

Eye on China

A View from Shanghai

Week of April 14-April 20, 2007

Merchant Banking Advisory In China for Over Twenty Five Years

ChinaVest

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Market Weekly

Shanghai Composite Index

- 4/13 Close: 3518.27
- 4/20 Close: 3584.20
- Change: ↑ 1.874%

Shenzhen Composite Index

- 4/13 Close: 10,019.92
- 4/20 Close: 10,258.64
- Change: ↑ 2.382%

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Automobiles

1) Changan Ford Mazda Plants Scheduled to Begin Production this Year

Changan Ford Mazda, an auto joint venture between Ford, China's *Changan Auto*, and Japan's Mazda Motor Co, will begin production at two new plants this year. The first plant is a US\$312.5 million engine plant in Nanjing, Jiangsu province. The plant will begin operating in the first half of 2007, and will have annual production capacity of 350,000 engines. By the end of the year, production will begin at a second Nanjing plant, which will produce cars. The US\$480 million plant will produce 160,000 autos a year. It is expected to produce the new Mazda 2 and the Ford Mondeo, which are both small economy models. The Changan Ford JV was established in 2001, and began production of automobiles in southwest China's city of Chongqing in 2003. Mazda, which is 33%-owned by Ford, later joined the venture.

2) China's Auto Output Growing Fast

Zhang Guobao, the deputy head of the National Development and Reform Commission (NDRC), China's top economic planning body, was recently quoted as saying, "China's auto output could reach 15 million by 2008." Although it seems that figure may be exaggerated, as it would put China at about the same production level as the United States and Japan, it nonetheless illustrates the pace at which the industry is growing. In 2006, China produced 7.28 million vehicles (a 27% increase from 2005) and surpassed Germany as the world's third-largest auto nation. In 2007, a further 15% increase is expected, bringing vehicle production to about 8.5 million. In 2006, China also became the world's second-largest market for new vehicle sales, behind the United States.

Chemicals

3) Degussa to Construct €250 Million Plant in Shanghai

Degussa, the world's largest specialty chemicals company, will build a €250 million chemical plant in Shanghai. The chemicals produced by the future plant will be used in a variety of different products, from LCD screens to paints. Degussa already has a strong presence in China, with 18 joint ventures and subsidiaries engaged in a range of activities. The German chemical behemoth's China operations yielded €460 million in revenues last year, up 60% from 2005. Yu Dahai, Degussa's China president, said the firm hopes to increase those revenues to €820 million within three years, and will continue to invest €100 million per year on the mainland. "We're investing in technology. This strategy will help us create more revenue with fewer staff," Yu added.

Energy

4) Chinese Coal Company Striving for United States Listing

Lu'an Group, China's seventh-largest coal mining enterprise, said it wants raise up to RMB20 billion in an IPO to fund expansion. The group's president said the company may try to list in New York, but gave no further details. However, Wang Ye, a coal analyst with CITIC Securities, postulated that such a plan may be a bit far-fetched. "I think the target of the proceeds is larger than Lu'an can actually get, and there will be some difficulties in getting governmental approval on its overseas listing. The A-share market is a more practical channel for Lu'an to raise capital," Wang noted. Lu'an's president also said the company is speaking with major investment banks UBS and Citigroup about IPO plans. Lu'an is based in northern China's Shanxi province, the nation's leading coal mining area. Over two thirds of China's energy is supplied by coal.

Food & Beverage

5) Wahaha Claims Contract with Danone Invalid

The fight between Wahaha and Danone has taken an odd turn. Wahaha chairman Zong Qinghou was quoted this week as saying that the original agreement signed between the two companies in 1996 is invalid. He said he erred by failing to submit the contract to China's trademark office, therefore he does not believe the firms have a legal joint venture. The row between the two companies is complicated. Danone, which holds a 51% stake in the JV with Chinese beverage company Wahaha, attempted to acquire several Wahaha subsidiaries for RMB4 billion. Wahaha refused to sell, citing that it considered the acquisitions "predatory." In retaliation, Danone decided to take legal action against Wahaha for setting up companies that used the Wahaha brand in direct competition with the JV. Zong Qinghou fired back, stating that Danone "knew about the companies outside the JV and audited them every year." He went on to say that Danone is the "true" culprit in competition with the JV, as Danone purchased significant stakes in several major national rivals of Wahaha after the formation of the JV in 1996. The dispute between the two companies is ironic, as the JV is considered one of the most profitable in China. The situation is still quite confusing, and the outcome will almost certainly have important legal ramifications for future corporate disputes.

Household Products

6) SEB Receives Approval to Takeover Chinese Cookware Maker

French household product maker SEB has received approval to purchase *Zhejiang Supor Cookware*, China's large cookware manufacturer. The Ministry of Commerce (MOFCOM), the Chinese regulatory body responsible for such approvals, deliberated whether SEB's proposed acquisition would create monopoly conditions in the cookware market, as Supor's competitors claimed. SEB will pay a reported RMB2.37 billion for a 61% stake in Shenzhen-listed Supor. "SEB will have access to Supor's factories to reduce costs, while the deal will also bring in capital and help Supor expand," said Zhang Qi, an analyst at Haitong Securities. Supor reported 2006 revenues of more than RMB2 billion and profits of RMB102.2 million. SEB's most famous cookware brand is T-Fal, while its famous household product brands also include Krups appliances (coffee makers, can openers, etc.) and Rowenta vacuum cleaners. The Paris-listed company's market cap is approximately €2.2 billion.

Industrial

7) MOFCOM Begins Antitrust Probe into Schneider Electronics' Cooperation with Delixi

The Ministry of Commerce (MOFCOM) has begun an antitrust probe into the strategic cooperation agreement between France-based Schneider Electric and China's *Delixi*. Schneider is the world's largest producer of low-voltage electronics products, while Delixi, based in the city of Wenzhou in east China's Zhejiang province, is China's second-largest producer of low-voltage electric appliances. Delixi's main competitor is *CHINT Group*, which is also based in Wenzhou, and is China's largest player in the same sector. CHINT claims that if Schneider acquires Delixi, it will create a monopoly. It will be interesting to keep an eye on this deal, as decisions by MOFCOM in such cases could serve as future precedent setters. Delixi's 2005 sales of approximately US\$1.6-1.7 billion were only slightly lower than CHINT's US\$1.9 billion. Schneider's annual sales total about US\$14.5 billion. Schneider produces a number of worldwide brands, including the well-known Square D brand of tools commonly seen in the United States.

Electronics

8) Lenovo and Microsoft to Establish Joint Research Center

Lenovo and Microsoft will set up a multi-million-dollar joint venture R&D center in Beijing. The two parties will each contribute 50% of the capital and will share intellectual property rights. Craig Mundie, Chief Research and Strategy Officer at Microsoft, said the JV will focus on opportunities in the consumer and mobile markets such as digital photography, digital media, and the internet. The joint R&D center will be established at Lenovo's current Beijing research base. The two companies already have a good rapport. Lenovo, which claims more than a 30% share of the mainland computer market, last year sold 5 million computers in China that were preloaded with legitimate copies of Windows.

Internet

9) China's Online Game Market could Reach RMB30 Billion by 2010

Wu Shilin, the deputy director of China's General Administration of Press and Publication, said China's online game market will break RMB30 billion in 2010. He said the industry is in a stage of rapid development, and that Chinese online game companies have the necessary R&D, design, and marketing capabilities. The Chinese online game market reportedly reached RMB8 billion in 2006. Since the inception of a national computer game publication initiative in 2004, Chinese companies have produced over 40 games with a 60% share of the mainland market. However, a large share of that RMB8 billion of revenue in 2006 was likely generated by the world sensation "World of Warcraft" game, which was developed outside of China. Online game distributor and operator *The9* holds the license to run the game on the mainland. Some of China's most successful games include "Journey Westward," "Legend of Mir" and "O2Jam."

Semiconductor

10) Private Equity Firms Consider Stake in SMIC

Some of the world's major private equity firms are reported to be considering taking a stake in China's largest semiconductor producer, *Semiconductor Manufacturing International Corp* (SMIC). Bain Capital, General Atlantic partners, and KKR are said to be interested, with Shanghai-based SMIC planning to sell a 20-25% stake for about US\$600 million. "SMIC wants to engage two, ideally three investors, so no single investor has too much control," a source said. SMIC CEO Richard Ru Gin Chang wants to maintain absolute management control, which could make a deal with private equity groups difficult to complete. Chang is also said to be holding out for bids from other private equity groups such as TPG Newbridge and Blackstone, and has extended the deadline for completing a deal which had originally been set for the end of April. TPG was part of a group that took a 10% stake in Lenovo two years ago for US\$350 million. SMIC, which is listed on the NYSE and the Hong Kong Stock Exchange, recorded about US\$1.47 billion in sales in 2006, but is still not profitable. The company's market cap is roughly US\$2.7 billion.

Telecommunications

11) Nortel to Establish Global Operations Center in Shanghai

Telecommunications equipment giant Nortel has announced that it will open a global operations center in Shanghai, which will serve suppliers and customers across Asia. The operation will be called the "Center of Excellence for Global Operations in Asia," and will open later this year. It will handle a full range of services including strategic purchases, supply chain operations, and order processing. "China's cost-competitive environment provides the ideal climate for increased investment in procurement; the Shanghai center will provide essential technical and operation support where it is required most," said Joel Hackney, senior VP for Global Operations and Quality for Nortel. The company's annual procurement in China already exceeds US\$1 billion.

12) Vodafone to Increase Procurement in China

UK-based Vodafone said it would increase its investment in Chinese components to US\$1.34 billion in the next three years. The company will open a sourcing center in China to handle the initiative. Vodafone is one of the world's top 5 telecom operators, with market cap of over US\$150 billion.

Banking

13) BoComm Planning Multi-Billion-Dollar IPO

China's fifth-largest bank, *Bank of Communications* (BoComm), will issue 3.19 billion A-shares on the Shanghai Stock Exchange, most likely raising between RMB20 billion and RMB24 billion (US\$3.1 billion). The bank has already started accepting bids for the new shares, which will represent 6.5% of its enlarged share capital. BoComm, which is currently listed on the Hong Kong Stock Exchange, will become China's third dually-listed commercial bank along with *ICBC* and *China CITIC Bank*. The central government recently reclassified the bank as a "large state-owned commercial bank," now making it one of China's Big Five, along with ICBC, Bank of China, China Construction Bank, and Agricultural Bank of China. This move is apparently to keep some major banking assets in the hands of the government, especially as major foreign banks are gaining full entry into China's commercial banking sector. It has also been reported that the China Insurance Regulatory Commission (CIRC) is expected to give BoComm life insurance and property insurance operating licenses in the near future.

14) Carlyle's Acquisition of Stake in Chongqing City Commercial Bank Rejected by Regulators

The Carlyle Group's bid for a 7.99% stake in *Chongqing City Commercial Bank* was rejected by the China Banking and Regulatory Commission (CBRC). The rejection is due to regulators' concerns that in some cases, buyout firms don't add enough value to Chinese companies. Regulators would rather approve transactions involving strategic investors that will be in it for the long haul, as opposed to private equity firms with a philosophy of buying and selling assets for a profit. Chongqing City Commercial recently received approval to sell a 17% stake to Hong Kong's *Dah Sing Bank* for RMB171.7 million, and Carlyle had agreed to take a 7.99% stake for RMB80.7 million.

15) CCB and Bank of America to Establish Credit Card JV

China Construction Bank (CCB), one of China's Big Five state-owned banks, will set up a credit card JV with Bank of America. The venture, which will market co-branded cards, will leverage CCB's market presence in China and Bank of America's credit card expertise. Bank of America will take a 37% stake in the JV. CCB launched its first credit card in 2003, and has issued 6.34 million cards since, claiming about 20% of the mainland market share. However, China's credit card market is growing rapidly, and with more and more players entering the market, each is looking to differentiate itself. The government has yet to release new regulations governing Sino-foreign credit card joint ventures, but once the regulations are enacted, the new CCB/Bank of America JV will be ready to operate. This will be the third cooperative venture between the two banks. Bank of America also owns a minority stake in CCB, which it purchased in 2005. In related news, Bank of America just received approval from the China Banking Regulatory Commission (CBRC) to conduct Yuan-denominated banking business in Beijing.

Insurance

16) Lloyd's of London to Begin Reinsurance Business in China

Lloyd's of London, the world's leading global specialty insurance market, has opened its first office in China, formally launching its reinsurance operation in Shanghai. The China Insurance Regulatory Commission (CIRC) last month gave Lloyd's approval to underwrite onshore reinsurance business in China. "We sincerely hope and firmly believe that Lloyd's will bring its world leading insurance concepts, advanced underwriting skills, and strong connectivity to Shanghai and to China, and will help Chinese companies better manage their risks in the world," said Shanghai's vice mayor at the opening ceremony. Lloyd's chairman Lord Peter Levene indicated that he already has some specific plans for the Lloyd's China operation. "Currently, the most attractive business for Lloyd's China is reinsurance for the 2008 Olympics in Beijing," he said. Lloyd's of London is a gathering place for insurance underwriters, who use the Lloyd's market to come together and form underwriting syndicates.

Ports

17) Lianyungang Port to Raise RMB747 Million in Shanghai IPO

Jinagsu Lianyungang Port Co set its IPO offering price at RMB4.98 per share, at the top of indicative range. The port group is selling 150 million A-shares on the Shanghai Stock Exchange to raise RMB747 million. The offering, which represents more than a third of the Lianyungang Port's enlarged share capital, is priced at about 28x 2006 fully diluted earnings. Lianyungang is located on the coast of the Yellow Sea in the northernmost section of Jiangsu province. The city lies a few hours southwest of the coastal city of Qingdao, China's third-largest port by container throughput. The government has designated the city as a special development zone, and has big plans to grow Lianyungang into an important international shipping center that connects China to the rest of Asia.

18) Shanghai Port Surpasses Hong Kong

The port of Shanghai has surpassed Hong Kong in container throughput for the first time, handling 5.88 million twenty-foot equivalent units (TEUs, the standard measure for container throughput) in the first quarter. This exceeded Hong Kong's 5.5 million TEUs, making Shanghai the world's second-busiest container port after Singapore. The port of Shanghai, which includes the RMB18 billion Yangshan deepwater port 32 kilometers off the coast and connected to land by a bridge, is not projected to slip out of the No. 2 position anytime soon. In 2008, the port of Shenzhen is also projected to pass Hong Kong, knocking HK to fourth spot. Shenzhen is a mainland city located just across the border from Hong Kong in southern China. Hong Kong was the world's busiest container port until 2005, when Singapore took the lead. Shanghai's first quarter TEU throughput grew at an astonishing 28%.

Regulations

Regulators to Significantly Limit HK Listings by Mainland Companies

Chinese regulators will now start operating under a new unofficial policy, approving Chinese companies' IPO listings in Hong Kong *only if* the offering raises at least US\$1 billion. The China Securities Regulatory Commission (CSRC) will also allow H-share offerings when Chinese companies are simultaneously listed on the mainland. The new rules are intended to grow the market cap of the domestic Chinese stock markets and help soak up some of the estimated US\$4 trillion in excess domestic liquidity that has led to soaring prices in Chinese stocks. Chinese citizens are essentially prohibited from investing their money in foreign markets and poured money into stocks last year. In years past, the Chinese markets performed poorly, and it would have been unreasonable to force companies to list on the mainland. However, with the robust performance of the Shanghai and Shenzhen exchanges in 2006 and 2007, it now makes sense to list more Chinese companies on the mainland as part of the maturation process of the markets. CSRC does understand that it would be too great a shock to completely shut Hong Kong out after years of Chinese H-share listings, but the new policy will confine most IPOs to the mainland. Sources do report, however, that "exceptions can be made for valid reasons."

Macro

China Explains Unexpected Rise in First Quarter Forex Reserves

China's foreign exchange reserves surged US\$135.7 billion to US\$1.2 trillion in the first quarter. The growth was larger than expected and raised more than a few eyebrows in the international economic and political world. With a first quarter trade surplus of US\$46.5 billion and 1Q foreign direct investment of US\$15.9 billion, US\$73.3 billion of the forex increase remained unaccounted for. To end the speculation about the source of the US\$73.3 billion, China offered a public explanation. An official with the People's Bank of China (PBOC), China's central bank, said much of the increase was due to the PBOC unwinding swap agreements with some of the country's commercial banks. Before the unwinding, the swaps had kept forex reserves off PBOC's books. The official also said that after many of the large overseas IPOs conducted by Chinese companies in the last 18 months, some of the proceeds from the offerings have been repatriated to take advantage of the appreciating renminbi, contributing to the spike. In a Financial Times article, Stephen Green of Standard Chartered Bank in Shanghai said other factors were also responsible for higher reserves, chiefly interest earned on existing holdings and the impact of currency revaluations on China's portfolio of currencies. The US\$1.2 trillion is over 37% higher than China's forex holdings at the end of the first quarter last year.

United States not Planning more Tariffs on Chinese Goods

The United States said it would not impose additional antidumping tariffs on Chinese goods in the near future. Recently, the US imposed tariffs on glossy paper imports, which only accounted for about 0.1% of the goods China exported to the United States in 2006. "I don't want to downplay the significance of our decision two weeks ago, but we're not considering any cases for any other sectors at this time," David Spooner, the Assistant Secretary of Commerce for the United States. Meanwhile, China imposed tariffs on imports of electrolytic paper from Japan, saying that a year-long investigation showed that imports are hurting Chinese industries. The tariffs range from 15% to just over 40%.

Macro

China Says it Will Allow WTO to Decide its Fate Over US Trade Complaints

In addition to the recent paper tariffs, the US also filed two WTO complaints against China over piracy and restrictions on the sales of American books, music, and films in China. China said it is willing to let the cases go through the WTO judicial process. China is citing its efforts and solid progress in the intellectual property area, as well as the fact that piracy isn't just a unilateral issue. China's National Copyright Administration spokesman Wang Ziqiang said, "No country can be compared to China in the intensity and efforts made in combating intellectual property rights infringements." Wang added that technological advancements have made piracy easier, and said that nations must work together to solve the problem. "These are global issues that cannot be resolved overnight." From the time a WTO complaint is filed, the two parties have 60 days to work out a compromise before the case goes before a WTO panel of judges.

Deals in China

M&A Activity

Acquirer	Description	Target	Description	Amount	Deal details
Best Buy	US-based leading electronics retailer	Jiangsu Five Star	major Chinese electronics retailer	N/A	additional 20% stake (Best Buy purchased 50% of Five Star last year for US\$180 mil)
Changhong	major Chinese electronics manufacturer	Meiling	China-based manufacturer of electronic appliances	estimated RMB 174 Mil	20.03% stake
Wachovia	major US-based banking group	Luwan Laiyin Plaza	large real estate development in Shanghai, including a five-star hotel and luxury apartments, owned by Shanghai Sandalwood Real Estate	RMB 850 Mil	non-controlling stake (assumed, although not disclosed)
Singapore DBS Asset Management	asset management arm of Singapore-based DBS bank	Changsheng Fund Management Co	Chinese fund management company	N/A	33% stake
LifeBrandz	Singapore-based brand development and brand management company	four restaurant, bar, and club operators in China	operators of some well-known venues, especially in Shanghai	estimated RMB 90 Mil	controlling stake

Deals in China

IPO Pipeline

Company	Description	Exchange	Size	Financial Advisors
Bank of Communications	top 5 Chinese state-owned bank, already HK-listed	Shanghai	RMB 20-24 Bil	N/A
Lianyungang Port	operator of port of Lianyungang in northern Jiangsu province	Shanghai	RMB 747 Mil	N/A
Guotai Jun'an Securities	top 3 Chinese brokerage	Shanghai	up to RMB 3.4 Bil	N/A
CHALCO	China's leading aluminum producer (will privatize its Shanghai-listed subsidiaries, Shandong Aluminum and Lanzhou Aluminum, and swap shares with those shareholders when listing)	Shanghai	N/A	N/A
Foreland Fabritech Holdings	China-based fabric manufacturer with 2006 revenue of RMB 315 mil and profits of RMB 75 mil	Singapore	SGD24.21 Mil (approx US\$16 Mil)	Daiwa Securities and Kim Eng Capital (both of Singapore)