

CHINA'S INTERNET

THE WORLD'S LARGEST INTERNET COMMUNITY

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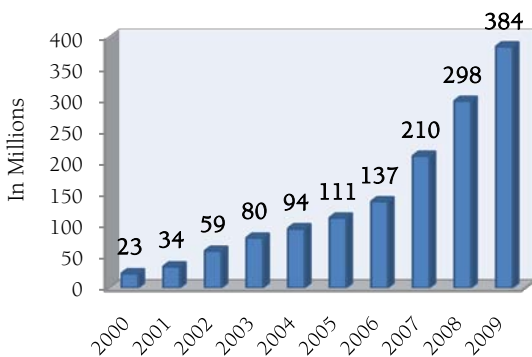
INTRODUCTION

China has a population of about 1.3 billion people, a fast-growing economy, and an emerging middle-class population that is already as large (or larger) as the entire population of the United States – and is growing fast. One result of this transition is the explosion in Internet use. Over the last two years, China has overcome the U.S. to become the largest base of Internet users on the planet. This large set of people can also be thought of as an impressive potential customer base. Across a wide range of businesses and industries, the Chinese Internet market provides ample investment opportunity.

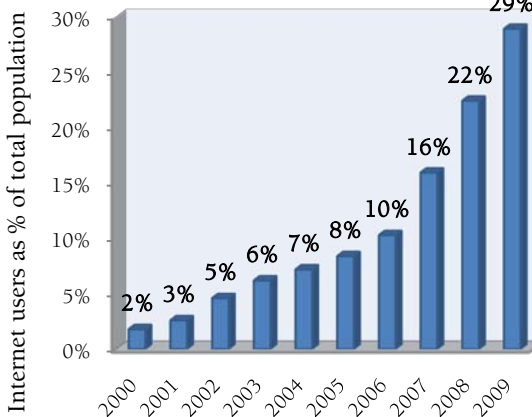
Putting some numbers around this, China now boasts 384 million Internet users as of the end of 2009. This is well above the total population of the United States, and the number is up about 180% in the last three years.

Another way to evaluate this market is by penetration of the Chinese population. With the jump in 2009 Internet users, the penetration rate jumped to 28.9% -- that is, total internet users divided by the Chinese population. This was a sizable jump from 22.4% in 2008, and an extremely low 10.3% back in 2006. The trend is very positive...although when comparing this penetration rate to other major developed and emerging economies, China is still near the bottom of the list. As the chart on the following page shows, the major developed countries (U.S., Japan, Korea) each have Internet penetration rates between 74%-77%, dwarfing China. Even among emerging-market economies, China falls a few percentage points below Brazil and Russia. So while the raw size of the Internet population in China is staggering and at the top of the list, we still may be in for substantial growth in the online population in the coming years as China closes some of the gap.

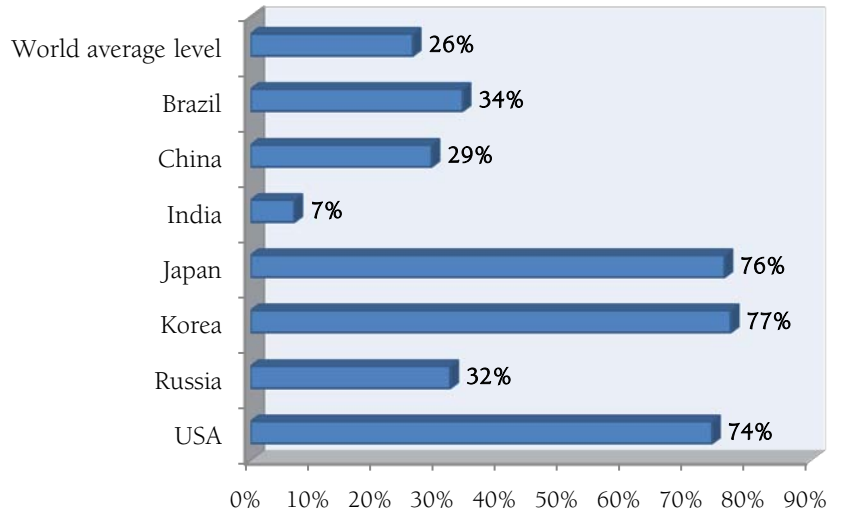
Number of Internet Users in China



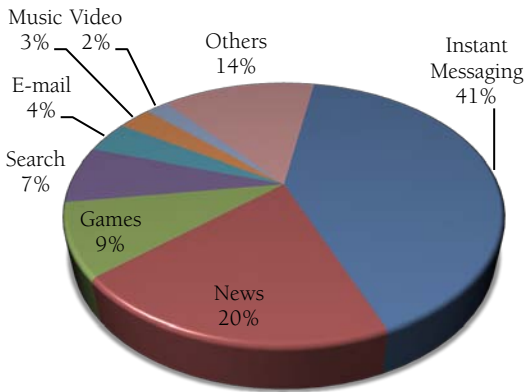
Internet Penetration in China



Internet Penetration Rates

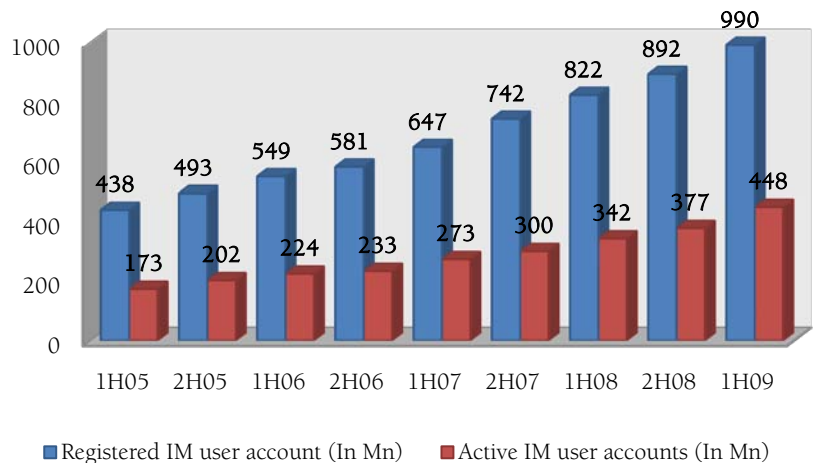


IM continues to be the first stopover for "netizens" in China



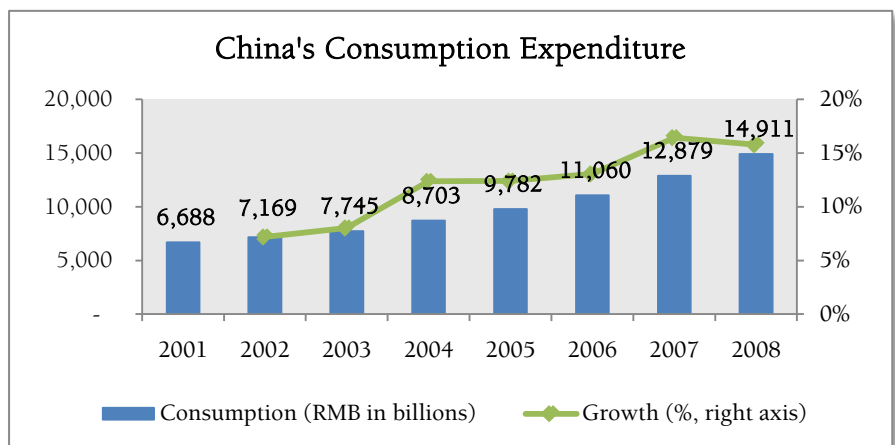
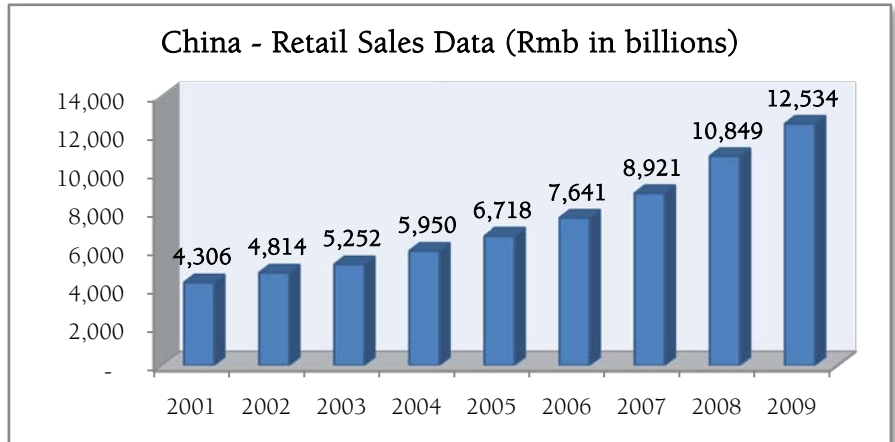
Another way to look at the scale of the Chinese Internet is through instant messaging, or "IM". In China, instant messaging is the primary "first application" a new Internet user will engage. This is different than in the U.S., where email is the first application of which a new user takes advantage. Looking at the chart below, QQ is China's largest IM platform with nearly 90% market share. In the first half of 2009, QQ almost reached a billion registered users (990 million). The more realistic estimate of users is the "active" IM users category, which has grown in each half-year period on the chart, and now stands at 448 million registered users. This doesn't necessarily define an investment opportunity, as most IM is free. However, it does point to a large pool of Internet users that will soon be, if not already, looking for other things to do online, things to buy, games to play, etc.

QQ User Accounts - Registered IM users and Active IM users



E-COMMERCE

Electronic commerce, or “eCommerce”, has become a meaningful part of business in the U.S. You just have to think of Amazon.com and how successful they have been to realize the industry is changing – and it is across the board with a large majority of retailers today. As you look toward China, the same thing is happening. First, from the big picture perspective, Chinese retail sales doubled over the last five years – from about RMB 6 trillion to about RMB 12 trillion (or about US\$880 billion to US\$1.8 trillion). Consumption expenditures are on the same trajectory, with double-digit growth since 2004.

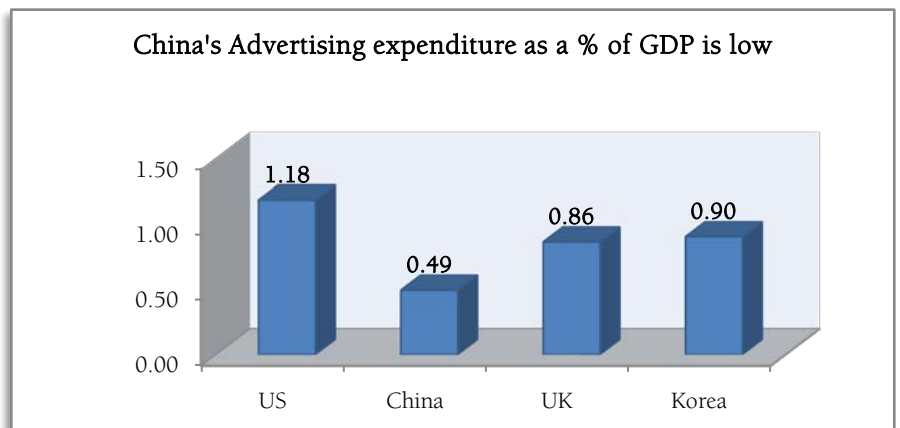
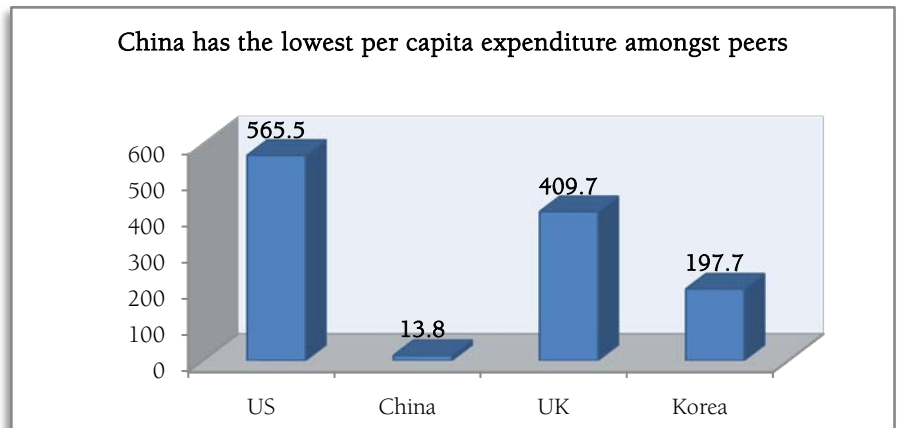


As you look at the online eCommerce opportunity, you don't have to see significant penetration on a percentage basis to create a large market. For every percentage point of additional market penetration, you would add US\$18 billion or so to the eCommerce market. This is happening in some forms in China today. For example, one of the largest online retailers in China, privately held Taobao (includes retail and online auction – analogous to Amazon plus eBay), is responsible for 50% of all package delivery in China (per Morgan Stanley estimates). This is an enormous statistic and points to a substantial eCommerce market and opportunity in China today and going forward.

ONLINE ADVERTISING

Think of the online advertising space in the U.S. and you likely think of Google and its search-based advertising business. As you look to China, the online advertising industry is similarly dominated by a single competitor and there are a few others with small market share. Interestingly, with Google's recent political challenges and the shutting down of Google's Chinese website, the market dynamics could shift in the near term and in the coming years.

In terms of the advertising industry overall, China spends much less than its peers on both a percentage of GDP basis, and on a per capita basis. The charts in the bottom-left margin demonstrate this point; however, the per capita number is almost astonishing. Granted, the enormous Chinese population plays into the equation; however, the U.S. spends about 40 times more per capita than China, while the U.K. spends ~30x more and Korea spends 14x more. A conclusion one can take from the data is that China is likely to gradually close at least a portion of this gap. As China's economy grows (sizably), the advertising industry is likely to grow as well. However, the combination of macroeconomic growth with a "catching up" factor could produce even faster growth in advertising. As we have seen in the U.S., it is potentially likely that some of this growth in advertising shifts to online advertising and away from the more traditional advertising media.



ONLINE GAMING

The online game industry is likely still in its early stages both in China and in the U.S. The industry is taking on many of the types of games found in the U.S. market, including massively multiplayer games, social networking games, and a range of others.

Looking to the chart and table below, the industry continues to evolve, although importantly, the scale is there and the revenue growth rates are impressive.

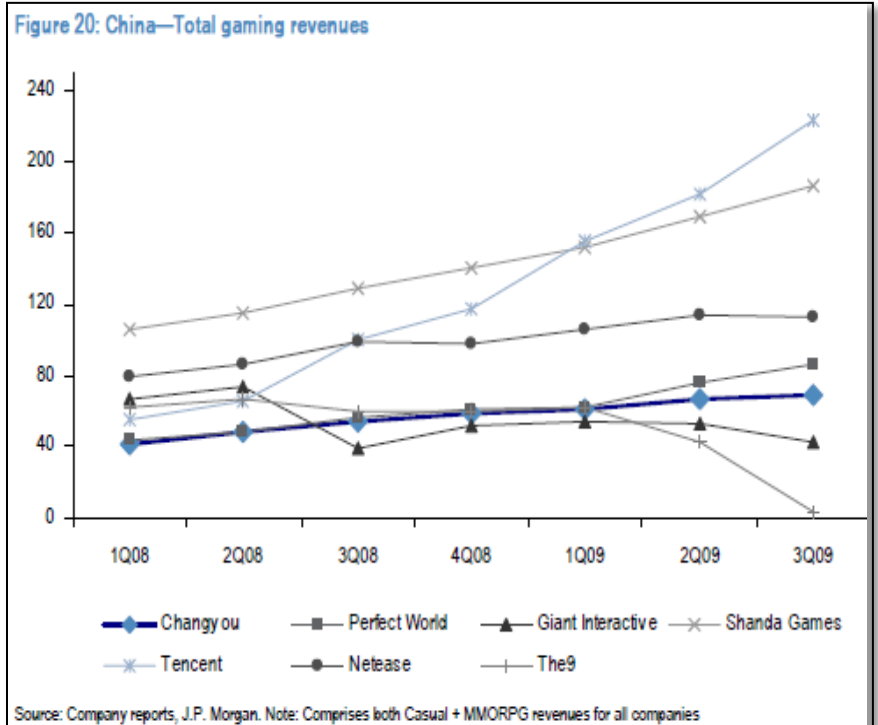


Figure 21: Tencent outperformed other key game players in 1H09

Company	1H09 revenues (in US\$MM)	Y/Y growth
QQ Games	331.0	172%
Shanda Games	321.7	45%
Netease	219.9	33%
Perfect World	138.5	51%
Changyou	128.2	44%
Giant Interactive	108.0	-23%
The9	104.7	-19%
Netdragon	49.3	6%
Kingsoft	47.0	43%

Source: Company reports, J.P. Morgan.

The top nine Chinese online game companies generated about \$1.5B in revenue in the first half of 2009. Annualizing the number gives you at least a \$3B market – and likely materially higher considering the substantial double-digit growth rates experienced by six of the nine companies in the table. As particular games go in and out of favor, there is likely to be some volatility in the space, although it appears that more gaming activity is heading to the Internet.

CONCLUSION: WHERE ARE THE OPPORTUNITIES?

The numbers speak for themselves. China's Internet opportunity is substantial, and is likely to drive long-term growth across a number of segments. From an investment perspective, there are a number of areas that represent potential investment opportunities:

- eCommerce
- Advertising
- Gaming
- Online Travel
- Social Networking
- Multimedia – music, video, others
- Mobile Internet

Much like the U.S. market, the Internet is likely to significantly further impact a range of industries. We expect this large emerging-market industry will continue to present a wide range of interesting investment opportunities in the coming years.



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