



People's Republic of China

Domestic-to-domestic activity is rapidly increasing, but foreign activity has flattened out due to high valuations and regulatory uncertainty

Current Environment

China's economic growth shows no sign of slowing, with GDP growth of 10.5 percent forecast for 2007. Although there is some evidence of increases in consumption, fixed asset investment remains the main driver of growth, supporting the growth in exports. The trade surplus for the first six months came to US\$112.5 billion, which is 83 percent more than the same time last year, with the total trade surplus in 2007 estimated by the National Development and Reform Commission to be US\$300 billion.

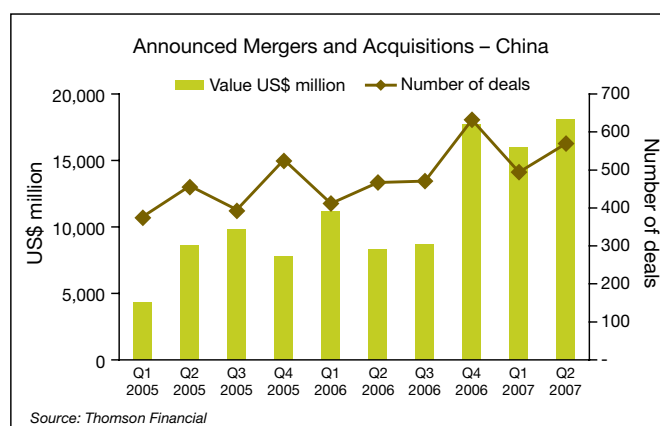
Despite US frustration with China's slow pace of currency revaluation, it seems that China will maintain a gradual approach. The Yuan reached a new high of 7.6 to the US Dollar in June, and has now strengthened by approximately 8 percent from the peg it occupied for ten years. As an attempt to manage the trade surplus, China also announced reductions in VAT credits available to exporters across a wide range of products. This builds on cuts made three years ago, before China had started to allow the currency to strengthen. Although these reductions should force Chinese exporters to pass on the cost increase by increasing their prices, the flipside is that foreign companies who have relocated manufacturing activity to China will suffer a reduction in profitability.

The underlying health of the economy has allowed the government to turn its attention to President Hu's goal of building a harmonious society, an initiative for reassessing priorities and re-distribution of the benefits of twenty years of rapid growth. Spending on healthcare and education has been allowed to grow at double the rates budgeted for. Increasingly, attention is being paid to softer issues, spurred on by media reports of shocking incidents such as the Shanxi brick kiln forced-labour discovery and the ongoing issues surrounding the quality of Chinese food exports. Environmental issues are also getting more attention, with popular protests against new chemicals factories forcing plans to be shelved, and the State Environmental Protection Agency (SEPA) taking action to order the closure of heavy polluting factories, run by high-profile listed companies who SEPA have previously not challenged.

History may be repeating itself in China's stock market, where a bull-run prompted by government reforms in April 2006 has stuttered in June. In the first week of July, the main index fell by 10 percent, the second 10 percent correction in two months. Whilst many well-connected investors have made fortunes and cashed out (prompting a boom in demand for luxury goods and cars) many less savvy investors could get left underwater as the markets fall, in a repeat of the last bull market in 2001. However, with the eyes of the world on Beijing for the 2008 Olympics, most commentators believe that the government will take measures to support the domestic stock markets to avoid any major corrections until after the games. With most listed companies being state-controlled, many large market players being state entities,

and with the government taking new steps to control the release of the overhang of non-tradable shares, there are plenty of tools at the disposal of the government to support the stock market. Another encouraging sign for the medium term is that many of the red chips, China-based companies with listings in Hong Kong (but not on the mainland itself), are being encouraged to make second listings back in China, bringing larger, higher quality companies onto the domestic stock exchanges.

Deal Activity



Overall, the disclosed value of M&A activity in China (excluding Hong Kong) was US\$34 billion for the first half of 2007, compared to US\$19 billion in the first half of 2006. The number of announced deals climbed from 879 in the first half of 2006 to 1,063 in the comparable period for 2007.

However, the total picture obscures a key theme of the most recent 18 months: there is a clear divergence in trends between domestic and foreign M&A activity in China. Domestic activity is increasing quickly, fuelled by financing available from equity markets, providing the funds to allow leading companies to act as industry consolidators. In those sectors of the economy that existed under the central planning system, ownership is fragmented and M&A is now being allowed to be used as a tool to consolidate industries such as energy, cement and steel, but often into the hands of state-controlled groups. As a result, the reported data is distorted by capital market related party transactions, such as Dongfeng Electrical Machinery's purchase of Dongfeng Boiler Group from its parent (US\$2 billion), and Beijing Enterprises Holdings' purchase of Beijing Gas Group from its parent (US\$1.5 billion). Both were sales of assets from non-listed parents to listed subsidiaries, designed to raise funds for investment in other businesses by the parent. There have also been a number of backdoor listings during the period, which inflate the deal value but cannot be considered as true change-of-control M&A transactions. In sectors that are effectively deregulated, such as retail, market forces have been driving consolidation.



A good example is the recent activity of Guodian, one of the five national power generators. Its non-listed parent company, China Guodian, has two listed vehicles that own some of its highest quality assets, GD Power Development (which holds assets in northern China) and Guodian Changyuan Electric Power Co., Ltd. (which holds assets in southern China). Earlier in June, GD Power Development took advantage of buoyant sentiment to issue additional shares and debt to finance its purchase of six power plants from China Guodian.

Foreign activity, however, has flattened out, partly due to increasing valuation expectations (again, fuelled by equity markets) and also due to the uncertain regulatory environment. The deal environment is still feeling its way through regulations announced in summer 2006, which have widely been interpreted as being protectionist, and have been accompanied by intense media scrutiny of high-profile private equity transactions, such as Carlyle's reported attempt to purchase a majority interest in Xugong, a leading construction equipment manufacturer. Carlyle also have reportedly not gained regulatory approval for a proposed investment in Shandong Haihua, a soda ash manufacturer. On the other hand, in a surprise move, US\$3 billion was invested by the Chinese government in Blackstone. This is an innovative experiment that could give Blackstone an advantage in getting deals approved on the mainland, as well as providing a new channel (with higher returns than US treasuries) for China to invest abroad. Another positive for private equity is that the deals that are being closed are getting larger: there were 11 deals of over US\$100 million in the first six months of 2007, compared to only one a year earlier.

In addition to the aftershocks of this regulatory change, the new factor impacting upon deals is the higher valuation expectations of Chinese vendors. Encouraged by the gains in the Hong Kong and Shanghai stock markets and the huge first day gains of several prominent IPOs, domestic vendors routinely benchmark their valuations to IPO multiples, making it more difficult to reach an agreement on valuation.

Another noteworthy regulatory reform, despite not directly impacting M&A, is the new Enterprise Income Tax law, coming into effect on 1 January 2008. This law unified the two separate corporate income tax regimes that were applied to domestic and foreign enterprises, eliminating the preferences enjoyed by foreign investors, whilst at the same time lowering the maximum tax rate from 33 to 25 percent.

Outlook

China's GDP growth is forecasted to maintain rapid growth in excess of 10 percent in 2007, with an emphasis on the quality of growth (another key theme of the harmonious society campaign) rather than growth for growth's sake. This change in priorities is likely to benefit investors in sectors such as power generation, water, healthcare and education.

The fundamentals remain strong for an increase in activity, with domestic-to-domestic deal activity to the fore. Across huge swathes of once state-controlled industry, a wave of consolidation is taking place that is currently mainly a domestic activity. Once these roll-ups reach a certain size, then these companies will seek capital and larger deals may become available for foreign investors to participate in.

However, in the medium term, we expect growth in foreign M&A activity to be moderated by the impact the current bubble mentality is having on valuation expectations. A gradual correction in the domestic stock market would have a beneficial effect in restoring reality to valuation expectations.

Private equity investors have been forced to rethink the way they view China. There is a gradual realisation that China may not be a pure buyout market, and minority positions and pre-IPO investments could remain important opportunities in the medium term.

In summary, in the medium term we expect the rapid growth of domestic M&A activity to continue as long as it is supported by the equity markets, and foreign activity to remain stable. The consensus view amongst analysts is that there will be no major correction in the equity markets until after the Beijing Olympics in 2008, hence expect this divergence to remain until the end of 2008 at the earliest.

