



People's Republic of China

Outbound activity goes quiet whilst domestic M&A growth continues

Current Environment

During the first half of the year, China's economy has continued to forge ahead with GDP growth in 2006 forecast to be 9.8%, almost unchanged from the 9.9% achieved in 2005. Most of this growth is still being driven by exports (which in 2005 almost doubled on 2003, itself a record year, to US\$780 billion) and demand from the US, which has driven the trade surplus to a forecast record of US\$144 billion in 2006. Investment to support the trade surplus is also continuing to grow rapidly at over 20%. Despite increases in energy costs, consumer price inflation remains below 4%. Following the slight relaxation of currency controls in 2005, the Yuan has strengthened against the US dollar from its pre-relaxation high of around 8.3 to the dollar to around 8 to the dollar now, and is expected to continue its gradual strengthening, thus supporting the flow of speculative funds into China.

One area of concern is the real-estate market, in which concerns over a developing bubble have led to the Government introducing a number of measures to restrict credit to developers, increase tax on speculative transactions, and encourage developers to build more small-size units for lower-income households. However, the net effect of these measures seems unlikely to be sufficient to outweigh the speculative gains on offer. One upside for foreign investors is that a number of developers have had to broaden their sources of finance and the number of real estate related deals has been gradually rising in response.

Hence the economic fundamentals remain remarkably strong, and there appear to be no short-term barriers to maintaining this rate of growth. As long as there are no shocks in the major destination markets for Chinese goods then growth looks set to continue. Although there have been repeated fears raised about overheating in the economy and excess investment in capacity, reported profits appear to be holding up, which suggests that domestic demand is also growing strongly.

On the political front, the National People's Congress ("NPC") was held in March, at which the Eleventh Five-Year Plan was launched for 2006-2010. That China still has these plans may come as a surprise to readers who thought China had left behind the era of central planning, but in their current form they act as communications of broad statements of medium-term strategy. Much emphasis was placed on social welfare issues, as the leadership become concerned about the widening income gaps between the coastal and inland economies, and the urban – rural divide.

Stock market reform

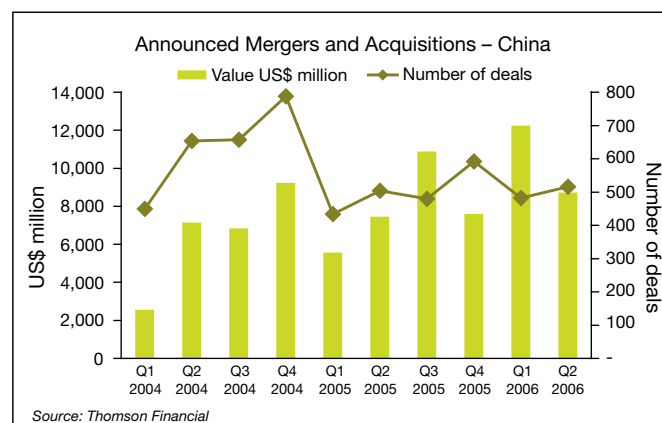
A major development in 2006 has been the resuscitation of the domestic stock markets, which for six years had sunk and flat-lined even while the wider economy maintained its rapid growth. The cause had been the overhang of non-tradable shares, through which the Government had maintained control over most listed companies, and the regular announcements by the Government that this problem would eventually be dealt with by the mass disposal of these shares.

The reform plan announced in 2005 was initially met with scepticism but has in fact been a great success, such that around 60% of companies had converted all of their shares to tradable shares by March 2006. The success of this reform has been reflected by the markets which have risen by 60% since the start of the year.

It seems that regulators have been emboldened and have introduced further reforms, including resuming IPOs (which had been suspended a year earlier), and a new set of M&A regulations that apply to listed companies, including a strategic investor scheme permitting foreign companies to buy into listed companies. One key element of the new regulations is that share swaps are to be allowed for the first time, and although there have only been a handful of deals performed so far under the new regime, early signs are encouraging that the restructuring that M&A permits will be a key tool in improving the quality of listed companies.

However, despite this new-found energy, Hong Kong will remain the market where the best quality Chinese companies are traded for the foreseeable future. The world's largest IPO for four years, Bank of China, debuted on the Hong Kong Stock Exchange in the second quarter of 2006, and was 30 times oversubscribed, which reflects the desire of global investors to share in the China success story.

Deal Activity



Deal activity remains robust, with the value of deals continuing to rise in the first half of 2006, but the volume falling. Investors continued to be eager to buy into Chinese bank shares pre-IPO, with the Industrial and Commercial Bank of China ("ICBC") completing the sale of minority stakes to Goldman Sachs, Allianz, and American Express for about US\$3.8 billion in May 2006, making ICBC the recipient of the largest amount of foreign investment in the financial services industry in China to date. ICBC had chosen the underwriters for its jumbo IPO in Hong Kong later in 2006, which in terms of size is expected to surpass that of Bank of China.



In the consumer goods sector, InBev agreed to acquire Fujian Sedrin Brewery in a series of transactions for a total cash consideration of US\$736 million, the largest deal to date in China's beer industry, for one of the last remaining independent regional brewers. Also, Danone bought into Huiyuan, one of China's largest juice suppliers, for a reported US\$200 million.

In the media and entertainment sector, Focus Media Holding completed the acquisition of its rival Target Media for a reported US\$348 million, forming China's largest outdoor advertising company and obtaining an estimated 90% share of the market in the process. Japan's Recruit Co. also bought into 51Job, an online employment agency.

A notable deal occurred in the consumer durables sector, in which a hedge fund, Pacific Alliance, acquired Goodbaby, an exporter of children's transport (eg strollers and prams), for a reported US\$122 million, marking one of the first significant hedge fund buyout deals.

Real estate has become another hot investment target, and a number of mainland developers have IPO'd in Hong Kong during the first half of 2006. In May, Hong Kong's New World agreed to purchase 100% of Hunan Success from Hunan Development for US\$90 million, joining other investors such as Carlyle Group, Warburg Pincus, Macquarie and Morgan Stanley, which have all announced real estate deals in the period.

Outlook

All the indicators remain positive for the healthy growth of M&A in China. Stock market reform and the opening of listed companies to M&A activity brings into play a whole new set of opportunities for investors. Private equity activity remains strong, and hedge funds are also getting in on the action. Investment banks, private equity funds, and deal advisors are all rapidly expanding their operations (often by poaching staff from one another) to support this rush of activity. In fact, human resource constraints are the biggest single challenge to dealmakers in China.

One cloud on the horizon is the rise in protectionist sentiment. However, China is by no means unique in this respect, and it is only to be expected that there will be a response to the increase in activity levels. At the same time, there have not been any significant deals reported by Chinese companies overseas during 2006, and hence the general perception is that M&A is currently one-way traffic. However, in our opinion the fundamentals are too strong at present for this concern to be a barrier to the rising tide of deals, and although total value may fall as the large investments into banks come to an end, the outlook for the rest of 2006 is for further increases in activity.

