

# Wall Street's war for China

The big investment banks are fighting for a piece of the action in the world's fastest-growing economy. Inside their multibillion-dollar battle.

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**FORTUNE**

(FORTUNE Magazine) - On a Friday in March, executives from some of the world's most powerful investment banks gathered at the Beijing headquarters of the Industrial & Commercial Bank of China to compete in one of the richest beauty contests of all time.

One after another, teams from each firm were led to a chilly tenth-floor conference room where they were given 60 minutes to describe their plan for selling the state-owned bank's shares to foreign investors. Contestants battled in pinstripes, not swimwear, and sought to dazzle with the brilliance of their PowerPoints more than their smiles.

But in this master-of-the-universe pageant the prize was well worth turning on the charm. Victors would claim the right to lead ICBC in a \$12 billion public offering this fall, the world's largest in seven years. The mandate would mean hundreds of millions of dollars in advisory fees, millions more in follow-on business, and the chance to forge a long-term partnership with China's largest bank--not to mention fat bonus checks at year-end.

[Goldman Sachs](#) ([Research](#)) was the hands-down favorite. Its executives had courted ICBC for years. On his many trips to China, CEO Hank Paulson had called regularly on chairman Jiang Jianqing. Jiang's daughter had worked as a summer intern at Goldman in New York City. Earlier this year Paulson had underscored the firm's commitment by pledging to buy a 7% stake in the bank for \$2.6 billion.

ICBC hadn't even invited Goldman's archrival, [Morgan Stanley](#) ([Research](#)), to submit a proposal, allowing Fred Hu, a polished, Harvard-trained economist, to make Goldman's pitch with confidence.

So it was no small shock when, a few days later, ICBC notified contestants of its decision. The IPO would be shared by five firms: [Merrill Lynch](#) ([Research](#)), [Credit Suisse](#) ([Research](#)), [Deutsche Bank](#) ([Research](#)), China International Capital Corp. (China's only domestic investment bank), and an ICBC subsidiary based in Hong Kong. Goldman's services were not required.

That Goldman could be so abruptly chucked out of such a high-profile deal for reasons that remain unclear hints at the perils faced by Western investment bankers as they jostle for position in the world's fastest-growing economy. When Paulson began making regular forays to China in the early 1990s, China's Communist leaders were struggling to fathom global capital markets. Liu Erhfei, who accompanied Paulson on some of those meetings as a junior Goldman banker (and who now leads the Merrill Lynch team that trumped Goldman on the ICBC deal), recalls Chinese officials' difficulty in grasping what, exactly, investment bankers do: "The response was, 'You're a banker, but you don't take deposits and you can't give me a loan? Why am I talking to you?'"

In the years since, China's leaders have learned a thing or two about firms like Goldman--not least of which is how to play them off against one another. Now, as market forces unleashed more than two decades ago gather momentum and China's rulers seek foreign investors to help bring fiscal discipline to their state-owned dinosaurs, China is emerging as a battleground for the world's largest investment banks.

Over the past three years China has spawned some of the world's largest IPOs, including the \$3 billion listing of China Life Insurance on exchanges in New York and Hong Kong in 2003 and China Construction Bank's \$9 billion offering on the Hong Kong stock exchange last fall. This month the Bank of China, China's second-largest bank, hopes to raise \$9.9 billion from an IPO in Hong Kong. All told, the value of mainland deals in the pipeline this year could top \$30 billion, and dozens of other Chinese companies have declared their intention to seek a foreign listing by 2008.

And it's not just IPOs. Increasingly, Chinese firms are players in the world's biggest cross-border mergers and acquisitions. Completed deals involving Chinese firms reached a record \$28.5 billion in 2005, according to Thomson Financial, up from \$1.9 billion in 1995. That figure is sure to climb as China eases restrictions on foreign investment and more of its own firms venture abroad.

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Global financial giants themselves are responsible for a large chunk of China-bound investment. In the past two years Western firms including Goldman, Bank of America, Merrill Lynch, American Express, and HSBC have spent more than \$20 billion to acquire stakes in Chinese banks. And Morgan Stanley, Goldman, and [Citigroup \(Research\)](#) have all launched ventures to cash in on China's booming property markets.

Never mind that China accounts for only a sliver of worldwide investment banking activity. Dealogic, a financial consultancy, estimates that since January 2005, mainland deals generated \$1 billion in investment banking revenue, only a little more than 1% of the \$85.1 billion global total. Still, executives at nearly all the major international investment banks hail China as a vital component of their plans for growth. And they have gone to extraordinary lengths to secure a foothold in this new market.

In angling for a piece of last year's China Construction Bank offering, J.P. Morgan turned to Henry Kissinger, while Deutsche Bank enlisted Germany's then-Chancellor Gerhard Schroder to write a letter to Chinese Premier Wen Jiabao. (Neither ploy succeeded.) Paulson, Morgan Stanley's John Mack, and Merrill's Stan O'Neal each made at least half-a-dozen trips to China last year. Several firms, including Merrill, UBS, and Credit Suisse, have put the offspring and in-laws of Communist Party heavyweights on their payrolls, and others have spent millions poaching star dealmakers.

In February, days after Morgan Stanley's top China banker, Jonathan Zhu, left for a private equity firm, the bank snatched away Citigroup's top China rainmaker, Wei Christianson. Citi retaliated by stealing Morgan Stanley's co-head of investment banking for China, Zhao Jing, prompting Morgan Stanley to raid Citi for another member of its China team. Merrill's Liu has worked for Rothschild, Goldman, Morgan Stanley, and Smith Barney. Goldman's star China dealmaker, Fang Fenglei, who has access to China's top financial officials, was once the prime mover at Morgan Stanley's joint venture, China International Capital Corp.

Goldman and Morgan Stanley own stakes in Chinese brokerages, and other foreign firms are wooing local partners. Everyone says they are preparing for the day when Western investment banks are allowed to manage the pension funds of Chinese companies, peddle financial services to China's prodigious savers, and trade debt and equity on China's exchanges as freely as they do in Japan or South Korea. "We know the opportunities will be big," says Michael Berchtold, Morgan Stanley's Asia Pacific president, "and we want to make sure that as they continue to arise, we're ready with the right capabilities."

In the race to become China's investment bank of choice, Morgan Stanley took an early lead. In 1992--the year Brilliance Auto floated shares on the New York Stock Exchange in China's first foreign IPO--Jack Wadsworth, then Morgan Stanley's Asia Pacific chairman, approached China Construction Bank with a proposal to establish the country's first domestic investment bank. The idea won support from China's reform-minded vice premier, Zhu Rongji, and in 1995 the two banks formed China International Capital Corp. (CICC). Morgan Stanley bankrolled the venture with \$35 million in exchange for a 35% stake, and it offered personnel and financial know-how.

But it was a troubled marriage. Mainland staffers chafed at Morgan Stanley bankers' oversized salaries and egos. Morgan Stanley staffers griped that local colleagues were holding out on them on deals. The larger problem was that Wadsworth envisioned CICC as an onshore platform for his investment banking operations in Hong Kong, while his counterpart, China Construction Bank president Wang Qishan, saw the venture as an independent entity free to do deals with anyone. The rift broke into the open in 1997, when Fang, a rough-hewn former People's Liberation Army soldier who was CICC's savviest dealmaker, helped steer an advisory role in the foreign listing of state-owned telecommunications giant China Mobile to Goldman, not Morgan Stanley.

Fang says he tried to pitch the deal to Morgan Stanley first but got the brushoff from bankers in New York (a claim the firm disputes). In any event, Wadsworth's failure to land China's first megadeal undermined his credibility at headquarters, and relations between the two sides deteriorated. Fang was eventually forced out, and in 2000, Morgan Stanley pulled its executives from CICC and relinquished control. The venture is now run by Zhu Rongji's son, Levin Zhu.

Morgan has since made its peace with China Construction Bank and, though now a passive investor in CICC, has collaborated with it on a number of big deals. Last year Morgan Stanley served as lead underwriter for China Construction Bank's Hong Kong listing, making it the top investment bank in China in 2005. CICC's ability to dictate which foreign firms get a piece of the action is waning, though. And Christianson, an Amherst-educated Beijing native married to an American lawyer, will face stiff competition as she tries to keep her new employer out in front.

At 7:20 on a recent Friday morning, Peter MacDonald, chief operating officer of Goldman Sachs Gaohua Securities, convenes a group of nine salespeople and analysts in a cramped conference room in Beijing. Counterparts at Goldman offices in New York, London, Hong Kong, and Taipei join in by speakerphone. As cranes twirl over construction sites outside, questions fly around the table. "Chris, you spent the day on the road with management at Sinochem. Any surprises?" Someone else weighs in with a view on Shanghai Raw Water: "We're incrementally more positive."

What's remarkable about this meeting is that it's happening in Beijing. Goldman, which got a foothold in China in the early 1990s, is the only foreign securities firm with a trading platform on the mainland. But securing it has required some clever footwork. As a show of good faith to China's regulators, Goldman agreed to pay \$68 million to bail out clients of Hainan Securities, a scandal-plagued brokerage it had no connection to that collapsed in 2001. Next it advanced Fang and five co-investors \$100 million to launch Gaohua Securities, a new brokerage.

The final step was the creation of Goldman Sachs Gaohua, a joint venture in which Gaohua holds 67% and Goldman owns 33%, the maximum allowed. Goldman won't discuss the terms of its loan to the Fang group, other than to say it gives Fang, who serves as chairman of both Gaohua and the joint venture, ample incentive to remain a part of the Goldman team. The aim of all this was to create a legal framework granting Goldman effective control over a mainland investment bank, even if, on paper, it's owned by someone else.

How much control is a matter of debate. "What's to stop Fang from dumping Goldman the way he dumped Morgan Stanley at CICC?" asks the regional head of one large Western firm. J. Michael Evans, chairman of Goldman Sachs Asia, isn't fazed: "That's not something I worry about. Fang thinks of himself as a Goldman person. I trust him 100%."

A more interesting question is what the partnership is worth. Trading shares on China's exchanges isn't exactly a lucrative proposition. Fees are low, and well-run companies are in short supply. From an investment banking standpoint, many Goldman competitors do just fine chasing mainland deals from lightly taxed regional offices in Hong Kong. But Evans says Gaohua "gives us on-the-ground insight into the challenges of China's capital markets and puts us in the best possible position to work with regulators on how to tackle them."

Evans takes a similarly broad view of Goldman's failure to win the ICBC deal. Losing a deal here or there, he shrugs, won't distract Goldman from its long-term China strategy. Such equanimity is remarkable, given the intensity of Goldman's pursuit. But it's true that Goldman has won its share of big China deals. In addition to China Mobile, it led PetroChina's \$2.9 billion listing in 2000 and co-managed Ping An Insurance's listing in 2004 and the \$2.2 billion listing of the Bank of Communications in 2005. It is also leading the Bank of China IPO.

Some believe Goldman's role as advisor to the Bank of China doomed its bid for ICBC. Acting as book runner for both banks in the same year would have required separate teams of salesmen, lawyers, accountants, and compliance experts. Sources close to ICBC say the final decision was made not by Jiang but by the State Council, Beijing's highest policy authority. But the reasons for Goldman's 11th-hour rejection remain murky. The State Council's information office declined FORTUNE's request for an interview, as did other banking and regulatory officials and executives at ICBC.

Evans says the outcome highlights Beijing's determination to spread the deals around. "Decisions were taken to maintain a sense of balance," he says. "China needs to preserve the ability to work with multiple overseas service providers. We understand that, and we're not overly surprised at the outcome."

China's effort to find balance can throw foreign bankers for a loop, as Merrill's Liu was reminded on a dusty April morning that found him pacing Beijing's Avenue of Eternal Peace, mobile phone pressed to one ear, trying to explain to a reporter how Merrill lost a \$2 billion deal. Liu was among the first wave of Chinese students granted permission to further their education in the U.S. after the Cultural Revolution. He earned degrees from Brandeis and Harvard Business School and found himself besieged by offers from American banks.

Liu, who has been with Merrill since 1999, jokes that now, at 48, he's getting too old to be an investment banker. But for the past two years his China team has notched a series of key deals, enabling Damian Chunalal, head of Merrill's Asia operations, to boast that Merrill is "the house with greatest momentum" in China. The ICBC deal is a trophy fish for Merrill, but to land it, Liu has had to let a smaller catch swim free. ICBC executives demanded that Merrill forfeit its role underwriting the IPO of China Merchants Bank, the country's sixth-largest. Merrill's place was quickly filled by J.P. Morgan, until now a minor player on China's investment banking scene.

No firm has had more difficulty finding its footing in China than Citigroup. In 1999 its underwriting team misread global demand for shares of China National Offshore Oil Corp. so badly that the offering had to be withdrawn, earning Citi the dubious distinction of having managed China's only botched IPO. In 2001, desperate to get back in the game, Citi lured Margaret Ren, daughter-in-law of former Chinese Premier Zhao Ziyang, away from Bear Stearns with a salary reported to exceed \$8 million.

Ren brought Citi a slew of deals, including China Netcom, Mingsheng Bank, and China Life. To keep Citi from getting pushed out of the \$3.5 billion China Life IPO, she went head-to-head with CICC's Zhu. Ren prevailed with help from senior Citigroup executives,

including Robert Rubin, chairman of the bank's executive committee, and the following year China Construction Bank hired Citi to assist with a \$5 billion listing.

Then things unraveled. Citi fired Ren, alleging she had submitted false documents to U.S. regulators in connection with an investigation into the China Life listing. (Ren could not be reached for comment.) Last May, China Construction Bank kicked Citi off its underwriting team after executives reneged on a promise to take an equity stake. Earlier this year Christianson, hired as Ren's replacement, decamped for Morgan Stanley after only 18 months on the job.

Now Citi is trying to rebuild. Its strategy, says regional investment banking head Mark Renton, is to create a broad team of China experts rather than chase after the next hot rainmaker and to capitalize on Citi's extensive corporate banking network. But how to get the corporate and investment banking functions to work together?

"At Citi, the corporate banking culture dominates," grouses one former Citigroup investment banker. "If you're on the corporate side, why mess with your nice, dependable lending franchise to help some cowboy on the investment side cut a deal?"

To replace Citi on its underwriting team, China Construction Bank turned to Credit Suisse--much to the consternation of John Mack, CEO of lead manager Morgan Stanley, who had been forced out of Credit Suisse. In a meeting with China Construction Bank officials in Beijing after Citi's ouster, Mack argued that Morgan Stanley and CICC didn't need help from a third firm to manage the Chinese bank's IPO. But his objection was rebuffed.

Though it may lack the swagger of its Wall Street rivals, Credit Suisse has proved remarkably effective in China. Between 2003 and 2005 it raised more money for mainland companies than any other foreign investment bank. And it has done so without Chinese partners, compensating in part by luring top Asian executives and institutional investors to Hong Kong for the region's biggest financial conference.

Stoking the frenzy of China stock offerings are two forces: Beijing's belief that selling foreigners minority stakes in China's state-owned behemoths will improve corporate governance without sacrificing government control, and global investors' belief that owning shares of Chinese companies is a sensible way to profit from the economy's torrid growth.

Neither proposition is self-evident, but both are finding accommodation in Hong Kong. Five years ago investment banks steered their Chinese clients to the New York Stock Exchange or Nasdaq. But Hong Kong has loosened listing requirements while Sarbanes-Oxley has made them more costly in the U.S. Mainland enterprises now account for a third of all companies listed on the Hong Kong exchange and half its market value.

The affinity between Chinese firms and foreign investors is also evident in Beijing, along Finance Street, the proud new corporate corridor west of Tiananmen Square, where a score of China's corporate giants are erecting gleaming new headquarters. At one end of Finance Street sits the Bank of China building, designed by I.M. Pei, with a bamboo grove and a reflecting pool in its soaring lobby. Upstairs, Zhu Min, executive assistant to the president, describes how foreign investors are helping to make the bank more transparent. Non-Chinese citizens now hold four seats on the governing board. Experts from the Royal Bank of Scotland, which paid \$3 billion for a 10% stake, offer advice on risk management, technology, and customer service. The bank's chief credit officer is a Briton from HSBC.

But problems run deep. A recent study by accounting firm Ernst & Young estimates bad loans at China's four largest state-owned banks at \$358 billion--more than twice what officials acknowledge and nearly half of China's foreign currency reserves. From the window of his office near Beijing's Forbidden City, Ernst & Young partner Jack Rodman, an expert in distressed debt, gazes out at the frenzy of construction. Chinese banks, he marvels, continue to dole out credit to money-losing enterprises, harebrained infrastructure schemes, and speculative property developments. Why are global investors so keen to share in such excess? "The level of foreign interest in Chinese banks," he says, "defies all logic."

The campaign to sell China's banks to foreign investors gathered momentum in 2003, as Chinese planners feared the nation's financial system was hurtling out of control. An earlier effort to cleanse bank balance sheets by transferring \$170 billion in dud loans from state banks to government-backed asset-management companies had proved too timid. A more rigorous accounting revealed an additional \$450 billion in bad loans. And analysts estimate that China's banks racked up another \$225 billion in a speculative lending binge between 2002 and 2004. The newly appointed administration of Hu Jintao concluded that selling bank shares to foreigners--who would insist on global standards--was the last best hope. But Beijing has limited foreign ownership of Chinese banks to 25%, and even that has left Hu vulnerable to criticism at home that he is giving away the family silver.

How will the experiment end? Will China's new IPO darlings hold up in the face of more bad loans, or rising interest rates, or a dip

in Chinese growth? China Inc.'s new foreign partners can only hope that today's investment banking beauty pageants don't turn ugly tomorrow.