Agricultural Bank of China Ltd. (Symbol: 601288.SH / 1288.HK)

Research Commentary / Risk Review

Initial Public Offering Performance

Agricultural Bank of China Ltd. (1288.HK) shares rose 2.2% on the Hong Kong debut Friday, following the bank's lackluster debut in Shanghai on Thursday. AgBank shares ended the first day of trading on the Hong Kong stock exchange at HK$3.27, compared with an IPO price of HK$3.20. The benchmark Hang Seng Index edged down 0.03% to 20,250. Trading volume in AgBank's shares totaled HK$10.47 billion. Shares posted an opening day gain of less than 1% in Shanghai and just over 2% in Hong Kong, far below management's target of 10%. AgBank sold 40% of the Shanghai offering to 27 strategic investors including China Life Insurance and China State Construction. The Hong Kong listing had 11 cornerstone investors which subscribed approximately 25% of the issue.

Comments

The weak performance of the AgBank IPO, even with prices artificially supported by government-controlled entities, evidences the lack of faith which investors have in the quality of the assets held by China's state-run banks, as well as the vulnerability of the Chinese domestic economy, characterized by weak economic fundamentals and an inability to grow broad domestic consumption.

Rising Levels of Problem Loans at China's State Banks

China's state banking regulator recently reiterated serious concerns regarding increasing problem loans at China's major state-owned banks.[1] The volume of loan origination continues unabated through the use of private trust companies to disguise the loans as investments, resulting in understated credit exposure. An additional risk is the inability of Chinese corporations to refinance bank debt via issuance of bonded debt in the wake of escalating corporate bond defaults.[2]

Repudiation of External Sovereign Debt and Refusal to Repay China's Foreign Loans

The Chinese Government's repudiation of China's defaulted full faith and credit external sovereign debt (est. $270 billion) has created a significant contingent liability which may adversely affect China's ability to maintain the continued publication of a false investment-grade sovereign credit rating in the face of the new U.S. financial reform legislation, which makes it easier for investors to sue credit rating agencies in instances involving the deliberate or reckless for-profit publication of fraudulent ratings.[3]

Outlook

AgBank's lackluster IPO performance, particularly in the face of the central government's directive to state-controlled investors to intervene in the market in order to ensure that shares did not fall below the issue price, will likely have a negative impact on planned future fundraising by the Industrial & Commercial Bank of China (ICBC) and the Bank of China.

Additional Research:

- Research Bulletin: China Sovereign Risk Review
- Risk Review Magazine: Reassessing China's Sovereign Risk

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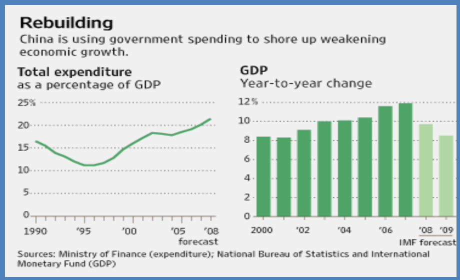
[1] China Banking Regulatory Commission annual report for 2009 (released June 15, 2010). Statement by Indiana University's Dr. Scott Kennedy, who specializes in China's political economy: "If you have any credibility, you would probably be rating everything junk in China." Statement by Mr. Gordon Chang, former partner at Paul, Weiss, Rifkind, Wharton & Garrison in Beijing: "China has less borrowing capacity than many people think; it is not as creditworthy as many people think."

[2] "Lenders Want Their Money From Chinese Milk Supplier", *Wall Street Journal* (May 5, 2010), describing the latest wave of Chinese corporate bond defaults starting at the beginning of 2009.

[3] The standard of care employed by the three primary credit rating agencies is evidenced by the following electronic mail communication contained in the findings of the investigation into the practices of the three primary credit rating agencies by the United States Securities and Exchange Commission. The electronic mail was sent by an Analytical Manager at Standard & Poor's to a Senior Analytical Manager at the same firm: *"Let's hope we are all wealthy and retired by the time this house of cards falters."*

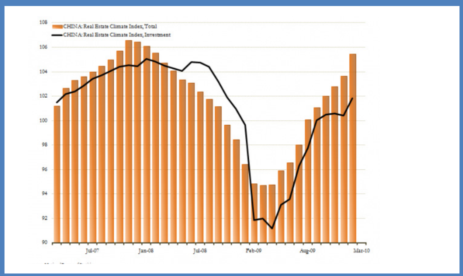
China Country Risk

• Rising incidence of social unrest and civil disobedience including worker protests over low wages, resulting in erosion of competitive advantage in global export markets and further increasing political instability.



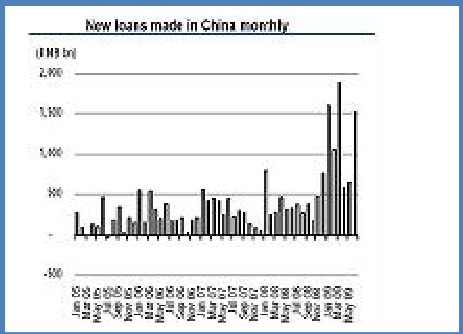
Source: Ministry of Finance; National Bureau of Statistics and International Monetary Fund

• Convoluted political economy of China's multiple urban residential property bubbles creates impetus for additional monetary easing, leading to inflation risk and multiple asset bubbles, magnified by the 'shark loan' phenomena which threatens to further inflate the current housing bubble.



Source: National Bureau of Statistics

• Resurgence in loan origination by China's State Banks which continues at an unrelenting pace through the use of private trust companies to disguise new loans, reaching 20% of the entire loan target for 2010 in just the first two weeks of the year.



Source: People's Bank of China

• Severe environmental degradation resulting from widespread air and water pollution, posing health risks to both urban and rural populations.