

Philequity Corner (November 26, 2012)

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Hunt for Banking Supremacy

From a virtual flat line the past months, PNB's share price all of a sudden surged last week to a fresh intraday high of Php89.20. Rumors quickly spread that BPI offered its shares to the group of *Kapitan* and pegged the value of PNB (after merging with Allied Bank) at Php96 per share. In valuation terms, the rumored offer translates to 1.8x P/BV. On November 21, both banks requested for a trading suspension. The following day BPI and PNB confirmed talks but no announcement of a consummated deal happened. Lucio Tan reportedly did not agree to the pricing. The Ayala camp, nevertheless, stated that it remains hopeful that a sale could be arrived at before the end of the year.

3 + 4 = 1

The marriage of BPI (#3) with PNB-Allied (#4) will cement the former's lead in the industry with an asset size of more than Php1.38 trillion and deposits of Php1.1 trillion. This will dislodge BDO, also an aggressive acquirer, from the top spot. The enlarged BPI will also widen the gap over competition in terms of market reach given an enviable network of ~1,400 branches. This would dwarf BDO's presence of 760 branches.

Bank Rankings			
In P' billion	Assets	Loans	Deposits
BPI-PNB-Allied	1,376.9	703.4	1,076.0
BDO	1,174.2	722.9	859.9
Metrobank	953.7	481.4	662.1
RCBC	353.2	189.7	233.6
ChinaBank	312.1	79.8	261.4
Security	252.6	108.4	138.0
UnionBank	227.8	90.9	155.9
UCPB*	211.8	69.7	168.1
Phil Trust	105.7	37.1	88.7
EastWest	97.5	61.0	69.3

Note: *All figures are based on 3Q2012 unaudited financial statements except for UCPB (2Q2012).

Succession & Estate Planning

We have long seen that Lucio Tan has been initiating his succession and estate planning. While many merely speculated on *Kapitan*'s possible divestment moves, the sale of his cash cow, Philip Morris, to rival Fortune Tobacco served as an eye opener for us. In our Philequity article **Size Matters** (2 August 2010), we opined that, "*After the sale of Fortune Tobacco, there are now talks that Philippine Airlines (PAL) is opening its doors to foreign investors and carriers for a possible sale and/or strategic tie-up. PNB-Allied Bank may not be far behind.*" PAL, as we now know, ended up with a partnership with San Miguel under the leadership of Ramon Ang. The recent spin-off of Tanduay allowing the consolidation of assets under the holding company, LTG, was likewise a preparatory step. Although the negotiations with BPI remain fluid and in-progress, the sale of the combined PNB-Allied Bank is apparently not far behind. **Clearly, partnering with a strong entity in the sector with proven and superior management is *Kapitan*'s strategic preference.**

Sleeping Giant Awakens

After a long hiatus, Ayala Corporation (AC) has regained its hunger and drive. The new-found aggressiveness of the Ayala group – from Ayala Land's lucrative bid in FTI, to Globe's offer to buy the debts of Bayantel, and to Manila Water's foray into Vietnam – calls for a big move, too, at its banking unit. After all, BPI has a long history of successful acquisitions on its résumé. Looking at its recent bank acquisitions, one could observe that BPI pays a premium for its targets. In 1999, Far East Bank (Php135 billion in asset size) fetched a 2.3x P/BV and in 2005, Prudential Bank (Php55 billion in assets size) got a valuation of 2.0x adjusted P/BV. Our Philequity article, **Size Matters**, details the previous acquisitions of BPI.

Rumored Price = Php96/share (or 1.8x)

Crunching the numbers based on the figures that floated around the market, it appears that the implied swap ratio will be 3.1 PNB shares for every BPI share. In effect, AC, which presently owns 43.9% of BPI, will be diluted to 33.1%. Despite the dilution, the Ayalas will retain a veto block in the merged entity. Lucio Tan's camp, on the other hand, will be the most significant minority shareholder with a

20% equity stake. In contrast to BPI's past acquisition, the 1.8x multiple for PNB pales in comparison considering the extensive domestic branch network and overseas footprint that will bolster BPI's remittance business. When BDO acquired Equitable-PCIBank, the bank paid a hefty 2.9x adjusted book value in order to attain industry leadership. UBP paid 2.5x for iBank. **Considering BPI is already at 3x, we are not surprised that *Kapitan* has turned down the initial offer price. Just for the name alone, PNB could command at least 2x.**

BPI-PNB-Allied Share Swap		
Rumored	PNB-Allied	BPI
Outstanding Shares	1,086	3,556
Share Swap Price	96	90
Implied Market Cap	104,252	320,072
Combined Market Cap		424,324

Resulting Ownership Structure of the Merged BPI-PNB-Allied		
AC	140,512	33.1%
LT Group	83,402	20.0%

Fair and Square

In assessing the potential value of this blockbuster transaction, we perused deeply into the financial statements of PNB and Allied Bank. Our book value estimate for the combined banks starts at Php67.41 per share. To be more conservative and to get the tangible book value, we assumed (1) a 50% discount on the Non-Performing Loans (NPLs) which are already net of 100% coverage, and (2) a 25% haircut on the value of its Real & Other Properties Acquired (ROPA). (See table for sensitivity.) Considering the surge in property values, the assumptions we factored in considerably lowers the risk. Our toned down BV/share guesstimate is Php59.03. Given this, we think Lucio Tan can fetch more than the rumored 1.8x P/BV. Back in 2010, Wealth Securities came out with a report on PNB with a target price of Php100/share based on a 2.2x P/BV. See **Wealth Vault** report dated 24 September 2010.

Impairment Assumptions	2012 PBV Multiple				
	PNB-Allied	2012	1.5x	2.0x	2.5x
Stated BVPS	67.41	101.12	134.82	168.53	
50 NPL / 25 ROPA	59.03	88.55	118.07	147.58	
50 NPL / 50 ROPA	54.58	81.88	109.17	136.46	
50 NPL / 75 ROPA	50.14	75.20	100.27	125.34	
50 NPL / 100 ROPA	45.69	68.53	91.37	114.22	

Fair Price = Php118/share (or 2.0x)

Using our own estimates, *Kapitan* would be fairly rewarded using a P/BV multiple of 2.0x. This places a value for PNB equivalent to Php118 per share. This, in our view, would be a more palatable offer. At this level, Lucio Tan will end up with a higher stake of 22.9%. AC, meanwhile, would hold less at 31.3%. With no veto power, AC may try to use a combination of shares and cash in order to minimize the risk of dilution.

BPI-PNB-Allied Share Swap		
Rumored	PNB-Allied	BPI
Outstanding Shares	1,086	3,556
Share Swap Price	118	90
Implied Market Cap	128,219	320,072
Combined Market Cap		448,291

Resulting Ownership Structure of the Merged BPI-PNB-Allied		
AC	140,512	31.3%
LT Group	102,575	22.9%

Suitors

As PNB lets the cat out of the bag, there could be potential suitors willing to bid against BPI until the homestretch. Rumors have surfaced that BDO is interested. Metrobank could also be in the hunt. After all, Lucio Tan's daughter, Cherry, is married to George Ty's son, Alfred. UnionBank and Security Bank could also be acquirers waiting for the right fit. In an industry where rank matters, PNB's game changing proposition could attract not only the likes of BDO and Metrobank but also the foreign banks. The entry of Malaysia's CIMB in Bank of Commerce reinforces the argument of regionalization. In our Philequity article **Acquirers or Targets?** (6 September 2010), we observed that *"As the country is back in foreign investors' radar screens, a number of foreign banks may consider entering via strategic tie-ups. This is value enhancing to banks struggling to be competitive. Chinese banks, for instance, may plan to expand their footprint and include the Philippines. ICBC, Bank of China, China Merchants Bank, and Bank of Communications are some of the Chinese banks on expansion mode."* This will create more excitement in the market.

A Catalyst

Bank M&As are healthy for the banking industry as well as for the stock market. Fewer but stronger banks is what the Bangko Sentral has been advocating all along. In fact, banks in the region like in Singapore, Malaysia, and Thailand are very much larger in size compared to our Philippine banks. As a catalyst for the PSEi, an acquisition at the scale of PNB would cause a re-valuation which would trigger share prices of second-tier banks to move higher. The next wave of M&A could start with PNB.

Mutual Fund Seminars

The Philippine Investment Funds Association (or PIFA) will be conducting a free investment seminar today, November 26 from 5:00 PM to 8:00 PM. Venue is at the 19/F PS Bank Bldg., 777 Paseo de Roxas Ave., Makati City. Topic: "Why investment in the mutual fund is the best way to build wealth?" Interested applicants can attend and visit the Philequity booth. We shall be handing out investment kits.

Bank Valuation and Possible Takeover Seminars

In line also with this article and on the current excitement over possible bank mergers, we shall be holding a seminar on Bank Valuation and possible M&A permutation. Slots are limited. This will be held on November 29 at 3:30 PM. Venue will be at the Philequity office, 20/F East Tower, Tektite building. Please feel free to email or call if you're interested to attend.

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