

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

- 10/24 Close: **1,839.62**
- 11/7 Close: **1,747.71**
- Change: **↓ 4.996%**
- Since 1/1/08: **↓ 66.783%**

Shenzhen Composite Index

- 10/24 Close: **6,158.95**
- 11/7 Close: **5,753.10**
- Change: **↓ 6.590%**
- Since 1/1/08: **↓ 67.781%**

Exchange Rate

- 10/24: US\$1 = **RMB 6.855**
- 10/24: US\$1 = **RMB 6.841**
- Change: **↑ 0.204%**
- Since 1/1/08: **↑ 6.468%**

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Deals in China

Random Tidbits

Beverage

1) PepsiCo Plans Aggressive Growth in China

PepsiCo Inc. announced plans to invest US\$1 billion in China over the next four years, the company's largest investment in the country in nearly 30 years. The funds will primarily be used to expand PepsiCo's manufacturing capacity in Western China, enlarge local R&D, develop sales teams for increased distribution, enhance marketing efforts, and develop customized products for Chinese consumers.

PepsiCo's investment in China is part of the company's global strategy to invest in high-growth developing markets. This year, Pepsi has already made substantial investments in other BRIC countries, with a US\$500 million, three year, commitment to expand manufacturing, R&D, and product development in India. In Russia, the company spent US\$1.4 billion to acquire the country's largest juice maker. PepsiCo has also made several investments in Brazil and Ukraine, among other countries.

In China, PepsiCo's large investment will help the company combat its larger rival *Coca-Cola* in the competitive beverage market. Coke, Pepsi's largest competitor worldwide, holds a slight lead in China's market for carbonated beverages, and just last month made an aggressive move to expand its presence in the soft drink market with an unprecedented US\$2.4 billion acquisition of China's largest juice maker, *Huiyuan* (still pending government approval). PepsiCo, however, is also a major player outside of the beverage market and is looking at expanding its snack food offerings in China. PepsiCo's snack food lines include such brands as *Lays* potato chips, and *Quaker* brand names.

Automotive

2) Luxury Car Market Driving Strong

Porsche reported that China has officially overtaken Latin America as the luxury sports car company's third largest market, after the United States and Germany. China now accounts for 7.5% of Porsche's global sales, purchasing more than 7,600 units between August 2007 and September 2008. The growth in China's demand for Porsche vehicles is quite remarkable, particularly considering that the company only entered the China market in 2001, and as late as 2004 only had annual sales of 400 units. The company expects the 911 series, which sold 500 units last year, to be a critical car model for the further expansion of sales and brand development in China.

China, which is now the world's second largest auto market, has also become one of the top buyers for other luxury car makers. *Rolls-Royce* recently announced that China is also now their third largest market, behind the U.S. and the UK. Just last week, Rolls-Royce opened its 7th showroom in China, with more to come. Although that may not sound like many, particularly for such a large country, Rolls-Royce has fewer than 90 showrooms world-wide and did not have any showrooms in China prior to 2001.

Aviation

3) GE, CACC Agree to Airplane Deal

In a significant step in the development of China's aviation industry, *Commercial Aircraft Corp of China (CACC)*, the country's main airplane manufacturer, has secured the country's first order from an overseas firm for commercial aircrafts. *General Electric Co. (GE)*, has agreed to purchase 5 Chinese-designed regional jets, with an option to buy 20 more for US\$750 million, or US\$30 million per jet. The airplanes, known as the ARJ21-700, are classified as regional jets. They have a 70 person passenger capacity and a 2,000 mile flight range. GE will supply the engines for the aircrafts and plans to lease the planes to domestic Chinese airlines for use in China.

CACC's ARJ21 is the first aircraft in China's aviation industry to compete internationally in the commercial aerospace sector. By starting with smaller, regional jets, the company will avoid competing directly with the likes of *Boeing* and *Airbus* initially; however, by 2020, CACC intends to produce larger aircrafts that will directly compete with aviation's global powers. For now, the company will be fighting *Bombardier Inc* (Canada) and *Empresa Brasileira de Aeronautica SA* (Embraer-Brazil) for market share among other small aircraft manufacturers. CACC was established earlier this year with a US\$2.6 billion capitalization from several SOE's. The company was created with a 10-plus year vision to create a China designed and manufactured jumbo jet.

This deal will strengthen GE's relationship with CACC as the company attempts to establish themselves in China's emerging aviation industry, which is expected to grow 5-fold by 2026, according to Airbus. GE expects to sell US\$4 billion in engines over the next 20 years to CACC (*WSJ*).

Looking Local: Beijing Uses its Manners



Anyone who spent time in Beijing in the year preceding the 2008 Olympic Games probably bore witness to several of the city government's innovative measures to encourage an improvement in the city's habits. Banners and notices hung throughout Beijing pushed for

residents to "wait in line for buses," "refrain from spitting on the street," and "provide assistance" to tourists visiting the city. If you were lucky, on the first Monday of every month, beginning a full year before the Games, you may have caught sight of the two "role models" dressed as cats instructing subway passengers on proper line etiquette in the most crowded city stations.

According to Reuters, Chinese researchers who spent over 3,000 hours observing the public in Beijing have proven the government campaign successful, saying that Beijing's behavior shot to a new high of 83.68 on the "civilization index." The new score is a significant jump from the 65.21 score recorded in 2005, according to the study conducted by the Humanistic Olympics Studies Center at People's University in Beijing.



This year's researchers found that a whopping 97% of Beijing residents were willing to give directions to a stranger, up from 71% in 2005. Meanwhile, rates of public spitting and cursing fell below 1% during the Olympic games.

A positive change? Or a loss of Beijing flavor? The verdict will have to be left up to each individual to decide. Unfortunately there was no word on how Shanghai, ChinaVest's home in China, performed on the index.

Infrastructure

4) China Considering US\$583 Billion Infrastructure Plan

China's transport ministry announced plans last week to spend up to US\$586 billion on new road and port infrastructure projects over the next 3 to 5 years. Government authorities said they are considering the increase in infrastructure funding in order to help stimulate domestic demand, as well as to speed up efforts previously laid out to expand China's highways and ports, a plan which calls for 95% of all towns and 80% of all villages to be linked via a national road network by 2020.

In the long run we believe that the current economic downturn will have little effect on China's ability to maintain its strong growth. Infrastructure remains an attractive play, as do many of the related industries that benefit from China's changing urban landscape. Projections from McKinsey estimate that China's cities will add 325 million more people by 2025, and they expect China's urban population to exceed 1 billion by 2030. Today, about 600 million people live in urban China. The population change will continue to drive infrastructure growth. Demand for energy is expected to more than double in the coming years and demand for water is expected to increase by 70% to 100%. Moreover, urbanization will bring with it demand for other important infrastructure projects, such as roads, rail, subways, schools, housing, and health care facilities, among others.

Urbanization is a powerful movement in China that will continue to shape the nation's future economy. The changes in China's demographics, particularly the migration of rural populations to urban centers, which have taken place over the last 20 years, have contributed to a rise China's middle class, now a powerful factor in the domestic economy. The comparison between China's economic growth and urbanization from 1990 to 2007 shows an interesting correlation; during this period GDP grew 10 times, from US\$224 million to US\$2.18 trillion, while the urban population doubled from 254 million to over 600 million (McKinsey). Such rapid change requires intensive infrastructure investment, and as these trends continue, and China's urban populations continue to expand, we may see even more of the government's attention turning to the future development of China's infrastructure systems.

General Technology

5) Intel Capital Continues Tech Investments

Intel Capital continued its technology investment spree with a US\$20 million injection into *Trony Solar Holdings*, a leading Chinese thin-film solar cell company. The investment marks the company's first venture into China's clean technology sector. *Trony Solar*, located in Shenzhen, will use the funds to enhance research & development. *Intel Capital* also announced technology investments in *NP Holdings Ltd*, which is involved in electricity storage systems, and *View High*, a software provider for the healthcare industry. Financial information was not disclosed for the later investments.

Intel Capital established a US\$500 million fund earlier this year to invest in China technology companies after exhausting its US\$200 million fund that was started in 2005. Since starting the new fund, *Intel* has invested in a total of 6 Chinese technology companies. Company representatives reported that despite the current economic downturn, *Intel* is committed to continue investments in China, and expects to focus more on the clean tech sector in the future. Just 10 years ago, less than 5% of the company's investments were completed outside of the U.S. Today they hold 37% of investments overseas, most of which are located in Asia. Over the past decade, *Intel Capital* has invested in over 80 companies throughout Greater China.

Software

6) UFIDA Acquires Two Software Firms

Beijing based software developer, *UFIDA*, announced last week the acquisition of two domestic software companies. The headlining investment is a US\$55 million acquisition of *Chunyaun Technology Development Co., Ltd*. *UFIDA* will acquire 100% of the company, buying out 85% from founding shareholders and 15% from early stage investors. *Chunyaun Technology* focuses its business on the research, development, and sale of government resources planning software. *UFIDA's* second acquisition was the purchase of *Turbo CRM*, a Chinese customer relationship management software company, for US\$6.6 million.

UFIDA, founded in 1988, is one of China's most recognized software firms. The company develops and sells software for businesses across many industries, including the following types of software: business management, ERP, financial, group management, human resource management, and SMB management software. The company has set out on an aggressive growth schedule, using M&A as a critical tool for expansion, and hopes that these latest acquisitions will complement its industrial chain and strengthen competitiveness. *UFIDA* reported profits of RMB 103 million for the first three quarters of 2008.

Telecommunications

7) PCCW To Be Privatized With US\$1.9 Billion Buy-out

China Unicom, together with Hong Kong tycoon Richard Li, has offered US\$1.9 billion to buy-out 52% of Hong Kong telecommunications provider *Pacific Century Cyberworks (PCCW)*. Richard Li, who already holds a 28% stake in PCCW through his Singapore-based company, *Pacific Century Regional Development (PCRD)*, will pay for 76% of the cost to privatize. *China Network Communication Group*, which is now owned by China Unicom due to the recent restructuring of China's telecommunication industry, will pay the remaining 24%. China Unicom previously owned 19.9% of PCCW. Once the deal is finalized, the company will be delisted from the Hang Seng index.

PCCW was originally established by Richard Li as investment holding company in 1994. Prior to that, Mr. Li successfully built *STAR TV*, Asia's first satellite network that eventually sold to *News Corp* for US\$950 million. PCCW is Hong Kong's largest telecommunications company, with operations in 10 countries and territories. The company's main products include telephone, internet, mobile phone, and cable services.

Banking

6) NSSF to Make Strategic Investment in CDB

The *National Social Security Fund (NSSF)*, China's national pension fund, plans to invest RMB 20 billion to RMB 30 billion into policy lender *China Development Bank (CDB)* as a strategic investor. According to NSSF chairman, Dai Xianglong, the move is part of NSSF's efforts to diversify its portfolio. The investment will make the fund CDB's third shareholder, along with the *Ministry of Finance* and *Central Huijin Co.*, an investment arm of *CIC-China Investment Corp* that injected US\$20 billion into CDB just last year. CDB is currently undergoing a transformation from its original role of the country's largest policy bank to a market-oriented commercial bank and plans to set up a shareholding company in the near future. NSSF will be the bank's sole strategic investor.

NSSF first won approval from the State Council in April to invest up to 10% of its total assets in private equity funds and maximum 20% in industrial and commercial enterprises. Analysts have said the social security fund, which is actively exploring more investment channels to gain higher return, has gradually become the largest player in China's private equity fund market, with investment gains growing from RMB 19.5 billion in 2006 to RMB 112.92 billion in 2007. As of last year, NSSF had assets over RMB 516 billion. The fund also plans to invest in *Beijing-Shanghai Express Railway*, *Bank of China*, *Bank of Communications*, and a number of other financial institutions.

Bonds

7) Construction Bank Plans China's First Commercial Mortgage Bonds

China Construction Bank, the nation's second-largest lender, announced plans last week to raise up to RMB 2 billion (US\$292 million) in China's first domestic commercial mortgage-backed bond sale. The sale is in line with the government's plan to develop China's bond and asset-backed securities markets in an effort to both reduce companies' reliance on bank loans and cut risk for lenders. According to *Moody's Investors Service*, with lending still tightly controlled by the central bank, it is likely that Chinese banks will begin to diversify the loans they securitize in order to meet regulatory capital requirements and win business. According to Moody managing director, Michael Ye, "It's in everybody's interest to develop China's securitization market, since it provides Chinese banks with a new funding avenue and risk management tool" (*Bloomberg*).

China Construction has hired *Standard Chartered Plc* to advise the sale, which is expected to receive government approval by next year. In 2005, the bank was selected by the government for a pilot program in which it became the first in China to sell RMB 3 billion of securities backed by residential home loans. Asset-backed bonds were not previously available in China. According to Moody's, China's financial institutions raised RMB 16.5 billion in the first half of this year from securitization deals.

Other Financial

8) New Roles for State Finance Arms

The *State Council* announced a decision last month to adjust the roles of *Central Huijin Co.* and *China Jianyin Investment Co.*, two securities related subsidiaries operating under the umbrella of the *China Investment Corp (CIC)*, the nation's sovereign wealth fund. As a result of the reshuffling, Central Huijin will now act as a policy financial investment institution that controls majority stakes in the largest state-owned banks. As mentioned in the last edition of the *ChinaVest* newsletter, the first task for Central Huijin will be to inject US\$19 billion into the *Agricultural Bank of China (ABC)*, one of China's "Big Four" state-owned banks, taking a 50% stake as part of ABC's restructuring. Jianyin, on the other hand, will abandon its plan to become a financial holding company to serve as an investment platform for companies. This decision means that a number of financial assets that are currently controlled by Jianyin, for example *China International Capital Corp (CICC)*, China's first investment bank, will need to be reallocated by CIC. The State Council's decision expands on supervisory measures for securities companies released in April of this year that prohibit any two, closely affiliated firms from engaging in similar businesses without special permission. The limit does not take full effect for five years.

Jianyin was founded in 2004 through the restructuring of *China Construction Bank*. The firm is wholly owned by Central Huijin, which itself was formed to restructure and inject capital into troubled state banks and securities firms. Jianyin began as a manager for bad assets in Chinese state banks and securities firms, and its oversight has since expanded to cover six securities firms, among which are *Huaxia Securities*, *Nanfeng Securities*, *Xinan Securities* and *Beijing Securities*. Jianyin also holds an approximate 9% stake in China Construction Bank, making it the bank's second largest shareholder. Meanwhile, throughout its lifetime Central Huijin has restructured and injected capital into its own batch of firms, including *China Galaxy Securities*, *Guotai Junan Securities* and *Shenyin Wanguo Securities*.

Regulatory

China Opens Exchangeable Bonds System

Despite a slew of government initiated stimulus measures, in just one week the price gap between A shares and their Hong Kong-listed counterparts has shrunk by more than 50%, as panic selling has caused the mainland stock markets to keep falling. In an effort to reverse this trend and encourage increased investment, Chinese market regulators have tried introducing a number of financial innovation plans, lowering interest rates, lowering the reserve requirement for banks, raising loan quotas, slowing down the rapid appreciation of the RMB, and so on.

Now, in its latest move, the *China Securities Regulatory Commission (CSRC)* has released final guidelines for an exchangeable bonds investment scheme. An exchangeable bond is a type of corporate bond issued by shareholders that can be exchanged for shares based on set conditions. The final guidelines include a number of amendments inspired by the public commentary offered during an August pre-release period. Among the revisions is that stocks used as collateral for exchangeable bonds must be unrestricted shares that cannot trade as common stock before the bonds mature. The goal here is to control the scale of unrestricted stock on the secondary market during the current downturn of China's stock exchanges. In the past year alone, the Shanghai Composite Index has lost more than 65%.

According to statement from one CSRC official, the launch of exchangeable bonds will serve as an alternative means for listed companies to raise capital in China, hopefully easing the impact of heavy selling. Unlike convertible bonds, which increase the amount of outstanding shares, exchangeable bonds merely shift equity ownership. Moreover, "The interest rate for exchangeable bonds can be much lower than other corporate bonds and bank loans, so it offers a low-cost financing method for companies hit by the credit crunch" (*Caijing*).

Along with the new guidelines, however, regulators plan to impose tough restrictions on bond issuers and the use of equities as collateral, meaning that exchangeable bonds will not be easily accessible. According to Bohai Securities, currently only one-third of listed companies in China are qualified to meet CSRC's proposed eligibility requirements. Moreover, exchangeable bonds are not going to be cheap. Companies will be forced to pay financial services firms to evaluate the bonds and set prices, and in the current bear market, cheap stock prices may create a huge gap between buyers and sellers.

In addition to exchangeable bonds, the government's effort to boost the market includes encouragement for share repurchases by state-owned enterprises and their listed subsidiaries.

China Cuts Rates to Spur Growth, Again

For the second time in less than three weeks, China's central bank has cut interest rates in an effort to spur economic growth during the current global financial crisis. The benchmark one-year lending rate was dropped to 6.66% from 6.93%, while the one-year deposit rate was lowered to 3.60% from 3.87%. The revisions came into effect on October 30.

Regulations & Macro

According to Zhang Xiaojing, an economist with the Chinese Academy of Social Sciences, "The drastic economic slowdown during the past months is clearly crying out for more policy boosts and the move comes as the downside risk looms larger" (China Daily). Weakening demand from the west has caused the domestic economy to slow, at least by Chinese standards. In the third quarter, GDP growth dropped to 9%, marking the first time China has experienced single digit growth in five years. China's export sector, a major driver of growth, has been China's biggest victim of the global economic slowdown. In the first three quarters of 2008, exports grew by 22.3%, 4.8 percentage points lower than the same period last year. Some of the more pessimistic analysts have warned that if the global economy doesn't pick up, export growth might dip into negative territory next year. However, as reported in the last edition, China's expansion continues to push forward at a healthy pace.

Two months ago, the central bank also cut the cost of bank loans by 0.27%, the first time since 2002, and lowered reserve ratios by 1%, the first such move in nine years, to keep the economy from sliding further.

Macro

As the Economy Melts, the World Looks East

Although the region may not be big enough to carry the entire weight of the global financial crisis on its shoulders, analysts expect Asia to be the primary growth region for multinational companies in coming years. Historically multinationals have looked to Asian countries for low cost operations, primarily cheap manufacturing and labor. However, with economic growth dwindling across most of the developed world, these companies are now counting on Asia, and principally China, for revenue growth.

Although China's GDP growth is expected to drop a few percentage points in 2008, this is coming down from 2007's red-hot 11.9% growth rate. While economists are predicting that the US economy will shrink by 0.8% in 2009, China's economy will grow anywhere between 7.5% and 8.8% (depending on the economist). In past slowdowns, China did not have a large enough consumer market to warrant the kind of attention it is now receiving. Today it does. The number of Chinese nationals with middle class purchasing power is currently estimated at 80-100 million and is expected to reach 290 million by 2011.

Companies operating in a wide range of industries have already begun shifting their efforts to take advantage of the "rise of the east." In 2007, between 30-40% of earnings of the S&P 500 came from outside the US, according to Fred Alger Management, Inc. In the first half of 2007, US companies' profits in the US were flat, while profits earned overseas rose 20%. The trend will accelerate this year and next year because of the global financial crisis. According to Forbes, fast food giant McDonalds plans to open 125 new outlets in China by the end of this year, 18% more than the company opened in China in 2007. Software company CA will spend US\$30 million to expand its R&D facility in India. French hotelier Accor will triple its hotels in China, Hong Kong and Macao by 2010, and Intercontinental will manage six new hotels in China. GE has already predicted that within the next decade, 60% of their revenue growth will come from developing countries, mostly China and India, up from 20% in the past decade.

Deals in China

M&A Activity

Acquirer	Description	Target	Description	Amount	Deal details
NeoStem, Inc.	collection, processing and long-term storage of adult stem cells	China Biopharmaceuticals Holdings, Inc.	wholesale and retail distribution of medical and healthcare related products	n/a	51% stake
TomoTherapy Incorporated	maker of the Hi-Art(R) treatment system for advanced radiation therapy	Chengdu Twin Peak Accelerator Technology Inc.	linear accelerator manufacturer	n/a	100% stake
Shine Media Acquisition Corp.	blank check company	China Greenscape Co., Ltd.	providers of urban greenery to China's growing cities and development zones	n/a	100% stake
The Hartcourt Companies, Inc.	provider of educational services in China	China E & I Development Co. Ltd.	provider of online education in China	n/a	100% stake
China Organic Agriculture, Inc.	a diversified food products company	Dalian Huiming Industry, Ltd.	major agricultural trading company	US\$10.6 Mil.	60% stake
Zhuzhou CSR Time Electric Co	Chinese train-borne electrical system manufacturer	Dynex Power	Canadian train manufacturer	US\$14.53 Mil.	75% stake

Deals in China

IPO Pipeline

Company	Description	Exchange	Size	Financial Advisors
China Metallurgical Group Co. (MCC)	main businesses are construction, resources exploitation, manufacturing and real estate	Hong Kong/Shanghai	n/a	n/a
Juneyao Creativity Co.	operates its own shops for sports merchandise and also designs and produces sporting goods for franchisees	Shanghai	n/a	n/a
Asian Coast Development Ltd (ACDL)	luxury resort developer	Hong Kong	US\$1 billion	n/a
CITIC Dameng Holdings	CITIC Resources' 80 percent-owned manganese subsidiary	Hong Kong	n/a	n/a
Shenzhen Salubris Pharmaceutical Co. Ltd.	global integrated pharmaceutical group	Shenzhen	n/a	n/a

China, Taiwan Conclude Historic Trade Talks

On November 4, after on-and-off talks dating back to the early 1990s, Taiwan and Mainland China made economic history with a bold agreement on food safety, the expansion of direct cross-strait charter flights and the establishment of shipping and postal links. The talks were held in Taipei, and were attended by China's top negotiator with Taiwan, Chen Yunlin, the highest-ranking Chinese official to visit Taiwan in almost six decades.

According to Taiwan's Department of Health (DOH) minister, Yeh Ching-chuan, Taiwan's food sector has suffered a series of blows as a result of the importation of melamine-tainted food products from China. In order to prevent future problems, the two governments agreed to expand free exchange of information regarding food safety issues. Under the agreement, if any product is considered faulty or dangerous, the government responsible will recall the product in question and halt its shipment.



China's top negotiator with Taiwan, Chen Yunlin, left, shakes hands with his Taiwan counterpart Chiang Ping-kung
(Source: AP News)

Under the shipping agreement, commercial vessels from both sides will be able to sail directly across the Taiwan Strait between 11 Taiwanese and 63 Chinese ports, no longer having to detour through Okinawa. As a result, the sailing time for one-way trips from Taiwan to the mainland will be reduced by half, and with fuel costs expected to drop, shipping lines' costs for cross-strait operations are expected to fall by 15-30%. This decision will not only benefit shipping companies, but will help stimulate cross-strait economic interflows. Meanwhile, the postal agreement will offer significant savings on postal costs and delivery time, and the flight agreement will extend cross-strait passenger flights from 36 to 108 per week and shorten travel times (before, all flights had to go through Hong Kong airspace).

Although the subject of politics was left out of last week's talks, some in Taiwan fear that closer ties with China, even if they only involve trade, will make Taiwan overly dependent on the mainland. Economically, however, there is no doubt that this agreement will have a positive effect on Taiwan's domestic growth. As the joint statement from three chambers of commerce representing Japan, the U.S. and Europe said, "Taiwan can only benefit from having greater interaction with one of the world's fastest growing markets" (AP News).