

# Eye on China

## A View from Shanghai

Merchant Banking Advisory In China for Over Twenty Five Years

### ChinaVest

#### Senior Management

Robert Theleen  
Wallace Mathai-Davis  
Jenny Hsui  
William Fuller  
Eugene Zhao  
Tao Tao  
Alexander Lee  
Erik Bethel

#### Editorial

David Greer  
Patrick Kelly  
Rajith Sebastian

### Market Weekly

#### Shanghai Composite Index

- 12/28 Close: **5,261.56**
- 1/18 Close: **5,180.51**
- Change: ↓ **1.540%**
- Since 1/1/08: ↓ **1.540%**

#### Shenzhen Composite Index

- 12/28 Close: **17,700.62**
- 1/18 Close: **18,131.38**
- Change: ↑ **2.434%**
- Since 1/1/08: ↑ **2.434%**

#### Exchange Rate

- 12/31: US\$1 = **RMB 7.314**
- 1/18: US\$1 = **RMB 7.258**
- Change: ↑ **0.766%**
- Since 1/1/08: ↑ **0.766%**

### Articles

#### Industrial & Consumer

- 1) Shareholders Vote Down Proposed Sale of China Eastern Stake
- 2) China Coal Energy Co to List in Shanghai
- 3) China Auto Industry Continues Strong Growth
- 4) WuXi PharmaTech to Acquire American Pharma Testing Company
- 5) Carlyle Buys Stake in Chinese Foodservice Chain
- 6) Chinese Footwear Firm Expands Overseas

#### Technology

- 7) Regulators Reject Changhong Stake Sale to Investors Incl. Microsoft
- 8) Leading Chinese Fabless Chip Company Buys U.S. IC Firm
- 9) VCs Invest in Chinese Mobile Social Networking Company

#### Finance

- 10) BoComm Gets Approval to Buy Changshu Rural Commercial Bank
- 11) Morgan Stanley to Sell Ownership in CICC
- 12) CCB and BoA Set Up China's First JV Leasing Enterprise

#### Regulations & Macro

- Mainland Now World's Fourth-Largest Equity Market
- China Finishes Year with World's Fourth-Largest GDP
- Gold Futures Begin Trading in Shanghai

#### Deals in China

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

#### Random Tidbits

## Air Travel

### **1) Shareholders Vote Down Proposed Sale of China Eastern Stake**

Shareholders of *China Eastern Airlines (CEA)* voted against selling a 24% stake to Singapore Airlines (SIA) and its parent company, Temasek Holdings (a Singapore state investment fund). The deal was reported in September, when SIA and Temasek offered US\$922.8 million (HK\$3.80 a share) for Shanghai-based China Eastern, one of China's Big Three state-owned carriers. Despite the fact that the sale was approved by Chinese regulatory authorities, state-owned *Air China* (parent: China National Aviation Holding Co) played a crucial role in blocking the deal through its hostile takeover bid during the past few months. The SIA/China Eastern deal required 2/3 approval from both CEA's Hong Kong and Shanghai-listed shareholders. Air China amassed over 12% and 3% of China Eastern's shares in Hong Kong and Shanghai respectively, enabling it to vote a significant number of shares to block the deal.

Air China is the only one of China's Big Three state-owned airlines (Air China, China Eastern, and *China Southern*) with a foreign partner, as it established a partnership with Hong Kong's Cathay Pacific in 2004. Many in the market believe that Air China's block of China Eastern's sale to SIA is part of a plan to make a future bid for China Eastern. The addition of CEA would not only make Air China the dominant carrier in China, but also increase its potential to become a major international airline. There is a lockup clause in the agreement between China Eastern and Singapore Airlines that prevents China Eastern from accepting offers from competitors until August 9, 2008.

Despite the fact that China Eastern has not been profitable since 2003, the recent battle between Air China and SIA illustrates the importance of China Eastern's regional position (CEA dominates the Shanghai market). It also illustrates how eager major airlines are to expand in the booming mainland aviation market, which is expected to grow by 5x over the next 20 years.

## Energy

### **2) China Coal Energy Co to List in Shanghai**

*China Coal Energy* announced plans for a second listing in Shanghai. Already listed in Hong Kong, China Coal Energy plans to raise US\$4-5 billion in its Shanghai IPO, in which it will sell about 11.5% of its enlarged share capital. China Coal, which is China's second-largest listed coal producer (by revenue) behind *Shenhua Energy*, has enjoyed a great deal of recent success. In 2007, the company achieved an estimated 90% increase in earnings and saw its stock price in Hong Kong rise by 4x. Money raised from the Shanghai IPO is expected to fund two new coal mine operations in Erdos, Inner Mongolia, and in northeast China's Heilongjiang province. China Coal Energy's Hong Kong IPO took place in December, 2006, with the group raising about US\$1.7 billion.

Shenhua Energy listed in Shanghai last October in a colossal US\$9 billion IPO. The mainland uses coal to generate about 70% of its energy.

## Automobiles

### **3) China Auto Industry Continues Strong Growth**

Robust sales in China's automobile market continued in 2007, surpassing 20% growth to reach 8.7 million units. Although sales have been strong, growth is slightly down from the mainland market's record 2006 year, when sales grew at 25% to reach 7.2 million units. Growth in 2008 is expected to remain in the double digits, possibly reaching 10 million units. However, some experts predict a slight slowdown due to increasing energy prices and tighter credit requirements imposed by the Chinese government.

GM remained the market leader in 2007 with a record-breaking 1 million units sold, achieving close to 20% sales growth for the year. Buick was GM's top brand, followed by Chevrolet. Luxury brand Cadillac achieved the highest growth rate, with a 148% increase in sales.

Volkswagen set a company record with over 900,000 units sold in China in 2007. With a growth rate of 28%, China officially surpassed Germany to become the largest consumers of Volkswagen vehicles. 2008 projections remain strong as VW expects to surpass 1 million units in mainland sales. Volkswagen has an 18% share of the China market.

Ford Motors outpaced the industry with 30% mainland sales growth in 2007. However, Ford still lags far behind market leader GM, with only 200,000 units sold. Ford brands in China include Ford, Volvo, Lincoln, Jaguar, and Land Rover.

## Pharmaceuticals

### **4) WuXi PharmaTech to Acquire American Pharma Testing Company**

Shanghai-based *WuXi PharmaTech* kicked off the new year with a US\$151 million acquisition of U.S. pharmaceutical testing firm AppTec. The acquisition, which includes WuXi taking on US\$11.7 million of AppTec's debt, will help expand WuXi's business into biopharmaceutical fields (its current focus is chemistry), increase its U.S. operations, and expand its customer base. WuXi PharmaTech is an R&D and lab research outsourcing company, providing services for the world's top drug companies (over 80 customers, including 9 of the 10 largest pharmaceutical companies by revenue). WuXi PharmaTech currently trades on the NYSE (market cap: US\$1.54 billion). It raised about US\$200 million in its IPO in August, 2007.

The company's primary business model is to provide its customers with inexpensive drug research and development, which is in large part accomplished through cheap Chinese labor (typical Chinese researchers earn around US\$30,000 annually, while U.S. researchers earn US\$250,000-300,000 [Wall Street Journal]). The AppTec acquisition may challenge WuXi's business model, as the company will take on high costs from its American counterpart. The benefits of an increased global presence and the ability to provide a broader spectrum of value-added services may justify the risk.

Specifically, AppTec is a testing, R&D, and manufacturing company for biopharmaceutical and medical device products. The St. Paul-based company has three facilities in the United States.

AppTec estimates its 2007 revenues at US\$70 million.

## Food & Beverage

### **5) Carlyle Buys Stake in Chinese Foodservice Chain**

The Carlyle Group recently invested US\$21 million for a 20% stake in *DIO F&B Group*, a Chinese foodservice restaurant chain. The investment will help DIO expand its DIO Coffee shops (which feature coffee and Western food offerings) to 1,000 outlets in China, up from the current 300 (Reuters). Growing foodservice chains are popular among PE and VC investors, as they take advantage of rising consumption among urban Chinese. The DIO deal is the second for Carlyle in the sector, who has also invested in *Babela Restaurant Management*, a Shanghai-based foodservice Chain that also serves Western style dishes.

## Footwear

### **6) Chinese Footwear Firm Expands Overseas**

*Aokang Group*, China's largest private footwear manufacturer, is set to create a strategic alliance with Italian shoemaker Valleverde. Eventually, Aokang would like to buy a stake in the Italian family operated shoe business. In the meantime, the two have formed a partnership, in which Aokang will help manufacture and sell Valleverde shoes worldwide (Reuters). This type of partnership is becoming increasingly common, as many Chinese firms are looking to obtain quality, reputable overseas brands. At the same time, many smaller European firms, often family run companies (especially in Italy), seek partners that can help them produce and distribute around the globe. While the relationship with Valleverde is strong, Aokang Group is also looking for other overseas partners/investors ahead of a future planned IPO, according to the company's chairman.

## Electronics

### **7) Regulators Reject Changhong Stake Sale to Investors Including Microsoft**

CSRC struck down *Changhong Electric's* deal to sell a 27% stake to Microsoft and nine other investors. Changhong is a major domestic electronics maker, and is China's second-largest manufacturer of TVs. Its share price on the Shanghai Stock Exchange currently stands about 1.5x above the price at which the deal was agreed. Within the last year, CSRC has stopped allowing sales of stakes in listed Chinese companies at discounted prices. Recently, in highly-publicized developments, Goldman Sachs' proposed purchases of minority stakes in appliance maker *Midea* and auto glass company *Fuyao Glass* met the same fate as the Changhong deal. In those deals, the share prices of Midea and Fuyao had risen as high as 4x above Goldman's agreed purchase price.

As one of the investors in the Changhong deal, Microsoft planned to pay RMB94 million for about a 1% stake. In June, the two companies agreed to partner in developing digital home entertainment products. The RMB94 million investment was slotted for the development of TVs, computers, and internet-based products (South China Morning Post).

## Semiconductor/Integrated Circuit

### **8) Leading Chinese Fabless Chip Company Buys U.S. IC Firm**

Shanghai-based semiconductor company *Spreadtrum Communications*, a Chinese "fabless" semiconductor company, wrapped up a deal to acquire San Diego-based Quorum Systems. Spreadtrum will pay at least US\$70 million in cash and stock to acquire Quorum, with the price possibly rising an additional US\$6 million. Both companies are "fabless" semiconductor enterprises, meaning they design chips but don't actually manufacture them. Spreadtrum specializes in chips for mobile communications devices, while Quorum's focus lies in chips for radio frequency (RF) devices. With the acquisition, Spreadtrum is looking to enhance its wireless communications product offerings. Spreadtrum listed on Nasdaq last July, raising US\$100 million in the IPO. Its market capitalization currently stands at about US\$400 million.

## Telecommunications

### **9) VCs Invest in Chinese Mobile Social Networking Company**

Three venture capital groups invested US\$10 million in a third round of financing into *Pica*, a Chinese mobile social networking service. Pica began as a mobile instant messaging company, but is reportedly switching to social networking to "avoid conflict with telecom operators" (Beijing Business). The three VC investors are Crosslink Capital, IDGVC, and BlueRun Ventures. Crosslink Capital and BlueRun Ventures are based in the SF Bay Area, while IDGVC is based in China. The investment by the three groups brings Pica's total funding to US\$20 million over three rounds of financing.

## Banking

### **10) BoComm Gets Approval to Buy Changshu Rural Commercial Bank**

CSRC granted *Bank of Communications (BoComm)*, China's fifth-largest commercial bank, approval to purchase 10% of *Changshu Rural Commercial Bank*. BoComm will pay RMB380 million for the stake. Changshu is a small city located on the Yangtze River about 3 hours from Shanghai. Throughout China, city commercial banks and rural commercial banks are looking to introduce strategic investors to help them expand to areas outside their immediate home regions. Among other reasons, expansion can help the banks compete in the long run with the large Chinese and international banking groups. After introducing strategic investors, these local banks are generally looking to raise more money through IPOs. Last summer, *Bank of Nanjing* and *Bank of Ningbo* became the first two city commercial banks to list. Another notable IPO occurred in September, when *Bank of Beijing* listed on the Shanghai Stock Exchange, raising close to US\$2 billion.

## Investment Banking

### **11) Morgan Stanley to Sell Ownership in CICC**

Morgan Stanley plans to sell its stake in one of China's top investment banks, *China International Capital Corp (CICC)*. Morgan Stanley holds a 34.3% stake in CICC, and plans to sell the Chinese investment bank to focus on a new mainland securities joint venture. The new joint venture, with Shanghai-based *China Fortune Securities*, does not allow Morgan Stanley to hold stakes in both firms.

CICC is an attractive target for foreign investors. The investment bank was the top-earning investment bank in underwriting IPOs in mainland China during 2007, and provides excellent access to China's booming stock markets. Among foreign investment banks besides Morgan Stanley, only Goldman Sachs and UBS can currently underwrite IPOs on the Shanghai and Shenzhen exchanges, as only they have their own JVs with Chinese investment banks. Considering that US\$61 billion was raised in domestic IPOs in 2007 (Agence France-Presse), CICC's position as the leader in domestic underwriting is significant. The sale of the stake could retrieve as much as US\$1 billion for Morgan Stanley. Rumors suggest that private equity firms TPG and J.C. Flowers & Co., as well as Hank Greenberg's Starr International have shown interest thus far.

## Leasing

### **12) CCB and BoA Set Up China's First JV Leasing Enterprise**

At the start of the new year, *China Construction Bank (CCB)* and Bank of America officially established China's first joint venture leasing company. The venture is valued at US\$616 million, of which CCB holds a 75.1% stake and Bank of America a 24.9% stake. A Bank of America spokesperson recently described the benefits of the partnership, saying, "China Construction Bank already has the marketplace, while Bank of America has the leasing background" (Bloomberg).

On March 1, 2007, the *China Banking Regulatory Commission (CBRC)* announced it would allow approved commercial banks (both domestic and foreign) to conduct leasing operations in China. CBRC had banned commercial banks from such activity for about 10 years. Other banks have been quick to follow with plans to establish their own leasing companies, such as *ICBC*, *China Merchants Bank* and *China Minsheng Banking Corp.* *Bank of Communications* has already established a financial leasing company, with US\$275 million in registered capital, which focuses on equipment leasing (aircraft, ships, construction machinery).

The CCB/BoA JV will focus in leasing equipment and facilities to China's power generation & transmission and rail industries, as well as airplanes and ships. Eventually the JV will also extend and obtain loans, sell leased items, and engage in consulting services. Incidentally, Bank of America owns about 9% of CCB, having purchased the stake in 2005.

China's leasing sector is extremely attractive to major international financial groups. China will need a vast quantity of equipment, much of it in the sectors mentioned above, to help drive its continued growth. Additionally, there is almost endless room for leasing enterprises to penetrate the market. Compared with developed countries, only a tiny fraction of equipment in China is leased instead of purchased.

## **Macro**

### **Mainland Now World's Fourth-Largest Equity Market**

The Chinese stock market is officially the world's fourth-largest equity market, only behind the United States, Japan, and the UK. Fueled by a surging prices and a slew of large IPOs, the combined market capitalization of the Shanghai and Shenzhen Stock Exchanges reached RMB32.44 trillion (about US\$4.5 trillion) at the end of 2007. That represented a 3.7x increase over the combined market cap at the end of 2006, which stood at a comparatively small RMB8.87 trillion. 126 new listings contributed RMB11.25 trillion of the RMB23.57 trillion increase in market cap. The 16 largest new listings, which include blue chips like PetroChina, China Construction Bank, and Shenhua Energy, contributed the vast majority of that figure (RMB10.49 trillion, or 93%). (China Knowledge)

### **China Finishes Year with World's Fourth-Largest GDP**

Germany held on to its spot as the world's third-largest economy at the end of 2007, staving off China for the time being. China wrapped up a year of breakneck growth, with GDP growing at an estimated 11.5%. Germany remained ahead of China partly due to the strength of the euro, which appreciated against the RMB by about 4% last year (in stark contrast to the dollar, which depreciated against the RMB by 5%). Germany's 2007 GDP is estimated at €2.38 trillion, which at the current exchange rate equates to RMB25.4 trillion (South China Morning Post). China's 2007 GDP is estimated at RMB23.4 trillion. Many experts believe that China is sure to move into the No. 3 spot in 2008, due in large part to a fast appreciating RMB and relatively high inflation (in addition, of course, to its high overall economic growth). December's consumer price index grew 6.6% over the same period in 2006 (Asia Pulse). Only a year ago, inflation stood at only about 2%. A sharp rise in food prices was the major cause for the mainland's high inflation in 2007 (about 4.7% for the entire year).

In 2005, China overtook France, Italy, and the UK to become the world's fourth-largest economy.

### **Gold Futures Begin Trading in Shanghai**

Soon after the start of the new year, gold futures made their debut on the Shanghai Futures Exchange (SFE). The event is another step in the maturing of China's financial markets. A developed medium for trading futures is essential for the efficiency of any financial market, as futures give companies effective hedging tools. Wang Chiwei, the CEO of major Chinese metals producer Jiangxi Copper, echoed those sentiments, saying, "As a company operating gold processing business, Jiangxi Copper needs a hedging tool to avoid risks resulting from price swings to ensure steady profits" (China Daily). Many hope the launch of gold futures will serve as segue into the launch of stock index futures. Due to numerous concerns, CSRC has continually delayed the introduction of stock index futures. One such concern is that stock index futures could destabilize the recently shaky domestic A-share markets, as an influx of "shorting" the market might rattle investors. Currently, no "shorting" is allowed in the mainland stock markets.

Before the introduction of gold futures contracts, the SFE already included futures contracts for other commodities like copper, zinc, aluminum, copper, natural rubber, and fuel oil.

# Deals in China

## M&A Activity

Acquirer	Description	Target	Description	Amount	Deal details
WuXi PharmaTech	NYSE-listed, China's leading provider of pharmaceutical testing services	AppTec Lab Services	St. Paul-based provider of testing for drugs and medical devices	US\$151 Mil	100% stake
Spreadtrum	Nasdaq-listed, Chinese fabless IC company	Quorum Systems	San Diego-based fabless chip company	up to US\$76 Mil	100% stake
Morgan Stanley	global financial services group	Kebao & Boloni	Chinese furniture and interior decorations company	RMB 140 Mil	10% stake
Jinchuan Group	China's largest nickel producer	Tyler Resources	Canadian mineral resources exploration company	approx. US\$210 Mil	100% stake
SAIF Partners	Asian venture capital fund	Shanghai Foxtown Industry	operates chain of discount stores	US\$40 Mil	22-28% stake
Carlyle Group	Washington, DC-based private equity giant	DIO F&B Group	Chinese foodservice restaurant chain	US\$21 Mil	20% stake
Jollibee	Philippines-based fast food restaurant operator	Hongzhuang-yuan	Beijing-based instant porridge chain	US\$50.5 Mil	controlling stake

# Deals in China

## IPO Pipeline

Company	Description	Exchange	Size	Financial Advisors
China Coal Energy	HK-listed, China's second-largest coal producer by revenue	Shanghai	US\$4-5 Bil	China International Capital Corp
ATA Inc	Beijing-based testing and education software provider	Nasdaq	US\$100 Mil	Merrill Lynch, Piper Jaffray
Maoye International Holdings	Shenzhen-based department store chain	Hong Kong	US\$905 Mil	BNP Paribas

### **Large Artificial Island Community Planned Off Coast of Shanghai**

It sounds like a project in Dubai. We recently learned that Shanghai will reportedly build an artificial island just south of the city in the Hangzhou Bay. News sources quoted an official with the Shanghai Municipal Ocean Bureau as saying the island would be a "sustainable community by the sea" that will house up to 80,000 people. The 700,000 square foot island will be built from construction waste, and will be in the shape of a magnolia, Shanghai's city tree. The island will get its electricity from wind and wave power generators, and its drinking water from desalination technology.

A Shanghai developer has supposedly just purchased one of the islands in Dubai for US\$28 million. The developer will even build a river through the island to resemble the Huangpu River (which runs through downtown Shanghai), and will build three bridges across the artificial river to resemble three of the actual bridges that traverse the Huangpu. (South China Morning Post). We wonder if the artificial island's faux Huangpu will be cleaner than the original.