1MDB
1Malaysia Development Berhad

# The big gamble

## Secretive Malaysian fund stirs controversy at home and abroad

By LESLIE LOPEZ / Kuala Lumpur

**Sometime in September 2009, currency traders at Malaysia's central bank, Bank Negara, were jolted by huge purchases of US dollars in the domestic currency market and quickly decided to halt the selling pressure on the local currency. They were promptly told to stand down by their superiors.**

The buildup of US dollar positions on that day paved the way for state-owned 1 Malaysia Development Bhd. (1MDB) to move US$1 billion out of the country for an investment in a British Virgin Islands entity.

"At the time, no one knew where the money was headed or why such a large amount was being taken out," said one senior Kuala Lumpur-based currency trader familiar with the episode.

"It was a company we needed to watch, because it came out of nowhere and showed clout," said another chief dealer at a foreign bank in Kuala Lumpur.

These days, 1MDB isn't just raising eyebrows. The secretive investment arm of the government is sending shockwaves through international bond markets and raising concern at home with its aggressive borrowings, opaque financial manoeuvres and risky bets. It is also becoming a hot political potato for Prime Minister Najib Abdul Razak's administration.

Opposition politicians insist that 1MDB is part strategic investment arm and part political slush fund for the Najib government, because of its generous financial handouts to key constituencies of the ruling Barisan Nasional (National Front) coalition.

In just over four years, 1MDB has racked up borrowings of more than US$11.97 billion (RM38 billion), corporate documents and published accounts reviewed by The Edge Review show. This huge accumulation of debt is against a backdrop of paltry profits, derived largely from the shuffling of assets on its Cayman Island investment and the revaluation of properties purchased at steep discounts from the government.

No Southeast Asian entity has accumulated so much debt in such a short time, and because the borrowings carry the implicit guarantee of the Malaysian government, bankers and economists say that 1MDB is emerging as a serious contingent liability for the Najib administration.

"1MDB doesn't have strong cash flows and, at the rate it is borrowing, sooner or later the government will have to step in to take responsibility," says a chief executive of a Malaysian bank, echoing a widely held view of 1MDB among the Kuala Lumpur business community.

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For now, a government bailout may not appear imminent. But close scrutiny of 1MDB's affairs reveal potential trouble spots that bankers and investment analysts say could suddenly spin out of control and plunge Malaysia into an explosive business scandal.

One potential flashpoint is 1MDB's original US$1 billion investment in 2009 in 1MDB PetroSaudi Ltd, an entity domiciled in the British Virgin Islands. 1MDB's most recent accounts lodged with Malaysia's Registrar of Companies show that the original investment has since more than doubled in value to US$2.3 billion, and is now "reinvested" in a company registered in the Cayman Islands. But bankers say that spectacular profits, derived from a series of financial flips with little-known entities, have raised concerns about the security of the venture.

1MDB's dizzying buildup of debt is also drawing international attention because of the fund's cosy relations with international banking powerhouse Goldman Sachs, which critics say has allowed the US firm to charge supernormal fees.

Over the last two years, Goldman has single-handedly structured and underwritten US$6.5 billion in bonds for 1MDB. Taken together with the US$1.6 billion the US firm raised for the state government of Sarawak on Borneo, Goldman ranks as the largest underwriter of bonds in Malaysia, outranking local powerhouses such as Malayan Banking and CIMB Group, which have long cornered the debt-raising business of state-owned entities.

1MDB declined to comment officially for this article but several government officials and financial executives involved in 1MDB's investments spoke to *The Edge Review* on condition of anonymity and argued that the picture isn't as tenuous as it appears.

Repayments on a portion of its loans in coming months will cut 1MDB's debts to roughly RM34 billion, which is backed by assets valued at roughly RM38 billion, they say. These include liquid assets of cash and other securities valued at RM16 billion.

The officials insist that the Cayman Islands investment is safe and a planned listing of the group's power-generation assets, set for sometime in the first half of next year, is expected to raise close to RM5 billion and strengthen its financial position.

"Viewed in a snapshot, there are some issues (that could be of concern). But the story going forward is positive," says one senior government official, who acknowledges that the veil of secrecy surrounding 1MDB has fuelled controversy over the fund's activities.

Private economists and bankers, however, aren't so sanguine. They note that 1MDB's huge borrowings are cause for concern for the Malaysian economy because of rising public sector debt.

Malaysia has consistently run budget deficits since the currency crisis that struck the region in mid-1997. That, in turn, has raised the nation's accumulated public debt, which currently stands at 53 per cent of the country's gross domestic product – the highest among the 10-member Association of South East Asian Nations (Asean).

The ratio of debt-to-GDP is a broad measure of the health of an economy and Malaysia has a self-imposed ceiling of 55 per cent. The problem, say private economists, is that the ratio doesn't take into account liabilities of state-linked enterprises such as 1MDB, which have been on a borrowing binge to fund development activities.

The following account of 1MDB's

## BEHIND 1MDB'S RISE, HEAVY DEBT

| | US$BILLION |
|---|---|
| Loans and borrowings at end-March 2012 | 2.45 |
| Purchase of Power Assets – Tanjong Energy | 3.69 |
| – Genting Sanyen | 1.75 |
| 10-year bond for strategic partnership with Abu Dhabi | 3.0 |
| Other loans | 1.08 |
| **Total** | 11.97 |

*Source: Annual Report and Corporate documents The Edge Review* rise from a secretive state-owned strategic investment fund to one of Malaysia's most debt-laden entities is based on documents reviewed by The Edge Review and interviews with dozens of bankers, financial consultants and government officials over the last four years.

Seeds of 1MDB were sown in early 2009, when businessman Low Taek Jho, who enjoys close relations with Prime Minister Najib, mooted the idea of creating a fund to manage the resources of the northeastern Terengganu state in Peninsular Malaysia.

Terengganu is a key oil-and-gas-producing state, but it has a high incidence of poverty because of poor management of its wealth over the last four decades. The plan called for the setting up of a 10-billion ringgit fund, called the Terengganu Investment Authority, with capital raised equally by the state and federal governments through a bond issue.

The Terengganu government got cold feet, however, when it realised that the annual repayments for the bonds would prove too much for the state's coffers. But Najib liked the idea of a strategic investment fund, and, shortly after assuming the premiership in April 2009, signed off on a government guarantee for the new fund to issue Islamic bonds to raise RM5 billion of seed capital. The money was quickly raised and the Terengganu Investment Authority was renamed 1Malaysia Development Bhd.

Almost immediately, the fund attracted controversy. Bankers attacked the maiden 30-year bond issue, because the coupon, which is the periodic interest payment a bond investor receives, was priced at an annual rate of 5.75 per cent, a level considered high for a government guaranteed bond. While there are no perfect comparisons, bonds issued by Malaysia's state oil corporation Petronas carry an annual coupon rate of around 3.6 per cent.

1MDB didn't waste any time spending the money it raised. Barely four months after the bond issue, the fund invested US$1 billion (roughly RM3.4 billion at the time) to acquire a 40 per cent interest in a joint-venture concern with PetroSaudi International Ltd., a little-known concern incorporated in Saudi Arabia.

The fund's move to plough 70 per cent of its seed capital into a single venture was seen as reckless. By mid-2010, 1MDB was turning to Malaysian and foreign banks for more funding, triggering speculation that the fund's aggressive bets had gone sour and would need fresh capital injections from the government.

At the time, 1MDB executives dismissed talk of financial trouble and insisted that the fund had turned a profit in its first year of operation. Audited accounts lodged with Malaysia's Registrar of Companies show that the fund applied some fancy financial footwork to register a profit for the fiscal year ended March 2010. According to the accounts, 1MDB sold back its investment in the venture it controlled with PetroSaudi for a profit of roughly RM630 million barely six months after making the original investment. That deal helped 1MDB show a first year profit of RM424.6 million.

While the headline number appeared impressive, the nature of the deal only stoked more questions, because it was a cashless transaction. After investing RM3.4 billion in cash for the venture, the state-owned fund accepted an 11-year repayment scheme structured like an Islamic bond, which included commitments from a private concern incorporated in tax havens such as the British Virgin Islands.

The deal was also red-flagged in 1MDB's account for the year ended March 2010 by its external auditors KPMG, which suggested that the transaction was of potential concern. In its report to shareholders of the company, KPMG flagged the transaction under the heading "Emphasis of Matter." It noted that the valuation of the transaction was undertaken by a third party and that 1MDB's management "believes that PSI (PetroSaudi International) is in good standing" and has the ability to meet all obligations. (An "Emphasis of Matter" is an item that is typically included in an independent auditor's report to highlight fundamental uncertainties that could have an adverse impact on a company in the future.)

1MDB's latest published accounts show that it disposed of its PetroSaudi investment in September last year to an undisclosed external party for US$2.318 billion. But bankers and analysts question why the state-owned fund has yet to bring the money back to help finance its other ventures.

Government officials and financial executives involved in 1MDB say that these concerns are misplaced and the funds will be used to take advantage of new overseas investment opportunities.

"Bringing the money back would also result in some hefty forex (foreign exchange) loses," argues one government official. The original investment was made when the Malaysian currency stood at just under RM3.4 to the US dollar. It is now at RM3.187 to the greenback.

While questions around the PetroSaudi venture aren't likely to go away anytime soon, attention is now focused on 1MDB's build-up of debt through the issuance of bonds in

## GOLDMAN SACHS' BOND UNDERWRITING IN MALAYSIA

| | US$BILLION |
|---|---|
| Sarawak government in 2011 and 2012 | 1.6 |
| 1MDB | |
| – Tanjong Energy | 1.75 |
| – Genting Sanyen | 1.75 |
| – 10-year bond | 3.0 |
| **Total** | 8.1 |

*Source: The Edge Review Research*

## 1MDB FINANCIAL SNAPSHOT
(FOR THE YEAR-ENDED MARCH)

| | 2010 | 2011 | 2012 |
|---|---|---|---|
| Total Assets (RM billion) | 4.955 | 8.143 | 9.534 |
| Total Borrowings (RM billion) | 4.390 | 6.689 | 7.815 |
| Profit (RM million) | 426.607 | 544.343 | 44.722 |

*Source: Annual Reports filed at the Registrar of Companies*

(US$1 = RM 3.19)

the international markets in order to invest in the property and electricity-generation sectors.

Over the last 18 months, 1MDB has raised close to US$9.37 billion (RM29.8 billion) in new debt. A big chunk of the debt – US$5.47 billion (RM17.4 billion) – was raised to acquire power generation assets in Malaysia and plants in Bangladesh, Egypt and the United Arab Emirates. The fund also raised another US$3 billion in late April to finance its equity interest in a 50:50 joint venture with the Abu Dhabi government.

The bond issues, which together represent one of the biggest privately placed issuance of US dollar debt in Asia in recent years, were structured singlehandedly by Goldman Sachs, and rival bankers argue that 1MDB and the Malaysian government overpaid for the deal.

Just like 1MDB's first bond issue of RM5 billion, the coupon rate attached to the bonds that Goldman structured was well above prices for the debt of state-owned entities. "Bonds typically carry a premium of between 10 to 20 basis points over the sovereign debt. The close to 300 basis point is really pricey," says one international bond trader.

Bankers say that 1MDB's decision to use only Goldman, which reportedly has earned more than US$250 million in fees from its Malaysian government-related advisory and bond issues, came at a cost to the Malaysian taxpayer.

"It would have been less expensive in terms of how the bonds were priced and also on fees if the deal were done by a consortium (of banks)," says a chief executive of a Malaysian bank.

But government officials say 1MDB can't be compared to other state-owned entities, such as national oil corporation Petronas and state-controlled power utility Tenaga Nasional, which regularly tap the international financial markets for funding.

They note that 1MDB only received RM1 million in equity funding from the government when it was incorporated and the government has been reluctant to provide guarantees for its bonds.

"Without any assets to show, turning to a rating agency is risky," says one financial executive who is involved in the fund's financial affairs. He adds that the fund's financial standing in international markets is improving and the build-up of assets has helped 1MDB cut the pricing of its bonds. For example, the most recent US$3 billion placement by Goldman carried a coupon of 4.4 per cent, compared to 5.9 per cent for its first bond issue.

Government officials and financial executives close to 1MDB also insist that Goldman's involvement was above board. They point out that Goldman secured the first mandate in June 2012 for a jumbo US$1.75 billion deal on the insistence of the International Petroleum Investment Company (IPIC), an investment company of the Abu Dhabi government, which was guaranteeing the bond issue. As for the mandate for the US$3 billion bond in late April, Goldman had to compete with other international players such as Standard Chartered and Morgan Stanley.

Critics of 1MDB's diversification into the energy sector say that the fund paid a hefty premium for Tanjong Energy, a portfolio of regional energy assets owned by tycoon T. Ananda Krishnan, and Genting Sanyen Power, the 17-year-old power plant controlled by Malaysian gaming and leisure group Genting Bhd., which is publically listed.

1MDB paid US$2.67 billion (RM8.5 billion) for Tanjong Energy and US$723 million for Genting Sanyen. The long-term concessions held by Tanjong and Genting were close to expiry at the time of the purchase, and energy industry executives say that the value of the aging facilities was roughly 50 per cent of what was paid.

"Even if these companies had secured fresh extensions to the power sale agreements, the values would still be at a discount of what was paid," says a chief executive of a boutique financial consultancy that specialises in the regional power sector.

Opposition politicians have also attacked the purchases, arguing that the hefty premiums 1MDB paid were designed to allow private companies to channel political contributions back to the ruling National Front coalition headed by Najib. Politicians and bankers close to the NF say that Tanjong and companies linked to Ananda contributed more than RM400 million to charity foundations linked to 1MDB, while Genting declared contributions of over RM190 million to charitable organisations linked to the state-owned fund for the first quarter of this year.

Government officials interviewed refused to disclose donations 1MDB-linked foundations have received from the private sector, saying only that such contributions were not linked to the state-owned fund's corporate transactions.

The official also defended the pricing of the power assets by 1MDB, arguing that the move was part of a larger government strategy to wrest control of power generation assets, which were privatised during the 1990s under former premier Mahathir Mohamad's government.

"On a stand alone basis, the acquisitions appear on the high side. But when taken as a collective asset, we believe that the purchase price can be defended," says one government official involved in the reorganisation of 1MDB assets.

The Tanjong and Genting power plants have a combined generation capacity of 4,700 megawatts, and 1MDB hopes to increase it up to 6,100 megawatts with its planned acquisition of another Malaysian private power concern, Jimah Power, for RM1.2 billion (US$377 million). The power plants will be merged into a new entity in coming months and 1MDB plans to make a public offering for the new company to raise as much as RM5 billion sometime in the first half of next year.

Apart from the power sector, government officials involved in 1MDB argue that the property sector will help shore up the group's finances. The fund owns 550 acres of prime land around Kuala Lumpur, which it intends to develop over 15 years.

"Energy and property will be the game changers going forward," says one government official seconded to 1MDB.

PetroSaudi International Ltd

- PetroSaudi International, a privately owned oil exploration and production company, was founded in 2005 by Tarek Essam Ahmad Obaid.
- With offices in Saudi Arabia, England and Switzerland, PetroSaudi has ventured into oil and gas developments in the Caspian Sea and oil fields that straddle the border of Turkmenistan and oil-rich Azerbaijan.
- It formed a joint-venture with 1MDB in September 2009 through a company called 1MDB PetroSaudi Ltd, incorporated in the British Virgin Islands, with 1MDB holding 40 per cent and PetroSaudi the remainder.
- 1MDB pumped in US$1 billion (RM3.49 billion at the time) into the joint-venture concern and in end-March 2010 sold its interest for US$1.2 billion (RM4.14 billion at the time) financed by a 11-year repayment scheme through an Islamic financial structure that carried as interest rate of 8.67 per cent annually . In a nutshell, 1MDB would earn roughly RM359 million annually and receive the full sum for the divestment 11 years later.
- 1MDB invests an additional RM1.57 billion under a similar Islamic financial structure, which carried an interest charge of 8.25 per cent annually and a bullet repayment in five years.
- In September 2012 1MDB exits from complex financial structure with PetroSaudi and walks away with proceeds of US$2.32 billion.
- Tarek Obaid's other investment in Malaysia is a controlling stake in UBG Bhd., an investment holding company previously controlled by the family of Taib Mahmud, the chief minister of the Sarawak state on Borneo. UBG, which is no longer listed on the Malaysian stock exchange, is held by Obaid through his wholly owned subsidiary PetroSaudi International Seychelles. He acquired the company in early 2010.

**Research by The EdgeReview**


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