

M&A in China

Update December 2008



Macro economic trends
Trends in M&A and domestic stock markets
Regulatory environment
Main issues and challenges for foreign investors in 2008
Outlook 2009



Macro economic trends

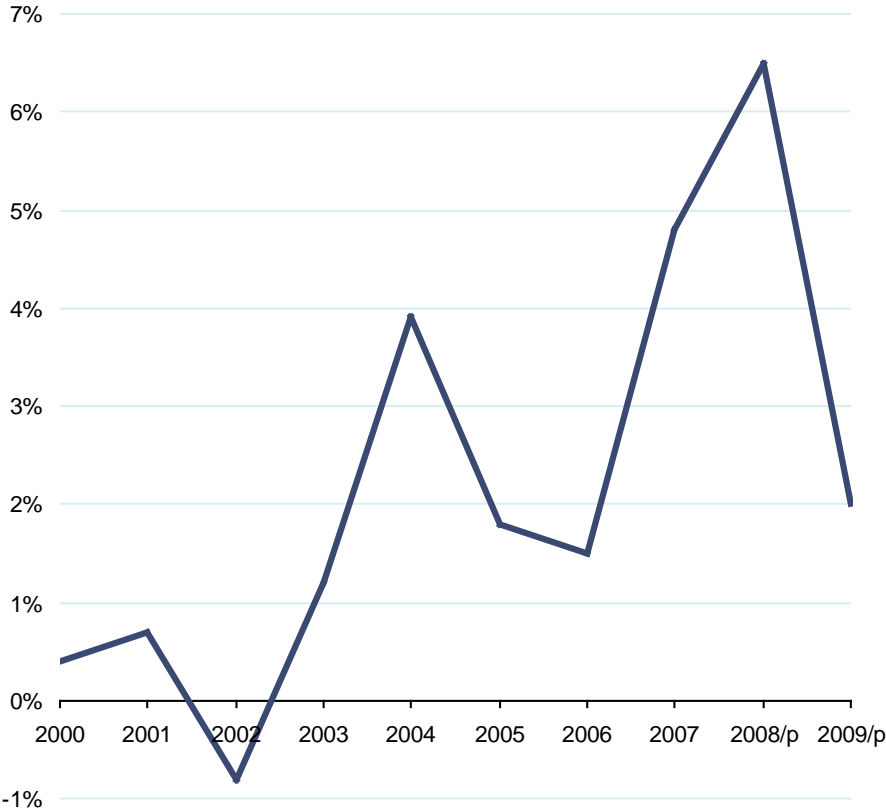


Soft landing or hard landing?

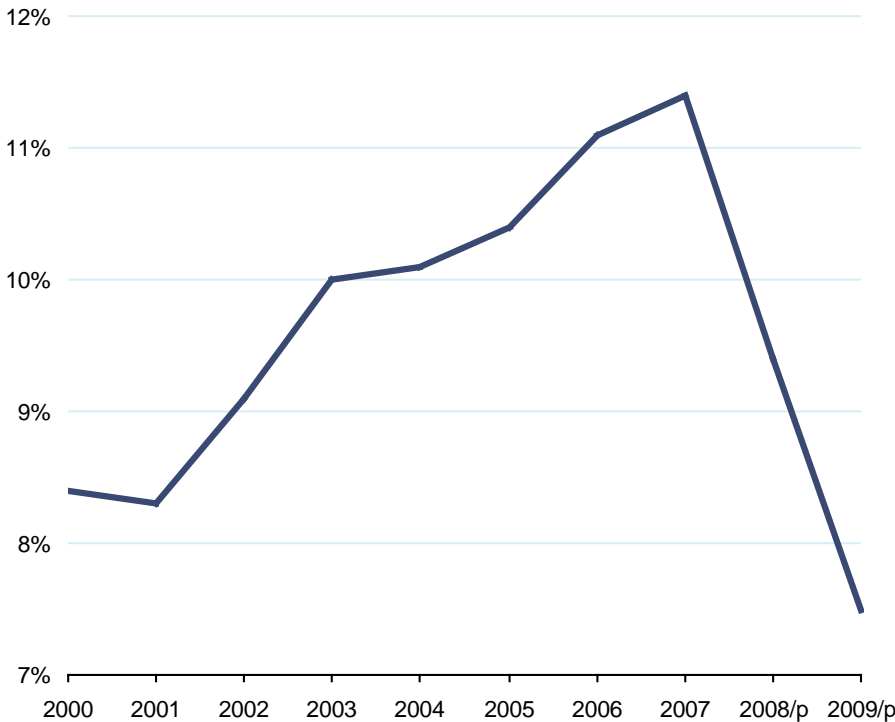
- **2007 GDP growth 11.4%, 2008 down to 9.4% according to the World Bank**
- **For 2009, GDP growth 8.5% according to IMF – World Bank's latest forecast is 7.5%, lowest since 2000**
- **Inflation (CPI) down to 2.4% in November (4% in October) from 8.7% peak in February**
- **Three drivers of economy: export, consumption and investment**
- **Export, consumption and investments down, unemployment may increase, the government is very concerned**

Forecast down for both GDP and CPI

CPI
2000 – 2009 (forecast)



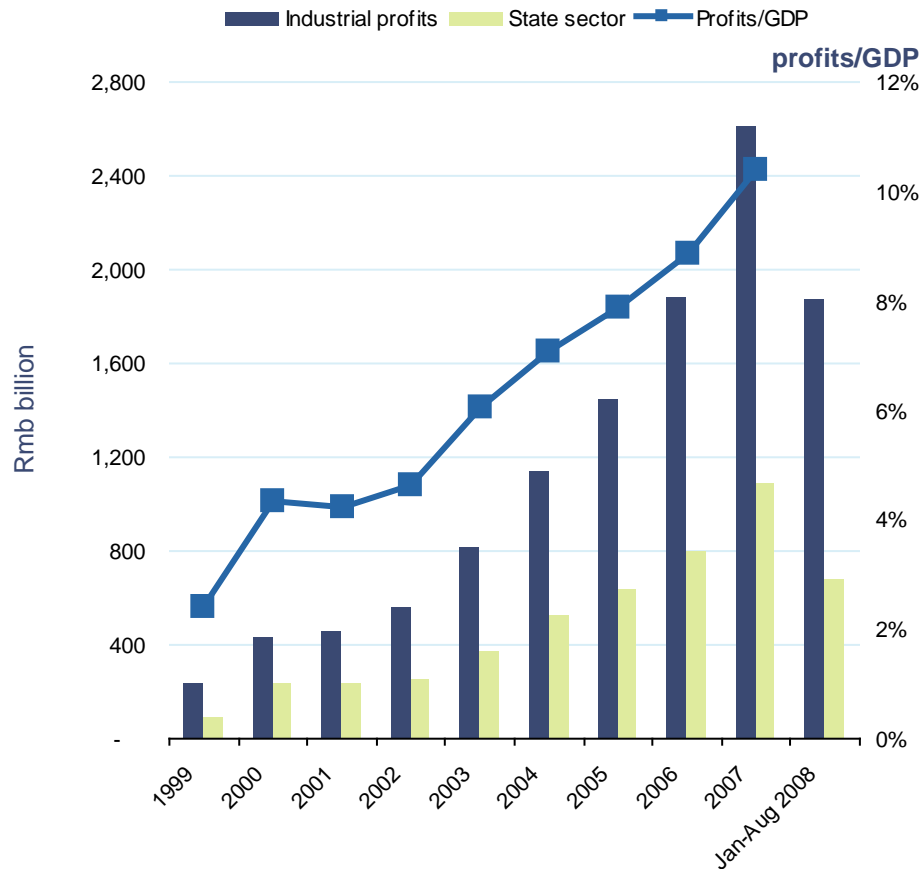
GDP
2000 – 2009 (forecast)



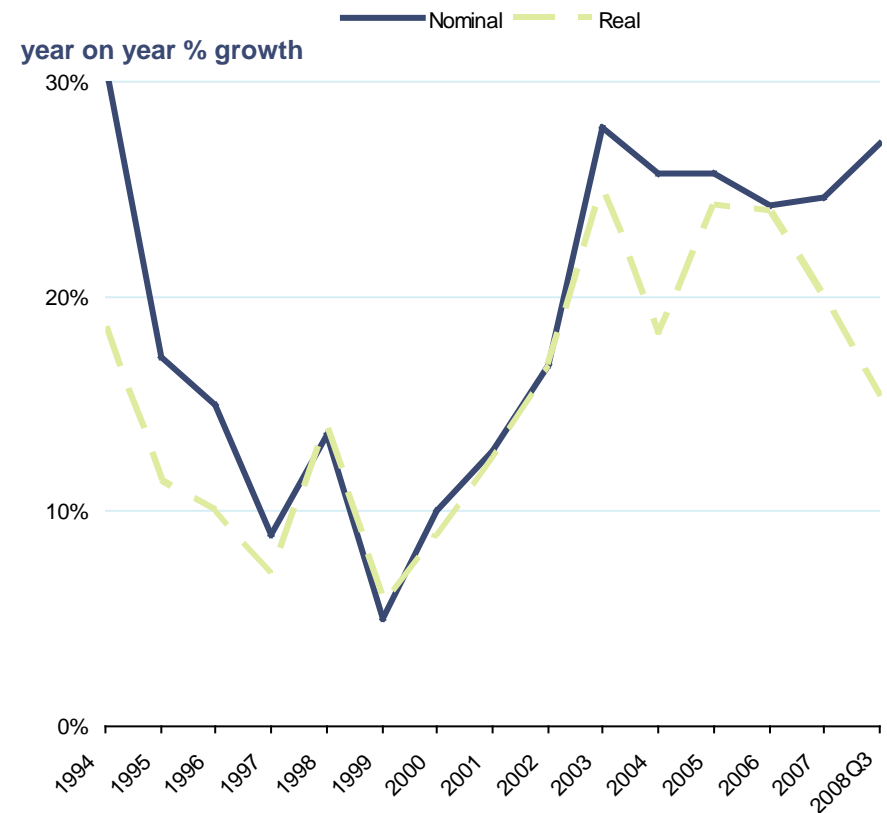
Source: The World Bank

Fixed asset investment weakening and industrial profit declining

Industrial profit 1999- August 2008



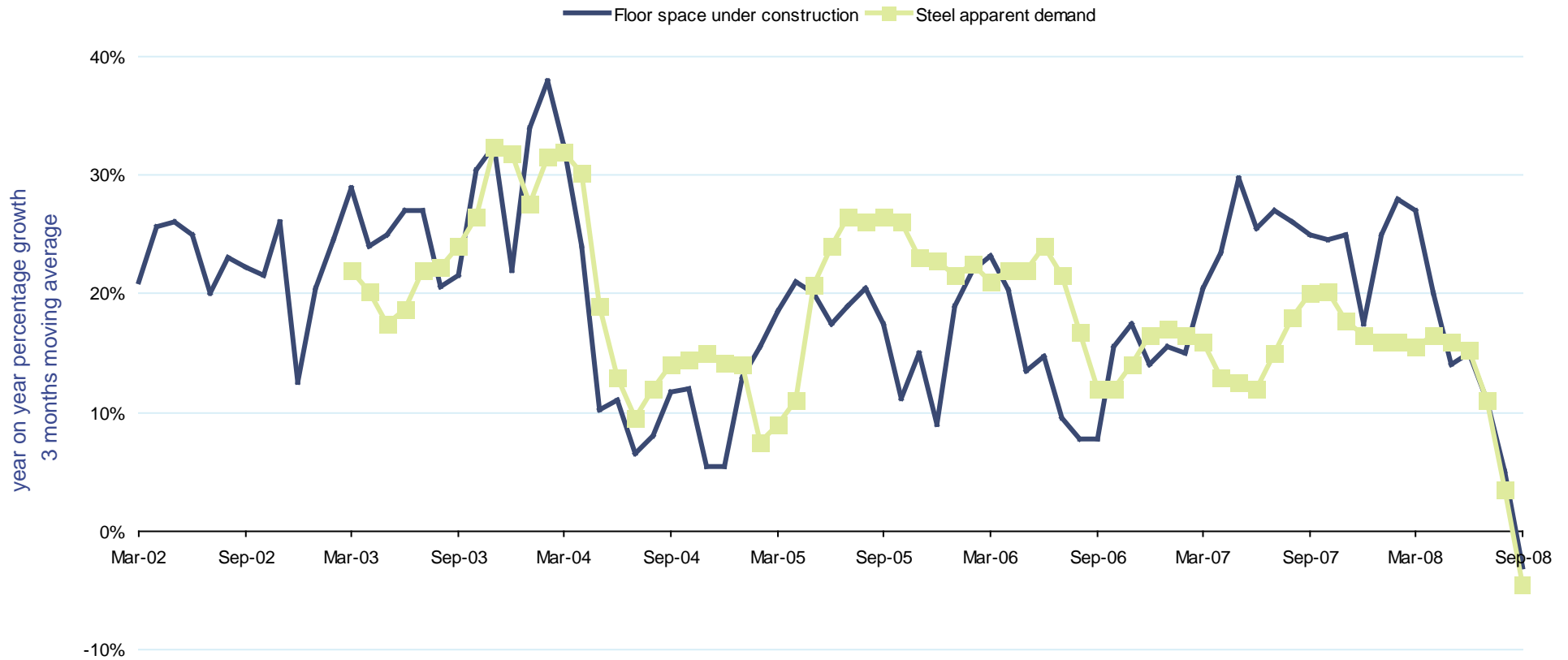
Fixed Asset Investment 1994- 2008Q3



Source: Dragonomics

Steel demand falling along with construction

Construction growth vs. steel demand
March 2002 – September 2008



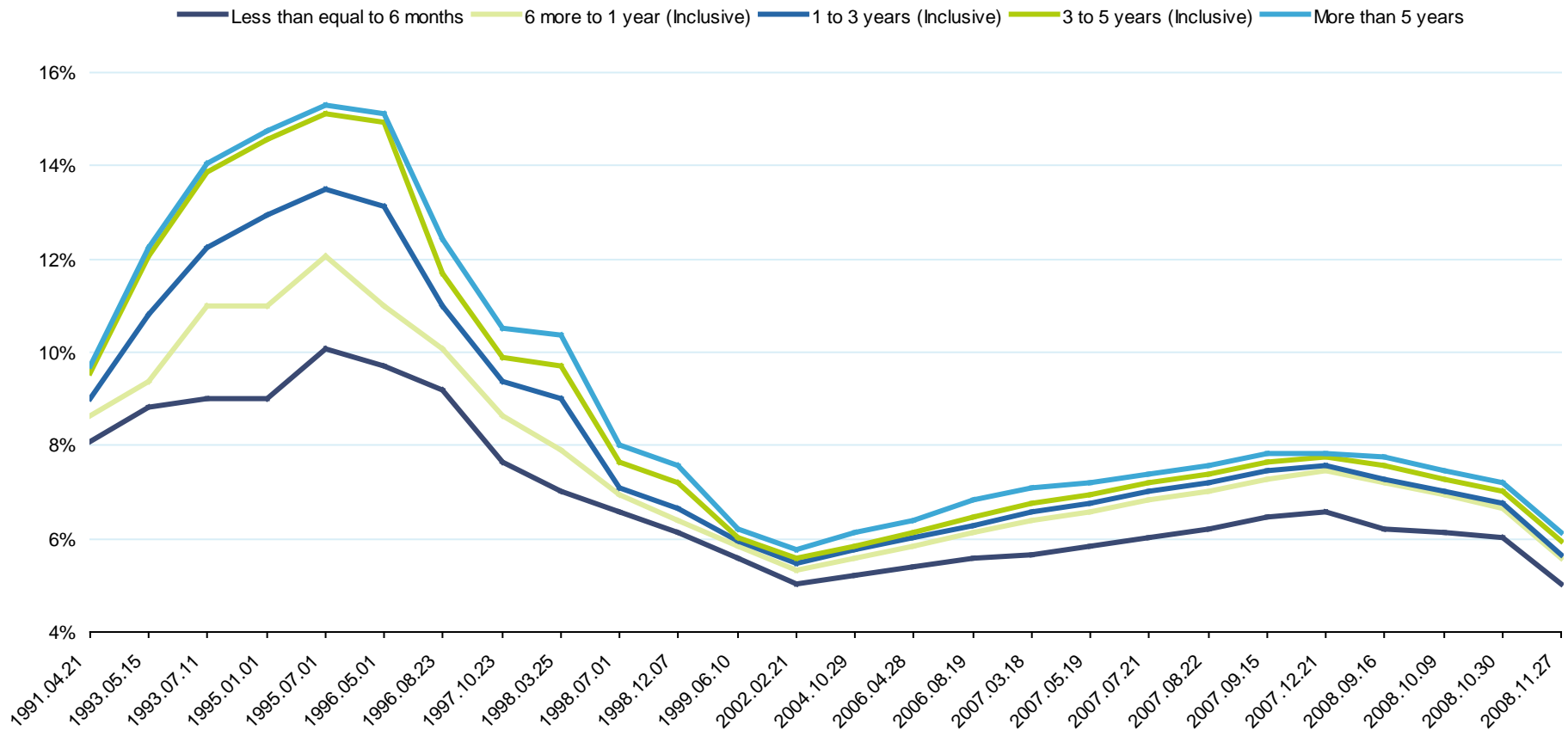
Source: *Dragonomics*

Note:

1. Apparent demand is domestic demand plus net import
2. Apparent steel demand not adjusted for inventories

Rmb benchmark loan rates are going down

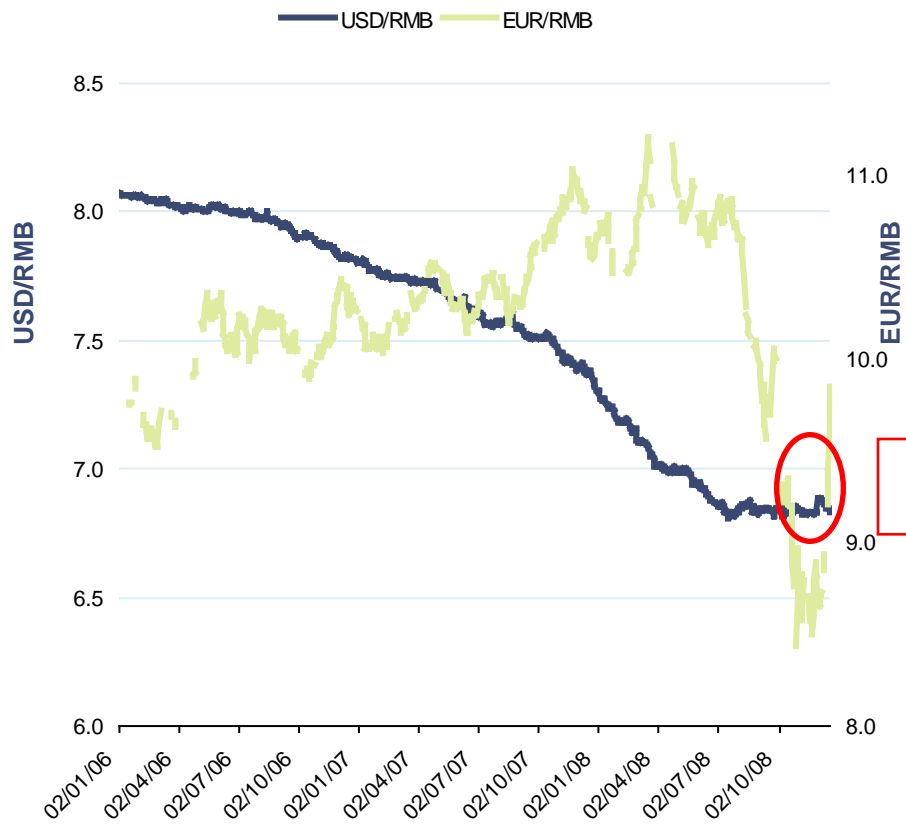
Historical Interest Rate April 1991 - November 2008



Source: the People's Bank of China

December 1, 2008 Rmb depreciation – Government stance: Rmb exchange policy no change

Exchange rate
January 2006 – December 18, 2008



USD/Rmb
November 11 – December 18, 2008



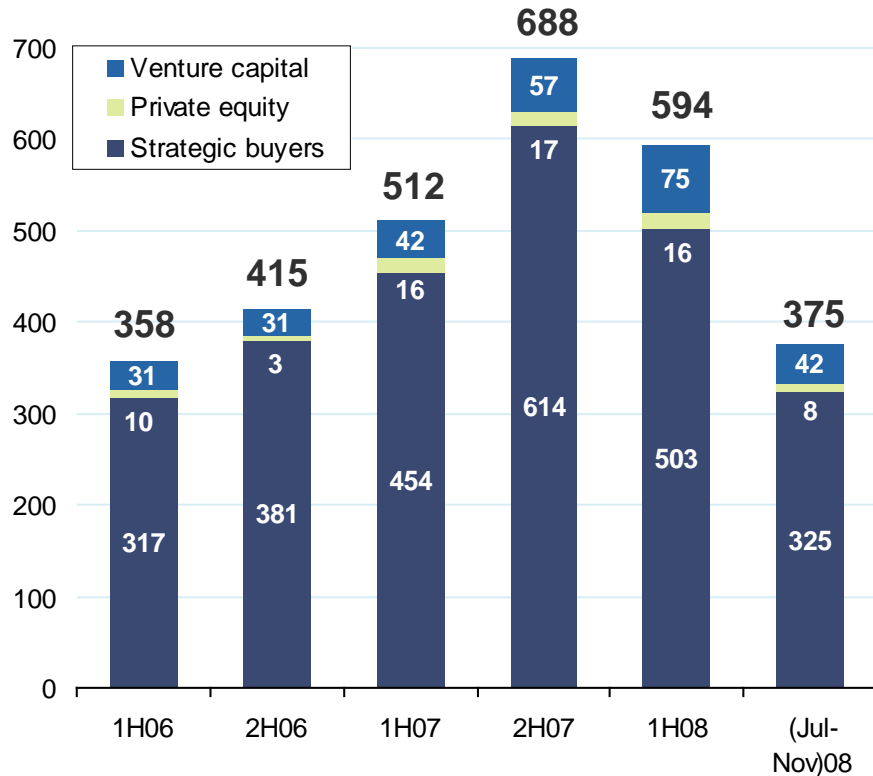
Source: Bloomberg

Trends in M&A and domestic stock markets

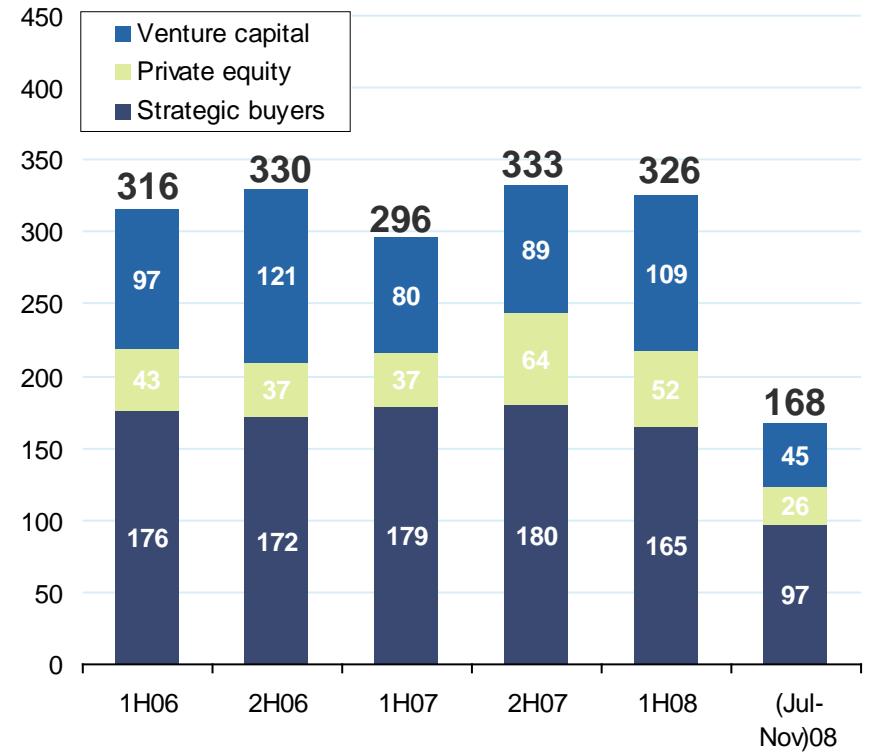


The domestic market is experiencing rapid decline and returned to 2006 levels

Deal Volumes – Domestic Buyer – 1H06 – November 2008



Deal Volumes – Foreign Buyer – 1H06 – November 2008



Period	1H06	2H06	1H07	2H07	1H08	(Jul-Nov)08
Total Deal Value, US\$bn	12.1	20.5	16.3	38.2	31.2	16.1

Period	1H06	2H06	1H07	2H07	1H08	(Jul-Nov)08
Total Deal Value, US\$bn	17.3	13.0	11.3	14.9	14.8	10.6

Source: M&A Asia

Note: We have excluded: outbound deals, property/real estate for individual properties, rumoured transactions, any purchase of brand rights, land acquisitions, equity placements in funds, stake purchases by mutual funds, open market share buyback/retirement of stock unless part of a privatisation, balance sheet restructuring or internal restructuring, investments in greenfield operations, going private transactions, and National Social Security Fund acquisitions. In 1H08, two deals (US\$72.3 billion) related to restructuring of the Chinese Telecom Industry have been excluded.

“Domestic” means China including Hong Kong and Macau

Deal volume at the end of FY08 is almost half of that at the beginning of the year

Total monthly deal volume January – November 2008



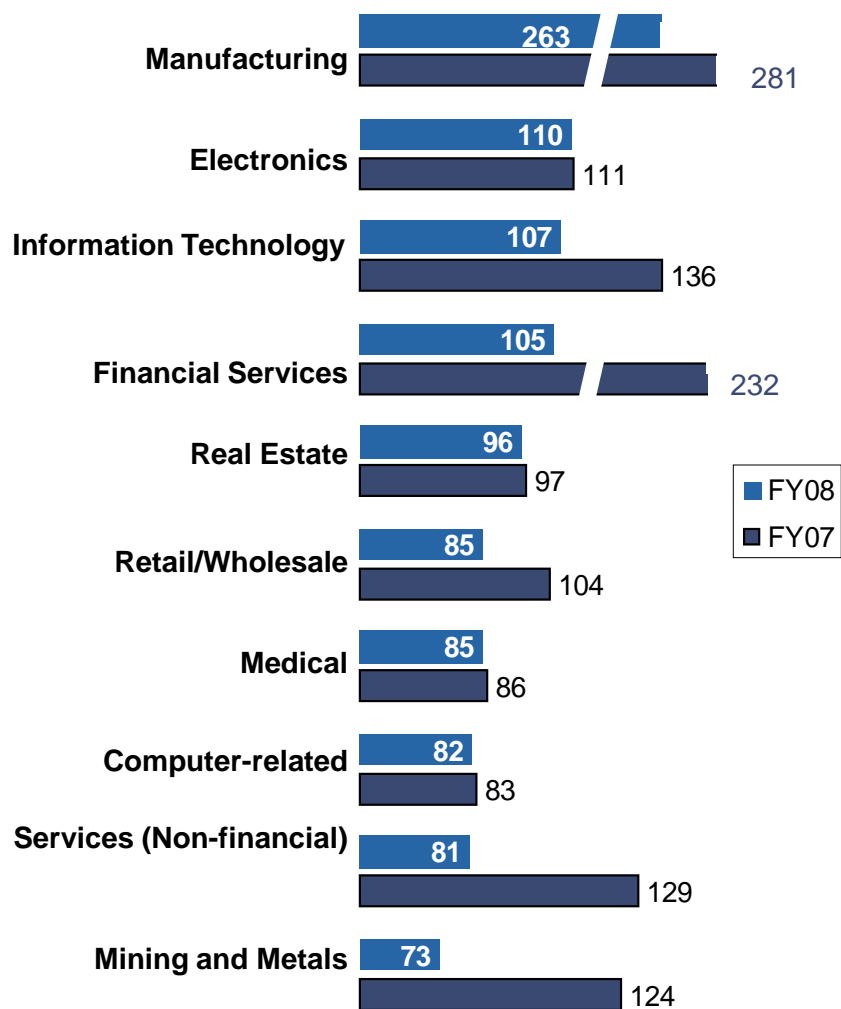
Source: M&A Asia

(1) Excluding 2 telecom deals

- 173 deals were announced in January 2008
- During FY08 the number of announced deals decreased gradually to 90 deals in November
- In the current market and at current valuation multiples, the demand for deals still exists, mainly from PE buyers that have raised the funds to invest, but the sellers are not yet willing to accept the lower prices ('valuation gap')
- Since strategic buyers are preserving cash to manage their companies through the downturn, many currently are waiting for better conditions for M&A transactions

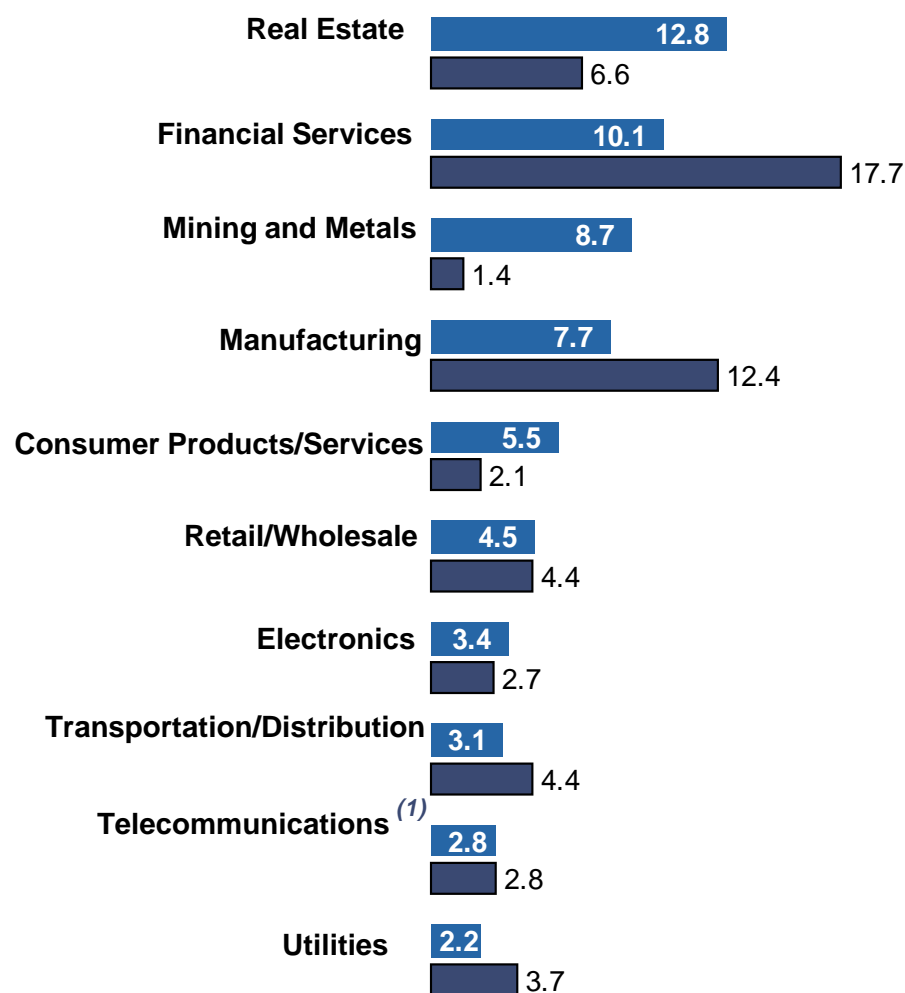
Manufacturing is the most active sector by number of deals, and Real Estate is the biggest sector by deal value

China/HK/Macau Deals – Top 10 sectors by number of deals, Jan-Nov, 2008



Source: M&A Asia

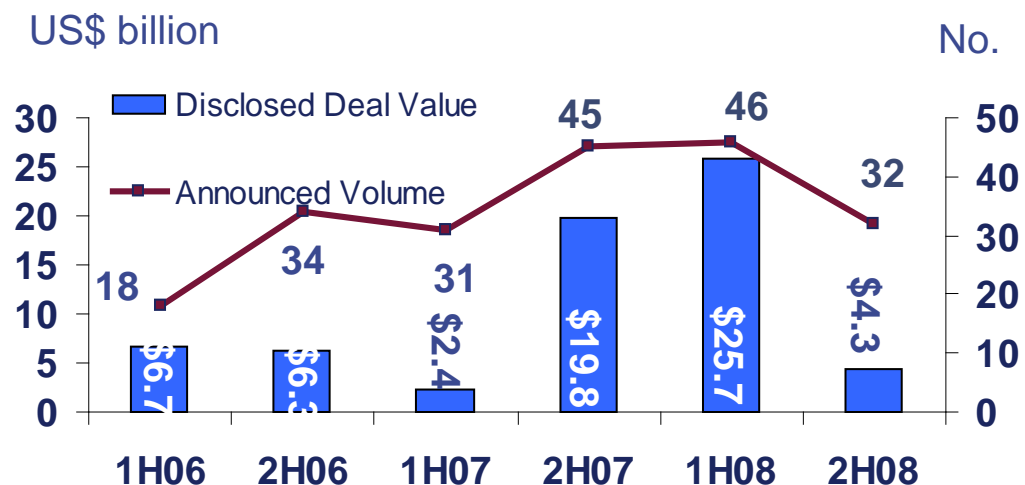
China/HK/Macau Deals – Top 10 Sectors by Deal Value (US\$ billion), Jan-Nov, 2008



(1) Excluding 2 telecom deals for US\$72.3bn

Outbound investment deal activity growth on-hold

**Outbound investment from China,
1H06 to 2H08***



Note: "Outbound" relates to mainland China company acquisitions abroad

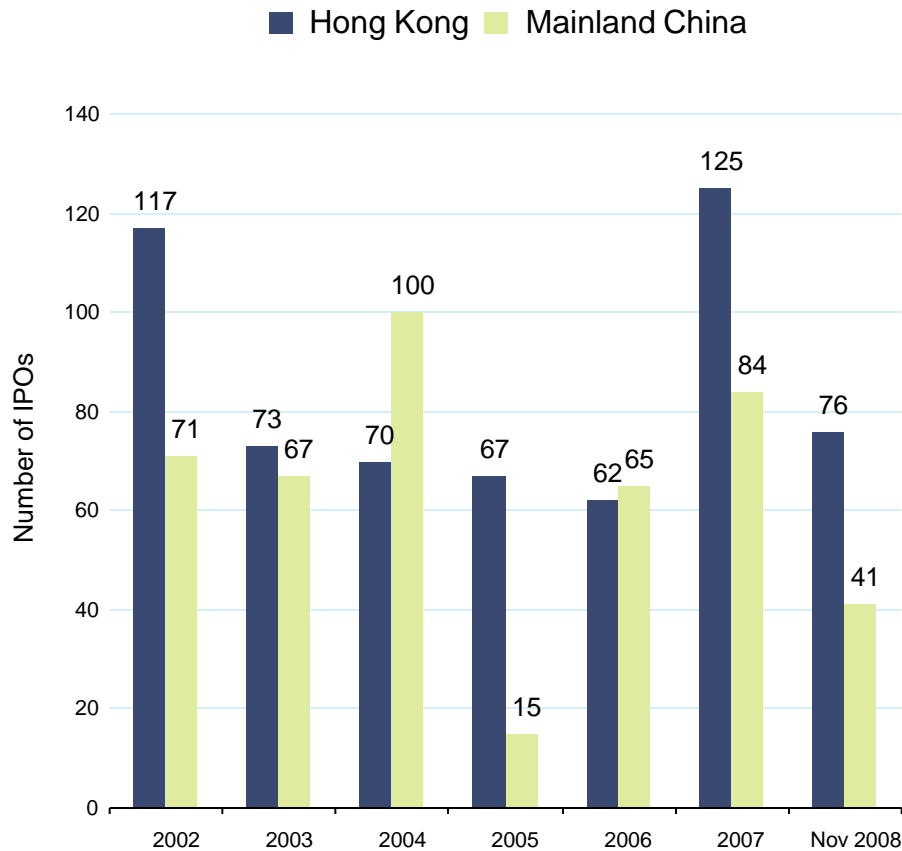
Source: M&A Asia

* Note: July - Nov 2008

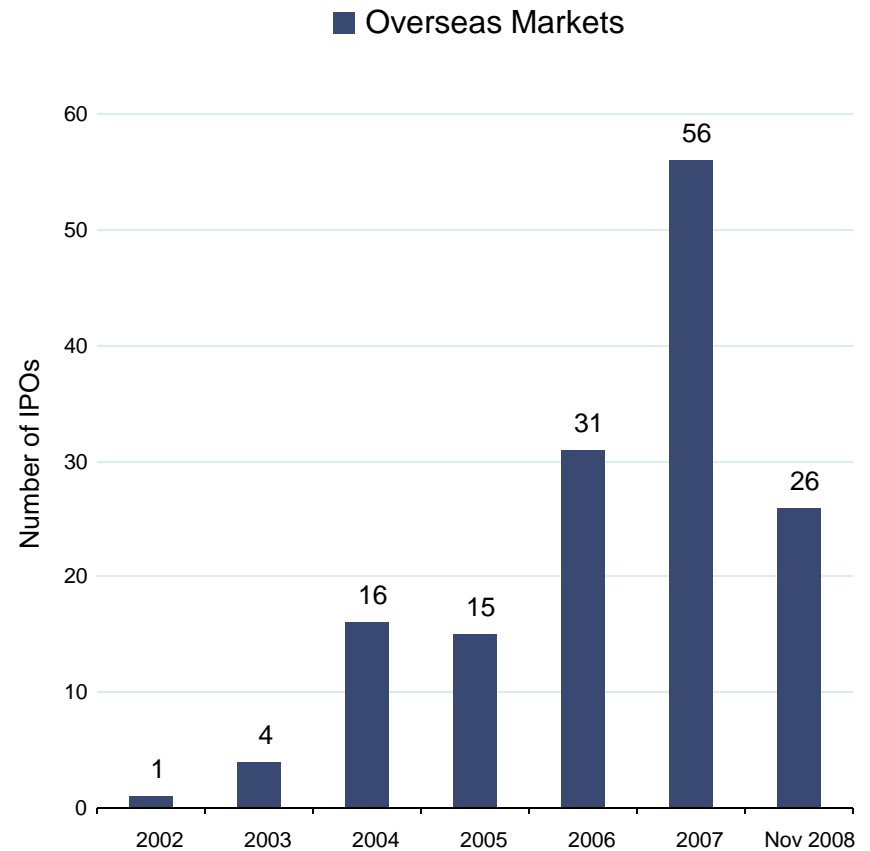
- Outbound volumes in 1H08 increased by 33% compared to 1H07 continuing the trend that commenced in 2006 but slowed in 2H08
- The most popular industries for Chinese companies to invest in overseas remained mining and financial services, but there was some diversification into various high tech industries
- The largest announced outbound investment was the US\$14bn purchase of a 12% stake in Rio Tinto by Chinalco and Alcoa
- Chinese investors have accrued large unrealised losses of more than Rmb200 billion on many of their past investments and so are exercising some caution in the current environment (CIC's investment in Blackstone and Morgan Stanley, Ping An's investment in Fortis, Chalco's investment in Rio Tinto, QDIIs etc)

IPO activities experiencing significant decline since its peak in 2007

IPOs on Hong Kong and mainland China markets, 2002- November 2008



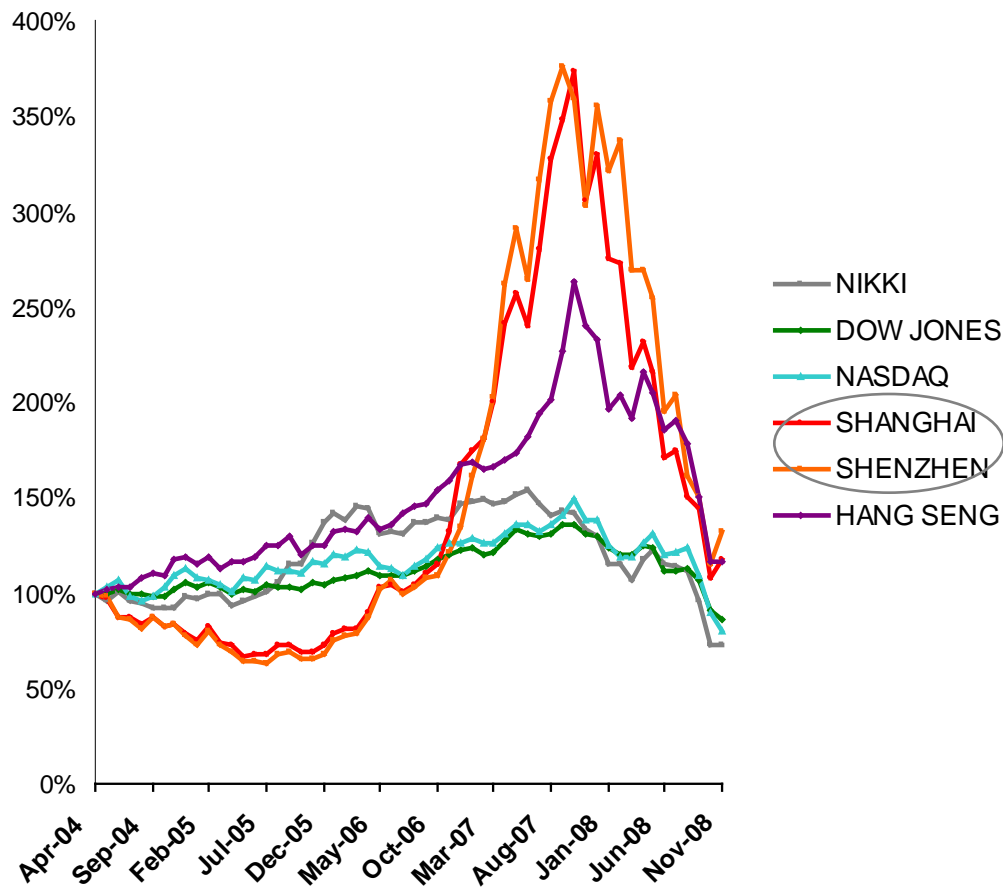
PE Venture backed IPO of Hong Kong / China companies, on overseas markets, 2002- November 2008



Source: M&A Asia, HKEx, ChinaVenture

Domestic stock markets crashed since January 2008 – bringing down vendor valuation expectations

Performance of
Chinese stock market indexes versus
other markets,
April 2004 - November 2008



- Private vendors in China are benchmarking their valuation expectations to equity market multiples, large first-day gains and general rising stock markets
- Domestic market peaked in October 2007 – vendor expectation sky rocketed
- The indices dropped back to September 2006 level – brought down vendor expectation significantly to a more realistic level

Source: Bloomberg

Regulatory environment



Expansionary economic policies announced recently

- **Rmb4 trillion (USD586 billion) stimulus package**
 - National infrastructure and social welfare projects, including constructing new railways, subways, airports and to rebuild communities devastated by an earthquake in the southwest in May
 - Including additional Rmb100 billion to be spent by the end of 2008
- **Property Restrictions Eased**
 - Lower down payments for first home buyers of small apartments; lower transaction taxes; relaxing mortgage interest to second home buyers;
- **Stamp tax on stock purchases scrapped**
- **Bank lending quotas abolished**
- **Bank lending for M&A allowed**
- **Interest rate cut and bank reserve ratios will fall**
 - Interest rate cuts: 0.27% on September 16, 0.27% on October 9, 0.27% on October 30, a biggest further cut of 1.08% on November 26; one-year loan rate at 5.58% and the deposit rate at 2.52%
- **Raising tax rebate on 3,770 export goods - 27.9% of the total**

Regulation remains an obstacle to M&A decision makers

- The stock market crash in January 2008, reduced vendors' high valuation expectations which was a main reason for M&A transaction failures in 2007
- Regulation concerns, the other main reason for M&A transaction failures in 2007 remains. A survey by PricewaterhouseCoopers over financial services firms shows that regulation is being viewed as the biggest obstacle to the firms' M&A ambitions
- Against this backdrop China appears to be pressing ahead with selected reforms with Shang Fulin, Chairman of the China Securities Regulatory Commission announcing it is preparing to launch a number of new financial tools including index futures, margin trading and securities lending which could act as a spur for the markets
- Followings are some of the regulations released recently that may have impact on foreign investors.

Revised encouragement for foreign investment

- **MOFCOM and NDRC revised their Catalogue Guiding Foreign Investment in Industry 2004:**
 - Encourages investment in high technology and innovation, high-end services, and environmental and energy-saving technologies
 - Restricts investment in high pollution or resource-intensive industries
 - Removal of some of the encouragement for mining activities (mining of tungsten, tin, antimony, molybdenum and fluorite prohibited)
 - Took effect from December 1, 2007

Anti-monopoly law – the new regulation

- **Effective from August 1, 2008, the law prohibits three types of monopolistic acts:**
 - Reaching monopolizing agreements
 - Abusing dominant market position
 - Concentration of business operators which may exclude or restrict competition

All companies seeking mergers or acquisitions would have to notify the anti-monopoly law enforcement departments if the actions meet the standard set by the State Council. The law does not declare the standards but authorizes the State Council to make detailed provisions in this regard.

Labor law and income tax law reform

- **Labor Contract Law passed in June 2007**
 - Formalized protection of employee rights
 - Employers are concerned about impact of labor costs and contracts / relationship with employees
- **Enterprise Income Tax Law took effect January 1, 2008**
 - Unifies the corporate income tax rate for FIEs and domestic companies at 25%
 - Higher income tax rate for FIEs (prior to the new law, the effective income tax rate for FIEs was 11%)

Main issues and challenges for foreign investors in 2008



Top Issues

Macroeconomic

China growth

Growth of China economy is uncertain. Companies facing squeezing margins and unable to fully pass on to customers.

Direction of Rmb

On December 1, 2008, Rmb central parity rate against USD was 6.8505, a slump of 56 bps over the previous trading day. The government indicates that there has been no change in its foreign exchange policy set in 2005. Market is divided on the direction of Rmb.

China tax reforms

Reduced types of available tax incentives like in the past. Only encouraged industries will continue to benefit. This impact the profitability of many Chinese companies.

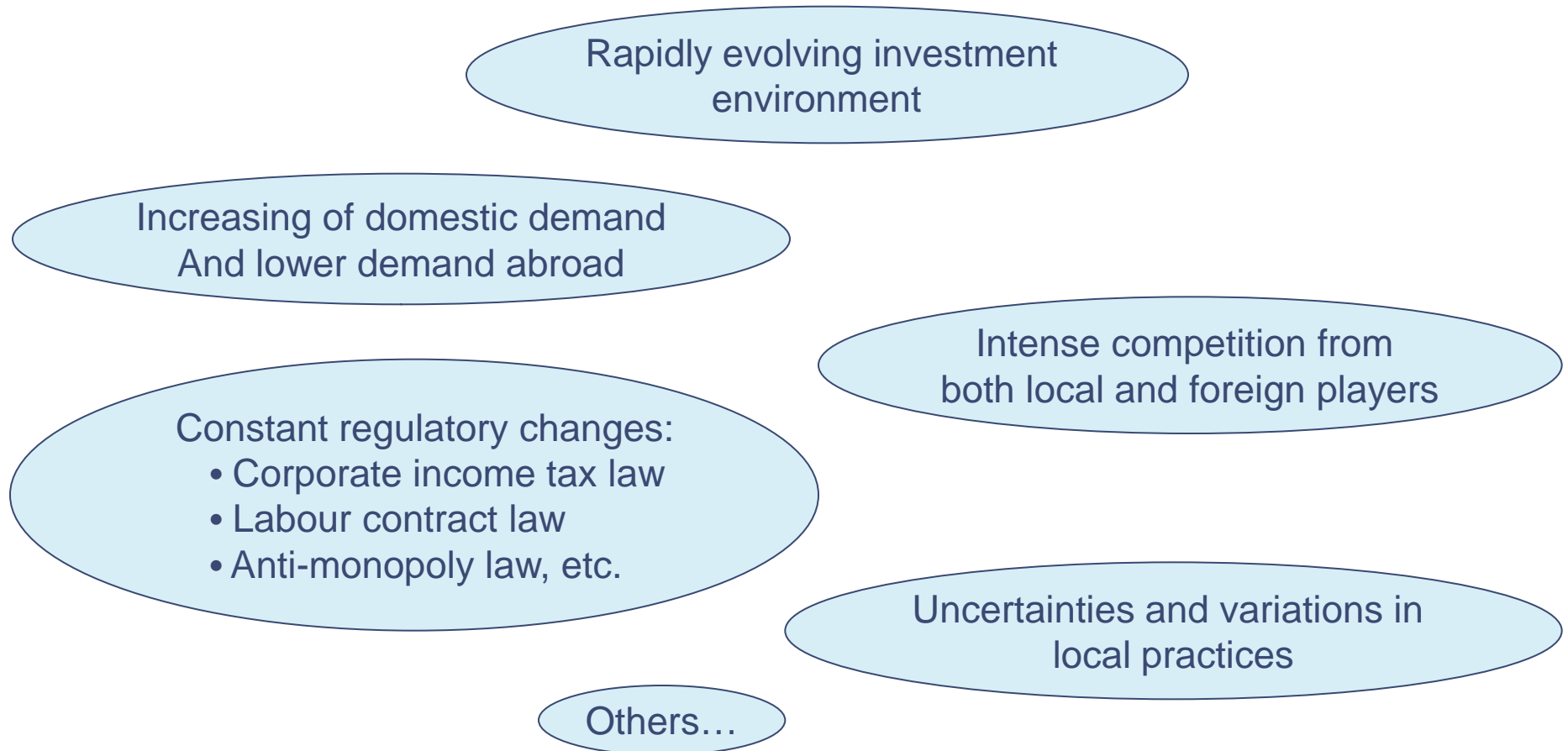
Western slow down

Some industries facing the “heat” and sharp decline in factory orders, e.g. textile and toys industry, resulting in factory closures in the last months.

Credit tightening

China’s relative high lending rates and tighten credit to curb inflation. Companies lack funding for capex and working capital. Resort to “creative” measures.

Challenges to Foreign Investors



Outlook 2009



Outlook 2009: the trends expected in 2009

Strategic

- Domestic and inbound deal activity expected to remain slow in the first half of 2009
- Expect to see some restructuring and quasi-distressed deals:
 - Domestic: Accelerated consolidation in industries with overcapacity
 - MNC: Sale of divisions / business segments including Chinese operations
- Hope to see a pick up in the second half of 2009 as valuation gaps close and buyers look to pick up assets at attractive prices. However, it is unlikely we will see growth for the year as a whole

Private Equity

- PE players see real opportunities to invest in these market conditions, and have the funds and capabilities to do so
- The valuation gap is their biggest challenge currently, and this may narrow in the second or third quarters of 2009
- May be some focus on PIPE (private investment in public equity) transactions because of relatively low stock market multiples
- Increasing activity of local Chinese PE funds is expected as part of a longer term trend

Outbound

- Growth in Chinese outbound deals expected to increase, with China likely to recover faster than other regions
- Strategic investment in natural resources, tender offers for listed companies will increase as average trading prices decline

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