

Eye on China

A View from Shanghai

Merchant Banking Advisory In China for Over Twenty Five Years

ChinaVest

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Market Weekly

Shanghai Composite Index

- 7/11 Close: **2,856.63**
- 7/25 Close: **2,865.10**
- Change: **↑ 0.297%**
- Since 1/1/08: **↓ 45.547%**

Shenzhen Composite Index

- 7/11 Close: **10,031.38**
- 7/25 Close: **9,923.16**
- Change: **↓ 1.078%**
- Since 1/1/08: **↓ 44.427%**

Exchange Rate

- 7/11: US\$1 = **RMB 6.855**
- 7/25: US\$1 = **RMB 6.839**
- Change: **↑ 0.233%**
- Since 1/1/08: **↑ 6.496%**

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Agriculture

1) Tyson Foods Buys China Poultry Operations

Tyson Foods has announced its decision to purchase a stake in Chinese poultry processor, the *Xinchang Group*. The deal gives Tyson 60% ownership in the country's 5th largest poultry producer. The agreement comes as Tyson continues construction on a plant outside Shanghai that will process and package chicken meat from 40 million chickens per year. Xinchang, located in Shandong province, has a processing capacity of 125 million chickens per year, with sales of US\$289 million in 2007. Upon completion of the deal, Tyson plans to focus funds on efforts to eventually double the company's current capacity.

China's meat industry is expected to see strong growth as an increase in refrigerator use among the growing urban population, as well as changing consumption patterns amongst Chinese consumers, continues to drive demand. China is currently the second largest producer of chicken, accounting for 17% of the world's production.

This is Tyson's second investment in China; earlier this year the company purchased a 70% stake in *Jiangsu Jinghai Poultry Industry Group Co.*, a chicken breeding company. The Xinchang deal still waits due diligence and government approval. Financial terms have yet to be disclosed.

Construction

2) Carlyle – Xugong Deal Expires

The *Carlyle Group's* highly publicized effort to acquire a stake in *Xugong Heavy Machinery* ended when its three-year contract to acquire the company expired last week. Carlyle first began negotiating with Xugong in 2005, with an offer to purchase an 85% stake. Faced with heavy opposition from a major national competitor, as well as from the Beijing regulators, the transaction never progressed. In 2007, the deal was renegotiated from a purchase of 85% of the firm to 45%. However that was still not enough to gain regulatory approval. Meanwhile, despite the uncertainty regarding Carlyle, Xugong continued to grow. Assuming Carlyle could have gotten regulatory approval, based on the company's recent performance (2007 revenues of US\$5.83 billion), the PE firm would have had to double its initial offer to US\$400 million in order to acquire a 45% stake (AVJC).

This deal illustrates many of the complexities involved when foreign PE firms invest in China. Even an experienced firm like Carlyle (over US\$1.3 billion in 30 China-related investments in the past two years alone) can find it difficult to navigate through the regulatory environment. In this instance, Xugong, which operates in an industry that has been marked "sensitive" to foreign investment, underwent more scrutiny with regulators than in typical cases. For investments involving a sensitive industry, approval is needed from over 10 authorities, at a national and provincial level. While the Xugong transaction passed through local government regulators, it was held up at the national level.

3) Merrill Lynch Invests China Cement Company

Merrill Lynch has agreed to invest US\$50 million for a 46% stake in *Ziping Cement*. *Ziping* is located in Wenchuan City, Sichuan Province, the epicenter of the devastating earthquake that struck China this past May. The investment will help increase *Ziping's* production capacity from 1 million tons to 3 million tons.

Demand for certain industries in affected regions has boomed since the earthquake, especially in industries that are vital for reconstructing. Many areas in Sichuan Province and surrounding areas are currently the focus of a rapid rebuilding effort, and are in urgent need of infrastructure. As a result, we foresee that industries such as infrastructure and construction, particularly cement, will continue to benefit from a large influx of capital into the region.

Energy

4) GCL Silicon Technology Files for US Listing

GCL Silicon has announced plans for an upcoming IPO on the NYSE, for which the company aims to raise between US\$750 million and US\$862 million. Funds will mainly be used to increase capacity over the next few years. The company plans to increase its production of polysilicon (a main component in solar technology) to 13,500 tons by 2010, and to 24,000 by 2011. Current capacity allowed the company to produce only 1,500 tons in the first three months of this year. The company will also build a new wafer production plant in order to reduce current costs of purchasing the wafers from third party suppliers. Wafer production is the final step in the value chain before the actual production of solar cells.

GCL Silicon, founded in 2006, is headquartered in Hong Kong. The company provides components for the manufacturing of solar equipment and is currently China's largest supplier of polysilicon, ranking among the top 5 worldwide.

In related news, *ET Solar Group* has received US\$31 million in PE funding from various investors. It is the company's second round of financing and will be used for expansion, as well as investment in alternative energy sources. *ET Solar* is a solar manufacturer specializing in ingot, wafer and module production

5) Wuhan General Approved for NASDAQ Listing

Wuhan General Group, manufacturers of industrial blowers and turbines, has announced its approval for listing on NASDAQ. Shares began trading on July 18th under the ticker WUHN. Prior to the listing, the company was previously traded on the OTC Bulletin Board (OTCBB). The move will help increase *Wuhan's* visibility and liquidity as well as increase the efficiency and cost-effective trading execution for investors.

Wuhan had revenues of US\$95 million in 2007.

Information Technology

6) China TransInfo Receives US\$15 Million Investment from SAIF

Asian PE/VC group, *SAIF Partners*, has invested US\$15 million in *China TransInfo Technology*, an OTCBB-listed company that provides traffic information products and a transportation media platform in China. With the investment, SAIF will receive a 13.2% stake.

Xinhua Finance News reports that TransInfo is anticipating revenues of US\$33 million and net income of US\$11 million for the full year 2008. The company is expected to move to the NASDAQ in the near future.

Diversified

7) Legend Capital Unveils US\$400 Million TMT-Focused PE Fund

Legend Capital, a well-known domestic private equity group, recently raised a new US\$400 million China private equity fund. Legend Capital is the investment arm of the Legend Group (the parent company of China's Lenovo--the world's fourth-largest PC producer). Legend Group invested US\$160 million of the US\$400 million total, while the rest was raised from a series of other LPs. "[Legend Capital] completed the fund-raising for the new fund with no difficulties as [their] limited partners' interest in investing in China is still quite great," said Chen Hao, the company's managing director. Up to 70% of the fund will be invested in technology, media and telecom (TMT) companies, while the remaining 30% will be invested in the consumer sector.

The fund is Legend Capital's fourth and largest fund; the previous three totaled about US\$400 million. The group is also in discussions with Chinese investors to establish a new RMB-denominated PE fund.

Looking Local: More Shanghai Netizens Shop Online

China's growing population of netizens has hit the news again recently, this time not for their provocative blogging, but rather their spending habits. According to a report released by the China Internet Network Information Center, the country's online shopping market has seen exponential growth over the past several years, driven by China's rapid pace of urbanization and the rising spending power of urban elites. Online shopping expenditures in big cities in China totaled RMB16.2 billion in the first half of 2008 alone. China's online shoppers make up 49.9% of the total online shopping population in the region, with more than 40% of these shoppers making an online purchase at least once a month.

Of the 19 cities surveyed, Shanghai topped the charts, with per-capita online spending of RMB1,107. Perhaps driven by online video gaming, male online spending was a bit higher than female spending (RMB8.4 billion vs. RMB7.8 billion).

Despite reports from 20% of buyers citing problems with their orders, it seems China's determined netizens are continuing to purchase goods online. With an expected 480 million online shoppers spending \$1.4 trillion by 2010, China is already primed to replace Japan as the largest online shopping market in the Asia Pacific.

These statistics are particularly interesting considering the large number of analysts who have predicted that e-commerce will not work in China. Citing China's high nationwide savings rates and minute levels of credit card ownership (currently <1% penetration), it is easy to cast doubts about the future of online purchasing. The figures above, however, are proving the pundits wrong.

ChinaVest will continue to watch the numbers, and provide updates on this market as changes continue to occur.

Real Estate

8) CapitaLand Sets Up US\$1 Billion China PE Fund

In recent news, there has been a steady stream of activity in China's property sector. *CapitaLand Ltd.*, Southeast Asia's biggest developer by sales, announced two weeks ago that it has established a US\$1 billion private equity fund, named Raffles City China Fund, to invest in prime mixed-use commercial properties in key gateway cities in China.

CapitaLand, a Singapore-based firm that owns more than 70 malls and develops homes in cities such as Shanghai and Beijing, made close to 30% of its revenue last year in China, up from 20% in 2006. The company said it plans to inject four of its commercial properties, including Raffles City Shanghai, Raffles City Beijing, Raffles City Chengdu and Raffles City Hangzhou, into the fund. The assets are valued at a total of US\$2 billion. As the fund's sponsor, the company said it has taken a 50% stake in Raffles City China, leaving the remaining stake to financial institutions and pension funds from Asia, Europe and North America.

Insurance

9) Two More Commercial Banks Approved to Sell Insurance Policies

The *Bank of China* and *China Minsheng Banking Corp.* have been given the go-ahead by the China Insurance Regulatory Commission (CIRC) to sell insurance. The two commercial banks join *Industrial and Commercial Bank of China*, *China Construction Bank*, *Hangseng Bank* and *Bank of East Asia* on the list of banks providing insurance, a list we expect to continue to grow in the near future.

As the financial industry in China continues to mature, commercial banks are trying to diversify their sources of income. Insurance premiums through bank channels grew 153% in the first half of 2008, accounting for more than half of the total premiums from life insurance. The CIRC has warned banks against the instability that an unduly fast growing investment-oriented insurance sector might incur. The admonishments include the fact that this move may weaken the "pure-play" insurance companies, the presumption that banks do not have the expertise to know how to properly invest the pensioners' money, and the possible mass withdrawal of insurance funds.

Insurance premiums amounted to RMB561.79 billion (US\$80.3 billion) nationwide in the first half of this year. They grew 51% over the same period in 2007.

Banking

10) Citibank Gets Green Light for Mainland Debit Cards

Citigroup now offers plastic. On July 17, the bank won approval to issue Renminbi-denominated debit (ATM) cards to its PRC customers. It is the third foreign bank to gain such approval, after the Bank of East Asia and Standard Chartered Bank. China's largest bank card processor, China Unionpay, has partnered with Citibank to issue the cards.

As per capita incomes increase, plastic is increasingly important for China's banking industry and for the Chinese economy. According to China Unionpay, at the end of last year, 169 Chinese financial companies had issued 1.5 billion bank ATM cards, 740,000 merchants accepted payment with these cards, and the number of ATMs reached 120,000. China Unionpay is the nation's monopoly bank-card-transaction network provider, and competes with mainly Visa and Mastercard in the credit card domain. Compared to the ATM/debit card market, credit cards are a virtual non-entity in China. Current estimates peg total credit card issuance at around 90 million (i.e. less than 1% of the Chinese population). Currently, there are no foreign banks that issue RMB-denominated credit cards.

In related news, *Pinpoint Ltd.*, an Australian firm that is Asia-Pacific's leader in credit card loyalty rewards, recently entered the China market. The firm is currently meeting with financial and strategic partners in China. Bob Gilman, CEO of Pinpoint China, who moved to Shanghai to run the operation, is sanguine about the industry. "We have a 25 year track record in loyalty rewards programs," he states. "When you combine our experience with a local Chinese partner in an industry growing at almost triple digit rates, we are extremely enthusiastic about the possibilities."

11) CCB Joins Private Banking Sector

China Construction Bank (CCB) announced last week that it would bid for a share of the country's increasingly large and lucrative private banking (high net worth) service industry. The bank will offer its services to people with liquid financial assets above RMB10 million (US\$1.5 million), and will focus on the wealthy urban centers of China - Beijing, Shanghai, Guangdong Province and Shenzhen.

In March 2007, *Bank of China* became the first Chinese-funded bank to provide such services, targeting those with liquid financial assets above US\$1 million. This came on the heels of Citibank, Standard Chartered and other leading foreign-funded banks, who began offering these services a year or so earlier. The play is very attractive - China has the world's fifth largest number of households with more than US\$1 million dollars in liquid assets, trailing only the United States, Japan, Britain and Germany. Furthermore, Chinese household savings are approximately 40%.

China Merchants Bank, CITIC Bank, and the Industrial and Commercial Bank all have offered similar services since last year to capture a share of the lucrative private banking sector.

Macro

Growth Remains Strong in First Half, Exceeding 10%

Although it was down slightly from 2007, China's economy enjoyed significant first-half growth in 2008. H1 GDP growth registered 10.4% YoY, with Q2 GDP falling slightly to 10.1%, down from 10.6% in Q1. A number of economic indicators reflected the continuation of China's strong growth, including rebounding retail sales and higher-than-expected urban fixed-asset investment growth. As a sign of China's fast-growing consumerism, retail sales were up 23% in June over the same period last year, despite the country's languishing stock markets.

In light of the continued progress, we believe that PBOC will likely retain its attitude on economic tightening in the short term. We also expect the central bank to keep enforcing loan quotas and raising the required reserve ratio for banks (which is already at an all-time high of 17.5%).

In the medium-term, the economic slowdown may quicken, as China increasingly feels the effects of the malaise in the West, and PBOC continues its tightening strategy. A recent Lehman Brothers report predicts that GDP growth could fall to 8.7% in the second half of 2008, and could drop to 8% for the full year 2009. Most economists, however, predict a full-year GDP growth rate of between 9-10%--not the torrid 12% we witnessed in 2007, but healthy nonetheless.

Inflation Falls for Second Straight Month, But Relief May be Short-Lived

Mainland inflation registered 7.1% in June, down from 7.7% in May. CPI growth has now fallen for the second straight month, and is down from well over 8% earlier in the year, the highest level in more than a decade. The slightly lower inflation is primarily due to a flattening out in food prices. Extreme increases in food prices have been the chief cause of China's rampant inflation since the middle of last year.

The recent downward trend in inflation might not continue, however. At the end of June, Beijing raised oil and power prices (China subsidizes both, rather than allowing the prices to fluctuate with the market), which could cause inflation to rise. Bank of China research also points out that China could raise oil prices again in a few months. Earlier this year, PBOC set its full year 2008 inflation target at 4.8%, which appears difficult to achieve. More realistically, economists predict that full year inflation will probably range between 6.5% and 7%.

Regulations

Taiwan to Lift Restrictions on Corporate Investment into Mainland China

In the last issue of the newsletter, we reported that Taiwan will allow its mutual funds to invest more of their assets in mainland stocks. The move is part of the new Kuomintang (KMT) government's promise to expand business relations with mainland China in order to boost the economy.

The Taiwanese cabinet has now announced that it will introduce more measures to further that end. Taiwanese companies that meet certain size and performance criteria will no longer be subject to restrictions on investments in mainland China. Currently, almost 600 companies meet the criteria. Cheng Cheng-mont, a Citigroup analyst in Taipei, points out that the new measures will not only increase investment from Taiwan into the mainland, but will also encourage Taiwanese companies to bring more money back to Taiwan. That should boost the Taiwanese stock market, which is an important part of the KMT's plans to boost the economy. For smaller Taiwanese companies that do not meet the criteria, the rules will lift the mainland investment cap from 20-40% to 60%.

Additionally, the new measures will eliminate mainland investment restrictions on units of foreign companies operating in Taiwan. "Removing the cap on China investments by foreign companies' subsidiaries here will transform Taiwan into the gateway to investing in Asia and China for foreign multinationals," said the Taiwanese cabinet. (Wall Street Journal)

ChinaVest will continue to monitor the changing economic developments between China and Taiwan.

Deals in China

M&A Activity

Acquirer	Description	Target	Description	Amount	Deal details
BMP Sunstone Corporation	specialty pharmaceutical company with a focus on women's health and pediatrics	Zhangjiakou Shengda Pharmaceutical Co., Ltd	manufacturer of pediatric pharmaceuticals	RMB30 Mil.	75% stake
Rizhao Port Co. Ltd	Chinese cargo warehousing and transshipping services for bulk cargoes	Lanshan Wansheng	China based iron ore transporter	n/a	64% stake
Harbin Tech Full Electric Co. Ltd	Chinese linear motors and special electric motors manufacturer	Hengda Electric Motor	China-based rotary motor manufacturer and distributor	US\$55 Mil.	100% stake
Sinochem International Corporation	Chinese state-owned chemicals group	GMG Global Ltd.	Singapore-listed agricultural company	US\$198 Mil.	51% stake
Hana Bank	South Korea's No. 4 banking group	Bank of Jilin	Northern China-based bank	US\$327 Mil.	19.67% stake

Deals in China

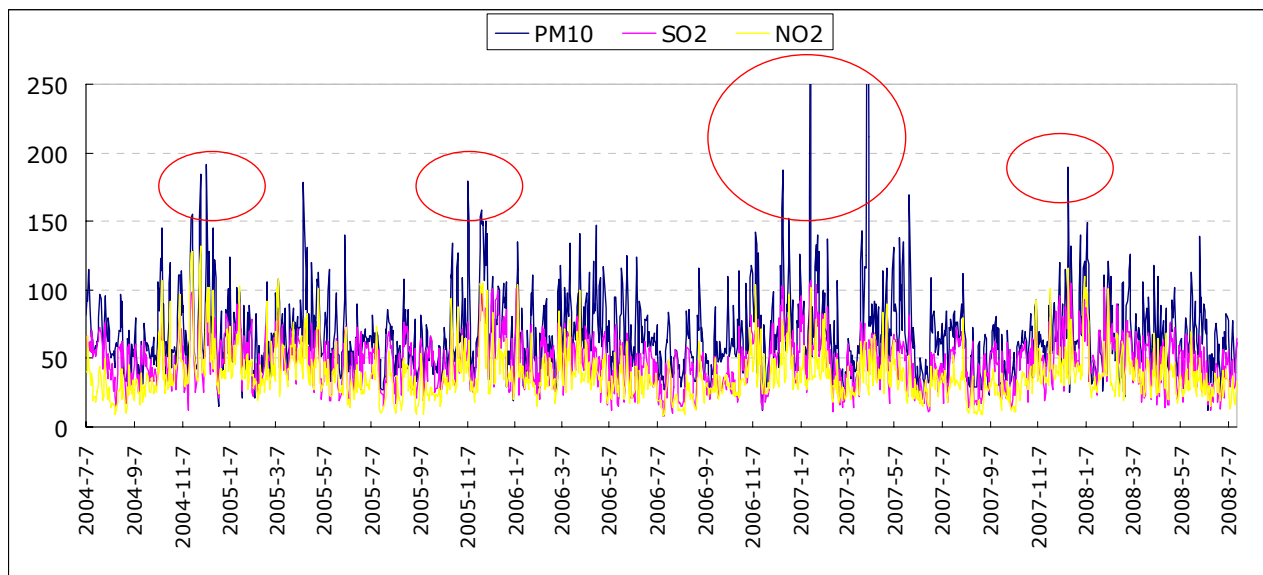
IPO Pipeline

Company	Description	Exchange	Size	Financial Advisors
China Distance Education Holdings Ltd.	China-based online education company	USA	US\$110.7 Mil.	Citi, Merrill Lynch, Oppenheimer, Piper Jaffray
China South Locomotive and Rolling Stock Co.	the world's leading supplier of rail transit equipments	Shanghai and Hong Kong	HK\$15 Bil.	n/a
Glorious Property Holdings	Shanghai-based property developer	Hong Kong	HK\$10 Bil.	JP Morgan, Deutsche Bank
New Century Shipbuilding Co Ltd	China's largest private shipyard	Singapore	up to \$1.5 Bil.	Credit Suisse, Goldman Sachs
Sinosteel Corp	one of the largest steelmakers in China	Shanghai	RMB10-20 Bil..	n/a
China Everbright Securities	one of China's ten biggest brokerages	Shanghai	RMB10 Bil.	Orient Securities
Panyu Chu Kong Steel Pipe Co., Ltd	the largest longitudinal seam welded pipe manufacturer and exporter in China	Hong Kong	US\$100-200 Mil.	ICEA Securities
Fujian New Huadu Supercenter Co., Ltd	China-based consumer retailer	Shenzhen	n/a	Essence Securities
Zhejiang Great Southeast Packaging	the largest professional manufacturer of packaging in China	Shenzhen	n/a	Haitong Securities Co., Ltd
Sunac China Holdings	mainland-based property company	Hong Kong	US\$200 Mil.	Deutsche Bank

Random Tidbits

China is home to 16 of the 20 most air-polluted cities in the world. One-third of the nation's land area is exposed to acid rain, just one of the many environmental side effects of the 2.1 billion tons of coal produced and burned last year (China Watch). China's smog, caused mainly by emissions from power plants, vehicles, and other human activities, continues to have a serious effect on urban air quality. In a 2003 World Bank survey of air pollution in 100 cities worldwide, more than 80 percent of the Chinese cities listed had sulfur dioxide or nitrogen dioxide emissions that were not compliant with World Health Organization (WHO) standards. Continued presence of these extreme levels is depicted in the graph below. This image graphs changes in Shanghai's air quality from July 7, 2004 to July 7, 2008. Air quality is quantified using China's Air Pollution Index (API), which measures levels of Particulate Matter (PM10), Sulfur Dioxide (SO2) and Nitrogen Dioxide (NO2) found in the air on a scale of 0-500. When levels are between 0 and 50, the air is considered to be clean.

Mapping China's Air Quality



(Source: Shanghai Environment Monitoring Center and ChinaVest Research)

For China's top officials, the sense of urgency in environmental cleanliness is most keenly felt in Beijing, one of the country's most polluted cities, and the designated host of the 2008 Olympic Games. In Beijing, residents are warned to stay indoors during the spring dust storm season, and flight delays from heavy smog are common. The city's air pollution could become a major embarrassment if Beijing does not meet its environmental targets by the opening ceremony in August. Although Beijing boasted 234 clear-sky days in 2005, 134 more than in 1998 (the year the city launched its "Defending the Blue Sky" campaign), the capital is experiencing ever-soaring motor vehicle growth, energy consumption, and construction in preparation for the Olympics.

Random Tidbits

As the graph above demonstrates, air quality in China is usually at its best through the rainy season, the months of June to September, as rain and wind direction can help sever the smog clouds and clear the air up temporarily. But the bettering of the air quality in China's cities will depend on major efforts throughout the country to make cuts on more than just fuel consumption and production.

ChinaVest's Shanghai home is doing its best to keep China on the wayward green efforts. In recent years the Shanghai Environmental Protection Bureau has upgraded or closed power plants, built new sewage-treatment plants and enacted monitoring factories and sewage plants. Over the next three years, Shanghai is making an effort to decrease industrial boiler emissions by 90% (Shanghai Daily). After lessening Shanghai's major air and water pollutants by 2% last year, Shanghai made its first substantial decrease in its levels of illness caused by sulfur dioxide and chemical oxygen demand. With the most dangerous air quality in Asia, affecting all of its inhabitants and killing up to 650,000 a year, China will have to continue extreme efforts for air purity for the sake of its own citizens as well as the rest of the worlds.

2008 Global Fortune 500 Includes 29 Chinese Companies

Traditionally dominated by US businesses, this year Fortune's annual ranking of the world's largest corporations, the Global 500, illustrates a distinct shift in global economic movement. Rather than established powerhouses such as the US and Japan, the highlight of this years list was the rising prominence of the emerging markets, with China stealing the show. While the US faltered this year, with the fewest businesses (153) in more than a decade, China boasts an unprecedented total of 29 companies on the list, as many as Italy, Spain and Australia combined. For China this represents an increase from 24 businesses last year and only 16 in 2005, while for the US it is a decrease from 162 in 2007, and 176 in 2005.

Organizing the list in terms of top companies by percent increase in profits tells an even stronger story, as most of the top 39 spots are held by emerging and developed markets like Taiwan, South Korea, France, the UK, and again, China. In fact, this list is absolutely dominated by Chinese firms, which hold 3 of the top 5 spots, and 10 of the top 25. In contrast, no US-based firm appears until the 40th spot. Although this form of ranking does not provide a list of the most profitable companies, it clearly demonstrates that emerging market countries are gaining economic ground, and gaining it quickly.

Below is a comprehensive list of the Chinese firms included in this year's Global 500.

Country Rank	Company	Global 500 Rank	Revenue (US\$ millions)	City
1	Sinopec	16	159,260	Beijing
2	State Grid	24	132,885	Beijing
3	China National Petroleum	25	129,798	Beijing
4	Industrial & Commercial Bank of China	133	51,526	Beijing
5	China Mobile Communication	148	47,055	Beijing
6	China Life Insurance	159	43,440	Beijing

7	China Construction Bank	171	41,307	Beijing
8	Bank of China	187	38,904	Beijing
9	Agricultural Bank of China	223	34,059	Beijing
10	China Southern Power Grid	226	33,861	Guangzhou
11	Sinochem	257	30,204	Beijing
12	Baosteel Group	259	29,939	Shanghai
13	Hutchison Whampoa	286	28,035	Hong Kong
14	China Telecommunications	288	27,856	Beijing
15	China FAW Group	303	26,391	Changchun
16	China Railway Group	341	23,732	Beijing
17	Noble Group	349	23,497	Hong Kong
18	China Railway Construction	356	23,335	Beijing
19	Shanghai Automotive	373	22,607	Shanghai
20	China State Construction	385	22,128	Beijing
21	COFCO	398	21,202	Beijing
22	China Ocean Shipping	405	20,840	Beijing
23	China National Offshore Oil	409	20,637	Beijing
24	China Minmetals	412	20,517	Beijing
25	China Communications Construction	426	19,991	Beijing
26	Jardine Matheson	437	19,445	Hong Kong
27	Aluminum Corp. of China	476	17,577	Beijing
28	China Metallurgical Group	480	17,515	Beijing
29	Lenovo Group	499	16,788	Hong Kong

Source: CNN.com