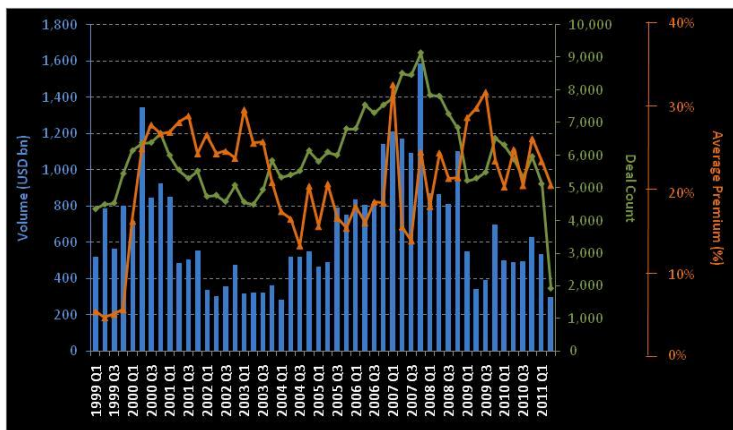


In the movie "Wall Street: Money Never Sleeps", Michael Douglas playing Gordon Gekko spoke to a university classroom and he said: "Someone reminded me I once said greed is good. Now it seems it's legal." To encapsulate the development of M&A over the past twenty years, my lame attempt is: "M&A used to be Anglo-Saxon, now it seems it's global."

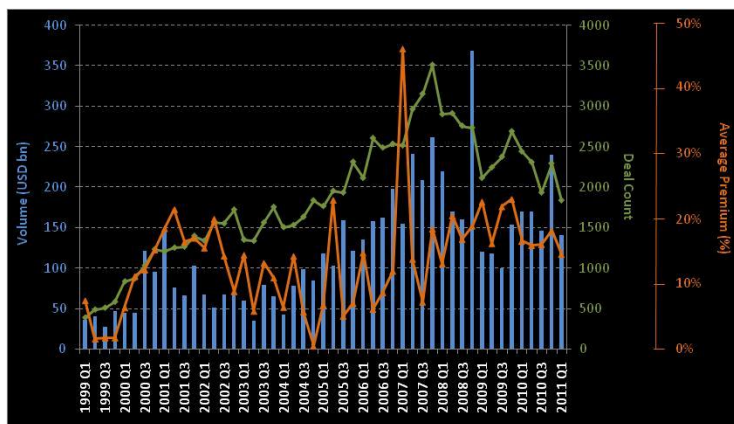
Figure 1: M&A Activities - Global



As well, corporations weren't doing M&A full time, now there's an expanding private equity industry. These people are paid to only do deals.

Globalization has always been led by pop culture, trade, capital flows, direct investments, and labor mobility - in this order. However, the capital formation for direct investments have traditionally been in greenfields and joint ventures.

Figure 2: M&A Activities – Asia



Corporate takeovers have been the province of Americans and Europeans. This is in part due to cultural reasons but mostly to do with the degree of institutionalization of stock markets. By and large, the ownerships of corporations in the United States and Western Europe are fragmentally held by investment management institutions. The ownership of corporations in the Emerging Markets including Asia are still largely family controlled. Institutional investors vote with their wallets while families often vote with their hearts. The latter is not always an economic decision.

## **Buy Versus Build**

The strategic imperative to expand market share locally and geographically have been a key driver of M&A transactions. The difference between investments in greenfield projects versus M&A is Buy versus Build. M&A yields immediate gratification.

M&A can be categorized into four distinct moves: 1. buy suppliers (backward integration); 2. buy customers (forward integration); 3. buy more of the same (horizontal integration); 4. buy anything (conglomeration). The private equity industry's model is very close to this fourth category.

## **Vertical Integration**

The industrial logic of Vertical Integration - backward and forward - is much about access of supplies or access of markets. Examples of backward integrations are: power utilities acquiring coal mines, palm oil refiner acquiring palm plantations, plastic polymer manufacturer acquiring an olefin cracker. The role reversals of the above pairings are basically forward integration.

## **Horizontal Integration**

Horizontal moves are all about buying market share, buying out competitors, and buying more of the same. The industrial logic is much about improving bargaining power with suppliers (purchasing) as well as with customers (pricing).

## **Conglomeration**

There were no precise moments but conglomeration roughly came with the Beatles and went out of fashion together with disco music. Yale University professor Burton Malkiel theorized in his book "A Random Walk Down Wall Street" that the age of conglomeration was fueled by the market's fad in electronics during an era that began around the 60's. That, electronics then is similar to the market's more recent

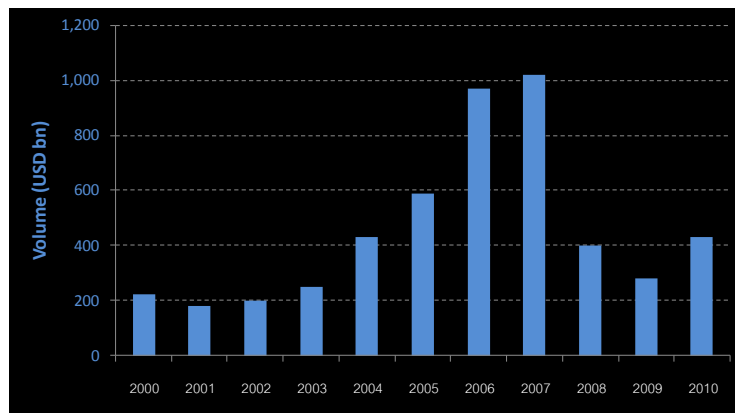
fascination with the Internet or Alternative Energy, there was much price misalignment and the stock prices of just about any company that had a toasters or hairdryers division which had its name romantically linked with electronics; and as professor Malkiel noted often they ended their company names with "NICS".

So the NIC companies using their 20 times price-to-earnings would buy off a prunes pureé producer which traded on 10 times price-to-earnings ratio and increase whatever the earnings the latter contributed to it which now also traded on 20 times. In an act likened to pulling a rabbit out of a hat, value creation can be lazy and instead pull out a blowdryer and the market bought it. Repetition of this process created conglomerates. Well, this, plus a lot of overconfidence.

### The Rise of Private Equity

It's not clear who pioneered<sup>(1)</sup> private equity but Jerome Kohlberg, Henry Kravis, & George Roberts in the aggregate known as KKR and handful of others like Teddy Forstman, William E. Simon were visible names in the 80's. It's almost as if private equity was ushered in as conglomerates were being tossed out. Capital markets became more demanding of managerial talents and their message was: "if you're good at tennis then compete in tennis and not baseball. Don't diversify for us because we have the ability to diversify for ourselves through choice investments of best-in-class." Thus, the beginning of unwinding of conglomeration via restructurings. Non-core companies were divested via Leveraged BuyOuts (LBO) and Management Buyouts backed by private equity.

Figure 3: Private Equity

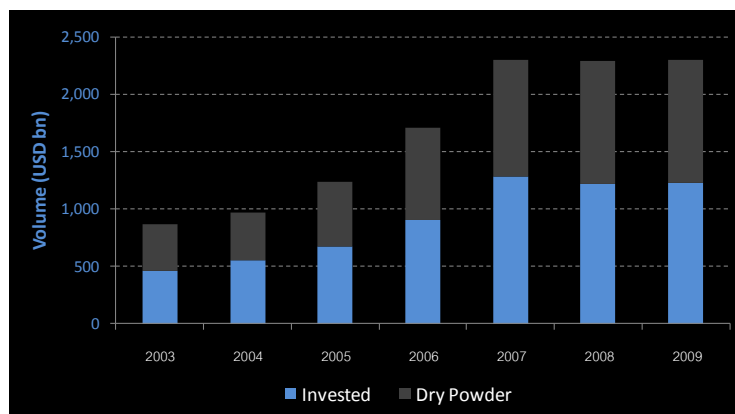


## The Business of Private Equity

Private Equity deals primarily in the context of direct equity investments in the private market as opposed to the public market. However, the writ of private equity is not confined to unlisted companies but often times deal with acquisitions of publicly listed companies by taking them private via delisting. Other times, private equity investors may buy significant minority stakes of companies that remain listed and the essence here is that unlike public equity investors, the private equity investors do not constantly trade in and out of their investments.

One other way of looking at private equity investment is to look at it as an asset class that is different to public equity investments. By their charter, they are commitments of funds from institutions such as pension funds, endowments, and, insurance companies known in the aggregate as Limited Partners (LPs) for a period of 10-12 years as the fund life. Investments are made during the Investing Period, say, the first 5-7 years and then divested during the Harvesting Period, say, in the last five years of the fund life. Dividends and divestment proceeds when are available are distributed to the LPs and there is no concept of reinvestment and thus the elimination of active trading of such and such stocks.

**Figure 4: Private Equity Asset under Management**



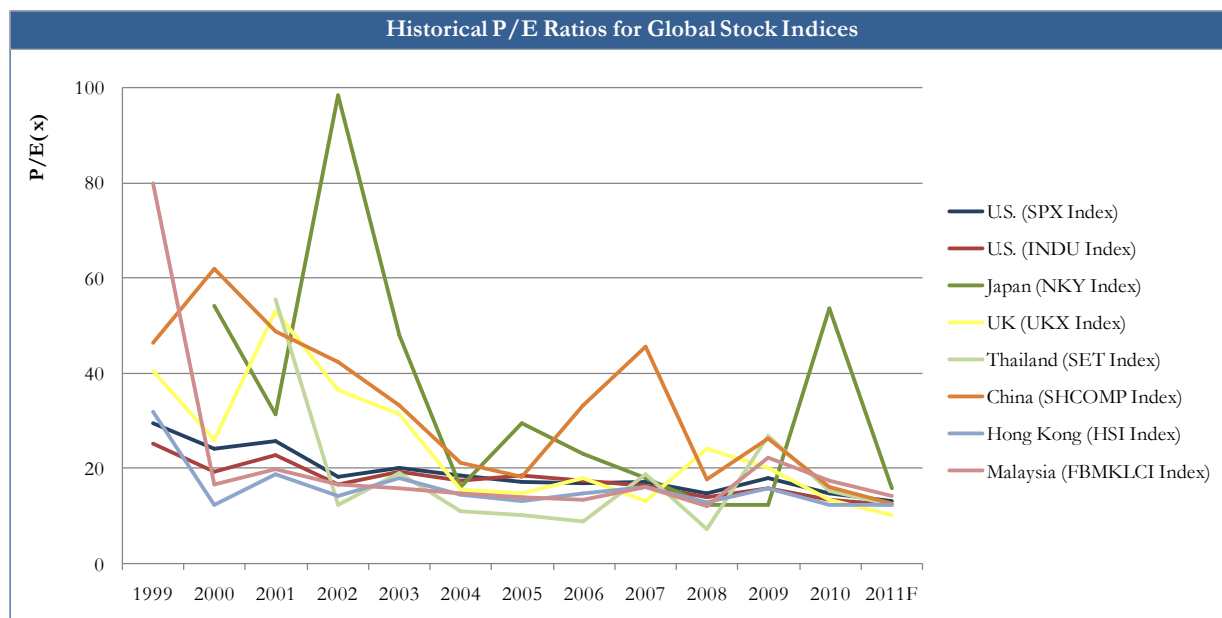
It was not until the mid-80's when Private Equity stepped into the limelight most visibly via the US\$30 billion LBO transaction of RJR Nabisco by KKR. And since then, it became an industry that hires people to buy, manage, monitor, sell, and fix companies. This industry is a major contributor to the professionalization of M&A.

## Globalization of Valuations

Twenty years ago, Japan traded on an average P/E ratio of 75 times: the Industrials traded on about 65 times and the Financials traded 120 times. When you pay seventy-five Yen to earn one Yen, that's a return of only 1.33 percent. If an American company trading on 25 times which it did some twenty years back wanted to merge with a Japanese company that was trading on 75, it couldn't and wouldn't based on the economic disparity. It was unexplainable why one dollar profit made in Japan traded three times higher than one dollar of profit made in the United States.

**Figure 5: The Convergence of Global Valuations**

- The indication of global valuation convergence will induce cross-border mergers, since companies in many countries are trading at comparable valuation multiples



Source: Bloomberg

Note: PE for Japan (NKY Index) in 2009 is assumed to be equal to that in 2008 as earnings in 2009 is negative

Not all companies trade on the same P/E ratio whichever country they're in because they come with different risk-reward profiles, earnings growths, quality of earnings, and a few other fundamentals. But if the disparity of valuations were purely due to trapped liquidity and other irrational behavioral aspects of investors then these assets are often times mispriced.

Today, valuations in key markets have converged. Notwithstanding anomalies in some markets or sectors, they're trading somewhere between low teens to high teens. One dollar return on fifteen dollar investment is 6.67 percent which is more like an equity

return with the prospect of growths. While it's not adopted as quickly as the blue jeans, finally valuation is global. I believe that here on a higher volume of M&A transactions will be facilitated by valuation convergence.

Note: (1) The opening sentence of Messrs. Mathonet and Meyer's book "J Curve Exposure" attest that it was Queen Isabella of Castile who did the first private equity deal. They cited Haenning who documented that: "Lacking the necessary resources, Columbus asked King John II of Portugal in 1484 to back his voyage but was refused. The next year he went to Spain to seek aid of Queen Isabella and King Ferdinand. Isabella not only furnished financial support, but also provided management and recruitment assistance. She went even one step further; she allowed Columbus to share in the profits." It seems to me that may be Queen Isabella is the first Limited Partner (LP)!

#### About the author

Pakpoom Vallisuta is founder of The Quant Group. Pakpoom is Chairman of the firm and is a board member of Duke University's Fuqua School of Business.