



STRATEGIC AND COMMERCIAL INTELLIGENCE

China investment analysis: SCI China and Hong Kong

ADVISORY



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China is emerging as an economic powerhouse. For foreign direct investment China continues to be the top destination; economic growth is robust; many multinationals in China are gearing up to expand their presence; an emerging consumer class is demanding world-class products and services.

Despite these changes, China remains a challenging environment in which to operate. The scale of China, the pace and fundamental nature of change in many sectors, and the still-developing infrastructures and systems: all provide a myriad of potential pitfalls for new entrants and established market participants alike.

Companies considering a China investment – whether an acquisition, a joint venture, expansion or ‘greenfield’ investment – need to do so only after a thorough assessment of the opportunities and the best way to position.


The Strategic and Commercial Intelligence (SCI) practice in China and Hong Kong is a key element of our Transaction Services offering, and was established to help clients make better-informed investment decisions – decisions based on independent, fact-based analysis of the underlying commercial landscape.

Our local knowledge and experience in the Hong Kong and Mainland China markets also complements our SCI practices in other parts of the world, providing critical inputs on cross-border transactions.

Now present in Beijing, Shanghai and Hong Kong, the Strategic and Commercial Intelligence team provides

- Market assessment and market entry strategy
- Location strategy
- Commercial due diligence assistance
- Business plan due diligence

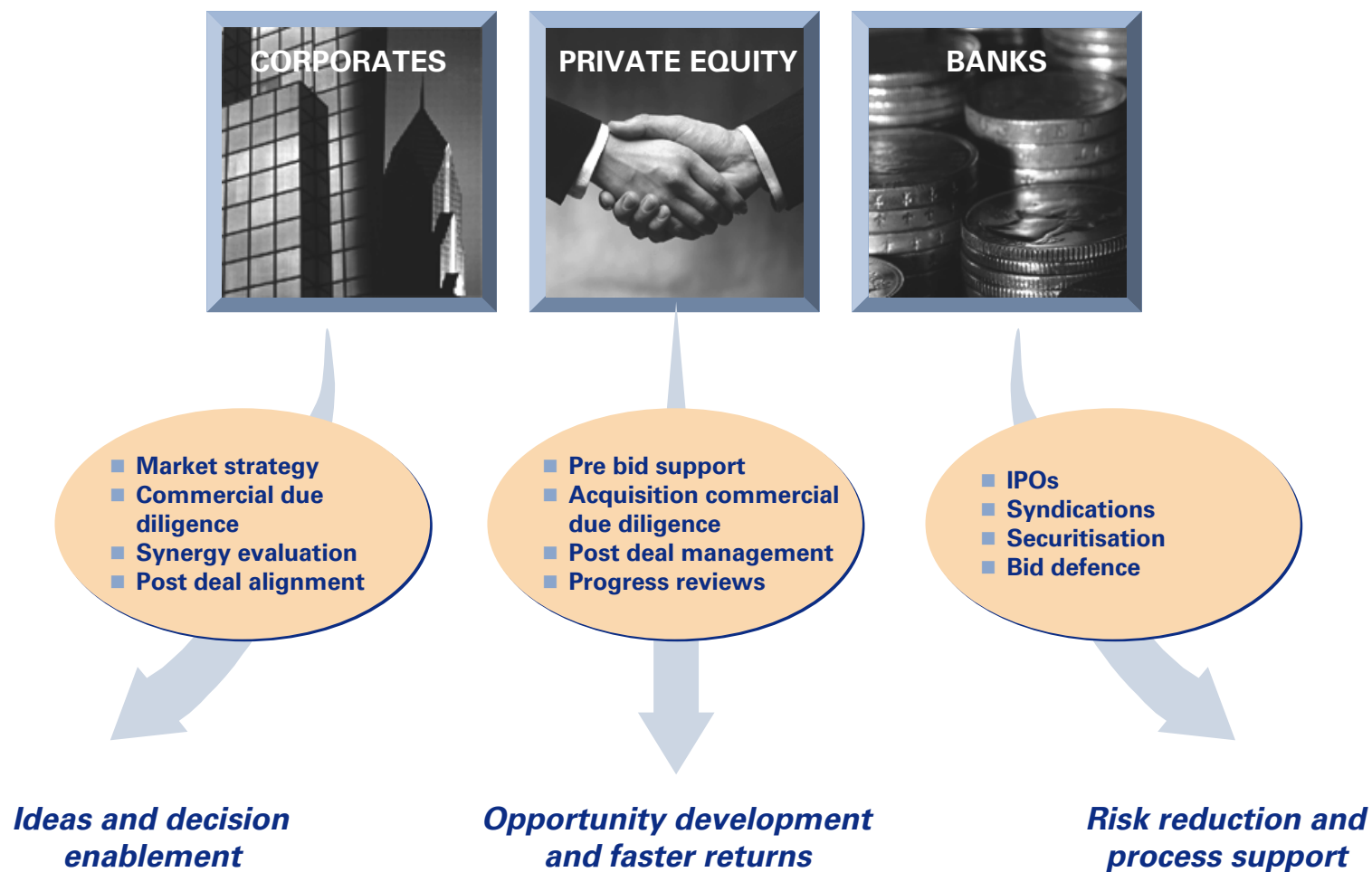
Our services and credentials are summarised in this document. I welcome you to contact me or any of my SCI team mates in Hong Kong, China or elsewhere in the world for further details.



Thomas Stanley
*Head of Strategic and Commercial Intelligence
China and Hong Kong*

- SCI in China and Hong Kong
- Support for China investment decisions
- Recent projects – China and Hong Kong

Strategic and Commercial Intelligence (SCI) is KPMG's investment strategy advisory group



SCI has dedicated teams 'on the ground' in key countries



Global practice, local presence

- Established in UK in 1999; now numbering 200+ staff in 19 offices, including London, New York, and Amsterdam

Dedicated practice

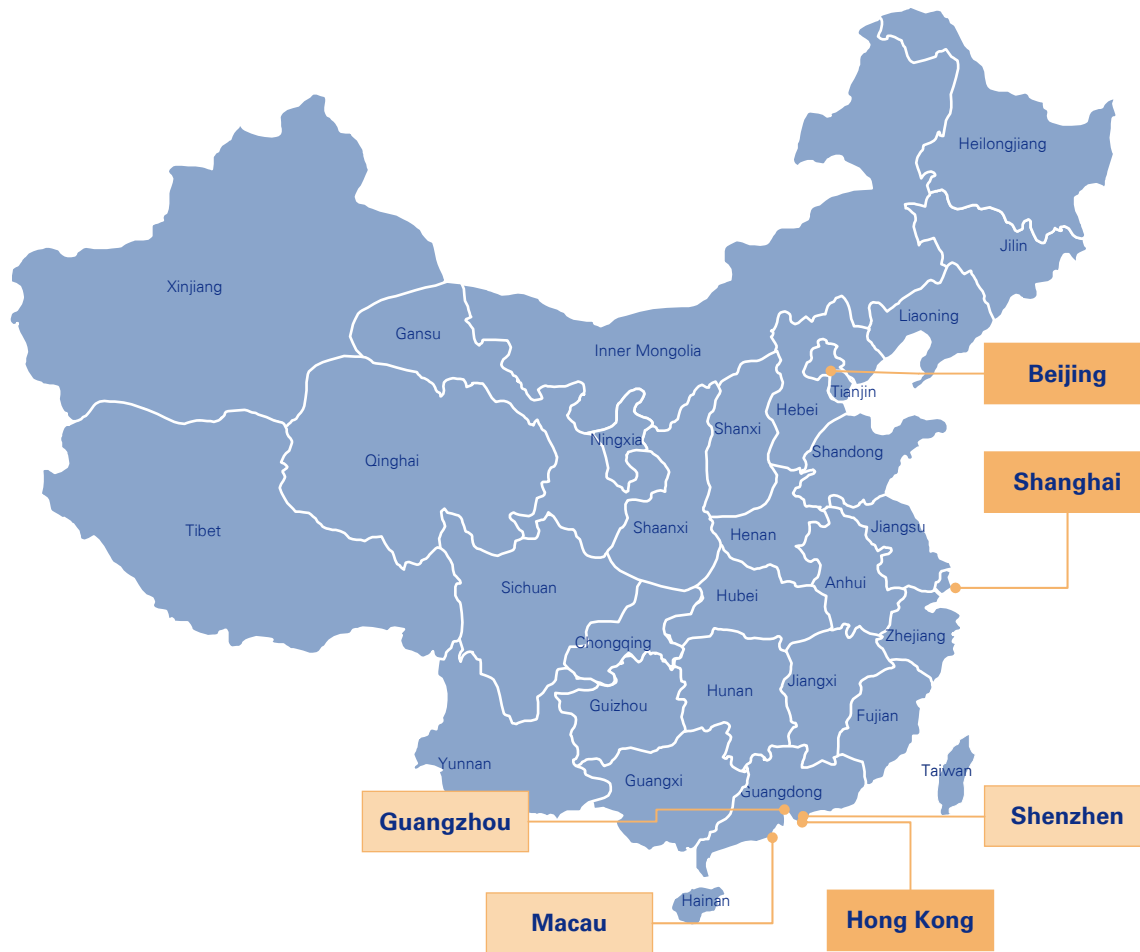
- SCI is a dedicated practice of full-time locally based professionals that know the region well
- SCI works closely with clients providing independent insights and information quickly

Integrated due diligence team

- Our SCI capability provides clients with a single integrated due diligence team that can address commercial issues critical to the future business performance of the target
- An integrated team shares knowledge and issues between the commercial and financial due diligence work streams and can provide clients with a single report

SCI utilises KPMG's existing global presence for local knowledge and contacts

SCI has a strong track record of assisting multinationals in China



SCI China

- SCI in Hong Kong was established in May 2001 and expanded to Mainland China the following year
- SCI now has dedicated, Mandarin-speaking staff in Hong Kong, Shanghai, and Beijing

Industry experience

- SCI has conducted over 100 projects for corporate, institutional and private equity clients in such sectors as
 - automotive
 - retail
 - financial services
 - food ingredients
 - energy and infrastructure
- In this market the most commonly required SCI assistance is in the areas of
 - market assessment and market entry strategy
 - location strategy
 - commercial due diligence
 - business plan due diligence

An integrated KPMG investment strategy group brings several benefits to our clients



INTEGRATED TEAMS

- Integration with other KPMG teams
- Share knowledge and issues between the workstreams
- Single team to manage and single report addressing issues



PROFESSIONALISM

- Focused team charged with developing clear opinions
- Organisation providing credible reporting
- Deliverables focused on client needs

SUCCESS



INVESTMENT SERVICES

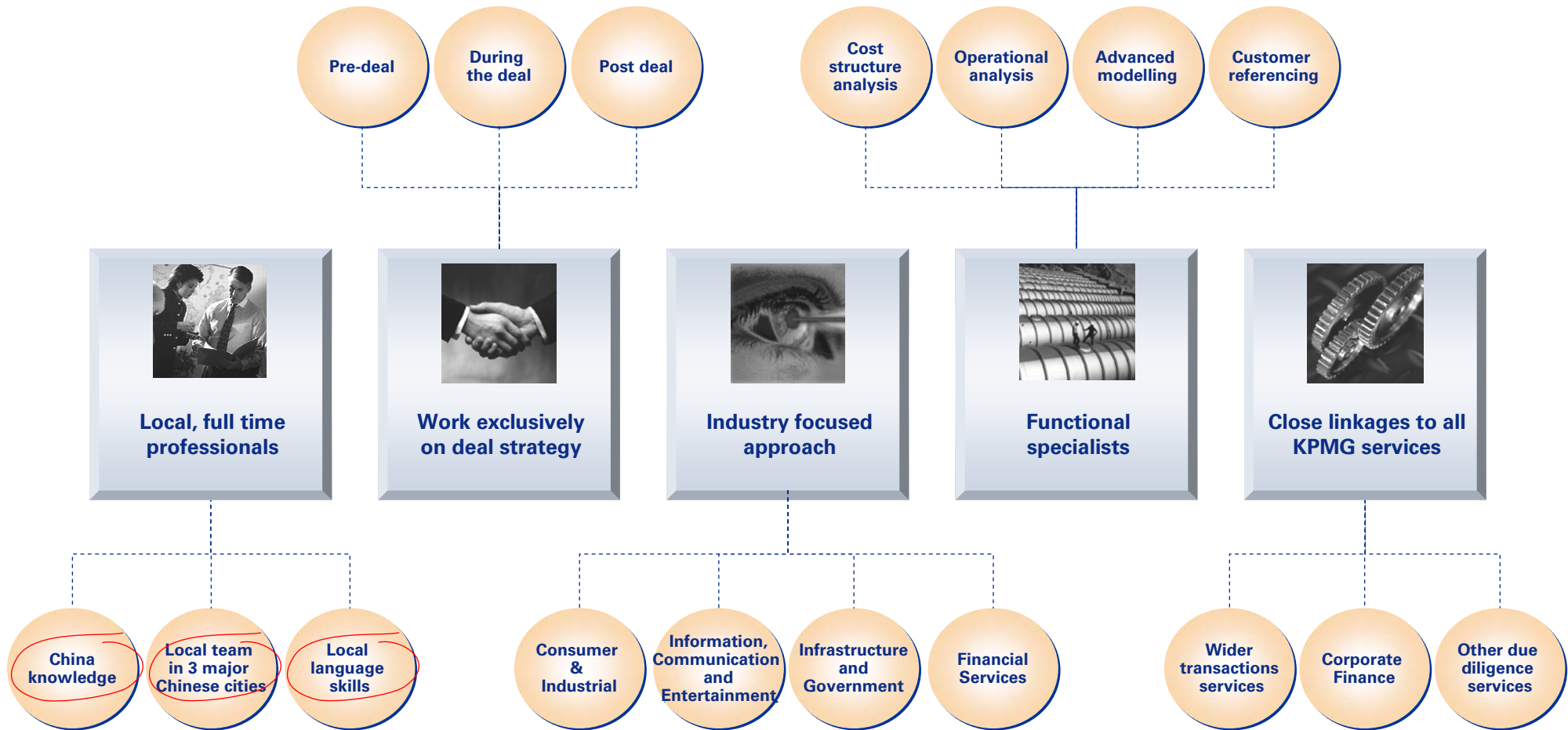
- Pre, during and post deal investment advisory services
- Tailored scope to meet client needs
- Market, technology and operations capabilities



SCALE

- Large dedicated investment strategy team
- Sector expertise
- Global coverage

SCI brings together all the elements needed to provide high quality investment support services to our clients

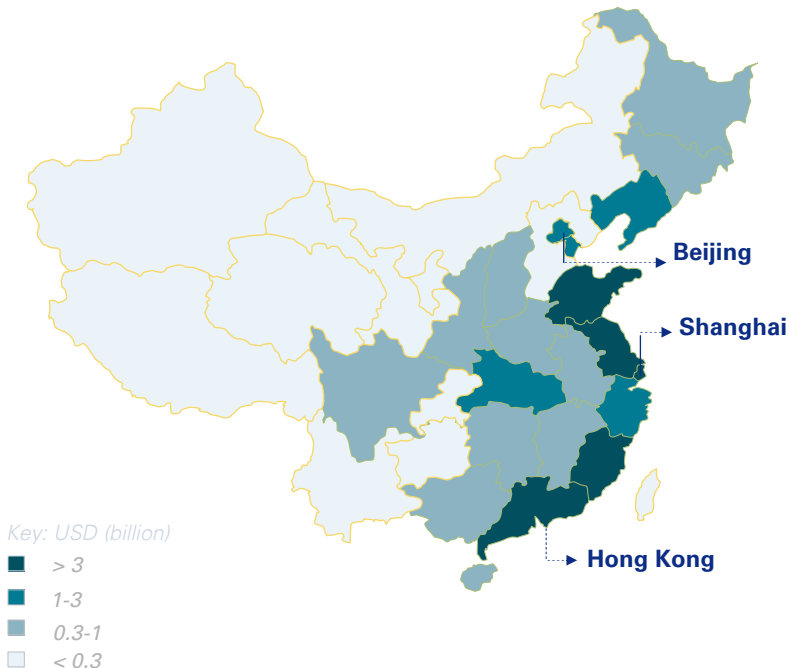


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- SCI in China and Hong Kong
- Support for China investment decisions
- Recent projects – China and Hong Kong

China is one of the world's largest recipients of foreign investment but the business environment presents significant challenges

Foreign direct investment by province 2003



Note: Taiwan not included in the analysis
Source: China Markets Yearbook, 2004

Increasing level of Foreign Direct Investment⁽¹⁾⁽²⁾

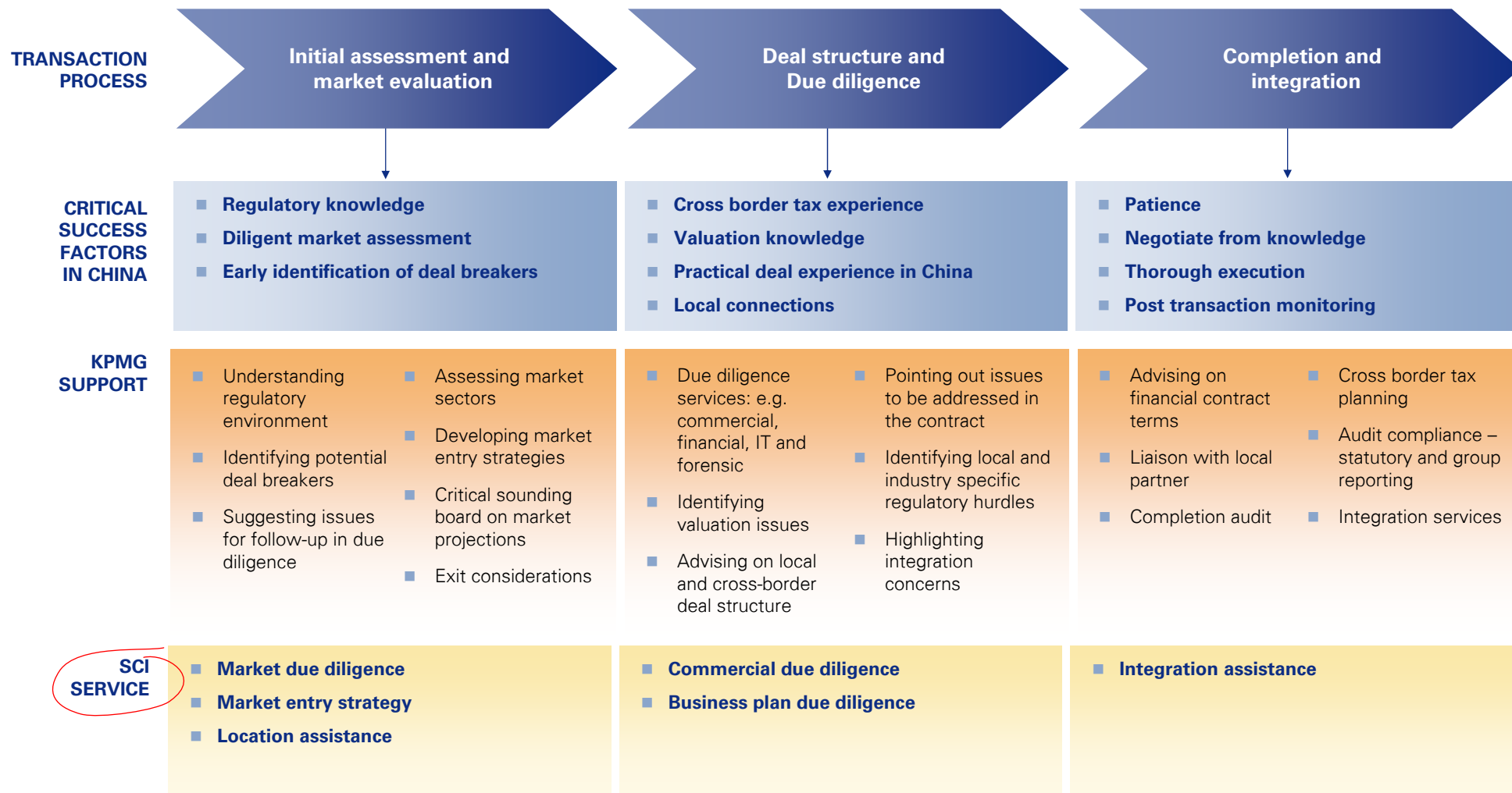
- China has been one of the largest recipients of foreign investment for the past 10 years and in 2003 overtook the US as the top investment destination
 - more than 400 of the world's top 500 companies have established operations in China
 - over 200 foreign investment companies and around 400 foreign research and development centres have been established
- By January 2003, the number of new registered foreign invested enterprises reached around 430,000 with a contract value of around USD 840 billion and actual investment value of around USD 450 billion
- Recent surveys indicate that a majority of foreign invested companies are already profitable

Successful investing in China

- However, a large number of foreign firms have failed in their entry into China or are struggling
 - in many cases this was due to not undertaking sufficient analysis of the market and opportunities
 - China's business environment, though improving rapidly, presents unique challenges even to well-established companies
- Patience, and a good understanding of the market place, competitors and customer demands forms the basis of establishing a sound entry strategy and successful presence in China

Source: (1) China Daily "FDI Surges in January Despite Weak Global Economy" February 2003
(2) Xinhua News Agency "Overall Evaluation of WTO Entry's Influence on China" June 2003

Our SCI team in China and Hong Kong can assist with a range of integrated investment support services



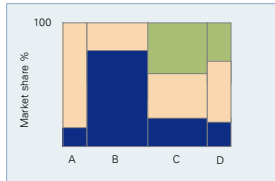
Further details on SCI services are covered on the following pages

An independent analysis of the size and nature of the opportunity is a must in China; SCI assists with market assessments and market entry strategies

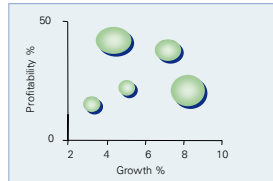
COMPETITIVE ANALYSIS

Attractiveness of the market and strategic positioning

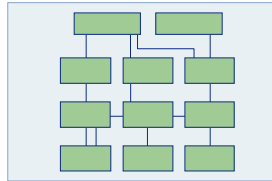
Market



Competition



Channels



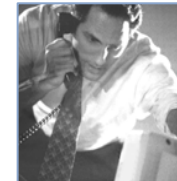
INTERVIEW PROGRAMMES

In depth understanding of customer needs

Specialists



Qualitative



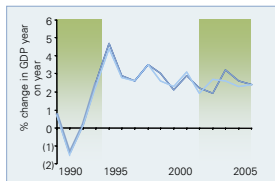
Quantitative



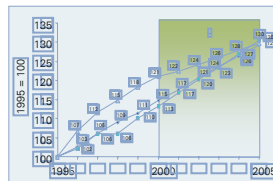
APPROACH

Emphasis on facts and evidence
Robust underlying logic
Credit committee level detail
Opinions on revenue and margin projections

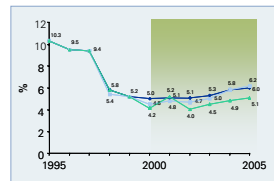
GDP annual % change



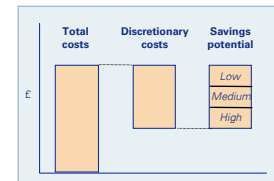
Household disposable income



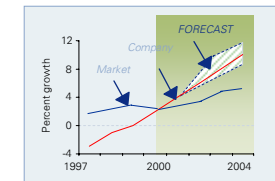
Savings ratio



Cost structure



Projections



At risk



Effects of macroeconomic climate

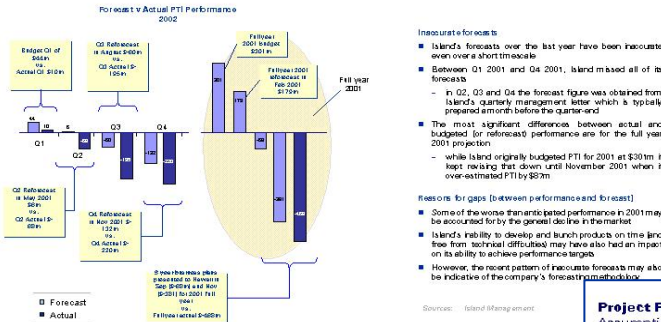
MACROECONOMICS ANALYSIS

Achievability of financial projection

FINANCIAL APPRAISAL

"Business Plan Due Diligence" provides fact-based intelligence on a company's projected business activities

Over the past year, it appears that Island has found it difficult to accurately forecast its performance – even within a particular quarter



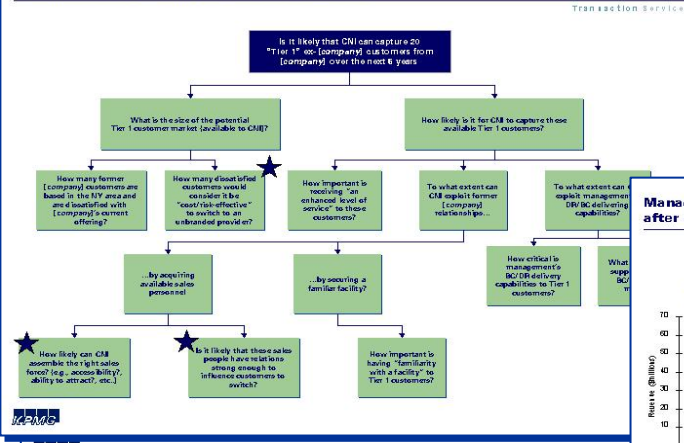
- Inaccurate forecasts**
- Island's forecasts over the last year have been inaccurate even over a short timescale
 - Between Q1 2001 and Q4 2001, Island based all of its forecasts
 - In Q2, Q3 and Q4 the forecast figure was obtained from Island's quarterly management letter which is typically prepared around 1 month before the quarter-end
 - The most significant differences between actual and budgeted (or retrocast) performance are for the full year 2001 projection
 - while Island originally budgeted PFI for 2001 at \$30m it kept revising that down until November 2001 when it over-estimated PFI by \$5m
- Reasons for gaps (between performance and forecast)**
- Some of the worse than anticipated performance in 2001 may be accounted for by the general decline in the market
 - Island's inability to develop and launch products on time and free from technical difficulties may have also had an impact on its ability to achieve performance targets
 - However, the recent pattern of inaccurate forecasts may also be indicative of the company's forecasting methodology

(1) We have management "defend" their financial projections - by requiring them to articulate the supporting rationale and major assumptions underlying the financial model

(2) Next, we break each major assumption down into its key drivers (or variables) - that can be measured and tested in order to evaluate the reasonableness of the overall forecasts

This demonstrates the difficulty in accurately forecasting volumes and prices in a competitive market and current projections should be viewed with caution

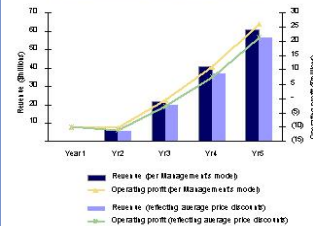
Project Rose
Assumption 1: CNI's ability to capture Tier 1 customers



(3) Our due diligence activities help clients understand how each key driver is expected to change in the future – and how these changes are likely to impact the business

Management's ability to achieve its revenue and profitability projections may be challenged, after considering all necessary pricing adjustments (primarily due to discount requirements)

Possible Impact of pricing discounts, on Revenue and Operating Profit, Years 1-6

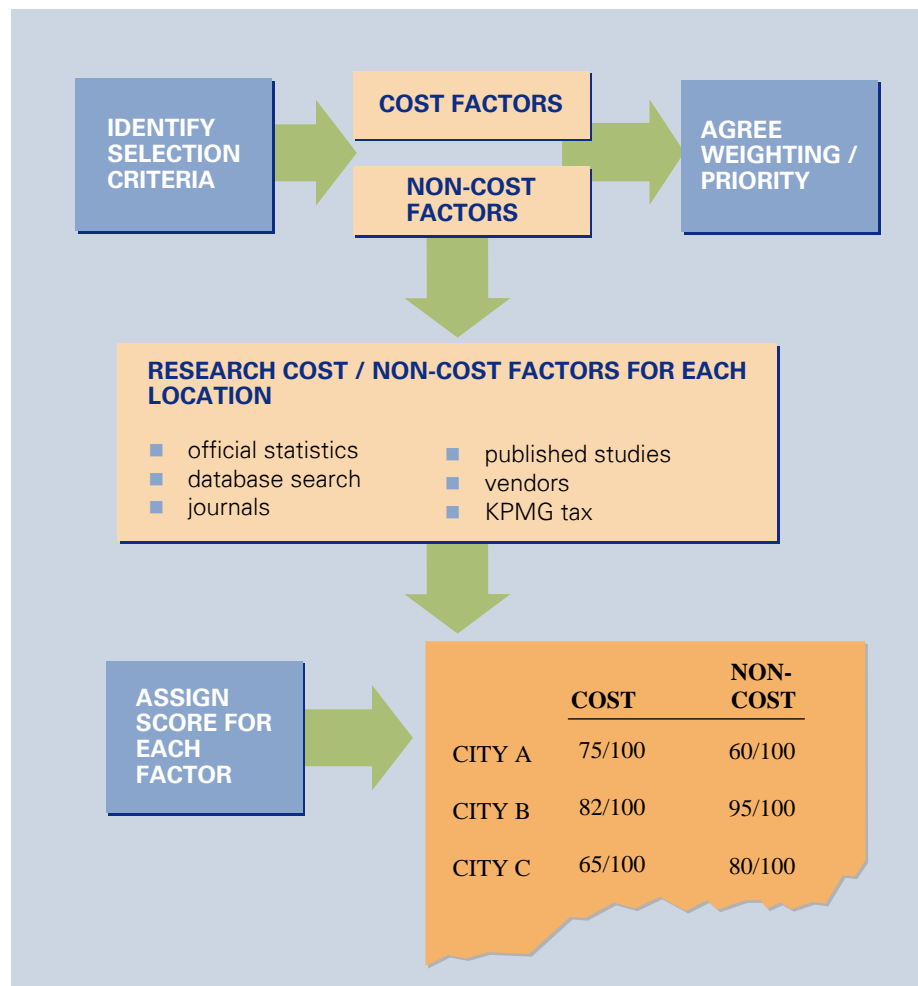


- Methodology**
- To understand the possible revenue and profit impact of reflecting customers' price discount requirements, KPMG used the following assumptions (obtained from Management):
 - The average contract lasts 3 years
 - Every contract is renewed after 3 years
 - Prices stay constant over the 6 year projected time period
 - No impact to costs as a result of pricing discounts
- Possible Impact**
- Due to the low number of assumed customers captured in years 1-2, the overall impact to revenue and profit over the explicit forecast period does not appear significant
 - As the volume of contracts won by CNI increases, the impact of price discounts also appears to increase
 - By Year 6 it is possible that Management's revenue and profitability projections may be impacted by as much as \$4m and \$3m respectively

Target Clients/Deals:

- Transactions where the target's growth projections are aggressive or unsupported
- Situations in which there is little historical information on which to rely – or when clients require due diligence on management's projections
- When a target company is dependent on a small group of customers and/or new business strategies
- Clients with very "company-specific" questions that need to be answered

Location strategy is a key concern for companies entering or expanding in China: our local knowledge helps clients make informed decisions



Well-structured approach

- We identify the cost and non-cost issues that will drive the location decision, and agree an appropriate weighting with clients
- To objectively score each potential location on these criteria, we research using a variety of sources
- A total score for each city is then calculated for cost and non-cost issues

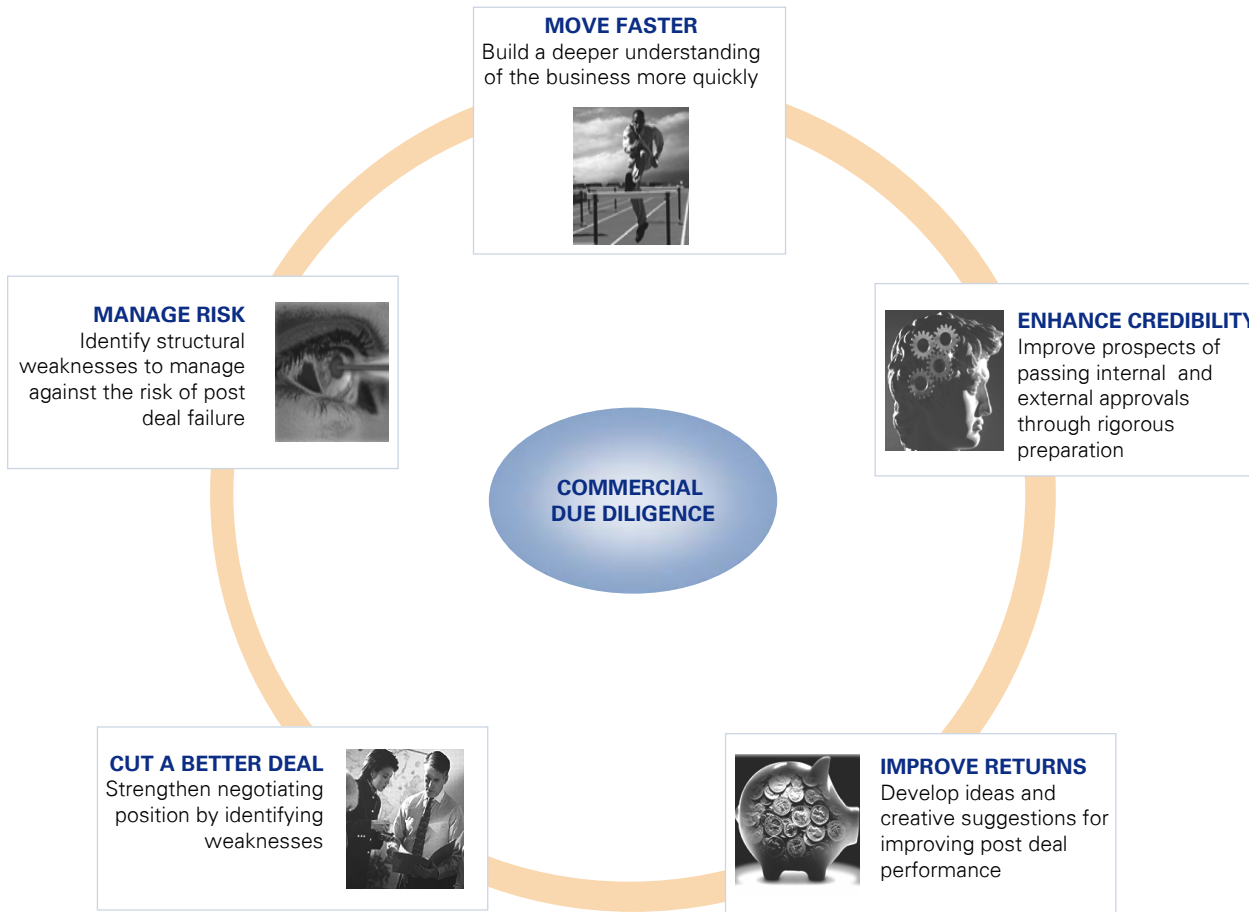
Cost and non-cost factors

- These vary by industry and each company's situation
- Common cost factors include
 - salary costs
 - taxation impact
 - overhead costs
- Common non-cost factors include
 - country risk
 - ease of doing business
 - quality of life
 - regulatory environment (e.g. ease of listing)

Benefits

- Location assessments provide clients with an independent assessment of the pros and cons of different cities and industrial zones in relation to their location needs

In this market deals often hinge on the assessment of the future commercial prospects of the Target: SCI provides commercial due diligence services to address these issues



Commercial due diligence

- Investors need to understand the commercial context in which a target company operates: is the company positioned to succeed?
- Commercial Due Diligence (“CDD”) is the process of appraising a target by reference to its competitors and its market
- CDD, combined with the financial, HR, IT and legal due diligence, helps the purchaser determine whether to proceed with the transaction
- The CDD approach uses multiple information sources and highly structured strategic analysis techniques to provide insightful, useful assessments on:
 - market sizing
 - competitive landscaping
 - market entry strategy
- KPMG is well positioned to provide these services:
 - global SCI network
 - unique KPMG library of purchased research
 - ability to draw on past global projects
 - network of industry, functional and country experts

Reports are concise and well structured; we focus on providing insights not just information

Reinsurance products

The current demand of reinsurance appears to be flat.

Insurance companies generally appear to welcome more advanced products from reinsurers.

Life insurance products offerings

1999: Group 56%, Individual 11%, Individual 14%

2002: Group 16%, Individual 16%, Individual 68%

Savings and protection products

- Interviewees provided mixed comments on existing market share of savings and protection products in the life insurance market.
- Domestic insurers view protection products as being dominant over savings.
- Whereas, foreign insurers hold a different view⁴¹.

Regulatory environment

Deal acquisition previously relied to a large extent on "personal connections", and the Target's connections in Qingdao are a key element of its business plan.

In key areas of the Target's planned underwriting business, the importance of strong Qingdao connections may be open to question.

Central Government

- Jiangsu (Nanjing)
- Shandong (Jinan)
- Shanghai

Other provinces: Gansu, Hunan, Hubei, Henan, Heilongjiang, Shaanxi, Sichuan, Tianjin, Xinjiang, Yunnan, Zhejiang.

Source: *China's Insurance Industry: A Report on the Current Situation and Future Prospects*, PricewaterhouseCoopers, 2002.

Key considerations in selecting a reinsurer

- "Good ratings, good financials, good reinsurance products"
- "Local language support by overseas, reinsurance capability"
- "Solvent capital"
- "Service, price, and corporate responsibility"
- "Local business products, reinsurance capability, and reinsurance"

Source: Interview with local insurance executives.

Textile machinery production

China's rise as an emerging global textile power has resulted in increased demand for domestically produced and imported textile machinery.

Full membership to the WTO is expected to bring added benefits to the sector.

Legend: >=300, 100-300, 50-100, 10-50, <10

Source: *China's Textile Industry: A Report on the Current Situation and Future Prospects*, PricewaterhouseCoopers, 2002.

China's consumption of textile machinery, US\$ billions 1987-2002

Year	Domestic (US\$ billions)	Imported (US\$ billions)	Total (US\$ billions)
1987	1.24	0.00	1.24
1990	1.27	0.00	1.27
1993	1.20	0.00	1.20
1996	1.8	0.00	1.8
1999	3.8	0.00	3.8
2002	3.81	0.00	3.81

Source: *China's Textile Industry: A Report on the Current Situation and Future Prospects*, PricewaterhouseCoopers, 2002.

Continuing sector reforms

- The move away from inefficient and outdated machinery to more efficient modern machinery brought on increased demand for newer higher quality machinery, satisfied by domestically produced and imported products.
- "Domestic textile machinery production greatly improved its quality and technical capability of its products through its reform."⁴²
- Imports of textile machinery increased by around 50% from 2000 to 2001 to satisfy increased local demand⁴³.
- Consumption of textile machinery grew at a compound annual rate of around 10% between 1998 and 2002, with the consumption of imported and domestically produced machinery being about equal.
- The demand for improved machinery to replace inefficient machinery is expected to continue, brought about by the completion of the industrial reform and industry goals set in the 10th 5 year plan.
- Very little Chinese textile machinery production is exported, as the majority (90%) of production is consumed domestically.

Impacts of China's WTO accession

- Imported machinery lost its duty free customs treatment in 1999 bringing tariffs in line with WTO requirements of around 6-10%.
- It is unlikely, therefore, that full WTO membership will bring about any dramatic changes to the price of imported machinery.
- Quotas set by the Multi-Fibre Agreement are being removed with China's accession to the WTO.
- this will remove restrictions on the quantity of textile exports from China and increase their competitiveness in the global market.
- China's foreign manufacturing partnerships accounted for around 24% of imported machinery in 2001, an increase from 18% in 2000⁴⁴.
- partnerships of this nature are expected to continue increasing as local and foreign firms combine knowledge of the local market with technological and managerial skills, respectively.

- SCI in China and Hong Kong
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- Recent projects – China and Hong Kong

Recent project experience



Non-bank consumer finance / Market strategy

- KPMG was engaged to assist a multinational retail bank with developing its market strategy into the non-bank consumer finance sectors; the bank identified two North Asian countries and sought information on the "sub-prime" consumer finance opportunities
- KPMG undertook primary and secondary research on the markets analysing the regulatory barriers to entry, the potential market size of the sub-prime market for non-bank consumer finance and other financial products, the competitive environment with a view to identifying potential targets, and customer purchasing behaviour
- The client used the results of the study to determine which markets it should enter and its preferred mode of entry



Fund management / Commercial Due Diligence

- KPMG's North American client was looking to form a fund management joint venture in China with domestic securities companies and engaged KPMG to provide commercial due diligence assistance
- As part of the assistance, we undertook three streams of work: a market assessment on the size and growth of the sector, the competitive landscape, customer base and regulatory environment; a partner due diligence, assessing capabilities, reputation and management depth; and an assessment of the financial model, including testing assumptions underpinning the model, projections and realisation
- The result of our work was used by the client to further their understanding of the China fund management market, provide confidence over the reputation of the target partner and provide information to further negotiations with the partner



Multifunctional sports stadium / Financial model assistance

- As part of the process for securing external investors to the projects, the Sports Bureau of a leading city in Guangdong Province requested KPMG to provide financial model assistance to evaluate the operating deficit of 2 new sports stadia over their 30 years operating period
- KPMG developed a financial model and provided assistance with key assumptions assistance in the project; this work included fieldwork to confirm assumptions with local government officials, operators of existing municipal sports halls and venues in nearby cities, and utilities providers
- We have also supported the client in its negotiations with potential bidders to operate the facility

Recent project experience



Quality hospitals / Market entry

- KPMG carried out a market entry study for a private European investor who was looking for an investment opportunity in China's quality hospital market. The project used primary and secondary sources to assess the current hospital market in China including the market size, health expenditure and trends, and the demand for quality hospitals
- Our work also included a detailed analysis of key drivers for hospital demand, identified issues regarding foreign investment restrictions and profiled six sub-sectors that were likely to be attractive investment targets
- The client used our findings to further pursue his investment plan on one of the six sub-sectors



Location analysis

- Assisted a multinational company in its identification of suitable locations for a IC design and manufacturing facility; client was under pressure to identify a location but lacked reliable analysis on which they could base their decision
- KPMG's role was to research and analyse the factors considered relevant to the location decision, including economic, social, infrastructure, cost of doing business, cost of living and the likelihood of attracting and retaining IC design engineers. Our role also included, at the outset of the assignment, facilitating management's identification of relevant factors
- In total we evaluated six cities and provided in a board-level presentation format the relative performance of each location against the client's key factors



Sporting products / Plant location study

- China location study for a US-based sporting goods manufacturing company establishing its first plant in China
- The project used primary and secondary sources to identify a number of locations with reference to the client's operational requirements e.g. proximity to suppliers and customers, cost factors, and logistics. From the long list of locations, a shortlist of 3 possible sites was identified.
- The client used our findings to facilitate the selection of the first manufacturing location in China