BUSINESS

New markets
HSBC's newest recruit signals expansion in wealth management
> BANKING & FINANCE B3

Tough sell
Chinese bonds hit by corporate governance fears and Greek crisis
> MARKETS & INVESTING B2

Snapshot
H-share index: 12,497.32
-259 points, 2.03%
Top blue-chip mover:
Li & Fung
-3.78%

Hang Seng Index
1.67%
• Close 22,347.23
• Down 379.2

In a state
Is a 'giant yard sale' the way to go for countries like Greece?
> BACK TO BUSINESS B14

ECONOMY

Bonds sell at higher yield than expected

China's finance ministry sold three-year bonds on behalf of 11 regional governments at a yield of 3.93 per cent, much higher than market expectations, but failed to fully sell out the offer due to worries over local government bad debt and thin trading. Reuters

CORPORATE

Li Ka-shing bids HK$30b for English water group

Li Ka-shing's Cheung Kong Infrastructure Holdings made a £2.4 billion (HK$30 billion) takeover bid for Northumbrian Water Group, offering 465 pence a share, in its second foray into Britain in a year. Northumbrian jumped to an eight-year high in London. Bloomberg

COMMODITIES

Peabody, ArcelorMittal bid for Macarthur Coal

Peabody Energy has teamed up with ArcelorMittal to offer US$5 billion for Australia's Macarthur Coal, the world's biggest producer of pulverised coal. The cash offer of A$15.50 (HK$129.62) a share represents a 40 per cent premium to yesterday's close. Reuters

ANALYSIS

BEIJING'S MIXED ECONOMIC STANCE DIVIDES ANALYSTS

The government has been raising interest rates repeatedly, yet leaders seem unclear about achieving price stability while balancing the need for growth

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Analysts are divided over whether last month's three-year-high consumer inflation rate and signs of slow growth would prompt any change or fine-tuning of the tightening policy in place.

On Saturday, the National Bureau of Statistics said the mainland's consumer price index rose 6.4 per cent in June, up sharply from the 5.5 per cent in May and well above the government's annual target of 4 per cent. This is the highest inflation rate since June 2008, when CPI hit 7.1 per cent.

To curb the politically sensitive consumer inflation rate, the government initiated a series of tightening measures since last year. The central bank raised the reserve requirement ratio (RRR) six times in the first half of this year alone, ordering banks to keep 21.5 per cent of their deposits – a record high – as reserves, in a bid to rein in excess lending.

Beijing has also raised interest rates five times since October, most recently on Wednesday.

Economists said a high inflation rate late last year also meant that interest rates would appear lower in the coming months when compared against the year-earlier period.

Premier Wen Jiabao (溫家寶) said the government would uphold and maintain the current direction of macroeconomic policy, keeping price stability as the main objective. However, Wen also said the government would "grasp the direction, strength and rhythm of its macroeconomic policies" as the economic development gets "complicated" with several uncertain factors.

However, central bank chief Zhou Xiaochuan (周小川) was more ambiguous. China "can tolerate a certain degree of inflation," he said in a speech at Tsinghua University over the weekend.

"It is difficult for China's central bank to only set one objective, that of controlling inflation."

On many of their recent inspection tours, top government officials have been stressing the importance of economic growth, their support for industrial adjustment and changes in the development model.

Anticipating slower inflation and economic growth in the second half, market watchers expect the macro-control policies will change to ensure growth.

There is also growing opposition to the tightening policy as increasingly more regional officials and economists are calling for an end to the cycle of interest rate and reserve ratio increases. Tim Condon, ING's head of research for Asia, said he interpreted Wen's recent comments as evidence that the balance of risks for policymakers had shifted to growth from inflation.

But Qu Hongbin, chief China economist at HSBC, said as inflationary pressures persist, monetary policy is expected to remain tight through the third quarter.

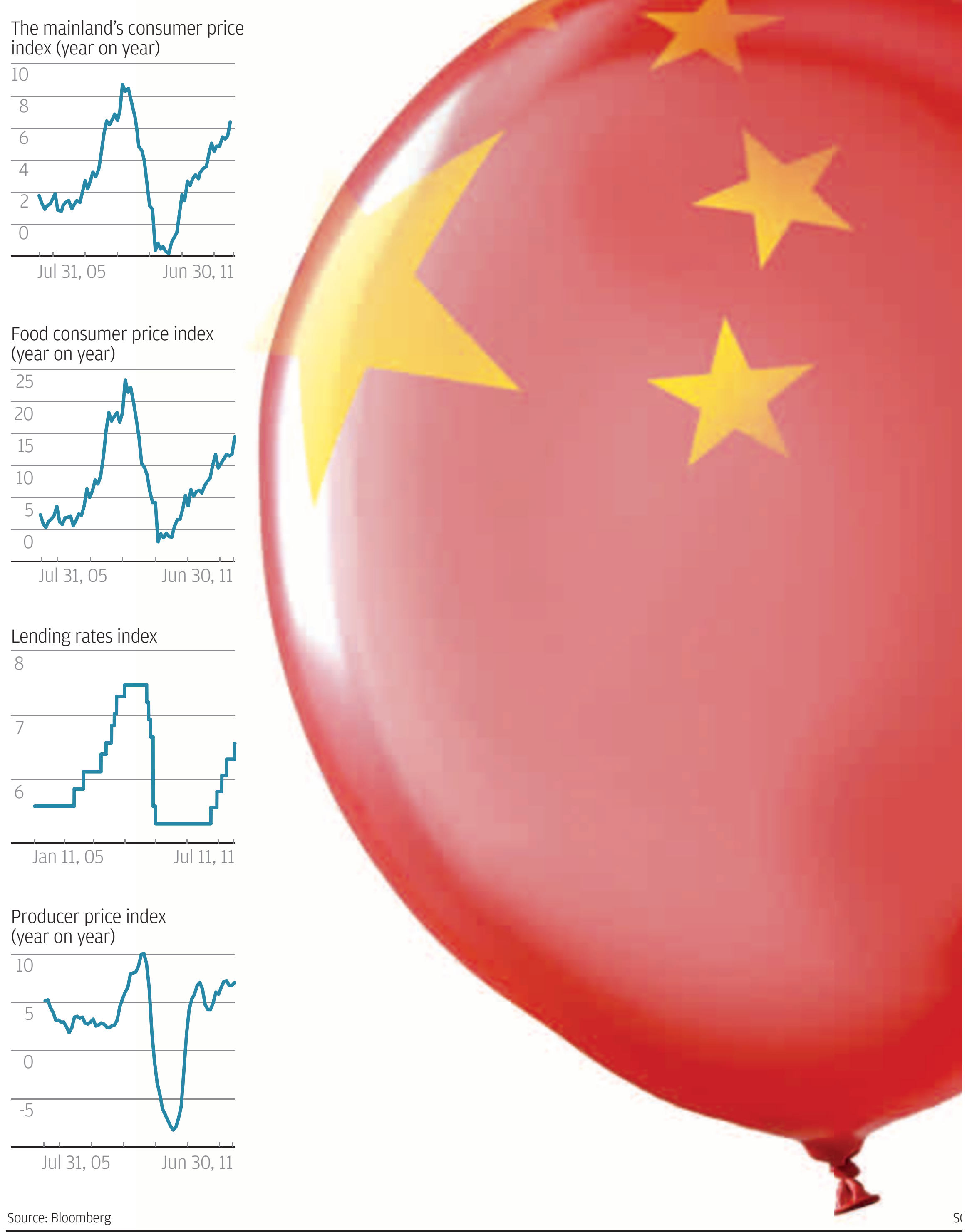
Wang Tao, chief China economist with UBS Securities, said: "If July CPI is as high as or higher than the June reading, we think there may be another rate hike in August. Other than the rate hike, we expect the current prudent monetary policy stance to stay unchanged."

Li Daokui (李稻葵), a member of the monetary policy committee of the central bank, said on Sunday that he did not see any possible relaxation of the current policy this year.

The Party leadership has declared that this year's economic priority is to curb prices, but inflation has risen steadily even as manufacturing and other sectors of the economy cooled in the face of repeated interest rate increases and other controls.

Inflation is politically dangerous for the regime as it erodes economic gains that underpin its claim to power and can fuel unrest. Thus any real relaxation of policy is likely to come only when inflation has significantly eased.

Up in the air
Analysts are divided over what the latest economic figures foretell



Source: Bloomberg

Government i-bonds stir little interest from public

Returns on the new debt offering keep pace with inflation but investors are still sticking to equities

Amanda Lee and **Martin Cheung**

The Hong Kong government's latest attempt to sell bonds to the public – this time inflation-linked bonds, or so-called i-bonds – has met with a tepid response from retail investors, who were underwhelmed at the official launch yesterday.

Despite its top AAA rating, the government failed to inspire public interest in buying bonds.

Liquidity for Hong Kong dollar bonds in the secondary market has been wafer-thin over the years, and many investors have been forced to hold their bonds until redemption.

Critics said the bond was another way for the government to hand out subsidies to those with cash to spare on i-bonds, without raising spending on social infrastructure to help low-income families.

But it is, for the first time, selling HK$10 billion worth of inflation-linked bonds to the public, who have seen their savings eroded by rising food prices and high rents for private housing.

The tax-free government bond, which matures in 2014, pays investors every six months at least 1 per cent interest. If inflation is higher than 1 per cent, the i-bonds will pay a rate linked to the composite consumer price index, a measure of inflation, over a six-month period.

The i-bonds, which require a minimum investment of HK$10,000, will be traded over the counter and will be listed on the stock exchange.

Chan Ka-keung, secretary for financial services and the treasury, said he expected a "healthy appetite" from small investors for the bond.

> **Secondary market liquidity for the bonds will be thin because people don't expect a lot of bonds to be available**
>
> ALVIN CHEUNG, ASSOCIATE DIRECTOR, PRUDENTIAL BROKERAGE

Brokers had a different story to tell. Alvin Cheung, associate director with Prudential Brokerage, said many investors prefer equities to bonds because they believed there was more chance that the investments would produce a return.

"Secondary market liquidity for the bonds will be thin because people don't expect a lot of bonds to be available. This means bid-offer spreads will be wide, adding to trading costs."

One investor said she planned to buy HK$30,000 worth of i-bonds. "It's not a lot of money, for sure, but we'll be happy to take it as a form of social welfare," she said.

Frances Cheung, a senior strategist at French bank Credit Agricole, forecasts the first interest payment would be 5 per cent, reflecting rising prices in the city.

But the coupon on the bond could also fall, depending on what happens in the US, where the Federal Reserve could raise interest rates as early as the third quarter of next year as inflation becomes a bigger concern for the world's largest economy.

Given the Hong Kong's currency peg to the US dollar, a rise in US rates will also ease some inflationary pressures in the city but interest on the so-called i-bonds would be lower.

Cheung at Credit Agricole said investors should aware that interest payments on comparable investments, such as other Hong Kong government bonds, could be higher than the inflation-linked bonds.

> MONITOR B12

AVIATION

Cessna in talks with China's Avic

The jet maker hopes to break the market duopoly of Gulfstream and Bombardier through mainland tie-up

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Cessna, the leading light and mid-size business jet manufacturer, is in talks with Aviation Industry Corporation of China (Avic) to jointly develop the mainland market, as it bets an increasing number of buyers will see private jets as more than a high-altitude sports car.

"The mainland is still an uneducated market," said Trevor Esling, Cessna's vice president for international sales. "Most of the purchases are trophy-buying."

Although Cessna produces some of the best high-performance jets in the world, Cessna has failed to appeal to affluent buyers on the mainland who are looking for a "Porsche" instead of a "Honda".

There are approximately 120 corporate jets registered on the mainland, with most private jet sales spilt between Gulfstream and Bombardier, which sell jets with larger fuselages that allow owners to add more luxury facilities on board. Cessna jets are often priced more affordably compared with rival jets.

Esling said he believed the demand for small and mid-sized private jets would increase when mainland buyers realise business jets have value beyond being a luxury vehicle. "If a US$12 million private jet can carry you from Beijing to Shenzhen or Hong Kong, why bother to buy a jet for US$60 million?" he asked.

He said talks with Avic to jointly design and produce private jets were at the preliminary stage, and it is believed that competitors – including Gulfstream, Bombardier and Embraer – were in talks with Avic as they eye the lucrative and undeveloped mainland market.

Beijing is pressing hard to close the gap with western rivals in its aircraft manufacturing industry. As corporate jets are technologically more advanced than commercial jets, Chinese manufacturers need technological transference from international jet makers.

"The PLA would be one big potential client for us," Esling said. However, Cessna cannot sell planes to the People's Liberation Army because the American government imposed sanctions on exports of high-technology products to the mainland military.

Nevertheless, the joint venture with mainland partners might open a window for American jet manufacturers to sell their products to PLA, an industry veteran said. "But it still depends on the negotiations between the two governments," the person said. Cessna has already teamed up with Shenyang Aviation Industry Corporation to produce a two-seat trainer in the province of Liaoning. The production line of the Skycatcher in Shenyang is scheduled to make 100 aircraft this year.

> **The mainland is still an uneducated market. Most of the purchases are trophy-buying**
>
> TREVOR ESLING, CESSNA'S VICE PRESIDENT FOR INTERNATIONAL SALES

The Kansas-based aircraft maker, which started making small aircraft more than 80 years ago, was the first foreign company to sell private jets to the mainland.

Two Citation jets, which were delivered to the Chinese Academy of Science in 1982, are still in use. They still get spare parts and maintenance from Cessna even though the aircraft model is no longer in production. Cessna's aircraft have been well received by government departments, such as the Civil Aviation Administration of China. The government owns about 10 of the 30 Cessna corporate jets on the mainland.

Gunning for China: Cessna's Citation XLS jet. Photo: SCMP Pictures

ACCOUNTING

Auditors face uphill battle with mainland companies

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Auditors face an increasingly difficult task trying to verify the financial records of some mainland companies.

Getting banks to verify the financial information companies supplied had become a "high-risk area" for auditing firms trying to get third-party confirmation of records of mainland companies, said Cheung Yuk-lam, a forensic and dispute services partner at Deloitte.

He recently told a Deloitte employee to go to a bank on the mainland to check a confirmation document about a company's financial records that had earlier been couriered to the auditing firm's Hong Kong office. "Out of nowhere, people from the company suddenly appeared, grabbed the confirmation document and ran off," said Cheung at a seminar on the warning signs of fraud, organised by the Hong Kong General Chamber of Commerce.

"In the past, bank confirmations used to be an easy and risk-free area that any junior auditor could do, but now it is one of the biggest risks."

Company customers and clients, traditionally another major source of third-party confirmation, were equally dodgy. Cheung said his team once visited a company whose office was beautifully furnished but had its name printed on a piece of cardboard pasted on the glass of an office. When the team returned to the office three days later, the firm had vanished.

Cheung did not identify the clients or explain what happened to them. But he said backdoor listings of mainland companies through reverse takeovers were most likely to pose the risk of fraud. He cited the recent allegations of fraud raised by the short-seller firm Muddy Waters.

In May, Deloitte resigned as auditor for Xiamen software manufacturer Longtop Financial Technologies. Listed on the New York Stock Exchange, the company is the target of a probe by the US Securities and Exchange Commission amid allegations of accounting fraud.

Two months earlier, Deloitte resigned as auditor for China MediaExpress, a Nasdaq-listed company based in Fujian, saying it could not rely on the company's financial statements.

Rating agency Moody's yesterday introduced a 20-point "red flag" screening framework to highlight corporate governance and accounting risks for companies in emerging markets.

Mainland companies with the highest number of red flags are West China Cement, Winsway Coking Coal, China Lumena New Materials, Hidili Industry International Development and LDK Solar.