

Eye on China

A View from Shanghai

Week of June 2-June 8, 2007

Merchant Banking Advisory In China for Over Twenty Five Years

ChinaVest

Senior Management

Robert Theleen
 Wallace Mathai-Davis
 Jenny Hsui
 William Fuller
 Eugene Zhao

Editorial Staff

Erik Bethel ebethel@chinavest.com
 Patrick Kelly pkelly@chinavest.com.cn

Market Weekly

Shanghai Composite Index

- 6/1 Close: **4,109.65**
- 6/8 Close: **3,913.14**
- Weekly Change: ↓ **4.782%**
- Since 1/1/07: ↑ **46.260%**

Shenzhen Composite Index

- 5/31 Close: **12,944.33**
- 6/8 Close: **12,850.69**
- Weekly Change: ↓ **0.723%**
- Since 1/1/07: ↑ **93.327%**

Exchange Rate

- 6/1: US\$1 = **RMB 7.657**
- 6/8: US\$1 = **RMB 7.658**
- Weekly Change: ↓ **0.013%**
- Since 1/1/07: ↑ **2.043%**

Articles

Industrial & Consumer

- 1) Schaeffler Opens New Bearings Plant in Taicang
- 2) Baring and IFC Take Stake in Chinese Refrigerant Manufacturer
- 3) Danone Files Suit Against Wahaha; Zong Resigns as Head of JV
- 4) China Water and Drinks Does US\$30 Million Placement
- 5) Chinese Mining Firm Makes Overseas Investments
- 6) Eli Lilly Ramps Up Investment in China

Technology

- 7) Majority of Venture Capital Investment in China Goes to TMT
- 8) No New Internet Cafes to Open in 2007
- 9) Chinese VC Fund Invests in Two Local Internet Companies
- 10) Three VCs Invest US\$8 Million in Shanghai-Based Online Ad Firm
- 11) Five Online Game Firms to List Within 12 Months
- 12) Southwest China's First 8-Inch Wafers Produced in Chengdu
- 13) IBM/Lehman Brothers Fund Makes First Investment

Services

- 14) Focus Media Makes Another Acquisition in Online Advertising
- 15) CIRC to Allow Insurers to Invest 15% of Assets Overseas
- 16) Ping An to Invest up to US\$10 Billion Overseas
- 17) UBS to Underwrite First A-Share Offering
- 18) Xinhua Finance Media Buy Domestic Mobile Service Provider
- 19) Property Developer KWG Ups IPO Target to HK\$4 Billion
- 20) Warburg Close to Acquiring Stake in Chinese Furniture Retailer

Regulations & Macro

- Shares Plunge at the Start of the Week, Rebound at the End
- Funds Raised in Mainland IPOs to Double Last Year's Total
- IFC to Invest Over US\$600 Million in China in FY2007

Deals in China

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

Random Tidbits

Automotive

1) Schaeffler Opens New Bearings Plant in Taicang

German-based Schaeffler Group, the world's second-largest producer of bearings, inaugurated a new 110,000-square-meter factory in Taicang, Jiangsu province. Taicang is the first inland port city on the Yangtze River. We provide more information on Taicang in a recent ChinaVest research piece on China's inland waterways (www.chinavest.com). Schaeffler's new factory, a €180 million investment, will be one of the largest in the world. It will also be Schaeffler's second in Taicang, where the firm built its first factory in 1998. Schaeffler has been quite active in China recently. The company just opened a major R&D center in Shanghai which concentrates on bearings for automotive, aerospace, and other industrial sectors. The German company is also trying to acquire Chinese state-owned enterprise *Luoyang Bearing*.

Chemicals

2) Baring and IFC Take Stake in Chinese Refrigerant Manufacturer

Baring Private Equity Asia and International Finance Corp (IFC—the World Bank's private sector investment arm) will acquire a combined 27.3% stake in Chinese refrigerant producer *Dongyue Group*. The stake will cost a reported US\$47.2 million. Dongyue is China's No.1 producer of "environmentally-friendly refrigerants" with 45% market share. The company, located in Shandong province, will use the investment from Baring and IFC to expand production capacity.

Food & Beverage

3) Danone Files Suit Against Wahaha; Zong Resigns as Head of JV

On Monday, June 4, Danone filed suit against JV partner *Wahaha* in the California Supreme Court for "breach of contract." The French food group is accusing Wahaha of selling Wahaha drinks in competition with their joint venture. Danone has also reportedly filed for arbitration in Stockholm. "As we have said since the beginning, our purpose is to stop the illegal production and sales of our joint venture products," said a Danone spokeswoman. "We consider that settling this difference out of court is still possible and our priority." Wahaha says Danone is "bluffing" with the suit which they believe is an attempt to pressure Wahaha into selling its stake in the joint venture. Danone currently owns 51% of the JV. Danone is using the California legal system to sue the British Virgin Islands-based holding company that controls Wahaha's assets. A California court should have no jurisdiction over the case, as it involves non-U.S. entities and sales of products outside the United States. However, Danone may be trying to get the court to accept jurisdiction on the grounds that neither China nor the BVI have a sufficiently developed legal system to handle the dispute.

Later in the week, Wahaha CEO Zong Qinghou resigned as head of the JV. In his resignation letter, Zong said he could "no longer endure the slander and tyranny of the two managers appointed by Danone," referring to the Danone-appointed board members of the JV, Emmanuel Faber and Qin Peng. Zong will remain the CEO of the rest of Wahaha. It is yet unclear who will take charge of the JV. Danone believes Faber will succeed Zong in that position.

Food & Beverage

4) China Water and Drinks Does US\$30 Million Placement

China Water and Drinks Inc completed a US\$30 million private placement. The placement accompanies China Water and Drinks' listing on the OTCBB via a reverse takeover (RTO). A reverse takeover is an alternative way for a firm to go public, wherein a company's shares are acquired by an already-listed shell company. China Water and Drinks produces and distributes bottled water, and operates four bottling facilities in China. It bottles water under its own brand for sales on the mainland and produces bottled water for domestic and international companies including Coca-Cola and Danone. The company had 2006 revenues of US\$35.7 million and US\$8.8 million in earnings. The US\$30 million investment will fund the expansion of production capacity and possibly acquisitions.

Mining

5) Chinese Mining Firm Makes Overseas Investments

Yunnan Tin, the world's largest tin producer, has purchased a 5% stake in emerging Australian nickel firm Metallica Metals for about US\$5 million. Brisbane-based Metallica's major asset is a "nickel laterite project" in Queensland. Nickel can be produced from either sulphide or laterite ore. About 72% of the world's nickel resources are laterites found mainly in tropical locales such as Indonesia, Cuba, Brazil and New Caledonia. The remaining 28% are sulphides primarily located in Canada and Russia. Australia has both sulphide and laterite nickel deposits. One way to extract nickel is called heap-leaching, where ore is put into heaps and acid is used to separate the nickel from the ore. Yunnan Tin has been a pioneer in nickel heap-leaching, so the company believes its experience will add value to Metallica Metals. Yunnan Tin will also invest US\$8.7 million and US\$1.2 million in two separate tin smelting joint ventures in Indonesia. The company will hold a 51% stake in both JVs. As we've said before, Chinese firms are keen to secure overseas mining assets to secure future resource supplies. Last week, we outlined Jinchuan Group's (China's largest nickel producer) purchase of an 11.03% stake in Australia's Allegiance Mining.

Pharmaceuticals

6) Eli Lilly Ramps Up Investment in China

Eli Lilly will invest US\$100 million over the next five years on R&D in China. Rather than establishing its own R&D Center, Eli Lilly will fund biotech, chemical drug, and clinical research in tandem with Chinese partners. An executive with the Indianapolis-based pharma giant said in an interview two months ago that the company plans to double its clinical trials in China this year over last year's total. "As China becomes a bigger part of our global picture, we have to have a better appreciation of how our product works on the Chinese," a company spokesman said. Gao Huijun, a senior researcher in a division of the *Shanghai Food and Drug Administration*, added to those sentiments, "The overseas drug makers have to get a better understanding of Chinese patients if they want to boost sales here. It's also cheaper to conduct R&D in China, with cheaper talent who are as good as their overseas counterparts in certain areas, and it's easier for them to find volunteers for drug tests." Separately, Lilly Asian Ventures just invested US\$10 million in *BioVeda China*, the first international VC fund that focuses on life sciences investments in China. BioVeda China claims to have led more than US\$120 million in financing for six companies during the past 12 months.

Diversified

7) Majority of Venture Capital Investment in China Goes to TMT

More than 65% of first-quarter venture capital investment in China went to technology, media and telecommunication (TMT) sectors according to a report by ChinaVenture Investment Consulting. The study noted that TMT received about US\$340 million of the approximately US\$520 million of VC funding. The report also said that VCs invested US\$199 million of the TMT total in IT. Additionally, Chinese VCs invested more in TMT while foreign VCs invested more in other industries. In 2006, TMT industries took US\$1.38 billion of the almost US\$2.2 billion in venture capital investment in China. Another study, a joint report issued by DowJones Venture One and Ernst & Young, quoted total 2006 VC investment at about US\$1.9 billion.

Internet

8) No New Internet Cafes to Open in 2007

China will not grant licenses to any new internet cafes this year. Regulators claim that this is necessary because they are growing increasingly concerned that "internet material is harmful to the young population." The regulators cite violent online games, gambling sites, and sexually explicit material as types of web content that need to be eradicated. Inspectors will also attempt to determine whether internet cafes are illegally renting out their licenses and failing to register the identities of users. The initiative is based on President Hu's order to clean up China's "internet culture."

9) Chinese VC Fund Invests in Two Local Internet Companies

Qiming Venture Partners, a US\$200 million Chinese venture capital fund, invested in two domestic internet companies. The fund invested US\$10 million in *Love21cn*, an online dating website with 5.5 million registered users. Recently, *Love21cn* also received a RMB40 million (US\$5.2 million) investment from three of the co-founders of NYSE-listed *New Oriental Education*. "China's wedding and dating market has huge potential. People are willing to pay a comparatively high price to enjoy a good dating product or service," said J.P. Gan, *Qiming Venture Partners'* managing director. *Qiming* also led a multi-million-dollar Series A investment in *Captiv8*, a firm that places real-time advertising in online games and integrates its advertising system into online video programs. *Captiv8* has reportedly signed cooperation agreements with Visa and Intel. The exact size of the investment was not disclosed.

10) Three VCs Invest US\$8 Million in Shanghai-Based Online Ad Firm

Shanghai-based *CTS Media* received an US\$8 million second round of financing. *CTS* is an online streaming advertising company that inserts ads into online videos. *Steamboat Ventures* (a Disney VC arm), *Draper Fisher Jurvetson*, and *Sequoia* made the joint investment. *Steamboat* invested US\$5 million of the total.

Internet Games

11) Five Online Game Firms to List Within 12 Months

The Shanghai Daily reports that up to five domestic online game firms are expected to list on overseas markets within the next 12 months. This is according to Kou Xiaowei, vice director of the General Administration of Press and Publication (GAPP). "Second-tier domestic game firms have popped up and their average income growth is even higher than the market leaders Shanda (Nasdaq, market cap: US\$2 billion), NetEase (Nasdaq, market cap: US\$2.3 billion), and The9 (Nasdaq, market cap: US\$1.1 billion)," said Kou, who didn't name the five companies. However, industry experts believe firms *Zhengtu*, *9you*, and *Kingsoft* are among the five (Kingsoft is best known for its anti-virus and office software). Chinese software firm *CDC Corp* (Nasdaq, market cap: US\$932 million) also said it would invest US\$300 million in online game firms and conduct an IPO for its games business next year.

Semiconductor/Integrated Circuit

12) Southwest China's First 8-Inch Wafers Produced in Chengdu

Chengdu Chengxin Semiconductor Manufacturing Company successfully made the first 8-inch wafers manufactured in southwest China. Chengdu is the capital of southwest China's Sichuan province. The local government in Chengdu has been eager to attract semiconductor manufacturing, offering financial backing to build wafer fabs in the area.

Software

13) IBM/Lehman Brothers Fund Makes First Investment

IBM and Lehman Brothers have jointly paid HK\$132 million (US\$17 million) for a 7.7% stake in *Kingdee International*, China's second-largest enterprise-management software company. This will be the first investment made by IBM and Lehman's US\$180 million private equity fund, which the two firms set up late last year to take minority stakes in Chinese companies. IBM also announced that it will form a global alliance with Kingdee. This will help Kingdee become an international player in the enterprise-management software and e-business applications fields. Kingdee's 2006 profits rose 35% to RMB97 million from the previous year. The company is listed in Hong Kong, with market cap of RMB3.26 billion. IBM and Lehman will each hold a 3.85% stake in the company.

Advertising

14) Focus Media Makes Another Acquisition in Online Advertising

Nasdaq-listed out-of-home advertising firm *Focus Media* is further supplementing its online ad capabilities by purchasing *iResearch*. *iResearch* is an internet consultancy, which also has a product that tracks and analyzes online ads. "Its ad monitoring and analysis system can help Focus expand in the online ad sector," said a source close to the deal. The deal is rumored to be worth US\$10 million. Focus Media made a step into online advertising in March with the acquisition of Chinese online ad firm *Allyes AdNetwork* in a US\$300 million deal. Focus Media's most successful ad medium has been flat panel television displays in elevators and other high-traffic areas. The company is China's largest overseas-listed advertising firm. Its market cap currently stands at US\$4.7 billion.

Insurance

15) CIRC to Allow Insurance Companies to Invest 15% of Assets Overseas

The China Insurance Regulatory Commission (CIRC) issued new draft rules that allow Chinese insurers to invest up to 15% of their assets in overseas markets. The rules will allow investment in mature exchanges, namely the NYSE and the London Stock Exchange. Insurers will be permitted to invest in stocks, options, fixed-income securities, mutual funds, derivatives, and money market products. Considering that Chinese insurers had total assets of RMB1.97 trillion as of the end of last year, the new 15% rule means they can invest up to RMB300 billion overseas. CIRC is working hard to allow insurers to diversify their investments. "There will be concrete progress this year toward letting insurers set up fund management companies," said Sun Jianyong, director of the insurance fund management regulatory department of the CIRC. The final rules on overseas investment will be released in one to two months. The previous threshold for overseas investment was 5%.

16) Ping An to Invest up to US\$10 Billion Overseas

Ping An Insurance announced that it will invest up to RMB74 billion (US\$9.7 billion), which accounts for 15% of its RMB494 billion in assets (as of the end of 2006), in overseas markets. The decision follows CIRC's announcement that Chinese insurers will be able to invest up to 15% of their assets in New York and London (see point 14 above). "We want to make our investment portfolio more balanced," said President Louis Cheung. "Investment channels like long-term corporate bonds are underdeveloped in China, so putting more money into overseas holdings will help cover our long-term liabilities. Everyone wants to invest in China...But in terms of a 30-year investment period, concentrating only on China may not be the best way to go." Ping An currently has about US\$2 billion invested overseas, mainly concentrated in the Hong Kong Stock Exchange. Ping An is China's second largest life insurer. It is listed in Hong Kong and in Shanghai, with market capitalization of HK\$117.2 billion.

Investment Banking

17) UBS to Underwrite First A-Share Offering

UBS will underwrite its first A-share sale. The investment bank will underwrite *Western Mining's* IPO on the Shanghai Stock Exchange. UBS will become the second foreign firm, after Goldman Sachs, to underwrite a listing on the A-share market. Western Mining is located in northwest China, and is one of the country's major players in lead, zinc, and copper mining. The miner will list soon, as the China Securities Regulatory Commission (CSRC) just approved its IPO application. UBS originally set up its Chinese venture in 2005. According to Bloomberg News, Chinese companies have raised more than US\$41 billion in A-share offerings since the beginning of last year. Between January and May, underwriting fees reached RMB2.5 billion for A-share offerings. In the first quarter of this year, Goldman Sachs earned significant underwriting fees from Ping An's RMB38.9 billion Shanghai IPO, becoming the first foreign investment banking venture in China to do so.

Media

18) Xinhua Finance Media Buy Domestic Mobile Service Provider

Nasdaq-listed *Xinhua Finance Media (XFM)* will acquire 100% of *Beijing Mobile Interactive Co (M-in)*. XFM wants to integrate the mobile phone medium with its existing services. The company is China's leading finance and entertainment media enterprise. It targets wealthy Chinese mainly through TV, radio, and print. M-in has developed applications for a wide range of mobile media, including wireless application protocol (WAP), text messaging, JAVA-based applications including games, and much more. The company is also China Mobile's exclusive partner for the Monternet mobile phone educational channel, which is used by two million Chinese a month and comes "pre-downloaded" on all Sony Ericsson phones sold on the mainland. XFM will initially use M-in's capabilities to allow viewers to interact with TV shows via text messaging. The partnership will also create future applications for XFM's audience, including mobile applications and financial news updates on mobile phones. XFM will pay US\$10 million for M-in, plus further cash and stock consideration based on performance hurdles in 2007 and 2008.

Real Estate

19) Property Developer KWG Ups IPO Target to HK\$4 Billion

Guangdong-based property developer *KWG Property Holdings* is planning a HK\$4 billion IPO. The company had previously planned to raise HK\$2.3 billion. KWG develops medium- to high-end residential property. It currently has 10 projects under development. The company is also a player in the hospitality sector and manages three Guangdong hotels in a partnership agreement with global hotelier Starwood. KWG is expecting earnings to increase more than 5x to almost RMB1 billion this year. A property sales increase of almost 3x and a more than two-fold increase in the average sales price per square meter will be major factors driving the earnings increase.

Retail

20) Warburg Close to Acquiring Stake in Chinese Furniture Retailer

Private equity group Warburg Pincus is close to purchasing a 20% stake in Chinese furniture retailer *RedStar Macalline* for RMB1.5 billion (roughly US\$195 million). Privately-held RedStar has 33 franchises in more than 20 cities. The company also has experience working with major international retail players such as IKEA and Wal-Mart. RedStar had 2006 sales of RMB10.6 billion (roughly US\$1.4 billion). The company would like to list in Hong Kong or on the A-share market in the future.

Macro

Shares Plunge at the Start of the Week, Rebound at the End

Last week, Chinese stocks continued their downward trend stemming from the "stamp duty increase" on May 30. Stamp duties are taxes on stock trades, and the government raised these duties from 0.1% to 0.3% per trade (applicable to both buyers and sellers) in an attempt to cool the market. As a result, the markets saw the largest single day drop (on June 4) since the February 27 mini-crash. The Shanghai Composite Index fell almost 8% from its opening value, closing at 3,670.40. Many stocks hit the maximum 10% daily loss (the "magic number" that triggers the suspension of trading). On Tuesday the panic continued, with prices continuing to plummet in the morning. The Shanghai Composite Index fell to an intraday low of 3,404.15. By this time, shares had fallen 21.5% from the previous Tuesday, May 29 (the day before the stamp duty). The drop was the result of panic selling by the speculators who make up a large percentage of the investors in the A-share market.

The equities rollercoaster turned abruptly and shares rebounded in a big way, closing at 3,767.10 on Tuesday. The rebound was likely due to a number of factors. One factor was the sentiment that the panic sell-off was overblown. A more important factor was the fact that the Chinese government took measures to restore investor confidence. Top officials with the People's Bank of China (PBOC) and the National Social Security Fund "reiterated their confidence" in the long-term prospects of the market, while newspapers ran reassuring articles. The China Securities Regulatory Commission (CSRC) also approved four new mutual funds, hoping to get new money flowing into the market. From Wednesday through the rest of the week, A-shares climbed steadily. The Shanghai Composite Index finished the week at 3,913.14, down only 4.8% from closing the previous Friday and down 1.7% from the index's opening value on Monday, June 4.

It is estimated that the government could reap an additional US\$40 billion annually from the new stamp duty increase. The calculation is based on current trading levels.

Funds Raised in Mainland IPOs to Double Last Year's Total

A recent Ernst & Young report stated that Chinese companies are expected to double the amount of money raised through A-share listings this year. Total funds raised could reach RMB280 billion (US\$36.7 billion) this year, up from RMB146.3 billion last year. IPOs by state-owned enterprises (SOEs) such as CNOOC and China Mobile will lead the surge. The CSI 300 index is trading at about 40x earnings, while Hong Kong's benchmark Hang Seng Index trades at only about 16x earnings. "Market volatility" on the mainland "won't have a big impact on companies' listing plans," said ENY's China IPO head Terence Ho. "Chinese mainland companies have much more desire to list now than they did five years ago."

IFC to Invest Over US\$600 Million in China in FY2007

The International Finance Corporation (IFC), the World Bank's private investment arm, will invest more than US\$600 million in China in FY2007, which ends on June 30. IFC invested US\$639 million in China in FY2006. About 50% of the US\$600 million for this year will be invested in the financial sector. 40% will go to rural and underdeveloped areas. China receives the third-largest allotment of IFC funds, with only Russia and Brazil receiving more.

Deals in China

M&A Activity

Acquirer	Description	Target	Description	Amount	Deal details
IBM/Lehman Brothers Private Equity Fund	US\$180 million fund created in 2006 to invest in Chinese companies	Kingdee	China's second-largest enterprise-management software firm, listed in HK	HK\$132 Mil	7.7% stake
Focus Media	leading Chinese out-of-home advertising firm, Nasdaq-listed	iResearch	Chinese internet consultancy	US\$10 Mil (rumored)	controlling stake
Baring Private Equity Asia, IFC	HK-based private equity group; IFC is the private sector investment arm of the World Bank	Dongyue	China's top manufacturer of environmentally friendly refrigerants	US\$47.2 Mil	27.3% stake
Anshan Iron & Steel	major Chinese steel maker	Gindalbie	Perth, Australia-based miner, ASX listed	US\$32.5 Mil	12.94% stake
Yunnan Tin	China-based miner, world's largest tin producer	Metallica Metals	Australian nickel prospect, ASX-listed	US\$5 Mil	5% stake
Xinhua Finance Media	Nasdaq-listed finance and entertainment media enterprise	Beijing Mobile Interactive Co	provider of a range of mobile services and applications	US\$10 Mil	100% stake

Deals in China

IPO Pipeline

Company	Description	Exchange	Size	Financial Advisors
Yingli Green Energy	solar company, manufactures photovoltaic products	NYSE	US\$377 Mil	Goldman Sachs, UBS
KWG	Guangdong province-based residential property developer	Hong Kong	HK\$4 Bil	Morgan Stanley, Goldbond Securities, ICEA
Jiangsu Times	supermarket chain based in east China's Jiangsu province	Hong Kong	up to HK\$700 Mil	N/A
Yongcheng Coal & Electricity Group	Henan province-based group, focuses on coal mining, also has other operations like thermal heating and alumina refining	Hong Kong and Shanghai	RMB 12 Bil	N/A
Guangzhou Automobile Group	major Chinese automaker, has manufacturing JVs with Honda and Toyota	Hong Kong and Shanghai (simultaneously in early 2008)	RMB 600-800 Mil	N/A

Shanghai to Start Doling Out Fines for Blaring Horns

On June 1, new rules went into effect that subject drivers to fines for honking their horns on the streets of Shanghai. Drivers can be fined up to RMB200, while those on scooters can be fined RMB50. There will be a two-week grace period before tickets are given. Police even went through the trouble of handing out 50,000 fliers to educate drivers. If you live in China, as we do, you understand that because horns are used so often, it seems improbable that the police can effectively control all drivers (and their horns). According to current plans, only those who blare their horns "excessively and unnecessarily," which in our experience means substantially everyone, will be fined. In 1999 there were 8,000 cars in Shanghai. In 2003 there were 700,000. Today, there are 2.2 million.