

Summer 2011

China Briefing

China

PRECISE. PROVEN. PERFORMANCE.

The Olympic cities: Beijing and London

With Olympian competition in mind, GAM economist Koray Yesildag and client director Douglas Branson consider the relative stock market investment merits of China and the UK.

China, the 2008 Olympic host, recovered far quicker than developed markets from the financial crisis. Large foreign currency reserves accumulated since its previous crisis in the late 1990s have proved useful. China's GDP growth rate now is outstanding in comparison to developed economies. Where the UK's GDP growth was marginal at the end of 2010, China's exceeded 10%.

Surely, therefore, China's stock market is the obvious choice for investment? Not necessarily. The real picture is more complex. China has grown very strongly in the past decade due, at least partly, to inappropriately loose monetary policy – the currency peg with the US dollar means that China “borrows” its policy stance from abroad. Now, however, inflation is starting to rise and the government is playing catch up by tightening monetary policy. But investors have been left wondering whether these moves are too late to prevent a serious problem. As a result, the Chinese stock market has underperformed both the US and the UK markets – down 30% at its worst point in 2010 and finishing the year 10% lower than it began. Of course, there is a risk that if China tightens its

monetary policy too sharply, growth could be damaged. A fine balancing act needs to be performed in the short term.

In the longer term, however, China's growth story remains intact. Living standards are still far behind those of developed economies, creating plenty of growth potential. Nevertheless, in the short term and certainly during 2011, the Chinese investment ride could be rocky.

So what about the 2012 Olympic host, London? As noted, UK GDP growth is relatively poor. There is also the huge fiscal deficit, rising inflation and concern about the Bank of England's credibility. However, domestic economic problems should not be conflated with stock market weakness. The FTSE performed pretty well in 2010. Why? Because the major stocks traded in the UK are those of international companies with operations in emerging markets. Global infrastructure and commodities players are thriving – and many are London listed. Medium term investing in the UK stock market therefore remains an attractive proposition.

douglas.branson@gam.com

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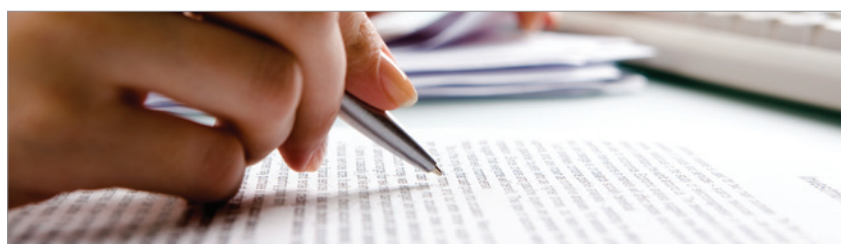


China's accounting aligns

As China has moved from a planned to a more market-orientated economy, so PRC accounting standards (originally based on an old Soviet model) have had to change to reflect the increased emphasis on profits and return on capital employed.

Two sets of generally accepted accounting practice are currently used – the 'new' China Accounting Standards (CAS), effective for all listed companies from 1 January 2007, and the 'old' Accounting Standards for Business Enterprises (ASBE), developed over 20 years. The new and old PRC GAAP comprise 38 and 16 accounting standards respectively, plus application guidance and regulations. There are many differences, but the New GAAP is generally more principles-based, and requires more fair value measurement and disclosures. The PRC Ministry of Finance has announced that all large and medium-sized entities will be required to change to the New GAAP with Beijing and Shanghai leading the way this year.

The New PRC GAAP was pronounced substantially convergent with IFRS by the



International Accounting Standards Board and Chinese companies listed in Hong Kong have recently been allowed to report solely in accordance with PRC standards without the requirement to produce a second set of HKFRS or IFRS financial statements.

However, there are still some differences between CAS and IFRS. For instance, CAS 8, *Impairment of Assets* prohibits the reversal of all impairment losses, whereas IAS 36 only prohibits the reversal of goodwill impairment. CAS 20, *Business*

Combinations requires the pooling method for combinations under common control and does not address accounting for reverse acquisitions.

Finally, for accountants disappointed that IFRS has become more rules-based and lengthy as it becomes more aligned with US GAAP, it is encouraging that Chinese regulators have declared themselves in favour of principle-based standards.

helen@ms.com.uk

Asian tax strategy

In some Asian countries, foreign investors may not be allowed to set up branches and so need to establish a local company. Where they have a choice, foreign investors considering an investment in Asia need to consider a number of tax-related issues:

- the relative income tax rates for branches and companies;
- the rate of withholding tax on after-tax profits remitted by a branch to its overseas head, as compared to the withholding tax rate on dividends remitted by a company to its overseas parent;
- the possibilities for branches to credit foreign taxes against the branch's income tax liability;
- whether losses sustained by a branch can be offset against the branch's head office in its home country;
- there are usually no capital taxes or stamp duties due on

capital contributed to a foreign branch, whereas these taxes are due in most, if not all, Asian countries if the same capital is contributed to the shares of a company;

- some countries may have restrictive policies towards the granting of tax incentives to branches of foreign companies, whereas domestic companies may be eligible for such incentives if certain requirements can be met.

When a foreign investor sells or reorganises its foreign investment, many Asian countries impose a capital gains tax on the incremental value of the investment. The rate of capital gains tax typically ranges between 10% and 20%, though the tax may be reduced under certain favourable double tax treaties.

Asian Private Equity

Peter Hwang from PineBridge Investments casts his eye over private equity investment opportunities in Asia.



Although the US on average continues to account for around 70% of global private equity (PE) fundraising, there has been steady growth in private equity fundraising in Asia since 1999. China and India, both markets identified as predominantly growth equity / expansion capital investing, continue to play important roles in the rise of Asian private equity.

Following the global financial crisis, the macroeconomic fundamentals of these two countries remain intact. This is further supported by the strong recovery in M&A and investment activities since the second quarter of 2009. Demonstration of a healthy level of exits with strong performance over several years further supports the trend that the General Partner universe, particularly in China and India, will continue to expand and remain as key markets for limited partners for years to come.

In China, while many fund managers position themselves as value-added investors, this merely means providing finance, improving corporate governance, providing restructuring for public listing, and very little to do with 'operational' value-add.

But the model is slowly shifting to embrace the importance of operational value-add as a differentiator when negotiating with entrepreneurs in an environment where liquidity is not an issue. However, as it is an emerging phenomena and one of many evolving trends shaping China's private equity landscape, there is little efficacy to the effectiveness of PE as 'transformational' capital and even less evidence on how it translates into returns.

India is another high growth market, but with different underlying growth drivers uncorrelated with China. While China's move to transition from an export-driven economy to a more domestic consumption driven economy is recent, one of India's key economic growth drivers has long been domestic consumption.

The biggest bottleneck for India's true potential GDP growth, while still enviable at the current high single digit real GDP growth rate, has been seen as its poor infrastructure. Undoubtedly, there is tremendous potential for private equity opportunities in India as illustrated not only by growth equity but also the increasing number of control transactions and PIPE deals uniquely attractive for India.

Looking ahead, prospects for Asian private equity fundraising in 2011 are encouraging with a continued rise of Limited Partner interest in capturing the Asian 'growth story'. Already off to a busy start with a number of successful fundraises announced early in the year, it is anticipated that 2011 will see more incumbent GPs and new/first-time managers on the road to fundraise compared to last year.

peter.hwang@pinebridge.com



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Profile: Helen Tang

A partner in Moore Stephens Hong Kong, Helen Tang enjoys the challenge of meeting her audit clients' expectations.



Born and raised in Hong Kong until her teenage years, Helen completed her studies in the UK. After university she trained as a chartered accountant with a mid-sized London firm, where she gained her ACA. In 1990 she returned to Hong Kong and joined Moore Stephens, becoming a partner in 1998.

Though she has advised on a range of business issues and transactions, including public flotations and corporate restructuring, Helen is an audit specialist. "I love auditing," she says. "It exposes you to a variety of industries and it's satisfying to be able to meet clients' expectations. Client satisfaction is a top priority – whenever we receive a request from an overseas office or an existing or potential client, we make it a priority to respond promptly."

Helen's clients cover a wide range of sectors, including insurers, lawyers, restaurants and entertainment businesses, a mix of Hong Kong-based trading companies and multinationals with

manufacturing plants in mainland China. "Everyone wants to tap into the Chinese market," Helen says. "I also have many Chinese clients, from big listed companies to small trading companies. That creates particular challenges because there are some cultural differences between mainland China and Hong Kong." Apart from serving her clients, Helen is also vice-chairman of Moore Stephens Asia Pacific. "This provides a good channel for establishing relationships with other member firms," she says. "It's helpful for referring clients who need advise elsewhere."

Away from the office Helen is busy raising two sons, but also finds time to volunteer at a recycling plant, support a local orphanage and to dance. "My passion is Latin ballroom," she says.

helen@ms.com.hk

Office profile: Moore Stephens Hong Kong

Established back in 1975, Moore Stephens Hong Kong's early clients were principally maritime in nature, a reflection of the international firm's long relationship with the shipping industry. "While the firm still has considerable shipping expertise and acts for a number of substantial shipowners, ship operators and maritime service providers, our client base has expanded" explains Managing Partner Jim Fulton. "Clients range from global listed entities through to small, family-owned companies, covering a wide variety of sectors, including shipping, insurance, electronics, property development, textiles, clothing, solicitors, financial services, professional organisations – in fact most of the sectors found in a major financial centre."

Not surprisingly considering its location and relationship to Moore Stephens International, many of the firm's clients are

international, and they are winning a number of smaller listed company clients too. "An increasing amount of the firm's work has a North American connection, involving in the listings of Chinese companies," says Jim. "Enquiries also come in on a daily basis from Europe and North America about tax issues and setting up operations in China."

Since 1992, Moore Stephens Hong Kong has been very active in developing the Moore Stephens accounting and consulting network in China. "Virtually every new piece of work gained by Moore Stephens Hong Kong has a Chinese aspect," Jim says.

For more information please visit:
www.moorestephens.com