performing assets. The BSP's stance has not changed. At present, it still does not issue licenses for new banks or new bank branches. This move is conducive for bank M&As.

6. **Price.** Valuation plays a critical role in bank M&As. Gleaning from past M&A deals, acquisitions designed for the purpose of simply expanding branches or increasing asset size typically resulted in low valuation multiples. On the other hand, those acquisition targets with market niche were transacted at high valuation multiples.

   If a new cycle of bank M&A were to happen this time around, sellers may be richly rewarded with attractive valuations. Banks these days carry clean balance sheets and have high ROEs.

Banking on M&A

In next week's article, we shall highlight potential bank targets. We shall also feature other banks that are in search mode aside from BPI which we previously classified as a clear acquirer. Also, odd as it may seem, other banks can be both acquirers and targets, just like how we view PNB.

The 2Q GDP growth of 7.9% puts the country back on the radar screens of foreign investors. The country's growth was in tandem with our peers' in the region. A re-rating should stimulate more investments and facilitate the entry of foreign investors, which encourages M&A activities. In fact, some foreign banks are already looking at the country as a possible investment destination. The banking landscape is indeed competitive but nevertheless conducive for M&As.

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