

Eye on China

A View from Shanghai

Week of May 5-May 11, 2007

Merchant Banking Advisory In China for Over Twenty Five Years

ChinaVest

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Market Weekly

Shanghai Composite Index

- 4/30 Close: **3,841.27**
- 5/11 Close: **4,021.68**
- Change: ↑ **4.697%**

Shenzhen Composite Index

- 4/30 Close: **10,865.88**
- 5/11 Close: **11,489.93**
- Change: ↑ **5.743%**

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Automobiles

1) Two Chinese Automakers Planning US\$1 Billion Listings for 2007

The South China Morning Post reported that *Beijing Auto* and *Changan Auto*, two major Chinese auto manufacturers, could each raise US\$1 billion in Hong Kong offerings this year. Like many Chinese automakers, both companies have sizeable JVs with foreign auto companies. Beijing Auto has JV's with DaimlerChrysler and Hyundai. The 50-50 JV with Hyundai will be one of the first Sino-foreign auto joint ventures to produce a Chinese branded vehicle. It will be released in 2008. To date, Sino-foreign auto JVs usually import the foreign carmaker's technology and produce foreign-branded vehicles. Changan Auto, which is based in southwest China's city of Chongqing, has a large JV with Ford called Changan Ford Mazda, as well as a JV with Japan's Suzuki. In other news, Changan's first foreign plant is scheduled to begin operations this year. The plant is located in Pakistan, and will produce about 10,000 cars a year.

Energy

2) PetroChina Makes Major Oil Discovery

PetroChina, China's second-largest oil company (in terms of revenue), announced China's largest oil discovery in over 40 years. The field is in the Bohai Bay, located off the coast of Tianjin (southeast of Beijing). PetroChina says the site contains over 1 billion metric tons of oil, which equates to about 7.5 billion barrels. Considering that China consumes just over 7 million barrels a day, the discovery is expected ease China's demand for crude imports. In 2006, China imported 47% of the oil it consumed. This year, China's demand for oil will rise about 6%, while domestic production will grow by only about 2%. By 2012, annual production at the new oil field in Bohai could reach 10 million metric tons, or about 200,000 barrels a day. Eventually, production at the field could hit 25 million metric tons a year, or 500,000 barrels a day. Experts say the Bohai Bay could have an additional 20 billion metric tons (150 billion barrels) of "possible" oil reserves which could be drilled for the next 100 years. Last year, PetroChina's net income was US\$18.5 billion, nearly half of ExxonMobil's US\$40 billion. PetroChina's stock market cap of US\$220 billion is also almost half that of ExxonMobil (US\$458 billion). ExxonMobil is the world's largest oil company.

3) Alstom Acquires Chinese Power Equipment and Service Provider

Alstom announced the completion of the acquisition of *Qingdao Sizhou*, a Chinese company specializing in "boiler auxiliaries." Qingdao Sizhou provides equipment and services for the coal-fired power generation industry. Sizhou's equipment is used in more than 500 power plants in China. The company, which is located in the coastal city of Qingdao in northeast China's Shandong province, posted sales of more than €50 million last year. The acquisition is part of Alstom's plan to become a full service player in China's power generation industry. Walter Graenicher, president of Alstom's power service sector, said, "Sizhou's leading market position and developed customer base offer us a unique opportunity to build a presence in the rapidly growing Chinese power service market." The acquisition comes on the heels of Alstom's approval to purchase a 51% stake in *Wuhan Boiler*, a boiler manufacturer located in central China. Separately, Alstom and a Chinese partner just received a €120 million order to provide 144 subway trains to the city of Nanjing. Alstom's share of the contracts with the partner is €36.8 million.

Energy

4) China SPAC Announces Acquisition Agreement

Chardan South China South Acquisition Corp, a special purpose acquisition company (SPAC), announced that it entered into an agreement to purchase a Chinese distributed power generation company. Foreign-traded SPACs are acquisition vehicles that are increasingly being used in China. Initially, a SPAC is structured as a shell company that usually lists in the American OTCBB ("over the counter" stock market), although some list on the AMEX or London AIM markets instead. Its initial assets include cash and a management team. Its sole purpose is to make an acquisition within 18 months after the OTCBB listing. Once this happens, the acquired company merges into the SPAC shell, the listing name changes, and the company may eventually trade on the Nasdaq, AMEX or other market.

The Chardan South China SPAC agreed to acquire *GaoKe*, an engineering company in the distributed power generation industry. Chardan South China began trading on the OTCBB in August, 2005 and raised US\$34.5 million. Distributed generation involves generating power on a smaller scale closer to the consumer rather than at a larger central power station. Distributed power technology is considered to be significantly more efficient than traditional power generation.

The Chardan South SPAC's management team has also raised two other China SPACs. The first one, which went public in March 2004, became the first SPAC to complete an acquisition in China. It acquired an agricultural company, now called *Origin Agritech* which currently trades on the Nasdaq market (trading symbol: SEED).

Pharmaceuticals

5) Chinese Pharmaceutical Firm Eyeing Japan Listing

Shanghai Genomics, a pharmaceutical R&D outsourcing services company, wants to launch a Japan IPO before the end of July. The company specializes in the development of treatments for lung, liver, and viral afflictions, as well as treatments to aid with fractured bone recovery. In 2005, the company merged with GNI, an international pharmaceutical development group with offices in the U.S., UK, and Japan. GNI currently owns a majority stake in Shanghai Genomics. "GNI would prefer to see the company listed on the Japanese market as it is more familiar with the market in Japan," said Zhu Zhongyuan, an executive with Shanghai Genomics. Mr. Zhu also said the company has multiple products in late-phase clinical trials that are expected to gain Food & Drug Administration approval next year. "Shanghai Genomics remains open to commercializing those new products and we will be considering the two options of licensing or self-production," Mr. Zhu said. As reported in an earlier ChinaVest newsletter, the Tokyo Stock Exchange is looking to grow its share of Chinese listings. It listed its first Chinese company last month, *Asia Media*, which conducted an IPO on the exchange's "Mother Market" for startups in a US\$25.3 million offering.

Electronics/Media

6) Two Chinese Companies List on NYSE During May Holiday

On May 3, two Chinese companies began trading on the New York Stock Exchange. *Qiao Xing Mobile Communication Co* (trading symbol: QXM) raised US\$160 million in its IPO. It floated 13.3 million shares, pricing them at US\$12. The company's shares have traded between US\$10 and US\$12 since the offering and the company's stock market value is roughly US\$580 million. Qiao Xing Mobile manufactures and sells mobile phones, and is a subsidiary of Nasdaq-listed *Qiao Xing Universal Telephone* (trading symbol: XING, market cap of US\$336 million).

Also, on May 3, Shanghai-based TV shopping network *Acorn International* (trading symbol: ATV) began trading on the NYSE. The company's US\$119 million offering consisted of 7.7 million shares, each priced at US\$15.50. Shares jumped 38.7% on the first day to close at US\$21.50, and closed at US\$23.25 on Friday, May 11—up 50% over the IPO price. The company's stock market value is US\$695 million.

Internet

7) Alibaba.com to Raise US\$1 Billion with Hong Kong Listing

Alibaba.com, China's leading B2B online marketplace, will raise up to US\$1 billion in a Hong Kong IPO sometime this year. "I expect Alibaba will use the money from a listing to make acquisitions because the e-commerce sector in China is still very fragmented," said Steven Liu, a technology analyst at DBS Vickers Securities Ltd. The Alibaba Group, a larger holding company in which Yahoo! owns a 40% stake, will probably only list the *Alibaba.com* site, which is its most profitable. Alibaba Group also runs China's top online auction site *Taobao.com* and the *Yahoo! China* website. Experts say that when *Alibaba.com* goes public, it could be worth over US\$4 billion. *Alibaba.com* had revenues of US\$100 million in the first half of 2006, and it hopes to grow these revenues to over US\$1.3 billion by 2009. In 2005, Yahoo! purchased its 40% stake in the Alibaba Group for US\$1 billion. Alibaba hired Morgan Stanley, Goldman Sachs, and Deutsche Bank as its advisors for the IPO.

Internet/Semiconductor

8) Intel Capital Announces Two China Investments

Intel's Venture Capital arm just announced two new China investments. It led a US\$12 million Series B round for *51.com*, China's leading social networking website. Other participants included Redpoint Ventures and Sequoia Capital China. The firm, *51.com*, is a social networking and blogging site with 60 million subscribers. "China's internet economy, with its 137 million users, is second only to the U.S. We foresee great potential for continued growth." said Cadol Cheung, Managing Director for Intel Capital Asia Pacific. He added, "Social networking web sites in particular are growing at unprecedented pace in China, with consumers demanding unique local flavor." Intel Capital also announced a US\$10 million Series B round for *Phoenix Microelectronics*, a Chinese "fabless" integrated circuit (IC) design house focusing on chips for mobile phones. Warburg Pincus and Synopsys also participated in the Series B round.

Telecommunications

9) China Mobile Looks for Asia Acquisitions But Won't Rush

Last week, Wang Jianzhou, CEO of *China Mobile Communications*, told the Wall Street Journal that his company is searching for acquisitions in Asia, but "valuations are too high" at the moment. China Mobile Communications is the parent of *China Mobile Ltd*, the world's largest mobile operator, with 316 million subscribers. Despite comments about high valuations in Asia, China Mobile Communications made its first international acquisition in the first quarter of 2007, buying 89% of Pakistani mobile operator *Paktel* for US\$284 million. Wang said there are definite advantages to going international, even with China Mobile expanding its domestic subscriber base by 4 to 5 million people per month. He specifically pointed out that the company understands how to operate in emerging markets and can achieve low-cost purchases due to its size. While waiting to make further acquisitions in Asia, China Mobile is currently deploying China's first trial 3G network, which is based on a homegrown TD-SCDMA standard (which is different from the 3G standards used globally). Beijing has repeatedly stressed the need to get 3G services online by the 2008 Olympic Games. Wang also said that his firm will focus on increasing its revenue per user, which is slowly dropping because many new subscribers are from rural areas (who pay lower rates and use the mobile phone less frequently than urban residents). As reported in a recent ChinaVest newsletter, "Millward Brown's Global Brand Rankings" recently ranked China Mobile as one of the world's top 5 brands, placing behind Google, General Electric, Microsoft, and Coca-Cola.

Banking

10) ICBC Applies to Operate in New York

China's largest bank, *Industrial & Commercial Bank of China (ICBC)*, has approached U.S. regulators and applied to establish a branch in New York. The upgrade from representative office to branch will allow ICBC to provide depository and lending services in the U.S. This could be an important step in ICBC's international expansion plans. Separately, ICBC is in talks to buy UK-based *Travellex*, the world's largest airport currency exchange company. The deal could be worth over US\$1 billion, and would be far and away its largest overseas purchase. Last October, ICBC completed the world's largest IPO, raising US\$22 billion in a simultaneous listing on the Hong Kong Stock Exchange and the Shanghai Stock Exchange.

Financial Services

11) Barclays to Acquire Stake in Chinese Trust Company

UK-based Barclays Bank has reached an agreement to acquire *Xinhua Trust and Investment Co*, a leading Chinese trust company. Barclays plans to acquire a 19.99% stake—the maximum allowed by regulators. The parties did not disclose financial details of the deal. Xinhua Trust currently has RMB7 billion in assets under management, and is located in southwest China's Chongqing Municipality. If the deal goes through, it would represent the first foreign firm to take a stake in a Chinese trust company. In the trust sector, ChinaVest believes that there will be numerous foreign acquisitions in the future. Trust companies often have subsidiary businesses in securities, fund management, and other areas, making them attractive to foreign firms that want to gain a customer base and a foothold for their brand in China's fast growing financial services industry. Chinese trust companies are eager to receive foreign capital and expertise as they seek to become fully-functioning financial management enterprises.

Healthcare

12) New China-Focused SPAC Begins Trading on AMEX

China Healthcare Acquisition Corp, a new China SPAC, debuted on the AMEX on Thursday, May 10. The IPO raised US\$51 million in 8.5 million US\$6 "units." To elaborate on the SPAC explanation in point 4 above, a SPAC IPO is raised in "units." Each unit contains one share and either one or two warrants. The shares are freely tradable any time, both before and after the SPAC shell makes an acquisition. However, the warrants cannot be exercised unless an acquisition is made and the acquired company merges into the SPAC shell. The number of China SPACs has now reached double digits, but only three have completed acquisitions, while one disbanded before making an acquisition and had to return the IPO proceeds to shareholders. In other SPAC news, OTCBB-listed *Yucheng Technologies*, which merged into the shell of a US\$20.7 million SPAC earlier this year, is now trading in the Nasdaq market. Yucheng provides specialized IT services to China's banking sector. Yucheng was one of the three China SPAC acquisitions mentioned above. One of the others was completed by the Chardan management team (from earlier in the newsletter), which now trades on the Nasdaq as Origin Agritech.

Retail

13) Ladies Shoe Retailer could Raise Over US\$1 Billion in HK Offering

Major Chinese shoe retailer *Belle International* will raise up to HK\$8.7 billion in a Hong Kong IPO. Approximately 1.4 million shares will be sold at HK\$5.35-HK\$6.20 apiece and will begin trading on May 23. According to the South China Morning Post, the offering has already attracted HK\$120 billion from institutional investors. French luxury goods icon LVMH will purchase HK\$234.6 million (US\$30 million) worth of shares in the IPO, and Belle's CEO said the company will "seek cooperation" with LVMH. Belle has a network of 3,828 stores in China, as well as 35 internationally. It plans to add 1,000 stores a year. With the expanding wealth of the Chinese middle class, many investors seem interested in making investments in the high-end shoe sector.

14) Winshare to Raise US\$200 Million in IPO

Xinhua Winshare Bookstores is launching a Hong Kong IPO and seeks to raise about US\$200 million. Xinhua Bookstores is a state-owned bookstore with locations throughout China. As part of the tightly controlled media industry, the stores are currently run as not-for-profit entities. However, Xinhua's partner, Winshare, which runs 200 outlets in southwest China's Sichuan province, was established as a "for-profit limited company" last May. The IPO shares will be valued at 18x - 20x projected 2007 earnings (Barnes & Noble and Borders are actually trading at higher PE multiples of 23x - 26x). Last year, 80% of Winshare's revenue came from sales of textbooks and other educational material, as Sichuan is a province with a large student population. After the IPO, the company will grow by purchasing booksellers in other provinces. Last August, Borders and HMV Group (a major UK-based book and audio-visual product seller) were reported to have interest in acquiring stakes in Xinhua Winshare, saying they would be willing to wait until Winshare went public if necessary. Winshare will be one of the first Chinese companies to list in Hong Kong after the China Securities Regulatory Commission (CSRC) said it would stop allowing Chinese H-share IPOs that raise less than US\$1 billion (unless the companies simultaneously list in China).

Regulations

Chinese Regulators Shut Down Polluting Enterprises

China closed down 3,176 polluting enterprises last year, the result of an initiative to inspect 720,000 enterprises for their pollution discharge. China's *State Environmental Protection Agency (SEPA)* put special emphasis on industrial parks, which are often home to numerous polluting enterprises and construction sites. SEPA visited 2,000 industrial parks housing 30,000 companies. They severely punished 4,162 companies. The environmental protection watchdog also suspended 163 future projects that are potentially harmful to the environment, involving total investment of RMB770 billion. As part of the ongoing effort to continue the fight against polluting enterprises, SEPA placed 6,000 companies on a pollution watch list. These companies have been required to install pollution monitoring and control systems that report readings directly to local regulators. All 6,000 will be subject to monthly on-site inspections. As many of our readers are aware, severe pollution is a major side-effect of China's rapid growth. Realizing the importance of the issue, regulators are taking measures to improve the situation. However, the challenge of attempting to breathe the air in some of China's major cities proves that there is still a long way to go.

Macro

China's Stock Market Bubble Swells

Stock prices in China's markets continue to rise with the Shanghai Composite Index breaking 4,000 for the first time this week. Despite warnings of a bubble, as well as PBOC's (People's Bank of China, the country's Central Bank) announcement that it will raise the reserve ratio once again in an effort to cool the economy, Chinese retail investors continue to funnel their money into the stock markets at an astounding rate. Last month, almost 5 million new stock trading accounts were opened, more than 1.5 times the 3 million accounts that were opened in the whole of 2006. On May 8 alone, the first day after China's May Holiday, investors opened 368,500 new stock trading accounts. The *China Securities Regulatory Commission (CSRC)* may soon take steps to restrict inflows into the stock markets. According to UBS, this could include capital gains taxes and penalties/taxes on short-term buying and selling activity. CSRC also reiterated this week that Chinese companies must use fund-raising proceeds (like IPOs) for their intended purpose, and not to add to the stock speculation by purchasing securities in other companies. Regulators are also trying to make sure individuals aren't using bank loans to speculate in the markets. Chinese citizens cannot invest in overseas markets, and with savings deposits paying less than 3%, millions of Chinese individuals are "betting" on stocks. With increasing amounts of new capital pouring in, we expect a correction. The question is when will it occur and how large will it be. In the first five months of 2007, the Shanghai Composite Index rose over 50%.

Macro

Chinese Companies Purchase US\$4.3 Billion of Goods from U.S.

Last week, a Chinese delegation traveled to San Francisco and signed US\$4.3 billion in bulk purchases with U.S. technology firms. The move, which arguably makes a small dent in the U.S.-China trade deficit, is intended as "good public relations" in anticipation of a visit by high-ranking Chinese officials to Washington later this month. Shanghai-based Semiconductor Manufacturing International Corp (SMIC) agreed to purchase US\$1.86 billion worth of equipment from U.S. firms over the next five years. The U.S. firms include Applied Materials and KLA-Tencor. Additionally, China's largest PC manufacturer *Lenovo* agreed to purchase US\$1.3 billion worth of software from Microsoft. The Chinese delegation, which represents about 200 Chinese companies, is expected to continue to travel throughout the U.S. and sign more purchase agreements with American firms. Original plans had been for total purchases to total over US\$12 billion, and further deals will likely include products in sectors like machinery, agriculture, and textiles. In March, the United States imposed tariffs on glossy paper imports from China. Shortly thereafter, the U.S. filed a copyright complaint against China with the WTO. Because of the high profile nature of the U.S. trade deficit with China and the delicate political nature of the situation, we expect that China's efforts to smooth the issue won't stop at bulk purchases. Beijing may also cut export rebates in certain sectors, namely metals.

PBOC Raises Yuan Deposit and Foreign Deposit Reserve Ratios

For the seventh time in a 12-month period, China's central bank raised the required reserve ratio for yuan deposits. PBOC will raise the rate half a percentage point from 10.5% to 11% in its continued attempts to cool the perceived "overheating economy." China's GDP grew 11.1% in the first quarter of 2007. PBOC will continue to use monetary policy to try to control the economy and keep inflation down. Lately however, the technique hasn't had the desired effect, as many banks already have ample yuan reserves, and hikes in the RRR don't significantly affect their lending. Earlier in the year, Beijing said it wanted to keep 2007 GDP growth below 10%, but that now seems highly unlikely. PBOC also just raised the foreign currency deposit reserve ratio from 4% to 5%. Of the US\$165 billion in foreign currency deposits, the hike could trim roughly US\$1.7 billion from the Chinese economy. Both rate increases will go into effect on May 15.

Macro

CSRC to Delay Introduction of Index Futures

China will most likely miss its June 30 goal to launch stock index futures on the China Financial Futures Exchange. Due to fears about introducing index futures too quickly, as well as fears of a market downturn, the *China Securities Regulatory Commission (CSRC)* is being conservative. CSRC is paying extra attention to writing the trading rules and making sure brokers and investors are properly trained. "Although we've applied for a license to trade index futures, we were told to wait and learn more about potential risks," said an executive at a Shanghai-based broker. "We have yet to gain a clear timetable from the regulator about the product's launch." The delay in introducing the index futures is expected to be a few months. Although CSRC is worried about introducing the futures amid possible market volatility, the futures index could actually help dampen the volatility by giving speculators a way to bet on drops in stock prices. China does not currently allow short positions in stocks. In the first quarter of this year, CSRC released the regulations that lay the groundwork for financial futures trading. Previously, regulators only permitted futures trading in commodities, having shut down financial futures trading in 1995.

Shanghai FDI Down 7% in Q1

Contracted foreign direct investment (FDI) in Shanghai totaled US\$3.17 billion in the first quarter, down 7% from the first quarter of last year. Stricter land-use rules and the new unified income tax law were the chief causes of the decrease. The new tax law has evened the tax rate for foreign-invested enterprises (FIE) and domestic enterprises, raising the rate for FIEs from 15% to 25%. Roughly 59% of the 909 approved foreign-funded projects were capital injections into existing FIEs, which are grandfathered from the full effects of the new tax law for a period of time. As far as the breakdown of the US\$3.17 billion, 196 manufacturing projects accounted for US\$1.26 billion, up 3.34% from Q1 2006. Highlighting China's stricter land use rules enacted to cool down the real estate sector, foreign investment in property development projects dropped 31% to US\$612 million.

Deals in China

M&A Activity

Acquirer	Description	Target	Description	Amount	Deal details
Barclays	UK-based banking group	Xinhua Trust	leading Chinese trust company	N/A	19.99% stake
Alstom	French industrial conglomerate	Qingdao Sizhou	China-based power services and equipment company	N/A	controlling stake
CITIC Resources	HK-listed, China's fourth-largest oil producer	Tincy Energy Resources	Chinese company with rights to develop and operate an oil field in Bohai Bay	US\$150 Mil	90% stake
Legend Holdings	parent company of Lenovo Group	Shijiazhuang Pharmaceuticals	major China-based pharmaceutical firm	at least RMB 840 Mil	100% stake
Zhenhua Port Machinery	Shanghai-listed, Shanghai-based manufacturer of port cranes	Jingjiang Nanyang Shipyard Company	shipyard in Jiangsu province (acquisition includes ships and cranes)	RMB 400 Mil	controlling stake
Chardan South China Acquisition Corp	OTCBB-listed SPAC	GaoKe	China-based distributed power generation engineering company	US\$34.5 Mil	GaoKe will swap shares with the SPAC and begin trading on the OTCBB

Deals in China

IPO Pipeline

Company	Description	Exchange	Size	Financial Advisors
Belle International	Chinese ladies' shoes retailer	Hong Kong	up to HK\$8.7 Bil	Morgan Stanley, Credit Suisse
Alibaba.com	China's leading B2B online marketplace	Hong Kong	US\$1 Bil	Morgan Stanley, Goldman Sachs, and Deutsche Bank
Tianneng Power	Zhejiang province-based battery manufacturer	Hong Kong	up to HK\$531 Mil	HK-based Kingsway Capital
Xinhua Winshare	Chongqing-based bookseller	Hong Kong	US\$200 Mil	BOC International
Hengda Real Estate	Guangzhou province-based real estate company	Hong Kong	US\$500-750 Mil	N/A
China Print Power	Chinese book producer for international market	Singapore	SGD 8 Mil (US\$5.27 Mil)	China Construction Bank