

# Eye on China

A View from Shanghai

Week of March 17-March 23, 2007

Merchant Banking Advisory In China for Over Twenty Five Years

## ChinaVest

### CEO

Robert Theleen  
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Jenny Hsui

### Vice Chairman

William Fuller

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## Market Weekly

### Shanghai Composite Index

- 3/16 Close: **2930.48**
- 3/23 Close: **3074.29**
- Change: ↑ **4.907%**

### Shenzhen Composite Index

- 3/16 Close: **8147.32**
- 3/23 Close: **8489.86**
- Change: ↑ **4.204%**

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- 2) Three Chinese Solar Energy Firms Seek to List in US
- 3) Anheuser Busch to Expand China Presence
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- 5) Traditional Chinese Medicine Maker Lists on NYSE

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## Aircraft

### **1) China to Manufacture Large Passenger Aircraft**

China's State Council recently approved a plan for China to design and build passenger jets that would carry more than 150 people. The ability to build large passenger jets is part of China's long-term development plan, and this announcement will move the country toward that goal. New large aircraft would compete with Boeing and Airbus, the companies that currently control the entire large passenger aircraft market. Competing with those two giants would be especially important given the size of commercial aircraft industry in China in the future. Between 2006 and 2025, China will see demand for almost 3,000 large passenger aircraft, totaling about US\$349 billion, second only to the United States. Boeing and Airbus also estimate that internationally there will be demand for about 23,000 passenger jets (with capacity of over 100 passengers) in the next 20 years, totaling about US\$2.6 trillion. China is already building its own 78-105 passenger jets, with the maiden flight scheduled for next March. There are already about 70 orders for the smaller planes.

## Energy

### **2) Three Chinese Solar Energy Firms Seek to List in US**

Following in the footsteps of Chinese solar companies' recent listings on US exchanges, three Chinese solar cell manufacturers are planning Nasdaq IPOs year to raise a total of about US\$1.1 billion. Tianwei Yingli New Energy Resources plans to list in the second quarter and raise about US\$500 million, while LDK Solar Hi-Tech is planning a third quarter listing to raise about US\$400 million. CEEG (Nanjing) PV-Tech Co is also planning about a US\$200 million IPO. Just last month Chinese firm JA Solar raised US\$225 million in a Nasdaq listing, and shares are currently trading around 20% above the IPO price. Trina Solar and Solarfun Power Tech both debuted in December 2006, with Trina raising about US\$98 million in a NYSE listing and Solarfun raising about US\$150 million in a Nasdaq listing. Trina's shares are currently trading between 130% and 140% higher than the IPO price, while Solarfun's shares are hovering around the offering price. Suntech, China's leading solar cell manufacturer, listed on the NYSE in December 2005, raising about US\$396 million by selling shares for US\$15. Suntech's shares are currently trading around US\$35 (IPO stats do not include over-allotments). Investors have shown they are willing to buy into the growing alternative industry, especially considering the worsening energy situation in China.

## Food & Beverage

### **3) Anheuser Busch to Expand China Presence**

Anheuser Busch said it will ratchet up its distribution efforts in China, as the company and other international brewing conglomerates are looking for growth outside of relatively stagnant markets in North America and Europe. Anheuser Busch will begin selling its Budweiser brand in county-level cities, boosting the number of cities in which the flagship brand is sold to 200 in the next five years (up from the current 100). The brewing giant also said it will sell its Harbin premium brands in 33 more cities in 2007. "As the largest-volume and fastest-growing beer market in the world, China is the most important market for Anheuser-Busch outside the United States," said Y.R. Cheng, Anheuser Busch's managing director for China. Currently, Anheuser Busch has a 2% share of China's beer market, but holds 40% market share in premium beer. The company predicts that per capita beer consumption will double in the next 10 years. Other international brewers like SABMiller and Carlsberg also have plans to significantly expand their profitability with major pushes in China.

## **Machinery**

### **4) Carlyle Again Reduces Stake in Bid for Xugong**

It appears that the Carlyle-Xugong saga finally appears to be coming to an end, with Carlyle agreeing to take a 45% stake in the Chinese construction equipment manufacturer. Carlyle will also take a minority position on the board of the venture, with four out of nine seats. This latest concession from the private equity firm should get it the regulatory approval it needs to go forward with the stake acquisition. Carlyle had originally agreed to take an 85% stake in Xugong in November 2005, but could not gain regulatory approval for the deal. Regulators took a very cautious approach, as the deal would have involved a foreign party acquiring a majority stake in a company in a "strategic industry." In late 2006, Carlyle agreed to reduce the stake it was seeking to 50%, but couldn't get approval as some regulators still wanted to see the Chinese firm hold on to at least a 51% stake. Now that Carlyle has accepted the minority stake, it is not expected to have problems gaining approval. Under the new M&A rules that took effect last September, foreign investment into industries of strategic importance or foreign investment in famous Chinese brands is subject to extra review by regulators, especially the Ministry of Commerce (MOFCOM).

## **Pharmaceuticals**

### **5) Traditional Chinese Medicine Maker Lists on NYSE**

Traditional Chinese medicine company Tongjitang raised almost US\$100 million with a NYSE IPO. Its shares began trading on March 16. The company sold almost 9.9 million American Depository Shares (ADS) for US\$10 apiece. It had originally planned to sell the ADSs for US\$15-17, but was forced to lower the price after the Shanghai market crash on February 27. Tongjitang is a vertically integrated traditional medicine company focusing on the development, manufacturing and marketing of traditional medicine. The company had US\$62.1 million in revenue in 2006.

## Semiconductor/Integrated Circuit

### **6) China Becomes World's Largest IC Producer**

China has become the world's largest integrated circuit (IC) producer, with the IC market generating RMB486 billion in sales in 2006. 35.6 billion IC chips were produced, growing 36% from 2005. These figures were provided by Yu Zhongyu, the head of the China Semiconductor Industry Association. The industry has seen rapid growth in the last 15 years. In the early 1990s China's IC industry had revenues of only RMB1 billion. In 2006 that figure rose to its current level, with the semiconductor market as a whole producing RMB580 billion in revenue.

### **7) Intel Gets Approval to Build US\$2.5 Billion Fab Factory in China**

Intel has received approval from the National Development and Reform Commission (NDRC) to build a US\$2.5 billion wafer fabrication facility in Dalian (northeast China). The facility will have a monthly production capacity of 52,000 12-inch, 90-nanometer integrated circuit chips. This will be Intel's first fab factory in Asia, and the US\$2.5 billion will represent the largest ever foreign hi-tech investment in China. It will bring Intel's total investment in China to US\$4 billion, where the chipmaker already operates chip packaging and testing facilities in Chengdu (southwest China) and Shanghai.

## Software

### **8) Chinese OEM in Alliance with Indian Software Firm**

India's California Software Company has entered into a strategic alliance with Chinese electronics firm Malata, a leading global OEM for mobile phones, DVD players, MP3 players, LCD screens and other devices. California Software's software engineering services and support will allow Malata to make devices with more sophisticated feature sets. "This is a great opportunity for Calsoft to enter an important and growing market like China," said California Software managing director and CEO S. Sam Santhosh.

## Telecommunications

### **9) Bidding Process for China's 3G Network Begins**

China Mobile, China's largest mobile company, has started inviting bids for up to RMB24 billion in contracts to build China's first trial 3G network. The China Mobile network will be based on the home-grown TD-SCDMA standard, which is different from the WCDMA standard in Europe and the CDMA2000 standard in the United States. The company asked major international and local telecom equipment providers around the world to submit bids, such as Nokia and Ericsson from Europe and ZTE and Datang from China. The issuance of licenses has run into delays, and MII (Ministry of Information Industries) isn't expected to issue 3G licenses to mobile service providers until the first quarter of 2008. Experts suggest that the reason for the delays is the Chinese government wants to give the TD-SCDMA standard time to develop and catch up with the standards more widely used in Europe and the US before a TD-SCDMA-based network goes into commercial operation. The government has long stated that it wants 3G service in China before the Olympic Games.

## **Telecommunications**

### **10) China Mobile Mulling Domestic Listing**

China Mobile is considering issuing A-shares on the Shanghai Stock Exchange later this year. The company is a red chip that is currently incorporated and listed in Hong Kong. Red chips are companies that are incorporated and listed in Hong Kong, but whose business is based on the Mainland. There are 85 red chip companies with total market cap of about HK\$2 trillion. China Mobile is among other large red chips considering listings in Shanghai later this year, such as CNOOC and COFCO. The China Securities Regulatory Commission (CSRC) would welcome the listings of such large conglomerates in Shanghai, as it would help the maturing process China's capital markets.

## **Advertising**

### **11) Focus Media Eyeing WVAS Acquisitions**

The China Securities News reported that Nasdaq-listed Focus Media is negotiating acquisitions with four Chinese internet companies. The newspaper cited a source saying that Focus Media is looking for acquisitions in wireless value-added services. At the end of 2006, Focus Media had US\$529 million in cash, which was mainly earmarked for acquisitions. Just recently, Focus Media announced its acquisition of Allyes Information Technology, China's largest online ad firm, in a deal that could be worth up to US\$300 million. Beijing-based Focus Media is best known for advertising for its LCD screens in places such as buildings and elevators.

## **Banking**

### **12) Bank of Beijing Planning US\$1 Billion Dual Listing**

Bank of Beijing, one of China's largest city commercial banks, plans to raise US\$1 billion in a dual listing on the Hong Kong and Shanghai exchanges. Bank of Beijing will follow other Chinese state-owned and joint-stock commercial banks that have gone public in the past year. In recent months, Bank of Beijing has prepared for its public listing by getting the approval to provide foreign currency accounts, by getting its non-performing loan ratio to 3.49% and its capital adequacy ratio to 12.87% (as of the end of 2006). Its 2006 pretax profit jumped 70.8%. In 2005, ING spent about US\$215 million to acquire a 19.9% stake in Bank of Beijing; the International Finance Corporation (IFC), the private investment arm of the World Bank, also acquired a 5% stake. Bank of Beijing was founded in 1996 as Beijing City Commercial Bank, and changed its name in January of 2006.

## **Financial Services**

### **13) Bank of China and RBS Launch Private Banking Venture**

Bank of China (BOC) and Royal Bank of Scotland (RBS) have launched a private banking joint venture. The new venture will focus on individuals with more than US\$1 million in disposable investable assets. The first two private banking branches will open on March 28 in Beijing and Shanghai. The JV will initially operate under the BOC name, but the branding will change in time. "This is a natural extension of Bank of China's existing range of services for wealthy customers and at the same time establishes the first ever private bank exclusively based in China," Bank of China president Li Lihui said. In 2005, RBS headed a consortium that purchased a 10% stake in BOC for US\$3.1 billion. The two launched a joint credit card in January 2006 and have sold about 1.2 million cards since.

## **Financial Services**

### **14) China's Asset Management Industry to Grow to US\$1.4 Trillion by 2016**

McKinsey Consulting released a report predicting that asset management in China will grow to become a US\$1.4 trillion industry in 10 years. In 2006, there were only US\$156 billion in assets under management, but the market is expected to grow at about 25% annually for the next decade. In a nation where people are rapidly becoming wealthier, consumers will be looking for higher-yield outlets for their money than bank accounts. Shanghai McKinsey principal Stephan Binder also said that asset management business will get a boost when overseas-listed Chinese firms returning home for domestic listings bring with them higher corporate governance standards. The asset management market is in its infancy, leaving much room for firms to make inroads. The McKinsey report said that last year, assets under management in China amounted to 8% of GDP, compared to 214% in the United States. Three out of the top 10 companies in China in terms of assets under management have foreign investment, with Credit Suisse, Deutsche Bank, and Amvescap holding stakes.

### **15) China's Eagle Investment and Bear Stearns to form US\$500 Million Alliance**

Eagle Investment Group and Bear Stearns Merchant Banking, which is Bear Stearns' private equity arm, will form a US\$500 million alliance to invest in China's retail sector. Each party will invest US\$250 million. The venture will invest in local retailers with national potential. Bear Stearns Merchant Banking has a solid history of investing in the retail sector, previously investing in such companies as Aeropostale and Vitamin Shoppe. The chairman of Eagle Investment Group is Wong Kwong Yu, one of China's richest people, who is worth about US\$2.3 billion. He made his fortune with Gome Appliances, China's largest electronics retailer. "With our years of retail experience in China, I am looking forward to working with the Bear Stearns Merchant Banking team as they extend their successful track record into China," said Wong of the deal.

## **Logistics**

### **16) FedEx to Offer One-Day Express Service in China**

FedEx announced that it would offer one-day express delivery service in China beginning May 28. The service will serve 19 Chinese cities, while a one-to-two-day delivery service will serve 200 cities. "The Asia-Pacific region is the fastest developing area of FedEx's international business. In China, about 90% of our customers are expecting a reliable domestic delivery service, that's why we have decided to tap into the domestic market," said Chen Jialiang, president of FedEx's China business. The announcement was made in Hangzhou, where FedEx has set up its mainland handling center in Hangzhou Xiaoshan International Airport. Hangzhou is the capital of east China's Zhejiang province, and is located a few hours' drive south of Shanghai.

## Regulations

### **Two Major Laws Pass at NPC**

China's Property Rights Law and Enterprise Income Tax Law both overwhelmingly passed at this year's session of the National People's Congress (NPC) in Beijing. The laws were seen as major steps in leveling the playing field in China. The Property Rights Law is seen as a good first step to providing property protection. Meanwhile, the Enterprise Income Tax Law made the tax rate for domestic and foreign enterprises similar.

The property law aims to grant equal property protection for state, collective, and individual property. It outlines that buildings, possessions, and income can be acquired, owned and used for profit. It also tries to prevent local governments from arbitrarily expropriating land from individuals for their own projects. In one comprehensive document, the new law addresses most of the property issues that were previously either spread throughout other laws or not addressed at all. Theoretically, the new law will also provide the framework of rules under which property disputes can be settled. The right to own property was written into the constitution in 2004, but without a legal framework, it essentially had no tangible effect.

The Property Rights Law was highly controversial, having been hotly debated for well over a decade. Certain members of the Chinese government said that outright private property ownership goes against China's socialist ideals. However, other officials countered that the idea is to create a system under which all stakeholders have equal rights. In keeping with China's socialist society, the law does clearly say that the state owns all land. Some say that due to the state's control over the land, the new law really doesn't significantly improve the situation for China's farmers. Farmers currently rent the right to use the land from the state, and since the law doesn't allow farmers to actually own the land, they are still subject to being evicted. The new law also reiterates the rule that farmers cannot take out a mortgage on the land they use.

Time will determine the effectiveness of the new law. Disputes and problems will arise, and for the law to serve its purpose, these issues will need to be solved in a logical fashion. For instance, 180,000 homeowners have already petitioned the government, saying that a technicality in the new law prevents them from taking action against developers and property management companies.

The other major law that passed at the NPC was the Enterprise Income Tax Law which stipulates that the new unified tax rate will be 25% for both domestic and foreign companies. Previously, domestic enterprises paid 33% while foreign enterprises could pay as low as 15%. The new tax regulation will also help standardize the corporate tax incentive system across China and concentrate incentives in certain central government-designated industries. Before, more arbitrary incentives were given on a regional basis. Although less controversial than the Property Rights Law, this new tax regulation will allow Chinese firms to become more competitive in their respective industries.

## Regulations

### **China to Create State Investment Company for Investing Forex Reserves**

China will create a cabinet-level investment corporation to invest its US\$1 trillion in foreign exchange holdings because, according to Finance Minister Jin Renqing, "We can achieve more profit from the investments." The government did not give specifics regarding how much money would be allocated to the new company or when it would go into operation. However, the market expects that the investment corporation will begin operations with about US\$200 billion, which would immediately make it China's largest fund management company (roughly the same size of CALPERS, the largest U.S. pension fund).

Although the true composition of China's forex holdings is a secret, experts believe that up to 75% of the stockpile could be held in US dollars, mainly in Treasuries. This brings up the question of how reallocation of funds into higher-risk investments will affect the US dollar. Premier Wen Jiabao has assured doubters that the new company won't affect the dollar, saying, "It is true that in China's foreign exchange reserves, US dollar-denominated assets account for a large proportion. I can assure you that by instituting such a foreign exchange company, it will not have an impact on the US dollar-denominated assets." His statements are significant partly because they acknowledge that China does have significant dollar-denominated forex holdings. Chinese officials usually do their best to avoid discussing the dollar. In a television interview, US Treasury Secretary Hank Paulson also said that China's buying and selling of US Treasuries wouldn't have a major impact, pointing out that China's holdings don't even amount to a day's trading of Treasuries on the global markets.

It is still unclear how the money will be invested. Finance Minister Jin did say the new corporation would study other governments' investment funds, and specifically cited Singapore's Temasek Holdings, which is in charge of roughly US\$90 billion. Temasek owns stakes in companies in different industries around the world, and says it has averaged 18% annual returns since its inception in 1974. Regardless of how the new company invests the money, it will certainly have to deal with multiple factors that will create a difficult task for its managers. One such issue is the continuous appreciation of the Renminbi, which could make it more difficult for the investment company to achieve high enough returns from foreign investments. Nevertheless, it is entirely possible that while China may continue to hold U.S. treasuries, it may also complement this by acquiring inexpensive (by Chinese currency standards) U.S. hard assets such as real estate and even companies.

Until the formation of the new state company, the State Administration of Foreign Exchange (SAFE) will continue to manage China's forex reserves. Even after the company goes into operation, most of the reserves will still stay under the management of SAFE.

## **Macro**

### **US to Allow China's Accession into Inter-American Development Bank**

China and the Inter-American Development Bank (IDB) have signed an MOU, agreeing that China will enter North & South America's largest development institution. After the United States withdrew its opposition to China joining the IDB, an agreement between the parties could finally be reached. The IDB, whose members are from North America, Europe, and Asia, loans money to 26 member nations in Latin America and the Caribbean to fund economic and social development projects. Joining the IDB will further facilitate trade between China and Latin America. Since 1999, China's trade with the region has increased by five times, fueled largely by China's demand for the region's natural resources. To gain entry, China will buy a small stake in the IDB and make a large contribution to the bank's special operations fund, which provides soft loans to the IDB's poorest member nations. Currently, the organization's only Asian members are Japan and South Korea, but an IDB official said that China's entry should also pave the way for India to join in the future.

# Deals in China

## M&A Activity

Acquirer	Description	Target	Description	Amount	Deal details
Xinhu Holdings	Zhejiang-based investment holding company	Xiangcai Securities	Brokerage house in China	US\$29.7 Mil	7.04% stake
Joincare Pharmaceutical Group Industry	Shenzhen-based pharmaceutical company	Livzon Pharmaceutical Group Co., Ltd.	Zhuhai-based pharmaceutical company	US\$17.15 Mil	5.4% stake
Wal-Mart Stores Inc.	Worldwide chain supermarket	Bounteous Co.	Bounteous operates 101 hypermarkets in 34 Chinese cities under the Trust-Mart banner	US\$1,000 Mil	35% stake
IFC and KKR	Investment company affiliated the World Bank, KKR is a PE firm	Henan Tianrui Cement	Henan-based cement company	N/A	N/A
Long Yuan Construction Group	Zhejiang based construction company	Hangzhou Dadi Wangjia Manufacturing	Zhejiang-based construction company	US\$7.85 Mil	30% stake

# Deals in China

## IPO Pipeline

Company	Description	Exchange	Size	Financial Advisors
Henan Hengxing Science & Technology	Steel entangle line manufacturer	Shenzhen	RMB 41 Mil	Guangfa Securities
Jiangsu Xinmin Textile Science & Technology	Jiangsu-based textiles company	Shenzhen	RMB 30 Mil	Guoxin Securities
Zhejiang Leo Co., Ltd	Mini-type pump and garden machine manufacturer	Shenzhen	RMB 19 Mil	Guangfa Securities