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Recovering to a new reality

What a difference half a year makes. We started the year on a sombre note, staring into an economic abyss. Plunging stock markets, frozen credit and runs on banks threatened to bring about a global financial meltdown that would send the world into the Great Recession. Six months later, with the economies still on fiscal life support, major Asian bourses have recovered over a third of their losses from the 2007 peaks and there are growing concerns that we may be witnessing the start of another asset bubble – except that this time, it is built on the smouldering rubble of a still-tattered real economy.

All the signs are indicating that, as a result of massive support provided by governments, the global economy is finally beginning to creep out of a recession unprecedented since the Great Depression. Confidence is returning and fears of a global financial meltdown have abated. Asia, if its stock markets are any indication, is leading this return of exuberance. In the last six months, while the Dow Jones Industrial Index and FTSE 100 fell 4%, Asian bourses ex Japan gained over a third of their values, with the Shanghai Composite topping the charts at a whopping 61% rise, erasing its 64% loss in 2008. Similarly, real estate prices in parts of Asia are now near their pre-crisis levels. Property sales in China, according to its statistics bureau, rose 45% in the first five months to RMB1 trillion (US\$146billion), compared to a 20% drop in 2008.

Low interest rates, quantitative easing and the wealth effect have contributed to the recovery of Asian stock markets and real estate, which has raced ahead of the real improvement in economic fundamentals. In an effort to keep its economic engines humming at the magical 8% growth (which the Chinese government believes is the level needed to create sufficient jobs for its growing work force), China's central bank scrapped its loan quotas in November 2008. This led to an unprecedented increase in bank lending. In the first half of 2009, China banks extended RMB7.4 trillion (US\$1.1 trillion) worth of new loans, significantly more than the RMB4.9 trillion for all of 2008 when the economy grew at 9%. Unfortunately, 20% of these new loans were invested in the stock market, driving up stock and real estate prices.

Despite the positive signs and general acknowledgement that the worst of the recession is behind us, we may be looking at a long U-shaped or a bumpy W-shaped recovery. The world that will emerge at the end of this long tunnel is likely to be very different – both economically and geopolitically. Some of these changes will be immediately perceptible, others will bring forth or set the wheels in motion for strategic tectonic shifts. The brave new world that we are likely to recover into heralds uncertainty and risks, but also presents opportunities.

Pressure on government to increase tax revenue

The Great Recession was averted by extraordinary levels of government intervention and fiscal spending, funded by public debts. Public debts of OECD countries rose from 50% to 100% of GDP. In the US, the Obama administration expects its public debt to double by 2019 to three-quarters of its GDP. In the medium term, the colossal public debt overhang will exert upward pressure on bond yields and interest rates, dampening asset valuation and economic growth. Reducing this overhang is no mean feat. Budget deficits in the US alone will hit US\$1.58 trillion this year, and a further US\$7 to US\$9 trillion of deficit is expected over the next decade. The annual interest cost of US public debt may exceed US\$0.6 trillion in 2019.

The public debts and fiscal deficits have to be reduced over time. Given governments' limited ability to increase or levy new taxes during the long and slow economic recovery, there will be greater focus on plugging tax loopholes

and increasing fiscal revenue under existing legislation. China, for example, is undergoing a complete overhaul of its tax regime and constantly introducing legislation to plug existing policy and implementation loopholes. The US has taken action against UBS and tax advisors selling offshore tax shelters, and their clients. Revenue authorities of various countries have also taken great interest in transfer pricing arrangements and activities of foreign corporations operating within their sovereign boundaries, with a view to minimise tax revenue leakages. Many corporations with cross-border value chains are now playing catch-up to get their house and documentation in order, before being caught out at the next tax audit.

The upshot of these developments is that tax structuring, due diligence and securing water-tight tax indemnities are more critical than ever in M&A, especially for cross-border transactions or those involving targets with multinational operations.

Long bumpy W-shaped recovery?

The current level of global monetary and fiscal stimulus, which includes some US\$2 trillion of stimulus spending, is not sustainable. Exiting from these stimulus policies and spending entails significant risks. Left on for too long and the inherent inflationary pressures, currently kept under the lid by excess capacity, may boil over. On the other hand, lifting the measures too early may undermine the nascent recovery. Judging from past records, one has to be rather optimistic to believe that the governments will get the timing and balance right. The chance of a W-shaped recovery, or a double-dip recession if one sees the glass as half empty, is fairly real.

Against this backdrop, investors are likely to continue to focus on defensive sectors – such as pharmaceutical and healthcare, infrastructure and education – and businesses that possess the right fundamentals to ride out the long bumpy recovery.

Changing Asia's export-led growth model

For a few more years, US households will deleverage and rebuild their nest eggs with increased savings in the shadow of weak housing prices and a looming credit card debt burden. US consumer debt has declined, and its saving rate has risen to 6.9% in May due to unemployment. US household consumption is expected to shrink by 4% in 2009 and 2010, before returning to 2008 levels in 2011. The still-rising unemployment rate in the US, expected to hit 10% this year, does not help. It will be a long while before we see a return to the credit-fuelled consumption of the past decade.

Going forward, Asia's export-driven economic model, which has worked well so far and pulled hundreds of millions out

of poverty in the past decade, needs to be rebalanced with Asian consumption. This structural change has to be led by Asian countries with large populations – China, India and Indonesia – and can only be achieved in the medium to long term as it will require increase in household income and policy changes to improve social safety nets. With US consumption accounting for about 18% of global GDP and at 6.7 times that of China's, the fall in US and Europe consumption will leave a void that cannot be filled for the next few years.

Asian businesses dependant on exports to US and Europe will have to adjust to the lower export demand, or refocus their products and markets to Asia. As the economic model evolves, there will be casualties and opportunities for consolidation.

Window of opportunity for Asian banks

The bulk of the US and European banks are likely to remain capital impaired over the next couple of years, as they deleverage and de-risk under greater regulatory scrutiny. Bank lending conditions are expected to remain tight and credit constrained even as interest rates are kept low in the near term. Asian banks, with relatively unimpaired balance sheets, have a window of opportunity to step up their game and intermediate the massive capital needs of a growing Asia.

At the same time, capital-stretched Western banks have started disposing their Asian assets and operations to raise cash and consolidate their global businesses to conserve capital. We have seen Nomura acquiring Lehman Brothers' Asia investment banking business; Sumitomo Mitsui acquiring Citigroup's Nikko Cordial and Nikko Citigroup Ltd; ANZ taking over RBS' retail businesses in Asia; AIG selling Nan Shan Life, its Taiwan life insurance business; and ING considering the sale of its private banking operations in Asia. These present Asian banks with unique opportunities to pick up talent, know-how and scale.

Overlay these with the fact that Asian banking markets are fragmented with many small, unsophisticated domestic players, we expect that M&A and consolidation activities in this sector will remain in high gear for the foreseeable future.

Asia, growth engine of the brave new world

The International Monetary Fund does not expect the Advanced Economies of the US and Euro area to show sustained pickup in economic activity until the second half of 2010. Advanced Economies are expected to contract 3.8% in 2009. In 2010, they are projected to grow an average of only 0.6%, with US growing 0.8% and Euro area contracting 0.3%.

On the other hand, Developing Asia is expected to grow 5.5% in 2009 and 7% in 2010. China is projected to grow 7.5% and 8.5% over these two years, and India at 5.4% and 6.5% during the same period. While substantially more subdued than the 13% and 9.4% growth that China and India achieved respectively in 2007, they still make Asia the fastest growing and most economically attractive region in the world. At this rate, China will replace Japan as the world's second largest economy by 2010, less than two years after overtaking Germany's third place in 2008. The fundamental drivers for both inbound and intra-Asia M&A therefore remained strong despite the global recession.

Asia is also flushed with corporations with strong balance sheets and cash-rich sovereign wealth funds. In the past year, they have continued to flex their substantial financial muscle to make acquisitions both within Asia Pacific and outbound, across the globe. Much of these activities, led by Chinese buyers, have been focused on the resources and energy sectors. We expect these, and food, to remain Asia's key investment themes in the coming years as Developing Asia seeks resources, energy and food security in response to its fast-growing and urbanising economies and populations. Politically, this is top priority for emerging Asia as its low-income masses do not have the means to withstand sharp inflation on these necessities. One only needs to look back to 2008 and the potentially destabilising social unrests on the back of sky-rocketing oil, food and resource prices to understand why.

Finding a new geopolitical equilibrium

Since the 1980s, the economic centre of the world has been slowly shifting from the Atlantic Ocean to the Pacific Ocean – starting with the Japan miracle, followed by the Asian Tigers and the opening up of China. With the end of the Cold War and the growing economic might of China, the geopolitical centre has followed suit. The current recession is accelerating this shift.

Beyond economics and geopolitics, what is immensely more powerful is how this economic renaissance is shaping the Asian psyche and its confidence on the world stage. The reaction of ordinary Chinese citizens to protests in the West during the Beijing Olympic torch relay; the demonstration in India for the shoddy immigration treatment of their beloved Bollywood actor, Shah Rukh

Khan, in the US; or China voicing its concerns about the growing US deficit and its impact on their US\$776 billion chest of US Treasury securities, are but some recent examples of this new-found confidence. There are parallels to the post-World War II years, except that now, it is their geopolitical equality rather than independence that is being demanded by Asians.

The world will continue to be in transition for many more years as it seeks out a new geopolitical and economic equilibrium. On the long road to recovery where high unemployment is expected to persist, this awkward transition may result in greater protectionism, nationalism and de-globalisation. We have already seen various signs of these over the past year, as politicians walk the fine line between populist measures and economic efficiencies. If these are not kept under control, they could dampen both the economy and M&A.

Recovering to a new reality

The concerted massive government interventions have averted a global financial meltdown. The world economy appears to have bottomed-out at the end of the first quarter of 2009. Confidence is returning, credit taps are unlocked and the stock market bulls are charging again – in an economy that resembles a china shop. Clearly, it is too early to pop the champagne. The road to recovery is likely to be slow, long and bumpy, and the world that awaits us at the end of the tunnel will operate on markedly different geopolitical dynamics and economic models.

While the new reality is fraught with uncertainty and risk, it also presents significant opportunities for M&A. The slower growth and more subdued credit will result in more realistic valuations, which will be welcomed by corporate strategic investors. Private equity will find it challenging to realise desired returns from some of their pre-recession investments, and increasingly difficult to achieve those returns on new investments by financial engineering alone. They will have to focus on transforming businesses and creating value, or accept lower exit valuations. In this new reality, attention to value drivers and operational details of the business is the key to success. The market will reward those who can spot value enhancement opportunities pre-deal, and deliver on them post deal.