

Eye on China

A View from Shanghai

Week of March 31-April 6, 2007

Merchant Banking Advisory In China for Over Twenty Five Years

ChinaVest

CEO

Robert Theleen
Wallace Mathai-Davis

President

Jenny Hsui

Vice Chairman

William Fuller

Managing Director

Richard Wang
Eugene Zhao

Market Weekly

Shanghai Composite Index

- 3/30 Close: **3183.98**
- 4/6 Close: **3323.58**
- Change: ↑ **4.384%**

Shenzhen Composite Index

- 3/30 Close: **8549.20**
- 4/6 Close: **9268.23**
- Change: ↑ **8.410%**

Articles

Manufacturing

- 1) KKR Makes First Investment in China
- 2) Yongchuang Coal Plans US\$1.5 Billion Hong Kong IPO
- 3) Anheuser-Busch to Build US\$63 Million Brewery in South China
- 4) Pepsi to Double Workforce in China in Next Five Years
- 5) CNOOC Shareholders Reject Fund Deposits with Parent
- 6) Carlyle Takes Stake in Steel Tube Manufacturer

Technology

- 7) Hitachi to Turn Shenzhen into Mega-Manufacturing Center for Hard Disk Drives
- 8) Baidu Launches First Overseas Site in Japan
- 9) Online Marketplace Firm Alibaba to Set up in Japan
- 10) Chinese Government May have Given Intel up to US\$1 Billion in Incentives
- 11) Samsung Electronics to Introduce New Chip Production Line in China
- 12) Fidelity Asia Ventures Leads Largest Round of Financing for Chinese Software Outsourcer
- 13) ZTC Debuts on AIM

Services

- 14) Chongqing Bank Receives Approval to Sell Stake to HK's Dah Sing Bank; still Awaiting Approval for Stake Sale to Carlyle
- 15) MGM to Explore Non-Gaming Hotel and Resort Opportunities on the Mainland
- 16) Starwood to Triple Number of Properties in China
- 17) Allianz China Life to Receive Capital Injection
- 18) Country Garden Starts Retail Sale for HK\$12.9 Billion IPO

Regulations & Macro

- US Announces Antidumping Tariffs on Paper Exports from China
- Shanghai and Shenzhen Indices Hit Daily Record Highs
- Nasdaq Looking for more Chinese Companies

Deals in China

- M&A Activity – A Closer Examination
- IPO Pipeline

Construction Materials

1) KKR Makes First Investment in China

KKR made its debut in China by acquiring Henan-province based *Tianrui Cement*. Tianrui Cement is privately owned by Mr. Li Liufa and his family. KKR is reported to have paid approximately US\$100 million for the controlling stake. The cement industry in China is extremely fragmented, with thousands of players spread throughout China, none controlling more than a small fraction of the market. Tianrui will use the proceeds from KKR's investment to improve its technology, expand into neighboring Liaoning province and potentially acquire other companies in the industry. Currently, there are roughly 5,000 cement companies of various sizes in China.

Energy

2) Yongchuang Coal Plans US\$1.5 Billion Hong Kong IPO

Yongchuang Coal is planning a US\$1.5 billion IPO on the Hong Kong Stock Exchange later this year. The company is based in southwest China's Sichuan province. China's coal companies are raising funds as the government is pushing the industry to consolidate. The government's intention is to build three or four coal giants and roughly ten medium-sized enterprises. Yongchuang's IPO is one of three expected large IPOs for Chinese coal companies on the Hong Kong Stock Exchange this year. *Shanxi Coking Coal Group* also plans to raise at least US\$1 billion later in 2007, while *Yongcheng Coal & Electric Group* is planning a US\$1.5 billion offering. The mainland's second-largest coal company in terms of sales, *China Coal Energy*, raised US\$1.9 billion in a Hong-Kong listing last December. Chinese coal companies are growing considerably due to the enormous rise in energy consumption. According to Deutsche Bank, the country's energy demand is projected to rise about 11% in 2007 and 10% in 2008. China relies on coal for about two-thirds of its energy needs.

Food & Beverage

3) Anheuser-Busch to Build US\$63 Million Brewery in South China

Anheuser-Busch will build a new US\$63 million brewery in south China's Guangdong province to produce Budweiser beer. The intention, according to Anheuser's executives, is to double sales of Budweiser in China by 2010. "China's beer market has great potential for development, and building a brewery in south China could help improve the productivity of Budweiser and lower the cost," said Cheng Yeren, the Greater China Managing Director for Anheuser-Busch's Asian branch. The brewery is scheduled to be completed in 2008 and will have annual production capacity of 260 million liters. Anheuser-Busch opened its first China brewery in central China's Hubei province in 1995. That facility has annual production capacity of 420 million liters. Anheuser Busch also owns 27% of China's largest brewer *Tsingtao*, and in 2004 bought *Harbin Beer*, another domestic brand. The American brewer's total investment in China amounts to over US\$1.8 billion. China's beer market is the world's largest, and grew almost 15% last year. Double-digit growth should continue for at least the next few years, and foreign brewers have been accelerating expansion in the country to increase their presence during this critical growth period.

Food & Beverage

4) Pepsi to Double Workforce in China in Next Five Years

At a seminar in Beijing, PepsiCo CEO Indra Nooyi said the company is planning to double its workforce in China in the next five years. Pepsi currently employs 15,000 people in China. The company has invested over US\$1 billion in China to date, and plans to invest an additional US\$850 million in its China operations between 2006 and 2009.

Petroleum

5) CNOOC Shareholders Reject Fund Deposits with Parent

Shareholders of CNOOC, the mainland's largest offshore oil producer, voted against extending a three-year-old waiver that directs the company to deposit funds with *CNOOC Finance*, the financing arm of its parent. A majority (52.2%) of shareholders voted against the extension. In April 2004, independent shareholders approved the same proposal for a three-year period. Because of the vote, CNOOC will now use mainland banks in China for deposit services. CNOOC said its arrangement with CNOOC Finance has, in the past, helped it achieve more efficient settlements and funds transfers, as well as saving transaction costs. CNOOC chairman Fu Chengyu said that the company saved about RMB18 million in transaction costs last year by using CNOOC Finance instead of commercial banks. However, critics of the intra-group deposit system say it creates unnecessary risks. CNOOC shareholder activist David Webb said the system reduces transparency and raises the probability for unsound lending and overly concentrates risk within the CNOOC organization. Other state-owned enterprises in China also use intra-group financing arrangements, including domestic oil giants PetroChina and Sinopec. CNOOC Finance is 32% owned by CNOOC and 63% owned by its parent, China National Offshore Oil Corp.

Tubing

6) Carlyle Takes Stake in Steel Tube Manufacturer

Washington, DC-based Carlyle Group has acquired a 49% stake in China's *Yangzhou Chengde Steel Tube Co* for US\$80 million. Yangzhou Chengde Steel is China's leading large-diameter steel tube maker. The deal received all the necessary regulatory approvals and has already been completed. "Carlyle's wide reach in global industrial companies could bring us crucial resources and benefit our partners and clients in the future," said Zhang Huaide, Yangzhou Chengde's founder and chairman. Chengde Steel plans to use part of the capital injection to fund a RMB500 million expansion project. This particular transaction was much smoother than Carlyle's *Xugong Construction Machinery* deal (see past issues of *ChinaVest Weekly* for details). Carlyle has recent experience in the steel tube sector. Last March, the private equity group acquired major US-based steel pipe maker John Maneely Co for US\$568 million.

Electronics

7) Hitachi to Turn Shenzhen into Mega-Manufacturing Center for Hard Disk Drives

Hitachi Global Storage Technologies (Hitachi GST), the world's leading producer of hard disk drives, will further consolidate the production of media and head-gimbal assemblies (HGA) in Shenzhen, China in an effort to turn its Shenzhen operations into a "mega-manufacturing center." HGAs are key components in the manufacturing of hard disk drives. The mega-manufacturing strategy aims to centralize the entire manufacturing supply chain, which will significantly increase Hitachi GST's ability to deliver products to customers on time and in the right quantities. As part of the centralization, Hitachi GST will shut down factories in Mexico and Japan, and will lay off about 11% of its 40,000 worldwide employees. Much of the production from those facilities will be transferred to Shenzhen. According to analysts, the centralization effort makes sense, as most of Hitachi GST's customers have their manufacturing facilities in Asia. The market is quite robust, as according to the International Data Corp, the Asia-Pacific hard disk drive market (excluding Japan) will grow 26% this year.

Internet

8) Baidu Launches First Overseas Site in Japan

China's search engine leader *Baidu.com* has begun to compete with the likes of Google outside of China. Baidu recently launched its first overseas search engine in Japan where www.baidu.jp will roll out on a trial basis. Nasdaq-listed Baidu announced its plans to expand into Japan last December, saying it would initially invest US\$15 million in the initiative. Baidu's further expansion plans involve other Asian markets. Baidu's market cap currently stands at about US\$3.2 billion.

9) Online Marketplace Firm Alibaba to Set up in Japan

Alibaba.com, China's leading online marketplace, is planning to establish a branch in Japan later this year. Down the road, the company also wants to expand in the United States and Europe. "Our emphasis will be to develop overseas buyers and help Chinese mainland suppliers explore the international market and attract more buyers from Europe, the US and Japan," said an anonymous official with Alibaba.com Corp. The site provides a place for millions of Chinese suppliers to find international customers to whom they can export their goods. Expanding in other countries would increase awareness of the Alibaba marketplace around the world. In addition to the Alibaba.com global trade website, Alibaba also operates the Yahoo China website, China's major online auction site Taobao.com, and major online payment site Alipay.com.

Semiconductor/Integrated Circuit

10) Chinese Government May have Given Intel up to US\$1 Billion in Incentives

Gartner reports that Intel may have received up to US\$1 billion in incentives to build its new chip factory in Dalian. Nick Jacobs, a spokesperson for Intel, mentioned that obtaining incentives has become a common method for Intel to make investments in the semiconductor sector. Intel wouldn't disclose detailed information on the transaction, but the Chinese government, in an attempt to attract large foreign firms, often provides favorable tax treatment, land and other incentives to firms like Intel. Intel will build a US\$2.5 billion chip fabrication facility in the northeastern city of Dalian. It will be Intel's first chip fabrication factory in China (it already has packaging and testing facilities), and will represent the largest-ever high-tech investment in China. Intel will also work with the Dalian government to create a "Semiconductor University" in the city (see last week's ChinaVest newsletter for more details).

11) Samsung Electronics to Introduce New Chip Production Line in China

Samsung Electronics Co, the world's second-largest semiconductor producer, will begin operations on a new chip assembly production line in Suzhou, China. Suzhou is Jiangsu province's second-largest city; a two hour drive from Shanghai. The new line will be Samsung's fourth assembly production line in Suzhou. The size of the Chinese semiconductor market is expected to double by 2010, and Samsung Electronics wants to achieve US\$5.5 billion in mainland semiconductor sales by that time. The Korea Times also reported that Samsung Electronics will soon begin producing some of its high-tech multi-chip package (MCP) microprocessors in Suzhou, moving some of its MCP production out of Korea for the first time. "We have already agreed on a plan. We will begin to roll out MCPs at the Suzhou lines later this year," said an anonymous source with the company. He went on to say, "We have yet to establish the related facilities at Suzhou, but it will not take much time. We feel the need to diversify production sites at a global level." This would be a significant step since the high-storage, small-sized MCPs are some of the most sophisticated chips produced. They are used in such products as notebook computers, mobile phones, and PDAs.

Software

12) Fidelity Asia Ventures Leads Largest Round of Financing for Chinese Software Outsourcer

Fidelity Asia Ventures recently led a US\$45 million Series-B round of financing for Beijing-based software outsourcing firm *iSoftStone*. *AsiaVest Partners* and *Info Tech Pacific Ventures*, which had initially invested in *iSoftStone* last year, joined the deal, along with new investor Mitsui Ventures Global Fund. To date, this is the largest round of financing in China's fast-growing software outsourcing sector. *iSoftStone* currently has offices in China, the United States, Japan, and Korea, and has 2,500 full-time employees.

Telecommunications

13) ZTC Debuts on AIM

Shenzhen ZTC Telecommunications recently debuted on London's AIM market, becoming the 53rd Chinese enterprise to list on AIM. ZTC raised about RMB60 million in the offering. The company manufactures low-cost mobile handsets and focuses on customers in China's lower-income rural areas. It does not have a large manufacturing capacity, producing only about 1.5 million handsets in 2006. Instead, it makes many different models targeting different demographic groups. With its unique business model, ZTC can take a phone from design to market in only three months, keeping up with trends and producing phones with various specialty features. Part of the reason the company listed overseas is that it will soon sell phones in other countries, including Europe and India.

Banking

14) Chongqing Bank Receives Approval to Sell Stake to HK's Dah Sing Bank; still Awaiting Approval for Stake Sale to Carlyle

Chongqing City Commercial Bank has received government approval to sell a 17% stake to Hong Kong's Dah Sing Bank, but is still waiting for approval to sell an additional 7.99% stake to the Carlyle Group. Dah Sing has agreed to pay RMB171.7 for its stake, while Carlyle will pay RMB80.7 million for its stake if it receives government approval. Chongqing is a major city and municipality located in southwest China. "The approval was for our deal with Dah Sing alone. [The banking regulators] are still going through the stake sale to Carlyle," said bank spokesman Huang Changsheng. Regulations limit the total foreign stake in a Chinese bank to 25%, while no single foreign institution can hold more than 20%.

Hospitality

15) MGM to Explore Non-Gaming Hotel and Resort Opportunities on the Mainland

MGM has signed an agreement with the *Diaoyutai State Guesthouse* in Beijing in which the two entities will partner to develop luxury non-gaming hotels and resorts. Diaoyutai Guesthouse is a complex that is used to house foreign dignitaries on visits to China's capital. Although the new partnership is aimed at exploring opportunities globally, it will initially target the mainland. MGM said that it will rely on a brand using the MGM Grand and Diaoyutai names. This would be MGM's first venture in the fast-growing mainland hospitality sector. Although gaming is not allowed on the mainland, creating brand awareness in China could create business abroad for MGM, with Chinese traveling to MGM resorts in Las Vegas and Macau. MGM's US\$1.6 billion gaming resort in Macau is scheduled to open this year.

16) Starwood to Triple Number of Properties in China

Starwood Hotels and Resorts opened two more hotels in Shanghai at the end of March, the Sheraton Shanghai Hotel & Residences in Pudong and the Four Points by Sheraton. The company will open six more properties in China in 2007, and hopes to triple its number of properties on the mainland in the next few years. The company currently operates 34 hotels in China, while another 37 are under construction. "We hope to bring all our nine brands to the China market and increase the total portfolio to 100 by 2010," said Qian Jin, senior vice president for Starwood's China operations. "The new hotels will be located in both first-tier and second-tier cities." Starwood's currently-operating brands in China include Sheraton, Westin, St. Regis, Le Méridien, and Four Points by Sheraton.

Insurance

17) Allianz China Life to Receive Capital Injection

Shanghai-based Allianz China Life Insurance, a 50-50 JV between German giant Allianz and China's CITIC Trust & Investment Co, has received approval from the China Insurance Regulatory Commission (CIRC) to raise its capital to RMB1 billion. The injection will raise its capital 82% from the current RMB550 million. The company wants to make a major push to increase its presence in China's growing life insurance market. Last year, Allianz China Life's premiums increased more than four fold to about RMB1.2 billion, moving it from No. 8 to No. 4 among China's foreign-funded life insurers. The company began working in China in 1999 and operates in about 15 cities.

Real Estate

18) Country Garden Starts Retail Sale for HK\$12.9 Billion IPO

Mainland property developer Country Garden has begun the process for listing 2.4 billion shares for its IPO on the Hong Kong Stock Exchange. The shares, which will begin trading on April 20, will be priced between HK\$4.18 and HK\$5.38, representing 16.7x to 21.5x this year's forecasted earnings. If the shares are priced at the top end of the indicative range, the offering would raise about HK\$12.9 billion, making it the largest real estate IPO on the Hong Kong market and the largest mainland-based real estate company on the exchange. Country Garden, based in southern China's Guangdong province, is a large-scale developer that uses a low-cost land purchasing strategy to achieve maximum profits. It has 22 projects in Guangdong and five other residential projects around China in various stages of development. The company is forecasting over RMB4 billion in profits this year, up from RMB1.52 billion last year, and will pay a dividend to shareholders after the IPO amounting to 40% of earnings.

Macro

US Announces Antidumping Tariffs on Paper Exports from China

Last week, the United States decided to impose antisubsidy laws and slap tariffs on "glossy paper exports" from China. The US has taken the stance that Chinese companies are receiving unfair subsidies in the form of low-interest loans from state-owned banks and certain tax breaks. WTO rules prohibit government subsidies for exports, as it gives exporters an unfair advantage.

Glossy paper accounted for only a small fraction of the US\$288 billion in imports from China last year (approximately 0.1%). The United States' choice to impose a tariff on glossy paper, as opposed to a more significant import, is seen as making a signal to China, rather than as an offensive action. The United States clearly wants to solve the subsidy issue amicably with China and doesn't want to damage trade relations. The Wall Street Journal quoted US Secretary of Commerce Carlos Gutierrez as saying the move "does not signal any retreat from economic engagement... [But] we will use every tool at our disposal to guarantee our workers and our companies have a level playing field."

China's government immediately released a statement declaring its "strong objection" to the move. However, experts are predicting that China will not take any major action retaliatory action before the tariffs go through their approval process, as Beijing will also want to solve the issue with the US using a cooperative approach. China has already decided to purchase US\$12.5 billion of goods from the US ahead of a visit to Washington next month by Chinese officials. Lehman Brothers economist Mingchun Sun speculated on some other action China may take to smooth out the situation. "One reaction may be to change trade policies like imposing export taxes on some products like steel, which is the next potential target. Export taxes and measures like cutting VAT rebates will also probably be introduced fairly soon on other products like coal and maybe textiles."

The new glossy paper tariffs range from 10.9% to 20.4%.

Shanghai and Shenzhen Indices Hit Daily Record Highs

The Shanghai and Shenzhen Composite Indices both set closing price records each day during the week of Monday, April 2 to Friday, April 6. The Shanghai Composite Index finished the week at 3,328.58, up 4.4% from the close on Friday, March 30. The Shenzhen index experienced higher gains, closing at 9,268.23 on April 6, *up more than 8.4%* in the same week. The Shenzhen Composite Index also broke 9,000 for the first time. The mainland's stock markets have obviously more than recovered since the crash on February 27, when both Shanghai and Shenzhen plummeted 9% in a single day. As of closing on April 6, the Shanghai index has increased by 19.9% while Shenzhen has gained 19.0%.

Macro

Nasdaq Looking for more Chinese Companies

Nasdaq CEO Robert Greifel was in Beijing this week for a ceremony with representatives from the 40 Chinese companies that are currently listed on the exchange. "In organizing this little ceremony, Nasdaq is clearly hunting for more Chinese companies," said Zhang Zhimin, a senior analyst with Securities Research. Six Chinese companies have already listed this year. "China is our fastest-growing market outside the United States. We are optimistic about the number of Chinese companies that can list on Nasdaq," said Xu Guangxun, chief representative of Nasdaq in China. As an indicator of the state of the IPO environment in China, a PwC report said that in 2006, Chinese IPOs raised US\$62 billion, to US\$48 billion raised in the United States.

Deals in China

M&A Activity

Acquirer	Description	Target	Description	Amount	Deal details
KKR	private equity group	Tianrui Cement	Henan province-based cement maker	less than US\$100 Mil	controlling stake
Alliance BMP	80-20 JV between Alliance Boots, a leading UK-based pharmaceutical retailer and wholesaler, and Beijing Med-Pharma	Guangzhou Pharmaceuticals	third-largest pharmaceutical wholesaler in China	RMB 545 Mil	50% stake
3Com	US-based communications hardware company	H3C	China-based JV between 3Com and Huawei Technologies	US\$882 Mil	3Com completed the purchase of Huawei's 49% stake in the JV
Carlyle Group	US-based private equity group	Yangzhou Chengde Steel Tube Co	China's leading producer of large-diameter steel tubes	US\$80 Mil	49% stake
Wanxiang	leading Chinese auto parts supplier	one of Automotive Component Holdings' (ACH) plants	ACH is the component business that is controlled by Ford	N/A	the plant is located in Michigan and produces drive trains and other components
Dah Sing Bank	Hong Kong-based bank	Chongqing City Commercial Bank	sixth-largest city commercial bank in China, with RMB 1.52 billion in registered capital	RMB 171.7 Mil	17% stake (Carlyle's additional 7.99% stake still awaiting regulatory approval)

Deals in China

IPO Pipeline

Company	Description	Exchange	Size	Financial Advisors
Country Garden	Guangdong-based property developer	Hong Kong	HK\$12.9 Bil	N/A
Yongchuang Coal	Sichuan province-based coal miner	Hong Kong	US\$1.5 Bil	N/A
China Molybdenum	third-largest Chinese molybdenum miner	Hong Kong	US\$600 Mil	led by China International Capital Corp
Yangzhijiang Shipbuilding	Chinese shipbuilder	Singapore	US\$622 Mil	N/A
Nanjing Bank	seventh-largest city commercial bank in China	Shanghai	N/A	CITIC Securities