

Goldman Sachs: Strategy for Success

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1 Background

The Chinese marketplace is approaching a new era: state-directed economic regulations are being relaxed in a shift toward capitalism, with both Chinese and foreign investors eager to access the world's largest population. At present, China's investment banking industry is struggling with many examples of domestic failures such as Hainan Securities, and foreign banks are increasing their efforts to gain a presence in the commercial and investment banking markets. As demand for banking services continues to grow, the question of how a securities firm should best position itself operate in this developing economy remains.

2 Market Forces

New Entrants Entrants are not an immediate threat to Goldman, but they could be beyond the horizon. Traditionally, the major players in Chinese investment banking have been established state-owned banks, but recently foreign investment banks have been playing a larger role. Starting an investment bank requires an enormous amount of human and financial capital. However, as Chinese banks gain experience through partnerships with foreign firms, they could have incentive to create competition, at which point they may

receive favorable treatment from the government. This threat is well mitigated by forming a joint venture with well-connected Chinese as in the case of Goldman Sachs Gao Hua.

Buyer Bargaining Power Typically, investment banking services are required for major changes in corporate structure (such as mergers, IPOs, and raising capital). When a company sees one of these steps as necessary to increase long-term viability, it will not hesitate to pay for it and cannot avoid the use of an investment bank. Most corporations would rather pay the premium for a firm with a reputation for success than take a risk with a large portion of their assets. This allows investment banks with strong reputations to command a premium from their buyers.

Supplier Bargaining Power The suppliers to an investment bank are those who contribute capital—investors to contribute capital—the debt and equity markets. Suppliers are constrained by the market. For a given level of risk, they are bound to expect a given return. While it may take significant work to convince investors to contribute capital, they do not have significant bargaining power over price.

Substitute Products There are no effective substitutes for an investment bank. The services they provide are unique, and require a high level of knowledge and experience. While commercial banks may offer some overlapping services, they are usually unwilling to incur the levels of risk inherent to investment banking.

Rivalry/Competition Foreign investment banks, with their experience and capability, are better suited to serve the expanding Chinese marketplace than domestic banks acting alone. Investment banks offer services of underwriting, market analysis, credit procurement, and merger and acquisition advising. Research has shown that pricing is not the competitive point in the investment banking market. However, there is a great deal of competition for

each assignment given the limited supply of deals. Investment banks also compete on follow-up offerings, in which a company switches investment banks. The company's decision to switch is often based on the investment bank's outlook for the company. If the outlook is positive, the company is more likely to retain the investment bank. If the outlook is less than positive, companies have a tendency to switch. There is little to no retaliatory behavior on the part of banks for the simple reason that bankers as advisors are not in a cartel-like position to exact discipline and market pricing.

Complements The major complements in Goldman's China strategy exist between Goldman Sachs' traditionally impeccable reputation and Fang Fenglai's business experience and connections in China. While Gao Hua may have had trouble commanding premiums in deals on its own, Goldman Sachs alone would have issues with access to Chinese Markets given government regulation. Working together, the firms can win profitable bids for deals throughout China, including government divestitures of state-owned corporations.

3 Profitability Forecast

Based on the above analysis, Goldman Sachs' entry into China appears promising. Competition among investment banks is light, with clients choosing a bank based on its reputation and particular skills. Buyers have some bargaining power by choosing which investment bank to hire, but in the limited Chinese investment bank market this is greatly reduced. Investment banks set commission rates and underwriting fees without regard to the size or clout of the client. Substitutes are virtually non-existent: a firm that needs an investment bank's services has virtually no alternative. Currently, new entrants do not pose a major threat to Goldman Sachs. Goldman Sachs' reputation is a major complement to its Chinese operations. The creation of Goldman Sachs Gao Hua was a landmark in Chinese investment

banking, allowing Goldman Sachs to operate a full-service investment bank in its image, without the restrictions placed on foreign firms. The Chinese government's decision to allow Goldman Sachs this privilege currently appears to be due to Goldman Sachs' particular situation, namely the inclusion of Fang Fenglei, a businessman of considerable political influence, and Goldman Sachs' previous dealings with the Chinese government. It is unlikely that the Chinese government will grant foreign investment banks this same privilege in the near future. Considerations outside the six forces analysis are considered below.

A plethora of IPOs among major players in Chinese industry, such as Shanda Interactive and The9 Limited [sic], is attracting international securities firms in search of large underwriting and investment banking fees. Through 2005, Goldman Sachs had advised on \$23 billion of mergers and acquisitions in Asia, half of which came from China. Goldman Sachs is the leading underwriter for Mainland China's international listings.

Earlier this year, GS—along with Allianz AG and American Express—announced a \$3.78 billion deal with China's biggest bank, state-owned Industrial and Commercial Bank of China. In the deal, GS will hold a 7% stake, and Allianz will hold a 2.5% stake. GS has worked heavily with China Netcom Group Corp. and China Natural Petroleum, advising on \$8.3 billion of acquisitions. GS was also involved in the \$1 billion share offering of Ping An Insurance Group Co.

China's once fully state-owned banking industry is undergoing a process of reform and limited privatization. Recently, as part of a drive to improve financial reporting transparency, the Chinese government has wrote off approximately \$283 billion of non-performing loans from state-owned banks' financial statements. In an effort to reverse China's reputation for corruption, many convicted embezzlers and corporate swindlers have been incarcerated. International financial institutions have invested \$17 billion in Chinese banks in the past three years. International interest is spurred by the desire to rebuild these banks and in the process develop a lucrative position in the Chinese banking and financial services market.

Continued economic growth and deregulation combined with privatization of banking in China make China a very profitable market for Goldman Sachs. Goldman Sachs has already gained a huge first mover advantage with the creation of Goldman Sachs Gao Hua, especially in the access to China's equity and debt markets (previously restricted to Chinese companies). These markets are predicted to be Asia's largest by 2010, when they will be far along the learning curve in running a fully operational Chinese investment bank. Concentration and growth in information and technology sectors to create brand awareness in that sector will do much for Goldman Sachs. Working on important technological IPOs will signal to other I/T companies that Goldman Sachs is at the top of the "short list" of investment banks to hire. In particular, the semiconductor industry appears very promising.

4 The State of Goldman Sachs

Strengths Goldman Sachs' strengths (specific to the Chinese marketplace) can be defined in two main categories: Chinese relations and corporate reputation. In these two respects, Goldman Sachs is consistently outperforming rival investment banks.

Chinese relations Favorable political and personal relations in China are currently Goldman Sachs' biggest strength. For a foreign financial institution to be successful, it is essential to establish good relations with the government, relationships which affect dealings in all business sectors and can facilitate winning valuable assignments and lucrative deals. On the personal level, Goldman has forged partnerships with influential Chinese businessmen which serve two functions: they generate business for Goldman Sachs and they enhance Goldman Sachs' relationship with the government.

Goldman Sachs has taken steps toward gaining the favor of the Chinese government by serving as advisor in large debt offerings by four of China's largest state-owned banks.

This position has proved to be essential to Goldman Sachs' success in China. In 2004, Goldman Sachs was granted approval by the China Securities Regulatory Commission to create a new investment bank, called Goldman Sachs Gao Hua (GSGH). In creating GSGH, Goldman Sachs partnered with Fang Fenglei, a well-known and politically connected Chinese investment banker, and Lenovo Group, China's largest computer maker. As part of the deal, GSGH acquired the operating license of the failed Hainan Securities, which Goldman Sachs paid \$67 million to bailout. This gave Goldman Sachs the ability to deal in mainland stocks and bonds, as well as access to China's equity and debt markets, a privilege previously given only to Chinese securities firms. This licensure gives Goldman Sachs (through GSGH) a first-mover advantage in accessing China's burgeoning trading and securities markets as a principal.

Strong ties to the government will aid Goldman Sachs in positioning itself to be on the "short list" for lucrative business and assignments. Goldman Sachs has already achieved a milestone in the form of GSGH, which permits them to act as a licensed broker/dealer in China. This was realized against strong opposition from a powerful domestic broker/dealer lobby.

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Powerful businessmen facilitate economic transactions in the Chinese marketplace. The government responds favorably to businessmen of political clout. This is called "Guanxi" (friendship) and is essential to the current conduct of business in China. GSGH, an extremely valuable asset to Goldman Sachs operations in China, was facilitated by the inclusion of Fang Fenglei as a partner. Fang is a well-known investment banker of considerable political clout who possesses many valuable ties to senior political leaders. Another strategic partnership was formed by Goldman Sachs' dealings with China Netcom (CN). A leading CN advisor is

Jiang Mianheng, the son of China's president. Jiang is a driving force of China's technological advancement. Goldman Sachs' investment in CN gives it a formidable political ally and also a possible source of revenue from technological ventures in the future.

Reputation Goldman Sachs' stated claim is: "Our assets are our people, capital and reputation. If any of these is ever diminished, the last is the most difficult to restore." The promise of an untarnished reputation is an important factor in the Chinese business world, especially as China prepares to enter the WTO. There is a great need to improve financial reporting transparency and corporate governance of China's business. It is clear that the Chinese government is looking to GSGH to be a paradigm. In this regard Goldman Sachs can maximize its market share, credibility and positioning through insistence on transparent and internationally recognized financial reporting and "best practices" corporate governance, reputable dealings, and high standards of personal and institutional corporate ethics. This emphasis on reputation and corporate governance has the attention of the Chinese government and is a desired trait of corporate China. Demonstrating Goldman Sachs' serious commitment to reputation should provide the firm with large premium gains from investment banking fees.

In addition to these two main categories, Goldman Sachs has a great deal of experience in the technological sector (see "opportunities"). It has been able to consistently recognize growing industries and service firms within those industries, generating to huge profit margins in the process.

Weaknesses Goldman Sachs' main weakness upon entering the Chinese investment banking market was lack of experienced personnel. China International Capital Corporation (CICC), the investment bank joint venture between Morgan Stanley and China Construction Bank, had been in service for nearly a decade and was believed by Chinese businessmen to have the best reputation. Upon entering the market with Goldman Sachs Gao Hua,

Goldman Sachs mined much of CICC's talent, including head of operations Fang Fenglei. This resulted in the transfer of 15 of 45 GSGH staff from CICC. This immediately reduced Goldman Sachs' main weakness in this market.

Opportunities The Chinese market is one of unparalleled economic growth. Every week, more than \$1 billion in foreign direct investment (FDI) comes into the country. China has averaged a 9% increase in its gross domestic product (GDP) over the past 25 years. The growth rate of foreign trade has averaged 15% since 1978. In 2005, China accounted for 30% of Asian business transactions (excluding Japan).

Chinese firms have begun investing heavily abroad. In 2003, Chinese firms invested \$3.32 billion overseas. Lenovo, a Chinese computer giant, recently acquired the personal computer division of IBM in a \$1.75 billion deal. CNOOC, a Chinese oil company, was recently engaged in a bidding war for U.S.-based Unocal that topped \$18.5 billion. These examples demonstrate the market for investment banking services that arises in China as Chinese companies have capital and are willing to deploy it strategically to enhance their business.

China is no longer solely a manufacturing power. Industry development has occurred in the technology and research and development sectors. The IPO of Chinese search engine Baidu.com has drawn considerable interest both in China and abroad, with rumors of "google-esque" returns. By mid-2004, foreign investors had established over 700 research and development centers, totaling approximately \$4 billion in investment. Both Lucent and Intel have announced plans to open multi-million dollar research centers to compliment their existing Chinese manufacturing operations. The semiconductor industry has garnered favorable forecasts, with predictions of it becoming the world's second largest within a few years. Chinese universities awarded 465,000 sciences and engineering degrees in 2001, second only to the U.S. The recent cracking of the rice genome by Chinese geneticists generated much

attention in the scientific community.

The semiconductor industry appears very promising. China is on pace to become the world's second largest manufacturer within a decade. Goldman appears to have recognized the boom in this industry: the firm has invested nearly \$50 million in Semiconductor Manufacturing Industrial Corp. (SMIC), which has now become one of the leading semiconductor foundries in the world. Goldman Sachs analysts have predicted that this initial investment will double once the company goes public. By investing in this business and other infrastructure businesses, Goldman Sachs has positioned itself to be on the "short list" when it comes to doling out investment banking assignments from these companies. Not only will Goldman Sachs get investment banking and advisory fees from SMIC, it will also enjoy appreciation and gains that the underlying investment will yield.

Internet usage is widespread in China. China could soon experience a "dot china" boom, similar to the American version in the late '90's. Goldman Sachs' services have been recruited by several Internet companies, most notably Shanda Interactive, an online gaming service, and Baidu.com. Goldman Sachs' growing experience in handling high-profile Chinese Internet IPOs is important to winning future assignments. It will promote Goldman Sachs' reputation among serious "dot china" companies.

Goldman Sachs is able to provide credibility and secure execution in an otherwise underdeveloped market. In short, China's banking industry and market has not kept pace—developmentally or service-wise—with China's phenomenal growth. Goldman Sachs is a model of the professionalism, discipline, execution and knowledge base that Chinese banks strive to emulate. Goldman Sachs has experience with product innovations and exchanges that are essential to developing world markets. They also bring the promise of management skills and internationally accepted standards of accounting and corporate governance.

Threats Threats to Goldman Sachs' operations in China come in two forms: threats posed by the Chinese government/market, and threats posed by rival investment banks. Of the two, the former is presently more significant.

While Goldman Sachs has forged good relations with the Chinese government, the government still controls the affairs of business and is not likely to fully relinquish its grip on power and influence in the foreseeable future. Its enforcement has been seen as fickle, and may depend largely on personal connections and influence. Contract enforcement will remain a concern until serious reforms are made by the regime.

China's banking and financial market has been the subject of much scrutiny by foreign investors. Though it is in the process of reform, it is still riddled with corruption, inefficiency, and execution problems. Many banks allegedly lend money based on political clout and influence rather than on financial merit. As a result, China has a staggering non-performing loan problem. This corruption is enabled by China's inefficient legal system, which has limited experience in modern enforcement of contracts, collateral realization and securities laws.

China is currently experiencing a small resurgence in protectionist sentiment, believed by some to be response to CNOOC's failed Unocal bid and demands to revalue the Yuan. The director of the National Bureau of Statistics has called for measures to curb "hostile takeovers aiming to monopolize the Chinese market."

Intellectual property law is currently underdeveloped. This is a major impediment to the development and production of new technologies and the protection of profits gained from inventions and innovation. Consumer product and industrial piracy is widespread and predictable. While this sector of the law is improving, it is not currently enough to ensure secure business practices with respect to proprietary intellectual property.

The domestic Chinese investment banking services market was formed relatively recently. Domestic investment banks do not have the history, clientele, or reputation possessed by

Goldman Sachs. Domestic banks typically pay their employees one third of the salaries of similarly ranked staff in foreign firms, making employees easy targets for talent mining by foreign investment banks. There is also a powerful domestic broker/dealer lobby acting as a barrier to foreign entry in the investment banking market. However, Goldman Sachs has already overcome this obstacle with the creation of Goldman Sachs Go Hua.

One of the direct and major competitors to Goldman Sachs' operations in China is China International Capital Corporation. It has gained experience working on both domestic and international securities offerings and advisory work in the years since its creation in 1995. Many Chinese businessmen believe it to have the best reputation in China's investment banking market.

There is other competition by foreign investment banks in the Chinese market. The Union Bank of Switzerland (UBS) recently announced that it would invest \$500 million into Bank of China, and take a 20% stake in Beijing Securities. Last year, the Hong Kong and Shanghai Banking Corporation (HSBC) took a 19.9% stake in the Bank of Communications. Citigroup recently announced that it is leading a consortium to purchase a majority stake in the Guangdong Development Bank.

5 Conclusions

Goldman Sachs brings its powerful competitive assets to the Chinese marketplace in the form of its capital, expertise, talent, and reputation. In order to succeed in a variable but expanding Chinese economy, Goldman Sachs must concentrate on key strategic issues. Maintaining a reputation for integrity, security, corporate governance and sound business practices is essential to success. Strong relations with the Chinese government are essential to facilitating Goldman Sachs' Chinese business strategy. Forming partnerships with influential Chinese businessmen is a good way to gain access to the government and to garner credibility

in the Chinese business world. Strategic investments and involvement in the technology sector of the Chinese market will lead to a wealth of IPOs and advisory assignments.

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