From Wall Street to Beijing: Global Finance Has New Rules, New Players

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The rising power of hedge funds and private equity investment, continued sharp competition among Wall Street firms, and growth in China and India are the key drivers of global finance today, according to industry leaders at a recent Wharton Finance Conference whose theme was *From Wall Street to Beijing: Thriving in a Changing Environment.*

Speakers on one of the conference panels, entitled *Financing Growth in Expanding Markets,* noted that privatization and rapid growth in Asia and India, along with structural change in Latin America, are creating strong capital markets in emerging economies. These local markets are increasingly taking a role in capital formation at the expense of Wall Street. "Throughout the 1980s, the U.S. was the driver of the world economy, and the world focused on exporting to it. The reality is that in the last two, three or four years the real growth engines are India and China," with Japan now beginning to emerge as well, said James R. Birle, Jr., managing director and head of global equity capital markets at Merrill Lynch.

Birle noted that most capital raised for investment in China used to go to state-owned firms, but now private Chinese companies are also drawing support from investors around the world. In addition, Chinese companies seeking to go public or raise additional capital are bypassing Wall Street and turning to capital markets in Hong Kong or elsewhere. "There is enough liquidity in the local market. They don't need to come to the U.S. to list on the New York Stock Exchange," he said, adding that requirements of Sarbanes-Oxley legislation, which improved the transparency of corporate accounting following the scandals at Enron and other U.S. firms, also make Wall Street less attractive to Chinese companies looking for investment. "Another issue is the litigious nature of the U.S.," he continued. "A Chinese company will say, 'Why come here if I don't have to?'"

Birle sees little worry that speculative "hot money" will drive the Chinese economy into a bubble. While there has been some short-term investment from U.S. and European hedge funds, he said most investment in China has come from corporate foreign direct investment and institutions, such as pension funds, with a long-term horizon.

Jeff Shafer, vice chairman of Citigroup's public sector business, discussed the Chinese banking industry, which traditionally has been burdened by bad loans. But recently, he said, the industry is privatizing. China Construction Bank floated shares on the Hong Kong Stock Exchange October 28, raising $8 billion in China's largest IPO. Two other state-run banks, Industrial and Commercial Bank of China and Bank of China, are expected to go public in the next year.

"Everybody is alarmed about the banking system, but the Chinese have spent a tremendous amount of energy in the last two to three years resolving this problem and I think they are going to succeed," said Shafer, pointing out that the government has put money into the banks to reduce the level of non-performing loans. "The big problem is how to keep [the banks] from making a new round of non-performing loans."

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The Chinese appear to be introducing banking reforms that will improve governance, such as independent boards and disclosure requirements, Shafer noted, adding that the Chinese reforms are "arguably better than the bureaucratic Sarbanes-Oxley rules in this country." Birle suggested that the banking privatization shows Chinese authorities are able to formulate a policy response when they need to. "My sense of the Chinese leadership is that they feel a responsibility to deliver a rising standard of living. The present system will be accepted by the public as long as they deliver."

Looking ahead, Shafer said that the next challenge for the Chinese is to transition from an export-dependent economy. "The Japanese never learned to live on anything other than exports, but the Chinese will have to because it is going to be a bigger economy."

Mobile Telecom in India

India is another major focus of international attention in emerging markets, according to the panelists. Roy Rodrigues, managing director of Bear Stearns' technology investment banking group, said India will begin to seek greater access to capital markets in the next 12 to 14 months as mid-sized companies increase their acquisitions. "We will begin to see them get a little more aggressive."

The Indian mobile telecom sector, along with real estate, aviation and pharmaceuticals, will be hot growth areas, Rodrigues predicted. "You will see growth where there is minimal government intervention." Mobile telecom in India has been successful, he said, because the government considered it a luxury that would only reach a small market and so did not bother to get involved in pricing. As a result, the market flourished.

India desperately needs investment in infrastructure, but that sector is struggling, according to Rodrigues, who notes that officials have put the cost of necessary infrastructure improvements at $150 billion. The problem is that every time the private sector thinks about investing in a public project, "the government wants to interfere and decide pricing. That's when the private sector" gets discouraged.

Davis Terry, managing director and co-head of UBS Investment Bank's global telecommunications group, agreed that telecom would be at the forefront of Indian finance deals. In India, where information technology is a leading industry, telecom is as important, if not more important, than steel and power, he said.

Eastern Europe and Russia have been neglected by capital markets, but they, too, will provide new opportunities for investors willing to look closer, Terry added. "It's not going to be as big as Asia, but it's coming into its own. I think ultimately we are going to see that economy continue to attract lots of outside capital. Countries like Poland and Romania are going to be interesting areas."

Fiscal Prudence in Latin America

Latin America, where earlier generations of investors were burned by financial crises, is stabilizing and will also provide solid investments, the panelists said. According to Carlos Mauleon, managing director and head of Latin American debt capital markets and investment banking at Barclays Capital, the macroeconomic climate in the region has improved because governments have been able to tame inflation and interest rates. "Government realizes that being fiscally prudent makes sense. This has created confidence in pension funds, which are growing. That money has to go somewhere."

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For investors in the rest of the world facing low rates of return, Latin America seems all the more attractive. "There is a lot of liquidity in the market now," he said. "All of a sudden, all these international investors are looking for somewhere to put their money." He pointed out that the development of derivatives and swaps markets has eliminated some of the risk in Latin America investment because they can provide a hedge against currency crises. "This is new for emerging markets and it is key."

Martin Farina, managing director in JPMorgan's North American financial institutions group, recalled the days when inflation in Brazil was rising 1% a day and Maoist Shining Path guerillas were terrorizing Peru. "In the last 10 to 15 years you have seen a lot of structural changes, such as those in the banking structure. The region is significantly better than it was 10 or 15 years ago."

In addition to banking reform, Farina noted the rise of private pension funds in Latin America as a new source of capital that is fueling business growth. "If you compare the local markets and how much they have delivered vis a vis Wall Street, I would say the local markets have done a better job of financing the growth from an equity perspective and a debt perspective," said Farina. "There is still a long way to go and there will be a few more crises, but certainly we are making progress."

Farina also mentioned Africa, which he said falls below China, India and Latin America in economic strength, but is at least gaining some attention in the United States. "You think of Latin America as the Third World, but when you go to Africa it's a world of its own, unfortunately. The challenges the continent has are significantly more important than Latin America and China."

While Wall Street has had little interest in financing deals in Africa, he said the Bush Administration has increased its investments there. "It's a completely different situation (than other emerging markets) and more complicated, but I would like to think that the U.S. is very much focused on it, perhaps more than in Latin America."

Trends Shaping Global Markets

In a keynote speech to the conference, Dow Kim, Merrill Lynch executive vice president and president of global markets and investment banking, laid out five major trends shaping global financial markets. First, he said, margins are dropping to commodity levels for Wall Street firms. Fees for initial public offerings, which were once 7% of the deal, are now 3% or 3.5%, divided among multiple lead managers. "This trend of shrinking margins is not likely to reverse anytime soon."

The continued rise of hedge funds is also a major force in finance today, said Kim, who noted that 8,500 hedge fund managers control $1 trillion in assets. He predicted the hedge fund industry would divide into three types of firms. About a dozen strategic-management funds will focus on investing for pension funds and wealthy individuals, providing returns of 20% to 22%. A second group of funds with $1 billion to $10 billion in assets will command premium fees for returns of up to 50% for high-risk ventures. Then there will be a group of "wannabes" formed by ambitious traders, which will eventually consolidate under regulatory scrutiny and pressure from investors. "But overall, we see continued growth going forward."

Large Wall Street firms will also continue to expand, he predicted. "Clients will continue to consolidate their relationships with half a dozen firms and these firms will be global with a full set of capabilities." While there may be some room for regional or specialty firms in niche markets, it will mainly be the "large players who will gain market share at the expense of the mid-tier organizations. This is especially true in the global equities business because the barriers to entry are extremely high."

Kim also observed that price-to-earnings multiples paid for financial service firms, regardless of their

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specialty, are converging in a range of 11% to 13%. "What the market is telling us is the business model itself doesn't matter nowadays. What matters is that your operation can grow earnings."

He predicted that as market-risk premiums begin to diverge again -- and there is some evidence to suggest that is starting to happen -- firms with a diverse range of services would win business over specialists. Finally, he said, institutional securities would be a secular growth business going forward. "Although our businesses are still cyclical, we see continued secular growth in asset classes and geographic locations," noted Kim, who pointed to India, China and Eastern and Central Europe as areas that will experience particularly strong growth. "Some areas will grow faster, but by and large we expect economic expansion across all businesses."

The Outlook for Hostile Takeovers

Changes in securities laws following scandals at Enron Corp. and other companies, along with the continued rise of hedge funds, may be leading to a new era of hostile takeovers, according to speakers on a panel titled, *Hostile Takeovers: Poised for a Comeback?*

Panel moderator Dennis Berman, a mergers and acquisitions reporter at *The Wall Street Journa*l, suggested today's takeovers are characterized by many small skirmishes compared to the major nuclear takeover battles of the 1980s. "A crude analogy is World War II versus modern warfare," he explained. In the past, hostile takeovers were like World War II battles with two clearly defined fronts waging all-out war. Now, he said, mergers and acquisitions are more like guerilla warfare. "You have shareholder activists, hedge funds, mutual funds all taking a stance."

Richard L. Easton, a partner at Skadden, Arps, Slate, Meagher & Flom specializing in mergers and acquisitions and Delaware corporate law, agreed that new players are becoming involved in the process and said directors are more likely to hear them out than in prior years. "We are clearly in a very active market, not so much for corporate control, but in enhancing shareholder value. Hedge funds are interested in the short-term performance of their funds. If the stock price is stagnant they are there to agitate, not necessarily for what is in the long-term best interest of the company or its widest stockholder base. They are focused on how to get six points in a week."

At the same time, Easton noted, boards are facing greater scrutiny and are reluctant to ignore suggestions from shareholder activists and funds. The Sarbanes-Oxley legislation, which makes corporate officials personally liable for fiduciary duties, has also made independent board members more cautious about dismissing an unwanted bid. "Outside directors are feeling the heat," he said, and are less willing to simply follow the lead of management when it comes to advice from shareholders.

Lisa Beeson, managing director at Wachovia Securities, said boards are not only responding to takeover solicitations, but thinking strategically in advance of offers. "They are hiring their own set of advisors and counsel. There is a lot more activism on the part of boards which hedge funds are taking advantage of."

According to Charles S. Edelman, senior managing director at Bear Stearns and head of mergers and acquisitions for its global industrial group, a hostile takeover bid is a major undertaking for the acquirer and makes it difficult to gain information that might help executives and directors decide whether to go through with the deal. "If you go hostile," you may not be able to conduct much due diligence, "depending on how the target reacts. If you end up in court and appeal to shareholders directly, there is no time to do due diligence."

In keeping with the conference's global theme, Berman asked about the recent failure of Chinese companies to take over Unocal Corp., the U.S. energy firm, and appliance manufacturer Maytag Corp.

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"We are recognizing that they can play in the big leagues. It's still a bit of a learning process, but there is a tremendous pool of capital out there," said William Anderson, managing director in Goldman Sachs' mergers leadership group.

Anderson pointed to the acquisition of IBM's PC business by China's Lenovo as a less heralded, but successful cross-border transaction, and he predicted investment banking in China would grow. "I do see a lot of U.S. companies working on strategic partnerships in China," he said. "It may take a long time, and there are a few twists and turns left, but in a couple of sectors we will definitely see Chinese companies stepping up."

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