

An abstract geometric diagram consisting of a series of lines and circles. A diagonal line runs from the top-left towards the bottom-right. Several circles of varying sizes are placed along this line. Lines radiate from these circles, connecting them to other points on the diagonal line. The circles are colored in shades of grey, red, and orange. The overall composition is clean and modern, with a focus on geometric shapes and lines.

# Sovereign Wealth Funds

2013

**ESADE**

Ramon Llull University

ESADEgeo-CENTER  
FOR GLOBAL ECONOMY  
AND GEOPOLITICS

**KPMG**

**INVESTIN  
SPAIN**



# Index

Foreword	5
Introduction	7
Sovereign wealth funds investment behaviour 2012	11
I Geographic Analysis	17
Sovereign wealth funds in Spain and Latin America	19
The great wallet of China: China Investment Corporation (CIC) and State Administration of Foreign Exchange (SAFE)	41
The Gulf funds after the financial crisis	51
II Sector Analysis	59
Sovereign wealth funds and new technologies	61
Financing the expansion of global energy: the role of sovereign wealth fund investments as strategic private equity	77
Sovereign wealth funds and real estate	87
Appendix. ESADEgeo Sovereign Wealth Funds Ranking 2013	105



# Foreword



# 1. Foreword

The world economy continued to slow in 2012; 2013, however, as forecasted by the IMF, should mark a turning point following which a new bullish phase in the world's economic cycle should gain momentum. In 2012 and part of 2013 the international economic scene was dominated by financial strains in Europe and uncertainties associated with the US *fiscal cliff* and the slowdown of emerging economies. Additionally, over and above short-term considerations, the world economy continued to undergo profound and far-reaching change at a dizzying pace, in the form of the rise of new centres of economic power in emerging and developing countries.

As shown in the 2012 Sovereign Wealth Funds Report, one of the main manifestations of this new dynamic is the increased investment power of emerging countries with trade and budget surpluses from oil and other commodities, as reflected in sovereign wealth funds' transactions. These funds now manage more than \$5.5 trillion and constitute an ever more significant and influential economic reality. Nevertheless they remain somewhat unknown in the corporate and academic worlds as well as many public administrations. Being aware of the importance of these new players in the global economy, ESADE Business School, KPMG and ICEX-INVEST IN SPAIN have launched this initiative to disseminate information as widely as possible. Here is the second in the series: the Sovereign Wealth Fund Report 2013.

The Report addresses the main activity of sovereign wealth funds in 2012 and early 2013, analysing the motivation of the different funds and their investment strategies. As usual, we will examine the relationship of these funds with Spain and Latin America. Additionally, we will be turning our focus on funds from the Gulf and China.

Spain and its companies remained again this year at the centre of attention of the sovereign wealth funds, not only in these funds' traditional sectors of operation, such as energy and finance, but also in real estate, technology and infrastructure.

In addition to analysing current trends and the main transactions worldwide, with a special focus on Spain, in this second report we will examine in greater depth the relationships between these funds and other sectors. The analysis will cover the SWFs' "natural" sectors, such as energy, sectors of future interest in many countries with SWFs, such as infrastructure and the quest for alternative investments outside the funds' comfort zone –i.e. real estate– to improve the low returns resulting from the expansionary monetary policies that have been put in place. Lastly, we will explore a new and surprising area: the link between sovereign wealth funds and new technology.

**Javier Solana,**  
President, ESADEgeo

**John Scott,**  
President, KPMG España

**Jaime García-Legaz**  
Secretary of State for Trade

# Introduction

**Javier Santiso**

Professor of Economics, ESADE Business School

Vice President, ESADEgeo - Center for Global Economy and Geopolitics

## 2. Introduction

### 2. INTRODUCTION

Sovereign Wealth Funds 2013 is the second report produced by ESADEgeo, supported by KPMG and INVEST IN SPAIN, now part of ICEX. We would like to start by thanking both institutions for the support they have given us, enabling us to complete this report on sovereign wealth funds. We would like to pay particular thanks to Elena Pisonero, then at KPMG and now the chairwoman of Hispasat, for her enthusiasm and vision, without which this initiative would not have seen the light of day. I would also like to thank Javier Capapé and Tomás Guerrero's excellent analysis and report coordination and Samuel Granados for his outstanding graphics and infographics.

This work has not been an isolated effort. It is part of a range of activities undertaken by ESADEgeo over the last two years. In 2011, Javier Santiso together with the then Finance Minister, Juan Carlos Echeverry, and his team, advised Colombia's government on the creation of its sovereign wealth fund. We have also launched a series of conferences on emerging markets –ESADEgeo Globalization Lab– focusing on emerging economies, many of which have such institutions: On 30 May 2011 a GLab<sup>1</sup> was held on sovereign wealth funds with Victoria Barbary, a member of the Monitor Group (London) at the time. On 7 February 2012, Christopher Balding of the Peking University HSBC Business School (Shenzhen, China) was in attendance to present his latest book<sup>2</sup>. Both of these experts have contributed to this report and are ESADEgeo Research Fellows. In addition, we have also contributed a chapter on political bias in sovereign fund investments to *Sovereign Investment*, a book edited by Karl Sauvant<sup>3</sup>. Our 2012 Report is already recognized internationally. It is the only specialized source cited in the World Investment Report 2013, edited by the UNCTAD, when it talks about Sovereign Wealth Funds<sup>4</sup>.

This Report is divided into two themed sections. Before these two sections we address the main trends shown by sovereign wealth funds in 2012 (Victoria Barbary). In the first, we analyse the profiles of those funds, the main deals they have been involved in over the last year and the opportunities that these "giants" of state capitalism offer for various regions and countries. We focus in particular on Spain and Latin America (Javier Santiso), China (Christopher Balding and Ellen Campbell) and the Middle East (Christopher Balding and Komal Shakeel). In the second section, we examine the activity of sovereign funds by sector: new technologies (Javier Santiso), energy (Patrick Schena) and real estate (Xavier Reig).

<sup>1</sup> Available at <http://www.esadegeo.com/globalisation-lab/index/page1/1>. Victoria Barbary is currently the Director of the Institutional Investor's Sovereign Wealth Center.

<sup>2</sup> Sovereign Wealth Funds: The new intersection of money and politics. 2012. Oxford University Press: <http://www.esade.edu/web/esp/about-esade/today/news/viewelement/219441/1/el-economista-christopher-balding-detalla-los-desafios-que-afrota-los-fondos-soberanos-de-inversion-en-una-conferencia-de-esadegeo>.

<sup>3</sup> Santiso, J., & Avendaño, R. (2012). Are Sovereign Wealth Fund investments politically biased? A comparison with mutual funds. In K. P. Sauvant, L. E. Sachs, & W. P. F. S. Jongbloed (Eds.), *Sovereign Investment: Concerns and Policy Reactions* (pp. 221–257). New York: Oxford University Press.

<sup>4</sup> Available at [http://unctad.org/en/PublicationsLibrary/wir2013\\_en.pdf](http://unctad.org/en/PublicationsLibrary/wir2013_en.pdf).

A number of conclusions can be drawn from this analysis:

- The phenomenon of sovereign wealth funds is spreading rapidly throughout all emerging regions: they are not just limited to Asia and the Middle East, but also exist in Africa and Latin America. There are currently over 80 operating sovereign wealth funds, with assets exceeding 5.5 trillion dollars. This year, the number of existing and potential funds exceeds one hundred for the first time.
- In 2012 we witnessed a deepening of South-South relations. This is demonstrated by the many emerging economy fund deals –both Arab and Asian– involving developing economy companies. An example of this phenomenon is the 1.7 billion dollar investment by the Malaysian fund Khazanah in January 2012 to acquire 15% of the main Turkish health holding company, Acibadem Healthcare Group.
- In our earlier report, we highlighted that Europe was the main recipient of investment in 2011 and that Spain and its companies were the main destinations for sovereign funds, receiving 8.34 billion dollars of investment, ahead of France, the UK and Germany. In this Report, we find that Spain remains the leading destination for sovereign funds. Sovereign funds' deals in Spain in 2013 include increases in the capital invested by the Qatar Investment Authority in Iberdrola and by Temasek in Repsol, and the first major real estate transaction with the purchase of Barcelona's Hotel W by Qatari Diar. This would seem to show that Spain and its companies remain a focal point for leading sovereign wealth funds.
- The growth of sovereign wealth funds offers both a financial and industrial opportunity for Spain. The industrial shareholdings of Spain's banks and savings banks (many now bailed out or taken over by the State) and the need for many Spanish multinationals to deleverage provide excellent opportunities for funds to take stakes in the capital of Spain's industrial companies, which need new capital for both their development and restructuring.
- The funds are substantially changing their investment strategies. They are increasingly seeking strategic investments in industrial groups, particularly those involved in technology and telecommunications. These investors are becoming even more sophisticated. As part of their investment in high added value sectors, investment in information technology increased by 90% on 2011, outstripping traditional sectors for investment, such as energy, real estate and finance. Furthermore, we have noticed a new trend: investment in start-ups. The acquisition of 5.6% of the Chinese start-up Alibaba for 2 billion dollars by the China Investment Corporation (CIC) fund appears to have opened the floodgates in this regard.

- Sovereign funds have recovered their appetite for the real estate sector and are dominating mature markets. A further sign of the sophisticated management of sovereign wealth funds is their strong and increasing presence in the real estate sector. In Europe, sovereign wealth funds were behind the two largest transactions by volume in 2012. These are the leading international funds; they are involved in 7 out of 10 of the largest cross-border transactions. One significant development is the entry of the Norwegian fund NBIM into the US property market through TIAA-CREF. Domestically, the 200 million euro purchase of Barcelona's Hotel W by Qatari Diar –the real estate arm of Qatar's QIA– may mark a change in the trend and act as a catalyst for further deals by sovereign wealth funds in this sector in Spain.
- In summary, the growth of sovereign wealth funds –particularly from emerging economies– continues apace. This trend corroborates a rebalancing in the wealth of nations, which is now more apparent than ever, and which is clearly demonstrated by these sovereign wealth funds. Emerging markets are the leading players in this financial, commercial and industrial rebalancing. This is not a new trend. However, there is a new detail which is particularly significant: we are currently seeing massive rebalancing of innovation and technology among emerging economies, further confirming the investment strategies of the sovereign wealth funds. They are the new and big players of the world that is currently emerging.



**Victoria Barbary**  
Director, Sovereign Wealth Center  
Non-Resident Fellow, ESADegeo - Center for Global Economy and Geopolitics

# Sovereign wealth funds investment behaviour 2012



## 3. Sovereign wealth funds investment behaviour 2012

### 3. SOVEREIGN WEALTH FUND INVESTMENT BEHAVIOUR 2012

Despite continuing global economic uncertainty in 2012, sovereign wealth funds remained active in financial markets. Sovereign wealth funds' investment activity in 2012 changed little from the previous year, suggesting that we are now observing a new normal for these investment giants.

However, politicians and policymakers hoping that sovereign wealth funds would take advantage of their long-term investment horizons to help revive developed economies by taking on more risk for greenfield infrastructure projects, or support newly emerging markets in Africa, will be disappointed. By and large, sovereign wealth funds have played it safe since the financial crisis. As a group, they appear to have chosen to take advantage of the growing demand for commodities in emerging markets. Sovereign wealth funds have also sought to capitalize on rising discretionary income in the developing world in a related but more understated trend that is reflected by investments in consumer-oriented industries. However, sovereign wealth funds have concentrated on industry leaders in established emerging markets such as China, India, Malaysia and Turkey, rather than true frontier markets.

#### Activity

In 2012 the Sovereign Wealth Center's database captured 202 publicly disclosed direct investments by 21 sovereign wealth funds, with a total reported value of \$54.6 billion. This represents a slight drop in recorded activity from 2011, when it captured 206 investments with a total deal value of \$66.3 billion.

That said, sovereign wealth fund investment activity appears to have stabilized over the past three years at a high level by historical standards. Elevated as it may be, this new level remains considerably below that observed at the height of the 2008-'09 financial crisis, when several funds supported major financial institutions in Switzerland, the U.K. and the U.S., investing nearly \$58 billion between November 2007 and October 2008.

These investments catapulted sovereign wealth funds into the limelight, prompting politicians in the U.S. and European Union to voice concerns about the potential for foreign governments to use sovereign wealth fund investments for political purposes.

In response, 26 sovereign wealth funds formed the International Working Group of Sovereign Wealth Funds in May 2008. The group drafted and agreed to abide by a set of Generally Accepted

Principles and Practices known as the Santiago Principles for the Chilean city in which they were signed. These principles laid out standards of transparency, accountability and good governance, and bound their signatories to invest solely on commercial grounds. Most signatories improved their transparency when it came to disclosing deal flow, portfolio, strategy and organizational information.

The second effect of sovereign wealth fund bailouts of American and European banks has been more interest in these funds' activities because the financial sector is now aware of their size and potential firepower. Consequently, journalists have tended to monitor their investment behaviour more closely, whereas until 2007 sovereign wealth funds largely escaped notice.

That said, sovereign wealth fund investment activity has increased. Major sovereign funds such as China Investment Corp. (CIC), Korea Investment Corp. (KIC) and Qatar Investment Authority (QIA), all three of which only launched the mid-2000s, have made big contributions to the number of high-profile direct investments made by sovereign wealth funds. China and Qatar have been particularly active.

Many sovereign wealth funds have also increased the number of investments they undertake themselves rather than through external asset managers. This trend started in 2009, partly because investment managers had failed to shield the funds' portfolios from losses despite charging high fees, prompting several sovereign wealth funds to build internal fund management capabilities. These sovereign wealth funds' management teams now have greater control and visibility over investment strategies and have reduced their funds' fee bills. As a result, we can now observe investments that would previously have been untraceable. Observable sovereign wealth fund investment may be settling into a new normal following the financial crisis, with the funds undertaking more direct investments focused on large illiquid assets such as property and infrastructure, which makes their activities easier to track. But there are two noticeable trends in publicly reported sovereign wealth fund investment behaviour: greater visibility and increased direct investment.

Finally, the global shortage of capital and many institutional investors' flight to safety has reduced competition for deals, winning sovereign wealth funds assets they might have lost to competitors during the mid-2000s bubble. This phenomenon is particularly noticeable in large illiquid asset classes such as infrastructure, where sovereign funds have increased their exposure to help hedge against inflation and ensure steady long-term returns.

## Geography

Developed markets accounted for the bulk of sovereign wealth funds' direct investments in 2012. Europe remained the most attractive region for sovereign wealth funds, accounting for 54 percent or \$29.5 billion of their reported investment value for the year. However, this capital flow doesn't represent a vote of confidence. The funds mostly bought safe-haven real estate

assets in London and Paris, and picked up monopoly infrastructure assets such as water utilities and gas pipelines in Europe. Traditionally, sovereign wealth funds have been attracted to technology and industrial companies in the European Union to facilitate technology and knowledge transfers to their home economies. But only one such investment was sizable: QIA's purchase of 3 percent of German technology giant Siemens for more than \$3 billion.

Chart 1

Geographic analysis. Sovereign Wealth Fund Foreign Direct Investment 2007-2012



Source: Sovereign Wealth Center (2013).

Although the U.S. experienced stronger economic growth than the European Union in 2012, it only attracted major direct investments from sovereign wealth funds in the commodity sector. Several major funds, including the Abu Dhabi Investment Authority (ADIA), Government of Singapore Investment Corp. (GIC) and the Hong Kong Monetary Authority, invested in real estate. Sovereign wealth funds also bought into the general partnerships of several privately held investment firms such as Santa Monica, California-based Chernin Group and Washington-based EIG Global Energy Partners, and made a smattering of investments in U.S. technology and telecommunications. That said, sovereign wealth funds largely continue to invest under the radar in the U.S., perhaps reflecting the opinion of Gao Xiqing, CIO of CIC in a panel discussion at the Boao Forum for Asia in April 2013: "The U.S. is not one of the most welcoming countries in the world for us."

## Sectors

Financial services, real estate, commodities and infrastructure accounted for almost 80 percent of sovereign wealth funds' total publicly reported direct investment in 2012. The emphasis on these sectors shows that sovereign funds are undertaking more diversified, long-term strategies. Uncertainty in public markets is driving this trend. Several sovereign wealth funds have chosen to invest in sectors like commodities and infrastructure. These provide greater diversification and take advantage of the funds' long-term investment horizons by capturing illiquidity premiums, harnessing secular macroeconomic trends and providing steady income.

### 3. Sovereign wealth funds investment behaviour 2012

Chart 2

Sector analysis. Sovereign Wealth Fund Direct Investment 2007-2012



Source: Sovereign Wealth Center (2013).

Real estate was the most important sector for sovereign wealth funds in 2012, accounting for a quarter of their reported direct investment, 52 investments valued at \$13.6 billion. For the most part, funds made these investments in developed markets, especially in safe-haven commercial assets in London and Paris. The \$741 billion GPF drove the uptick in SWF real estate investment as it accelerated its purchases of premium real estate assets in major European cities during the year, seeking to fulfil its 5 percent allocation to this sector<sup>1</sup>. In 2012 it invested more than \$4.5 billion in prime European commercial properties.

The State Oil Fund of the Republic of Azerbaijan (SOFAZ) started investing in real estate in December 2012 after a revision of its founding legislation that lets the fund allocate up to 5 percent of its capital to the asset class. SOFAZ spent more than \$400 million on properties in London and Moscow and announced the purchase of 8 Place Vendôme in Paris for €135 million (\$174 million), the transaction completed in March 2013.

In 2012, sovereign wealth funds largely shunned the financial services sector, in a reversal of a longstanding trend: just 22 percent of sovereign wealth funds' total publicly reported direct investments

were in financial services, down from 44 percent in 2010. Where sovereign wealth funds did invest in financial services, they tended to take stakes in financial institutions in established emerging markets. For example, Singapore's Temasek Holdings purchased \$130 million worth of shares in León, Mexico-based Banco del Bajío in June, GIC invested \$151 million in Ankara-based Türkiye Halk Bankası at a share offering in November, and Hong Kong-listed China Pacific Insurance (Group) Co.'s new share issue raised more than \$1.3 billion from ADIA, GIC and Norway's Government Pension Fund Global (GPF) in September.

In 2012, sovereign wealth funds also focused on energy and non-energy commodities. Companies that produce natural resources, from liquefied natural gas (LNG), to gold, coal, fertilizer and agricultural produce, accounted for 25 percent, or \$13.4 billion, of the funds' total annual reported spend. Since the global financial crisis, commodity producers have become increasingly important for sovereign wealth funds as they seek to hedge inflation at home by capturing the long-term returns of the ongoing commodity price supercycle. This long-term bet on commodities also represents funds' desire to gain from the increasing consumption of consumer goods and energy in emerging markets as discretionary incomes grow in markets such as Brazil, China and India. As committed long-term investors, sovereign wealth funds

<sup>1</sup> More recently, Øystein Olsen, Central Bank Governor, talked about raising the bar to the 10% of the global portfolio in ten years.

are well placed to benefit from these trends, despite recent price volatility.

## Conclusion

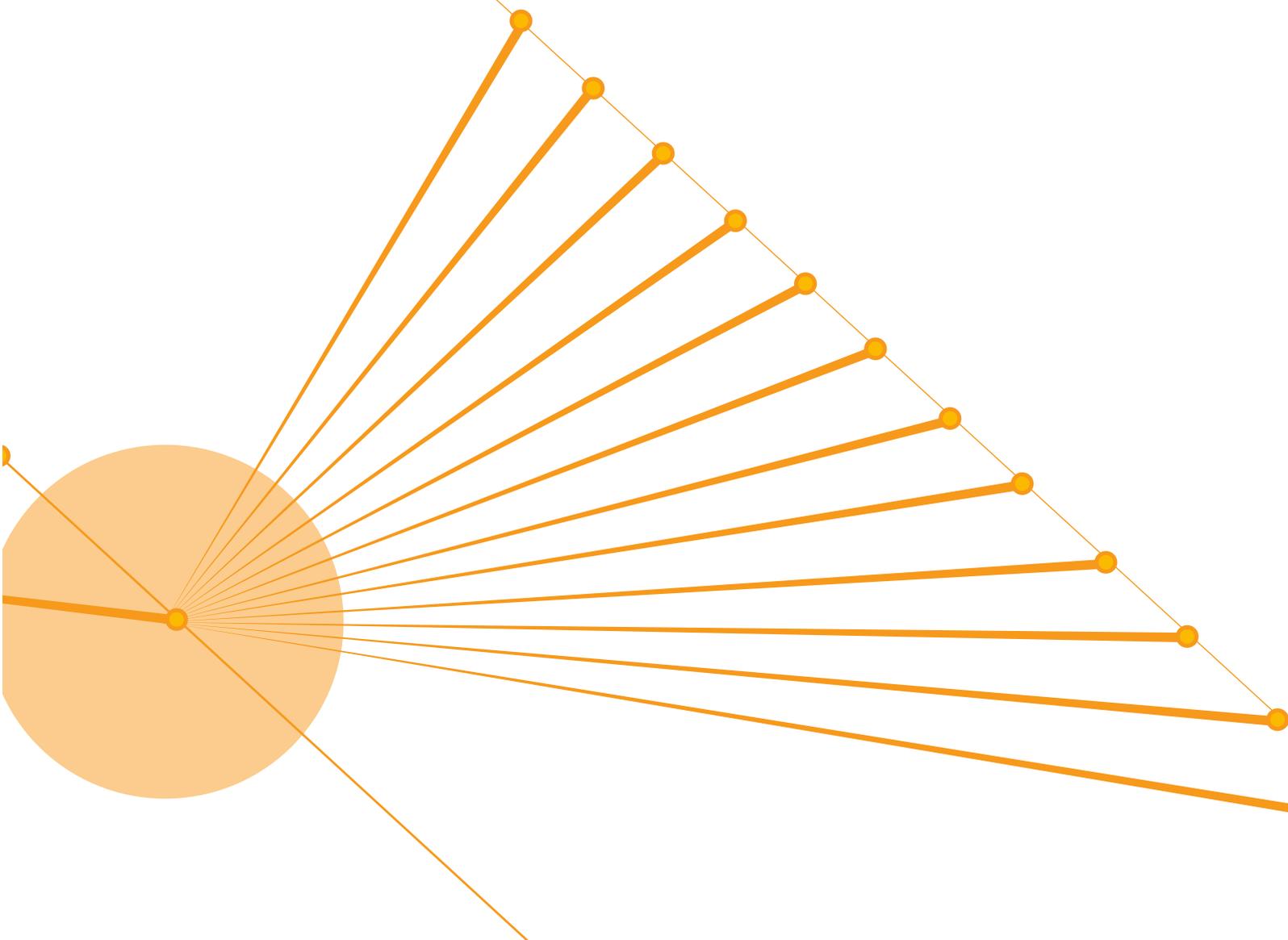
Sovereign wealth funds continue to be targeted by governments around the globe to use their long-term investment horizon to invest in infrastructure and increase their risk appetite to invest in frontier markets. However, their direct investment behaviour in 2012 suggests that they remain immune to these entreaties, instead concentrating on finding targets with strong return and growth prospects that can inflation-proof their portfolios at relatively modest levels of risk.

However, as the wider search for yield continues, sovereign wealth funds may be squeezed; as valuations rise and competition for assets increases, this may encourage them to expand their operations into other asset classes such as infrastructure that has long-term return horizons, although this investment is only likely to take place in developed markets with strong regulatory regimes.



# I

## Geographic Analysis





**Javier Santiso**

Professor of Economics, ESADE Business School

Vice President, ESADEgeo - Center for Global Economy and Geopolitics

# Sovereign wealth funds in Spain and Latin America



## 4. Sovereign wealth funds in Spain and Latin America

### 4. THE SOVEREIGN WEALTH FUNDS IN SPAIN AND LATIN AMERICA

In our previous report we made some surprising discoveries about unprecedented trends in the sovereign wealth funds industry. One of them was the rise in investments made by sovereign wealth funds and state enterprises in Spain and in Spanish companies<sup>1</sup>. In 2011, Spain and its companies became the preferred European option for the sovereign wealth funds, ahead of the UK, Germany and France.

We have also seen a rise in SWF investments (particularly by Arab and Asian funds) in Latin America. Sometimes the two trends were closely linked: Arab funds invested in Spanish companies, attracted by their presence in Latin America; others invested directly in these companies' Latin American subsidiaries.

In 2012-13 these trends continued, as we shall see in this chapter. Sovereign wealth funds continued to bet on Spanish companies, especially those with a strong presence in the emerging markets of Latin America. To invest for example in Banco Santander, as did Qatar Holding, is to invest in a European (Spanish) company, but with a very specific profile: what we may refer to as a "Euro-Latin" multinational. In 2012 Banco Santander obtained 50% of its profits from Latin America. More specifically, 26% came from a single country, Brazil (and it was precisely in subsidiary company Banco Santander Brasil that the Qatari sovereign wealth fund invested directly), ahead of Mexico (12%) and Chile (6%). To appreciate the importance of these figures we need only to remind ourselves that Spain contributed barely 15% of the profits that year, the UK 11% and USA 10%. A similar case is that of its rival BBVA, whose Latin American base is in Mexico, as opposed to Brazil.

Thus sovereign wealth funds' plays on Spain and its companies have a Latin American influence in many cases. Such was the case, for example, of Singapore's Temasek fund, which at the beginning of 2013 paid more than €1 billion for a 5% stake in oil company Repsol. At the same time the more conservative sovereign wealth funds, such as that of Norway, have maintained their plays on Spain. In 2012, Norges Bank Investment Management (NBIM), which manages Norway's sovereign wealth fund, said that 2.9% of its total portfolio was invested in Spanish assets (fixed income and equities). In 2011, NBIM had 4.1% of the fund invested in Spain, compared with 4.6% in 2010. In spite of this reduction, Spain still ranks eighth on the list of the countries in which the Norwegian sovereign wealth fund has the most investments, ahead even of the Netherlands and Norway's neighbour Sweden.

The attractive valuations of many Spanish companies, combined with their cash requirements and their need to reduce debt, are opening up significant opportunities for investment funds, sovereign

or otherwise. In 2012-13, major Spanish companies accelerated the sale of assets, with transactions totalling more than €15 billion. The Ibx 35 companies reduced their financial debt by a total of €18 billion in 2012, with Telefónica and ACS accounting for more than half the deleveraging transactions (€10.5 billion reduction in net financial debt), ahead of Repsol, Endesa and Iberdrola.

In 2012, venture capital funds such as Triton and Bain Capital acquired assets from Abengoa (Befesa) and Telefónica (Atento) for just over a billion euros in each deal. For its part the French fund Edifice injected €150 million into Isolux Corsán in 2013, to position the company as a leader in the management of parking facilities, and KKR contributed €320 million to Uralita. As well as sovereign wealth fund Temasek, companies – many of them state-owned – from emerging countries also took part in significant transactions, the most notable being the purchase of 20% of NH Hoteles by China's HNA group (for just under €240 million), the acquisition of 32% in Medgaz by Algeria's Sonatrach together with CEPSA, which was already wholly-owned by IPIC of the UAE, and, at the beginning of 2013, the purchase of 51% of Galician shipbuilder Barreiras by Mexico's state-owned oil company Pemex.

This shows, if proof were needed, that foreign investors' appetite for Spain has not diminished – rather the opposite the crisis is (re-)awakening it. Foreign investment in the Spanish stock exchange rose to 39% – still below the 40% reached in 2009 when the crisis started, but above the low points of early 2012 (38%). Evidence of foreign investor appetite can also be seen in former French President Sarkozy's establishment of an investment fund for Southern Europe, with a special fund for Spain. One of the promoters is Qatari sovereign wealth fund Qatar Investment Authority, founded in 2005 and with more than \$130 billion in assets. In December 2012 it committed €250 million to Sarkozy's venture capital fund. The fund has yet to close or become operational, but apparently it already has a name (Columbia Investments) and an HQ (in principle London or Paris). The objective is to achieve a venture capital fund of a billion euros to invest in assets in Southern Europe, with a particular focus on Spain.

Undoubtedly 2013 and 2014 will be years of considerable change in Spanish corporate shareholdings, and it will not be unusual for more sovereign wealth funds or state-owned enterprises and multinationals from emerging countries to take stakes in them, as was shown once again by the entry of Temasek and Pemex into Spanish companies in the period 2012-2013.

### Sovereign wealth funds in Spain

Some of the most notable transactions of 2012-13 were those featuring Asian sovereign wealth funds, in particular those of Singapore and China. While in 2011 Arab funds, particularly Qatar Holdings, were the main protagonists investing in Spanish companies, more recently the Asian funds have had a higher profile.

<sup>1</sup> See the chapter on Spain in the previous report <http://itemsweb.esade.edu/research/esadegeo/SWFsReport2012.pdf>.

At the beginning of 2013 the Singaporean fund Temasek made its debut in Spain with an equity stake in the oil company Repsol. In mid-2013 the new shareholder's stake in the Spanish multinational amounted to 6.3% (Temasek already held 1.25% of Repsol). The investment amounted to more than \$1 billion and is, in fact, Singapore's biggest investment in Spain to date. This percentage makes it the fourth biggest shareholder in the oil company, behind La Caixa (12.20%), Sacyr (9.53%) and Pemex (9.37%), as shown in the graph below.

Chart 1  
Temasek enters Repsol

Shareholders, expressed as a percentage of the total capital



Source: ESADEgeo (2013) with data from CNMV (2013).

This investment reflects a dual logic, which we had also stressed in last year's report: both financial (investing) and strategic (industrial). One of the major trends of the past few years followed by various sovereign wealth funds has been precisely the pursuit of a dual financial and strategic objective. Temasek's Repsol deal fits into this logic.

Temasek did not simply take advantage of the oil company's attractive valuation: it also sought to maximise strategic and industrial synergies. Singapore aims to become a hub for the LNG trade in Asia and so reduce its dependence on Indonesia and Malaysia. The play on Repsol enables it to diversify its supply sources and, above all, to strengthen its position in the LNG business. Although Repsol recently sold nearly all its LNG assets to Shell, it has significant know-how in this area, of which Temasek seeks to take advantage. For Repsol, as well as being financially attractive, the deal is also strategically important. With Temasek on board, the oil company can open doors not just in Southeast Asia but throughout the whole continent.

Temasek is the archetype of the strategic funds we referred to in our previous report: funds that seek firstly investments that generate a financial return, but that also have industrial and strategic spin-offs. With assets of more than \$190 billion, it has been one of the main drivers of Singapore's rise through flagship companies such as SingTel in telecommunications and Singapore Airlines in the air transport sector, and in the energy sector. Its presence in Repsol is its first direct foray into Spain – it had an indirect presence through its investee companies, particularly Inmet Mining, with copper mining projects in Seville.

## 4. Sovereign wealth funds in Spain and Latin America

Temasek's investment in Repsol also illustrates two of the trends that we highlighted in our previous report: the advent of emerging country investments and the attraction of using Spain as a springboard from which to access new emerging markets. Repsol, like many Ibx companies, has a specific profile among OECD countries' companies as a whole: its strong presence in emerging markets, including (but not only) in Latin America. This DNA, which combines decision-making in an OECD country with a strong presence in emerging markets, makes these companies a very attractive target for sovereign wealth funds and investors from emerging countries. This is a significant trend, which should be emphasised with a view to the future.

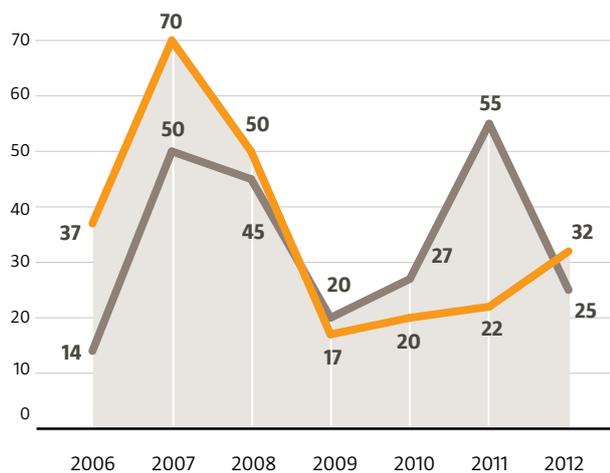
Since the mid-2000s we have been seeing an unprecedented rise in investments by emerging countries. This is reflected, for instance, in the boom in direct foreign investment by emerging economies in mature economies. In 2012 these investments reached \$32 billion, surpassing the \$25 billion of investments by mature economies in emerging economies, as shown in the following graph.

Chart 2

### The rebalancing of wealth

Value of investments (\$bn)

- From Emerging Economies to Advanced Economies
- From Advanced Economies to Emerging Economies



Source: ESADEgeo (2013) with data from PricewaterhouseCoopers (2013).

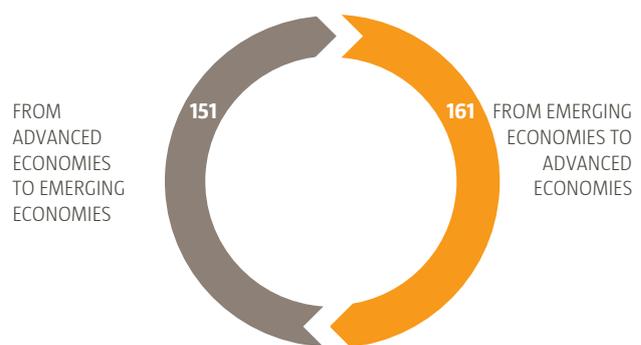
### The rise in investments from emerging countries in OECD countries

This trend points towards the current and future dynamic: the rise in investments from the South<sup>2</sup> – in which sovereign wealth funds are also participants. We have seen a striking change in the dynamics of capital flows over the past few years. Between 2008 and 2012 the total value of transactions carried out by investors from emerging economies in mature economies was \$161 billion, which is more than investments by mature economies in emerging ones (\$151 billion for the same period).

Chart 3

### Change in capital flows (2008-2012)

Value of transactions, in billions of dollars



Source: ESADEgeo (2013) with data from PricewaterhouseCoopers (2013).

The growing investment of sovereign wealth funds (and also of state-owned or private sector multinationals from emerging countries) in Spanish companies throughout the present decade is an illustration of this broader trend. One sector in which, until now, Arab and Asian sovereign wealth funds in particular have been especially active in Spain and Spanish companies is the energy sector. The following table shows the presence to date of sovereign wealth funds in companies in this sector, also including holdings by state-owned enterprises such as Sonatrach, Sinopec, Enel and Pemex<sup>3</sup> and the holdings of the Norwegian sovereign wealth fund (we will analyse this case in detail later on). Some companies, such as CEPSA, have been completely taken over; in other cases, if we add up sovereign and state holdings such as those in Repsol, they represent nearly a quarter of the total shareholding. In others, such as Iberdrola, it is more than 10%. As we can see, in this sector sovereign wealth funds and state-owned enterprises are already major shareholders in several Spanish multinationals.

<sup>2</sup> This is also the case of Latin America and its multinationals. Regarding this point and the possibilities for Spain as a hub for Latin American multinationals looking to expand into Europe, the Middle East and Africa, see Javier Santiso, *The Decade of the Multinationals*, Cambridge and New York, Cambridge University Press, 2013.

<sup>3</sup> Pemex recently put up for sale 4.9% of Repsol, more than half its holding in the Spanish oil company, for €1 billion. Temasek, the Singaporean sovereign wealth fund, has shown interest in increasing its stake in Repsol (6.3%) starting with the shares that Pemex has put up for sale.

Table 1

## Sovereign wealth funds and SOEs in Spanish energy companies

Spanish company	Sovereign wealth fund or state-owned enterprise*	Country of origin	Holding (\$bn or% of capital when indicated)
Repsol	Temasek	Singapore	6.3
	Pemex*	Mexico	9.5
	Government Pension Fund-Global	Norway	1.26
Repsol Brasil	Sinopec*	China	40%
Cepsa	IPIIC	UAE	100%
Iberdrola	Qatar Holding	Catar	8.4
	Government Pension Fund-Global	Norway	1.75
Gas Natural Fenosa	Sonatrach*	Argelia	4
	Government Pension Fund-Global	Norway	0.91
Endesa	Enel*	Italy	92%
	Government Pension Fund-Global	Norway	0.17

Source: ESADEgeo, 2013 and CNMV, 2013.

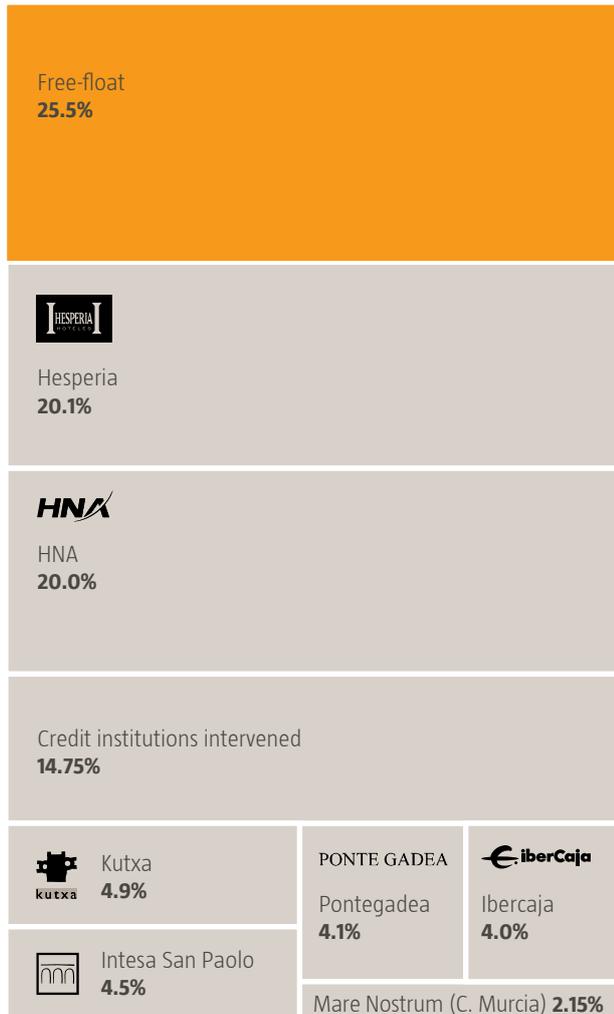
Emerging country entities' incursions into Ibx companies also featured a striking case in another sector: hotels. Following an unsuccessful first attempt, in 2012 the Chinese company HNA succeeded in its second attempt to acquire 20% of hotel chain NH. This case is also striking because HNA has thus become one of the hotel chain's major shareholders, together with Hesperia (which still has another 20% after the entry of HNA).

The example of NH also illustrates the stimulus that stakes in financial institutions in administration will exert in the future, as we shall see presently. In the case of NH, institutions placed in administration following the restructuring of the banking sector hold just under 15%. If we add the 6% of IberCaja and the former Caja Murcia, this brings the shares that can be expected to change hands in the future to more than 20%.

## 4. Sovereign wealth funds in Spain and Latin America

Chart 4

Distribution of shareholdings in the capital of NH after the entry of HNA



Source: ESADegeo (2013) with data from NH Hoteles (2013).

### Spanish companies take centre-stage

In the period 2012-2013 numerous transactions were carried out by funds involving foreign subsidiaries of Spanish multinationals or Spanish companies. An example of the former was the case of the Ferrovial group and Iberdrola; a classic example of the latter was that of Abertis and Hispasat.

Ferrovial is a clear example of a Spanish multinational needing to deleverage and refocus its business that has been able to open up a path into the world of sovereign wealth funds using the attraction of one of its subsidiaries (in this case not in an emerging country but in an OECD member). In 2012 the group accelerated its policy of disinvestment in its UK associate, the former BAA. In all it sold nearly 16% of Heathrow Airport Holdings to Qatar Holding, in two tranches valued at nearly a billion euros. Moreover, and also in 2012, Ferrovial opened the way to Chinese fund CIC, divesting itself of a further 5.72% of its stake in the UK airport manager for some €320 million. Ferrovial's stake in Heathrow Airport Holdings will be reduced to 33.65% once the transaction with Qatar Holding has been completed.

In total, in 2012 Ferrovial reduced its stake in Heathrow Airport Holdings from 44.27% to 33.65%, after selling shares for €587 million to Qatar Holding and for some €320 million to a subsidiary of CIC International Co. These sales yielded Ferrovial capital gains of €186 million. In a single year it allowed several sovereign wealth funds into one of its subsidiaries, from two different regions: Asia and the Middle East. After these transactions we can say that sovereign wealth funds effectively "control" the UK's (and Europe's) leading airport. If we add up the holdings of Qatar, China and Singapore (which is also now a shareholder) they account for 42%. The other major shareholder continues to be Spain's Ferrovial, which retains 34%.

## Chart 5

### Heathrow in the hands of the SWFs



Sources: Heathrow Airport Investment Report (2013).

Qatar Holding has been a particularly active investor in Spanish companies. In 2011, as we highlighted in last year's report, it became one of the main shareholders in Iberdrola and Santander, investing more than \$2 billion in each and acquiring stakes of more than 6%. In 2012 it also took a stake in Iberdrola, another example of how a Spanish multinational with a strong Latin American presence manages to attract the investment of a sovereign wealth fund in one of its subsidiaries, in this case in an emerging country. Qatar's play on Iberdrola is explained not so much by Spain as by Brazil, where the energy multinational has substantial industrial projects.

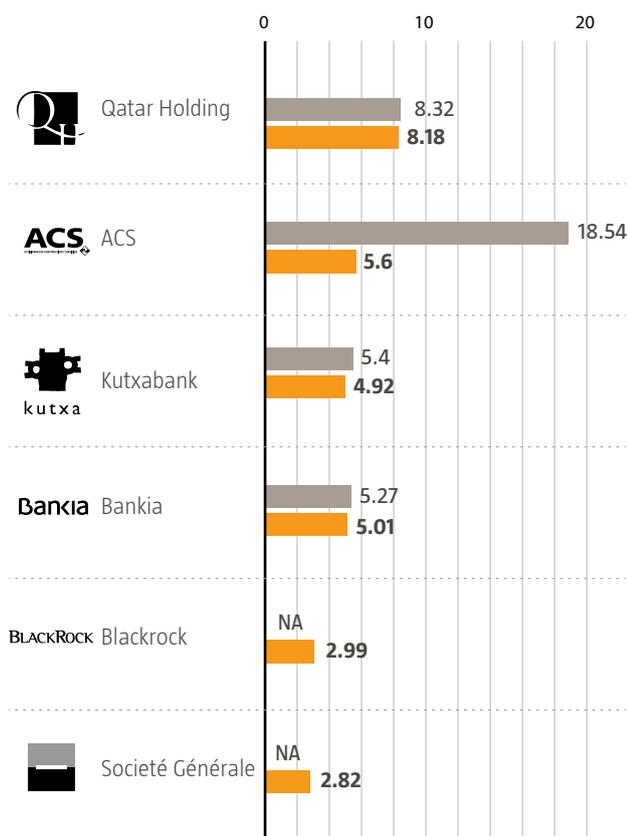
Qatar Holding has thus become the main shareholder in Iberdrola. In barely two years this Ibx multinational has extensively reconfigured its shareholding structure, attaining a much greater international presence via a sovereign wealth fund. A few years ago, Spain's ACS was the main shareholder in Iberdrola, with just over 18%. During 2012 it had to dispose of this stake in view of its need to deleverage, which allowed international investors such as BlackRock, Société Générale and others to move in. The arrival of Qatar Holding not only injected liquidity, but also further stimulated international investor appetite for the energy company. The entry of a sovereign wealth fund served to anchor the investment of other international institutional investors.

## 4. Sovereign wealth funds in Spain and Latin America

**Chart 6**  
Qatar Holding becomes the main shareholder of Iberdrola

Major shareholders, expressed as a percentage of the total capital

● A year ago ● Now

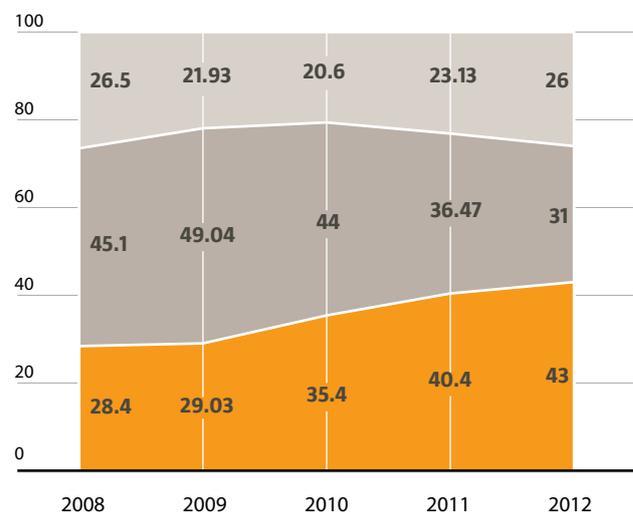


Source: ESADegeo (2013) with reports from corporate governance 2011 and 2012.

Iberdrola is an illustrative example of the huge shareholding restructuring that is taking place in major Spanish companies. Specifically, it shows the growing internationalisation of its shareholding. As displayed in the following graph, at the onset of the crisis, in 2009, 49% of Iberdrola was in the hands of Spanish entities. By 2012 this percentage had fallen to 31%. In parallel with this, holdings of foreign entities (among them Qatar Holding and other international investment funds) rose from just over 29% to a total of 43% between 2009 and 2012. In a sense, one might say that, while the decade of the 2000s was a decade of internationalisation of revenues for many Ibx companies, that of the 2010s looks to be the decade of internationalisation of capital. The changes seem unlikely to stop here: in Iberdrola, to continue with this example, several banks and savings banks have holdings either because of regulatory requirements (Kutxabank) or because they are imposed due to their being in administration (Bankia), and they will have to dispose of these investments, which amount to nearly 10% (to which the 5.6% still in the hands of ACS should be added).

**Chart 7**  
Iberdrola: Internationalizing the capital of the company\*

● Foreign entities ● Spanish entities ● Private investors



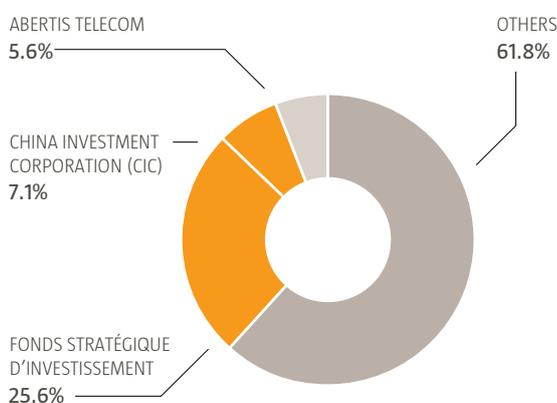
(\*) Distribution of share capital by type of shareholder, in percentage.

Source: ESADegeo (2013) with data from the Iberdrola Corporate Governance Report (2013).

Lastly, we should highlight the case of Abertis and Hispasat: a 'multi-layered' transaction. In 2012 Abertis Telecom sold 7% of

its stake in satellite multinational Eutelsat to the Chinese sovereign wealth fund CIC. Abertis Telecom retains 5.6% of the capital. The remainder is now spread between CIC and the French sovereign wealth fund, which holds 25.6% of the capital. In all, one third of Europe's leading satellite company is now in the hands of two sovereign wealth funds, one Chinese and the other French.

**Chart 8**  
Shareholding Eutelsat: More than 30% in the hands of SWFs



Source: ESADEgeo (2013) with data from Eutelsat (2013).

The consequences of this Chinese holding mean that, indirectly, CIC has opened a window on Hispasat, a Spanish multinational in which Eutelsat holds more than 27%. The other two major shareholders continue to be Abertis (with just over 33%) and the Spanish State, via INTA, CDTI and SEPI (with a further 26%). Telefónica, for its part, holds just over 13%.

### Financial funds' stakes

The more financial-type funds, which are not looking for industrial synergies, also continued to bet on Spain. This is particularly the case of the Norwegian sovereign wealth fund: Spain ranks eighth on the list of countries in which this fund has invested most. In total, at the end of 2012, the Norwegian fund had investments worth almost €15 billion in Spain. The majority (€8.5 billion) corresponded to fixed income, and the rest to equities, 3.9% more than in 2011. The main change was in fixed income, where the Norwegian fund reduced its exposure to Spanish debt between 2011 and 2012 by nearly a third (-28%).

This transaction shows, if proof were needed, the growing appetite of sovereign wealth funds for high added value sectors (in this case communication satellite technology) as we shall see later in a specific chapter. It also shows the ability of a player (Abertis) to attract investment from sovereign wealth funds.

**Chart 9**  
Shareholding Hispasat



Source: ESADEgeo (2013) with data from Hispasat (2013).

Table 2

### The (great) financial rebalancing of the Norwegian sovereign wealth fund's Spanish portfolio in 2012

Investment*	2012	2011	2012/2011
Fixed Income	7,862	9,010	-12.74%
Central Government Debt	712	2,313	-69.21%
Equities	6,297	6,060	3.91%
Total	14,871	17,383	-14.45%

\* € million

Source: ESADEgeo (2013) with data from NBIM (2013).

## 4. Sovereign wealth funds in Spain and Latin America

This is the world's biggest sovereign wealth fund, with assets of \$741 billion in 2013; in other words, 1.6 times the total capitalisation of the Ibex 35. In 2012 the Norwegian fund made two kinds of changes with regard to Spain: it increased its play on Spanish companies, in particular the major Ibex 35, and at the same time reduced its exposure to Spanish public debt. Its portfolio of Spanish treasury bonds at the end of 2012 stood at Nkr 5.26 billion (€712 million), 69% less than in 2011. Spain thus ceases to be one of the ten preferred countries of the Norwegian fund for forming its sovereign fixed income portfolio. In 2011 it was still the eighth biggest sovereign issuer in the portfolio. It has been displaced by emerging countries such as Mexico and South Korea; the emerging countries are the fund's new major focus.

This movement in Spanish fixed income is in contrast to that in Spanish equities, though this was not peculiar to Spain. The Norwegian fund has reduced its investments in fixed income to an all-time low, which now represent 36.7% of its total portfolio. The move to equities was in fact seen in many countries, while it reduced exposure to government bonds. Thus in 2012 more than 61% of its portfolio was invested in equities, with some Spanish companies standing out among them. In total, at the beginning of 2013, the Norwegian fund had investments in 69 Spanish listed companies (compared with 75 in 2011). These investments are not all direct; some of them are through private sector asset managers. In Spain, part of the Norwegian sovereign wealth

fund's portfolio has been managed since 2011 by a Spanish manager: Bestinver.

In Spain, apart from the Ibex, a few smaller stocks stand out. The fund owns 4.3% of Rovi pharmaceutical laboratories, nearly 4% (compared with 2.73% in the previous year) of Miguel y Costas and nearly 3% of Azkoyen. It also has stakes in the Ibex, particularly in NH Hoteles, Santander, BBVA and Telefónica. It increased its holdings in the majority of these companies compared with the previous year. Thus at the beginning of 2013 Norway held 2.12% of Banco Santander (compared with 2.05% the year before), 2.21% of BBVA (2011: 1.98%), 2.15% of Telefónica (2011: 1.88%) and 1.75% of Iberdrola (2011: 1.2%). It also held 2.38% of Pescanova, the Galician multinational undergoing difficulties and subject to an arrangement with creditors.

Not surprisingly, the top ten Spanish holdings and investments include Ibex majors Santander and Telefónica, in each of which it has invested more than a billion euros. These are followed by companies such as BBVA, Inditex and Iberdrola (in all three of which it increased its investment in 2012) and then by Repsol and Ferrovial. Amadeus, Gas Natural and Grifols complete the top ten, these last three each with investments of less than €100 million (see table 3).

Table 3

## The main Spanish plays of the Norwegian sovereign wealth fund

Government Pension Fund-Global (Norway) in Spain				
Top 20	Company/Bank	2012	2011	2012/2011
1	Santander	1,389	1,029	34.98%
2	Telefónica	990	1,145	-13.53%
3	BBVA	833	646	28.94%
4	Inditex	600	404	48.51%
5	Iberdrola	447	341	31.08%
6	Repsol	240	573	-58.11%
7	Ferrovial	181	170	6.47%
8	Amadeus	131	95	37.89%
9	Gas Natural	123	67	83.58%
10	Grifols	106	63	68.25%
11	Abertis	93	81	14.81%
12	Banco de Sabadell	90	89	1.23%
13	ACS	77	90	-14.44%
14	DIA	70	52	34.61%
15	Enagás	62	55	12.72%
16	Banco Popular	53	73	-27.39%
17	Indra Sistemas	47	44	6.81%
18	Corp Financiera Alba	43	42	2.38%
19	CaixaBank	38	72	-47.22%
20	Acerinox	33	49	-32.65%
	<b>Total</b>	<b>5,646</b>	<b>5,180</b>	<b>9.00%</b>

Source: ESADEgeo, 2013, with data from the NBIM, 2013. (€ million)

In the global top ten of its investments however, not a single Spanish company appears. Nor do Spanish companies appear in the world top ten of the fund's biggest percentage shareholdings: here the leaders are Ireland's Smurfit Kappa (in which the fund holds 9.5%), the UK's Great Portland Estates (8.9%), several Finnish companies such as Stora Enso and UPM-Kymmene (8% of each), and even one or two Chinese companies, such as China Water Affairs (7.6%).

Apart from fixed income and equities, there is another interesting point for Spain. The fund has started to invest in real estate. To date this represents just 0.7% of its portfolio, but it is increasing and expected to reach 10% in a few years. For the time being, however, Spain does not seem to be on its radar for this segment: in 2012 it disposed of various stakes in half a dozen Spanish companies, nearly all of them in the real estate sector. Such was the case for example of Realia and Quabit, also exiting Banco Pastor and Banco de Valencia.

## 4. Sovereign wealth funds in Spain and Latin America

### Infographic 1

#### Public investees after the FROB

The Spanish public sector expands its influence beyond traditional investees such as SEPI, Grupo Fomento and Grupo Patrimonio. Now, after major nationalizations, the public sector includes relevant banking holdings.

#### Traditional Public Investees

Information at December 31, 2012

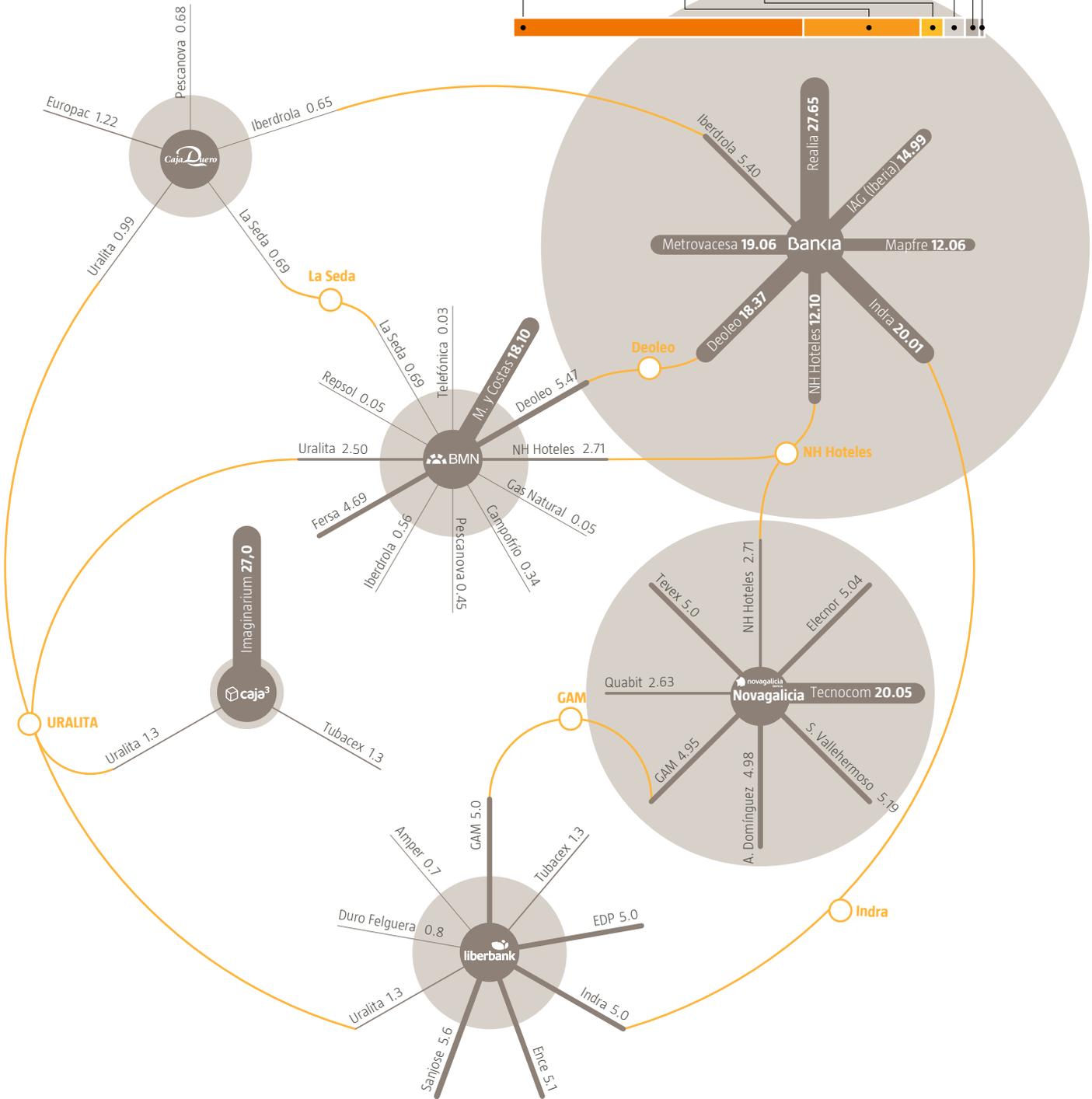
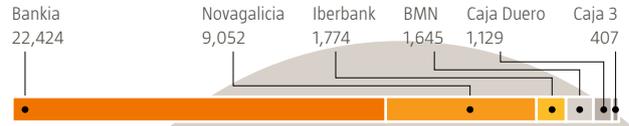


Source: ESADEgeo (2013).

## New banking investees

Spoke: percentage of capital  
Shaded area: total assistance in cash from FROB

## Total assistance in cash from FROB (€ million)



## 4. Sovereign wealth funds in Spain and Latin America

### Banks' holdings More opportunities?

The industrial holdings of Spanish banks and savings banks present more future potential opportunities for the sovereign wealth funds.

The two main cases, in view of their size, are the associate companies of Bankia and La Caixa. To a lesser extent we also find other savings banks, many of them now in administration, nationalised or liquidated.

La Caixa is looking to re-establish a holding company for its holdings (recreating what used to be called Critería) to be able to sell some of them. The Basel III rules, which penalise industrial investments, work in favour of a move of this kind, which would allow La Caixa to strengthen its solvency and focus on its banking business. Of the more than €18 billion still held by the savings banks in companies, La Caixa accounts for some €13 billion –without counting holdings in the finance sector or unlisted companies such as Agua de Valencia or Isolux. In Critería, the unlisted investment company, there are still several legacy holdings, such as GasNatural (in which La Caixa holds nearly 35%) and Abertis (with nearly 23%). CaixaBank, which is listed, controls several strategic assets such as Repsol (in which it holds 12.2%) and Telefónica (5.6%), and others that the entity took over as it absorbed other financial institutions; such is the case of Deoleo (5%) or Fluidra (8%).

The holdings of these former savings banks (many now in administration, or held partly or wholly by the State) also cover many companies. By way of example, Isolux Corsán is held by two families (Delso and Gomis, each with 28%) but also by Banca Cívica (25%) and CajAstur (12%). Isolux in turn holds 11% of Aernnova, an avionics company that at one time was in talks on an acquisition by an Arab fund (Mubadala). More and more tangled: Aernnova, from Vitoria, is in turn partly held (34%) by Banco Castilla-La Mancha, and by EBN Banco (11%)<sup>4</sup>. This simple example shows the complex web of shareholdings; many of these positions will have to be unwound over the next few years, and this calls for a more strategic reflection. The savings banks in administration (or partly nationalised) offer a wide range of industrial holdings, each one a potential opportunity for long-term investment partners (beyond the logic of short-term financial transactions).

Bankia has significant industrial holdings in key sectors such as new technologies and defence. It holds more than 20% of Indra. It also has stakes in Metrovacesa (19%), NH Hoteles (nearly 16%), Mapfre (15%), IAG / Iberia (12%) and Iberdrola (5.4%), to mention just a few of the more significant ones (Infographic 1). For all these companies, Bankia will play a role in deciding their future owners. In

some cases, an investment by a sovereign wealth fund, i.e. long-term capital, could be an option to assess.

One striking case is that of the Ibex listed company Indra. Not only does Bankia hold 20% of this technology multinational, but other savings banks such as Liberbank also hold a further 5%.

Another savings bank in administration with a significant industrial portfolio is Novagalicia. It holds for example 20% of technology company TecnoCom and 5% of companies such as Sacyr, Elecnor, Tavex and Adolfo Domínguez.

Amper is a good example of a company partly held by savings banks which, in the past, aroused the interest of sovereign wealth funds. Caja Castilla-La Mancha is one of the shareholders, with 8.08%. Monte de Piedad y Caja de Ahorros San Fernando de Guadalajara. Huelva, Jerez y Sevilla is another shareholder, with 3.03%<sup>5</sup>, in total, they account for more than 11%, to which we might add the 6.1% held by Telefónica, which is looking to dispose of non-strategic holdings to raise liquidity as it did in 2012 with Atento and Rumbo.

The remaining savings banks have insignificant holdings, although the amount of disinvestments will lead to major restructuring of shareholdings. Caja3 is above all present in Imaginarium (23%) and to a lesser extent in Uralita (1.3%) and Tubacex (1.3%). But it all adds up: in Uralita's shareholding we also find other savings banks that will have to dispose of their holdings, such as Caja España Duero which holds nearly 5% (see graphs hereunder) and Liberbank (with a further 1.3%). We also find BNM (2.5%), another entity with (very) minority holdings in major listed companies such as Telefónica, Iberdrola, GasNatural, Repsol, Pescanova, NH Hoteles and Campofrío. In total, the various savings banks referred to hold just over 5% of Uralita, a company that in 2013 had to turn to US venture capital fund KKR in order to find the liquidity that it was unable to obtain in the traditional financial system.

The imperatives of disinvestment of Spain's (former) savings banks and banks will lead to more changes in shareholdings in the rest of the decade. Moreover, this phenomenon comes together with the major deleveraging undertaken by Spanish companies and multinationals themselves. In 2012 alone, Ibex majors, led by Telefónica, ACS<sup>6</sup> and Repsol, reduced their borrowings by nearly €17 billion, by selling off assets considered as non-strategic. Table 4 shows the key figures.

This movement accelerated in 2012, and all the indications are that 2013 will see similarly intense deleveraging. Overall, the Ibex

<sup>4</sup> See annual report [http://www.aernnova.com/user/en/images/memoria\\_aernnova\\_11.pdf](http://www.aernnova.com/user/en/images/memoria_aernnova_11.pdf)

<sup>5</sup> See <http://amper.laborsavirtual.com/accionistas-amper.html>

<sup>6</sup> In May the German construction company Hochtief, which is wholly-owned by ACS, sold its airports division to the Canadian pension fund PSP for €1.1 billion. With this transaction ACS was aiming to reduce its indebtedness.

companies face debt payments of more than €45.8 billion in 2013. Some, like Iberdrola, ACS and FCC, have current debt maturities of more than €4 billion each; Repsol, about the same; Sacyr more than €3 billion; Acciona and GasNatural more than €2 billion;

Abengoa, Abertis, Ferrovial, and RRE more than €1 billion each. In the case of Telefónica debt maturities amount to €10 billion. The majority of these companies already made a substantial effort in 2012, reducing total indebtedness of the Ibx to €270 billion.

Table 4

Total debt and financial debt of the main companies in the IBEX 35

Top 20	Entity	Total debt 2012*	2012/2011	Net Financial Debt**	2012/2011
1	Telefónica	66,662	0.5%	58,815	-8.6%
2	ACS	11,070	-30%	6,543	-44%
3	Repsol	18,794	-6.2%	12,891	-25.8%
4	Endesa	9,158	-27.8%	7,172	-27.5%
5	Iberdrola	32,883	-1%	29,840	-4.2%
6	OHL	5,322	-19.3%	4,539	-16.5%
7	ArcelorMittal	20,200	-0.4%	16,717	-3.3%
8	Amadeus	1,894	-15.5%	1,495	-18.8%
9	Grifols	2,774	-6.2%	2,301	-12%
10	Ferrovial	8,224	4%	5,244	-5.7%
11	Acerinox	1,163	10.7%	581	-34.5%
12	Sacyr	9,372	-2.2%	8,747	-2.8%
13	DIA	965	12.9%	615	8.7%
14	Indra	702	18.0%	633	23.2%
15	REE	4,960	4.5%	4,920	4.1%
16	Abertis	16,848	15.9%	14,466	2.3%
17	Acciona	9,046	1.0%	7,850	5.9%
18	IAG	4,798	-1.7%	3,436	18.2%
19	FCC	8,391	-4.4%	7,225	11.6%
20	Abengoa	11,693	14.9%	9,200	42.9%
	<b>Total</b>	<b>244,919</b>		<b>203,230</b>	

Note\*: Total debt has been calculated by adding items 1131 and 1133 of the balance sheet filed with the CNMV, corresponding to the headings "owed to banking institutions" under current and non-current liabilities.

Note\*\*: Net financial debt has been obtained by subtracting "cash and cash equivalents" (item 1072) from total debt.

Source: ESADEgeo, 2013, based on CNMV data, 2013.

## 4. Sovereign wealth funds in Spain and Latin America

### Sovereign wealth funds' investments in Latin America

Many of the state holdings lack a key attraction that private sector Spanish companies have had for a number of Arab and Asian funds, namely a strong presence in Latin America. As we saw in the case of Temasek with Repsol or Qatar Holding in Iberdrola (covered explicitly in the 2012 sovereign wealth funds report) the Latin American attraction has been and continues to be important for these investors.

Latin America was very much on the investment radar of the Arab and Asian funds. Some, like Temasek, even opened offices in Mexico and Brazil, while others search for opportunities in Latin America from their international bases in Toronto (CIC) or London (GIC). None has opened an office in Spain to use the country as an investment springboard for both Europe and Latin America (for example Qatar Holding could take advantage of its already important links in this regard with Iberdrola, Santander or Ferrovial and set up an international base for Latin America and Europe in Madrid).

The region is clearly on investors' radar. They are interested not just in the traditional (energy) sectors but also in sectors with greater added value, including technology sectors (see chapter on sovereign wealth funds and technology in this report.) We are already seeing investments by sovereign wealth funds in local technology groups such as Televisa and América Móvil in Mexico, and Sonda in Chile.

Table 5

### Sovereign wealth funds' investments in Latin American technology companies

Top 5	Company	Country	Sovereign Wealth Fund	Investment*
1	América Móvil	Mexico	Government Pension Fund-Global	408
2	Telefónica Brasil	Brazil	Government Pension Fund-Global	183
3	Grupo Televisa	Mexico	Government Pension Fund-Global	131
4	Amyris Biotechnologies	Brazil	Temasek	25
5	Sonda	Chile	Government Pension Fund-Global	10

\* \$ millions

Source : ESADEgeo, 2013.

The investments of these Arab funds sometimes involve significant amounts, as with the Brazilian group EBX owned by Eike Batista, in which Abu Dhabi fund Mubadala carried out the biggest transaction to date by an Arab fund in Latin America, with an investment of \$2 billion in 2012. Temasek made significant investments in Odebrecht Oil & Gas (in which it now holds 14.3%), thus showing its appetite for investing in BRIC countries. Temasek was also very active in China, including in technology sectors, taking positions in Alibaba. It holds a further 15.4% in San Antonio International.

Table 6

## Main equity holdings of sovereign wealth funds in Latin American companies as at 1 Jan, 2013

Sovereign Wealth Fund	Company	Country	Value	Sector
Fundo Soberano do Brasil	Petroleo Brasileiro Petrobras SA	Brazil	\$4,897 million	Energy
Mubadala	EBX	Brazil	\$2,000 million	Mining/Energy
NBIM	Petroleo Brasileiro Petrobras SA	Brazil	\$888 million	Energy
NBIM	Vale SA	Brazil	\$762 million	Mining
NBIM	Itau Unibanco Holding SA	Brazil	\$656 million	Banking
NBIM	Banco Bradesco SA	Brazil	\$415 million	Banking
Temasek	Odebrecht Oil & Gas	Brazil	\$400 million	Energy
NBIM	Companhia de Bebidas das Americas Ambev	Brazil	\$373 million	Food and drink
NBIM	Ecopetrol	Colombia	\$280 million	Energy
NBIM	Telefonica Brasil SA	Brazil	\$184 million	Telecommunications
NBIM	Itausa Investimentos Itau SA	Brazil	\$172 million	Financial
Government of Singapore Investment Corporation	BR Properties SA	Brazil	\$167 million	Real Estate
Abu Dhabi Investment Authority	Ecopetrol	Colombia	\$136 million	Energy
NBIM	Banco Santander Brasil SA	Brazil	\$117 million	Banking
NBIM	Alpargatas SA	Brazil	\$107 million	Footwear.
NBIM	Sociedad Quimica y Minera de Chile SA	Chile	\$93 million	Chemicals
NBIM	Latam Airlines Group SA	Chile	\$91 million	Aviation
Government of Singapore Investment Corporation	Alliancse Shopping Centers SA	Brazil	\$69 million	Real Estate
Temasek Holdings	Petróleo Brasileiro Petrobras SA	Brazil	\$63 million	Energy
Abu Dhabi Investment Authority	Macquarie International Infrastructure Fund Ltd	Bermuda	\$24 million	Financial
Korea Investment Corporation	Credicorp Ltd	Peru	\$9 million	Banking
Texas Permanent School Fund	Everest Re Group Ltd	Bermuda	\$7 million	Financial

Source: Fletcher SWF Transaction Database, 2013 (originally created by Monitor Group).

China's CIC also made its first investments in Latin America, particularly in Brazil. Thus in 2011 CIC's investments in the region reached 5.4% of its investments in listed companies, still far behind North America (41.9%), Asia (29.8%) and Europe (21.7%), but ahead of Africa and the Middle East (1.2%). For the time being its portfolio is dominated by investments in financial institutions (17% of the total equity portfolio) and in the energy sector. In Brazil its investments in inflation-linked bonds stand out.

Brazil, is in fact, currently the main focus of attention in the region for these investors. Table 6 shows all the investments made by sovereign wealth funds in Brazil, in companies as diverse as mining company Vale, cosmetics multinational Natura, bus company MarcoPolo and the country's major banks. In total these investments amount to \$8.87 billion in 2013.

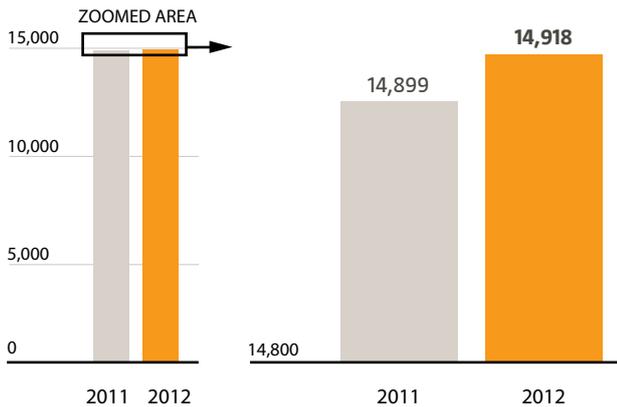
Other countries receiving growing attention are Mexico, Chile and Colombia, and in certain cases Peru and Panama. Temasek of Singapore has invested in LAN (1.2%), the Chilean airline that merged in 2012 with Brazil's TAM to form LATAM, a world leader in the sector. For its part GIC, also from Singapore, has invested indirectly in Latin American assets such as the multinational Bunge, listed on the New York Stock Exchange, in which it has held 5% since 2012 (for a total investment of nearly \$500 million). As well as investments in listed companies, GIC embarked on an aggressive strategy of investing in private equity, with more than 11% of its investment portfolio in venture capital in emerging markets; it makes investments of between \$50 million and \$600 million in emerging market venture capital funds, including those specialising in Latin America. It participated in Latin American fund Advent (total \$1.3 billion) in 2007<sup>7</sup>.

<sup>7</sup> According to Preqin's database, among its holdings in venture capital funds is one striking one: that held in the CBRE real estate fund for the Iberian Peninsula, established in 2000 with a total of €500 million in AUM. Also, in 2004, it invested in Mexican real estate fund Prologis SGP Mexico (the fund raised a total of \$250 million).

## 4. Sovereign wealth funds in Spain and Latin America

Chart 10  
The SWFs continue investing in Latin America

Total amount of investment (\$M)



Source: Fletcher SWF Transaction Database, 2013 (originally created by Monitor Group).

In Latin America, one notices not just the growing number of transactions being carried out by the various sovereign wealth funds that are present in the region, but also the significant number of countries that have established sovereign wealth funds (Chile, Mexico and Trinidad and Tobago) or are studying the possibility of doing so (Bolivia and Guatemala).

In 2011 Colombia, Latin America's fourth biggest oil producer and the world's fourth biggest coal exporter, launched a sovereign wealth fund based on savings from royalties on oil extraction. Like the Chilean funds, this fund has been framed within a fiscal responsibility act to ensure its proper functioning, but unlike Chilean funds, it not only has as its main objective the promotion of saving and the stabilisation of the country, but also has entrusted to it the mission of driving and stimulating Colombia's manufacturing sectors by means of new technologies and innovation. A similar mandate to that of Mubadala in the UAE or Khazanah in Malaysia.

In that same year, the then Minister of Economy and Finance of Peru, Ismael Benavides, announced in a meeting of investors at the New York Stock Exchange the possibility that part of the assets of the Fiscal Stabilisation Fund, currently \$7.1 billion, be used to create a sovereign wealth fund similar to those already existing in the region.

Infographic 2  
World Map of Sovereign Wealth Funds (2013)

ASSETS UNDER MANAGEMENT (US\$ billions)



Source: ESADegeo SWF Tracker (2013).



## 4. Sovereign wealth funds in Spain and Latin America

More recently, in 2012, Panama approved the creation of another vehicle: the FAP ('Fondo de Ahorro de Panamá' or Panama Savings Fund). This sovereign wealth fund, which was formed with the resources of the Fondo Fiduciario para el Desarrollo (Fiduciary Development Fund), currently manages \$300 million and hopes to increase volume using revenues from the operation of the Canal.

Table 7

Recently created Latin American sovereign wealth funds (US\$ billions)

Country	Sovereign Wealth Fund	Management	Established
Peru	Fondo de Estabilización Fiscal*	7,1	2011
Colombia	Fondo Soberano de Colombia	0,7	2011
Panama	Fondo de Ahorro de Panamá (FAP)	0,3	2012

\* In 2011 the Minister of Economy and Finance of Peru, Ismael Benavides, confirmed the use of contributions from the Fiscal Stabilisation Fund to prime a new sovereign wealth fund.

Sources: SWF Tracker, ESADEge (2013).

In spite of the proliferation of new funds, their size, domestic nature and stabilising mission are such that to talk of Latin American sovereign wealth funds in practice still means to talk of Chile and Brazil.

In the case of Chile's two sovereign wealth funds, the FEES (Economic and Social Stabilisation Fund) and the FRP (Pension Reserve Fund) with \$15 billion and \$5.8 billion respectively, their performance and exemplary record resulting from the fiscal discipline with which they have been associated since their inception have made both vehicles world references of best practice, comparable to that of Norway.

Until 2012 the investment policy established by the Chilean authorities for the two funds was characterised by a strong trend towards low-risk assets. In 2012, after arduous debate which was not without controversy, significant changes were made to the investment criteria, and the possibility of including equities in the Chilean funds' portfolios was opened up. The conservative investment policy of the FEES (Economic and Social Stabilisation Fund) remained unchanged, but for the Pension Reserve Fund, limits of 15% and 20% were established for equities and corporate bonds respectively in the fund's portfolio.

In Brazil, until the creation of the Fondo Soberano do Brasil (FSB), the country had been promoting the development of its SOEs, such as mining company Vale or oil company Petrobras, through BNDESPAR, the subsidiary of the Brazilian Development Bank BNDES (Banco Nacional de Desenvolvimento Econômico e Social)<sup>8</sup>. Since its establishment in 1952, BNDES has acted as a strategic fund, helping to ease the capital restrictions of major Brazilian companies listed in the stock exchange and helping them to improve their ability to undertake long-term investments<sup>9</sup>.

<sup>8</sup> See the chapter by Luciano Coutinho, João Carlos Ferraz, André Nassif and Rafael Oliva in Javier Santiso and Jeff Dayton-Johnson, (Eds.). *The Oxford Handbook of Latin American Political Economy*, Oxford University Press, 2012.

<sup>9</sup> See Sergio Lazzarini and Aldo Musacchio, 2010, "Leviathan as a minority shareholder: a study of equity purchases by the Brazilian National Development Bank (BNDES), 1995-2003," Harvard Business School Working Papers.

Created in 2008 from oil production revenues, the continent's other major fund, the Fundo Soberano do Brasil (FSB), has opted for a less conservative investment policy than its Chilean counterparts. Since its inception it has invested heavily in equities (85%) rather than fixed income (15%), which since the onset of the financial crisis has lost its safe haven status. Until now, the bulk of the investments in equities has been concentrated in the local market, and specifically in two stocks: Petrobras (75% of the fund's assets) and Banco do Brasil (10%).

Table 8

Main Holdings of BNDES at 31 Dec. 2012

Company	%
Fibria	30.40%
JBS	20.53%
Suzano	17.87%
Light	13.46%
Mafrig	12.25%
Renova	12.25%
All	12.10%
Electrobras	11.86%
Petrobras	10.37%
Mpx	10.35%

Source: BNDES, 2013.



**Christopher Balding**

Associate Professor, HSBC Business School at Pekin University Shenzhen Graduate School

**Ellen Campell**

Senior Consultant for Strategic Innovation Group, Booz Allen Hamilton

# The great wallet of China: China Investment Corporation (CIC) and State Administration of Foreign Exchange (SAFE)

## 5. The great wallet of China: China Investment Corporation (CIC) and State Administration of Foreign Exchange (SAFE)

### 5. THE GREAT WALLET OF CHINA: CHINA INVESTMENT CORPORATION (CIC) AND STATE ADMINISTRATION OF FOREIGN EXCHANGE (SAFE)

#### Introduction

While most sovereign wealth funds grow from an excess of natural resource wealth, Chinese funds grew out of years of current account surpluses accumulated from ensuring a fixed exchange rate. The maintenance of an undervalued RMB in order to boost China's export powerhouse created an appetite which could only be satisfied with trillions of dollars of United States public debt and currency<sup>1</sup>. As a result, China is by far the largest holder of foreign exchange reserves with the next largest holder, Japan, managing just over a third of the Chinese total<sup>2</sup>. This has resulted in significant opportunity cost as some estimates have found a real hurdle rate of nearly 10% given currency and inflation losses<sup>3</sup>.

However, as reserve growth slows and the RMB appreciates, competition between the two Chinese SWFs for the available capital has ramped up. Finally, China's unique geopolitical position and governing system result in investment objectives tainted by political requirements, in spite of the claimed independence.

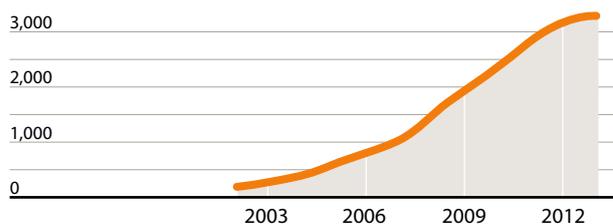
#### Background

The Chinese government's predominant concern through the 2000's was economic growth through export promotion driven by an undervalued currency. This was maintained via debt and currency purchases financed by an expansion of the domestic money supply, of which about 70% ended up as U.S. dollar assets. The undervalued renminbi drove an enormous accumulation of US dollar holdings since 2000 as shown in Chart 1 below.

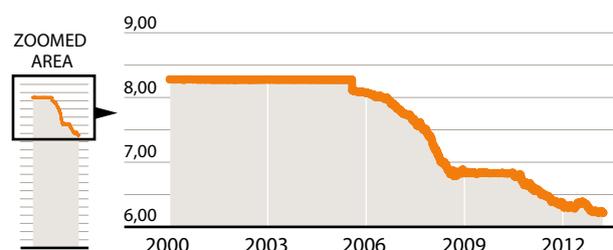
Chart1

Growth of Chinese Reserves and Dollar Depreciation

#### Chinese Reserves in Billions USD



#### RMB/Dollar



(\* ) Data from January of each year.

Source: Federal Reserve H10. Also see Table 1, p. 3. Wayne Morrison and Marc Labonte, "China's Holdings of U.S. Securities: Implications for the U.S. Economy", December 6, 2012, Congressional Research Service.

<sup>1</sup> 1.208 trillion USD in Treasury bills as of December 2012 (online at [www.treasury.gov/resource-center/data-chart-center/tic/Documents/mfh.txt](http://www.treasury.gov/resource-center/data-chart-center/tic/Documents/mfh.txt)). The rest is held in currency, agency debt, corporate debt, and equities. Congressional Research Service estimates a total of 3.3 trillion USD in total as of September 2012.

<sup>2</sup> 3.3 trillion for China compared to 1.2 trillion for Japan. The third largest, Saudi Arabia, holds a mere 621 billion. This data is as of September/October 2012. Wayne Morrison and Marc Labonte, "China's Holdings of U.S. Securities: Implications for the U.S. Economy", December 6, 2012, Congressional Research Service (online at [www.fas.org/sgp/crs/row/RL34314.pdf](http://www.fas.org/sgp/crs/row/RL34314.pdf)).

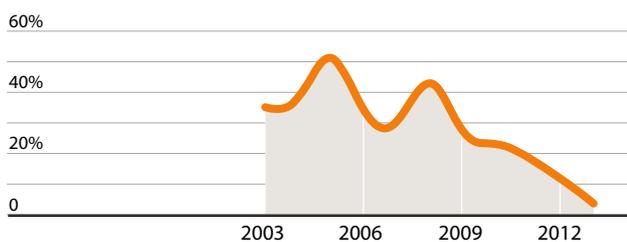
<sup>3</sup> US currency denominated holdings are estimated by various sources to make up about 70% of Chinese reserves. "See testimony of Brad Setser, Senior Economist, Roubini Global Economics and Research Associate, Global Economic Governance Programme, University College, Oxford, before the House Budget Committee, Foreign Holdings of U.S. Debt: Is our Economy Vulnerable?, June 26, 2007, p. 11. In addition, the People's Daily Online (August 28, 2006) estimated China's dollar holdings to total FX reserves at 70%. "Though publicly, the PBOC has declared its intention to diversify its holdings, there is little evidence of this in practice."

The export driven economy, undervalued currency, and low wage urbanizing labor brought large current account surpluses, but the maintenance of a fixed exchange rate regime resulted in significant opportunity costs. As the renminbi has appreciated against the US dollar, foreign exchange reserve accumulation has slowed dramatically. The slowly depreciating dollar combined with remarkably low U.S. interest rates resulted in China incurring significant real financial losses. However, China was forced to continue investment in U.S. debt and currency for fear of a rapidly appreciating RMB derailing their double digit growth<sup>4</sup>. This policy has been changing in recent history through a combination of political pressure and economic pressures as can be seen in Chart 2.

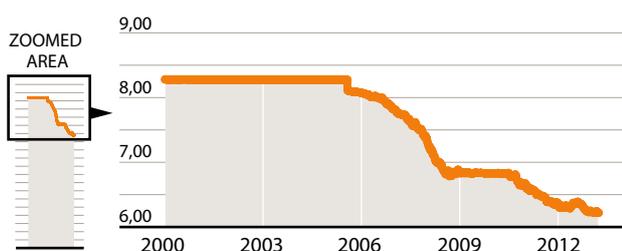
Chart 2

RMB/USD Exchange Rate and Chinese Foreign Exchange Reserve Growth

Growth Rate of Chinese Reserves



RMB/Dollar



(\* ) Data from January of each year.

Source: U.S. Federal Reserve, Congressional Research Service and Author's Calculation.

Policy-makers concerned about maintaining employment levels for masses of migrant laborers were less concerned with the opportunity cost losses incurred in real terms on foreign exchange holdings. However, as the total volume increased adding to the domestic money supply and inflationary pressures, the declining renminbi eased pressure on foreign exchange growth. Additionally,

<sup>4</sup> Another concern might have been maintenance of U.S. solvency through continued purchases. As the finance joke goes – ‘if you owe the bank \$1000 - that’s your problem. If you owe the bank \$1,000,000,000 – that’s the bank’s problem.’

the increased demand for U.S. debt drove down interest rates, increasing United States consumption of Chinese goods<sup>5</sup>. Before the establishment of the Chinese Investment Corporation (CIC), end-of-period inflation in the United States averaged 3%, while ten-year Treasury bills went as low as 2.68%. The Chinese tended towards holding long-term maturity Treasury debt and currency with relatively low yields compared to corporate debt, further exacerbating the differential between their implied cost of capital and returns<sup>6</sup>. In addition, between 2005 and 2008, the dollar depreciated 6% annually compared to the RMB. This meant that China was incurring large real losses –approaching 10% annually in 2009. In the year 2007, before the formation of the CIC, real losses would have been \$125 billion, or nearly \$100 for every man, woman, and child in China.

The China Investment Corporation

The China Investment Corporation (CIC) was a first step to combat the increased incurrence of real losses due to holding ever-increasing amounts of low yielding long term US public debt. Chinese economic and financial leaders decided that active investment in riskier assets was necessary to combat the ongoing losses<sup>7</sup>. However, in order to create an SWF that was clearly independent from existing entities like the People’s Bank of China or the State Administration of Foreign Exchange (SAFE), the Chinese followed a novel policy to create China’s first (independently established) sovereign wealth fund (SWF). Instead of directly injecting capital from foreign exchange reserves, the Chinese government put together a bond offering purchase of 1.6 trillion RMB which was used to purchase \$200 billion USD at the then-exchange rate from the People’s Bank of China. These bonds had ten to fifteen year maturities and paid an initial yield of 4.3-4.68%. This meant that in order to break even, the CIC had to earn at minimum approximately 4.5% in nominal annual returns. Adding in currency losses resulting from making returns in dollars but owing debt in renminbi, the real hurdle rate to break even quickly remained around 10% annually, increasing the risk required to earn such returns. Despite the impression that the CIC received endowed capital, the Chinese Ministry of Finance actually created a highly leveraged hedge fund with a low nominal hurdle rate and high real hurdle.

In the unfavorable world economic climate since the creation of the CIC in 2008, earning its cost of capital much less the real hurdle rate

<sup>5</sup> ‘The Fed Didn’t Cause the Housing Bubble’, Alan Greenspan, March 11, 2009 (online at [online.wsj.com/article/SB123672965066989281.html](http://online.wsj.com/article/SB123672965066989281.html)). Contrasted with John Taylor’s opinion that Federal Reserve policy is more responsible 2009, ‘The financial crisis and the policy responses: an empirical analysis of what went wrong’ (online at [www.nvieg.net/teaching/taylor1.pdf](http://www.nvieg.net/teaching/taylor1.pdf)).

<sup>6</sup> Data for 2012 from U.S. Treasury indicates that the Chinese held about 37% long-term Treasuries, 13% U.S. agency and corporate debt and stocks, 2% short-term debt (including short-term Treasuries). Given that U.S. currency is estimated to make up about 70% of Chinese reserves, we estimate an additional 20% in dollar FX reserves, and a final 30% mix of currency and debt and stock from other countries. A mix of 50% long-term US debt and 20% currency reserves would result in nearly \$80 billion being lost on the U.S. proportion of reserves alone in 2012, given relative interest, inflation, and FX rates.

<sup>7</sup> See Zhang 2007, from Balding Ch 7.

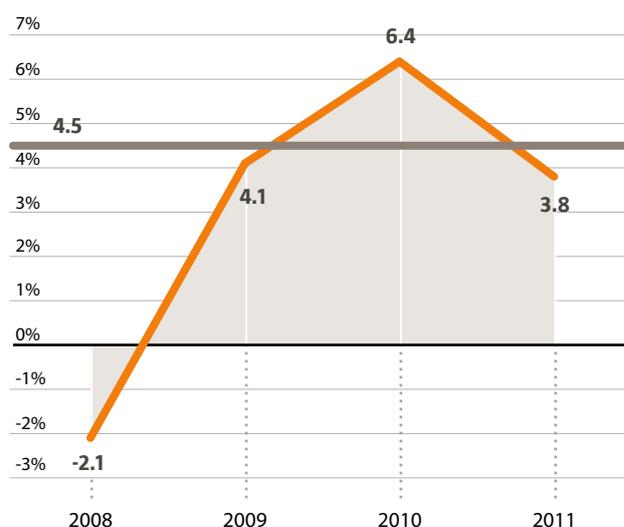
## 5. The great wallet of China: China Investment Corporation (CIC) and State Administration of Foreign Exchange (SAFE)

has proved difficult if not impossible. Though it has been noted that the CIC's managerial framework is becoming increasingly professionalized, this has not led to a distinct break with either the political direction of Beijing in portfolio construction or the improvement in returns necessary to cover the cost of capital<sup>8</sup>. This has led to a change in tone in the last few years, with the CIC evincing increased lack of patience at being considered the world's white-horse investor<sup>9</sup> and increased interest in portfolio diversification, increasing its direct investment and partnering instead of contracting with private-equity fund managers who have skills the CIC lacks<sup>10</sup>. This newfound directness, however, may lead to increased regulatory hurdles as the CIC attempts to expand into countries already suspicious of Chinese investment goals. CIC International has gone through four broad investment phases to date, starting in 2007 and 2008 with significant investments in the U.S. financial sector such as Morgan Stanley and Blackstone. However, the losses on these investments incurred during the financial crisis in North America and Europe resulted in negative publicity that caused political concern and a re-evaluation of sovereign wealth fund strategy in China. Having gotten severely burned by the U.S. financial crisis, the second phase, through most of 2008 and part of 2009, focused on low risk holdings primarily of cash and other highly liquid holdings. This coincided with a restructuring and recruitment drive. The CIC emerged from this in 2009 and 2010 with a series of investments that was 70% focused on the natural resources and energy sectors<sup>11</sup>. This was followed by another quiet period – this time while the CIC maneuvered politically to be given more investment funds, having run through their allotment. Achieving this goal in March 2012, the most recent round of investments has focused on direct investment partnered with private equity firms, as well as foreign infrastructure. Another new development was the creation of country-specific investment funds, such as the 2011 Russia-China Investment fund and the 2011 China Belgium Mirror Fund. The problem with CIC returns is their inability to earn their cost of capital as shown in Chart 3.

Chart 3

CIC Returns vs. Explicit Cost of Capital

- CIC Global Portfolio: Aggregated returns since inception
- Break even line: Cost of capital



Source: China Investment Corporation Annual Reports and Authors' Calculation.

Given their estimated 4.5% cost of capital, their accumulated returns since inception have failed to meet their explicit cost of capital owed to the PBOC. Even though there this debt is essentially owed to itself, this might be the biggest risk of CIC fails to generate enough free cash flow to service its debt.

The CIC notes in its 2011 annual report that the cumulative annual return since inception of its global return portfolio is a paltry 3.8% - not even enough to cover their explicit cost of capital via the funds they borrowed from the People's Bank of China (PBOC). Consequently, to boost their total returns, the CIC has been incorporating the profits of the major state banks of China onto their returns. It can do this because of the original \$200 billion USD in capital, about 35% was converted back into RMB and used for domestic investment under the umbrella of Central Huijin Investment Corporation (Central Huijin). CIC purchased Central Huijin for a minimum \$125 billion USD less than the market value of the assets at the time. The undervalued nature of the asset purchase has allowed the CIC to report higher returns and balance sheet growth by incorporating those assets over time rather than reporting them at market value at the time of purchase. This artificial growth from incorporating the true market value of assets rather than the undervalued artificial

<sup>8</sup> Eiichi Sekine, 2011 "The Governance of China Investment Corporation on Its Way to Becoming a Sophisticated Institutional Investor." *Nomura Journal of Capital Markets*, 2(3).

<sup>9</sup> "China fund slams 'indolence' in Europe", AFP November 6, 2011. (online at [www.google.com/hostednews/afp/article/ALeqM5jTLXDWun3ydeCVS0k5q4EoNXewA?docid=CNG.463620b2366c6b89f6ebc0bc9538e28d.3c1](http://www.google.com/hostednews/afp/article/ALeqM5jTLXDWun3ydeCVS0k5q4EoNXewA?docid=CNG.463620b2366c6b89f6ebc0bc9538e28d.3c1)). Also, "Chinese official brushes aside calls to buy European debt", Reuters February 13, 2012 (online at [http://www.nytimes.com/2012/02/14/business/global/china-investors-brush-aside-calls-to-buy-european-debt.html?\\_r=0](http://www.nytimes.com/2012/02/14/business/global/china-investors-brush-aside-calls-to-buy-european-debt.html?_r=0)).

<sup>10</sup> "China's CIC makes investment shift" - Wall Street Journal, September 19, 2012 (online at <http://online.wsj.com/article/SB10000872396390443720204578003781099968180.html>).

<sup>11</sup> Friedrich Wu, Christine Goh, Ruchi Hajela, 2011, "China Investment Corporation's Post-Crisis Investment Strategy," *World Economics*, 12(3). (online at [http://www.relooney.info/O\\_New\\_11323.pdf](http://www.relooney.info/O_New_11323.pdf))

price paid by CIC has driven their reported portfolio holdings to nearly \$500 billion USD at the end of 2011 from \$200 billion USD in 2007. CIC is incorporating the profits rather than the market price as the share prices of state owned banks have not performed well in recent history<sup>12</sup>. Though this is an acceptable accounting methodology, as CIC owes significant debts to the PBOC, it grossly overstates their ability to service the real debt with realized cash flows. In other words, the CIC is playing accounting tricks to boost its stated returns and still has difficulty meeting the cost of capital obligations explicit in its debt to the PBOC and even more so in its implied real hurdle rate.

### Breakout Analysis: Even the China Investment Corporation is Fudging Financial Data?

A major problem when studying the Chinese economy or financial statements of firms is the accuracy of the underlying data. In a notable case for 2012, only two Chinese provinces report GDP growth below the national average. The veracity of data about the China Investment Corporation is no different. Despite beginning operation in 2008 with \$200 billion USD of borrowed capital and two-thirds of its portfolio earning an average of 3.8% less than the CIC cost of capital, their assets under management have somehow swelled to nearly \$500 billion USD in the 2011 Annual Report. CIC financial statements appear deceptive and inaccurate. There are three obvious examples where CIC financial statement display serious irregularities. First, while CIC was founded in September 2007 with \$200 billion in borrowed capital and states in its year end 2008 annual report it earned a total of 6.8% on registered capital in 2008, its balance sheet somehow ended the year with \$298 billion USD of assets. That represents a nearly 50% growth during the 2008 financial crisis when it claimed to earn only 6.8%. As its assets this year are expected to approach \$600 billion, that represents a tripling of assets under management in 6 years while it claims that its global portfolio has averaged under 4% and less than their cost of debt capital. Second, despite wide spread publicity of the fact that CIC borrowed its capital from the People's Bank of China, this has never appeared on its balance sheet as a liability or as an expense item on their income statement. Third, according to the CIC 2011 Annual Report, in 2009 and 2010, CIC earned the exact same rate of return of 11.7%. While we do not have access to the necessary CIC portfolio data required to pass judgment on the accuracy of 11.7% returns of their portfolio in two consecutive years, it is statistically highly unlikely.

While the CIC expressly states that its global investments are non-political in nature, it also expressly states that its domestic investments held in Central Huijin, which comprises a significant portion of its overall portfolio, are political. Central Huijin holds a controlling interest in the four major state owned Chinese banks, which account for approximately 65% of the Chinese banking market (See Table 1). Additionally, it holds key stakes in major Chinese investment firms and development banks which are acknowledged to be politically motivated entities by their managers and Beijing. In other words, a significant portion of the CIC portfolio is explicitly political in nature<sup>13</sup>.

The impact of this explicit politicization can be seen in a number of ways. Central Huijin's mid-crisis recapitalizations of Chinese banks appear less like financial decisions motivated solely by a desire for returns and more like a government rescue reminiscent of the U.S. TARP program. Although their charter states they do not interfere in day-to-day operations, they are swift to intervene when there is need to stabilize share prices.<sup>14</sup> For instance, in 2010 Central Huijin sold bonds it then used to purchase additional shares of the major state owned banks.<sup>15</sup> This debt-financed asset purchase had a two-pronged effect. First, it reduced the dilution of Central Huijin holdings of the major state banks in secondary offerings to private investors. Second, it provided a quiet publicly-backed capital injection, some might say bailout, after a year when bank lending in China had *tripled*. While the merits of publicly backed bailouts of private financial firms are widely debated worldwide, they are indubitably problematic when disguised as part of an explicit state strategy of global investment. In another instance, the U.S. Federal Reserve blocked CIC attempts to subsidize loans to portfolio companies or related firms in the U.S. branches of Chinese state-owned banks. In other words, even if the claims of the CIC about its managerial non-interference with regards to Central Huijin are true, given the legal subsidiary status relationship between them, even the Federal Reserve maintains doubts about the actual separation of authority<sup>16</sup>.

<sup>13</sup> Central Huijin's holdings/contributions are listed in billion shares for joint stock companies and in billion yuan RMB for companies with limited liability (including wholly state-owned companies) unless otherwise indicated. The list of holdings as of December 31, 2011, is available on the Central Huijin website. (online at [www.huijin-inv.cn/hjen/investments/popup.htm](http://www.huijin-inv.cn/hjen/investments/popup.htm)). After another round of investment, as of October 2012, Central Huijin owned 35.43% of the Industrial and Commercial Bank of China, 40.16% of the Agricultural Bank of China, 67.65% of the Bank of China, and 57.15% of China Construction Bank, as well as significant shares in many other Chinese financial institutions. "Chinese banks reveal Central Huijin investment", Xinhua, October 13, 2012 (online at [www.chinadaily.com.cn/bizchina/2012-10/13/content\\_15815185.htm](http://www.chinadaily.com.cn/bizchina/2012-10/13/content_15815185.htm)).

<sup>14</sup> The same moral hazard arguments made about TARP, about the risks of offering a government-backed get-out-of-jail-free card to major banks, can arguably be applied to the effect Central Huijin interference might have on day-to-day operations at Chinese financial institutions. "China pumps cash into major banks as the shadow banking sector grows", Forbes, October 10, 2011. (online at [www.forbes.com/sites/afontevicchia/2011/10/10/china-pumps-cash-into-major-banks-as-the-shadow-banking-sector-grows/](http://www.forbes.com/sites/afontevicchia/2011/10/10/china-pumps-cash-into-major-banks-as-the-shadow-banking-sector-grows/))

<sup>15</sup> See Michael F. Martin 2010. China's Sovereign Wealth Fund: Developments and Policy Implications. Congressional Research Service. September 23, 2010.

<sup>16</sup> "CIC holds the shares of Central Huijin in accordance with relevant directive issued by the State Council. However, the investment business of CIC and the share management function conducted on behalf of the State Council by Central Huijin are completely separated." (online at [http://www.huijin-inv.cn/hjen/aboutus/aboutus\\_2008.html?var1=About](http://www.huijin-inv.cn/hjen/aboutus/aboutus_2008.html?var1=About))

<sup>12</sup> The official explanation is that "Return on Capital is based on the accounting income of CIC's global portfolio, and the cash income and cash dividend declared from its domestic investments...Since CIC's domestic investments are for long-term purposes and their disposals are under restriction, CIC believes cash returns to be more appropriate performance metrics for its domestic investments." China Investment Corporation, Annual Report 2008.

## 5. The great wallet of China: China Investment Corporation (CIC) and State Administration of Foreign Exchange (SAFE)

Table 1

Reported Central Huijin Holdings as of December 31, 2011

Company Name	Type of Entity	Core Business	Percentage (%)
China Development Bank Corporation	Joint Stock Company	Banking	47.63
Industrial and Commercial Bank of China, Limited	Joint Stock Company	Banking	35.43
Agricultural Bank of China, Limited	Joint Stock Company	Banking	40.12
Bank of China Limited	Joint Stock Company	Banking	67.60
China Construction Bank Corporation	Joint Stock Company	Banking	57.13
China Everbright Bank Co., Limited	Joint Stock Company	Banking	48.37
China Reinsurance (Group) Corporation	Joint Stock Company	Insurance	84.91
New China Life Insurance Co., Ltd.	Joint Stock Company	Insurance	31.26
China Jianyin Investment Limited	Wholly State-Owned Company	Investments	100.00
China Galaxy Financial Holdings Co. Ltd.	Limited Liability Company	Investments	78.57
Shenyin and Wanguo Securities Co. Ltd.	Joint Stock Company	Securities	37.23
Guotai Junan Securities Co, Ltd.	Joint Stock Company	Securities	21.28
China Securities Co, Ltd	Joint Stock Company	Securities	40.00
China Investment Securities Co. Ltd.	Wholly State-Owned Company	Securities	100.00
UBS Securities Co. Ltd.	Limited Liability Company	Securities	14.01
China Everbright Industry Group Limited	Wholly State-Owned Company	Investments	100.00
Jiantou Zhongxin Assets Management Co. Ltd.	Limited Liability Company	Assets Management	70.00

What continues to concern critics and policy makers is the political nature of the CIC. While the CIC claims that it selects investments “based on the pure economics of each deal” and in order to “realize the diversification of the state’s foreign exchange assets...operating entirely in accordance with commercial principles” the investments tell a different story. They portray a sovereign wealth fund highly concentrated in key industries highlighted by Communist Party leadership at the expense of nearly all other options. Given Beijing’s stated economic development concerns, access to financial capital, technology, energy, and natural resources are all high priorities. It is not a coincidence that financials, energy, and natural resources comprise the dominant portion of the CIC International portfolio. Even CIC’s Executive Vice President Wang Jianxi admitted in 2010 that “China factors” had been considered when investments were chosen<sup>17</sup>. However, although these investment patterns appear to fit Beijing mandates for economic development goals, there appears to be sound investment logic against this portfolio construction. Financials, technology, energy, and natural resources are all highly volatile industrial sectors that significantly increase total portfolio risk. While there have been some moves to diversify into lower risk areas like British infrastructure, these too have a political flavor, as

<sup>17</sup> “For example, CIC has invested a lot in Australia, whose economy is closely linked to the Chinese demand for its rich resources, he said.” “CIC takes a cautious approach to 2010 investments.” Wall Street Journal, 5 March 2010. (online at <http://online.wsj.com/article/SB30001424052748703502804575101273905336364.html>)

they are accompanied by “begging bowl” trips from the British Chancellor and lead to the opening of the British market to broader Chinese investment<sup>18</sup>. Despite the assurances of the CIC and the Chinese government, both the explicitly political nature of Central Huijin and the apparent political nature of a concentrated portfolio of holdings, in areas Beijing has deemed vital to Chinese development, should raise concerns over the purpose of the CIC.

### The State Administration of Foreign Exchange

Even before it began to invest, CIC gained a significant domestic competitor via the State Administration of Foreign Exchange Reserve (SAFE), which quietly opened up its own investment management portfolio. Driven primarily by domestic infighting between different power centers, CIC and SAFE should be seen more as competitors than complements. Though the exact size of their holdings is difficult to know in detail recent research from Preqin or

<sup>18</sup> “Chinese Sovereign Wealth Fund Buys Thames Water Stake”, The Guardian, January 20, 2012. (online at [www.guardian.co.uk/business/2012/jan/20/china-sovereign-wealth-fund-thames-water](http://www.guardian.co.uk/business/2012/jan/20/china-sovereign-wealth-fund-thames-water)). Additionally “Yesterday, Britain and China took their first steps to increase collaboration in infrastructure investment. The UK-China Investment Conference is a follow-up to the Economic and Financial Dialogue held between Chancellor George Osborne and Vice Premier Wang Qishang last month, which resulted in the creation of an Infrastructure task force. The agreement provides the potential to deepen commercial ties between the two nations, going beyond goods and services to pave the way for investment cooperation. Energy, transport and urban development were outlined as major areas for collaboration during the talks (online at [www.britishchamber.cn/content/uk-china-investment-conference](http://www.britishchamber.cn/content/uk-china-investment-conference)).

the Sovereign Wealth Fund Institute show how SAFE holdings have grown larger than the CIC portfolio<sup>19</sup>. Judging from their known holdings, there exist significant overlap between the SAFE and CIC portfolios, which remain heavily focused on financials, natural resources and commodities, and technology.

The State Administration of Foreign Exchange (SAFE) was originally created to manage foreign exchange reserves. Prior to its establishment in March 1979, the Chinese government held a mere \$167 million of FX reserves<sup>20</sup>, compared to the \$3.44 trillion reported as of March 2013<sup>21</sup>. Over the course of this expansion and the corresponding evolution of China's exchange rate policy, the role of SAFE became increasingly complex. SAFE was initially inside the Bank of China system and was only transferred to a leadership position within the People's Bank of China in 1982. In 1986, SAFE was given the duty of monitoring the foreign exchange swap market. By 1988, SAFE was issuing a "priority list" for the use of foreign exchange to guide which firms would get access to the swap market. In March 1996, the SAFE began to loosen its chokehold on foreign-funded enterprises' foreign exchange transactions. In March 1997, SAFE was given the duty of verifying import payments in addition to improving the export payments verification process initiated in 1991 to limit capital flight. More recently, SAFE has been granted control over approval of Chinese outward direct investment. SAFE also closely monitors any repatriation of Chinese overseas investment profits along with approval rights over repatriation of any FDI funds<sup>22</sup>.

Today, SAFE operates eight branches, which regulate the Chinese balance of payments, current account, capital account, and foreign exchange reserves. The Reserve Management arm is tasked with "operating and managing the state foreign exchange reserves according to relevant national strategy and principles" and the Central Foreign Exchange Business Center has a "mandate mainly identical to the Reserve Management Department"<sup>23</sup>. On January 14, 2013, an interview shed more light on the new "Co-Financing Department". This department is charged to make "innovative" use of foreign reserves in order to support Chinese companies expanding abroad<sup>24</sup>. First listed in the 2011 annual report published in June 2012, the Co-Financing Office had not previously and still does not appear in the English language translation of the website.

For almost any commercial-scale foreign exchange transaction, application to and approval from the SAFE is required. In China's export-based economy, this means the SAFE and their officials wield enormous economic power. As a 2012 US State Department report on China's investment climate notes, "sectors requiring extensive government approval are the most affected [by corruption], including banking, finance, and construction"<sup>25</sup>. However, much of this regulatory power may disappear if China liberalizes its capital accounts<sup>26</sup>. A report issued in February 2012 stated that goals for 2015 included relaxation of controls on foreign investment related to trade and promotion of Chinese overseas direct investment. Any such reform would require streamlining or eliminating many SAFE approval procedures reducing their potential regulatory capture. This process had already begun with draft regulations published in May 2009 permitting domestic firms to register their source of foreign exchange financing after the fact rather than requiring SAFE advance approval<sup>27</sup>. As of 2012, regulations had evolved to the point that foreign-invested enterprises no longer need pre-approval to open foreign exchange accounts and are now allowed to freely convert or retain their local income. Additionally, a case-by-case review by the SAFE is no longer required for foreign exchange transactions that affect China's capital account, as this duty is now managed by designated foreign exchange banks<sup>28</sup>.

SAFE, unlike the CIC, has not attempted to claim that their international investments follow a purely financial logic. In 2012, a partnership with the China Development Bank and the Export-Import Bank of China aimed to provide low-interest foreign exchange loans exclusively to commercial enterprises undertaking overseas projects considered nationally strategic<sup>29</sup>. However, recently, their administrator Yi Gang has hinted that the SAFE's attempts to boost the nation's resources and security through investment reached the point that low-quality domestic companies were able to get inexpensive SAFE funding by pushing nationalist buttons<sup>30</sup>. This has only have been exacerbated by the poor incentives to conduct due diligence offered to the banks conducting loan application reviews<sup>31</sup>. He said SAFE needs to work harder to avoid failed overseas investments.

<sup>19</sup> While many estimates exist of the total SAFE assets under management, we could find not find a disaggregated list of holdings or methodology of how the headline estimates were arrived at. Even searching corporate filings, investment holdings databases, and news reports yielded little evidence of their total assets.

<sup>20</sup> This is end-of-year 1978 data. At this time, China's FX reserves also tended to fluctuate wildly – from positive \$952 million in 1977 to negative 1.3 billion in 1980, for example. Reserves broke \$1 trillion in 1996 and have not decreased year-on-year since 1992.

<sup>21</sup> Source SAFE website: English language, Data and Statistics, Forex Reserves, The Time-Series Data of China's Foreign Exchange Reserves. (online at <http://www.safe.gov.cn/>).

<sup>22</sup> "Liberalization and the Evolution of China's Exchange System: an Empirical Approach", May 2006 – World Bank Beijing. (online at [http://siteresources.worldbank.org/INDIAEXTN/Resources/events/359987-1149066764594/Paper\\_MinZhao.pdf](http://siteresources.worldbank.org/INDIAEXTN/Resources/events/359987-1149066764594/Paper_MinZhao.pdf))

<sup>23</sup> For more details of the responsibilities of the respective arms, see here: Gov.Cn – SAFE Organization Structure (online at English [http://www.gov.cn/english/2005-09/26/content\\_70186.htm](http://www.gov.cn/english/2005-09/26/content_70186.htm)).

<sup>24</sup> "China to use forex reserves to finance overseas investment deals" January 14, 2013 – Bloomberg (online at [www.bloomberg.com/news/2013-01-14/china-to-use-forex-reserves-to-finance-overseas-investment-deals.html](http://www.bloomberg.com/news/2013-01-14/china-to-use-forex-reserves-to-finance-overseas-investment-deals.html)).

<sup>25</sup> U.S. Department of State, "2012 Investment Climate Statement (online at <http://www.state.gov/e/eb/rls/othr/ics/2012/191128.htm>)

<sup>26</sup> Nicholas Borst, "Capital Account Liberalization and the Corporate Bond Market", Peterson Institute for International Economics (online at <http://www.piie.com/blogs/china/?p=1093>).

<sup>27</sup> Nicholas Lardy and Patrick Douglass, "Capital Account Liberalization and the role of the RMB", February 2011, Peterson Institute for International Economics Working Paper (online at <http://www.iie.com/publications/wp/wp11-6.pdf>)

<sup>28</sup> Department of State 2012 Report on Investment Climate of China (<http://www.state.gov/e/eb/rls/othr/ics/2012/191128.htm>)

<sup>29</sup> "Banks, SAFE cooperate to keep forex flowing" April 19, 2012 – CaixinOnline (online at english.caixin.com/2012-04-19/100381773.html)

<sup>30</sup> Yi Gang, January 2013 article in Century Weekly published by Caixin Media. Translation from Bloomberg "China to use forex reserves to finance overseas investment deals" January 14, 2013. (online at [www.bloomberg.com/news/2013-01-14/china-to-use-forex-reserves-to-finance-overseas-investment-deals.html](http://www.bloomberg.com/news/2013-01-14/china-to-use-forex-reserves-to-finance-overseas-investment-deals.html))

<sup>31</sup> "Banks, SAFE cooperate to keep forex flowing" April 19, 2012 – CaixinOnline (online at english.caixin.com/2012-04-19/100381773.html)

## 5. The great wallet of China: China Investment Corporation (CIC) and State Administration of Foreign Exchange (SAFE)

SAFE is even more opaque than the CIC with regards to publishing its overseas holdings, so it is hard to determine whether specific failed investments sparked this concern. For example, Heritage Foundation's China Global Investment Tracker only identifies about \$10.4 billion worth of the SAFE's overseas investments, compared to \$39.4 billion for CIC<sup>32</sup>. The Economist estimates that as of March 2011, SAFE held \$22.1 billion in FTSE stocks, following a strategy of investing small and discreet amounts<sup>33</sup>. ESADEgeo estimates that its Hong-Kong based subsidiary, SAFE Investment holds, at least, \$21bn in FTSE 100 securities as of December 2012. It was heavily concentrated, unsurprisingly, in energy, basic materials, and financials such as Royal Dutch Shell (\$3.5bn), BP (\$2.2bn) or Vodafone (\$1.5bn). However, it held no disclosed stakes in any of the 30 members of the Dow Jones Industrial Average. SAFE's investments mirror the CIC's in other ways. For instance, Gingko Tree Investment, a wholly-owned subsidiary of SAFE, has invested more than \$1.6 billion in at least four U.K. infrastructure deals, as of February 2013<sup>34</sup>. Guan Tao, who heads the International Balance of Payments Department, told reporters that the SAFE had earned \$128 billion on its foreign exchange investments in 2011<sup>35</sup>. This was the first statement by an official on SAFE earnings on reserves, and implies a rate of return on investment of about 4%<sup>36</sup>.

Perhaps the long-term worry, domestically and internationally, concerns why SAFE is competing with CIC rather than collaborating. The most likely theory is that it wishes to secure a long-term powerful niche within China's bureaucracy<sup>37</sup>. Realizing the period of closed capital markets and accounts is drawing to a close and will most likely end within ten years, SAFE is pursuing other rent seeking activities. Another reason may lie in the history of the two agencies and the rivalry of their superiors—the Ministry of Finance for the CIC and the People's Bank of China for the SAFE. The CIC was created after economists largely from the Ministry of Finance, the National Development and Reform Commission, and the State Council's Development Research center began to critique the SAFE's handling of the foreign currency reserves—specifically, the extremely low return they were earning on them. The central bank took this as an affront to its experience and abilities. The CIC was initially staffed largely by people connected with the Ministry of Finance, and the People's Bank of China was forced to sell Central Huijin to them at a significant discount to market prices. Now that Lou Jiwei, for many years head of the CIC, has been promoted to Minister of Finance

under the new administration, it is possible the CIC will, among other things, get the clearly delineated funding mechanism its proponents have been lobbying for.

### The Politics of Investment in the CIC and SAFE

A primary concern of policy makers and scholars has been the potential combination of financial investment capital and state directed influence. CIC and SAFE remain subject to political control by the Chinese Ministry of Finance and the Communist Party which exercises strict control over financial and investment policy. Furthermore, given the bureaucratic rivalry that has developed between CIC and SAFE, their respective interest in investing to please government power brokers only furthers the concern that they do not invest for solely market purposes<sup>38</sup>. As others have noted, the CIC and SAFE will remain subject to this political framework that seeks a variety of objectives and potentially conflicting goals<sup>39</sup>. However, as the post-crisis global financial world has changed, China has shown less reticence in using its great wallet for political purposes outside its borders. There is little public evidence to date that CIC or SAFE have actively worked to direct corporate strategy or shift economic patterns, but given their known investment patterns this may be an increasing concern.

While the CIC and SAFE have both repeated that their investment strategies adhere to market principles and are not subject to political or policy influence, a review of their investment holdings fails to support their claims. Reviewing a dataset of outward Chinese investment since 2005, if we consider only direct investment by CIC and SAFE, there is a very clear pattern that emerges. CIC and SAFE investment has focused heavily on finance, commodities, technology, and energy.

Since inception, more than 80% of known CIC investment has been in these areas with the remainder primarily in real estate. SAFE investment reveals a similar industrial focus. Since 2008, 94% of known SAFE investment has been in finance or energy assets. If we consider indirect investments made by companies in whom CIC or SAFE holds controlling stakes such as the China Development Bank and ICBC, the percentage focused on areas deemed strategic assets by the Chinese government only increases due to the outward foreign direct investment push among Chinese resource firms. The CIC and SAFE holdings are not well diversified portfolios designed to maximize risk adjusted returns. Their portfolios are excessively concentrated in highly volatile sectors like commodities and financials.

<sup>32</sup> Heritage Foundation, "China Global Investment Tracker" (online at [www.heritage.org/research/projects/china-global-investment-tracker-interactive-map](http://www.heritage.org/research/projects/china-global-investment-tracker-interactive-map)).

<sup>33</sup> "China's investments in the FTSE: is it SAFE?" March 14, 2011 – the Economist. (online at [www.economist.com/blogs/newsbook/2011/03/china%E2%80%99s\\_investments\\_ftse\\_100](http://www.economist.com/blogs/newsbook/2011/03/china%E2%80%99s_investments_ftse_100))

<sup>34</sup> "China invests forex reserves in UK property", February 27, 2013 – People's Daily. (online at [english.people.com.cn/90778/8146562.html](http://english.people.com.cn/90778/8146562.html)).

<sup>35</sup> "China's foreign investment return on the rise". April 29, 2012 – Xinhua. (online at [news.xinhuanet.com/english/china/2012-04/29/c\\_131560039.htm](http://news.xinhuanet.com/english/china/2012-04/29/c_131560039.htm)).

<sup>36</sup> "China taps forex stash for globalization cash", January 20, 2013. Market Watch, WSJ. (online at [articles.marketwatch.com/2013-01-20/markets/36446289\\_1\\_forex-reserve-management-operations-loan-officers/2](http://articles.marketwatch.com/2013-01-20/markets/36446289_1_forex-reserve-management-operations-loan-officers/2))

<sup>37</sup> Logan Wright, "CIC and SAFE: Coordination or Bureaucratic Conflict?", June 24, 2008 – China Stakes. (online at [www.chinastakes.com/2008/6/cic-and-safe-coordination-or-bureaucratic-conflict.html](http://www.chinastakes.com/2008/6/cic-and-safe-coordination-or-bureaucratic-conflict.html))

<sup>38</sup> Wu, Friedrich, Christine Goh, and Ruchi Hajela, 2011, "China Investment Corporation's Post Crisis Investment Strategy." *World Economics*. 12(3): 123-152.

<sup>39</sup> Thomas, Stephen and Ji Chen, 2011, "China's Sovereign Wealth Funds: Origins, Development, and Future Roles." *Journal of Contemporary China*. 20(70): 467-478.

Despite becoming large international investors, CIC and SAFE remain opaque investors with complicated organizational structures where different branches with different purposes are responsible to overlapping authorities. As others have noted, these excessively complicated organizational and management structures are designed to obfuscate responsibility and holdings as viewed both by insiders and outsiders<sup>40</sup>. The ability of these Chinese SWFs to successfully manage domestic and international political concerns and play a constructive role in macroeconomic financial policy will ultimately determine their success.

## Conclusion

The CIC and SAFE are major players in the sovereign wealth universe. However, their investment politicization may cause them trouble as they attempt to expand geographically or increase their influence. The significant portfolio concentration by CIC and SAFE in industries specifically described as targeted sectors by Communist Party leadership will cause foreign critics and governments to question the appropriateness of granting market access to China. Furthermore, the portfolio devised by CIC and SAFE, using best available information, is risky with excessive volatility due to extreme concentration in finance and commodities. Given the explicit leverage used to create CIC, this becomes problematic as it must generate enough cash flow to service the debt to the PBOC. Macroeconomics is also creating headwinds for CIC and SAFE. While currency and capital account liberalization may benefit the Chinese economy and financial services industry, continued currency appreciation makes it that much more difficult to pay back renminbi-denominated debt or meet the implied real hurdle rate required to break even. Finally, the domestic competition between CIC and SAFE may play out in interesting ways as China continues to liberalize its capital flows and affiliates of both institutions are promoted to higher positions under the new administration. In the complex world of Chinese politics and financial engineering, the CIC underneath the Chinese Ministry of Finance owes money to the PBOC which has created its own asset management branch in SAFE. While all technically part of the same government, these SWFs represent internal factions competing with each other for influence. The elevation of Lou Jiwei from head of the CIC to Finance Minister of China should demonstrate between the CIC and the center of power in Beijing. The rise of Ding Xuedong, little known in financial circles except as a career bureaucrat in the Finance Ministry, to lead the CIC should be seen as a continuation of CIC investment policies and strategies with a close relationship with the Party and political influence.

Significant and complex risks surround CIC and SAFE. The financial risk from poor portfolio construction, the use of leverage, the political risk facing outward Chinese foreign investment, and the factional competition between CIC and SAFE create serious concerns on many levels. As the new Chinese Premier Xi Jinping lays out his vision for a “renaissance of the Chinese nation”, one has to wonder whether the CIC and SAFE will take part in this vision or whether their risky activities will cause problems for the harmonious society.

---

<sup>40</sup> Eaton, Sarah and Zhang Ming, 2010, “A Principal-Agent Analysis of China’s Sovereign Wealth System: Byzantine by Design.” *Review of International Political Economy*. 17(3): 481-506



**Christopher Balding**

Associate Professor, HSBC Business School at Peking University Shenzhen Graduate School

**Komal Shakeel**

Research Assistant, HSBC Business School at Peking University Shenzhen Graduate School

# The Gulf funds after the financial crisis



## 6. The Gulf funds after the financial crisis

### 6. THE GULF FUNDS AFTER THE FINANCIAL CRISIS

Middle Eastern sovereign wealth funds, primarily located in the Gulf, have struggled to effectively manage their oil wealth and redefine their corporate and investment strategies in a post-financial crisis world. Anchored by some of the largest, oldest, and most financially conservative funds, the Saudi Arabian Monetary Agency (SAMA), the Kuwait Investment Authority (KIA), and the Abu Dhabi Investment Authority (ADIA), the Gulf funds<sup>1</sup> have attempted to revamp their management, risk level, and corporate strategy to accommodate increased public demands for transparency. New funds and challenges, however, have also risen. The Qatar Investment Authority, founded only in 2005, has quickly become a major international investor, and Dubai has endured the first debt default of a sovereign wealth fund country. While the varieties of funds derive their wealth mostly from oil and gas, they have built their economies and charted a course for their sovereign wealth funds in very different ways. These governments seek to diversify their income sources through broad economic development and investment projects designed to preserve their wealth.

Gulf countries due to their exports being priced primarily in US dollars have become *de facto* dollarized economies. Their exchange rates are fixed relative to the US dollar and, given the implied link between the US market and global oil prices, the Gulf funds are tied closely to US markets both financially and economically. Research has found that balancing the national wealth portfolio of oil dependent countries, sovereign wealth funds would best be served by a conservative portfolio of cash or cash like instruments and high levels of excellent credit quality fixed income instruments with relatively small amounts of equities<sup>2</sup>. The intuition is that a national wealth portfolio overweighed to non-monetized commodity resources will best be served by increasing its financial asset allocation in low volatility assets *not* correlated with oil like high credit quality fixed income. While Gulf funds have attempted to diversify their economies away from oil, most notably in the Emirates focusing on entertainment and finance, they have largely been unsuccessful in shifting their export dependency and overall macro-economic fundamentals away from commodity dependency. Gulf funds financial assets, excluding SAMA, are heavily invested in equity markets increasing their national wealth risk given the strong correlation between oil and equities. Furthermore, despite their domestic economic and financial reliance on commodity prices, Gulf SWF's have made significant investments in natural resource holdings further concentrating their exposure to volatile commodity prices. Capital inflows into Gulf States and their SWFs are driven by oil exports, and their growth for the foreseeable future will remain dependent on the price of oil.

The stated purpose of these funds is to protect the national wealth. This leads to an implicit investment conservatism that is generally reflected in their portfolio holdings. With some exceptions, investment capital is held in a conservative portfolio of high credit quality fixed income and blue chip equity firms. SAMA, relative to ADIA, KIA and QIA, is conservative in its investments and not well diversified while the others hold more classically constructed portfolios. Given many Gulf States' drive to become the financial centers of the region, there appears to be a significant overlap of investment areas and, in order for each to thrive simultaneously without devouring the others, specialization is in order. The development of the Gulf economies beyond oil and the role natural resource wealth via SWFs will play remains an open question.<sup>3</sup>

Perhaps the biggest risk to SWFs and the Gulf States' growth is political. The inherent investment, corporate, and financial conservatism is being challenged by events and domestic populations demanding political change and government accountability. Some Gulf States have already made significant payments out of national wealth holdings to citizens, designed to ensure stability during periods of political turmoil. Saudi Arabia and Qatar have taken steps during periods of unrest that drew upon national wealth resources to minimize political risk<sup>4</sup>. However, the activist push for additional oversight and accountability in Kuwait, Qatar, and other Gulf countries could have an impact in challenging the risk management and national financial strategies within these funds<sup>5</sup>. The primary risk to national economic and financial sustainability and SWFs' capital accumulation is excessive and poorly managed public spending out of oil bounty. The current political situation in the aftermath of the 'Arab Spring' makes such factors important in risk management and investment strategies.

#### The Saudi Arabian Monetary Authority

Despite their regular inclusion as a sovereign wealth fund, SAMA appears to manage a very conservative portfolio that strays little from standard central bank operations and investment holdings. Currently ranked second in the ESADeGeo SWF Ranking, it manages assets worth \$676bn. SAMA largely adheres to its role as the central bank and is conservative in its investment role as an SWF. Embracing the outlines set in the Basel 1, Basel 2 and Basel 3, SAMA is embracing its role as primary financial regulator for Saudi Arabia adopting Enterprise Risk management on par with developed economies<sup>6</sup>. Though this hints at changes to SAMA risk management procedures,

<sup>1</sup> We identified 19 Middle Eastern SWFs in our ESADeGeo Ranking. We focus here on the four largest funds. We wrote about other well-known Middle-East SWFs such as IPIC (now 100% owner of Cepsa) or Mubadala in our previous report.

<sup>2</sup> See Christopher Balding and Yao Yao, 2011, "Sovereign Wealth Funds in the Shadow of Commodity Based National Wealth", *International Finance Review*. 12: 293-312.

<sup>3</sup> See Asim Ali and Shatha Al-Aswad, 2012, "Persian Gulf based SWFs & Financial Hubs in Bahrain, Dubai and Qatar: A Case of Competitive Branding", *Sovereign Wealth Fund Initiative*, The Fletcher School, Tufts University.

<sup>4</sup> See Bernard Haykel, 2013, "Saudi Arabia and Qatar in a Time of Revolution", *Center for Strategic & International Studies*.

<sup>5</sup> See Brandon Friedman, 2012, "Battle for Bahrain: What One Uprising Meant for the Gulf States and Iran", *World Affairs*.

<sup>6</sup> See Hani Mounir Khoury, 2012, "Where does Saudi Arabia stand in terms of Risk management", *Middle East Matters*, Deloitte.

it does not reflect a change in the investment strategy of SAMA which remains conservative and focused on safely managing the currency. As the driver of national economic activity linked closely to the oil sector and foreign markets, specifically financial flows in US dollars, stability in the Saudi riyal is the primary focus of SAMA. The SAMA investment strategy, though rather opaque, is not transparent with its specific holdings, even though the Saudi economy is still seen as one of the most open to foreign investments compared to other GCC countries<sup>7</sup>. The objectives of SAMA, as stated in the official charter, do not include any investment responsibilities or mandates as a SWF, but only currency and foreign exchange research management tasks. The main tasks are to regulate the currency and carry out central banking functions<sup>8</sup>. However, it has become the *de facto* SWF for Saudi Arabia<sup>9</sup>.

While SAMA maintains a theoretically reasonable portfolio of low volatility, high credit quality fixed income securities designed to serve central banking needs and balance oil price swings in national wealth, there remain valid questions about portfolio design. Exposing itself to the lowest level of risk of Gulf funds, this begs the question as to whether they should expose their fund to higher levels of risk. Maintaining strict control over its political and economic stability, Saudi Arabia has the weight to protect its markets from any political uprisings, as demonstrated during the Arab spring. The economy remained largely unaffected which depended on external demand for oil. This has allowed it to keep external pressures at bay, as they can afford to assume less risk<sup>10</sup>. However, whether this policy is optimal and prevents economic diversification and development still remains an open question. The biggest restriction on investment expansion is the ideological foundation of the strict Arab society. Islamic finance principles which allow no interest income from lending, as well as the procedure of making sure each investment is Shariah compliant limit introduction of various investment instruments. SAMA and Saudi Arabia, is gradually expanding its presence in the Sukuk market. Malaysia was the leader in Islamic finance over the past decade, but this market has been rapidly expanding in Saudi Arabia. Given the pressures for economic and political development, SAMA may have to revise its strategies and maybe its transparency<sup>11</sup>.

## The Kuwait Investment Authority

As one of the oldest SWFs in the world, founded in 1953, KIA has helped Kuwait endure and rebuild from devastating conflicts and has become a major diversified institutional investor. KIA's lengthy history has given it a greater understanding of the pitfalls of direct

investment without proper oversight and today it prefers a diversified, low risk portfolio generally consisting of passive holdings. Within the fixed income universe, KIA seeks to invest in government-owned securities, agency/corporate bonds, treasury inflation-protected securities, and treasury bills within North America, Europe, Asia and emerging markets. For its equity investments KIA is a low turnover buy and hold investor, purchasing value and growth stocks of companies across all market capitalization. KIA does, however, have ventures in real estate, private equity, public equity, fixed income, and alternative investment markets span the globe as one of the most geographically diverse SWF's<sup>12</sup>. It has stakes in well known companies like Citigroup and the German car manufacturer Daimler. Investments in the Citigroup and the Merrill Lynch were controversial, made at the height of the 2008 crisis; despite these losses KIA has endured, the United States remains a primary investment destination<sup>13</sup>. The KIA is a global diversified investor. Nowadays manages assets worth \$290bn and occupies the seventh place in the ESADegeo SWF Ranking.

The Kuwait Investment Authority, however, is working to expand potential investment markets. Among the new prominent economic and investment partnerships KIA is targeting there is an increased presence in Chinese capital markets. After years of having only one branch outside of Kuwait in London, the KIA has now expanded operations to Beijing, gaining 'qualified investor' status in China with full trading rights on the Shanghai stock exchange<sup>14</sup>. As it moves from traditional markets to new areas, KIA's public image and organizational structure becomes more important. The management for KIA is selected by the Board of Directors and out of private sector representativeness. The inclusion of public sector oversight of KIA stems from scandals more than twenty years ago when funds were misused (as proved in our 2012 Report) and poor investment oversight angered Kuwaitis who demanded greater accountability. On paper the governance structure of KIA is quite rigorous. The reporting and auditing involves the big four as well as a diversified team of ministers with wide authority. As KIA moves towards expansion, transparency and public scrutiny will become more commonplace in the regular affairs of the gulf sovereign wealth fund. Unlike other Gulf SWFs however, Kuwait and KIA remain heavily dependent on oil with no attempts at economic diversification. As one study noted, "some of Kuwait's policies of rent distribution, such as subsidizing utilities and providing public employment, have resulted in substantial distortions, inefficiencies and institutional deficiencies."<sup>15</sup> Given the recurrent risk of excessive growth in public expenditure driven by excessive reliance on oil prices, Kuwait seems unwilling to be able to confront its economic rigidities. Rather than leveraging its financial influence through the KIA to promote,

<sup>7</sup> [http://redmoneyevents.com/2012/2012\\_IFNforum\\_SA.asp](http://redmoneyevents.com/2012/2012_IFNforum_SA.asp)

<sup>8</sup> <http://www.sama.gov.sa/sites/samaen/RulesRegulation/BankingSystem/Pages/BankingSystemFD01.aspx>

<sup>9</sup> [http://archive.treasury.gov.au/documents/1963/PDF/6\\_overview\\_of\\_islamic\\_finance\\_banking\\_and\\_insurance.pdf](http://archive.treasury.gov.au/documents/1963/PDF/6_overview_of_islamic_finance_banking_and_insurance.pdf)

<sup>10</sup> <http://www.arabianbusiness.com/saudi-bank-lending-growing-fastest-in-gcc-region-408668.html>

<sup>11</sup> [http://redmoneyevents.com/2012/2012\\_IFNforum\\_SA.asp](http://redmoneyevents.com/2012/2012_IFNforum_SA.asp)

<sup>12</sup> <http://investing.businessweek.com/research/stocks/private/snapshot.asp?privcapId=21922514>

<sup>13</sup> <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/6745295/Kuwait-Investment-Authority-sells-stake-in-Citigroup-for-2.4bn-after-just-two-years.html>

<sup>14</sup> <http://www.arabianbusiness.com/kuwait-wealth-fund-aims-boost-china-investments-425619.html>

<sup>15</sup> See Laura El-Katiri, Bassam Fattouh, and Paul Segal, 2011, "Anatomy of an Oil-Based Welfare State: Rent Distribution in Kuwait", Kuwait Programme on Development, Governance, and Globalization in the Gulf States No. 13.

## 6. The Gulf funds after the financial crisis

economic development, Kuwait has relied primarily on consumption of oil production to fund an expansive welfare state. Given the large ongoing oil revenues to Gulf States that sustain continued consumption, the long term efficacy of failing to promote domestic economic development will depend on Kuwaiti development.

### The Abu Dhabi Investment Authority

Having lost its title as the world's largest sovereign wealth fund (it occupies now the fifth position in our ESADEge SWF Ranking with \$450bn assets under management), and facing greater scrutiny of its activities, the Abu Dhabi Investment Authority (ADIA) opted to embrace its role as a global institutional investor<sup>16</sup>. Since 2009, it has released annual reports detailing its investment strategies, allocation, and governance structure, among other key details. Managing some of the largest per capita oil reserves in the world, ADIA invests in potentially the largest variety of assets of any SWF including developed, small cap, and emerging market equities, but also government bonds, alternatives assets, real estate, private equity, cash and infrastructure<sup>17</sup>. ADIA while holding a broad range of assets, has assumed a conservative strategy designed to minimize investment risk. With a large percentage of its assets externally managed and targeting index replicating strategies, ADIA is returning a respectable 6.9% twenty year annualized return that is a reasonable expansion of financial risk<sup>18</sup>. ADIA, along with Norges Bank Investment Management, has become one of the most classically built portfolios with broad asset, geographic, and risk profile diversification. While this may represent sound investment portfolio construction, given the overweighting of national wealth and income that comes from oil, it may be more prudent to hold a higher percentage in low risk and volatility assets to offset the inherent volatility of commodities.

The ADIA annual report and other announcements show an increased emphasis on a clear public relations strategy and a clear separation between management and government. Following criticism about its lack of independence from the government and its investments having a political aspect, ADIA has gone through a process designed to increase professionalization of its management and diversified itself economically from being oil dependent. Despite ADIA's insistence, however, the separation of powers between ADIA and the government remains questionable. The executive management is still appointed by the ruler of the Emirates. In fact, the Managing Director Hamed bin Zayed Al Nahyan comes from the ruling family and carries significant political weight in key decisions. To publicly address this concern, ADIA went so far as to hire Landor, a marketing and creative design firm to help create a public relations strategy in order to promote its role as benign global

sovereign wealth fund. While it maintains a classically constructed portfolio promoting economic development and diversification, the political risk associated with ADIA and its direct management by the Al-Nahyan remains of some concern.

ADIA's long term economic diversification strategy is its distinctive quality. Abu Dhabi, backed by the financial influence of ADIA, has placed the most emphasis of all the Gulf fund states on attempting to move away from oil as the driver of the economy. Abu Dhabi has made significant moves into finance, tourism, and entertainment, among others, normally involving public investment funds from the ADIA or other domestically owned public investment vehicles. While the investments in diversification still have not demonstrably moved the Emirati economy away from its dependency on oil, Abu Dhabi and ADIA have declared their intention to lessen their dependency on commodities. Evident in its Economic Vision 2030 project, Abu Dhabi's strategy change involves sustainable development which involves expansion in the service industry as well as promoting industrial zones and specialized production in petro chemicals moving beyond basic extraction activities<sup>19</sup>. While the Abu Dhabi and ADIA economic diversification has not yielded a significant decrease in its reliance on oil, it is undoubtedly the most ambitious strategy in the Gulf region to reduce reliance on commodity revenue.

### The Qatar Investment Authority

Though the newest of the Gulf funds, founded only in 2005, the Qatar Investment Authority, which manages \$135bn in assets, has become one of the most aggressive and least publicity averse investors in the Gulf. Qatar Holdings is an indirect subsidiary of QIA but the primary driver of QIA's investment activity. Whereas Gulf investors have tended historically to be low yield and low risk investors that remained close to central banking and cash management operations or passive portfolio investors in companies, Qatar has taken a more active investment role. It has made direct controlling investments in headline grabbing glamorous flagship investments not intended to avoid publicity. QIA's acquisition of the British Luxury Chain Harrods and the Knightsbridge department store is one of its many noteworthy investments. Qatar also has significant stakes in European economies and their luxury sectors. Some of its notable investments are in French luxury brands Louis Vuitton and Moët Hennessy in addition to flagship real estate such as the Neo building, a neo-classical architecture masterpiece which houses the US embassy and luxury hotels, along with hotel W in Barcelona, the first big property acquired in Spain<sup>20</sup>. It also has stakes in the German car company Porsche (recently sold) and Italian luxury goods maker Valentino.

<sup>16</sup> See "Abu Dhabi Investment Authority No Longer Has the World's Richest Sovereign Wealth Fund Says SWFI", *Arabian Money*, November 5, 2012.

<sup>17</sup> <http://www.adia.ae/En/Investment/Portfolio.aspx>

<sup>18</sup> See 2011 Review: Prudent Global Growth.

<sup>19</sup> See Himendra Mohan Kumar, 2011, "Abu Dhabi Economy: Diversification in focus", *Gulfnews.com*.

<sup>20</sup> <http://dohanews.com/post/25708833302/qatari-group-reportedly-buying-four-french-luxury>.

Building upon these, though concentrating its resource risk, QIA has taken a stake in the Royal Dutch Shell and French oil company Total. Investments in the US involve stakes in the high end jewelers Tiffany & Co. as well as luxury hotels<sup>21</sup>. Although not as advanced as the Abu Dhabi diversification strategy, QIA has also been heavily involved in seeking to diversify the Qatari economy beyond oil. Qatar Inc. has followed many of the same strategies of Abu Dhabi and ADIA. This includes investing in a domestic financial industry, education hubs, and tourism and entertainment completed by their being named the host of the 2022 World Cup (our first report detailed investments of Qatari investors in the European soccer industry). Like Abu Dhabi, however, it remains to be seen whether their economy will become self sustaining without the continual flow of oil revenue or whether these are mere boom time vanity projects.

Their investments are well diversified ranging from real estate, oil investments, and tourism and hotel ownership, including purchase of holiday destination islands. However, in its short short time in existence, QIA has differentiated has differentiated itself in two key areas. First, QIA has not sought to avoid publicity or the types of headline investment that attract attention from the public or regulators. Most investments are in well known brands or companies with some that could be considered national champions or flagship assets. Conversely, most sovereign wealth funds have actively avoided purchasing well known consumer brands, national champions, or flagship assets that might attract attention. While QIA has avoided any investments that might be directly or indirectly related to national security concerns, they have demonstrated little reticence about making major investment in headline assets, unlike their Gulf SWF counterparts. Second, QIA has also taken a more active role in many investments than other SWFs. To avoid charges of political interference or simply unwanted influence, many SWFs including those from the Gulf, have eschewed an active investment role or even board seats, acting more as a passive portfolio investor. QIA has purchased entire assets, in some cases including leverage capital, and has not been reluctant to accept board seats for minority stakes and other involvement that indicates a high level of control over their portfolio. While economically, active shareholding should be encouraged, given the political sensitivity in many countries about SWF investment, especially in national champions or flagship assets, it remains a riskier political strategy. The QIA has plotted a very different investment and public relations strategy that inherently carries greater risk than many other SWF's and it remains to be seen if it can avoid the potential pitfalls.

## Comparing the Gulf Funds

Given their geographic proximity, cultural similarities, and economic dependence on oil, comparing Gulf funds with each other seems relevant and worthwhile. Different controversies arise regarding political motivations of these funds, specifically with regard to target countries, and some analysts concerns regarding terrorism or promoting orthodox Islam. This came forth most notably in the attempted Dubai Ports agreement to manage certain ports in the United States, which was eventually scuttled, ostensibly for national security concerns. It is therefore useful to return to their basic strategies focusing on their accountability and transparency frameworks to compare their differing strategies across a range of factors.

### Investment Strategy Comparison

Each Gulf fund has laid out different investment purposes and objectives. SAMA manages the domestic money supply functioning as a central bank while KIA and ADIA have been delegated the task of preserving the Emirate's funds for future generations. Whereas SAMA has been involved in financial planning for the past four decades, KIA and QIA have only recently announced their formal long term development plans<sup>22</sup>. Increasing social, cultural and political globalization may have contributed towards this shift in strategy given the scrutiny from the US and European markets. The investment strategies of the Gulf funds indicate a very different approach to national wealth management and risk acceptance levels.

Table 1

### Investment Strategy

Fund	Strategy	Notes
Saudi Arabian Monetary Authority	Conservative	Central banking strategy focused on liquidity management holding, primarily high credit quality, low volatility sovereign and corporate with a significant amount of cash and cash like instruments.
Kuwait Investment Authority	Balanced	Preserving national wealth through diversified investment.
Abu Dhabi Investment Authority	Balanced	Managing and preserving the citizen wealth in highly risk averse investment opportunities.
Qatar Investment Authority	Aggressive	Preserving and extending national wealth through high profile investments in targeted countries.

<sup>21</sup> <http://www.arabianbusiness.com/how-qatar-is-spending-its-billions-470413.html?tab=Comments>

<sup>22</sup> See Martin Hvidt, 2013, "Economic diversification in GCC countries: Past record and future trends", *London School of Economics and Political Science*.

## 6. The Gulf funds after the financial crisis

Gulf funds investment strategies range from central banking cash and liquidity management operations to aggressive direct control of assets. In each case, there is a sound logic for each specific investment strategy. SAMA maintains a conservative cash a high credit quality fixed income portfolio. KIA's strategy is more diversified, or it seems to be, because more of it is disclosed<sup>23</sup>. ADIA and QIA have proven to be the most aggressive and diversified investors. Despite concern over politically motivated global investments, there is little evidence of this in practice. The line between finance and politics behind these investment decisions is seldom clear. Given the management control accorded by the government or ruling families, where the government stops and where independent asset management begins remains difficult to discern. Their different investment strategies indicate a range of risk acceptance and return objectives targeted by each fund. The long term impact on returns or the broader economy remains to be seen.

### Public Relations Strategy

Beyond investment strategy, each fund has plotted different public relations strategies. KIA clearly states on their website it is against Kuwaiti law to release information to the public on KIA activities. However, KIA is known as a media friendly fund and management is not shy about expressing opinions on a variety of topics. The MD expressed great disappointment in American politics and the way they handled the debt crisis. ADIA went through an image rebuilding utilizing the public relations firm Landor. It was seen as having lack of independence from the politics of the country in investment matters, harming its position as an independent asset manager.

Table 2

### Public Relations Strategy

Fund	Strategy	Notes
Saudi Arabian Monetary Authority	Conservative	No formal acknowledgement of SWF activities. No annual or other regular reporting on activities, strategy, or holdings. Only formal information release in annual statistical brief.
Abu Dhabi Investment Authority	Moderate	Carefully managed interaction with Media and stakeholders.
Kuwait Investment Authority	Moderate	Regular update on investment activities. Media friendly releases. Top management communication with media and partners
Qatar Investment Authority	Open	Very frequent and open announcements of any investments

<sup>23</sup> [http://fletcher.tufts.edu/SWFI/~media/Fletcher/Microsites/swfi/pdfs/2012/profiles/KIA%20Fund%20Profile\\_v2.pdf](http://fletcher.tufts.edu/SWFI/~media/Fletcher/Microsites/swfi/pdfs/2012/profiles/KIA%20Fund%20Profile_v2.pdf)

Observations about the way KIA deals with different economies highlights the extent it depends on its political and economic power in the global arena. In addresses to the Chinese and Canadian authorities the comments are more politically correct, having a submissive tune, but with the US and the Europe in its post debt crisis phase the communication is of a harsher tone.

### Economic Development Objectives

The common factor in formulating investment and economic policy is risk aversion. While a low risk and low volatility portfolio strategy may fit the classical model to balance the high volatility national wealth anchored in oil, it preserves a national dependency on commodities. Conversely, investing in economic development for oil dependent economies incurs not insignificant risk given the difficulty of diversifying away from commodities. Though given this extreme reliance on oil prices to drive Gulf economies, a development strategy seems warranted. SAMA is the most risk averse while QIA seems to be the least. The level of diversification varies although they are all heavily oil based wealth funds.

Table 3

### Economic Development Objectives

Fund	Diversification Strategy	Notes
Saudi Arabian Monetary Authority	None	There are no apparent direct or indirect economic development objectives for SAMA on the Saudi economy. It has no stated domestic economic development objectives or known investment holdings in the Saudi Kingdom.
Kuwait Investment Authority	Limited	No significant domestic investment or industrial development objectives.
Abu Dhabi Investment Authority	Economic diversification	Actively seeking to diversify the domestic economy with significant domestic investment into finance, entertainment, and tourism.
Qatar Investment Authority	Economic diversification	Seeking to reduce the reliance on oil with active industrial policy and domestic investments focused on finance, tourism, and education.

Only ADIA and QIA are actively seeking to diversify their local economies using their financial leverage as a cornerstone to create capital markets which then spill over into other industries. KIA is mostly responsible for preserving the wealth of the Kuwaiti citizens for future generations. SAMA serves to regulate the Saudi economy as a central bank and its investment operations are not as extensive.

## Conclusion

Despite their initial and superficial similarities, Gulf SWFs have significant differences in their investment, corporate, and economic development strategies. The Gulf SWFs are formulating their investment strategies based upon very different objectives. SAMA is focused on liquidity and cash management operations holding a theoretically prudent portfolio but linking its economy to oil over the long run. ADIA and QIA have charted a new course for their economy. A riskier portfolio coupled with significant domestic holdings and active industrial policy seeking to stimulate new sectors of the economy have taken Abu Dhabi and Qatar into uncharted waters. The long term wisdom of either strategy has yet to be clearly demonstrated and each have prudent reasons supporting their strategy.

There are two primary risks facing Gulf SWFs. First, Gulf funds face a significantly higher level of political risk than other funds. Whether directly through further spill over from the Arab Spring into their countries, restrictions on international investment, or via more indirect channels such as increased transparency and accountability of SWF activities, there is significant political risk associated with Gulf SWFs. Second, there is significant financial and economic risk due to imprudent public expenditure policies. Commodity rich states have a long history of excessive public expenditure or poor investment leading to significant losses or contractions. In recent history, oil prices have remained buoyant shielding the Gulf economies from the economic slowdown which has hit the global economy since 2008. Should oil prices decline from a prolonged slowdown in global growth or financial shocks, this would have a significant impact on oil dependent Gulf economies and funds.

The Gulf funds present an overlapping and competing vision for the future of the Middle East. Saudi financial conservatism or Qatari and Emirati risk taking and dynamism. Each comes with specific risks and potential payoffs with no clear outcome and the future still to be decided.



# II

## Sector Analysis



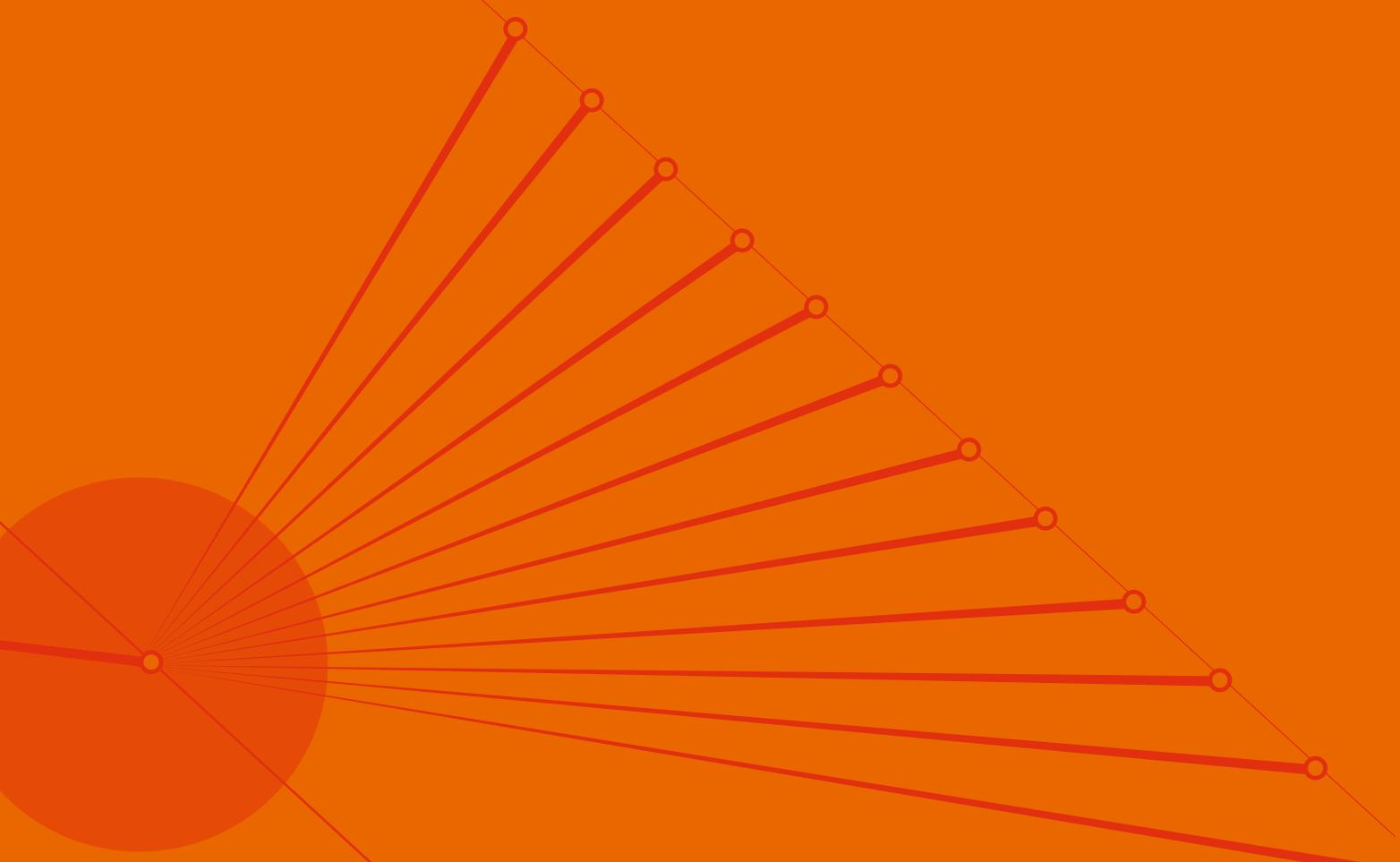


**Javier Santiso**

Professor of Economics, ESADE Business School

Vice President, ESADEgeo - Center for Global Economy and Geopolitics

# Sovereign wealth funds and new technologies



## 7. Sovereign wealth funds and new technologies

### 7. SOVEREIGN WEALTH FUNDS AND NEW TECHNOLOGIES

Sovereign wealth funds give rise to all kinds of fantasies. Some dream of their coming to save them, others fear their taking stakes for obscure political reasons<sup>1</sup>. Some believe they are interested only in raw materials or low added value sectors, or that they are dazzled by assets such as luxury hotels and prestige brands<sup>2</sup>. Others fear that, on the contrary, they will make off with strategic industrial assets. As is so often the case, the truth is actually more complex, and also much more interesting.

In our first report, published in 2012<sup>3</sup>, we exploded the myth that sovereign wealth funds were not much interested in Europe as a whole and especially in Spain. Not only did we show that sovereign wealth funds had invested a record \$81 billion in 2011 (in a total of 237 transactions), but also that Europe was on their investment radar: in 2011 it was the region receiving most investment (nearly 35%), ahead of Asia (32%) and the Americas (less than 7%, North and South). More surprising perhaps is the fact that, in Europe, the country receiving most investment is Spain: a total of \$8.4 billion (including investments in Spain and in Spanish companies), ahead of France (\$3.6 billion) and the UK (less than \$3 billion). The biggest transactions were carried out above all by Arab funds, from the UAE and Qatar.

In this report, and in this chapter in particular, we wish to help demolish another myth: that sovereign wealth funds are interested only in assets relating to commodities, financial sectors and little else. Proof of this is that in 2012, while sovereign wealth funds' direct investments plummeted from \$89.5 billion to \$57.3 billion, investments in the information technology sector increased by 90%, ahead of traditional investment sectors such as energy, property and finance.

This change of trend is gradually leading sovereign wealth funds to invest in technology-intensive. Moreover, it is translating not just into increasing investment by SWFs in the information technology sector, but also into higher levels of investment in other technology-intensive sectors such as healthcare, pharmaceuticals, communication media and start-ups. The fifteen biggest transactions carried out in 2011

and 2012 by sovereign wealth funds in technological sectors totalled \$8.5 billion. Many of these were directed at "atypical" technology-intensive sectors, as shown by the transactions carried out in 2012 by Abu Dhabi's Mubadala to acquire, together with other companies, Britain's EMI Music Publishing for \$2.2 billion, and that carried out by China Investment Corporation<sup>4</sup> (CIC) to acquire 5.6% of Chinese start-up Alibaba for \$2 billion.

In fact we can see that these funds are massively realigning their investment strategies. Ever since the onset of the crisis in 2008, they have increasingly been seeking strategic investments in industrial groups, particularly technology and telecommunications. The transactions carried out in Spain were all of this kind, motivated by financial and strategic plays (Cepsa, Iberdrola, Santander).

China, Singapore, Malaysia, United Arab Emirates: plays on low-yield assets and equity investments are being replaced by a growing presence in industrial projects, in a search for partners with technological assets. All in all more than 57% of funds are already operating through private equity, and the majority also carry out transactions that simultaneously seek financial and industrial returns<sup>5</sup>. This presents an opportunity to develop strategic alliances for groups established in the OECD with a strong presence in emerging markets, something that the sovereign wealth funds are actively seeking at the moment.

This has been well understood by some Spanish groups, in particular Sener and Indra, with strategic associations with the UAE's Mubadala, and Iberdrola, which has an alliance with Qatar Holding<sup>6</sup>. More recently, in mid-2012, China's CIC bought a stake in satellite operator Eutelsat, from Abertis, which also has a stake in Hispasat. In this chapter we look at sovereign wealth funds' deals with technological groups such as Intel—China's CIC having reached an investment agreement with Intel Capital in 2010—, as proof that we are witnessing an emerging trend which will cease to be anecdotal during the decade 2010 to 2020.

### Sovereign wealth funds: strategic investors in the technology sector

The onset of the crisis in OECD countries in 2008 led to a far-reaching change in the investment strategies of emerging countries' sovereign wealth funds, which no longer confine their interest to investments in fixed income or equities and purely financial returns,

<sup>1</sup> See Rolando Avendaño and Javier Santiso, "Are sovereign wealth fund investments politically biased? A comparison with mutual funds" in Karl Sauvant ed. *Sovereign investment: Concerns and policy reactions*, Oxford University Press, 2012, pp. 221-257.

<sup>2</sup> All this is partly true, but only partly. Sovereign wealth funds invest in star brands, for example buying the Italian luxury brand Valentino in 2012 for €700 million (Qatar), or in prime real estate assets such as the 8 Place Vendôme property bought by a fund from Central Asia, also in 2012 (SOFAZ of Azerbaijan), or 90 Boulevard Pasteur, bought by ADIA (UAE) from the Crédit Agricole group for €250 million at the beginning of 2013. In 2012 alone sovereign wealth funds bought 38 large and/or luxury properties, in transactions valued at around \$10 billion. The Norwegian fund, with more than \$700 billion in assets, bought properties in Paris, Berlin and Zurich. Qatar Investment Authority (QIA) has been the most active in this type of transaction. It bought half a dozen luxury hotels in France in 2012 for a total of nearly €800 million from the US group Starwood Capital (after having paid more than \$2.2 billion in 2010 for the iconic British store Harrods). However this same Authority, staying with French examples, also buys and invests in industrial assets, such as the French construction and engineering company Vinci, in which it holds 5.6%, and the media and digital group Lagardère, with a 10% stake.

<sup>3</sup> See Javier Santiso, ed. *Sovereign Wealth Funds 2012*, Madrid, Invest in Spain / ICEX, KPMG and ESADE Business School, 2012.

<sup>4</sup> See <http://www.china-inv.cn/cicen/index.html>

<sup>5</sup> As regards sovereign wealth funds' investing in private equity, it is interesting to note that, according to data from before the crisis (2003-2007) nearly 10% of investments in private equity featured a sovereign wealth fund. See the recent article by Shai Bernstein, Josh Lerner and Antoinette Schoar (HBS), 2013, "The Investment Strategies of Sovereign Wealth Funds", *Journal of Economic Perspectives* 27(2), 219-38, available at <http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.27.2.219> and also the chapter of this same report written by Patrick J. Schena on sovereign wealth funds and investments in energy.

<sup>6</sup> See <http://www.qatarholding.qa/About%20QH/Pages/default.aspx/>

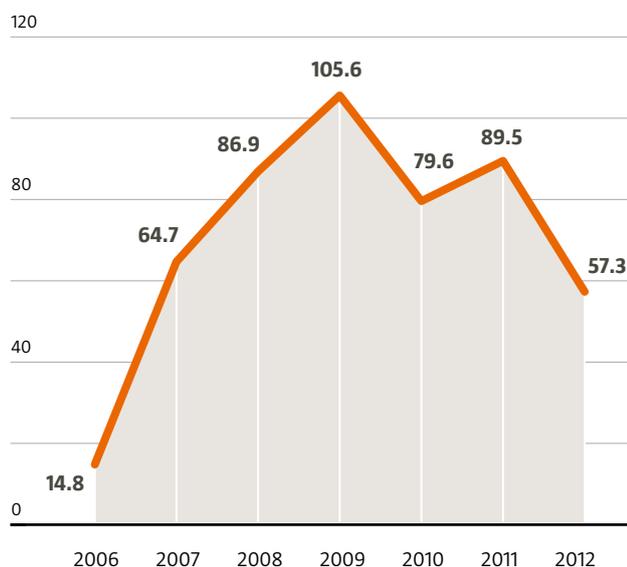
but are also seeking long-term strategic investments leveraged with industrial partners— a trend which we highlighted in our first report on sovereign wealth, published in 2012<sup>7</sup>. Sovereign wealth funds are carrying out more and more deals in technology sectors. Over the past few years we have seen the number of deals proliferate, from the UAE, through Singapore, to China.

It is particularly striking that although sovereign wealth funds cut back on their direct investments in 2012 (to \$57.3 billion, from a 2011 peak of nearly \$90 billion), their investments in the information technology sector continued to grow. In other words sovereign wealth funds are now turning towards segments with greater added industrial value. Direct investments in the information technology sector increased by 90% in 2012, making it the sector with the second biggest increase, ahead of real estate, energy and finance. However investments in the telecommunications and media sectors showed a decrease. The most notable transactions point to an upturn in investments in this sector and to an increase in the trend towards high added value industrial sectors. As we shall see, there have even been forays by SWFs into the world of start-ups, something previously unheard of.

Chart 1

SWFs are suffering the effects of the crisis

Direct investments of SWFs (\$bn)

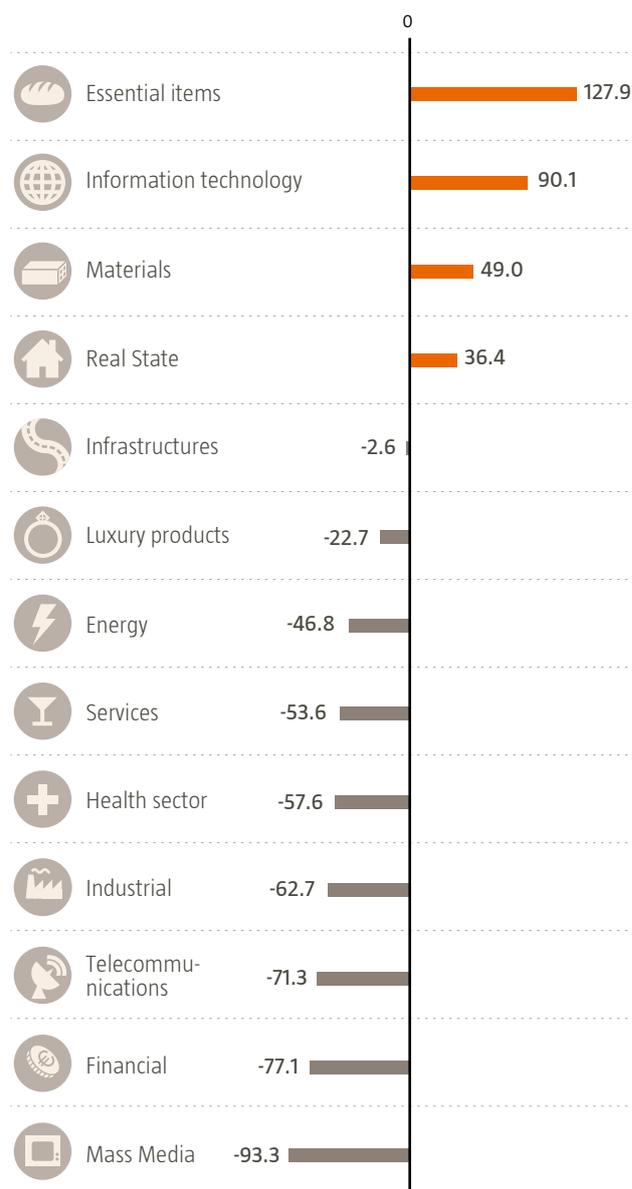


Source: ESADEgeo (2013) with data of Sovereign Wealth Fund Transaction Database (2013).

Chart 2

SWFs redouble their commitment to new technologies

Annual variation by sector (In percentages)



Source: ESADEgeo (2013) with data of The Fletcher SWF Transaction Database (2013).

<sup>7</sup> See Alexander Dyck, University of Toronto, Rotman School of Management, and Adair Morse, University of Chicago, Booth School of Business, "Sovereign Wealth Fund Portfolios", December 2011, available at <http://www.aeaweb.org/aea/2012conference/program/retrieve.php?pdfid=181>

## 7. Sovereign wealth funds and new technologies

During the period 2011 to 2012 the value of the main investments carried out by sovereign wealth funds in technology-intensive sectors surpassed \$8.5 billion. Of the fifteen biggest investments made by sovereign wealth funds in those two years, ten went to emerging economies, confirming technological lift-off in these countries, and five to developed economies, highlighting the sovereign wealth funds' growing interest in western know-how. Evidence of this can be seen in the fact that the transaction carried out by Abu Dhabi's Mubadala fund to acquire UK record label EMI Music Publishing through a joint venture with Sony/ATV and a consortium of co-investors, was the biggest investment in technology sectors during 2012, amounting to approximately \$2.2 billion (See table 1 for details).

However if there is one trend that can be picked out with total clarity from the SWFs' biggest deals in technology-intensive sectors, it is the increase in so-called South-South relations, in which Asian sovereign wealth funds, led by Malaysia's Khazanah, were the main protagonists, with investments of approximately \$2.8 billion in technology sectors during 2011 and 2012<sup>8</sup>.

Khazanah opted to extend and internationalise the structure of its main unit, the powerful healthcare holding company IHH Healthcare Berhad, which is the second biggest provider of healthcare services in the world by market valuation. This found expression in the purchase in 2011 of an 8.82% stake in Indian healthcare company Apollo Hospitals for approximately \$100 million and the January 2012 acquisition of a 15% stake in Turkey's biggest healthcare holding company Acibadem Healthcare Group for \$1.7 billion which, together with the 65% that IHH already held, gave the Malaysian fund a 75% stake in the Turkish healthcare group (Infographic 4).

The Government of Singapore Investment Corporation<sup>9</sup> (GIC), for its part, channelled its investments into a wide variety of technology sectors, ranging from aerospace, where it took a stake in Ireland's Avolon Aerospace Leasing Limited for \$300 million, through software, investing \$150 million together with Bain Capital to acquire 40% of the Indian company Genpact, to healthcare, where in 2012 it took a small stake in India's Vasan Healthcare for \$100 million.

GIC's focus on the technology sector also takes in private equity and venture capital. It has a special unit, Global Technology Group, to carry out these investments. The strategy is to increase investments in emerging markets too (hence GIC's entry in 2010, together with China's CIC, into Brazilian bank BTG Pactual with a 4.5% stake.) For the time being however, the bulk of investments in innovation is

through US and European venture capital funds such as Sequoia, which is quite an institution in Silicon Valley.

However, according to data gathered by Preqin<sup>10</sup>, it also made plays on emerging market venture capital funds, most notably China's iD TechVentures (formerly Acer Technology Ventures) with offices in Shanghai, Beijing and Taipei and some \$500 million under management<sup>11</sup>. It also participated as an investor in several Israeli venture capital funds, particularly Giza Venture Capital, a veteran venture capital fund that has been in existence for twenty years and has invested more than \$500 million in some one hundred or so start-ups<sup>12</sup>. Another investment it made was in Jerusalem Venture Partners, a venture capital fund established in 1993 which now manages \$900 million in investments in start-ups<sup>13</sup>. In 2012, it also took part in the financing round for Advent's private equity fund for Latin America, which raised a record total of \$1.65 billion. These investments in emerging countries' venture capital funds are in addition to the more traditional ones in European venture capital funds such as France's Innovacom<sup>14</sup> or Germany's Wellington Partners Venture Capital (with offices in Munich, London, Zurich and Palo Alto)<sup>15</sup>, and US funds such as Sequoia Capital<sup>16</sup>, Battery Ventures<sup>17</sup>, Lightspeed Venture Partners (which has teams in China, India and Israel as well as the US)<sup>18</sup> or Atlas Venture<sup>19</sup>.

Not all the investments made by sovereign wealth funds in the South-South context went to traditional sectors. In 2011, another of Singapore's sovereign wealth funds, Temasek<sup>20</sup>, set a new precedent, departing from the traditional range of sovereign wealth funds' investments by investing in two Chinese start-ups in the e-commerce sector, Alibaba and Vancl, with stakes of \$400 million and \$230 million respectively. In line with this, China's biggest sovereign wealth fund, China Investment Corporation (CIC), also decided in 2012 to invest \$2 billion in Alibaba to acquire 5.6% of the company.

<sup>8</sup> See [http://www.khazanah.com.my/docs/KAR2013\\_MediaStatement\\_170113.pdf](http://www.khazanah.com.my/docs/KAR2013_MediaStatement_170113.pdf)

<sup>9</sup> See [http://www.gic.com.sg/images/pdf/GIC\\_Report\\_2012.pdf](http://www.gic.com.sg/images/pdf/GIC_Report_2012.pdf)

<sup>10</sup> See *2012 Preqin Sovereign Wealth Fund Review*, 2012 Preqin

<sup>11</sup> See <http://www.idtvc.com/about.aspx>

<sup>12</sup> See <http://www.gizavc.com/>

<sup>13</sup> See <http://www.jvpvc.com/>

<sup>14</sup> See <http://www.innovacom.fr/>

<sup>15</sup> See <http://www.wellington-partners.com/wp/index.html>

<sup>16</sup> See <http://www.sequoiacap.com/>

<sup>17</sup> See <http://www.battery.com/>

<sup>18</sup> See <http://lsvp.com/>

<sup>19</sup> See <http://www.atlasventure.com/>

<sup>20</sup> See <http://www.temasekreview.com.sg/index.aspx>

Table 1

Main transactions of sovereign wealth funds in technology-intensive sectors 2011-2012

Company	Country	Sovereign Wealth Fund	Investment
EMI Music Publishing	UK	Mubadala Development Company*	2,200
Alibaba	China	China Investment Corporation	2,000
Acibadem	Turkey	Khazanah	1,700
IHH Healthcare	Malaysia	Khazanah	1,000
Alibaba	China	Temasek	400
Avolon Aerospace Leasing Limited	Ireland	Government of Singapore Investment Corporation	300
Vandl	China	Temasek	230
Genpact	India	Government of Singapore Investment Corporation	150
IHH Healthcare	Malasia	Kuwait Investment Authority	150
Apollo Hospitals	India	Khazanah	100
Vasan Healthcare	India	Government of Singapore Investment Corporation	100
Portola Pharma	USA	Temasek	89
CardioDx	USA	Temasek	58
Marin Software	USA	Temasek	30
Amyris Biotechnologies	Brazil	Temasek	25

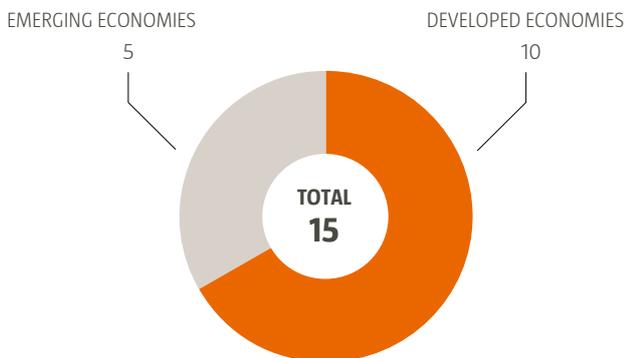
Note: investments in \$ millions.

\*Mubadala made this investment through a joint venture with Sony/ATV and a consortium of co-investors, which included GSO Capital Partners, Jynwel Capital and David Geffen.

Source: ESADEgeio 2013, with data from the Sovereign Wealth Fund Initiative, The Fletcher School, 2013.

Chart 3

SWFs' investments in technology, by type of market (number of deals)



Estimation based on the main operations made by the Sovereign Wealth Funds in intensive technology sectors for the years 2011 and 2012.

Source: ESADEgeio (2013) with data of The Fletcher SWF Transaction Database (2013).

Temasek (Singapore)

The sovereign wealth funds' interest in the telecommunications sector is not new. Temasek for example, controls 100% of major Singaporean media companies such as MediaCorp and Singapore Technologies Telemidia.

Singaporean sovereign wealth fund Temasek has historically been the driving force behind telecommunications operator SingTel. It still has a significant holding in the operator's capital (54%) and SingTel's current Chairman, Simon Israel, was previously executive director and President of Temasek. This operator is buying up technology start-ups, particularly in the United States. In 2012 it acquired Amobee, a mobile marketing company, for \$321 million, and shortly afterwards Pixable, a New York-based start-up established by Spaniard Iñaki Berenguer, for more than \$26.5 million. It also takes part directly in local acquisitions or holdings; as in the case of start-up TheMobileGamer in which it took a 35% stake in 2012 (check Infographic 3 for detailed descriptions).

In 2011, SingTel launched a venture capital investment arm to promote technological acquisitions: SingTel Innov8, with \$200 million in investment capacity. In 2012, it took a stake in start-up General Mobi, partly held by Taiwan's Mediatek. At the end of 2012 it invested in California start-up Everything.me which runs an innovative HTML5 platform, together with Telefónica Ventures, the corporate venture capital arm of Spain's Telefónica. Altogether, with Mozilla and other venture capital funds such as Draper Fisher Jurvetson (DFJ), BRM Group and Horizons Ventures, \$25 million have been invested in this technology start-up. SingTel Innov8 has been particularly active, and in 2013 has investments in more than 25 companies and three corporate offices: Singapore, San Francisco and Shanghai.

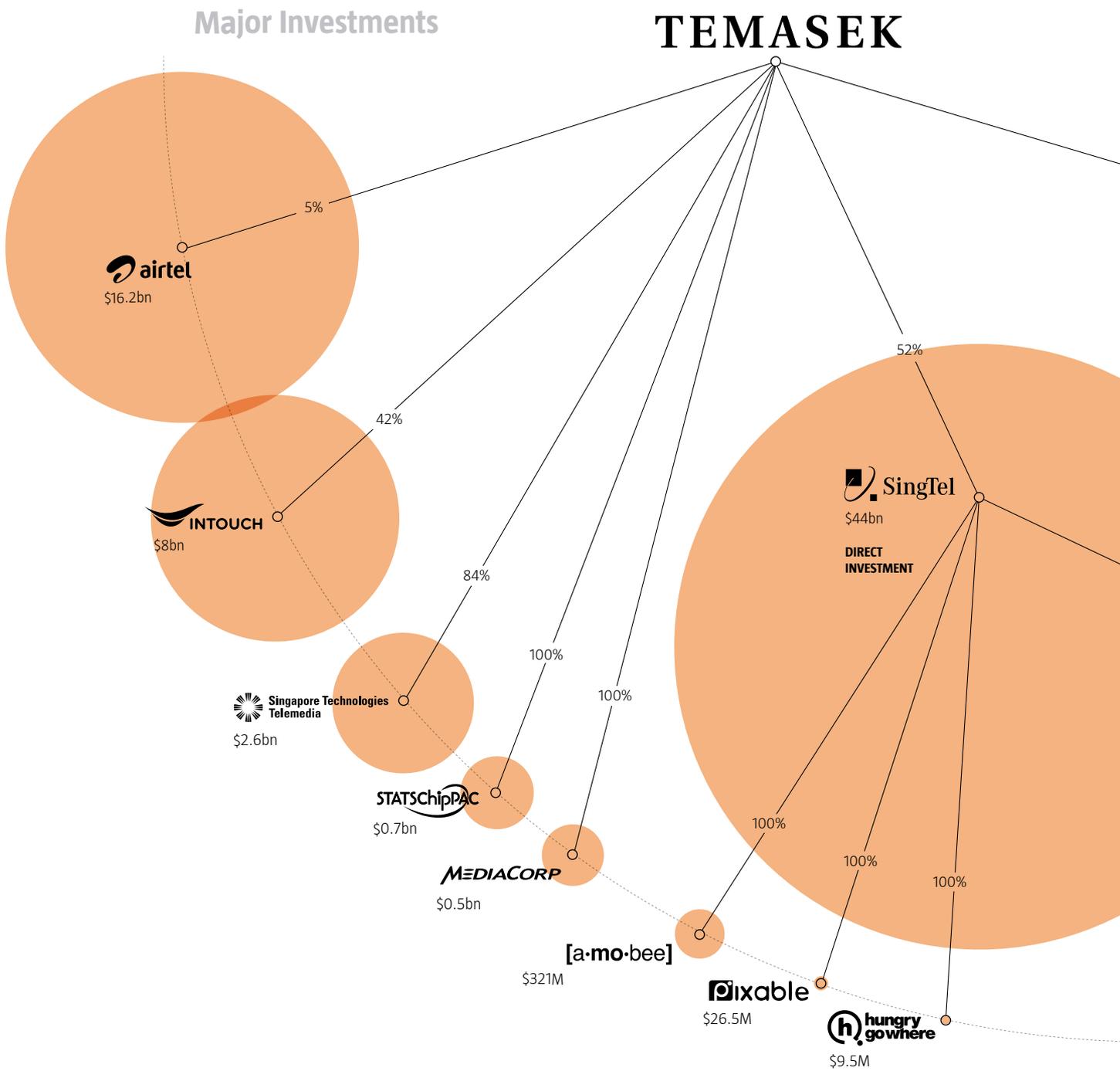
Temasek's play on the technology sector is not anecdotal. Close to 22% of its investment portfolio is in the telecommunications, media and technology sectors. It holds 32% of Indian operator Bharti Airtel and 5% of Telekom Malaysia. It has investments in financial start-ups such as California's SecondMarket, together with the Li Ka Shing Foundation, and in digital marketing start-ups, having taken part in the \$30 million 2012 financing round for US start-up Marin Software<sup>21</sup>. It has also invested more than \$400 million in Chinese start-up Alibaba (40% owned by Yahoo!) In May 2012, Alibaba bought back half of Yahoo!'s stake in the company for an amount of \$7.1 billion.

<sup>21</sup> Li Ka Shing, owner of Hutchinson Whampoa, has greatly increased its investments in technology start-ups. In 2007 it took an additional 0.8% stake in Facebook for an amount of \$120 million, bringing its total investment in Facebook to \$450 million. It also invested in Skype before it was taken over by eBay, and in Siri shortly before it was acquired by Apple. It has recently invested in other start-ups such as Spotify and HzO. Its latest investment was in December 2012, in Israeli start-up Waze. The investor arm is Horizon Ventures, a venture capital fund with offices in Hong Kong and London, with \$150 million in assets and some thirty start-ups in its portfolio.

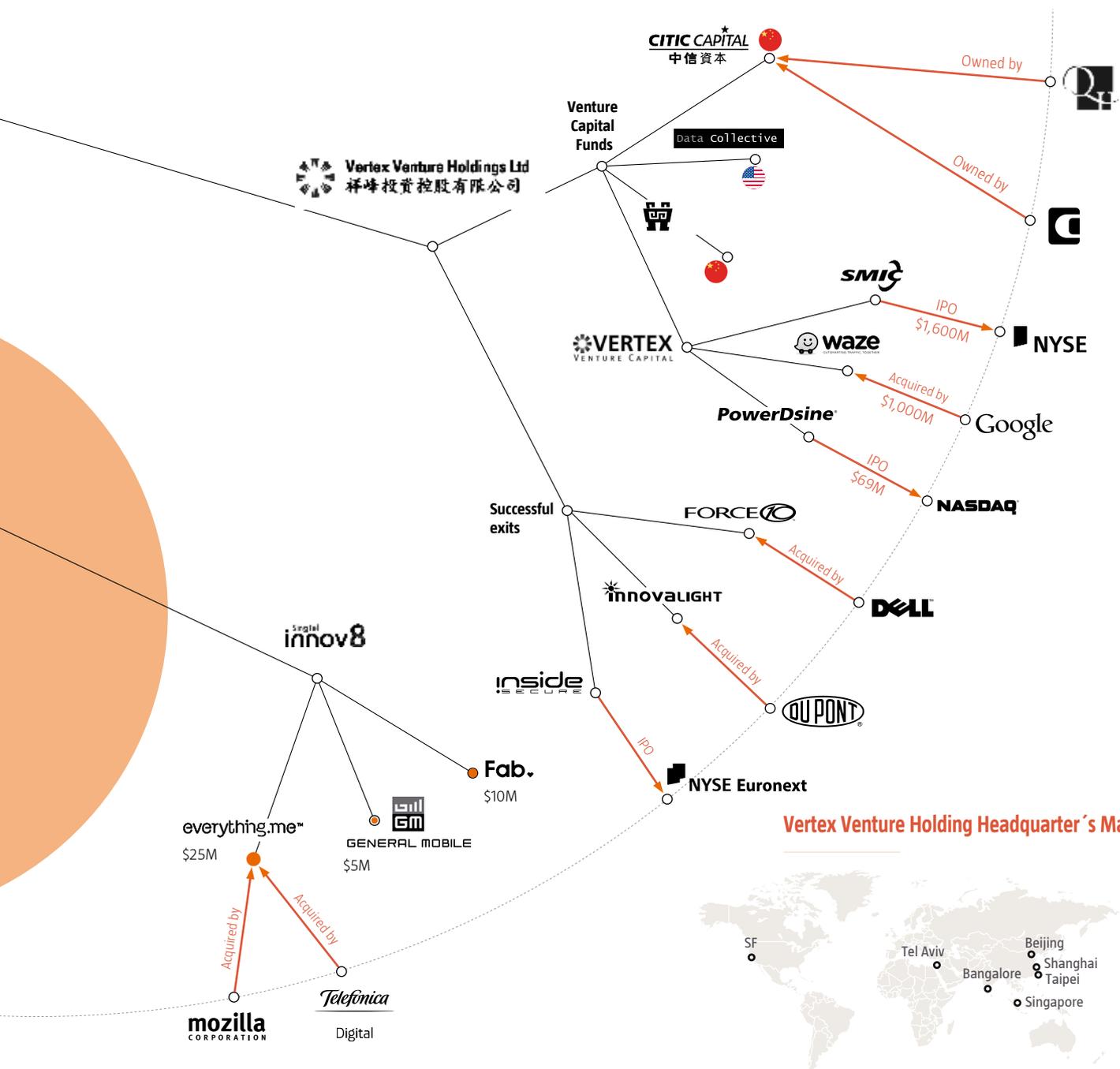
## 7. Sovereign wealth funds and new technologies

### Infographic 3

### Temasek's commitment to innovation and startups



## Vc funds and Startups ecosystem



## 7. Sovereign wealth funds and new technologies

Temasek invests in venture capital funds, particularly in Israel, with stakes in Giza Venture Capital and Vertex Venture Capital<sup>22</sup>. It too has an investor arm specialising in venture capital: Vertex Venture Holdings, which invests in emerging markets, in the US and in Asia<sup>23</sup>. It is invested in more than 350 start-ups and a total of 90 venture capital funds in the US, Europe and Asia, with a total capital deployed in this activity of more than \$1.2 billion. The Vertex group's HQ is in Singapore, but it also has international offices in Silicon Valley (USA), Beijing and Shanghai (China), Taipei (Taiwan), and Bangalore (India). As yet it has no offices in Europe or Latin America. So far Vertex has very few direct investments in Europe, one of them being in a French start-up in Aix-en-Provence called Inside Secure (in the past it had stakes in seven more start-ups, including technology ventures such as Gemplus and Genesys). Temasek also took stakes in venture capital funds in the energy sector, such as Norway's \$750 million Energy Ventures<sup>24</sup> and California's Morgenthaler, an initial investor in such prestigious companies as Apple<sup>25</sup>.

In 2012, Temasek announced that it was looking for opportunities to invest in Europe. The fund is particularly interested in multinationals and companies with strong businesses in emerging Asian and Latin American markets. In June 2012, its strategist Tan Chong Lee noted that it is also looking to form strategic alliances with industrial operators who are considering M&A deals or expansion. The size of the investments could be as much as \$1 billion for a single deal. Its current priorities include technology, biotechnology and healthcare. Investments in the US and Europe currently represent less than 8% of Temasek's portfolio. Europe has become attractive to Asian sovereign wealth funds, which see low valuations, strong industrial capacity and, in some cases, companies with strong businesses in emerging markets. We have discussed Temasek, but there are also other Asian funds such as South Korea's KIC<sup>26</sup> (\$42.8 billion in assets under management at the beginning of 2012) and Malaysia's Khazanah (\$27.9 billion).

### China Investment Corporation (China)

Chinese sovereign wealth fund China Investment Corporation (CIC), with more than \$480 billion under management, signed a strategic agreement with Intel in 2010. This was the first time a sovereign wealth fund had carried out a transaction of this kind with a technology company. Both institutions are looking to invest globally in technology companies, through Intel's corporate venture capital arm: Intel Capital. Previously, in 2008, Intel had already set up a \$500 million fund to invest in China (China Technology Fund II). In 2012, CIC invested in start-up Alibaba, confirming its interest in technology sectors.

CIC has turned the spotlight onto Europe. The crisis has sent valuations plummeting, opening up significant investment opportunities. In 2012, venture capital fund A Capital, with offices in Europe and China (Beijing, Brussels, Hong Kong and Shanghai), raised capital in China to invest in technology companies in Europe. The objective was to raise \$500 million for technology deals in Europe. In May 2012, the Belgian and Chinese authorities jointly established the Belgium-China Direct Equity Investment Fund, known as the Mirror Fund (with initial assets of €50 million and an overall objective of €250 million) to invest in European companies, including technology ones. The agreement was entered into between CIC and the Belgian government's Federal Holding and Investment Company (SFPI/FPIM).

In 2010, A Capital had assisted Chinese multinational Fosun in taking a 7.1% stake in France's tourism company Club Med. In mid-2012, it took a stake in Danish technology company Bang & Olufsen (B&O), together with Chinese luxury goods distributor Sparkle Roll. A Capital founding partner André Loesekrug-Pietri is to be proposed as a member of the board of B&O.

Chinese sovereign wealth funds' enthusiasm for technology is not confined to Europe. It already extends to Palo Alto and Tel Aviv, the world's two major hubs for start-ups and technology companies. Venture capital fund West Summit Capital, in which CIC has a stake, also has an office in Silicon Valley (its six partners are US nationals of Chinese origin). It has equity holdings in companies such as US start-up YouMe (a video streaming platform held by venture capital funds such as Accel, Khosla, Menlo and Intel Capital), Italian start-up Accent, which came about through a spin-off from ST Microelectronics; and France's electronic security company Inside Secure, in which France's *Fonds Stratégique d'Investissement*<sup>27</sup> (Strategic Investment Fund) also has a stake, and the venture capital arms of Motorola, Qualcomm, Samsung and Nokia.

<sup>22</sup> See <http://www.vertexvc.com/index.asp>

<sup>23</sup> See <http://www.vertexmgt.com/about.asp>

<sup>24</sup> See <http://www.energyventures.no/>

<sup>25</sup> See <http://www.morgenthaler.com/>

<sup>26</sup> See <http://www.kic.go.kr/en/index.jsp>

<sup>27</sup> In 2012 this strategic fund took part in the financing round of Viadeo, France's answer to LinkedIn, which has a strong and growing presence in France and China. With €24 million raised, it is one of the biggest deals of its kind carried out in the past few years by a European start-up.

In 2012, China took another step forward. It created the first Sino-American incubator, Innospring, in the heart of Silicon Valley, in Santa Clara. It was founded by two Chinese venture capital funds, Northern Light Venture Capital and GSR Ventures, each with \$1 billion, together with California's KPCB. Altogether in 2011 alone Chinese venture capital funds took stakes in 28 US start-ups. In symmetry with this, several incubators were set up in Shanghai and Guangzhou to facilitate the entry of US start-ups. In 2009, former Google executive Kai-Fu Lee created an incubator with \$180 million (Innovation Works) closely linked to California's Sequoia fund and Russia's DST.

In 2011, China's direct investment abroad amounted to \$68 billion. Chinese FDI in Europe was \$10.5 billion (34% of Europe's total incoming FDI). For the first time in recent history, Chinese investment in Europe surpassed that in any other region, including Asia (\$8.2 billion, 27% of the total) and North America (\$6.4 billion, 21% of the total). Transactions covered all sectors: infrastructure (UK), electricity (Portugal), machinery (Germany), luxury yachts (Italy) and telecommunications (Austria).

Chinese investment in Europe increased threefold in 2011. A report by US consultants Rhodium notes that these 2011 levels (more than \$10 billion) could grow much more during this decade, to between \$250 billion and \$500 billion of investments in Europe. In 2012, CIC booked additional investment capacity of \$200 billion. Also in 2012, CIC took an 8.7% stake in UK's Thames Water, its first UK investment.

In Spain and France CIC has interests through Spanish multinational Abertis. In June 2012, the Spanish company sold 7% of French satellite operator Eutelsat to CIC for €385 million. At the beginning of 2012, with the sale of Telefónica's stake to Abertis, the constructor became 47% owner of Hispasat, in which the Spanish state has a 25.7% holding. Through its stake in Eutelsat, the Chinese fund now has an indirect presence in Hispasat: Eutelsat is one of the major shareholders, with 23% of the capital.

As well as Europe, CIC continues the technological assets trend pointed out above: in 2012, it invested \$2 billion in Alibaba, enabling the e-commerce start-up to buy back shares held by Yahoo!, which still holds more than 20% of the company's capital. It also has small stakes in other technology companies such as RIM. As we remarked at the beginning of this section, CIC and Intel Capital announced a highly significant agreement on joint investment in technology assets outside China. So far Intel Capital has invested nearly \$10 billion in more than 1,100 technology companies in 50 countries (100 of them in China). In 2011, Intel Capital continued to bet on China, which with \$90 million became the second biggest country in the world in terms of investments received from the corporate joint venture.

## **Mubadala (United Arab Emirates)**

Another of the most active strategic investors has been Abu Dhabi's Mubadala. This fund has a financial and industrial focus. In the first instance it seeks financial return, but this is not its only or ultimate objective: there is always a strategic dimension to its investments.

Mubadala is looking to make investments in Europe and Latin America. It is interested in healthcare clusters and new energy sources. In the healthcare sector, it invested and reached agreements with the Imperial College Diabetes Centre in 2012. To promote this area it has a specific subsidiary, Mubadala Healthcare. It has investments in high-tech assets such as AMD and GE and is strongly interested in the area of new technologies and telecommunications. Mubadala aims to transform Abu Dhabi into a regional- and world-level ICT cluster (it has holdings in Etisalat Nigeria, Prodea Systems, EMI, etc.) It is also seeking joint-ventures with technology companies. Such is the case of US company HP, with which it jointly owns technology company Injazat Data Systems.

## 7. Sovereign wealth funds and new technologies

Table 2

### Main Industrial Holdings of Mubadala

Entity	Sector	Capital (%)
EBX Group	Diversified Metals and Mining	5.63
Emirates Aluminum Company Limited	Aluminum	50
General Electric Company	Industrial Conglomerates	76
Guinea Alumina Corporation Limited	Aluminum	8.33
Petrofac Emirates L.L.C	Construction and Engineering	51
SMN Power Holding SAOG	Independent Power Producers and Energy Traders	38.88
Spyker N.V.	Automobile Manufacturers	17
Vagaru Holdings Pvt. Ltd.	Construction and Engineering	63
Dolphin Energy Limited	Oil and Gas Exploration and Production	51
Joint Stock Company KazMunayGas National Company, Caspian "N" Block	Oil and Gas Exploration and Production	25
Liwa Energy Limited	Oil and Gas Exploration and Production	100
Pearl Energy Limited	Oil and Gas Exploration and Production	100
Production Services Network Emirates LLC	Oil and Gas Equipment and Services	51
E-ON-Masdar Integrated Carbon	Renewables	50
London Array	Renewables	20
Torresol Energy	Renewables	40
Shams 1*	Renewables	60

\* 20% of this joint-venture is held by Abengoa Solar.

Source: ESADeGeo (2013) with data from Mubadala, 2013.

In 2012, Mubadala invested \$2 billion (5.6%) in Brazilian group EBX, confirming its appetite for Latin American assets. Spain is not unknown to Mubadala: it has joint ventures with Abengoa, Indra and Sener<sup>28</sup>. As well as the technology and telecommunications sectors, it is interested in healthcare clusters and new energy sources (through Masdar and Masdar venture capital.) Its investments in these fields clearly reflect the dual search for financial returns and strategic alliances that will enable Dubai to acquire expertise in sectors unrelated to its easily accessible but finite oil reserves. Masdar Capital manages \$540 million of investments.

Masdar Venture Capital runs two funds. The second one, set up in 2010 with Masdar and Deutsche Bank as main partners, has as limited partners Siemens, GE, and such Japanese institutions as JBIC and the Development Bank of Japan<sup>29</sup>. In 2011, it invested in a California technology company, eCullet, leading a round of \$38 million, and in 2012 it invested in another US start-up, FRX Polymers, leading a round of \$26.7 million (together with BASF Venture Capital)<sup>30</sup>.

<sup>28</sup> Sener and Masdar created Torresol Energy, a joint venture held 60% by Sener and 40% by Masdar. See <http://www.torresolenergy.com/TORRESOL/home/en>

<sup>29</sup> See <http://www.slideshare.net/dqgonline/dqg-asq-excellence-the-future-of-business-mar-1214-2011-dubai>

<sup>30</sup> See Masdar's complete portfolio: <http://www.masdar.ae/en/#investment/portfolio-companies>

Table 3

## Main technology holdings of Mubadala

Entity	Sector	Capital (%)
Abu Dhabi Aircraft Technologies LLC	Aerospace and Defense	100
Abu Dhabi Ship Building PJSC	Aerospace and Defense	40
Advanced Micro Devices, Inc.	Semiconductors	19
Al Wathba Marionnet L.L.C.	Biotechnology	10
Al Yah Satellite Communications Company	Information & Communications Technology	100
Bayanat	Information & Communications Technology	100
Du-Emirates Integrated Communications	Information & Communications Technology	20
Emerging Markets Telecommunication Services Limited	Information & Communications Technology	30
Etisalat Nigeria	Information & Communications Technology	30
Injazat Data Systems LLC	IT Consulting and Other Services	60
Piaggio Aero Industries S.p.A.	Aerospace and Defense	31.5
SR Technics Switzerland AG	Application Software	70
Intermolecular	Semiconductors	3.7
Globalfoundries	Semiconductors	100
Caxelda	Semiconductors	19

Source: ESADEgeo (2013) with data from Mubadala, 2013.

In 2008, Mubadala also helped to lay the foundations of Advanced Technology Investment Company (ATIC) as an instrument with which to enter the semiconductor market, which is highly knowledge-intensive and highly integrated into the world's most competitive industry. Both are target segments in which the United Arab Emirates, and in particular Abu Dhabi, are seeking to position themselves. With this strategy in mind, ATIC signed a strategic agreement with US technology multinational AMD to set up a new industrial semiconductor plant in addition to that of Dresden, Germany. The newly established company is called GlobalFoundries. In 2009 ATIC continued with its strategy of consolidating itself as a player in this market and acquired the Singaporean company Chartered Semiconductor in order to integrate it and so construct the first integrated world leader in the semiconductors market. In 2012, ATIC acquired 100% control of GlobalFoundries, buying back the part that was still in the hands of AMD. Also in 2012, ATIC (GlobalFoundries) opened a new factory in New York, with more than 1,300 employees. This is to date the world's most advanced industrial semiconductor plant<sup>31</sup>.

The interest of UAE funds in the technology sector is not confined to Mubadala. ADIA<sup>32</sup>, the major UAE fund, is gradually increasing its investments in alternative assets (including real estate, as shown by its 2012 hiring of Pascal Duhamel, a French HEC graduate who had previously worked for Morgan Stanley, to head up this area). In the field of new technologies, investments in venture capital funds stand out in particular.

According to Preqin data, in 2007 ADIA invested in an energy venture capital fund, the Shell Technology Ventures Fund. It also has investments in a US venture capital fund called New Venture Partners, set up in 1997 as Lucent/Bell Labs New Ventures Group and converted in 2001 into an independent venture capital fund. New Venture Partners' original business model consists in promoting spin-offs of technology companies that do not always use patents or technologies for their traditional businesses (among this fund's corporate partners are BT and Philips)<sup>33</sup>. In all it created some 50 spin-offs, from companies such as Lucent/Bell Labs, British Telecom, Philips, Agere, Boeing, Intel and Telstra. In 2006 New Venture Partners established a new \$300 million fund, in which ADIA took a stake.

<sup>31</sup> Concerning this case, see <http://knowledge.wharton.upenn.edu/article.cfm?articleid=3163>

<sup>32</sup> See <http://www.adia.ae/En/About/About.aspx>

<sup>33</sup> See <http://www.nvpllc.com/>

## 7. Sovereign wealth funds and new technologies

### Qatar Holding (Qatar)

Qatar Holding, part of the Qatar Investment Authority, is also increasing its industrial investments; in Europe too. In 2012, for example, it invested in French company Vivendi (it holds 2%).

Qatar Holding has been the most active sovereign wealth fund in Spain. Its 2011, investments in Iberdrola and Santander show on the one hand that its objectives include financial yardsticks but also industry ones, and on the other hand that it has Latin America in its sights. It is the biggest shareholder in Iberdrola (more than 8%, for an amount of €1.9 billion). With an investment of \$2.7 billion in Santander Brasil (5%) it has also become one of the biggest shareholders in the Spanish bank. It also holds 10% of Hochtief, a German company owned by Spanish ACS. It has invested in Portugal, taking a 2% stake in Energias de Portugal in 2011 (€160 million). Qatar Holding is probably the strategic SWF that is more open that is most open to transactions with or involving Spanish companies, always providing there is such a strategic dimension.

As part of this same logic, the Qatar Foundation<sup>34</sup>, Qatar's other major investment vehicle and main sponsor of Barcelona Football Club, recently acquired, for \$1.26 billion, a stake of nearly 5% in Bharti Airtel Ltd, India's leading mobile telephone operator and the world's fourth biggest telecommunications company by number of subscribers. With this investment, the foundation controlled by Sheikha Mozah, the second wife of the Emir of Qatar, enters the attractive Asian telecommunications market and positions itself strategically in Africa, where Bharti Airtel has a strong presence in more than 15 countries.

Table 4

#### Industrial Holdings of Qatar Holding

Entity	Capital (%)
Hochtief	10%
Iberdrola	8.4%
Volkswagen	17%

Source: Qatar Holding, 2013.

<sup>34</sup> See <http://www.qf.org.qa/>

Table 5

#### ICT Holdings of Qatar Holding

Entity	Capital (%)
Lagardère	13%
Qtel	51.60%
Turkuvaz	25%

Source: Qatar Holding, 2013.

Qatar, via the Qatar Investment Authority (QIA), is also actively backing several technological ventures made through venture capital and private equity funds. It usually invests in funds of more than \$500 million, taking stakes of less than 5%. For smaller investments it uses the Qatar Foundation. Qatar invests particularly in green technologies, such as the UK-Qatar Clean Technological Investment Fund, which has \$400 million. It also continues to bet heavily on emerging markets, as is shown by the creation at the end of 2012, together with Credit Suisse (in which QIA holds 6% and whose London office it recently bought from it), of Aventure Capital Management, which will invest mainly in the Middle East, Turkey and other frontier markets.

### Sovereign wealth funds: Potential partners for European and/or Spanish technology companies?

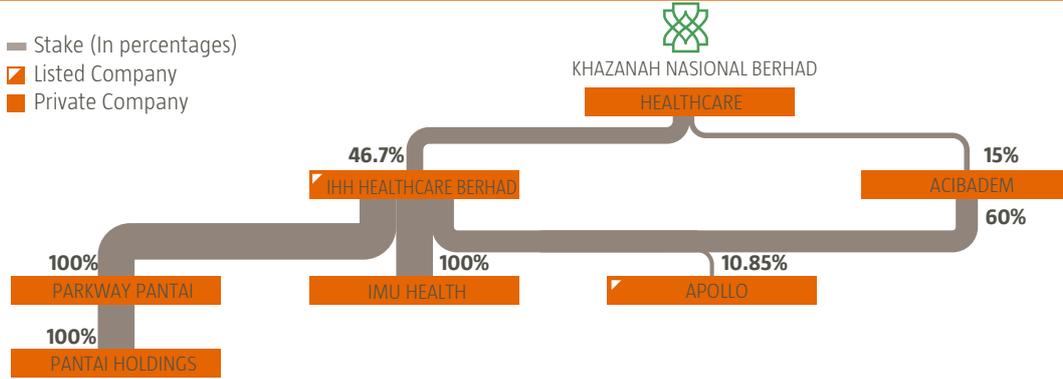
The interest of sovereign wealth funds and similar entities in the new technologies also extends to other emerging countries.

In mid-2012 Russia's Rusnano Capital created a fund specialising in nanotechnologies, together with I2BF Global Ventures, an international fund specialising in this sector, based in New York and with offices in London, Moscow and Dubai. The fund established amounts to \$150 million. Rusnano Capital was created in 2010 in order to promote new technologies. It has a total of \$1 billion in assets. In all it manages five funds focusing on sectors such as medicine/pharmaceuticals, renewable energy sources, the development of new products and nanotechnology.

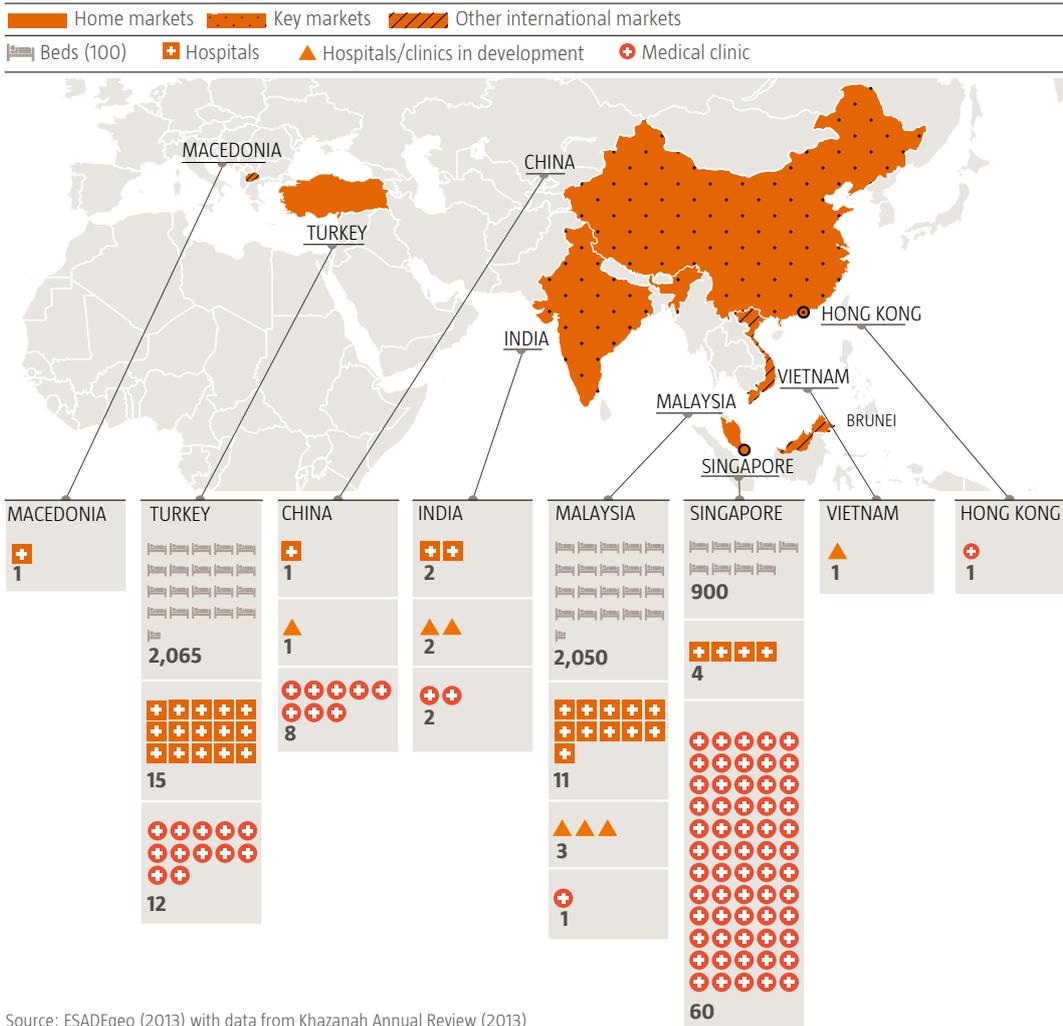
In the OECD countries, certain sovereign wealth funds have also shown interest in stakes in technology companies. The most notable case is that of the French sovereign wealth fund, FSI (Fonds Stratégique d'Investissement), established in 2006. Since its creation it has invested a total of more than €4 billion in over 1,500 companies<sup>35</sup>.

<sup>35</sup> See <http://www.france-investissement.fr/>

Infographic 4  
 Khazanah Healthcare Holding Structure



IHH Healthcare Berhad



Source: ESADEgeo (2013) with data from Khazanah Annual Review (2013)

## 7. Sovereign wealth funds and new technologies

In 2013, FSI, jointly with Alstom and the multinational nuclear power company Areva, created a strategic fund of nearly €125 million to invest in SMEs in the sector. In 2012, the FSI also took part in the round for start-up Viadeo, a social network that competes with LinkedIn, with a contribution of €10 million out of a total of €24 million. The parent company of the FSI, Caisse des Dépôts et Consignations (CDC) –comparable to Spain’s ICO– has equity stakes worth more than €2.5 billion in digital and telecommunications companies (including Orange or France Telecom). The FSI has stakes in networks (TDF, Eutelsat), electronic components (Soitec, Gemalto, 3S Photonics, Inside Contactless), hardware and software industries (Bull, Avanquest, Cylande, Qosmos) and even in online blogs and video companies such as Dailymotion.

The FSI also takes part in financing rounds for venture capital funds, such as that of Ventech, set up in 2012 (€75 million in total); that of Sofinnova Partners which also closed its fund in 2012 with a total of €240 million; and Elaia Partners which closed with a total of €45 million for investing in start-ups. In total, the parent of the FSI, CDC Entreprises, has holdings in nearly 260 venture capital funds, covering almost the entire range of French industry. In 2012 the French government, via the CDC, increased the Fonds National d’Amorçage (FNA) to €600 million, to invest in technological venture capital funds.

Beyond these European cases, several sovereign wealth funds could be potential partners of European –and Spanish– technology companies. Here we could sketch out a map, by way of illustration, of some potential players in search of opportunities in these sectors, and particularly interested in Europe.

Khazanah (Malaysia), owner of telecommunications operator Axiata, aims to open an office in Europe in 2013 to explore technology deals. Khazanah could be a partner for e-health projects throughout Europe and/or takeover bids in the new technologies, telecommunications and healthcare sectors. In 2012, its assets increased by an eye-catching 24% following the listing of IHH Healthcare Bhd. in May for more than \$2 billion; in January it acquired Turkey’s Acibadem Healthcare Group for \$1.7 billion. It currently manages more than \$27.9 billion.

Mubadala (UAE) is actively looking to promote an e-health cluster and to lay foundations with European partners to promote niches such as smart cities; M2M and smart grids are on its investment radar. Mubadala could be a partner for M2M projects, smart cities/smart grids in Europe. It has close to \$56 billion in assets under management.

CIC (China) has its sights set on Europe, and in the past already formed a strategic alliance with Intel Capital for global investments and start-ups. In May 2012 it took a stake in technology company

Alibaba. In June 2012, CIC bought Abertis’ stake in Eutelsat (part-owner of Hispasat) for €385 million. It has more than \$480 billion under management and aims to place \$50 billion in Europe.

Temasek (Singapore) is the major shareholder in SingTel and is greatly increasing the number of transactions with digital start-ups, technology operators and telecommunications infrastructure companies. Europe and Latin America are on its opportunity radar screens. In 2007, it led an investment of \$1 billion in Bharti Infratel, Bharti’s telecommunications tower operator<sup>36</sup>. In mid-2012, its strategist stated that Europe was a priority investment area for the future. It might invest as much as \$1 billion per transaction in industrial projects. It has nearly \$200 billion under management. It could be interested in a group with assets in both Europe and Latin America. It has offices in London, focusing on European transactions, and in Mexico and São Paulo, from where it studies Latin America.

To these funds we must add others that are evaluating investments in industrial operators or jointly looking at M&A deals and expansion. Such is the case of South Korea’s KIC (\$42.8 billion) and Abu Dhabi’s Aabar Investments (\$10 billion in assets) which holds more than 9% of Daimler and has already invested in Spain in the past (in Santander). It is also the case of Mumtalakat (\$8.8 billion), the sovereign wealth fund of Bahrain (the private equity section of which is headed by a Hispano-American, Argentine Pablo Fetter). Mumtalakat has stakes in Batelco, the national telecommunications operator with a presence in various Arab and African countries. The Kuwaiti fund KIA<sup>37</sup>, entered the nuclear energy sector, taking a 4.8% stake in France’s Areva in 2010, and the luxury high-tech automotive sector with its 6.9% stake in Germany’s Daimler, according to data from Preqin. KIA has also invested via venture capital in funds such as ICICI Venture<sup>38</sup>, a subsidiary of Indian bank ICICI.

### Conclusions

Sovereign wealth funds no longer look solely at assets linked to commodities or financial service sectors as they did in the past. They are investing, as shown in this chapter and others of this report, in “alternative” assets beyond fixed income or equities, but also increasingly in real estate, infrastructure, private equity and even in technology start-ups, as we have seen. Only the most sophisticated sovereign wealth funds are capable of undertaking these complex investments. In Africa, for example, where the phenomenon of sovereign wealth funds is going through an unprecedented boom, with nearly 20 funds created

<sup>36</sup> Temasek has invested \$500 million in Bharti Infratel, with 30,000 telecommunications towers. Temasek continues to occupy a place on the board of Bharti Infratel.

<sup>37</sup> See <http://www.kia.gov.kw/En/Pages/default.aspx>

<sup>38</sup> See <http://www.iciciventure.com/>

or in the process of being created in 20 of the continent's countries, they are still essentially invested in fixed income assets or equities and very fond of government bonds or blue chips, some of them European, as in the case of the Angolan or Libyan funds.

Sovereign wealth funds' appetite for strategic and industrial investments comes from the Middle East and Asia, where the most sophisticated funds now seek added value, build research centres and develop industrial champions. And they are doing this in sectors such as aerospace, telecommunications and other cutting-edge industries. Moreover, these funds are increasingly seeking direct investment. In this way they avoid intermediaries and reduce operating risk, since these are directly linked to strategic industrial partners. The agreements entered into by Mubadala with US multinationals such as GE and HP bear eloquent testimony to this trend, as do those with Europe's EADS, Sener and Indra.

The determination to continue to build positions in technology sectors was confirmed towards the end of 2012 when it increased its stake in the capital of US technology company AMD (Advanced Micro Devices); Mubadala became, with 19% of the capital, the major shareholder in the California-based company. Some deals were not completed (for example the purchase of 71% of Spanish aviation component and structure manufacturer Aernnova, aborted in mid-2012<sup>39</sup>). All these transactions show the growing interest in cutting-edge technological and industrial assets, in particular in OECD countries, whether in the US or in Europe.

It is also important to stress the investor appetite of certain emerging countries, such as China in particular, for the industrial and technological heartland of Europe: Germany. In 2011, China surpassed the USA as the leading industrial investor in Germany, with a total of 158 industrial projects (20% of the total) ahead of the USA's 110. Medium-size companies in Germany's 'Mittelstand', Germany's industrial core, such as Kiekert, Putzmeister and PC maker Medion, fell one after another under the control of Chinese companies. Some of the biggest deals in Europe took place further North, in Sweden, with the acquisition by China's Geely of Swedish automaker Volvo in 2010 for more than \$1.8 billion<sup>40</sup>.

What opportunities for Spain does this growing interest of sovereign wealth funds in cutting edge sectors bring with it? There are three kinds of opportunity. The first is purely financial. The more passive sovereign wealth funds such as that of Norway can find assets to invest in leading technology companies such as Telefónica, Amadeus, or Indra, and even in industrial sectors that are also intensive in innovation and new technologies or energy sources such as Iberdrola, Acciona or Abengoa. Also, and this is the second opportunity, they can seek alliances of a more strategic and industrial nature, as they have already done with Iberdrola, Indra and Sener. Lastly we should point out that Spain could capitalise on its hosting, throughout almost the whole decade 2010 to 2020, the World Mobile Congress, a major event of the digital and telecommunications industry. Why not imagine an Innovation Forum under this umbrella, bringing together sovereign wealth funds and digital, technology and telecommunications industries?

In this way Spain would lay the foundations for a brand, a positioning, centred on innovation and technology. This new positioning would allow long-term interaction between industrial and financial players in search of opportunities. Furthermore, it could be the entry point to Europe for certain strategic funds such as Khazanah or Mubadala that so far have no European office and who could set up in Madrid or Barcelona (an idea that we already stressed in the first report). All this would prepare us for what will without doubt be the future rise, not just of these sovereign wealth funds in search of financial and strategic investments, but also their ever greater enthusiasm for finding technology niches and companies in which to invest and on which to build value chains in their countries of origin. Countries which, sooner than we might think, will become markets for many European technology companies, particularly Spanish, if indeed they are not already...

<sup>39</sup> The Basque group Aernnova, formerly Gamesa Aeronáutica, has more than 4,000 employees with nearly 18 plants and engineering centres spread over several Spanish regions, the USA, Mexico, Romania and India. Its total annual billings are around €450 million. The price asked for 71% of the group was more than €500 million, which Mubadala considered too high.

<sup>40</sup> On the rise of Chinese investments in Europe (including Spain), see the work of Ivana Casaburi and Adrián Blanco Estévez, "China-Europe-Spain: the awakening of Chinese companies' investments in Europe and Spain", ESADEgeo Position Paper 29 January 2013.



**Patrick J. Schena**

Adjunct Assistant Professor, Fletcher School, Tufts University

Senior Fellow and Co-Head, SovereignNet, Fletcher School, Tufts University.

# Financing the expansion of global energy: the role of SWF investment as strategic private equity



## 8. Financing the expansion of global energy: the role of SWF investment as strategic private equity

### 8. FINANCING THE EXPANSION OF GLOBAL ENERGY: THE ROLE OF SWF INVESTMENT AS STRATEGIC PRIVATE EQUITY<sup>1</sup>

#### Introduction

By any measure, the role of the energy sector in any economy has strategic implications for both economic development and national security. Countries that are predominantly or rapidly emerging energy consumer nations struggle to sustain economic growth, while insuring adequate access to future energy sources. In many such countries, the energy sector is controlled or dominated by state-owned or government-linked corporations, further adding to the complexity of strategic sourcing. Countries that have long been energy producers, particularly those of the Persian Gulf region, face a different set of strategic challenges. For them, energy revenues have been a significant and critical contributor to public finance<sup>2</sup>. However, because their long-term growth is linked to depleting real assets, they have sought first to transform their energy wealth into deployable financial assets and then to diversify their economies to support long-term multi-sector sustainability. Here too governments are the key actors in this strategic transition, controlling real, productive, and financial assets through sovereign or government-linked entities.

The strategic consequences associated with both the production and consumption of energy have been accentuated in recent years as the world has undergone a quiet revolution in energy sourcing. Technological advances have facilitated access to “unconventional” sources of both oil and gas, even as renewables become more economically viable. These developments have the potential to significantly modify the structure of global supply and demand for energy and so the economics that in part drive energy security. This shift promises to be especially impactful in the case of the US, where dramatic increases in the production of shale oil and gas have already reduced imports and further increase energy diversity, while potentially even converting the US into a net exporter in the future. More broadly the macro-economic implications of unconventional sources, particularly for consuming economies, will have global impacts as the combination of transferrable technology and distributed source rock increases the potential that other economies will have the opportunity to reduce their dependence on imported energy over time<sup>3</sup>.

Forward-looking estimates for future investment to develop the global energy sector vary widely, but are generally consistent with

respect to the enormity of the overall scale. Whether McKinsey Global Institute, who estimates the power component of cumulative global infrastructure investment to be close to \$10 trillion by 2030, or the International Energy Agency<sup>4</sup>, who estimates cumulative upstream oil and gas investment at \$15 trillion by 2035<sup>5</sup>, the scale of future energy investment is well beyond the capacity of the private sector alone to fund. Rather global energy investment necessarily requires active state engagement to facilitate scalability, insure geostrategic access, transcend investor horizons, and mitigate geopolitical risk.

Given the transitional nature of global energy sourcing and the tight link between energy use and economic development, long-term returns on investment across key components of the sector—unconventional sources, renewables, and both up and down stream services—are attractive to institutional investors who anticipate expanding energy usage along with the sustained growth of emerging and frontier economies. Bain & Company’s most recent annual study on global private equity<sup>6</sup> reports that the energy sector has become a “magnet” for private equity as evinced by the growth of new sector-focused funds and the volume of both M&A and new direct investment. Whereas prior to 2009 much of the new investment in energy was concentrated in the power and utility subsector, since then renewables and other components of the oil and gas value chain—including oilfield equipment and services—have attracted sizable direct investment. Bain expects this trend to continue, driven in part by annual worldwide capital and operating expenditures within the industry of over \$1 trillion. Similar sentiments have been expressed by Chia Song Hwee, Temasek’s Co-Head of Portfolio Management, who sees energy and resources as a “growth segment” with “great long-term potential”<sup>7</sup>.

The similarities, and in fact synergies, between private equity and large sovereign wealth funds (SWFs) have been widely acknowledged. Those funds with both the capacity and scale to maintain direct investment programs augment asset allocation strategies, supplementing PE limited partnership investments with in-house managed portfolios. Like their private counterparts, SWFs too have been attracted to the energy sector, having directly invested USD \$75-100 billion by some estimations<sup>8</sup>, much of this since 2009. SWFs expend considerable effort to establish themselves as financial investors and to disavow association with multi-impact or “double bottom line” investing, particularly when perceived to involve the geopolitical interests of the sovereign.

<sup>1</sup> The author wishes to thank Michael Joyce, MIB candidate at the Fletcher School, for his research assistance and technical expertise.

<sup>2</sup> See Sven Behrendt, “Beyond Oil: Global Energy Security and Sovereign Wealth Funds”, 26 July 2010, accessed at [http://www.ensec.org/index.php?option=com\\_content&view=article&id=252:beyond-oil-global-energy-security-aamp-sovereign-wealth-funds&catid=108:energysecuritycontent&Itemid=365](http://www.ensec.org/index.php?option=com_content&view=article&id=252:beyond-oil-global-energy-security-aamp-sovereign-wealth-funds&catid=108:energysecuritycontent&Itemid=365).

<sup>3</sup> Lisa Hyland, et al, “Realizing the Potential of U.S. Unconventional Natural Gas”, *Center for Strategic & International Studies*, April 30, 2013, p 4.

<sup>4</sup> See McKinsey Global Institute, “Infrastructure Productivity: How to Save \$1 Trillion a Year”, January 2013.

<sup>5</sup> See International Energy Agency, “World Energy Outlook 2012 Executive Summary”, accessed at <http://www.iea.org/publications/freepublications/publication/English.pdf>.

<sup>6</sup> See Bain & Company, “Global Private Equity Report 2013”, pp 32-34.

<sup>7</sup> “Temasek Spends More on Investments, Adds Energy Holdings”, *Bloomberg* 5 July, 2012.

<sup>8</sup> See UN Conference on Trade and Development, “World Investment Report 2012”, particularly, pp 13-16 and Table 1.6.

However, as a practical matter, it would be naïve and perhaps disingenuous to consider SWF investment in energy-related projects in strictly financial terms. In this short brief, our objective is rather to examine SWF investment in the energy sector as strategic private equity.

### The Case of SWF Investment in Energy

To assess the scope and scale of SWF investment in the energy sector, we conducted a detailed empirical analysis of direct investments by SWF in related energy subsectors using the Fletcher SWF Transaction Database<sup>9</sup>. The database was supplemented with fund host country macro-economic data in order to better understand the relationship of the fund to the domestic energy profile of the SWF host country. We identified over 200 individual SWF transactions in the energy sector since 1986. For purposes of the present analysis, we further constrain our study from 2004 to the present. We found that this period contained nearly 80% of the total transactions in our sample and allowed us to better isolate a structural transition that appears to be underway in energy investment.

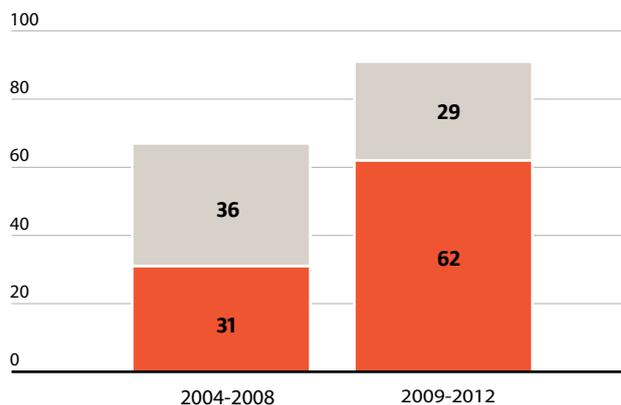
First to note, we are able to trace 94% of the transactions since inception to ten funds in six countries, which divide conveniently along consumption/production lines. Funds from consumer countries include the China Investment Corporation, Government Investment Corporation of Singapore and Temasek (both from Singapore), and Korea Investment Corp. Among producers funds include Abu Dhabi Investment Authority, International Petroleum Investment Corporation, Istithmar, and Mubadala (all of UAE), Kuwait Investment Authority, and Qatar Investment Authority. Taken together these ten funds constitute over \$2 trillion or nearly 40% of the approximately \$5.5 trillion of total assets managed by SWFs globally. Taking the global financial crisis of 2008 as a natural inflection point, we further segmented the sample from 2004-08 and 2009-2012, along the lines suggested by Bain for private equity. We find (see Chart 1) that whereas funds from both producer and consumer countries invested equally in total deal count prior to the crisis, in its aftermath, funds from consumer countries, led largely by Temasek and the rapid emergence of the CIC and KIC, have outpaced investment by their producer counterparts by over 2 to 1.

<sup>9</sup> The database was originally created by the Monitor Group.

Chart1  
Ten most active SWFs

Number of transactions by country type

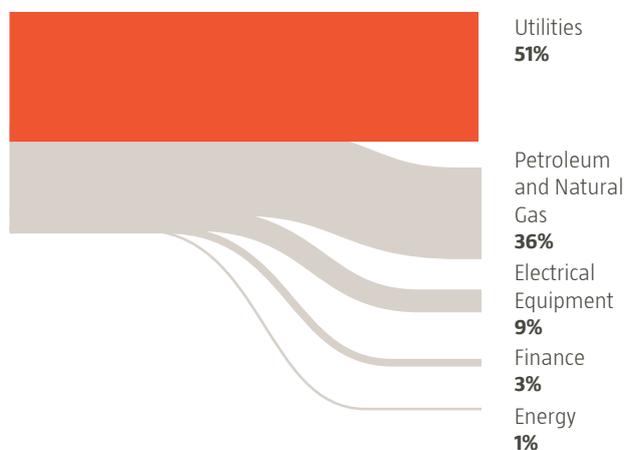
● Consumer ● Producer



Source: The Fletcher SWF Transaction Database (2013)

Also, consistent with the Bain analysis for PE generally, sectoral allocation of SWF investment in energy has also shifted markedly since the financial crisis. As indicated in Chart 2, in the years preceding the financial crisis, over 51% of SWF energy-related transactions were in utilities, followed by investments in petroleum and natural gas. During this period Temasek and Mubadala were among the most active investors in both subsectors.

Chart2  
Allocation of SWFs Energy Transactions (2004-08)



Source: The Fletcher SWF Transaction Database (2013)

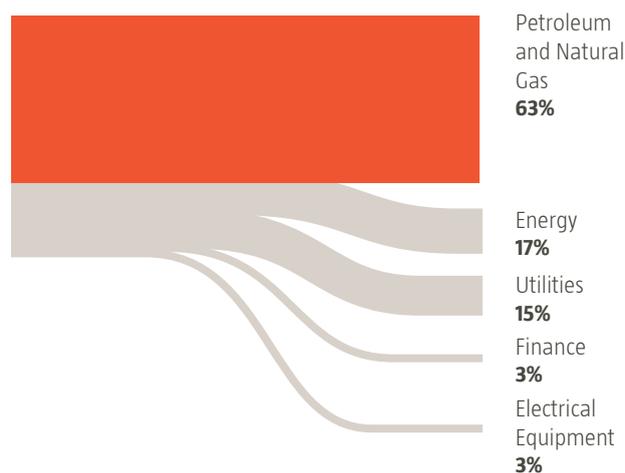
## 8. Financing the expansion of global energy: the role of SWF investment as strategic private equity

Since the crisis, SWFs have shifted investment away from the utility subsector to petroleum, gas, and other energy related projects (see Chart 3). This is reflective of the technological and production advances in unconventional sources, but also substantially increased interest in renewables, as a source of strategic diversification. In this period, nearly 80% of total transactions consist of resource and other energy-based deals, including renewables. Investments by SWFs of the Asian consumer countries dominate the former as these countries attempt to diversify from strategic sourcing perspective. An interesting representative example is Temasek's recent investment to establish Pavilion Energy Pte. Ltd. to diversify its resource economy and increase its energy assets. Pavilion will focus on the liquefied natural gas (LNG) industry and specifically invest in upstream project development, storage and re-gasification terminals, and LNG shipping<sup>10</sup>.

Conversely, funds from producer countries have shown considerable interest in the renewable energy sector as a means to diversify their economies away from a continued dependence on hydrocarbon revenues<sup>11</sup>. Representative of the latter is the UAE's attempt to establish a center of excellence in renewable energy working through Mubadala's investment in Masdar, established in 2006. Masdar is a wholly owned state-enterprise of Mubadala, whose mission is to serve as "a catalyst for the economic diversification...guided by Abu Dhabi Economic Vision 2030"<sup>12</sup>. Recently Abu Dhabi and the UK announced the signing of a memorandum to establish a co-investment framework between Masdar and the UK's Green Investment Bank to facilitate investment in renewable projects in the UK<sup>13</sup>. Similarly, in Qatar, a major source of global natural gas reserves, the QIA shares a diversification mission and has similarly embraced the renewable sector. Representative of its investment agenda in the subsector are deals on the Iberian Peninsula with Iberdrola (Spain) and EDP (Portugal)<sup>14</sup>.

Chart 3

### Allocation of SWFs Energy Transactions (2009-12)



Source: The Fletcher SWF Transaction Database (2013)

Finally, from a locational or geographic perspective, the deals in our sample are overwhelming outbound (80%) to the investing fund, i.e. there is little evidence of home bias by SWFs in the sector. In some respects this is consistent with the strategic nature –particularly source diversification– of the transactions. Geographically (see Chart 4), North America, Asia, MENA, and Europe have experienced the highest intensity of deal and capital flows. Among funds in consumer countries, perhaps expectedly, North America and Asia dominate. Among funds in producer countries, again perhaps expectedly, Europe, MENA, and Asia have attracted the majority of deals.

<sup>10</sup> "Singapore's Temasek Launches New Firm for LNG Investments", *Reuters*, 5 April 2013.

<sup>11</sup> Simone Tagliapietra, "Investing In the Energy Sector: Evidence from China and The Gulf", *Polinares Working Paper*, N° 76, 12 December 2012.

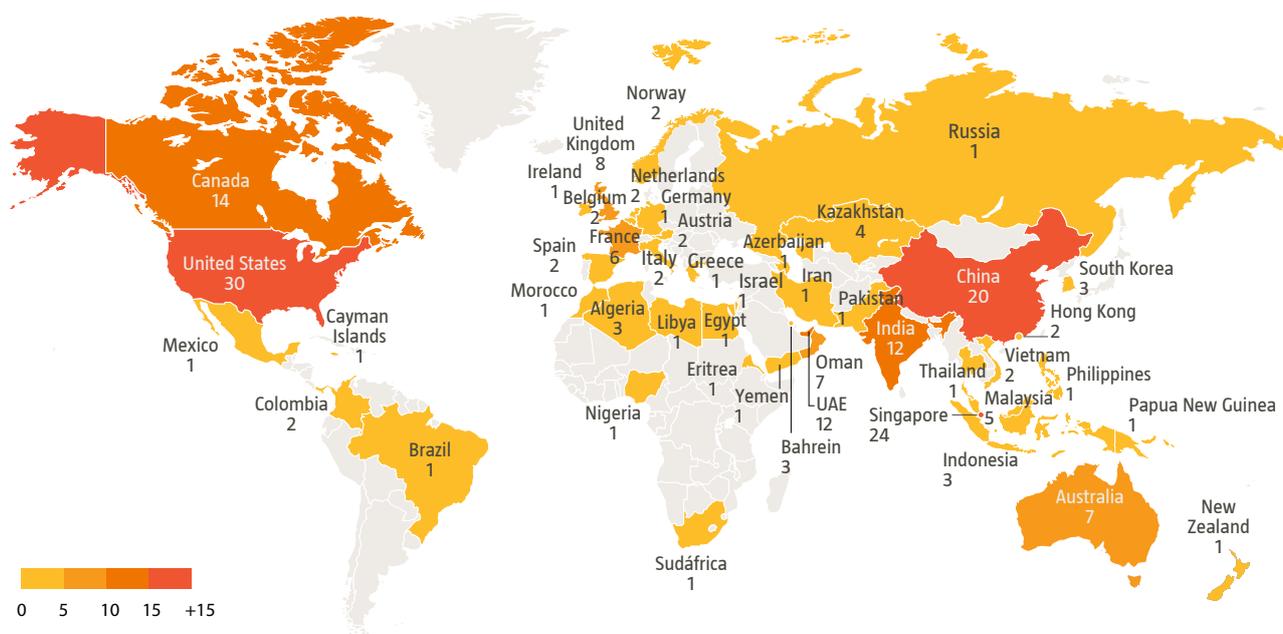
<sup>12</sup> See <http://www.masdar.ae/en/masdar/detail/launched-by-the-abu-dhabi-leadership-in-2006-with-the-mission-to-advance-re>.

<sup>13</sup> "Abu Dhabi Posed for UK Clean Energy Deal", *Financial Times*, 29 April 2013.

<sup>14</sup> Tagliapietra, *op cit*.

Chart 4

## Number of Deals by Country



Source: The Fletcher SWF Transaction Database (2013)

### SWFs as Strategic Private Equity

SWFs –most especially the large funds that actively participate in global energy investment– occupy a unique position as global institutional investors with inherent competitive advantages. These funds are not burdened with substantial short-term liabilities and so generally have low liquidity requirements. For this reason they have the potential to enjoy longer effective investment horizons and exploit liquidity premia that other investors must pay. In addition, longer investment horizons also afford SWFs some insulation from the volatility of equity returns and thus better equip them to harvest equity risk premia<sup>15</sup>. This is especially true when investing in alternative asset classes and especially private equity. Importantly, it is these same attributes that enhance the appeal of SWFs as investment partners –both for private equity portfolio companies and co-investors.

Unlike other investment managers, SWFs are also unique in having asset owners whose interests are intimately linked with those of the state as a whole and whose stewardship over the assets is not

isolated simply by virtue of the organizational distance that a SWF structure provides. Thus, funds may also share non-financial objectives of their stakeholders, particularly those related to advancing national strategic economic goals. Dyck and Morse, in studying the portfolio decisions of SWFs, construct a model of portfolio choice, which attempts specifically to assess the role of strategic economic or state planning interests in motivating SWF asset allocation decisions. They use the existence of a national strategic plan in the SWF’s host country –as in the case of Abu Dhabi’s Economic Vision 2030– as their proxy for strategic motivation and find evidence that SWFs do in fact share the national strategic planning objectives of the state and reflect these in their investment decisions<sup>16</sup>. Interestingly, the access to state resources and other state assets<sup>17</sup> –including political resources– that strategic private equity may afford the SWF, can add further to its competitive advantages as a global investor.

Haberly<sup>18</sup> examines this aspect of SWF strategic behavior. He defines strategically oriented SWFs as those who seek to advance both

<sup>15</sup> Scott E. Kalb, “The Growing Trend in Cooperation among Sovereign Wealth Funds”, latter published in Donghyun Park, *Sovereign Asset Management for a Post Crisis World*, 2011. At the time of his writing, Kalb was Chief Investment Officer of the Korea Investment Corporation.

<sup>16</sup> Alexander Dyck and Adair Morse, “Sovereign Wealth Fund Portfolios”, *Initiative on Global Markets, University of Chicago, Booth School of Business, Working Paper No. 61*, 2011.

<sup>17</sup> We include here as well strategic political intelligence.

<sup>18</sup> References here are to Daniel Haberly, “Strategic Sovereign Wealth Fund Investment and The New Alliance Capitalism: A Network Mapping Investigation”, *Environment and Planning A*, 2011, Vol 43, pp1833-1852.

## 8. Financing the expansion of global energy: the role of SWF investment as strategic private equity

shareholder value, in the form of financial return, but also national stakeholder value through the development of specific relationships, which advance national, particularly economic, interests. Furthermore he moves beyond the strategic motivations of any single fund to consider the role of the SWF—through investment and operating partnerships—to operationalize the globalization of the sovereign's strategic agenda. In doing so he elevates various network-based affiliations between the state and corporate sectors into an emerging system of 'state-led global alliance capitalism', which integrates the objectives of the SWF with those of recipient states and their multinationals. In this system, the SWF leverages its competitive advantage by offering stable, long-term capital, a degree of political risk mitigation, and access to expanded business opportunities both within and beyond its jurisdiction, in exchange for improved access to technology, resources, or markets.

Conceptually, some of what Haberly describes, in the broader context of state-corporate relations, can be understood as a logical extension of the development role of the state, particularly in Asia. The developmental state has long been studied as a vehicle to mobilize scarce resources for rapid national economic development. Discrete state entities, including state-owned or government-linked enterprises, planning agencies, and financial or economic ministries have been active direct and indirect investors, encouraging the contribution of private capital into state-sponsored projects through commitments of both financial and political resources<sup>19</sup>. As SWFs have proliferated particularly since 2000<sup>20</sup>, they have taken a place in this national development agenda<sup>21</sup>, which positions them squarely in the global nexus of states, private capital, and global corporates.

### Co-Investor as Strategic Partner

Bain & Company view SWFs as attractive investment partners because, whether through energy revenues or surplus foreign currency reserves, they hold large and expanding pools of capital, which they seek to deploy in higher-earning alternative investments. Beyond capital, SWFs enjoy great appeal to private equity general partners (GP) as they represent patient capital invested over long time horizons that can participate as a traditional limited partner or as co-investor, but can also offer ancillary benefits in the case of mutual interest in a target company. Bain estimates that the 10 largest SWFs could invest between \$30 billion to \$60 billion in private equity over the next several years.

SWFs also acknowledge the benefits of strategic partnering through direct co-investment. According to Scott Kalb, former Chief Investment Officer of the Korea Investment Corporation, these include the ability to establish economies of scale through direct investment, generally lower transaction costs attributable to shared due diligence expenses and fewer fees to private equity GPs, risk reduction through joint monitoring and pooling of shared interests, and mitigation of political risk that may result from perceived conflicts of interest with recipient country stakeholders.

Given the strategic dimensions of the global energy sector and the scope and scale of current and future required investment, we further dissected our energy transaction sample for evidence of networked strategic partnering. Our approach was to focus on co-investment patterns exclusively in the global energy sector involving SWFs, particularly since the financial crisis. We identified 19 transactions (see Table 1) with a SWF at the center of the deal, which involved a co-investment partnership. The nature of the co-investment alliance varied with respect to institutional participation. However, consistent with Haberly, we were able to identify a large and extensible system of alliances that intersect public and private sector institutions—government, financial, and corporate.

<sup>19</sup> To clarify, globalizing the development model in East Asia through state investment seemed always part of the state's agenda. A case in point is the author's involvement in the early development of the venture capital industry in Taiwan (ROC), where the ROC Ministry of Finance sponsored and participated as limited partner in an early stage VC fund, managed by a US technology multinational as general partner. The MoF was motivated both by the need to promote a local VC market and access to technology-based DFI and foreign markets for Taiwan's value-added technology products. Its participation and "guidance" led over twenty of the largest Taiwanese corporations joining as limited partners.

<sup>20</sup> For a detailed analysis of the buildup of SWFs, see Eliot Kalter and Patrick J. Schena, "Into the Institutional Void: Managing the Sovereign Wealth of Emerging Economies", forthcoming as a chapter in *Investing in Emerging and Frontier Markets*, Euromoney Books, 2013.

<sup>21</sup> It is important to caveat that this role—especially in the case of Asian SWF—is not tightly integrated from a development perspective and still evolving. See for example, Saadia M. Pekkanen and Kellee S. Tsai, "The Politics of Ambiguity in Asia's Sovereign Wealth Funds", *Business and Politics*, Vol. 13 [2011], Iss. 2, Art. 3.

Table 1

## Selected Energy Co-Investment Deals

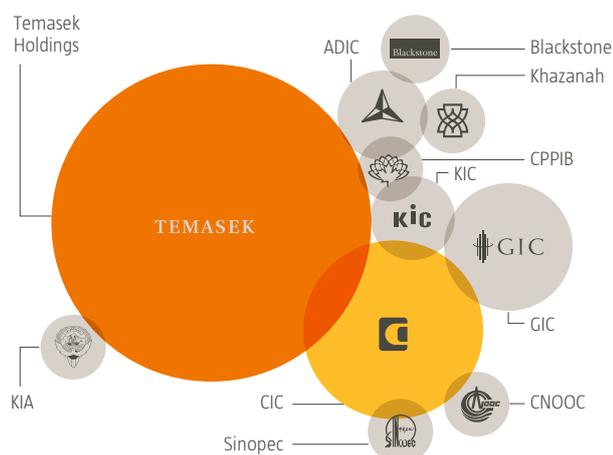
Investment	Investors	Country of Target	Sector	Year
Amyris	Temasek, Total Gas & Power USA, SAS, Naxyris SA, Bolding Investment SA	USA	Energy	2012
Barclays Natural Resource Investments	QIA, Qatar Asset Management Company, Qatar Financial Centre Authority	UK	Finance - Nat Rsc PE Fund	2012
BG Group Project	CIC, CNOOC Group	Australia	Petroleum and Natural Gas	2012
Cheniere Energy Partners	CIC, GIC	USA	Petroleum and Natural Gas	2012
Sunshine Oil Sands	CIC, Sinopec Group, EIG Global Energy Partners	Canada	Petroleum and Natural Gas	2012
Tamar Energy	Brunei Investment, ADIC, Khazanah, and the Al Subeaei Group, RIT Capital Partners plc, and Fajr Capital	UK	Energy	2012
CITIC Resources	Temasek, KIA, NSSF, BTG Pactual, Fubon Life Insurance, Och - Ziff Capital Management, NSSF	China	Petroleum and Natural Gas	2011
Consortium 5 Power Plants	GIC, Arclight, GE Energy	USA	Utilities	2011
Enogex Holdings LLC	CIC, GIC, John Hancock Financial Services, Northwestern Mutual Life Insurance Company, Arclight	USA	Petroleum and Natural Gas	2011
Frac Tech	ADIC, KIC, Temasek, RRJ Capital	USA	Petroleum and Natural Gas	2011
Gassled	ADIA, CPP Investment Board, Allianz	Canada	Petroleum and Natural Gas	2011
Helioscentris Energy Solutions	KIA, Life Energy	Germany	Energy	2011
Huaneng Renewables	CIC, Temasek, GE	China	Energy	2011
Osum Oil Sands Corp.	KIC, GIC, KERN Partners, Warburg Pincus, Blackstone Partners, Camcor Partners	Canada	Petroleum and Natural Gas	2011
SolarEdge	Temasek, Norvest Venture Partners, GE, Opus Capital, Walden International, Genesis Partners, Lightspeed Venture Partners	Israel	Energy	2011
Chesapeake Energy Corp.	CIC, KIC, Temasek, ADIC, Blackrock, Hopu Investment	USA	Petroleum and Natural Gas	2010
Laricina Energy Ltd	KIC, CPPIB	Canada	Petroleum and Natural Gas	2010
SouthGobi Energy Resources Ltd	CIC, Temasek	Canada	Petroleum and Natural Gas	2010
China Gas Holdings Ltd	Temasek, Oman	Hong Kong	Petroleum and Natural Gas	2005

Sources: Fletcher SWF Database, Capital IQ

## 8. Financing the expansion of global energy: the role of SWF investment as strategic private equity

Chart 5 illustrates the significant concentration of direct energy investments through nested consortia primarily clustered around Temasek and CIC. When analyzed in conjunction with Table 1, the alliance patterns reveal significant SWF partnering between and among: 1) other SWFs; 2) private equity general partnerships, e.g. Hopu Investments, RRJ Capital; 3) large national and provincial pension funds, e.g. Canada Pension Plan Investment Board (CPPIB), 4) divisions of independent private sector corporates, e.g. GE Energy; 5) state-owned enterprises, e.g. CNOOC and Sinopec; and 6) portfolio companies, e.g. BTG Pactual, Blackstone.

**Chart 5**  
Selected SWF-Centric Co-investment Clustering 2010-2012



Source: The Fletcher SWF Transaction Database (2013)

Beyond simply co-investment per se, the investment patterns and structures of strategic partnering that emerge from these transactions suggest a robust foundation that is capable of supporting the mobilization of large-scale investment in global energy. For example, while the selected transactions are largely concentrated in the resources sector in North America, they also suggest the potential to partner across regions and energy subsectors.

Deal structures are diverse and include not only investments in public companies, IPOs, and private projects, but also greenfield deals. Deal-specific participation too is flexible and may include various combinations of SWFs, PE funds, and other institutional investors. Notable examples of well-publicized public deals include Chesapeake Energy and Cheniere Energy, both US publically-listed companies in natural gas and related subsectors. Both deals involved wide participation by SWFs. The former, concluded in 2010, included ADIC, CIC, KIC, and Temasek, in

addition to PE investors Blackstone and Hopu Investments, as well as Franklin Templeton. Cheniere was co-invested in 2012 by CIC, GIC, and once again Blackstone - a CIC portfolio company, it is important to note. With respect to greenfield investing, GIC also partnered with GE Energy Financial Services and Arclight Capital, an energy-focused private equity firm, to consolidate five Georgia natural gas-fired power plants to form the largest independent power producer in the southeastern US<sup>22</sup>.

While all deals involve financial investment at their core, many are accompanied or followed by production, operating, or supply arrangements by affiliates of the investors, whether state-owned enterprises or divisional counterparts (as in the case of GE noted above). We focus here on two noted examples involving CIC either directly or indirectly in partnership with Chinese state-owned oil companies Sinopec and CNOOC. In 2012, CIC joined Sinopec and China Life Insurance to participate in the Hongkong IPO of Canadian-based Sunshine Oilsands. Sinopec had previously signed an agreement to develop a joint venture with the company and has been exploring ways to accelerate exploration and production<sup>23</sup>. CNOOC, an investor in BG Group's LNG project in Australia, recently announced a 20-year gas purchase agreement with the company. It is believed that both CIC and SAFE Investments independently hold stakes in BG.

Deal sponsorship and leadership also vary as a function of the interests and expertise of the investing parties. For example, Temasek, with considerable experience and substantial leadership in the sector, will participate in deals organized by others. Here it is interesting to point out the active leadership of a private investor group, with ties to Temasek, in organizing and structuring large-scale energy deals particularly involving Asia SWFs. RRJ Capital, led by brothers Richard and Charles Ong, is a Hong Kong-based private equity fund focused on China and Southeast Asia. Richard Ong was founder and CEO of Hopu Investments, which was instrumental in structuring the 2010 private transaction to fund Chesapeake Energy previously noted. Charles Ong, prior to joining RRJ, spent 10 years at Temasek, holding several executive positions including Chief Investment Officer and Chief Strategy Officer. Since forming RRJ, the Ong's have participated in the Cheniere deal also noted earlier and as well have played a lead role in organizing a USD 3.5B investment for a 70% stake in Frac Tech, which provides hydraulic fracking services. The deal included KIC and CPPIB, in addition to RRJ and Temasek<sup>24</sup>. The remaining 30% of Frac Tech –interestingly– is held by Chesapeake Energy.

<sup>22</sup> <http://www.arclightcapital.com/News/Press-Releases-Articles/ARCLIGHT-TEAMS-WITH-GE-AND-SINGAPORE-S-GIC-TO-FORM.aspx>.

<sup>23</sup> "Sunshine Oilsands Favors a Venture With Sinopec to Tap Oil Sands", *Bloomberg*, 16 Aug 2012.

<sup>24</sup> "Frac Tech Got \$3.5 Billion", *The Wall Street Journal*, 13 May 2011.

Finally, as in any private equity transaction, post investment monitoring is critical to insure effective review and governance. Once again monitoring structures vary from full board participation to more passively oriented arrangements. Because of de facto government involvement in any transaction involving SWFs and due to the sensitive nature of these affiliations, particularly in cases potentially involving national security, governance structures may take the form of indirect or delegated monitoring. An interesting case in this regard is CIC's participation in Cheniere. In this transaction CIC co-invested with portfolio company, Blackstone, among others. Blackstone was awarded board seats. CIC, for its part, deflected political pressure, by assuming a passive posture concerning governance. It does not sit on the Cheniere board, but rather monitors and influence indirectly in part through Blackstone<sup>25</sup>.

### Parting Thoughts

SWF investment in global energy is aligned with the current and emerging strategic energy imperatives of fund host countries. Direct investment in the sector is highly concentrated among the largest funds in major energy consumer and producer countries. The enormous scale of future investment to develop the energy sector requires the mobilization of both public and private resources—both real and financial—to meet the global challenges of universal energy access. SWFs, among the largest institutional investors globally, are well suited to lead investment in the sector because of their scale, long-term effective investment horizon, and ability to mobilize political resources to facilitate the operational extension of investment programs and to mitigate political risk. For these and other reasons they are also sought-after investment partners and co-investors.

SWFs have embraced the opportunities presented by structural shifts in global energy sourcing and have actively partnered with each other, other large global institutional investors, private equity funds, state-owned and government-linked corporations, and portfolio companies to scale deals, mitigate risks, but also to contribute meaningfully to other components of their host countries' strategic energy agenda particularly with respect to diversification. The pace of SWF investment in the sector has accelerated since 2008 and refocused in line with the technological and production advances in new energy sources. The success of strategic investment partnerships and other forms of co-investment will enhance deal flow among key investors. As SWF assets and capacity continue to expand and the number and size of in-house direct investment programs grow<sup>26</sup>, sovereign capital flows into global energy will continue on their current trajectory, if not accelerate further over the near horizon.

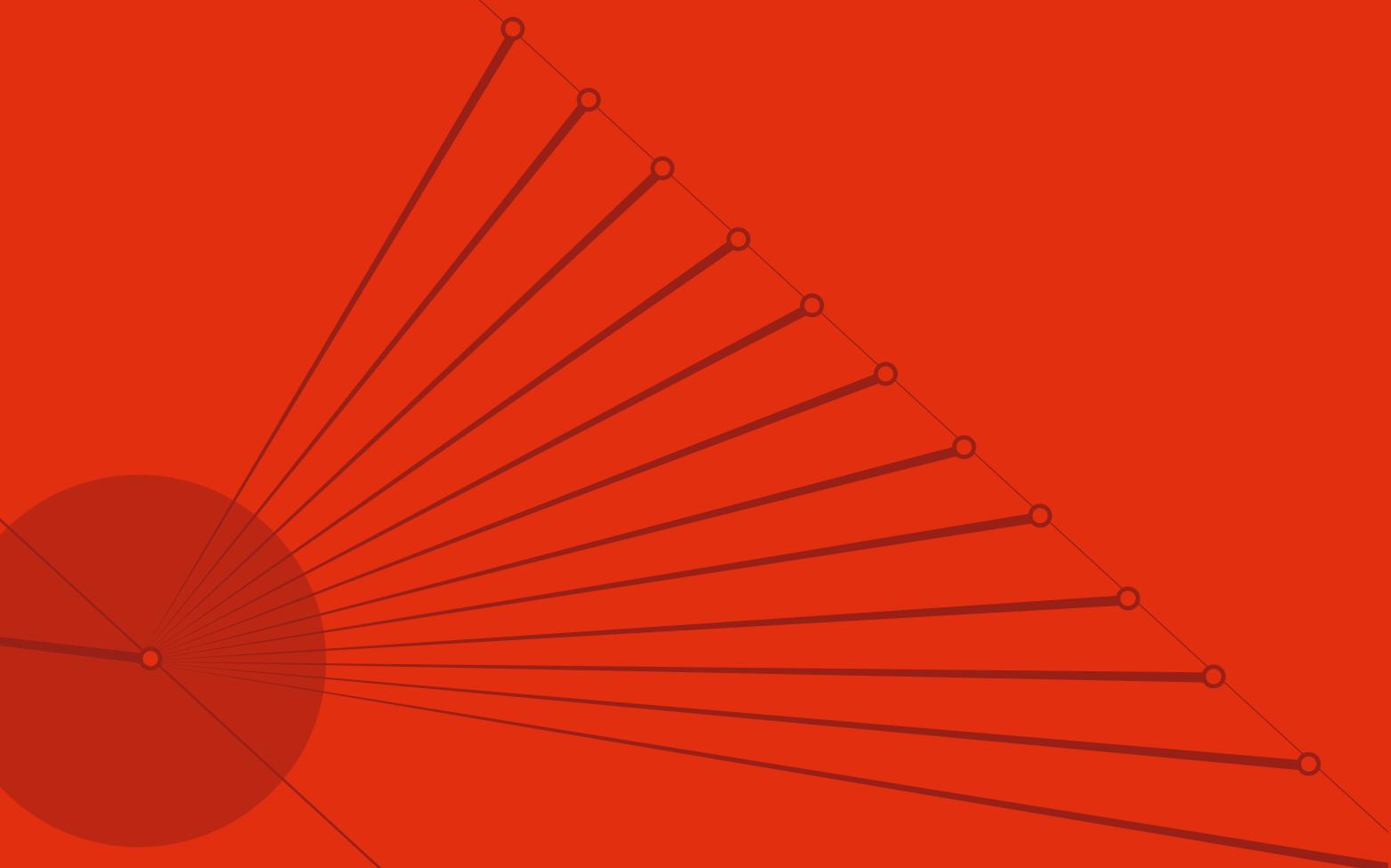
<sup>25</sup> "China Fund Invests in US Gas Export Plant", *Financial Times*, 21 August 2012.

<sup>26</sup> SWFs stand to benefit from significant cost savings by switching to insourcing private equity. Savings attributable to in-house programs have been estimated to be nearly 150 basis points (25 bp vs 165 bp for externally-managed programs). See "Insourcing' trend growing among big institutional investors", *Pensions & Investments*, May 13, 2013 accessed at <http://www.pionline.com>.



**Xavier Reig**  
CEO and Co-Founder, Black Capital

# Sovereign wealth funds and real estate



## 9. Sovereign wealth funds and real estate

### 9. SOVEREIGN WEALTH FUNDS AND REAL ESTATE

#### Introduction

Today's real estate market can be summed up in just two words: *core* and *complex*. Real estate has been one of the worst hit sectors in the global financial crisis. Investment<sup>1</sup> in 2012 amounted to 436 billion dollars, more than double the figure for 2009, but a long way short of the 2007 peak of 759 billion dollars. Since then, investors have been gradually retaking positions, bringing with them liquidity for certain asset classes and locations, but this has not yet spread to the whole of the market.

Given the generalised volatility in the markets and the current financial repression, the priority for capital has been seeking safe refuge rather than returns; not only have sovereign wealth funds been no exception to this, they have actually taken advantage of the situation.

We are talking about so-called "safe-havens". These are prime locations that are traditionally highly liquid, as they represent global financial hubs where leading multinationals have their bases. We are talking specifically of core assets, with very tight returns between 4% and 6%, where value—in addition to location—comes from the security of long-term cash flow from high-value tenants. In summary, these are prime locations in mature real estate markets, with a history of liquidity, price transparency, legal security and high-volume assets.

Whilst it is very difficult to get into such assets when the going is good, the recent financial turbulence led to payment problems for many owners, enabling sovereign funds to acquire strong positions in these unique assets as a result of two factors: their liquidity and their long-term business vision.

London is the best example in Europe; the 17 billion dollars invested there in 2012 dwarfed the 5.6 billion dollars invested in Paris and 3.5 million dollars in New York. The UK's capital has always been of great interest to Arab funds, but competition has now increased with the appearance of new Asian players, resulting in the transfer of the HQs of many leading financial entities to sovereign wealth funds since 2010, including: Bank of America (acquired by the Kuwait Investment Authority, KIA), Credit Suisse (Qatar Investment Authority, QIA) and HSBC (the State Oil Fund of Azerbaijan, SOFAZ).

Pressure on core European assets today comes from three sides. Firstly, we have Arab funds and their long history in Europe, for example KIA, the Abu Dhabi Investment Authority (ADIA), QIA and the Oman Investment Fund (OIF). Secondly, we have new Asian players, such as Permodalan Nasional Bhd, China Investment Corporation (CIC) and the Hong Kong Monetary Authority (HKMA), as well as the Norwegian fund managed by Norges Bank (NBIM). And finally, we have all the other risk-averse institutional players, who have moved their exposure to government bonds into core real estate products due to the spread between the returns on these asset classes in the current macroeconomic climate (Chart 1).

<sup>1</sup> Source: Jones Lang Lasalle-Global Commercial Real Estate Investment

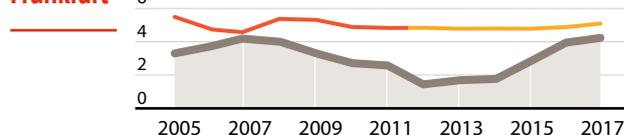
Chart1

European Office Yields vs. Bond Rates

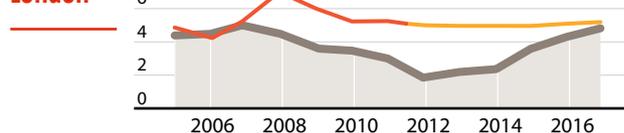
In percentages

● Bond Rate ● Prime Yield ● Forecast

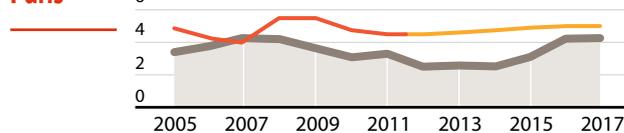
#### Frankfurt



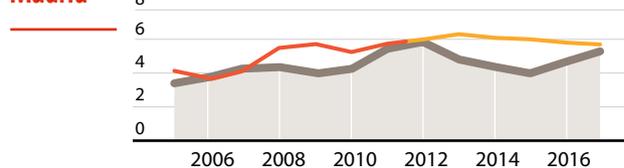
#### London



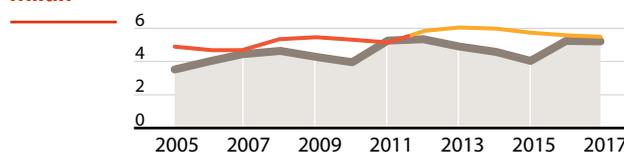
#### Paris



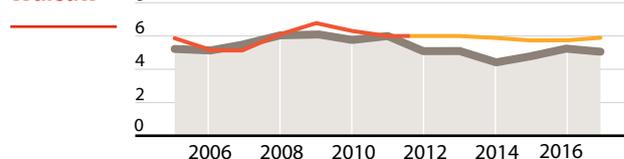
#### Madrid



#### Milan



#### Warsaw



Source: RREEF Real Estate, Global Insight, PMA.

As a result, the supply of such core, high-volume products in the most liquid European locations in 2013 is less visible and increasingly less profitable, although there are still opportunities. In London, yields on office products have fallen to 4.5% for prime locations; this is not due to occupation levels, but rather to an increased volume of bidders and scarcity of the product. Furthermore, if we factor in the depreciation of the pound, as with the yen, the yield falls to 3%. This compares with yields on similar products in Madrid and Barcelona of around 6.5 or 7%.

Only some sovereign wealth funds with a long-term investment horizon and unusual strategies are prepared to pay this price premium: these are non-market factors or new entrants who consider this a strategic step for consolidating their position in a new region. In cross-border deals, new players use London as a first stepping stone into Europe, before moving on, mainly to Paris, Frankfurt and Moscow.

The United States looks like setting the benchmark in 2013. This is being driven by the gradual recovery in its economy and an increased supply of core products with higher yields than premium European locations (around 6% in New York). New York, Boston, Washington, San Francisco and Los Angeles look to become the main destinations for capital. For example, at the start of the year, GIC paid 900 million dollars for a San Francisco tower, one of the city's landmarks.

The trend among the main real estate funds in 2013 is moving away from core strategies towards more complex, higher-risk deals with higher returns; these are known as value-added and opportunistic strategies.

There are three typical types of real estate investment strategies (Table 1). Defensive or core strategies involve buying low-risk assets. This means the asset is in a prime location, is in good condition and its tenants are triple A rated, preferably corporate, with long-term contracts. Leverage on such deals is low –not exceeding 40%– with returns in the range 4% to 6%. The investor is seeking constant, long-term cash-flow generation. Value-added strategies involve assets with lower occupation rates, resulting from poor management or the building's need for refurbishment: once these problems are resolved, the asset could potentially interest a core investor. Leveraging is usually between 40% and 70%, with returns of around 15%. Finally, opportunistic strategies. These require higher leverage (in excess of 70%) and more intensive management and value creation, whether because of needs for development, change of use, renovation, etc. This always requires the involvement of local specialists. In other words, these deals go beyond simply investing, and present a much higher risk as a result. They also include deals in emerging and at risk countries. These offer much higher returns, exceeding 18%.

Table 1

## Commercial real estate investment options

Investment Styles	Typical Fund Return Targets		Typical Fund Leverage
	Core Value-Add Opportunistic	4%-8% 14%-17% > 18%	40%-70% 40%-70% > 70%
Property Type Focus	Core Property Types	Non Core Property Types	
	Office Retail Multifamily Industrial	Hotels/lodging Healthcare/Senior housing Self-storage Other niche sectors	
Geographic Focus	Core Property Locations	Non Core Property Locations	
	High-barrier-to-entry urban locations Primary markets Developed countries/markets	Lower-barrier-to-entry urban locations Secondary/tertiary markets Developing countries/markets	

Source: Author's calculations and NEPC, LLC.

Sovereign vehicles invest in opportunistic deals indirectly, through investments in specialist real estate funds. Whilst some players are investing directly in eye-catching property developments –such as “Battersea Power Station” and “The Shard” in London–, these are just the tip of the iceberg. According to a study by the specialist American company CBRE<sup>2</sup>, direct investment accounts for only 40-50% of the total volume, with the remainder flowing towards holdings in real estate funds (30-40%), listed companies (5-10%) and debt (20-25%). There was a resurgence in opportunistic real estate investment funds in 2011 and 2012. The best example of this is the Blackstone Real Estate Partners BREP VII fund closing at 13 billion dollars, the largest in history, supported by over 250 global investors.

There have also been other major changes in the sector. Whilst Europe and the United States were the main recipients of real estate capital prior to 2008, Asia overtook America in 2011 thanks to the rise of new locations in emerging economies (China, India, Indonesia, Vietnam and Malaysia) and paralysis of investment in the United States. In 2013, Southern Europe continues to be a sterile location for growth, given its macroeconomic situation. Meanwhile, the rest of Europe and the United States have been on the up since last year, attracting large volumes of both local and international capital, particularly in core and opportunistic strategies, but always in prime locations.

Emerging Asia is the hotbed of new global players in the world of sovereign wealth funds. The experience acquired in regional real

<sup>2</sup> Source: CBRE Global View Point- Sovereign Wealth Funds 2008.

## 9. Sovereign wealth funds and real estate

estate development, with highly complex activity, has enabled these funds to take on more mature and previously unexplored markets for them in Europe, America and Australia directly and confidently, in search of both alpha and beta. Whilst European and American investors appear doubtful about taking firm positions through direct investment in emerging Asian markets, Arab investors –being more in touch with both– are positioning themselves very actively.

In short, we are faced with a totally polarised real estate market in traditional European and US locations. Capital is only flowing to prime locations, gradually putting pressure on core product prices, forcing capital to move towards higher-risk opportunities in the same locations, with secondary locations remaining off the radar of international capital. Table 2 shows the 25 top deals in Europe in 2012.

Table 2

### Top 25 deals Europe 2012

#	Asset	Location	Buyer	Vendor	Price (€M)	Dom/ Cross Swf
1	Uetlihof complex	Zurich, Switzerland	Norges Bank Investment Management	Credit Suisse	830	C SWF
2	Two office buildings	Berlin and Frankfurt, Germany	Norges Bank Investment Management and AXA Real Estate	NA	784	C SWF
3	90 High Holborn and One Exchange Square	London, UK	Permodalan Nasional Berhad	KanAm	660	C
4	Six offices	London	Brookfield Office Properties	Hammerson	644	C
5	DNB's headquarters	Oslo, Norway	DnB Liv and DnB Scandinavian Property Fund	DNB	624	D
6	Plantation Place	London, UK	Moise Yacoub Safra	One Plantation Place Unit Trust	616	C
7	Cité du Retiro and Néo	Paris, France	Invesco Real Estate on behalf of Middle Eastern fund	KanAm	600	C SWF
8	Five offices	Paris, France	Norges Bank Investment Management/Generali	Generali	550	C SWF
9	52 Hoche and Avant Seine	Paris, France	Hong Kong Monetary Authority advised by JP Morgan Asset Management	Eurosic	508	C SWF
10	Boulevard MacDonald	Paris and Neo Vélizy, France	Foncière Partenaires fund (managed by BNP Paribas REIS)	BNP Paribas (development arm)	500	D
11	Philips High Tech Park	Eindhoven, Netherlands	Chalet Group consortium	Philips	425	D
12	1 Silk Street	London, UK	Permodalan Nasional Berhad	Beacon Capital	423	C
13	Credit Suisse's HQ at One Cabot Square	London, UK	Qatar Investment Authority	Crédit Suisse private company	400	C SWF
14	Broadgate West office complex	London, UK	Hines and HSBC Alternative Investments Limited	Jones Lang	384	C
15	Peterborough Court and Daniel House	London, UK	Qatari Investment Authority	LaSalle acting as receiver	382	C SWF
16	Office development at King's Cross	London, UK	AXA Real Estate jv unnamed investor	BNP Paribas (development arm)	380	D
17	Uni-Invest portfolio CMBS	Netherlands	Patron Capital/TPG	Opera Finance (noteholders)	359	C
18	Drapers Gardens	London, UK	Rreef Real Estate	Evans Randall	356	C
19	Allianz building	Munich, Germany	IVG Immobilien	Allianz	330	D
20	Winchester House	London, UK	China Investment Corporation	KanAm	312	C SWF
21	Part of a portfolio	Lyon, France	Funds managed by Grosvenor	ANF Immobilier	310	C
22	Ducat Place III	Moscow, Russia	O1 Properties	Hines	286	C
23	Kings Place	London, UK	Deka Immobilien	Parabola Land	285	C
24	Silver City business park	Moscow, Russia	O1 Properties	Evans Randall	271	C
25	Junghof building	Frankfurt, Germany	Tishman Speyer	Helaba	267	C

Source: PropertyEU Magazine (2013)

## Why are sovereign funds investing in the real estate sector?

Whilst direct investment by sovereign funds in 2012 plummeted from 89.5 billion dollars to 57.3 billion, investment in the real estate sector increased by 36.4% on 2011<sup>3</sup>, outpacing traditional sectors for investment, such as energy and finance. 38 deals<sup>4</sup> by sovereign funds were identified in 2012, with a value of 10 billion dollars. Most funds are in the process of increasing the weight of real estate assets in their portfolios, or are considering investing for the first time, as with SOFAZ and HKMA in 2012. According to sector sources, this could reach 10% on average in the next 5-10 years.

When analysing their reasons, we should first consider the most basic: the sector fits the two main aspects of their investment approach perfectly, i.e. high-volume assets and long-term investment horizons. Secondly, this asset profile offers insurance against long-term inflation, devaluation of the fund's currency of origin, stable cash flows and, finally, diversification, balancing the portfolio in one way or another. Thirdly, the economic background. Low bond yields and stock market volatility are obliging more conservative fund managers to implement more aggressive strategies in search of higher yields outside the financial markets, anticipating in turn a scenario of higher future inflation. Sovereign funds with no experience in the real estate sector have jumped into it, mainly into assets with less demanding management requirements and risk –core assets– putting pressure on their prices. This has resulted in traditional players moving towards more complex –and less over-crowded– deals in value-added and opportunistic strategies.

Finally, we should also take into account a further type of argument that goes beyond technical and financial aspects: the historic aspect. It is worth remembering that little more than a decade ago, some of the home countries of these sovereign wealth funds did not have any quality real estate infrastructure. In less than two decades, they have provided their country with infrastructure, thanks to the explosion of this sector, driven by liquidity from their oil exporting economies. The most extreme examples are to be found in the Persian Gulf. The United Arab Emirates (UAE), Qatar, Kuwait, Oman and Saudi Arabia are involved in extremely technically complex local urban developments. The UAE and Qatar are also investing visibly in leading multinationals in order to absorb their know-how and to structure a base of human capital capable of replicating such actions internationally. The saturation of their domestic markets, due to their small scale and the selection of the real estate and tourism sectors for positioning the country's brand globally, have been the levers for this development. For most of the oil-dependent emerging market funds, these are the sectors they know best and which have driven their growth.

## The situation in Spain

The economy of the Iberian peninsula is still paying the price for its dependence on bricks and mortar. In 2013, the real estate sector was not just in paralysis, but was in self-destruct mode as bank restructuring continued. It was only in the middle of 2012 that the financial sector was finally obliged to take the lid off its balance sheet and face up to reality: however, the flip side of this is the emergence of a range of investment opportunities.

Total investment in 2012 amounted to 21 billion euros, with 50% concentrated in three large deals, two of which could fit the profile of foreign institutional investors. The first of these was the acquisition of Madrid's Torre Picasso<sup>5</sup> from the construction company FCC for 400 million euros by Pontegadea Investments, owned by Amancio Ortega, the founder of Inditex. The second was the sale of the old headquarters of the Santander bank in Madrid for 215 million euros to the Spanish property group Villar Mir. And finally, the sale of 439 branches of Caixa Bank to the Carso Group, owned by the Mexican Carlos Slim, for 430 million euros.

This photo shows two of the current attributes of the sector. Firstly, the presence of family offices as the main players. Their deeper knowledge of the market and long-term vision looking beyond fundamentals allows them to adjust risk and, thus, prices, leaving few options for international groups. Their lack of price references due to there being no liquidity in the market, together with observing the microeconomic situation from outside the country, logically, means that risk for these international groups is weighted upwards. The second trend is the influx of Latin American players, who accounted for 22%<sup>6</sup> of deals in 2012. Looking beyond clear geographical differences, we can liken this to Arab funds in London. Cultural factors, together with language and similar legal frameworks, encourage this investor profile.

There has been very little sovereign fund activity through direct investment in the peninsula, and confidentiality agreements mean that what there is has little visibility. However, we will detail some of the main examples that have been reported. The first case we are aware of<sup>7</sup> was ADIA, which acquired IBM's Madrid headquarters in 1994, with a yield of 6.5% when prime yields were 7.5%; BNP Paribas RE (previously Atisreal) advised on the deal. In March 2013, this asset belonged to one of Morgan Stanley's investment vehicles. In 2013, the Abu Dhabi fund had at least 3 more properties, two of which were commercial products acquired from the fund that developed them (ING Real Estate) with the third being offices in Sant Cugat (Barcelona), which it bought through AXA Real Estate Asset

<sup>5</sup> The deal was completed on 31 December 2011.

<sup>6</sup> Source: Savilles.

<sup>7</sup> Source: An analysis of the investment strategy of International Real Estate Funds in Spain from 1998 to 2007; Doctoral candidate: Joaquín J. Piserra.

<sup>3</sup> Source: ESADegeo with Sovereign Wealth Fund Transaction Database figures, 2013.

<sup>4</sup> Source: Bocconi Sovereign Investment Lab.

## 9. Sovereign wealth funds and real estate

Management in 2006. We should also mention Aabar, an investment holding of ADIA, which financed the purchase of part of the debt package (£200 million) of Royal Bank of Scotland contracted by the Irish group PropInvest when it acquired Santander's Financial City. The Arab group's strategy is to be able to opt to own the property for 2.3 billion euros in the event of non-payment by the current owners, who have had liquidity problems since 2011. Sources in the sector suggest that this deal could take place in 2013, despite the legal complexities involved. Finally, we should mention Port Tarraco (Tarragona), acquired in 2011 by Qatari Diar, QIA's real estate arm, for 64 million euros, to establish a marina for its recreational fleet in the Mediterranean.

There are a number of reasons for the low volume of direct investment in Spain. However, the most important is the market itself. The universe of core, large-volume real estate products – worth over 100 million euros – is very limited and has very slow rotation. Such existing assets, both offices and commercial premises, are the jewel in the crown for many local portfolios, thus slowing rotation even further.

However, the recent Qatari Diar deal for Barcelona's W hotel – better known locally as the “Vela” or “Sail” – could mark a turning point in the trend. The real estate arm of Qatar Holding paid 200 million euros for the hotel. The owners – construction sector companies OHL, FCC, Comsa-Emte and BCN Godia – each have a 25% stake. The deal was announced in June. However, details of the deal have not yet been released. This is the type of deal that could put Barcelona and Madrid into the sights of sovereign wealth funds, now that their appetite for the real estate sector is awakening.

Indirect investment is more difficult to assess. The possibilities are simply infinite. The most recent example is Puerto Venecia in Zaragoza, the largest shopping centre in Spain when it opened in late 2012, developed 50:50 by Orion Capital and British Land. Two of the main investors in the British company are sovereign funds: the Norwegian NBIM and the Government of Singapore Investment Corporation (GIC), with stakes of 5.02% and 4.73%, respectively, in May 2012. British Land put its holding and administration of the centre up for sale in the second quarter of 2013 for 150 million euros, as part of its strategy of withdrawing to its domestic market. As discussed in the chapter dedicated to Spain and Latin America, in May 2013 the Norwegian fund had holdings in the capital of 69 Spanish companies, including 2.40% of Meliá Hoteles and 2.04% of NH Hoteles, as well as stakes in most of the large construction companies.

### The profile of sovereign wealth funds

We can classify the behaviour of sovereign wealth funds in the real estate sector based on two aspects. Firstly, their investment strategy

from among the three categories we have described above: core, value-added and opportunistic. Secondly, consistency in their investment decisions based on market criteria and common sense<sup>8</sup>, taking into account the special nature of this type of asset.

We can see and touch, and even enjoy, real estate assets. That is why there have been investment decisions based on reasons other than purely economic motives, and these have come to define investment patterns for the general public given the media interest they arouse. This has traditionally happened with sovereign wealth funds from non-democratic countries, where the final decision often rests on the whim of one person, rather than a rational, democratic decision-making body, separating the fund's observed behaviour from market fundamentals. In such cases, there is often a “trophy asset” aspect to be included in the equation. On the other hand, more developed democratic traditions and transparency make it difficult for governments and groups with power to make discretionary decisions ignoring market logic and the good of society.

In terms of investment strategies, the strategy used is closely connected to the market in which the funds are active and the profile of their domestic economy. Some emerging countries have leveraged their economic growth through their sovereign funds, resulting in substantial infrastructure and urban development. The objective for sovereign wealth funds in mature markets has been to diversify their portfolios, mainly through the financial markets, with no need to promote urban developments domestically, except in some individual cases.

Whilst it is true that many of these opportunistic strategies in emerging economies would not fit the classic definition due to the absence of real leverage or the search for non-financial returns, sovereign funds are increasingly offering greater transparency in their more operational and less strategic investment vehicles, enabling them to approach the markets for capital, whether through bond issues or public share offerings. These approaches confirm the increasing sophistication of their financial structures, whilst increasingly obliging them to base their decisions on market criteria.

In 2013, the traditional indirect investment behaviour of a sovereign fund – a core strategy in mature markets and an opportunistic strategy only in the domestic market – is no longer feasible. As they seek diversification and returns, and as they increase in size and acquire experience in the sector, saturating their domestic markets, emerging economy sovereign funds are now daring to replicate abroad the property development strategies that have worked in their domestic economies. Today they are involved in real estate

<sup>8</sup> As references, we have used the level of democracy in the country, as measured by The Economist Intelligence Unit's Democracy Index, and the level of control of corruption, as measured by the World Bank, giving each 50% weighting. We consider that a higher score guarantees a strategy based on common sense, distancing decisions from personal interests.

development activity that would have been unimaginable just 15 years ago, when the most they dared risk outside their domestic market was to refurbish a property, without changing its use.

The most visibly active funds in 2012 were from Arab nations and south-east Asia, together with Norway. There is an increasing trend for Malaysian funds to invest jointly with Arab funds in order to take on common challenges, given their cultural closeness, both being Muslim. There are 35<sup>9</sup> Muslim countries with sovereign wealth funds, and they are increasingly tending to use Islamic financial instruments in their deals, both in direct investment and in indirect investment through unlisted real estate funds.

In the specific case of Malaysia, where around two-thirds of the population is Muslim and with the most structured market of Islamic financial instruments, Kuala Lumpur has developed into a business and tourism hub for the Arab world, acting as a springboard to the rest of Asia. Qatar has been particularly active, with major real estate developments, including building the first Harrods Hotel in Kuala Lumpur. Another example is the Pavilion shopping centre in Kuala Lumpur, developed by Qatar Holding with local partners, after it bought out Kuwait Finance House (KFH), which operates according to Islamic principles and is under the control of KIA, which has a 10% stake. However, the new star is undoubtedly Abu Dhabi, which had tried to enter the market through Mubadala and Aldar, but which did not consolidate its interest until May 2013, when its sovereign holding company Aabar signed a 1 billion dollar joint-venture agreement with the local sovereign fund 1MDB to develop, among other projects, a new financial and commercial district in the capital of the Asian peninsula.

To the south of Malaysia is Singapore –appropriately nicknamed the Europe of Asia– which has two sovereign funds, GIC and Temasek, with 12 and 7% exposure<sup>10</sup> to the real estate sector, respectively. The larger of the two, GIC, has a global focus, with over 200 properties in more than 30 different countries; its portfolio includes holdings in the main listed companies. Its investment vehicle in the sector is GIC Real Estate. Temasek, on the other hand, continues to take a regional approach, with just 22% of its assets<sup>11</sup> outside Asia in 2010. It acts more like an investment and economic development fund, holding in its portfolio stakes in specialist real estate companies in various areas, some of which are listed. One of the main of these is CapitalLand, in which it has a 41% stake<sup>12</sup>. This is one of the leaders in the region, with 58 shopping centres in China, among other assets. We should also mention Mapletree, which Temasek owns in full. This has four REITs in its specialist portfolio in the Asian market; the most recent of which was presented in April 2013, with one of the investors being the Norwegian sovereign wealth fund.

<sup>9</sup> Source: Fletcher.tufts.edu- Lawrence -Islamic Sovereign Wealth.

<sup>10</sup> Source: IRERS 2010, Kuala Lumpur.

<sup>11</sup> Source: Temasek.

<sup>12</sup> Source: CapitalLand 40.8% Feb. 2013.

Staying on the same continent, we should also highlight China's CIC fund, which became involved in real estate in 2010, aiming to achieve a 5% holding of real estate products in its portfolio. In March 2013, it had invested in properties in London, Paris and Frankfurt, amongst others. It has invested in the full range of possible products. Our stroll through Asia ends with the Korea Investment Corporation (KIC) which, according to its CEO Scott E. Kalb in 2010<sup>13</sup>, was looking at entering Latin America and India, and increasing its Chinese portfolio. By the end of 2012, real estate accounted for 1.6% of its portfolio<sup>14</sup>, with a value of 911 million dollars. Its objective is to increase this to 10% between 2015 and 2020.

However, we should remember that direct investment is estimated to represent only 40-50% of the total. Indirect investment through holdings in real estate funds represents around 30-40%, with a bias towards funds that follow value-added and opportunistic strategies. The use of funds to channel their investments follows a logic of diversification –in terms of geography, products and strategy– helping them take advantage of opportunities in markets to which they otherwise might not have access or where they lack sufficient knowledge. There can be no doubt that the holdings of sovereign funds in financial institutions –such as CIC's 12.5% holding in Blackstone Group and 9.8% in Morgan Stanley– has led to greater cooperation between them. The best example of this was in 2011, when Morgan Stanley's cash-flow requirements obliged it to dispose of its Japanese mortgage portfolio at a hefty discount, selling it to Blackstone for 1.1 billion dollars, enabled by financial support from CIC. Alliances between these types of players are becoming ever more frequent.

We will now analyse the behaviour of three funds representing extreme positions based on the aspects mentioned at the start of this section; these were also the most active in 2012 and 2013.

### Norway and its perfect democracy

The way that Norway's sovereign wealth fund works is the best example of transparency, good governance and democracy, with the ultimate good of the people being put before the interests of individuals.

In 2008, it was decided through a vote in parliament to expose 5% (27.5 billion euros<sup>15</sup>) of their portfolio to the real estate sector. This marked the start of a public strategy based on three key aspects: diversification of risk, seeking higher returns in less liquid assets and ensuring international purchasing power. Management of the fund –the Government Pension Fund Global– has been contracted out to Norges Bank Investment Management (NBIM), the asset

<sup>13</sup> Source: The KIC's Chief Investment Officer, 2010. Fetgatter, James A. Chief Executive, AFIRE. Personal Interview. 5 April 2013 / Sovereign Wealth Funds: Encouraging Foreign Investment in U.S. Real Estate - Christopher Stanhope DiBittetto Real Estate Capstone MPRE 950-02, Georgetown University.

<sup>14</sup> Source: KIC 2012 Annual Report / CEO Presentation.

<sup>15</sup> Source: NBIM - Total assets in First Quarter 2013: 4,182 billion kroner.

## 9. Sovereign wealth funds and real estate

management unit of Norway's central bank. NBIM has set up an internal team to manage its new real estate unit.

Prior to investing directly in real estate assets, the fund had only worked with financial assets, basing all of its decision making on purely rational and numeric criteria, following the benchmarks of international indexes, and guided by sustainability and corporate social responsibility. On starting to invest directly in this new asset class, where management is more complex and information not so perfect, the Norwegians set up a process where a criterion of financial rationality takes precedence over any other premise, whilst limiting and controlling individual decision-making powers democratically. Parliament is ultimately responsible for approving the investment strategy and the tolerance limits for each type of asset: NBIM has to report its accounts to parliament once a year through the Finance Minister.

The real estate mandate includes not just direct investment but also shareholdings –through remunerated instruments in listed and unlisted companies– and shares in specialist investment funds. In short, any instrument that gives rights to land and existing buildings. Its exposure in March 2013 was 0.9%, although this only includes direct investments, as we will see below. Given the total amount that NBIM has to invest in the real estate sector (5% of its portfolio amounts to 37 billion dollars, and, as mentioned elsewhere, this could increase to 10% over the next 10 years) and its financial profile, the Norwegians have designed a strategy around two approaches: firstly, investment in low-risk assets, and, secondly, geographic and product diversification. As we can see from the deals they have been involved in so far, core assets will form the bedrock of the portfolio, with a target of 50%. The targets for value-added and opportunistic strategies are 30 and 20%, respectively.

Following their guidelines, the core product should be distributed globally, subject to a limit of no country exceeding 10% of the total, with the exception of the USA, UK and France, which could account for 35%. They have already met their European target, and are now focussing on the American market, where they are aiming for 30%. There is no global criteria for value-added and opportunistic deals, as the approach here is to identify the niche markets for developing such opportunities.

Analysing the type of product, there are individual limits of 60% for offices and commercial premises; 30% for industrial; and 15% for developments of new product. Furthermore, the leverage of the portfolio is limited to an overall ratio of 50%, never exceeding 70% on individual deals. NBIM's objective is to achieve a net return on its real estate portfolio equal at least to the Investment Property Databank (IPDs) Global Property Benchmark, excluding Norway and adjusted for the impact of leverage and management costs. Any other non-financial considerations are excluded from decision making.

As we have mentioned already, the total exposure of funds to the sector is not limited to direct investment. We must also include holdings in listed companies and REITs, and investment funds. The benchmark used by NBIM to structure its equity portfolio is based on the FTSE Industry Group Financials, which includes both "Real Estate Investment & Services" and REITs. At the start of 2013, these accounted for 3.5% and 2.5% of its equity portfolio respectively, and were not considered part of its real estate strategy. If we examine the shareholder structure of the 20 largest construction companies on each continent, we find that NBIM has a significant holding in most of these, with the exception –so far– of the United States, due to differences in listing criteria.

The deals that the Norwegian fund was involved in up to the first quarter of 2013 fit perfectly with its mandate, which, as we have seen, only considers the deal's risk/return ratio; i.e. real estate deals are considered to be mere financial deals. Moreover, we can see from the following examples that the fund is supported by its partner investors who specialise in each product type, and to whom management of the asset is entrusted. In other words, NBIM is only half involved in the financial side.

The Norwegian fund was involved in the following deals to March 2013:

- **2010:** It's first direct investment in The Crown State Partnership in London, taking a 25% holding, using a structure of up to five companies so as to limit the risk of the investment to the investment vehicles themselves and to avoid any kind of claim reaching the parent fund: this is normal practice in the sector.
- **2011:** In July, the fund invested in Germany through a joint-venture with AXA Real Estate for acquisition of 50% of a collection of seven prime office and commercial assets in Paris valued at 1.4 billion euros; this was followed at the end of 2011 by a second 50:50 joint investment in a portfolio of assets worth 290 million euros.
- **2012:** The same strategy was followed with the Generali Group in July 2012, once again acquiring 50% of its Paris portfolio: 5 premium assets worth 275 million euros. In the fourth quarter of 2012, the fund diversified its product, acquiring 50% of the UK's Meadow Hall shopping centre for 393 million euros; the remaining 50% is held by the developer British Land, which is responsible for managing the asset. The fund also entered the Swiss market in the fourth quarter of 2012. However, on this occasion it pursued a different strategy, using a 25-year "sale & lease back" formula with an option for a further 15 years, acquiring 100% of the headquarters of Credit Suisse for 1 billion Swiss francs. The existence of a single tenant for the 25 years of the deal practically eliminated the need for management, enabling NBIM to do the deal without a partner. 2012 ended with joint deals with AXA Real

Estate to acquire two office buildings in Germany (Berlin and Frankfurt) for 410 million euros, dividing each asset 50:50.

- **2013**, NBIM made a major leap forward. Firstly, with the acquisition of 50% of the logistics systems of Prologis for 2.4 billion euros, with 195 assets in 11 European countries, including Spain. This investment enabled the vendor to meet its payment obligations and reduce its liabilities. And finally, the long-awaited entry into the United States. This was through a joint-venture (through a 49.9% share) with the American fund TIAA-CREF to acquire properties worth 1.2 billion dollars. This involved four office buildings in New York, Washington DC and Boston. The choice of the American market as the second zone following Europe was due, mainly, to its similarities to the European market in terms of maturity and transparency. The scale of this initial investment confirms the fund's intention that the United States should account for 30% of its real estate portfolio.

### Qatar and personal governments

Qatar and its investment vehicles are the clearest example of funds with personal characteristics. The main characteristic of these sovereign wealth funds is that, irrespective of the professionalism of the management team, which in this case is very high, the whims of the governing party may take precedence in certain situations over any other consideration: this is sometimes dressed up as national branding, but at others it is purely motivated by personal interests. The result is a portfolio of international assets with a much higher profile in terms of unique architecture, as the objective of the investment is to position the country both in the location and in the minds and mouths of the local population.

In the case of the Qatar Investment Authority (QIA), with its high exposure to the real estate sector (estimated<sup>16</sup> at 32% of its portfolio in 2012), we must include other variables in their investment criteria, in addition to profits and national branding. These are political and commercial strategies that affect its main activity: oil and gas production and export. Some of its investment decisions in politically unstable markets can only be explained from this perspective. For example, we could mention urban developments in Palestine, Sudan and Yemen, where, in addition to its role as a mediator trying to pacify the terrorists and bring stability to the region, Qatar also has interests in exploiting the oil fields in the latter two countries.

Decisions in Europe are also subject to this "commercial" logic. For example, London is attractive for two reasons. Firstly, because it is the safest of safe-havens, and, secondly, because the UK is a strategic client. The figures show this clearly: in 2011 the UK

received 21% of the Emirate's exports of liquid natural gas, accounting for 86% of such imports. France, Italy and Spain account for just 13%. Recently, Greece has joined the list of purchasers, where Qatar has undertaken investments.

QIA is expanding its international real estate holdings through two vehicles: Qatar Holding and Qatari Diar. Whilst these have separate management teams, they share the same principal source of finance and a common ultimate goal: the prosperity of Qatar under the mandate of the Emir. It is therefore often difficult to establish clear lines of separation between the interests of the two, other than operational differences.

Qatar Holding, the holding company for a multi-sector global portfolio with strategic investments for the country in existing assets, is used as a way of getting a foot in the door in a sector or location for subsequent positioning through new business vehicles. One strategy we have seen is Qatar Holding acquiring an asset to be transformed, with Qatari Diar as the real estate arm then designing, financing and managing the development, either on its own or in joint-ventures with local companies. Another strategy is the acquisition of significant stakes in the capital of real estate companies to facilitate Qatari Diar's access to their developments. This was the case, for example, with the UK's "Songbird Estates" in order to take control of "The Canary Wharf Group", a promoter and developer in the City of London. It has also taken positions in the capital of leading construction companies, joining their Boards, enabling it to facilitate and look out for the interests of the company's joint-ventures in the Emirate, as for example in the cases of Germany's Hochtief and France's Vinci (in this case through Qatari Diar). Furthermore, Qatar Holding's portfolio includes the UK's Harrods department store and above all the Katara Hospitality hotel group, which we discuss in greater detail later.

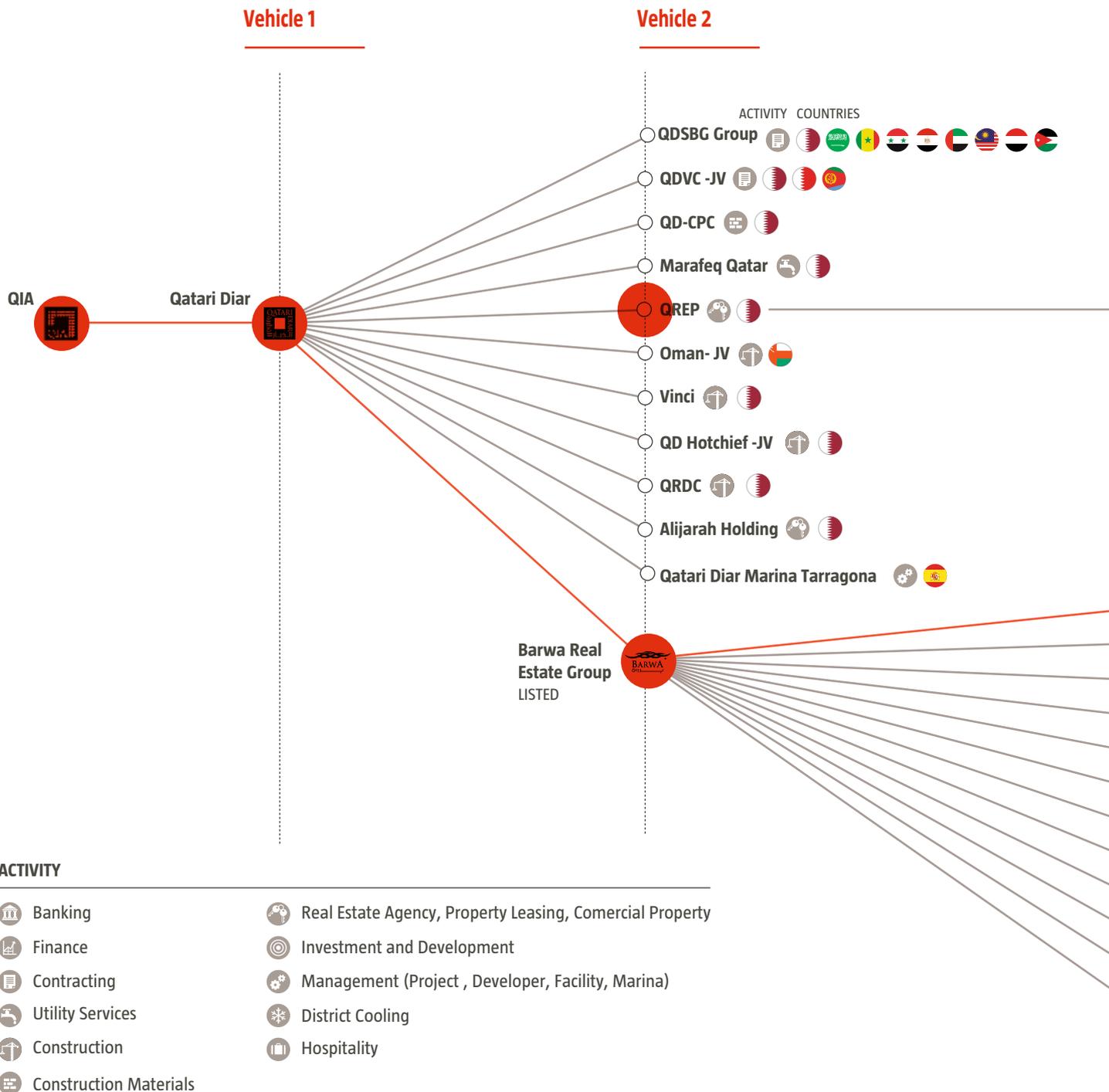
On the other hand, Qatari Diar is more of an operational tool. It was launched in 2005 as a developer and construction company, with the objective of becoming the driver for domestic real estate projects; it has since established itself in both mature and emerging markets as one of the main global players to watch. In January 2012, its capitalisation, boosted by a bond issue backed by the state of Qatar, was 4 billion dollars, with 49 projects under development or planned, worth a total of 35 billion dollars. Unlike other sovereign wealth funds, its *leitmotiv* is value creation through unique, large, highly complex property developments. The best example of this is Qatar's new Lusail City: 38km<sup>2</sup> of property development with capacity for 500,000 people, which Qatari Diar is driving. Internationally, and on a somewhat smaller scale, we should also mention the "Washington DC City Center" and London's "Shard" skyscraper, for which it facilitated financing, as well as managing the development.

<sup>16</sup> Source: Preqin 2012.

## 9. Sovereign wealth funds and real estate

### Infographic 5

#### Qatar real estate empire: Qatari Diar

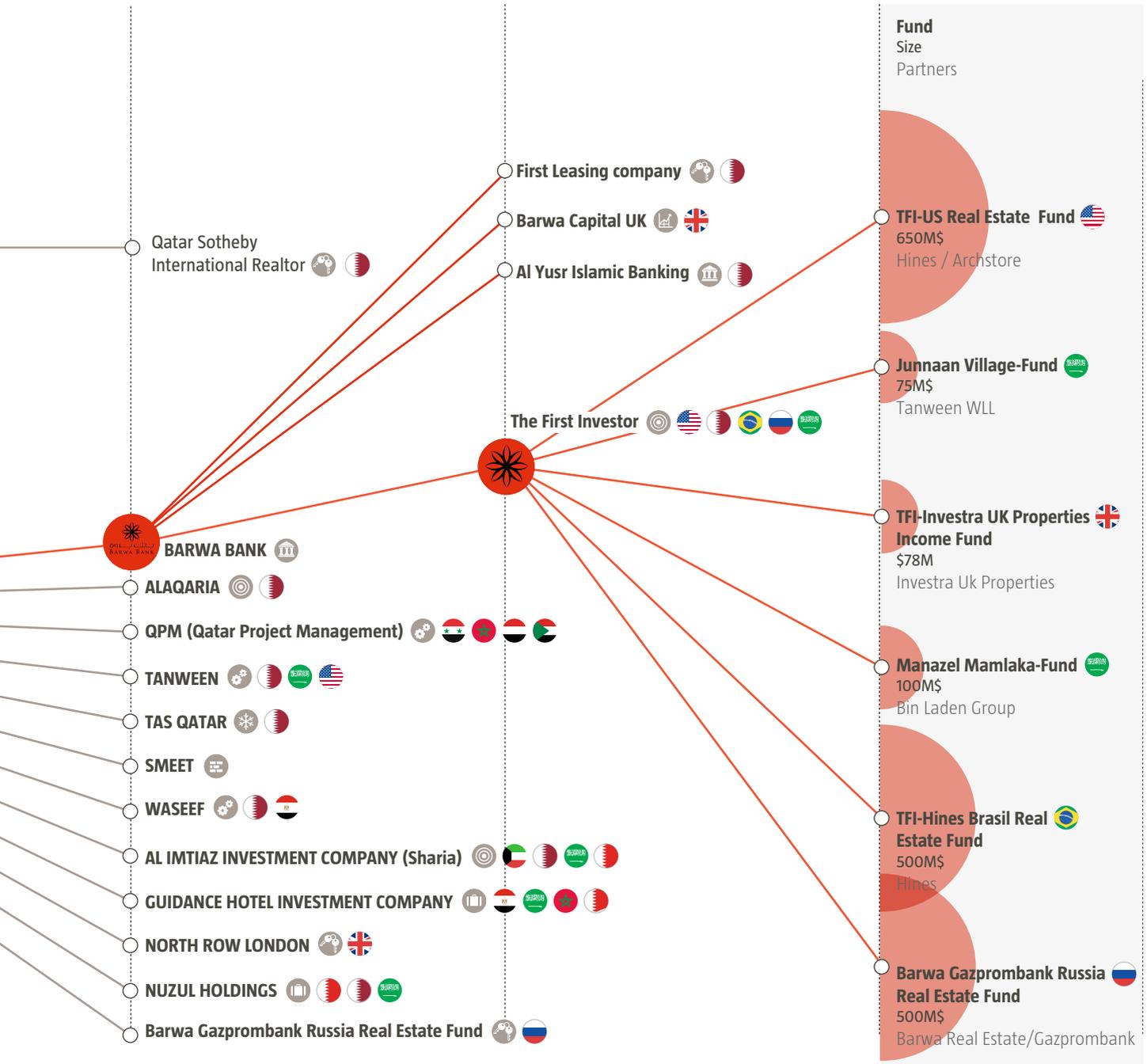


Source: ESADEgeo (2013)

**Vehicle 3**

**Vehicle 4**

**FUNDS**



## 9. Sovereign wealth funds and real estate

In addition to differences in their objectives, Qatari Diar is also set apart by its value chain. This is much more complex and extensive, based on other vehicles, whether owned entirely or partially by itself or the group, that enable it to expand its business lines across the whole spectrum of real estate services. In just 8 years, Qatari Diar has created a universe of specialist companies covering the whole value chain, from project design to finance, development, construction and management and sale of the finished product, achieving a high degree of horizontal and –to a lesser extent– vertical integration in its local projects. This trend will continue given its real estate and public-infrastructure project pipeline planned to 2020, which is worth 195 billion dollars in total <sup>17</sup>.

Many of Qatari Diar's specialist vehicles come under the umbrella of the Barwa Real Estate Group, a listed real estate company of which it controls 45%, where we can identify the full range of services needed for real estate development activities. This includes finance (Barwa Bank), facility management (Waseef), project management (QPM), construction product supply (Smeef), marketing (Sotheby's) and many other types of companies, including the most strategic of all, The First Investor investment bank, which structures a range of international real estate funds subject to Sharia Law; one of its most recent creations was set up to invest in the Brazilian market in 2012. We will examine this in more detail later.

In summary, Qatar Holding and Qatari Diar are the tip of the arrow in the international development of the Emirate's real estate industry. The high degree of integration achieved locally can not be replicated in mature markets further afield such as Europe and the US; however, it has found space in some Arab markets, which are less highly developed and culturally more similar. In Western markets, its activities focus on high value-added services, such as finance, urban planning and project management.

Qatar invested in a multitude of international projects in 2012 and the first two months of 2013, through a range of vehicles. In 2012, it was the 6th largest investor in the European office market, with investments totalling 782 million euros <sup>18</sup>. As with NBIM, it is instructive to look at some of the deals in which it was involved in this period to increase our understanding of its international behaviour. These include:

- **February 2012.** Qatari Diar invests 517 million dollars to acquire the London headquarters of Credit Suisse, in Canary Wharf, through lease back until 2034. This is a core product. It is easier to understand the deal if we note that Qatar Holding owns 6% of Credit Suisse and 27% of Songbird Estates PLC, which in turn manages and owns 69% of the Canary Wharf Group. The latter

signed a joint-venture with Qatari Diar in 2011 for redevelopment of the Shell Centre, home to the HQ of Shell International, in the centre of London. This involved the two companies investing a total of 489 million dollars in a 999 year lease on the land. Both the investment and the project management will be shared, concluding with the construction of 2 mixed-use and 6 residential buildings. Qatar Holding acquires the La Fayette shopping centre in Paris for 500 million dollars, joining Harrods (London), Sainsbury (UK), Pavilion and Fahrenheit (Kuala Lumpur) in its portfolio.

- **March 2012.** The First Investor (TFI), the investment arm of Barwa and Barwa Bank, in which Qatari Diar is the largest investor with 45% of the capital, closed the TFI-Hines Brazil Income Real Estate Fund with a total of 500 million dollars, and made its first investment by acquiring the Sao Paulo World Trade Centre complex. This is the first close-ended real estate fund in Brazil structured under Sharia Compliance.
- **April 2012.** Qatar Holding increases its ownership of one of the most luxurious enclaves in the Mediterranean, the Costa Smeralda on Italy's island of Sardinia, from 14.3% to 100%, acquired from Colony Capital. The sale price – which has not been published – included an obligation to cover debts of 200 million euros. This resort consists of 5 luxury hotels, together with a 700-berth port, the Porto Cervo marina and the Pevero Golf Club. The Qatar group has real estate development investment plans valued at 1 billion euros for the coming 7-10 years. These include doubling hotel capacity to 900 beds, all in the high-end luxury category, plus a leisure park and a tourism school.
- **July 2012,** Qatari Diar began work on the first luxury resort in Tunisia –the Tozeur Desert Resort, an 89 million dollar investment in the region– consolidating its commitment to tourist development in North Africa. Its largest development, the Nile Corniche, is in Cairo, involving mixed real estate development worth 464 million dollars, including a Hotel St. Regis, offices and residential property.
- **August 2012,** Qatar Holding acquired 22% of CITIC Capital Holdings Ltd, a Chinese private-equity company based in Hong Kong, of which CIC also holds 31.3%, with over 4.4 billion dollars under management; Temasek has a holding in its latest real estate fund. In August, Qatari Diar also signed a joint-venture with Oman's Tourism Ministry to develop three mixed-use tourist resorts, including a marina.

<sup>17</sup> Source: NBK Bank

<sup>18</sup> Source: [www.propertyeu.info/index-newsletter/swfs-dominate-big-office-deals-in-2012](http://www.propertyeu.info/index-newsletter/swfs-dominate-big-office-deals-in-2012)

- **December 2012**, it acquired property in Paris' Champs-Élysées, including the famous Lido cabaret and an office complex for 100 million euros. It also relaunched the Qatar National Hotel Company (QNHC) under a new name: Katara Hospitality. The group currently owns 24 hotels and resorts (either operating or being developed) in 8 countries; it plans to increase this to 60 hotels by 2030. It should be noted that its internationalisation began in 2006 with the purchase of Egypt's Renaissance Sharm El Sheikh Golden View Beach Resort, and that only 10 of the 25 hotels in its portfolio are in Qatar. It has made a spectacular commitment to iconic examples of classic architecture in Europe, with the Royal Savoy Lausanne, the Excelsor Hotel Gallia Milan and the Peninsula Paris coming into operation in 2013, and the stunning Bürgenstock Resort Lake Lucerne in Switzerland coming into operation in 2015. In addition to Europe, it is also active in the Comoro Islands, Morocco, Egypt, Singapore and Thailand. It aims to communicate an image of the Emirate worldwide through its hotels, always committed to the most luxurious developments, whilst respecting historical and cultural roots.
- **January 2013**, it presented plans for the first Harrods hotel, to be located in Kuala Lumpur, and to be followed by a hotel in London and another in Sardinia. This reaffirms its strategy of positioning the Harrods brand, an icon for luxury and customer service, at the most exclusive end of the hotel sector. The venture, a 626 million dollar joint-venture, will be a complete urban development project, including offices, a shopping centre and residential property, planned for 2018. Its partner in the project, Jerantas Sbh, is also indirectly under Qatari control, through a joint-venture set up to develop Kuala Lumpur's Pavilion shopping centre.
- **February 2013**, it expanded its Constellation Hotels Ltd. portfolio with the purchase of 4 luxury hotels in France (Paris, Nice and Cannes) from the Groupe du Louvre, a subsidiary of Starwood Capital, for around 750 million euros. Management of the assets was passed on to Hyatt, with a corresponding change of name. The deal was only supported by the Qatari investment bank QInvest, belonging to the Qatar Islamic Bank, of which QIA controls 10%, and which in turn obtained the finance from Germany's Aereal Bank and the Qatar National Bank, of which QIA also controls 50%.
- **March 2013**, it expanded its portfolio with the 302 million pound acquisition of the London Park Lane Hotel from the InterContinental Hotels Group, which will continue to manage the asset, integrating it into the portfolio of Katara Hospitality as its first hotel in the UK capital.

## Malaysia and the emerging democracies

We cannot compare democracy in Malaysia to democracy in Norway, but it is nevertheless a key element in understanding this emerging economy. Three main factors are worth considering with regard to Malaysia. The first is the presence of oil in its waters. The second is that Malaysia has a perfect population pyramid, which is very young and with a very solid base. And thirdly, Malaysia is the world's leading producer of palm oil and rubber. The government has a vision of converting the country into a developed state by 2020. To this end, it has prepared a plan dividing the country into five economic development zones. It has two funds based on oil revenues; a semi-public investment fund; and various types of national pension funds, which have substantial cash surpluses as a result of the youth of the population.

Malaysia created its first sovereign fund –Khazanah Nasional– in 1993. It manages 28 billion dollars through a business-industrial holding company that comprises a wide-ranging group of companies from 15 sectors that are key to the functioning of the country, including health, agriculture, banking and telecommunications, and, of course, real estate. In the real estate sector, one of its investment vehicles –Iskandar Investment– is the driver of a major new urban development in terms of its strategic location and scale, located on the border with Singapore, spanning three-times the size of the neighbouring country. The real estate interests of Khazanah involve international capital, and it is therefore supported by other sovereign wealth funds with interests in the region investing and participating in the development. Its most strategic relationship is with Temasek. The joint-ventures set up with Temasek are seeking to jointly develop projects in Iskandar and Singapore. The two sovereign funds are responsible for diplomacy so that other companies in their groups can be involved in each stage of the project. Of these, we would highlight CapitaLand and Mapletree on the Singapore side and UEM Land (under Khazanah Nasional) on the Malaysia side. Iskandar represents a new era in their historically difficult relationship. Both sides benefit from the joint project: the peninsula can piggy-back on the vigorous growth of its small neighbour for its own development, whilst the island needs lower-cost space for expansion given its own

## 9. Sovereign wealth funds and real estate

shortage of free space, enabling its companies to become ever more competitive.

The next sovereign fund is 1MDB. This was created by the Finance Ministry in 2009. It is more strategic in nature and less operational, focusing only on sectors important for the country's future, such as energy, agriculture, tourism and real estate. It has three urban development projects in its portfolio, the most significant of which is Kuala Lumpur's new financial district, the "Tun Razak Exchange". This is a joint development with the Arab sovereign fund Aabar for a new district including commercial, residential and office property; this 3 billion dollar joint-venture was signed in April 2013.

Then we have Permodalan Nasional Berhad (PNB), a state investment fund that (as of September 2012) had 62.6 billion dollars of funds from the public sector and exclusively Malaysian private investors under management. Among other assets, the fund invests in all listed domestic companies so as to safeguard the interests of the country. Its international real estate exposure began in Australia in 2010 with the 291 million dollar purchase of the Santos Palace in Brisbane. Its first action in Europe was the £350 million purchase of London's 1 Silk Street in December 2011. In early 2012 it expanded its London portfolio with two more assets, One Exchange Square, headquarters of the European Bank for Reconstruction and Development, and 90 High Holborn, both for £500 million, making it the largest office investor in the world on an annual basis. It also invests in the local market through its PHNB vehicle and its 407 million dollar PNB REIT.

The most active of its pension funds is the Employees Provident Fund (EPF), reporting to the Ministry for International Trade and Industry (MITI), which had 1.5 billion dollars available for investment in the UK in 2010. It has also been involved in deals in Australia, both directly and through investment funds, with the objective of reaching 23% exposure to the sector. Although carried out under the mandate of its own managers, its international activities are implemented through the MITI with advisors from Khazanah Nasional.

The next fund is the Tabunj Haji Fund: this is an Islamic fund reporting to the Finance Ministry. Its first London investment was in 2012. This investment was carried out under Islamic principles through the Kuwaiti-British company GateHouse. Other vehicles include Lembaga Tabung Tantera and KWAP, both reporting to the Defence Ministry. This fund has a target of 3% real estate exposure. It is involved in a joint-venture with EPF for investment in the UK. Its first international steps in the sector were also, as in the previous cases, in Australia, investing in two office buildings, with returns of 6%. The first was in Melbourne in 2010 and the second in Sydney

in 2011. KWAP is also involved in the CIMB-Mapletree Real Estate Fund and is one of the largest shareholders in the first Islamic REIT for industrial products, the Axis Real Estate Investment Berhad.

In addition to its defensive strategy investments in London, this fund is also involved in a new challenge: "Battersea Park", an iconic landmark of industrial architecture acquired in 2012 for conversion to residential use. The project is being handled by a consortium of Malaysian companies: the aforementioned EFP fund (20%), the property developer-construction company SP Setia (40%) and the real estate division Sime Darby (40%). Although the latter two are listed companies, they are under the control of the Government, in the case of SP Setia, through PNB which owned 51% in mid-2012. The multinational Sime Darby—one of the largest holdings in the country and the largest palm oil producer—is controlled through Finance Ministry companies.

We can safely say that Malaysia and its funds have come to Europe to stay.

### Challenges and opportunities

Estimates of real estate sector impact based on these new portfolio configurations indicate that real estate could come to account for 10% of the portfolio. This, together with constant growth in their investment capacity, puts these funds in a strong position on the new global game board.

Most funds are seeking to position core assets as the nucleus of their portfolios. Supply of such assets tends to dry up, and their returns will continue to be restricted. There are two factors affecting the market at the moment: on the one hand, a shortage of credit means there are only a few new developments; but on the other hand, supply is continuing to be created by the need to release liabilities. However, both of these are offset by the ever greater presence of institutional and sovereign funds in the market, which is growing faster than supply. This is making products even scarcer and the market more crowded. Once these assets are acquired by sovereign wealth funds with no investment horizon, it becomes very unlikely that they will come back onto the market. Investors with different profiles are considering divesting due to changes in economic conditions, but, if the asset is high-quality, short- to medium-term sensitivity will be zero.

We expect sovereign funds to be obliged to move towards more exposed positions, both through direct investment, implementing innovative strategies that require more sophisticated management, and indirectly, by increasing their positions in specialist real estate funds.

There are a multitude of opportunities beyond the mature markets. As the markets closest to them implement measures to improve their transparency, they will rapidly position themselves on the map of global real estate players. This has been the case with Brazil and Turkey, with Arab and Asian sovereign funds investing in shopping centres and offices as a result of improved legal frameworks.

Taking a global overview, the future in 2013 is Asian. China and India together have 2.4 billion people, Indonesia 242 million, Bangladesh 144, the Philippines 94, Vietnam 87 and Thailand 69. No other part of the world has such a population density and economic growth together with consumer demand. The sovereign funds are well aware of these numbers. The best positioned for this challenge are those in Singapore, because of their physical proximity and understanding of the markets, greater acceptance of risk and their highly professional structures. We have seen the Norwegian fund acting as one of the key investors in a Temasek REIT. These alliances will become ever more common.

Sovereign wealth funds with less experience in the sector have no choice but to form agreements with other specialist players, particularly in emerging economies, where there is a lack of transparency and sources of local confidence are needed to ensure success.

And while we are talking about specialists and niche markets, we should once again mention GIC. As in 2005, when they became involved in university residences, expanding their real estate business in mature markets towards services beyond pure hotels, so we could imagine similar opportunities arising, for example, in the storage niche.

The financial sector offers the most medium-term investment options. If we consider that their divestments in the sector are still in their infancy—a Morgan Stanley study found that at the end of 2012 the banks had only achieved 20-25% of their targets—there is still a 4-5 year period for unwinding their current positions<sup>19</sup>; in addition to real estate, these include a debt market that is becoming increasingly interesting. Today, the largest investment funds are heading in this direction, and we can be sure that sovereign wealth funds will take positions in them.

However, the largest opportunity undoubtedly lies—particularly considering the previous paragraph—in replacing banks in support for developers and investors, both through mixed investment vehicles and through new non-banking financial instruments. This brings us to a third recent example of GIC in the UK, where, in association with real estate finance specialists Laxfield Capital, it has launched a credit facility for the British developer valued at £1.0 billion. This strategy is similar to the one it launched in India in 2012 supporting local developers. A larger example—of a different nature—can be seen with KIA's involvement in "Hudson Yards" in Manhattan, which we have already mentioned. This project had been paralysed since the start of the financial crisis due to lack of credit. Their high degree of tolerance, together with the long investment horizon and lack of financing needs, made them the ideal partners. In the current climate of financial weakness, when the sector's traditional financing instruments are limited, sovereign funds are positioning themselves as a new source of capital, the new knight on white chargers in the real estate sector.

## Opportunities in Spain

We can draw three conclusions from an analysis of the main direct deals made by sovereign wealth funds globally: Size matters; quality matters; and the market matters. Most investments are over 100 million euros, with low risk tenants (Triple A) in locations with highly-liquid real estate markets. The reality is that we can count the number of options meeting the first requirement in Spain on one hand. With the second, we might increase the number of candidates, particularly in Madrid. But we will ultimately come up against a lack of liquidity, if there are a large number of deals.

<sup>19</sup> Source: Banks Deleveraging and Real Estate-Blue Paper – Morgan Stanley Nov 2012

## 9. Sovereign wealth funds and real estate

The main problem with such assets is scarcity: this makes them strategic assets in the portfolios that hold them, and their owners will only release them in the event of extreme necessity, as with the construction company FCC and the Torre Picasso in Madrid. The truth is that the whole of Spain's real estate stock is up for sale, but there is a gap between the expectations of vendors and purchasers. There is too much shyness and not enough liquidity. Perhaps the Hotel W deal will encourage a change in the attitudes that have dominated negotiations in Spain to date.

The price references of local investors serve no purpose for international investors. They want to see other international competitors backing the same horse; that is what gives them confidence. Our market needs a leading investor to take this step and light the way. However, there are a number of reasons to be optimistic. Firstly, the increase in the European investment market against all expectations in the first quarter of 2013, despite the Eurozone's poor economic indicators. Secondly, the resurgence of opportunistic funds over recent years, with Barcelona and Madrid in their sights. Finally, adjustments in the financial sector could encourage increased lending to the real estate sector in the future. In parallel to this, the banks are disposing of their real estate assets and reducing their exposure to the sector, opening up interesting opportunities for foreign investors.

The obstacles to the market clicking are disappearing. When will this happen? Nobody knows, but there is certainly an appetite out there. Office rental prices per m<sup>2</sup> in Barcelona are three times lower than in Paris, offering returns of 6.5%, far in excess of other prime European markets. Madrid and Barcelona are not London, New York or Tokyo. But they are the strongest locations in southern Europe, together with Milan. And we should not forget that Spain is still the 5th largest European economy.

If we consider the profile of the sovereign funds, Spain would stand out on their maps as a unique opportunity, a niche, and they need to be ready to adapt their strategy to this scenario and its many opportunities. However, the most important thing –and the first thing they should do –is to get support from local teams. This is the only way to manage the whole complex stage of value creation.

In addition to the attractiveness of some luxury hotel assets in Barcelona and Madrid. The best opportunities are in redevelopment; i.e. in change of use, particularly in the former of the two cities because of its attraction for tourism. We are talking in particular of government bodies and financial institutions obliged to reduce their liabilities and exposure to the sector. They have iconic buildings in prime areas, that would be very attractive for transformation into hotels or shopping centres. This is also true of many listed and unlisted companies.

We have seen this in practice in the heart of Madrid with the Canalejas complex. The Villar Mir group has invested 500 million euros to develop a shopping centre and the first hotel for the American Four Seasons chain in the city.

We could imagine this being repeated in Barcelona by an Arab fund to promote a luxury shopping centre for cruise-liner tourism. How about a new Harrods in Plaça Catalunya? Or perhaps a boutique hotel on Via Layetana or Passeig de Colón? The recent opening up of new licences in the area surrounding the historic heart of Barcelona means we can imagine something like this happening. Barcelona –and in particular its Paseo de Gracia area– is developing into a destination for high spending power tourism. This is shown by the high occupancy rates at the Hotel Mandarin Oriental, and the interest of new chains in the same market segment in the area.

And then there are the Balearic Islands. Jumeirah, Dubai Holding's hotel operator, is running a hotel in Solle, Mallorca, with German capital. A similar development with Arab capital is not unthinkable. We should remember that the Emir of Qatar recently bought a Greek island, and has established Puerto Tarraco (Tarragona) as his maritime base for the Mediterranean. Mallorca and Barcelona are on the radar. Today, Chinese capital seems more interested in the Balearic Islands, and Arab capital in Barcelona.

It is also worth remembering that Spain has many international operators that are active in Latin America, but are not active in Asian and Arab markets, with the exception of one of the two listed companies, Meliá International and NH Hoteles. Asian groups have no tourism interest in Latin America and more specifically the Caribbean, but Arab capital might be an option, given the interest they have shown. Katara Hospitality has a licence to develop a hotel complex on Cuba's Cayo Largo island. The experience of Spanish hoteliers in the Caribbean could be a very valuable asset, particularly that of Meliá Hoteles with higher value customers.

In the public sector, SAREB has become the largest real estate company in Europe. This will present many investment opportunities once its product has been classified. However, given the diversity of the assets, the only option for a sovereign fund would be to identify and commit to a good local team with in-depth knowledge of the market. An alternative would be to invest in different private funds specialising in buying real estate assets or debt.

Finally, we could also imagine smaller niche markets focused on private equity, such as the company Aykos<sup>20</sup>, in Barcelona. This engineering company employs modular building technology for high-end hotels and hospitals, to which the French leader Saint-Gobain is committed. The future of building, and particularly high-quality products in emerging economies, must involve this model of industrial construction, and it could become one of the most innovative business lines for global developers. In 2012, ADIA entered the health and real estate market in India. Is it impossible to imagine Mubadala becoming a supplier of prefabricated modules for its hospitals using Spanish technology installed in the Arab Emirates?

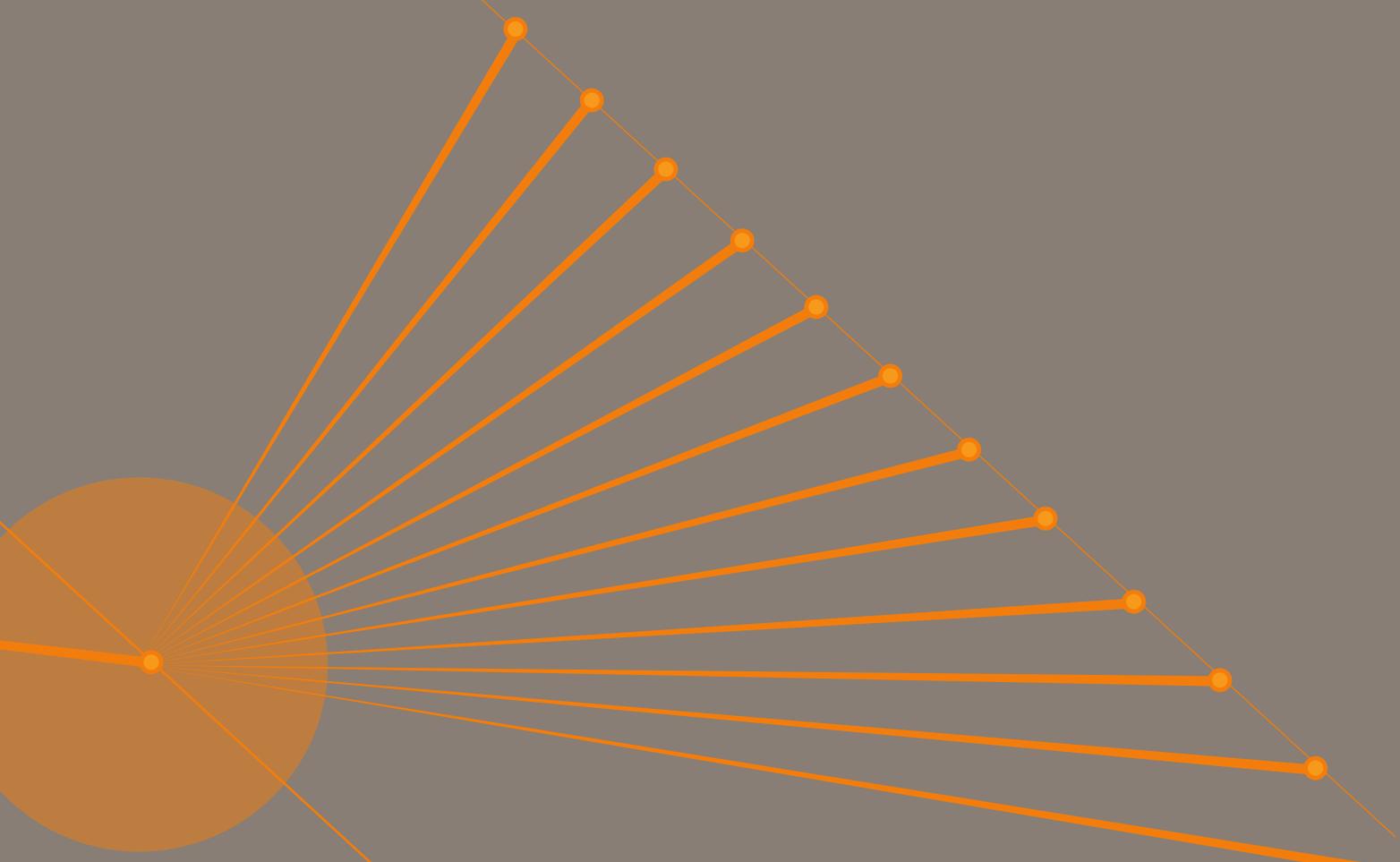
In summary, Spain offers a universe of niche opportunities for those sovereign funds capable of adapting their strategies to take advantage of them. They must simply dare to be different.

---

<sup>20</sup> [www.aykos.com](http://www.aykos.com)



# Appendix. ESAD Egeo Sovereign Wealth Funds Ranking 2013



# ESADEgeo Sovereign Wealth Funds Ranking 2013

Table 1

ESADEgeo Sovereign Wealth Funds Ranking 2013\*

Ranking	Sovereign Wealth Fund	Assets under Management (\$bn)	Country	Established
1	Government Pension Fund Global	715.00	Norway	1990
2	SAMA Foreign Holdings	676.30	Saudi Arabia	1952
3	State Administration of Foreign Exchange (SAFE)	589.50	China	1997
4	China Investment Corporation	500.00	China	2007
5	Abu Dhabi Investment Authority	450.00	UAE	1976
6	Hong Kong Monetary Authority Investment Portfolio	326.00	Hong Kong (China)	1993
7	Kuwait Investment Authority	290.00	Kuwait	1953
8	Government of Singapore Inv. Corp.	220.00	Singapore	1981
9	Temasek Holdings	198.00	Singapore	1974
10	National Social Security Fund	178.90	China	2000
11	Qatar Investment Authority	135.00	Qatar	2005
12	Samruk-Kazyna **	101.50	Kazakhstan	2008
13	Dubai World	100.00	UAE	2006
14	National Wealth Fund	86.72	Russia	2008
15	Western Australia Future Fund	85.10	Australia	2004
16	Revenue Regulation Fund **	77.00	Algeria	2000
17	Investment Corporation of Dubai **	70.00	UAE	2006
18	Mubadala Development Company PJSC	65.30	UAE	2002
19	International Petroleum Investment Company	65.10	UAE	2000
20	Libyan Investment Authority	62.96	Libya	2006
21	Kazakhstan National Fund	62.00	Kazakhstan	2000
22	Korea Investment Corporation	56.60	South Korea	2005
23	Alaska Permanent Fund	45.00	USA – Alaska	1976
24	National Development	42.80	Iran	2011
25	Brunei Investment Agency	39.00	Brunei	1983
26	Khazanah Nasional Berhard	39.00	Malaysia	1993
27	State Oil Fund of Azerbaijan (SOFAZ)	34.30	Azerbaijan	1999
28	Texas Permanent School Fund	28.80	USA – Texas	1854
29	Strategic Investment Fund **	25.80	France	2008
30	New Zealand Superannuation Fund	23.17	New Zealand	2001
31	National Investment Corporation	20.00	Kazakhstan	2012
32	New Mexico State Investment Council	17.30	USA – New Mexico	1958
33	Alberta Heritage Savings Trust Fund	16.80	Canada	1976
34	National Pensions Reserve Fund	15.20	Ireland	2001
35	Fondo de Estabilidad Económica y Social (FEES) **	14.80	Chile	2007
36	Timor-Leste Petroleum Fund	12.90	Timor-Leste	2005
37	Bahrain Mumtalakat Holding Company BSC	11.10	Bahrain	2006
38	Emirates Investment Authority	10.00	UAE	2007
39	Abu Dhabi Investment Council	10.00	UAE	1999
40	Russian Direct Investment Fund	10.00	Russia	2011
41	Dubai International Capital	10.00	UAE	2004
42	State General Reserve Fund	8.20	Oman	1980
43	Fondo de Estabilización Fiscal **	7.10	Peru	2011
44	Permanent Wyoming Mineral Trust Fund	6.30	USA – Wyoming	1974
45	Fondo de Reserva de Pensiones	5.80	Chile	2006
46	Pula Fund **	5.30	Botswana	1994
47	Fundo Soberano de Angola	5.00	Angola	2012
48	Sovereign Fund of Brazil	5.00	Brazil	2008
49	China-Africa Development Fund	5.00	China	2007
50	Zimbabwe SWF	4.90	Zimbabwe	2012
51	Heritage and Stabilization Fund	4.70	Trinidad and Tobago	2000
52	Italian Strategic Fund **	4.30	Italy	2011
53	Public Investment Fund	3.90	Saudi Arabia	2008
54	1Malaysia Development Fund Bhd (1MDB)	3.20	Malaysia	2009
55	Mauritius Sovereign Wealth Fund	3.00	Mauritius	2010
56	Alabama Trust Fund	2.20	USA – Alabama	1985
57	Ras Al Khaimah (RAK) Investment Authority	2.00	UAE	2005
58	Fonds de Stabilisation des Recettes Budgétaires **	1.64	Democratic Republic of the Congo	2005
59	Idaho Endowment Fund	1.40	USA – Idaho	1969
60	Oil Revenues Stabilization Fund of Mexico **	1.30	Mexico	2000

Ranking	Sovereign Wealth Fund	Assets under Management (\$bn)	Country	Established
61	Nigeria's Sovereign Wealth Fund	1.00	Nigeria	2011
62	Western Australia Future Fund	1.00	Australia	2012
63	North Dakota Legacy Fund	0.90	USA – North Dakota	2011
64	Fondo para la Estabilización Macroeconómica (FEM) **	0.80	Venezuela	1998
65	Colombia Sovereign Wealth Fund	0.70	Colombia	2011
66	Palestine Investment Fund	0.70	Palestine	2003
67	State Capital Investment Corporation	0.60	Vietnam	2006
68	Sovereign Fund of the Gabonese Republic **	0.40	Gabon	1998
69	Revenue Equalization Reserve Fund	0.40	Kiribati	1956
70	Government Investment Unit **	0.30	Indonesia	2006
71	National Fund for Hydrocarbon Reserves **	0.30	Mauritania	2006
72	Fondo de Ahorro de Panamá (FAP)	0.30	Panama	2011
73	Oil Revenue Stabilization Fund (ORSF)	0.15	South Sudan	2008
74	Fund for Future Generations **	0.08	Equatorial Guinea	2002
75	Ghana Stabilization Fund **	0.06	Ghana	2011
76	Human Development Fund **	0.05	Mongolia	2008
77	National Investment Fund **	0.04	Syria	2012
78	Ghana Heritage Fund **	0.014	Ghana	2011
79	Permanent Fund for Future Generation	0.009	Sao Tome and Principe	2004
80	Stabilization Fund **	0.003	Mongolia	2011
81	Oman Investment Fund	N/A	Oman	2006
82	Oman Investment Corporation	N/A	Oman	2005
<b>Total (trillions of dollars)</b>		<b>5.625</b>		

Source: ESADEgeio (2013) with information obtained from funds' annual reports and websites. In their absence we relied inter alia on the estimates of SovereignNet (The Fletcher School-Tufts University), Ashby Monk (Institutional Investor), GeoEconomic and Preqin.

\* This list contains the 82 active sovereign wealth funds as at May 2013.

\*\* Using a stricter definition, these sovereign wealth funds would be excluded from the ranking. For example, funds dedicated exclusively to stabilisation, with 100% domestic portfolios, or investing only in fixed income.

Table 2

## Potential new funds

Ranking	Sovereign Wealth Fund	Assets under Management (\$bn)	Country	Established
1	Slovenia SWF	N/A	Slovenia	N/A
2	Papua New Guinea SWF	N/A	Papua New Guinea	N/A
3	Japan SWF	N/A	Japan	N/A
4	India SWF	N/A	India	N/A
5	Israel SWF	N/A	Israel	N/A
6	Philippines SWF	N/A	Philippines	N/A
7	South Africa SWF	N/A	South Africa	N/A
8	Lebanon SWF	N/A	Lebanon	N/A
9	Bolivia SWF	N/A	Bolivia	N/A
10	Georgia SWF	N/A	Georgia	N/A
11	Sierra Leone SWF	N/A	Sierra Leone	N/A
12	Tunisia SWF	N/A	Tunisia	N/A
13	Kenya SWF	N/A	Kenya	N/A
14	Uganda SWF	N/A	Uganda	N/A
15	Zambia SWF	N/A	Zambia	N/A
16	Mozambique SWF	N/A	Mozambique	N/A
17	Namibia SWF	N/A	Namibia	N/A
18	Rwanda SWF	N/A	Rwanda	N/A
19	Tanzania SWF	N/A	Tanzania	N/A
20	Liberia SWF	N/A	Liberia	N/A
21	Guatemala SWF	N/A	Guatemala	N/A

Note: These 21 funds were not active when this edition went to press. Their creation is currently being discussed in the various States.

This report was developed by ICEX Spain Trade & Investment initiative by:

- **Javier Santiso** (Editor). Professor of Economics, ESADE Business School  
Vice President ESADEgeo Center for Global Economy and Geopolitics.
- **Victoria Barbary**. Director, Sovereign Wealth Center.  
Non-Resident Fellow, ESADEgeo. Center for Global Economy and Geopolitics.
- **Christopher Balding**. Associate Professor, HSBC Business School at Peking University  
Shenzhen Graduate School.  
Non-Resident Fellow, ESADEgeo Center for Global Economy and Geopolitics.
- **Patrick Schena**. Adjunct Assistant Professor, Fletcher School, Tufts University  
Senior Fellow and Co-Head, SovereignNet, Fletcher School, Tufts University.
- **Xavier Reig**. CEO and Co-Founder, Black Capital.
- **Ellen Campbell**. Senior Consultant for Strategic Innovation Group, Booz Allen Hamilton.
- **Komal Shakeel**. Research Assistant, HSBC Business School at Peking University  
Shenzhen Graduate School.

#### **Analysis and Coordination**

**Javier Capapé**. Research Assistant, ESADEgeo Center for Global Economy and Geopolitics.

**Tomás Guerrero**, Research Assistant, ESADEgeo Center for Global Economy and Geopolitics.

#### **Infographics and design**

Samuel Granados

NIPO (paper): 726-13-032-2

NIPO (on line): 726-13-034-3

DL: M-23128-2013



