

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

- 8/31 Close: **5,218.83**
- 9/7 Close: **5,277.18**
- Weekly Change: **↑ 1.118%**
- Since 1/1/07: **↑ 97.243%**

Shenzhen Composite Index

- 8/31 Close: **17,872.11**
- 9/7 Close: **17,674.10**
- Weekly Change: **↓ 1.108%**
- Since 1/1/07: **↑ 165.89%**

Exchange Rate

- 8/31: US\$1 = **RMB 7.556**
- 9/7: US\$1 = **RMB 7.550**
- Weekly Change: **↑ 0.079%**
- Since 1/1/07: **↑ 3.427%**

Articles

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- 2) Nestle Seeking Bottled Water Acquisitions in China
- 3) Chinese Winery Acquires Canadian Winery

Technology

- 4) Intel to Move Planned Future Production from India to China
- 5) SMIC May Acquire NEC's China Chipmaking JV
- 6) Binhai Becomes World's Top Mobile Phone Manufacturing Region

Services

- 7) China Eastern Sells Stake to Singapore Airlines
- 8) CSRC Rejects Hangzhou Bank's IPO Bid
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Random Tidbits

Building Materials

1) Goldman Sachs Enters China's Cement Industry

Goldman Sachs agreed to purchase a 25% stake in Chinese cement maker *Hongshi Holdings* for RMB 600 million (roughly US\$80 million). Hongshi has annual production capacity of 16.5 million tons. Goldman and Hongshi had reportedly been in negotiations since October, 2005. This is the latest in a series of significant deals in China's highly fragmented cement sector. The cement industry landscape in China is punctuated by many small players (well over 1,000) competing in various regional markets. These firms often don't have the necessary capital to grow and leverage economies of scale. As a result, the government is promoting investment from both domestic and foreign players in order to help consolidate the industry. The world's largest cement firms, like Lafarge, Holcim, and Heidelberg, have all increased their China presence in 2007. Financial buyers have also been active in the sector. In March, KKR purchased a minority stake in *Tian Rui Cement* for under US\$100 million. The Tian Rui/KKR venture also received a RMB3 billion loan to acquire and "roll-up" other cement firms.

Food & Beverage

2) Nestle Seeking Bottled Water Acquisitions in China

Datamonitor reports that Nestle is targeting bottled water acquisitions in China as part of its rapid expansion plan. According to CEO Carlo Donati, the company needs to expand its geographic presence on the mainland. Nestle currently only has about 2-3% market share in the sector. Bottled water sales in China are growing in the mid to high teens. Danone currently has the top market share among foreign players. It owns 51% of a JV with China's top bottled water producer, *Wahaha*.

3) Chinese Winery Acquires Canadian Winery

Chinese wine producer *Tonhwa Grape Wine* purchased a 75% stake in a Canadian winery for US\$6.6 million. The Canadian winery is Ontario-based King's Court Estate Winery, which produces "icewine." For those who are unfamiliar, icewine is a type of desert wine. To produce it, the grapes are picked while frozen during autumn's first frost. The frozen water is then easily pressed out, leaving a concentrated, extra sweet grape. Canada is the world's largest icewine producer due to its cold and relatively consistent climate. Tonhwa was founded in 1937, and is China's first icewine producer. It is located in China's northern (and cold) Jilin Province. The Chinese winemaker acquired King's Court in order to expand its capacity and gain expertise.

Semiconductor/Integrated Circuit

4) Intel to Move Planned Future Production from India to China

Intel will move planned future semiconductor production facilities from India and Vietnam to China. The company claims the move was a part of wanting to be "closer its consumers," which are generally electronics manufacturers on the mainland. Semiconductor consumption has grown at around 30% in China during the last few years. In fact, in 2005, growth in Chinese semiconductors accounted for 90% of the world's total growth. Intel is breaking ground on a US\$2.5 billion semiconductor fabrication facility in the northeastern city of Dalian. It will be Intel's first chip fabrication facility in China. Currently, the company only has chip testing and packaging facilities on the mainland, but no fabrication.

5) SMIC May Acquire NEC's China Chipmaking JV

Semiconductor Manufacturing International Corp (SMIC) is negotiating to acquire Shanghai-based chipmaker *Hua Hong NEC*. Hua Hong NEC is a 50-50 JV between Shanghai's *Hua Hong Microelectronics* and Japan's NEC. Negotiations between SMIC and Hua Hong NEC have reportedly ensued for months. Merging the two companies could create a larger player that can more effectively compete with Taiwanese companies (the largest being TSMC and UMC) for market share in China's chip industry. China's semiconductor industry is centered around electronics products such as mobile phones, MP3 players, and notebook computers. Chinese chipmakers currently hold about 30% market share on the mainland. China also accounts for 20% of the world's semiconductor demand (China Economic Review).

Hua Hong NEC has tried numerous times to raise money through a listing in Hong Kong, but has encountered difficulties with the stock exchange's listing requirements. As recently as a few months ago, the group planned to raise US\$300 million in a Q3 2007 listing. However, it seems that at this stage, shareholders believe a merger with SMIC is a more viable way to raise capital. SMIC, Mainland China's largest semiconductor producer, is listed on the NYSE and in Hong Kong. Its stock market value stands at US\$2.12 billion.

Telecommunications

6) Binhai Becomes World's Top Mobile Phone Manufacturing Region

The *Binhai New Area* is now the world's largest cellphone manufacturing base. Binhai New Area is a special economic zone in the northern city of Tianjin (population 10 million; located southeast of Beijing). The government is pushing Binhai to become a top global business center and wants the area to focus on industries such as high-tech, finance, and shipping (Tianjin is a major coastal port city). Essentially, Binhai is trying to become the next *Shanghai-Pudong New Area* (formerly shipyards and rice paddies and now home to Shanghai's financial district). As of the beginning of 2007, 10% of the world's mobile phones were produced in Binhai. Motorola and Samsung are the top international brands with manufacturing operations within the economic zone.

Air Travel

7) China Eastern Sells Stake to Singapore Airlines

Shanghai-based *China Eastern Airlines* (NYSE, HK, and Shanghai-listed) finally agreed to sell a 24% stake to Singapore Airlines (SIA) and Temasek Holdings (a Singapore state investment fund) for US\$918 million. It marks the first time a foreign carrier has taken a significant stake in a major Chinese airline. Through the purchase, SIA, the world's largest airline by market value, will gain more access to China's booming aviation sector. Fueled by rising purchasing power among the Chinese, air travel is growing around 20% per year. From China Eastern's perspective, the deal will help the airline improve its operations. The company posted significant losses in 2005 and 2006, as well as a RMB384 million loss in the first half of 2007. "China Eastern sees the benefits of Singapore Airlines' brand and managerial expertise through this deal and hopes that it will help improve our own management," said Li Fenghua, the chairman of China Eastern. The cash injection will also help relieve pressure on China Eastern's debt-heavy balance sheet. The deal must still gain approval from shareholders and regulators, although no hiccups are expected. SIA will purchase a 15.7% stake while Temasek will take an 8.3% stake. China Eastern is one of China's three major state-owned airlines, the others being *China Southern* and *Air China*.

Banking

8) CSRC Rejects Hangzhou Bank's IPO Bid

The *China Securities Regulatory Commission (CSRC)* rejected *Hangzhou City Commercial Bank's* IPO application. The bank had hoped to raise over US\$650 million in by listing on one of the two domestic stock markets. The *Securities Times* reports that the application was turned down because too large a stake in the bank is owned by employees. "CSRC has been enforcing a rule that employee stakes in listed financial institutions will be capped at 5%," said a source (Xinhua News Agency). Hangzhou Bank's employee ownership reportedly stands around 10%. Hangzhou Bank is China's fourth-largest city commercial bank by assets (Bloomberg).

We've spoken at length in recent newsletters about recent developments surrounding China's "city commercial banks." The country's 114 city commercial banks generally only operate within their home cities. However, increasing numbers are realizing they must expand outside their home areas in order to achieve the economies of scale necessary to compete with larger players. Thus, these banks are attracting foreign strategic investors in order to gain access to banking best practices before going public. Commonwealth Bank of Australia owns a 19.99% stake in Hangzhou Bank, while the Asian Development Bank owns an additional 5%. In July, *Bank of Nanjing* and *Bank of Ningbo* became the first two city commercial banks to list. On September 11, *Bank of Beijing* will raise US\$1.7 billion in a massive IPO on the Shanghai Stock Exchange.

Education

9) Carlyle Invests US\$20 Million in Chinese Education Firm

Washington, DC-based private equity giant Carlyle Group will spend US\$20 million for a stake in Chinese educational services company *NeWorld Education Group*. Details on the transaction were not disclosed. NeWorld is strong in Japanese language training, and has 65 schools in China. The cash injection will help NeWorld expand to about 120 schools within two years. China's educational market is growing fast, with the language/career training sector expanding at about 30% per year. Last September, *New Oriental Education* (market cap: US\$1.96 billion) listed on the NYSE in a US\$110 million IPO. (China Knowledge)

Hospitality

10) Budget Hotel Chain Receives Big Investment from Big Players

Curiously named Chinese budget hotel operator *7 Days Inn* received US\$95 million of investment from three major global financial investors. The investors were Merrill Lynch, Deutsche Bank, and private equity firm Warburg Pincus. The familiar sounding 7 Days Inn is also planning an IPO in 2008 and says Nasdaq is a possibility. The company currently has 60 hotels, with another 70 under development. This is the second time Warburg Pincus has invested in 7 Days Inn—the private equity group invested US\$10 million in November, 2006. The new trend among China's private equity investors is the branded budget hotel sector, as many believe the market is significantly underserved. In the United States, branded budget hotels make up 60% of all hotels. In China, they make up only 3%. Last week we discussed other major investments into China's budget hotel sector. In late August, U.S.-based hedge fund/investment group Aetos Capital invested US\$50 million in the operator of *Super 8* hotels on the mainland. Earlier this year, budget brand *Hanting Hotels* received an US\$85 million round of venture capital financing. As a point of reference, budget brand *Home Inns* (market cap: US\$1.04 billion) raised over US\$100 million in a Nasdaq IPO in the fourth quarter of last year. (PacificEpoch)

Leasing

11) ICBC to Establish Financial Leasing Company

Industrial and Commercial Bank of China (ICBC), the mainland's largest bank, will establish its own financial leasing company. The company will lease ships, airplanes, and other equipment to companies. Besides ICBC, four other Chinese commercial banks have been approved to conduct financial leasing business. The *China Banking Regulatory Commission (CBRC)* released new regulations on March 1 that allow commercial banks to participate in financial leasing (regulators forced banks to leave the sector in 1999). Additionally, in December 2006, *Bank of China* (the mainland's second-largest bank) purchased Asia's largest aircraft leasing company, Singapore Aircraft Leasing Enterprise, for US\$965 million. The merged company is now called *BOC Aircraft Leasing Enterprise*.

Historically, the Chinese leasing market has been underutilized. Leasing volume in China accounts for less than 0.1% of GDP. By comparison, leasing volume in the U.S. is about 31% of GDP. Financial leasing is generally used to finance capital intensive assets such as construction machinery and aircraft. The rapid growth in sectors like construction and air travel makes the Chinese leasing industry even more attractive.

Other Financial

12) China to Lift Moratorium on Foreign Stakes in Local Securities Firms

CSRC, China's equivalent of the American SEC, will reportedly resume allowing foreign capital into the securities brokerage industry. The securities regulator hasn't allowed foreign investment into securities firms since 2004 when the government began an industry-wide restructuring initiative. At that time, CSRC feared that well-funded foreign players could drive poorly-run domestic firms out of business. Summing up the situation, CSRC chairman Shang Fulin said, "At earlier stages, many Chinese securities firms were set up by people from the banks, and they brought along their 'habits' in the bank that were not suitable for securities operations, such as buying stocks with customers' deposits." Other nations, including the U.S., have pressed China to reopen the sector. Furthermore, China understands that it must do so as part of its WTO commitments. Before the moratorium, only Goldman Sachs, UBS, and Morgan Stanley were able to set up mainland joint venture securities brokerages. The cap on foreign holdings in a JV stands at 33%, but that should rise to 49% in the future.

Domestic brokerages have recently taken full advantage of the lack of foreign competition, realizing billions in profits from the stock market frenzy of 2006 and 2007. In the first half of 2007 alone, brokerages raked in RMB4.2 billion in trading commissions. Foreign enterprises clearly want the opportunity to compete in the China market. They also want to set up in China in order to be able to underwrite IPOs on the Shanghai and Shenzhen Stock Exchanges. Today, only Goldman Sachs and UBS have underwritten domestic IPOs. For example, UBS is underwriting *PetroChina's* upcoming US\$5-billion-plus Shanghai offering.

13) Fund Management Firm to Launch Overseas All-Equities Fund

China's largest mutual fund company, *China Southern Fund Management (CSFM)*, will launch the nation's first fund aimed solely at investing in stocks listed on foreign equity exchanges. The fund is an approved member of China's Qualified Domestic Institutional Investor (QDII) program, which allows only certain financial institutions to invest money in overseas capital markets. Outside of QDII, Chinese companies and individuals cannot invest in overseas markets. CSFM will launch the fund on September 12, and aims to raise about US\$2 billion. The fund will invest in stocks and mutual fund products, focusing on markets in 10 countries. CSFM will devote about 40% of the fund to stocks listed in Hong Kong, namely shares of dually-listed Chinese companies (this means they are listed in both Hong Kong and on the mainland). The company believes the valuations of those stocks in Hong Kong will begin to catch up to the valuations on the mainland exchanges. On average, shares of dually-listed companies trade on the mainland at PE ratios 90% higher than their PEs on the Hong Kong exchange. "The Hong Kong market features low valuation, ample liquidity and rosy corporate earnings growth," said one of the managers of the fund. "We believe the stock price there has huge room to improve" (Shanghai Daily).

CSRC has approved a few other billion-dollar-plus QDII funds in the last two months. Beijing is using QDII as a way to funnel some of China's excess liquidity outside the mainland. However, considering China's US\$4.7 trillion in domestic savings, a few billion dollars invested overseas still barely makes a dent in the country's excess liquidity. Hence, the surge in the domestic markets will continue.

Regulations

PBOC Hikes Required Reserve Ratio for Seventh Time in 2007

The *People's Bank of China* (PBOC—China's central bank) will raise the required reserve ratio for banks by 0.5% to 12.5%. The hike, which is the seventh this year, will take effect on September 25. By making banks keep a higher percentage of their deposits on hand, PBOC hopes to slow the pace of loans and thus curb liquidity. PBOC and other regulatory bodies have taken a variety of measures this year to try and curb liquidity. Among them, PBOC recently raised interest rates twice in a one month period, actions that were also spurred by skyrocketing inflation in China. Due to rising food prices, July's inflation hit a 10-year high of 5.6%. Second-quarter GDP growth hit a 12-year high of 11.9%.

Mainlanders Must Wait to Invest Directly in Hong Kong Stocks

Regulators will delay the beginning of a scheme allowing mainland individuals to trade stocks listed on the Hong Kong exchange. The *State Administration of Foreign Exchange (SAFE)* originally approved the pilot program on August 20 and trading was set to begin by the end of August. However, Beijing will delay the program for "one to two months" (China Securities Journal) for a variety of reasons. Beijing is worried that money could flow out of the mainland to Hong Kong too quickly, destabilizing the domestic markets and causing a sell-off. China's securities and banking regulators want to encourage the purchase of QDII products for the time being (QDII is discussed in greater depth in the China Southern Fund Management article). Regulators can control the amount of QDII outflow with quotas. Regulators also want to educate individuals about the "risks" associated with investing overseas (one would assume this includes foreign exchange risks). The China Securities Journal reports that when the scheme takes effect, individuals in the cities of Tianjin, Shanghai, Beijing, and Guangzhou will be allowed to take part. Originally, SAFE said it would only allow citizens to open trading accounts in Tianjin.

When the pilot scheme takes effect, it will mark the first time individuals can invest directly in equities on foreign markets. Currently, they can only invest overseas through QDII products. To keep too many folks from investing in Hong Kong stocks right away, regulators will require citizens to deposit at least HK\$300,000 (roughly US\$38,000) in their trading accounts.

NYSE to Set Up Office in Beijing

CSRC gave NYSE Euronext approval to set up a representative office in Beijing. It will be the first representative office of a foreign stock exchange on the mainland. NYSE and other foreign stock exchanges want to set up offices in China to promote their markets and attract more Chinese listings. The development is a byproduct of the first Strategic Economic Dialogue between China and the U.S. last December, when China pledged to allow foreign stock markets to establish mainland offices. Nasdaq, the London Stock Exchange, and the Deutsche Borse are also planning to set up offices in China (Bloomberg). To date in 2007, nine Chinese companies have listed on the NYSE.

Deals in China

M&A Activity

Acquirer	Description	Target	Description	Amount	Deal details
Singapore Airlines and Temasek Holdings	Asia's most profitable airline; Temasek is Singapore state investment fund	China Eastern	China's third-largest airline, based in Shanghai	US\$918 Mil	24% stake
Goldman Sachs	major international investment bank	Hongshi Holdings	China's sixth-largest producer of cement clinker	RMB 600 Mil	25% stake
China Merchants Securities	top 10 Chinese securities brokerage	Xinjiye Futures	Chinese futures dealer	RMB 120 Mil	100% stake
Titan Petrochemicals	Asian petroleum logistics company, deals with oil storage facilities in south and east China	Quanzhou Shipbuilding Industry	shipyard in southeast China's Fujian province	US\$170 Mil	100% stake
Omnicom Group	int'l advertising and marketing services group, NYSE-listed, market cap: US\$16.71 billion	Consultech	Chinese company that provides marketing services to int'l and domestic healthcare firms	N/A	controlling stake
CNOOC	China's third-largest oil producer, state-owned	China Power New Energy Development	HK-listed Chinese renewable energy firm (also involved in numerous other unrelated sectors)	HK\$729 Mil	15.6% stake

Deals in China

IPO Pipeline

Company	Description	Exchange	Size	Financial Advisors
Qunxing Paper	Shandong-based manufacturer of environmental decorative base paper	Hong Kong	HK\$1.6 Bil	ICEA, UOB, Kim Eng Securities
China National Materials Industry Group (Sinoma)	cement and non-metallic materials group	Hong Kong (Q4 2007)	US\$300-400 Mil	BOC International, UBS
Global Sweetener	China's largest producer of corn-based sweeteners	Hong Kong	HK\$612 Mil	Goldbond Securities, DBS Vickers

Random Tidbits

Two-Thirds of China's Adult Males Smoke

According to Asia Pulse, 32% of the world's smokers reside in China. The more staggering fact, however, is that *two-thirds* of Chinese men above the age of 15 are smokers. Understanding that smoking is a major public health issue, the government said it would eliminate all promotion of tobacco products by 2011. Technically, an advertising ban has been in place since 1996, but tobacco producers still use loopholes to promote their products.