

# Eye on China

## A View from Shanghai

Week of May 26-June 1, 2007

Merchant Banking Advisory In China for Over Twenty Five Years

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### Market Weekly

#### Shanghai Composite Index

- 5/25 Close: **4,179.78**
- 6/1 Close: **4,000.74**
- Weekly Change: ↓ **4.283%**
- Since 1/1/07: ↑ **49.534%**

#### Shenzhen Composite Index

- 5/25 Close: **12,681.45**
- 6/1 Close: **12,432.69**
- Weekly Change: ↓ **1.962%**
- Since 1/1/07: ↑ **87.038%**

#### Exchange Rate

- 5/25: US\$1 = **RMB 7.662**
- 6/1: US\$1 = **RMB 7.657**
- Weekly Change: ↑ **0.065%**
- Since 1/1/07: ↑ **2.049%**

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- SOEs to Start Paying Dividends to Government
- CSRC to Simplify Bond Issuance for Domestically Listed Companies
- Chinese Companies Buy US\$32.6 Billion Worth of Goods from U.S.
- 90% of Chinese Companies Expect M&A within One Year

#### Deals in China

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## Automobiles

### **1) New Toyota Plant in Tianjin Starts Production**

*FAW Toyota Motor Co.* just began producing cars at its new plant in the northern Chinese city of Tianjin. FAW Toyota is a joint venture between Toyota and Chinese auto producer FAW. This is the JV's third plant. Initially the JV produced the Corolla, Toyota's successful compact car brand. In the future, the plant will produce other models. The new plant's annual capacity of 200,000 cars will vault Toyota into the lead among Japanese automakers in China. Including the new plant, Toyota will produce about 643,000 cars a year. Honda, the second largest player in China, produces 530,000 cars in its Guangzhou joint venture. FAW Toyota is also using more Chinese parts in new cars to reduce costs.

## Energy

### **2) LDK Solar Lists on NYSE in Large IPO**

*LDK Solar* listed on the NYSE on Friday, June 1, raising over US\$469 million. The IPO was the largest by a Chinese company on a U.S. exchange since November of 2004, when China Netcom raised over US\$1 billion in a listing on the NYSE. LDK's American Depository Shares were sold in the IPO at US\$27 apiece, and closed after the first day at US\$27.20. The company makes multicrystalline solar wafers, which are used to make solar power cells. LDK is the fifth Chinese solar company to list in New York in the past seven months. NYSE-listed *Trina Solar's* (market cap: US\$1.1 billion) shares have been the most successful so far, trading 130% above the IPO price. In early June, another Chinese solar company, *Yingli Green Energy*, will list on the NYSE.

## Food & Beverage

### **3) More Drama Between Danone and Wahaha**

The latest issue between joint venture partners Danone and *Wahaha* (China's largest bottled water company) is Danone's objection to Wahaha's low sales projection for their JV. Wahaha's chairman forecasted 3% sales growth this fiscal year, despite the fact that the JV had a 23.5% growth rate in the first four months. Danone asked for an "immediate board meeting" to discuss the figure and wants to make sure the JV's revenue is being properly recognized. Problems between the two firms began about two months ago when Danone signaled its intent to take over Wahaha's non-JV assets. Wahaha said a takeover would be "predatory." Both were then drawn into an embarrassing public dispute, with Danone threatening to sue Wahaha for breaking its non-compete agreement by setting up companies outside the JV to sell Wahaha branded products. The parties exchanged more accusations, but the problems seemingly died down over the past 2-3 weeks. Ironically, the JV, created in 1996, has been one of the most profitable in China. Danone is involved in a number of projects in China. In addition to the Wahaha joint venture, Danone also holds a 22% stake in a JV with China's largest juice producer, *Huiyuan* (listed on HKSE, market cap: HK\$13 billion).

## Medical

### **4) Shanghai Century SPAC Reaches Agreement with Medical Supplier**

AMEX-listed special purpose acquisition company (SPAC) *Shanghai Century Acquisition Corp* is likely to purchase *Kelun*, China's largest producer of "intravenous products," including IV bags, vials and solutions. As we discussed in the May 11 newsletter, a SPAC is a publicly listed shell company with cash and a management team. Once the management team finds a firm to acquire, that company merges into the shell and subsequently becomes a publicly traded company. Shanghai Century raised US\$115 million in its IPO in April, 2006. This money will be injected into Kelun. The deal is still a long way from completion. Shanghai Century's shareholders must still approve the acquisition. If the deal does go through, Kelun could eventually apply to move from AMEX to Nasdaq or the NYSE. The SPAC model regained popularity a few years ago. More than 10 "China SPACs" have been raised, the first in 2004. Three have completed acquisitions.

## Mining

### **5) Chinese Nickel Producer Takes Stake in Australian Mining Firm**

Last month, *Jinchuan Group*, China's largest nickel producer, finalized an agreement to purchase an 11.03% stake in Australian firm Allegiance Mining. Allegiance is an emerging nickel producer, with its first nickel mining project in Tasmania set to begin in the fourth quarter. Jinchuan will pay about US\$32 million for the stake. The agreement will give Jinchuan access to the aforementioned nickel project and to future discoveries made in Tasmania. The deal is another example of Chinese mining firms securing assets around the world in an effort to secure future resource supplies. In the May 18 newsletter, we outlined *Zijin Mining's* acquisition of AIM-listed Monterrico Metals, which held the rights to a copper and molybdenum mining project in Peru.

## Internet

### **6) Chinese Financial Website Considering US\$500 Million Nasdaq IPO**

China's leading financial website *Eastmoney.com* is planning to list on Nasdaq within six to nine months. This is according to the company's CEO, Qi Shi. "We are almost like a financial MySpace, where lots of people come together with a common interest in discussing stocks," Qi recently told Reuters. Eastmoney has daily traffic of 150 million internet users, making it the world's 125th busiest website. It expects earnings of about US\$13 million this year. Eastmoney also just entered into an alliance with Chinese advertising company *Focus Media* (Nasdaq, market cap: US\$4.75 billion), the Chinese media company best known for its flat-panel advertising screens in elevators and other high-traffic areas. "The 130 million high-end clients of Focus Media are what Eastmoney needs. We will share advertising strategies and information, and build Eastmoney into the flagship of global financial portals," said Qi.

## Semiconductor/Integrated Circuit

### **7) Hynix-ST Semiconductor Investing Additional US\$1.5 Billion**

*Hynix-ST Semiconductor* will invest an additional US\$1.5 billion in its 12-inch wafer production. The company is a JV between Korean semiconductor manufacturer Hynix and Swiss IC maker STMicroelectronics. Hynix holds a two-thirds' stake in the JV and ST owns one-third. The JV is located in Wuxi, a city less than two hours from Shanghai. 12-inch wafers sit at the higher end of the technology curve for semiconductors, and manufacturing is capital-intensive. The US\$1.5 billion investment will bring Hynix-ST's investment in 12-inch wafer manufacturing to US\$4 billion, and it will boast the largest wafer fab of its kind on the mainland. Hynix-ST is a relatively new venture, just beginning operations last October. It has already realized about US\$600 million in sales.

## Telecommunications

### **8) 3G Likely Not Offered Before China Olympics**

Due to restructuring in the telecom industry, China is expected to delay issuing 3G licenses until after the Olympic Games. The government had previously set a goal to have 3G services operational by the 2008 Games. China's two major mobile operators are *China Mobile* and *China Unicom*, while the two major fixed-line operators are *China Telecom* and *China Netcom*. The restructuring will position the four operators to provide 3G services based on the three worldwide standards. China Mobile will handle China's homegrown TD-SCDMA standard, which it is currently building in eight cities. China Telecom will purchase China Unicom's CDMA network and will provide 3G services based on the American CDMA2000 standard. China Unicom and China Netcom will merge to provide WCDMA-based services, which is the main 3G standard in Europe. As far as competition between the three standards, it appears that TD-SCDMA-based equipment will have the advantage in China. "The TD-SCDMA patent fees are much cheaper than those for the two foreign standards," said Yang Hua, secretary-general of the TD-SCDMA Industry Alliance. China's equipment manufacturers will have to pay patent fees equal to about 10% of sales on equipment based on the CDMA2000 and WCDMA standards.

## Air Travel

### **9) SIA and Temasek May Pay US\$930 Million for China Eastern Stake**

Sources say that Singapore Airlines (SIA) and Temasek Holdings may pay a total of US\$930 million for a combined 24% stake in *China Eastern*, China's third-largest airline. SIA will reportedly pay about US\$600 million and Temasek US\$330 million. Temasek Holdings is the Singapore government's investment fund, and it owns 56% of SIA. China Eastern would give SIA access to an airline market that is expected to grow 5x by 2025. SIA would also get major access to the desirable Shanghai market, where China Eastern is based. China Eastern, on the other hand, has been bleeding cash for several years, and it lost hundreds of millions of dollars in 2006. SIA would likely gain strategic control and help the Chinese airline restructure. China Eastern said it is lobbying for Chinese regulatory approval for the deal. Meanwhile, the Center for Asia-Pacific Aviation (CAPA) said the deal may spur China's aviation regulatory body to open up more flights into and out of Shanghai-Pudong (Shanghai's international airport) in the near future. If the deal goes through, China Eastern's partner will be one world's best-run airlines. SIA, with FY2006 profits of US\$1.4 billion, is Asia's most profitable airline. Its market cap exceeds US\$15 billion.

## Financial Services

### **10) Foreign Players to Gain More Access to China's Brokerage Sector**

Following up on agreements made at the Strategic Economic Dialogue in Washington, China will further open its securities industry to foreign players. By the end of the year, China will raise the ownership cap on domestic securities firms, although it's still unclear how high. Currently, foreign firms can only take a maximum 33% stake in Chinese securities companies. China will also resume allowing foreign brokerages to set up JVs with local securities firms. The practice was halted last year to allow domestic players to recover from a down period and to prevent foreign players from taking over the market. Before the halt, only UBS and Goldman Sachs had set up Sino-foreign JV brokerages. By the end of the year, foreign players will be allowed to conduct brokerage and asset management services, as well act as principal investors. One firm that has been particularly interested in setting up a Chinese brokerage is Morgan Stanley. "We welcome the further opening of China's financial sector," said Hans Schuettler, CEO of Morgan Stanley Asia. "This reflects the government's commitment to develop a more efficient and stronger domestic capital market." Morgan Stanley already holds a 34% stake in a mainland investment banking venture, but would like to move into offering domestic brokerage services as well. Separately, Morgan Stanley is rumored to be seeking a 49% stake in China's *Jutian Fund Management* (49% foreign stakes in fund management companies are permitted, but not securities brokerages).

## Financial Services

### **11) AEGON to Enter China's Fund Management Industry**

Dutch insurance giant AEGON has agreed to purchase 49% of China's *Industrial Fund Management Company*. One of its current owners, a Chinese entity known as *Industrial Securities*, will hold the remaining 51%. The move will allow AEGON to enter China's growing mutual fund management market. AEGON said the deal is part of its "long-term commitment to the Chinese market." AEGON already has an insurance JV with *China National Offshore Oil Corp (CNOOC)* that operates in Shanghai, Beijing, and the eastern provinces of Jinagsu and Shandong. Industrial Fund Management currently has RMB17 billion under management. In other news, Industrial Securities is rumored to be planning a listing in Shanghai for 2007 or 2008.

## Insurance

### **12) China Pacific Considering Dual Listing; Sells Stakes to U.S. Firms**

The Economic Observer reports that *China Pacific Insurance Group* is rumored to be planning a dual listing in October, raising up to RMB30 billion. Reuters also reported that China Pacific Group raised its share capital by 43% through a placement. In the placement, Carlyle Group and Parallel Investors Holdings, an overseas investment arm of New Jersey-based Prudential Financial, have taken a combined 19.99% stake. Carlyle and Prudential Financial just divested a combined 24.98% stake in China Pacific Group's life insurance arm in order to allow China Pacific to list. The American heavyweights have essentially traded those shares for stock in the whole group (since the whole group is going public). China Pacific is expected to go public in Hong Kong but the dual listing in China's A-share market is still undetermined. The group is the mainland's third-largest life insurer.

### **13) CIRC to Buy RMB1.62 Billion Stake in Life Insurer**

The *China Insurance Regulatory Commission (CIRC)* will take funds from its RMB8 billion "insurance protection fund" to buy a stake in *New China Life*, the country's fourth-largest life insurer. New China Life will issue new shares representing a 22.53% stake, for which CIRC will pay RMB1.62 billion. Foreign trio Zurich Insurance (18.99% stake), the IFC—International Finance Corp (1.5% stake), and Meiji Yasuda Life Insurance (4.5% stake) currently hold a combined 24.99% stake in New China Life, the maximum percentage of a mainland insurer that can be foreign-owned. The stake purchase comes on the heels of an embezzlement scandal at New China Life involving former chairman Guan Guoliang. The three foreign stakeholders borrowed money from New China Life with Guan's authorization, and have yet to pay back the loans. They will apply some of the proceeds from the share sale toward the unpaid debts. This will be the first time CIRC has dipped into the insurance protection fund to buy a stake in a company. The insurance protection fund is set up to help clients of an insurance company if it goes bankrupt.

## Other Financial

### **14) Private Equity Expected to Invest US\$10 Billion this Year**

Private equity groups are expected to invest about US\$10 billion in China this year, down from US\$11.7 billion last year. Xiong Yan, the president of the *China Beijing Equity Exchange*, said he thought China still hasn't sufficiently opened up purchases of stakes in state-owned enterprises. The China Beijing Equity Exchange is one of the markets where stakes in state-owned companies are put up for sale. It is a home, if you will, for orphaned state owned assets. Private equity firms routinely troll the waters of the Beijing Equity Exchange looking for companies to acquire.

In China, 17 Asian private equity firms have raised US\$7.6 billion in the first five months of 2007. That number triples the amount raised at the same point in 2006. In all, private equity invested US\$122 billion in Asia last year, seven times the amount invested in 2005. Global private equity investment in 2006 totaled US\$738 billion.

In the first quarter, 36 venture capital investments were made in China totaling US\$343.5 million. Venture capital investment has fallen 5% from the same period last year, while the total number of deals has fallen by 10%. The decline is mainly due to the new M&A regulations released in September, 2006. For many reasons, venture capital and private equity firms rarely acquire Chinese companies directly. Instead, they invest in the offshore entity (e.g. Cayman Islands, BVI) that controls the Chinese company. Because the new M&A rules make it more difficult to set up offshore holding companies, we see a resulting in a drop in activity. "Everyone believes [VCs] are looking at more deals," said Bob Partridge of Ernst & Young in Hong Kong. "But the actual closing of deals seems to be getting more delays because of issues around being able to set up offshore structures."

### **15) Chinese Private Equity Group to Set Up Yuan-Denominated Fund**

Chinese private equity group *Hony Capital* is planning to raise its first yuan-denominated fund. Hony is the private equity arm of *Legend Holdings*, which is also the parent of Lenovo Group, China's largest PC manufacturer (who also acquired IBM's PC business several years ago). Since overseas investors need dollar-denominated returns, foreign private equity funds generally invest dollars in offshore holding companies that control the assets of Chinese companies. It is extremely difficult to repatriate money from inside China's borders. The yuan fund would be a major step for private equity in China, especially if executed by a group with the stature of Hony Capital. The firm is China's second-largest homegrown private equity group, with about US\$700 million under management. The Wall Street Journal quoted Liu Chuanzhi, the CEO of Legend Holdings, as saying that the fund would allow Hony to capitalize on China's appreciating currency and growing stock markets. He said they hope to get government approval to set up such a fund quickly. "With approval, contributors would include China's national pension fund and local insurance companies," Liu added.

## Shipping

### **16) COSCO Planning Multi-Billion-Dollar Shanghai Listing**

Hong Kong-listed *China COSCO Holdings*, the major Chinese shipping conglomerate, is planning to list on the Shanghai Stock Exchange. The China Securities Regulatory Commission (CSRC) will review COSCO's listing application immediately. COSCO owns Asia's largest container shipping line. COSCO will issue roughly 1.8 billion A-shares, representing 20% of its fully diluted share capital. Referencing current trading prices on the Hong Kong Stock Exchange, the share issue could raise more than RMB15.2 billion (about US\$2 billion). Container traffic through China grew 23.8% in 2006, and China now accounts for one-quarter of the world's container handling. COSCO said it will use a large portion of IPO proceeds to buy ships.

## Regulations

### **Government Imposes Stamp Tax to Cool Stock Markets**

On Wednesday, May 30, the *State Council* (China's cabinet) unexpectedly raised "stamp duties" (taxes on stock trading) in an effort to cool the overheating stock markets. The State Council raised the stamp duties from 0.1% to 0.3% on trades, and the tax applies to both buyers and sellers. The stock markets promptly plunged, with the benchmark Shanghai Composite Index ending down 6.5%. The drop was the second-largest single-day fall since 1999; second to the 8.8% correction on February 27 of this year.

The stamp tax is designed to reel in some of the speculative trading that has led to the meteoric rise of China's markets. The benchmark Shanghai Composite Index has risen by about 50% this year and has increased 3.5x since the beginning of 2006. Earlier in May, the government tried other cooling measures without much success. The *People's Bank of China (PBOC)*, China's central bank, raised deposit and lending rates and twice raised the required reserve ratio for banks. The government also started letting banks (and thus citizens through their banks) invest in overseas stocks, although the allocation was too small to be truly effective. When all of the previous measures had little effect on the stock market, the State Council decided to directly intervene in the markets with the stamp tax. Analysts aren't convinced that the stamp tax will deflate the swelling stock market bubble. Should the stamp tax have little effect, the government may consider a capital gains tax on earnings from stock sales in the range of 20%.

Unlike the February 27 Chinese stock market mini-crash, the world's markets didn't panic on the news of China's correction. After trading down at the beginning of the day, the S&P 500 actually closed on May 30 at a record high. The Shanghai Composite Index closed the week down 4.3%.

In related news, the "100 millionth" stock trading account was opened in China about a week ago. Recently, citizens have been opening accounts at a pace of 350,000 per day. Statistics like these show how rampant the speculative investing has become.

### **SOEs to Start Paying Dividends to Government**

China's *State Council* said it will launch a pilot program requiring state-owned companies to pay dividends to the government. The purpose is to cool the "overheating" economy, as state-owned companies have been pouring earnings back into operations and expanding rapidly. The plan will begin with the 158 firms that are directly owned by the central government. Local governments will decide dividend policies for local government-owned firms. According to a statement released by the State Council, the government will use the dividend payments for industrial development planning, to advance high-tech industries, and supplement the national social security system. The Wall Street Journal reported that from January-November 2006, profits at the 158 central government-owned companies rose 18.9% over the same period in 2005.

## Regulations

### **CSRC to Simplify Bond Issuance for Domestically Listed Companies**

CSRC's deputy chairman Fan Fuchun said that CSRC would soon begin approving corporate bond issuances by firms listed on the mainland. "The preliminary preparations for listed companies' debt offers have been basically completed, and the debt issuance will soon be started," Fan said at a domestic financial forum. Currently, the National Development and Reform Commission (NDRC), China's overarching economic planning body, approves the issuance of bonds with maturities greater than one year. That authority will apparently move to CSRC, which currently only approves the issuance of convertibles. Fan said debt issues by domestically listed firms will play an important role in developing China's capital markets. Apparently CSRC wants to streamline that process, which also presents Chinese-listed companies with other issues like bond issuance quotas. Fan also said China would launch a growth market for smaller companies when the time is appropriate. He did not elaborate.

## Macro

### **Chinese Companies Purchase US\$32.6 Billion Worth of Goods from U.S.**

A delegation of Chinese companies that traveled around the U.S. before the Sino-U.S. Strategic Economic Dialogue signed agreements with American companies to purchase US\$32.6 billion worth of goods. Part of the purpose of the trip was to try to reduce the trade gap between the two countries. The purchasing contracts covered a wide range of industries. The transactions included cars, third generation nuclear reactors, semiconductor manufacturing equipment, soybeans, mobile phones, computers, textiles, and a host of other goods. In all, the delegation traveled to 24 U.S. states. The US\$32.6 billion exceeded all expectations for the trip. Prior to the tour, published reports said the Chinese delegation was likely to sign procurement contracts for about US\$12.5 billion worth of goods.

### **90% of Chinese Companies Expect M&A within One Year**

A study conducted by the Economist Intelligence Unit (EIU) and law firm Norton Rose found that 90% of Chinese companies expect to be involved in M&A activity within the next 12 months. This includes either making an acquisition or being acquired. The results of the study, which surveyed executives from 258 executives in Asia, were reported in the Financial Times. The most interesting statistic the study produced was that buyouts by Asian companies in North America and Europe jumped from US\$2.6 billion in 2002 to US\$15 billion in 2006. And with many Chinese firms finding themselves with an abundance of capital, we expect to see acquisitions by Chinese companies abroad continue to grow for years to come.

# Deals in China

## M&A Activity

Acquirer	Description	Target	Description	Amount	Deal details
Bank of Communications	China's fifth-largest bank	Hubei Trust	Hubei province-based trust company	RMB 1.22 Bil	85% stake
AEGON	major Dutch insurer	Industrial Fund Management	Chinese fund management company, arm of Industrial Securities	N/A	49% stake
Gateway Capital	U.S. property fund	Huana Real Estate	Zhuhai-based real estate developer	RMB 240 Mil	50% stake
Singapore Airlines, Temasek	Asia's most profitable airline; Temasek is the Singapore government's investment fund	China Eastern Airlines	Shanghai-based airline, China's third-largest	US\$930 Mil	24% stake
China Insurance Regulatory Commission	China's insurance regulator	New China Life	China's fourth-largest life insurer	RMB 1.62 Bil	22.53% stake
Tack Fat Group	HK-based, HK-listed ODM apparel manufacturer with market cap of HK\$2.2 billion	Best Favour	retailer and distributor of apparel, owner of the successful XXESS brand	HK\$330 Mil	90% stake
Jinchuan Group	China's largest nickel producer	Allegiance Mining	Australian mining firm	US\$32 Mil	11.03% stake

# Deals in China

## IPO Pipeline

Company	Description	Exchange	Size	Financial Advisors
Eastmoney.com	China's busiest financial website	Nasdaq	US\$500 Mil	Goldman Sachs (rumored)
COSCO	Chinese shipping conglomerate, currently listed in Hong Kong	Shanghai	US\$2 Bil (tentative)	China International Capital Corp
Grand Ocean	Chinese department store operator	Hong Kong	HK\$2 Bil	Merrill Lynch
Longhu	Chongqing-based property developer	Hong Kong	US\$1 Bil	N/A
China Pacific Group	Chinese insurer, mainland's third-largest life insurer	Hong Kong, possibly Shanghai as well	RMB 30 Bil (rumored)	N/A