People's Republic of China

External macro factors are pulling down overall activity levels, but strong fundamentals should mean any downturn in M&A activity is not prolonged

Current Environment

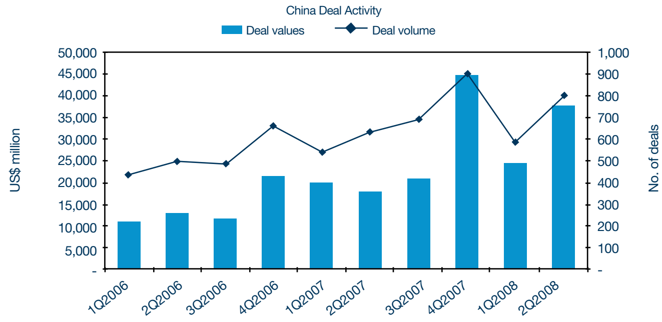
The start of 2008 has been a difficult period for China with severe winter storms in February and a massive earthquake hitting Sichuan province in May. These domestic natural disasters occurred during a time of increasing global anxiety about an economic slowdown and significant inflationary pressures, with oil prices at record levels. This tough environment has followed better than expected economic performance in 2007 where China's National Bureau of Statistics revised full year GDP growth upwards from 11.4% to 11.9% in April, the fastest rate of growth since 1994. GDP growth forecasts for 2008 are slightly down at 10% with the EIU and World Bank's latest expectations at 9.8% and the Chinese Government estimating 10.3%. Compared to most other major economies, China has been relatively less exposed to the global economic slowdown with less integration into the global financial system and less exposure to the sub-prime crisis, and a strong growing domestic consumer economy. Its international competitiveness in exports has remained strong, despite the continuing appreciation of the yuan versus the US dollar.

Inflation in China is being 'exported' to other countries due to the vast volume of Chinese produced goods traded internationally. After hitting a 12-year high of 8.7% in February, Chinese inflation has now declined in June to 7.1% as key factors pushing up food inflation (approximately one-third of the CPI basket) have eased. However, other factors driving inflation have persisted, including newly negotiated iron ore contracts for Chinese steel producers which saw price rises of 90% in June; also in June, removal of Chinese Government oil subsidies saw fuel prices increase 18% overnight; and in big cities/major production regions wage and housing price inflation have continued. Fighting inflation has become the number one priority of the Government, which fears the impact of rising prices on social stability.

The Shanghai and Shenzhen stock market indices have fallen faster than the major global stock market indices after undergoing two years of breakneck growth. The Shanghai composite index was trading at 2,736 on 30 June 2008, 52% of its value on 1 January and 45% of its value at its peak on 16 October 2007. There was an attempt to dampen the recent fall with a reverse in stamp duty levied starting from May 2007 till April 2008, but there was only a temporary rally.

The Chinese yuan exchange rate was at 6.87 to the US dollar at 30 June, an appreciation of 21% since Beijing removed its currency peg in summer 2005 (although over the same period the yuan has actually depreciated against the euro by 7%). These rate movements have impacted Chinese companies exporting in highly competitive industries like textiles and hence some companies have closed or relocated to lower-cost areas as they became unprofitable. Nevertheless, there are a number of benefits to China as the rate increase forces companies to be more competitive, and this means that Chinese companies have more purchasing power overseas for resources and assets.

Deal Activity



Source: Thomson Reuters, based on total domestic, inbound and outbound deals announced as of 30 June 2008

The value of domestic deals announced in China (excluding Hong Kong) in H1 2008 was US$47.9 billion, up from US$44.6 billion (7.4%) in H2 2007 and US$31.8 billion (50.5%) in H1 2007, but H1 2008 was boosted by a single telecoms deal of US$15.8 billion (see below). Deal volume in H1 2008 was 1,305 deals, down from 1,490 deals (-12.4%) in H2 2007, although up from 1,086 (20.2%) in H1 2007.

The largest area of deal activity remains domestic-to-domestic deals. Over the period the trend of industrial consolidation has continued, driven by a desire to improve efficiency, gain geographical expansion, upstream/downstream synergies or technology capture. Faced by fragmented markets and margin pressure, Chinese executives have opened up to M&A as a new growth driver.

The single largest domestic deal announced in H1 2008 was China Telecom's US$15.8 billion acquisition of China Unicom's CDMA technology wireless unit. This is part of a wider government-encouraged restructuring of China's telecoms industry to have three operators in both fixed line and wireless services such that China Mobile, the current dominant market player in wireless, is presented with stronger competition. Once this deal is completed, it is due to be followed later in the year by an even larger deal which will see China Unicom buying the domestic fixed line operator, China Netcom, for US$23.8 million. Aside from telecoms the most active sectors in H1 2008 for domestic-to-domestic deals have been materials, industrial products, retail & consumer and technology. Some examples of notable domestic deals announced include:

- Shanghai Bashi Industrial group agreed to acquire the auto-parts making assets of Shanghai Automotive Industry Corp (SAIC) for US$1.3 billion
- Qinghai Digital Net agreed to merge with Qinghai Salt Lake Industry, a chemicals manufacturer, in exchange for shares, valued at US$2.0 billion
- Guangdong Midea Electric Appliances acquired a 24.01% stake in Wuxi Little Swan, another household appliances manufacturer for US$236 million

- Panzhihua New Steel & Vanadium announced it would merge with Pangang Group Sichuan Changcheng Special Steel in a stock swap transaction valued at US$961.7 million. Concurrently, Panzhihua New Steel & Vanadium Co also announced it would merge with Chongqing Titanium Industry also for a stock swap valued at US$518 million

Inbound foreign corporate acquisitions have weakened in H1 2008. Many international companies have weaker balance sheets and have become less aggressive in overseas expansion. At the same time, regulators in Beijing have slowed and tightened their approval process because they have been distracted by wider economic concerns, with the fight against inflation being the priority. However, there have been some notable inbound deals announced including:

- Deutsche Bank announced plans to raise its stake in Huaxia Bank to 13.7% from 8.36% for US$553 million in cash in a privately-negotiated transaction
- Tata Communications International, a wholly-owned unit of Tata Communications, announced plans to acquire a 50% interest in China Enterprise Communications Ltd, a telecommunications and information technology services provider
- Pfizer Inc planned to merge with Tianjin Tianyao Pharmaceutical Co, a pharmaceuticals manufacturer and wholesaler

Chinese Private Equity industry continues to develop

The Chinese private equity industry continues to gain traction. Locally-incorporated, yuan-denominated funds such as CDH, Hony and Pingan have several advantages over foreign counterparts. First, the approval process is not as complicated as they qualify as domestic deals and therefore do not have to undergo the foreign investment approval process. Second, as yuan-denominated deals, they face less scrutiny from the foreign exchange regulator and incur less forex risk. Third, domestic investments and the domestic stock exchanges are available as exits. For domestic funds, the main channel has been the domestic bourses and even in the current bear market the listings of Joyoung (CDH) and USTC iFlytek (Legend) both saw share prices more than double on the first day of trading. New listings have been greatly reduced in Shanghai (four IPOs in H1 2008, H1 2007:12), but increased in Shenzhen to 54 in H1 2008 (H1 2007:38). Recent private equity backed Hong Kong IPOs have seen mixed success, with Little Sheep restaurants (3i/ Prax Capital) and A8 Digital Music (IDG, KPCB) both seeing share prices drop considerably below the IPO price within a couple of days of trading. IPOs of Chinese companies on overseas exchanges have slowed down to a trickle, with US bourses only listing two Chinese companies in 2008 to date, compared to 26 in 2007 and 41 in 2006 (many of which were private equity backed). This slowdown of foreign listings followed encouragement from Beijing for companies to list domestically coupled with increased regulatory burden required for overseas listings.

In 2007, as IPOs on the Shanghai and Shenzhen bourses attracted higher pricing than Hong Kong, many international funds started to consider ways in which they too could gain access to domestic bourses, but this has become less attractive with the crash of the domestic markets, and in addition the legal barriers for foreign funds to establish a domestic fund have so far proved too challenging. Domestic funds are working hard to develop and sustain their advantage over foreign funds in being able to complete deals more quickly and exit in more attractive markets, and in the process are attracting talent and capital. Whilst this is not yet to the detriment of international funds, the competitiveness of domestic funds is growing steadily.

Large increase in Chinese outbound acquisitions

Chinese outbound acquisition activity has seen an increase with Chinese companies looking to gain access to resources, new markets, technology and management expertise. By May 2008, total outbound deal value had reached US$31 billion, already exceeding the full year 2007 total outbound deal value. Outbound investments have accelerated recently as many Chinese companies are sitting on large cash piles raised from IPOs, and with the Chinese yuan appreciating overseas assets are becoming cheaper. The most active sectors of outbound acquisitions continue to be those securing access to natural resources, and in H1 2008, examples of major deals include Aluminium Corporation of China taking a 12% stake in Rio Tinto for US$14 billion; China Offshore Services' US$2.5 billion acquisition of Awilco Offshore, an offshore drilling and accommodation rig services business; and Sinosteel in a hostile takeover bid for Midwest, an Australian Iron Ore prospector. Financial services has also continued to be another particularly active outbound investment sector with the biggest deal being China Merchants' Bank acquisition of Hong Kong's Wing Lung bank for US$4.7 billion. With investment bankers queuing at the door of CIC, China's sovereign wealth fund, we expect to see more large deals in H2.

Outlook

The second half of 2008 starts with Beijing hosting the summer Olympics which will see Beijing effectively shut down for a month. As well as the direct disruption, China's hosting of the Olympics has also created a number of other barriers such as slower and more stringent processes for approving visas for foreigners. The fight against inflation will continue to divert the attention of the authorities, and we see no acceleration in regulatory approval procedures being likely.

Overall the macro-economic fundamentals are still solid in China with GDP forecasts for full-year 2008 at 10%. For M&A activity there are also a number of other general drivers in the short- to mid-term particularly, many cash rich companies and funds; low stock market indices reducing inflated deal valuation expectations; and a desire from companies to expand geographically, consolidate and acquire new technology. In particular for private equity, tightening of bank liquidity and the moribund domestic stock market creates opportunities to provide finance for companies looking to grow. We see no sign of a slowdown in outbound acquisitions.

A number of risks still remain in the Chinese market including inflation and high oil prices which could slow Chinese economic growth more than expected. Continued weakness in the US dollar will also hurt the export sector. Nevertheless, China remains the most attractive destination in Asia for private equity due to its high-growth companies and relatively more open-deal environment, and with its coffers bursting, the flow of outbound deals is expected to increase further.