

M&A and Restructuring in the Asian Banking Industry

By

Kyuyeol Cho

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Professor Seung-Joo Lee

ABSTRACT

Mergers and acquisitions(M&As) among financial institutions are occurring at a rapid pace in Asia after the financial crisis. Asian governments began to reshape their banking industries by closing or nationalizing insolvent banks, and forcing M&A deals between banks. This paper examines the key issues of M&A and restructuring in the Asian banking industry and is organized into three parts: theoretical approach, regional survey, and case study. The Asian banking industry since the financial crisis experienced a major restructuring and recapitalization through the introduction of new foreign capital or the adoption of aggressive M&A strategy. Korea's banking industry also faced the situation where the IMF forced the Korean government to lead the restructuring of the financial sector. The Korean banking industry experienced massive shutdowns and mergers of ailing financial institutions for the first time in its history. This paper also examines, through a case study, the takeover of Korea First Bank(KFB) by Newbridge Capital, which marked the first step to bring foreign competition into the Korean banking sector. Newbridge's takeover of KFB is expected to modernize the Korean banking system, promote transparency in bank management, and rebuild the relationship between business and government.

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1. Introduction

The banking industry is consolidating around the world. Mergers and acquisitions (M&As) among financial institutions are occurring at a rapid pace in the US and in Europe, and emerging as part of the solution to problems of the financial crisis in Asia. It is expected that a new wave of M&As between large banks and other types of financial institutions will emerge. The main motivation behind this consolidation trend is to maximize shareholder's value by improving the product development process, transferring best practices and core competencies from one bank to another, and reducing funding costs and operating expenses.

After the Asian financial crisis, most banks in troubled countries suffered from soaring non-performing loans and the collapse of stock and real-estate markets. As a result, most Asian governments began to reshape their banking industries by closing or nationalizing insolvent banks, forcing M&A deals between banks, and eliminating domestic restrictions on foreign ownership. Local banks in the region could no longer rely on internal growth to expand their business in the global market.

M&A provides several advantages. Banks with a large capital base and diversified assets can be more competitive than small banks with a limited line of business. Big banks can create economies of scale and compete better on price. The governments of Asian countries also realized that a sound banking system was essential for sustained economic growth. Across Asia, privately and state-owned local banks will face vastly changed markets in the 21st century, compared to those of the 1980s and much of the 1990s. Customers will be more demanding, competition more intense, and accounting much more transparent (Dominic

Casserley, 1999, p.401). Therefore, the biggest challenge to Asian local banks is to develop a new strategy to ensure their success in a world of mega-banks.

In this sense, Korean commercial banks, which still lack sufficient scale and profitability, are compelled to merge without government pressure in order to survive in a tougher environment. The Korean banking industry is now in a calm before the storm of the second round of restructuring. The Korean government should provide the necessary rules and guidelines to ensure banking autonomy and managerial independence. Considering the importance of a well-functioning banking system to Korea's economic stability, it is important for the Korean government to complete the financial restructuring successfully.

The takeover of Korea First Bank(KFB) by Newbridge, a U.S. investment firm, was finalized on December 23, 1999. This M&A deal marked the first step to bring foreign competition into the Korean banking sector. Newbridge's takeover of KFB is expected to modernize the Korean banking system, promote transparency in management, and help Korea's financial sector regain international confidence. The new top management team of KFB has installed strong financial discipline in terms of pricing and balance sheet management, and is providing KFB an opportunity to reclaim its legacy.

This paper aims to examine the key issues of M&A and restructuring in the Asian banking industry. This paper is organized into three parts: theoretical approach, regional survey, and case study. In the theoretical approach, the paper reviews the main motivations for bank M&A, the key M&A processes, the concept of synergy value, and how to value banks in a M&A deal. The regional survey examines the transformational process of key local banks in Asia and the recent

M&A activities in Singapore, Hong Kong, Japan, and Korea. Finally, the case study examines the merger between KFB and Newbridge, focusing on the issues of strategic motivations, deal structure, negotiation, and post-merger integration.

2. Theoretical Approach to Bank M&A

2.1. Motivations of Bank M&A

Bank M&As take place mainly because: 1) relevant banks expect to increase their shareholders' value or reduce their risk exposure through diversification; or 2) bank managers involved expect to get higher salaries, greater job security, and better employee benefits from managing a larger bank (Allen N. Berger, 1999, p.144~151). In this section, I will discuss some of the main motives of the recent wave of bank M&As.

2.1.1. Value Maximization Motives

Increasing Efficiency and Potential Profit

Banks can maximize their value through M&As by increasing their market power or their efficiency. The decision to acquire another bank is motivated if M&As can improve profit potential of the acquiring bank and increase the market value of the acquiring bank's shareholders. Shareholder's value will increase through M&As only if the future cashflows of the merged bank exceeds the sum of the future cashflows of the two individual banks (Allen N. Berger, 1999, p.145).

In a substantial portion of bank M&As, larger, more efficient banks tend to take over smaller, less efficient banks. Normally, acquiring banks appear to be more cost efficient, profitable, and have smaller non-performing loans than target banks.

Efficiency may be enhanced by M&As if the acquiring bank's management is better trained than the management of the target bank, and so the acquiring bank transfers its best practices and core competencies to the target bank, resulting in more effective control over operating expenses. More recently, it has been proved that cost savings through M&As can be achieved by laying off unnecessary staff, closing branch offices, and eliminating duplicate jobs (Allen N. Berger, 1999, p.144~146).

Reducing Risk Exposure

Many M&A experts still believe that bank M&A can reduce both cash flow risk and earning risk. M&A gives the acquiring bank opportunities to open up new markets or broaden the menu of financial services which has different cash flows in timing from the cash flows generated by existing services. It will reduce the acquiring banks' risk exposure from relying on too narrow a lineup of services (Peter S. Rose, 1998, p.168~176). This risk reduction effect will make the acquiring banks stable enough to withstand wide fluctuations in the economic conditions and competitive environment of the banking industry.

Some banks may try to increase the value of their access to the government's financial safety net(including deposit insurance) through M&As. If financial market participants perceive very large banks to be "too big to fail", - i.e., that explicit or implicit government guarantee will protect debtholders or shareholders of these banks - there may be incentives to increase size through M&As in order to reduce the bankruptcy risk (Allen N. Berger, 1999, p.144~146).

2.1.2. Non-Value Maximization Motives

In some cases, M&As are not directly motivated by the desire to increase the shareholder's value of the acquiring bank. Stakeholders, such as managers and governments, other than shareholders may have the initiative to make a decision for M&As. In addition, other factors, such as technological progress, and financial distress may be the cause of expanding the recent M&A activities in the banking industry.

Manager-Utility Maximization

The management of acquiring banks may be motivated by the desire to increase the acquiring bank's size regardless of whether the acquisition is a value-creating activity. The separation of ownership and management may lead managers to increase their own utilities rather than maximize shareholder's value. If the size of the bank or managers' compensation is closely related with manager's utility, then managers will take the high growth strategy.

Manager's compensation tends to increase with bank size, so managers hope to achieve personal financial gains by engaging in M&As. In addition, managers are likely to easily find their non-monetary rewards, such as power, prestige, and obtain a greater degree of job security in larger banks. Finally, managers who feel little pay sensitivity to their performance tend to make M&A deals that do not maximize shareholder's value (Allen N. Berger, 1999, p.146~147).

Technological Progress

Since the end of the 1980s, technological progress in the banking industry has increased scale economies by providing diversified financial services and improving efficiency. Progress in payment technology has also created network and scale economies in banking business. New tools of financial engineering, such as financial derivatives, risk management, off-balance-sheet financing have been more efficiently devised and provided by larger banks. Therefore, the fast pace of technological progress played a major role in facilitating M&A activity in the banking industry (Allen N. Berger, 1999, p.148).

Rescue of Troubled Bank

M&As may be an efficient way of resolving problems of financial distress in the banking industry. Banks that are troubled due to high non-performing loan ratios, or their own inefficiency and low profitability are often taken over as an efficient alternative to bankruptcy or other means of exit. Government's financial regulators may also act to force the pace of recapitalization by adopting aggressive M&A policies, including measures to nationalize or close troubled banks (Allen N. Berger, 1999, p.149~150).

2.2. The M&A Process

The rapid revolution in communications and electronics has created enormous pressure for changes in all of the important sectors of the banking industry. M&As have been actively used as a tool to respond to these changes and achieve strategic objectives in the banking business. However, as M&As have a significant

impact on the overall profitability and financial health of banks, the same thoughtful planning and execution for M&A deals as the introduction of a new project, should be implemented. This section is devoted to a brief outline of the M&A process, starting with the development of strategic planning and ending with the execution of the M&A agreement.

2.2.1. Strategic Planning

A successful M&A program must be a major part of a bank's overall strategic plan. M&A can support a number of important strategic goals including growth, diversification, and access to international best practices. However, in many cases, M&As fail to achieve their strategic objectives. Some M&A deals are done more to increase the self-interest of managers than to maximize shareholder's value. Therefore, an integrated M&A program should be based on the evaluation of both internal and external factors, identifying competitive strengths and weaknesses, reaffirming strategic objectives, technological needs, and other strategic issues.

The first step in developing strategic planning of M&A deal should be a thorough analysis of the acquiring bank itself. A comprehensive analysis of the acquiring bank's own strengths and weaknesses is a normal part of the strategic planning process. Despite the importance of this strategic analysis, some acquiring banks fail to give enough time and resources to this area. A brief check list of the issues to be reviewed should be as follows: (Thomas Thamara, 1998, p.334)

- Analysis of the sources of past profitability
- Geographic constraints of banking business
- Significant changes expected in the banking business environment of the future

- Competitive strengths and weaknesses in the new banking environment
- Strengths and weaknesses of existing and potential competitors

The next step is to identify the objectives and goals of the acquiring bank in order to ensure that a proposed M&A deal will help the acquiring bank achieve its primary objective of increasing shareholder's value. M&As should offer clear advantages over achieving the same objectives through internal growth. These advantages may include a lower level of risk, time saving, and lower costs.

After understanding its own strengths and weaknesses, and its strategic objectives and goals, the acquiring bank should develop flexible M&A criteria. M&A criteria should be broad, but specific enough to help the acquiring bank identify a potential fit of the deal and review the alternative target banks. If the criteria is too rigid in scope, a less attractive target bank may be acquired because the more attractive target banks were already taken.

2.2.2. Screening M&A Candidates

After developing the strategic plan of a proposed M&A deal, the acquiring bank should screen potential M&A candidates to identify the right partner who would offer the maximum relative synergy. In order to select the best candidate, the acquiring bank should perform a very detailed valuation of potential candidates, taking into account both the value of the target bank on a stand-alone basis and the value of synergies that would be created by the proposed M&A (Thomas Thamara, 1998, p.335).

This valuation should be supplemented by a careful sensitivity analysis of the

target bank to changes in some critical assumptions. This valuation procedure¹⁾ enables the acquiring bank to quantify the relevant risks of the deal and helps set the maximum purchasing price from the acquiring bank's point of view and the minimum selling price from the target bank's point of view. The price gap between these two prices gives benefits to both parties, thanks to the value creation of M&A deal. The following key principles can be used as a tool to check whether a proposed M&A candidate is appropriate or not.

Table 1. Key Principles in Screening M&A Candidates

No.	Contents of Key Principles
1	Calculation of Value Creation by M&A : The value of the merged bank equals the value of the acquiring bank before M&A, plus the value of the target bank before M&A, plus the value of any <i>synergy</i> .
2	Pricing M&A Transaction The maximum price that the acquiring bank should pay for the target bank is the sum of the target bank's value before M&A, plus the value of the <i>synergy</i> .
3	Benefits from M&A for the Acquiring Bank The benefits from M&A for the shareholders of acquiring bank is the maximum price(see 2) less the actual price paid.
4	Every increase in the price paid for the acquiring bank is a direct transfer of funds from the shareholders of target bank to the shareholders of acquiring bank.
5	If there is no <i>synergy</i> in M&A transaction, the share price of acquiring bank will drop if the acquiring bank pays a premium over the market value of target bank.
6	If there is <i>synergy</i> in a M&A transaction, there is a range of purchasing prices over which both parties can benefit.
7	There will be a negative impact on the share price of acquiring bank if the acquiring bank overpays, even in a synergistic M&A transaction.

Source : Thomas Thamara, *Banker's Guide to New Growth Opportunities*, 1998, p.328 ~333.

2.2.3. Structuring M&A Deals

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1. The valuation procedure has the following three principal steps:
 - ① Valuation of the acquiring bank on a stand-alone basis
 - ② Valuation of *synergies* resulting from M&A
 - ③ Sensitivity analysis of the resulting valuation

The previous screening process is designed to identify the prime M&A partners. Once having identified the prime M&A partner, the acquiring bank should try its best to have a good relationship with its counterpart well in advance of negotiation. Once negotiations have commenced, the valuation process discussed previously would help reduce the difference of views between both parties. M&A deals will take place only if both parties agree on the negotiating terms, including the price of the deal.

In any M&A deal, the pricing range is determined by quantifying the target bank's estimated value on a separate basis and its combined value after M&A deal (Ernst & Young, 1994, p14~15). By using multiple valuation methods, the ceiling and floor price range can be determined and the critical factors that affect the value of the deal will be clearly identified. Price considerations are generally the main issues of negotiation between both parties. Terms and conditions that provide an economic advantage for one party usually impose an economic disadvantage on the other (Ernst & Young, 1994, p.15). Once both parties move toward agreement, the acquiring bank has to organize a team of managers, lawyers, CPAs, and specialists to conduct due diligence²).

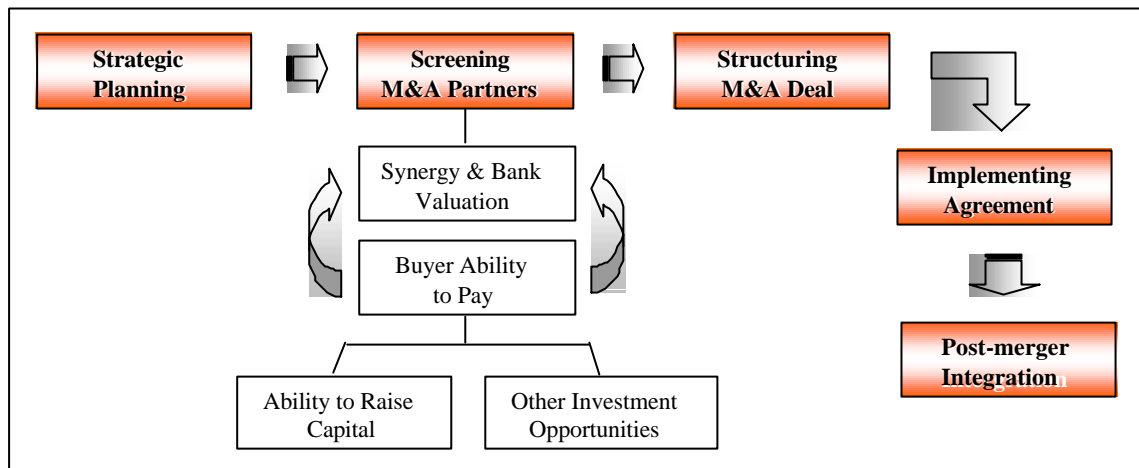
2.2.4. Implementing the Agreement

The implementation process is a demanding process asking for strong relationship at senior and junior management level of both parties. Drastic reduction in staff or branch offices, if necessary, should be made as swiftly as possible. In many cases, regulatory agencies tend to let a long time pass between the initial

2. Due diligence is a process that involves learning as much as possible about the target bank's business, financial status, and other operations (Ernst & Young, 1994, p.16).

agreement and the implementation of the agreement. This time delay can cause the target banks' management to increase the uncertainty and second-guess about the deal.

Figure 1. M&A Deal Process



2.2.5. Post-Merger Integration

The main objective in the post-merger integration process is to make a smooth transition of ownership, initiate the planned changes, and move toward the acquiring banks' way of doing business without destroying the benefits and advantages gained in the deal. There is no formula for post-merger integration process³). However, it is evident that mismanagement of this integration process is one of the main reasons for M&A failure. The goal of post-merger integration is a transformation, not a revolution. When changes must be made, the acquiring banks should follow the best established practices in organizational change management (Ernst & Young, 1994, p.226).

2.3. Synergy Valuation

3. for more details, see Bruce R. Robinson, Strategic Acquisitions, 1995, p.131 ~140.

The acquiring bank is always looking for the largest possible relative synergy. From the acquiring bank's point of view, synergy value is very important. As synergy increases, the maximum price the acquiring bank is willing to pay also increases. It will cause a M&A deal creating high synergy value to be more attractive to the shareholders of target bank. The next discussion is devoted to the concept of synergy value, the main sources of synergy, and the synergy trap.

2.3.1. Concept of Synergy Value

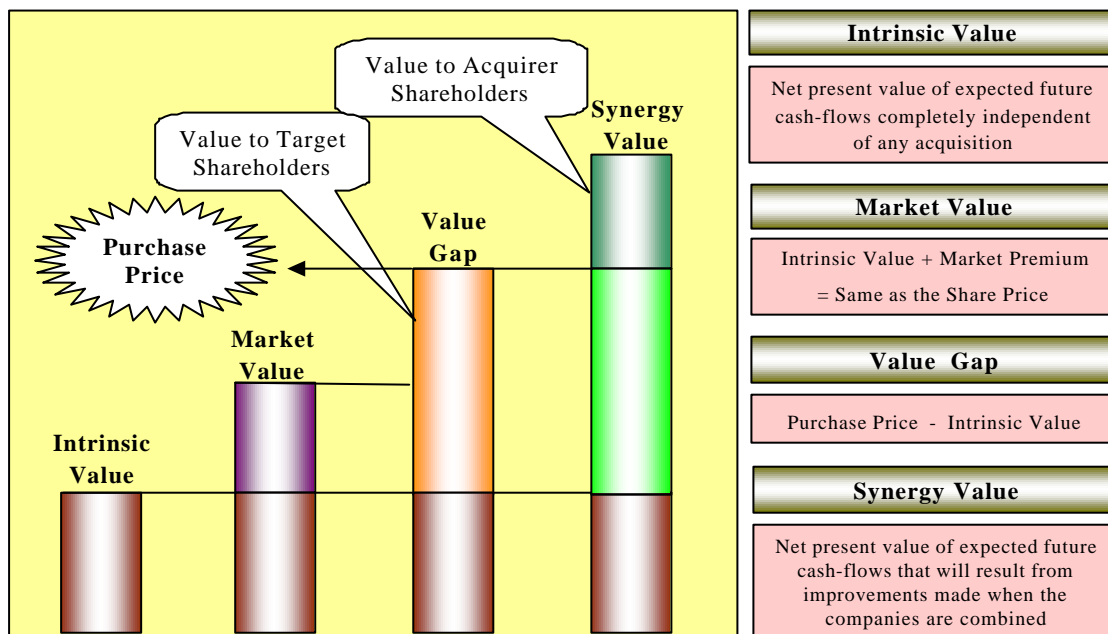
Synergy value is the net present value of the cash flows that will be generated from the two combined banks above the cash flows that two separate banks would have generated if a proposed M&A had not occurred. The valuation of synergy is the key process in M&A deal in order to give benefits to the shareholders of both parties.

In today's M&A market, the purchasing price of an acquisition tends to be always higher than the intrinsic value of the target bank, which is based on the net present value of expected future cash flows completely independent of any acquisition. Acquiring bank needs to be sure there are enough cost savings and profit generating synergy value in a proposed acquisition. In order to justify the premium and judge the merits of a proposed acquisition, acquiring bank also needs to understand several distinct concepts of value (See Figure 2).

Pricing an acquisition correctly is so difficult that many M&A deals fail to create their expected value before the deal. Many failures occur just because the acquiring bank pays too much for the acquisition. The reason so many acquisitions are overpaid are that senior executives of acquiring bank get caught up in the

excitement of the deal and have illusionary synergies. Therefore, the key to success in an acquisition is not only to know the maximum price to pay, but also have the discipline not to pay a penny more if a proposed acquisition destroys the value. Acquiring bank needs to figure out how large a value gap, the difference between the purchasing price and the intrinsic value, it can bridge through synergy value.

Figure 2. Concept of Synergy Values in M&As



Source : Harvard Business Review, July-August, 1999, p.140

2.3.2. Sources of Synergy Value

Synergy value can be created by enhancing an existing strength or by combining strengths and weaknesses. It is not easy for the acquiring bank to generalize about which course is appropriate for its choice. The following are the main sources of synergy in M&As between banks.

Improved Skills in Operation and Management

The skill level of operation and management is a key source of synergy, especially in M&As between banks with complementary strengths and strategies. For instance between a retail bank which has a core-competence in domestic deposit gathering and a relatively low risk exposure for its credit balance, and a wholesale bank which has strengths in foreign exchange and corporate finance and a relatively high risk exposure for its credit activities.

Process improvements occur when managers transfer best practices and core competences from one bank to another. The best practices in operation and management can be transferred in either direction after the M&A deal. M&As are desirable when it is necessary to acquire management skills in a short period of time. In addition, cost savings can be realized by eliminating duplicate jobs and branch offices especially in M&A deal between two banks which have similar business patterns and strategies.

Economies of Scale

Financial or geographical benefits resulting from economies of scale is another source of synergy in bank M&As. Financial synergy can be obtained from economies of scale in funding, because large banks can easily access the international money markets at lower cost than small banks can. Meanwhile, geographical synergy can be acquired by allowing customers to access the same banking services over a wider geographical area. The broader geographical coverage enables the merged bank to retain customers it would otherwise lose, or host new additional customers who would not otherwise be attracted. This geographical synergy factor has contributed to spreading the M&A boom in the

banking industry for the last decade.

2.3.3. The Synergy Trap

In many cases, it's not uncommon to find that the acquiring banks are paying too much for the deal. One study covering M&A activities in the past 75 years concluded that over half of M&As failed to create their expected synergy value (Allen N. Berger, 1999, p.139). Logically, an acquisition strategy can be adopted by the acquiring banks only when it gives a greater value than other strategic alternatives. The synergy value can be defined as $2 + 2 = 5$. However, this equation has several pitfalls due to the unique characteristics inherent in an acquisition deal.

Paying a premium for an acquisition, the acquiring banks have to meet both the performance criteria the market is expecting and an even higher performance target added by a premium. The premium represents the value of the additional performance requirements (Mark L. Sirower, 1997, p.6). Synergy value can be defined as performance gains beyond those the market already expects. The net present value(NPV)⁴ of an acquisition can be acquired by subtracting a premium from a synergy value. Therefore, the acquiring banks that do not fully recognize this basic equation are apt to fall into the synergy trap.

4. Net Present Value(NPV) = Synergy - Premium

① $\text{Synergy} \geq \text{Premium}$: Successful acquisition

② $0 \leq \text{Synergy} \leq \text{Premium}$: Paid too much for the acquisition, resulting in decrease in the share-holders' value.

③ $\text{Synergy} < 0$: Pure value destroying acquisition, resulting in a complete loss of the premium paid for an acquisition(For more details, see Mark L. Sirower, The Synergy Trap, p.18 ~74).

2.4. Bank Valuation

In general, there are two approaches for bank valuation. The first one is the *discounted cash flow(DCF) approach*, calculating the present value of expected cash flows⁵⁾ of a bank. The second one is the *relative valuation approach*, estimating the value of a bank by using a common variable such as price/earning(P/E) ratio, price/book value(PBV) ratio, and so forth. This section will examine these two approaches in more detail.

2.4.1. Discounted Cash Flow(DCF) Approach

This approach is basically to calculate the present value of expected future cash flows of a bank. There are two ways to DCF approach. The first one is the *equity approach* which estimates just the equity value of a bank, while the second one is the *entity approach* which estimates the entity value, including both equity and debt, of a bank. While both approaches discount expected cash flows, the relevant cash flows and discount rates are different under each approach (Aswath Damodaran, 1996, p.10). Brief comparisons of the two approaches are as follows:

The entity approach is to discount the expected free cash flows to entity at the WACC in order to first get the value of entity, then it subtracts the value of the debt to obtain the value of equity. Even though both approaches give the same result mathematically, the equity approach is more appropriate and convenient for valuing banks. There are a number of conceptual reasons for it.

5. For more details regarding the definition and calculation of cash flows to bank's shareholders, refer to Tom Copeland, Valuation, 2nd ed., 1995, p.500 ~501.

Table 2. Comparisons of Equity & Entity Approach

	Equity Approach	Entity Approach
Valuation	The value of equity is obtained by discounting expected cash flows to equity at the cost of equity.	The value of entity is obtained by discounting expected cash flows to entity at the WACC.
Cash Flows	<i>Cash Flows to Equity</i> (Cash flows left over after meeting operating expenses, interest and principal payment, and any capital expenditures)	<i>Cash Flows to Entity</i> (Cash flows left over after meeting operating expenses and taxes, but before making payments to any claimholders)
Discount Rate	Cost of Equity ¹⁾	WACC ²⁾
Equity Value	Equity Value	Entity Value - Debt Value

1) The cost of equity is the rate of return that investors require to make an equity investment in a bank. The cost of equity can be calculated by using either Capital Asset Pricing Model(CAPM) or Dividend Growth Model.

① CAPM Model : Cost of Equity(R_e) = $R_f + \beta(R_m - R_f)$

⇒ R_f : Risk free rate, β : Beta of the bank, R_m : Expected return on the market index

② Dividend Growth Model : $R_e = \text{DPS}_1/P_0 + g$

⇒ DPS_1 : Expected dividends per share next year, P_0 : Price of the bank's stock today, g : Growth rate of dividends

2) The WACC is defined as the Weighted Average Cost of Capital of different components of financing, including debt, equity, and hybrid securities, used by a bank to fund its financial requirements. The WACC can be calculated by the following formula.

$$\text{WACC} = R_e[E/(D+E)] + R_d[D/(D+E)]$$

⇒ Cost of Debt(R_d) : Pretax rate(1 - Tax rate), E : Value of Equity, D : Value of Debt

(For more details, see Aswath Damodaran, Investment Valuation, 1996, p.9 ~ 19, p.47 ~ 68)

First, the deposit franchise given by the government to the bank potentially allows the bank to create value on the liabilities side of its balance sheet (Tom Copeland, 1995, p.499). Banks can raise capital with customer's deposits at lower cost than borrowing in the capital market. As the equity approach regards liability as part of business operations, it is more appropriate for valuing the bank. Second, because the cost of capital for deposits with customers is really hard to calculate and the spread gap between the interest received on loans and the discount rate(WACC) is very small, a minor error in calculating the WACC can

cause huge fluctuations in the value of the entity. Therefore, it is strongly recommended to choose the equity approach in valuing a bank.

2.4.2. Relative Valuation Approach

There is no doubt that DCF approach is the conceptually correct method in estimating the value of a bank. However, calculating expected future cash flows and estimating the discount rate are often difficult, in practice. As a result, new rules of thumb were developed to determine the premium in bank M&A deals. This section will present the alternative approaches using multiples such as price/earning(P/E) ratio and price/book value(PBV) ratio for valuing a bank.

Price/Earning(P/E) Ratio

The P/E ratio is one of the most widely used valuation approaches due to its simplicity to calculate and compare with other stocks. Even though there are a lot of reasons for using P/E ratio, there are also a number of things to keep in mind for using this multiple in practice. That's because the P/E ratio is not meaningful when the earning per share(EPS) is negative or volatile. The P/E ratio approach is particularly useful in case there are a large number of comparable entities being traded in the financial market and the market is, on average, pricing these entities correctly (Aswath Damodaran, 1996, p.14).

The value of equity for a stable entity can be calculated by using the Gordon growth model⁶. The equation of P/E ratio is described as: $P_0/EPS_1 = P/E \text{ Ratio} =$

6. The Gordon growth model can be used to value an entity that is in a stable growth stage in terms of dividend payment. This model relates the value of a stock to its expected dividends in the next time period, the required rate of return on the stock, and the expected growth rate in dividends.

Payout Ratio)/(r - g_D). The P/E ratio has a positive relationship with the payout ratio and growth rate, and a negative relationship with the required rate of return reflecting the riskiness of the bank. Individual P/E ratios are often expressed in relative terms. When a bank's P/E ratio is higher than the P/E ratio of the average P/E ratio of the same industry, it insinuates that the bank is considered to have more growth potential than the average growth expectation of the remaining listed banks. When we know the P/E ratios of both the acquiring bank and the target bank in an actual M&A deal, the exchange ratio of stocks between the two banks can be determined without difficulty.

Price/Book Value(PBV) Ratio

The book value of equity can be defined as the gap between the book value of assets and the book value of liabilities. The book value of assets decreases predictably due to allowable depreciation of the assets as time goes by. Meanwhile, the book value of liabilities keeps maintaining its initial value regardless of time. However, the market value of assets is affected by some factors such as expected future cash flows and profit potential. As a result, the book value of assets tends to deviate from the market value of assets. Since the book value is generally accepted as a measure of the relatively instinctive value, investors who are not sure of the DCF value consider using the price/book value(PBV) ratio⁷⁾ as a benchmark for comparison. The PBV ratio is determined

$$\text{Value of Stock}(P_0) = \text{DPS}_1 / (r - g)$$

⇒ DPS_1 : expected dividends one year from now, g : growth rate of dividends forever,
 r : required rate of return for equity investor

Since $\text{DPS}_1 = \text{Earning per Share}(\text{EPS}_0) \times (\text{Payout Ratio})(1 + g_D)$, the value of equity can be rewritten as: $P_0 = [\text{EPS}_0 \times (\text{Payout Ratio})(1 + g_D)] / (r - g_D)$. Rearranging to get P/E ratio, $P_0 / \text{EPS}_0 = \text{P/E ratio} = (\text{Payout Ratio})(1 + g_D) / (r - g_D)$. If P/E ratio is stable in terms of expected earnings in the next time period, this can be simplified to: $P_0 / \text{EPS}_0 = \text{P/E ratio} = \text{Payout Ratio} / (r - g_D)$.

For more details, see Aswath Damodaran, Investment Valuation, p.191 ~218 & p.291 ~317.

by the gap between the return on equity and the required rate of return of a bank. If the return on equity is higher than the required rate of return, the market value of equity will also be higher than the book value of equity. In addition, the PBV ratio can also be used to check the equity value of a bank whether it is undervalued or overvalued compared with other similar banks.

However, there are some disadvantages to using the PBV ratio in valuing banks. First of all, the book value such as earnings and fixed assets of a bank can fluctuate depending on the accounting criteria used for depreciation and other variables. It is obvious that the PBV ratio is not reliable in case the accounting standards differ widely across banks. Second, when we apply the PBV ratio for financial institutions that have low fixed assets, the book value is not so conceptually meaningful and the PBV ratio may not appeal to investors as a tool for measuring value.

7 The PBV ratio can be derived in a similar way with the P/E ratio, except for using the concept of the return on equity, defined as $EPS_0/(\text{Book Value of Equity})$. The PBV ratio can be written as: $P_0/BV_0 = \text{PBV Ratio} = (ROE \times \text{Payout Ratio})/(r - g_r) = (ROE - g_r)/(r - g_r)$
 $\Leftrightarrow P_0$: Value of Equity, BV_0 : Book Value of Equity, g_r : Growth Rate of Dividends
 r : Required Rate of Return, g : $ROE(1 - \text{Payout Ratio})$

The PBV ratio is an increasing function of the return on equity, the payout ratio, and the growth rate, and a decreasing function of the riskness of an entity.(For more details, see Aswath Damodaran, Investment Valuation, 1996, p.318 ~337)

3. Recent M&A Trends in the Asian Banking Industry

3.1. Rebuilding Asian Banks

The Asian banking industry since the financial crisis in 1997 can be characterized as restructuring and recapitalizing for survival through the introduction of new foreign capital or the adoption of aggressive M&A strategy. When the Asian economies were booming in the past two decades, the regional banks in those countries were the prime beneficiaries, enjoying protective policies of their governments from foreign competition.

However, after the financial crisis, most banks in troubled countries suffered from the soaring non-performing loans and the collapse of stock and real-estate markets, resulting in a significant decline of collateral value below the level required to cover outstanding loans. As a result, most Asian governments began to reshape their banking industries by closing or nationalizing insolvent banks, forcing M&A deals between banks, and eliminating domestic restrictions on foreign ownership. This section examines the performance of regional banks in Asia, the transformational process of these banks, and then examines the emergence of new leaders in the Asian banking industry.

3.1.1. Operational Performance of Asian Banks in 1998

According to the Asiaweek "Financial 500", published in September 10, 1999, banks in the main crisis countries, such as Indonesia, South Korea, and Thailand suffered a total loss of U\$4.49 billion in 1998. The huge losses were mainly due to loan write-offs of financially troubled banks.

Asian banks are now preparing the ground for sustainable growth. Let's take a look at Singapore. Only nine banks were ranked within 500 in 1998, down from 12 last year, but their total assets went up to U\$171 billion from U\$153 billion. That's because Overseas Chinese Banking Corp.(No. 59) and Overseas Union Bank(No. 79) absorbed their once-autonomous units, Four Seas Bank and International Bank of Singapore, respectively. In case of Korea, the number of banks in the top 500 dropped to 19 from 28 due to mergers and closures, while assets rose to U\$452 billion from U\$395 billion. Meanwhile, Indonesia, where the financial crisis hit hardest, saw both the number of banks and their assets drop from 50 banks with U\$108 billion in assets to 36 banks with U\$52 billion.

Table 3. Asian Banks in the 500 Ranking by Country
(At the end of 1998)

Country	No. of Banks in 500	Assets (U\$ Bil)	Deposits		Net Profit('98) (U\$ Mil)	
			Ratio(%)	(U\$ Bil)		Ratio(%)
Australia	22	507	4.6	301	3.9	4,220
China	22	1,351	12.2	1,041	13.5	2,738
Hong Kong	26	370	3.3	309	4.0	3,472
India	54	181	1.6	141	1.8	1,364
Indonesia	36	36	0.5	45	0.6	△19,426
Japan	144	7,038	63.4	4,709	61.0	△64,644
Malaysia	34	134	1.2	108	1.4	△235
Singapore	9	171	1.4	146	1.9	842
South Korea	19	452	4.1	267	3.5	△11,348
Taiwan	46	538	4.8	420	5.4	3,255
Thailand	13	152	1.4	122	1.6	△9,329
Etc	75	176	1.5	115	1.5	1,173
Total	500	11,106	100.0	7,724	100.0	△87,918

Source : Asiaweek, September 10, 1999

The total assets of banks ranked within the above 500 fell nearly 11% in 1998 compared with 1997. Especially, in both South Korea and Thailand, the total

assets of listed banks in 1998 were 42% and 36% less than the total assets in the previous year, respectively. The poor performance of listed banks was even worse in the bottom line. The 500 listed banks earned 22% less profits in this year than in 1997. Surprisingly, most of the bad news came from Japan that was the world's second- largest economy and had a huge trade surplus. The net loss of profit of Japanese listed banks in 1998 amounted to U\$64.6 billion mainly due to the weakened yen and soaring non-performing loans of more than U\$600 billion at the end of March 1999.

3.1.2 Transformational Processes of Asian Banks

The renewal of Asian banks is under way with the restructuring processes involving closing, nationalizing, and merging ailing banks. Asian banks are struggling not just to survive, but to transform themselves into more competitive and profitable banks with innovative services, upgraded skills in risk management, and transparent accounting system. Across Asia, commercial and state-owned banks will face totally different markets in the 21st century compared to those in the 1980s - 90s. In order to meet the new challenges of this century, Asian banks need to implement the transformational programs which will help them reshape strategies, redesign the banking systems, develop new human resource policies, and finally improve performance. There is no universal program that can meet the needs of Asian banks for survival. However, the following three stages can be illustrated for reviewing the transformational process.

The first stage will be to recapitalize and restore public confidence lost after the financial crisis. In 1998, foreign banks like Citibank and HSBC succeeded in attracting deposits from Malaysia and Singapore with the help of frightened

depositors moving money from local banks to these foreign banks which were seemingly more secure. In order to get back this flexible money, local banks are required to show that they are financially sound by writing-off non-performing loans, raising new funds, and implementing recovery strategies.

The next stage will be to refocus on areas where they can build competitive advantage and sustain a truly competitive position in the future. In this stage, local banks should make it clear that they have to create a fact-based approach to future challenges and opportunities for building a strong, transparent, and logical foundation for transformational process. Local banks must alter not only their strategies but also their basic corporate culture. Those who fail to build the basic foundations and implement transformational strategies are likely to disappear. The final stage is to enhance their ability with regard to leadership, human resources, risk management, marketing, and credit analysis. Local banks should be able to compete with world-class global banks that are expected to have considerable market share in Asia by 2005. To overcome the final stage, local banks need to make a continuous effort for redesigning key processes to improve their performance and lower costs.

3.1.3 Emergence of New Leaders in the Asian Banking Industry

Many Asian banks, except for state-owned banks, are controlled by families. Being merged can infer losing authority and even their jobs. The main sources of M&A waves in this region are not bankers looking for greater efficiencies or profits, but government officials trying to strengthen the financial system. Regulators and supervisory agencies are the main drivers of M&As in Asia. Half of Asia's banks will either acquire or be acquired within the next two years, and

new leaders will emerge as a result of restructuring and consolidations.

A number of aggressive banks started to drive M&A strategy either for survival or for growth. DBS Bank, Singapore's largest bank, acquired banks in Thailand, Hong Kong, and the Philippines. Major global banks, such as ABN-Amro and GE Capital decided to take over some troubled banks in the region. Those banks that have ambitious strategy for M&A will have more opportunities to reshape the Asian banking industry and become new leaders in the next decade. The financial crisis of Latin America in the early 1990s gives us a good historic lesson that a surge of bank M&A activities occurred not at the initial stage of the crisis, but at the time of recovery. Two years have passed since the financial crisis occurred in Asia. It's obvious that there will be a surge of bank M&A activities in the near future.

However, those who adopted an aggressive M&A strategy in Asia will face a number of challenges. One of them is how to value the price of acquired bank in M&A deal. Because of the volatility of asset price and the difficulty of macroeconomic forecasting in the region, there will be a huge valuation gap between acquirers and acquirees. It will cause straight-forward deal structures to end in a failure. More creative and flexible deal structures are demanded to result in success.

Another challenge is to recognize that some government officials play a key role in the M&A deal process. In order to finalize M&A deal negotiations successfully, government support typically through the assumption of bad loans or loss-sharing agreement are critical. When the M&A surge comes to an end in Asia, only a couple of players will emerge as the post-crisis leaders with leadership positions in

Asia for the next decade. The boldest players will seize the opportunity to reshape Asia's banking industry.

	Banks	Assets	ROE	Nationality
Big 5	IBJ-DKB-Fuji Bank Group	1,400	3.5%	Japan
	Sanwa-Asahi-Tokai Bank Group	981	3.5%	Japan
	Sumitomo-Sakura Bank Group	943	4.7%	Japan
	Deutsche Bank	888	23.3%	Germany
	Bank of Tokyo-Mitsubishi	866	3.8%	Japan
Others	Citigroup	695	25.4%	USA
	UBS	600	20.4%	Switzerland
	Chase Manhattan	390	25.8%	USA

3.2. Recent M&A Activities in Asia

When the Asian financial crisis broke out in 1997, it was obvious that the initial step to rebuild the troubled economy was to recapitalize the banking sector. Many Asian governments poured huge public money into troubled local banks to make them clean. However, huge money was not enough to recapitalize the troubled bank due to the extremely large amount of non-performing loans. Strategic M&As were needed to help them raise funds and survive in the global financial market. In the first half of 1998 alone, there were more than 25 mergers or acquisitions in the Asian banking sector. In the first decade of the 21st century, there will be hundreds of major financial sector M&As. This section will cover recent M&A activities in Asia's key countries.

3.2.1 Singapore

During the late 1990s, Singapore was a unique market where the government protected local banks but also encouraged investment in expensive technological developments and constrained growth of certain credit products (Dominic Casserley, 1999, p.225). In Singapore, the local banks except for DBS Bank started as family-owned banks and built up a successful financial business on that base. Over time they have merged and consolidated. Today the founding families remain the principle shareholders, and are in several instances also involved in the management of the bank.

The MAS⁸⁾ is now considering to announce rules requiring local banks to dispose of non-core assets, which will lead to renew them into more profitable and competitive entities. The renewal process is moving forward in Singapore. Singapore's merger wave will gain more impetus if the MAS will give a license to new foreign banks to do local business. At the end of 1998, Keppel Bank became Singapore's fifth-largest bank when it merged with Tat Lee bank. In 1998, Keppel TatLee banking group recorded U\$32 million of net income, down 28% due mainly to loan-loss provisions. However, by June 1999, net income surged to U\$66 million and earnings per share doubled.

Table 4. Performance of Top 9 Banks in Singapore

(Unit : U\$ Mi)

8. The MAS(Monetary Authority of Singapore) was established in 1971 for acting as a financial agent of the government to regulate all elements of monetary, banking and financial aspects of Singapore.

Rank	Name of Bank	Assets	Profits	Profit as % of		500 Rank
				Assets	Equity	
1	DBS Bank	59,606	134	0.2%	2.4%	32
2	Oversea-Chinese Banking Corp.	33,566	256	0.8%	6.3%	59
3	United Overseas bank	30,394	222	0.7%	6.6%	69
4	Overseas Union Bank	26,058	109	0.4%	4.4%	79
5	Keppel TatLee Bank	12,102	32	0.3%	2.2%	149
6	Chung Khiaw Bank	4,768	48	1.0%	7.6%	261
7	Industrial & Commercial Bank	2,413	23	1.0%	5.2%	337
8	Bank of Singapore	1,945	16	0.8%	9.5%	356
9	Far Eastern Bank	444	2	0.5%	3.4%	450

Source : Asiaweek, September 10, 1999

Consolidation will result in a few dominant local banks and a few specialist firms in Singapore. Easier market entry will strengthen some multinational banks, but the intensified position of the enlarged local banks will actually limit the scope for new multinational entrants to fresh approaches like direct on-line banking (Dominic Casserley, 1999, p.227). The banking environment in Singapore will only become more open and competitive. Local banks should concentrate on their core competencies and build strong and institutionalized management structure to compete in the global banking era. Ultimately, their improved performance will benefit all depositors and shareholders, and strengthen the financial system as a whole.

3.2.2 Hong Kong

Hong Kong has maintained its long-standing position as a free market model and had no constraints on new bank licenses. However, all banks were allowed to have only one branch. The logic behind this branch limit was that there were already enough banks to provide a competitive environment and the HKMA⁹⁾

wanted to avoid excessive competition, which would drive profits down so low as to threaten industry stability (Dominic Casserley, 1999, p.215). The HKMA also specified a couple of lending guidelines. The HKMA set a cap on mortgage loans, fixing it at 70% of the property's value, and also asked banks to try to keep their total real estate loans at less than 40% of all loans. In general, the HKMA managed the banking industry toward maintaining margins and capital strength.

However, there were clear signs that the old oligopoly in Hong Kong's banking industry would have to change. During the mid-1990s, both ABN Amro and GE Capital entered the mortgage market in Hong Kong to share the lucrative margins in that area. At the end of 1998, Singapore's DBS purchased Kwong On Bank. Thus, the first decade of the 21st century is likely to be marked by M&A booms in the banking industry.

The first sign of consolidation in Hong Kong's overcrowded banking sector is expected to emerge in 2000 despite the barriers of family ownership and continued profitability at banks. In March 2000, the Bank of China Group's announced that its 12 sister banks would merge into one large bank, becoming Hong Kong's second biggest bank. According to the preliminary plans, the merger process will be completed by the end of 2000. The consolidation will bring about huge benefits, such as significant cost savings and heightened competition, to the Bank of China Group's.

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9. The HKMA(Hong Kong Monetary Authority) was established in 1993 by merging the Office of the Exchange Fund with the Office of the Commissioner of Banking. It is the government authority in Hong Kong responsible for maintaining monetary and banking stability.

Rank	Name of Bank	Assets	Profits	Profit as % of		500 Rank
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1	HongKong & Shanghai Banking	189,433	1,383	0.7%	14.0%	15
2	Hang-Seng Bank	53,884	870	1.6%	15.8%	37
3	Bank of East Asia	17,401	119	0.7%	6.6%	111
4	Dao Heng Bank	15,715	162	1.0%	11.5%	122
5	Nanyang Commercial Bank	11,107	143	1.3%	11.6%	156
6	Shanghai Commercial Bank	7,073	107	1.5%	11.2%	192
7	Wing Lung Bank	6,676	77	1.2%	10.9%	197
8	Po Sang Bank	6,591	101	1.5%	10.1%	203
9	Wing Hang Bank	6,211	65	1.0%	11.4%	214

Source : Asiaweek, September 10, 1999

3.2.3. Japan

In Japan, non-performing loans seem to grow despite regular attempts by banks to write them off. Japanese financial institutions altogether had more than U\$600 billion in bad loans at the end of March, 1999. The number, based on more stringent reporting standards than were previously in place, was more than double what the banks themselves had reported. The Japanese banking sector came to near collapse over the last three years as domestic asset prices tumbled and banks were exposed to a huge increase in bad loans.

Despite the financial deregulation in Japan, many Japanese banks continue to look on banking as simply as taking in deposits and lending the funds out again. But their global competitors regard banking as much more than that--like arranging transactions and collecting fees. The average returns of global competitors are between 15% and 20%, much higher than the returns of Japanese banks.

An efficient and competitive financial sector is absolutely essential for the

vitality of Japanese economy in the 21st century. The financial system reform, Japanese Big Bang, commenced in November 1996 under the three principles¹⁰⁾ of free, fair and global, aiming to rebuild the Japanese financial market into an international market comparable to the New York and London markets. As the first step, the revised Foreign Exchange Law was changed to totally liberalize cross-border transactions in April 1998. Then, the Financial System Reform Law, that was required to implement the financial system reform, was enforced in December 1998. As a result of the financial system reform, the Japanese financial sector has entered a new era of competition. Reorganization of the financial sector through M&As is rapidly promoted and foreign institutions are increasingly penetrating into the Japanese market.

The reform was making good progress. In August 1999, the Dai-ichi Kangyo Bank(DBK), the Fuji Bank, and the Industrial Bank of Japan(IBJ) announced a merger plan, creating the world's biggest bank with assets of more than U\$1.3 trillion, using the framework of financial holding companies. Two months later, the deal between Sumitomo Bank, the country's third-largest bank, and Sakura Bank, the country's fifth-largest bank, was announced to form what was expected to be the world's second largest bank, with assets of more than U\$900 billion. Before the actual merger of two banks, which is expected to take place by April 2001, the banks are scheduled to take an unspecified stake in the other partner, make alliances in all business areas, and integrate computer systems.

In addition, the newly merged bank will reduce their combined employees by 9,300, or nearly 30% by March 2004. In October 1999, Asahi Bank, the country's ninth-largest bank, and Tokai Bank, the country's eighth-largest bank, announced

10. ① free : toward a free market where the market mechanism prevails, ② fair : toward a transparent and credible market, ③ global : toward an international market ahead of its time

plans to combine at the end of 2000, creating Japan's third-largest bank with total assets of U\$550 billion. Four months later, Sanwa bank, a big Japanese city bank, decided to join the Asahi-Tokai bank's deal. The Sanwa-Tokai-Asahi deal looks sensible enough. Sanwa bank is strong in Osaka, Asahi bank in Tokyo and Saitama, and Tokai bank in Nagoya, so the three banks make a good geographical fit.

In all, 10 of Japan's 11 largest banks are joining to form four bank groups over the next couple of years. The four bank groups will all be among the world's top five banks ranked by assets. Only Germany's Deutsche Bank will be ranked within the top five. However, in terms of Return-On-Equity(ROE), each of the Japanese big bank group starts with ROE of less than 5%. In contrast, global competitors such as Deutsche Bank, America's Citigroup and UBS of Switzerland enjoy ROE of more than 20%. It may be difficult for the Japanese bank groups to catch up with Western competitors in profitability within a couple of years, unless they change quickly.

Table 6. World's Top Five Banks Ranked by Assets

(Unit : U\$ billion)

	Banks	Assets	ROE	Nationality
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Despite the financial deregulation in Japan, many Japanese banks continue to look on banking as simply as taking in deposits and lending the funds out again. But their global competitors regard banking as much more than that--like arranging transactions and collecting fees. The average returns of global competitors are between 15% and 20%, much higher than the returns of Japanese banks.

An efficient and competitive financial sector is absolutely essential for the vitality of Japanese economy in the 21st century. The financial system reform, Japanese Big Bang, commenced in November 1996 under the three principles¹³⁾ of free, fair and global, aiming to rebuild the Japanese financial market into an international market comparable to the New York and London markets. As the first step, the revised Foreign Exchange Law was changed to totally liberalize cross-border transactions in April 1998. Then, the Financial System Reform Law, that was required to implement the financial system reform, was enforced in December 1998. As a result of the financial system reform, the Japanese financial sector has entered a new era of competition. Reorganization of the financial sector through M&As is rapidly promoted and foreign institutions are increasingly penetrating into the Japanese market.

The reform was making good progress. In August 1999, the Dai-ichi Kangyo Bank(DBK), the Fuji Bank, and the Industrial Bank of Japan(IBJ) announced a merger plan, creating the world's biggest bank with assets of more than U\$1.3 trillion, using the framework of financial holding companies. Two months later, the deal between Sumitomo Bank, the country's third-largest bank, and Sakura Bank, the country's fifth-largest bank, was announced to form what was expected

13. ① free : toward a free market where the market mechanism prevails, ② fair : toward a transparent and credible market, ③ global : toward an international market ahead of its time

to be the world's second largest bank, with assets of more than U\$900 billion. Before the actual merger of two banks, which is expected to take place by April 2001, the banks are scheduled to take an unspecified stake in the other partner, make alliances in all business areas, and integrate computer systems.

In addition, the newly merged bank will reduce their combined employees by 9,300, or nearly 30% by March 2004. In October 1999, Asahi Bank, the country's ninth-largest bank, and Tokai Bank, the country's eighth-largest bank, announced plans to combine at the end of 2000, creating Japan's third-largest bank with total assets of U\$550 billion. Four months later, Sanwa bank, a big Japanese city bank, decided to join the Asahi-Tokai bank's deal. The Sanwa-Tokai-Asahi deal looks sensible enough. Sanwa bank is strong in Osaka, Asahi bank in Tokyo and Saitama, and Tokai bank in Nagoya, so the three banks make a good geographical fit.

In all, 10 of Japan's 11 largest banks are joining to form four bank groups over the next couple of years. The four bank groups will all be among the world's top five banks ranked by assets. Only Germany's Deutsche Bank will be ranked within the top five. However, in terms of Return-On-Equity(ROE), each of the Japanese big bank group starts with ROE of less than 5%. In contrast, global competitors such as Deutsche Bank, America's Citigroup and UBS of Switzerland enjoy ROE of more than 20%. It may be difficult for the Japanese bank groups to catch up with Western competitors in profitability within a couple of years, unless they change quickly.

Table 6. World's Top Five Banks Ranked by Assets

(Unit : U\$ billion)

Banks		Assets	ROE	Nationality
Big 5	IBJ-DKB-Fuji Bank Group	1,400	3.5%	Japan
	Sanwa-Asahi-Tokai Bank Group	981	3.5%	Japan
	Sumitomo-Sakura Bank Group	943	4.7%	Japan
	Deutsche Bank	888	23.3%	Germany
	Bank of Tokyo-Mitsubishi	866	3.8%	Japan
Others	Citigroup	695	25.4%	USA
	UBS	600	20.4%	Switzerland
	Chase Manhattan	390	25.8%	USA

Source : Standard & Poor's, AFP

3.3. Recent M&A Activities in the Korean Banking Industry

Since the IMF crisis, many M&A deals between commercial banks occurred as a way of preventing their insolvency. The ailing banks were one of the major obstacles to reform the financial sector which aimed at enhancing efficiency and promoting competition. The government decided to shutdown the non-viable banks in 1998. This financial policy was part of the IMF bailout package. Following this drastic measure, the government plans to merge three nationalized banks, HanvitBank, Korea Exchange Bank, Cho Hung Bank, into one super bank in the form of a financial holding company in 2000.

At the same time, the government made public that it would encourage a merger among Kookmin Bank, H&CB and other healthy banks by giving them incentives such as purchase of bad loans and cross-border business expansion. After the current restructuring process in the banking sector, it is expected that banks will change their focus towards universal banking, in which a financial institution

provides a full range of financial services from banking to insurance. This section will cover the two restructuring stages of the Korean banking sector from 1998 to 2001.

3.3.1. 1st Round of Bank Restructuring(1998 ~ 1999)

Korea's banking industry was faced with a situation in which external organizations such as the IMF forced the Korean government to lead the financial sector restructuring process. The banking industry experienced massive shutdowns and mergers of ailing financial institutions for the first time in its history(SERI, July 1999, p.1). The banking industry has been a priority sector for the Korean government to take reform measures during this period. The government shut down five undercapitalized commercial banks on July 28, 1998, thereby starting the banking sector restructuring. The closed banks were merged by five healthy banks through the purchase & assumption(P&A) method¹⁴.

However, the 1st round of reforms in the banking sector focused mainly on settling the non-performing loans(NPLs) of banks and stabilizing the financial market. There was more room to make fundamental changes in the banking sector in a way to prevent future insolvency. In order to build a sound banking system, Korean banks still have a lot of problems to solve. Thanks to the infusion of public funds¹⁵, the burden of NPLs in the banking sector was greatly reduced. But, many foreign investors believed that the actual amount of NPLs was much

14. An asset-selling method where a healthy bank undertakes liabilities and healthy assets of the closed bank, and the Korea Asset Management Corporation purchases non-performing loans of the closed banks.

15. The term 'public funds' is virtually taxpayers' money because it came from funds raised by the Korea Asset Management Corporation and Korea Deposit Insurance Corporation through bond issues, all carrying the government's repayment guarantee(Two years after the IMF Bailout, SERI, March 2000, p.70)

more than what had been reported.

Table 7. The 1st Round of Bank Restructuring in 1998

BIS Ratio ₁	Bank Restructuring		
	Restructuring Process	Related Banks	No. of Banks
Under 8%	Shut-down(Exit)	Dongnam, Dongwha, Kyungki, Chungcheong Daedong	5 Banks
	Merger	CBK + Hani, CHB + Kangwon + Chungbuk	5 Banks
	Re-capitalization	KEB, Pyungwha	2 Banks
	Sold to Foreign Investor	KFB, Seoul	2 Banks
Over 8%	Merger	Hana + Boram, Kookmin + KLB	4 Banks
	Management Improvement Orders	Cheju, Pusan, Kyongnam	3 Banks

Note : 1) As of the end of 1997

Unlike countries where sound banks were merged to form strategic alliances, many Korean banks were merged in 1998 as a way of preventing their insolvency. It is not surprising to see that some of these new banks born from mergers have not performed well. Moreover, some banks are now pursuing mergers and other ways to become bigger in order to avoid a merger or closure during the upcoming 2nd round of bank restructuring.

3.3.2. 2nd Round of Bank Restructuring(2000 ~ 2001)

Despite the successful 1st round of bank restructuring in 1998, the Korean banking sector is still lacking in size, profitability, and transparent practices which

have not been established in management and corporate governance. The government has already announced plans to create two or three super-banks with assets ranked within the world's top 100 through mergers. In this regard, the government took preliminary steps, including enactment of the Financial Holding Company Law and the Partial Depositor's Protection Act expected in 2001, to facilitate the process of bank restructuring.

As deposit insurance limits is expected to be lowered in 2001, surplus money will flow to the most competitive banks in Korea. This trend of money flows will lead to facilitating domestic bank mergers soon. Many financial analysts set forth their views on three scenarios for domestic bank mergers with regard to the upcoming 2nd round of bank restructuring. Mergers can occur around banks in which the government has a sizable sum of shares.

In the first scenario, some large government-owned banks will be merged by forming a financial holding company. The government plans to encourage three large banks, Hanvit Bank, Korea Exchange Bank and Cho Hung Bank into which it has injected huge public funds, to form a universal financing holding company covering businesses in the areas of securities, insurance, and banking. The merger of the three banks would lead to the creation of a super bank, with about 200 trillion won in total assets, and 125 trillion won in total deposits, big enough to be one of the world's top 100 banks. The government expects that it will encourage a merger among Kookmin Bank, H&CB and other healthy banks by giving them incentives such as purchasing bad loans and cross-border business expansion.

In the second scenario, mergers are expected to occur between government

-owned banks and commercial banks. If this scenario becomes true, the merger process will be implemented promptly, because the government can control the government-owned banks. However, this scenario was not discussed concretely among the parties concerned.

Finally, the third scenario is a merger between commercial banks. A large scale merger between healthy commercial banks would generate a super-bank with a ranking in the world's top 100. A merger is recommended between two commercial banks which specialized in retail banking and corporate finance banking, respectively. This combination will probably maximize the synergy effect of bank merger. Another possibility is a merger between a large commercial bank acting as the core player of new merged bank, and a small healthy commercial bank. However, it is not clear that small banks are willing to participate in this deal.

4. Case Study : KFB & Newbridge Merger

The takeover of Korea First Bank(KFB) by Newbridge Capital, was finally completed on December 23, 1999 after 15 months of negotiation. The Korean government and the IMF agreed in December 1997 to sell KFB and Seoul Bank to foreign investors in return for the IMF bailout package amounting to U\$58 billion. Newbridge Capital held a 51% stake in the new bank with capital injection of 500 billion won while the remaining 49% was held by the Korean government. This deal marked the first step to bring foreign competition into the Korean banking sector. Newbridge's takeover of KFB is expected to modernize the Korean banking system, promote transparency in management, and rebuild the relationship between business and politics. This chapter will examine the case of KFB & Newbridge Merger focusing on the issues of strategic motivations, deal structure, negotiation process, and post-merger integration process.

4.1. Overview of the Deal

4.1.1. Brief Overview of KFB, FSC and Newbridge

Korea First Bank used to be one of the leading commercial banks in Korea, and as its name implies, it has been the first in terms of assets, customer base, business performance, branch network, and the like. Meanwhile, Newbridge Capital was recognized by many financial experts as a perfect partner for KFB's M&A and for the tasks of turning KFB around and remaking it as a great bank. This section will cover a brief introduction of the main parties concerned in the KFB & Newbridge M&A deal.

Korea First Bank(KFB)

KFB was established in 1929 in the name of Chosun Gerchuk Bank and was renamed as Korea First Bank in 1958. KFB was one of the best commercial banks in Korea and was awarded the 'Best Management Bank' in 1991 and 1993. The Return on Asset(ROA)¹⁶⁾ of KFB was the highest in the early 1990s compared with other domestic commercial banks. However, KFB's ROA started to decline sharply mainly due to the increasing accumulation of non-performing loans resulting from its main corporate customers' insolvency¹⁷⁾.

After the Asian financial crisis broke out, most Korean commercial banks, including KFB, suffered from negative ROA. Especially, KFB's ROA was getting worse because KFB was the largest debt holder of Hanbo and KIA that went bankrupt at that time. KFB focused on corporate finance banking rather than retail banking and was the main credit bank of the two bankrupt companies. As of the end of 1999, KFB operated 339 branches across the nation, four overseas offices and two international joint venture companies. KFB had 4,829 employees, down from over 8,000 before the November 1997 financial crisis, with a total of 4.5 trillion won in paid-in-capital.

Financial Supervisory Commission(FSC)

The Financial Supervisory Commission(FSC) was established in April 1998 to promote and facilitate a sound credit order within the financial sector, ensuring the

16. The ROEs of KFB was 0.57% in 1991, 0.73% in 1992, 0.68% in 1993, and 0.46% in 1994, respectively.

17. The main corporate customers' insolvency rates of KFB was 0.06% in 1995, 0.02% in 1996, -4.61% in 1997, -7.94% in 1998, respectively.

fairness of financial transactions, and protecting the interests of the consumers. After the Asian financial crisis, FSC has led the ambitious structural reform program to rectify the root causes of the crisis and return the Korean economy to the path of strong and sustainable growth (FSC, Financial Reform & Supervision in Korea 2000, April 2000, p.25~27).

Newbridge Capital Ltd.

Newbridge Capital was established as a private equity investment company by two leading investment firms, Texas Pacific Group(TPG) and Blum Capital Partners(BCP) in the United States. Newbridge Capital is a fund for investment gaining profits by purchasing troubled companies, enhancing their value through restructuring, and reselling them. Newbridge Capital has gained a good reputation in the M&A market by revitalizing Continental Airlines and American Savings Bank in the late 1980s. The fund was known for relatively long-term investment capital having 10 years of maturity with 8.5% of expected yield rate. Newbridge Capital raised the first fund of U\$105 million, which was mainly invested in Chinese manufacturing industry. They also raised the second fund of U\$300 million from 1997, among which U\$250 million was already raised as of the end of 1998.

Newbridge's strategy is to bring the extensive investment management experience of its founding shareholders to the emerging markets of Asia and Latin America. Specifically, Newbridge's investment philosophy is focused on the following (KFB, Annual Report 1999, p.11):

- Identifying undervalued businesses with long-term growth potential which are viewed by most investors as too risky or too complex.

- Creating value in its invested companies through new strategic direction, improved management efficiency and better access to capital.

- Leveraging upon the extensive portfolio of the Texas Pacific Group and Richard C. Blum & Associates from around the world.

Newbridge is now a global investment firm with offices in key financial centers such as Singapore and San Francisco. Newbridge and its affiliates are known for managing approximately U\$10 billion of committed capital. TPG is a leading private equity firm, BCP is a significant investor in both private and public equities. TPG and BCP control some 35 companies around the world with total annual revenues in excess of U\$30 billion. Other financial data and the detailed fund size by project and by region of Newbridge were not available.

4.1.2. Strategic Motivations of the Deal

FSC was the negotiating arm of the government in this deal, while the Ministry of Finance and Economy(MOFE) acted as the controlling shareholder of KFB. KFB was not in a position to take part in the negotiation of the deal. Therefore, it is more meaningful to identify the strategic motivations of both the government(FSC) and Newbridge in this section.

Financial Supervisory Commission(FSC)

The main purpose for selling KFB to Newbridge Capital was to make the financial sector as sound as possible by introducing international best practices and

modern managerial knowhow. FSC was sure that the successful sale of KFB would give a good opportunity for domestic commercial banks to improve the way they do business and help regain international confidence. FSC had a strong belief that foreign capital inflows was the key to a successful economic recovery. Since liquidity in the domestic financial market was extremely limited, the only possible option for funding further bank restructuring was to attract foreign capital by selling off inefficient banks and public corporations to foreign investors.

FSC believed that the failure to sell KFB could delay or jeopardize the government's efforts to transform commercial banks into globally competitive banks. In fact, it is undeniable that most commercial banks, including KFB have extended corporate loans without proper credit analysis, which led to a large amount of non-performing loans. Commercial banks were in need of upgrading their credit processes and replacing their bureaucratic organizations with a profit-oriented mindset. FSC believed that KFB's sale to foreign investors could facilitate the transformation of domestic commercial banks into profit-oriented and competitive banks in the future.

Implementing international best practices through transparent management and backed and run by a world-premier financial group, the FSC had a strong belief that KFB would be one of the nation's safest banks and a role model for the whole Korean financial industry and be reborn as a premier financial institution in Korea. The strategic motivation of the government(FSC) was to recover its capital injection after the normalization of KFB and the ensuing profits to be made by it. The successful M&A deal between KFB and Newbridge will help improve the nation's sovereign ratings, and in return further boost the fast-recovering economy(KFB, Annual Report 1999, p.11).

Newbridge Capital Ltd.

Newbridge injected U\$500 million into the takeover of KFB, its largest investment in Asia. Newbridge's strategic motivation was to convert KFB into a clean bank, introduce international standard practices, add value, and resell it to another private investor, and then get huge capital gain like American Savings Bank(ASB), one of the largest failed financial institutions in the U.S., in 1996.

Newbridge's strategy was to bring the extensive direct investment experience of its partners and shareholders to the markets of Asia and Latin America. Newbridge is a long-term private equity investor who tends to keep the assets much longer than what the general public expects. In addition, Newbridge has a contingency plan to invest an additional 200 billion won in 2000 - 2001 years to keep KFB financially sound and strong.

4.2. Deal Structure

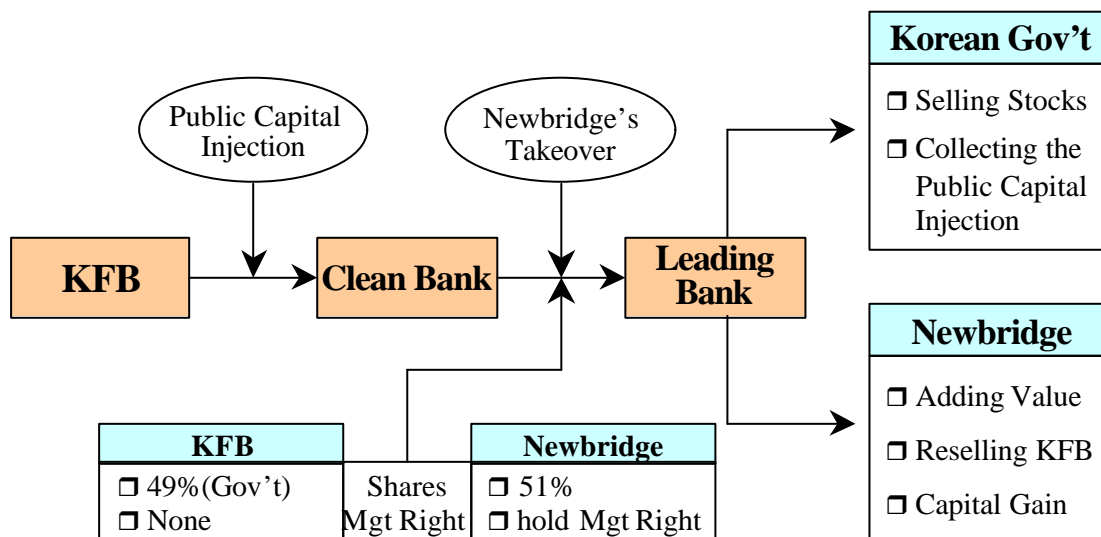
The government and the IMF agreed in December 1997 to sell KFB to a foreign institution in return for a \$58 billion bailout package. Then, the government injected 1.5 trillion won into KFB, which became insolvent following a series of corporate failures during the period of financial turmoil. Newbridge won the initial bid for the takeover of KFB on December 31, 1998 in closed competition with other foreign investors, including Hongkong and Shanghai Banking Corporation. Newbridge was given exclusive right for the takeover of KFB, resulting in severe criticism against the government for its lack of bargaining power. This section reviews the key issues related to the basic structure of the

deal and the main terms of MOU.

4.2.1. Basic Structure of the Deal

FSC infused 5.3 trillion won of public capital into KFB before selling it to Newbridge. FSC injected 4.2 trillion won worth of capital into KFB through rights offering, while Korea Asset Management Company(KAMC) purchased its non-performing loans amounting to 1.1 trillion won. The huge public capital injection was inevitable, so FSC could facilitate KFB's sale process. The recovery of KFB became an even more urgent task for FSC as KFB was on the verge of collapse without immediate capital assistance. As the ailing KFB became a clean bank with the injection of public capital, Newbridge started to speed up the delayed negotiation process.

Figure 3. Basic Structure of the Deal



Negotiations between FSC and Newbridge failed to meet the deadline of May 1999 due to differences over KFB's asset value and terms of sharing future losses

from KFB's troubled loans. However, negotiations, deadlocked since FSC and Newbridge signed a MOU December 1999, were finally completed on September 18, 1999. FSC hoped that the new KFB would reemerge as a leading local bank by regaining international competitiveness under the Newbridge ownership. Then, it will be possible for FSC to collect the huge public capital by selling KFB's shares to the stock market. Meanwhile, Newbridge, as a long-term investment firm, planned to maximize KFB's potential value, resell it to another private investor, and then get capital gain.

4.2.2. Main Terms of MOU

FSC exchanged a Memorandum of Understanding(MOU) with Newbridge on December 31, 1998 to sell 51% of the government's stake. The MOU set out general terms of sale of nationalized KFB. The main terms of MOU are as follows (Press Release, FSC, December 31, 1998):

- Bad assets and a portion of liabilities of the bank will be separated out and transferred to a bad bank
- Newbridge consortium will take a 51% stake, whereas the government will take a 49% stake of the bank
- The government will share in the upside potential of the bank by taking a 49% stake of the bank and through warrants worth 11% of government stake as premium
- The cost involved for Newbridge consortium will be equivalent to 51% of new asset value needed to bring the BIS ratio of the bank up to a to-be-determined level

- Newbridge consortium will be prohibited from selling its stake in the bank without permission of the government for a period of 2 years.
- A put-back option will be available for new NPLs that surface during the first year and up to a certain amount for the second year.
- As a way to guarantee autonomy of bank management, the government will delegate voting rights to the Newbridge consortium, provided that it does not sell all of its stake, file for bankruptcy, issue new shares, reduce capital, or act against government's interest.

4.3. Negotiation

The government announced that the negotiation process to sell KFB to Newbridge was completed on July 2, 1999. However, it was known that the two sides still had not reached a final conclusion. The government's intention was to wrap up the six-month bickering negotiation over KFB sale before President Kim started his official trip to the U.S. on July 1, 1999. The Newbridge team was upset at this surprising news and strongly rejected the government's unilateral action. For Newbridge, President Kim's U.S. visit had nothing to do with a private deal with the U.S. investor. The Korean government still had no idea at all about how to deal with a private negotiation. This section reviews the negotiation process, bargaining power, some of the disputed issues of negotiation.

4.3.1. Negotiation Process

Since the IMF bailout package, the government injected 1.5 trillion won worth of public capital into KFB and reduced capital in order to assist its financial difficulty. The government also laid off 3,000 employees and shut down 74

branches. However, even this action was not enough to make KFB a clean bank. After a few months of negotiations with Newbridge, the government came up with the idea of injecting a huge sum of recovery funds into KFB, signaling a further delay in finding a new owner.

However, the government has dragged out the sale process for months, jeopardizing the entire framework of the nations financial restructuring. With President Kim's trip to the U.S. scheduled for the first week of July 1999, the government was reported to have decided to complete the deal with Newbridge before the state visit began. The consensus was reached by top decision-makers at the Blue House, the Ministry of Finance and Economy, and FSC. The government announced that the deal was almost done in principle and it would depend on the final will of the government to finish the deal. But, it was disclosed that the situation had not changed, in that there were still a number of issues remaining unsolved.

The two sides have been discussing the terms and conditions for KFB's sale since signing an MOU on December 31, 1998. However, negotiations between both parties resulted in a failure to reach a conclusion due to differences over KFB's asset value and the terms for sharing future losses arising from KFB's bad loans. Newbridge demanded that each debtor's ability to repay matured loans be reflected in the price, in accordance with standard international practices. On the other hand, the FSC demanded that the rapidly improving situation of the Korean economy be included in the final price.

On June 11, 1999, Moody's Investors Service, which has the strongest influence on the future of the Korean economy, sent a strong warning to FSC over its delay

in the sale of KFB. The government faced its biggest challenge in the reform of its troubled banking sector with the delay of KFB sale, and so decided to inject an additional 4.2 trillion won worth of capital into KFB, while Korea Asset Management Company purchased its non-performing loans, amounting to 1.1 trillion won.

However, at the end of July 1999, the Daewoo Group announced that they were suffering from a serious liquidity crisis and provided additional assets worth 10 trillion won to its creditors as new collateral in an attempt to get new loans and a rollover of short-term liabilities. Unfortunately, KFB was the main creditor bank of Daewoo Group. This caused the deal process to be delayed further. Even though the FSC made public that the delay of the sale was not related at all to the liquidity crisis of Daewoo Group, foreign financial experts believed that unless the Daewoo crisis was fully resolved, FSC would not transfer the ownership of KFB to Newbridge. FSC was expected to have difficulty in handling the Daewoo crisis once KFB was taken over by Newbridge. While dragging out the process of selling KFB to Newbridge, FSC was severely criticised by the world's financial community. FSC received formal complaints from foreign countries for making discriminatory remarks against Daewoo Group's foreign creditors.

As time went, FSC and Newbridge came to a mutual understanding that they had to complete the takeover process soon. FSC agreed that it would cover losses arising from the ailing KFB's non-performing loans for two years after the completion of the sale. In other words, all Newbridge's financial losses from bad KFB loans in the first two years would be guaranteed by the Korean government. The general public were critical, saying that the government gave them too excessive a burden. Meanwhile, Newbridge agreed to pay 500 billion won for the

takeover of KFB and injected another 200 billion won in the next two years to support further recovery of KFB. Finally, the takeover of KFB by Newbridge was completed on September 18, 1999 after almost nine months of ups and downs in the negotiation process.

Table 8. Historical Timetable of the Negotiation Process

Date	Historical Events
Nov. 24, 1997	The government asked IMF for a U\$58 billion organized rescue package to deal with the country's financial crisis
Jan. 30, 1998	The government reduced paid-in capital of 720 billion won to 100 billion won and injected the first public capital(1.5 trillion won) into KFB
Apr. 23, 1998	Morgan Stanley selected as a lead manager of the deal
Dec. 31, 1998	The government signed an MOU with Newbridge on the sale of 51% of KFB's stakes
May 12, 1999	No agreement was reached for the sale of KFB and it was put back on sale for open bids, with Newbridge submitting a new proposal
Jun. 11, 1999	Moody's Investors Service warned the Korean government over its delay in selling KFB
Jul. 9, 1999	The government injected a second public capital(4.2 trillion won) into KFB
Sep. 17, 1999	The government signed the final contract with Newbridge to sell a 51% stake of KFB
Jan. 20, 2000	Newbridge injected KRW 500 billion into KFB

4.3.2. Bargaining Power

The Financial Supervisory Commission(FSC), the government's arm of financial and corporate sector restructuring, was responsible for negotiations with Newbridge, which was well known as a hard bargainer based on its previous deals. One of its best-known tactics was to push demands to the extreme before coming back to renegotiate if the other party didn't accept. Also, Newbridge was the only purchaser in this deal. Meanwhile, FSC had fierce external pressure to complete

the deal before the President's official U.S. trip, which was scheduled for the first week of July, 1999. FSC worried that any further delay in negotiations might harm the economic relationship between Korea and U.S. Additionally, on June 11, Moody's Investors Service sent a strong warning to the government over its delay in the sale of KFB. Therefore, the bargaining power of FSC was not as strong as that of Newbridge.

4.3.3. Wrangling Issues of Negotiation

There were a lot of pending issues to be dealt with in the course of facilitating the takeover negotiation between FSC and Newbridge. Among them were the continued employment of bank personnel in an effort to minimize the number of layoffs, maintaining loans already advanced, and protection of small shareholders in KFB. Needless to say, it was imperative that the government see to it that all of these matters were swiftly and prudently resolved.

The toughest issues, which could not narrow the differences between the two sides were price-related ones, such as the method of measuring KFB's asset value, governing laws, and protection clause. The government agreed in the MOU that it would cover losses arising from KFB's non-performing loans for two years after completion of the deal. But, detailed negotiations were not progressing smoothly over the issue of defining the market value of the ailing bank's total assets. Newbridge demanded that each debtor's ability to repay matured loans be reflected in the price, in accordance with international standard practices as listed in the MOU. Meanwhile, the government argued that other means should be used to reflect the distinctive nature of the local economy, which was different from that of advanced nations.

The other wrangling issues were the period of the put back option by which the government would cover KFB's non-performing loans and laws governing potential disputes. The government offered that Newbridge could sell an unlimited amount of non-performing loans to it in the first year and a partial amount in the second year after its takeover of KFB. But, in this regard, Newbridge wanted to clarify the definition of non-performing loan based on international standard practices.

Table 9. Key Issues of Negotiations

Issues	FSC	Newbridge
Ownership	Korean Gov't : 49% Newbridge : 51%	No Objection
Sale Price	5,000 won per Share	No Objection
Asset Value Methods	Book Value Near Face Value of Loans	Fair Market Value (Mark to Market Accounting)
Protection (Put Option)	1 yr : All Amount Guaranteed 2 yr : Partial Amount Guaranteed	Basically Agreed (Definition of NPL to be clarified)
Governing Law	Domestic Law	Internationally Accepted Law

4.4. Post-merger Integration

The post-merger integration is the key process to make the M&A workable. Only after two entities come together and begin to work toward the M&A's purpose, can synergy value be created. The post-merger integration is an interactive and gradual process in which individuals of two entities learn to work together and cooperate in the transfer of strategic capabilities. After taking over KFB,

Newbridge established a new vision and strategy of new management and reorganized KFB. In this section, I will review the post-merger integration process of KFB.

4.4.1. Reorganization

Newbridge has gone through a complete reorganization to revitalize KFB and established a new vision and strategy for the new management. The reorganization replaced the previous system of 15 departments and 9 teams with 5 divisions, 17 departments and 14 teams. The new management focused on simplicity, practicality and flexibility in designing the formation of the new organization. Each individual's responsibility and authority was more clarified and defined for its strategic priority. The new system decentralized and reduced the number of tiers between manager levels to enable direct reporting to top management. The most drastic change was to adopt the CCO¹⁸⁾ system and strengthened its role and authority. The CCO controls all the Bank's credit-related operations through the supervision of Credit Risk Management and Credit Review & Compliance Department. In order to make the lending process transparent, the CCO assigned a loan compliance officer to each branch of the bank.

In addition, Newbridge reshuffled the top management team of KFB. Newbridge appointed Robert T. Barnum¹⁹⁾ as Chairman of the Board of Directors, Wilfred Y. Horie²⁰⁾ as President and Chief Executive Officer, and Chulsu Kim²¹⁾ as Vice

18. Chief Credit Officer who is responsible for credit control and credit risk management including non-performing loans, distressed assets and workout management.

19. Mr. Barnum was formerly president of American Savings Bank, a troubled bank which Mr. Barnum successfully helped turn around.

20. Mr. Horie recently served as Senior Executive Vice President and Head of International Operations of Associates First Capital Corporation, the largest diversified finance company traded on New York Stock Exchange.

21. Dr. Kim was Professor of Economics and International Trade at Sejong University in Seoul and

Chairman of the Board. KFB set up a new Board of Directors comprised of five Korean and three foreign nationals chosen for their familiarity and expertise with the international best practices. All the Directors were distinguished individuals in their respective fields. The new management reflected the basic concept and principle of the reorganization, which was "efficiency in the decision-making process". Unlike other Korean banks, there was only one layer between senior managers and the CEO, which made the decision-making process quick and efficient. Newbridge was confident that KFB would grow into a very successful and profitable banking operation under the leadership of the new top management.

4.4.2. Transformational Leadership of Horie

When Mr. Horie took office as CEO of KFB on January 21, 2000, many bankers were skeptical of the foreign president's ability to introduce advanced financial management. However, the Horie-style management was slowly proving its merits. KFB led by Horie has accomplished small but important changes. Horie's "on-the-spot management" was to reform the previous stereotype to immediately reflect the demands from the customers. When he met traders right after he was appointed as CEO, he became aware of Korean commercial bank's conservative and inflexible business style. With regard to personnel appointment of branch head, he decided that every branch head should stay at the post for over 3 years. In order to gain profit and confidence from customers, Horie believed that all branches should do business suitable to the specific characteristics of the relevant region. In this sense, the Korean commercial banks have frequently implemented personnel transfers where branch heads could not demonstrate their expertise.

the former Deputy Director General of World Trade Organization.

When Mr. Horie served as Senior Executive Vice President of Associates First Capital Corporation, he initiated the company's expansion into nine countries, including India and France, by focusing on M&As or joint ventures. Moreover, while heading the company's operations in Japan, he successfully overcame the traditional barriers of the Japanese financial market and created the largest non-Japanese finance company serving retail customers, and turned the Japanese into the highest growth sector of Associates' international operation (KFB, Annual Report 1999, p.13).

Mr. Horie had a vision to make KFB one of the best commercial banks in Korea. In order to accomplish his vision, he invited 17 business leaders and scholars to guide the bank as members of the new Board of Directors. In addition, he attracted a lot of first-class professional managers to support him to operate the daily business of the bank. Most of them had sufficient experience and expertise in western banking know-how and advanced financial techniques. He put importance on attracting a large pool of first-class human resources and getting the best out of those people. He also adopted a performance-based promotion system reflecting the Korean traditions based on experience and seniority. The new promotion system was to strike a good balance between the Asian way and the Western way.

Finally, Mr. Horie stressed the need for credit evaluation methodology to reduce troubled loans. He thought that almost all of the troubled banks of the world owed their bankruptcy to the lack of solid principle in their credit evaluation system. It was essential that KFB have a sound loan portfolio in the future. So, he established a new position of Chief Credit Officer(CCO), responsible for

running the lending operations and improving the credit evaluation system. Soo Ho Lee, who spent many years as a credit specialist at the Bank of America, was appointed as the first CCO of KFB.

4.4.3. Formulation of Vision & Strategy

Mr. Horie made it clear that KFB would place top priority on customer satisfaction by developing better products and focusing on retail banking and small-medium enterprise(SME) banking. The new vision of KFB was to achieve superior profitability by becoming a market leader in retail and SME banking. In order to achieve its goal, KFB prepared a set of transformational strategies for each of its core areas. One of the transformational strategies was to sell more differentiated products and services through business alliances and cross-selling. KFB was willing to pursue all forms of strategic alliances with relevant businesses, especially those directly related to household customers. KFB put emphasis on developing consumer-oriented products and services easily available to consumers. In this section, I will cover KFB's detailed action plans by business segment under the new vision and strategy.

Consumer Lending

Consumer lending is one of the fastest-growing segments as well as one of the most competitive segments in Korea's banking business. As KFB did not show good performance in this segment, it is now aggressively developing a marketing plan to attract consumers. KFB began to formulate a corporate strategy in consumer lending focusing on two concepts: availability and convenience, from the customer's point of view. KFB is focusing on developing consumer-oriented

products easily available to the majority of consumers. At the same time, it is strengthening strategic alliances or partnerships with consumer-related entities such as automobile dealers, housing construction firms, and so on. In addition, KFB is planning to develop an internet banking infrastructure to make loan application and approval possible on-line. Finally, in order to operate an accurate credit evaluation procedure, KFB is in the process of developing an advanced credit scoring system by modifying the one used by its overseas affiliates.

Small-Medium Enterprise Market

The Small-Medium Enterprise market has not been well developed in Korea due to the rapid and preferential growth of large companies. The SME market is expected to rapidly expand in the next few years, because the government is willing to support this segment. The financial institutions also do their best to attract some prominent SMEs with increasingly attractive products and services. As the SME market was a new challenge for KFB which had focused on serving large corporations, KFB decided to develop or import advanced and unique techniques which are essential for the successful operation of a risk management and credit evaluation system. Additionally, the bank adopted other action plans in order to be competitive in the SME market. Some of them are as follows (KFB, Annual Report 1999, p.15):

- Develop new-to-bank programs for new clients
- Develop new fee-generating products
- Develop the sales force's capability by strengthening in-house training programs
- Operate business centers for serving SME customers
- Delegate more credit authority to branch heads to increase credit applications

- Upgrade information systems to improve services for SME clients' non-financial needs

Deposit-Taking & Credit Cards

KFB has had weak deposit-taking for the past few years due to its financial trouble. Thus, KFB's strategy in deposit-taking focused on recovering confidence in the bank. First, KFB planned to differentiate its products and services to satisfy its customers, and introducing a loyalty program to show gratitude to its large depositors. Second, KFB made an effort to expand its mass customer base by utilizing its good relationship with large corporations to increase deposit accounts from their employees. Last, KFB decided to implement cost reduction in all areas. Branch operations were downsized and layouts were redesigned. Automated services and electronic banking were expanded.

With regard to the credit card business, one of the most competitive segments in the Korean banking industry, KFB intensified its efforts to attract new customers. Because of the limited BC network in using credit cards, KFB is considering to develop a new credit card and looking into the feasibility of introducing new products such as revolving and corporate purchasing cards.

4.4.4. Strategic Alliances

Mr. Horie aggressively pursued all forms of strategic alliances with relevant businesses, particularly those directly related to household customers. He fully leveraged KFB's existing relationship with large corporations to generate fee income and sell consumer products to their employees. The first case of strategic alliance was to sign with Korea Life Insurance Co.(KLIC) in an attempt to broaden its

profit base and provide better service to its customers. Under the strategic alliance with KLIC, KFB will jointly develop financial products, utilize each other's offices and cooperate in providing services on the Internet.

The second case of a strategic alliance was to sign a collaborative agreement with Samsung Capital Co. in an attempt to strengthen its retail banking operations. KFB will take over Samsung's auto and other consumer loans, worth 200 billion won, and plan to acquire the mortgage and other loans from the finance company. The strategic alliance with Samsung Capital Co. is expected to give KFB a stable source of profit and help activate its consumer banking by attracting prime clients.

An increasing number of local commercial banks are making strategic alliances with the non-banking sectors in order to survive in the fierce competitive market. As competition in the financial service industry escalates amid increasing presence of foreign rivals in Korea, financial institutions, including banks and insurers, are seeking alliances with each other. Such a trend is expected to dominate the current domestic banking sector in consideration of the growing customer demand for one-stop financial services and on-line banking. Banks and other financial institutions are looking for the right partner to expand their profit base, benefiting from cross-selling their various financial products, such as insurance and stock investment funds. In this sense, KFB together with Hana Bank²²⁾ are pioneers in strategic alliances in the banking sector.

22. The Hana Bank made a strategic alliance with Allianz AG to allow the German insurance giant to use some of its branch offices to sell insurance products and with cyber stock brokerage firm, Paxnet, to provide its customers with real-time stock information.

4.5. Evaluation of the Deal

The successful sale of KFB set the stage for true reforms to take hold in the Korean banking system. Failure to sell would likely have perpetuated the long-standing structural weaknesses inherent in the banking system, and undermined the international competitiveness of Korea's industrial base. KFB's sale presented an excellent opportunity for local banks to improve the way they do business, set a benchmark for the banking industry in Korea, limit excessive governmental control of the banking industry, and regain international investors' confidence in Korea's financial reforms.

However, due to the delayed process and the government's mistakenly announcing the completion of the deal without any consensus with Newbridge, the government showed clumsiness in international negotiations, harmed the economic relationship between Korea and U.S, and placed excessive burden on taxpayer's shoulders. It taught us a good lesson that political factors should not be involved in the negotiation process. Also, the agreement with IMF on the sale of KFB put the Korean government in an inferior position in terms of bargaining power, which led to unfavorable terms and conditions of the deal.

After finalizing the deal, Newbridge acquired majority ownership of KFB with full management responsibility. With a clean balance sheet and new management, KFB began to streamline the structure, and invited a number of experts from outside, and adopted advanced banking practices. The new CEO, Mr. Horie, continued to install strong financial discipline in terms of pricing and balance sheet management. With the strong leadership of Mr. Horie, the new credit system under the CCO made the credit approval process transparent in the area of consumer and SME financing.

5. Conclusion

The current restructuring and M&As in Asian banking is being driven by the need for economies of scale and the desire for increased market share in a globalizing economy. Whether government-initiated or market-driven, these restructuring activities will have to face many unpredictable challenges arising from the local and global banking environments. Banking and the financial sector is one area that is particularly going through unprecedented changes and transition.

After the financial crisis, most Asian governments began to reshape their banking industries by closing or nationalizing insolvent banks, and forcing M&A deals between banks. Asian M&A deals tend to take longer than deals in advanced countries due to complex issues related to labor, management control, creditor's agreement, and regulatory authorities. Asian banks are struggling not just to survive, but to transform themselves into more competitive and profitable banks with innovative services, upgraded skills in risk management, and transparent accounting system. When the M&A surge comes to an end in Asia, only a few players will emerge as the post-crisis leaders with leadership positions in Asia for the next decade. The boldest players will seize the opportunity to reshape Asia's banking industry.

Korea's banking industry faced a situation in which the Korean government led the restructuring process of the financial sector. The Korean banking industry experienced massive shutdowns and mergers of ailing financial institutions for the first time in its history. However, the Korean banking industry did not seem to be fully prepared for all the changes and opportunities. The Korean banks and pertinent regulatory authorities should look to a new paradigm as they continue their restructuring effort.

KFB was merged by Newbridge, a U.S. investment firm, on December 23, 1999 after 15 months of negotiation. This deal set the stage for Korean bank's restructuring and marked the first step to bring foreign competition into the Korean banking sector. Newbridge's takeover of KFB is expected to modernize the Korean banking system and promote transparency in bank management. Looking back at the last two years of KFB's M&A deal and post-merger integration process, we can say that the deal helped Korea's financial sector regain international confidence and gave KFB a good opportunity to reclaim its legacy.

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