

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

- 9/21 Close: **5,454.67**
- 9/28 Close: **5,552.30**
- Weekly Change: **↑ 1.790%**
- Since 1/1/07: **↑ 107.53%**

Shenzhen Composite Index

- 9/21 Close: **18,228.57**
- 9/28 Close: **18,864.55**
- Weekly Change: **↑ 3.488%**
- Since 1/1/07: **↑ 183.80%**

Exchange Rate

- 9/21: US\$1 = **RMB 7.524**
- 9/28: US\$1 = **RMB 7.524**
- Weekly Change: **No Change**
- Since 1/1/07: **↑ 3.749%**

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Random Tidbits

Air Travel

1) Air China, Cathay Pacific Fail to Beat SIA for Stake in China Eastern

Air China and Hong Kong-based airline Cathay Pacific failed in a short-lived attempt to usurp Singapore Airlines (SIA) and Temasek Holdings (a Singapore state investment fund) in their acquisition of a stake in *China Eastern Airlines*. About a month ago, SIA and Temasek agreed to purchase a combined 24% stake in China Eastern (the smallest of China's three major state-owned airlines) for about US\$920 million. However, China Eastern's shareholders have yet to ratify the deal. Air China (another one of China's "Big Three" state-owned airlines) and Cathay Pacific hoped to present their own competing offer for the 24% stake, sway shareholders to their side, and maneuver the deal away from Singapore Airlines. The offer would have "replaced that previously proposed by Singapore Airlines and Temasek Holdings" said a statement by Cathay Pacific (Financial Times). Regardless, it seems the plan will not go through.

In his recently published book, Air China CEO Li Jiayang described his desire to keep foreign investment out of the industry and build Air China into an "international super-carrier" (Financial Times). Air China's bold move was obviously designed to keep SIA, the world's largest airline by stock market capitalization, from gaining a significant foothold in China's growing air travel industry. And as one major state-owned carrier would've gained a bigger stake in another, a deal would have consolidated more market share into the hands of one of the biggest domestic players (Air China actually already owns 11% of China Eastern, a feat achieved by continually purchasing shares over the last six months).

The SIA/Temasek deal, which now looks like it will not be derailed, should provide China Eastern with the management expertise it needs. China Eastern has posted large losses in both of the past two years, and carries quite a bit of debt on its balance sheet. SIA, Asia's most profitable carrier, will gain increased access to China's aviation sector, especially the booming Shanghai market. Overall, air mileage in China increased by about 20% last year (BBC), and that growth is unlikely to slow down any time soon.

Education

2) Chinese Educational Services Company Planning Nasdaq Listing

Noah Education, a China-based provider of interactive educational services, plans to raise US\$140 million in an upcoming Nasdaq IPO. According to Nasdaq, Noah will use the proceeds for potential acquisitions, to enhance its branding and sales channels, and to develop its educational content. In recent newsletters, we've discussed other investments in China's growing educational sector. Last week, we discussed SAIF Partners' US\$10 million investment in *Huayu International Education Group*, a company that provides IT education in China. In the September 7th issue, we covered Carlyle Group's investment in *NeWorld Education*, a foreign language training chain based on the mainland. Noah Education is probably encouraged by last September's successful listing by China's *New Oriental Education* (market cap: US\$2.42 billion) on the NYSE. New Oriental's shares currently trade at a robust 4.43x premium to the IPO price.

Energy

3) China's Largest Coal Producer Raises US\$8.9 Bill in Shanghai IPO

Shenhua Energy, China's largest coal producer, will likely raise close to US\$9 billion in its IPO. It will list on the Shanghai Stock Exchange on October 9. The IPO will be the largest to date on the mainland stock market, breaking the days-old, US\$7.7 billion record set by *China Construction Bank (CCB)*, one of China's largest state-owned banks. The bank listed on September 25. Shenhua Energy will use the proceeds from the listing for acquisitions and to improve its "coal, power, and transportation systems" (Xinhua News Agency).

Shenhua Energy's IPO not only breaks the record for largest-ever Chinese domestic IPO, but also attracted a record amount of subscriptions. Investors placed RMB2.66 trillion worth of orders for the IPO shares, breaking that particular record for the second time in about two weeks (CCB: RMB2.26 trillion, Bank of Beijing: RMB1.9 trillion).

Shenhua will be the second "red-chip" to list on the mainland (CCB was the first). Red-chips are Chinese companies that are incorporated and listed overseas. CCB and Shenhua are both listed in Hong Kong; some other red-chips are listed in Hong Kong and in the United States. Chinese regulators only just began allowing red-chips to list on domestic stock exchanges. Beijing is strongly encouraging some of the large red-chip firms to list in China, hoping to soak up some of the excess liquidity in the domestic capital markets. The skyrocketing PE ratios for mainland stocks show that the market demand is growing almost unabated. The trillions of RMB in subscriptions to recent Shanghai IPOs, as mentioned above, also highlights the point.

Due to high demand, CCB's stock price shot up 32% on the first day of trading, rewarding those lucky enough to get their hands on shares in the IPO, with a handsome early profit. Two weeks ago, we saw *Bank of Beijing's* share price jump 81% on its debut! We expect to witness a similar effect on Shenhua's first day. As a point of reference, mainland China IPOs have raised US\$40.5 billion so far this year, far surpassing the US\$21.1 billion raised in all of 2006 (Thomson Financial). The significance of the numbers is important. Put into perspective, the NYSE, Nasdaq and Amex combined raised US\$49 billion in 2006.

4) PetroChina to List in Shanghai in Massive IPO

State-owned *PetroChina* will soon become the third red-chip to list on the Shanghai Stock Exchange after CCB and Shenhua Energy (mentioned above). The *China Securities Regulatory Commission (CSRC)* recently approved the offering, in which PetroChina will likely raise US\$6-7 billion. The oil giant will use the funds in a variety of projects that will boost petroleum and petrochemical production. Incidentally, Warren Buffet just cut Berkshire Hathaway's stake in PetroChina for the fourth time in three months. Berkshire has netted a 7x return since buying shares in PetroChina in 2003 (Bloomberg).

Based on the value of its Shanghai-listed shares after the IPO, PetroChina may pass General Electric as the world's second-largest company in the world by stock market value. HK- and NYSE-listed PetroChina's market cap currently stands at US\$331.4 billion, while GE's value is about US\$424 billion. With the inflated prices in the A-share markets, PetroChina's Shanghai stock price could rise high enough to push its market value well over US\$400 billion.

Food & Beverage

5) Chinese Food Service Chains Raising Money for Expansion

Multiple restaurant chains are ramping up their expansion plans. As a nation, the Chinese frequently eat outside the home, and restaurant chains are expanding in order to take advantage of rising incomes and rapid urbanization. *Quanjude*, a Peking duck restaurant chain, plans to go public next month on the Shenzhen Stock Exchange. Quanjude actually already holds a reasonable slice of China's restaurant chain market, at close to 2% (American Chamber of Commerce). Another chain, *Shanghai BABI*, specializing in "steamed buns," is actively entertaining venture capital funding. The chain staged a roadshow for more than 25 VC firms this past weekend (Shanghai Daily). It has 97 stores in Shanghai now, and plans to expand into other first- and second-tier cities in the future, hoping to reach 500 stores by 2010.

A number of other food chains are looking to introduce capital for expansion, and the sector is promising for investors. Venture capitalists have invested in a number of restaurant chains in recent years, such as tea house/restaurant group *Chamate* and hot-pot chain *Inner Mongolia Little Sheep* (Shanghai Daily).

As a point of reference, KFC leads China's foodservice industry with a 14.7% market share, while McDonald's comes in second at 8.3% (American Chamber of Commerce).

Electronics

6) Dell to Sell Products in Chinese Electronics Chain

Dell announced that it will begin selling its computers through China's largest electronics retailing chain, *Gome*. Until this point, Dell has relied on its telephone and internet direct-sales model to sell desktop and laptop computers in Chinese customers. Currently ranking fourth in market share, Dell trails Lenovo and HP in China PC sales. China is the world's second-largest PC market. Within the last year, Dell has also added in-store sales to its direct-sales strategy in other nations, such as the UK and the U.S.

The PC giant will initially sell its machines at 50 Gome stores, and will place Dell employees in the stores to assist customers. Later, it will expand to more Gome locations, which span 160 Chinese cities. The in-store sales may prove more successful for Dell than telephone and internet sales, as the Chinese value the on-location retail shopping experience more than American customers. The Chinese also generally prefer purchasing ready-to-go products, rather than spending the time to build their own product piece-by-piece, which customers can do when they purchase a Dell online or over the phone.

Internet

7) Software Company/Online Game Operator to List

Beijing-based software company *Kingsoft* began its Hong Kong IPO, and plans to raise up to HK\$767 million. Kingsoft makes anti-virus software, translation software, and operates online games. It will use about HK\$170 million of the proceeds for recruitment and R&D.

Kingsoft will become the latest Chinese online game company to go public. *Shanda* (market cap: US\$2.65 billion), *Netease* (market cap: US\$2.1 billion), *The9* (market cap: US\$1.01 billion), and *Perfect World* (market cap: US\$1.51 billion) are already listed on Nasdaq. More are expected to list on international stock exchanges in the future, such as *9you*, *ZhengTu*, *CDC Games*, and *NetDragon*. The Chinese are enamored with online gaming, and current estimates place the number of Chinese online gamers at over 40 million. According to Credit Suisse, online games constitute the largest segment in China's internet sector. The segment will grow 35% in 2007 to achieve revenues of about US\$1.3 billion. International Data Corp (IDC) predicts that the 35% growth rate will continue until 2010.

Banking

8) CBRC Head Says U.S. Won't Reciprocate in Bank Approvals

The head of the *China Banking Regulatory Commission (CBRC)* said China would be more willing to allow American financial institutions to take larger stakes in Chinese banks if the U.S. grants banking licenses to Chinese lenders. "Bilateral cooperation is very important if we want to broaden our market entry policies and open the door much wider," said CBRC chairman Liu Mingkang in an interview with the *Financial Times*. Specifically, Mr. Liu is referring to the applications of two Chinese Banks that seek to operate in the U.S. (*Industrial and Commercial Bank of China (ICBC)* and *China Merchants Bank*). Only two Chinese banks currently have branches in the U.S., *Bank of China* (which has operated in the States since the 1930's) and *Bank of Communications*.

American banks have repeatedly asked for greater market access in China. Foreign investors are limited to a 20% equity stake in a single Chinese bank, and total foreign holdings cannot exceed 25%. In recent bilateral trade discussions, China raised the reciprocity issue, asking U.S. regulators to provide licenses to Chinese banks. The Federal Reserve, which has approval authority over the matter, evaluates all foreign banks using the same criteria. These criteria include corporate governance and transparency. The Fed is unlikely to change its policies, which may continue to add to the friction between China and the U.S. on these issues. It must be noted that Liu Mingkang did not specifically say that the United States' delay in granting approval to Chinese banks will *directly* cause Beijing to delay allowing larger stake purchases in its banks. However, he did say the delay from the U.S. side will "automatically have some backlash here [in China]." (*Financial Times*)

Leasing

9) Chinese Aircraft Leasing Company Buys US\$340 Million Worth of Engines

BOC Aviation, Asia's largest aircraft leasing company, purchased forty-six V2500 aircraft engines for US\$340 million from *International Aero Engines (IAE)*, which makes engines for the Airbus A320 aircraft. IAE is a joint venture of multiple international aircraft engine manufacturers. The engines will power 20 of BOC Aviation's Airbus planes.

BOC Aviation was formerly known as "Singapore Aircraft Leasing Enterprise" (SALE), but Bank of China purchased SALE for US\$965 million last December. "V2500 is the fit choice for BOC Aviation's fleet, the youngest in the leasing business," said Jon Beatty, President and CEO of IAE (*Asia Pulse*). Last week, we mentioned that four more Chinese banks will soon set up aircraft leasing businesses. Bank of China beat those companies into the aircraft leasing sector with its purchase of SALE. Leasing is still an underutilized form of asset financing in China, and both domestic and foreign financial institutions seem eager to participate. According to aircraft engine manufacturer *Rolls Royce*, Chinese airlines' demand will account for 660 engines over the next 20 years. The engines will cost about US\$65 billion in total.

Other Financial

10) Two Bankers Quit Posts to Start RMB Private Equity Funds

Two major players in China's financial community left their posts to start their own China-focused private equity funds. Fang Fenglei, the head of Goldman Sachs' China operations (and also one of the founders of Morgan Stanley's China JV partner—*China International Capital Corp*), plans to start his own RMB-denominated fund. Frank Tang, the head of China investment at Temasek Holdings (Singapore's government investment fund), will leave his post to do the same.

As we've repeatedly pointed out in recent newsletters, China's private equity and venture capital industries are moving away from foreign funds and toward local, RMB-denominated capital. The new paths of the two aforementioned bankers emphasize this point. According to the Centre for Asia Private Equity Research, the Chinese government has approved 11 new RMB funds with total investment of US\$10.6 billion since 2006 (Financial Times). That number will continue to rise, and the funds will receive capital from the government, from state-owned enterprises, from domestic private enterprises, and from foreign private enterprises. In our opinion, it will be interesting to see how foreign financial institutions compete with RMB-denominated funds in the future.

11) Trust Companies Become First to Gain QDII Licenses

The 21st Century Business Herald reports that CBRC has approved *CITIC Trust* and *Shanghai International Trust & Investment (SITI)* to participate in the Qualified Domestic Institutional Investment (QDII) program. QDII allows select financial institutions to invest money in overseas capital markets. Outside of QDII, Chinese institutions and individuals can only invest in the domestic markets. CITIC Trust and SITI will become the first trust companies to participate in the QDII program. They will join banks, insurance companies, fund management companies, and securities brokerages.

Unfortunately, the trust companies' overseas investments will be limited to low-yield fixed-income securities (e.g. investment-grade bonds). Many of the other QDII financial institutions mentioned above can invest in overseas stocks and mutual funds, structured products, swaps, futures, and other derivatives. Thus, trust companies may have trouble attracting demand for their QDII offerings. Rumors suggest that regulators are already drafting a law that will expand the scope of trust companies' QDII investment, allowing them to better compete with other financial institutions.

The government is currently restructuring the trust industry. In the past, many trust companies generated most of their revenue by lending money like a bank, as opposed to conducting more traditional trustee business. Since the trust business does include involvement in the capital markets, giving trust companies QDII privileges equal (or nearly equal) to those of other financial institutions should aid the competitiveness of the trust industry.

Regulations & Macro

Regulations

China Will Limit Amount Mainlanders Can Invest in Hong Kong Stocks

The government confirmed that it will impose limits on how much money mainlanders will be able to invest in Hong Kong-listed stocks. Currently, Chinese individuals cannot directly invest their money overseas. They are only allowed to invest in the Shanghai and Shenzhen Stock Exchanges, which in part explains the meteoric surge in 2006 and 2007. However, regulators will soon begin allowing "select" mainlanders to invest in Hong Kong-listed stocks. The scheme is designed to ease some of China's liquidity problems. The plan was originally slated to begin in August, but will be delayed until either October or November. Beijing is wary of allowing relatively unchecked investment in Hong Kong, fearing that Hong Kong's market could be overbought, creating an enormous bubble. Beijing also fears that an exodus of money from the mainland could destabilize the A-share markets and cause a crash in Shanghai and Shenzhen.

Thus, when the scheme does take effect, the Chinese will have a limit on how much they can invest. We have also seen reports that mainlanders will have to deposit a minimum of RMB300,000 in their trading accounts to be allowed the right to invest in Hong Kong. This could significantly cut the number of people that can take part in the scheme. Until the new Hong Kong investment plan takes effect, Beijing will use the QDII program (discussed earlier in the newsletter) to systematically funnel liquidity off the mainland. The government likes the QDII program because it can use quotas to control the exactly how much money flows out of the country.

Deals in China

M&A Activity

Acquirer	Description	Target	Description	Amount	Deal details
China Fair Land Holdings	HK-listed, Chinese property developer	Amazing Wise Ltd	owner of a large commercial and residential development (under construction) in Fuzhou, SE China	HK\$3 Bil	100% stake
CITIC Resources	one of China's top five oil producers	Tincy Group	owner of the rights to an oilfield in NE China	US\$148.2 Mil	90% stake
Gome	China's largest electronics retailer	Shaanxi CellStar	owner of 22 mobile phone retail outlets	up to US\$10.7 Mil	100% stake

Deals in China

IPO Pipeline

Company	Description	Exchange	Size	Financial Advisors
Shenhua Energy	China's largest coal producer	Shanghai	US\$8.9 Bil	China International Capital Corp, China Galaxy Securities
Xinjiang Xinxin Mining Industry	China's second-largest nickel producer	Hong Kong	US\$500 Mil	BOC International
Soho China	Beijing-based commercial property developer	Hong Kong	US\$1.65 Bil	HSBC, Goldman Sachs, UBS
DaChan Food	mainland chicken supplier, China's largest slaughterer of chickens	Hong Kong	US\$116 Mil	Cazenove Asia
Kingsoft	Chinese software developer and online game operator	Hong Kong	HK\$767 Mil	Lehman Brothers
Noah Education	China-based provider of interactive educational services	Nasdaq	US\$140 Mil	Deutsche Bank Securities, CIBC World Markets, Thomas Weisel Partners, First Shanghai Securities
China Aoyuan Property Group	Guangdong province-based residential property developer	Hong Kong	US\$465 Mil	Credit Suisse, Morgan Stanley

Random Tidbits

Man Dies after Three-Day Internet Binge

Usually when we read about a death after days of bingeing, we expect to hear grizzled tales of excessive drug or alcohol use. But how about death caused by excessive internet usage? This was recently the case at an internet cafe in the southern Chinese city of Guangzhou, where a man who had been surfing the internet for three days straight suddenly dropped dead. Paramedics could not revive the 30-year-old, whose death was said to be caused by "exhaustion." It is still unclear what websites he was visiting.

This incident showcases a strange, but apparently real example of China's "internet addiction" problem. At all times of the day and night, internet cafes provide access to millions surfing the internet and playing online games. China has almost 150 million internet users. Beijing's fears have promoted "internet boot camps" to try and wean young people off their addiction. Some, however, are calling for a more proactive approach. This includes giving young people access to a wider range of extracurricular outdoor activities, and getting parents to "force their children to pursue more constructive endeavors." According to state news sources, the "vast majority" of Chinese students chose to spend their summer vacations indoors, many using the internet all day long. Only 4% chose to play outside and only 9% participated in educational camps. Although the man who died was not a young student, his death certainly highlights an internet culture that is, according to Beijing, spiraling out of control.