



People's Republic of China

China's relentless growth continues as the investor base broadens and investment volumes increase

Current Environment

The Chinese economy has continued its rapid expansion and achieved 10.5 percent GDP growth in 2006, compared to 9.9 percent in 2005, which continues to be driven by domestic investment and exports. The trade surplus with the United States increased to US\$160-170 billion this year, and the threat of a recession in the US is one of a few major risks on the horizon. As in previous years, investment spending remains a key driver of GDP growth, rising by 23 percent in real terms: about the same as in 2005, despite ongoing government efforts to restrain investment. The Yuan has continued to strengthen gradually against the US dollar at a rate of about 5 percent per annum since the managed revaluation announced in 2005, which could result in the end-2007 rate being around 7.5 to the US dollar. So far, it appears that Chinese exporters have absorbed most of the impact themselves.

GDP growth is expected to decrease marginally to 9.8 percent in 2007 because of the slow-down in the global economy, particularly in the United States, and because of the Chinese government's intention to control investment growth increasingly, by encouraging a more calculated, integrated, and balanced development, focused on the quality rather than quantity of foreign investment. This GDP growth will be supported by an increase in consumption, which is expected to rise by 12 percent in real terms in 2006.

M&A Regulatory Changes

New M&A regulatory changes in 2006 are a reflection of the ongoing evolution of China's legal environment, as regulation races to keep up with changes in the broader domestic and global economy. The changes introduced in 2006 reflect the fact that the government has now accepted M&A as a necessary tool in China's ongoing economic development, allowing fragmented industries to consolidate and grow from local and regional bases to become nationally and internationally competitive.

The success of the reform of the non-tradable share system carried out in late 2005 and 2006 gave new life to domestic stock markets, with the Shanghai market going up by over 130 percent in 2006, following six years in the doldrums. By arranging compensation for existing shareholders of companies who had a significant overhang of non-tradable shares, in exchange for making those shares tradable, investor confidence rebounded.

M&A regulations for listed companies, introduced earlier in the year, highlight the government's approach of relaxing control over changes in ownership of listed companies, while trying to prevent abuse of these new regulatory freedoms. The new framework introduced gives a clearer process for takeovers than existed before.

Partly in response to increasingly protectionist sentiment in the developed world, China also introduced new regulations on foreign M&A, focusing on the review requirements for foreign acquisitions in strategically important industries, which have been widely viewed as being protectionist in nature. Several high profile transactions were delayed during their approval process as these regulations were implemented. However, it should also be borne in mind that this was partly in response to the fact that there are now large acquisition targets available in China (which was not the case two or three years ago) and more large deals are being done. A further argument can be made that these regulations at least make clear powers that already existed but which were not encoded in regulation, and hence give a framework for foreign investors to work within.

Underlying activity has continued to grow and is providing an important means to expand China's economy by increasing efficiency, directing capital, and facilitating the flow of FDI into the economy.

Deal Activity



Deal activity rose 10.7 percent to 1,945 announced deals in 2006 in China (excluding Hong Kong) compared to 1,757 in the whole of 2005. Total disclosed value of announced deals in China in 2006 amounted to US\$43.5 billion, far exceeding the US\$30.5 billion disclosed for the full-year 2005.

The increase in deal volume was driven by buoyant market sentiment and a wider range of participants. M&A became more of a domestic story in 2006, with a rapid increase in domestic-to-domestic deals. The total number of disclosed transactions in which both seller and acquirer were domestic Chinese companies increased by 67 percent.

The main sectors contributing to the increase were financial services, manufacturing and retail. The largest announced domestic deal in 2006 was Gome Electrical Appliance's 61 percent acquisition of China Paradise Electronics, its competitor in home appliance retailing, for US\$675 million. This transaction was partly settled by offering shares in Gome as permitted under the new regulations.



As in 2005, the financial services industry was the most active single sector in both value and volume. The largest deal in the industry announced in 2006 was the US\$3.1 billion acquisition of Guangdong Development Bank by a Citigroup-led consortium. Other transactions in 2006 included BBVA's investment of US\$1.3 billion in both China Citic Bank and Citic International Finance Holdings.

Deal value in the retail sector grew 75 percent to US\$3.9 billion, driven by regional and national chain formation and the entry of foreign retailers. In the consumer goods sectors, deal value grew 183 percent, with the number of deals remaining more or less constant. This is the result of six large deals with a total deal value of approximately US\$2 billion. This is to be compared with 2005, when all deals had a value lower than US\$100 million. The largest deal in this sector was InBev's acquisition of Fujian Sedrin Brewery in a series of transactions with a total cash consideration of US\$750 million, the largest deal to date in China's beer industry, with Fujian Sedrin being one of the last remaining independent regional brewers.

Chinese outbound investments increased by US\$14.1 billion in 2006, with 61 percent of deal value related to acquisitions of oil and gas companies in Russia, Kazakhstan, Nigeria, and Singapore.

Outlook

Looking forward, deal activity in 2007 will continue to grow, driven by accelerating industry consolidation. China is experiencing a rapidly maturing M&A market, with involvement from a broader range of participants and with accessibility to a deeper pool of funds for investment. Deals in consumer products, real estate and retail will increase as China's middle class keeps growing.

As a result of regulations facilitating capital market transactions, domestic M&A activity should increase. Large foreign buyouts are likely to face temporary delays in approval processes until the interpretation of new government policies and regulations is clearer, which will bring increased transparency and should encourage further activity.

Private equity activity is also likely to increase as funds raised in 2006 have reached record levels and need to be invested. Funds raised for venture capital are also at historic highs and the flow of attractive targets in emerging industries continues to increase.

Outbound investment is likely to remain resource-focused but strong policy support is likely to be tempered by an increasing awareness of the risks that Chinese companies are taking on when making outbound investments. While the energy deals by the state-run oil and gas giants are likely to continue, it is expected that players in other industries in China will look abroad to seek value-added acquisitions and to obtain resources to sustain manufacturing and construction. Acquisitions are therefore to be expected in industries such

as timber and metals, as well as in businesses with proven distribution channels, technology, and recognised products and brands.

