

# Eye on China

## A View from Shanghai

Merchant Banking Advisory In China for Over Twenty Five Years

### ChinaVest

#### Senior Management

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

#### Editorial

Erik Bethel [ebethel@chinavest.com](mailto:ebethel@chinavest.com)  
Patrick Kelly [pkelly@chinavest.com.cn](mailto:pkelly@chinavest.com.cn)

### Market Weekly

#### Shanghai Composite Index

- 11/9 Close: **5,315.54**
- 11/23 Close: **5,032.13**
- Weekly Change: ↓ **5.332%**
- Since 1/1/07: ↑ **88.084%**

#### Shenzhen Composite Index

- 11/9 Close: **17,160.12**
- 11/23 Close: **16,217.51**
- Weekly Change: ↓ **5.493%**
- Since 1/1/07: ↑ **143.98%**

#### Exchange Rate

- 11/9: US\$1 = **RMB 7.432**
- 11/23: US\$1 = **RMB 7.421**
- Weekly Change: ↑ **0.148%**
- Since 1/1/07: ↑ **5.072%**

### Articles

#### Industrial & Consumer

- 1) China Aims to Double Nuclear Power Capacity
- 2) German Wind Power Company Plans €50 Million China Expansion
- 3) Carlyle to Spend US\$100 Million for Stake in Luxury Hotelier
- 4) Arcelor Reportedly Buys Chinese Steel Maker
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- M&A Activity – A Closer Examination
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#### Random Tidbits

## Energy

### **1) China Aims to Double Nuclear Power Capacity**

Last week, the state-owned *China National Nuclear Corporation* announced plans to double its nuclear power capacity by 2020. Only 2% of China's energy comes from nuclear power, and the plan outlines an increase to 4%. Compared to developed nations, China's portion of energy from nuclear power would still remain quite low. The United States and the EU derive approximately 20% and 30% of their electricity from nuclear power, respectively, with France leading the way at 80%. Currently, China has 11 functioning nuclear facilities with eight more under construction and another eight in planning stages. The total cost of the 16 new power plants will be approximately RMB400 billion (roughly US\$54 billion). In addition to doubling nuclear power, China plans to double the use of renewable energies by 2020. Coal is China's traditional source of power, and still accounts for 67% of the nation's electricity production.

### **2) German Wind Power Company Plans €50 Million China Expansion**

German wind turbine manufacturer *Nordex* announced that it plans to invest €50 million to expand its production capacity in China. With the investment, Nordex wants to grow its share of wind turbines in the Chinese market from 3% in 2006 to 15% by 2011. The German group is setting itself up to become a main supplier for the future of construction of large-scale wind farms on the mainland. Additionally, the company's investment will not only expand its reach into China, but will also help it build a manufacturing base to supply the entire Asia region. Nordex has been a pioneer in alternative energy in China for almost a decade, establishing its first plant in 1998. As mentioned in the previous article, China is planning to double its use of renewable energies by 2020, making wind energy one of the more attractive sectors for foreign investment.

## Hospitality

### **3) Carlyle to Spend US\$100 Million for Stake in Luxury Hotelier**

The Wall Street Journal reports that private equity firm Carlyle Group has acquired a minority stake in a Chinese hotel chain, *New Century Tourism Group*. The proposed deal is estimated at an initial US\$40-50 million, and will rise to US\$100 million early in 2008. New Century is a privately-owned company with a focus on high-end hotels, as well as other real estate projects. New Century plans to list in Hong Kong in 2008 or 2009.

## Industrial

### **4) Arcelor Reportedly Buys Chinese Steel Maker**

ArcelorMittal, the world's largest steel company, is reportedly close to becoming the first foreign-owned enterprise to gain control of a Chinese steel company. Earlier this month, Arcelor paid US\$647 million for a 27.3% stake in Hong Kong-listed *China Oriental Group*. However, a filing with the Hong Kong Stock Exchange since stated that ArcelorMittal has taken a 73% stake. Neither Arcelor nor China Oriental has confirmed or denied the reports. A China Oriental statement added, "China Oriental is not at liberty to discuss any issues prior to the posting of a formal announcement, which is currently being prepared" (CNN). Based on the purchase price of the original 27.3% stake, it is estimated that ArcelorMittal would have to pay about US\$1.73 billion to acquire a 73% stake. There is no word on whether the Chinese government would approve the transaction, but even reports of such a deal come as a mild surprise. Chinese regulators, led by the *Ministry of Commerce (MOFCOM)*, examine all foreign M&A deals. MOFCOM focuses on whether transferring key Chinese assets to foreign hands would threaten the domestic industry, compromise important Chinese brands, or threaten China's national security. Particularly in sensitive manufacturing industries like machinery, steel, and mining, MOFCOM strictly regulates the sale of majority stakes in large Chinese firms to foreign companies. We'll continue to update this development in future newsletters.

In a related transaction, ArcelorMittal has been trying since 2006 to acquire a 38% stake in *Laiwu Steel*, China's ninth-largest steelmaker. However, regulators have not approved the deal, reportedly because the price agreed in the original transaction is too low.

### **5) Goldman Sachs Gets Approval for Stake in Tool Maker**

The *China Securities Regulatory Commission (CSRC)* approved Goldman Sachs' acquisition of a 12% stake Chinese measuring tool manufacturer *Yangzhiguang*. However, the approval is reportedly on the condition that Goldman will revise the terms its deal with Yangzhiguang, paying more than originally stipulated for the stake. In late 2006, Goldman agreed to pay RMB3.99 per share for 60 million shares of Shanghai-listed Yangzhiguang, for a total of about RMB240 million. Yangzhiguang's shares currently trade at about RMB25, and reached a peak of RMB30 in September.

China wants to keep investors from acquiring stakes in listed Chinese companies at deep discounts, which had occurred in the past. In fact, Goldman recently had two similar China private equity investments turned down. In August, CSRC denied Goldman Sachs' purchase of a 10.7% stake in *Midea*, a major Chinese appliance maker, as Midea's share price stood about 4x higher than the price Goldman agreed to pay. According to the agreement, Goldman would've paid about RMB716.6 million for the stake. Earlier this month, CSRC denied Goldman a 10% stake in auto glass maker *Fuyao Glass* for the same reason, in a deal that would have been worth RMB890 million. After those two disappointments, approval for the Yangzhiguang deal is certainly a relief for Goldman. However, the firm has not made any statements regarding how much more it will have to pay for Yangzhiguang's shares to complete the deal. Earlier this year, CSRC said it would no longer allow stake purchases in listed Chinese companies at greater than a 10% discount to the share price.

## Infrastructure

### **6) China Railway to List in US\$5.5 Billion IPO**

State-owned *China Railway Engineering Group*, the world's third-largest construction group, has begun its dual IPO on the Shanghai and Hong Kong stock markets. China Railway has raised US\$3 billion for the Shanghai portion of the offering, which in total will raise approximately US\$5.5 billion. Shares will begin trading in Shanghai on December 3, and on December 7 in Hong Kong. The Shanghai share sale saw overwhelming demand, breaking an all-time mainland record for investor subscriptions (US\$457.2 billion worth). China Railway needs new capital to buy equipment, raise capacity, and improve technology. Investment in China's infrastructure is expected to boom in the upcoming years, as its road, rail, and port system tries to catch up with its recent growth. Currently, China Railway Group derives nearly 90% of its revenues from infrastructure construction. The group's primary focus is in the construction of roads, highways, railways, and bridges; its most notable project was the completion of the Qinghai-Tibet railway line, the world's highest elevated rail, which traverses terrain over 16,000 feet above sea level. Recent industrial IPOs in Shanghai have proven quite successful, such as *PetroChina*.

Also noteworthy about the China Railway listing is that the *China Investment Corp (CIC)*, the government's newly-founded investment arm, will buy US\$100 million worth of Hong Kong-listed shares in the IPO. The government created CIC to invest some of the country's US\$1.5 trillion in foreign exchange holdings (the reason CIC will buy the Hong Kong shares rather than the domestic A-shares). CIC made global news by spending US\$3 billion for a 10% stake in U.S. private equity firm Blackstone Group in June. In the future, we can expect to see CIC continue to buy shares in state-owned enterprises listed on foreign stock exchanges.

## Internet

### **7) Chinese User-Generated Video Website Receives VC Funding**

China's most popular video sharing website *Youku.com* (essentially a Chinese YouTube) recently closed a US\$25 million third round of funding. U.S.-based VC group Brookside Partners led the investment. Brookside is a subsidiary of private equity group Bain Capital. Other investors included Shanghai-based venture capital group Chengwei Ventures, Silicon Valley VC group Sutter Hill Ventures, and San Francisco-based investment management company Farallon Capital Management. Those three parties were also previous investors in *Youku.com*, with Farallon providing the initial US\$3 million in venture funding for *Youku.com* in March 2006. ([pacificepoch.com](http://pacificepoch.com))

In previous newsletters, we covered VC investments in China's two other largest user-generated video websites, *Tudou.com* (July 20 newsletter) and *56.com* (September 14 newsletter).

## Telecommunications

### **8) China Mobile Adds 6.6 Million Subscribers in October, May Also Add iPhone**

*China Mobile*, the world's largest mobile operator, added 6.6 million new subscribers in the month of October. This brings the company's total to 356.27 million subscribers, a number almost 20% larger than the entire population of the United States. China Mobile has increased its subscriber base by 55 million so far this year. Mainland China now far outpaces any other country in the world, with about 520 million mobile users. China Mobile continues to rack up new customers by providing cheap mobile service to rural customers, who have little disposable income but are eager to enjoy the lifestyle of modern China. The company is also reportedly deep into negotiations with Apple to sell the iPhone with China Mobile service. The mainland's urban residents love spending their rapidly rising disposable incomes on the latest trendy consumer products. Offering the iPhone would help China Mobile consolidate its leading position in urban markets. By early next year, China Mobile will almost certainly list on the Shanghai Stock Exchange in a colossal IPO worth about US\$11 billion. The group is already listed in Hong Kong and on the New York Stock Exchange, with a stock market value of US\$336.3 billion.

## **Banking**

### **9) Gov't PE Fund to Buy RMB1 Billion Stake in City Commercial Bank**

The *Bohai Industry Investment Fund*, a Chinese government-backed private equity (PE) fund, will pay RMB1 billion (US\$135 million) for a 10% stake in *Chengdu City Commercial Bank*. Bohai is a RMB6 billion fund based in the northern port city of Tianjin, and is China's first government-backed PE fund. The investment in Chengdu Bank is significant, as it sees domestic PE money flowing into the banking sector, an area in which foreign PE players have made little progress. Earlier this year, the Carlyle Group attempted to acquire a 7.99% stake of *Chongqing City Commercial Bank*. However, Chinese regulators nixed the deal, saying Carlyle didn't offer enough strategic value to Chongqing Bank. Back on the subject on Chengdu City Commercial Bank, Malaysia-based Hong Leong Bank recently agreed to pay about US\$262 million for a 19.99% stake in Chengdu Bank (November 9 newsletter), the largest percentage stake a foreign entity can own in a mainland bank.

Chengdu City Commercial Bank was established in 1996, and operates 29 branches and 114 outlets in Chengdu, the capital of southwest China's Sichuan province. In 2006, it reported RMB12.4 million (US\$1.7 million) in profit and RMB1.4 billion (US\$189 million) in assets. (China Daily, Wall Street Journal)

### **10) GE Capital May Open in China Next Year**

GE Capital International Financing Corp expects to open a wholly-owned bank in China next year to support its expansion in the country, an official at a GE Capital unit said. Information suggests that GE Capital is close to winning approval from U.S. regulators to expand banking services to China, and plans to submit an application to the *China Banking Regulatory Commission (CBRC)* by the end of 2008.

GE Capital is the global consumer lending unit of General Electric, and currently owns 20 banks around the world. The company is also looking to operate non-banking financial services in China. In separate news, *Shenzhen Development Bank (SDB)*, a mid-sized Chinese bank, last month cancelled a two-year old stake sale agreement with GE Capital (October 26 newsletter). The deal called for GE to buy a 7% stake in SDB for about US\$100 million. The transaction was likely terminated due to a large increase in SDB's share price since the deal was signed, similar to the failed Goldman Sachs deals we discussed in the article above. (Xinhua News Agency)

## **Banking**

### **11) Three Chinese Banks Eye Stake in Standard Chartered**

*Industrial and Commercial Bank of China (ICBC), Bank of China (BoC) and China Construction Bank (CCB)*, China's three largest banks, were rumored to be interested in acquiring a 17% stake in UK-based Standard Chartered Bank. The stake is currently held by Temasek Holdings, a Singapore government investment arm. Temasek is the largest shareholder of Standard Chartered. The Financial Times reported that the three Chinese banks, which are all state-owned, have been in touch with Temasek regarding the stake. Temasek originally acquired an 11.5% stake in Standard Chartered in 2006, later increasing it to the current 17%.

Although Standard Chartered is headquartered in London, 90% of its profits come from operations in Asia, West Asia and Africa. It has 1,600 branches in 50 countries and employs 60,000 people. In China, Standard Chartered has 30 branches but plans to add another 10 by the end of the year. In March 2007, it became one of the first four foreign banks to receive a license to conduct RMB-denominated business on the mainland. As a result, income from its Chinese operations more than doubled in the first half of 2007.

Standard Chartered is attractive to the Chinese banks because of its profitable and expanding operations in Africa, the Middle East and Asia. However, whether or not a deal will ever be completed is in question, even if the rumors are valid. One person with knowledge of the situation told the Financial Times, "The [Chinese] banks have all tested the waters regarding the Standard Chartered stake, but Temasek has made clear that it is not a willing seller." All three Chinese banks denied any interest. (Financial Times, China Economic Review)

## **Insurance**

### **12) China Pacific Close to Launching Large Dual Listing**

*China Pacific*, China's third-largest life insurer by premiums, is on the verge of launching a large dual IPO in Shanghai and Hong Kong. The IPO will be worth up to a combined US\$6 billion. The company, which is only six years old, expects to float A-shares in Shanghai before year end, and H-shares in Hong Kong in the first quarter of 2008. The company will likely raise more than half the total funds in the Shanghai offering. Although the mainland and Hong Kong markets are going through a rough patch, we must remember that multi-billion-dollar IPOs are the norm, with two US\$9 billion offerings taking place in Shanghai within the past two months (Shenhua Energy and PetroChina). We also saw earlier in the newsletter that China Railway's IPO received more investor subscriptions than any mainland IPO to date. China Pacific will likely have no trouble raising the funds, and Chinese regulators will be happy to have another large domestic IPO to soak up a bit more liquidity.

The Wall Street Journal noted that the dual listing could mean a handsome profit for Carlyle Group. Two years ago, Carlyle and U.S.-based insurer Prudential spent about US\$410 million for a stake in China Pacific. Carlyle currently owns about a 20% stake. Using a very rough guess, we estimate that China Pacific could sell about 20% of its enlarged share capital in the dual listing. If the listing raises US\$4 billion-US\$6 billion, Carlyle would clearly be sitting on a fantastic return.

## **Macro**

### **China Raises Rates, Restricts Bank Lending**

The *People's Bank of China* (PBOC—China's central bank) once again raised the required reserve ratio (RRR) for banks, hiking it 0.5% to 11.5%. It marks the ninth time this year PBOC has increased the RRR, which aims to curb lending by increasing the amount banks must keep on hand. Economic indicators still show much faster growth in China than most believe is ideal. GDP grew 11.5% YoY in the third quarter, only slightly slowing down from the 12-year high of 11.9% in the second quarter. At the beginning of the year, Beijing said it would aim its policy moves to keep GDP growth under 10%, given inflationary concerns.

Inflation also continues to skyrocket, with October's consumer price index rising 6.5% (an 11-year high, equal to August's 6.5% YoY increase). That inflation portends an imminent hike in interest rates, which would be the sixth this year. PBOC's ideal inflation rate is below 3%. At the beginning of the year, inflation stood at about 2%, but has since spiraled upward due to rising food prices. And the fact that food is the culprit is the largest source of worry for China, because it makes it difficult for hundreds of millions of Chinese who live on very low incomes to afford their basic necessities. Prices for pork, which is China's staple meat, have approached double their 2006 prices at times this year.

So far in 2007, Beijing has tried a multitude of measures to control the economy. In addition to rate hikes and RRR increases, a major step was reducing or eliminating export tax rebates on almost 2,300 export products, as China attempts to reduce its reliance on exports (especially of low-tech, low value-added goods) and slow the growth of foreign funds flowing into the mainland. The initiative hasn't yet shown major results, although over time it will likely help. Last week, PBOC used another new tactic, by reportedly restricting lending by banks until the end of the year. Other monetary policy hasn't done the trick, as banks are cashing in on the boom, extending 17.66% more in new loans in the first ten months of 2007 than in the same period in 2006.

### **Mainland Shares Continue to Fall**

A combination of factors is contributing to the recent downward momentum in the mainland stock markets. A major cause of the recent downturn is cooling measures from China's central bank, which will make it more difficult for companies to obtain financing. Amid another quarter of sky-high growth and another month of record inflation, the central bank is taking a number of steps to slow down the economy. It started with the ninth 0.5% hike in the required reserve ratio, mentioned above. Also mentioned above, PBOC told banks to essentially stop extending new loans for the rest of the year. Specifically, according to the Xinhua News Agency, PBOC will limit total lending for the remainder of the year to RMB85 billion, a small sum compared to the RMB3.5 trillion in loans written in the first ten months. And with the sizzling growth and ballooning inflation figures, the market is bracing for an upcoming hike in interest rates, which will add to the difficulty in obtaining loans.

Additionally, the market is expecting the upcoming introduction of stock index futures. Stock index futures will for the first time allow investors in the mainland stock markets to "short" the market, or bet on a downturn. Until now, investors have only been able to take long positions, which has contributed to the wild speculation-driven volatility of the past two years. Introducing bets on downturns is certainly a major step in the maturing process of the domestic capital markets, and the government hopes it will dampen some of that volatility. Much of the "shorting" of the market will be done by institutions, which will use the tool as a hedge, although

# Regulations & Macro

there will surely be many using the "short" to speculate. Regardless of the breakdown between hedging and speculation, investors expect that when the index futures are introduced (tentative date is December 28), the influx of short positions will exert downward pressure on prices. This is likely another factor influencing the recent lackluster performance of the Shanghai and Shenzhen markets.

The Shanghai Composite Index reached its all-time high on October 16, at 6,092. Since, it has dropped 17.4% to 5,032, and stands at the same level it did in August. So far in 2007, the index has risen 88%.

## Macro

### **Shanghai Stock Exchange May Eventually Include Foreign Companies**

China is considering allowing foreign multinational companies to float shares on the Shanghai Stock Exchange (SSE). Currently, only Chinese companies can list on the Shanghai and Shenzhen stock markets. According to Que Bo, the assistant general manager of the Shanghai Stock Exchange, "market research toward a listing plan is currently underway" (China Economic Review). China is thinking of the move to help cope with the country's glut of liquidity, which has caused the meteoric rise in the domestic stock markets during the last two years (the Chinese cannot directly invest their money outside of China, so their money creates excess demand for too few domestic stocks). With US\$5 trillion in personal savings and foreign exchange pouring into the country at the rate of US\$24 billion a month, China continues to search for ways to soak up that excess money.

Beijing has been encouraging "red-chips", Chinese companies that are incorporated and listed abroad, to conduct large IPOs in Shanghai. The first three have done so in the last two months: *China Construction Bank*, coal producer *Shenhua Energy*, and oil giant *PetroChina*. Additionally, in a plan designed to release some pressure by giving domestic money a foreign outlet, the *State Administration of Foreign Exchange (SAFE)* will soon begin the "through-train" scheme, which will allow citizens to invest a limited amount directly in the Hong Kong stock market. However, regulators have delayed that plan partly due to the current downturn of mainland stocks, fearing the through-train could cause an exodus of money to Hong Kong and destabilize the Shanghai and Shenzhen markets.

Certainly allowing domestic investors to buy shares in the biggest multinationals would provide some help for the liquidity problem. Que Bo, the SSE assistant GM, mentioned Coca-Cola, HSBC, and Siemens as examples of companies Shanghai would fancy (China Economic Review), although it remains too early for any actual candidates to emerge. We certainly shouldn't hold our breath waiting for any foreign giants to list in Shanghai within the immediate future.

# Deals in China

## M&A Activity

Acquirer	Description	Target	Description	Amount	Deal details
Bank of China	China's second-largest commercial bank	Bank of East Asia	largest independent Hong Kong-based bank	HK\$3.95 Bil	4.94% stake
ArcelorMittal	world's largest steel producer	China Oriental Steel	HK-listed steel maker based in northern China	estimated US\$1.73 Bil	73% stake
Bohai Industry Investment Fund	Chinese government-backed private equity fund	Chengdu City Commercial Bank	city commercial bank located in SW China	RMB 1 Bil	10% stake
Belle International	HK-listed, major Chinese ladies footwear manufacturer and retailer	Shanghai Aurora Footwear	Shanghai-based OEM footwear manufacturer	RMB 563 Mil	100% stake

# Deals in China

## IPO Pipeline

Company	Description	Exchange	Size	Financial Advisors
China Railway	state-owned infrastructure construction company	Shanghai first, then Hong Kong	US\$5.5 Bil	BOC Int'l (SH and HK offerings), UBS (SH and HK), JPMorgan (only HK)
China Pacific	China's third-largest life insurer	Shanghai first, then Hong Kong	US\$4-6 Bil	UBS (Shanghai and HK offerings), Credit Suisse (only HK)
WSP Holdings	manufacturer of casing, tubing, and drill pipes for the oil industry	NYSE	US\$287.5 Mil	JPMorgan
Liaoning Publishing & Media	NE China-based publishing house	Shanghai	RMB 700 Mil	Ping An Securities
Dongyue Group	China's largest refrigerant producer	Hong Kong	HK\$1.37 Bil	Citigroup

## **Firefighters Douse 50-Year Coal Bed Fire**

In western China's Xinjiang Autonomous Region, the Xinjiang "Coalfield Firefighting Office Project" put out a coal bed fire that had burned for more than 50 years. The fire was fueled by coal about 350 feet below the surface. "First, we drilled into the burning coal bed and then poured water and slurry into it to lower the temperature," said Miao Pu, head of the fire fighting team. "After the temperature dropped, we covered the surface to starve the fire of oxygen." The fire had spewed more than 70,000 metric tons of toxic gas into the air each year since it started burning in the 1950s. Apparently in Xinjiang, these long-term fires hundreds of feet underground are fairly common, with some lasting for a thousand years. Apparently the fires, which start spontaneously, are extremely difficult to fight, partly because of their depth. For reference, Xinjiang has about 40% of China's total coal reserves.