ChinaVest 中國

Week of October 20-October 26, 2007

Eye on China

A View from Shanghai

Merchant Banking Advisory In China for Over Twenty Five Years

ChinaVest

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Market Weekly

Shanghai Composite Index

- 10/19 Close: **5,818.05**
- 10/26 Close: **5,589.63**
- Weekly Change: ↓ **3.926%**
- Since 1/1/07: ↑ **108.92%**

Shenzhen Composite Index

- 10/19 Close: **18,834.80**
- 10/26 Close: **18,506.52**
- Weekly Change: ↓ **1.743%**
- Since 1/1/07: ↑ **178.41%**

Exchange Rate

- 10/19: US$1 = **RMB 7.522**
- 10/26: US$1 = **RMB 7.492**
- Weekly Change: ↑ **0.399%**
- Since 1/1/07: ↑ **4.159%**

Articles

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Automobiles

1) Daimler to Invest US$300 Million in SE China Vehicle JV

Daimler AG will spend US$300 million to build a joint venture commercial vehicle factory in southeast China's Fujian province. The venture, which includes China's *Fujian Motor Group* and Taiwan's China Motor Group as partners, will make 40,000 commercial vehicles a year (e.g. vans and multi-purpose vehicles, or MPVs). Daimler is pressing to increase production in the world's second-largest vehicle market. The German automaker also recently agreed to spend US$102 million for a 24% stake in *Beiqi Foton*, China's largest commercial vehicle manufacturer. The deal is awaiting Chinese government approval. With these moves, Daimler, which is already the world's largest commercial vehicle producer, is positioning itself to take advantage of a mainland commercial vehicle market growing at 26% a year (Shanghai Daily).

Bottling

2) MOFCOM Gives PE Group Approval to Buy Stake in Chinese Bottler

The Wall Street Journal reports that private equity group CVC Capital Partners received approval from the Chinese government to acquire a 29% stake in *Zhuhai Zhongfu Enterprise Co* for US$225 million. Shenzhen-listed Zhuhai Zhongfu (market cap: RMB6.91 billion) is China's largest manufacturer of plastic bottles, and counts Coca-Cola and Pepsi among its customers. Multiple government bodies, including the *Ministry of Commerce (MOFCOM)*, review all potential foreign acquisitions of Chinese companies. Among other things, MOFCOM decides whether any deal relinquishes control of key assets or key Chinese brands to foreigners (typically foreign companies have a better chance of completing the acquisition if the deal is for a minority stake). The Zhuhai Zhongfu acquisition was initially announced in March, and has been awaiting approval since. The deal size is at the higher end of what we're now seeing with China private equity deals. The majority of PE deals are less than US$100 million in size, as the business and regulatory environments in China are not conducive to the massive buyouts that are prevalent in the West. Additionally, given the large amounts of liquidity in China, the regulatory agencies increasingly favor "strategic" buyers (i.e. companies like Coca-Cola, Honeywell, Bosch, etc) over financial buyers (such as PE firms) because strategic buyers presumably add more value than "just bringing money" to a prospective acquiree.

Hospitality

3) Home Inns to Spend US$45 Million to Expand Hotel Portfolio

Nasdaq-listed Chinese budget hotel operator *Home Inns* (market cap: US$1.66 billion) will spend RMB340 million (US$45 million) to acquire *Top Star*, the operator of 26 economy hotels on the mainland. After the acquisition is completed, Home Inns will boast 320 hotels under its brand. "We are solidifying our leadership position," said CEO David Sun. "In addition, we are demonstrating our ability to grow rapidly through acquisition as well as organically" (Reuters). The branded budget hotel sector has traditionally been significantly underserved in China. Earlier this year, we reported that under 5% of China's hotels are budget branded hotels, compared to about 60% in the United States (China Hospitality News). Branded hotels reap about 60% higher revenues than unbranded hotels, a fact that highlights why foreign and domestic investors are so keen to consolidate the sector. And it's clear that while the sector is less saturated, Home Inns wants to build up its brand so it can hold a long-term leading position amidst increasing competition. Reuter's reports that Home Inns wants to increase its portfolio to 1,000 hotels with a few years, with 20% of that expansion coming via acquisitions. Home Inns went public on the Nasdaq last year. Its shares currently trade 250% above the IPO price.

Luxury Goods

4) Chinese Jewelry Producer Lists on Nasdaq

This week an interesting Chinese company listed on the NYSE. The firm, *FUQI International,* manufactures gold and platinum jewelry. It raised US$57.5 million in its IPO and its market value (as of the time of this report) is approximately US$185 million. While FUQI's business model only focuses on manufacturing jewelry and selling through wholesale channels, the firm's expansion plans include opening a series of branded retail stores in China. FUQI's stock finished the first day up 16% over the US$9 IPO price, but finished down 6% at US$8.50 on October 26.

Market Research

5) German Firm Spends US$20 million to Buy Chinese Companies

German market research firm GFK will acquire two top Chinese market research firms. GFK (market cap: €960 million) provides research in a variety of sectors, and claims to be the world's No. 5 market research firm. Rumors suggest that the company will pay a total of RMB150 million for Chinese market research groups *CMM* (RMB100 million) and *Sino Market Research Co* (RMB50 million). GFK's business in China is focused on retail and technology research. Both of the Chinese companies also specialize in these areas (e.g. durable consumer electronics, home appliances). The acquisition will likely turn GFK into a leader in China with respect to retail and technology-focused market research (Asia Pulse). GFK had been trying to acquire CMM and Sino Market Research since 2000, as the German group has continuously looked to secure a better local presence in China.

Pharmaceuticals

6) TPG to Invest in Pharmaceutical Outsourcing Company

Private equity giant TPG will take a stake in Shanghai ChemPartner, a "pharmaceutical research outsourcing company." Pharmaceutical outsourcing is growing considerably in China. In the course of developing a drug, there is a tremendous amount of chemical "fine tuning" involved. Pharmaceutical outsourcing companies perform early stage chemical development, including combinatorial chemistry, medicinal chemistry, etc. They also perform clinical trials. This work is performed by PhD chemists in China at a fraction of the cost of their contemporaries in the developed world. The most successful pharma outsourcing company in China is *Wuxi PharmaTech*, which listed on the New York Stock Exchange in August.

The financial terms of the Shanghai ChemPartner deal were not disclosed, but the Wall Street Journal reported that the deal size is larger than US$30 million. The WSJ added that US$30 million would equate to about a 20% stake in the company.

Software/IT

7) Provider of Software to Chinese Banks Lists on NYSE

On October 25, China's *Longtop Financial Technologies* recorded the one of the best first trading days of any stock on the NYSE this year. Its shares surged 85% over the US$17.50 IPO price. The company provides software and tech services to financial institutions, including three of China's four largest banks. Presumably, investors like high-value-added technology plays in fast growing industries in China such as commercial banking. Additionally, a company executive stated that as a Chinese company, Longtop has clear advantages over other international players because they better "understand" how to work with Chinese customers (Wall Street Journal). Longtop's market capitalization currently stands at roughly US$800 million. Longtop's 2006 sales were US$50 million and its EBITDA was roughly US$20 million. Its shares are currently trading at 96x trailing earnings.

Another smaller Chinese company, that participates in the same sector, is already listed on Nasdaq. *Yucheng Technologies* (market cap: US$147 million) also provides software and IT services to Chinese banks. It recently announced a US$3.3 million acquisition of small mainland company that provides similar services.

Investment Banking

8) Bear Stearns and CITIC Securities to Take Stakes in Each Other

Wall St. investment bank Bear Stearns and *CITIC Securities*, the brokerage subsidiary of one of China's largest financial conglomerates, have agreed to enter a significant cooperative alliance. Each firm will invest US$1 billion in the other, with CITIC Securities taking a 6% stake in Bear Stearns (with an option to increase the stake to 9.9% in the future) and Bear Stearns taking a 2% stake in CITIC Securities (with an option to increase the stake to about 5%). The deal will give Bear Stearns access to investment banking and securities brokerage business in China, while providing CITIC Securities with management expertise and access to international markets. The two parties will also set up an investment banking JV in Hong Kong to offer services in Asia. The deal makes sense for CITIC, as it helps the firm build up an international presence in order to serve its Chinese clients down the road. As the RMB appreciates, more Chinese companies will invest abroad, and domestic financial firms with overseas experience will have an advantage in engaging and maintaining these clients. The alliance will also allow CITIC Securities to sell Bear Stearns' investment products to Chinese investors through the Qualified Domestic Institutional Investor program (QDII—the program allows qualified Chinese financial institutions to invest in overseas capital markets), which will benefit both parties (Xinhua News Agency).

Bear Stearns was ripe for a stake purchase after taking a heavy blow from the recent sub-prime lending crisis, which included the collapse of two its hedge funds. The investment bank's market value has fallen some 25% this year, giving CITIC the opportunity to buy shares at a cheaper-than-normal price. However, Bear Stearns is apparently delighted at the opportunity to get involved in China's financial markets. Bear Stearns CEO Jimmy Cayne said the opportunity to create an alliance with CITIC was the most attractive deal he had come across in 40 years. "It's a giant step into the most exciting market in the world," he added (Financial Times). This year, Bear Stearns' market cap has fallen from about US$19 billion to US$13.4 billion. During the same period, China's skyrocketing stock market has caused CITIC Securities' market value to quadruple to almost US$50 billion. As another point of comparison, Goldman Sachs' market cap is US$94 billion and Morgan Stanley's is US$68 billion.

Insurance

9) Chinese Insurance Intermediary to List on Nasdaq

Chinese insurance intermediary *CNinsure* plans to raise US$102 million in a Nasdaq IPO, and will likely list early in November. CNinsure distributes insurance policies from large domestic and international insurance groups, and collects commissions from the companies. The IPO prices the shares at a PE of about 25x, higher than other large international insurance intermediaries like U.S.-based Marsh & McLennan (about 17x). CNinsure will reportedly use the money to expand through acquisitions, and plans to acquire or enter JVs with other insurance agencies. The agency market in China is apparently quite fragmented, and ripe for small acquisitions. Judging from recent IPO's, Western investors may rush to buy shares as soon as CNinsure's lists. For the first nine months of the year, mainland insurance agency premiums have risen 44% YoY. The investment is another China consumption play, feeding off the country's high growth and rising incomes. (FinanceAsia.com)

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Banking

10) ICBC to Spend US$5.5 Billion on Stake in S. African Bank

Industrial and Commercial Bank of China (ICBC), China's largest bank and the world's largest by market value, will spend US$5.5 billion for a 20% in South Africa's Standard Bank. Standard Bank is South Africa's largest bank. The stake purchase will be largest-ever outbound acquisition by a Chinese company, and the second-largest acquisition in South Africa's history. Through the purchase, ICBC will gain a significant presence in Africa, a continent rich in oil and mineral resources. The Chinese government estimates that this year alone, trade between China and the African continent will increase to US$65 billion. "Through our tactical alliance with Standard Bank, ICBC can improve its global deployment of assets and give our customers superior cross-border financial services," said ICBC chairman Jiang Jianqing. The motivation is clearly very similar to that of CITIC Securities in its alliance with Bear Stearns, albeit in different sectors (and geography). The deal will mark ICBC's third major overseas acquisition: the bank acquired 90% of Indonesia's Bank Halim last December and acquired 80% of Macau's second-largest bank, Seng Heng Bank, in August for about US$585 million. The *China Banking Regulatory Commission (CBRC)* is encouraging mainland banks to increase their overseas operations to prepare for the further international expansion of Chinese companies. ICBC and other banks are also trying to gain approval from the U.S. Federal Reserve Bank to open branches in the United States. Only two mainland banks, *Bank of China* and *Bank of Communications*, currently operate in the U.S.

11) GE Fails to Gain Stake in Chinese Bank

The Financial Times reports that Shenzhen-listed *Shenzhen Development Bank* (*SDB*—market cap: RMB93 billion), a mid-sized Chinese bank, officially called off a deal to sell a 7% stake to General Electric. In October 2005, GE signed an agreement with SDB to pay about US$100 million for a 7% stake. But the deal had to wait until SDB completed its share flotation reform (essentially making state-controlled shares publicly tradable), which SDB didn't finish until 2007. GE agreed to buy the shares for RMB5.25 per share, but by mid-July of 2007, SDB's shares had risen to over RMB30 (current price: RMB45). SDB clearly was not interested in completing the sale at such a severe discount. Regardless, the *China Securities Regulatory Commission (CSRC)* no longer allows listed Chinese companies to sell stakes for more than 10% "under market value." Many foreign institutions are eager to acquire shares in China's banks and other financial institutions, as it gives them increased access to the country's booming economy and its nearly US$5 trillion in savings. As an aside, private equity group TPG is a strategic investor of SDB, holding a 16.68% stake.

China's soaring stock markets have caused numerous potential foreign acquisitions to fail, many of which we don't hear about. The Shanghai Composite Index stands at 3x above its October 2006 value. And in a country where some deals often take up to 2 years to complete (including regulatory approval), it's no surprise that acquiring stakes in public companies is so difficult. One publicized example was Goldman Sachs' proposed acquisition of a minority stake in appliance maker *Midea*. The two parties agreed to terms in late 2006. MOFCOM (Chinese M&A regulator) approved the deal, but CSRC (securities regulator) struck it down in August, 2007, as Midea's share price reached 4x the price Goldman agreed to pay.

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Other Financial

12) VC and PE Investment Hit Monthly Highs for 2007

China Knowledge reports that venture capital and private equity investment in China both hit 2007 monthly highs in September. Chinese companies received a total of US$365 million in VC funding, up 54.7% over August's total. Out of the 29 investments, 10 were in technology, media, and telecom (TMT) industries. Most interestingly, however, *9* investments were made in China's fast growing education and training segment. This sector is reportedly growing at up to 30%, which doesn't come as too much of a surprise from a nation with rapidly rising purchasing power and a population with a strong emphasis on education. For the entire third quarter, Chinese companies received US$897 million in VC funding, according to Zero2IPO.

Private equity investment also soared in September, with six investments totaling US$990 million (China Knowledge). The US$990 million exceeded the total for all of January through August. However, one uncharacteristically large investment accounted for most of that total—Blackstone's US$600 million investment for a 20% stake in state-owned chemical company *China National Blue Star Group*. As we mentioned earlier in the newsletter, deals of that size are uncommon. Overall in the third quarter, 15 China-focused private equity funds raised a record US$9.7 billion. Traditional PE investments, namely manufacturing and real estate, still account for most of the investments in China's PE sector. However, high-tech and media investments will become more and more prevalent.

13) Sequoia Capital Invests in Private Investment Advisory Firm

VC group Sequoia Capital recently spent less than US$5 million to buy a >20% stake in a Chinese financial advisory firm. The firm, called *Noah Private Wealth Management*, is an independent financial advisor that provides clients with investment advice. Noah generates its revenues through commissions, acting as an intermediary between investors and financial institutions. Noah has branches in four cities, and hopes to expand to 20 branches by the end of 2008. Eventually, the company hopes to go public in the United States. "The financial advisory market is in its infant stage and has a lot of potential to develop," said Neil Shen, founding managing partner of Sequoia Capital China. Noah Private Wealth Management should not be confused with Noah Education, which recently went public on the New York Stock Exchange (Shanghai Daily).

Macro

China Soon to Overtake Germany as World's Third-Largest Economy

China's economy grew at brisk 11.5% in the third quarter, a slight slowdown from Q2's 11.9% growth, which represented a 12-year high. Additionally, China will soon pass Germany to become the world's third-largest economy, behind the U.S. and Japan. China's GDP will reach almost US$3 trillion this year. By comparison, the United States' 2006 GDP was US$13.2 trillion. Some in Beijing are happy with the slowdown from Q2, and will try to make sure that growth continues to slow. "Due to macro-economic controls, we have turned the economy from being an over-heating one to being one of speedy growth," said a spokesman with China's National Bureau of Statistics (BBC). However, the growth is still too fast. At the beginning of 2007, Beijing hoped to keep economic growth for the year below 10%. The faster-than-ideal expansion has led the government to take a number of measures in an attempt to stem the tide. Those include raising interest rates five times, raising the required reserve ratio (RRR) eight times, reducing export tax rebates on thousands of goods, and even tripling the tax on stock trades to cool the stock market. These steps are all designed to curb the surge in lending and to slow exports (and thus the growth of the trade surplus, which is growing at about US$25 billion a month). Since receiving the Q3 economic figures, the *People's Bank of China* (*PBOC*—China's central bank) has been mulling whether to raise interest rates again. PBOC will likely hike rates once more before the end of the year, as it searches for a way to slow inflation. The CPI growth jumped to over 6% in August and September for the first time in 11 years. On Thursday, October 25, the specter of another rate hike drove Chinese stock prices down. The Shanghai Composite Index plummeted 4.8%, the worst one-day drop since May 30. The Shenzhen Composite Index suffered even worse, dropping 5.43%.

M&A Activity

Acquirer	Description	Target	Description	Amount	Deal details
Home Inns	Nasdaq-listed Chinese budget hotel operator	Top Star	small Chinese budget hotel operator with 26 hotels	RMB 340 Mil	100% stake
CVC Capital Partners	European private equity group	Zhuhai Zhongfu Enterprise	Zhuhai-based maker of plastic bottles, Shenzhen-listed	US$225 Mil	29% stake
GFK	Germany-based market research firm	CMM; Sino Market Research Group	Two China-based market research companies	RMB 100 Mil for CMM, RMB 50 Mill for SMR (rumored)	100% stakes

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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$1.5 Bil	Deutsche Bank, Goldman Sachs, Morgan Stanley
CNinsure	Chinese insurance intermediary	Nasdaq	US$102 Mil	Morgan Stanley
Zhong An	mainland property developer, majority of properties are low-rise residential	Hong Kong	HK$3.4 Bil	Deutsche Bank, JP Morgan
Jinchuan Group	Asia's largest nickel producer, based in western China's Gansu province	Hong Kong (in 2008)	US$4 Bil	Guotai Junan Securities
Giant Interactive Group	China's most profitable online game company	NYSE	> US$800 Mil	Merrill Lynch, UBS, JPMorgan

China Launches its First Lunar Orbiter

On October 24, China launched its first lunar orbiter. The "Chang'e I," named for a Chinese moon goddess, cost about US$180 million. China is the first developing country to build a lunar orbiter. "The lunar probe is an important stimulus for China's scientific development, a significant demonstration of China's overall national capacity and a promotion of its national prestige on the international stage," said Luan Enjie, chief commander of the country's lunar orbiter project. The spacecraft is expected to enter the moon's orbit by November 5, and will begin sending pictures back to earth by next month. It will orbit the moon and collect data for about a year. The spacecraft is designed to take 3D surveys of the moon's surface, investigate the composition of the lunar surface, and understand the composition of the air between the earth and the moon.

A major motivation for the exploration is discovering how much of the substance "helium-3" is on the moon. Scientists believe helium-3 could be an excellent source of energy in the future when fossil fuels run out. "We will explore the new energy prospects on the moon for mankind. After all, the earth's resources are not inexhaustible," said Ouyang Ziyuan, chief scientist of the lunar program, adding there is about 15 tons of helium-3 on the Earth, while the volume of helium-3 on the Moon is estimated at one to five million tons. (Xinhua News Agency)

As far as future lunar exploration, China has outlined a three-step program. The first step is this lunar orbiter. In the future, China plans to launch spacecraft that will actually land on the surface of the moon, and send moon rovers to explore the surface. Preliminarily, those missions are planned for 2012 and 2017. Fifteen years or more into the future, China hopes to send a manned mission to the moon (Shanghai Daily).