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Seeking opportunity in crisis

Happy New Year! Most of us have never looked forward to the end of a year as much as we did the last one. For M&A, 2008 had, for all intents and purposes, ended on 15 September, the day Lehman Brothers filed for bankruptcy and Merrill Lynch was taken over by Bank of America. Confidence plunged and fear of systemic meltdown gripped the business world. The credit crunch, which up until then had ravaged mainly the US and parts of Europe, intensified overnight into a global credit freeze. Stock markets across the world plunged. The global banking system and financial markets went into full cardiac arrest. The sub-prime crisis, which until then had been confined mainly to the financial sector, spilled into the real economy.

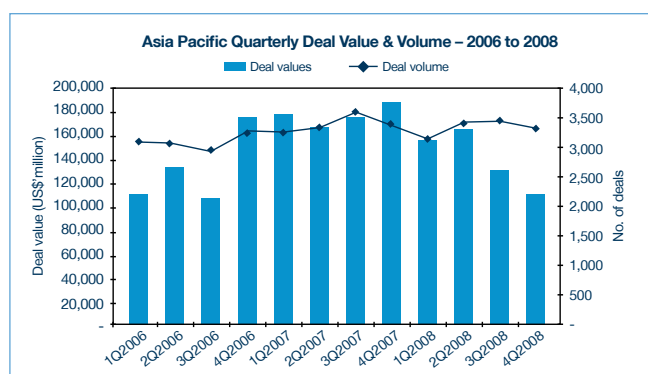
Governments around the world swung into action immediately. The US pushed through a US\$700 billion Troubled Asset Relief Programme in early October. This was originally slated for the purchase of toxic mortgage-related assets but was re-designated in November for recapitalisation of financial institutions. The Federal Reserve also launched two new programmes in November to buy up to US\$800 billion in mortgage and consumer loan-backed securities. Over in Europe, the United Kingdom threw a £500 billion lifeline to its banks for recapitalisation, bond guarantee and liquidity; Germany and France announced Euro 500 billion and Euro 360 billion rescue packages respectively.

Credit, the lifeline of both the financial market and the economy, had to be restarted quickly. As a measure of the fear that existed in the credit market, TED Spread shot up from 1.3537% the Friday before the Lehman collapse, to 4.636% on 10 October, its highest level since measurement started 25 years ago. In desperate attempts to thaw the credit freeze and get banks to lend to customers and to each other, over a trillion dollars was pumped into money markets to increase liquidity. Interest rates were also cut aggressively in quick succession by central banks around the world, with the Fed Fund rate lowered to 0 – 0.25% on 16 December. In addition, governments guaranteed not only inter-bank loans to encourage lending, but also customer deposits to prevent panic withdrawals and a run on banks. As much as US\$33 billion was withdrawn by customers in the US in the ten days following Lehman's collapse.

There are early signs that the credit market is improving as a result of these drastic measures. The three-month LIBOR which ended 2008 at 1.43% has continued to spiral downwards in January 2009 to 1.18%. This is off the high of 4.8% on 10 October, and even lower than the 2.8% just before the Lehman collapse. TED Spread ended 2008 at 1.34% and further dropped to 0.958% in January. Nevertheless, we are not out of the woods yet. Even as we start a new year, credit remains tight. Banks burnt by the crisis are licking their wounds and still downsizing their loan books to minimise capital requirements. Even Asian banks that have been largely unscathed by the sub-prime crisis are credit-shy as they hunker down in anticipation of tough times ahead when the crisis develops into a full blown global recession.

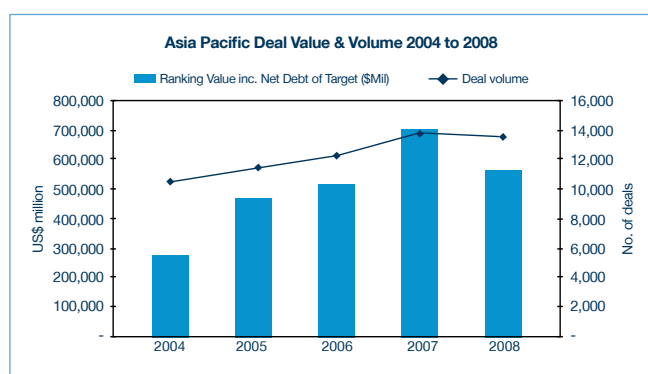
The difficulty in securing credit and the volatile stock markets, coupled with the loss of business confidence and uncertainty with regards to the extent and depth of the recession, had knocked the wind out of M&A. The fourth quarter, which traditionally sees a hive of M&A action, was deafeningly quiet this time. M&A activity, already slowing down in first half of 2008 compared to both halves of 2007, dropped 21% in deal value in the third quarter, and a further 15% in the last quarter. Comparing the two fourth quarters in 2007 and 2008, the fall was a

whopping 42%. Given that many of the deals announced in the fourth quarter were already in advanced stages of negotiation by the time of the Lehman bankruptcy, we expect that deal announcement statistics will continue to be depressed in the first half of 2009.



Source: Thomson Reuters, based on total domestic, inbound and outbound deals announced as of 31 December 2008

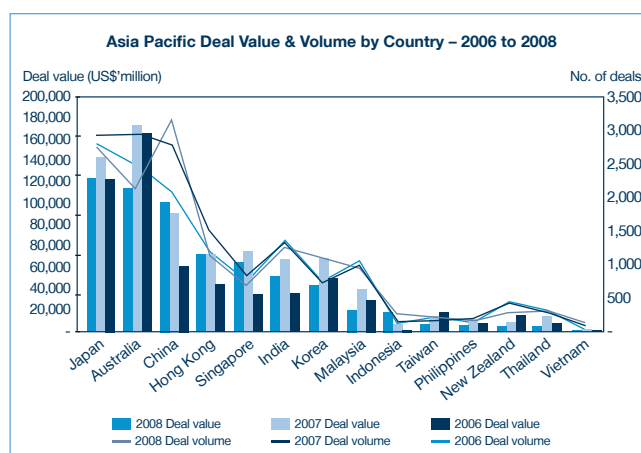
Not surprisingly, year-on-year M&A value and volume for Asia Pacific was down 21% and 4% respectively. The steepest falls have come from Australia and Japan, the two most developed countries in the region. China reported growth in both deal value and volume, which may be a result of the longer deal execution process and its predominantly growth capital deals. Anecdotally, we noted that deal activity in China slowed down substantially in the fourth quarter.



Source: Thomson Reuters, based on total domestic, inbound and outbound deals announced as of 31 December 2008

2009 started with the economy in intensive care. The general prognosis is that this will be a long-drawn recession, and recovery will be slow. The US economy has been in recession since December 2007 and it may take at least another year before it starts to recover. President Obama has given himself three years to turn the economy around.

The Economist Intelligence Unit forecast that the global economy will contract by 0.9% in 2009, and world trade is expected to contract by 2% as a result of collapsing import demand from the US, Europe and Japan.



Source: Thomson Reuters, based on total domestic, inbound and outbound deals announced as of 31 December 2008

Asia Pacific, while not decoupled from the US-European economies, has been somewhat insulated and may just be the silver lining amidst the storm clouds. It was relatively unscathed by the direct impact of the sub-prime crisis as Asian financial markets and institutions are less sophisticated. However, it could not escape the global liquidity crunch and credit freeze arising from US and European banks' capital deficiency crisis; and Asia's export-led economies are bracing for the full impact of the US-Europe recession to hit in 2009. Asia's exports to US and Europe account for 31% of its US\$33 trillion exports.

The IMF expects Asia Pacific ex Japan to grow by 5.5% in 2009, thanks to the projected 6.7% growth for China. The Chinese government has projected a more optimistic 8% growth (versus 9% in 2008), although Premier Wen Jiabao recently admitted that achieving it would be a tall order. Premier Wen also disclosed that China is considering additional measures beyond the RMB 4 trillion (US\$580 billion) stimulus package that it announced earlier. With US\$1.8 trillion in reserves, the Chinese government has the financial muscle to weather this crisis. Premier Wen is upbeat that there are already first signs of a rebound. China's official manufacturing index, the purchasing managers' index, rose steadily from a record low of 38.8 in November to 41.2 in December and 45.3 in January 2009. State-owned Chinese banks also heeded the government's call. Loan volume has risen, hitting a record Rmb1.2 trillion (US\$175 billion) in January. It would take a

few more months to tell whether the Chinese economy has indeed bottomed out, or if this is a false dawn. While an early China recovery will have positive side effects for Asia, it will not replace the US and single-handedly revive the global economy. The US and Europe account for 60% of the world's US\$30 trillion personal consumption, whereas China only accounts for 3.3%. Nevertheless, an early China recovery augurs well for Asia's M&A landscape.

Corporate investors with a strong heart and a stronger war chest will find 2009 a unique window for strategic acquisitions. This is the time to use M&A to leapfrog competitors, transform value chains, break into new markets and secure competitive advantage for the next decade. Across all sectors of the economy, significant pain is still to come, especially for those that relied on short term credit from banks. Hard-pressed businesses may have to sell assets and businesses to raise cash for deleveraging. Stressed assets, distressed and motivated sellers, lower gearing and subdued stock markets will result in more attractive pricing - a boon to strategic investors. Strategic investors will also have an upper hand in competitive bidding, as there would be synergistic value which only they can appreciate and unlock. More importantly, businesses which in more normal times are not available for sale may come into the market. One needs to look no further than the financial sector for such examples. With the deluge of bad news everyday, it is easy for corporations to get caught up with day-to-day operational and cost management issues, losing sight of this strategic acquisition window. To avoid this trap, besides gearing up for a long recession in their scenario planning, corporations should also revisit their strategy, and challenge themselves to better leverage on acquisitions to make a quantum leap. There is currently no shortage of private equity funds in the region. Corporations should explore how they can tap on such money for growth, or co-invest with private equity to reduce their acquisition outlay and associated financial risks.

While fund-raising by private equity is exceedingly difficult in the current environment, many private equity funds are sitting on substantial uninvested funds. Globally, unused private equity funds at the end of 2008 stood at US\$1 trillion, with almost half in buyout and another 20% in real estate. Of the unused buyout funds, US\$45 billion are held by funds focusing on Asia and "Rest of the World". That is substantial firepower, and private equity sees buying opportunities as valuation nosedives and alternate sources of capital dry up. However, a yawning

valuation gap has emerged as sellers are holding out for better valuation when the stock and financial markets stabilise. The same conditions are causing buyers to be extra prudent. This gap will only begin to narrow when both sellers and buyers perceive that the economy has hit rock bottom, which could be anywhere between the second and fourth quarter of this year. What is certain is that buyout transactions will be curtailed in 2009 as normalisation of the financial system is expected only in 2010, and even then, the lending environment will certainly be far more conservative than pre-2008.

Sovereign Wealth Funds ("SWFs") have generally stayed on the sidelines in the last quarter of 2008, apart from the £5.5 billion injection into Barclays from Qatar Holding and the ruler of Abu Dhabi. Faced with mounting paper losses on their US\$50 billion or so investments in the past two years to shore up US and European banks, over and above those from their other portfolio companies and trading positions, SWFs are likely to remain cautious throughout the first half of 2009. Controlling some US\$3 trillion of funds, and having a longer investment horizon, SWFs are able to capitalise on the dearth of credit to exploit cash deal opportunities. Nationalistic sensitivity remains the biggest stumbling block for SWFs' cross-border investments. As we have seen in recent years, while SWFs may be welcomed as white knights during tough economic times when their funds are needed by the host countries to save companies and jobs, sentiments and politics can change very quickly once the economy recovers. To mitigate this, we expect more SWFs to co-invest with private equity or strategic investors, especially so if sensitive industries or controlling stakes are involved.

This will be a year of opportunities, and also significant risks in M&A.

- Controlling shareholders will exploit the depressed stock markets to take their companies private. A case in point is Hong Kong-listed PCCW Ltd.
- Consolidation of the banking industry will continue as banks deleverage and merge for strength. For Asian buyers, this will create acquisition opportunities in both the Western banks' Asia operations and their non-core global businesses. Nomura acquired Lehman's investment banking business in Asia in the aftermath of its collapse. AIG's on-going sale of ILFC, one of the largest aircraft leasing businesses in the world, is rumoured to be attracting interest from Asian and Middle Eastern SWFs.

- Lavish government stimulus spending will boost the infrastructure industry.
- The oil and mining sectors will remain active as China continues with M&A to secure resources at relatively low prices. Australia-listed Straits Resources has received interest from Chinese and other Asian buyers for its 47% Singapore-listed Asia Resources, even as it issued AUD\$80 million of convertible bonds to Standard Chartered Private Equity.
- The environment is clearly on the agenda with the call for the Green New Deal, although the payback could be delayed by a few years as a result of the recession.
- Other sectors that are badly hit, like retail, real estate, transportation and logistics, will see mergers of necessity as troubled companies align with stronger ones for survival.
- Outbound M&A by Asia corporations will increase as they capitalise on the crisis to acquire Western companies for market access, technology, intellectual property, brands and even international management know-how, as we saw in Lenova's acquisition of IBM's personal computer business a few years ago.

We expect to see a surge in distressed deals in the second half of 2009 as more short term debts become due in the coming months. These deals typically have higher risks,

but shorter execution timeline. The Bank of America takeover of Merrill Lynch is a good example of what could go wrong and how it could drag down the buyer. The challenge for buyers will be to conduct incisive due diligence in the timeframe permitted - to understand the financial position, cash flow and capital requirements of the business to be acquired, and the value that can be unlocked post-acquisition. To preserve value, distressed deals will require swift and decisive action post-acquisition to take control, restructure and integrate. For distressed businesses, a substantial portion of their value to buyers may arise from post-acquisition restructuring and synergistic integration. It is thus imperative that a high-powered integration team be set up at the start of deal execution, and planning for post-acquisition activities conducted concurrently and fed to the deal execution team. Parts of the plan, including taking control, should be put into action as soon as the deal is signed.

As we enter the eye of this unprecedented financial storm with dread and trepidation, we brace ourselves for the trail of economic destruction ahead. There is pervasive uncertainty about the new world economic order that awaits us. It is too early to predict what new regulation we will see, how the financial sector will be restructured, and what impact these will have on future economic growth and asset prices. What is certain is that the winners will be those with the vision, extraordinary courage and discipline to seek out opportunities amidst the prevailing crisis. ■