

IN THE SPRING of 1997, a colleague and I spent a week conducting legal due diligence in Jinan, Shandong province, trying to come to grips with extremely heavy Shandong accents and obscure power generation vocabulary to verify a prospectus for an impending Hong Kong initial public offering. After several day-long management interviews punctuated only by respites of fried chicken sandwiches brought in from the local KFC, we desperately needed a change of scenery.

On our final day, we moved quickly through a short morning session and asked the directors of the company what local attractions we should squeeze in before our flight the next day. Without hesitation, our hosts recommended that we take in the Yellow River.

According to them, it embodied the spirit and strength of the Chinese people and was something that all Chinese people should see.

We excitedly packed the two tons of documents we had collected, jumped in to a taxi, and with an enthusiastic wave to our hosts, were off. Having endured interminable traffic, we rounded the corner from the parallel frontage road we were on, and finally set our eyes upon the mighty Yellow River.

Behold, to our great surprise and disappointment, the Yellow River — known both as China's pride for its fecundity and the country's sorrow for its incredible destructive power — was irrefutably dry. OK, not as dry as a desert but certainly parched enough to walk across on our bare feet, which we did. We took turns snapping each other's photos for proof to potential doubters but sadly, we have never had any problems convincing people that it was true.

Years of over-utilization and indifference

“Foreign players should be encouraged to build and run water treatment facilities in local municipalities”

Tap in to the water sector

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to water resources management has contributed dramatically to the increasing duration and total area of dry-out on the Yellow River. In the year of our visit, the Yellow River failed to reach the sea for 226 days. At one point that year, the Yellow River trickled to a complete stop 780 kilometers upriver from the river mouth.

Unfortunately, this is only one example of water resource neglect. The examples are far too numerous for this article but by conservative estimates, more than 50 percent of the rivers in China are too polluted to serve as sources of drinking water, and about one third are too polluted even for industrial or irrigation purposes. An unsustainable situation no matter how one looks at it.

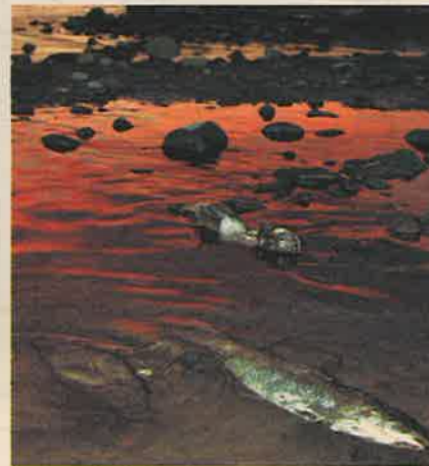
What makes the situation even more dire is that, to begin with, the mainland is not exactly overflowing with freshwater. On a per capita basis, China claims just 1,856 cubic meters of water per person, compared with a world average of 6,895 cubic meters per person.

There is guarded optimism that a step change in attitude within the central government leadership is taking place.

Some argue that the unwanted international attention given the massive benzene spill in the Songhua River (pictured right) and the subsequent laughable cover up attempt downstream by the Harbin city officials helped convince the central government that the status

quo was no longer acceptable. Whatever the reason, since the beginning of this year there have been increasing signs that the government is trying to take a more balanced approach to growing the economy. The 11th Five Year Plan establishes a target to reduce pollution discharges by 10 percent by 2010. There has also been a noticeable increase in the rhetoric from the State Environmental Protection Agency and the official Xinhua news agency directed at combating pollution.

Assuming that this shift in thinking translates to action, one obvious place the government should start is requiring local governments to install and operate standardized wastewater treatment facilities. At the same time, the government should create an envi-



ronment whereby foreign players are encouraged to build, operate and transfer facilities and technology to local municipalities.

A company well-positioned to take advantage of a new Chinese environmental consciousness is the French Veolia Environment (VIE FP).

Veolia, through its water division Veolia Water, is arguably the world's leading water services company. Veolia Water specializes in the outsourced management of water services for municipal or industrial customers.

It is a world leader in engineering, design and execution of construction projects for turnkey facilities, and water treatment plants. As of today, Veolia has 18 contracts in the mainland including deals with major cities such as Shanghai, Shenzhen and Kunming.

The 30-year contract with Kunming signed at the end of 2005, is set to generate revenues exceeding 1.6 billion euro (HK\$15.9 billion) over the period. In January, Veolia Water announced the signing of a partnership contract with Beijing Yanshan Petrochemicals (a subsidiary of Sinopec) to operate facilities to collect, treat and recycle industrial wastewater at a site located 50 kilometers southwest of Beijing. Under the 25-year pact between Veolia Water and Sinopec, the joint-venture will be managed by Veolia Water and will generate estimated revenues of 580 million euro.

Veolia Water's track record and recent mainland deals are particularly impressive considering that it did not sign its first contract in the country until 1997.

I, for one, hope that they continue to announce contracts at their current pace, if not for them and a positive return on investment, then for the hope of one day seeing the Yellow River the way it was described to us.

EXPERIENCE HAS SHOWN me that valuation, liquidity and momentum combined can always move a market.

Since last December, these three factors have conspired to send the shares of China plays back up close to the peak reached in August 1997.

Although the mainland's economic growth has been on a tear for years, the bull market in China plays only began last July, after Beijing allowed the yuan to rise for the first time in a decade.

This year, every retreat should be seen as a buying opportunity. These are times to test your fishing skills.

Liquidity is always the trigger for reviving a long-slumping bear market like China's. Counting both household savings and corporate deposits, the cash parked in the country's top five banks waiting for the good opportunities amounts to 80 percent of annual gross domestic product.

No one knows how much cash is squirreled away outside the formal financial system.

International hedge funds constitute another reservoir in waiting.

A recent report by Goldman Sachs found that the portfolios of emerging market long-only funds are on average 12 percent underweighted on China compared with the MSCI Emerging Markets Global

Make a move on mainland firms

Yang Liu

Lead manager of Atlantis China Fund and chairman of Atlantis Investment Management (Hong Kong)



“Baoye Group, a builder listed in 2003, has generated returns above 1,000 percent”

Index. How many people really achieved decent returns from China in the past three years? You really do not want to miss the next rally. This time around, it will be powerful and durable!

Now the market is filled with big-name Chinese enterprises, including the three dominant telecommunications companies, three oil giants, three large insurers and three big banks.

The state will not allow any of these companies to collapse. The question is how to make money off them.

The yuan has risen about 3 percent against the US dollar over the past 10 months and will pass the Hong Kong dollar peg of 7.75 to the US dollar sometime in the next year.

Beijing's move to license “qualified institutional investors” from abroad to invest domestically, and locally to invest abroad, has created new opportunities for arbitrage

among the select few already credentialed.

Over the past 15 years, the mainland has produced a steady bounty for the Hong Kong market. Privately-organized companies have nearly become a must-own asset class. Most are still small, but there are more than a 100 to choose from.

Baoye Group, a Zhejiang Province builder listed in June 2003, has generated returns exceeding 1,000 percent for its early investors.

Even passive investors in Tsingtao

Brewery, which became Hong Kong's first H-share listing in July 1993, have seen their shares go up 250 percent, proving that state-owned enterprises can be profitable too. The Hang Seng Index will open its doors to H-shares in August and these are likely to quickly dominate the blue-chip benchmark.

It is possible, too, that global fund investors will soon create an independent asset class for Chinese equities as is true for Japanese stocks.

It is worthwhile spending time to understand why a company listed on different exchanges can be valued much more highly on one than another, and how you can benefit from such gaps.

The Chinese market has always been characterized by volatility and that will not change for the foreseeable future due to its nature and size.

The key is to maximize the potential upside and minimize the downside.

