

Eye on China

A View from Shanghai

Week of July 14-July 20, 2007

Merchant Banking Advisory In China for Over Twenty Five Years

ChinaVest

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Market Weekly

Shanghai Composite Index

- 7/13 Close: **3,914.40**
- 7/20 Close: **4,058.85**
- Weekly Change: **↑ 3.609%**
- Since 1/1/07: **↑ 51.706%**

Shenzhen Composite Index

- 7/13 Close: **12,816.42**
- 7/20 Close: **13,417.96**
- Weekly Change: **↑ 4.694%**
- Since 1/1/07: **↑ 101.86%**

Exchange Rate

- 7/13: US\$1 = **RMB 7.576**
- 7/20: US\$1 = **RMB 7.573**
- Weekly Change: **↑ 0.040%**
- Since 1/1/07: **↑ 3.128%**

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- 2) Fosun Lists in Hong Kong, Falls Short of Lofty Expectations
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- Consumption on Pace to Reach Highest Growth Since 1997
- Flow of Money Into Domestic Bourses Slows; Liquidity Still High
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Random Tidbits

Automobiles

1) Toyota's China Sales Up 77% in First Half

Toyota's auto sales in China for the first half of the year rose to 212,000, 77% more than the same period last year. The Japanese automaker has said that it wants to sell 450,000 cars in China this year. During the first half of the year, the "Camry" model was the fourth best-selling car model on the mainland. Toyota makes its cars on the mainland through joint ventures with *First Auto Works* (FAW—one of China's top three automakers) and *Guangzhou Automotive*. Overall, the Chinese purchased 3.08 million passenger cars in the first half of 2007, up 25.9% over the first half of 2006.

Diversified

2) Fosun Lists in Hong Kong, Falls Short of Lofty Expectations

Shanghai-based conglomerate *Fosun International* (current market cap: HK\$69.75 billion) listed on the Hong Kong Stock Exchange on July 16, raising US\$1.5 billion. The highly anticipated IPO, which was one of Hong Kong's most popular in terms of investor subscriptions, underperformed the expectations of many. Experts thought Fosun's share price would surge as much as 40% above the IPO price. It only finished the first trading day up 12%, but did finish the week up 21%. However, as can be the case in Greater China, the hype was probably overdone. At its current 21% premium to the IPO price, Fosun International is still trading at a lofty PE multiple of 50x, well above that of other major global and China-centric conglomerates. Fosun is China's largest non-state-owned conglomerate, and its business scope covers steel, mining, real estate, pharmaceuticals, financial services, and retail. In some of its operations, Fosun resembles a major private equity group. First, it acquires businesses, often using leveraged financing. Then it looks to exit some of its investments through IPOs to make a profit.

July 16 saw another Hong Kong IPO by a Chinese company, when supermarket and hypermarket operator *Times Ltd* (market cap: HK\$3.88 billion) listed in a US\$113 million offering. It had a solid first week, with its share price closing on Friday, July 20, at a 10.3% premium to the IPO price. All of the recent IPOs by Chinese retail and consumer companies speak to the explosive growth of consumption on the mainland.

3) Twenty-Two Chinese Companies Make Fortune Global 500 List

Fortune Magazine just released its Fortune Global 500 list for 2007. This year's edition features 22 mainland companies, with petroleum giants *Sinopec* (#17 on the list; 2006 revenues of US\$131.6 billion) and *China National Petroleum Corp* (parent of *PetroChina*; #24; 2006 revenues of US\$110.5 billion) leading the way. In 2006, only 19 Chinese companies made the list. The new arrivals this year are mining group *China Minmetals* (#435), the mainland's third-largest oil producer *CNOOC* (#469), and major Chinese shipping conglomerate *COSCO* (#488). No Chinese companies fell off the list.

Energy

4) China's Second-Largest Coal Producer to List in Shanghai

Hong Kong-listed *China Coal Energy* (market cap: HK\$62.5 billion), China's second-largest coal producer, announced that it would soon list on the Shanghai Stock Exchange. Based on its Hong Kong stock price, the issue of 1.525 billion A-shares in Shanghai could raise up to US\$3 billion. The company will use most of the proceeds from the IPO to invest in coal, methanol, coke, and power projects around China. Shareholders will vote on the listing plan September 7. China's largest coal producer, *China Shenhua Energy* (Hong Kong-listed, market cap: HK\$109.1 billion) will also list in Shanghai in an upcoming RMB40-50 billion (US\$5.3-6.6 billion) listing. With energy consumption rising fast on the mainland, the timing seems optimal for China's coal companies to list on the domestic stock markets. China relies on coal for about 70% of its energy. China Coal Energy and Shenhua Energy will join a host of other companies planning multi-billion-dollar IPOs in Shanghai this year, including *China Mobile*, *PetroChina*, *China Construction Bank*, *China Netcom*, and others.

Diversified

5) Government to Set Aside RMB100 Million Fund for Tech Investment

The Chinese government will establish a RMB100 million venture capital fund to invest in technology-based small- and medium-sized enterprises (SMEs). However, the fund will also put money in VC firms that invest in technology companies, instead of investing directly in the tech companies themselves. The *Ministry of Finance* and *Ministry of Science and Technology* will jointly administer the fund. Due to risk concerns, banks and some investment firms often steer clear of very early-stage technology companies. In an attempt to further assist the technology sector, in February of this year, the government enacted a tax rebate system for venture capital tech investors. Dating back to 1999, the government has invested RMB4 billion in mainland tech companies.

Internet

6) VCs Invest US\$19 Million in Chinese Video Sharing Website

Chinese online video sharing website *Tudou.com* formally announced that it just secured its third round of funding. *Capital Today* and General Catalyst Partners led the US\$19 million round of financing, which *Tudou.com* will use to fund its new advertising platform. "As our audience in China continues to grow and spend more time on *Tudou*, there will be tremendous potential for advertisers to increase brand awareness with a large absorbed Chinese audience," said Gary Wang, founder and CEO of *Tudou* (ChinaTechNews.com). *Capital Today* is a Shanghai-based VC group that invests in companies positioned to take advantage of rising Chinese consumerism. General Catalyst Partners is a venture capital firm based in Cambridge, MA, which invests in technology companies. Other VC groups which already held stakes in *Tudou.com* also took part in this round of financing. According to a recent report by the Data Center of the China Internet, *Tudou.com* is China's second most popular video sharing site (#1 is *youku.com*).

Internet/Telecommunications

7) IDG Invests in Online Movie Company

International Data Group (IDG) invested US\$20 million in *Beijing Netmovie*. *Netmovie* runs three online movie channels: one is an online broadband movie channel, one is an internet cafe channel, and one is a mobile phone channel. It legally purchases movies from the producers and shows them to customers for RMB2-3 (less than US\$0.40). Apparently the internet cafe channel has proven to be the most successful, generating revenues of RMB10 million (US\$1.3 million) per month. *Beijing Netmovie* claims to have over 10,000 movies in its library.

Online Games

8) Chinese Software Company to List Online Games Unit on Nasdaq

Nasdaq-listed Chinese software company *CDC Corp* (market cap: US\$1.08 billion) plans to separately list *CDC Games*, its online games unit. The group would like to raise US\$200 million in the IPO. CDC said it wants to differentiate its games unit from the rest of the company. The listing is expected to take place in the fourth quarter of this year. CDC Corp also reportedly purchased *OPTIC*, a publisher of online games in China with 43 million registered users. Last week we reported that Chinese online game developer and operator *Perfect World* plans to raise US\$165 million in an upcoming Nasdaq IPO. Three Chinese online game companies are already listed on Nasdaq: *Shanda* (market cap: US\$2.3 billion), *NetEase* (market cap: US\$2.26 billion), and *The9* (market cap: US\$1.26 billion).

Advertising

9) Shanghai-Based Advertising Firm Receives VC Investment

Beijing Youth Daily recently reported that Shanghai-based advertising firm *Digital Advertising Channels (DAC)* recently received US\$35 in venture capital financing. Investors included AsiaVest Partners, Seven Network, and IDG Technology Venture Investment. DAC operates TV advertisements on 330 Chinese college campuses and runs advertisements in 14 Chinese airports. China-based IDG Technology Venture Investment is a return investor—it previously invested in DAC's campus TV advertising services in 2004 and 2005.

Air Travel

10) Singapore Airport Joins with Shenzhen Airport in Investment JV

The operator of Singapore's Changi International Airport (Changi Airports International—CAI) formed a joint venture with China's *Shenzhen Airport Group* that will invest in regional airports on the mainland. The JV is CAI's first strategic partnership, and is Shenzhen Airport's first tie-up with a foreign entity. Shenzhen Airport will own 51% of the JV, while CAI will take a 49% stake. The JV will look to invest in promising medium-sized airports in China and take part in their management to optimize growth potential. Additionally, CAI CEO Chow Kok Fong said he may want to open some flights between Changi and some of China's medium-sized airports (none currently exist). Shenzhen Airport is China's fourth-largest airport (located just across the border from Hong Kong), and is ranked 34th in the world in international air cargo transport. Changi Airport is the world's 22nd-busiest in terms of passenger traffic. CAI has recently been investing in airports around Asia, including eastern China's Nanjing Lukou International. The deal also highlights Singapore's interest in China's booming aviation industry. About a month ago, Singapore Airlines and Temasek Holdings (a Singapore government investment fund) agreed to purchase a 25% stake in Shanghai-based *China Eastern Airlines* (China's third-largest airline) for US\$930 million. Singapore Airlines, which is 56%-owned by Temasek, and CAI are both controlled by Singapore government entities.

Banking

11) Local Banks Become First Chinese City Commercial Banks to List

Bank of Nanjing and *Bank of Ningbo* became the first two Chinese city commercial banks to go public on July 19, raising a combined US\$1.46 billion in their A-share IPOs. As is the case with many listings on mainland exchanges, eager investors drove stock prices through the roof. Bank of Nanjing, which raised RMB6.93 billion in its Shanghai IPO, saw its stock finish the week 80.6% above the IPO price. Bank of Ningbo, which raised RMB4.14 billion in its listing on the Shenzhen Stock Exchange, had an ever better first two days. Its shares closed on Friday up 2.65x over the IPO price. According to Bloomberg, Bank of Ningbo's listing was the largest in Shenzhen since Bloomberg has kept track of that statistic (beginning in 1999). Nanjing is the capital city of Jiangsu province, and is located about four hours west of Shanghai on the Yangtze River. Ningbo is a large port city in Zhejiang province, located across the Hangzhou Bay south of Shanghai.

City commercial banks in China generally only operate within their home city. They've been introducing foreign strategic investors to add capital and management expertise so they can expand into other areas and achieve economies of scale. Bank of Nanjing's foreign strategic investors are BNP Paribas and the International Finance Corporation (IFC—the World Bank's private sector investment arm). Bank of Ningbo's foreign investor is Singapore's Oversea-Chinese Banking Corp. Numerous other city commercial banks will follow their lead and raise money in the stock markets in the near future. *Bank of Beijing* and *Bank of Shanghai* are expected to stage dual listings in Hong Kong and Shanghai. *Bank of Dalian* (a northeastern Chinese coastal city) and *Bank of Chongqing* (a major city in southwest China) will issue A-shares in Shanghai.

Financial Services

12) IFC to Form JV with State-Owned Asset Management Company

The 21st Century Business Herald reports that the International Finance Corporation will establish a joint venture with *China Cinda Asset Management Corp*, one of China's four state-owned asset management companies. The JV will be capitalized at US\$300-400 million, with IFC holding a 14% stake. GE Commercial Finance will also hold a stake in the venture. The four state-owned asset management companies were set up in 1999 to take on and dispose of RMB1.4 trillion of bad debts from the country's largest state-owned banks. The asset management companies have successfully reached targets for disposing of the loans, and now look to become more diverse financial institutions. IFC also owns a 14% stake in a joint venture with *Huarong Asset Management*, another one of the four state-owned asset management companies (Deutsche Bank and AIG hold a joint 35% stake in that JV). The foreign investment and expertise will help the asset management companies branch out into other areas, such as investment banking.

Insurance

13) China Life to Acquire Trust Company for RMB3.6 Billion

China Life, China's largest life insurer, will buy a 60% stake in *China Credit Trust (CCT)* for RMB3.6 billion (US\$475 million). CCT is a leading Chinese trust company, and its operations include securities brokerage, fund management, annuities, and futures. The acquisition would expand China Life's scope of financial services accordingly. Chinese insurance institutions are seeking to become more well-rounded, one-stop financial services groups. They also seek higher investment returns for their holdings, and China is about to allow mainland-based insurers to invest in overseas stocks. The government also recently doubled the amount insurers could invest in the domestic bourses. From the standpoint of the trust companies, China wants to restructure the trust industry, and wants to encourage investment by financial institutions to further that goal. Trust companies currently derive too much of their revenue from lending money, whereas they should engage in more traditional trust business, such as annuities and other financial offerings.

Infrastructure

14) China to Spend RMB620 Billion on Metrorails Over Next 10 Years

China's Ministry of Construction said the country will spend RMB620 billion (US\$82 billion) over the next 10 years to build subways and light rails to ease congestion in Chinese cities. The massive undertaking will add 1,700 kilometers (about 1,050 miles) of subway and light rail in 15 Chinese cities. The initiative will nearly quadruple the length of China's urban railways, which currently stands at 602 km (about 370 miles). By 2020, Beijing's subway is expected to surpass London's to become the world's largest with 561 kilometers of track (about 345 miles).

Other Financial

15) Head of Goldman Sachs' Mainland Ops Wants to Establish PE Fund

Fang Fenglei, the head of Goldman Sachs' investment banking joint venture in China, wants to set up a RMB6 billion (US\$790 million) Renminbi-denominated private equity fund, according to the *Shanghai Daily*. The newspaper said Fang hopes to establish an independently run fund, but would have no plans to step down as the head of *Goldman Sachs Gao Hua Securities*. Renminbi-denominated PE funds are a relatively new instrument. The first one, called the *Bohai Industry Investment Fund*, was established last year to invest in companies in the city of Tianjin's Binhai New Area (a special economic zone). The RMB6 billion fund is managed by *Bank of China International*. Renminbi-denominated funds have good potential, as they tap into the significant amount of mainland money available for investment. Additionally, the government has made it more difficult for foreign funds to acquire stakes in large state-owned enterprises (SOEs). Domestic funds can have greater flexibility in their investment options, especially since much of the investment in the funds comes from SOEs. However, Vincent Chan of HK-based venture capital firm JAFCO Asia says Fang won't want too much investment to come from the SOEs. "The key question is whether he can diversify his funding, as most domestic funds are raised from the SOEs, which isn't ideal" said Chan. Fang would have to gain regulatory approval to go forward with his private equity fund.

Real Estate

16) Sinochem to List Real Estate Arm in US\$500 Million HK IPO

As early as next month, another large Chinese property developer could list in Hong Kong. *Franshion Properties*, which is wholly-owned by major Chinese SOE *Sinochem*, plans to raise up to US\$500 million in the offering. Sinochem is one of China's 15 largest firms, with 2006 revenues of US\$23.1 billion. Franshion develops medium- and high-end residential and office properties. The listing represents a change of heart for Sinochem, which recently wanted to list *Jinmao Group* instead, which is its other real estate arm (Sinochem owns 54% of Jinmao Group). Current plans include listing Franshion and injecting Jinmao Group's flagship asset, "Jin Mao Tower," into Franshion shortly after Franshion goes public. Jin Mao Tower is an office building and hotel in Shanghai, and is the world's fourth-tallest building. However, complications arose because *COFCO* owns 22% of Jinmao Group and won't allow Sinochem to transfer Jin Mao Tower out of Jinmao Group.

Macro

Second Quarter GDP Growth Hits 12-Year High

China's second-quarter GDP growth surged to a 12-year high of 11.9%, outstripping the 11.1% growth in the first quarter. Some of the rise can be traced to the first half of 2007's 85% increase in the trade surplus, which reached US\$113 billion at the end of June. The huge surplus was due in part to a mad rush to export as many goods as possible before July 1, when the Chinese government reduced or eliminated export VAT rebates on thousands of goods (we described this in the June 22 newsletter). Inflation is also a significant contributor to the second quarter GDP jump. Rising mainly on the back of food prices, inflation in June hit 4.4%, up from 3.4% in May. As recently as November 2006, inflation stood at only 1.9%. Foreign investment into China also rose significantly in the first half, and consumption by the Chinese is strong and continuing to grow.

We can expect Beijing to enact certain measures in the second half of 2007 that will aim to cool the economy. Experts predict two more interest rate hikes this year, as well as the reduction or elimination of the 20% tax on earnings from savings account interest. The government hopes these measures will encourage people to keep money in the bank instead of putting it the overvalued stock markets. Already this year, the *People's Bank of China (PBOC)*, the country's central bank, has tried to control liquidity by raising interest rates twice and raising the deposit reserve ratio for banks five times. These and other measures have done little to nothing to cool the economy. Interestingly enough, at the beginning of the year the government set a goal to keep GDP growth under 10%. Last year, GDP grew at 11.1%.

Consumption on Pace to Reach Highest Growth Since 1997

According to a report by the State Information Center, consumer retail sales are expected to grow by 15.8% this year, which would constitute the highest consumption growth rate since 1997. Although inflation due to rising food prices has pushed consumption up, the rising incomes and consumption appetites of urban residents is also a major factor. In fact, the report stated that real consumption growth (discounting inflation) is expected to hit 12.8%, which is higher than last year. It's amazing that consumption in China can continue to grow at such high rates year after year. Using real rates and not including inflation, at 12.8% annual growth, a Chinese citizen consumes more than twice as much as he did only 6 years before and 3.3x as much as 10 years before. Interestingly, the report said that 3-5% inflation is acceptable considering the high consumption and GDP growth rates. This notion is contrary to the sentiments of PBOC, which desires to keep inflation under 3%.

Macro

Flow of Money Into Domestic Bourses Slows; Liquidity Still High

The flood of new investors into the domestic stock markets has slowed down significantly in June and July. On July 2, the Chinese opened *less* than 100,000 new trading accounts for the first time since March 12. For the rest of July, that number has continued to fall. Some of the fervor to get into the markets has dwindled, as they have been volatile the past two months and haven't consistently surged upward as they had earlier in the year (the Shanghai Composite Index is trading at about the same level as two months ago). The market's modest performance is due to a few factors, including increased taxes on trades ("stamp tax"), anticipation of further government measures to reduce liquidity, and inflation worries. In April and May, Chinese citizens were opening an incredible 350,000 new trading accounts a day.

However, there's still ample liquidity in the market. This is evidenced by investors' behavior in some of the recent domestic IPOs. Investors sometimes subscribe trillions of RMB to these listings, all hoping to get a piece. When they don't get shares in the IPO, they can't wait to buy them on the open market soon after the listing. (When investors subscribe to IPOs in large amounts, it temporarily soaks up liquidity, as all of the subscription money is frozen in bank accounts. But since only a small percentage of those who subscribe to the IPOs actually get shares, everyone else's money is returned. Many of those investors then go into the open market and buy the new shares, driving the price up.) Investors sent *Western Mining's* share price up 2.5x soon after it began trading earlier this month. We already discussed the successes of Bank of Ningbo (listed in Shenzhen) and Bank of Nanjing (listed in Shanghai).

Although over 10 multi-billion-dollar IPOs are expected in Shanghai later this year, it may not have a major effect on liquidity. Considering that the combined market cap of the Chinese stock markets is well over US\$1.5 trillion, the overall demand for A-shares should continue to outweigh supply for the foreseeable future (Chinese citizens still cannot directly invest their money in foreign markets).

Macro

First Issue of Renminbi Bonds in Hong Kong a Success

Earlier this month, the *China Development Bank* (a policy bank) announced that the issuance of Hong Kong's first Renminbi bonds was a success. CDB issued RMB5 billion worth of bonds, and said investors showed solid interest, as it received about RMB14 billion worth of subscriptions. Half of the RMB5 billion of bonds were allocated to retail investors and half to institutional investors; incidentally both pools of investors subscribed to about RMB7 billion worth of the bonds. "The encouraging subscription result of CDB's Renminbi bonds highlights the strong demand of investors in Hong Kong for Renminbi-denominated investment instruments, including high-quality Renminbi bonds," said Joseph Yam, chief executive of the Hong Kong Monetary Authority. China will use the proceeds from the bond offering to fund infrastructure projects on the mainland.

Chinese regulators just last month outlined the process for mainland commercial banks and policy banks to issue Renminbi bonds in Hong Kong. Investors and residents of Hong Kong certainly like getting their hands on RMB—they have about RMB26 billion in RMB bank deposits. Their demand for the new bonds and RMB deposits comes as no surprise, considering the continued appreciation of the yuan against the Hong Kong dollar and most other currencies. In the wake of CDB's successful issue, China's central government just gave the *China Export-Import Bank* (another policy bank) approval to issue RMB2 billion worth of Renminbi bonds in Hong Kong. Commercial banks China Construction Bank and Bank of China are also considering a similar issuance.

Deals in China

M&A Activity

Acquirer	Description	Target	Description	Amount	Deal details
China Life	China's largest life insurer	China Credit Trust	one of China's leading trust companies	RMB 3.6 Bil	60% stake
Guizhou Aviation Industry Corp	subsidiary of China's largest aircraft manufacturer, state-owned AVIC I	Dongfang Machine Tool	one of China's six largest heavy machine tool manufacturers	N/A	100% stake
CDC Games	online games unit of Chinese software company and web portal operator CDC Corp	OPTIC	online game publishing arm of conglomerate CITIC Pacific	N/A	controlling stake

Deals in China

IPO Pipeline

Company	Description	Exchange	Size	Financial Advisors
China Coal Energy	China's second-largest coal producer, HK-listed	Shanghai	up to US\$3 Bil	N/A
Tiangong International	Chinese steel manufacturer	Hong Kong	HK\$827 Mil	N/A
Franshion Properties	real estate arm of Sinochem, develops mid- to high-end residential and office properties	Hong Kong	US\$500 Mil	Deutsche Bank, DBS Vickers
CDC Games	online games unit of Nasdaq-listed Chinese software company and web portal operator CDC Corp	Nasdaq	US\$200 Mil	N/A
Yong Xin International	Chinese manufacturer of high-precision stainless steel strips for steel cables	Singapore	US\$11.9 Mil	N/A
China Reinsurance	only mainland-based reinsurance group	Hong Kong and Shanghai	US\$2.6 Bil (planned for later in 2007)	N/A

Family Planning Commission Revised One-Child Policy

China's *Population and Family Planning Commission* recently made a major revision to the one-child policy, and will allow parents that are both only children to have up to two kids. This is the first such revision since the one-child policy's implementation in 1979. The one-child policy has always permitted many rural families to have two children. When having too many children, Chinese citizens are subject to strict fines, often well in excess of their annual incomes.