

Welcome to the June 2010 edition of Pragma's China Newsletter, written by Jesa



News from Jesa: **Investing in China, an Italian perspective**

On 2nd June 2010, *Intesa San Paolo Bank* held a conference in Shanghai about "*Sustainability, Energy efficiency, Urban System: new challenge for the development*", which allowed two different worlds and cultures to share their points of view.

Within 20 years, urban expansion will lead to 15 cities with more than 25 million inhabitants in the world. The Director of the Institute of Research on World Economy *Mr Xu Mingqi* criticized the western development model and blamed architects and developers to apply town-planning models that may not be suitable for China. The President of the Global Footprint Network *Mr Mathis Wachernagel* echoed *Professor Xu*, reminding us that we were currently consuming more than what our planet is able to create in one year. During the conference, the Shanghai World Expo 2010 was defined as "*the last Nineteenth-century style World Expo*" but I wonder how Milan 2015 will be able to be more up-to-date than Shanghai 2010, since Shanghai is dealing with essential matters such as the development of cities whose population outnumbers rural population.

To illustrate the opportunities of Chinese development, the current commercial relationship between China and Italy was given as an example during the conference. The President of Confindustria *Mrs Emma Marcegaglia* pointed out the positive attitude of Italian institutions that take into account the opportunities of this huge market was essential.

However, despite the fact that China has a lot of opportunities, I think that it is necessary to rethink the way of investing in this country. Although Italian institutions and creativity are necessary, it is difficult to exploit market opportunities without being physically present in the market.

Some days ago, a big commercial mission organised by *ABI, ICE* and *Confindustria* took several companies to China, with B2B meetings and conferences about how to do business in China. I am not sure that these kinds of missions are very efficient, since they take entrepreneurs to China who do not have a clue about this country, no long term strategy and who do not have the human and financial resources which are essential in order to succeed.

This is the reason why Jesa is currently developing a new approach, whose aim is to increase private equity fund activities and give investments the best chances of success.



by **Saro Capozzoli**
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What is Jesa?



Pragma's and
Jesa's logos in
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Jesa is a service company headquartered in Shanghai specialising in facilitating start-up of new industrial productions while providing reliable management and control solutions. We operate 4 main branches in China and a foreign office in Ulaan Baatar (Mongolia).

Since 1998, Jesa has built a team of 70 specialized employees in addition to 25 save technicians following "in loco" projects. Commercial relationships are exclusive and strictly confidential, ensuring the highest expertise on every single commercial and technical issue.

Jesa is a leader in managing manufacturing processes and eliminating any industrial and regulatory problems while helping our clients financial resources and time.

Jesa is currently expanding its services providing support to those companies seeking to develop distribution network and retail system in China as well as in Mongolia.

We also perform HR audit and investment analysis (trouble-shooting analysis) to verify performances in support to companies already established in China, and we provide tax and accounting consultancy.

The launch of the Margin Trading and Short Selling Pilot Program in China

"The margin trading and short selling pilot program has been running smoothly with a steadily increasing trading volume since its official launch", said Mr. Nie Qingping, the office director of the Margin Trading and Short Selling

Management Panel of the China Securities Regulatory Commission, at the China Fund Summit 2009 on April 9th 2010 in Beijing. According to China's current capital market reform, the margin trading and short selling pilot program is initially limited to six brokerages - CITIC Securities, Guotai Junan Securities, Haitong Securities, Guosen Securities, Everbright Securities and GF Securities. A second list of five additional brokers is going through the process of evaluation in the meantime, with approval to be expected within the next months. The securities regulator has chosen 90 companies - listed in Mainland China - as target stocks for the program, covering the top 50 Shanghai-listed firms and the top 40 Shenzhen-listed firms by market value.

Data from the stock exchange shows that the total amount of money borrowed for margin trading and short selling has experienced a period of steady increase since the official start of the program on 31st March 2010; taking into consideration the Shanghai Stock Exchange for instance, 5,886 million RMB were borrowed on March 31st, 22,077 million on April 9th and 50,664 million on April 23rd. However, an average day's trading volume for margin trading and short selling is less than the volume of a big market player. Still, - as Tycoons pointed out - the light trading volume in early stages of the program cannot refute the enormous business potential for margin trading and short selling. The current situation is also consistent with the Supervisor's intent to prevent risks in order to ensure a stable progress whenever a new product or business enters the market. In addition, the transaction performance up till now indicates that the security lending business makes up only a very small and symbolic fraction of the program. Compared to margin trading, security lending has greater market significance, since it is able to improve Chinese market efficiency. To this end, professionals suggest that regulatory arrangements and technical details be improved in order to promote investments in the security lending business under suitable conditions. The official launch of stock futures is expected to stimulate margin trading and short selling. Rational answer with limited trading volume at the early start. Practices from international markets show that the transaction volume of margin trading and short selling generally accounts for 15% to 20% of the whole market volume. Regarding Mainland China's market, however, this ratio is less than 1% at present.

This is due to several factors. First, investors are not familiar with the new business and most of them prefer studying the market instead of being involved at this point. Second, the expectation of the upcoming stock index futures makes market observers more prudent. Uncertainty in the macro policies baffles investors' judgment about market forecasts, which restricts leverage demand for margin trading and short selling. Third, according to the principle of risk control, in the current phase very strict limits were set in order to guarantee scopes and investment targets, which in turn influence investors' sentiment. Therefore, this pilot phase is the right progress as regarded by Supervisors. Even though the overall volume is small, there are signs showing that the business is being gradually accepted by the market. The accounts for the margin trading and short selling business have increased from 73 in the first day to 520 on April 9th. Analysts indicate that in such situations the trading volume is expected to have a rapid increase when there is a significant unilateral market. In addition, with the direct stimulation from the upcoming stock index futures, margin trading & short selling is coming in handy for the agencies to influence the futures market through the spot market. To date agencies' clients are mainly commodity futures players but this situation will probably change during the next years. Securities lending needs reform to break through the "bottleneck". However, the securities lending business has to face many policies and technical obstacles. The biggest problem in the current program is the small volume of security lending compared to margin trading (the latest data on the Shanghai Stock Exchange showed that the ratio between the two businesses is 5,000:1). Other problems are stock restrictions in security lending and high risks caused by expensive transaction fees. Security brokers have to offer security lending services by means of their own stocks and only 90 companies listed in Mainland China are selected as target stocks for the program. In fact, most brokers cannot even cover the list so far. The biggest controversy stems from brokers having to lend out their stocks to clients through short selling, this leading to the beat down of the price of their own stocks. If the quantity is large enough, this will seriously affect the market value of their stock pool. This activity is unreasonable and is against the brokers' interests.

Shanghai Expo: some figures



The UK Pavilion known as the "Seed Cathedral". Its wooden structure is pierced by more than 60,000 acrylic rods containing a variety of seeds from different plants.

Shanghai World Expo 2010 has been defined as the biggest Expo ever in the history. The theme "Better City Better Life" expresses the interest that the international community has for urban strategies and possible development.

Here are some numbers about this Expo:

- Covered area: 5,28 square km;
- 200 participating countries;
- 50 International organization;
- 70 million of visitors are expected during the 6-month exhibition;
- 72.000 volunteers are working in the Expo area, other 100.000 in the service centres across the city;
- Up to 10th June 2010, 12 million people have visited the Expo area.

However supervisors are aware of the issue: the China Securities Regulatory Commission Offices said that in the future, fund managers will choose the securities for short selling. In mature markets such as Europe and the US, security brokers only act as intermediaries in security lending and target stocks are mostly owned by long-term stock holders. There are two ways to tackle policy obstacles: one is to switch the trusteeship system from the clearing broker to the security broker in order to expand the source of short selling. Unfortunately, considering the current management level and bad history, this is nearly impossible to realize. Another way is to set up a third party that will integrate the functions of assessment, assurance and intermediary. This company will become the middleman among capital, security categories and demanders of the margin trading and short selling service. It will undertake customers' credit risk assessment and provide assurance service. In recent years, fund products have been very similar and performance depends mainly on market situation. The interest of fund investors to invest in long-term investments has decreased. However, with the launch of margin trading, short selling and stock index futures, there will be new hedging tools available: investment returns on long-term products will be relatively stable and fund investors will be more focused on operational abilities, rather than market index opportunities. Of course, the launch of margin trading, short selling and stock index futures cannot change the long-run direction of the market and the introduction of short-term hedging mechanisms cannot make complete changes to its operational features.

Anyway, the supervising institution actively introducing these two innovative businesses aims to enhance the development of China's capital market, and has an obvious intention of building a better and stronger A-share market. Therefore we believe that these two innovative businesses will have positive effects and will become milestones of China's stock market development process.

The Chinese Economy - First Quarter 2010 Results

According to the preliminary estimation, the gross domestic product (GDP) of China in the first quarter of this year was 8,057.7 billion yuan, a year-on-year increase of 11.9 percent, which was 5.7 percentage points higher than that in the same period last year as Li Xiaochao, spokesman of the National Bureau of Statistics of China has reported on 15th April. He also listed the following achievements for the Chinese economy for the first quarter:

- The agricultural production was good with increased acreage of grain crops.
- Industrial production picked up with a substantial increase in economic efficiency of enterprises.
- Investment in fixed assets increased rapidly and that in real estate continued to accelerate.
- Sales on domestic markets enjoyed steady and fast growth and the new areas for consumption increased rapidly.
- The year-on-year consumer prices went up while producer prices for manufactured goods increased rapidly.
- Foreign trade recovered rapidly and trade deficit was seen in March.
- The urban and rural population's income continued to grow with rapid growth in income transfer.
- The growth rate of money supply dropped from the high level while the newly increased credits declined as compared with that a year ago.

This brief summary makes some relevant points, but is far from painting the whole picture.

China posted a \$7.24 billion trade deficit in March, its first in almost six years, the official Xinhua News Agency reported, citing customs figures. Although the return to deficit after many years of surplus could help ease pressure on China to allow the value of its currency to rise against the dollar - a key source of contention with the US and other developed trading partners - Chinese officials, including China's minister of commerce, Chen Deming, described March's deficit as only temporary. Although part of the rebalancing package as suggested by the IMF, Chinese officials still resist pressure to allow the yuan to rise in value, saying the trade sector remains weak and prey to weaknesses elsewhere. 'China must be prudent about the outlook for exports as the risk of a double-dip slowdown in world economic growth exists'-said chief engineer of the Ministry of Industry and Information Technology, Zhu Hongren at a press conference. 'Pressure to appreciate the RMB from some developed countries may also have a negative effect on Chinese exporters'-Zhu added.

Zhang Liqun, a researcher with the State Council's Development Research Center said that the country's economy was not yet on a path of sustainable growth as domestic demand still largely relied on government incentives. Zhang said that China needs to expand consumption demand by readjusting income distribution and stepping up urbanization. Economic restructuring and a change of growth model at the same time should be promoted for longer-term sustainable growth.

Above mentioned, at the same time an urbanization process is taking place as tens of millions of workers have been laid off during the global financial crisis. Many of them are leaving their native villages, drifting back to the cities, where they are not however finding as many openings as needed which led to an unemployment rate of 4.2% for the first quarter as reported by Xinhua News Agency.

Another problem arising - as pointed out by Stephen Green, Standard Chartered's head of Greater China research in Shanghai - is that Chinese central planners could be faced with an asset-price bubble in the second half of the year that could trigger a sharp credit contraction in 2011 unless growth is coaxed onto a more sustainable pathway. Although a lot of experts share this idea, the IMF sees this jump in prices as a sign of healthy growth, rather than a real estate bubble.

On the inflation front, March's consumer price index was 2.4% higher than a year earlier, easing slightly from a 2.7% rise in February. Meanwhile wholesale prices for the month were up 5.9% year-on-year, compared to a 5.4% rise in February.

Regarding the future for potential investors in China, James McGregor, a bestselling author on China business says 'There is no market like China in the world. It is a continental-sized market that has another billion people to reach the middle class. If you develop a product here and could scale it up enough, you can be a global winner.' In a number of ways, doing business in China has become easier in recent years because business practices have become more established and there is a better legal framework. Still there is a sense among some in the foreign business community that regulations and rules are selectively applied to the advantage of Chinese companies. Other set-backs exist as well, like China's indigenous innovation policy, which has a clause to allow re-innovation of foreign technology. This policy is a barrier to intellectual property protection that discourages innovation in China. Still, many foreign companies now have little choice but to enter China since it is emerging as the really key market of the 21st century.

Last but not least, a survey conducted by the Development Research Center of the State Council through its Chinese Entrepreneurs Survey System (CESS) reveals that nearly 80 percent of Chinese entrepreneurs view rising costs of raw materials and labor as the biggest challenge for the future.

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