ASIA PERSPECTIVE

China Economic Update Report

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This Issue

The Expected Recovery Stumbled

China's GDP rose 7.7% year-on-year in the first quarter of 2013, declined 0.2 percentage points quarter-on-quarter, and it was 0.3 percentage points lower than expected. Total retail sales of consumer goods rose 12.4% year-on-year, contributing 4.3 percentage points to aggregate GDP growth.

In May exports grew with 1% year-on-year, which compared to previous month's 14,7% growth, is significantly lower. The drop in May came right after the government instituted a sweeping crackdown on trade invoices and capital flows. China recently tightened the restriction on fake export invoices used to hide money flows, cutting the nation's trade figures, revealing subdued global demand that will weigh the economic growth. On May 5th, the administration of Foreign Exchange announced that it would send out notices to companies whose goods and capital flows do not match as well as those bringing large sums of cash into the country.

In June, new loans jumped to the highest level in almost two years as shrinking capital inflows led to a cash squeeze before the Dragon Boat Festival. The one-day repurchase rate, which measures interbank funding availability, climbed 253 basis points, or 2.53 percentage points, to 8.68% in Shanghai, the biggest jump since July 2011 according to a weighted average rate compiled by the National Interbank Funding Center.

FDIs increased in Q1 2013

In the first quarter of 2013, Chinas total FDIs increased with an annual percentage of 1.44% from US$ 29.47 billion in the first quarter of 2012 to US$ 29.9 billion in the first quarter of 2013. The monthly FDI data was higher than expected with an increase in February and March on 6.3% and 5.7% respectively, breaking the trend of 15 months negative or flat growth.

During the first quarter, FDIs into the western region of China increased by 20% year-on-year, with the central and eastern regions experiencing a relatively flat development.

FDIs from the U.S increased by 18.5% while FDIs from the EU surged by 45% year-on-year in the first quarter of 2013.

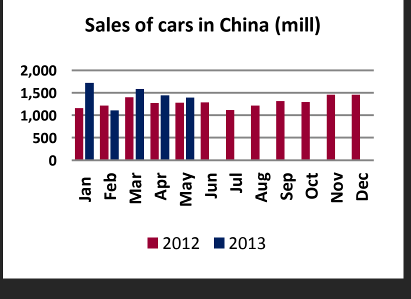
In April FDI inflows into China amounted US$ 8.4 billion, up by 0.4% year-on-year, the lowest level in three months, influenced by China's rapidly increasing labor costs and uncertainties in the economy.

Unexpected Growth in the Chinese Automotive Industry in Q1 2013

The Chinese automotive industry for passenger vehicles saw high growth for the first quarter of 2013, beating both the forecasts set by the government and the industry.

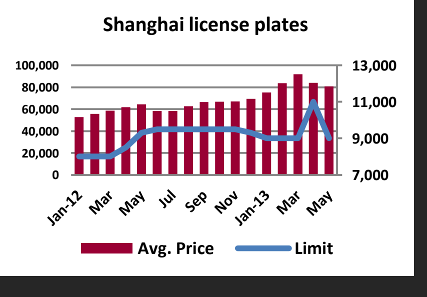
The government and industry forecast for 2013 are 8% and 10% respectively, and they still remain, indicating that neither the government or the auto-motive industry expects the first quarter's high growth to continue. The growth from actual sales spiked to approximately 50% in January followed with a drop in February of 8% before increasing again in March to 15% year-on-year.

The rapid growth in January and March have already generated an overall growth rate of 5% compared to the sales in 2012, even if the rest of the year stays at 2012 levels.



The production and sales of automobiles in China in March helped drive the total figures for the first quarter of the year past the 2-million mark for the first time in history. In March, 2.09 million units of automobiles were sold, up 10.9% year-on-year, while 2.04 million units were produced, a 10.7% increase year-on-year.

In tier 1 cities, the passenger vehicles growth this quarter are mainly a result from increased purchasing power among consu-mers, but also a result from newly implemented policies. Major cities have now limited the quantities of car license plates available for purchase each month. For Shanghai the number is limited to 9,000 plates in May, a drop by 2,000 from April. This leads to an increased number of older cars being scrapped so that owners can sell the license plate and instead buy a new low cost car from the sale, using a second tier license plate. License plates from second tier cities can be bought in Shanghai for a much lower price, but it limits the owners to only drive on ground level during rush hours - elevated highways are only for Shanghai registered license plates during rush hours.

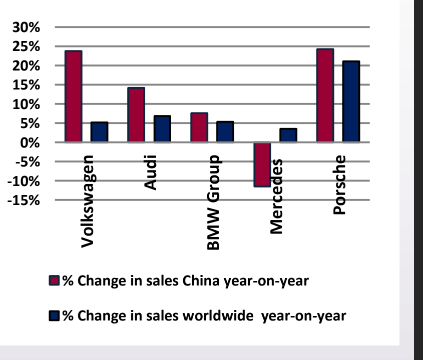


The result of this policy is that the average cost of a Shanghai license plate has risen to 85,000 CNY, and almost 50% of car sales were low priced domestic cars.

Overall, the automotive industry for passenger cars in China had a strong quarter and China will remain the largest market for car manufactures.

China is about to become the most important market for German carmakers

Sales of German cars rose first quarter of 2013 in China, with the only exception being Mercedes who saw a decline in sales.



Volkswagen increased the sales in China with 23.7% year-on-year while the sales in Europe declined by 10.2%, making the European market only two-thirds the size of the Chinese market.

Porsche, part of the Volks-wagen group, also had a strong start in 2013 with a sales incr-ease of 21.1% worldwide and an increase in China of 24.2%.

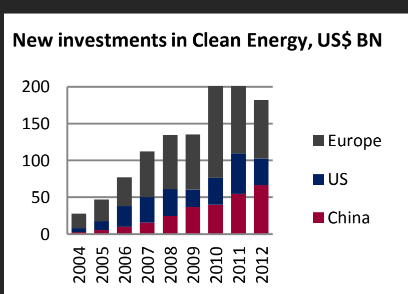
Also Audi reported strong growth in the first quarter of 2013. The growth rate in China was more than double their worldwide growth rate.

In Q1 2013, the global sales for Mercedes Benz increased 3.5%, while China sales decreased by 11.5%. China remains the third most important national market for Mercedes Benz following the US and Germany.

Q1 Hit the Lowest Level of Investments in Cleantech (Worldwide) Since 2009

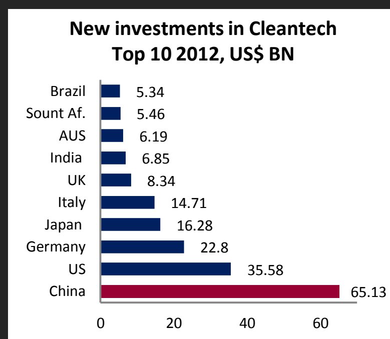
In the first quarter of 2013, new investments in Cleantech worldwide reached its lowest level since 2009, according to Bloomberg. The first quarter investments amounted to US$ 40.6 billion, down 22 percent from the same period 2012.

The decline was manifested in a significant drop in average deal size as well as deal volume. The decline reflects the effects of policy uncertainty in key clean energy markets such as the United States and Germany. It is also a result from a slowdown in financing in some relatively buoyant markets such as Brazil, and a drop of investment levels caused by the recent sharp decline in technology costs, particularly those of solar panels.



During Q1 2013, investments in China dropped 15%, while Europe and U.S dropped 25% and 54% respectively year-on-year. When excluding India and China, the rest of Asia bounded the negative trend with an increase in Cleantech investments of 47%, jumping to US$ 10.1 billion, mainly driven by the high activity among Japanese investors.

Despite the drop during Q1, Cleantech investments in China has experienced strong growth in recent years, going from US$ 2.6 billion in 2004 to US$ 65.1 billion in 2012., which is the steepest and most consistent growth among the G20 countries.



In 2012, China accounted for 27% of the total Cleantech investments among the G20 nations, adding 23 GW of renewable energy capacity, or 25% of the world's newly installed capacity.

Chinese Cleantech investments went primarily into Solar energy, increasing from US$ 13.9 billion in 2011 to US$ 25.7 billion in 2012. Wind, meanwhile, saw a small rise from US$ 26.8 billion to US$ 28.1 billion as some projects were delayed because of grid connection issues. The surge in China's solar development came as Beijing trimmed it's national feed-in tariff, but falling system costs enabled developers still to see a return. Furthermore, oversupply in the industry worldwide opened for the manufacturers in China to develop new projects in their own country to take up some of the slack.

Chinese companies moves assembly abroad to avoid EU solar panel tariffs

With Europe and China still negotiating the planned import tariffs on Chinese solar PV panels (averaging as much as 47%), Chinese manufacturers have started to assemble their solar panels overseas in order to maintain their low-cost advantage.

Among the Chinese companies preparing move assembly overseas is Trina Solar Ltd., JinkoSolar Holding Co. and Canadian Solar Inc. By shifting assembly location the Chinese companies will avoid the tariffs and keep their competitive low prices on the European market. The tariffs represents one of the biggest anti-dumping actions made by the EU to date.

Change in governmental financial incentives in Electric Vehicles

Among many Cleantech initiatives taken by the Chinese government is their commitment to develop the usage of electric vehicles (EV) as a replacement to regular cars. As of 1st of April 2013, China had some 39,800 EVs on the roads, whereas 80% of these were used for public transportation. In an attempt to increase this amount, and to make China less dependent on oil, gas and coal, the govern-ment has planned to phase out direct financial incentives of purchasing EVs. Focus will instead be on supporting EV manufacturer's R&D activities in an attempt to lower the cost for manufacturers, making an EV purchase more attractive for the consumers while also giving incentives to the supply side.

China's E-commerce Market sales reaches US$ 57 Billion in Q1 2013

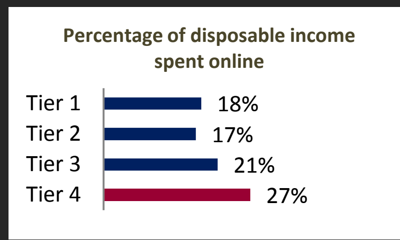
China's e-commerce market has increased steadily in recent years. In 2012, e-commerce sales reached an estimated US$ 190 billion, almost equaling the U.S market, which currently is the largest in the world. China's online retail industry is expected to grow to at least US$ 420 billion by 2020, which would account to more than the total combined markets of U.S, Japan, U.K, Germany and France. The e-commerce market in China has grown 120% annualized since 2003, while the US market in the same period has grown 17%, albeit from a higher initial volume.

Today, more than 70% of China's e-commerce business is customer-to-customer, mainly derived from a few leading sites such as Taobao and Paipai.

In Q1 2013, the online shopping market in China reached a total sales of US$ 57 billion, an increase of 37% compared to the same quarter last year.

E-commerce is also driving consumers to buy new products, especially in lower-income cities where physical retail stores, if at all present, do not offer the same broad selection as online market-places.

A recent study has shown that the percentage of disposable income spend on e-commerce is much higher in tier 4 cities compared to the other tiers.



This offers a large potential for further market expansion, and many of the large e-commerce sites are setting up distribution centers in tier 3 and tier 4 cities to decrease the delivery time and increase service in these areas.

While enjoying high growth rates, the Chinese e-commerce market is still underdeveloped compared to the US market. Currently, online sales account for less than 6% of China's total retail market, compared to 10% in the US. However, this percentage increases fast in China and is expected to reach 10-16% by 2020.

The Chinese online market is fiercely competitive, with online retailers fighting for market share and traffic using mainly price as a competitive advantage. Although competing on price may result in increased short-term sales for individual sites, it continues to hurt the aggregated industry profitability, and many experts believe this to be a key issue when moving towards a more healthier industry.

Survival of the fittest

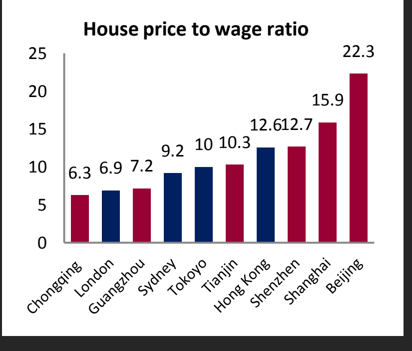
Due to the competitive environment in the e-commerce market, many larger players are currently revising their strategies in attempt to maintain their leading positions. On May 7th, e-tailer Dangdang started selling left-over stock at discounted prices, despite their earlier strategy to target the middle and high-end clothing segment. Dangdang recently reported Q1 2013 revenues at US$ 213.7 million, an increase of 23% compared to same period last year. However, when compared to their main competitor Jing-dong (former 360buy), which achieved a Q1 2013 growth rate of 155% year-on-year, it is clear that Dangdang is falling behind. This has put further pressure on Dangdang's share price, which has dropped from US$ 35 in 2011 to US$ 6.6 in July 2013.

VIPshop sales increased 207% in Q1 2013

VIPshop.com, an e-commerce site focusing on limited discount deals, maintained their high growth rate from 2012 in the first quarter of 2013. The total sales increased from US$ 101.3 million to US$ 310.7 million a growth rate of 206.8% year-on-year. As many other similar companies, Vipshop previously struggled with a strategy focusing on mid-priced brands. They have during 2012 however changed their focus by optimizing the product selection towards more high-end brands, creating a niche that attracts the much sought after high-income consumers.

China's Real Estate Market: Is Tight Control Enough?

China's average housing prices in 70 cities continue to rise despite a renewed attempt by the government to bring prices under control. A recent survey from Credit Suisse indicate that the worlds most expensive city to buy real estate in, taking average income into consideration, is Beijing; in fact there are 6 cities, or 7 if including Hong Kong in China out of the top 10 cities.



Many economists are afraid that the property market is soon at the point of overheating. Given its size, the effects of a sudden decline in housing prices will surely affect not only China, but impact the global economy as a whole. Given the extensive side effects, it is not a surprise that analysts such as Jonathan Anderson, former economist at UBS, has described China's property market as the "*most important sector in the known universe*".

Jonathan Anderson's claims are perhaps exaggerated, but not necessarily untrue. Real estate alone amounts to approximately one fifth of the Chinese investments.

In the range of activities that makes up the Chinese real estate market, we find not only a great part of China's economy, but also the demand for a range of external commodities such as Japanese construction equipment, Australian iron ore, Chilean copper and European furniture. A decline in the Chinese property market could consequently not just impact China's economy, but spread to other industries in other parts of the world with unpredictable effects.

As a result, the Chinese Central Government has implemented new measures in an effort to tighten controls of the market. China's State Council released the "*Circular on Effectively Regulating the Real Estate Market*" (Guobanfa NO. 17, on March 1, 2013). The Circular has rolled out an array of property cooling measures, including a 20% capital gains tax on property sales in cities where housing prices are believed to be rising too quickly.

However, the effects of the tightened regulations still remains to be seen as house price continues to rise in China.

Property control measures

First tier cities in China have already implemented property control measures, and many second tier cities have also released detailed regulations focusing on controlling housing prices in their respective locations. Among the regulations implemented is an imposed 20% capital gains tax.

Furthermore, residents without Hukou (permanent household registration) are only permitted to buy one house in the cities that have implemented property control measures.

In Beijing, one of the distinct feature in the new regulations is that single adults with Beijing Hukou are banned from buying a second home in the city. This new regulation is an attempt to improve earlier regulations, which resulted in couples divorcing in order to be able to buy four houses instead of two or access cheaper financing. Limiting single adults to one house in the city is expected to curb this "fraudulent" divorce phenomenon.

In Shanghai, banks can no longer lend to buyers of third homes and beyond, and financial institutions are required to adjust their requirements for down payment ratios and interest rates for second home buyers at an "appropriate" time. In addition, the local Shanghai government has implemented a policy aimed at keeping the commercial housing land supply at a level not lower than the actual average annual supply in the past five years, in an attempt to cool down housing prices

ASIA PERSPECTIVE

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