

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

- 9/5 Close: **2,202.45**
- 9/19 Close: **2,075.09**
- Change: ↓ **5.783%**
- Since 1/1/08: ↓ **60.561%**

Shenzhen Composite Index

- 9/5 Close: **7,264.20**
- 9/19 Close: **7,154.00**
- Change: ↓ **1.517%**
- Since 1/1/08: ↓ **59.935%**

Exchange Rate

- 9/5: US\$1 = **RMB 6.847**
- 9/19: US\$1 = **RMB 6.855**
- Change: ↓ **0.117%**
- Since 1/1/08: ↑ **6.277%**

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Food & Beverage

1) Tsingtao Brews Up Deal in Shanghai

Carlsberg Hong Kong and Tsingtao Brewery have come to terms in a deal that will give Tsingtao the remaining equity holdings of *Tsingtao Beer Shanghai Songjiang*. Tsingtao purchased a 75% stake in the Shanghai brewery from Carlsberg in 2000 for US\$19 million; Carlsberg will now sell its remaining 25% stake for US\$7.5 million. The sale is based on a price established in the original agreement, and is considered to be very favorable for Tsingtao; especially considering the Shanghai brewery posted 2007 profits that were up 30% over the previous year. The new equity position allows Tsingtao to both improve its coverage of the Shanghai market and consolidate autonomy in managing its business. Carlsberg, on the other hand, says the sale will allow it to better focus on developing its rapidly growing Carlsberg brand as well as its other beer businesses in China.

Over 99% of total beer sold in China is produced locally, meaning that control of local breweries, especially in cities like Shanghai, is essential for a company to enhance its market position. Tsingtao last year held a 13% market share in China with net profit of US\$82 million.

2) China Goes Wild for American Foot-longs

Subway, the world's largest submarine sandwich chain, plans to aggressively expand its franchise business throughout mainland China. As the world's most promising emerging, high growth market, China presents a huge opportunity for the company to increase its share of the Asian fast-food market. Subway has announced that it will grow its China presence by boosting its number of stores to 1,000 outlets nationwide by 2015, a 10-fold increase. Subway first entered the China market 10 years ago with several locations in Beijing. Despite facing tough competition from other international fast food chains, such as McDonalds and KFC, the company thinks the time is right to expand. Not only have Chinese consumers become more accepting of "western style" food in recent years, but they also now seek diverse fast food alternatives.

Over the past several years, Subway has been gaining traction in the Chinese market (65% sales growth in 2007), and with the planned 1,000-store expansion, foot-long subs will now be available nationwide.

Automobiles

3) SAIC Approved For Shanghai Acquisition

China's largest auto manufacturer, *SAIC Motor Corp.*, received regulatory approval to acquire a 50.3% stake in *Shanghai Diesel Engine Co.* SAIC will pay US\$127 million for a controlling stake in the company.

Shanghai Diesel Engine Co. is one of China's largest manufacturers of diesel engines. The company produces engines for a wide variety of machinery, including heavy-duty vehicles, passenger cars, ships, and mobile power stations, among others. SAIC, who has significant joint venture partnerships with both GM and Volkswagen, expects the acquisition to help position them to become an even more significant player in the industry.

Metals

4) Sinosteel Takeover Complete

State-owned metals trader, *Sinosteel*, has officially completed its hostile takeover of Australian *Midwest Corp.* Sinosteel purchased the remaining shares of the Perth-based iron ore company through the acquisition of a 15.2% stake from *Harninger Capital*, giving Sinosteel over 98% control of the company. Earlier this year, Sinosteel gained control of Midwest through a US\$1.3 billion bid, blocking a potential merger with another Australian mining firm.

In many ways the deal symbolizes a change in China's global presence. Not only is it the first time a Chinese company has flexed its muscles in a hostile overseas acquisition, but the deal also illustrates China's influential power in the international business landscape, its demand for natural resources, and its ability to navigate complex cross-border transactions. Control of Midwest will give Sinosteel greater access to Australia's abundant natural resources. It will also ease dependence on international iron companies, such as *BHP Bilton*, *Vale*, and *Rio Tinto*, which control most of the world's iron trade. Midwest mainly operates in Western Australia, and upon completion of new mines, it will produce over 17 million tons of iron ore per year.

Looking Local: Sanya Goes for Glitz



Source: Shanghaiist.com

Dubai's Burj Al Arab hotel ten year-reign as the world's only "7-star" property is about to come to end as construction is set to begin later this year on China's first, and the world's second, 7-star hotel. The Fairmont Haitang Bay Resort will be located in Sanya, the increasingly glitzy metropolis on the north coast of China's Hainan Island.

The hotel will be designed by UK-based W.S Atkins Plc, which also designed the Burj Al Arab, and will include 702 rooms, a luxury yacht club, a golf course, and the biggest ocean park in Asia. Sanya's urban planning authorities have allotted a 2 billion RMB budget for the hotel's construction. Its facilities will be spread over 150 square kilometers, an area equivalent to one-fifth the size of Singapore!

Hainan is fast becoming a Chinese hot-spot destination. The tropical island province has been dubbed "The Hawaii of China," and is currently the country's number one domestic vacation destination. According to the provincial tourism bureau, Hainan hosted 18 million travelers in 2007, up 15% from the previous year. Nearly 6 million of these visitors were foreigners, a staggering 63% increase from 2006.

Fans of the unattainably expensive rejoice! For everyone else, the next time you find yourself standing in line for lamb skewers at Haitang Bay's Uyghur kebab stands, keep an eye out—you may just catch a glimpse of the rich and famous.

Metals

5) Chinese Steelmakers Vow Not to Tolerate Price Increases from Vale

An official with the *China Iron and Steel Association (CISA)* said Chinese steelmakers may stop buying iron ore from Brazilian mining giant Vale if it raises its prices. Chinese steel companies buy iron ore from Vale at prices stipulated in already agreed-upon contracts. Vale apparently wants to raise prices to the same levels paid by European steelmakers. With the Chinese economy slowing somewhat, China's steel output in 2008 may fall below earlier predictions, making steelmakers even more wary of potential price hikes.

Vale, formerly known as CVRD, is the world's second-largest mining company. Its market cap currently stands at US\$115 billion. In August 2007, *Baosteel*, China's largest steel company, set up a JV steel plant with Vale in Brazil.

Internet

6) Northern Light Invests in New Social Networking Site

Chinese social networking site *Kaixin001.com* has received a US\$4-5 million investment from *Northern Light Venture Capital*. Launched in April, Kaixin is a relatively new social networking site, still in the private beta stage. With features such as music sharing, games, and 1GB of online storage space, the site reportedly already has more than 20 million users. Kaixin joins other social networking service providers in China such as *Tencent*, *Tianya*, and *Xiaonei*. Northern Light is one of China's most active local VC groups.

Software

7) ERP Software Company Braves the Market, Lists on Nasdaq

On September 9, Chinese ERP software company *Pansoft* debuted on Nasdaq, choosing to list despite adverse market conditions. The company raised US\$8.4 million in the IPO. Thus far, Pansoft has generated most of its revenues by selling customized software to China's largest state-owned oil companies. According to Xinhua, the company plans to focus on large SOE customers in the future. Pansoft will use most of the IPO proceeds to acquire companies and recruit employees.

As the US markets have spiraled downward, it comes as no surprise that Pansoft's shares have taken a hit since the listing; at the end of Friday, September 19, shares were trading at a 30% discount to the IPO price.

8) IT Outsourcing Firm Raises US\$45 Million

China-based *Global Data Services (GDS)*, an IT outsourcing and disaster recovery software company, has received US\$45 million in venture capital funding. Investors included *Softbank China Venture Capital*, *Suzhou Ventures Group*, the *International Finance Corp* (the private investment arm of the World Bank), and domestic VC group *CEL Venture Capital*. Suzhou Ventures Group is a state-owned VC firm, and CEL Venture Capital is owned by SOE conglomerate China Everbright Holdings. (Zero2IPO) A number of industry analysts predict that China's software outsourcing industry will overtake India's within a few years.

Banking

9) Bank of China to buy 20% of Rothschild

Bank of China (BOC) has agreed to acquire 20% of private bank *La Compagnie Financiere Edmond de Rothschild (Rothschild)* for EUR236.27 MM.

This acquisition will make the Chinese bank Rothschild's second largest shareholder. The largest is Benjamin de Rothschild, who holds more than 74%. Whilst this is not the first outbound deal in the sector by China, it is certainly the first high profile deal in the Eurozone area. The deal is synergistic, as it strengthens BOC's international presence, while providing Rothschild with access to the rapidly developing Chinese market.

10) China Banks' Exposure to Global Crisis Minimal, For Now

It was a tumultuous week in the global financial markets! *Lehman* goes out of business, *Merrill Lynch* gets acquired, the US government bails out *AIG*, one of the world's largest insurers, oil prices tumble, the dollar rallies, gold prices spike, and global stock markets spike up and down like manic depressives.

So how did all this affect the Chinese banks? While we will continue to watch this space closely, so far the exposure of China and Hong Kong's banks to the ongoing crisis seems contained. Take, for example, Lehman Brothers. *Industrial Construction Bank of China (ICBC)* said it had US\$152 million of Lehman exposure, *Bank of China (BOC)* US\$76 million, and each *Bank of Communications*, *BOC Hong Kong*, and *China Merchant's Bank (CMB)* had approximately US\$70 million. For each bank, this exposure represents less than 0.03% of their net assets.

At face value, Chinese banks are not directly exposed to Wall Street's I-banking meltdown. However, they are unfortunately still faced with major problems related to it. Questions still exist regarding the total exposure of the banks in China to subprime bonds – BOC has already written down US\$2 billion, although in relation to the rest of its portfolio, the amount is small. Despite the well capitalized balance sheets, banks on the mainland face the risk of panic-selling. In addition, plummeting bond prices could lead to further impairment of US securities exposures of Chinese banks.

Banks in China are also particularly vulnerable to recession in the United States and other developed economies. Almost one quarter of the country's economic growth stems from the expansion of its exports. If exports slow (signs indicate that this is already happening), the Chinese economy slows, lending slows, and banks have lower margins.

11) CIC Bids for Morgan Stanley Stake

Continuing our discussion of the global financial crisis, US investment bank *Morgan Stanley* is in talks to sell a stake of up to 40%. Among the top bidders are China's sovereign wealth fund, *China Investment Corp (CIC)*, and US-based *Wachovia Bank*.

It is rumored that Morgan Stanley's top management would prefer to sell the stake to CIC rather than merge with US lender Wachovia. CIC already injected US\$5.6 billion into Morgan in December for a 9.9% stake, and if CIC's current bid is successful, the fund will hold just under 50% of the US investment bank.

CIC, which manages an impressive US\$200 billion, has imposed its financial muscle by scouring the world for acquisition targets. That said, if CIC were to raise its stake in Morgan Stanley, the action could trigger a backlash at home as well as in the United States. China's central government has actually requested that CIC allocate its funds in other areas in order to prop-up China's sagging domestic stock market.

Regulatory

China Adjusts Trading Tax, Takes Other Steps to Boost Ailing Stock Markets

In an attempt to boost the floundering domestic stock markets, regulators have eliminated the “stamp tax” (trading tax) on purchases of A-shares. Previously, the stamp tax levied a 0.1% fee, as a percentage of the value of the trade, on buyers and sellers. The change removes the tax on buyers, but leaves it in place on sellers. The day of the announcement (September 19), the Shanghai Composite Index jumped 9.5%, just slightly below the 10% daily gain/loss limit for A-shares.

In May 2007, regulators actually increased the stamp tax from 0.1% to 0.3% in an attempt to reel in stock prices, which at the time were increasing at breakneck speed. Then in April 2008, after seven months of market decline, the State Council lowered the stamp tax back to 0.1%. That move led to a 9.3% jump in the Shanghai Composite Index on the day of the announcement, and helped spur a subsequent rally that lasted about two weeks. Considering that rally, and considering the general irrational behavior of the domestic markets, the September 19 jump in share prices comes as no surprise. China's stock markets are still highly affected by speculative investing. As a result, any regulatory moves that don't affect the fundamentals of listed companies, such as changes to the stamp tax, can cause major swings in the market.

In addition to the elimination of the tax on share purchases, two other announcements also contributed to the September 19 rally. First, in another move designed to restore investor confidence, *Central Huijin*, an arm of the *China Investment Corp* (CIC—the country's sovereign wealth fund), began buying up A-shares of China's three largest banks (*ICBC*, *Bank of China*, and *China Construction Bank*). Related to the Wall Street meltdown, Chinese banking stocks had been hit especially hard this week, with ICBC, BOC, and CCB each tumbling 15-20% on September 16-17. As each of the banks have market capitalizations well in excess of US\$100 billion, the resulting negative effect on overall market sentiment apparently gave Central Huijin the impetus it needed to take action.

With respect to the second announcement, China's *State-owned Assets Supervision and Administration Commission* (SASAC) said it would encourage state-owned firms to purchase shares in their publicly-listed subsidiaries. Li Rongrong, the head of SASAC, said that SASAC has long wanted SOEs to “become an active force in facilitating a stable development of the stock market” (China Daily).

We expect the aforementioned moves to have a short-lived positive effect on the markets. In the medium-term, the crisis in the West, the beginnings of a slowdown in China's economy, and the potential of more shares flooding the market may continue to exert downward pressure on the market.

Macro

PBOC Cuts Rates to Combat Slowing Growth

At the beginning of the week, *People's Bank of China (PBOC)* signaled a major shift in monetary policy by cutting interest rates and reducing the required reserve ratio (RRR) for banks. The moves mark the end of two years of monetary tightening aimed to control excessive growth and, over the last year-plus, reign in inflation. In light of the crippling credit troubles in the West and the potential slowdown in China, Beijing switched from a strategy of "slowing down the economy" to "maintaining steady, relatively fast development."

Specifically, PBOC enacted a 27-basis-point cut in the benchmark one-year lending rate (reducing it to 7.2%) and a 100-basis point cut in the RRR (reducing it to 16.5% from the current record high of 17.5%). The changes will take effect September 25, 2008.

The release of August's economic data seems to have given PBOC the reassurance it needed to begin its "loosening" strategy. Inflation dropped significantly in August to 4.9% YoY, its lowest point in 14 months. Government subsidies for farmers, along with other factors, have finally combined to quell the meteoric rise in food prices, the chief cause of high inflation in 2007 and 2008. Although inflation has been dropping for the last four months, only in August did the figure finally settle into an "acceptable" range (CPI growth had exceeded 6% since summer 2007). Curbing inflation has been PBOC's top concern, especially considering the severe strain that surging food prices were putting on the hundreds of millions of Chinese who spend up to 1/3 of their incomes on food. "With these [new] inflation numbers, we move much closer to the time when Beijing decides inflation is not an issue anymore," writes Standard Chartered economist Stephen Green. We should note, however, that even though inflation is falling, non-food inflation is higher than usual, something Beijing will have to monitor closely. One of the primary factors driving non-food inflation is energy costs, which China has been forced to raise amid rising global prices (China enforces price controls and subsidies on oil and electricity).

In the next few months, Beijing will take further measures to spur the economy and assist ailing exporters. These moves may include a further reduction in interest rates and the RRR, easing lending quotas, and granting tax breaks to certain industries. In recent weeks, regulators have already begun to ease restrictions on lending to certain industries, and have increased value-added tax rebates to textile exporters.

Prior to this week, PBOC had not cut interest rates since 2002. Between July 2006 and June 2008, PBOC raised the RRR 18 times. Since April 2006, PBOC had hiked the benchmark one-year lending rate eight times.

Deals in China

M&A Activity

Acquirer	Description	Target	Description	Amount	Deal details
Anglo American plc	one of the world's largest diversified mining companies	Magma Metals Limited ("Magma")	Perth, Australia, based explorer	US\$7 Mil.	12% stake
Anshan Iron and Steel	Liaoning-based steelmaker	Chongqing Titanium	Chongqing-based listed steelmaker	n/a	10% stake
Hengan International Group Co. Ltd	Hong Kong-listed personal hygiene products manufacturer	QinQin Foodstuffs Group Co. Ltd	mainland food producer	HK\$260 Mil.	51% stake
PetroChina Co Ltd	China's largest oil and gas producer	CNPC Exploration and Development Co (CNPC E&D)	subsidiary of China National Petroleum Co. (CNPC)	US\$11.8 Bil.	50% stake
ZKC Environmental Group Co Ltd	waste water treatment operator	Shenzhen Hua Qiang Chuang Xin Investment Company Limited	investment holding company with interest in water treatment business	US\$34 Mil.	60% stake
Shanghai Duolun Industry Co. Ltd.	engaged in real estate and trading businesses	Shanghai Wei Yuan Investment Ltd.	investment holding company with interest in metal ore mining assets	US\$18 Mil.	40% stake
Enric Energy Equipment Holdings Ltd	energy equipment manufacturer and integrated business solutions provider	Full Medal Limited	transportation, storage and processing equipment manufacturer and services provider	US\$356 Mil.	100% stake
Enric Energy Equipment Holdings Ltd	energy equipment manufacturer and integrated business solutions provider	Sound Winner Holdings Limited	transportation, storage and processing equipment manufacturer and services provider	US\$805 Mil.	80.04% stake

Deals in China

IPO Pipeline

Company	Description	Exchange	Size	Financial Advisors
Renhe Commercial Group	Mainland underground shopping centre operator	Hong Kong	HK\$4.5 Bil.	Morgan Stanley, BOC International, UBS, HSBC
Want Want China Holdings Ltd	China's largest maker of rice cakes and flavored milk	Taiwan	about US\$100 Mil.	n/a
Jiangsu Huachang Chemical Co. Ltd	China-based manufacturer of basic chemicals and related products	Shenzhen	n/a	n/a
Strikeforce Mining and Resources Ltd (SMR)	Russia-based molybdenum miner	Hong Kong	US\$200 mil	BOC International
Zhejiang Quartz Crystal Optoelectronic Technology Co. Ltd	China-based photoelectric parts manufacturer	Shenzhen,	RMB213.20 Bil.	n/a
China Agri-Industries Holding	packaging unit of Oils & Foodstuffs Imports and Exports Corp (COFCO)	Hong Kong	HK\$2 Bil.	China International Capital Corp, Citi, BOC International

Chinese Tourists Bring Home Radioactive Souvenir

On a brief trip to Kyrgyzstan earlier this month, three tourists from the city of Aksu, in China's Xinjiang Province, came back with slightly more than they bargained for. While shopping at a local flea market, the tourists paid US\$2000 for what they described as a 274kg (604lbs) "glowing marvel," hoping to resell it in China for a fortune. With dollar signs in their eyes, upon their return to China, the men decided to slice off a piece of the slab and



Source: www.siberianlight.net

take it to experts at Beijing's Tsinghua University in order to establish its true value. After identifying the souvenir as a chunk of depleted uranium, however, the scientists called the police.

Depleted uranium is a weak radioactive by-product of uranium enrichment. It is used for radiation shielding in medical radiation therapy, industrial radiography equipment, and in containers for transporting radioactive materials. Apparently there are still a number of uranium disposal sites in Kyrgyzstan, left over from Soviet-era uranium mining.

The souvenir was confiscated from the travelers, but having established that the men truly had no idea what they had bought, local prosecutors decided not to file charges of nuclear trafficking. Instead, the three men were taken to a local clinic, where doctors thankfully found no signs of radiation poisoning.

Though nuclear waste certainly makes for a unique souvenir, for future travels, these three might want to consider sticking to the airport gift shop.