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Mergers and Acquisitions

A phenomenal change has been witnessed in the banking industry of Pakistan in recent years, owing to the liberal reforms executed by the State Bank and the effective restructuring of banks. The industry has been transformed from an indolent, government dominated sector into a much more active, competitive and profitable industry. In order to sustain this strong performance, the State Bank aims to further consolidate the banking sector by encouraging Mergers and Acquisitions. This is becoming an increasingly global phenomenon.

This report will examine the basic economics of mergers and acquisitions in the banking industry while highlighting the differences that exist between the two. It shall then move to explore the key principles behind such deals before examining the performance of the Pakistani banking industry in the light of banking sector reforms which are directly and indirectly aimed at encouraging Mergers and Acquisitions in the industry.

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Pakistan: The new site for Global Winds?

A phenomenal change has been witnessed in the Pakistani banking industry in recent years as it transformed from an indolent, government dominated sector into a much more active, competitive and profitable industry. This transformation obvious in terms of increased profitability and its role in promoting economic growth is now a leading story of a sector success that proclaims how effective corporate restructuring and privatization of banks has changed the backdrop of the entire banking industry.


Though the country started without any worthwhile banking network, it has now acquired a flourishing banking sector owing to proactive banking sector reforms executed by the State Bank. The reforms were launched and implemented over the last decade. Since then the pace and sequencing of these reforms has been aligned and modified consistently to provide an impetus to the industry.

Deregulation and restructuring established a strong footing in Pakistan when the government embarked to privatize the state owned banks and allowed the liberal entry of new domestic and foreign banks. At the same time the State Bank did away with all restrictions and barriers on the conduct of business of all banks by the end of 1990s. While promoting banking sector liberalization, the State Bank ensured introduction of efficient and comprehensive regulation, consistent with international standards and best practices, and implemented institutional restructuring and strengthening.

Accordingly Pakistan has developed a sound banking system, which consists of a wide variety of institutions ranging from a central bank (State Bank) to commercial banks and to specialized agencies to cater for special requirements of specific sectors. The banking industry's assets have risen to over \$60 billion; its profitability is at a record high while the non-performing loans (NPLs) have reached their lowest mark. Credit is fairly diversified and system risks facing the banks are well under control while almost three fourth of the total banking assets are in private hands.

The strong performance of the banking industry as a consequence of these liberal policies has aroused immense foreign interest. The present foreign stake comes to approximately half of the total paid-up capital of all the financial institutions regulated by State Bank. And this is nowhere near to the end of the success story. The Government continues its restructuring process of the banking industry in 2007 as it is already in the process offering a proportion of shares of a few large banks in international markets by floating Global Depository Receipts (GDRs). This will further dilute government holdings in large banks.

Besides this, more optimistic changes are expected to occur in this thriving sector. The revised minimum capital requirements introduced by the State Bank, which necessitate a minimum capital level of PKR 6 billion by December 2009, will make structural change



inevitable. This is because many small institutions will have no choice but to merge or be acquired in order to meet the limit. In fact, taking cue from the minimum capital requirements imposed by the State Bank, many market led mergers and acquisitions are already taking place within the banking industry.

What is interesting to note is that this trend of Mergers and Acquisitions in the banking industry is not only witnessed in Pakistan; in fact the banking industry all over is becoming an increasingly global industry, which knows no geographic and territorial boundaries. This increasing trend is largely a result of unprecedented growth in competition, the continued liberalization of capital flows, the integration of national and regional financial systems, and financial innovations.


This report will examine the basic economics of mergers and acquisitions in the banking industry while highlighting the differences between the two. It shall then move to explore the key principles behind such deals before examining the performance of the Pakistani banking industry in the light of banking sector reforms which are directly and indirectly aimed at encouraging Mergers and Acquisitions in the industry.

Friendly Agreements and Aggressive Takeovers

Although often used interchangeably, the terms merger and acquisition mean slightly different things. Merger is defined as the combination of two relatively comparable organizations while an acquisition often refers to the take over of a smaller company by a larger one.

Corporate organizations and other companies embark on a merger deal with other company/companies in an attempt to expand their operations while aiming to augment their long term profitability. Generally mergers occur in a consensual setting where executives from the respective companies mutually decide the terms of the deal in a due diligence process to ensure that the benefits of the merger are reciprocated to both parties. In the pure sense of the term, a merger happens when two firms, often of about the same size, agree to go forward as a single new company rather than remain separately owned and operated. This kind of action is more specifically referred to as a *merger of equals*. The individual stocks of the companies are surrendered and a new company stock is issued in its place. In practice, however, actual mergers of equals do not happen very often.

What usually happens instead is that one company buys another and the terms of the deal simply allow the acquired firm to proclaim that the action is a merger of equals, even if it's technically an acquisition. This is largely because being bought out often carries negative connotations. Therefore, by describing the deal as a merger, the acquiring firm tries to make the takeover appear more pleasant.



Hence whether a purchase is considered a merger or an acquisition largely depends on whether the purchase is friendly or hostile and how it is announced. In other words, the real difference lies in how the purchase is communicated to and received by the target company's board of directors, employees and shareholders.


This means that an acquisition may be only slightly different from a merger in real world. More specifically, an acquisition takes place when one company takes over another and establishes itself as the new owner. From a legal point of view, the target company ceases to exist, as the buyer absorbs the entire business and the stocks are traded under the name of the buyer. An acquisition can take the form of a purchase of the stock or other equity interests of the target entity, or the acquisition of all or a substantial amount of its assets. All acquisitions, unlike mergers involve one company purchasing another and there is no exchange of stock or consolidation as a new company. Though like mergers acquisitions are often congenial, they can be more hostile on other occasions. This takes place when a larger company acquires a controlling interest in a weaker bank or otherwise wins over the bank's majority shareholders against the will of the management.

One plus One equals three?

Regardless of their category or structure, the key principle behind all mergers and acquisitions is to create synergy in order to increase the shareholder value over and above that of the sum of the two companies. This follows from a fairly simple logic: Two companies together are more valuable than two separate companies. Thus the success of a merger or acquisition depends on whether this synergy is achieved.

Synergy allows for enhanced cost efficiencies of the new business, usually taking the form of revenue enhancement and cost savings. Through mergers and acquisitions the concerned companies seek economies of scale, efficiencies and enhanced market visibility.

Since generally all mergers result in downsizing, reducing the total number of employees, costs are reduced significantly in terms of the subsequent decline in total wages. Additionally a merger or acquisition deal results in improved market reach and industry visibility. This is because the marketing and distribution of the resulting company is usually enhanced, offering new sales opportunities. A merger can also improve a company's standing in the investment community as bigger organizations often have an easier time raising capital than smaller ones. It is for this reason that increasing the minimum paid up capital requirement of banks is used as a strategy for consolidation of banks through Mergers and Acquisitions. For example the State Bank has raised the capital requirements to increase the possibility of mergers and acquisitions in the banking industry. This is discussed in detail later in the report.



Moreover the resulting consolidation from the mergers and acquisitions especially those involving foreign banks help in penetration of international skills and technology allowing the bank to develop a competitive edge. This will result in introduction of innovative financial products in the domestic market.


However it must be realized that synergy is not automatically created once two companies merge. In many cases, a merger might just do the opposite of what it is aimed at: one and one can add up to less than two. This means that mergers can often fail to add significantly to the value of the acquiring firm's shares, recording a net loss instead. This is because mergers are vulnerable to factors like incompatibility of technology, equipment, or corporate culture which can cause the resources to be diverted away from new investments. These issues may be aggravated by inadequate research or by concealment of losses or liabilities by one of the partners. Overlapping subsidiaries or redundant staff may be allowed to continue, creating inefficiency, or conversely the new management may cut too many operations or personnel, losing expertise and disrupting employee culture.

Hence in order to be considered a success a merger or acquisition must result in increasing the shareholder value faster than if the companies were separate, or prevent the deterioration of shareholder value more than if the companies were separate.

The Success Story

As mentioned in the beginning of the report, the robust performance that is currently seen in the banking industry is quite recent and in sharp contrast with the poor performance of the sector witnessed in the past decades. In the mid 1990s for instance, the Pakistani banking industry consisted of a large number of banks with most of these being government owned banks. These were not only accused of offering poor customer service but were also unprofitable and technically insolvent. Though there were more foreign banks than there are today, they were not very significant and failed to have a substantial share in the industry except in the case of Citibank, Standard Chartered and ABN Amro.

As the banking sector privatization was facilitated with the establishment of the Privatization Commission, weaker banks were merged with relatively bigger banks. Eleven banks were regrouped into five large banks, four of which were subsequently privatized. In addition the government successfully offloaded 26% stake of its largest bank, National Bank of Pakistan through stock market. Currently, the top five banks cumulatively account for 52.6% of the total banking sector assets. And the State Bank seeks to further consolidate the industry in order to develop a stronger and robust banking system by encouraging Mergers and Acquisitions via increasing the minimum paid up capital requirements.



The trend of consolidation in the banking industry, which began in the US and spread to Europe, Middle East, and South East Asia, has now reached the subcontinent. A process of consolidation as a viable solution has followed each crisis in the banking sector. In the aftermath of the crisis in South East Asia in 1997, when capital outflows plunged the banking sector, central banks of the states found consolidation as one of the crucial remedies. Following the South East Asian model of financial liberalization, the State Bank as the regulating body embarked on the process of consolidation of the banking sector.

As a result the State Bank executed a policy that called for a phased increase, over a period of five years, in the Minimum Capital Requirement of commercial banks to eventually reach at least PKR 6 billion (\$100 million) by the year 2009.

Table 1

Minimum Capital Requirements for Banks/DFIs	
Minimum Paid Up Capital (net of losses) to be increased to:	Deadline by which to be increased
Rs 3 billion	By 31-12-2006
Rs 4 billion	By 31-12-2007
Rs 5 billion	By 31-12-2008
Rs 6 billion	By 31-12-2009

Source: SBP

Subsequently the past three years have seen an increasing trend towards mergers/acquisitions in the banking industry; with the acquisition of Prime Bank by ABN Amro being the most recent. More recent and happening were the market rumors regarding The Barclays Bank of the UK negotiating with one of the groups for a merger/acquisition deal. Anticipations that which Group will be Barclays so called target bank continued to circulate until they were slightly put to ease when Barclays showed keen interest in its Dutch competitor, ABN Amro. The table on the next page shows the merger/acquisition deals that took place in the past three years in the banking industry.

The details in the table show that mergers/acquisitions in the banking sector can be classified into the following categories:

- i. Acquisitions of the branches of foreign banks by the Pakistani banks
- ii. Acquisitions of Pakistani banks by the foreign investors and
- iii. Merger of Pakistani banks with the other domestic banks

Table 2: Mergers/ Acquisitions from 2004-2006

Date	Merger/Acquisition
2004	Acquisition of Bolan Bank by Iqbal Ali Muhammad Group
2004	Merger of Bank of Ceylon-Pakistan Operations with and into Dawood Bank Ltd
2004	Merger of Credit-Agricole Indosuez-Pakistan Operations with NDLC-IFIC Bank
2004	Merger of Trust Investment Bank Ltd, Fidelity Investment Bank Ltd and Doha Bank with and into Trust Commercial Bank Ltd.
2004	Merger of Trust Commercial Bank with and into Crescent Commercial Bank Ltd
2005	Merger of Ibrahim Leasing Ltd with Allied Bank Ltd
2005	Acquisition of majority shares of Dawood Bank Ltd by Atlas Group
2006	Merger of Atlas Investment Bank with and into Atlas Bank Ltd
2006	Merger of Rupali Bank with and into Arif Habib Rupali Bank Ltd
2006	Merger of First Allied Modarba Ltd with and into Allied Bank Ltd
2006	Acquisition of majority shares of Union Bank Ltd by Standard Chartered Bank (Pakistan) Ltd
2006	Merger of Habib AG Zurich with and into Metropolitan Bank
2006	Acquisition of Prime Commercial Bank by ABN Amro (Pakistan)

It is because of the increasing trend towards Mergers and Acquisitions that the policy action involving the enhancement of paid up capital is regarded as State Bank's determination to achieving further consolidation in the industry. Since the small banks cannot meet these requirements easily, they are coerced to merge with other small banks or be acquired by some large banks.

As a result domestic private banks have either injected their own capital or sought alliances and partnerships to augment capital. On the other hand domestic or foreign banks have stepped in to acquire middle or small-sized banks to expand their capital and outreach. Excluding specialized financial institutions (such as microfinance and Islamic banks who have been allowed new licenses) the State Bank has imposed an embargo on new conventional bank licenses.



The secrets of the Success Story

The strong performance of the banking sector of Pakistan is impressive. The industry enjoys the position of one of the most thriving banking sectors amongst its regional peers. The profits reached an all time high when the profits of the commercial banks crossed over USD 1 billion for the first three quarters of calendar year 2006. The increased profitability has been the result of a combination of factors including a rise in earning assets of commercial banks, a rise in advances to total assets ratio, a decline in operating expense relative to income and a rise in SME, consumer finance and agriculture sector lending which currently constitutes over one third of total outstanding advances. The most important impact on the profitability margins however comes from the corporate restructuring of the banks.

The process of capital enhancement and consolidation is progressing well. Of the current total thirty nine commercial banks, eight banks conformed to the stipulated capital requirements of 2009 and sixteen banks successfully raised capital to meet the minimum capital requirement of 2006 while the other eleven banks are well on their course to meet the prescribed limit. The remaining banks that remain below the stipulated requirements are either in the process of being privatized (such as the SME Bank) or in the process of being merged or acquired into/by other groups. While capital injections have been spurred by the possibility of recourse to capital markets or foreign interest in banking system, the impetus to consolidation emerges from the wave of Mergers and Acquisitions, which in turn is driven by foreign interest in Pakistani banks triggered by their profitability. Hence a virtuous cycle of increased profitability and consolidation is spurred by the State Bank's move to increasing the minimum capital requirement for the banks. Nevertheless critics have often accused mergers and acquisitions for having negative social and economic implications especially in terms of increasing unemployment which results from downsizing. What is important to realize is the fact that such negative pressures can be contained if a strong economic and social structure is developed.

The consolidation process spurred by current trend of mergers and acquisitions in the banking sector promises increased prospects for sustainable banking sector growth. This combined with macroeconomic stability will continue to attract more international players by virtue of greater number of mergers and acquisitions providing access to global financial market. This would also help widen the scope of business on the fast changing global scenario as well as professional exposure to the local banks. Hence the benefits of the consolidation process which stimulate further economic growth are likely to withstand the undesirable economic and social repercussions of mergers and acquisitions.



Economic Snapshot

Fiscal year 06														
	Units	Feb	March	April	May	June	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb
<u>Inflation</u>														
Headline Inflation	%	8.05	6.91	6.16	7.12	7.65	7.63	8.93	8.73	8.11	8.07	8.88	6.64	7.39
Core inflation	%	7.00	6.67	6.43	6.58	6.29	6.28	6.20	6.16	5.70	5.62	5.5	5.3	5.72
Food inflation	%	7.48	5.42	3.64	5.59	7.78	7.44	11.08	11.26	10.54	10.62	12.71	8.7	9.99
Non-food inflation	%	8.44	7.98	8.01	8.21	7.55	7.77	7.43	6.98	6.41	6.27	6.22	5.2	5.59
<u>T-bill (Wgt Avg)</u>														
3 month	%	8.10	8.10	8.10	8.10	8.29	8.32	8.63	8.64	8.64	8.64	8.64	8.64	8.64
6 month	%	8.29	8.29	8.29	8.29	8.45	8.49	8.81	8.81	8.81	8.81	8.81	8.81	8.81
12 month	%	8.78	8.79	8.79	8.79	8.79	8.79	9.00	9.00	9.00	9.00	9.00	9.00	9.01
<u>External Sector</u>														
Export	Mln US\$	1,292	1,536	1,450	1,527	1,533	1334	1392	1392	1288	1448	1536	1227	n.a
Import	Mln US\$	1,854	2,269	1,656	2,330	2,685	2383	2267	2172	2162	2139	2365	2100	n.a
Trade balance	Mln US\$	(562)	(733)	(206)	(803)	(1152)	(1049)	(875)	(780)	(874)	(691)	(829)	(873)	n.a
<u>Remittances</u>	Mln US\$	339	444	401	507	464	376	435	422	410	448	475	391	457
<u>Forex Reserves</u>	Mln US\$	11,516	12,487	13,021	13,003	13,137	12,725	12,631	12,512	12,503	12,460	12,960	13,212	13,378
n.a = Not Available														



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