

## China Investment Corp: Coughing up Cash

CIC's cash holdings fell 55.4% during 2009 (from 87.4% to 32%) much to the delight of third-party managers. Yet how CIC will go about disbursing the remainder of its cash in hand for 2010 is the greater question.

CIC had an ROC of 12.9% for 2009, versus 6.8% in 2008

By now, the headline figures from CIC's 2009 annual report should be well-digested by any fund management house doing or hoping to do business with the fund. With a healthy declared return on capital of 12.9% (up from 6.8% last year) and a much-improved return from overseas investments of 11.7% (up from -2.1%), CIC has reasons to be proud of the results achieved from the additional USD58bn it invested during the year. Readers should note that CIC calculates global return using a mix of equity and cash accounting methods and does not rebase capital deployed to include past years' gains. While CIC employs this method consistently and cautions that it may overstate real income, Z-Ben Advisors believes the extent of overstatement may not be clear to all. Internally, we typically discount CIC's reported global return rate by 15% or more and expect to apply a larger discount in future years as the capital base compounds.

2009 was a boon to CIC's existing and potential third-party managers, as the fund's cash holdings experienced a precipitous drop in 2009, finishing the year at 32%, well down from end-2008's level of 87.4%. This decrease was due to a better market outlook and, we suspect, some gentle pressure from State Council and else-

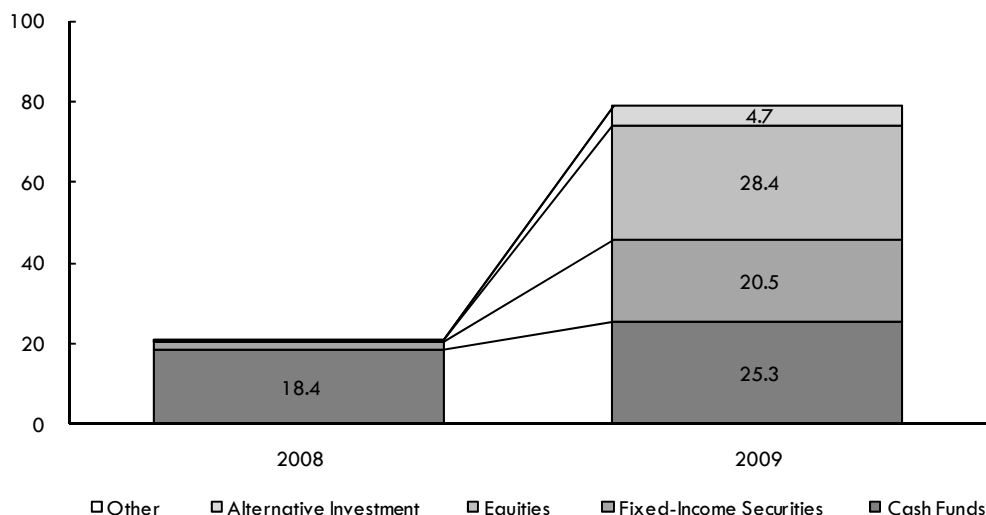
where to get off the dime and prompted meaningful investment activity from CIC, both direct and indirect, with the latter category now making up 59% of the portfolio. We suspect, from our observations of NCSSF and the habits of other, conservatively-managed Chinese institutional investors, that CIC will retain at least 10% of its assets in cash over the next few years. That leaves a further 22% of current assets available to be invested, primarily with overseas third-party mandate managers, as well as the USD100bn in additional State funding expected to arrive in 2010.

### The Interesting Bits

So far so good, if also so sketchy. Rough estimates of what sectors CIC has bet on are only a broad indicator of future behaviour, a point we made earlier this year when discussing the implications of CIC's scaled-down 2010 funding. More interesting to us than the raw (we can't quite bring ourselves to describe CIC's books as cooked) numbers was the expanded view of CIC's operational departments which the annual report afforded. The four departments introduced last year – the Public Market, Tactical, Private Market and Special Investment Departments – all survived and additional details of

CIC reduced cash holdings to the delight of third-party managers

### CIC Portfolio Composition (USD bn)



SOURCE: Z-BEN ADVISORS

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their purviews are given. Z-Ben Advisors suspects that, barring an upheaval in world markets, the Tactical and Private units will come under the greatest pressure in the remainder of 2010, for reasons that require a short tour of CIC's current circumstances to articulate.

As we noted in a Flash Report earlier this year, CIC's initial request for a further USD200bn in funding was rebuffed by the Ministry of Finance, likely at the suggestion of State Council. CIC was, instead, encouraged to apply for a USD100bn top-up. Z-Ben Advisors' understanding of the MoF/State Council's decision is that it represents short-term conservatism in order to enable longer-term aggressiveness. Although CIC was judged to have done well in assembling a portfolio of indirect equity and fixed-income positions, as well as a good range (if somewhat narrow in sectoral focus) of direct holdings in public companies, it had not achieved equal success in developing its property and alts holdings. The 2009 annual report makes clear, for the first time, that these are the responsibility of the Private and Tactical departments, respectively, and that these holdings' combined weight at the end of 2009 was only 6% of the total portfolio. We expect the depth and range of both departments' holdings to be improved considerably by the end of the year, with an internal target as high as 20% or more for the combined weight in the portfolio by the time the next USD100bn is spent.

At time of writing, the Private Department's next move towards that goal was the subject of considerable press speculation, much of it focused on the possibility that CIC might bid for all or part of the **Harvard Endowment** property portfolio. We have no view on whether or not that particular transaction will come off. However, we think of it as an instructive example of one of CIC's favored investment approaches: large-scale bottom-feeding. One of the few advantages of CIC's size and liquidity is its unequalled ability to write a check on the spot. That advantage can sometimes best be exploited when facing a motivated seller, for whom the fast disposal of an illiquid asset may mean the difference between survival and bankruptcy. In such circumstances, CIC can take advantage of

the restricted pool of potential buyers to obtain deep discounts, something it has achieved in past investments in bottom-fishing property funds managed by **Morgan Stanley** and others. Such deals, if consummated on a scale similar to the mooted Harvard transaction, solve a persistent second problem for CIC: how to manage its scarce internal resources efficiently.

### The Predictable Bits

With something like USD100bn to invest annually – a sum only likely to increase in coming years – doing deals of USD100m at a time would paralyze CIC's 250-strong staff (although that number will rise past 300 by the end of the year, according to a recent hiring announcement from the fund). Indeed, doing deals USD1bn at a time is proving frustratingly slow for CIC's portfolio controllers. There likely aren't many distressed sellers in the world with USD2bn+ portfolios out to bids. However, we won't be surprised if CIC attempts to negotiate deals with all of them by the end of the year. It also seems reasonable to us to believe that CIC may have to hold its nose and buy, regardless of market prospects, into a larger number of North American and European REITs if it is to expand its property exposure at speed. Finally, there is one little-discussed property market which can offer CIC the size and ease of access it seeks, if it's really prepared to take a contrarian position: Japan.

Less public attention has been paid to the struggle that the Tactical Department will face to scale its operations up quickly without losing focus. Thanks to the annual report, we now know that this department runs three internally-hedged and two externally-managed alts portfolios, which are essentially thematic FoHFs. It seems reasonable to us to assume that the majority of CIC's publicly-known smaller holdings – those disclosed to the SEC, for example – make up the contents of these internally-managed funds, which include a hedged global equity portfolio and a long-only value fund. It is far more difficult to assess what might constitute the contents of the externally-managed holdings, although CIC has been linked to a number of alt-space players in the past year. This externally-managed portion of the Tactical Department's

Tactical and Private units under most pressure

Look for CIC to increase its property and alts holdings in 2010

CIC will continue to bottom-feed

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remit appears to us to be the one most likely to grow quickly in coming months, although perhaps not as quickly as the property component of CIC's portfolio. We suspect that, both now and in the near term, property will outweigh alts in the asset mix by a factor of two or three to one, suggesting that alts make up less than 2% of the portfolio now and will only grow to 5-6% by end-2012. While that may seem a low total, CIC could conceivably be a USD1tr fund by that date, making it one of the world's largest alts investors.

CIC could become the world's largest alts investor

In our view, the Tactical Department must choose between two options in order to expand its footprint quickly, both of which require the use of a greater number of offshore third-party managers. It can either increase dramatically the size of its current funds, which almost inevitably means hiring many more managers with styles similar to those already engaged, or it can diversify the number of styles managed beyond the current (and remarkably broad) Directional and Non-Directional portfolios. The latter choice would also open CIC's checkbook to a much wider number of third-party managers. Which choice will the fund's managers make? Unfortunately, it's likely to be some of both, in our view: some conservative doubling down with existing managers who have strong, low-volatility track records, some initial positions

CIC still has a lot of work to do in 2010

taken with new managers in new style boxes, giving the appearance, if not the benefits, of broad alt exposure.

### The Less Predictable Bits

A fair question to ask at this juncture of the fund's development is: what does CIC want from the rest of 2010? In our view, the answer may be less straightforward than at any time in the organization's history. CIC had a fair wind through most of 2009 and was, arguably, slow to capitalize on the opportunities the market rebound made available. It has, we believe, satisfied but certainly not exceeded the expectations of its creators in assembling a robust and well-diversified portfolio. It now faces a global market whose direction is much less certain than at any time in the past year and, worse luck, does so at a time when the domestic markets it cannot touch appear poised to move much higher. In these circumstances, we suspect that the thing CIC wants most is time to work. If it can complete the labor of establishing its initial portfolio, a realistic miniature of its mature form, then, we believe, CIC's managers will at last be able to sit back and judge the first part of the fund's history successfully concluded. The last five months of 2010 likely won't see that effort completed. However, with luck, the back of the work may be broken this year.

### CIC Direct Investment (Since Establishment)

INVESTMENT TARGET	CONTRACT DATE	INVESTMENT AMOUNT(BN)
Chesapeake	Jun/10	NA
Penn West Energy Trust	May/10	CAD 0.44
Penn West Energy Trust	May/10	CAD 0.82
GCL-Poly	Nov/09	USD 0.72
AES Corp	Nov/09	USD 1.58
PT Bumi Resources	Sep/09	USD 1.90
Noble Group	Sep/09	USD 0.86
South Gobi	Nov/09	USD 0.50
Nobel Oil	Sep/09	USD 0.27
JSC KazMunaiGas Exploration Production	Jul/09	USD 0.94
Poly Hong Kong	Sep/09	HKD 0.41
Songbird Estates	Aug/09	GBP 0.15
Teck Resources	Jul/09	USD 1.50
Goodman Group	Jun/09	AUD 0.20
Morgan Stanley	Jun/08	USD 1.20
Morgan Stanley	Dec/07	USD 5.60
Black Stone	May/07	USD 3.00

SOURCE: Z-BEN ADVISORS