

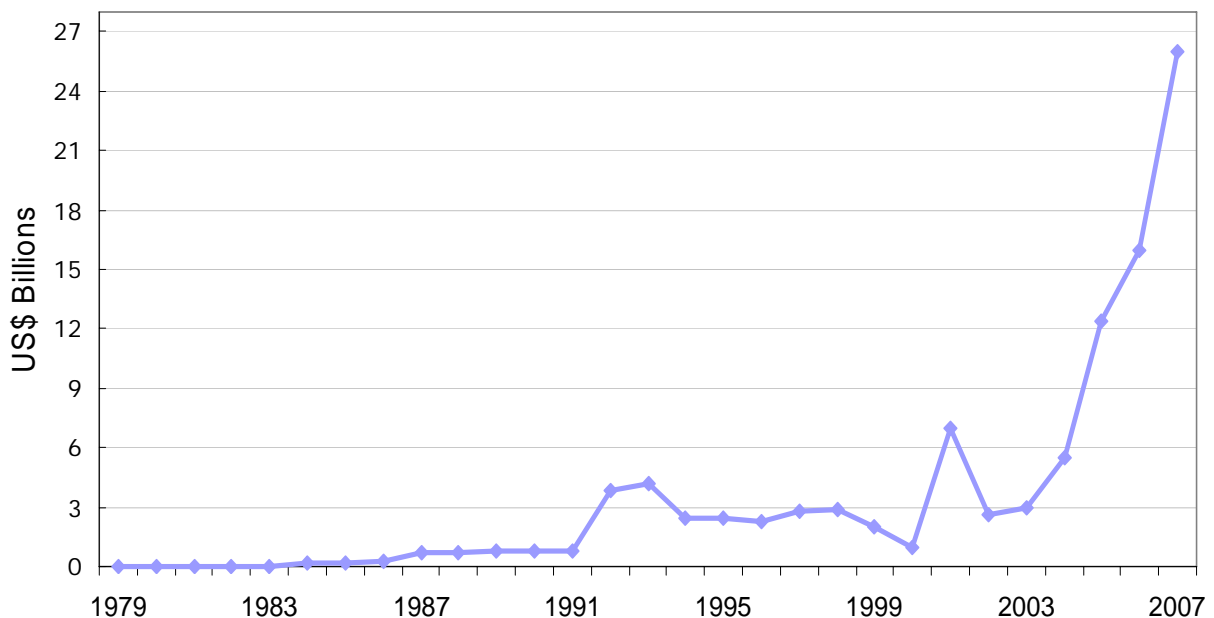
September 5, 2008

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China Goes Outbound The Case for Overseas M&A

In the first six months of 2008, Chinese outbound M&A reached US\$32 billion, accumulated from a total of 102 deals. This amount alone has already eclipsed that of the entire year of 2007 (US\$26 billion from 166 transactions) and dwarfs preceding years by significant orders of magnitude. Today, China's total cumulative outbound investment stands at close to US\$150 billion, and growth is unlikely to slow in the near to medium term. This article is the first in a series that explores the trend; seeking to illustrate both why China is increasingly going overseas and the scope and dimensions of those outbound investments. Upcoming articles will feature Chinese investments in Latin America and also in Africa.

China's Outbound Foreign Investment (1979-2007)



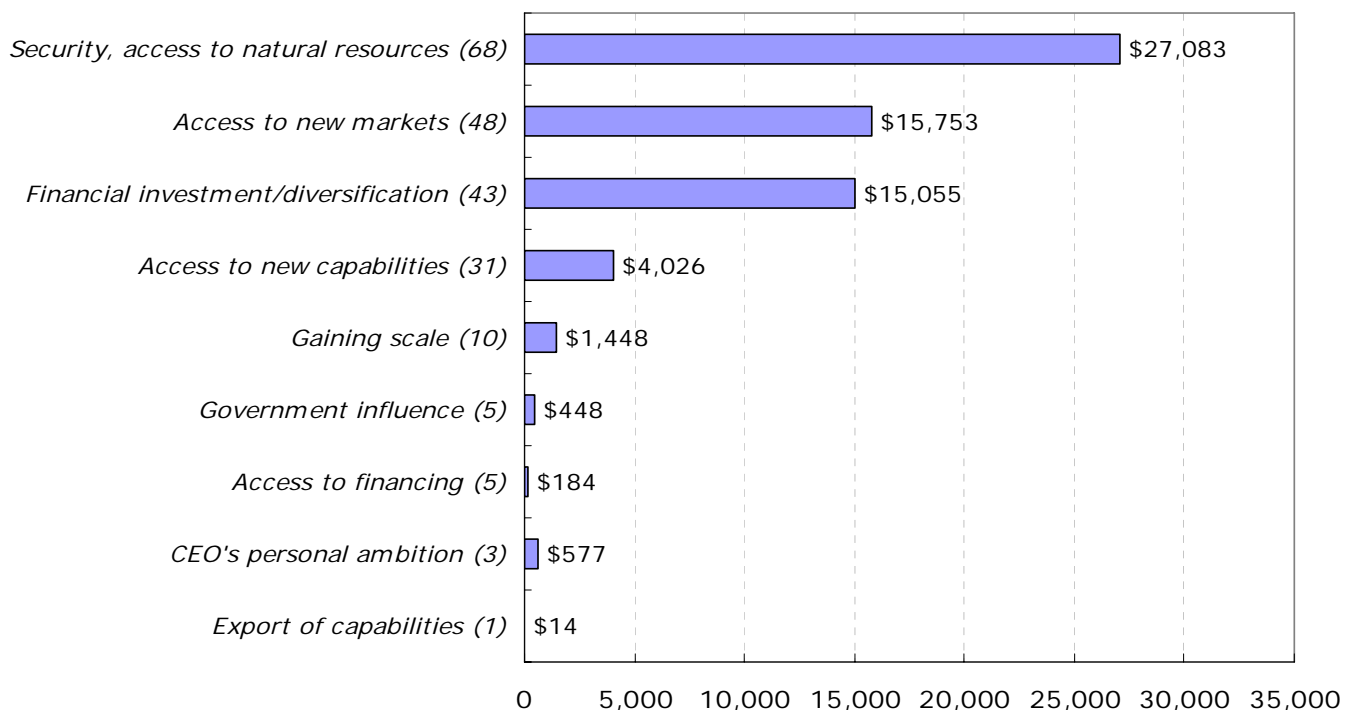
Sources: ODCE, Ministry of Commerce, China Statistics Bureau

Rationale for Overseas Investing

Chinese companies have many reasons for undertaking cross-border deals, with some of the most common motivations including access to resources, brand building, and strategic rationale. Recent cross-border deals outside of the resources arena have also stemmed from Chinese firms wanting to move up the value chain. As an example, Lenovo's acquisition of IBM's laptop business allowed it to gain access to global branding and distribution. Still other Chinese companies have made acquisitions in order to enhance their operations, with such notable examples as Chinese car manufacturers acquiring US or European auto parts companies and even well-known car brands (such as Rover and MG). The graphic below highlights Chinese outbound M&A deals by strategic rationale from 1995-2007.

Primary Rationale
(Number of Deals)

Total Deal Value
(US\$MM)



Source: McKinsey and Company 2008

To date, most of the cross-border deals have involved large, publicly traded Chinese firms that used to be state owned enterprises. For most of these companies, the Chinese government is still a substantially large shareholder (in some cases up to 70-80%). Because of these companies' critical mass, and given that they enjoy government policy directives and support, it is logical that they have been in the forefront of China's globalization efforts.

Target	Target Nation	Acquiror	Industry	Deal Value (US\$MM)
Rio Tinto plc (12%)	United Kingdom	Chinalco; Alcoa	Iron	\$14,316
Standard Bank Group (20%)	South Africa	ICBC	Financial Services (Banking)	5,490
Wing Lung Bank	Hong Kong	China Merchants bank	Financial Services (Banking)	4,700
Fortis Investment Management (50%)	Netherlands	Ping An Insurance (Group) Co of China Ltd	Financial Services (Diversified)	3,468
Tuas Power Ltd	Singapore	China Huaneng Group	Utilities	3,117
Total SA (1.6%)	France	State Administration of Foreign Exchange	Oil	2,935
BP plc (1%)	United Kingdom	State Administration of Foreign Exchange	Oil	2,044
Midwest (50%)	Australia	Sinosteel	Steel	1,320
Shaw Brothers (Hong Kong) Ltd (75%)	Hong Kong	Country Garden Holdings Co Ltd	Real Estate	1,282
Oil & Gas Assets (AC/P22, AC/L6 and AC/RL1 (Puffin and Talbot oil fields))	Australia	China Petrochemical Corp	Oil	560

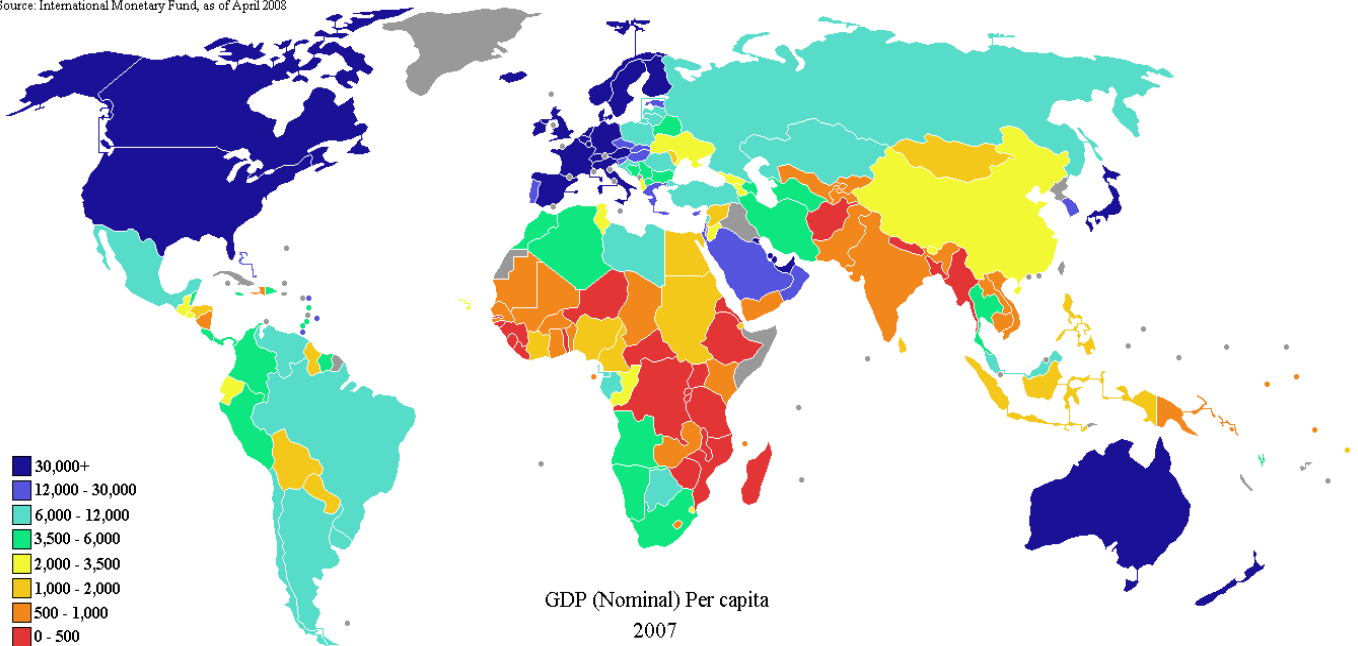
Source: Deal Logic, ISI, ChinaVest

Mining and Resources

The bulk of China's outbound M&A activity is in natural resources, whether in Australia, Africa, or Latin America. Within the natural resources sector, Chinese acquirers have been especially active in offshore mining, with approximately US\$16 billion worth of transactions in 2008 alone. Behind this activity lie a few simple facts: China has 20% of the world's population, a meteoric growth rate, and yet relatively few natural resources.

The figure below highlights global per capita GDP figures in nominal terms. In other words, this is the GDP of each country divided by the population figure. It is not adjusted by purchasing power parity (i.e. how many goods you can buy in any given country per unit of currency).

Source: International Monetary Fund, as of April 2008



China's current nominal GDP per capita stands at around US\$2,500¹. If this figure were to double (i.e. hit South Africa or Panama levels), Chinese consumption of minerals would increase astronomically. Iron ore and aluminum imports could increase by 5x; oil consumption could increase as much as 8x; and copper 9x. The math is straightforward. With increased spending power, Chinese consumers will acquire more automobiles, electronic goods, home appliances and other products. Meanwhile, the Chinese government will continue to build schools, roads and power plants. These tectonic socioeconomic changes require resources that China does not have in great abundance. Clem Sunter, a noted South African futurologist, and Head of the Anglo American Chairman's Fund, puts it this way: "The game is simple but unprecedented. Whereas Britain put 30 to 40 million people through an industrial revolution in the mid-to-late 19th Century and had the colonies to draw its raw materials from; whereas America put 150 million people through an industrial revolution at the turn of the 20th Century and had its own raw materials; China is putting 1.3 billion people through an industrial revolution with neither colonies nor substantial indigenous resources besides coal."

Over the past few years, Chinese companies have launched an unparalleled assault on natural resource firms across the globe. In Latin America, Peru Copper was acquired for US\$800MM. In Australia, the list includes Midwest, Murchison Metals, Gindalbie Metals, and Australian Resources. This year China even went

¹ Source: IMF 2007

into Afghanistan, spending roughly US\$4 billion on the Anyak copper mine—the largest single investment in the history of that country.

In large part due to the US\$14 billion equity purchase of mining giant Rio Tinto, the UK (Rio Tinto's headquarters) was the most targeted destination country by Chinese acquirers so far this year. Singapore was second, with US\$3.6 billion from several energy-related deals. The most acquisitive company in recent years has been Chinalco (China Aluminum Corp), but almost any of China's resource firms are M&A acquirers, including Petrochina, Baosteel, and China National Petroleum Corporation (CNOOC). COFCO, a grain trading giant, and China Minmetals, which mines and trades metals, are seen as potential acquirers as well. Minmetals already has a copper exploration division in Chile—part of a venture with Chilean mining giant Codelco. Minmetals entered the Fortune 500 this year at #435, with sales of US\$17 billion. COFCO is #405 in the Fortune 500 list, with sales of US\$18 billion.

While Chinese resource companies often have government-backed mandates for going overseas, evidence suggests that once an overseas M&A deal is completed, profit trumps national strategy. For example, about two thirds of the oil from China's overseas assets does not get sent back to China. Instead, it is sold in the global marketplace at spot prices. Gasoline prices in China are capped, therefore oil refineries in China (unless heavily subsidized by the government) operate at a loss.

Agriculture

Minerals and crude oil are one part of the equation; the other is farming. China is losing its ability to be self-sufficient in food as its rising wealth has prompted dietary changes, including much a higher consumption of meat, which requires a large amount of land as well as imported feed. China has 40% of the world's farmers but only 7% of the world's arable land and 6% of the world's renewable water resources. These resources are already strained due to urbanization, industrialization, and pollution. Many China experts argue that China must expand overseas if it is to guarantee its food security. In the first quarter of 2008, food prices in China rose 25% from the previous year. China is still a net exporter of agricultural commodities, but is increasingly reliant on soybean imports (China imported 60% of the soybeans it consumed last year).

Chinese companies have recently been encouraged to buy international farmland, particularly in Africa and Latin America, in an effort that Beijing believes may help guarantee food security. In a proposal drafted by China's Ministry of Agriculture, Chinese domestic farming companies are now tacitly encouraged to acquire overseas companies and assets, meaning this is now a central government directive. Beijing previously enacted similar policies in the petroleum, mining and financial services sectors, but agricultural investment abroad (to date) has been limited. The first of potentially many future examples of Chinese outbound M&A in the agricultural sector just occurred. In July 2008, COFCO, China's leading grain,

oils and food company, acquired a 5% stake in Smithfield Foods Inc., the largest pork processor in the United States.

Financial Sector

Not long ago, Chinese banks were investment targets for foreign acquirers. Today, they are buyers. This shift came about as Chinese banks cleaned up their balance sheets, took on foreign shareholders, and conducted IPO's. Several years ago, Chinese banks had balance sheets with extremely high percentages of non performing loans (NPL's). These loans have been reduced from roughly 30% of total loans in 2001 to only 7% in 2007. As the NPL's continue to drop, the higher performance has catapulted the 4 largest Chinese banks to rank among the global top 10 in terms of stock market value. The insurance industry has undergone a similar change. Today, China's 2 largest insurers are also among the global top 10.

With large amounts of liquidity at their disposal, Chinese financial institutions have been on a buying spree. Some of the more notable acquisitions include China Investment Corporation's (CIC) US\$5 billion stake in Morgan Stanley, its US\$3 billion stake in The Blackstone Group, and China Development Bank's US\$3 billion stake in Barclays. The graph below highlights selected purchases in 2006-2008.

Chinese Investor	Global Target	Transaction
Industrial and Commercial Bank of China (ICBC)	Standard Bank (South Africa)	US\$5.49 billion for 20% share; raising PE fund to jointly acquire African mineral assets
China Investment Corporation (CIC)	Morgan Stanley	US\$5 billion for 9.9% share
Bank of China	Singapore Aircraft Leasing	US\$3.4 billion for 100%
Ping An Insurance	Fortis	US\$3.2 billion for 4.99% share plus US\$3.3 billion for half of asset management unit
China Development Bank (CDB)	Barclays	US\$3 billion for 3.1% share
China Construction Bank (CCB)	Bank of America (Asia) HK	US\$1.25 billion for 100%

Source: McKinsey, ISI, Deal Logic

Seeking more than just financial returns, Chinese financial services companies are making global acquisitions with a strategic rationale in mind. These companies hope to learn from their global peers and gain access to best practices in areas spanning from IT to risk management. In addition, owning regional banks, such as Standard Bank in South Africa (ICBC acquired 20% of Standard Bank for US\$5 billion), provides access to a strategic client base that China needs—in this case African mining, energy and other resource companies. The ICBC-Standard Bank venture recently spawned an Africa-centric private equity fund which seeks to make investments in resources businesses throughout the region.

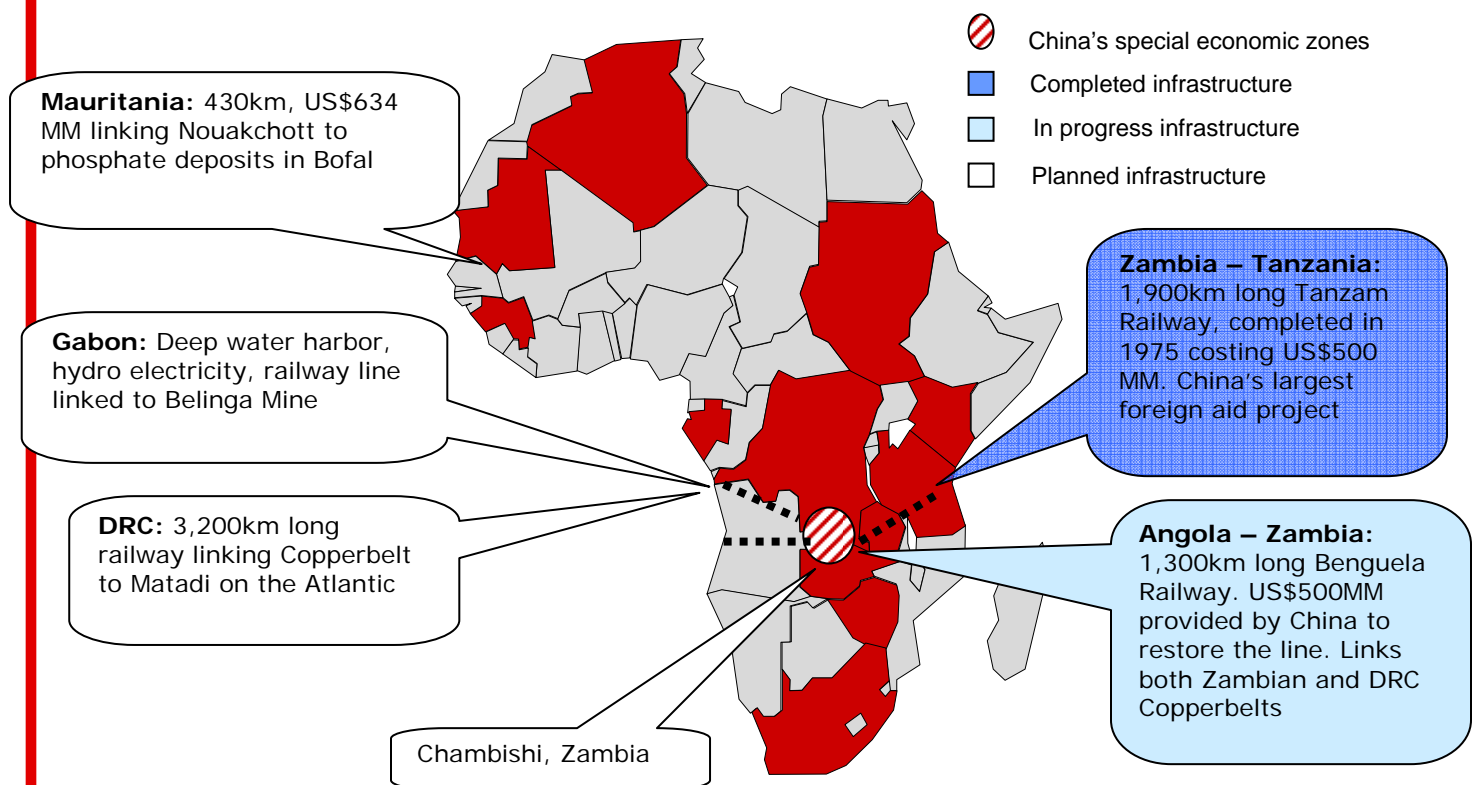
Chinese banks are upping the ante. In recent weeks, rumors have confirmed that China Development Bank (CDB) has conducted due diligence on a bid for Germany's Dresdner Bank. CDB had initially been interested in acquiring Dresdner's securities business, but expanded its scope to include other businesses in the wake of sharp declines in the shares of western financial companies. Dresdner Bank, a unit of Allianz SE, was acquired in 2001 in a deal worth \$36.6 billion. Whether or not CDB wins the bidding process is not as important as the gesture. In addition to doing competitive due diligence on the target, the experience of bidding for a large foreign bank could be seen as a dry run for other, larger bids in Europe or the United States.

With an initial bequest of US\$200 billion, China Investment Corporation (CIC), a sovereign wealth fund, is China's most visible institutional financial investor. However, there are other important entities that have also made foreign investments. One of these is SAFE (State Administration of Foreign Exchange), which manages China's US\$1.8 billion in foreign exchange reserves. For a long time SAFE invested mainly in US Treasuries; however, it has recently begun to diversify its holdings, partly linked to concerns that a falling US dollar reduces the purchasing power of its Treasury holdings. In the first half of 2008, SAFE invested US\$2.0 billion for a ~ 1% stake in British Petroleum (BP), acquired a US\$2.8 billion (1.6%) stake in French oil giant Total, and invested US\$2.5 billion in US private equity firm Texas Pacific Group (TPG).

Risks to Overseas Investments

Chinese firms are in an interesting situation. Their increasing wealth means they can afford to make acquisitions, but oftentimes Chinese buyers are regarded with suspicion. After a series of high profile failed attempts (including CNOOC's failed Unocal bid in 2005), many of China's state-owned giants have been cautious about being too visible in bidding for American firms. Instead, they are on an acquisition spree in places like Africa and Latin America where there are abundant natural resources and where building roads, bridges and rail lines helps foster political goodwill. The graphic below highlights Chinese infrastructure investments in Africa. The countries in red are those which have Chinese investments.

Chinese Infrastructure Projects in Africa



While Chinese firms are aggressive in Emerging Markets, they seek to maintain a low profile in the developed world. To fly below the radar screen, Chinese enterprises have recently begun trying to partner with Western firms when bidding for foreign companies. Yet the failure of Chinese telecom infrastructure giant Huawei (who partnered with Boston-based private equity firm Bain Capital) to acquire 3Com has largely discredited this strategy. Although many similarly structured deals are still in the works, a number of others have been dropped. Another approach has been to make minority investments; Chinese state investment funds have bought chunks of Blackstone, Morgan Stanley and

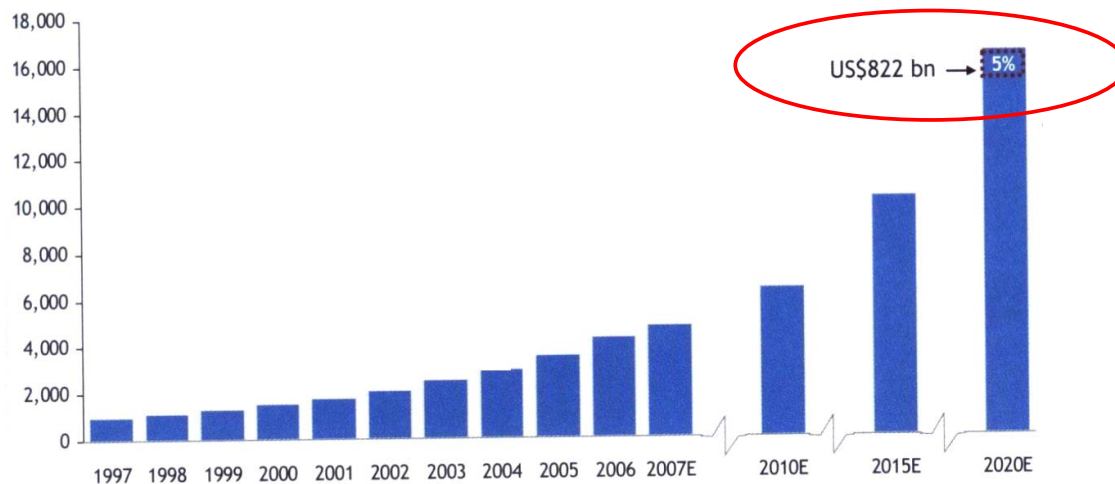
Barclays. However, these investments in public companies, particularly in falling stock markets, have actually lost money and have caused political fallout in Beijing.

One of the greatest barriers to the globalization efforts of Chinese companies is a dearth of employees with the right experience. Lacking people with the proper knowledge of international economic environments, Chinese companies face difficulties both negotiating deals and operating their overseas acquisitions.

Conclusion

Despite the challenges, we are confident that Chinese outbound M&A is here to stay, and, if anything, will continue to grow. JP Morgan predicts that by the year 2020, China will have an aggregate of US\$16.4 trillion in domestic savings. Assuming China deploys a mere 5% of its savings overseas, it would imply that China will export US\$822 billion worth of capital annually.

Total Savings in China



Source: CEIC, JPMorgan

Chinese companies have great potential to reach beyond their home market. As more companies succeed internationally, others will likely follow. In interviews conducted by Business Week with executives at 39 Chinese companies, nearly 80% cited globalization as a strategic priority. Having already witnessed the massive influx of foreign firms into China, Chinese companies searching for raw materials, talented employees, technologies, brands, or customers, are themselves now looking to become multinationals.