

Eye on China

A View from Shanghai

Merchant Banking Advisory In China for Over Twenty Five Years

ChinaVest

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Market Weekly

Shanghai Composite Index

- 8/8 Close: **2,605.72**
- 8/22 Close: **2,405.23**
- Change: **↓ 7.694%**
- Since 1/1/08: **↓ 54.287%**

Shenzhen Composite Index

- 8/8 Close: **8,658.78**
- 8/22 Close: **8,101.68**
- Change: **↓ 6.434%**
- Since 1/1/08: **↓ 54.628%**

Exchange Rate

- 8/8: US\$1 = **RMB 6.871**
- 8/22: US\$1 = **RMB 6.856**
- Change: **↑ 0.218%**
- Since 1/1/08: **↑ 6.263%**

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General Industrial & Consumer

1) Blackstone Getting Busy in China

Over the past few weeks, *Blackstone Group* has made headlines with a variety of investments in China. Blackstone, in which *China Investment Corp* (China's sovereign wealth fund) purchased 10% in 2007 for US\$3 billion, opened its first China office this past month in Beijing. The private equity fund is hoping to leverage its local and national relationships to further penetrate China's PE environment.

Clean Energy Group

This month Blackstone announced it will be opening a new business group that will focus on investments in the clean energy sector. The group will focus on investments in solar, wind, biofuels, and other renewable energy technologies. The group is anticipated to be highly active in China, as the country has become a hub for clean tech manufacturing and innovation, especially in solar and wind turbine technology. Investment in China's clean tech sector is estimated to reach US\$720 million in 2008. Globally, investment in clean energy was US\$117 billion in 2007.

Co-investment with Haier

It has also been reported that Blackstone will join *Haier* in a bid for the highly publicized sale of GE's appliance unit. Haier is China's largest producer of home appliances (white goods) and the world's third largest home appliance manufacturer. Haier is hoping to acquire GE's home appliance arm in order to help develop its presence in the US market. GE's home appliance unit is expected to sell for US\$7 billion.

Shanghai Real Estate Investment

Reports have surfaced that Blackstone is in discussions with *Super Ocean Group* for the purchase of four high rise office buildings in Shanghai. The deal is estimated to be valued at over US\$1 billion, which may include an option to only purchase three of the four buildings. Blackstone's name has been mentioned as a potential buyer, along with a few others. However, full details of the possible transaction have not yet been disclosed. Super Ocean Group said they are selling the properties in order to raise funds for growth in other sectors.

Logistics

2) YRC Worldwide Acquires China Logistics Company

Kansas-based logistics company, *YRC Worldwide*, has successfully closed its acquisition of Shanghai based *Jiayu Logistics Co*. YRC acquired 65% of Jiayu for US\$47 million, with an option to purchase the remaining shares in 2010 for no more than US\$39 million.

Jiayu is one of China's largest providers of truckload ground transportation, with over 30,000 customers, 1,800 employees, 200 locations, and 3,000 vehicles. YRC believes the acquisition will substantially help to build its China business and will provide the company with end-to-end supply chain capabilities. YRC is one of the world's largest transportation and logistics providers. Its more notable brands include Yellow Transportation, Roadway Express, Reimer Express, and USF Holland.

Locomotive

1) China South Locomotive IPO's for US\$1.5 Billion

Despite a sharp downturn in the local and international stock markets, this past week *China South Locomotive & Rolling Stock Corp (CSR)* successfully raised US\$1.5 billion to list in both the Hong Kong and Shanghai stock markets. The offering was highly anticipated, and was oversubscribed by a factor of 300X. The company sold roughly 14% and 26% of its enlarged capital in Hong Kong and Shanghai, respectfully. Proceeds from the listing will be used to expand capacity, in particular for high-speed rail cars and urban light cars.

CSR was founded in 2007 as a subsidiary of State-owned *China South Locomotive & Rolling Stock Industry*. The company's main business is the manufacture, sale, leasing, refurbishing, and R&D of locomotives, passenger carriers, freight wagons, and rapid transit.

CSR expects to benefit in the coming years from the massive development of China's infrastructure, in particular the growth of its inter-city and urban rail networks. In its latest 5-year plan, Beijing committed US\$175 billion for rail infrastructure expansion and upgrades throughout the country, which is planned through 2010. The high growth rate of China's rail systems is expected to continue in the long term, as China is eager to establish state-of-the-art rail lines to service the country's massive public and logistical transportations needs.

The stock was launched at a very difficult time in the capital markets. Shares of the company have risen and subsequently fallen in the past several days over broader concerns over the markets in both China and Hong Kong.

Looking Local: Expo Tunnel Breaks Through to Puxi



As the 2008 summer Olympics begin to wind-down in Beijing, those of us here in Shanghai have already begun turning our sights to China's next global event: the 2010 Shanghai World Expo. In preparation for Expo, Shanghai has already begun to take on a number of extremely large and ambitious construction projects.

One such project, the 2.67 kilometer Xizang Road S. Tunnel linking the Puxi and Pudong Expo sites, made notable headway last week, as digging underneath the Huangpu River finally broke through to the other side. Constructed by the *Shanghai No. 2 Engineering Co.*, the Xizang Road S. Tunnel is the only tunnel being built especially for the Expo. The tunnel begins on the Shanghai Bund (South), virtually in front of our office, and will cut straight southeast, 1.2 kilometers below the River, to connect with the corner of Pudong Road E. and High-tech Road W.

Now that the main structure of the tunnel is complete, officials of the Shanghai No. 2 Engineering Co will go forward with plans to open the link before the end of June, 2009, to construction vehicles working on World Expo projects. The final tunnel will have two lanes in each passage, and is designed to transport 60,000 to 70,000 vehicles an hour during the Expo.

Energy

4) Shunda Planning US IPO

In yet another offshore Chinese solar IPO, *Jiangsu Shunda Group*, a manufacturer of silicon wafers, announced recent plans for a New York listing to take place sometime in early 2009. The company expects to raise approximately US\$1 billion, with the new proceeds going towards increased capacity and production. Specifically, the company plans to construct a second polysilicon plant, in addition to its first plant, which is set to open this month. The new plants will increase production of polysilicon to 6,000 tons annually.

Shunda manufactures silicon wafers for a number of major domestic and international solar cell producers, including *Suntech Power*, *Q-Cells AG*, and Japan's *Sharp Corp.* The company expects profits of RMB400-500 million (roughly US\$60-70MM) this year, a number that is projected to increase to over RMB2 billion (US\$300MM) for 2009 with the opening of its new production facilities.

Shunda has already met all regulatory requirements for the listing.

TMT

5) Goldman & Legend Capital Invest In LCD Ad Screen Company

Goldman Sachs and local PE group *Legend Capital* have invested US\$58 million in Chinese advertising firm *Universe Media Holdings*. *Universe Media* places LCD advertising screens in passenger trains in China. The company was formed through the merger of *Epin Media* with *GuangYuan Media*, which together operated more than 75,000 LCD screens in over 500 trains. *Goldman Sachs* had previously invested in *Epin*, while *Legend Capital* already held a stake in *GuangYuan*.

The out-of-home advertising sector, particularly in LCD screens, remains popular for investors who want to take advantage of China's rising domestic consumption. *Focus Media* (Nasdaq, market cap: US\$3.96 billion) is still the dominant force in the out-of-home ad sector, but a number of newer companies, such as *Universe Media*, have cropped up in niche markets. Another example is *AirMedia* (market cap: US\$763.20 million), which listed on Nasdaq in a US\$225 million IPO last November (see November 9, 2007 issue of the *ChinaVest* newsletter). *AirMedia's* niche is LCD ad screens placed in Chinese airports and on airplanes.

Infrastructure

6) Chinese Transportation Management Solutions Company Preparing US\$150 Million HK IPO

The *South China Morning Post* reports that *China ITS*, a Chinese company that provides transport infrastructure services, will launch a US\$150 million IPO in Hong Kong next month. Specifically, *China ITS* provides transportation technology systems for roads and railways. The company's systems currently operate in 29 provinces.

Transport infrastructure solutions is a promising area in China, as it takes advantage of the country's large-scale investments in infrastructure. Other companies in this sector are also seeking to raise funds for expansion.

Banking

7) China's Spenders Switching from Cash to Plastic

For many years Chinese consumers had to carry large sums in cash to make purchases. No matter how much one planned to spend, it used to be rare to find a store willing to accept any form of payment other than cash. Now, however, wallets are starting to become a little thinner. According to a press release issued last week by *Bank of China*, plastic is "officially taking over" in the country's urban centers.

To date, China has issued 1.6 billion ATM bank cards, the equivalent of one debit card per person and one credit card per every ten people. According to the report, the average user has 3 ATM cards (for various reasons), meaning that in China, fewer people actually have cards than the stat lets on. That said, growth is astonishing, and is expected to continue – ATM card numbers are expected to double for the next 5 years, while credit card spending, which is currently very rare, will increase at a 70% rate annually.

In the past seven years, China's ATM card issuers have increased from 50 to more than 200, the number of ATMs has increased from 40,000 to 140,000, and points of sale from 300,000 to over 1.5 million. While only 120,000 businesses accepted bank cards seven years ago, today that number has risen to over 900,000. China's ATM cards can now even be used in 28 countries and regions. Analysts predict that while the ATM card market has shown tremendous growth, the real opportunity lies in the credit card market. China has an estimated 3% credit card penetration, compared to HK, Taiwan (over 70%) and the U.S. (over 80%).

8) ICBC Get's Gold in Bank Olympics

Based on recent news, it seems that China's athletic successes in Beijing have spread to the international banking sector. China's largest bank, the *Industrial & Commercial Bank of China* (ICBC), "wins the gold medal in profits" and has reported a 57% jump in half-year profits this week, outstripping any of its rivals worldwide. ICBC made RMB64.5 billion (US\$9.4 billion) in the first six months of 2008, with assets of RMB9.4 trillion as of June 30. The bank, which only three years ago had to be bailed out by the government, had already overtaken the likes of Citigroup and HSBC to become the world's most highly valued bank. It can now be hailed as the world's most profitable bank.

This growth came in contrast to its global banking peers that have been embroiled in the credit crisis and have had to make large write-downs. Although ICBC is profiting from the continued growth of the Chinese economy, however, the global slowdown could have an impact. That said, the bank is relatively well hedged, as its entire loan book has only a 2% exposure to borrowers whose profits arise from exports. In addition, only 0.09% of its total assets were linked to the US sub-prime market, while holdings in US mortgage firms Freddie Mac and Fannie Mae also constituted just a tiny fraction of its assets.

Private Equity

9) Hefei Raises a Local PE Fund

We've reported a number of times recently on companies raising domestic private equity funds, a trend that we expect will continue as government, and particularly municipal, coffers continue to fill up. The latest such company is *Hefei State-owned Assets Holding Co., Ltd* ("Hefei State-owned Assets"), who concluded an agreement last week with *Shenzhen Capital Group Co., Ltd.* ("Shenzhen Capital") to establish a RMB200 million fund, the *Hefei Venture Capital Fund*.

Each of the main shareholders contributed 35%, with the remaining 30% coming from other investors. The fund will invest in Hefei-based ventures that are currently at seed, growth or late stages, in hopes of helping to facilitate the development of the local economy. Meanwhile, a fund management company will also be established to be responsible for the investment details and manage the fund after it is created.

Shenzhen Capital was established in October 2002. It is one of the largest investment companies in China, with registered capital of RMB1.6 billion. It has invested in over 180 deals, including 36 listed on 13 stock exchanges both in China and abroad.

Regulatory

New Anti-Monopoly Law Takes Effect

Regulators in China recently promulgated the new Anti-Monopoly Law, which took effect on August 1, 2008. The law widens the scope of business activity that would trigger monopoly reviews from government by expanding the definition of a “monopoly.” It also further defines the thresholds that would trigger a monopoly review for M&A deals and other types of cooperative activity. According to the new rules, deals involving companies with combined global revenue of about US\$1.5 billion—and where at least two of the parties each have turnover in China of US\$60 million—will be subject to the provisions of the new Anti-Monopoly Law (Financial Times).

The provisions of the law classify potential monopolistic activities into three categories:

1. Monopoly Arrangements— This section widens the definition of monopolistic cooperative arrangements. Previously, only arrangements between “business operators” were generally considered to fall in the monopoly category (Thelen Reid). In contrast, the new law uses language that allows any type of arrangement between two or more parties to be considered monopolistic, if it unfairly hinders competition.

2. Abuse of Market Position— This section of the new law refers to monopolistic activity by market leaders. The law states that market share will be the chief criterion in determining market leadership, but does not specifically designate a method for determining market share. This section also includes language that opens the door for more activity to be deemed “abuse of market position”, including the ability of a business operator “to control the sales and resources markets, the financial and technological conditions of a business operator and the degree of difficulty for other business operators to enter the relevant market” (Thelen). The nebulous language in the “Abuse of Market Position” section allows regulators significant discretion over what is and is not considered monopolistic.

3. Concentration of Business Operators— The term “concentration of business operators” is introduced in the new law as a broader description to replace the term “mergers and acquisitions”. The new term includes the following activities in addition to M&A:

- a. “Takeovers of controlling power through equity or asset acquisition or contractual arrangements”; and
- b. “Contractual arrangements resulting in the ability to exercise decisive influence over other business operators” (Thelen Reid).

As with section two, the language in this section is extremely vague, leaving regulators with room for interpretation.

According to the new law, transactions found to meet any of the broad criteria listed above will be subject to a monopoly review, which could take up to six months. Though it is not yet clear which regulatory bodies will conduct such reviews, the *National Development and Reform Commission* (NDRC—China’s top economic planning body) and the *State Administration for Industry and Commerce* (SAIC) have reportedly set up task forces to implement the new law.

Some are worried that the Anti-Monopoly Law could have serious negative implications for foreign firms attempting to execute deals in China. In our opinion, however, the environment for foreign investment will remain essentially unchanged. Anti-monopoly considerations similar to those in the new law have already been covered in a number of past regulations, including the M&A Rules that were promulgated in 2006. In accordance with those M&A Rules, which themselves introduced significantly stricter reviews on acquisitions by large foreign enterprises, it is the responsibility of China's *Ministry of Commerce* (MOFCOM) to handle monopoly concerns regarding foreign investments. Regulations in China, such as the M&A Rules of 2006, have long used vague language to allow regulators to interpret the rules as they see fit for a particular situation. Additionally, the regulatory bodies for specific industries (e.g. the China Banking Regulatory Commission for the banking industry) set specific rules for their own industries with the purpose of preventing monopolies.

The new law seems to do little more than tweak rules from the past to make them more specific in some areas, and more all-encompassing in others. Although the new law will have some effect, the bottom line is that any deal that creates monopoly concerns according to the Anti-Monopoly Law would almost certainly have faced a similarly stringent regulatory review before August 1, 2008.

Macro

Inflationary Pressure Eases for Second Straight Month

Inflation fell for the second consecutive month in July, with CPI growth registering 6.3% YoY, down from 7.1% in June. The drop is more than most expected, with analysts' predictions averaging 6.7%. Once again, the main cause of lower inflation is a drop in food price inflation, which fell from 17.3% in June to 14.4% in July, on the back of an increase in supply. Accounting for one-third of the CPI, surging food prices have been the primary cause of the rampant inflation that has plagued mainland China during the past year. Non-food price inflation edged upward in July due to the recent hikes in fuel and energy prices—China enforces price controls on fuel and energy, and raised prices due to rising costs in the global market.

In the last issue of the newsletter, we discussed China's change in macro strategy. Amid signs of slower export growth, which foreshadows a slowdown in economic growth over the next 18 months, Beijing has switched its focus from tightening and inflation control to maintaining relatively fast growth. Lower inflation is good news for policy-makers, as it will allow them to back off the strict tightening stance that has prevailed for the past 18 months. For example, the *People's Bank of China* (PBOC—China's central bank) has used a series of hikes in interest rates and in the required reserve ratio in order to slow loan growth and drain money from the economy. If inflation was not showing signs of decline, PBOC would likely remain focused on controlling prices with further RRR increases (and possibly more interest rate hikes), which would in turn have a slowing effect on the economy.

Analysts believe that even though another series of increases in fuel and energy prices looms on the horizon, the continued drop in food price inflation will drive down overall CPI growth for the remainder of this year and into 2009. As a result, we don't expect and major tightening moves in the short-term.

M&A Activity

Acquirer	Description	Target	Description	Amount	Deal details
Anyang Chemical Industry Group (Anhua)	production base of fertilizer and chemical industry in Henan province	Jiutian Chemical Group	manufacturer and distributor of chemical products	S\$86.6 Mil.	28.4% stake
Suntech Power Holdings Co Ltd	manufacturer of photovoltaic (PV) cells and modules	Nitol Solar	Russian polysilicon producer	US\$100 Mil.	minority stake
China Golden Development Holdings Ltd	China-based department store operator	Xi'an Century Jinwa Zhonglou Shopping Center	Xian-based shopping center	RMB180 Mil.	76.43% stake
China Powerplus	portable power tool company	China Steel Australia	nickel pig iron producer	\$US22.41 Mil.	46.25% stake
Ping An Insurance	the life insurance arm of Ping An Insurance (Group) Company of China Ltd.	Yunnan Baiyao	maker of traditional Chinese medicine	RMB 1.4 Bil.	9.61% stake
YRC Worldwide Inc.	Kansas-based transportation services company	Shanghai Jiayu Logistics Co. Ltd.	one of China's largest trucking services companies	US\$44.7 million.	65% stake
GCL-Poly Energy Holdings Ltd	China-based renewable energy firm	Duolun coal mine project	coal mine in Duolun, China's Inner Mongolia Autonomous Region	RMB 128 million	55% stake
FUQI International, Inc.	a leading designer of high quality precious metal jewelry in China	Temix	a 50 outlet branded jewelry store chain with locations principally in Beijing, Shanghai, and Ningbo	RMB135 Mil.	100% stake

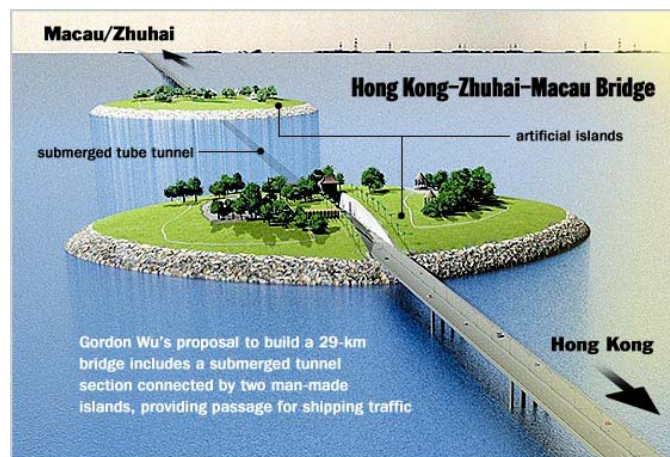
IPO Pipeline

Company	Description	Exchange	Size	Financial Advisors
Huayi Brothers Group Ltd	one of China's largest filmmakers	Shanghai	RMB several hundred Mil.	CITIC Securities, Merchants Securities
Guangzhou Auto	China's sixth-largest carmaker	Shanghai	US\$1 Bil.	n/a
Accelink Technologies	one of China's largest components vendors	Shenzhen	RMB487 Mil.	n/a
Jiangsu Shunda Group	China-based silicon wafer manufacturer	NYSE	US\$1 Bil.	n/a
Keen High	the world's third largest original design manufacturing maker of MP3 and MP4 players	Taiwan	n/a	Fubon Financial
China National Pharmaceutical Group (Sinopharm)	manufacturer and distributor of pharmaceutical and medicinal products	Hong Kong	US\$750 Mil.	UBS, China International Corp
Longfor Properties	Chongqing-based real estate developer	Hong Kong	at least HK\$7.8 billion	n/a
Metersbonwe Group	manufacturer and retailer of casual clothing	Shenzhen	RMB1.8 Bil.	UBS
Jiangsu Rongsheng Heavy Industries Co Ltd	China's largest private shipbuilder	Hong Kong	at least US\$1 Bil.	Goldman Sachs
Hunan Publishing Investment Holding Group	a Chinese state-owned media conglomerate	Shanghai	RMB1.5 to 2 Bil.	n/a

Financing Agreement Reached on Hong Kong-Zhuhai-Macau Bridge

The cities of Hong Kong and Guangdong reached an agreement this month on financing the construction of the Hong Kong-Zhuhai-Macau Bridge. Construction of the body of the bridge will cost a total of US\$5.5 billion. Hong Kong has agreed to finance 42% of the initial costs, Guangdong 44%, and Macau 12%. The rest will be sought through loans.

The design of the bridge, under heavy discussion for several years, received final approval from the Chinese Transport Ministry this past July. The bridge will have six lanes stretching across approximately 30 kilometers, and will be made up of a series of overwater bridges and underwater tunnels that have been factored in so that navigation channels will remain open. At the two ends of the bridge, two artificial islands will be built, from which Hong Kong, Macau, and Zhuhai will be accessible.



Source: www.time.com

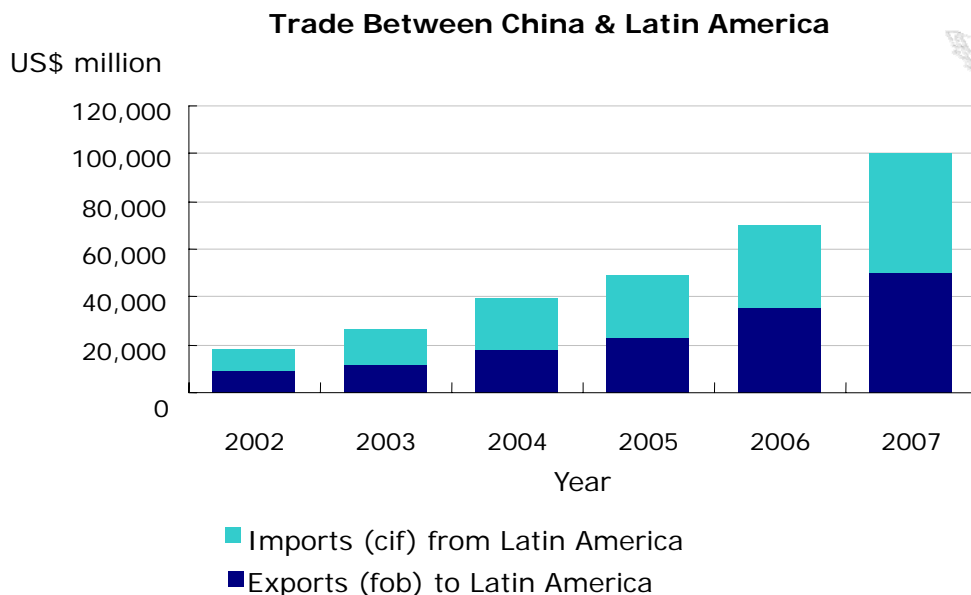
The idea for the bridge was proposed in 1982 by Gordon Wu, chairman of the HK listed *Hopewell Holdings Ltd*, and has taken over twenty years to design and pass through government approval. Construction of the bridge is expected to have a number of positive long-term effects on the region. By cutting down on travel times between Hong Kong and China's western shore, the bridge promises to give companies and individuals in Hong Kong far easier access to previously remote provinces, enhancing the flow of labor, goods, and capital between China and the rest of the world.

Some scholars have warned, however, that the bridge also comes with a number of serious drawbacks, especially for Hong Kong's tourism industry, which depends significantly on stopover visitors. Although Macau currently attracts a rather different market than Hong Kong, the bridge will allow tourists from Mainland China to bypass Hong Kong all together, stripping the city of its role as a conduit for visitors to Macau.

Nonetheless, differences in opinions exist. While Hong Kong, Zhuhai and Macau will become more accessible, there is no way to know to what degree the bridge will make the region more attractive as a whole to tourists. Meanwhile, construction of the bridge is scheduled to begin no later than 2010, and is expected to give a significant boost to the construction industry, helping to alleviate unemployment and underemployment in the region.

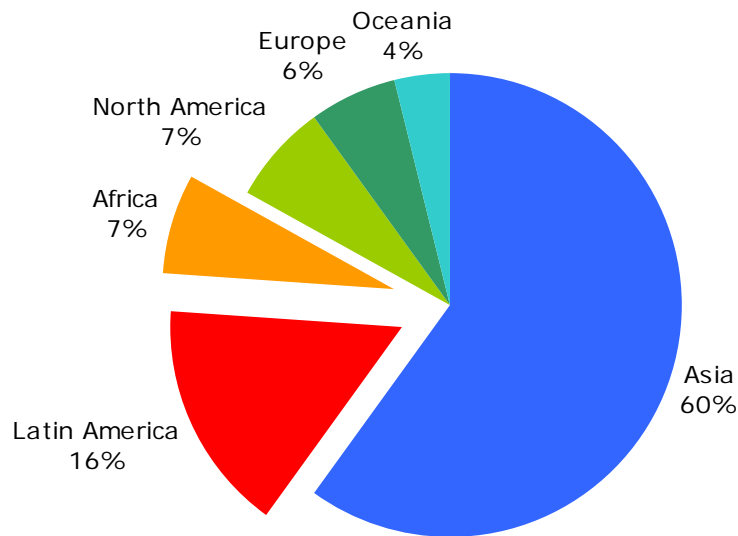
Latin America is on China's radar screen. The past few years have brought about several important governmental visits, trade accords, and more than one sizeable deal. ChinaVest has accordingly made a concentrated effort to expand our expertise in this important region. This initial article provides a brief introduction into the development of China's involvement in the region. In the future, "Eye on Latin America" will provide up-to-date information about specific deals, areas of investment opportunity, and general changes in this strategic relationship.

Given China's lack of arable land as well as a relative lack of natural resources, China has been looking to Latin America as a supplier of copper, soy, iron and other commodities. It has also tacitly encouraged state-owned and private Chinese companies to enter emerging markets. China has made unparalleled commitments in Latin America. In 2004, Chinese President Hu Jintao set a mark trade to the region to hit US\$100 billion by 2010, declaring that "Sino-Latin American co-operation is facing an unprecedented historical opportunity. We should seize it and work side-by-side to push this friendly co-operation towards continuous progress" (*China Daily*, 2004). In 2007, three years ahead of schedule, total trade between China and Latin America reached US\$102.7 billion. The largest market was Brazil, whose bilateral trade with China amounted to US\$29.7 billion, followed by Mexico with \$14.9 billion.



Even though China's eagerness to engage economically with the region is not yet fully reflected in its direct foreign direct investment (FDI), nearly a quarter of its FDI goes to Latin America (US\$22 billion in 2007). Of course, it is not a matter of size, especially if we compare this figure to the United States' US\$350 billion investment in the same period, but rather of growth. From 1993 to 2003, China's trade with Latin America increased by 600 percent (*Xinhua News Agency*, 2004); from 2003 to 2013 we will observe an equivalent increase in cross-border investments.

China's Outbound Foreign Direct Investment (2005)



From a business perspective, we believe that it makes sense for investors to look at the increasingly important links between China and Latin America. Informed investors should also realize that some countries in Latin America are developing stronger links to China than others. Some, like Chile, see themselves as a country operating in the Pacific Rim and have for many years been proactive in integrating with Asia. China is now Chile's top trading partner, and in 2006 the two countries signed a Free Trade Agreement. Mexico is another area that is likely to see activity, as its border with the United States, as well as a highly developed "maquiladora" industry will make it a high priority area for many Chinese companies.

Over the coming weeks ChinaVest will provide more specific information developments in this increasingly important region.