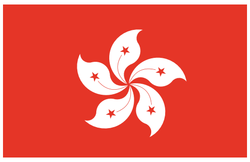

# Hong Kong

*Weakening exports are likely to lead to negative growth. Conditions in 2009 will depend on the resumption of growth in key export markets including the US and China*

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## Current Environment

Hong Kong's economy slowed notably in the third quarter of 2008 with GDP growth of 1.7% in real terms compared to the 4.2% growth seen in the second quarter of 2008. This was the slowest pace since 2003 when Hong Kong was hit by the SARS crisis. In November 2008, the HKSAR government lowered the GDP growth forecast from 4.0% – 5.0% to 3.0% – 3.5% in real terms for the full year 2008, implying negative growth in the fourth quarter of 2008 for the first time since mid 2003.

Total export of goods grew by 1.4% in real terms in the third quarter of 2008 compared to 4.4% growth in the second quarter of 2008, representing a deceleration from the first two quarters of 2008 and also the worst performance since the first quarter of 2002. Exports to the advanced economies, notably the US, were directly affected by the rapidly slowing demand in these economies as a result of the global downturn.

Growth in the export of services in the third quarter of 2008 softened to 5.3% compared with 8.1% in the second quarter of 2008 caused by the deceleration in exports of financial services amid the financial market distress and the notably slower pace of expansion in inbound tourism.

Overall consumer prices rose by 3.1% in November 2008 compared to the equivalent period in 2007. Netting out the effects of the Hong Kong SAR Government's one-off relief measures, including the Government's payment of three month's public housing rentals, the implementation of an electricity charge subsidy, and a government rates concession, the increase in the composite Consumer Price Index in November 2008 was 5.6%, compared to 3.4% in 2007. The increase was due mainly to a surge in food and energy prices, as well as hikes in housing rent.

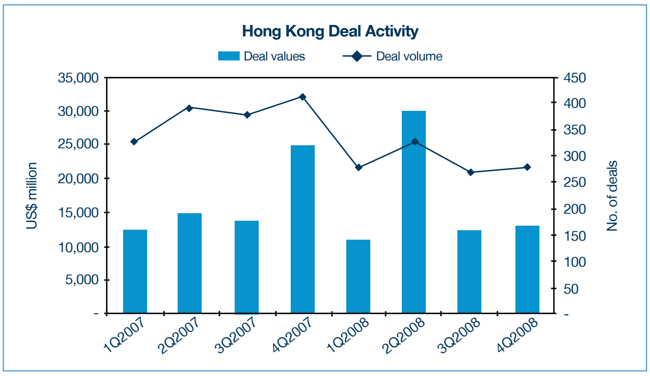
The seasonally adjusted unemployment rate in September to November 2008 was 3.8%, a slight increase from 3.6% in the same period in 2007, reflecting the slowdown in business activities in both the domestic and overseas trade sectors.

As a result of poor economic fundamentals, the Hong Kong stock market fell substantially in 2008, as the Hang Seng Index dropped by over 65% from the record highs of 31,000 in October 2007 to 10,680 in October 2008. Market capitalisation also dropped by over 39% from US$2,633 billion in the fourth quarter of 2007 to US$1,600 billion in the third quarter of 2008. In line with other exchanges, the market staged a modest rally towards the end of 2008.

The number of IPOs dropped significantly from 82 in 2007 to only 28 in the first three quarters of 2008. The funds raised through IPOs also fell significantly from US$37.2 billion to US$8.0 billion in the respective periods.

The Hong Kong property market has retreated in 2008 after a surge in 2007. Buying sentiment, particularly for residential properties, was dampened by the discouraging performance of the financial markets and the continued news of recession around the globe. The overall number of sales transactions on residential properties declined by nearly 40% during third quarter of 2008 compared to the same period in the prior year.

## Deal Activity




Source: *Thomson Reuters, based on total domestic, inbound and outbound deals announced as of 31 December 2008*

The value of deal activity in the second half of 2008 decreased to US$25.3 billion from US$41.1 billion in the first half of 2008. For the full year 2008, deal values increased by 0.2%, or US$123 million, compared to 2007. However the number of announced deals decreased from 1,508 to 1,148. Some of the major deals in each industry sector included:

## Telecommunications

China Unicom Ltd, the Hong Kong listed arm of Unicom Group, agreed to merge with China Netcom Group Corporation (HK) Ltd, a Hong Kong listed domestic counterpart in June 2008 for US$29.6 billion. The offer price represented a premium of 3.0% over China Netcom share's closing price on 30 May 2008. After the merger, China Netcom became a wholly-owned subsidiary of China Unicom. The deal was completed in October 2008.

PCCW Limited announced in November 2008 a proposal to take the company private. This followed the unsuccessful sale of 45% of HKT Group Holdings Ltd, a subsidiary of PCCW Limited providing telecommunications services, media and information technology businesses, in October 2008 due to lower than expected offers from bidders as a result of the deterioration in market conditions. The proposed privatisation has been granted consent by the Office of the Telecommunications Authority, but is still subject to shareholder approval at the time of writing. If the privatisation proceeds, it is expected that companies connected with Richard Li would hold 66.7% while China Netcom would hold the remaining 33.3%.

## Real Estate

Hong Kong listed real estate developer Franshion Properties (China) Limited agreed to acquire Wise Pine Limited, a Hong Kong real estate and hotel investment company, from Sinochem Hong Kong Group Company Limited and seven other shareholders for US$2.2 billion in June 2008. The acquisition will help Franshion Properties tap into the luxury hotel sector and strengthen its position in property and hotel operations. As at January 2009 the deal has not been completed and is still subject to regulatory approval.

## Energy and Mining

Black Sand Enterprises Limited, a subsidiary of the Hong Kong listed investment holding company Intelli-Media Group (Holdings) Ltd. engaged in the distribution of video products, has agreed to acquire First Pine Enterprises Limited, a Filipino company engaged in mining activities, from Kesterion Investments Limited, a BVI based investment holding company, for US$730.7 million in May 2008. The acquisition is in line with Black Sand Enterprises Limited's strategy to diversify into the business of exploration, drilling, mining, and trading of natural resources, particularly the mineral magnetite in sand form.

Jade Green Investments Ltd., a subsidiary of Hong Kong listed company Fushan International Energy Group Ltd., agreed to acquire three coking coal mines located in Shanxi from Fortune Dragon Group Ltd. for US$1.35 billion in May 2008. The acquisition will help Jade Green Investment Ltd. expand its business and strengthen its competitiveness in through economies of scale. The deal was completed in July 2008.

## Financial Services

China Merchants Bank Co Ltd ("CMB"), a Shanghai and Hong Kong dual listed commercial bank, announced the acquisition of Wing Lung Bank Ltd, a Hong Kong listed bank for US$4.7 billion in June 2008, and the transaction was completed in October 2008. This acquisition offers CMB an opportunity to establish a sizeable customer base and distribution network in Hong Kong.

CITIC Group Holding, a China based investment holdings group, together with a listed Spanish bank, Banco Bilbao Vizcaya Argentaria SA ("BBVA"), proposed to take private CITIC International Financial Holdings ("CIFH"), a financial services subsidiary of CITIC Group Holding listed in Hong Kong, through a scheme of arrangement in June 2008 for US$1.5 billion. The transaction was completed in November 2008.

## Retail

The Coca-Cola Company announced an offer in September to acquire the entire outstanding share capital of a Hong Kong listed company, China Huiyuan Juice Group Ltd. for US$2.5 billion. The Coca-Cola Company plans to leverage the position of Huiyan as a leading domestic juice maker in China, allowing it to be more competitive in terms of branding and sales effectiveness. The deal is currently under regulatory scrutiny, as it would be the largest foreign takeover of a local firm, and faces strong opposition from other domestic juice producers as it may threaten their market share in China.

## Transportation and Logistics

Enric Energy Equipment Holdings Ltd, a Hong Kong listed company, agreed to acquire Sound Winner Holdings Limited, a Chinese transportation services provider owned by China International Marine Containers (Hong Kong) Company Ltd. and CIMC Vehicle Investment Holdings Company Ltd. for US$805 million in September 2008. The acquisition will enable Enric Energy Equipment Holding Ltd. to expand its business segments as well as strengthen its financial performance.

### Private Equity

Morgan Stanley Private Equity Asia, a Hong Kong based private equity unit of Morgan Stanley and Shinhan Financial Group Co Ltd, agreed to acquire Norske Skog Korea Co. Ltd. from Norske Skogindustrier ASA, a listed Norway based producer of printed paper, for US$833.1 million in August 2008. The transaction is in line with Norske Skogindustrier ASA's strategy to reduce its debt levels by approximately 25%.

Asia Packing Group Holdings Limited, a Hong Kong based investment holding company formed by CVC Capital Partners Limited, acquired a 53.9% stake in Hung Hing Printing Group Ltd, a listed Hong Kong based company engaged in the printing and manufacturing of paper and carton boxes, for US$112.2 million in April 2008. The transaction was completed in July 2008.

## Outlook

Hong Kong's economy is still closely tied to the major economies around the world and the current global economic crisis is expected to have a significant impact on Hong Kong's economy in 2009. Hong Kong's export orders will likely decline, reflecting weak retail markets in the US and Europe. Companies with close ties to the Chinese economy are also likely to face challenges, particularly in the first half of 2009.

The Hong Kong government and Hong Kong Monetary Authority have recently taken measures, such as the HK$100 billion loan guarantee to non-listed companies, to unfreeze the credit shortage and inject liquidity back into the banking sector, and aid small and medium enterprises ("SMEs"). It remains to be seen whether these government measures will alleviate the financial crisis but it should at least provide relief to SMEs in the short term. However, all companies will need to manage their cash flow and working capital needs effectively, in particular assessing counterparty and supply chain risks. Steps to manage cost levels will also be imperative in managing the current downturn.

IPOs in Hong Kong are expected to rebound slightly in 2009, on the assumption that the economies of Hong Kong and China will stabilise in the second half of 2009.

In respect of M&A, both corporate and financial buyers continue to look for attractive deals despite the current environment. However, most transactions have been put on hold as buyers lower their prices but sellers are unwilling to lower their valuations significantly, creating a valuation gap. Most M&A deals are expected to be delayed in the first half of 2009, but there will be a quick recovery when the valuation gap starts to narrow sometime in the second half of 2009. Obtaining financing may continue to prove more challenging and costly. M&A activity in 2009 could see more of a shift to strategic investors with strong balance sheets looking for undervalued companies or distressed businesses. ■