

# Eye on China

## A View from Shanghai

Week of June 23-June 29, 2007

Merchant Banking Advisory In China for Over Twenty Five Years

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### Market Weekly

#### Shanghai Composite Index

- 6/22 Close: **4,091.45**
- 6/29 Close: **3,820.70**
- Weekly Change: ↓ **6.617%**
- Since 1/1/07: ↑ **42.805%**

#### Shenzhen Composite Index

- 6/22 Close: **13,725.72**
- 6/29 Close: **12,546.45**
- Weekly Change: ↓ **8.592%**
- Since 1/1/07: ↑ **88.750%**

#### Exchange Rate

- 6/22: US\$1 = **RMB 7.629**
- 6/29: US\$1 = **RMB 7.625**
- Weekly Change: ↑ **0.052%**
- Since 1/1/07: ↑ **2.457%**

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- 1) Fosun to Raise US\$1.4 Billion in Upcoming HK IPO
- 2) Chinese Incinerator Manufacturer to List in Frankfurt
- 3) Siemens and GE Interested in Chinese Industrial Firm

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- Government to Spend US\$852 Million to Stabilize Pork Prices
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## Diversified

### **1) Fosun to Raise US\$1.4 Billion in Upcoming HK IPO**

Chinese conglomerate *Fosun International* will raise about US\$1.4 billion when it goes public in Hong Kong later in July. Fosun is a conglomerate involved in a number of sectors, including steel, real estate, mining, retail, pharmaceuticals, and financial services. It often uses leverage (e.g. bank loans) to acquire companies, similar to U.S. buyout firms such as KKR, Carlyle and TPG. Fosun will use about RMB900 million of the proceeds to invest in iron ore mining operations. Investors in the IPO include Hong Kong's richest man, Li Ka-shing.

## Industrial

### **2) Chinese Incinerator Manufacturer to List in Frankfurt**

*ZhongDe Waste Technology* will become the second Chinese company to list in Germany. The firm, specializing in solid waste incinerators, will list its German subsidiary. In March, *Gongyou Machines*, a wood-working machine manufacturer, became the first Chinese company to list in Frankfurt, raising a relatively small €4.5 million. ZhongDe's IPO will be a bit larger as the company expects to raise about €70 million when it lists on July 6. According to Reuters, ZhongDe is listing in Frankfurt because, "investors are familiar with the industry and it will give ZhongDe access to international markets." If successful, the IPO could trigger a wave of Chinese firms listing in Frankfurt. As a point of interest, "Zhong" means China and "De" means Germany.

### **3) Siemens and GE Interested in Chinese Industrial Firm**

Siemens and GE are competing for a 25% stake in *Shenyang Blast-blower*. One of the two conglomerates will win the bid, under the condition that the winner will transfer technology to the Chinese firm. Shenyang Blast-blower produces compressors and other products that are often used in the petrochemical industry. *Sinopec* and *CNPC* (the parent of PetroChina), the mainland's two largest petroleum companies, recently agreed to pay RMB540 million for 30% stakes in Shenyang Blast-blower. Assuming that the valuation remains the same, it would imply that Siemens or GE will likely pay at least RMB450 million for a 25% stake. Separately, Siemens Venture Capital provided second round financing to Chinese clean energy company *PowerU* earlier in June.

## Internet

### **4) eBay to Return to China**

eBay will reportedly return to China sometime this summer after an earlier attempt failed. This time, it will operate within the confines of a joint venture established in 2006 with Chinese/HK internet concern *Tom Online* (which owns 51% of the JV). One way the JV will try to differentiate itself is by acting as a third-party escrow service. In essence, it will hold payments in escrow until the customer is satisfied with the product purchased. Tom/eBay also seeks to differentiate itself by being more vigilant than its competitors in monitoring sellers. These efforts could be vital for success in China, where counterfeit goods proliferate. Tom/eBay hopes to gain ground against China's top online auction site *Taobao.com*, which overtook eBay's *EachNet* auction site and now has a relatively strong lead in the online auction space. Meg Whitman, eBay's CEO, said that in this particular foray into mainland China, eBay will concentrate on better service, reliability, and security.

### **5) Gobi Partners Leads US\$20 Million Investment in Online Ad Firm**

VC Group *Gobi Partners* led a US\$20 million investment in a Chinese online advertising and online integrated services provider *Longtuo*. Longtuo will use the funds to update its technology and develop a new online advertising platform. "We expect that Longtuo will go public on the Nasdaq in 2008. We do not exclude the possibility of an IPO on other stock markets if there are preferential policies available," said an investment manager with Gobi Partners. Earlier last year, the VC firm also provided Longtuo with US\$3 million in startup financing. Gobi Partners focuses on venture investments in Chinese IT and digital media companies.

### **6) KPCB China Invests US\$25 Million in Red Baby**

Earlier in June, Kleiner Perkins Caufield & Byers (KPCB) agreed to invest US\$25 million in *Red Baby*, an online retailer of mother and baby products. Red Baby achieved 2006 revenues of RMB200 million. In April, KPCB launched its China operation by opening offices in Shanghai and Beijing. KPCB China, which hired its management team from Softbank Asia Infrastructure Fund and well-known China VC group *TDF Capital*, has a US\$360 million fund dedicated to making investments in mainland China. KPCB made its name in Silicon Valley with numerous home run technology investments including Google, Ariba, and Juniper Networks.

## Semiconductor/Integrated Circuit

### **7) NDRC Approves Hynix-ST's US\$1.5 Billion Expansion Project**

The *National Development and Reform Commission (NDRC)*, China's top economic planning body, officially approved a project to expand *Hynix-ST Semiconductor's* 12-inch chip production line in Wuxi (a city about an hour-and-a-half from Shanghai). The 12-inch chip segment sits at the higher end of the semiconductor technology spectrum, and production is extremely capital intensive. The expansion project will cost the company US\$1.5 billion. It will bring total investment in Hynix-ST to about US\$4 billion. We first reported on this project in the June 1 issue of the newsletter, before the Hynix-ST had received approval for the US\$1.5 billion investment. The 12-inch production facility will be largest of its kind in China. Hynix-ST is a joint venture between two major semiconductor companies—South Korea's Hynix (owns two-thirds of the JV) and Switzerland's STMicroelectronics (one-third).

## Air Travel

### **8) SIA Receives Preliminary Approval to Buy Stake in China Eastern**

Singapore Airlines (SIA) and Temasek Holdings (a Singapore state investment fund) have received preliminary approval to purchase a combined 25% stake in *China Eastern Airlines*. SIA will reportedly pay about US\$600 million (an implied 16% stake) and Temasek will pay about US\$330 million (an implied 9% stake). China Eastern, based in Shanghai, is China's third-largest airline. The airline will benefit significantly from SIA's management expertise, as SIA is Asia's most profitable airline. SIA, meanwhile, will gain more access to China's rapidly growing passenger aviation market (flights through Shanghai in particular). The deal has been in the works for a while, but China Eastern President Li Fenghua said for the first time that Chinese regulatory body the *State-Owned Assets Supervision and Administration Commission (SASAC)* had given the deal preliminary approval. China Eastern is also expected to turn a profit for the first time in three years in 2007.

## Banking

### **9) First City Commercial Banks to Go Public Will List in China**

The *China Securities Regulatory Commission (CSRC)* has approved the listing plans of two Chinese city commercial banks. *Bank of Nanjing* will issue 700 million A-shares on the Shanghai Stock Exchange, likely raising between RMB5.5 billion and RMB6.5 billion. *Bank of Ningbo* will issue 450 million A-shares on the Shenzhen Stock Exchange, although it is still unclear how much money it will raise. City commercial banks offer banking services only within their local area. Quite a few are trying to raise money and expand beyond their home territory. Many will have to expand to realize the economies of scale necessary to compete with other lenders, especially now that the sector is open to foreign competitors. It is not clear exactly when Bank of Nanjing and Bank of Ningbo will list. They will become the first two city commercial banks to go public. The cities of Nanjing and Ningbo are located in booming east China, both within a few hours of Shanghai.

## Financial Services

### **10) BBVA to Establish Spain-Based Fund to Invest in Shanghai Market**

Spanish banking group Banco Bilbao Vizcaya Argentaria (BBVA) will set up a fund in Madrid to invest European money in the Shanghai Stock Exchange. *CITIC Capital*, an investment management company in which BBVA indirectly holds a stake, will manage the fund. BBVA purchased a 5% stake in China CITIC Bank earlier this year for €501 million, as well as a 15% stake in Hong Kong-based sister bank CITIC International Financial Holdings for €488 million. BBVA will apply for a Qualified Foreign Institutional Investor (QFII) license, which will allow it to invest in Chinese stocks. BBVA said it also wants to get a Qualified Domestic Institutional Investor (QDII) license with CITIC Capital. This will allow the two to invest Chinese funds overseas. According to a JPMorgan Chase report, Chinese financial institutions will invest US\$100 billion in overseas stocks and bonds by the end of the year.

## Healthcare

### **11) Chinese Medical Firm Lists on AIM**

*China Medical System Holdings (CMS)* raised £10 million by listing on London's AIM market. The company currently distributes pharmaceuticals and is also trying to develop its own drugs. Its market cap at listing was about £65 million. AIM, a part of the London Stock Exchange, is a market oriented towards emerging growth companies. It is attractive for many reasons, one of which is relatively low compliance hurdles and compliance costs (especially when compared to Sarbanes-Oxley in the United States). Currently, over 50 Chinese firms have listed on AIM and the number continues to rise. In the near future, three more Chinese firms are expected to IPO on AIM: a solar company, a real estate company, and a video surveillance provider.

## Media

### **12) Focus Media Leads US\$20 Million Investment in Chinese Film Maker**

*Focus Media* led a US\$20 million Series C round of financing for *Huayi Brothers Media Group*, China's top private entertainment company. Huayi Brothers mainly produces films and TV shows in China. According to the Shanghai Morning Post, the group produced four out of the top 10 grossing films at the box office in 2006. Huayi Brothers will go public on an overseas exchange sometime in 2008. Nasdaq-listed Focus Media (market cap: US\$5.4 billion) is a leading "out-of-home advertising company" in China. It is well-known for its LCD advertising monitors in high foot-traffic areas such as elevators. Focus Media also recently agreed to buy Shanghai-based internet consultancy *iResearch* for US\$10 million. *iResearch* has an online ad tracking system which will help Focus Media expand its presence in the online advertising sector.

### **13) Large Chinese Media Company to Partner with Microsoft**

Microsoft agreed to form a strategic partnership with government-run *Shanghai Media Group (SMG)*, China's second-largest broadcasting company. Microsoft will help create entertainment applications for computers, TVs, and mobile phones. The software company's web portals will also offer SMG content. SMG president Li Ruigang said the company "hopes to work out more and better business models in digital media services, and increase the Chinese culture's influence through Microsoft's distribution of its contents" (Shanghai Daily). The partnership will mainly target young Chinese. Earlier in June, SMG also entered into a partnership with Intel. The semiconductor giant will help SMG develop HDTV for broadband internet and for mobile phones.

## Retail

### **14) Operator of Mainland Department Stores to List in HK**

China's retail sector will witness yet another IPO, as Hong Kong's *New World Development* is expected to raise up to HK\$2.36 billion (roughly US\$300 million) in an upcoming IPO. New World Development currently operates 27 department stores in mainland China and plans to increase that number to 30 in 2008. The listing will be one of quite a few recent China department store offerings. These include a US\$300 million Hong Kong listing by *Intime* last March, as well as the US\$1.27 billion IPO for women's shoe company *Belle*, in one of Hong Kong's most popular IPOs ever. Department store operator *Grand Ocean* is also planning a US\$250 million Hong Kong IPO in July. New World Development's shares are expected to begin trading July 12.

## Regulations

### **Chinese Insurers to Invest in Overseas Stocks within Three Months**

The South China Morning Post reports that within about three months, the Chinese government will allow domestic insurance companies to invest in overseas stock markets under the Qualified Domestic Institutional Investor (QDII) program. This will be another step in diverting investment into overseas assets instead of into the domestic stock market. Beginning July 5, Chinese brokerages and fund managers will be permitted to invest in overseas stocks, bonds, convertibles, and many types of derivatives. The government also just recently began allowing Chinese banks to invest in overseas stocks. The large amount of money the Chinese continue to invest in the domestic markets could potentially cause a bubble to form. The ability to invest overseas will not only have a cooling effect on the mainland, but will help insurance companies and banks diversify their stock holdings in case a domestic bubble bursts.

## Macro

### **China Takes Further Measures to Reduce Liquidity**

China has taken two major steps in an attempt to control the liquidity that is causing the stock markets and real estate markets to overheat. The Ministry of Finance will issue RMB1.55 trillion worth of treasury bonds, which will be used to soak up US\$200 billion in foreign exchange reserves. The other measure will be to cut or remove the tax on personal savings.

The T-bond issue will be the largest ever for China. It will serve two main purposes—to remove currency from circulation and to reduce China's foreign exchange holdings, which reached US\$1.2 trillion at the end of March. The US\$200 billion will fund China's government foreign exchange investment company, which will invest the money abroad. It will also reduce China's forex holdings by one-sixth. By reducing the tax on personal savings, the government hopes to encourage more people to save money instead of pouring it into the stock markets and real estate markets. The low returns (roughly 3%) from savings accounts currently make it a distinctly unattractive option to Chinese citizens. Considering inflation (more than 3%), real returns on Chinese savings accounts are negative.

Recently, China tried many different approaches to curb excess liquidity without much success. These approaches include hikes in interest savings rates, savings rates, and deposit reserve ratios for banks, as well as tripling the "stamp tax" on stock trades (a tax on trades for both buyers and sellers). Recently, regulators began allowing Chinese financial institutions to invest money from China in riskier overseas assets. Separately, several major Chinese firms plan to raise billions of dollars in Shanghai IPOs by year-end, which will also soak up some money. The announcement of the aforementioned state forex investment company is also part of the effort to curb liquidity. Chinese citizens have an estimated US\$4 trillion in domestic savings.

Some analysts are encouraging the Chinese government to speed up the process of establishing the forex investment company. It should be up and running this year, after which it can invest the US\$200 billion overseas.

Although recent liquidity-reducing measures haven't yet proven to be terribly successful, recently, the stock markets have stayed relatively stable. The Shanghai Composite Index ended Friday at 3,820.70, roughly the same as it was two months before.

## Macro

### **Government to Spend US\$852 Million to Stabilize Pork Prices**

The Chinese government will allocate US\$852 million to "contain" pork prices. Most of the money will go to an insurance scheme to insure female pigs against disease and natural disasters. Recent surging pork prices have caused inflation in China. In fact, live pig prices in April rose 71% over March. The government will also spend US\$61.6 million to assist poor families who have suffered due to the recent rise in food prices. Approximately 70% of the meat consumed in China is pork. Other than a major strain of blue ear disease, another major cause of rising pork prices in China is the demand for corn in ethanol production. Ethanol producers are willing to pay much higher prices for corn than pig farmers. The government said it will probably ban the use of staple foods in bio-fuel production in the future.

### **China Launches US\$1 Billion China-Africa Development Fund**

China officially launched a US\$1 billion investment fund that will finance investment in Africa. *China Development Bank*, a policy bank, will finance the China-Africa Development Fund. The fund will provide financing for Chinese companies to participate in African markets, and will focus on industries that are vital to Africa's development. The new fund will eventually grow to US\$5 billion. In May, the African Development Bank held its annual board meeting in Shanghai, an event that highlighted China's desire to increase its presence in Africa. At the event, China pledged to spend US\$20 billion over the next three years to aid infrastructure and development projects on the African continent. Chinese companies had invested a total of US\$11.7 billion in Africa as of the end of 2006.

# Deals in China

## M&A Activity

Acquirer	Description	Target	Description	Amount	Deal details
Arcelor Mittal	world's leading steel group	Rongcheng Chengshan Steel Cord	Shandong province-based, makes steel cord and wire used to reinforce tires	US\$27 Mil	approx 90% stake
Shanghai Industrial Holdings	HK-listed entity with health, food, and toll road ventures	Shanghai Urban Development	state-owned developer of residential and commercial properties in Shanghai	RMB 2.13 Bil	40% stake
Focus Media	Nasdaq-listed, leading Chinese out-of-home advertiser	Huayi Brothers Media Group	China's largest film producer	US\$20 Mil	N/A
Home System Group	Guangdong province-based, OTCBB-listed distributor of home appliances	Weihe Appliances	Guangdong province-based manufacturer of ceiling fans and residential lighting	US\$45 Mil	controlling stake

# Deals in China

## IPO Pipeline

Company	Description	Exchange	Size	Financial Advisors
Fosun International	Shanghai-based conglomerate, involved in steel, real estate, mining, retail, pharmaceuticals, financial services	Hong Kong	up to US\$1.4 Bil	Morgan Stanley, UBS, CICC
Stella International	Taiwan-owned, manufacturer and retailer of shoes in China	Hong Kong	US\$388 Mil	Goldman Sachs
Bank of Nanjing	Jiangsu province-based city commercial bank	Shanghai	RMB 5.5-6.5 Bil (preliminary)	CITIC Securities
Bank of Ningbo	Zhejiang province-based city commercial bank	Shenzhen	N/A	Goldman Sachs Gaohua Securities
KWG	Guangdong province-based residential property developer	Hong Kong	HK\$4 Bil	Morgan Stanley, Goldbond Securities, ICEA
New World Development	Hong Kong-based, operates department stores on the mainland	Hong Kong	HK\$2.36 Bil	HSBC, Deutsche Bank
ZhongDe	manufactures solid waste incinerators	Frankfurt	€70 Mil	Sal. Oppenheim, BOC International, CLSA

## **China Communist Party's School Holds Forum in Tandem with Harvard**

Harvard University and the *Central Party School* recently held a joint forum on social development in China. The Central Party School is the Communist Party's university. It provides education in subjects such as economics, foreign policy, and a host of other courses, to promising members of the Party. The forum was designed to bring some of the world's "top minds together" to discuss ways to solve some of China's social development problems. Central Party School vice president Wang Weiguang prefaced the forum by saying, "Through the forum, we can further mutual understanding, evolve better solutions and lay the foundations of future collaboration." BBC also noted, "Professor Barry Bloom, head of the Harvard School of Public Health, hoped the forum would mark the successful beginning of an informative and provocative dialogue 'between scholars and policy makers of our two universities and countries'." Incidentally, China's President Hu Jintao served as the president of the Central Party School from 1993 until 2002.

## **Temperatures Heating Up Inside Nanjing's Government Buildings**

One can assume that many a government official in the east Chinese city of Nanjing will be in for a sweaty summer. The city will not allow its government offices to turn on the air conditioning until the temperature reaches 33 degrees Celsius (a balmy 91.4 degrees Fahrenheit). Summers in Nanjing are extremely hot and humid. The thrifty A/C policy is part of China's effort to reduce energy usage. "As government officials, we shall do our part in saving energy," said one Nanjing government official. China has set out to cut energy consumption by 20% per unit of GDP between 2006 and 2010, but got off to a slow start, achieving only a 1.23% reduction in 2006.