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PLANTING STAKES

Battered by subprime losses, Citigroup went looking for help. Some $18 billion later, the bank had a few new investors, a few old and a lot more geographic diversity

by
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IN A SIX-MONTH PERIOD FROM MID-SUMMER to mid-January, government-allied, offshore institutional investors poured more than $40 billion into blue-chip American and European financial institutions. Singapore's Temasek Holdings Pte. Ltd. and China Development Bank invested about £2.5 billion ($4.9 billion) in Barclays plc. Temasek forked over an additional $5 billion to Merrill Lynch & Co., while China Investment Corp. invested the same amount in Morgan Stanley. The Abu Dhabi Investment Authority plowed $7.5 billion into Citigroup Inc., grabbing a 4.9% stake. The Government of Singapore Investment Corp. Pte. Ltd. infused Sfr11 billion ($10 billion) into UBS of Switzerland.

The biggest deal was the last. Announced Jan. 15, Citigroup engineered an $18.4 billion investment package from both onshore and offshore institutions, two prominent individuals and the public. While the nature of the shares issued make it impossible to determine what stake of Citigroup that investment converts to, at Citigroup's current market capitalization, $18.4 billion represents a 14.25% share.

In a $12.5 billion convertible preferred issue, Singapore's GIC led with $6.88 billion, while the Kuwait Investment Authority kicked in $3 billion. The New Jersey Division of Investment, part of the state treasury department, invested $400 million. Extrapolating from Securities and Exchange Commission documents and other sources, Los Angeles-based money manager Capital Group of Cos., Citigroup's largest institutional shareholder, appears to have invested $1.75 billion, while Saudi Prince Al-waleed bin Talal, the bank's single biggest individual shareholder, put up $450 million. Al-waleed's legal advisers declined to comment. So, too, did a Capital Research press officer. Former Citigroup chief Sandy Weill tossed in an additional $20 million, the same documents appear to indicate.

And there was more. Over $6 billion came through two public offerings announced at the same time: a $3.25 billion preferred issue and a $2.9 billion convertible.

While other major investments in Citigroup and its competitors can't be ruled out, this one culminates a recent shoring-up operation of the balance sheets of some storied names in finance. It also represents what promises to be an unparalleled transfer of capital from emerging markets to developed ones.

For all these reasons, it gets our nod as the inaugural Deal of the Quarter.

A quick word on what we're calling the Deal of the Quarter. Unlike any of our deals of the year features (see M&A Deals of the Year, Feb. 11), the focus of Deal of the Quarter is not big, significant or necessarily important. Rather, we're looking at complex, innovative or technically challenging transactions. Our purpose in this feature is to take apart a complicated deal and display it in all its intricacies—or at least as much as we can fathom and present on a few magazine pages. The emphasis here is on dealcraft, peeling away the layers to display the play of personalities, the financing or the structural, regulatory or legal complexities of a recent transaction.

The Citigroup financing is not a deal that involves a change in control at all. Instead, it's a financing transaction driven by the serious hits the bank absorbed from the subprime mortgage mess and, of course, one shaped by capital pouring into financial services from overseas.

The capital in all six financial institution deals since last summer came largely from sovereign wealth funds, government entities flush with foreign exchange reserves, often from the run-up in commodities or energy prices. Given the attention they've generated, sovereign wealth funds appear to have suddenly surfaced. Some, in fact, have been around for three decades. Much, of course, has been made of possible hidden agendas of sovereign wealth funds. Since almost all are opaque at best, their motivations aren't clear. Taken at face value, they are long-term passive investors seeking opportunities globally. None have asked for board representation. A more skeptical reading is that these funds are extensions of government policy, engaging in what one Singapore lawyer calls "soft diplomacy."

"It's hard to believe that some portfolio manager made the decision," says Edwin Truman of the GIC investments in UBS and Citigroup. Truman is a senior fellow at the Peter G. Peterson Institute

The fine print: bailing out Citigroup

In a rash of investments of sovereign wealth funds into U.S. financial services companies, the $18.4 billion* infusion by six investors (including two U.S. funds and former Citi chairman Sandy Weill) stands out for its size and complexity. Not only had Citi's capital been drained by enormous subprime mortgage writedowns but the stock price had been falling and Washington had grown increasingly sensitive to sovereign deals. These factors helped shape the financial transaction announced on Jan. 18. Here are the details.

Four institutional investors (Government of Singapore Investment Corp., Kuwait Investment Authority, New Jersey Division of Investment and the Capital Group) plus single-biggest individual Citi shareholder, Prince Al-waleed bin Talal of Saudi Arabia, and former Citi head Sandy Weill.

BASIC COMPONENTS: Convertible preferred securities with a 7% coupon and a conversion premium of 20%, or $31.62 a share; investors may convert shares into common stock at any time; Citibank may force conversion after Feb. 15, 2013; non-voting investors may not seek board representation

Offering of preferred securities to the public

Straight preferred securities with an 8.125% coupon

Offering of preferred securities to the public

Convertible preferred securities to common shareholders with a 6.5% coupon and a conversion strike price of $33.73 a share; same conversion rules apply

RESULT OF THE DEAL

The new capital allowed Citi to raise its **Tier I capital ratio** to 8.8%, far above the 7.5% target level below which it had fallen at the end of the third quarter. It also should be more than enough to shelter the bank from further mortgage and loan-related write downs, at least one bank observer believes.

Corporate counsel:
Andy Felmar, Joseph Tedeshi, Michael Zuckert, Michael Tarpley

LEGAL ADVISERS

Sidley Austin LLP: Susan Lewis, Prabhat Mehta, Paul C. Adams, Norman D. Slonaker, William S. Eckland, Joel D. Feinberg, Daniel M. Rossner

Corporate counsel: Deputy Attorney General Rubin D. Weiner

Gibbons P.C.: Frank Cannone, Cheryl Gorman

Hogan & Hartson LP: Bruce Gilchrist, Colin Craik, Mark Mazo, Jim Rosenhauer, Merry Chavez Anderson, Jonathan Pisha, Scott McClure, Nancy O'Neil

Paul, Weiss, Rifkind, Wharton & Garrison LP: Robert Schumer, Michael Hong, Ariel Deckelbaum, John Kennedy

INVESTORS

INVEST

Government of Singapore Investment Corp. Pte. Ltd.

INVESTMENT: $6.88 billion

One of two Singapore Government-owned sovereign wealth funds, it holds under management what it says is "well over" $100 billion. Outside estimates believe the true amount is more than $300 billion. Tends to be a passive investor, primarily in treasury bills, equities and real estate. In December 2007, it made an investment of Sfr11 billion ($10.1 billion) in UBS, giving it a 9% stake in Europe's largest bank.

New Jersey Division of Investment

$400 million

Manages seven public pension funds of New Jersey totaling $81.3 billion in assets. Held almost 13 million Citigroup shares before the investment. Also made investment in Merrill Lynch.

Saudi Prince Al-waleed bin Talal (Undisclosed)

A member of the Saudi royal family and one of the world's richest individuals (net worth of $20.3 billion according to Forbes), Prince Al-waleed invested $590 million in Citicorp in 1991, which made him the bank's single largest shareholder. He held 243.75 million shares, or 4.89%, immediately before November's Abu Dhabi investment.

$12.50 billion

$3.25 billion

$2.90 billion

Citi also cut its dividend 41% from 54 cents a share to 32 cents, saving itself about **$4.4 billion.**

*Equals about 14.25% of current market cap. However, ultimate stake depends on when shares converted.

SOVEREIGN WEALTH FUNDS: WHAT ARE THEY? Government investment funds: They are usually funded from foreign exchange reserves, although some are primed by commodity export revenues, most notably oil. Twenty-four different nations hold SWFs. The largest–and one of the oldest–is the Abu Dhabi Investment Authority, whose assets are estimated to total almost $900 billion. The smallest is a $2 billion fund held by Azerbaijan. SWFs invest in a wide variety of assets. They now hold major stakes in everything from luxury hotels and department stores to private equity firms and banks.

ADVISERS for Citigroup

Sullivan & Cromwell LLP (M&A): H. Rodgin Cohen, Robert Downes, Mitchell Eitel, Alan Sinsheimer, Mark Welshimer, David Hariton, Eli Jacobson, Andrew Gladin, Wendy Goldberg, Sagi Goldberg, Daniel Altman, Francesca Don Angelo, Kenji Taneda

Cleary Gottlieb Steen & Hamilton LLP (Capital markets): Alan Beller, Jeff Karpf, Elizabeth Chang, Adam Fleisher, Colleen Harp, Neil Markel, Ken Bachman, Kevin Burke, Neil Whoriskey

Skadden, Arps, Slate, Meagher & Flom LLP (Public offering): Gregory Fernicola, Stuart Finkelstein

Corporate counsel:

Michael Trissel, Walt Buckley

Gibson, Dunn & Crutcher LLP:

Steven Guynn, Jeffrey Trinklin. Christopher Bellini, Frederick Walters, Anna Zhuravitsky, Melissa Torres, David Ware

ORS

Capital Research Global Investors/Capital World Investors (Undisclosed)

Two divisions of Capital Research and Management, the advisory arm of the tight-lipped, privately owned asset managers, Capital Group. Best known for its American Funds group of mutual funds, one of the largest in the U.S. Assets under management total more than $1.5 trillion. Citigroup's biggest institutional investor, the group held 230.54 million shares as of Sept. 30, 2007, or 4.63% of total, according to FactSet Research Systems Inc.

Kuwait Investment Authority

INVESTMENT: $3 billion

Autonomous government body that manages two Kuwait government funds, the General Reserve Fund and the Future Generations Fund, totaling more than $300 billion. Invests across the board. Owns 7% of DaimlerChrysler and 10% of Chinese bank ICBC. Also invested $2 billion in Merrill Lynch & Co. the same day as the Citigroup deal was announced.

Sanford I. Weill/The Weill Family Foundation (Undisclosed)

The former Citigroup head and current chairman emeritus has a net worth of $1.8 billion (according to Forbes). He said he helped introduce potential investors to the bank on this deal and told the bank he wanted a stake. Before retiring in 2006, he held about 16.56 million shares.

Source: The Deal

COMMITTEE ON FOREIGN INVESTMENT IN THE UNITED STATES

CFIUS subjects acquisitions of "critical infrastructure" by foreign entities–especially government-backed–to a mandatory, 45-day, Washington interagency review. The overall intent is to restrict investments that threaten national security, but how broad that can be defined is unclear, both in terms of reach and in terms of what constitutes a controlling stake. In the aftermath of an aborted attempt in 2006 by a Dubai company to acquire operations of six U.S. ports, an acquisition CFIUS cleared, politicians weighed in. A new law became effective Oct. 24, 2007. Implementing regulations and definitions must be issued by April 25, 2008.

Under the old regulations, a controlling stake was defined as 10% or more. Less was considered a safe harbor. That meant the $12.5 billion investment in Citigroup wouldn't be subjected to CFIUS review. However, Congressional intent of the new law is another matter. Some legislators have demanded the role of sovereign wealth funds be particularly scrutinized.

PREVIOUSLY ON "CITIGROUP GOES TO MARKET"...

On Nov. 26, 2007, Citigroup announced a $7.5 billion private placement with the Abu Dhabi Investment Authority, the world's richest sovereign wealth fund. When conversion is complete, ADIA could eventually hold up to 235.63 million common shares, although it also pledged not to own more than 4.9% of Citi's voting stock from this and any other acquisition. Under the terms of the deal, ADIA is issued preferred shares, with an 11% per annum interest rate. ADIA must convert the securities into common shares beginning March 2010 at a maximum strike price of $31.83. The strike price was reduced because of the subsequent $12.5 billion issue.

for International Economics and an authority on sovereign wealth funds.

But there's a good case to be made that capital infusions in these kinds of banks not only provide a measure of global stability, but in the long run represent solid investments, with lots of upside. These are banks that aren't going to "disappear overnight," said GIC's deputy chairman, Tony Tan, in an interview late January with Singapore newspaper the Business Times. "In the case of UBS, they have a worldwide global wealth management business which is something not replicable by any bank. Citigroup has an international worldwide consumer business which is also unique."

Tan himself is a case, however, for an obvious nexus between the funds and politics. He was deputy prime minister for 10 years and is at the absolute center of Singapore's longtime political ruling class.

Another Singaporean source cautions that, at least for GIC, the Citigroup deal wasn't a stretch at all in terms of the amount paid and made sense on many levels. GIC "has always liked banks," the source says. According to Tan, the sovereign wealth fund already owned 0.3% of Citigroup.

Add to that personal relationships. GIC had far more than just a passing acquaintance with Citigroup CEO Vikram Pandit. GIC was one of the original investors in Old Lane Partners LP, the Asia-oriented, $4.5 billion hedge fund Pandit founded and eventually sold to Citigroup for an undisclosed amount in April 2007. As part of that sale, Pandit became head of Citigroup's alternate investments group.

In addition, Citigroup's new chairman, Win Bischoff, is an "old Asia hand." He was managing director of Schroder's Asia Ltd. for more than a decade in the 1970s and 1980s.

The January Citigroup investment was a variation on a club deal. Although terms were the same, each investment was negotiated separately, one source says. Citigroup reached out to selected individuals and institutions, says another source, who adds there was an attempt to spread investment sources geographically among Asia, the Middle East and the U.S to reduce any political concern about regional concentration in the bank. Of those who ultimately invested, only the New Jersey fund manager approached Citigroup.

"It wasn't a secret that [Citigroup] was looking to sell preferred stock to investors," says Susan Burrows Farber, chief administrative officer at the investment division of New Jersey's Treasury Department. "We had the money. We made the call."

In the case of the Kuwait Investment Authority, the Kuwaitis had repeatedly indicated the desire to invest long-term in Citigroup, sources say. The search for investors understandably turned to Capital Group, which, as of Sept. 30, owned a 4.62% stake in Citigroup.

Including Al-waleed is even more understandable. He was not only one of the largest single shareholders, but one of the longest-standing. Al-waleed's $590 million bailout of the bank in 1991 gave the prince a 4.9% stake, which was widely viewed as helping save Citi and giving him a handsome return. After the Abu Dhabi investment, the prince's stake was no longer the bank's largest, which voided his eagerness in increasing his holdings, says one source. Al-waleed also openly dropped his support of Charles Prince, Citigroup's former chairman and CEO, after Citigroup announced two write-downs within three weeks. That loss of support, a wide range of observers believe, contributed to Prince losing his job.

Weill told BusinessWeek that several weeks before the investment came together, he told Pandit he would introduce the bank to potential investors and would put in money himself. It isn't clear what role, if any, Weill actually played in matchmaking. "They gave me a call and said they would be doing a deal and if I was interested in investing they'd love to have me." He would not say how much he invested.

The deal was done within days, says Burrows Farber. That $400 million marked the first time New Jersey had gone directly to a corporation for an equity stake. While New Jersey owned millions of shares in Citigroup, it had substantially reduced its financial sector holdings. "We were very underweight," Burrows Farber says. "We were motivated by a desire to increase our exposure" and negotiated terms that were extremely favorable. The investment division manages pension funds that totaled $81.3 billion at the end of last year.

Another of the advantages of the deal, Burrows Farber adds, was that there were no investment banker serving as middlemen. "Doing it directly, there were no fees."

Only the Kuwait fund, says one deal source, used an outside investor, Lazard. A source close to the deal says Lazard joined KIA at the last minute, after the investment bank soured on one undisclosed potential investor (who didn't invest in the end). "KIA needed advice to get them over the top, and Lazard helped them," the source says. Lazard bankers included Joseph Maybank, Gary Parr, Timothy Dana and Evan Russo.

While there were fewer bankers than normal, there were a ton of lawyers. Each investor had its own legal team, and Citigroup used three firms—Sullivan & Cromwell LLP, Cleary Gottlieb Steen & Hamilton LLP and Skadden, Arps, Slate, Meagher & Flom LLP—plus the bank's own corporate counsel. Taking the most prominent role among the Citi legal talent was longtime banking lawyer Rodgin Cohen, S&C's managing partner and a key legal adviser in most of the recent sovereign wealth fund investments in financial institutions.

According to one source, Citigroup didn't seek approval from the Committee on Foreign Investment in the United States because individual investment levels were far below the 10% threshold that usually triggers a 45-day review. On the other hand, officials at the Federal Reserve and Treasury Department and senior lawmakers were all briefed on discussions.

Truman, for one, believes the "copycat" factor shouldn't be discounted in Citigroup's ability to raise funds. One financial institution goes to sovereign wealth funds; other banks follow. One sovereign wealth fund writes a multibillion-dollar check; the others want to show they can do the same.

All told, Citigroup raised about $30 billion over two months, a pace and amount one deal insider terms "unprecedented." He adds that several other investors asked to be let into the last deal. But the bank decided it had more than enough to weather any storm and still has capital left over to take advantage of any opportunities for acquisitions that came its way as a result of the market and economic tumult. ■

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