



# CHINA MANUFACTURING

THE WALL STREET JOURNAL BRIEFING

www.briefing.wsj.com

Vol. 1 No. 19 OCTOBER 6, 2005

## Inside

**General Electric** plans to buy a 7% stake in Shenzhen Development Bank. **PAGE 2**

**China Construction Bank** is seeking \$7.7 billion as it kicks off its IPO roadshow. **PAGE 2**

A new fund will step in to protect investors when brokerage houses fail. **PAGE 3**

**UBS** confirms plans to buy a brokerage-firm stake. **PAGE 3**

Lasco discovers the road to making machinery in China can be a bumpy one. **PAGE 4**

**Omron** shows its interest in China by holding its first board meeting outside Japan. **PAGE 4**

Foreign auto makers are stepping up their investments in trucks and buses. **PAGE 5**

Chinese companies are tapping a new source of funding: commercial paper. **PAGE 5**

Buying interest in **Shenhua Energy** is rekindling despite high coal prices. **PAGE 6**

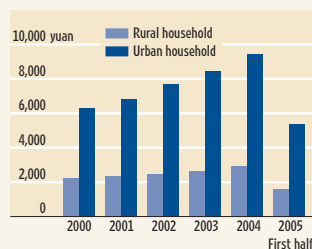
More fashion houses are dropping 'Made in Italy' for 'Made Elsewhere' labels. **PAGE 7**

Beijing's pursuit of trade deals underscores its desire to become a great power. **PAGE 8**

Textile talks with the U.S. make progress, but end without an agreement. **PAGE 8**

## KEY INDICATOR

**Annual net income**  
Per capita, in yuan



Source: National Statistics Bureau

©2005 DOW JONES & COMPANY. ALL RIGHTS RESERVED.  
ISSN 1815-8463



## Steelmaking Capacity Could Hurt Prices

World steel industry leaders are worried that mounting overcapacity in China could push down steel prices at some point, despite continued steady demand growth for their products world-wide.

"In coming years, there will be massive, massive excess capacity" in China, said Nicholas Lardy, an expert on China and a senior fellow at the Institute for International Economics in Washington, in a speech to a group of steel industry executives at the International Iron and Steel Institute annual meeting in Seoul.

China added about 50 million metric tons of steelmaking capacity in 2004 and will add more than that in 2005, taking that country's annual steelmaking capacity to roughly 400 million tons, according to Mr. Lardy. That is enough to meet the country's annual demand until 2015, he said.

Mr. Lardy said government efforts in China to consolidate steel capacity and limit expansion could take longer than expected, largely because of resistance from Chinese provincial govern-

### Too Much?

Global crude steelmaking capacity

COUNTRY	2005 WORLD SHARE*	CAPACITY* in millions of metric tons
China	26%	2003: 230 2005: 330
EU	15	199 191
Japan	9	121 117
U.S.	8	103 100
Russia	6	74 78
S. Korea	4	49 49
India	4	39 45

\*2005 figures are estimates Source: OECD

ments that seek to foster local steelmakers.

The Chinese buildup comes at a time when producers have stumbled in efforts to curb capacity growth elsewhere in the world by cutting back on subsidies paid by governments. Talks at the Organization for Economic Cooperation and Development in Paris aimed at ending state sub-

sidies have fallen apart as trade representatives couldn't agree upon how to implement changes. "These [talks] are not likely to restart in the near future," said Ian Christmas, secretary general of the IISI. "We believe it is still a real issue that, at some stage, if we want a competitive dynamic and open business, we have to address."

In addition to China, steel companies also are grappling with lofty prices for raw materials and energy and face growing competition from rival materials such as plastics, aluminum and cement in key markets such as automotive and containers. And yet, the industry is also enjoying one of its strongest periods of prices and profits as the result of a global commodity boom.

"We are in a very prosperous industry and we believe the outlook for next year is very positive," said Mr. Christmas. "We are not saying it is all gloom and doom. We are saying there are risks and dangers going forward."

## Leaders Get Set to Tackle Rich, Poor Gap

China's Communist Party leaders are set to meet soon to approve a national economic-policy blueprint for the next five years aimed at smoothing uneven development that has fueled unrest around the country.

Members of the party's powerful Central Committee will convene in Beijing from Oct. 8 to Oct. 11. Besides giving the green light to China's next five-year plan covering 2006 to 2010, the meeting may result in some personnel changes that reflect President and party chief Hu Jintao's continued push to consolidate power, according to people familiar with the situation.

Traditionally, China's five-year plans, modeled after the former Soviet Union's, have set specific goals for everything from economic growth to steel production to livestock numbers.

Details of the coming plan haven't been publicly announced.

But for the first time, it is being dubbed a "five-year blueprint" instead of a "five-year plan" to reflect the government's step-back approach to managing the economy under a market system. Economists say a main focus of the plan will be to address the growing inequities between China's prosperous coastal regions and its poorer inland and rural regions, where the majority of China's 1.3 billion people live.

The plan is expected to shift the emphasis from strong economic-growth rates to the strengthening of social services, like education and health care.

Whether Mr. Hu's government can meet these goals in coming years could be critical for the country to maintain the

overall stability that has for the past decade helped it attract record levels of foreign investment, exceeding an estimated \$66 billion this year. China's growth rate is expected to surpass 9% this year.

For years, many economists and Chinese officials saw the key to stability simply as maintaining a high-enough growth rate to generate jobs and opportunities; some Chinese could get rich first and others could catch up later.

But the increasing numbers of large-scale, violent protests around the country over the past year or two have sparked concern at the top levels of government that more must be done to address the growing wealth gap and surging discontent over such issues as corruption, environmental degradation and soaring educational and health-care costs.

## LEADING THE NEWS

# GE to Buy a 7% Stake in Shenzhen Bank

U.S. financial-services and industrial giant General Electric Co. is set to buy a minority stake in Shenzhen Development Bank Co., as GE looks to enter China's developing consumer-finance market, people familiar with the situation say.

The purchase of about 7% in the southern China-based Shenzhen Development Bank, the rare Chinese bank already effectively controlled by foreign investors, would boost its level of foreign ownership to nearly 25%, the maximum permitted under Chinese regulations.

A 7% stake is valued around \$100 million, or about 785 million yuan, based on Shenzhen Development Bank's total 1.95 billion shares outstanding and the most recent market close of 5.76 yuan per share.

The investment by GE's consumer-finance group, a major provider of personal and corporate financial services such as credit cards, would fit a pattern by foreign companies aiming for a foothold in China. The investment would provide Shenzhen Development

## Yet Another Suitor

General Electric Co. has set its sights on Shenzhen Development Bank with a stake purchase that could help it expand in the consumer finance business; below, a look at the bank's performance

### Daily closing share price\*

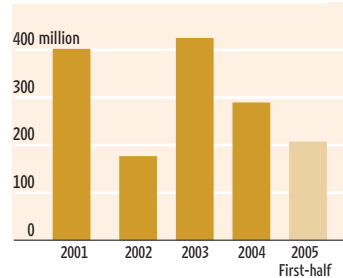
From last October, when Newbridge Capital bought a major stake, in yuan



\*Shares were suspended on Sept. 28; markets have been closed this week for Golden Week holiday  
Sources: Thomson Datastream; the company

### Net profit

In millions of yuan



Bank with much-needed capital and pave the way for GE to enter China's slowly evolving consumer-finance market, and eventually its commercial-lending and banking market.

GE has been investigating the Chinese market for about four years. GE has said it sees Asia as key to the growth of its consumer-

finance business. Overall, GE expects to get as much as 60% of its growth from developing markets over the next decade, specifically China and India.

Newbridge Capital, a U.S. private-equity company, has owned nearly 18% of Shenzhen Development Bank for about a year and is the single biggest shareholder.

## American Convicted of Dealing In Fake DVD Movies Expelled

China said it deported an American convicted earlier this year for dealing in fake DVD movies over the Internet, in a case that marked a new level of cooperation with U.S. law-enforcement authorities.

A lawyer for Randolph Hobson Guthrie III confirmed the 38-year-old was flown to Los Angeles, five months after a Shanghai court handed down a 2 1/2-year sentence and a \$60,000 fine. He and accomplices had been in custody in Shanghai since mid-2004.



Randolph Hobson Guthrie III

The scion of a banking family that traces its lineage to steel magnate Andrew Carnegie, Mr. Guthrie was raised in New York City, attended prestigious U.S. schools and had lived in Shanghai for a decade.

What appeared to make Mr. Guthrie stand out among distributors of pirated DVDs in China was that he moved his merchandise to the U.S. and elsewhere overseas. China rarely announces arrests of pirates who sell copied movies domestically, even though cheap copies of Hollywood hits are readily available in urban areas throughout the country.

China's official Xinhua news agency said Mr. Guthrie was expelled and "handed over to the U.S. police" but provided no more details.

Zhai Jian, Mr. Guthrie's lawyer in Shanghai, said his client was accompanied by two Chinese agents on the flight, but he declined to say whether Mr. Guthrie faces more jail time in the U.S.

In April, the Shanghai No. 2 District Court ruled that Mr. Guthrie sold illegal copies of Hollywood movies over the Internet, using eBay and other sites to find customers in the U.S. and Europe.

## Beijing Media Shares Fall 19% After Arrests

The share price of China's first state-owned media company to list outside mainland China fell 19% following an announcement that police had detained six of the company's employees.

The detentions of executives from Beijing Media Corp. highlight the continuing difficulties of commercializing China's opaque state-owned media sector and the potential corporate-governance risks that overseas investors face as more Chinese companies seek to raise capital abroad.

After the Hong Kong stock exchange temporarily suspended trading of Beijing Media's shares, the company issued a statement saying three employees from the advertising department were being held on allegations of bribery. It was uncertain whether the allegations were related to work conducted for Beijing Media. Three other advertising-department employees, including a vice president, had also been detained, but police hadn't yet explained why.

## SHARE OFFERING

### China Construction Bank Prices IPO, Seeks \$7.7 Billion

China Construction Bank, the country's third-largest bank by assets, kicked off what could be China's biggest initial public offering of stock to date, as the lender seeks to raise as much as US\$7.7 billion, according to people familiar with the deal.

The sale represents the first of shares in the country's so-called Big Four banks, which collectively control about 60% of China's banking assets.

China Construction is selling 26.49 billion shares for HK\$1.80 to HK\$2.25 (23 U.S. cents to 29 U.S. cents) each, raising between US\$6.1 billion and US\$7.7 billion, according to people familiar with the deal. At those prices, it would overtake **China Unicom's** 2000 US\$5.65 billion IPO as China's biggest and could be the biggest IPO globally for the year, according to market-data tracker Dealogic. At the top of the range, it would rank as the world's eighth-biggest to date.

Led by Chairman Guo Shuqing, the bank's management on Oct. 5 began a two-week period of investor meetings around the globe from Hong Kong and Singapore to London and Denver to peddle the shares slated for listing on Hong Kong's stock market at the end of the month.

In recent years, Beijing has tried hard to revamp China's banking sector. Since 2003, the government has injected US\$60 billion into three of the Big Four banks, including US\$22.5 billion for China Construction, in an effort to clean up their balance sheets.

China Construction and its team of underwriters—**China International Capital Corp.**, **Credit Suisse First Boston** and **Morgan Stanley**—are hoping that a combination of state-led changes, foreign strategic investment and the strength of the country's economy will overshadow concerns about corruption, bad lending and the absence of risk controls.



## DEALS &amp; INVESTING

## New Fund Aimed at Protecting Investors

China launched a multibillion-dollar fund that will step in to protect investors when brokerage houses fail and will act as a guardian of good practice for the nation's struggling stock market.

The much-anticipated emergency fund—which analysts and investors hope could amass as much as 50 billion yuan, or about \$6 billion—will be managed jointly by three government economic agencies and is part of a long-running project to reform China's unprofitable brokerage sector.

China's securities companies have faced the challenges of a long slump and poor liquidity in the country's stock markets in recent years, with many of them struggling to survive. Brokerage house failures have affected a string of well-known companies including **China Life Insurance Co.**, **China Southern Airlines** and **Shanghai Automotive Co.** All lost money or were forced to make heavy provisions when their brokers failed.

Since 2004, regulators have shut or ordered the takeover of a number of brokerage houses,

including the fifth-largest, **China Southern Securities Co.** The regulators are in the process of bailing out better-performing ones, such as **Guotai Junan Securities Co.** and **Shenyin & Wanguo Securities Co.**

China is enlisting foreign expertise and cash for the effort: **UBS AG** of Switzerland said it is in talks to buy control of **Beijing Securities Co.** for \$210 million.

The new fund, called the Fund to Protect Securities Investors, will be used to compensate creditors of bankrupt brokerage houses or firms that are taken over by the securities regulator, according to a joint notice in major securities newspapers issued by the China Securities Regulatory Commission, the People's Bank of China and the Ministry of Finance.

A company to manage the fund was to begin operations in early October.

"The launch of the fund will allow us to quickly compensate investors, in particular small investors, when brokerages face closure or bankruptcy," said a statement from the company set

up to run the fund. "It's also part of China's efforts to create mechanisms to protect the interests of investors, which have already existed in many mature markets."

The fund won't be used to compensate investors for losses caused by stock-market fluctuations, according to the rules.

Funding will come partly from the trading fees of the Shanghai and Shenzhen stock exchanges, interest received on subscription funds during offerings of stocks and convertible bonds and a levy on securities companies' revenue, according to the rules.

The fund also will monitor brokerage houses, alert regulators to potential risks, and recommend actions, according to a statement from the three agencies managing it.

China-registered securities companies will be required to pay 0.5% to 5% of their operating revenue to the company that manages the fund. The company overseeing the fund also can apply to the State Council, China's cabinet, to raise money by issuing bonds, according to the rules.

## UBS Confirms Proposal to Buy A Stake in Beijing Securities

UBS AG confirmed it is in talks to restructure the operations of **Beijing Securities Co.** and plans to pay as much as \$210 million for a 20% equity stake in the restructured Chinese brokerage firm.

The confirmation comes after UBS had announced it is investing 645 million Swiss francs, or about \$500 million, in state-owned **Bank of China**, the nation's second-largest bank, to create a partnership in investment banking and securities services for Chinese clients.

The deals are the latest in a series of strategic investments by foreign banks seeking footholds in the fast-growing and increasingly competitive Chinese banking market.

UBS said it is in talks with Beijing's Assets Supervision and Administration Commission and the International Finance Corp. to restructure the operations of **Beijing Securities** into an entity to be managed by UBS.

The proposal "is a key element of UBS's strategy for the

Chinese domestic securities market," said UBS Chief Executive Peter Wuffli.

UBS said it was negotiating with IFC, the investment-banking arm of the World Bank, and other authorities over an initial structure controlled by Beijing with a 33% equity stake. UBS, which would manage the restructured operation, would hold a 20% stake. IFC would hold a stake of less than 5%.

A consortium of Chinese domestic strategic investors would hold the remaining 42%. The new securities company formed by the restructuring would provide domestic debt and equity underwriting in China, as well as other services, UBS said.

China is due to fully open its banking industry to foreign competition by late 2006.

With a stake in **Beijing Securities**, UBS would bring its expertise to a brokerage firm that booked a loss of 160 million yuan, or nearly \$20 million, last year.

## Lender Issues \$1b in Bonds

**China Development Bank**, the largest of China's three policy banks, raised \$1 billion in 10-year bonds, topping off a week that saw a hefty \$2.35 billion in fresh bond issuance from Asian countries, excluding Japan.

The offering pulled in around \$6.25 billion in orders, allowing the bank to price the bond at 0.86 percentage point over corresponding Treasuries, at the tight end of revised guidance of 0.86 to 0.89 percentage point over Treasuries.

"There is significant onshore support for these sort of issues," John Teng, head of Asia credit research at **Nomura International**, said in explaining the hefty demand for the latest offering. "Second of all, investors are looking for a pickup over Chinese sovereign bonds. Sovereign bonds have been expensive and these have been a proxy for sovereign risk."

Sold at 98.86 cents on the dollar, the new **China Development Bank** paper was yielding 5.147% on a 5% coupon.

## FINANCE

## Fosun Plans to Tap Asia Bond Market

With only one bond on the road this week—a high-yield deal from China-based **Fosun International Ltd.**—the new issues market for Asia is taking a breather after sales of a hefty \$2.35 billion in new paper.

Still, bankers say it is premature to forecast a quiet final few months of the year.

There are some \$9 billion to \$12 billion in potential deals for the rest of the year, although **Lehman Brothers** in its latest credit call forecast "actual issuance is likely to be lower as some of the deals talked about in the market are unlikely to come anytime soon."

Among those expected to tap the market before year end are several sovereign borrowers including China, South Korea and Indonesia, numerous South Korea-based corporate issues and a handful of sub-investment-grade companies.

Last year saw \$41.4 billion in new issuance denominated in U.S. dollars, euros or yen from Asia, excluding Japan and Australasia. At the start of this year, many predicted rising U.S. rates and the fading Asian bid would mean few fund raisings this year. But appetite for Asian paper has continued strong, complemented by demand from outside the region, where issuance has been slower. Since the start of the year, U.S. rates have risen by 1.5 percentage points to 3.75% and are expected to increase to 4.25% by the year end.

Reaching out to investors this week is **Fosun International**. The first-time borrower is looking to raise \$500 million in seven-year bonds with the help of **Citigroup Inc.** and **Morgan Stanley**. As befits a high-yield issuer making a market debut, Fosun is conducting an extensive weeklong roadshow, taking in Asia, Europe and the U.S.

Fosun, a leading Chinese steel manufacturer with interests in property and pharmaceuticals, last week received bond ratings of double-B-minus with a stable outlook from **Standard & Poor's Ratings Services**.

## COMPANY INSIDER

## Road Proves Bumpy for Machinery Maker

Lasco Umformtechnik GmbH, a closely held German manufacturer of machinery for metal forming and building materials, saw an opportunity for producing recycled building materials, such as fly-ash blocks, in China several years ago and decided to try selling its production lines in the country. But the road has proven to be a bumpy one.

A manufacturer of machine tools, production lines and automation technology, Lasco started selling its fly-ash-block production lines in China five years ago. Fly ash is a byproduct of coal-fired power plants and is usually, if not recycled, disposed of in landfills, causing environmental devastation. Fly-ash blocks are increasingly used in construction as a substitute for clay bricks.

In the five years since, Lasco has sold only five of the production lines to its Chinese customers, most of whom are power plants that want to recycle their waste. In contrast, it has sold nine metal-forming production lines—used to make machine tools and to form solid and sheet

metal—which make up one-quarter of the company's global sales. Annual revenue from the sales of brick-making production lines in China amount to 1 million euros (\$1.2 million), versus 5 million euros globally. Overall revenue figures were not available.

**Shandong Electric Power Corp.**, which produces an annual output of 118 million megawatts of power, is Lasco's biggest customer in China of fly-ash-block production lines and has been producing its own fly-ash blocks since mid-2003.

But Lasco is running into home-grown competition.

"Local manufacturers are copying our technology," said Herbert Rueger, director of sales for Lasco.

Against a backdrop of state initiatives promoting the recycling of residue created by combustion in power generation, permission to build additional power plants or increase capacity can be obtained only if a considerable part of the residue created in the combustion process is recycled.

Under that scenario, China

appeared to be a promising market with high growth potential for companies such as Lasco. Mounting power scarcity in the country called for more power plants to be built, and in turn churn out more fly ash, a major component in manufacturing recycled building materials.

According to Han Jianfeng, an engineer with the Confederation of Chinese Metalforming Industry, the cost of a standard brick-production line made by local manufacturers is only half that of Lasco's.

Adding to the problem, said Cai Yong, an industry expert with CCMI, "There are many domestic manufacturers of machinery for [producing] fly-ash bricks, as the production of such building materials is encouraged by the government because it's more environmentally friendly."

As a result, "we will have to withdraw part of our business from the China market if market prospects dim," Lasco's Mr. Rueger said. "For now, we will focus on our metal-forming business, which is our bread and butter."

## Omron Expresses Commitment With Shanghai Board Meeting

Omron Corp., a Kyoto-based manufacturer of technological equipment, held its first board meeting outside Japan in Shanghai last month.

"This is to send a message inside and outside the company that we are looking at China as a very important place," said Omron spokesman Yasushi Kawamoto. He noted that Omron remains confident about the Chinese market despite other Japanese companies taking a more cautious approach because of strained Sino-Japan relations and possible further revaluation of the yuan.

Omron—which makes sensing and control technology used in automated traffic signals, ticket-vending machines and fully automated train-station systems—aims to boost revenue in China from the current 55 billion yen (\$481 million) to 150 billion yen for the fiscal year ending in March 2008.

It also plans to invest 30 billion yen in China over three years from 2004. The money will be used to integrate the company's three

factories in Shanghai, and to construct a new factory in Guangzhou that will manufacture car electronics parts such as power windows and keyless entry systems, Mr. Kawamoto said. The factory is scheduled to start operation in January. Some of the funds will also be used for mergers and acquisitions, but he declined to provide details.

"China is a touchstone to test our international competitiveness. For us, losing in China means losing out in the world," he said.

Total annual revenue for the company for the period ended March 2005 was 608.6 billion yen, with a net profit of 30.2 billion yen.

All seven company executives attended the daylong meeting in Shanghai to discuss business strategies and corporate social responsibility, among other issues.

The company doesn't know if it will hold such meetings in China on a regular basis since it can be difficult to coordinate a schedule with outside directors.

## Deal With RBS Includes Pledge Of a Buyback

**Bank of China** has promised to buy back **Royal Bank of Scotland Group PLC's** \$3 billion stake if the Chinese bank fails to go public within three years, a Bank of China director said.

Anthony Neoh, who became Bank of China's first independent director in August, said the promise was part of the downside protection the Scottish lender secured for its investment. The price RBS paid for its stake also could be lowered if a pre-initial-public-offering audit turns up unexpected problems, Mr. Neoh said.

An RBS spokeswoman said she couldn't comment on the specifics of the guarantees.

An RBS-led group and Singapore's state-owned investment company **Temasek Holdings Ltd.** have each invested about \$3 billion for 10% stakes in Bank of China, mainland China's second-largest lender by assets. **UBS AG** became the lender's latest strategic investor, agreeing to pay \$500 million for about 1.6% of the bank.

## STEEL

## Mittal Sets Sights On Expansion In India and China

**Mittal Steel Co.**, the world's biggest steelmaker by production, is looking to get bigger and is betting on India and China as part of its plan.

The Dutch steel company sealed a deal in China last month, making it the first foreign steelmaker to take a large stake in a major local steel producer, **Hunan Valin Steel Tube & Wire Co.** And it is pushing ahead with plans to sign a memorandum of understanding with the Jharkhand state of India to build a plant, according to Aditya Mittal, Mittal Steel's president and chief financial officer.

The signing will take place "shortly, which means within this month," said Mr. Mittal during an interview over the weekend on the sidelines of the International Iron and Steel Institute conference in Seoul. While the plant eventually will have an annual production capacity of 12 million metric tons, the capacity will come online over time, he added. "The first phase will be around six million tons. And then we will expand it to the second phase," Mr. Mittal said.

The moves come as global steel demand is forecast to rise by 4.2% to 5.2% next year, reaching 1.04 billion to 1.05 billion metric tons, compared with 998 million tons projected for this year, the IISI said. The industry group said strong growth continues to come from China, which should see a 10% rise in steel demand this year and 7%-to-10% growth next year.

Mr. Mittal also isn't concerned about China's creating a steel glut, as the government pushes forward with plans for industry consolidation and discourages steel exports through its latest steel policy. "We see the Chinese steel industry as being very reasonable and understanding what their role is vis-a-vis the global steel industry," he said. "So China will not be a destructive force in the global steel industry."



## STRATEGIES

# Experts Tout Jiangling as Ford Increases Involvement

Having made strides in the passenger car market in China, foreign auto makers are stepping up their investments in trucks and buses, and investors looking to bet on that market, should consider **Jiangling Motors Corp.**'s Class B shares, analysts said.

Buying Jiangling Motors, one of China's largest makers of light trucks and vans, could be seen as buying into **Ford Motor Co.**'s future commercial-vehicle business in China, said Simon Wang, chief strategist at Xiangcai Securities in Shanghai.

Ford owns 30% of Jiangling Motors, and says it is interested in increasing its stake. As it buys more shares in the Chinese commercial-vehicle maker, Ford also plans to inject new products and technology into the company.

"We are very focused on China and expect sales volume to grow for at least the next three years," said David Thomas, vice president of China Distribution Operations at **Ford Motor China**.

Ford's commitment should add value to Jiangling's B shares, which are attractive thanks to

## Ford Focus: China

Shares of Jiangling Motors could benefit from Ford Motor's intent to boost its 30% stake

A shares in yuan



Note: Markets have been closed this week for Golden Week holiday

B shares in Hong Kong dollars



Source: SunGard PowerData (TradeLine)

the company's continued profitability and falling production costs, analysts said. Four out of five analysts polled by Dow Jones Newswires have a "buy" recommendation on the stock.

China's automobile market, which suffered a downturn late last year and early this year, has started recovering. In August overall vehicle sales in China were up 24.2% from a year earlier to 292,400, according to the China Association of Automobile

Manufacturers Web site. Sales of light trucks rose 17% to 59,000, a spokeswoman at CAAM said.

But the recent turnaround in vehicle sales hasn't translated into profits for everyone. Billions of dollars of new investments in the auto industry by foreign and local companies have led to price wars and margin erosion. Among six major listed auto companies in mainland China, only Jiangling Motors saw profit rise in the first half. All the others—**Brilliance**

**China Automotive Holdings Ltd.**, **Chongqing Changan Automobile Co.**, **FAW Car Co.**, **Tianjin FAW Xiali Automobile Co.** and **Shanghai Automotive Co.**—were either hit by profit falls, or racked up losses.

Jiangling B shares' price/earnings ratio is around 5.6, well below an average of around 10 for most auto shares in China, according to Zhang Xin, analyst at Guotai Junan Securities in Beijing.

Jiangling's first-half net profit rose 3.4% to 256.1 million yuan (\$31.6 million) from a year earlier, thanks to strong sales. Revenue in that period rose 6.7% to 3.09 billion yuan.

Chief Financial Officer Manto Wong said revenue in the second half is expected to be 3.25 billion yuan, versus 2.88 billion yuan in the year-earlier period, but said he couldn't give profit forecasts.

B shares are denominated in Hong Kong dollars or U.S. dollars and are fully open to foreign investors, while A shares are yuan-dominated and accessible only to the Chinese and a select number of foreign institutions.

## Nascent Market Proves Popular Source of Funds

Chinese companies have been cutting borrowing costs this year by tapping a new source of funding: commercial paper.

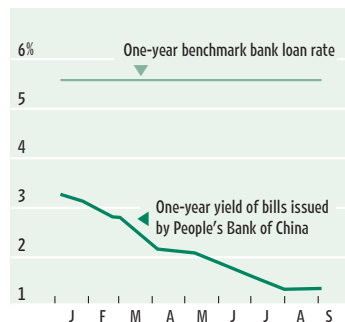
Since Beijing gave companies the green light to issue commercial paper, or financing bills—short-term obligations used to obtain cash—in the first quarter of this year, dozens have outlined fund-raising plans. The 21 companies that have sold such instruments have, on average, raised the equivalent of \$304 million each, according to data from the **China Government Securities Depository Trust & Clearing Co.**

This latest source of financing is a welcome development for cash-hungry companies such as **Air China** and **Aluminum Corp. of China** at a time when regulators aren't allowing stock-market fund raising. **Jinan Iron & Steel Group** recently launched a one billion yuan, or \$124 million, sale of 2.95% one-year bills.

Establishment of this financing channel marks a step forward in the government's effort to launch a true corporate debt

## Corporate Blessing

Bank-loan rate



Source: People's Bank of China

market and wean the economy off what many analysts view as an unhealthy reliance on banks; currently, banks claim 95% of loans and other financial assets in China.

The People's Bank of China, the country's central bank, which regulates bill issuance, said in August that the instruments are designed to make borrowing more transparent and distribute

default risks more widely than bank loans do.

Yet the enthusiastic embrace of the instruments by blue-chip companies means banks may be lending less to their best customers. For now, the totals being raised are small compared with overall bank lending of \$2 trillion last year in China, and there are indications that many companies are using funds raised from bill issues to supplement, rather than to replace, bank borrowings.

A big question mark is how productively the money is being deployed and whether cash-strapped smaller companies will be allowed to launch funding programs.

One big incentive for Chinese companies to sell commercial paper is the low interest charge. At about 2.6% for recent 365-day issues, the rate is about half that imposed by banks on regular working-capital loans. Banks currently charge about 4.7% for one-year loans, including a 10% discount to the benchmark one-year lending rate.

## Ciba Decides China Is Out, Singapore In

In an effort to spread its risk, **Ciba Specialty Chemicals Holding Inc.** will invest \$100 million in a new plant in Singapore that will make antioxidants, a component used by the plastics industry.

Ciba Specialty Chemicals, which makes products for the plastics, rubber, paints, ink and textile industries, has one other antioxidants plant in Asia, located in China. The Singapore plant will be twice the size of the one in China and will supply the plastics industry in Southeast Asia, Japan and the Middle East.

"We don't want to put all our eggs in one basket in China," said Armin Meyer, chairman and chief executive.

Ciba considered building the new plant in four other sites, including China and Malaysia, but opted for Singapore because of its stable political and economic environment, good infrastructure, and easy access to raw materials, Mr. Meyer said.

## COMMODITIES

# Shenhua Energy Stokes Fresh Interest

Investors have been jittery about the prospects for Chinese coal companies ever since coal prices showed signs of peaking in the middle of this year, giving a lukewarm reception to the country's biggest coal producer, **China Shenhua Energy Co.**, soon after its market debut in Hong Kong in June.

Buying interest is beginning to rekindle, however, as investors now see limited downside for coal prices.

Diminishing supply after Beijing ordered the closure of small unsafe coal mines, coupled with China's insatiable appetite for energy to fuel its economic boom, are likely to support prices.

Shenhua Energy, in particular, will benefit from sustainable high coal prices and robust production-volume growth.

The company, which derives a large chunk of its sales from coal, owns the world's No. 2 coal reserves and has exposures to power, rail and port assets. Many investors favor Shenhua Energy over its Hong Kong-listed rival **Yanzhou Coal Mining Co.** for the former's growth potential and favorable revenue mix.

## Heating Up

China Shenhua Energy's daily closing share price since its IPO in June, in Hong Kong dollars



Source: Thomson Datastream

Shenhua Energy, which owns 5.9 billion metric tons of proved and probable reserves and operates 21 operating mines in western and northern China, expects production to rise to 149 million tons by 2007, an increase of 47% from last year.

Shares of Shenhua Energy have risen 14% since the company's June initial public offering, which raised HK\$25.5 billion (\$3.3 billion). But the stock is off its peak of HK\$9.25 in early August.

Of 17 analysts polled by

Thomson Financial, 11 rate Shenhua Energy a "buy," "outperform" or "accumulate," with the remainder rating it a "neutral" or "hold," with a median target price of HK\$9.50.

Shenhua Energy is trading at about eight to nine times to 2006 earnings per share, compared with Yanzhou Coal's six times—a premium that analysts described as reasonable because of growth potential. Investors also prefer bigger companies: Yanzhou Coal's market value of about HK\$11 billion pales in comparison with Shenhua Energy's HK\$30 billion capitalization.

Shenhua Energy's valuation also compares favorably to an estimated average price/earnings ratio of about 15 among Hong Kong blue-chip issues and an average of 14 among North American coal-mining companies, including **Peabody Energy Corp.**

China, the world's largest coal market by annual production and consumption, saw coal prices peak in the middle of 2005 but the decline since then, analysts said, has been due to seasonal inventory buildup and looks set to be temporary.

# Coal Exports Down on Quotas, Demand

China's August coal exports maintained the downtrend, as strict export quotas and declining international demand stemming from an easing supply shortage continued to arrest export growth.

Given the uncertainty of international price direction in the months ahead, it remains unclear whether China's coal exports will pick up this year.

August coal exports fell 7.5% on year to 5.93 million metric tons, down for the fifth straight month. In the January-August period, China exported 48.34 million tons of coal, down 17.4% on year.

The coal export quota for 2005 is 80 million tons, 7.7% lower than actual exports of 86.7 million tons in 2004.

However, if coal exports continue to decline at the current pace for the rest of this year, total exports for the full year might be 72.5 million tons, or 7.5 million tons below the quota.

Weak international coal prices are one of the main reasons behind the drop in coal exports,

analysts said.

For example, in Australia—the world's top coal exporter—thermal coal export prices fell below \$50/ton at the end of July for the first time this year, indicating ample supplies in the international market. The price is currently \$45.50/ton for delivery in the fourth quarter on a free on board basis.

Taking taxes, freight and fees into account, this price is almost the same as China's domestic coal prices. At the Qinhuangdao Coal Exchange Center, the largest coal trading center in China, the latest FOB price of Datong quality mix coal is 435 yuan (\$54) to 443 yuan/ton.

Added to this, China's appreciation of the yuan from July has further increased export costs of coal produced in China.

As a result, global demand for China's coal has begun to decline. Chinese coal producers, on the other hand, have no firm intention to export more due to declining international coal prices.

In addition, China's decision to cut the coal export rebate from 11% to 8% from May 1 also damped coal producers' interest to export.

Cheaper international coal prices also partly encouraged China's coal imports. China imported 16.7 million tons of coal during the January-August period, up 54.6% from a year earlier.

Although growth in domestic demand is not as strong as expected, growth in coal output also slowed, partly due to the government's crackdown on unsafe coal mines in a bid to curtail deadly accidents.

China's coal output for the first eight months totaled 1.3 billion tons, up 8% from a year earlier. The growth, however, is well below full-year growth of 13.2% in 2004. Analysts mostly believe the balanced fundamentals in the domestic coal market are expected to persist for the rest of the year.

As such, domestic coal prices are likely to remain steady until the end of this year.

## IN BRIEF

### Chile Codelco, China Minmetals Delay Deal Signing

Chilean state copper giant **Corporacion Nacional del Cobre de Chile**, or Codelco, and **China Minmetals Corp.** have delayed the signing of a long-term copper supply deal totaling \$2 billion, a Codelco source said.

As a result, a \$500 million Minmetals payment scheduled for Sept. 30 was postponed until the end of the year, the two sides agreed following a meeting in Santiago.

In May, the two state metals companies—the world's biggest copper producer and buyer—signed a letter of intent on a joint venture under which the Chinese company would contribute as much as \$2 billion in return for 15-year copper deliveries from Codelco.

Mining Minister Alfonso Dulanto said only details of the contract remain to be resolved, adding that he hoped the accord could be signed soon.

The deal also includes an option for Minmetals to acquire a 25% stake in Codelco's planned Gaby mine.

In addition, Codelco intends to sell another 24% stake in the mine, and many mining analysts speculate Minmetals will likely acquire that stake as well.

### Chile CAP Unit Gets \$500m Iron Deal

**Compania Minera del Pacifico SA**, a unit of Chilean steelmaker **CAP SA**, has signed a deal valued at some \$500 million to supply iron ore to China's **Jinan Iron & Steel Co. Ltd.**, the unit said in a stock market filing.

Under the deal, Minera del Pacifico will supply 1.3 million tons of the mineral annually for 10 years from 2006.

However, the total dollar amount of the annual sale will vary because the parties indexed the price of the ore to world market fluctuations and agreed to set the price for the next year annually at the beginning of each calendar year, Minera del Pacifico said.

## FOCUS

## OUTSOURCING

## More Fashion Houses Opt for 'Made Elsewhere' Label

For years, European luxury-goods firms manufactured T-shirts and jeans in Eastern Europe and North Africa, but they drew the line at their fanciest collections, which commanded premium prices precisely because they were "Made in Italy." Now, pushed by rising labor costs, currency fluctuations and competition from low-price brands, Valentino and other firms in Italy and France are breaking one of the strictest taboos in high fashion: They are starting to produce some of their most exclusive lines in developing countries.

Celine, a unit of luxury-goods giant LVMH Moët Hennessy Louis Vuitton SA, is manufacturing some handbags in China, including its denim-and-leather Macadam bags, which sell for \$500, according to people familiar with the matter. Though it still makes its swankiest label in Italy, Giorgio Armani SpA says it produces 18% of its Armani Collezioni—which pitches wool trousers for \$450 and silk jackets for \$1,500—in Eastern Europe.

Even "Made in Italy" stalwarts such as Prada, Gucci and Tod's say they are tiptoeing into foreign sourcing. Last year, Gucci Group NV began sewing some sneakers at a factory in Serbia while leather-goods company Tod's SpA produces a part of its Hogan sneaker line in Hungary and is considering moving that to China.

Companies from sneaker makers to automotive giants have long outsourced to China and Mexico, but luxury-goods brands have always touted Italian and French production as essential to the

luxury experience. The "Made in Italy" label, with its centuries-old history of artisanship, has justified exorbitant prices. If their clothes are stitched at low-cost factories, how will consumers react? Will luxury brands eventually have to bow to pressure and lower prices at the expense of their margins?

"Our 'Made in Italy' has to be defended with force," Claudio Scajola, Italian minister for productive activities, said at the Milan fashion shows in September.

Alaa Arafa, the businessman who owns the Egyptian factory making Valentino suits, has little sympathy for such complaints. "Yes, some Italian jobs will be lost, but the writing is already on the wall," he says. "No Italian girl will sit at the sewing machine anymore, no matter how much you pay her."

As a result, executives are beginning to change their tune. "We can't be closed-minded. China will be part of the process for everybody," says Franco Pene, chairman of Gibo SpA, a high-end Italian manufacturer that produces clothes for fashion labels Marc Jacobs, Michael Kors and Paul Smith. Gibo says that for now, it produces only in Italy.

The first shift came during the 1990s luxury-goods boom. Some high-end fashion companies quietly began moving production of secondary, less expensive lines to Eastern Europe to help meet rising demand. Italian handbag maker Francesco Biasia, whose purses sell for between \$350 and \$500, started shifting production to China and Eastern Europe in the late 1990s.

## First Steps

Some high-end European fashion labels are starting to use overseas factories

**Armani:** 18% of its Armani Collezioni made in Eastern Europe

**Celine:** Macadam line of handbags made in China

**Francesco Biasia:** 80% of handbag production done in China and Eastern Europe

**Gucci:** Some sneakers sewn in Serbia

**Hugo Boss:** ??\$550 suits made in China

**Prada:** Some shoes stitched in Slovenia; some handbag components made in Turkey

**Valentino:** \$1,300 white-label men's suits made in Egypt



A handbag from Celine's Macadam collection produced in China

The increasing strength of the euro also is eating into the margins of luxury-goods companies, which buy raw materials and pay workers in euros, but sell their products mostly outside the euro zone, in particular in the U.S. and Japan. Saving on production costs to boost margins has become an appetizing prospect.

With this sea change comes some ticklish challenges, including managing logistical headaches. Italian leather-goods company Furla SpA began making some wallets and handbags in China in 2002, hoping to cut production costs in half, says company Chairman Giovanna Furlanetto. But because Furla needs to get products in stores fast, it is spending more than it expected moving goods by plane instead of by boat, which is less expensive but takes longer. As a result, it has cut costs by only 30%.

Fashion trends change so

quickly that companies get only one shot to produce collections for any one season, a problem that makes quality control a top priority. Gucci says it tried using a factory in China to sew some of its sneakers but wasn't satisfied with the quality. Others have gone to extraordinary efforts to maintain quality. Independent New York fashion house Lafayette 148, which makes knitwear, sent one of the world's top knitwear experts to China two years ago to teach factory workers Italian knitting techniques.

Even harder than sustaining quality, executives agree, is managing the perceptions of consumers. Valentino, a unit of fashion and textile maker Marzotto SpA, rips out the "Made in Egypt" tags in its suits before shipping them to boutiques in Europe, where companies don't have to divulge where they make their products. For the U.S. and Japanese markets, where labeling rules are stricter, Valentino produces suits in Italy, where it also still makes its priciest items.

In the U.S. and Japan, "perceived quality is more important than real quality," says Valentino CEO Michele Norsa.

It is a proposition that seems to divide consumers. "If I knew an expensive piece came from China, I'd have a problem with it," says Robert Ekblom, a London-based banker. "I'd rather buy something unbranded," he adds. Daniela Witte, a 38-year-old stay-at-home mother, also from London, doesn't have such qualms: "If I love the color, the cut and the design, I don't give a toss about where it's made," she says.

## HEALTH

## North America Scientific's Shares Rise on Cancer Treatment OK

North American Scientific Inc.'s shares rose 30% in New York trading after the company said it received regulatory approval to market its Peacock radiation treatment for cancer in China.

The company, which hasn't posted annual profits in at least five years, had sought the approval earlier this year and told analysts in June that the process was taking longer than expected. Chief Executive L. Michael

Cutrer said in a statement that Peacock sales in China may start before Oct. 31, its fiscal year end.

"I'm hopeful we'll have our full range of products available in China during fiscal 2006," Mr. Cutrer said.

Mr. Cutrer offered no estimate of market opportunities in China, but has sought recently to expand international sales.

Peacock is an integrated ra-

diation therapy system that includes software and a delivery system.

The company also sells an ultrasound imaging system used in treating prostate cancer.

In June, the company cut its fiscal 2005 revenue outlook to \$37 million to \$42 million, from \$42 million to \$45 million, citing in part the regulatory delay in China, as well as the delayed launch of new products.

Fiscal 2004 revenue was \$24.7 million.

Earlier, Mr. Cutrer said he was disappointed with the lack of third-quarter sales growth, but said he expected revenue growth in the remainder of the year and in 2006.

The company posted a third-quarter loss of 20 cents a share, on revenue of \$8.1 million. The year-earlier loss was \$1.36 a share on revenue also of \$8.1 million.



## TRADE

# Beijing Quickly Builds Up Links in Asia

China has a new calling card: champion of free trade.

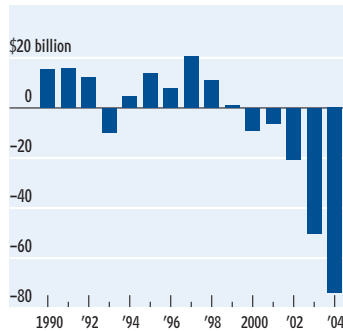
Since March, Beijing has opened free-trade talks with South Korea, Pakistan, Australia and Iceland. In November, it signed deals with Thailand, Malaysia and eight other Southeast Asian countries. Even though China's government still controls large swaths of the country's economy, it has sealed or is seeking free-trade pacts with 25 countries—up from zero two years ago.

China's pursuit of trade deals, combined with a flurry of big-ticket bids for energy and other assets, underscores its desire to don the uniform of a great power. Having created a credible army and a booming economy, China is positioning itself as a leader of global trade and investment, rivaling the U.S. in one of its traditional spheres of influence. As a result, China's market clout is making it a rallying point for countries looking for a counterweight to the world's lone superpower.

All this is raising alarms within the Bush administration, whose own trade agenda has lost

## Asia's New Big Buyer

China's trade boom and its hunger for imports have been a boon to its neighbors and earned it much goodwill. China's trade surplus/deficit with other Asian nations:



Source: National Bureau of Statistics of China, via Haver Analytics

momentum amid rising protectionism in Congress. A U.S. trade deal with five Central American countries squeaked through Congress by two votes this summer after months of Republican arm twisting. In particular, Washington is fretting over China's courting of countries on the outs with the U.S., including Venezuela, Cuba, Sudan and Uzbekistan.

Chinese officials say they aren't trying to rival the U.S. or stir trouble. Beijing's trade and investment agenda, they say, is designed to support an economy dependant on exports that also has a thirst for energy and raw materials. In addition, for decades, U.S. presidents have urged China to join the international economy and to take its rightful place on the diplomatic stage.

China's own economy still remains relatively closed. It doesn't allow a free flow of capital, restricts foreign stakes in key sectors, such as automobiles, telecommunications and banking, and restrains its population's movements. But in the narrower sphere of international trade, its alacrity in signing trade deals is making the U.S. appear sluggish.

China took just two years to strike a pact with 10 Southeast Asian countries. The agreement whittles import tariffs on commodities such as fruits and vegetables to zero by 2010. During the same period, in the Asian arena, Washington signed one 1,200-page deal with Singapore.

## Textile Negotiations Advance But End Without Agreement

Talks aimed at calming trans-Pacific tensions over trade in textiles ended without agreement, but U.S. officials suggested progress had been made toward a deal that would allow Chinese imports to rise without swamping the American market.

David Spooner, chief textile negotiator for the Office of the U.S. Trade Representative, said the two sides had narrowed differences over the scope of a potential agreement and how tightly imports would be controlled, but couldn't nail down final details after three days of talks in the U.S. capital.

Chinese shipments to the U.S. shot up after the beginning of the year with the expiration of a decades-old system controlling world-wide trade in textiles and apparel. Fearing disruption of the domestic market, the U.S.—exercising authority retained when China joined the World Trade Organization in 2001—responded to the surge by slapping on import controls, or “safeguards.”

The quotas hold import growth to 7.5% above the previous year's shipments, and have been applied to more than a dozen categories of clothing, covering everything from bras to knit shirts to trousers. Several petitions for even broader protections have been filed by U.S. textile producers, which have lost tens of thousands of jobs in recent years under pressure from foreign competition.

More negotiations are planned, though the dates and locations have yet to be worked out. The three-day session in Washington was the third round of talks aimed at resolving the dispute. Previous meetings in Beijing and San Francisco produced little progress.

But U.S. industry and government officials suggested the atmosphere of the latest meetings was better, with the two sides moving off of a broader discussion about whether there should be any import limits at all and onto details of a pact that would end the dispute.

## Signing of Chile Pact Is Likely

Chile and China likely will sign the free trade treaty currently being negotiated in November at the Asia Pacific Economic Cooperation Forum's annual leaders summit, Chile's chief trade negotiator said.

During the fourth round of talks, which took place in September, Chile presented a detailed tariff reduction proposal, which Chinese negotiators are currently analyzing.

The two nations' trade negotiators seek a deal that would gradually free 95% of bilateral trade from import duties.

## TALKING POINTS

### Brazil Considers Trade Sanctions On Chinese Goods

Brazil is considering trade sanctions against Chinese goods after trade talks in Beijing broke down, signaling a more difficult trade relationship in the future between Latin America's emerging economies and their fast-developing Asian rival.

Brazil, which granted China market-economy status last year, has been inundated with inexpensive Chinese textiles, shoes, toys, tires and auto parts, and wants voluntary Chinese export quotas.

Brazilian Trade and Development Minister Luiz Fernando Furlan told reporters that the government's foreign-trade council, Camex, “has already approved sanctions and President [Luiz Inacio] Lula [da Silva] has frequently said he favors them.” But he added that he wanted the talks to continue.

In the end, Brazil is unlikely to impose sanctions, as both sides have a lot at stake in making a trade relationship work, observers said. China sees Latin America, and especially Brazil, as an important source of raw materials to feed its red-hot economy.

The friction between China and Brazil exposes some cracks in the informal alliance they developed at the 2003 ministerial conference in Cancun of the World Trade Organization. At that meeting, Brazil led developing nations in demanding that U.S. and European nations cut their agriculture subsidies in order to reach agreement on other trade issues like intellectual property rights.

## THE WALL STREET JOURNAL BRIEFING

Michael Rivers, Editor  
Michael.Rivers@wsj.com  
(852) 2831-2527

Subscriptions  
service-wsjbriefing@dowjones.com  
www.briefing.wsj.com  
(852) 2831-2579

Contributors:  
Mara Yuan, Beijing  
Willy Wu, Shanghai  
Miho Inada, Tokyo

Robert Walter, Graphics Director,  
The Asian Wall Street Journal.

