EXECUTIVE INSIGHTS

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Construction and Building Markets in China: Build, Buy or Budge?

China's construction and building material markets have seen tremendous growth, as they are playing an increasingly important role in China's quickly developing economy. The industry was growing at 16.3% per annum during the 2001-08 period and represented ~RMB1.7trillion (~6%) of the country's GDP in 2008.

Over the next couple of years the market is expected to continue to grow rapidly at 10.1% per annum to reach ~RMB2.8trillion by 2013. The fundamentals for construction and building material investing remain strong driven by a host of initiatives incorporated in the government's 12th five-year plan. Urbanization will continue to be a key focus in the new five-year plan, including increasing the pace of construction of homes for low-income families, improving both intra-city and inter-city transportation infrastructure, and the continued construction of new industrial parks to continue the economic development.

On paper, these are ideal conditions for companies looking for growth in an otherwise still lackluster global construction markets. What is the right approach to take advantage of these opportunities? Build the business organically? Establish a foothold by acquiring existing local players? Or stay away from it all together, given the well known challenges of doing business in China? This article explores some of the considerations to make these trade-offs: build, buy or budge?

Sector Opportunities

The opportunities for companies and investors to participate in the growth of China's construction sector differ considerably and companies are wise to evaluate the specific opportunities posed in each market segment.

Real Estate: Several trends are expected to impact China's real estate market, including continued urbanization, government market controls, and low-income housing development.

Accelerating urbanization, from 38% in 2001 to an estimated 50% in 2010, is a key catalyst in China's real estate demand growth.

The Ministry of Housing and Urban Rural Developments confirmed that 5.8 million low-end affordable housing units will be built in 2010.

Infrastructure: Many large cities in China view the metro as a focus of city infrastructure development and have plans to increase metro lines in the near future. The government is also investing heavily in the development of the national railways.

Among 34 cities with more than 1 million population, 20 have constructed or are planning to construct metro systems. Railway's passenger and cargo capacity has already seen tremendous growth in recent years and is expected to continue as the Ministry of Rail expands the High Speed Rail network to become the largest and fastest in the world.

Construction and Building Markets in China: Build, Buy or Budge? is written by **Michael Brekelmans**, Partner and Director and **Ken Chen**, Partner and Director of L.E.K. Consulting's Shanghai office.

Industrial: Investment in China's industrial fixed assets has seen strong sustained growth over the recent past with little sign of abating in the near future. However, a number of major heavy industries started to experience some degree of overcapacity and a consolidation trend is under way.

For instance, the steel and cement industries will see an accelerated pace of mergers and restructuring, and state-owned enterprises will be amongst the leaders to drive cross-regional restructuring.

Regional Hotspots

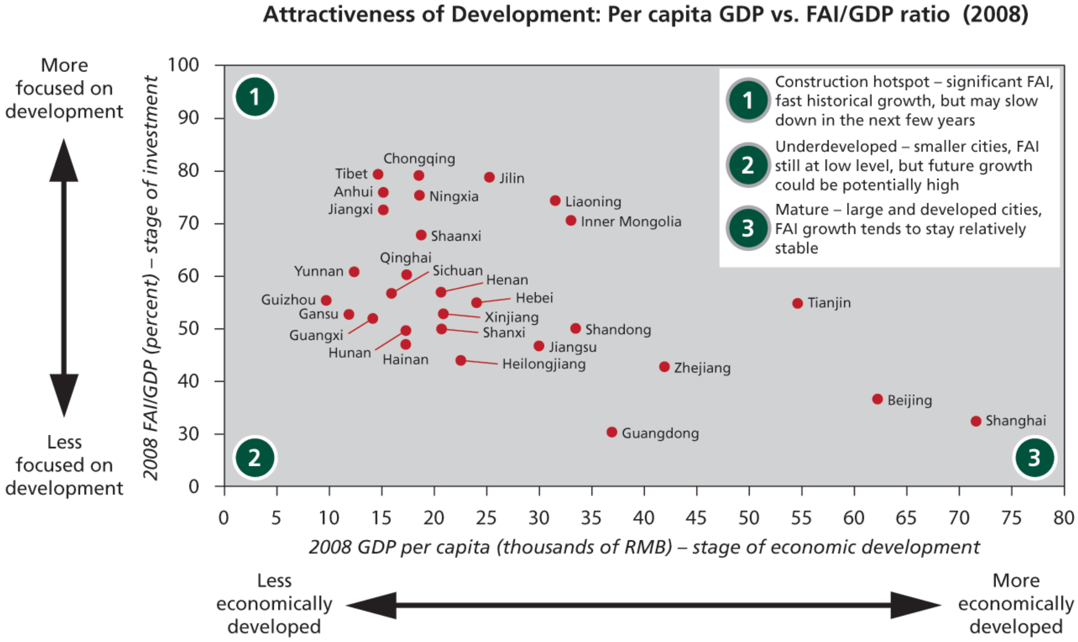
Opportunities differ by sector as described above but China also witnessed substantial regional geographical differences in terms of market opportunities. Construction and building material markets in China are often quite regional in nature in terms of market characteristics, competition, and distribution channels and partners.

Construction booms in China are often highly regional and are typically seen in regions where the focus on planned economic development is high and GDP per capita is lower.

Organic Growth vs. Acquisitions?

Companies looking to participate in China's booming construction and building materials markets can pursue organic growth by carefully selecting the markets and geographies that best suit their products and services.

*Note: *data till August 4, 2010*



M&A has been a route followed by both domestic and international players as a way to gain market access and establish a foothold. M&A activity in the construction sector peaked in 2007 and 2008 with a value of US$2.8bn and US$3.8bn respectively.

Since the peak in 2008, deal flow activity has slowed as companies became more cautious in funding acquisition during the global economic crisis and also reflecting the challenges of finding attractive targets and integrating them into existing operations.

The M&A route is a well established path for players to expand their footprint internationally. Major cross-border deals have been done by some of the global leaders in the industry. Taking cement as an example, Swiss company Holcim acquired Spanish firm Tarmac Iberia for £148 million (US$228 million) in 2008 to expand capacity and acquire presence in the market. Holcim then went on to buy the Australian operations of its Mexican rival Cemex SAB de CV for about $A2.02 billion dollars ($US1.62 billion) in June 2009.

When we look at China, we see there are opportunities as well. A number of private equity firms have moved in to invest in the construction sector in China. The table below shows examples of construction and building material deals completed by international PE firms in China in recent years:

Deal type	PE-growth	PE-growth	Minority stake purchase
Value	120	100	15
Stake %	25	3.6	N/A
Year	2008	2006	2009
Sector	Cement	Real estate	Iron and steel
Target company	Hongshi	Ruian	Yingliu International
Buyer	Goldman Sachs	HSBC	Babson Capital Management

Note: Value in millions of US$.

International corporate, or strategic, buyers have also been active in China in terms of acquisitions of local companies.

Examples include:

- French cement and building materials group Lafarge invested in Sichuan Shuangma Group in 2007. As a result, Shuangma's cement plants in Jiangyou and Yibin in Southwest China's Sichuan Province and other production facilities became part of Lafarge's solidifying its strong foothold in Southwest China.

- France's Schneider Electric has been merging local companies in China since 2005. An example is Baoguang Electrical Apparatus. Schneider has successfully built a strong position in supplying low voltage electronics to the construction sector in China and over the years has developed a deep national distribution network combined with continuous innovation and supplemented through local acquisitions.

- Lift maker OTIS has acquired local elevator manufacturers in different regions in China such as in Dalian, Xi'an and Sichuan. With increased capacity and local presence in China, OTIS has been equipped with strong after sales service and maintenance and became one of the leading players in China.

When we look at some leading domestic companies' growth strategy, we find that many are also expanding rapidly in China using a range of growth strategies, including organic growth and M&A. For instance, recently in the interior decoration and fit-out service sector all the industry leaders were aggressively pursuing growth outside of their regional hubs:

- As the industry leader, Gold Mantis plans to focus on advanced regions in China and increase its presence from 23 to 30 locations by the end of 2010 by establishing additional subsidiaries.

- Zhejiang Yasha has already established over 27 subsidiaries in tier 1 and large tier 2 cities across China and plans to establish even more. They will increasingly focus on markets outside its home province, especially areas where it is currently relatively weak, e.g. Hunan province.

In another recent example, Shanghai Wanye Enterprise's controlling subsidiary Wanye Xinhongyi Real Estate Co., Ltd. purchased a 100% stake in Anhui Hongxiang Real Estate Development Co., Ltd in 2008 to get a foothold in a new region and take control of Hanhai Xingzuo, the RMB280mn real estate project initiated by the target company.

Summary

China's construction and building material sectors have witnessed ferocious growth in recent years and with China's ongoing development and modernization this is likely to continue over the coming years despite some potential challenges in the short term. Opportunities exist for local as well as multinational players to participate in this market. Strategies will have to be developed carefully to identify the most attractive subsectors and geographies.

Breaking into new markets is however never easy, China's myriad of local regulations, relationship networks and cut-throat competition can make any strategy risky. Successful examples of companies that have selectively acquired local players whilst building on their strengths in product development and service, have shown how a presence in China's construction and building markets can be rewarding and build to last.

We would welcome the opportunity to discuss how we may support your organization in identifying the right opportunities in the industry. We have supported corporate and financial investors in a range of construction related services:

- Equipment Manufacturers
- Service Providers / Distributors
- Construction Materials
- Industrial/Residential Building Products

L.E.K. has been very active in advising both corporate clients and financial investors as they expanded into the sector. We would welcome the opportunity to discuss how we may support your organization in identifying the right opportunities in the industry.

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