

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

Editorial

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

Market Weekly

Shanghai Composite Index

- 10/12 Close: **5,903.26**
- 10/19 Close: **5,818.05**
- Weekly Change: ↓ **1.444%**
- Since 1/1/07: ↑ **117.46%**

Shenzhen Composite Index

- 10/12 Close: **18,864.55**
- 10/19 Close: **18,834.80**
- Weekly Change: ↓ **0.158%**
- Since 1/1/07: ↑ **183.35%**

Exchange Rate

- 10/12: US\$1 = **RMB 7.515**
- 10/19: US\$1 = **RMB 7.522**
- Weekly Change: ↓ **0.093%**
- Since 1/1/07: ↑ **3.783%**

Articles

Industrial & Consumer

- 1) Chinese Auto Parts Maker Considering Large Acq. of German Co
- 2) Macquarie Leads Largest Placement in Chinese Education Sector
- 3) Danone to Sell Holdings in Major Chinese Dairy Producer
- 4) Prominent VC Group Invests in Natural Beverage Company
- 5) MOFCOM Gives Bayer Approval for Largest China Pharma Acquisition

Technology

- 6) Gateway Nabs European PC Maker Packard Bell, Lenovo Loses Out
- 7) Alibaba.com to Raise US\$1.3 Billion in Hong Kong IPO
- 8) China's Top Online Game Operator to List on NYSE

Finance

- 9) Large Securities Brokerage Planning Huge US\$4 Billion IPO
- 10) GE Arm to Invest US\$50 Million in Chinese Financial Firm
- 11) CITIC Group Possibly Negotiating for Stake in Bear Stearns

Regulations & Macro

- PBOC Hikes Reserve Rate for 8th Time in 2007
- Shanghai Composite Index Passes 6,000
- CDB to Invest US\$10.7 Billion in China's High-Tech Companies

Deals in China

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

Random Tidbits

Auto Parts

1) Chinese Auto Parts Maker Considering Large Acq. of German Company

Reuters reports that *Ningbo Huaxiang Electronic Co*, a Chinese auto parts manufacturer, is in talks to acquire a German auto parts maker for a price of RMB1-1.5 billion. Huaxiang said the unnamed German company posted 2006 revenue of €250 million and profits of €25 million. Huaxiang's CEO said he was still uncertain as to whether the deal will go through, but hoped the two parties could wrap up an agreement within four months. Huaxiang also recently agreed to set up a 50-50 joint venture in Ningbo (a city south of Shanghai) with another German auto parts manufacturer, Schefenacker to make door handles and mirrors. Huaxiang and Schefenacker will each invest RMB50 million in the JV. China is a major player in the international auto parts industry. In fact, the country overtook Germany this year to become the second-largest auto parts exporter to the United States (behind Japan). China exported US\$1.94 billion worth of auto parts to the States in the first quarter of 2007 alone. Ningbo Huaxiang Electronic is listed on the Shenzhen Stock Exchange, with a market cap of RMB6.88 billion.

Education

2) Macquarie Leads Largest Placement in Chinese Education Sector

Australia's Macquarie Bank recently led the largest-ever private placement in China's education sector. Macquarie, as well as CID Capital, Cisco Systems, and Avenue Capital, participated in a US\$54 million round of financing for educational technology and services provider *Ambow Education Group*. "With a profound understanding of the Chinese education market and a strong R&D capability, Ambow leads the way by offering individual-based education services over an online and offline platform," said Dan Phillips, Executive Director of Investment Banking at Macquarie. Ambow provides educational services for both K-12 and vocational learning. (Zero2IPO)

In related news, on Friday October 19, *Noah Education*, a Chinese manufacturer and distributor of e-dictionaries and digital learning devices, completed its listing on the New York Stock Exchange. Noah raised US\$138 million in the IPO. Its stock price soared on the first day of trading, ending the day at a 42% premium to the IPO price. Noah follows Chinese educational services provider *New Oriental Education* (market cap: US\$2.6 billion) onto the NYSE. New Oriental's stock price has now increased 4.74x since its listing in September, 2006. In general, China's education sector is expanding extremely fast. The language and career training segments alone are growing at about 30% a year. We expect to see continued venture capital and private equity investment into the sector, as well as more China-based education companies listing on major stock exchanges.

Food & Beverage

3) Danone to Sell Holdings in Major Chinese Dairy Producer

Danone will sell its entire stake (20%) in *Bright Dairy*, one of China's largest dairy producers, for RMB934 million. As part of the sale, Danone will also pay Bright Dairy RMB330 million to terminate their cooperative agreement. Once the transaction is completed, Bright Dairy will no longer be allowed to use the Danone trademark. Danone's inability to gain a controlling stake in Bright Dairy and Bright Dairy's poor performance likely caused the French giant's exit. The Shanghai government merged Bright Dairy into a government-controlled food conglomerate, making it impossible for Danone to eventually gain a majority stake. And from a performance standpoint, as late as 2003, Bright Dairy led the mainland dairy market, but its market share has slipped precipitously since. In a related development, in June 2007, one major Bright Dairy shareholder said he would sue Danone for engaging in competition with Bright Dairy through its other holdings in China. Those holdings include Danone's 49% stake in *Mengniu Dairy* (China's largest producer of liquid milk), a 51% stake in a joint venture with bottled water leader *Wahaha*, and a 24% stake in *Huiyuan*, the country's largest producer of natural juices. Danone is still caught in a nasty legal battle with Wahaha, in which the French group claims Wahaha is violating a non-complete agreement by using the Wahaha brand name outside of the Danone/Wahaha joint ventures. The China Daily also reports that Bright Dairy is currently seeking overseas strategic investment. Danone and Bright initially created a joint venture in the dairy industry in 1992. Danone then became a 5% shareholder in Bright Dairy in 2000, and added to its stake with a few subsequent share purchases.

4) Prominent VC Group Invests in Natural Beverage Company

Hong Kong-based venture capital group *SAIF Partners* (Softbank Asia Infrastructure Fund) recently invested RMB200 million in China's *Jiangxi Runtian Natural Beverage Co.* Jiangxi Runtian produces bottled water, juice and tea. Jiangxi Runtian is currently undergoing a major restructuring initiative and SAIF will provide management expertise, which Jiangxi Runtian hopes will help propel it into the top position in China's natural beverage market. After Jiangxi Runtian improves operations, SAIF plans to take the group public. SAIF managing partner Andrew Yan said the VC group chose Jiangxi Runtian partly because it's in China's expanding fast moving consumer goods (FMCG) sector. With disposable income increasing so rapidly, many "consumer plays" have proved to be hot items with investors. And premium products like natural beverages can be especially attractive, as they benefit not only from increased consumption, but also from Chinese consumers upgrading their tastes. (Jxnews.com.cn)

Pharmaceuticals

5) MOFCOM Gives Bayer Approval for Largest China Pharma Acquisition

Bayer subsidiary Bayer Healthcare received approval from China's *Ministry of Commerce (MOFCOM)* to acquire the over-the-counter cold medicine business of private Chinese pharmaceutical group *Topsun Science & Technology*. Bayer will acquire the OTC segment for RMB1 billion, making it China's largest ever acquisition in China's pharmaceutical industry. Bayer Healthcare and Topsun agreed on the acquisition last October, but the deal has been waiting for government approval. MOFCOM evaluates foreign acquisitions on a few criteria, including whether they threaten Chinese industries by allowing key assets to fall into foreign hands. Whenever a potential majority acquisition by a foreign investor is on the table, it raises MOFCOM's antenna, but the regulator apparently sees no problems in this particular deal. The deal will also be beneficial for Topsun, as it will use the cash to repay some debts, and shift its focus to higher-end medicines. As part of the deal, Bayer Healthcare will pay an additional RMB192 million to Topsun if the transferred business meets certain future performance criteria. (China Knowledge)

Electronics

6) Gateway Nabs European PC Maker Packard Bell, Lenovo Loses Out

It appears that Gateway (the United States' third-largest PC manufacturer) will prevent *Lenovo's* attempt to acquire European PC manufacturer Packard Bell by buying Packard Bell itself. Gateway will pay US\$41 million to acquire most of the shares of Packard Bell. Lenovo, China's largest PC maker and the third-largest in the world, wanted to purchase Packard Bell to gain a distribution foothold in the European PC market, where it currently has almost no market share. Unfortunately for Lenovo, however, Gateway already held the first right of refusal to buy Packard Bell. And in August of this year, Acer (Lenovo's large Taiwanese competitor) bought Gateway for US\$710 million. Acer essentially purchased the right to buy Packard Bell when it bought Gateway, and will exercise that right, making Lenovo's entry into Europe tougher. Lenovo said it will now focus on organic growth in Europe. Acer is already #2 in Europe PC sales, and will consolidate that position with Packard Bell, which is Western Europe's fourth-largest PC seller. To add insult to injury, the acquisition is expected to propel Acer ahead of Lenovo as the world's third ranked PC maker (behind Dell and HP). Regarding Lenovo's international expansion, the group also recently said it would build a US\$20 million assembly factory in Mexico, which is expected to help propel the company into the U.S. market.

Internet

7) Alibaba.com to Raise US\$1.3 Billion in Hong Kong IPO

Alibaba.com, the online B2B marketplace in China designed to help small- and medium-sized enterprises (SMEs) buy and sell products, will list early next month on the Hong Kong Stock Exchange in a US\$1.3 billion IPO. *Alibaba.com* is a subsidiary of the *Alibaba Group*, which also operates China's largest online auction site (*Taobao.com*), China's largest online payment service (*Alipay.com*), and the Yahoo! China website. *Alibaba.com's* listing will be the largest-ever Chinese tech IPO. *Alibaba.com* will list in Hong Kong instead of Nasdaq despite the fact that other major Chinese internet companies have achieved extremely high PE ratios on the Nasdaq, such as Baidu (current PE: 188x). It is expected that *Alibaba.com's* IPO will be priced at a "discount" of about 45x PE (yes, in China PE's in the mid-40's are sometimes considered "low"). However, some suggest that *Alibaba.com* is playing it safe, knowing its Hong Kong IPO will prove quite successful in the longer term. (Financial Times) We believe that quite a bit of Chinese money will be moving into the Hong Kong market relatively soon, as Beijing loosens capital controls and begins to allow more mainland institutions and individuals to invest in Hong Kong. This should result in many Hong Kong-listed stocks moving steadily upward in the foreseeable future.

Yahoo! purchased a 40% stake in Alibaba Group (parent company) for US\$1 billion in 2005. Yahoo! will also purchase about 10% of the shares in *Alibaba.com's* IPO.

Online Games

8) China's Top Online Game Operator to List on NYSE

ZhengTu Game, the mainland's leading operator of online games, has applied to the U.S. Securities and Exchange Commission to conduct an IPO on the New York Stock Exchange. The company will also change its name to "*Giant Interactive Group*" before the listing. ZhengTu's turnover was reportedly up 734% in the first half of 2007, and its H1 operating profits reached RMB511 million, up 1,077% YoY. The company is China's most profitable online game company. It will join four other Chinese online game companies on the U.S. stock markets: *Shanda* (market cap: US\$2.63 billion), *NetEase* (market cap: US\$2.47 billion), *Perfect World* (market cap: US\$1.51 billion), and *The9* (market cap: US\$890.8 million). All four, however, are listed on Nasdaq. ZhengTu/Giant Interactive will become the first to list on the NYSE. It remains unclear how much money the company hopes to raise.

In other IPO news, another Chinese online game operator, *NetDragon*, plans to list on Hong Kong's GEM (Growth Enterprise Market) Board. NetDragon will raise up to HK\$1.3 billion, and plans to use some of the proceeds for acquisitions. The listing is scheduled for November 1.

According to Credit Suisse, online games constitute the largest segment of China's internet sector. The segment will grow at 35% this year. We saw Chinese software operator *Kingsoft* list on the Hong Kong Stock Exchange earlier this month, and we expect to see more online game listings on overseas exchanges in the future. *CDC Games*, the online games unit of Nasdaq-listed IT group *CDC Corp* (market cap: US\$778.4 million), is scheduled to conduct a US\$200 million Nasdaq IPO at the end of 2007 or the beginning of 2008.

Financial Services

9) Large Securities Brokerage Planning Huge US\$4 Billion IPO

Orient Securities, one of China's 10 most profitable brokerage houses, is planning to list in a large IPO on the Shanghai Stock Exchange. Orient hopes to raise about US\$4 billion, and will use the proceeds for acquisitions and other business expansion initiatives. About 10 domestic securities firms are hoping to go public in the near future. The industry was in dire straits only two years ago, but the stock market boom of 2006 and 2007 has been a bonanza for the securities companies. Now these companies are looking to take advantage of the propitious timing to raise capital through IPOs. Orient Securities' profits will likely reach RMB4 billion this year.

The domestic securities industry is also a very attractive JV sector for foreign investment banks. Aside from gaining access to the large amounts of capital the Chinese continue to invest in the stock markets, another goldmine for foreign firms is the ability to underwrite domestic IPOs. Only three foreign investment banks currently have mainland joint venture brokerage businesses: Goldman Sachs, UBS, and Morgan Stanley. In last couple of years, the government stopped allowing new foreign firms access, as the securities industry underwent restructuring. However, that will soon change, and other bulge bracket banks are expected to enter the market. The Chinese government is encouraging domestic brokerages like Orient to list quickly, and use the IPOs to raise the capital they will need to compete in a market with increasing foreign presence.

10) GE Arm to Invest US\$50 Million in Chinese Financial Firm

GE Commercial Finance will invest US\$50 million into *Credit Orientwise*, China's largest private credit guarantee company. Credit Orientwise specializes in guaranteeing loans to small- and medium-sized enterprises (SMEs), according to the Asian Development Bank (ADB), which invested in Credit Orientwise in 2004. GE Commercial Finance and Credit Orientwise "plan to set up a 50-50 joint venture engaged in inventory financing, purchase order financing, and other trade-related financing products in China and foreign markets." Additionally, rumor suggests that Citi Venture Capital and private equity giant Carlyle Group also have interest in investing in Credit Orientwise. As a point of reference, GE Commercial Finance claims total assets of US\$246 billion. (Asia Pulse)

Investment Banking

11) CITIC Group Possibly Negotiating for Stake in Bear Stearns

Major Chinese financial conglomerate *CITIC Group* is bidding for a stake in Bear Stearns, according to Jiang Dingzhi, the vice-chairman of the *China Banking Regulatory Commission (CBRC)*. Jiang made the statement on the sidelines of the 17th Party Congress in Beijing, but did not offer any other details about a potential bid. Bear Stearns, Wall Street's seventh-largest investment bank in terms of revenue, was hit extremely hard by the sub-prime crisis, which also led to the collapse of two of Bear Stearns' hedge funds. The group's market value has fallen about 25% this year. "At the moment, Bear Stearns is a bargain," Arthur Lau of JF Asset Management in Hong Kong told Bloomberg. Mr. Lau added that "for China, it's important to learn more about investment banking" (China Daily). The Financial Times reports that this isn't the first time CITIC Group's chairman, Chang Zhenming, has been interested in buying a stake in Bear Stearns. Last year, while president of *China Construction Bank (CCB)*, Chang led an attempt to buy a 20% stake in Bear Stearns. However, that attempt reportedly fell through due to lack of support from Chinese government officials.

The government is now encouraging Chinese financial institutions to expand into foreign markets. Multiple banks, including *Industrial and Commercial Bank of China (ICBC)* and *China Merchants Bank*, are currently trying to open branches in the United States. CITIC Group's holdings include stakes in the major mainland-based bank, *China CITIC Bank*, and Asia's largest securities brokerage, *CITIC Securities*. It must be said that despite the claims of the vice-chairman of CBRC mentioned above, CITIC Group has officially denied its interest in Bear Stearns.

Regulations

PBOC Hikes Reserve Ratio for 8th Time in 2007

The People's Bank of China (PBOC), China's central bank, raised the required reserve ratio for banks by 50 basis points to 13%, the eighth hike in the RRR so far this year. PBOC is trying to slow loan growth with the hope that it will curb China's significant liquidity and inflation problems. China has battled these problems in recent months, with inflation rising to an 11-year high of 6.5% in August and remaining high in September, at 6.2%. PBOC desires to keep inflation under 3%. The central bank will likely raise interest rates again before the year is out. The government also recently told banks to keep loan growth to 15% in the future. So far this year, banks have taken advantage of the country's breakneck expansion, loaning money at a record pace and raking in record profits. Loan growth has added to China's liquidity problems, which are especially apparent in the skyrocketing stock markets and real estate markets. In further efforts to cool the economy, the Chinese government also recently reduced export tax rebates for exporters. Lower exports would mean a lower trade surplus and less foreign money flowing into the country, slowing the rate at which liquidity expands. We haven't seen any tangible results from the tax rebate reduction, but economists contend that it will take at least six months to judge whether the regulations will truly put a dent in the trade surplus.

Macro

Shanghai Composite Index Passes 6,000

Spurred by the surging economy and frothy IPO market, China's stock market continues to soar, with the benchmark Shanghai Composite Index pushing past 6,000 for the first time on October 15 (although the markets finished the week slightly down from those heights). The combined market value of China's stock exchanges (the sum of the Shanghai and Shenzhen Stock Exchanges) has reached an incredible US\$3.4 trillion. Less than two years ago, China's market capitalization stood at only US\$400 billion. Now, China is the fourth largest stock market in the world (by comparison, the NYSE is roughly US\$20 trillion). Recent large IPOs in China have certainly added to investors' enthusiasm. In September alone, companies raised RMB149 billion (US\$20 billion) in 15 domestic IPOs, led by a China record RMB 66.58 billion (roughly US\$9 billion) IPO by coal giant *Shenhua Energy*. In the first three quarters of the year, funds raised in IPOs and secondary offerings totaled RMB425 billion, more than the total funds raised from 2002 to 2006. Pundits and "experts" have a range of opinions on the future of the domestic markets. Some believe the bubble will burst soon, while others believe the liquidity issues will ease, and the surge will taper off. What will happen in the stock market is unclear. What we do know, however, is that we definitely expect more multi-billion-dollar domestic IPOs by some of the largest Chinese companies. Beijing expects that through these offerings, excess liquidity could be soaked out of the market.

Macro

CDB to Invest US\$10.7 Billion in China's High-Tech Companies

Two government bodies, the *National Development and Reform Commission (NDRC—China's top economic planning body)* and the *China Development Bank (CDB—a major state-run policy bank)*, have signed a cooperation agreement that will add more government assistance to the growth of high-tech enterprises. Specifically, CDB will invest US\$10.7 billion in the country's high-tech companies during the next five years (China Economic Review). China is also moving closer to establishing a new stock market for growth enterprises, which is aimed at making it easier for growing Chinese companies to raise funds in the capital markets. Currently, strict financial hurdles, such as a profitability requirement for three consecutive years, make it difficult for domestic firms to list in Shanghai or Shenzhen. The Shenzhen Stock Exchange just announced that it will cooperate with Nasdaq to set up the new growth enterprise board. From Nasdaq's standpoint, it will gain a representative office in China, which will allow it to increase its marketing in hopes of attracting more Chinese listings.

The government is employing a variety of methods to push the development of high-technology companies, using such avenues as government-sponsored loans, government-sponsored venture capital and private equity, and tax breaks. China's next step is to move from a large, low-technology manufacturing base to an economy driven by high-tech, high-value-added industries.

Deals in China

M&A Activity

Acquirer	Description	Target	Description	Amount	Deal details
GE Commercial Finance	GE arm that provides commercial loans, leasing and other services	Credit Orientwise	China's largest private credit guarantee company	US\$50 Mil	minority stake
China Security & Surveillance Technology	Shenzhen-based, OTCBB-listed provider of security systems in China	Stonesonic; Jin Lin Technology	Stonesonic makes monitoring equipment hardware; Jin Lin specializes in developing intelligent transportation system products	RMB 330 Mil	100% stake in both
Legend Holdings	parent company of Lenovo Group	Cifi Group	Shanghai-based developer of middle-end real estate	RMB 49.5 Mil	minority stake

Deals in China

IPO Pipeline

Company	Description	Exchange	Size	Financial Advisors
Alibaba.com	online B2B platform of Alibaba Group, China's largest e-commerce company	Hong Kong	US\$1.3 Bil	Deutsche Bank, Goldman Sachs, Morgan Stanley
Longtop Financial Technologies	provides IT software solutions to the financial industry	NYSE	up to US\$166 Mil	Goldman Sachs, Deutsche Bank, Jeffries & Co
Orient Securities	China's eighth most profitable securities brokerage	Shanghai	US\$4 Bil	Everbright Securities

Underground 5-Star Hotel to be Built in Shanghai

A developer plans to build a five-star underground hotel in Shanghai by the end of 2010. The hotel will be built in a 330-foot-deep natural geological pit, which also once served as a quarry. A lake has formed at the bottom of the pit, and some of the structure will be built above the water line and some below the water line. The plans call for hundreds of hotel rooms, as well as a multitude of different business and recreational facilities. According to China Knowledge, the facilities will include an "underwater world", a sports and entertainment center, a water theme park, a mall, a cinema, a convention center, a spa, and restaurants and cafes. Hotel rooms will reportedly be both above and below the water line. It is also unclear which rooms and facilities plan to use windows.