ASIAMONEY

Domestic firms race to seize on global rivals' weakness

Date: 12 Jun 2009

Asia's leading local investment banks have an unprecedented opportunity to capitalise on the weakened state of international rivals by building market presence at home and abroad. But they must act fast if they want to give them a real run for their money because this vacuum is temporary and the key players won't be distracted forever.

By: Pamela Tang

It's standard for investment banking chiefs to dispute that their businesses are in trouble. But the time for such denials has long-since run out. Deal sizes and volumes in Asia and across the world have shrunk beyond all recognition over the past nine months, while daily trading levels have yet to recover the lustre they once enjoyed.

Add in the damage that investment bankers' reputations suffered over their role in creating the financial maelstrom in the first place, and you can see it has not been a happy division to be in.

International firms have seen their regional ambitions clipped by directives to reduce risk. Bloated banking and trading teams have been cut back, while once-secure underwriting relationships have been curtailed to cut back on risk exposures. The cuts have happened at nearly all banks, including Credit Suisse, Deutsche Bank, Morgan Stanley and UBS.

HIGH CASH FLOW STRESS

	2009 YTD		2008 YTD		2008	
	value (US$m)	No.	value (US$m)	No.	value (US$m)	No.
DCM	172,795	910	91,591	743	260,576	1,802
ECM	29,170	315	38,826	341	59,618	731
M&A	101,072	2,764	136,108	3,634	373,820	9,281

SOURCE: DEALOGIC

"Some banks have cut 30% to 40% of their investment banking staff," notes a senior recruitment specialist in the region.

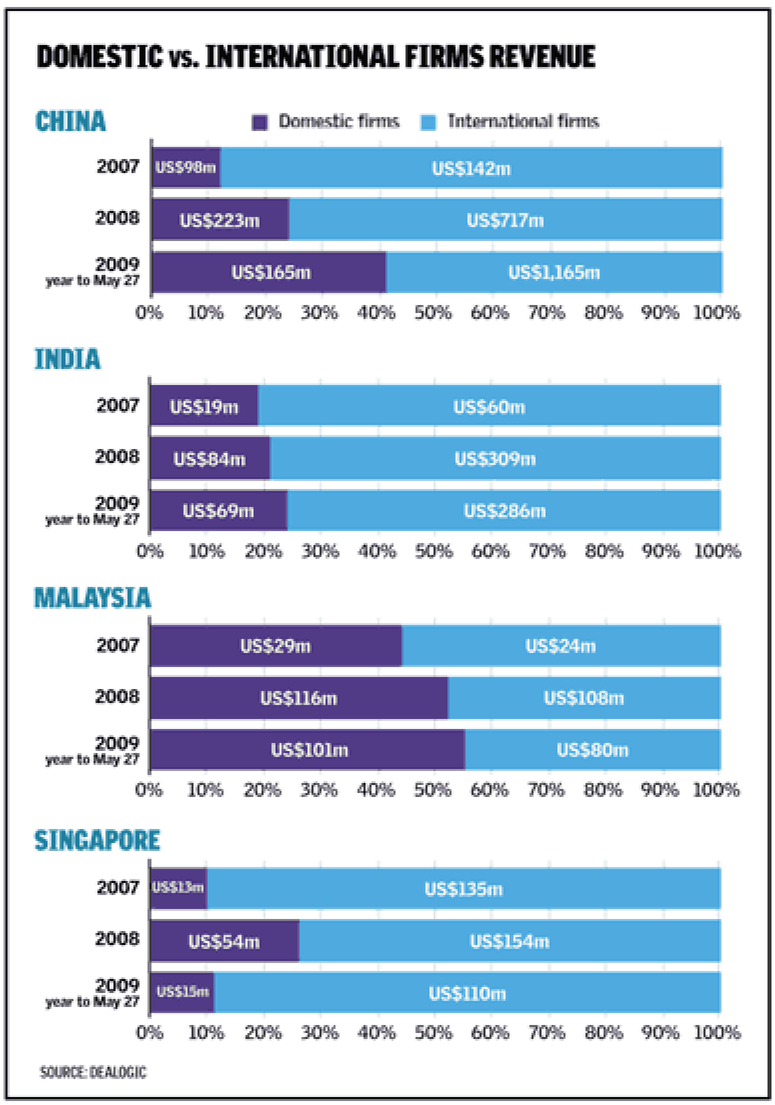
The worst-hit may even have to pull out of Asia at the behest of regulators hardly enamoured with the idea of risking tax payers' money on the furthering of overseas ambitions.

Royal Bank of Scotland is often cited as having the most uncertain future. Although the bank recently reiterated its desire to remain in investment banking in Asia, there is no guarantee it will be allowed to now that it is 70%-owned by the UK government.

Others, such as Bank of America-Merrill Lynch, have seen their talent pool drained by departures and dismissals. Internal difficulties have led senior dealmakers to move on, most recently Kalpana Desai, head of M&A for Asia Pacific ex-Japan.

And for ailing global institutions, yet more bad news could be in the offing, because the leading domestic investment banks in Asia have been monitoring the decline of their international counterparts with interest. They now have an excellent opportunity to grab a larger market share in the region.

"On the primary side, we are definitely seeing more clients engage us than before," says Clifford Lee, managing director of debt capital markets at DBS in Singapore. "This year we're really starting to see an increase in queries and that's in part due to some non-Asian banks focusing on their home markets."



The diminished status of the foreign players, combined with a natural alignment of regional banks with the needs of their corporate clients, offers a powerful advantage that many aim to exploit. Their ability to compete long term with their global rivals will hinge on how well they use this window of opportunity.

Business potential

Some domestic investment banks are further down the road than others. Kotak Investment Banking, DBS and CIMB (see profiles) have shown themselves to be credible opponents to international banks, even if there is room for improvement.

But while these local houses have an opportunity to grow, converting potential into business is the true test.

Some regional investment banks say this is happening already, pointing to deals with clients that often preferred to work with international firms. DBS recently scored a coup when it was named a joint-bookrunner for an inaugural US$1.5 billion bond issue by Qatar Telecom, which was set to price in the first week of June.

“This is a global bond for a top-tier Middle Eastern issuer and it’s quite rare, if ever, that an Asian bank is involved in a global transaction like this as a joint lead-manager,” notes Lee.

Kotak Investment Banking in India is also gaining traction with corporate customers that it had never previously worked with. It was the exclusive financial adviser to Wilo SE in its delisting of Mather & Platt Pumps, and worked on the same role for Navis Group in its offer for the acquisition of a controlling stake in Sah Petroleum.

One reason that these banks are snagging such large deals is that they are willing to underwrite them. Many local investment banks have strong balance sheets, and some have raised capital to raise their capacities. This helps them to commit capital to clients at a time when international rivals are yanking back their commitments in Asia.

This pull-back has another effect, too. International banks have been lending less, leaving Asian companies more reliant than ever on regional banks for money.

“Overall, DBS has a stronger franchise and is able to provide a fuller service such as packaging loans than some of the foreign banks,” notes the chief financial officer of a corporate in Singapore.

CIMB

South-east Asia's other notable investment bank is CIMB. Domestically, it has no rival.

"If you're talking about investment banking in Malaysia, they're really the best," says an executive at a local rival. "They're aggressive and innovative, and that is how good merchant banks should act."

It shares common traits with the strongest international banks in that it is proactive, constantly thinking of how it can help its clients. According to a source, the bank conceived and brokered the merger between Sime Darby, Golden Hope Plantations and Kumpulan Guthrie in 2007, the largest merger in South-east Asia at the time.

Traditionally CIMB is strongest in Malaysia, but it has also done well overseas. It acquired respected Singaporean brokerage GK Goh in 2005 and has built a growing Asian network comprising the city-state, Jakarta, Bangkok and Hong Kong.

It doesn't hurt the firm that its group chief executive Nazir Razak, himself an investment banker by background, is the younger brother of Najib Tun Razak, who was recently sworn in as the country's prime minister.

Aside from family connections, Nazir Razak is a seasoned banker with an eye for hiring the best people, which has strengthened CIMB's management bench. Plus, his presence at deal pitches has been a great aid to business.

"CIMB has been very focused under Nazir and I think they are doing well," says a finance manager at a large listed company and a long time client of the firm. "They have hired some pretty good people in Singapore and Malaysia."

One criticism that others have had of CIMB is its level of compensation, which Razak tacitly acknowledged when speaking to *Asiamoney*. Like many of its regional peers, CIMB still lags its international rivals in salaries and until it levels the compensation it could find that some of the brightest local talent falls through its fingers. ◢

To encourage regional lenders to keep their lines open, many corporates are now "including their bankers when they raise capital, even if it's just a nominal role", notes a treasurer at another large listed corporate. Many companies now have three or four bookrunners even on a small bond issue, he points out.

Domestic investment banks are getting more business because of this, and because they are actively sourcing for it.

"We're basically telling our clients that because we supported them in the past, it's now time to give us a fair share of the capital markets deals," says an investment banker with a domestic firm.

Although there are fewer profits to be made, it allows these firms to be engaged in larger deals, which will benefit them as they strive to expand their influence domestically and regionally. Of course, their inclusion in the fee pot means that the international banks get less to take home.

Changing dynamic

Domestic dealers are also benefiting from changes to the financing habits of their customers.

Many regional companies have been discouraged by increased market volatility, cost and uncertainty in international capital markets, and so have sought comfort in domestic issuance instead. This shift in funding preference has cushioned local firms from the fall-off in investment banking revenue.

Although equity and M&A remain deeply depressed, debt has emerged as a silver lining. There were 910 debt deals in Asia (ex-Japan) in the year to May 27 worth a total of US$172.8 billion, close to double that of the US$91.6 billion from 743 transactions in the corresponding period last year, according to data provider Dealogic.

Most of these deals were out of China, and the key beneficiaries have been the local investment banks, notably China International Capital Corp., because most of their international rivals have yet to begin local operations or lack licences to underwrite domestic debt.

India also offers an opportunity for local investment banks. Corporates there are starting to consider rupee debt having previously shunned it in favour of US-dollar funding. But Falguni Nayar, managing director at Kotak Investment Banking, notes that because this sort of fund-raising has become more expensive and comes with the risks of currency volatility, many have had a change of heart.

Domestic firms also appear to be gaining ground in secondary debt markets. DBS bank has seen an increase in secondary market activity in Asian bonds across the region as "many of the trading desks [at international rivals] have scaled back", says Lee of DBS. "When investors want to get in and out of the market, we are there to help facilitate that."

Tapping up talent

But while there is a clear opportunity for domestic firms to build up their prestige, the question is: will they grab it?

There are a litany of problems to overcome, including the need to establish an extensive international distribution network, attract the right mix of talent and build a sophisticated risk-taking culture. Until these issues are resolved, the ambitions of even the most aggressive local investment bank will be constrained.

Some recent foul-ups by domestic firms have added weight to the arguments of critics who say they can't compete.

In October, JM Financial bailed out of an agreement to underwrite 67% of Tata Motors' Rs19.57 billion (US$417 million) issue of differential voting shares at the last minute after it was poorly received by investors. It ended up underpinning just 9.85% of the

KOTAK INVESTMENT BANKING

Kotak Mahindra Bank's investment banking arm is so well respected in India that a rival banker at an international firm admits it "stands man-to-man against us on deals".

The institution is considered the country's strongest domestic investment banking franchise because of the quality of services it offers clients, who return time and again. This repeat business is no mean feat in a country known for a brutally competitive financial services industry.

"We have an in-depth understanding of the local market and thorough knowledge of industry verticals through dedicated sector experts," says Falguni Nayar, a managing director at the firm. "This combined with our strong advisory capabilities makes us the Indian experts with a strong value proposition to offer clients."

Such understanding stems from its years of investment banking activity. Founder Uday Kotak is credited with having brought strong promoter-to-promoter relationships which is a key ingredient to doing business in India. Plus, the firm's 10 year tie-up with Goldman Sachs, which was dissolved in 2006, also gave it much-needed nous.

"I've met the management a few times and they come across as very professional and have put together a formidable array of businesses from domestic broking to investment banking," says Jonathan Reoch, senior portfolio manager for Asian equities at AMP Capital Investors in Sydney. "They have a well-thought-out business plan and are certainly in the top tier of Indian investment banks."

Although Kotak is one of the best domestically, it has challenges to overcome too. One is to stay consistently strong in its home market against the growing competition, say observers.

Another issue it needs to address is building stronger regional distribution. It took a step forward in February when it inked an alliance with GCA Savvian Corp., a Japanese investment bank. This should offer it distribution capabilities in the world's second largest economy.

But more could be done. Kotak should build on this momentum to push outside its borders. China is the other country it should focus on. This would enable Kotak to build strength in Asia's other large investment banking market and the target for many of its customers.

In response, Nayar says, "We are working with six or seven international partners including firms strong in Africa and Russia. The only place we haven't covered is China and we should do more work there, and in Korea." ◢

issue, leaving Tata Sons to take on 60.7% of the total issue. However, rivals do concede that the deal came during poor markets.

Financial firms only tend to be as good as their staff, so the most pressing issue for firms on the rise is to build the right culture and get the best talent. Only by doing so can they expect to be genuine competitors.

"You've got to grab the client relationships now and then bed them down," says Nazir Razak, the chief executive of CIMB in Malaysia. "And clients reasonably have high expectations as they are [frequently] AAA clients, so you need to invest in the quality of service that they're accustomed to. Otherwise the global [investment and commercial banks] will come in and steal them back."

Until now, domestic banks have found it hard to pry top talent from their international rivals. Lower compensation and a constricting culture are often cited as reasons for this reluctance, but such resistance has started to melt.

Yet how long will these bankers last? Job security may trump compensation in the minds of many bankers right now, but it won't be forever. International banks are bound to start hiring again in a year or two, and unless there are significant changes to compensation and culture at local firms to encourage their senior appointments to stay, those that have joined them will quickly leave.

Firms such as Kotak offer that, but they are one of the rare ones. "We have a philosophy that we match the base compensation and even in terms of overall compensation it works out fine because we give a reasonable percentage in stocks and as our stock has performed, it is rewarding the employees," says Nayar. "If you look at total compensation, it's not significantly different."

CIMB's Razak takes a similar attitude. He notes that it is an expensive process to bring in people of higher quality, but adds: "If you take over the relationships [of senior corporates from international banks] and don't bulk up, you'll lose the relationships and won't make ends meet."

DBS GROUP

There are clearly advantages to being the investment banking arm of a large commercial bank in this present economic downturn. Just ask DBS.

"We have the knowledge on the ground, the reach to investors, the local distribution networks because Asia is our home," says Kan Shik Lum, head of equity capital markets at Singapore's largest banking group.

Certainly, its advantage over domestic peers comes from its long-term commitment to investment banking. In this downturn, the investment banking division has leveraged its banking relationships to participate in several notable deals this year. To do so requires a commitment to underwriting, which DBS has the money to do – especially after shrewdly tapping the equity markets for S$4 billion (US$2.79 billion) in December.

"I wouldn't say they have got the best capabilities if you compare them against the international investment banks, but in terms of working with the client and thinking of our interests, it has been a very positive experience," notes a chief financial officer of a corporate in Singapore.

DBS is moving in the right direction in many ways, but it could do better too. Unlike other Asian investment banks, DBS has never had much trouble attracting talented bankers as it offers attractive salaries. But observers believe that the bank should hire more aggressively in this downturn to round out its investment banking capabilities regionally, especially at a time when bankers are in plentiful supply and cheaper to recruit.

Doing so would also dispel criticism that DBS appears less nimble than its international peers, particularly outside its comfort zones of Singapore and Hong Kong. ◢

CHINA INTERNATIONAL CAPITAL CORP.

China's largest investment bank is a very successful institution, but its greatest asset is its biggest hindrance: strong government ties.

Its chief executive Levin Zhu is the son of former premier Zhu Rongji, and these ties have been helpful in winning landmark deals for years. Its influence has extended to the point that few major deals for state-owned enterprises elude it.

These deals have helped CICC to take home US$24 million in investment banking revenues this year – the most among international and domestic peers.

But these ties have also been a constant source of criticism. Fraser Howie, author of *Privatizing China* and a former CICC employee, said: "There's a wonderful phrase I'm stealing that says 'CICC is a joint-venture striving to become a state-owned enterprise' and I think that tells you a lot about it."

Serving China's largest government-linked companies will keep revenues coming, but CICC's longer-term prospects have been called into question. China's private enterprises will grow and their influence might even exceed that of state-linked firms. And in these areas CICC's influence is weaker than some domestic rivals.

It will also face rising competition from international rivals, some of which recently obtained licences and are sure to try and expand aggressively.

To raise its game, CICC needs to pay better. The firm is not known as a generous pay-master, offering up to 30% less in total compensation than its international rivals.

This is no way to attract bankers of the calibre it desires. "They want the best and the brightest, but the reality is that their inner workings combined with the lack of compensation are going to make that quite difficult," says a senior recruiter.

In response, Wei Ding, the firm's head of investment banking says, "Nevertheless, CICC has done the most among the Chinese banking houses in introducing performance-based compensation and building up the capabilities of [our] bankers."

Being more competitive will not only attract better bankers, it will also help in building capabilities and technical knowledge across Asia. It has to do so if it wants its public and private clients to believe it has the ability to go offshore. This, observers say, can be done via acquisitions or building a franchise organically. ◢

Cultural conundrum

Compensation is an issue more easily resolved than cultural differences. In many cases, these changes are resisted. China's aspiring financial firms in particular may find that bridging the gap is difficult.

"The real meaningful jobs [at Chinese investment banks] are very limited and your ability [as an expat] to influence change is zero," said Fraser Howie, author of *Privatizing China* and former CICC employee. "You're not being put in a position of power to change things and ultimately they don't want the system changed."

Beijing's policy of protecting its financial services industry and limiting international bank access has protected its local firms, but it has also stymied their development. Such firms have been accused of being uncompetitive and have little hunger or desire to excel. Instead, they rely on cushy relationships with government officials and business owners to get the best deals, many of which are simple to pull off.

"You are able to sell any bond deal in China if its rate of interest is higher than the one-year deposit rate and that's hardly difficult," added Howie. "And in the case of IPOs, they're priced very cheaply and so are heavily oversubscribed. You don't even need to call because there is no deal to sell, they sold themselves."

The government is relaxing its rules and admitting a trickle of foreign securities firms via domestic joint-ventures. But the consequences of this protectionism may already have taken root. History provides an ominous warning.

"China has to take a cautionary lesson from Japan's investment banks in the 1990s," says Michael Pettis, a professor at Peking University's Guanghua School of Management. "They went offshore, but because their domestic markets were so heavily shielded with little competition, they became completely irrelevant in the international markets."

No time to lose

Asia's aspiring regional investment banks have no time to lose if they want to build their operations sustainably, since their international rivals will not be distracted forever.

Many of the world's largest dealers have painstakingly built operations in the region in recent years, and recently reiterated their ambitions in Asia, home to the two greatest opportunities, China and India.

Senior executives at the local banks are well aware of the time pressure. "We'll see fewer of them competing with us, but the moment markets stabilise they will focus very keenly on China," says Wei Ding, head of investment banking at CICC in Beijing. "We are under no illusion that this competition will be gone forever. It will be introduced very soon and might even be more heated than before."

But until the global banks experience a period of recovery, sizeable investment into Asia is going to be limited. Local bankers know that they have a year, perhaps two, to establish their credentials as leading market players.

"What we have now is an opportunity and not a trend," says Lee of DBS. "It's up to the Asian firms to build on the advantage made possible by the temporary vacuum to properly position themselves. Only then, when the markets firm up and competitors come back, will we be a position to give them a real run for their money."

It will benefit domestic banks that investment banking globally has moved away from the high risk, high reward strategy that had characterised the industry. Regulators globally are expected to clamp down on capital ratios, compensation and aggressive risk-taking. It all dovetails well with the conservative nature of most Asian investment banks.

"Taking less risk cannot hurt you in the long run," says Nayar of Kotak. "Some of the global firms have historically taken on a lot of risk and you can see what has happened to them."

The world's international investment banks have gone through arguably the worst period in their history. But these institutions still have immense advantages at their disposal, and sooner or later they will be back.

Asia's leading local investment banks had better hurry if they want to become the go-to institutions within their own borders and beyond. The clock is ticking.