



China's Economic Stimulus: An update

Ongoing Opportunities for Foreign
Investors

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16 July 2009

INTRODUCTION TO APCO

APCO Worldwide is a global consulting firm and a leading provider of corporate advisory, government affairs, and strategic communication services in China. We have been serving clients in China since 1989. Today, our China team includes over 100 employees from a diverse range of backgrounds, including business, government, journalism, academia and civil society. We maintain well-established offices in Beijing, Shanghai, Guangzhou and Hong Kong.

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EXECUTIVE SUMMARY

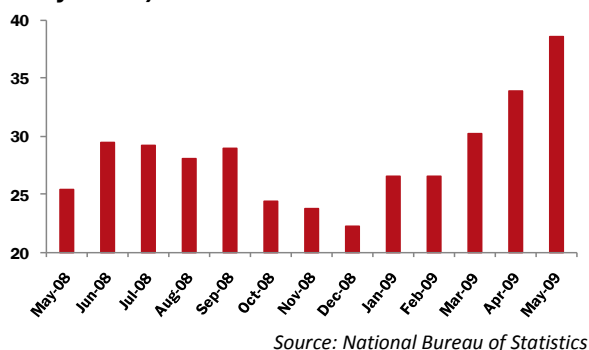
- In recent weeks a mood of cautious optimism concerning China’s economic growth prospects has started to take hold. The result has been the upward revision of many analysts’ 2009 full-year GDP growth forecasts, and a stronger Q2 2009 GDP growth result of 7.9 percent (compared to 6.1 percent in Q1 2009).
- Such optimism is a result of the government’s stimulus package and associated measures, the impact of which can be seen in the explosion of fixed asset investment (FAI) that has occurred in recent months. From January to May 2009, fixed asset investment (FAI) increased 32.9 percent in comparison to a year earlier.
- The stimulus funds have not taken the form of traditional government fiscal pump-priming but instead have come mainly from bank loans. From January to April 2009, new loans of RMB 4.58 trillion were created, nearly as much as the whole of 2008.
- An analysis of FAI by sector shows the funds have flowed into the prioritized sectors of infrastructure, energy transmission and distribution, social housing, environment management, health care and social security.
- The direct effect of this increase in funding across China’s regions can be seen in China’s Q1 2009 GDP figures. In this period while GDP growth was stable in eight central provinces and decelerated in 11 coastal provinces, growth accelerated in China’s 12 western provinces indicating stimulus funds and projects have had the most impact in China’s less developed regions.
- The main beneficiaries of stimulus funding have been Chinese companies, particularly state-owned enterprises (SOEs). However, opportunities for foreign-invested enterprises (FIEs) remain available. Companies such as Caterpillar, Siemens and MTR have led the way winning large stimulus related contracts across a range of sectors.
- A prerequisite for FIEs wishing to access opportunities arising from the stimulus is understanding the project approval and allocation process. FIEs must also have well-developed government relations strategies both at the national and provincial levels.
- The recently released ‘buy Chinese’ order will not exclude goods produced by FIEs in China. However, it is likely to increase pressure on officials to buy Chinese wherever possible.

THE STIMULUS TAKES HOLD

As spring has quickly given way to another sweltering Chinese summer, a mood of cautious optimism concerning China's economic prospects has replaced the pessimism that gripped forecasts in the winter months. Despite a GDP growth rate of 6.1 percent in Q1 2009, the lowest in a decade, many analysts are now predicting full-year growth close to the Chinese government's often-predicted target of 8 percent. For example, the World Bank has revised its full year 2009 GDP growth forecast from 6.5 percent (predicted in March 2009) to 7.2 percent, while recently released Q2 GDP figures for 2009 show the economy grew at a robust 7.9 percent.

This change in sentiment has come about largely as a result of the government's stimulus package and associated measures, the impact of which can be seen in the explosion of fixed asset investment (FAI) which has occurred in recent months. From January to May 2009, FAI rose 32.9 percent in comparison to a year earlier, and the increase seen in May of 38.7 percent is amongst the highest at any time in the last 10 years.

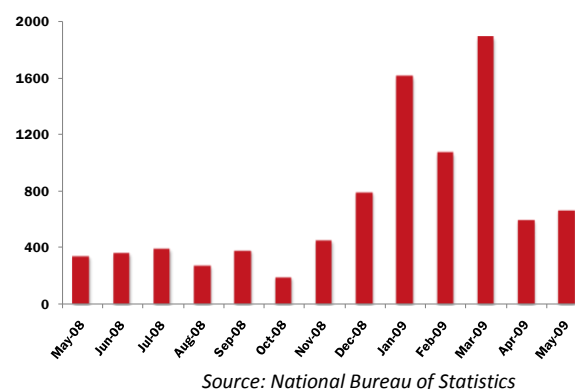
Chart 1: OYA % Increase of FAI (May 2008 to May 2009)



This investment is fundamental to China's current economic momentum. With the sharp downturn in exports that occurred in recent months (from January - May 2009 exports declined by 21.9 percent in comparison to the same period in 2008) and the ongoing limitations to private Chinese consumption, massive government-led investment is now the key driver of economic growth and central to the government's efforts to 'bao ba.'

This investment has not, however, taken the form of a traditional fiscal pump-priming programme with the majority of funds instead coming from bank loans. The expansion of credit has been unprecedented, with nearly as much lent in the first three months of 2009 (RMB 4.58 trillion) as was lent in the whole of 2008 (RMB 4.9 trillion). Any concerns over funding that may have existed when the first details of the stimulus package were announced in November 2008 have been answered with a seemingly unlimited supply of credit from China's state-controlled banking sector, acting as the financing agent of the government.

Chart 2: New Loan Creation, Billion RMB (May 2008 - May 2009)



However, it should also be noted that new loan creation, while still high, slowed significantly in April and May to under half the level seen in March. Concerns over long-term structural risks to the Chinese economy were reflected in comments by Liu Mingkang, chairman of the China Banking Regulatory Commission, who warned banks, "To pay close attention to mounting risk from the recent lending surge."

WHERE ARE THE FUNDS FLOWING?

Sectors - An analysis of FAI by sector gives a good indication of where much of this massive new pool of money is flowing. Not surprisingly, given the well-documented priorities of stimulus spending, the biggest increases in investment were in the infrastructure, energy transmission and distribution, social housing, environment management, health care and social security sectors.

The most significant increases were in transportation-related infrastructure projects, particularly in railway infrastructure. Fixed investment in railways increased by 94.2 percent from January to April 2009 over the same period last year. In other crucial sectors such as real estate, which accounts for 20 percent of total FAI in China, investment has started to accelerate rapidly. After bottoming out at 1 percent oya growth in January and February of this year, fixed real estate investment picked up to 12 percent oya in May. This is still a long way off the highs seen in previous years but nonetheless represents a significant recovery.

Table 1: OYA % FAI Increase by Sector (Jan 2009 – April 2009)

Sector	Jan-Apr OYA Increase
Railway Transportation	94.2%
Highway Transportation	50.2%
Urban Public Transportation	50.6%
Air Transportation	34.9%
Energy Related	18%

Source: National Bureau of Statistics

Regions - In terms of where funds are flowing geographically, China can be split into three broad regions – western China, central China and the coastal provinces. Although funds have been invested widely, it appears the major focus of spending has been in China’s central and western regions (*i.e.*, those regions where infrastructure is most under-developed and therefore where projects to support China’s long-term economic development are most easily available). An analysis of Q1 2009 GDP data in these regions also suggests they have benefited the most from the stimulus package. While GDP growth in this period decelerated in China’s 11 coastal provinces and was stable in China’s eight central provinces, growth accelerated in the 12 western provinces. However, it should also be noted that China’s coastal provinces have been far more adversely affected by the slowdown of their export industries, which are less developed in more inland regions.

Chart 3: Q1 2009 GDP Growth by Region



Source: Caijing

In May, the National Development and Reform Commission (NDRC) reported some of the tangible results of this new investment in the 6-month period following the announcement of the stimulus programme in November 2008.

Affordable Housing

- 214,000 affordable housing units completed
- 650,000 affordable units under construction

Rural Infrastructure

- Clean drinking water supplies for 14.6 million rural households provided
- Construction of 20,000 kilometres of rural roads completed

Infrastructure

- Work started on several new railway lines
- 445 kilometres of expressway completed
- 100,000 square metres of new airport terminals completed

Health care and Education

- 6,500 community and village clinics opened
- 150,000 square metres of middle school classrooms in rural areas upgraded

Environment

- 2 million hectares of afforestation
- New sewage plants with capacity of 2.83 million tonnes a day completed

Innovation

- 176 high-tech projects started
- 146 technology-upgrading projects started

WHO HAS BENEFITED SO FAR?

The biggest winners from China's economic stimulus package so far have been domestic Chinese companies, particularly SOEs whose combined investment has increased by 40.6 percent year-to-date over the same period in 2008. A preference for domestic goods and services under the stimulus package, widely predicted when the stimulus was first announced in 2008, was recently confirmed by a government circular issued in early June which mandates that where possible all products and services for government invested projects must be domestically sourced. This has quickly become known as the 'buy Chinese' order.

However, as confirmed by the NDRC, such a preference does not exclude goods produced by 'legal branches of foreign companies in China' and after the notice was released there has been evidence that national and provincial government agencies are continuing to buy foreign products. For instance on June 12th it was announced that both BMW and Mercedes (through their local JVs) had been added to the 2009/2010 central government procurement list.

There is also evidence that a number of FIEs have either already, or expect in the future to benefit significantly from the stimulus programme:

- James W. Owens, CEO of Caterpillar, said that in recent months the company's sales of excavators in the Chinese market hit its highest level in history, reversing the sharp drop seen in winter sales.
- Siemens has predicted that in the years 2010 to 2012 the Chinese stimulus programme will contribute to an RMB 20 billion increase in revenue for the group, accounting for 14 percent of increase in global revenue. Of this RMB 20 billion, half of all orders will come from energy conservation and environmental protection projects.
- Major contracts won by Siemens this year include the provision of signaling, train control and propulsion systems for China's first intercity mass transit - the Guang-

zhou-Foshan Line, a RMB 70 million contract with Weikang Medical Group to supply medical equipment and a RMB 100 million plus equipment supply contract with Hebei Iron and Steel.

- MTR, the Hong Kong mass transport constructor, has recently signed an agreement estimated to be worth up to RMB 30 billion for the construction, operation and maintenance of Shenyang's municipal subway system.

NEGOTIATING THE PROCUREMENT PROCESS - THE KEY TO ACCESSING FUNDS

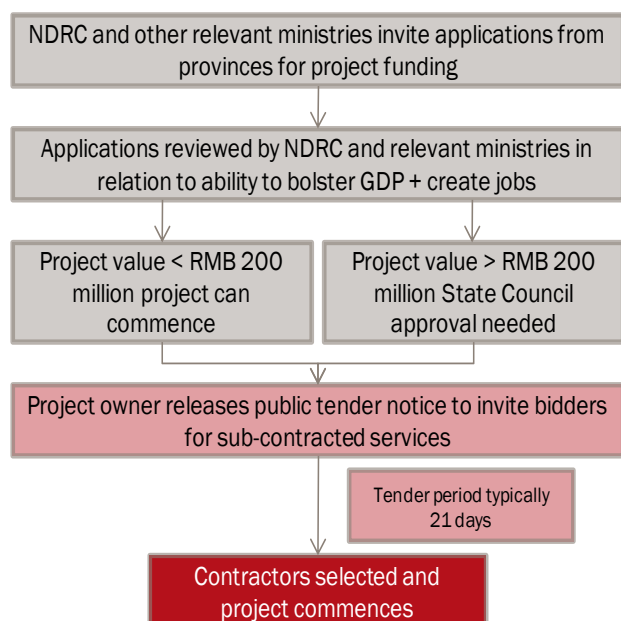
The question, therefore, is how have some firms been successful at accessing projects and funding while others have experienced difficulty?

The key for international firms seeking to benefit from opportunities arising as a result of the stimulus, and Chinese government-invested projects in general, is to have a well crafted government engagement strategy and understand the project allocation and procurement process. This is no easy task but remains a prerequisite to success. Although the issue of economic nationalism will remain an ongoing concern in this process, FIEs should seek to identify where capability gaps among Chinese firms exist.

For instance, as seen with the examples of both Siemens and MTR above, international manufacturers of locomotives, advanced signalling equipment and tunnelling equipment for China's massive railway and urban metro transport schemes are well-placed as domestic Chinese companies often lack the required skills and technology in such areas.

Companies seeking to access opportunities from the stimulus must carefully monitor both project approvals and the issuance of public procurement notices. Once a project is approved, the intervening period between approval and the issuance of public procurement notices for sub-contracted services is crucial as it allows companies to engage with relevant decision-makers and position themselves for when a final decision is made.

Chart 4: Investment and Allocation Process



RECOMMENDATIONS FOR FIEs

Monitoring of Project Approvals and Tenders: At present, every week hundreds of projects are being approved and public procurement notices issued. Monitoring these approvals and notices is essential as they hold the key to new business opportunities. Early reaction to project approvals will allow FIEs to engage with relevant decision-makers and be well-positioned when any final decision on the procurement of sub-contracted services is made.

APCO currently monitors over 60 websites daily to collate approval and tender notices. We also use our range of contacts across national and provincial governments to keep informed of the latest project opportunities available. We are able to produce a weekly database of such opportunities searchable by industry sector and geographical region. This allows our clients to stay ahead of the game, and well positioned to win new business flowing from stimulus investments.

Government Engagement Strategy: Engaging with the Chinese government has never been more important. Not only is massive government investment the major driver of China's current economic growth, but increasing protectionist pressure stemming from official

concerns over rising unemployment is a real challenge for any FIE seeking to do business in China. Consequently, understanding priorities and demonstrating the contribution your products and services can play in helping meet stimulus goals is essential. As such, having a carefully crafted government engagement strategy is key in helping identify business opportunities and crucially turn these opportunities into sales.

APCO has tailored government relations strategies for many of the world's leading companies in China. These strategies have helped our clients win significant government invested contracts across a range of sectors. APCO can map the stakeholders who matter to your business, develop channels and strategies to engage with decision makers and provide ongoing counsel on policy and regulatory developments.

Provincial Strategies: As well as helping FIEs engage with decision makers at the national level APCO has also helped our clients develop relationships across China's provinces. Increasingly, we are seeing substantial variations in policy implementation, funding allocation and procurement management at the provincial level. Understanding these often "under the radar" variations is crucial in accessing the stimulus funding, as it is at this level that investment is being realized and project opportunities are arising.

APCO can provide regular monitoring of developments at the provincial level, research reports mapping key stakeholders with engagement recommendations and market studies of opportunities throughout China.

APCO CONTACT DETAILS

For more information on any of the information contained in this briefing or how APCO can assist your business develop strategies to benefit from China's economic stimulus package, please contact:

<p>BEIJING Sharon Ruwart, Managing Director 16th Floor, NCI Tower 12 A Jianguomenwai Avenue Chaoyang District Beijing, China 100022 Phone: +86.10. 6505.5127 Fax: +86.10.6505.5257 sruwart@apcoworldwide.com</p>	<p>SHANGHAI Murray King, Managing Director 2102 CITIC Square 1168 Nanjing Road West Shanghai, China 2000041 Phone: +86.21.5298.4668 Fax: +86.21.5298.4669 mking@apcoworldwide.com</p>
<p>GUANGZHOU Ouyang Jun, Chief Representative Room A1309, Center Plaza Tower A 161 Linhe Xi Road, Tianhe District Guangzhou, China 510620 Phone: +86.20.3825.1955 Fax +86.20.3825.1016 jouyang@apcoworldwide.com</p>	<p>HONG KONG Larry Snoddon, CEO and Managing Director 9/F, Cambridge House, Taikoo Place 979 King's Road Hong Kong Phone: +852.2866.2313 Fax: +852.2866.1917 lsnoddon@apcoworldwide.com</p>