

# Eye on China

## A View from Shanghai

Week of August 4-August 10, 2007

Merchant Banking Advisory In China for Over Twenty Five Years

### ChinaVest

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### Market Weekly

#### Shanghai Composite Index

- 8/3 Close: **4,560.77**
- 8/10 Close: **4,749.37**
- Weekly Change: **↑ 4.135%**
- Since 1/1/07: **↑ 77.515%**

#### Shenzhen Composite Index

- 8/3 Close: **16,179.64**
- 8/10 Close: **16,323.44**
- Weekly Change: **↑ 0.889%**
- Since 1/1/07: **↑ 145.57%**

#### Exchange Rate

- 8/3: US\$1 = **RMB 7.583**
- 8/10: US\$1 = **RMB 7.575**
- Weekly Change: **↑ 0.105%**
- Since 1/1/07: **↑ 3.106%**

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## Automobiles

### **1) Chery Active in Tie-Ups with International Industry Players**

Chinese auto producer *Chery* made several recent moves aimed at becoming a significant international player. First, Chery entered into an agreement with Fiat in which it will supply 100,000 engines a year to the Italian automaker. "The cooperation will help improve Chery's competitiveness on the international market. We are glad to cooperate with Fiat and look forward to developing together," said Yin Tongyao, chairman and general manager of Chery. Fiat CEO Sergio Marchionne said the deal "paves the way for future cooperation." Fiat made it clear that it is much more impressed with Chery than its current JV partner in China, *Nanjing Auto* (even though Fiat and Nanjing Auto recently injected US\$800 million to revive their ailing JV). Second, within the past few weeks, Chery entered into a joint venture with U.S. Fortune 500 auto component manufacturer ArvinMeritor to produce vehicle chassis. Third (as reported in a previous CV newsletter), Chery entered into a major cooperation agreement with Chrysler in which Chrysler will initially label Chery compact cars with its own brand and sell them in North America and Europe. Later, the two will jointly develop small car models and sell them worldwide. Chery is China's fourth-largest automaker, but it exports more cars than any other Chinese auto company. This year, Chery expects to export over 100,000 cars.

## Consumer

### **2) Law Firm Attempts to Sue Company Over Contaminated Pet Food**

San Francisco-based law firm Audet & Partners is suing a Chinese company that was associated with the poisonous pet food exported to the U.S. that killed thousands of pets. The law firm filed the suit against *Binzhou Futian Biological Technology* in a California court. "It's time to hold all companies, regardless of the location of the business, financially and legally accountable for distributing toxic materials into the United States stream of commerce," said lead attorney William M. Audet. Audet is just one of a number of U.S. lawyers seeking legal remedy from Chinese companies over product quality issues. "Our firm's legal research has revealed that the law in the People's Republic of China actually provides for potential liability for distributing 'impure or fake materials' in products such as dog and cat food. We intend to argue that the China-based company is liable under both California law and applicable Chinese law," Audet added.

Although the recent rash of product safety issues will continue to spur legal action, plaintiffs in the United States and other countries will have a difficult time trying to secure judgments from Chinese companies. Audet believes that he can succeed, but the fact is that no known cases exist in which China has enforced a judgment handed down by a U.S. court (Washington Post). Chinese companies often don't even show up in court when they are sued in the United States, and there is no legal authority that can force them to do so.

## Energy

### **3) More Chinese Solar Companies Prepare For IPOs**

Two more Chinese solar companies are gearing up for eventual overseas IPOs. *Jiangsu Shunda Group* and *Asia Silicon* are each planning US\$200-300 million IPOs in Hong Kong or New York in the next six months. Both make polysilicon, which is used by downstream producers to make solar cells. The business is capital intensive (both companies are building US\$100-200 million plants). "Generally speaking, making polysilicon is a heavy-duty manufacturing business that can be done cheaper and better in China," an industry source told the South China Morning Post. Emerging markets-focused private equity group Actis already invested US\$40 million in Shunda, while Chinese venture capitalists *JOLMO Capital Management* and *Waichun* also invested a combined US\$40 million. From December 2006 to June 2007, six Chinese solar companies listed on NYSE or Nasdaq. It will be interesting to see if any of these players falter amid the intensifying competition.

### **4) Boqi Becomes First Chinese Company to List on Tokyo's Main Board**

*China Boqi Environmental Solutions Technology* listed on the main board of the Tokyo Stock Exchange on August 8. Boqi makes "anti-pollution" equipment, such as devices to reduce harmful emissions from coal fired power plants. Boqi's stock price surged in the first few days, ending Friday 47% above the IPO price. The company raised about US\$130 million (net of expenses) in the listing. Boqi is the second Chinese company to list in Tokyo, but the first to list on the main board. Recently, *Asia Media* listed on the TSE's "Mother Market" for growth enterprises, raising about US\$25 million in the listing. The Tokyo Stock Exchange is making a great effort to attract more foreign companies, and has publicly stated its intention to attract 10 Chinese companies within two years.

## Pharmaceuticals

### **5) WuXi PharmaTech Lists on NYSE**

China's largest pharmaceutical outsourcing firm, *WuXi PharmaTech*, raised US\$185 million in its NYSE listing on August 9. Its shares have performed well so far, currently trading at 32% above the IPO price. The company provides outsourced services such as drug testing, drug development, and laboratory testing, for major global companies. Its customers include nine of the world's ten largest drug companies. The pharmaceutical outsourcing sector, both in China and abroad, has grown significantly in recent years due to cost and time-saving advantages. China is one major beneficiary of that growth with inexpensive labor and large quantity of highly educated talent in the biotech field. WuXi PharmaTech doubled its revenue to about US\$70 million in 2006, recording healthy profits of about US\$9 million. The company's market cap currently stands at US\$3.33 billion.

## Electronics

### **6) Lenovo Acquisition Designed to Make Inroads in Europe**

Chinese PC maker Lenovo Group is negotiating the purchase of Dutch PC manufacturer Packard Bell. Packard Bell is Western Europe's fourth-largest desktop PC seller and sixth-largest notebook PC seller. Lenovo would like to establish a foothold in Western Europe, an area where it has a minimal market presence. Hong Kong-born entrepreneur John Hui purchased Packard Bell from NEC last year for about US\$91 million. The acquisition by Lenovo would also help it compete with Taiwan-based Acer, which currently ranks second in market share in Europe. Lenovo is the world's third-largest PC maker, while Acer is the fourth-largest. Last week we discussed Lenovo's plans to build assembly plants in Mexico and India. These are part of its plan to compete with Dell and HP in the U.S. market. In other news, Lenovo posted Q2 profits of US\$67 million, a 12x increase over the same period last year. The jump was due to increased sales and cost savings generated by a major restructuring initiative.

### **7) Lenovo to Launch Low-Cost PC**

Lenovo is also making news with a plan to target China's rural population with a no frills US\$199-399 PC. The computer connects to the television as a monitor, thereby saving the cost of an LCD screen. The PC, designed for China's rural population, will even include software to help farmers gather agricultural information. Many PC companies are interested in China's massive and largely untapped rural population. This market outnumbers the *entire* population of the U.S. by 2-3x. Only 10% of China's population of 1.3 billion owns a PC, implying that sales of lower-cost PCs such as Lenovo's should be extremely robust. As an indicator of the sector's potential, the rural market is a major driving force behind the growth in China's new mobile phone subscribers. Mobile companies attract rural customers with ultra-low-cost handsets and low-cost service. This will not be Lenovo's first low-cost computer in China, as it has already teamed up with Microsoft in a trial program that sold computers for about US\$300. Lenovo currently has an approximate 35% market share in China, a nation where, in 2006, PC sales exceeded US\$14 billion. The major factor challenging low-cost PC sales initiatives is the income level of China's rural residents. With an average annual income of only US\$600, a US\$199 PC will clearly be difficult for many to afford. (Wall Street Journal)

## Semiconductor/Integrated Circuit

### **8) Fabless Semiconductor Company Receives Venture Capital Funding**

AsiaVest Partners led a US\$14.5 million Series B round of financing in *Parade Technologies*, a fabless semiconductor firm that designs chips for high-tech digital TV applications. "Fabless" means the company designs but does not make the chips. Intel Capital and Legend Capital also participated in the funding. The investment brings Parade's total funding to US\$21.5 million. Parade's headquarters is located in Silicon Valley but its design center is in Shanghai. AsiaVest is a Greater China-focused VC group that manages about US\$1 billion. Legend Capital is a China-focused venture capital subsidiary of Legend Holdings (the parent company of Lenovo). Legend Capital generally focuses on tech-related investments.

## **Banking**

### **9) Government to Bail Out ABC with up to US\$40 Billion Injection**

The Chinese government plans to bail out *Agricultural Bank of China (ABC)* by providing a capital injection of up to US\$40 billion. ABC is the fourth-largest of China's "Big 5" state-owned banks, and the only one that hasn't gone public. The capital injection, which will most likely come from China's US\$1.33 trillion in foreign exchange holdings, would bring ABC's capital adequacy ratio to 8%, which is in line with international standards. The bank's poor financial situation is preventing it from going public. The bank is bogged down with a non-performing loan ratio of over 21%. A factor that makes ABC's reform extremely difficult is its conflicting mandate. ABC needs to both fund agriculture development in China (often a money-losing exercise) while trying to follow the banking industry's best practices. Its extensive banking infrastructure in rural areas has largely exacerbated this predicament, and it will be difficult to escape the problem. The Chinese government previously had to inject US\$60 billion to restructure the top three state-owned banks, *Industrial and Commercial Bank of China (ICBC)*, *Bank of China (BOC)*, and *China Construction Bank (CCB)*, before they were able to go public.

### **10) CDB to Become a Commercial Lender**

China's largest policy bank, *China Development Bank (CDB)*, announced plans to transform itself into a full-fledged commercial bank. CDB submitted the proposal to China's *State Council* for review. According to the plan, the government will give CDB a US\$20 billion cash injection as part of the bank's restructuring. As with the proposed cash injection into Agricultural Bank of China (see above), the money would most likely come from China's foreign exchange reserves. As a policy bank, CDB has mostly provided loans to state-owned enterprises in order to fund development projects. It hasn't restricted its loans to projects in mainland China, however. The bank's loan portfolio also includes major projects in places like Africa and Kazakhstan. Two to three weeks ago, CDB gave a major indication that it sought to become a commercial bank when it announced that it would acquire a multi-billion-dollar stake in UK-based Barclays Bank. CDB will spend an initial US\$3 billion for a stake in Barclays, and that figure could rise to US\$13.5 billion if Barclays succeeds in acquiring Dutch bank ABN Amro. In return for the US\$3 billion, Barclays will provide its commercial banking expertise and will give CDB access to its worldwide financial network. Historically, CDB has done an excellent job of making sound loans and its non-performing loan ratio currently stands at only 0.68%.

## Financial Services

### **11) Three Foreign Firms Gain Greater Access to Fund Management**

During the past few weeks, the *China Securities Regulatory Commission (CSRC)* gave the green light to four Chinese fund management companies to invest overseas as part of the Qualified Domestic Institutional Investor (QDII) program. QDII allows Chinese financial institutions to invest in securities traded overseas. Other than through the QDII program, Chinese companies and individuals cannot invest in securities or other investment products outside the mainland. CSRC just extended the QDII program to include fund management companies and securities brokerages (see last week's newsletter). The program was previously limited to banks and insurance companies. Three of the first four fund managers to receive QDII approval have foreign backing. JPMorgan Fleming Asset Management holds a stake in one of the companies, and Deutsche Bank holds a stake in another. U.S.-based Mellon Financial will manage the overseas investments for a third QDII-qualified fund manager, China Southern Fund Management. These CSRC approvals are very important steps for the foreign companies, as it gives them higher level of access to China's US\$4.87 trillion in personal savings. For Mellon Financial, its agreement with China Southern Fund Management represents its first major step into China. As we discussed last week, the QDII program has not attracted significant funds from retail investors, partly because the Chinese have enjoyed such high returns in the domestic markets and also because until recently, QDII investments were limited to low-yield foreign fixed income products (i.e. bonds). And when CSRC opened the program to stock investing this spring, only banks could offer QDII fund products. Analysts believe that by extending QDII to fund management companies, the program will be able to attract more investment. Within two years, JPMorgan predicts that CSRC will allow US\$20 billion of QDII investment by fund management companies. However, this number is still small when compared to the roughly US\$5 trillion in domestic savings.

## Healthcare

### **12) Chinese Chain of Dental Clinics Receives VC Investment**

Two foreign private equity investors, SIG Asia and Edinburgh-based Martin Currie, jointly invested US\$10 million in *Jiamei Dental*, China's largest private chain of dental clinics. The US\$10 million comes as part of a second round of financing. Jiamei hopes to raise a further US\$40 million from two other investors. Jiamei currently has 60 clinics, and hopes to use the investment capital to expand that number to 100. Private dental care is a growing sector, as Chinese citizens are using their increased spending power on new "luxuries" like quality dental care.

## Insurance

### **13) CIRC to Limit Overseas Insurance Investment to Blue Chips**

As we reported in the July 27 newsletter, the *China Insurance Regulatory Commission (CIRC)* recently allowed Chinese insurers to invest up to 15% of their assets in overseas stocks. CIRC is perfecting the rules before insurers actually make their investments. However, reports have surfaced that those investments will be limited to large, profit-making blue chip companies. According to the South China Morning Post and other sources, the rules will essentially limit investment to about a dozen of the largest Hong Kong-listed companies that are part of the benchmark Hang Seng Index. Many of those firms are actually mainland Chinese companies listed in Hong Kong. "The regulators hope to open up in a gradual manner to make sure that investors don't take risks quickly," said Huang Yiping, Citigroup's head of Asia Pacific economic and market analysis. "To insurers, this is just pragmatic." The gradual approach makes sense considering that 15% of mainland insurers' assets amounts to US\$380 billion.

## Real Estate

### **14) Singaporean Company Raises Two China Private Equity Funds**

Singapore-based Ascendas, one of Asia's leading business property developers, established two new China-focused private equity funds. The US\$528 million *Ascendas China Commercial Fund* will invest in commercial properties in China's tier-one cities. The other fund, the US\$396 million *Ascendas China Industrial & Business Parks Fund*, is focused on large parcels of land that will be converted to industrial parks. Ascendas will inject some of its current Chinese property assets into the two funds. In July, Ascendas reached an agreement with a Chinese partner to develop a US\$458 million IT park in the city of Hangzhou. The park will be its largest China investment to date. Ascendas will contribute about 30% of the investment into the funds, while other unnamed international investors will contribute the rest.

### **15) China's Largest Real Estate Broker Successfully Lists on NYSE**

Shanghai-based real estate broker and consultancy *E-House* raised over US\$200 million in its NYSE IPO on August 8. As of the date of this newsletter, its shares are trading at a 30.3% premium to the IPO price, putting the company's market cap at about US\$900 million. Investors are eager to take part in China's exploding real estate sector. Growth in real estate is linked to several factors including rising incomes, rapid urbanization, and lack of alternative investment opportunities for Chinese citizens (with few exceptions, they can only invest domestic financial markets and domestic real estate). *E-House* is China's largest real estate agency since 2004. It had sales of US\$51.9 million last year. Its profit margins are roughly 25-30%.

## Real Estate

### **16) Three More Real Estate Developers Listing in Hong Kong**

Three Chinese real estate developers are planning third-quarter IPOs on the Hong Kong Stock Exchange worth a total of about US\$1.5 billion. *Franshion Properties*, a real estate arm of *Sinochem* (a large state-owned petrochemical conglomerate), will list in Hong Kong on August 17. It raised HK\$3.31 billion (about US\$425 million) for the IPO. Details on the listing can be found in the July 20 issue of the newsletter. *Sino-Ocean Real Estate*, a subsidiary of major Chinese shipping group *COSCO*, plans to raise HK\$5 billion (US\$639 million) in its IPO. Sino-Ocean's other investors include Morgan Stanley, Merrill Lynch, and Standard Chartered. In other real estate IPO news, *Zhong'an Real Estate*, located in Zhejiang province (adjacent, and to the south of Shanghai), plans to raise HK\$4 billion (US\$512 million). The company had initially planned to raise HK\$3 billion, but increased that number amid strong investor demand in China's real estate sector and solid performance by China property stocks. A host of property developers have conducted successful listings in Shanghai and Hong Kong this year. In April, Guangdong province-based *Country Garden* had the largest ever listing by a Chinese mainland property developer, raising HK\$13 billion in its Hong Kong IPO.

## Macro

### **Rumblings of Trade War Growing Louder**

Certain members of the U.S. Senate continue to push for protectionist legislative action aiming to force China to accelerate the appreciation of the yuan. However, Treasury Secretary Hank Paulson reiterated his stance against using legislation to achieve that end. "Legislation is the wrong course, and I am determined to do a better job of convincing them that's the case," he said. "The way to deal with this is to engage with them directly the way we are," he added. President Bush agrees with Paulson, and says he will veto any such bill that comes across his desk. However, Senator Chuck Schumer (Democrat-NY) says a bill would have enough votes to override a Bush veto. That may or may not be true. At the moment, there are actually two bills in the Senate, one from the Banking Committee and one from the Finance Committee (both bills would use legislation, such as tariffs, to force faster yuan revaluation). The Senate is taking time to sort out which committee has jurisdiction over such a matter.

We believe the pragmatic approach is the Paulson/Bush method of working cooperatively with China on the currency issue. A rapid revaluation of the yuan would seriously cut into the profits of Chinese exporters, causing them to drastically increase prices. Those price increases would ultimately be paid by the U.S. consumer, which could spur inflation. It is also likely that the U.S. will already experience higher inflation due to rising prices from China within the next half year. This is due, among other factors, to China's recent reduction of export tax rebates on almost 3,000 goods (see June 22 newsletter for details). In short, China removed tax incentives for exporters, cutting into their margins. Indicators are already showing rising export prices as a result of the move.

And then there's the issue of China's massive foreign exchange holdings (about US\$1.33 trillion worth), much of which is in U.S. Treasuries. China's large holdings of U.S. debt gives Beijing leverage. China could conceivably reduce its dollar exposure by selling off large quantities of Treasuries. The UK's Daily Telegraph cited two high-ranking government officials as saying that China would retaliate with a sell-off if the U.S. imposes any type of the aforementioned yuan-related legislation.

We hope the two nations continue to tackle economic issues using a cooperative approach. The use of dialogue has already yielded tangible results in 2007, but some U.S. legislators are unsatisfied with any progress other than a major yuan revaluation. While the Senate is working on its course of action, ChinaVest will continue to monitor this potential trade war.

## Macro

### **FDIC Assisting China in Establishing Deposit Insurance**

The U.S. Federal Deposit Insurance Corporation (FDIC) recently signed an MOU with Chinese officials stipulating that FDIC will help China set up a deposit insurance system. "There is increasing need to set up the deposit insurance system in China," said *People's Bank of China* (PBOC—China's central bank) Governor Zhou Xiaochuan. "The time is ripe to establish the system because the level of China's financial supervision has been improving and the cost of setting up a deposit insurance system is low," he said. FDIC chairman Sheila Bair commented, "The MOU is a very positive and important step toward making a deposit insurance system in China a reality. The work of the Chinese to create a deposit insurer is critical for the country's continued progress in building the financial infrastructure necessary to sustain economic growth." With China's financial sector becoming increasingly influential and with deposits by Chinese citizens approaching US\$5 trillion, China recognizes the need for a deposit insurance security blanket. Although the performance of China's banks has vastly improved in recent years, many non-performing loans still exist (e.g. Agricultural Bank of China, mentioned earlier). China has been drafting deposit insurance legislation since last year. Sheila Bair and other FDIC officials visited China for about two weeks and the two sides discussed their proposed cooperation. Bair added that FDIC will provide support to China in the areas of technology, financial education, and risk control (Shanghai Daily). In other news, CSRC recently established an "investor protection fund," which will protect investors in the event securities brokerages go bankrupt. Brokerages will have to make biannual payments into the fund amounting to 0.5% to 5% of revenue, with the first payment due on August 30.

# Deals in China

## M&A Activity

Acquirer	Description	Target	Description	Amount	Deal details
H&Q Asia Pacific	Asia private equity arm of Hambrecht & Quist	Dalipal Pipe	Hebei province-based petroleum pipeline maker	US\$35 Mil	30% stake
Shenyin & Wanguo	China's third-largest securities brokerage	Tianyi Futures	futures brokerage owned by Shanghai Jiao Tong University	RMB 70 Mil	controlling stake
Arcelik	Turkish household appliance maker, Europe's third-largest	Changzhou Casa-Shinco Electrical Appliance	Chinese manufacturer of washing machines, with annual capacity of 200,000 units	RMB 60 Mil	controlling stake
China International Marine Containers (CIMC)	world's largest manufacturer of shipping containers, also a subsidiary of China's largest shipping group COSCO	Enric Energy Holdings	HK-listed manufacturer of natural gas containers, refueling stations, and other products	HK\$1.13 Bil	42.2% stake

# Deals in China

## IPO Pipeline

Company	Description	Exchange	Size	Financial Advisors
Franshion Properties	real estate arm of Sinochem, develops mid- to high-end residential and office properties	Hong Kong	US\$425 Mil	Deutsche Bank, DBS Vickers
Tech Pro	produces aluminum electrolytic capacitors, which are components in used computers and industrial systems	Hong Kong	HK\$200 Mil	N/A
Dragon Power	mainland company that generates power using bio-fuels (specifically straw and wood chips)	Hong Kong	US\$2 Bil (scheduled for 2008)	N/A
Sunmart Holdings	focused on manufacturing and exporting spray products that are used in consumer goods and pharmaceuticals	Singapore	US\$16.8 Mil	N/A
Alcha Aluminum	Jiangsu province-based aluminum producer with 2006 profits of US\$5.25 million	Shenzhen	N/A	Soochow Securities

## **China Addressing Internet "Addiction" Problem**

China is ramping up its campaign against internet addiction among the nation's youth. Internet and online game addiction is actually a significant problem on the mainland, with the "ailment" completely taking over the lives of millions. The country already has eight internet addiction clinics, which are extremely strict, military-like rehabilitation facilities (Asia Times).

The government also implemented an interesting anti-addiction system in the online games sector. Online game operators must now equip their games with a feature that revokes game "credits" a user earns (i.e. it removes some of the players' abilities) after long periods of play. The rule only applies to those under the age of 18. In order to play, the games now require users to register with their government-issued ID number, which allows the game to determine the user's age. The government will shut down games that don't adhere to the new anti-addiction system. China just recently began enforcing the new system, so its effectiveness remains to be seen.

China currently has 137 million internet users, and will surpass the United States (with 153 million users) for the global top spot within two years. About 70% of the mainland's internet users are under 30 years old (Asia Times).