THE FLETCHER SCHOOL
TUFTS UNIVERSITY

The Sovereign Wealth Fund Initiative
Spring 2013

Hunter or Prey? Only Time Will Tell[1]

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As the Italian political and economic landscape enters into a state of flux, foreign sovereign investors face the extraordinarily complex financial and institutional architecture of an European country.

Alien presence detected. Italy, a wealthy country with significant growth problems exacerbated by the Eurozone crisis, is becoming a top destination for investments by foreign sovereign investors. A recent study[2] by CONSOB (the Italian Securities Oversight Commission) about investments in Italy by SWFs was widely quoted in the press with alarming headlines. According to the report, over one third of Italian listed companies has a sovereign wealth fund among its shareholders, whereas within the EU the average presence is considerably lower (between 15% and 25% of listed companies). Albeit an impressive one, this figure should be taken with a grain of salt for two reasons. First, the size of Italian capital markets is not very big, as Italian companies predominantly rely on banks for funding and the number of public companies is very small. Second, it is very difficult to have a complete assessment of SWF investments in Italy, i.e. one that includes non-listed companies and assets, too. Contrary to listed companies, which are subject to very stringent disclosure requirements, acquisitions of non-listed companies are often performed by holding companies which are formally European (e.g. by one or more holding or sub-holding companies incorporated in Luxembourg).

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[2] Alvaro, Ciccaglioni, *"I Fondi Sovrani e la regolazione degli investimenti nei settori strategici"*, CONSOB Research Paper, publicly available at: http://www.consob.it/documenti/Pubblicazioni/Discussion_papers/dp3.pdf

To seduce them or to fight them? This is the question. Historically, Italy has been a recipient of investments by SWFs long before SWFs became a topic for scholars and finance practitioners. For instance, Libyan state entities famously invested in FIAT and Juventus back in the 1970s. Thus, investments by SWFs in Italy are no news per se. Instead, it is worth asking whether there has been a change in attitude within Italian institutions vis-à-vis these investors. In this respect, it should be noted that Italy is a country where the state has always played a very significant role in the economy. Indeed, the set of dilemmas faced by Italian institutions is that of Western countries where the state is not only a legislator/regulator but also a player. Italian authorities, who still own controlling stakes in the most important listed blue-chip companies and even bigger interests in several closely regulated industries, seem quite reluctant to take action. Seducing foreign investors or blocking them - this seems to be the key issue. From a legislative standpoint, back in 2008 an interagency committee on sovereign wealth funds was created to research, scrutinize and facilitate SWF investments in Italy. The committee, however, can hardly be compared with the US CFIUS and similar bodies entrusted with extensive powers of denial as it has little or no powers at all.

Italy's "state capitalism", and its close-loop financial architecture. When considering the Italian case, one should always bear in mind that the Italian state has an extensive presence in the country's economy. In fact, the State is not only a legislator, but also a regulator and enforcer. It also is a market player, and owns control stakes in some of the most known blue chip Italian companies, such as listed companies **ENI**, **ENEL**, **Finmeccanica** and other non-listed giants such as **Trenitalia** (the railways) and **Poste** (the postal network). After all, as former President of the Republic Francesco Cossiga famously put it, Italy is the largest socialist economy in the Western bloc. As a consequence of its being a champion of "state capitalism", Italy is now being looked at a potential case for further privatizations after the famous wave of privatization of the 1990s. Italy, this is the basic assumption, is suffering from the Eurozone crisis and struggling to recover, and the government is expected to gradually slash its debt/GDP level, as foreseen under the **European Fiscal Compact**[3]. Since the taxation level is already high – one of the highest within the Western hemisphere – privatization is seen as a standard means to both reduce public debt (via proceeds from sales) and increase efficiency of companies (as public investors are seen as generally more demanding shareholders than state shareholders). Expectations, however, will have to be gauged against reality, as politicians are generally very reluctant to get rid of state-owned companies. So, while the Italian state balance sheet can absorb privatizations, we don't see this a the main "entry gate" for sovereign investors. On

[3] The Fiscal Compact defines a balanced budget as a general budget deficit less than 3.0% of the gross domestic product (GDP), and a structural deficit of less than 1.0% of GDP if the debt level is below 60% or else it shall be below 0.5% of GDP. The treaty also contains a direct copy of the "debt brake" criteria as outlined by the Stability and Growth Pact, where it is defined below which rate debt-to-GDP levels above 60% of GDP should decrease. It is this "debt brake" that is expected to boost privatizations in high-debt countries with stakes in high-value companies.

a different note, we believe that sovereign investors, following the Italian political and economic landscape, might take greater interest in the peculiar close-loop structure of the Italian financial system.

To understand this structure, the recent Monte dei Paschi di Siena scandal is an interesting case. In this scandal, the top management of the oldest bank in the world, among other things, hid several documents about its derivative contracts. The case prompted the resignation of the head of the Italian Banking Association, former MPS President Giuseppe Mussari, but this did not stop polemics with bank shares falling on the stock exchange. To a large extent, the MPS case is a "black swan" event, whose final outcome is largely unpredictable. While this case became a top issue in the February 2013 political race, we believe that it its impact is not limited to the elections, but extends to the whole **architecture** of the Italian financial system. In fact, underlying the MPS case is the general architecture of the Italian financial system and its "closed loop" shape. More specifically, the **banking foundations** are part of a quasi-circular structure, in which: a) banking foundations are controlling shareholders of the largest domestic banks, b) a very large part of Italy's outstanding state debt is held by banks, and c) the state has a very clear interest in backing the banking sector and maintaining good relationships with the foundations. Moreover, Italian foundations are very often run by former politicians, and following a law issued in 2001, the governance is strongly influenced by local entities (Municipalities, Provinces, Regions) and thus by the local political leaderships. The banking foundations also have a key role in **Cassa Depositi e Prestiti**, ("**CDP**") the Italian multipurpose sovereign mega-corporate with a growing presence in the Italian economic landscape, where they are minority shareholders. With a view to sovereign investors, the developments of this architecture should be followed closely, as the weakening of the link between banks and banking foundations could lead to the opening up of the share capital of several Italian banks. Even if this sounds like an unlikely scenario, there already are major examples of this dynamic. Take the Unicredit case, for instance. Unicredit, Italy's second largest bank, was firmly in the hands of a handful of Italian banking foundations – the largest foundations were **Fondazione CRT**, **CariVerona** and **Banco di Sicilia** - until the financial crisis erupted in the Eurozone. At that stage, a skyrocketing spread made funding extremely burdensome for most Italian banks, including Unicredit. Moreover, the German BaFin (the German securities watchdog) explicitly prohibited cash pooling agreements between Unicredit's German subsidiary HVB and its Italian entities, as this would have entailed transferring "low-cost" money from Germany to a country, Italy, where funding costs were considerably higher. With a ban on arbitrage, Unicredit quickly faced a funding shortage

and had to launch a rights issue[4]. The foundations, at that stage, were not in the position to participate in the rights issue and got quickly diluted as new foreign shareholders entered (such as Pamplona, Capital Research and Abu Dhabi's sovereign wealth fund ADIA). Unicredit's case could serve as a proof-of-concept of the potential for sovereign investors interested in the Italian landscape and in a retail market with one of the highest savings rate in the world. Will the foundations loosen their grip on the banks? And, if so, will they side with sovereign wealth funds and under what conditions (explicit and tacit)? These questions – and no other ones – should be asked.

What is a "sensitive asset" in Italy? As we have recalled earlier, it is asset disposals triggered by cash needs that are more likely to take place. Moreover, disposals should not be expected only from the State (i.e. in the form of total of partial privatizations) but also from other shareholders, such as the banking foundations. That said, it is worth considering the domestic regulatory framework that governs the disposal of strategic assets. Like other western states, Italy retains the right to have a say in deals that entail sensitive assets, not limited to state-owned assets. On March 9, 2012, the Italian Council of Ministers approved a Law Decree (the "Decree") that changes Italy's "Golden Share" powers in certain strategic sectors and repeals Article 2 of Legislative Decree No. 332 dated May 31, 1994, as amended, which originally provided "Golden Share" powers to the Italian Government. The approval follows mounting pressure from the European Commission (the "EC"), which had threatened to bring Italy before the European Court of Justice for maintaining laws that it believed were in breach of EU rules on the free movement of capital. The EC had already opened violation procedures against Italy before the European Court of Justice in 2009. The Decree, which entered into force on March 16, 2012, limits the Italian Government's veto power on ownership changes to specific enumerated circumstances, such as when a buyer lacks the ability to provide adequate financial guarantees, is linked to non-democratic or non-EU states or is linked to organized crime or terrorism. In particular, the Decree provides different powers with respect to the Defense and National Security sectors than those with respect to the Energy, Transportation and Communications sectors. With respect to the Defense and National Security sectors, the Decree provides for the exercise of special powers in the event of a material threat to the Italian Government's essential interests in the defense and national security of Italy. In such an event, the Italian government may with respect to companies of strategic importance to the defense and national security of Italy:

[4] Reuters, "Rights issue priced at huge discount", Jan 4th 2013, available on-line at: http://www.reuters.com/article/2012/01/04/us-unicredit-idUSTRE8030XU20120104

i. Impose specific conditions relating to the security of supply and information, technology transfers and export controls in connection with the purchase, howsoever phrased, of participations in such companies;

ii. Veto resolutions of the General Meeting or the Board of Directors concerning (i) changes to the company's structure or corporate purpose, (ii) the dissolution of the company, (iii) the transfer abroad of the company's legal seat or (iv) the sale of any rights in or the use of tangible or intangible assets of the company as well as the assumption of constraints conditioning such use; and

iii. Oppose the purchase, howsoever phrased, of a participation in such a company, by any entity other than the Republic of Italy or Italian public entities, when such purchase would provide a buyer, directly or indirectly, including by virtue of shareholder agreements, a participation with voting rights that could jeopardize the interests of the defense and national security of Italy.

Generally, with respect to the powers listed above, the Italian Government must impose specific conditions or exercise its right of veto or opposition within 15 days from the date it receives notice of, inter alia, a resolution or purchase. However, the 15-day window can be suspended if the Italian Government requests additional information in connection with the relevant notification. In addition, the Decree permits certain penalties for, inter alia, non-compliance with any exercise of the above powers by the Italian Government. With respect to the Energy, Transportation and Communications sectors, the Decree requires that a company notify the Italian Government of any resolutions it adopts that would have the effect of changing such company's ownership structure or purpose, or winding up such company's business. The Italian Government is entitled to impose specific conditions to those resolutions, acts or transactions that would give rise to an exceptional situation of an actual threat of serious injury to public interests relating to the security and functioning of networks and systems and the continuity of supplies. The effectiveness of any such resolutions, acts or transactions will, upon notice to the Italian Government, be stayed for 15 days during which time the Italian Government may approve or impose conditions to such acts, resolutions or transactions. However, the 15-day window can be suspended if the Italian Government requests additional information. With respect to the Energy, Transportation and Communications sectors, the Italian Government is also entitled to exercise its veto power if the buyer was originally established outside the EU and subsequently establishes itself within the EU through the purchase of an EU company or branch. However, the Italian Government is entitled to exercise its veto power only if: there exists a link between the company(s) involved and a criminal

organization(s) or persons or entities associated with such organizations; the proposed intervention is necessary to ensure the continuity of supply and the maintenance, safety and operation of networks and facilities and the free access to the market.

With respect to this discipline, it is difficult to understand whether it will result in a comprehensive strategy vis-à-vis foreign investors, including sovereign investors. In fact, what matters even more than rules – which are no scarce good in Italy - is their actual enforcement and the *willingness* of governments to enforce these rules. As we write this note, there is no consistent track record that shows a particular orientation within Italian institutions. By analogy, several disposals of state-owned assets initiated under the prior legislature are likely to stay "frozen" until addressed by the new legislature. Take the **Ansaldo Energia** case, for instance. Ansaldo Energia is a non-military business company of the **Finmeccanica Group**, and its disposal – a move to slash debt at group level - has been considered a group priority of for quite a while. Several buy-side candidates are known, including German energy giant Siemens, a domestic consortium of investors and Korean group Doosan. After several stop-and-go episodes, it appears that the deal is on hold. It is also becoming clear that politicians do not see the disposal as a whole as a viable option, but it is less clear whether geopolitical issues are influencing this view (e.g. favoring an Anglo-American buyer rather than a German one, etc…) or domestic-only considerations. On a different note, **General Electric** has signed a $4 billion deal to buy Italian aerospace supplier **Avio** excluding its space division. Avio's space assets, worth an estimated 200-300 million euros, are expected to be sold separately upon approval by the Italian government, which considers them strategic. Possible buyers include French aerospace group Safran or EADS (Astrium) as well as US investors, but it is still unclear how politicians might react to the deal. If the new government feels reluctant to wholly sell Avio's space assets to foreign players, then even a domestic and semi-state player and co-investor such as the **Fondo Strategico Italiano** ("**FSI**") or **Cassa Depositi e Prestiti** ("**CDP**") could be seen as an alternative option.

A home-made white knight? CDP is a key state-owned player in the Italian economic system that "uses debt and equity instruments to support **strategic domestic companies** and **SMEs**, helping Italian companies to **expand internationally** and invest in **research"**[5]. Over time CDP has been credited with a variety of missions, such as acting as infrastructure lending house, trade insurance hub, state holding company, and **domestic co-investor** for foreign sovereign wealth funds. Underlying all these different missions is a long-term horizon. In fact, today's CDP is the latest step in a reflection about long-term investing as opposed to short-termism. According to a CDP position

[5] http://www.cassaddpp.it/en/enterprises/enterprises.html

paper (*"Long Term investments – The European Answer to the Crisis"*) released on June 22, 2009 at the **Long Term Investor Club**[6] in Paris:

> *A long term policy is needed for facing the great long term challenges of our society, including demographic change, scarcity of natural resources, environment protection and climate change, growing poverty worldwide, immigration, education and research. A long term policy framework must be based on strategic public and private/public investments in infrastructure, energy, environment, TLC (NGN), R&D and human capital, and must promote and favour those projects which have strong positive externalities for the economy as a whole, and for human well-being and social cohesion. These projects need investments with long term differed returns, which only a few financial institutions, technically strong, "market conform", but ethically driven, are ready to support. The Financial Institutions which may be "eligible" to be considered as Long Term Investors are, first of all, the institutions owned by public, semi-public or non-profit entities (States, Local Authorities, Banking Foundations, and the like): they do not seek speculative IRR or strong capital gains (also thanks to the structure of their balance sheets which enable them to retain assets in their portfolios in times of crisis thus playing a counter-cyclical role in the financial markets); they are able to spread risks between generations; and finally have, generally, a clear social responsibility in their missions. This allows them to "accept" non-speculative returns on their investments, as well as the willingness and the capacity to keep in their books long term assets and liabilities*[7]*.*

Often mentioned when a large national champion struggles for survival - Alitalia is just the latest case of a longer list – CDP is a large group with a complex governance, where the control shareholder (the Ministry of Finance) coexists with the banking foundations. Due to its unique position within a semi-state economy, CDP is at the epicenter of every discussion of large infrastructure deals, and in public debates it is frequently cited as a target for minority investments by sovereign wealth funds. Sovereign wealth funds, indeed, may consider a direct investment in CDP's share capital[8] or into a sub-holding such as CDP Reti, owning 30% of Snam. So far, the first agreement with a sovereign investor has been signed by FSI, whose mission is to acquire minority

[6] http://www.ltic.org/
[7] Full text available on-line at: http://www.cassaddpp.it/static/upload/007/007602.pdf
[8] Obviously, this could not happen without the consent of the Italian government

stakes in middle-size “national champions”. In November 2012, **Qatar** signed a deal[9] with FSI aimed at investing up to €2bn in Italian companies over the next four years. Although this has been depicted as a landmark deal, any assessment made at this stage would be premature. In fact, this deal falls within the scope of what commonly falls under the idea of “Made in Italy”, and so far it is impossible to analyze its effects. A more comprehensive analysis will be possible only as the joint venture starts its activities, and if other sovereign investors enter into similar agreements with FSI or CDP. Also – and more importantly – it will be possible to analyze the role of FSI and/or of its parent CDP as domestic “white knight” as talks between **Telecom Italia** and **Hutchinson Whampoa** progress. In the scenario of a merger/integration between the Italian TLC incumbent and H3G, the Italian subsidiary of the Chinese player, a carve-out of the highly sensitive telephone network would be a top priority and entail major security implications not only for Italy but also for its Western allies.

[9] Through the “IQ Made in Italy Venture”, Qatar and FSI aim to invest in companies active in food and food distribution, fashion and luxury, furniture and design, leisure industries and tourism. The deal will include an initial investment of €300m, made equally by the two entities, rising to as much as €2bn. Investments will be made on a case-by-case basis with the aim of spurring consolidation and supporting international growth.