

CIC's US Disclosures: Reading Between the Lines

The spare change in your pocket tells the world little about you. The same is true for CIC's recent 13-F filing with the SEC. We locate CIC's public holdings in the context of a wider - and much more interesting - portfolio.

CIC's portfolio polaroid is somewhat underdeveloped

CIC caught the majority of its observers by surprise last month by submitting its first-ever 13-F form to the US Securities and Exchange Commission. The document, required of any institutional investor with more than USD100m worth of listed securities in its portfolios on the last day of the calendar year, gives us a snapshot of CIC's investment approach that is simultaneously interesting and frustrating.

Here, we analyze the contents of CIC's filing and establish a better context in which to understand them. Seeing how the pieces fit, in our view, requires analysis of CIC's two other tools for accessing American securities: special purpose vehicles and mandates.

One Brick is Not a Wall

Let's start with the most important message: what CIC disclosed in its filing is almost certainly a massive undersampling of its real US exposure and, potentially, a very misleading indication of that exposure's focus. Taking the part for the whole can be a very dangerous mistake to make when considering the importance of these holdings in isolation.

Just over USD9.6bn worth of securities were listed in CIC's filing: not much, compared to our estimate of USD110bn in offshore investments. Knock out the three firms in which we believe CIC invested for positional purposes - **Morgan Stanley**, **Blackrock** and **Teck Resources**, each of which provides market intelligence that is portably equal in value to the growth of their own stocks - and the sum invested falls to USD3.6bn. Make further reductions for holdings in ADRs and passive ETFs (the majority of them resource and energy plays) and the remainder - CIC's direct equity exposure to the US - amounts to only USD715m. While that's not enough of a sample to draw meaningful conclusions about the shape of the overall portfolio, those holdings remain interesting, primarily because of their conservative nature.

Scan the list of CIC's directly-held US minority stakes and you'll find a directory of defensive, stable companies, with strong prefer-

ences for the resources, energy, financial and pharmaceutical sectors. Few of these holdings have operating histories of less than 50 years and most would be considered value-biased anchors in an equity income fund. In truth, a conservative CPA asked to create a portfolio for a nervous widow might offer the same list of names.

There is very little evidence of appetite for risk or for exposure to American spending power in CIC's holdings list. In fact, so marked is the preference for strong balance sheets, high dividends and global-exporting business models that one might consider the portfolio an example of how to short the US economy while investing only in US stocks. That lack of hunger for US growth leads us to suspect that CIC's ambitions for American returns are better expressed elsewhere in the portfolio: specifically, the special purpose vehicles and the mandates.

Three Little Words

Whether it's sex, drugs and rock'n'roll or Harry, England and St George, there's nothing like a catchy three-part phrase to fire the imagination. CIC has also adapted this rhetorical device, creating at least four special purpose vehicles bearing three-word names for a number of its most important US investments.

These SPVs' names - **Beijing Wonderful Investments**, **Stable Investment Corp**, **Terrific Investment Corp**, and **Fullbloom Investment Corp** - are rarely publicly mentioned and make their most significant appearances in the fine print of SEC filings. However, they are home to some of CIC's larger bets on the US (and global) markets and their holdings, added to those disclosed in the 13-F filing, improve our understanding of CIC's American intent.

Beijing Wonderful was the first SPV to be created, by **China Jiayin** prior to CIC's formal inauguration, so a vehicle could be used for the fund's then-9.9% stake in **Blackstone**. It was initially capitalized with Rmb10m. The Blackstone holding does not appear on CIC's 13-F filing, an omission that appears to us to have an innocent explanation. Rather than the commonly

USD9.6bn isn't, in analytical terms, a lot to work with

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traded stock of the company, Beijing Wonderful owns units in the non-traded Blackstone Holdings Partnership Units, which can be converted on a one-to-one basis for common stock should the owner decide to sell.

As the Partnership Units themselves are not tradable, they need not be listed on a 13-F filing. Although CIC announced its intent to increase its holdings in Blackstone to 12.5% in October 2008, it does not appear on any list of institutional holders of the company's common shares. Our explanation: CIC, through Beijing Wonderful, has continued to amass non-reportable Partnership Units, not reportable stock.

Like Beijing Wonderful, Terrific and Fullbloom were created as acquisition SPVs. Terrific appears, so far, only to have been used to purchase CIC's 15% stake in US energy developer **AES Corp**, valued at USD1.58bn. Like Blackstone, the AES position is not listed on CIC's 13-F filing, perhaps because the transaction was still not finalized at year's end. Terrific was represented in the purchase by Filip Moerman of **Cleary, Gottlieb, Steen and Hamilton**. Fullbloom has, by contrast, become CIC's vehicle of choice for global acquisitions. It was used to acquire stakes in Teck Resources (Canadian, but US-listed), **South Gobi Energy Resources** (listed in Toronto), **JSC KazMunaiGaz** (Kazakh, but London-listed) and the UK's **Songbird Estates**. Joris Hogan of **Torlys LLP** acted for Fullbloom in the Teck purchase.

The fourth SPV - Stable Investment Corp - appears to be CIC's key vehicle for accessing US money market funds. Stable first came to prominence during the implosion of **The Reserve's** Primary Fund, which broke the buck in September 2008. The SPV has also been used as the buyer of money market products from **Legg Mason, Invesco, DWS, Goldman Sachs**, and **JP Morgan**. While Stable appears to be CIC's key money market investor, Beijing Wonderful has also been used to invest in a **State Street** fund. This much of the SPVs' activities we can learn from regulatory filings. However, like CIC's 13-F, this information likely understates the true extent of the SPVs' reach.

Terrific, for example, uses one of China's

leading private equity law firms as its representative and the named attorney, Mr Moerman, is perhaps best known for his work in China on behalf of **TPG**. Fullbloom, meanwhile, lists Felix P. Chee as one of its key contacts for the Teck acquisition. Mr Chee, who advised CIC's private equity and hedge fund investments prior to the appointment of Bill Lv in October 2009, was formerly the president and CEO of **UTAM Corp** and has also been linked to CIC's rumored investments in **Oaktree, Capula**, Blackstone and Morgan Stanley funds, among others, last year.

Z-Ben Advisors strongly doubts that this much PE and hedge advisory firepower has been amassed solely to complete relatively routine friendly buy-ins. Far more likely, in our view, is that these and other CIC-operated SPVs are being deployed to gain access to a wider array of asset classes, especially those where a limited partnership structure is contemplated. CIC's more recent PE investments - one announced in partnership with **Intel Corp**, and others reported with **Apax Partners, Lexington Partners, Goldman Sachs** and **Pantheon Ventures** - are, in our view, more likely than not to have been structured using either the SPVs discussed above or others created for the purpose.

Such PE investments must be considered part of an effort to produce greater long-term growth than the portfolio components listed on CIC's 13-F filing. In combination with mandate investments aiming for index-plus-300bps returns, a better sense of where, in its portfolio, CIC is searching for yield begins to emerge.

The View from the Cheap Seats

While it is never possible to track CIC's total international portfolio in fine detail, the 13-F filing is, at least, helpful. Add those insights to Z-Ben Advisors' strong suspicion that CIC has spent essentially all of its USD110bn offshore dowry, and we are able to make a better-supported estimate of where the money is in play than we might otherwise attempt.

Of course, estimates require assumptions, so here are ours. First, we believe that CIC's small-scale investments in US-listed instruments have

Not every holding is reportable, however important

SPVs are home to some of the real investment action

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likely been replicated elsewhere, primarily London, although no regulatory filings comparable to the 13-F are available to prove it. Second, we suspect that CIC's appetite for investment risk grew steadily throughout 2009 and that the 13-F holdings represent some of the least-aggressive components of its total holdings. The more aggressive portion of CIC's portfolio was obtained through mandate exposures, which we believe were funded later in 2009 than the stock purchases listed in the SEC filing.

Third, we believe that CIC's internal infrastructure for evaluating PE, hedge fund and alt-asset transactions was substantially augmented in 2009 but was unlikely to have been a significant contributor to total spending. Although that will change in 2010, we doubt that CIC is currently as well-diversified across asset classes as it intends to become. Finally, we forecast that CIC's investments will conform to the barbell pattern so commonly found in Chinese institutional portfolios: larger-than-expected high-risk investments matched with larger-than-expected low-volatility (and low-yield) investments. This pattern may change over time but it would be surprising to learn that CIC has departed radically from the usual domestic starting point.

How then do we break down CIC's current portfolio? USD9.6bn of investments can be seen in the 134-F filing. An equal sum invested in other markets seems to us a reasonable guess. USD6bn in PE, hedge funds and alts we believe another reasonable guess, given long lead times to assemble a portfolio. USD20bn in money market funds (of whatever currency but likely primarily USD) is the kind of low-yield barbell component we would expect to find in any Chinese institutional investor's portfolio. USD 10bn in cash is the minimum likely reserve with which CIC would feel comfortable. That leaves USD55bn. All of it, we judge, is currently invested through third-party mandates.

Putting 50% of CIC's offshore funds in the hands of professional managers solved a number of organizational problems at once. The money was put to work immediately, it received high-quality management and oversight of a type CIC had little to spare, it extended enormously the geographic reach and asset class scope of the

portfolio and it remains eminently scalable. In our view, the percentage of CIC's assets managed through mandates is more likely to rise than fall. This could mean USD120bn or more of new mandate funding later this year.

Never Give an Estimate and a Date

Always one or the other but never both: that's the first rule of professional forecasting but we broke it (with some élan, we hope) earlier this year. We suggested that a decision whether or not to give CIC a further USD200-250bn from China's USD2.4tr of sterilized reserves would be made around Spring Festival. We think that call was the correct one. Moreover, we would bet heavily that the decision will be "yes" and, if anything, that we have underestimated the amount to be transferred.

Our reasons for believing the transfer will happen are simple: not only has CIC acquitted itself admirably since its founding, likely producing the best returns of any global SWF in 2008 and 2009, the problem it was created to solve has only grown larger. China had just less than USD2.0tr in reserves when the need for a diversifying investor such as CIC became clear. Those reserves have since grown by more than 20%, despite the global slowdown in trade and a 20% increase in the value of the yuan. There's clearly more work for CIC to do.

When will it happen? We'd bet dollars to donuts that State Council has already decided to go forward and only the amount and the process are in the final stages of debate. Formally, any decision from State Council would be informed by inputs from CIC's management and executive committees, other interested agencies such as Ministry of Finance and SAFE, and be presented by one of State Council's Standing Committees. That work, in our view, has largely been completed and, if CIC is signaling that strong buying opportunities are available, the state apparatus will move quickly to top up CIC's tanks. If CIC truly is hungry for returns, expect third-party mandates (plus alts) to win a much greater share of the total than in previous years. Keep your eyes open for a new round of RFI/RFP requests, likely in early Q2.

Improved internal infrastructure enables speed and spending

Mandates took the lion's share and will continue to dominate