Sovereign wealth funds 2016

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INVEST IN SPAIN

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Preface

1. Preface

The world economic environment in 2016 has seen greater stability than in 2015, as evidenced by the general reduction in volatility and risk premiums. It has also been driven by modest growth, which is subject to higher uncertainty, largely as a result of the continued geopolitical tensions and the doubts generated by the capacity of emerging economies to correct their macroeconomic imbalances in an orderly way.

In general terms, a slowdown can be observed in the growth of developed economies and a stabilization in emerging ones. Economic growth in the United States has slowed significantly compared to 2015, primarily due to a drop in investment, which was offset by consumer behavior, the good performance of employment figures and moderate inflation rates. In the European Union the situation has been marked by a moderate economic recovery driven by the continuation of the expansive policies enacted by the European Central Bank, which provides access to funding for households and companies. The current situation in Europe has been shaped by the victory of the Brexit camp in the European Union referendum in the United Kingdom, whose consequences have yet to be clearly seen.

Although emerging economies began their slowdown in 2015, 2016 has seen a gradual stabilization of their economic activities, backed by a lower risk perception. China has entered a new normality, characterized by more modest growth rates of around 6%-7% and the start of the awaited transition in its growth model. However it is not exempt from risks, including the overaccumulation of debt. Economic activity continues to decline in Latin America, still weighed down by Brazil, which continued slowing by more than 2% of its GDP, in a year that was supposed to mark the return to positive growth rates starting in 2017. The main Middle Eastern countries like United Arab Emirates, Qatar and Saudi Arabia saw a slowdown in their economic activity and greater pressure on their fiscal and current-account deficits.

In this international scenario, the investment activity of sovereign funds has increased worldwide. In 2015 these funds saw over 180 transactions, up 30% since the previous year, and they maintained their dynamism in the first half of 2016 with almost 100 transactions. This positive behavior, in line with the performance of the global cross-border mergers and acquisitions market —which in 2015 achieved its highest value since 2007—, is evidence that the current economic situation poses significant challenges, but also offers major opportunities for international investors.

To offer an in-depth look at its trends, strategies and transactions, we present the fifth edition of the sovereign funds report, a joint project by ICEX-Invest in Spain, IE Business School and KPMG. The new edition of this report is produced in a period that is characterized by cheaper crude than in previous years, and it analyzes the impact of this phenomenon on hydrocarbon-dependent economies and on their respective sovereign funds, whose investment and funding strategies have been adapted to this new reality.

Another issue in the spotlight is the increased sovereign fund investment in non-traditional sectors such as technology, with the so-called "sovereign venture funds", the hotel sector and the luxury trade. We also look at the performance of sovereign funds originating in regions that are traditionally less inclined to this type of vehicle, such as Europe —with the exception of Norway— and sub-Saharan Africa. The report includes a summary of the investments made by sovereign funds in Spain since 2011, a series of transactions that have already been discussed in depth in previous editions.

Finally, this set of editions contains a detailed analysis of sovereign funds by geographic area in the Middle East, Asia, –especially China and Singapore–, and in Latin America and Africa; and by sector, including real estate, the energy and financial sectors, infrastructure, agriculture, new technologies and sport.

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Executive Summary

2. Executive Summary

"Keep Calm and...Carry On": Sovereign Direct Investments in 2015-16

In line with general market performance, SWFs generated limited, flat or negative returns in some cases in 2015. **Direct investments by funds increased by 30% to 180 deals. However, total direct investment fell by 48% to US$47 billion.** As the report emphasizes, these are direct deals that are recorded in public sources. One of the reasons for this decrease is the growing involvement in deals through consortiums with expert local partners. This is particularly the case in the real estate sector. Real estate accounted for nearly 37% of capital invested by the funds. At the other extreme, investment in commodities fell to lows of less than 5%, while the financial sector was down to 12% from 17%. **Geographically, the US, India, China, the UK and Singapore were the favorite destinations, attracting 69% of investments by funds.** The doubling of deals in China and the tripling of deals in India were particularly noteworthy.

The chapter concludes by mentioning the impact of the UK's vote to end its membership of the European Union. The Brexit vote has not yet had any direct, observable effect on SWF deals, with real estate deals in London remaining popular through to the middle of 2016.

When the rainy day comes: sovereign wealth funds in an era of low oil prices

Lower-for-longer oil prices don't represent an apocalypse for sovereign wealth funds, regardless of the headlines. Kazakhstan or Russia are among the most heavily affected by the crisis. SWFs in these two countries have witnessed a repurposing in order to fill fiscal gaps. In addition, quasi-SWFs such as SAMA in Saudi Arabia or SAFE in China, have brought some confusion to the discussion. They are both different in nature to SWFs, they have flexible saving and spending rules and they were established to play the role of the central bank in managing foreign exchange reserves. Thus, these redemptions, $70bn in the case of SAMA, should be seen under this specific lenses.

In other words, the largest SWFs are not being severely influenced, in the short run. For example, ADIA in Abu Dhabi or NBIM in Norway, are both being tapped by their governments, yet in volume levels in line with the rules established for the SWFs. They both generate enough investment returns to meet the demands of their governments. But the **persistent low-oil-price environment will nevertheless have profound effects in the mid- and long-run,** compelling sovereign funds to shift their allocation strategies in three directions: towards **private markets (in 2015 they invested more than $25bn in real estate), in-source more of their operations and demand more of their partners.**

Unleashing the Potential of Sovereign Wealth and Pension Funds in Africa

There are 12 SWFs in operation in Africa. These funds manage US$154 billion, yet representing a mere 2.1% of the overall total for the SWF industry. However, **Africa has huge potential: 12 of the 28 countries worldwide considering setting up new SWFs are African.** There are two African SWFs in the top 25 by assets under management (AuM): Algeria and Libya. Sub-Saharan countries are also gaining importance, not only because of the creation of new funds, but also because of their governance. Botswana's Pula Fund is a clear example. It is already being studied as a success story. The Nigeria Sovereign Investment Authority is another. Its corporate governance and transparency are setting the bar for other countries with enormous natural wealth and huge capital requirements.

This chapter also looks at the little-known African pension funds. Led by a number of South African funds, assets under management for the African pension-fund industry is expected to reach US$1.1 trillion by 2020. Other countries, such as Nigeria, Namibia and Kenya, have also set up public and private pension funds.

European sovereign funds: co-investment platforms for the real economy

In Europe, SWFs are not well represented. Admittedly, Norway has the world's largest fund - the Government Pension Fund Global - with US$848 billion of AuM. While the strategies and deals of this fund are well known, less is known about the activities of other European funds. **The funds of Ireland, Italy and France manage around US$14.1 billion,** but the general public are unaware of them. The Irish fund, for example, is undergoing a "reorientation" of its mission, now pursuing the development of the domestic economy and support for employment rather than investment in a global portfolio. In Italy, the renowned CDP Equity was involved in one of the main deals when it acquired a 12.5% stake in oil company Saipem. **In this edition, we dedicate a chapter to in-depth analysis of European SWFs, focusing on their corporate structures and investment strategies. We also examine what the future holds for the Italian, French and Irish SWFs,** which are currently used for national development, as they redirect their strategies and structures.

Sovereign wealth funds check-in: Investment strategies in the hotel sector

In 2015, sovereign wealth funds (SWFs) invested over US$7.1 billion in hotel assets worldwide. The Qatar Investment Authority (QIA) was the biggest investor in this sector, investing over US$4 billion in acquiring hotels and hotel portfolios in London, Paris and Rome. QIA was involved in two particularly significant deals: the purchase of three iconic London hotels for US$3.3 billion, in a movement with substantial impact on its reputation, in addition to the financial returns that might be generated; and an acquisition of 10% of the shares and two seats on the board of directors of AccorHotels, the largest hotel group in Europe and the world's sixth largest. **Abu Dhabi's ADIA was the most active fund, with six deals in 2015,** including a hotel portfolio in Hong Kong (US$1.4 billion) and two Marriott hotels in New York and Miami (US$750 million). Other active SWFs included the Oman Investment Fund, which acquired seven Hilton hotels in Europe for €380 million, and the Korea Investment Corporation, which invested US$200 million in the InterContinental Hong Kong.

The tourism potential of China's emerging middle classes is making countries in the region a tempting prospect for funds, as demonstrated by deals in Hong Kong and Vietnam. Deals in Sudan, Morocco and South Africa suggest Africa is now also becoming a hotspot. The asset-light strategy pursued by many groups has resulted in the sale of a host of assets over recent years and SWFs have taken advantage of this opportunity. **The large scale of hotels, their long useful lives, the protection against inflation they offer and their connection to the dynamic tourism sector make them excellent options for portfolio diversification, while also promoting a country's brand recognition. Sovereign wealth funds accounted for close to 10% of the total value of international hotel deals in 2015.**

Sovereign wealth fund investment in the luxury industry

Despite the growth in the luxury sector in 2015, the search for returns has obliged SWFs to cut back dramatically on their riskier investments and acquisitions of non-real estate trophy assets, which are strongly connected to the luxury industry. As a result, **investment by funds in the luxury industry has plummeted, from US$13 billion in 2009 to just US$1.4 billion in 2015.** Qatar's sovereign wealth fund has solidified its position as specialist and a benchmark in this sector; it is the only SWF to have maintained its commitment to the sector over time. Deals by SWFs in this sector have not just sought to achieve juicy returns and protection, in some cases, against inflation, but also to **attract luxury companies and brands to their home countries and position themselves as "world-class investors": Qatar is an excellent example of this.**

Sovereign Venture Funds 2.0

Sovereign wealth funds (SWFs) continue to bet on innovation and technology. This has resulted in a proliferation of sovereign venture funds: sovereign wealth funds that invest in new technologies and innovation, startups and venture capital. Investments by these funds have expanded beyond large listed tech companies and now include the famous "unicorns," startups that have joined the US$1 billion club in record time. **Sovereign venture funds were involved in more than 30 major investments in startups in 2015,** led by Singapore's Temasek (with 16 investments) and GIC (with 8). Some of the most significant deals involved Uber, in which Saudi Arabia's Public Investment Fund recently invested US$3.5 billion, and Airbnb, into which Temasek injected US$150 million. **SWFs are also investing in the capital of startups at early stages of their investment lifecycle,** demonstrating the sophistication of some of these vehicles - such as Khazanah and the China Investment Corporation - and their strategic commitments to the digital economy. This trend is expanding globally and more funds are establishing venture capital teams to capture value of disruptive startups on the long run.

“Keep calm and...Carry on”: Sovereign direct investments in 2015-16

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1. "Keep calm and...Carry on": Sovereign direct investments in 2015-16

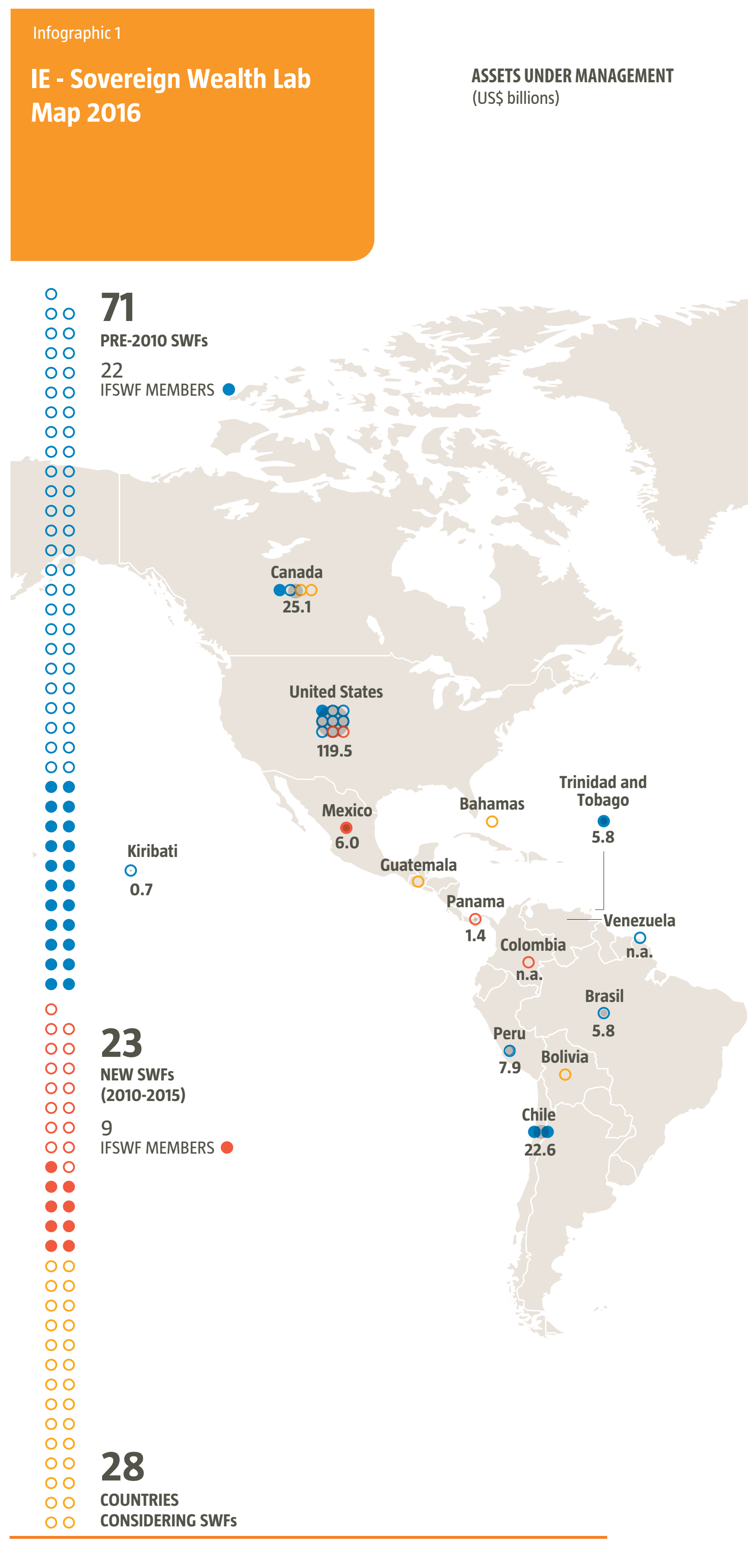
In 2015 returns across major global markets began a tortuous path that ultimately left many markets generally flat to down. Anemic to poor returns have likewise been reflected in recently released 2015 performance reports of several large sovereign funds.[1] The challenge posed to global asset owners and managers has been to navigate a host of structural issues that plague global markets – stagnant economic growth, depressed commodity prices, high demand for safe assets, continuing threats posed by disinflation and, for good measure, asset price volatility accentuated by election cycles, the growing threat of global terrorism, and cracks along the fault lines of the European Union. Credit Suisse has been sounding alarm bells that low returns are here to stay, projecting real bond returns of near zero and real equity returns of 4%–6% per annum for at least a decade.[2] McKinsey, focusing on US markets, draws similar conclusions of "diminishing returns".[3] Simple comparisons of one- and five- year returns across most major markets give added credence that a secular shift is indeed in the offing.

For the many sovereign investors that manage with a long-horizon, change is reflected in both tails of the "bell". Risks abound in both tactical and strategic decision-making, whether in adjusting weights, selecting managers, or hedging exposures. However, the ability to take a long view offers opportunities to identify and exploit secular change across markets in pursuit of enhanced long-term risk adjusted performance. Among sovereign investors this has been reflected in a steady growth in the number of funds trading liquidity for higher expected returns in real estate and infrastructure, as well as others types of private assets.[4] Such exposures are pursued both indirectly through external mandates and directly via discrete investments, usually the domain of the largest global SWFs with requisite scale and the capacity.

Our annual review represents an analysis of the latter – the direct investment activity of SWFs - with the goal to understand changes in their investment strategy and behavior. Our dataset consists of a public sample of SWF direct investments across all regions and sectors, updated through June 2016. While defining and cataloging SWFs remains elusive, assuming a global universe of 94 SWFs as counted in this report, our coverage includes approximately 20% of all entities. Based on holdings of nearly $5 trillion, this cohort

Infographic 1

IE - Sovereign Wealth Lab Map 2016



1 Note in particular Temasek, GIC, CIC, and ADIA.

2 See Credit Suisse Global Investment Returns Yearbook 2016, February 2016 accessed at http://publications.credit-suisse.com/tasks/render/file/index.cfm?fileid=AE3E00B9-91E2-D1FA-6C18765D3A968D73

3 See Richard Dobbs, Tim Koller, Susan Lund, Sree Ramaswamy, Jon Harris, Mekala Krishnan, and Duncan Kauffman, "Why Investors May Need to Lower Their Sights", McKinsey&Company, May 2016, accessed at http://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/why-investors-may-need-to-lower-their-sights

4 See Preqin, "The Preqin 2016 Sovereign Wealth Fund Review" and Invesco, "Invesco Global Sovereign Asset Management Study 2016", accessed http://igsams.invesco.com

Currently, there are 94 active sovereign wealth funds, two more than in our 2015 Report. 57 countries have established at least one SWF. Middle East, China, Southeast Asia and Norway are the four most active poles of SWFs. Assets under management exceed 7 trillion dollars. SWFs have widely spread in recent years: since 2010, 23 new funds were established. Other 28 countries are considering establishing a SWF. Debates over new SWFs are growing in East and South Africa and in Latin America. Thus, in 2016, there are more than 122 operating or prospective-SWFs. There are 31 funds members of the International Forum of Sovereign Wealth Funds.

Norway 848.3
Russia 133.8
United Kingdom
Ireland 7.6
France 1.0
Italy 5.6
Slovenia
Kazakhstan 149.7
Mongolia 0.3
Georgia
Azerbaijan 33.6
Turkmenistan n.a.
Syria n.a.
Iran 64.8
Morocco 1.5
Tunisia
Lebanon
Israel
Kuwait 553.2
Palestine 0.8
Qatar 304.0
China 1.996.1
South Corea 84.7
Japan
Algeria 77.2
Libya 60.0
Egypt
S. Arabia 643.9
Oman 18.8
India
Taiwan
Mauritania 0.03
Senegal 1.0
Nigeria 1.0
South Sudan n.a.
Bahrain 11.4
UAE 1.208.1
Vietnam 3.3
Philippines
Sierra Leone
Liberia
Ghana 0.5
Eq. Guinea n.a.
Uganda
Kenya
Malaysia 48.8
Brunei 39.3
São Tomé and Príncipe 0.01
Gabon 2.4
Congo n.a.
Rwanda 0.03
Tanzania
Indonesia 0.5
Papua New Guinea n.a.
East Timor 16.5
Angola 4.9
Zambia
Mozambique
Mauritius n.a.
Singapore 516.8
Botswana 5.5
Namibia
Zimbabwe
South Africa
Australia 119.0
New Zealand 19.3

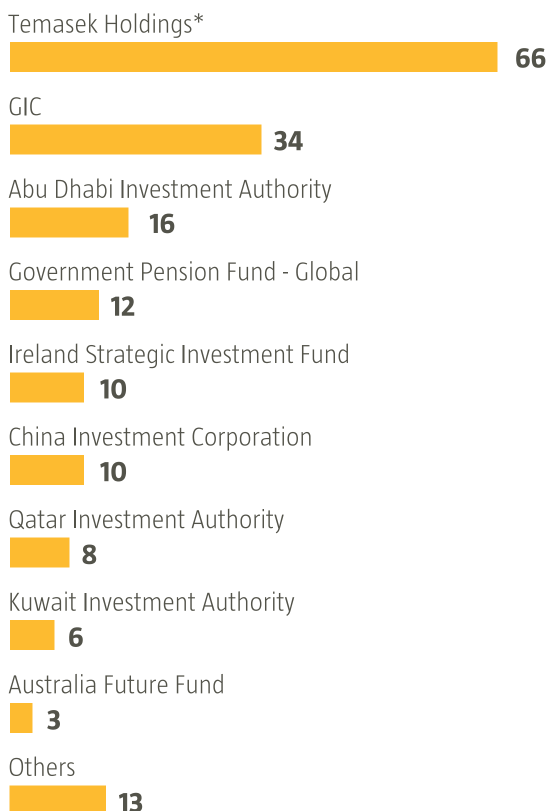
Source: IE SWLab SWF Tracker (2016)

1. "Keep calm and...Carry on": Sovereign direct investments in 2015-16

represents over 70% of the estimated global SWF assets under management and clearly reflects the disproportionate participation of the largest sovereign investors. Our analysis of the acquisition data in particular, suggests that this group has indeed "carried on" in the midst of market disruptions. In 2015, aggregate investment activity increased by over 30% to nearly 180 deals, deploying a minimum of approximately $47 billion in reported transaction capital.[5] Based on the number of deals completed in the first six months of 2016 direct SWF transactions appear on pace to exceed 200 in 2016.

We discuss our results below for both 2015 and, as preliminary, 2016. While generally we find a continuation of prior investment themes and destinations, some interesting secular shifts are discernible. In both periods sector and geographic preferences were somewhat consistent with themes developed in prior periods. For example, both the real estate and infrastructure sectors continued to attract significant sovereign capital. However proportionately investments in commodities and natural resources declined. Similarly, with respect to geography, key destinations such as the US, India, China, and the UK continued to attract sovereign investment. In 2015 Ireland joined these ranks based on the efforts of the Ireland Strategic Investment Fund (ISIF) to continue to scale up its investment activity. The ISIF is especially interesting as its emergence from the ashes of Ireland's National Pensions Reserve Fund reflects an expanding trend by governments to establish sovereign investment vehicles with strategic or development mandates specifically to catalyze investment into domestic economic sectors. This too is reflected in our data as the number of domestic transactions in our sample increased 25% to approximately 20. As in the Irish case, several sovereign or "strategic investment" funds have been established in developed market economies, such as Europe. These are analyzed in more detail in a separate contribution later in this volume on European SWFs.

Figure 1
The most active Sovereign Wealth Funds in 2015



* It includes close to 40 venture capital deals

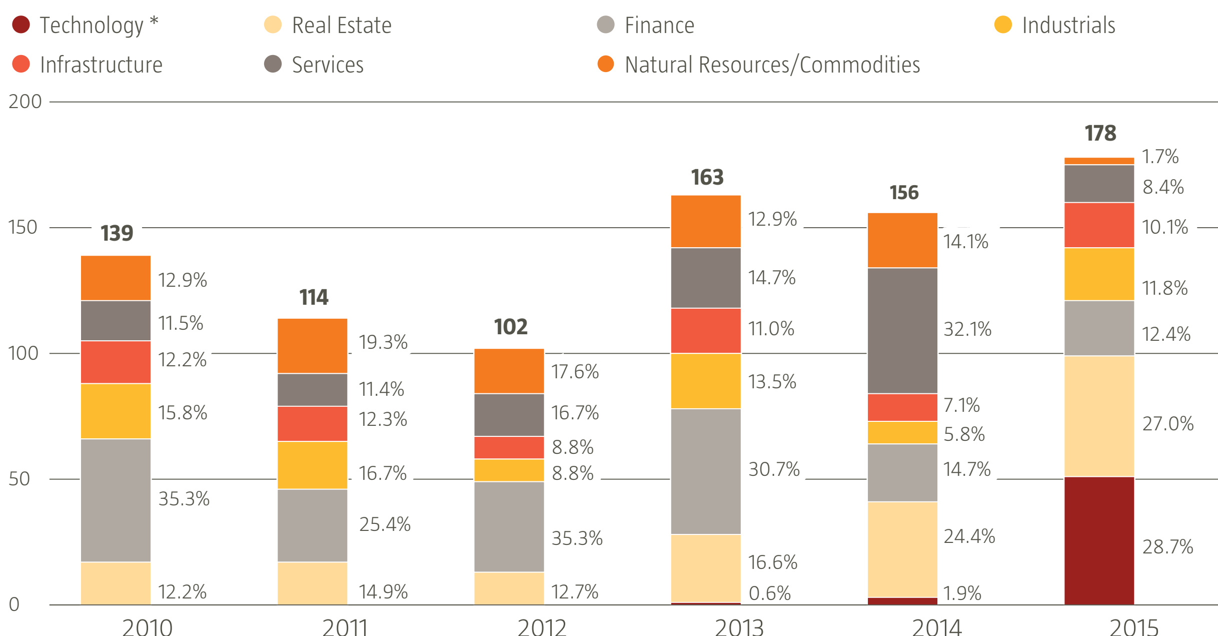
Source: SWF Transaction Database (Tufts University)

Certainly much of the media interest in SWFs during 2015 and the first months of 2016 was centered on the effects of lower oil prices on SWF flows, on the stability and growth of their asset under management, and on net impacts on SWF asset allocation. Deal teams among the largest funds – whether exporter or importer – nonetheless remained quite active during this period. The direct and indirect effects of declines in hydrocarbon and commodity prices reinforced core macro trends of slower growth and re-centered investors on enhancing returns and broadening portfolio diversification. Among sovereigns this was generally reflected in strategies that leveraged illiquidity premia and exploited global demographic shifts, while exploring the potential of new markets and technologies. Related investment themes included several linked directly to the residual impact of the oil price decline, as for example the attractiveness of renewables and green tech. We note in particular representative deals such as ADIA's investments in the Green Investment Bank and ReNew Power Ventures, as well as its recent co-investment with GIC in Greenko Energy Holdings. Others themes build on an expanding SWF investment base in bio-tech and life sciences, as well as disruptive technologies and business models both in developed and emerging markets. Temasek and GIC

[5] We track both acquisitions and divestiture. Our analysis here is on the former.

Figure 2
Sector Analysis (2010 - 2015)

Number of deals



* SWF subsidiaries' investments in venture capital (mostly technology) are not included before 2015.

Source: SWF Transaction Database (Tufts University)

continue to lead the way particularly through private equity deals, frequently executed through special purpose subsidiaries. Importantly, this theme too has expanded and deepened, particularly in e-commerce, not only among unicorns, such as GrabTaxi and Didi Kuaidi, but as well into smaller, venture-sized deals. Still, it is participation in large-scale real estate and infrastructure that garner particular attention justifiably. Together these sectors account for nearly 50% - over US $23 billion - of reported 2015 SWF invested capital.[6]

[6] We offer here a brief and cautionary note on methodology. Data on the value of SWF participation in deals is extremely difficult to collect and validate. All too frequently transaction amounts are expressed as aggregates with little clarity around specific commitments or levels of participation by co-investors. Also some sectors – such as real estate – might be better reported than others. While various techniques may be used to estimate or "range" SWF investment levels, we suggest that any interpretations of such data – and so any conclusions drawn - must be viewed with considerable caution. Our approach is to reference reported and verified SWF investments, recognizing both the possible presence of selected reporting bias and that missing data will significantly impact analyses and conclusions.

2015 Investment Activity

In 2015, the top five SWF direct investors were Singapore's Temasek and GIC, the Abu Dhabi Investment Authority (ADIA), Norway's Government Pension Fund – Global (GPFG), and the China Investment Corp (CIC), who together by deal count constitute 78% of our deal volume. This is more concentrated than 2014, when these same funds represented about 73% of deal volume. Also, as the CIC and ISIF each completed ten transactions, elevating it to the top five further concentrates deal volume (83%). Of particular note, Norway continued to build out its real estate portfolio, averaging approximately 1 deal per month.

Evaluating private equity deals separately, we note that Temasek and GIC—either directly or via subsidiaries—maintained an aggressive pace in this asset class. Principle among such structures is Vertex Ventures, one of several venture capital subsidiaries of

1. "Keep calm and...Carry on": Sovereign direct investments in 2015-16

Temasek, which itself completed nearly 50% of the venture deals we tracked. With respect to execution, Temasek's average commitment in such transactions is over US $350M, while Vertex average commitment – appropriately for the size and stage in which it investments – is estimated to be approximately US $18M.

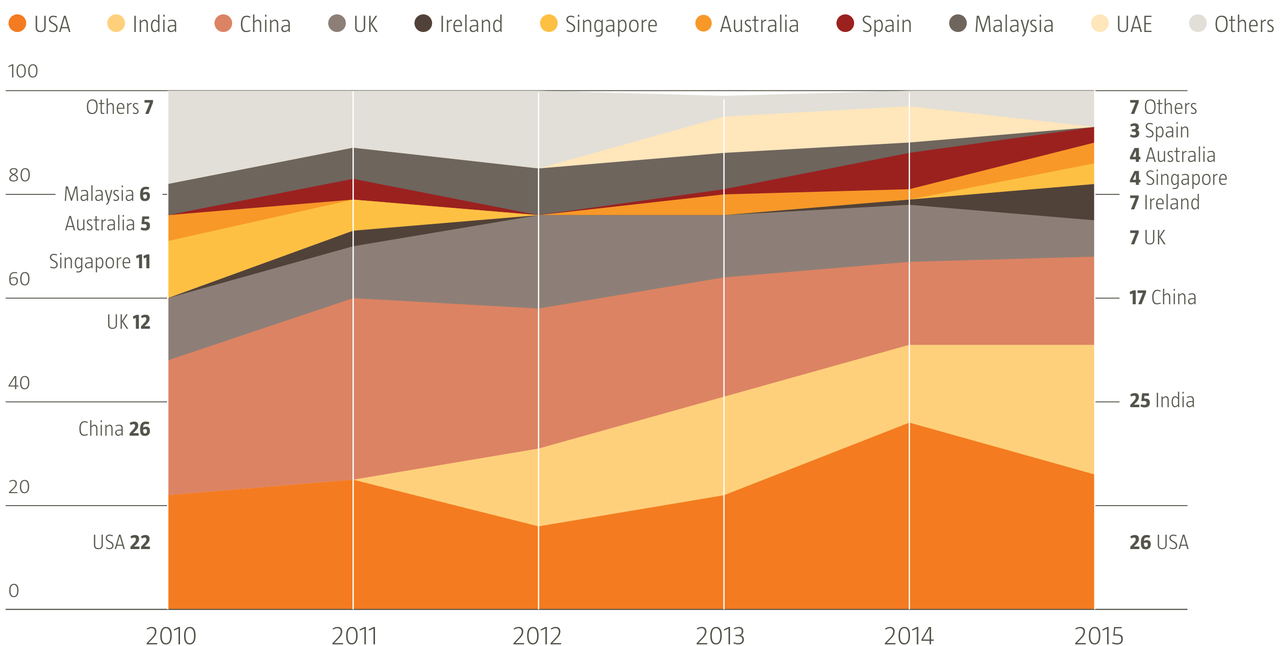
By sector real estate transactions dominated in 2015 representing 27% of the deal count led by GIC, GPFG, and ADIA (Figure 2). While increasing proportionately from 20% in 2014, total real estate transactions actually increased nearly two-fold to 48. This represents over 37% of total reported SWF invested capital in 2015. Conversely investments by SWFs in commodities and natural resources were significantly scaled back in 2015 owing to the structural decline in global commodity prices and what some have speculated as the end of the commodity supercycle. Proportionate investment in this sector declined from over 10% in 2014 to under 5% in 2015. Lastly, in financial services, a sector that dominated SWF deal volumes since 2009, year over year investments remained about flat, but declined proportionately.

By geography, the US, India, China, the UK, and Singapore remained attractive destinations for sovereign investment with 69% of total deal volume (Figure 3). This was an increase over 2014 (61%). While there were proportional shifts, deal volume was higher in each geography, in some cases by a factor of two (26 China deals) or over three (39 India deals). The US nonetheless continued its appeal as a sovereign investment destination with over 40 deals, an increase of over 60 percent year over year. As noted above, Ireland also climbed in the ranks but by virtue of the domestic investment activities of the ISIF. In fact, 12% of the 2015 SWF deals were completed domestically. The ISIF, in keeping with its development mandate, completed 9 of 21 total deals. Other funds with development or strategic mandates - notably Temasek, Samruk-Kazyna, CIC, and Mumtalakat - were likewise active domestically in 2015. In the case of Temasek it is interesting to note that its domestic 2015 deals were undertaken by its venture investing arms Vertex Venture Holdings and Heliconia.

Figure 3

Top 10 Destinations (2010-2015)

As percentage of total deals



Source: SWF Transaction Database (Tufts University)

Table 1

Largest deals in 2015

SWF Name	Target Name	Volume (US$ Million)	Target Country HQ	Target sector
Public Investment Fund	RDIF	10,000	Russia	Finance
Samruk-Kazyna National Welfare Fund JSC	Kashagan Oil Field	4,700	Kazakhstan	Natural Resources
Qatar Investment Authority	Manhattan West Properties	3,784	USA	Real Estate
Abu Dhabi Investment Authority	Hong Kong Hotels	2,390	Hong Kong	Real Estate
Government Pension Fund - Global	322 properties across 17 states	2,340	USA	Real Estate
China Investment Corporation	Australia Office Properties (Investa Property Group)	1,783	Australia	Real Estate
Government Pension Fund - Global	Trinity Wall Street	1,560	USA	Real Estate
Abu Dhabi Investment Authority	TransGrid	1,400	Australia	Infrastructure
Kuwait Investment Authority	TransGrid	1,400	Australia	Infrastructure
Qatar Investment Authority	HK Electric Investments	1,200	Hong Kong	Infrastructure

Source: IE Sovereign Wealth Lab based on SWF Transaction Database (Tufts University).

On the basis on the value of reported commitments by SWFs,[7] we find that approximately 22% invested capital was committed to companies or projects domiciled in the United States, 21% in Russia, 11% in China and Hong Kong, 10% in Kazakhstan, and 5% in India.

Noteworthy deals of size include the 10 billion dollar commitment to the Russia Direct Investment Fund by the Public Investment Fund of Saudi Arabia and the 4.7 billion dollar Samruk-Kazyna investment in a 50% stake in the Kashagan oil field acquired from Kazakhstan's state oil and gas company KazMunaiGas. Investments in the United States and Hong Kong were primarily in real estate, highlighted by the Qatar Investment Authority's investment in the Manhattan West development, Government Pension Fund Global's investment partnership with Prologis in American warehouses, and ADIA's investment in the Grand Hyatt, Renaissance Harbour View and Hyatt Regency and Hong Kong.

It is interesting to note that in each of the three aforementioned real estate transactions, the sovereign was engaged in a partnership or a consortium. Of the 21 real estate deals we reported for 2014, only 10 were as a contributor to a partnership or consortium. In 2015 18 of 33 real estate investments were in fact co-

Table 2

Average deal size

Sovereign Wealth Fund	Average Deal Size*
Public Investment Fund	5,550.00
Samruk-Kazyna National Welfare Fund JSC	2,403.00
Qatar Investment Authority	961.58
China Investment Corporation	944.33
Australia Future Fund	841.77
Abu Dhabi Investment Authority (ADIA)	682.12
Kuwait Investment Authority	681.50
Mubadala	500.00
Government Pension Fund - Global	496.12
The State Oil Fund of the Republic of Azerbaijan	435.00
Khazanah	300.00
GIC	263.31
New Zealand Superannuation Fund	260.58
Temasek Holdings	169.44
Ireland Strategic Investment Fund	128.58
Korea Investment Corporation	100.00

Source: IE Sovereign Wealth Lab based on SWF Transaction Database (Tufts University).
* Million dollars

[7] Note that substantial deals such as the GIC's purchase of Veritas (worth $8 billion), Temasek's investment in China's Postal Savings Bank IPO (worth $7 billion), and Temasek's financing of the EMC purchase ($67 billion) were not included in these figures as we could not accurately determine the level of SWF financial investment.

invested deals. This was coupled with a significant increase in the average size of real estate deals in which sovereigns participated. The combination might well suggest that sovereigns sought to deploy larger allocations to deals, but are opting to share transaction exposures, while leveraging the market expertise of co-investment partners. It is nonetheless telling that it is the largest SWFs by AuM - GPFG, ADIA, CIC, QIA and GIC – that account for most of the reported sovereign investment in real estate – over 90% - in 2015.

2016 Investment Activity: A Preliminary View

To assess continuity in SWF direct investment patterns into 2016, we extended our analysis cautiously to offer a preliminary view into 2016 deal activity. We find that in the first half of 2016 SWF investment has generally maintained its trajectory though at a somewhat faster volume pace. As of June 30, approximately US $21 billion in reported investment value was identified across approximately 100 deals. This suggests that while deal count may have accelerated, aggregate capital deployed – as reported – has not thus far. Once again Temasek, GIC, and ADIA, dominate the rankings with over 50% of the transactions, joined by the Qatar Investment Authority (5), the ISIF and Mumtalakat (each with 4), and the Kuwait Investment Authority (KIA), the Korea Investment Corp (CIC), the CIC, and the Russia Direct Investment Fund (RDIF) (each with 3).

Conspicuous by its absence from this roster is Norway. With over $845 billion in assets under management, the GPFG - among the largest SWFs – reported a loss for Q1 2016 and in January experience its first drawdown in 20 years. Managing liquidity requirements resulting from additional projected drawdowns in 2016, may in part account for a slowdown in deploying capital in direct deals in the first half of 2016. Norway's direct investments are in the real estate sector. Its mandate includes a 5% allocation to real estate, which remains partially filled at 3%. Over 75% of its real estate holdings are in the US and the UK, with 26.3% in the UK alone. This leaves open that real estate market conditions in its key markets may also account for its decision to deploy less capital in H1 of 2016. We return to this question below in an expanded discussion of Brexit. By sector, we note an increase in the pace of financial services deals when adjusted for commitments to pooled investment vehicles. Also there is some evidence that sovereign investment interest in commodity and natural resource deals may be intensifying. What is certain is that thematic investment in new technologies continues (nearly 20% of 2016 deals thus far). One investment garnering particular interest in the early part of 2016 is the $3.5 billion commitment to Uber by the Saudi Arabia's Public Investment Fund. This deal comes on the heels of CIC's 2015 investment in Singapore's Grab Taxi and Temasek and CIC's participation in the funding rounds of China's Didi Kuadi. Placed in wide relief, it reflects a thesis among SWFs – particularly from the perspective of long investment horizons - that the forces driving innovation in disruptive new technologies, including e-commerce, offer opportunities for both enhanced returns and diversification from traditional economies and business models. This theme is taken up and analyzed in more detail in a separate contribution in this volume on sovereign venture investing.

With respect to the real estate sector specifically, we identified 21 investments accounting for 20% of our preliminary 2016 reported total. Many of these investments were in the US market, such as the CIC's purchase of a minority stake in 1 New York Plaza for US $700 million and GIC's investment in student housing for US $665M. The largest real estate deal we have tracked in 2016 is the Qatar Investment Authority's purchase of Asia Square Tower One in Singapore for US $2.5 billion. Other significant transactions thus far include the Korea Investment Corporation's co-investment with Brookfield Property Partners in the Berlin property complex Potsdamer Platz and the State Oil Fund of Azerbaijan's (SOFAZ) venture into the Italian property market.

By geography, the US, India, China, Singapore, and the UK continued to attract sovereign capital yet at a pace (55%) slightly trailing 2015. Noticeably SWF real estate deal count in the UK declined in the first six months of 2016.

Brexit through Sovereign Eyes

As we prepared our analysis in the shadows of the Brexit vote, we were struck repeatedly by a lingering question: How do long-horizon sovereign investors evaluate and mitigate political risk? We thought to consider this question in the microcosm that is our dataset. We focused on a simple question: Does the data belie a sensitivity to the market risks associated with both property and currency values in the one and one half years leading up to the Brexit vote? Now several weeks removed it is interesting to return to our sector analysis with a focus on the UK. Certainly, the vote for Britain to leave the EU has precipitated much uncertainty with regard to timing, conditions, and so eventual impacts of the decision. Moreover, with its deep linkages across EU markets, this uncertainty in the UK's economic future is exported to other facets of SWF balance sheets.

Returning to our analysis, we found that SWF investment activity in 2015 offered little indication or insight into the impending vote. The 11 deals completed by SWF's in the UK in 2015 represented a marginal increase year over year. Also slightly over half those deals

were completed in the second half of 2015. In addition, seven of the eleven investments were in the infrastructure and property sectors in which real effective returns would likely accrue long after the Brexit dust had settled.

Through June 30, 2016, we identified four additional UK deals, i.e. one behind the H1 2015 pace. This includes CIC's business park deal (US $509M in January), as well as the KIA's London City Airport deal ($2.8 billion in February). Year to date through June 30, the FTSE EPRA/NAREIT UK Property Index was down 13.5 percent clearly reflecting the uncertainty the Brexit vote engendered and its adverse impact on UK real estate values. Similarly, the GBP weakened by over 10% through the same period.

The weakened Sterling and depressed UK property prices prompted the GPFG to reduce the value of its UK real estate holdings by 5% at June 30. However, these pricing adjustments likely affected pipeline deals. For example, in the case of Norway, GPFG in July announced a $164 million purchase of retail space on London's Oxford Street just 23 days after the Brexit vote.[8] Also in July the QIA was linked to the acquisition of London's Grosvenor House as part of a 3 hotel deal. Thus, the UK real asset market may yet present buying opportunities for large SWFs who seek to deploy capital to UK property assets and who may yet be on the sidelines in wait of attractive investment opportunities. Our eventual review of the full year 2016 will allow us to complete this analysis and perhaps shed additional light on the questions we posed above.

The emergence and evolution of what would eventually become known as "sovereign wealth funds" have their genesis in the early commodity stabilization funds deployed in a public policy capacity to mitigate the adverse effects of commodity price movements on fiscal balances and to immunize national economies against over-investment in the face of low absorptive capacity. Today, SWF mandates have expanded widely in some cases through outgrowing their asset bases, while in others to meet the discrete challenges of a specific strategic or policy remit. The decline in hydrocarbon prices, which deepened in 2015, raised real questions about the institutional viability of SWFs funded by oil revenues. As oil prices continue to seek a new equilibrium, oil exporters have taken an integrated approach to fiscal management, recognizing that SWF reserves represent one of many tools designed to support long-term fiscal sustainability. Critically, the innovation that is the sovereign wealth fund has re-emerged with further expanded mandates that include not only stabilization and savings, but also economic diversification and the catalytic function to promote inward foreign direct investment. SWFs "carried on" in 2015. As their evolution continues we should expected to see structural changes in investment behaviour that adapt to long-term secular trends in markets, while also reflecting these new institutional paradigms.

[8] Had the Government Pension Fund Global completed the purchase on June 15th instead of July 15th, the fund would have paid 5.6% more in Norwegian Kroners than it actually did.

When the rainy day comes: Sovereign wealth funds in an era of low oil prices

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2. When the rainy day comes: Sovereign wealth funds in an era of low oil prices

It is hard to conceive now that the price of a barrel of Brent Crude oil was $112 in June 2014. The price fell abruptly over the following six months, hitting a low of $48.42 in January 2015. A year later it had plunged again, to $30.80 per barrel as of January 2016.

Today, demand for oil is muted. Global economic growth is sluggish. China's economy, which had previously driven global growth, has now slowed as the government seeks to make it more consumer-orientated. The half-decade of high oil prices that followed the financial crisis encouraged greater efficiency in transport and heating technologies, the mainstays of petroleum consumption. Oil prices above $100 also encouraged a switch to other energy sources, such as wind and solar. This trend is only going to continue: in the Paris Agreement on Climate Change, countries across the globe pledged to reduce carbon emissions to keep anthropogenic global warming below 2°C above pre-industrial levels.

The oil market has also changed. Those years of high prices ushered in the shale revolution in the U.S., which is now the world's largest oil producer.[1] Though it exports little crude oil – Congress only lifted a 40-year-old ban on oil exports in December 2015 – the United States now imports much less, and that has created a glut of spare supply. The rise of U.S. oil production has also changed how market participants think about pricing. The market is more sanguine about geopolitical risk and is perhaps not fully pricing it in. The U.S. is now perceived to be the new "swing producer", while violent turmoil in Iraq and Libya has resulted in lower-than-expected output reductions.

Most importantly, perhaps, Saudi Arabia and the other countries of the Gulf Cooperation Council (GCC) have decided not to reduce production levels to stabilise the oil price. Ostensibly, this is because these countries wanted to maintain their market share in Asia; they feared that Iran and Russia would reap the benefits if they curbed production. Nevertheless, the issue has divided the Organization of Petroleum Exporting Countries (OPEC), the cartel that has dominated the oil market since the 1970s. OPEC's failure to reach an agreement to freeze oil output in April 2016 appears to have diminished its ability to balance supply and demand in its customary fashion.

The upshot of these shifts and changes in the oil market is that another era of $100 oil is a long way off. Those countries that accumulated considerable wealth thanks to high oil prices are going to have to adapt. And the consequences will be far reaching.

* The authors would like to thank David Evans for his assistance with this chapter.

[1] US Energy Information Administration

Fiscal Squeeze in the Gulf

Persistently low oil prices are putting pressure on government budgets in oil revenue-dependent states, most notably those of the Arabian Gulf. The media has been rife with speculation that governments will draw on the region's mighty sovereign wealth funds – which manage an estimated $7.2 trillion, according to the Sovereign Wealth Lab at IE Business School – to tap looming deficits. The International Monetary Forum, expects GCC countries to post a fiscal deficit as percentage of GDP of 9.9% and 12.3% in 2015 and 2016, respectively; and a current account balance of -7.0% in comparison to the 17.1% averaged for the period 2000-2012[2].

But it appears that many countries are holding fire on tapping their sovereign wealth funds. Instead, GCC countries largely seem to be taking advantage of their investment-grade credit ratings to borrow cheaply. To fund an expected $10 billion budget deficit in 2016, for example, Abu Dhabi raised $5 billion from its first bond sale in seven years in April of this year.[3] Qatar is also seeking to raise up to $5 billion from a planned bond sale to cover the 46.5 billion riyal ($12.8 billion) deficit it forecasts for 2016.[4] In January, Kuwait's finance ministry projected that the government would run a budget deficit of 12.2 billion dinars ($40.5 billion) in the fiscal year starting on 1 April 2016, and the government will issue foreign currency bonds to plug the gap, according to local news reports.[5] Meanwhile, the Kuwaiti government will continue to contribute the statutory 10% of oil revenues to the Future Generations Fund, the larger of the two asset pools managed by its sovereign wealth fund, the Kuwait Investment Authority (KIA).

Herein lies the rub. The governments of some oil-dependent states are indeed drawing on their central banks' foreign-exchange reserves to plug deficits. But central banks are not sovereign wealth funds.

The line dividing these two different financial institutions is not clear in some countries and this has brought some confusion in the international media when analysing the implications of lower and persistent oil prices for sovereign wealth funds and their domestic economies. Precisely, in this chapter we emphasize the differences between central banks and SWFs, and we refer to the institutions

[2] See International Monetary Forum, 2016, "Regional Economic Outlook: MENAP", available at: http://www.imf.org/external/pubs/ft/reo/2016/mcd/eng/pdf/menap0416.pdf

[3] See: Bloomberg, 26 April 2016, "Abu Dhabi Raises $5 Billion From First Bond Sale in Seven Years", available at: http://www.bloomberg.com/news/articles/2016-04-25/abu-dhabi-said-to-sell-first-bonds-in-7-years-to-fill-budget-gap

[4] See: Bloomberg, 4 May 2016, "Qatar Said to Plan Sovereign Bond of as Much as $5 Billion", available at: http://www.bloomberg.com/news/articles/2016-05-04/qatar-said-to-plan-sovereign-bond-sale-of-as-much-as-5-billion-insry7tt

[5] صحيفة الرأي, الكويت تتجه إلى إصدار سندات أجنبية لتمويل العجز, 8 May 2016

that lie between these two as quasi-sovereign wealth funds, i.e. the case of Saudi Arabia explained below. The same caveat applies for analysis made on the central bank and foreign exchange managers of China or Hong Kong.

Central Banks and Sovereign Wealth Funds

In resource-rich countries, central banks play an important role in building buffers of foreign-exchange reserves to stabilise fiscal policy and macroeconomic management in a downturn. They manage these reserves for liquidity and safety rather than returns, so that capital is available at any time.

Sovereign wealth funds provide an intergenerational transfer of wealth by investing "excess" resource revenues to generate long-term returns. In short, their function is to turn finite physical assets – oil, gas or diamonds, for example – into infinite financial assets. These capital pools provide an ongoing income stream when the resource is depleted or when it becomes a so-called stranded asset that is no longer worth exploiting – a situation that is becoming more likely for hydrocarbon producers as global agreements to limit carbon emissions gain traction.

Saving and Spending Rules

Confusing Middle Eastern central banks with sovereign wealth funds, the international media has fuelled speculation that the latter are selling assets to prop up ailing government budgets. The confusion seems to have arisen largely due to the actions of the Saudi Arabian Monetary Agency (SAMA). Although SAMA is the kingdom's central bank, it employs a form of tranching in its reserve management and is widely perceived to act like a quasi-sovereign wealth fund. SAMA has traditionally operated a long-term diversified portfolio that comprises higher-risk, higher-return assets than traditional central banks.

Khalid Alsweilem headed up SAMA's investment team for over 20 years. In a research paper for the Belfer Center for Science and International Affairs at Harvard University, he explains that the organisation is not formally bound by a strict framework that requires certain assets to be used for savings or stabilisation purposes.[6] Consequently, SAMA's liquidity requirements remain largely at the discretion of policymakers, rather than being determined by observed savings and spending rules of the kind that exist in other countries, such as Chile, Norway, the U.S. or – to some extent – Abu Dhabi.

[6] Khalid Alsweilem, A Stable and Efficient Fiscal Framework for Saudi Arabia: The Role of Sovereign Funds in Decoupling Spending from Oil Revenue and Creating a Permanent Source of Income, Belfer Center for Science and International Affairs, Harvard University

A Wave of Redemptions?

Viewed in this light, the reports that SAMA redeemed up to $70 billion in 2015, largely from equity managers, seem reasonable.[7] Saudi Arabia did indeed require a supply of capital to maintain its public spending programs. But the kingdom is a special case. In other countries, where stricter fiscal laws exist, sovereign wealth funds have been largely left alone. We have already seen that despite running a deficit, Kuwait is still contributing to its sovereign wealth fund.

Some sovereign wealth funds do have limited liquidity requirements. For example, the Abu Dhabi Investment Authority (ADIA) is "required to make available to the Government of the Emirate of Abu Dhabi, as needed, the financial resources to secure and maintain the future welfare of the Emirate", according to its website. Fitch Ratings estimates that the Abu Dhabi government will tap ADIA for up to $27 billion in 2016.[8] The Norwegian government also withdrew capital from its $860 billion sovereign wealth fund, the Government Pension Fund Global, in January 2016. The fund, which has well-defined spending and savings rules, transferred 6.7 billion kroner ($781 million) to the government as falling oil prices took their toll on Norway's economy. This was the first time the fund had made such a payment and it was financed by its investment income.[9]

In each of these cases, however, the fund has comfortably met the demands imposed on it. Potential withdrawals were either factored into the fund's strategy ahead of time – and a proportion of its portfolio held in liquid assets for the purpose – or dealt with in ways that had little effect on its less-liquid positions, such as cashing out dividends.

Still, there is anecdotal evidence that sovereign funds are redeeming from asset managers in some sectors, particularly listed emerging-market equities. In the third quarter of 2015, emerging-market equity specialist Aberdeen Asset Management reported net outflows of almost £13 billion ($19.5 billion). The company said the outflows were "compounded by a number of sovereign wealth funds reducing their market exposure in response to the low oil price".[10]

[7] See: Simeon Kerr, "Saudi Arabia withdraws overseas funds", Financial Times, 28 September 2015

[8] See: Mahmoud Habboush, "Abu Dhabi to Take Billions From ADIA for Debt, Fitch Says", Bloomberg, 2 February 2016

[9] See: Kjetil Malkenes Hovland, "Norway Taps Oil Fund for First Time as Falling Oil Price Takes Its Toll", Wall Street Journal, 4 March 2016

[10] See: Financial Times, 30 November 2015, "Sovereign wealth fund pullback hits Aberdeen Asset Management", available at: https://next.ft.com/content/3af38bec-9735-11e5-95c7-d47aa298f769

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But this explanation may have other interpretations. Like other long-term investors, sovereign wealth funds are operating in a world where returns are hard to come by. This challenging investment landscape, coupled with the challenges associated with the depressed oil price, means sovereign funds are struggling to meet their long-term savings mandates. Consequently, many funds are reassessing their portfolio strategies to make their money work harder.

Sovereign wealth funds' attempts to achieve this goal have manifested in three trends. Taken together, these developments help explain why asset managers are having to work harder to win mandates.

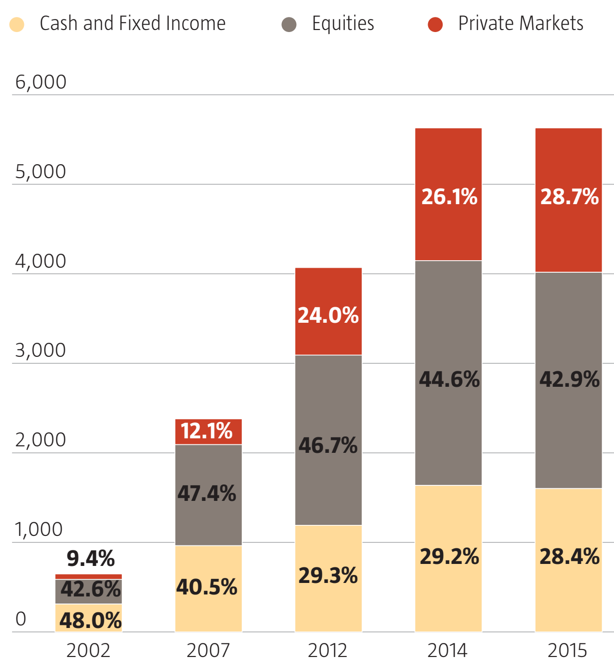
Insourcing

Sovereign wealth funds started to insource the management of a wide range of asset classes following the financial crisis in 2009. Although they have largely stopped wholesale insourcing, these funds continue to bring strategies in-house where they feel that internal teams can match an external manager's results net of fees.

Insourcing costs less than hiring externally and gives sovereign wealth funds more control over where their money is invested. This strategy also helps them to develop financial expertise at home. For example, the Qatar Investment Authority and ADIA play a major role in upskilling Qataris and Emiratis. Now that oil prices are lower, the need to diversify the skills base of these economies has arguably assumed greater importance.

Chart 1

Sovereign wealth fund asset allocation (2002-2015)



Source: Sovereign Wealth Center, 2015

But insourcing has also had a more profound effect: sovereign wealth funds have now become asset managers in their own right. So while they may only manage certain strategies in-house, they have become more knowledgeable across the investment spectrum. This means they can ask harder questions of their managers and expect more from them. As such, the relationship between manager and investor is evolving.

Partnerships

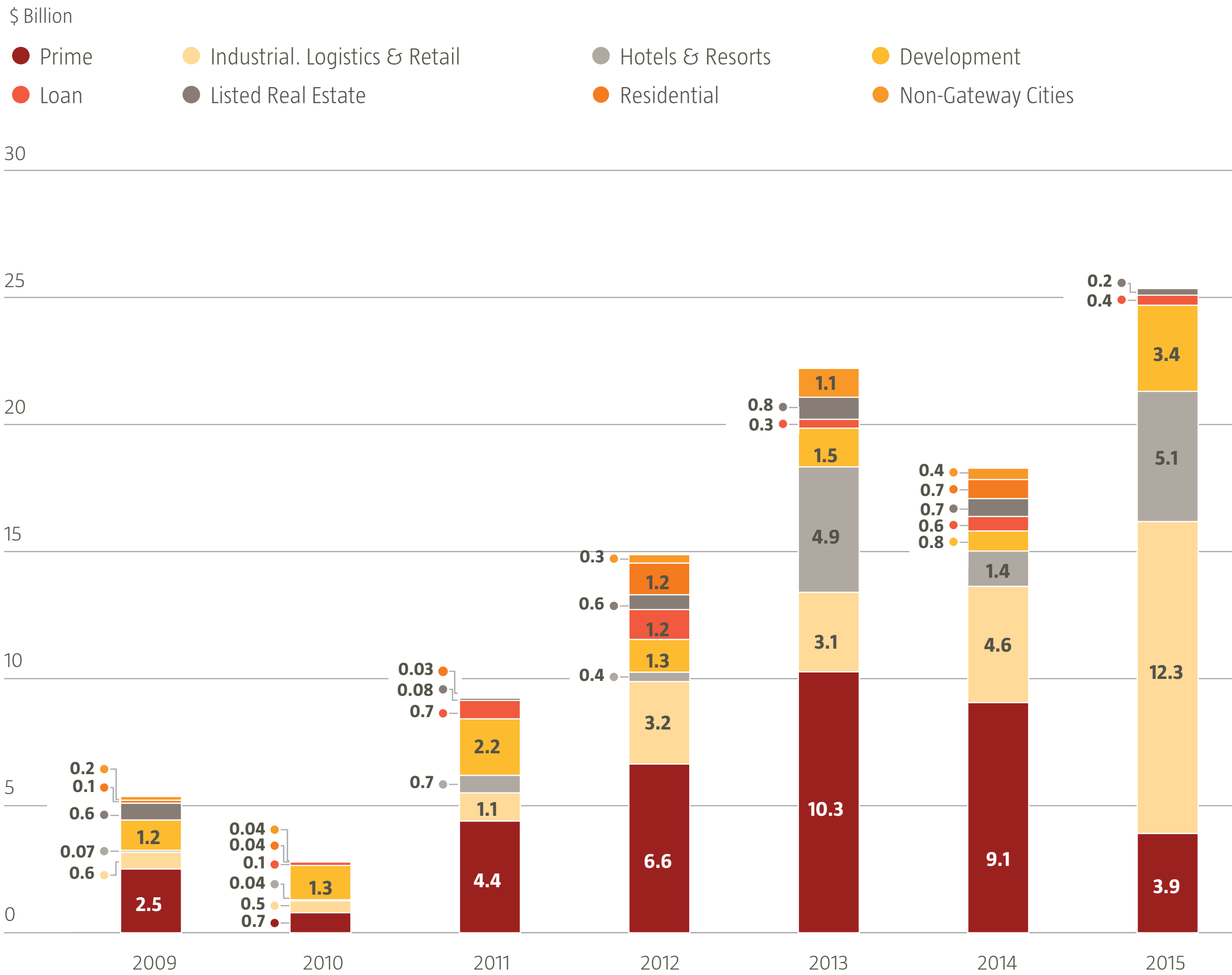
Bolstered by this additional knowledge, sovereign wealth funds are renegotiating their relationships with investment managers – and the balance of power is shifting. Many sovereign wealth funds are seeking to consolidate their roster of managers into a smaller number of more meaningful relationships. The managers they use will not only have to bring to the table skills that the sovereign wealth fund itself does not have, but also provide other value-added services, such as knowledge transfer and thought leadership, that help them solve their problems. Managers that are either a) not performing to the standards sovereign wealth funds believe their internal teams could attain or b) failing to provide additional alpha in the form of value-added services, will struggle to win sovereign wealth fund business.

Alternatives

Sovereign wealth funds are also allocating more to real assets. This trend may have accelerated over the past year or longer – as funds seek to escape the volatility that has ravaged listed markets – but it has been developing for almost half a decade (see Chart 1). At the end of 2015, sovereign funds held 29% of their total portfolio in private markets, that is $1.6 trillion invested in non-listed equities in sectors such as infrastructure and real estate.

Chart 2

Sovereign wealth fund investments in real estate. 2007 - 2015, by sub-sectors



Source: Sovereign Wealth Center, 2015

Such longer-duration assets match sovereign funds' long-term investment horizons. Infrastructure projects or mid-stage companies in capital-intensive industries, for example, have big ticket sizes, which only a few sovereign wealth and pension funds are able to write.

But suitable assets are few and far between – and competition is growing. In 2015, the few infrastructure assets that came to the market were sold at fiercely-fought auction processes. In the second half of the year, for example, several government funds competed for Transgrid, an electricity transmission network in the Australian state of New South Wales. After several months of intense bidding, the price of the long lease for the assets reached A$10.3 billion ($7.5 billion). The winning consortium included ADIA, Canadian pension fund Caisse de dépôt et placement du Québec and KIA's London-based subsidiary Wren House Infrastructure Management. It also included two local infrastructure firms, Melbourne-based Hastings Funds Management and Spark Infrastructure of Sydney, as operational partners.

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KIA's Wren House also completed two deals in Spain in 2015, a country whose infrastructure is attracting growing interest from sovereign funds. In March 2015, the KIA subsidiary partnered with Australian infrastructure giant Macquarie Group to buy the Iberian assets of German energy giant E.ON in a deal worth €2.5 billion ($2.7 billion). In May, it bought a 25% stake in Barcelona-based energy company Gas Natural Fenosa's international unit Global Power Generation, which distributes natural gas in Asia and Latin America, for $550 million[11].

In 2015, sovereign wealth funds' direct investments were largely in real estate and infrastructure. The Sovereign Wealth Center recorded 73 transactions worth $25.9 billion in construction and real estate (Chart 2). The Center also recorded the largest amount sovereign wealth funds invested in infrastructure in 2015 with 22 deals worth $10.2 billion.

But sovereign wealth funds have not just been investing directly in real assets. Major private equity, real estate and infrastructure managers are seeing major inflows from sovereign wealth funds as they seek to make longer-term investments. In a conference call in February 2015, David Rubenstein, the co-CEO of private equity Carlyle Group, said sovereign funds were growing as a proportion of Carlyle's investor base and would likely continue to do so. "We have seen that the largest sovereign wealth funds are now coming in to the market in very large sizes and making very, very large commitments, much more than we've ever seen before," Rubenstein said.[12]

Carlyle and other large private equity managers are changing their fee structures to enable them to keep that cash. Large investors and those who commit early to funds can now extract discounts on the fees they pay private equity firms. Major clients like sovereign wealth funds are also increasingly seeking separately managed funds rather than just committing to commingled funds with other investors.

Some private equity general partners, like London-based Terra Firma Capital Partners, are even looking to change their business model to attract major institutional investors. In January 2015, Guy Hands, Terra Firma's CEO, announced that, rather than raise a new fund, the firm would deploy €1 billion ($1.1 billion) of its own capital alongside co-investors such as sovereign wealth funds. This model gives the institutions greater influence over the assets in which they invest and say in how they are run. It also reduces their fee burden in return for being able to assess the deals themselves.[13]

Tapping funds

Some governments are indeed tapping their sovereign wealth funds to finance deficits resulting from lower-than-expected oil prices. A notable example is the National Fund of the Republic of Kazakhstan (NFRK). Originally designed as a stabilisation and savings fund to be invested only in foreign securities, the government is withdrawing cash from NFRK to prop up the domestic economy. In November 2014, Kazakhstan's President Nazarbayev decreed that $3 billion from the fund should be allocated to bolster structural reforms and support infrastructure projects between 2015 and 2017.[14] Since oil prices started declining in the second half of 2014, the government has removed substantial amounts of capital from the fund; by March 2016, the fund's value had fallen $13.7 billion from its peak of $77.2 billion in August 2014. The rate of withdrawals became so concerning to some officials that they raised concerns about its management.[15]

Another fund that has been used to help support its local economy is Russia's pension reserve fund, the National Wealth Fund. The fund is intended to support future payments to Russian pensioners and propped up the domestic economy during the financial crisis. It provided funds to Russia's development bank, Vnesheconombank, to support small-and-medium-sized enterprises, mortgage lending, the Russian stock market and banking system.

Since the imposition of international sanctions, the National Wealth Fund has also provided funding for major infrastructure projects. It contributed $23 million to Rostelecom's Digital Divide Project, which aims to provide high-speed fibre-optic internet to Russia's rural areas, and almost $3 billion to the Hanhikivi-1 nuclear power station project in Finland, which will help deliver energy security to Siberia. The fund has also supported the construction of major strategic projects for the government; it provided $1.75 billion of debt for the ZapSibNeftekhim, a new integrated petrochemical facility in Tobolsk, near Yekaterinburg, and $2.8 billion of financing to Yamal LNG, a

[11] See Javier Capapé, 2015, "Sovereign wealth funds in Spain and Latin America: Spain's consolidation as an investment destination" in Sovereign Wealth Funds Report 2015. Accessible at http://www.investinspain.org/invest/wcm/idc/groups/public/documents/documento/mde2/nje5/~edisp/doc2016619757.pdf

[12] See: Victoria Barbary, 2 March 2015, "At Private Equity's Davos, Firms Plan to Rip Up the Rule Book on Fees", Sovereign Wealth Center.

[13] See: Victoria Barbary, 25 February 2015, "At Terra Firma, Guy Hands' New Private Equity Model Draws Sovereign Wealth Funds", Sovereign Wealth Center.

[14] See: Reuters, 11 November 2014, "Kazakh leader orders government to open oil fund for projects", available at: http://in.reuters.com/article/kazakhstan-funding-idINL6N0T10WM20141111

[15] See: Wall Street Journal, 8 January 2016, "Kazakhstan's $64 Billion Question: Will Oil Fund Disappear?", available at: http://www.wsj.com/articles/kazakhstans-64-billion-oil-fund-in-jeopardy-central-bank-official-says-1452249926

major liquefied natural gas plant in Siberia. Yamal is the most northerly project of its kind – and central to Russia's goal to double its share in the global LNG market by 2020 from its current level of 4.5%.[16]

Repurposing

In both these examples, the concern is that the funds' money is being used for something other than their stated purpose. It is not that in either case the money is being used wrongly as the international media suggested; it is more that allocating the money in this way will not necessarily achieve the funds' stated aims.

In some cases, however, there has been genuine debate about repurposing funds to meet new economic realities. The most recent example is Nigeria's sovereign wealth fund, the Nigeria Sovereign Investment Authority (NSIA). In May 2016, Nigeria's Federal Ministry of Finance revealed plans to reposition the NSIA in line with the infrastructure objectives of the federal government. While the fund already devotes 20% of its assets under management to national infrastructure projects, Finance Minister Kemi Adeosun told reporters that this allocation may increase significantly. "What we are hoping is that the sovereign wealth fund now becomes a channel to attract further private capital, particularly from investment funds abroad", Adeosun said.[17]

Another example of this repurposing is Ireland.[18] In 2014 it officially established the Ireland Sovereign Investment Fund (ISIF) and terminated the operations of its predecessor, the globally diversified National Pensions Reserve Fund. Today, ISIF mission focuses in investing on a commercial basis "in a manner to support economic activity and employment in Ireland" and it invests mostly in Ireland. In the end, Ireland decided to change the approach of its SWF yet it serves to the ultimate goal of helping the domestic economy in different degrees. A long oil crises may add pressure for more repurposing as we saw in the case of Nigeria or Ireland.

The big one

But the most pertinent example of where low oil prices have changed the sovereign wealth fund environment is in Saudi Arabia.

As part of sweeping reforms to Saudi Arabia's oil-dependent economy – the so-called "Vision 2030" programme unveiled in April 2016 – Deputy Crown Prince Mohammed bin Salman al Saud announced that the Public Investment Fund (PIF), which invests largely at home, would be transformed into a global investor that will empower the Saudi state and diversify the kingdom's investments away from oil. The fund announced this intention with a bang in June, when it revealed it had made a $3.5 billion investment in car-sharing application Uber.

As part of PIF's metamorphosis, it would have up to $2 trillion in assets under management. But this figure is a red herring. The Saudi government is seeking to list 5% of the Saudi Arabian Oil Company (Saudi Aramco) and transfer the shares to PIF. PIF will likely have around $120 billion in the bank to invest abroad from the sale of the 5% of Saudi Aramco. The rest of the fund's new capital will be in the illiquid form of Saudi Aramco shares that the government is unlikely to want to sell. According to the International Monetary Fund's 2015 Article IV Consultation, PIF is worth around 1.4% of the kingdom's gross domestic product, or around $83 billion in assets under management.

This is, perhaps, the most profound change in an oil state's way of managing its oil revenue. Saudi has long debated whether to create a distinct sovereign wealth fund. The kingdom established the Saudi Arabian Investment Company (Sanabil Investments) in 2008 with $5.3 billion for this purpose. The fund is part of PIF and, therefore, to date, has largely invested at home.

Saudi Arabia's plan to create a major sovereign wealth fund by listing national oil company equity, rather than implementing a traditional saving-and-spending rule, or hiving off a portion of foreign exchange reserves, is a new and innovative way of turning oil reserves into a financial asset. Its efficacy will need to be judged with time.

Remodelling sovereign funds?

The realisation that oil prices will be lower for longer seems to have come as a surprise to many hydrocarbon-producing nations. Norway, for example, has often said that its sovereign wealth fund allocates capital on an infinite investment horizon.

These funds are designed to pay out on a rainy day. The accepted wisdom was that this would be many years in the future, perhaps either when oil had run out or been superseded as a fuel. But for many states that rainy day has come sooner than expected. It is here. Right now.

[16] See: Reuters, 4 May 2016, "Russia's Yamal LNG gets round sanctions with $12B Chinese loan deal".

[17] See: The National, 6 May 2016, "FG to reposition sovereign wealth fund – Adeosun",

[18] Check the chapter on European funds by Adam Dixon in this Report.

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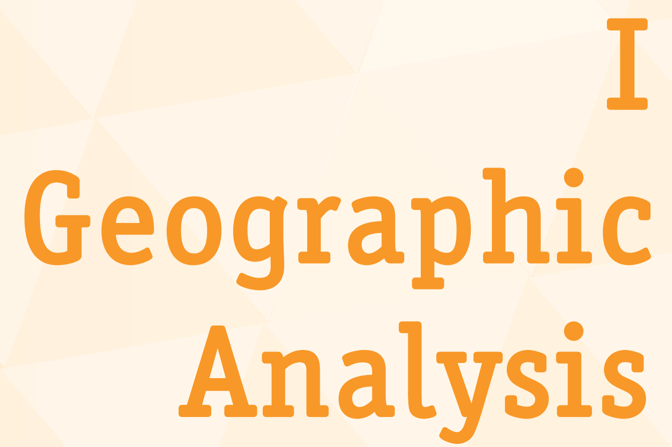
What are the implications of this development for sovereign wealth funds as a group? Clearly, the era of fast growth is over for the oil funds. But at the same time, sovereign funds are now fulfilling their ultimate purpose: generating cash for the government, while continuing to invest for the long term. In some respects, they are becoming more aligned with the U.S. permanent fund model adopted by sovereign wealth vehicles in Texas, Wyoming, New Mexico and Alaska.

Over time, sovereign wealth funds from oil-producing countries will have to think long and hard about their portfolio strategies. But one thing is clear: we are not living in a period of massive liquidations.

For these funds, stable, resilient returns will be paramount in the new environment. For this reason, they are likely to deploy a greater proportion of their cash in real assets with longer-term investment horizons. They are also likely to reduce their allocations to low-yield fixed income securities – and perhaps listed equities too, given the current volatility of that asset class. Sovereign wealth funds will use fewer asset managers, but provide them with larger, longer-term mandates. In return, they will demand closer relationships.

Lower-for-longer oil prices, therefore, don't represent an apocalypse for asset managers, regardless of the headlines. But the low-oil-price environment will nevertheless have profound effects, compelling sovereign funds to shift their allocation strategies, in-source more of their operations and demand more of their partners. These changes should enable these funds to become better stewards of their capital – and better able to meet their mandates under difficult circumstances.



I
Geographic Analysis

European sovereign funds: Co-investment platforms for the real economy

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3. European sovereign funds: Co-investment platforms for the real economy

With Norway sponsoring one of the largest sovereign wealth funds in the world, it may seem that Europe has a firm footing in the global community of state-sponsored institutional investors. But a simple perusal of the map of sovereign wealth funds shows that without Norway, Europe is mainly an investment destination and a provider of financial services for sovereign wealth funds from elsewhere. Other than Norway, European sovereign wealth funds are limited in number. In this chapter we analyse sovereign wealth fund development (and dismantlement) in Italy, France, and Ireland. When one looks closely at these, they seem more about fomenting national industrial policy and employment growth than anything else. They pale in comparison to the gigantic commodity-based sovereign funds in the Middle East or the foreign-exchange based funds of East Asia. And as a percentage of national GDP, they are a drop in the bucket.

But even though the handful of sovereign wealth funds (or institutions that look like them) in Europe are small, aside from the outlier Norway, their behaviour and the national policy context speaks to a growing resolve in the sovereign fund community toward direct investment and co-investment local assets[1], which is ultimately about national economic development and in some cases geopolitical positioning. Indeed, the collapse of commodity prices in 2015 has seen many resource-producing countries draw down assets to fund budget deficits. If the commodity super-cycle is truly over, then commodity-dependent governments could potentially speed-up efforts to rebalance their economies, focusing on strategic investments in the real economy at the expense of diversified global portfolio investing. But this shift would be moderated by absorptive capacity constraints. Global portfolio managers need not worry just yet!

The European experience (ex-Norway) also reveals the institutional fragility of sovereign wealth funds as a policy tool, whether the policy is long-term wealth preservation, macroeconomic management, or national strategic investment. The potential is there, but can we count on the necessary institutional longevity to match a truly long-term investment horizon, and to fulfil long-term policy objectives? To be sure, sovereign wealth funds look like the perfect long-term investors. They do not (normally) have any liabilities like pension funds, and they are not subject to the reporting or compensation arrangements that incentivise short-term decision-making in many parts of the financial services industry. Their time horizon is, in theory, infinite. As a result, the sovereign wealth fund has been portrayed often as the long-term investor par excellence, with the ability to provide sustainable patient capital that ensures prosperity in our fast-paced global economy.[2] But fulfilling a long-term investment strategy comes up against the changing winds of politics and economic crises. The recent experiences of Ireland and France, which saw fairly significant adjustments to the sovereign funds they sponsored, suggest caution when viewing the exponential growth of new sovereign wealth funds around the world in the last decade. Establishing an effective long-term investor is easier said than done. There is easily enough fodder for a pessimist to wager that the era of sovereign wealth funds that characterised the first two decades of this century will be a passing era. Some sovereign wealth funds will survive, but many may not.

It is all about foreign investment!

Founded in July 2011 as an equity holding company 80 percent majority owned by the Cassa depositi e prestiti, which is in turn controlled by the Italian Ministry of Economy and Finance, with the remaining 20 percent held by the *Banca D'Italia*, the *Fondo Strategico Italiano* (FSI), which it was recently renamed CDP Equity, has in short order emerged as a committed and ambitious player in the sovereign wealth fund space, despite only having around €4.4 billion of subscribed and paid-in share capital. The FSI (now CDP Equity) is too small to move markets or cause any serious unease in the sphere of geopolitics. But its involvement with the International Forum of Sovereign Wealth Funds (IFSWF), which it joined in August 2014, suggests Italy sees a long future hosting inward investment from sovereign investors around the world in support of Italian economic growth and development.

Almost as soon as the FSI joined the IFSWF, it set forth planning the Forum's 2015 annual meeting, which was held in Milan at the end of September, and which also coincided with Expo 2015. The FSI used the event as an opportunity to showcase Italy (and to a degree the rest of Europe) as an investment destination. If one did not know that the IFSWF was formed to promote the use of the Santiago Principles and to support the legitimacy of sovereign wealth funds in global financial markets, one would be forgiven in thinking that the Annual Meetings, and thus the IFSWF, is a platform for promoting co-investment opportunities. There is no doubt that Italy had an agenda—the geopolitical legitimacy of sovereign wealth funds is not in doubt![3]

[1] See: Jagdeep Singh Bachher, Adam D. Dixon, and Ashby H.B. Monk, 2016, *The New Frontier Investors: How Pension Funds, Sovereign Funds, and Endowments Are Changing the Business of Asset Management and Long-Term Investing,* London: Palgrave Macmillan.

[2] See for example, P. Bolton, F. Samama, and J. Stiglitz, eds., 2011, *Sovereign Wealth Funds and Long-Term Investing,* New York: Columbia University Press.

[3] These observations are based on the author's attendance at the IFSWF Annual Meeting in Milan.

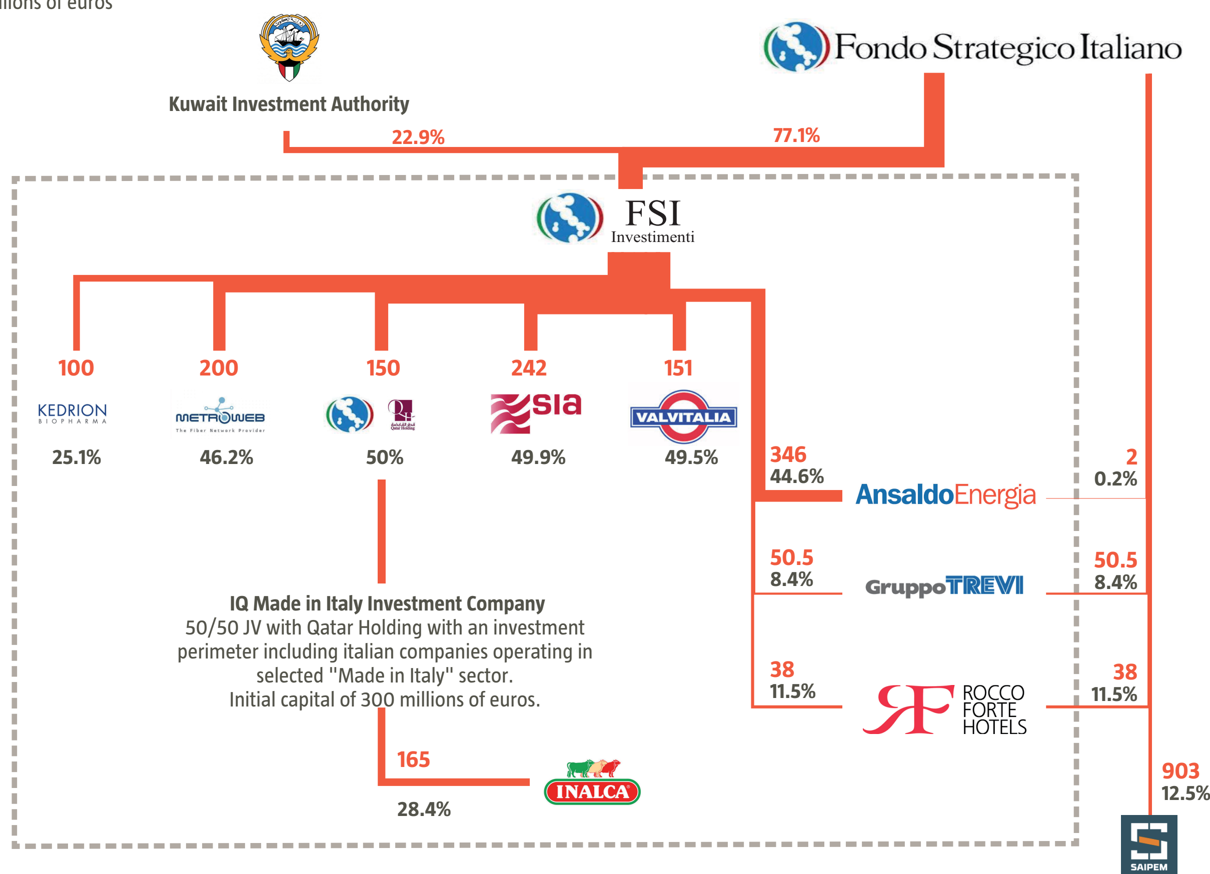
As would be expected, and under threat of EU state aid rules, the FSI is designed to operate under the same market-oriented decision-making standards as cognate private-sector investment companies. Hence, investments are made in terms of market return potential over the medium to long term. Yet, the FSI looks to invest in companies of "significant national interest" to the Italian economy, with the intent of helping Italian companies become larger and more competitive in international markets to the benefit of national economic growth. As such, the FSI presents itself as an active investor concerned with actively encouraging growth and change of investee firms in concert with other shareholders. It is not a passive portfolio investor. Since its inception, FSI has invested in a range sectors in the Italian economy, including pharmaceuticals, digital infrastructure, food and tourism, financial services, mechanical engineering, and projects that benefit the efficiency of local public services.

The main thrust of the FSI, which the hosting of the 2015 IFSWF Annual Meeting clearly articulated, is to attract greater foreign investment into Italy. In that regard, the FSI has developed several co-investments with major sovereign wealth funds. Indeed, co-investments account for a major part of FSI investment activities. In July 2014 the FSI joined together with the Kuwait Investment Authority (KIA) in forming FSI Investimenti, an investment company with €2.2 billion of assets and commitments. The FSI owns 77.1 percent of the joint venture and KIA owns the remaining 22.9

Chart 1

Italian sovereign wealth fund's investments

Millions of euros



Source: FSI Annual Report, 2015.

percent. The FSI Investimenti has significant holdings in Kedrion Biopharma, Metroweb, Valvitalia, Ansaldo Energia, Gruppo Trevi, Rocco Forte Hotels, and the IQ Made in Italy Investment Company. IQ Made in Italy is a 50/50 joint venture set up in November 2012 with Qatar Holding, which is a subsidiary of the Qatar Investment Authority. This kind of joint venture, such as FSI Investimenti, is aimed at developing Italian industrial capabilities to a higher global competitive standard, in this case with a focus on so-called "Made in Italy" sectors (e.g. food and food distribution, fashion and luxury, furniture and design, tourism, and lifestyle and leisure).

In addition to the co-investment partnerships with KIA and Qatar Holding, the FSI has signed several co-investment agreements with other sovereign wealth funds. In November 2013 the FSI signed a memorandum of understanding with the Russian Direct Investment Fund (RDIF) to establish a €1 billion investment platform, each committing to invest up to €500 million in companies and projects that develop foreign trade and foreign direct investment in Italy and Russia. However, it is not clear if any progress has been or will be made in moving this initiative forward, particularly given the international sanctions regime that Russia has been subject following its annexation of Crimea in March 2014.

The FSI also signed a memorandum of understanding with the China Investment Corporation concerning a co-investment agreement up to €500 million each, to support the promotion of economic cooperation between Italy and China in October 2014. Similarly, the FSI signed a memorandum of understanding with the Korea Investment Corporation for co-investments up to €1 billion in December 2014, with the aim of promoting economic cooperation and the exchange of information and expertise between the Republic of Korea and Italy. These agreements have yet to result in any announced deals.

Elections matter

The FSI has certainly made progress as a co-investment platform, and its commercial orientation and ambition are robust. Moreover, the FSI seems stable in Italy's vibrant and colourful democracy. Indeed, it is worth noting that the FSI was modelled after a similar French-government sponsored investment fund with an identical name only in French, the Fonds stratégique d'investissement. The latter was announced in November 2008 by the then French President Nicolas Sarkozy. Like the Italian version, the *Fonds stratégique d'investissement* was established as an arm of the state-owned *Caisse des dépôts et consignations* (CDC). And like the Italian version, the *Fonds stratégique d'investissement* was established with the aim of providing a stable source of capital to support the development and global competitiveness of small and medium-sized French companies. At the same time, its mission would be to secure the capital base of enterprises deemed strategic for the French economy and employment. Initially given €6 billion, the fund also took charge of an additional €14 billion in holdings of the CDC and the French government in large French companies such as Air France and Renault. And like the Italian version, the *Fonds stratégique d'investissement* almost immediately after its establishment signed a memorandum of understanding in early 2009 with a sovereign fund from the Middle East to co-invest with French companies, the Abu Dhabi government-sponsored Mubadala Development Company.

However, the *Fonds stratégique d'investissement* does not exist anymore, or at least not in its original form and as an independent entity. With the shift in political power and the election of President François Hollande in 2012 and the success of the *Parti Socialiste* in the French parliamentary elections, the form and function of the fund changed partially. In 2012 the Ayrault government created the *Banque publique d'investissement* (Bpifance), which brought together several state-owned financial institutions, including the *Fonds stratégique d'investissement*, that were focused on supporting the financial needs of small and medium-sized enterprises and mid-cap companies in France. The CDC and the French government each own 50 percent of Bpifrance. Within Bpifrance the assets of the Fonds stratégique d'investissement has become Bpifrance Investissement Mid & Large Cap. The assets include the €16 billion in companies of strategic national interest, and roughly €4.5 billion available for further investment.

In most respects the new Bpifrance does not diverge from the original focus and mission of the *Fonds stratégique d'investissement*: it still aims to foment more capable and globally competitive companies in the French economy. The apparent difference is that the fund is not explicitly focused on establishing co-investments with other sovereign wealth funds. This métier has been taken up by a new wholly-owned subsidiary of the CDC, CDC International Capital. Established in 2014, CDC International Capital has taken up the mantle as France's institutional collaborator with foreign sovereign wealth funds, with an investment capacity of up to €3 billion via its partnerships. The new fund forged partnerships with Qatar Holding in February 2014 and Mubadala in March 2014. Like the Italian FSI, CDC International Capital initiated a partnership with the RDIF in 2013, but it does not appear that this has ever been finalized. Perhaps more significantly, CDC International Capital is a co-founder of the Institutional Investor Roundtable, which is a grouping of large sovereign funds and pension funds that meet bi-annually to discuss common issues and investment strategies, and, more importantly, to find co-investment opportunities. Participation in this group gives this relatively small investment fund a seat around the table with

institutions several hundred times larger. Again, it is all about attracting foreign investment.

There has been some change, but the intent to foster local industrial capabilities for the long term is there. There is considerable continuity between governments, on the right and the left. It is too early to say, however, whether there are performance implications. If one worries about the long-term focus of the abovementioned French state-sponsored financial institutions, it is worth noting that the CDC was created in 1816. But then again, one's confidence in the long-term resolve of government sponsors to maintain a long-term investment strategy in the face of shifting economic conditions or electoral dynamics is tested when considering the changes that were made in 2010 to the *Fonds de réserve pour les retraites* (FRR)—France's globally oriented pension reserve fund.

Created in 2001, the FRR's mission was to accumulate reserves through 2020 that would then be paid out until 2040 to support the Baby-boomer retirement and mitigate its effects on the pay-as-you-go pension system. Recognising its long-term potential, the FRR would favour equities over bonds with an asset allocation typical of other large globally oriented sovereign wealth funds and pension funds. By 2006 the FRR had more than 60 percent of its assets in equities with the remainder in bonds and cash. A strategy document published in May of that year called for 10 percent of the portfolio to be invested in alternatives at the expense of low-risk assets. In effect, the FRR had quickly become a giant focused on the long-term like many other state-sponsored investment institutions and public pension funds.[4]

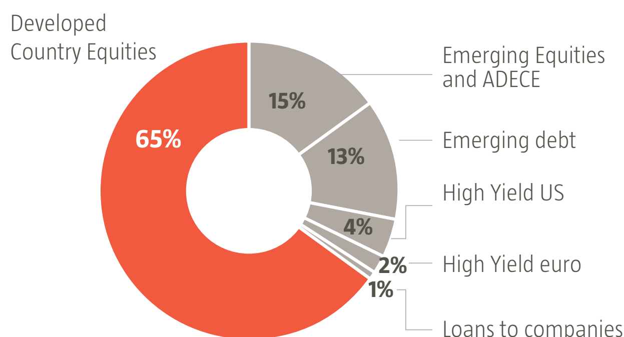
This vision of long-term investment planned to take advantage of the mean reversion in equities to maximize the potential pool of assets to support France's aging population came up against the Global Financial Crisis of 2008 and the ensuing recession in the real economy. In the 2010 pension reforms in France, the mission of the FRR was changed substantially. Owing to the degradation in the receipts and the deficit in the pay-as-you-go pension system, the FRR would pay €2.1 billion annually from 2011 to 2024 to the *Caisse d'amortissement de la dette sociale*, which is charged with amortising social security deficits. The latter would also receive the annual endowments that were intended for accumulation in the FRR to 2020. The *Caisse nationale de l'assurance vieillesse*, which manages the pay-as-you-go pension for salaried private sector workers, would also receive a one-off payment of €3.4 billion in 2020.

[4] See: Chapter 5 in Adam D. Dixon, 2014, *The New Geography of Capitalism: Firms, Finance, and Society*, Oxford: Oxford University Press.

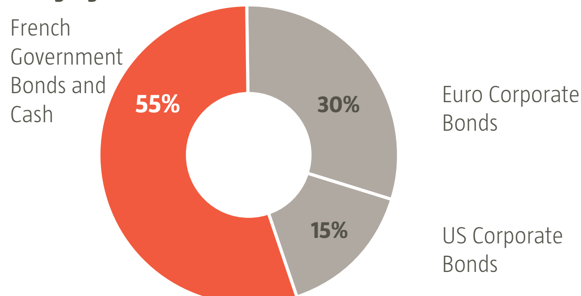
Chart 2

FRR's Portfolio Composition

Performance Assets



Hedging Assets



Source: FRR Annual Report, 2015

On the one hand, this fairly significant change to the mission in less than ten years of the FRR's existence suggests a defeat for long-termism. Or, bringing the pay-outs forward by a decade suggests that the initial projections were simply too ambitious. On the other hand, the FRR is still a pension reserve fund that is being utilised for its intended purpose: to help finance the costs of demographic aging in France. In this is regard, the FRR is still keeping with its mission. More importantly, there is still long-term ambition in the investment portfolio. As a consequence of the 2010 pension reform in France, the FRR's supervisory board split the approximately €35 billion portfolio into two: a performance component, which would invest in equities and other higher-risk assets, and a hedging component, which would invest in lower-risk fixed income securities and cash. In effect, the split allows the FRR to cover the short- to medium-term liabilities imposed by the 2010 reforms, while still being able to aim for higher risk adjusted returns over the long term. Ultimately, the FRR still ranks as a serious global portfolio investor.

3. European sovereign funds: Co-investment platforms for the real economy

From the global to the local

The repurposing of the FRR reminds us that accumulated financial wealth is used eventually and that eventual use is for purposes (or should be) that benefit the home economy and society. The collapse in commodity prices in 2015 has seen governments in resource rich economies drawing down heavily on their sovereign wealth funds. Some of the headlines in the financial media seemed somewhat shocked and unnerved by this, as if sovereign wealth would be a consistently reliable source of fees for the investment management industry.[5] And of course, there have been rumblings, mostly hyperbole, that some sovereign wealth funds could be exhausted. To be sure, resource dependent governments should never rely on high commodity prices, and should diversify (or at least have) a tax base and build up an efficient government sector. But the utilisation of accumulated sovereign wealth during periods of economic stress is exactly in line with the policy foundations of the sovereign wealth fund. Saving for future generations is an ideal goal, but it is better to leave future generations with productive capabilities, a healthy and educated workforce, and an institutionally sound and cost-effective public sector, rather than a trust fund invested in other people's and country's capabilities. For Governments fortunate enough to have surplus income, it is trying to find this balance of spending today versus saving for tomorrow, and investing at home versus diversifying globally. Periods of economic stress bring the dilemma of this balance into focus, as happened in Ireland recently.

In the decade or so before the 2008 financial crisis, the Irish economy was one of the fastest growing developed economies in the world, which had become referred to as the Celtic Tiger. Between 1995 and 2001 economic growth averaged 10 percent annually. The period thereafter until the financial crisis saw the economy clock a slower growth rate, but still averaged a healthy 5.45 percent annually over the period.[6] But Ireland, like many advanced economies was also aging rapidly. In a period of resounding economic growth and wealth creation, the Irish parliament passed the National Pensions Reserve Fund Act in 2000. The Act set forth the aim of prefunding as much as possible the cost to the government of social welfare and public service pensions from 2025 to at least 2055, with one percent of GNP would be paid each year from 2001 to at least 2055. Investment management would be delegated to asset managers through a competitive bid process. And the asset allocation at the commencement of the National Pensions Reserve Fund (NPRF) would be 80 percent equities and 20 percent bonds, owing to its long-term horizon, invested in securities within and without the Eurozone. Like the FRR, the NPRF was established with a clear goal of capturing the long-term global equity risk premium in order to maximize the terminal wealth of the fund.

Unlike the FRR, the 2008 financial crisis ultimately meant the death of the NPRF. The Celtic Tiger took a massive hit in the crisis. The housing bubble that formed in the preceding years collapsed. The economy contracted massively. Unemployment increased. The Celtic Tiger was no longer existing. The conditions certainly have improved in Ireland since the depths of the crisis, but this did not save the NPRF. Given the massive overextension of Irish banks in the property market, and the drag this had on recovery, the Irish parliament enacted legislation that repurposed the NPRF in 2009 to allow it to invest in Allied Irish Bank and the Bank of Ireland. In 2009 and 2010 the Minister for Finance directed the NPRF to invest €10.7 billion in the two banks. In late November 2010 the Irish government announced that it would invest up to a further €10 billion from the NPRF of the Irish government's €17.5 billion contribution to the €85 billion EU/IMF Programme of Financial Support for Ireland. In 2011 the Irish government announced plans to establish a strategic investment fund that would direct resource from the NPRF towards investments in the Irish economy deemed to be of strategic significance. In December 2014 the Irish Strategic Investment Fund (ISIF) was formally established as the successor to the NPRF, with a mandate to invest on a commercial basis in the Irish economy to support economic growth and employment. The NPRF ceased to exist.

Even before the ISIF was established, however, the NPRF had begun ramping up its investments in Ireland. In 2012 the NPRF Commission (the board that set investment strategy) saw growing potential in Ireland, given the capital scarcity left by the crisis. By the time of its closure and rebirth as the ISIF, the NPRF had already directed 20 percent, or €1.4 billion, in Irish investments of the remaining portfolio following the bank bailouts. The establishment of the ISIF, which has assets under management of €7.9 billion as of June 2016, would take this strategy forward and intensify it.

Like Bpifrance, or the Fondo Strategico Italiano, the ISIF has been given a double bottom-line mandate: it is to make a return but it needs to achieve economic development goals of fomenting productive capabilities and employment. And like its peers, the ISIF is tasked with seeking out co-investors where possible to verify the robustness of its due diligence and investment decision-

[5] See for example, Financial Times, 30 November 2015, "Sovereign wealth fund pullback hits Aberdeen Asset Management", available at: https://next.ft.com/content/3af38bec-9735-11e5-95c7-d47aa298f769

[6] World Development Indicators, World Bank, available at: http://databank.worldbank.org/data/reports.aspx?source=world-development-indicators

making, and to leverage the impact of its investments. Hence, the transition of the NPRF to the ISIF represents a shift from a sovereign wealth fund engaged in wealth creation and wealth preservation to a sovereign development fund focused on achieving second and third order economic benefits from the investments it makes.[7] At the same time, it represents a shift from the global to the local. It is a shift from investing in others' capabilities to one's own.

In 2015 the ISIF committed over €600 million to Irish projects, adding to the €1.4 billion it inherited from the NPRF. Combined with third-party capital, ISIF-backed companies, projects, and funds have received total capital commitments of €4.9 billion. These include investments in life sciences, information technology, commercial property, and infrastructure. In its economic impact report for the first half of 2015, the ISIF investments are supporting directly or indirectly 12,000 jobs, earning €218 million in wages and salaries, and a turnover of €645 million, of which 35 percent are from exports.[8] Going forward into 2016, the ISIF will be appointing investment management firms to support the multi-year transition from a globally invested portfolio, which it inherited from the NPRF, to one focused on Ireland.

So far the ISIF is successfully making its transition to a locally focused investor with direct economic impact. The importance of the latter should not be discounted. It is noteworthy that the ISIF is to publish twice yearly economic impact reports outlining its contribution to the Irish economy. As with any sovereign fund, demonstrating its worth is critical for underpinning its public legitimacy.[9] The ISIF, and by extension the elected officials that sponsor it, must demonstrate that it is using public resources efficiently and, ultimately, better than would happen if the capital were returned to taxpayers to invest in the market themselves. Indeed, the ISIF, like any other sovereign development fund, is investing opportunities that are open to other investors. For a developed democracy where elections enforce accountability and where there is usually no shortage of financial and investment management expertise, a state-sponsored investor has fairly high hurdles to overcome. They do not always stand on firm ground.

7 A. D. Dixon and A. H. B. Monk, *forthcoming*, "A Simple Typology of Sovereign Development Funds," in *The Frontiers of Sovereign Investment*, ed. M. Rietveld and P. Toledano (New York: Columbia University Press,.

8 See: *Ireland Strategic Investment Fund, Economic Impact Report as at 30 June 2015,* published 21 December 2015. Available at: www.ntma.ie (www.ntma.ie/download/isif2015reviewandh1economicimpact.pdf)

9 See: G.L. Clark, A.D. Dixon, and A. H. B. Monk, 2013, *Sovereign Wealth Funds: Legitimacy, Governance, and Global Power*, Princeton: Princeton University Press.

The future of sovereign investors in Europe

This chapter began with a suggestion that some sovereign funds would not survive. What happened in Ireland with the NPRF and the reformulation of the *Fonds stratégique d'investissement* and the FRR in France remind us that building a sovereign fund of any kind and maintaining it over time is difficult. It is true that neither of these cases are about the very large commodity-based sovereign funds that dwarf them in comparison. The giants of the sovereign fund world are not going anywhere anytime soon, even in the face of lower commodity prices. The same can be said for the giant sovereign funds in East Asia. Rebalancing economies to focus on internal consumer-led growth may slow the sources of their advance in some countries, but they are still very large (particularly in China). Moreover, developed democracies have many of the other inputs that make getting a sovereign fund right: an effective and resourced civil service, large pools of talent and services providers to call upon. The caution on expecting policy coherence and longevity of sovereign wealth funds is apposite, by this logic, when considering the many developing and emerging-market economies that have embraced them as a policy tool.

But the cases in this chapter shine a positive light on where sovereign wealth funds have come, when just a decade ago there was concern over the international legitimacy of these organizations in Western financial markets. The threat may never have been real, but it is important to not underestimate how xenophobia can rear its ugly head. Globalization is strong, but there are always forces that want to resurrect borders of all kinds. Europe may not see the emergence of new sovereign wealth funds from the ones that exist now, at least in comparison to the many new funds and planned funds in Africa for example. But Europe is still open for business.

The Italian government, like the French and Irish, is serious about attracting sovereign investments into their economies, going so far as to establish co-investment vehicles. The Belgium Federal Holding and Investment Company also has elements that would qualify it as a sovereign development fund. Much of its portfolio and activity is managing the Belgium government holdings of Bpost, the National Lottery, and the aviation and airport sector. There is, however, a small investment portfolio of €247 million (2014) that the fund pursues on its own behalf in interests that benefit the Belgium economy.[10] To be sure, understanding how these proto sovereign development funds develop and whether more governments in Europe jump on the bandwagon should provide sovereign wealth fund watchers with plenty of entertainment in the coming years.

10 See: The Federal Holding and Investment Company (SFPI-FPIM), available at: http://www.sfpi-fpim.be/

Unleashing the potential of sovereign wealth and pension funds in Africa

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4. Unleashing the potential of sovereign wealth and pension funds in Africa

Introduction

Over the last two decades, the African continent has experienced a period of unprecedented economic growth, leading to a new wave of widespread optimism and giving birth to a new narrative revolving around the concept of 'Africa Rising'[1]. Much of this growth is due to high commodity prices, mainly from extractive industries, which have produced significant economic returns for resource-rich African economies (AfDB, 2015). Although the sharp price decline of some key commodities is causing growth to slow, the continent continues to show a better economic performance and experience higher growth rates than most other regions in the world. Moreover, Africa is home to five of the world's 10 fastest-growing countries, with real GDP growth above seven percent in each.

Despite these improvements, the continent has a long way to go to lift its population out of poverty. Over 400 million people in Africa live in extreme poverty, comprising a third of the world's poorest people. In order to eradicate poverty, African countries need to achieve higher rates of economic growth, while at the same time ensuring that growth is inclusive and equitable. So far, economic growth in the region has not been inclusive or equitable enough and its impact on poverty and inequality has not been sufficient.[2] It is estimated that by 2030, despite major efforts in the context of current policies, 19 percent of Africa's population, or 300 million people, will still live in poverty[3].

A cornerstone of Africa's response required to address its poverty challenge is the need to bridge the massive infrastructure gap on the continent, which is estimated to require US$93 billion annually in investments in the next 10 years. To date, less than half of this amount is expected to come from various sources[4], thus leaving a financing gap of more than US$50 billion to fill. Against a backdrop of ever declining importance of official development assistance (ODA) and despite the progress in raising fiscal revenues, African countries need to raise more domestic finance -and more generally create fiscal space- to meet the infrastructure gap[5]. Planned policy interventions and incentives can encourage channelling of pension fund resources into infrastructure and other sectors by resolving the issue of sourcing long-term debt to infrastructure projects. In this regard, leveraging the full potential of existing and additional resources, such as Sovereign Wealth Funds (SWFs) and public pension funds, to go beyond traditional financing approaches and take a more direct role in supporting the economies can be an important path for the continent to pursue[6].

In the past two decades, SWFs have emerged as an important tool for governments to accumulate resources arising from the commodity boom, but also to serve as a cushion in times of lower commodity prices[7]. Significant revenues from commodities in this period have led to the inception of a number of SWFs in Africa, notably in oil exporting countries (e.g. Libya, Nigeria and Chad). Meanwhile, Africa's economic growth, coupled with the rise of the continent's middle class, has contributed to the expansion of pension funds across the continent.

The purpose of this chapter is to provide a brief overview of SWFs and public pension funds in Africa, and highlight some of their main challenges and opportunities, particularly in terms of the potential for such resources to be used to support Africa's economic transformation and fill its infrastructure gap.

Sovereign Wealth Funds and Pension Funds in Africa

Brief overview of SWFs in Africa

IE Sovereign Wealth Lab's SWFs ranking, one of the most comprehensive datasets on sovereign wealth funds, shows that 60 countries in the world reportedly manage US$7.2 trillion through 94 SWFs.[8] Of this, African SWFs represent a small, yet rising, share, currently constituting only around 2.1% (US$154 billion).

For the past two decades, Africa's SWFs have been rising in both absolute and relative terms. Growth has been closely connected to higher revenues from commodities stemming from a cycle of high prices, coupled with rising production volumes. As a result, the resource-rich African countries have accumulated significant excess reserves in SWFs from exports of natural resources. Oil-exporting countries such as Libya and Algeria and diamond exporting Botswana have pioneered the rise of commodity-based SWFs in Africa.

* This chapter has inputs from Thouraya Triki (African Development Bank), David Ashiagbor and Olivier Vidal (African Development Bank/Making Finance Work for Africa), and Javier Capapé (IE Business School).

1 See: Mahajan, V. ,2009, *Africa Rising: How 900 Million African Consumers Offer More Than You Think,* London: Pearson Prentice Hall.

2 The poverty rate in Sub-Saharan Africa, as measured by the percentage of people living below US$1.90 a day, fell from 56.8 percent in 1990 to 42.7 percent in 2012. This is, however, far less than the rate of poverty reduction in Asia. Source: World Bank http://povertydata.worldbank.org/poverty/region/SSA

3 Poverty is defined as living on less than US$1.25 a day, in 2005 purchasing power parity (AfDB, 2015).

4 97 percent of the external financing sources for the African infrastructure come from three resources: private participation in infrastructure (PPI); official bilateral and multilateral development financing (ODF), and official Chinese financing.

5 See: Sy, A. (2015). *Unlocking Public and private capital for Africa Infrastructure, Africa in focus,* Brookings Institute.

6 See: World Bank, 2015, *From billions to trillions: MDB contributions to financing for development.* Washington, DC: The World Bank.

7 See: Triki, T., & Faye, I. ,2011, *Africa's Quest for Development: Can Sovereign Wealth Funds Help?,* African Development Bank Group Working Paper Series.

8 The most updated data used for assets under management in this chapter come from IE – SWLab.

Table 1

Sovereign wealth funds share by region, 2015

	Middle East	Asia	Europe	America	Africa	Other
Share (%)	39.1%	40.3%	13.9%	2.7%	2.1%	1.9%

Source: Sovereign Wealth Lab Ranking 2016

Traditionally, SWFs were created to stabilize government's fiscal and/or foreign exchange revenues, accumulate savings for future generations and contribute to a wider national development[9]. SWFs have helped governments smooth the volatility of resource-driven revenues by lowering the effect of the varying cycles caused by commodity price volatility. Many African SWFs have been investing in their own countries, predominantly driven by stabilization motives, whereas the major SWFs in other regions have channelled their resources mainly in outstanding government bonds, the stock exchange and the real estate sector. Most African SWFs have been investing in liquid and safe assets (investment grade). This trend has limited the amount that they invest, as only a few African assets quality for such a size and risk profile.

Table 2

Major African SWFs

IE-SWLab Ranking	Country	Sovereign wealth fund	Size (US$bn)	Inception	Origin
17	Algeria	Revenue Regulation Fund	77.2	2000	Oil & Gas
23	Libya	Libyan Investment Authority	60.0	2006	Oil
54	Botswana	Pula Fund	5.5	1994	Diamonds & Minerals
57	Angola	Angola Sovereign Wealth Fund	4.9	2012	Oil
61	Gabon	Gabonese Strategic Investment Fund	2.4	1998	Oil
63	Morocco	Moroccan Fund for Tourism Development	1.4	2012	Oil
66	Nigeria	Nigerian Sovereign Investment Authority	1.0	2012	Oil
67	Senegal	FONSIS	1.0	2012	Non-Commodity
75	Ghana	Ghana Heritage Fund	0.3	2011	Oil
77	Mauritania	National Fund for Hydrocarbon Reserves	0.03	2006	Oil
78	Rwanda	Agaciro Development Fund	0.03	2012	Non-Commodity
79	São Tomé and Príncipe	Permanent Fund for Future Generation	0.01	2004	Oil

Source: IE–SWLab Ranking, 2016

According to the most recent estimates, altogether there are 21 operational or established SWFs in the region, up from 15 in 2011 (IE-SWLab, 2016). Only six African SWFs have assets over US$1 billion, led by the North African oil producing countries. According to IE-SWLab 2015 data, the Algerian Revenue Regulation Fund (RRF) is the largest SWF, with assets of over US$77 billion, followed by Libyan Investment Authority (LIA), with assets of over US$60 billion. This places them

[9] Stabilization Fund, Saving Fund and Development Fund

5. Unleashing the potential of sovereign wealth and pension funds in Africa

Box 1

Pula Fund – Botswana

The Pula Fund was established in 1994 by the Republic of Botswana to preserve "part of the income from diamond exports for future generations." The fund is also used for managing foreign exchange reserves that exceed the nation's medium-term requirements. It is one of the few sub-Saharan members of the International Forum of Sovereign Wealth Funds (IFSWF), seeking to invest the wealth in asset classes outside the commodity cluster in order to reduce the macroeconomic exposure to price fluctuations in the diamond industry. The Pula Fund has seen stable growth in recent years, growing from US$5.3 billion (2013), to US$5.5 billion (2015).*

The Fund consists of the Government Investment Account, which belongs to the Government of Botswana, and the Fund's foreign exchange reserves, which belong to the Bank of Botswana. In accordance with the Fund's objectives, the government strengthened its efforts to ensure that the resource revenues (both from government's fiscal excess or the central bank's foreign exchange reserves) are not financing non-recurrent government budget. Part of the revenue from mineral resources in Botswana is invested in health, education and other public expenditures, and stabilizing the local economy, while at the same time another part is used to accumulate foreign exchange reserves or saved for future opportunities in the Pula Fund.

The combination of government-owned fiscal assets and the central bank's foreign exchange reserves makes the Pula Fund unique, resulting in co-ownership of the fund and a hybrid governance model. The Pula Fund has a 10-year investment horizon and invests exclusively in foreign assets, such as public equity and fixed income instruments in developed economies.**

* See: Bank of Botswana. Retrieved April 04, 2016, available at: http://www.bankofbotswana.bw/

** See: Alsweilem, K. A., Commuine, A., Rietveld, M., & Tweedie, K., 2015, *A comparative study of sovereign investor models: Sovereign Fund Profiles.* Cambridge, MA: Harvard Kennedy School.

Box 2

Stabilization Fund and Heritage Fund – Ghana

The Petroleum Holding Fund (PHF) and the Ghana Petroleum Fund (GPF) were established by the national Petroleum Revenue Management Act of 2011. The government of Ghana prepared the act in order to ensure a strong legal basis for the effective and efficient application of the country's petroleum revenue. The financial resources are received and disbursed into three separate tiers of the two SWFs: the Consolidated Fund to support the annual budget; the Stabilization Fund to cushion the budgetary impact of annual volatility in oil revenues; and the Heritage Fund to provide an endowment for the future generations.

The two SWFs seek to provide "a cushion to budget imbalances due to unanticipated revenue shortfalls caused by a fall in the petroleum price or through adverse production changes" and "an endowment to support the welfare of future generations after the underground petroleum has been depleted"*. Despite recent market uncertainties, Ghana's Petroleum Funds have continued to deliver positive returns on investment, worth US$1.4 million in 2013, US$5.8 million in 2014, and US$12.3 million in 2015).**

While it is early to assess the Ghanaian experience, this case might provide an example for other countries in the region in terms of attempting to strike a balance between income preservation and national investment imperatives. Another key success factor in the Ghanaian case is that the transparency clauses of the SWFs are consistent with the requirements of the Extractive Industry Transparency Initiative (EITI). The challenge ahead is to keep strengthening the institutional structures of the funds, when the actual flow of resources starts increasing and the pressures to spend mount, particularly as the country is facing economic headwinds due to the decline of oil prices.

* See: Ayensu, F., 2013, Managing Ghana's Oil Revenue: Ghana Petroleum Funds, *Asian Journal of Humanities and Social Sciences,* 1(2), 1-14.

** See: Annual Report on the Petroleum Fund (Rep.). (2013, 2014, 2015). Accra: Republic of Ghana.

among the top 25 SWFs in the world in terms of the size.[10] Botswana's diamond-funded Pula Fund (US$5.45 billion) is larger than the more recently established SWFs on the continent, including those of Angola (4.9 billion), Gabon (2.4 billion), Morocco (1.4 billion), Nigerian Sovereign Investment Authority (1.0 billion), Senegal (1 billion), Ghana (0.49 billion) and Mauritania (0.03 billion).

The following case studies on Botswana's Pula Fund, established in 1994, and the more recently established Ghana Petroleum Fund highlight some of the key characteristics of the SWF experiences in the region. The Pula Fund (Box 1) represents one of the oldest and arguably best performing funds in Africa. It is geared towards stabilization and saving, and invests exclusively in foreign assets. The Ghana Petroleum Fund (Box 2) is a more recent experience with a clearer focus on playing a more active role in supporting the economy in the short term. Both funds try to combine the twin goals of preserving future income and investing in the local economy.

[10] It is worth noting that the recent commodity price drops have had a significant impact on the viability of the funds, and according to some estimates. The Algerian RRF has reportedly lost a third of its value since July 2015. Jeune Afrique (15 March 2016): Algerie, les reserves de change ont fondu plus de 25% en deux ans, See: http://www.jeuneafrique.com/310127/economie/310127/.

Brief overview of pension funds in Africa

Government employee pension systems and private pension schemes have been expanding in several countries in Africa, offering a viable option for long-term financing opportunities. This has been possible due to the rapid growth of the African population and workforce, and the emergence of an African middle class in particular, which is shaping the continent's way forward hand-in-hand with the impressive growth rates. Defined as those earning between US$2 to US$20 per day, Africa's middle class has grown to some 350 million people (34 percent of Africa's population), from 126 million in 1980 (27 percent of the population). This represents a growth rate of 3.1 percent in the middle class population from 1980 to 2010, compared with a growth rate of 2.6 percent in the continent's overall population over the same period. The middle class is projected to continue to grow and reach 1.1 billion by 2060, corresponding 42 percent of the population[11].

There is huge potential for pension funds in Africa. New research estimates that pension fund assets under management (AuM) in 12 African markets will rise to around US$1.1 trillion by 2020, from a total of US$293 billion in 2008[12]. According to estimates, so far only 5-10 percent of the population in sub-Saharan Africa is covered by pension schemes, whereas the corresponding number for North Africa is about 80 percent. Coverage is widely limited to formal workforce, although some countries, like Kenya, are introducing pension schemes also for the informal sector. In terms of growth, for example, Ghana's pension fund resources reached US$2.1 billion in 2014, whereas Nigeria has tripled its pension assets to US$27.4 billion during the period from 2008 to 2016.[13] As with SWFs, the vast majority of pension fund revenue is invested in government securities. These examples show that pension funds can be used for leveraging financing for different sectors within the countries.

Historically, pension funds have invested heavily in domestic debt. Pension funds and insurance companies represent up to a third of the domestic debt in some countries[14], making this the second largest lender group after retail banks. Namibia's government pension fund manages assets worth 80 percent of the country's GDP, whereas the equivalent number for Botswana is 42 percent[15]. However, with the exception of South Africa, domestic debt markets are mainly characterized by short-term maturities leading to 'reverse maturity transformation,' since longer-term debt is a more difficult investment target as markets fear the risk of inflation, default and lack of institutional investors[16]. Investment patterns also reflect a lack of securities, since the pension funds tend to invest heavily in safe assets because they are dealing with people's savings. This is why fund managers, in countries that allow pension funds to invest outside of their home country[17], have started to diversify and spread out their investments in stocks and infrastructure projects of other countries on the continent[18]. Moreover, the lack of yield curves is also hampering the development of long-term issuances in domestic markets.

As an alternative to investing in domestic debt, pension funds can play an instrumental role in bridging the aforementioned African infrastructure financing gap. However, so far most pension funds in the region have been rather hesitant to make investments in roads, ports and railways due to the lack of the matching maturity of the projects available. This is not a unique case, as even in advanced economies pension funds traditionally make investments only in brownfield infrastructure, not much of which is available locally. Regulation is often a major bottleneck. In other cases, although the regulation may be conducive to investments, these do not materialize because of issues regarding project readiness, as well as the lack of familiarity of the pension fund managers with infrastructure financing.

Some pension funds have set an investment limit on infrastructure and other requirements, such as establishing a statutory reserve fund, liquidity limits, limited securities and instruments for exit strategies. The most active investors in infrastructure have been the South African pension funds, but fund managers in other countries have also started to consider this asset class as a potential investment target. The South African Government Employees Pension Fund, the largest pension fund in Africa and among the 20 largest in the world[19], has infrastructure investments as a separate asset class that centers capital requirements in large infrastructure projects across Africa.[20] Due to the recent changes in the regulatory framework, this fund now allows pension funds to invest up to 25 percent of their assets in illiquid investments such as infrastructure

[11] See: Ncube, M. & L. Lufumpa, 9 Oct 2014, *The Emerging Middle Class in Africa*, Routledge.

[12] See: PricewaterhouseCoopers, 2015, "Africa Assets Management 2020", available at: www.amafrica2020.com

[13] See: National Pension Commission, Nigeria (PenCom), available at : http://www.pencom.gov.ng/

[14] Kenya, Madagascar, Mauritius, Rwanda, and South Africa

[15] See: African Capital Markets News, 13 March 2015, "What are African's pension funds investing into?", available at: http://www.africancapitalmarketsnews.com/2683/what-are-africas-pension-funds-investing-into/

[16] See: Magalasi, C. (25 June 2012) *Pacing Domestic debt market development in low income countries,* Presentation to "the African Forum and Network on Debt and Development".

[17] South Africa, Botswana and Namibia

[18] See: Wall Street Journal, 29 February 2016, "African Pension Funds Invest in Infrastructure Projects", available at: http://www.wsj.com/articles/african-pensions-funds-invest-in-infrastructure-projects-1430985433

[19] See: Towers Watson and Pensions & Investments, 2015, "Global 300 report", available at: http://pension360.org/worlds-largest-pension-funds-2015-edition-report

[20] The Pan-African Infrastructure Development Fund

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Table 3

Pension funds' assets under management in Africa

Ranking	Country	Assets under Management AuM (US$bn) - Country*	Pension fund	Type	Assets under management AuM (US$bn) - Pension Fund
1	South Africa	322.0	Government Employees Pension Fund	Public	124.0
			Telkom Pension Fund	Public	0.04
			Eskom Pension and Provident Fund	Public	48.3
2	Nigeria	25.0	Aiico Pension Managers Limited	Private	6.9
			Apt Pension Fund Managers Ltd	Private	0.1
3	Namibia	10.0	Government Institutions Pension Fund	Public	6.8
4	Kenya	7.3	National Social Security Fund	Public and Private	1.1
5	Botswana	6.0	Botswana Public Officers Pension Fund	Public	4.5
6	United Public of Tanzania	3.1	National Social Security Fund	Public and Private	0.9
			Public Service Pensions Fund	Public	0.7
7	Ghana	2.6	Social Security and National Insurance Trust	Public	2.1
8	Zambia	1.8	Kwacha Pension Trust Fund	Private	0.01
9	Uganda	1.5	National Social Security Fund	Private	1.5
10	Rwanda	0.5	Rwanda Social Security Board	Public or Private	0.5

Source: The Commonwealth, 'Pension Funds and Private Equity: Unlocking Africa's Potential'
* June, 2013

and private equity[21]. The Kenyan government has also been exploring ways to encourage the pension industry to fund the country's infrastructure and domestic needs.

Pension funds can also provide an additional source of funding for alternative assets such as private equity. So far, African pension funds have invested an estimated US$3.8-5.7 billion in private equity, out of a potential of US$29 billion[22]. While many African countries' regulations around exchange controls and asset allocation limit investments in equities, countries that have embarked on pension fund reforms have increased their investment allocation towards equities. At least six African countries (Nigeria, Rwanda, Tanzania, Kenya, Botswana and South Africa) have specific incentives in their pension funds to invest in private equity. Namibia has gone even further with a specific requirement for pension funds to investment a minimum of 1.75 percent of their assets in private equity[23]. Regulatory reforms that are currently taking place in many countries could encourage pension funds managers to directly acquire stakes in African companies, or to invest in private equity as limited partners, and in this way become a viable source of capital. The latest data indicate that in countries such as Kenya and Nigeria the amount of investment in private equity is increasing rapidly. One of the key challenges is how to encourage the portfolio diversification necessary for the systems to manage risk, whilst ensuring that diversification in itself does not become a source of risk as pension funds venture into hitherto unknown asset classes and markets (Common Wealth Secretariat, 2014).

In conclusion, African pension funds could increase their investments in infrastructure and other sectors if the regulatory regimes were more favourable and flexible[24]. Furthermore, the shortage of suitable instruments tailored to this asset class is a key

[21] Sy, A. (2015). Unlocking Public and private capital for Africa Infrastructure, Africa in focus, Brookings Institute.

[22] See: Common Wealth Secretariat, EMPEA and Making Finance Work for Africa, 2014, "Pension funds and Private Equity - Unlocking Africa's Potential", available at: http://www.avca-africa.org/media/1329/pension_funds_and_private_equity_2014.pdf

[23] See: Ashiagbor, 2015, "Africa's Abundant Treasury, Making Finance Work for Africa", available at: https://www.mfw4a.org/nc/knowledge-center/resources/documents/documents-details/file/africas-abundant-treasury.html

[24] See: OECD, 2007, "Principles for Private Sector Participation in Infrastructure".

Box 3

Government Employee Pension Funds (GEPF), South Africa

The South African Government Employee Pension Fund (GEPF) is Africa's largest pension fund and among the largest in the world.* The GEPF was established in 1996 to manage and administer pensions and other benefits of current and past employees of the Government of the Republic of South Africa. Its mission is to effectively manage and invest member assets to meet current and future liabilities. GEPF's accumulated funds and reserves have grown at an average rate of 14.9% over the past 10 years.**

With an asset base of over US$1 trillion, the GEPF has a membership of 1.2 million people from more than 325 government departments and some 300,000 pensioners and other beneficiaries. It owns, on average, about 20 percent of most of the companies listed on the Johannesburg Securities Exchanges (JSE) and about half of the government inflation-linked bond portfolio. The fund has recently set aside about five percent of its total of assets for infrastructure projects. The GEPF's investment strategy supports investment in road and air transport, logistics and telecommunications, and water provision.

* See: P&I/Towers Watson, "Global 300 research", available at: https://www.towerswatson.com/en/Press/2014/09/Top-pension-fund-assets-hit-15-trillion-US-dollars

** See: GEPF, 2016, "Annual Report 2015" , available at: http://www.gepf.co.za/uploads/annualReportsUploads/GEPF_Annual_Report_201415.pdf

issue, as the pension funds' first priority is ensuring payment of pensions to its contributors, not leveraging funding for development. Different options exist to channel funds: co-investments with the government, private equity, real estate, de-risking instruments, or cross boarder investment[25]. Meanwhile, some see the future of African pension funds investing in the continent's development with more scepticism, since the pension funds are considered to be too risk-averse to tackle higher risk projects, and for this reason not adequate for the investments required to support national development plans. In Africa, another major challenge is the high interest rates on governments bonds, which makes any alternative assets less attractive. Assets at the right stage of maturity for investment by pension funds are quite rare on the continent. For these reasons, pension funds managers often limit themselves to placing funds in short-term bank deposits, short-term government paper or property (Honohan & Beck, 2007).

SWFs and pension funds: Challenges and opportunities

SWFs in Africa seek mainly to establish "Future Generations Funds" aiming at saving the incomes of today, especially from finite and depleting natural resources, for the benefit of future generations and thereby achieving inter-generational equity. Many funds have established sub-funds for infrastructure and economic development as instruments to foster sustainable economic development and support structural transformation for higher productivity, such as the recent cases of Ghana, Nigeria and Angola.

Meanwhile, pension funds have different objectives and tolerance profiles than SWFs. They were created to save and provide retirement income to the current generation – by accumulating from one side and spending from the other.

These public investors can indeed enhance productivity and promote intra-African investments by allocating part of their assets to growing sectors in Africa, such as infrastructure, agriculture, water, power generation and transport. In this way, they can be used as instruments to maximize investments' risk-adjusted returns and accumulate resources for future generations. In particular, SWFs and pension funds can serve as a channel for economic diversification and regional integration, as stabilizing instruments for the financial systems' depth and breadth to combat volatility, and as support to non-bank financial institutions such as insurance and leasing companies, and private equity funds. The funds can also strengthen the capital base of Africa's financial institutions and help to improve the governance and business structures in these institutions, ultimately leading to more resilient financial systems[26]. For this reason, countries should aim to channel their assets to investment in the private sector in their own countries as a means of boosting sustainable growth and job creation, and focus on the maximization of investments and returns on domestic assets.

However, there are some bottlenecks related to the characteristics and management of the funds that must be addressed first. The lessons learned from international best practices also apply to SWFs and pensions funds in Africa to address their structural constraints, including improving governance, regulatory impediments, limited administrative and institutional capacity, bankability and the level of development of financial markets.

[25] See: Africa Investor, 2014, "African Sovereign Wealth and Pension Funds Summit Report".

[26] See: Triki, T., & Faye, I., 2011, "Africa's Quest for Development: Can Sovereign Wealth Funds Help?", African Development Bank Group Working Paper Series. Retrieved December 2011.

Table 4

Transparency Index of African SWFs (2016)

Sovereign Wealth Fund	Country	IFSWF Membership	EITI Compliance*
Revenue Regulation Fund	Algeria	No	No
Pula Fund	Botswana	Yes	No
Fundo Soberano de Angola	Angola	Yes	No
Fonds Gabonais d'Investissements Stratégiques	Gabon	No	No
Fonds Marocain de Développement Touristique	Morocco	Yes	No
Nigerian Sovereign Investment Authority	Nigeria	Yes	Yes
Fonds souverain d'investissement stratégiques	Senegal	No	No
Ghana Heritage Fund	Ghana	No	Yes
Ghana Stabilization Fund	Ghana	No	Yes
National Fund for Hydrocarbon Reserves	Mauritania	No	No
Agaciro Development Fund (AGDF)	Rwanda	Yes	No
Permanent Fund for Future Generation	Sao Tome & Principe	No	No
Fonds de Stabilisation des Recettes Budgétaires	Democratic Republic of Congo	No	Yes
Mauritius Sovereign Wealth Fund	Mauritius	No	No
Oil Revenue Stabilization Fund	South Sudan	No	No
Fund for Future Generations	Equatorial Guinea	No	No
Oil Revenue Stabilization Fund	Sudan	No	No

Source: IE–SWLab Ranking, 2016
* Extractive Industries Transparency Index (EITI), See: https://beta.eiti.org/countries (as of May 2015)

Governance

One of the key challenges related to the management of the African SWFs in particular is the issue of transparency and accountability. Public disclosure of assets, guidelines, strategies and structure is still extremely scarce, which makes governance the main bottleneck to be addressed. Table 4 depicts a comparative transparency index, reflecting the levels of transparency and accountability of the numerous African SWFs. Out of the 17 SWFs in the region, five sovereign wealth funds (Botswana, Angola, Morocco, Nigeria and Rwanda) have signed the International Forum of Sovereign Wealth Funds (IFSWF) membership agreement endorsing the Santiago Principles, while four are compliant with the Extractive Industry Transparency Initiative (EITI) standard[27]. In many cases, these SWFs are managed by, mainly, staff without arms-length distance to the national institutions (central banks or finance ministries), with sometimes more than one government entity involved in the management. Furthermore, other principles such as deposit rules are included in the governance guidelines, but they are not always available and enforced, and withdrawal rules are quasi-absent[28]. Thus, setting up transparent and accountable SWFs in several African countries is challenging.

The governance challenges for pension funds differ from one country to another. In a few cases, the funds' mandates oblige the resources to be used in a way that serves the interests of plan members. Furthermore, similarly to the case of pension funds in North Africa, for example, none of the countries has specific and publically available criteria regarding the profile of the members of

[27] Santiago Principles were launched in October 2008 by the International Working Group of Sovereign Wealth Funds in a joint effort with the IMF to foster trust, openness, transparency, and probity in the management of SWFs. For further details, see: www.ifswf.org.

[28] See: Triki (June 2015), *African Sovereign Wealth Funds: Where they will be in 2020?,* presentation at the University of Bocconi, power point slides available at: https://www.unibocconi.it/wps/wcm/connect/fa4bd0f1-9353-4388-82ce-d6631f09ef74/150528_SWFs+in+Africa_triki.pdf?MOD=AJPERES

the governing body. In some cases, the chairman and some members of the board are political appointees. For this reason, the governing body may be in need of improving the credentials and experience to manage the fund, impeding effective control of its compliance and investment strategy[29].

Generally, the countries that have reformed their pension funds systems, such as Nigeria, Kenya, and Ghana, allow the private sector to manage their funds and employ practices that are more transparent. Consequently, these have made notable improvements and have a higher diversification in their investment strategies[30].

Regulatory impediments

The regulatory requirements, which provide a framework for the scale and scope of the investments, are often restrictive in terms of sectors and proportions in which the funds can be invested. African pension funds are often constrained by capacity issues and lack of appropriate instruments. However, reforms implemented in recent years are slowly making it possible for local institutional investors to participate in alternative assets, for example.

In order for SWFs to leverage additional resources for the countries, there is a need to diversify investments decisions, loosen the investment limit cap and allocate a portion of funds to higher-risk asset classes without jeopardizing the prudential safeguards. Streamlined processes and a greater flexibility over the regulatory rules and practices would confer investments in a variety of asset categories and encourage the move towards more development-oriented investment vehicles with autonomous structures and well-established teams.

Pension fund management in Africa could also be improved by enhancing the capacity of the stakeholders involved to design and implement investment policies. Clear regulatory frameworks and guidelines should be developed for investment policies by defining the objectives and risk tolerance of the portfolio. The challenge for stakeholders here is to design and implement regulatory systems that encourage diversification, while ensuring that diversification itself does not become an added source of risk.

Capacity constraints

Beyond regulations, capacity constraints can be a major impediment to greater and more effective use of both SWF and pension funds. In many countries, there are no clear mandates for SWF governing bodies, leaving the SWFs exposed to political pressures. Furthermore, a mix of financial, regulatory and legal skills within African SWFs is needed to improve the operations required to effectively analyse risks and rewards. For example, the performance of different units and their staff within the Fund structures should be evaluated. There is a pressing need for capacity building to ensure that the fund managers and other staff have the adequate skill set required.

Many SWFs and pension funds often lack a track record in alternative assets, as discussed earlier. Investing in these assets is a complex process, and the relevant skills cannot be acquired overnight. This applies not only to asset managers, but also to regulators and policymakers, who are collectively responsible for the safe management of pension assets. There is a need to build capacity at all levels, which can also be achieved through actual investment in such assets. Another channel to improve capabilities is to co-invest with well-established foreign SWFs or public pension funds that provide both capital and expertise.[31]

As referred to earlier, asset management has been outsourced in only a few countries to private parties, such as specialized securities or equities trading companies, due to restrictions in legislation or because such institutions do not exist or are not apt to manage this size of funds. Outsourcing could be a useful strategy, yet it would need to be based on clearly defined investment strategies and benchmarks, and carried out through a public procurement process. Countries with weak management capacity at local level should consider hiring foreign fund managers[32].

Bankability

One main issue is the relatively small market size of African economies and lack of bankable projects. Although there is room for expansion by leveraging finance to several sectors in individual countries, projects will come from coordinated action between several countries. In fact, funding projects to reach 'bankability' before their full development stages is crucial in order to attract investors and additional funding. Another concern is the size of the investments; the growth of AuM across the continent hides huge disparities throughout the countries. For example, many African pension funds are so small that they are not able to make major

[29] See: Robalino, David & Whitehouse, Edward, 2005, *Pensions in the Middle East and North Africa. Time for Change,* Washington, DC: The World Bank.

[30] See: Oosthuizen, R., 2013, *Pension Reform in Sub-Saharan Africa: Current Status and Implications for Capital Market Development,* African Alliance Securities.

[31] See the chapter "European sovereign funds" in this report.

[32] More detail on strategic governance issues related to in-house capabilities is available at Aguilera, R., Capapé, J., & Santiso, J. , 2016,. Sovereign Wealth Funds: A Strategic Governance View. *Academy of Management Perspectives,* 30(1), 5–23.

investments that require larger amounts of capital[34]. Many of them do not have the necessary resources to manage larger scale investments, which has prevented them from investing in infrastructure projects that require a higher capital input than they can afford. Investing through funds is an option, although it also requires special skills.

The size of the African market as a whole – with more than 50 countries – is too large for any single SWF or pension fund to cover. Therefore, in the stage of expansion to other markets, there is a need to narrow down the investment and focus in selected key countries by hiring local asset managers as advisors (AfDB, 2015).

While the high returns offered by government bonds and listed securities have historically been a disincentive for both SWFs and pension funds to invest in other asset classes, some, such as private equity, have become a more attractive option.[33]

Global headwinds

A major challenge is posed by the end of the so-called 'commodity super cycle,' causing major commodity prices such as oil and iron ore to crash at historical lows. This, combined with other global headwinds such as declining ODA, China's economic slowdown and historically low interest rates, is causing a major economic slowdown in commodity dependent African economies and a reduction of new flows to countries owning SWFs. In 2015, the IMF estimated oil revenue losses as high as US$10 billion for Libya (about 20 percent of GDP) and US$20 billion for Algeria (about 10 percent of GDP). In Nigeria, foreign reserves fell by over 15 percent, from US$40.7 billion to US$34.5 billion, between September 2014 and January 2015.

According to the African Economic Outlook 2016[34], oil and other commodity prices look set to stabilize and increase slowly in 2017. Countries that rely on commodity revenues will have to cope with weaker current accounts and exchange rates, as well as additional fiscal pressures.

If commodity prices remain low or continue to decline, economic growth in resource-rich countries might slow down, as the governments need to cut spending. Due to these new constraints, SWFs might be forced to liquidate their vast holdings of financial assets, putting further pressure on market prices and potentially driving them to diversify their investments towards other sectors with more stable returns, such as real estate and agriculture.[35]

Conclusion

Even though the number of SWFs and public pension funds has been increasing in Africa, they have yet to play a significant role in investing in African economies compared to their peers from other regions. Recent global economic headwinds and declining commodity prices pose a significant threat to their capacity to continue their upward rally and to play a more active role in the economies. The impact on the development and operations of SWFs over the long term is yet to be seen.

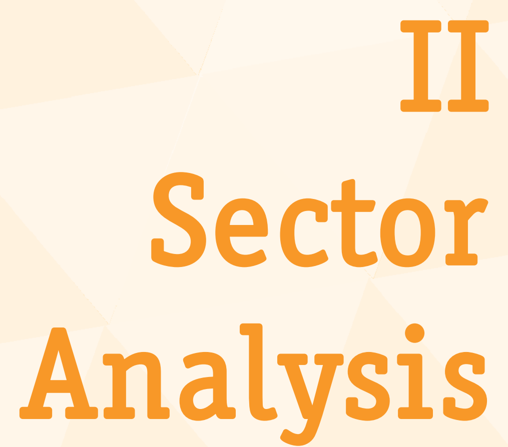
Africa's investment needs, the global discourse on financing for development and the role of domestic resources within that, all point to African SWFs and pension funds playing a more active role in responding to Africa's enormous financing needs. There is a clear opportunity for African governments to explore further ways to tap the full potential of these financial resources as instruments for achieving greater economic growth, particularly through greater infrastructure financing.

For this to happen, African governments need to develop more attractive frameworks for SWFs and pension funds, encouraging them to invest in asset classes that contribute more directly to addressing Africa's development needs, while operating with strong corporate governance structures and ensuring that resources are adequately managed. They should specifically aim to strengthen their active involvement in supporting sustainable economic growth and investing in non-traditional asset classes such as private equity.

[33] The average coupon of bond issues in Namibia, for example was 8.76% in 2014 compared to 10.10% in 2010 and in Botswana 7.75% in 2014 compared to 8.51% in 2010 (Sources African Financial Market Initiative (AFMI) www.africanbondmarkets.org/en/). According to the African private equity benchmark index, the annualized return of private equity on the continent in 2013 was 11.2%.

[34] See: African Economic Outlook. available at: http://www.afdb.org/en/knowledge/publications/african-economic-outlook/

[35] For a detailed analysis of the impact of lower commodities prices on SWFs, see the relevant chapter in this report.



II
Sector Analysis

Sovereign wealth funds check-in: Investment strategies in the hotel sector

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5. Sovereign wealth funds check-in: Investment strategies in the hotel sector

Introduction: strategic investment is in the air

Sovereign wealth funds (SWFs) fueled by natural resources are facing a period of uncertainty, against a backdrop of low oil and commodity prices. However, in many cases the very reason for setting up these funds was to rationalize management of these resources. One of the roles of SWFs is to cushion the domestic economy from the impact of swings in global commodity prices.

And commodity prices are subject to factors other than just domestic decisions. SWFs were created as a tool to absorb the effects of volatile international commodity prices on the domestic economy. They seek to exploit the good times, such as the super-cycle in global commodity prices between 1999 and 2008 (when oil prices increased from US$10 to US$140 per barrel), to accumulate wealth in an orderly fashion. Most of the SWFs active today date from this period. 66 funds have been created since 2000, compared to the 28 in existence before the new millennium. This equates to growth of 143% in the number of funds, with an injection of US$1.6 trillion into new funds.

But this period came to an end. The situation started to deteriorate rapidly in June 2014, when crude stood at US$115 per barrel. Barrel prices have since fallen in two periods, with an intensity similar to that in 2008 at the height of the Lehman Brothers crisis. In February 2016, the oil price fell below US$30 for the first time since 2004. There myriad reasons for this affecting both demand and supply, e.g. the development of shale oil in the United States, geopolitical issues between Iran and Saudi Arabia, and economic slowdown in China. This has resulted in an extremely delicate fiscal situation in many oil-producing countries.

In addition to being economically dependent on crude oil, some of the countries affected most, such as Iraq and Libya, are involved in armed conflicts or civil wars. The situation is also particularly critical in Nigeria and Azerbaijan, both of which have requested assistance from the International Monetary Fund. In Latin America, Ecuador and, in particular, Venezuela are facing the serious consequences of dependence on black gold to balance their public finances. However, some Gulf states, such as Kuwait, Qatar and the UAE, with extraordinarily low extraction costs and room for maneuver in debt markets, are facing a less challenging situation.

Saudi Arabia merits individual analysis: it is the world's second largest producer after the United States and the undisputed leader of the OPEC cartel[1]. It is also the only producer country that can, directly and independently, have some influence in future prices. The reasons that have led this country to run up a US$98 billion public sector deficit[2] while maintaining production (and therefore low prices) involves a complex explanation that is outside the scope of this article.

For the moment, gas prices in the country have increased by 40% following the elimination of subsidies, Aramco is preparing its IPO, and more privatizations and increased controls on discretionary spending by ministries are planned. Saudi Arabia is also considering tapping international markets with an ambitious debt issuance program. This "effort" associated with low oil prices is explained by the strengths of the Saudi economy. These include: low oil extraction costs, low debt (6.7% of GDP)[3] and substantial currency reserves (around US$670 billion, the third highest in the world after China and Japan). Although extraction is expected to remain low (Saudi Arabia has the second largest oil reserves after Venezuela), debt levels and currency reserves could be eaten away over a relatively short period.

The Kingdom's issuance plan expects targets a debt-to-GDP ratio of 50% in five years, while reserves (managed by the Saudi Arabian Monetary Authority) are being eroded rapidly, falling by more than US$100 billion between September 2014 and August 2015. Saudi Arabia's strategic decisions over the coming months will determine which way crude oil prices move and how the most important Arab economy's shaky situation will be handled. One of the most recent decisions is the creation the world's largest SWF (expanding its Public Investment Fund). This SWF will have control of two giants: Aramco, which will float at least 5% of its share in 2018, and the Sabic chemicals conglomerate. The new Public Investment Fund ("PIF") will have more than US$2 trillion in assets, twice the size of the current largest SWF, Norway's Government Pension Fund Global.

Saudi Arabia - like the other Middle Eastern producers with sovereign wealth funds - demonstrates the importance of adopting macroeconomic prudence policies in managing natural resources. This objective will be put to the test now that the good times are over, at least temporarily, and the bad times of low commodity prices have arrived[4]. However, governments use SWFs for a number of reasons, including strategic investment. In addition to reasons of prudence (rules that dictate the accumulation of natural wealth in the good times to avoid inflationary pressures and volatility in public revenues), SWFs are set up to generate higher returns than

1 Refer to OPEC data at: http://www.opec.org/opec_web/en/data_graphs/330.htm

2 From an Al Jazeera report on the 2015 budget deficit at: http://www.aljazeera.com/news/2015/12/saudi-arabia-hikes-petrol-prices-40-pump-151228154350415.html

3 http://www.ft.com/intl/cms/s/0/d1be572a-86fd-11e5-90de-f44762bf9896.html#axzz40EWiZd8u

4 See the Chapter in this Report on "rainy-day funds" and oil prices.

fixed-income instruments, so that the purchasing power of the huge reserves accumulated is not eroded in real terms. These strategic objectives, applied in different ways by different funds, play a crucial role in the current context of volatility and low returns. SWFs have increased their exposure to alternative assets and have entered the real-estate sector, private equity (and even venture capital) funds and invested in infrastructure. Against a backdrop of global uncertainty, SWFs are investing to diversify their revenues sources away from hydrocarbons, in addition to seeking returns. Saudi Arabia, Qatar, Oman and Kuwait receive more than 60% of their public revenues from oil and natural gas.

Diversifying portfolios and seeking returns: real estate

One of the strategic priorities for these countries - major oil producers or international trading centers (Singapore, China) - is to establish their position on the global economic map. It should not be forgotten that SWFs are managed by public institutions. This implies that their decisions will reflect the interests of the whichever government is currently in power, having greater or lesser freedom in their actions. Positioning the country on the global map means many things: talent networks, strategic trade and energy distribution hubs, transport, and so on. All of these activities are being developed to a greater or lesser extent by these countries, with the support of their sovereign wealth funds. Examples include the Gulf states competing to establish themselves as the airport hub for routes between Europe and booming Asia, Singapore's positioning as a major player in international trade and logistics, and China's use of its SWF to support its economic and commercial expansion with the new Silk Road Fund.

There is one further step in this jockeying for positioning, which mainly affects smaller countries. This is the inclusion of their countries in global tourism networks. As a result of this, sovereign funds have embarked on a fierce struggle to take control of some of the world's most iconic hotels. The search for returns is undoubtedly the main driving force behind this. Investment in the real-estate sector is nothing new for SWFs, as we will see below.

At year-end 2014, 60% of active SWFs were invested in real estate. Of these, the wealth of 57% is based on hydrocarbons (oil or natural gas); 36% are "non-commodity" funds, such as the China Investment Corporation (CIC) and GIC in Singapore; and the remaining 7% are "commodity" funds other than hydrocarbons (copper, diamonds, etc.).

There are three ways of increasing exposure to the real-estate sector: direct investment, stakes in real estate funds and investment in listed companies that invest in real estate. SWFs prefer direct investment, with 85% using this approach. The funds (Norway's Government Pension Fund Global, GIC, ADIA in Abu Dhabi, the Qatar Investment Authority and CIC) set up specialist teams (or subsidiaries) to invest in these assets and negotiate directly with the owners. SWFs (64%) are also increasing their exposure to this sector as investors (limited partners, LP) in private equity funds targeting the real-estate sector. Some cases have involved co-investment processes, with the SWFs acting as general partners (GP) together with leading players. Only a third of the funds (32%) follow the third approach: investment in listed companies focused on the sector[5].

One noteworthy fact is that every single SWF with over US$100 billion of assets under management (AuM) invests in real estate. This shows that the largest funds have the (financial, human and management) resources to invest in the highly complicated real-estate sector. Diversification is another important factor: in 2011, the Norwegian GPFG fund - which had previously refused to "complicate" its portfolio beyond fixed income and equity instruments - decided to create a subsidiary in Luxemburg (Norges Bank Real Estate Management) to begin investing in real estate.

The investment mandate was extended beyond Europe in 2013, and the fund is now investing heavily in the North American market. The two main motivations for Norges Bank Investment Management (NBIM, the public manager of the Norwegian SWF) are diversification and protection against inflation (income is usually indexed to price levels). This investment giant has grown from a new entrant into a major player in the sector in a very short period of time. To make up for its lack of experience, NBIM has entered into agreements with some of the US's most important real-estate asset managers, namely: TIAA-CREF (to purchase office buildings in Washington, New York and Boston), which was its first ally; Trinity Wall Street Church (offices in New York); Prudential (to acquire the emblematic 11 Times Square building in New York); Prologis US (the agreement with which includes 400 logistics hubs); Boston Properties; and MetLife (with emblematic buildings in Boston, New York and San Francisco). NBIM has made a total of 431 investments, worth over US$10 billion, making it one of the largest foreign investors in US real estate[6]. The Norwegian fund has doubled its investment in the USA in each of the three years it has been operating there (US$2 billion in 2013, nearly US$5 billion in 2014 and over US$10 billion in 2015). If this trend continues, NBIM's exposure could reach US$20 billion in 2016 - representing 20% of the US$100 billion that foreign investors allocated to the US real-estate sector in 2015[7].

5 Information from the Preqin Sovereign Wealth Funds Report 2015.

6 For more details on the Norwegian fund, see the chapter on GPFG in the 2014 Report.

7 US Real Estate to Draw More Foreigners. See http://www.bloomberg.com/news/articles/2016-01-04/u-s-real-estate-to-draw-more-foreigners-in-2016-survey-says

5. Sovereign wealth funds check-in: Investment strategies in the hotel sector

Norway is not alone in being attracted by the US market, as the vast majority of SWFs are also investing there: 90% choose the US as a destination for real-estate investment. This compares to 76% in Asia, 65% in the Middle East, 50% in Australasia and just 29% in Europe. As we will see, the latter figure shows that few funds are taking a chance on the European market. Europe and the US have two common features: they are destinations for real-estate investment, and they have few national SWFs. In comparison, the numbers for Asia and the Middle East are much higher, partly because SWFs in these regions are comfortable co-investing in real-estate assets and developments with local partners, which they know well, and are sometimes also managed by public companies. Even so, the numbers for Europe remain low in comparison with the US, and show how much more needs to be done to attract more SWFs. In Norway, NBIM works with regional partners such as AXA and Generali in France, and Pollen Estate and The Crown Estate (retail) in the UK. NBIM has also formed an alliance with Prologis (Europe) to increase its exposure in the logistics segment across multiple European countries, where it already has nearly 200 assets. The Norwegian fund's total exposure to European real estate is US$10 billion, and this is growing more slowly on average than its investment in the US (around 15% between 2013 and 2015)[8].

The hotel industry: a strategic destination for an increasing number of funds

According to JLL Research, global investment in hotels jumped 50% in 2015 to US$85 billion. There are two main reasons for this increase: cross-border investment and single asset transactions. More than 50 individual hotels sold for over US$600 thousand per room last year. Activity in 2016 is expected to be more measured, with fewer buyers of trophy properties, but will still show the interest in a sector that is consolidating its appeal.

The hotel industry is experiencing an unprecedented boom. In 2015, large hotel chains were regular cover stars in many media outlets, with some of the most significant deals involving single-asset acquisitions. The biggest deal of the year was Blackstone's US$6 billion purchase of Strategic Hotels & Resorts. The US was the most significant market. One of biggest investment stories was the possible merger of Marriott International with Starwood Hotels & Resorts. The US$12.2 billion acquisition proposed by Marriott would create the world's largest hotel group. Marriott-Starwood would have more than 5,500 hotels and 30 brands, including Westin, Sheraton, Ritz Carlton, St. Regis, Renaissance, Courtyard, AC Hotels and Fairfield Inn & Suites.

8 Figures for the Norwegian Government Pension Fund Global from: http://www.nbim.no/en/the-fund/holdings/

A few weeks later, China's Anbang Insurance Corp, which bought New York's legendary Waldorf Astoria for US$2 billion in 2014, increased the bid for Starwood to US$14 billion in an all-cash deal[9]. And while it still remains to be seen which will be the hotel deal of the year, the competition for the new group will be intense: competitors in this market, which has been extraordinarily active since the crisis, include the Americans, such as Hilton (bought by Blackstone in 2007 for US$26 billion), the British, such as InterContinental (IHG), and the French, such as Accor[10]. But the competition is not restricted to traditional rivals.

The whole sector is currently threatened by a single company: Airbnb. This startup was created in San Francisco in August 2008, allowing users to rent out their flats and homes privately. It is currently valued at US$25.5 billion[11], beating the stock market valuation of Hilton US$20.1 billion, and only slightly below the combined value of Wyndham (US$8.4 billion), Choice Hotels (US$2.9 billion), IHG (US$6.4 billion) and Accor (US$8.9 billion).

Airbnb had sales of US$900 million in 2015. It is currently offering 1.5 million listings in 34 thousand cities in 190 countries. Despite managing no properties of its own, this startup is threatening an entire industry, just as Uber is threatening the transport sector and Alibaba the retail sector.[12] SWFs are long-term investors in both cases. They have taken positions in the capital of these companies searching for significant present and future returns from the disruption they represent. The funds are betting on different areas: for Qatar Investment Authority it is Uber; while CIC and Temasek have invested in Didi Chuxing, Uber's Chinese competitor; CIC has also invested in GrabTaxi, Uber's competitor in Singapore; GIC has taken a stake in Ola, the local startup in India. No sovereign investors have yet declared an investment in Airbnb, but the Norwegian fund, and its US partner TIAA-CREF, recently acquired the building in San Francisco that is home to the headquarters of the Californian startup[13].

9 Details of the deal are available at: http://fortune.com/2016/03/31/starwood-anbang-marriott-2/

10 Information on the world's largest hotel groups is available at: http://www.statista.com/statistics/245684/number-of-hotels-of-international-hotel-groups/

11 A list of startups valued at more than US$1 billion is available at: http://graphics.wsj.com/billion-dollar-club/

12 For more information on startups and their appeal for long-term investors, see the 2015 Report (Santiso and Schena&Chaturvedi). Malaysia's Khzanah, the China Investment Corporation and Singapore's Temasek invested in Alibaba prior to its stock market floatation. See: http://www.ft.com/intl/cms/s/0/173b8bba-9bea-11e4-b6cc-00144feabdc0.html#axzz42Wfp7ttu

13 The story is available at: http://socialize.morningstar.com/NewSocialize/forums/t/352823.aspx

Sovereign wealth fund investment in the hotel sector

Despite crude price trends, investors from the Middle East and other SWFs in Asia and Singapore are continuing to increase their investment in hotels. They appear to be continuing to follow an international approach, given the limited supply of domestic assets. Sovereign wealth funds injected more than US$7.1 billion into the hotel sector in 2015, representing 8.4% of global hotel investment. Forecasts for 2016 point to a similar pattern and similar figures. International hotel investment is still hitting all-time highs, driven by large institutional investors and the family offices of some of the largest fortunes on the planet[14].

The following Chart and Table 1 are limited to sovereign wealth funds, showing the main deals in the hotel sector in 2015. In total, SWFs were involved in 18 deals - 4 sales and, in particular, 14 purchases - all of which exceeded US$20 million. SWFs were involved in single-asset transactions (10), asset portfolios (7) and one stock market floatation.

As we explain below, the deals involving sales, in some cases (e.g. Qatar Investment Authority in the sale of FRHI or GIC Real Estate in the sale of Hyatt Regency La Jolla) involved an injection of liquidity for the funds, which they then reinvested in the real-estate and hotel sector, as we can see from the purchases that followed the sales.

Given its importance for the sector and its interest in highly visible, renowned assets (trophy assets), the Qatar Investment Authority (QIA) merits careful analysis, as it has a wide range of investors and vehicles that are difficult to track. Through various subsidiaries, QIA has invested around US$4.0 billion in luxury hotel assets in Paris, London and Rome. This accounted for 56% of total investment of sovereign wealth funds in 2015, demonstrating the importance of the European hotel sector for SWFs.

The year's most important deal in the hotel sector involved Constellation Hotels Holding, a finance company headquartered in Luxemburg, and wholly owned by Qatar Holding. Constellation Hotels acquired the Maybourne Hotels Group in May 2015, purchasing the 65% of the group controlled by the Barclay brothers and the 35% controlled by Ireland's Paddy McMillen. Maybourne Hotels comprises three historic luxury hotels in the UK capital: Claridge's, The Berkeley and The Connaught. This deal was completed after nearly four years of legal battles between the brothers and the Irish millionaire, concluding with another victory for the Qatari negotiators[15], as occurred with Xstrata and the acquisition of land in Canary Wharf. This huge acquisition made Qatar once again the largest investor in trophy assets worldwide, with iconic investments such as Harrods and the Shard skyscraper in London.

The second largest deal of the year was the sale of the FRHI's hotel portfolio to French hotel group Accor for US$2.9 billion. FRHI Holding owns hotel brands such as Raffles, the Fairmont and Swisshôtel, managing 155 hotels in 30 countries. It has a marked bias towards the USA, where occupancy rates and revenue per available room (RevPar) are at their highest since 2007. Its assets include the legendary Savoy in London, Raffles in Singapore and the Plaza in New York. FRHI controlling shareholders were Qatar Investment Authority, Kingdom Holdings (the investment vehicle of the Saudi prince Alwaleed bin Talal) and Oxford Properties (the real-estate investment subsidiary of OMERS, the active pension fund for Ontario, Canada).

As indicated previous, sales involving sovereign wealth funds were not part of an exit strategy from the hotel sector, but rather a move to reorganize their investment strategy. A case in point is the Qatar Investment Authority's involvement in the sale of FRHI. The sale did not imply any waning interest in the sector. In fact, as part of the deal, QIA swapped shares in FRHI for 5% of the shares of Accor, giving it two seats on the board of directors of Europe's largest hotel group. Abdullah bin Mohammed Al Thani, CEO of QIA and member of the Qatari royal family, said that the deal would enable QIA to ramp up its operations in the hotel and real-estate sectors.

And a sovereign wealth fund was once again on the sales side of one of the biggest deals of the year in the sector. Once again, this was Qatar. Although at a higher level, Qatar also played a fundamental role in the acquisition of Glencore and Xstrata in 2013. With its seats on Accor's board, QIA is in an excellent position to learn about and exploit the sector through one of the world's 10 largest hotel groups[16].

Qatar is continuing its strategy of investing in singular, luxury hotels: Katara Hospitality (the hotel management, development and investment subsidiary of Qatar Holding) bought the iconic

[14] Full information is available in the JLL Hotel Global Outlook 2016, at: http://www.jll.com/Research/JLL-Hotel-Investment-Outlook-Global_2016.pdf?fd9b0943-1f50-42a7-8edb-1cc0529431e4

[15] The detailed story is in the Wall Street Journal at: http://www.nytimes.com/2015/04/24/business/international/battle-for-claridges-ends-in-sale-to-qatari-group.html?_r=0

[16] The deal described by Accor during the announcement is available at: http://www.accorhotels-group.com/fileadmin/user_upload/Contenus_Accor/Finance/Pressreleases/2015/UK/20151209_pr_accorhotels_frhi.pdf and the interest of the CEO in adding two of the five most sophisticated global luxury owners in the world into Accor's capital structure is explained at: http://www.ft.com/intl/cms/s/0/2d827274-9e93-11e5-b45d-4812f209f861.html#axzz452o47ZdI

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Table 1

Main hotel deals involving sovereign wealth funds (2015)

Asset acquired	Volume (US$ million)	Buyer	Seller	Month	Location
Maybourne Hotel Group (Claridge's, The Berkeley and The Connaught)	3,367.7	Constellation Hotels (Qatar Investment Authority)	The Barclay brothers; Paddy McKillen	May	United Kingdom
FRHI Holdings Limited	2,897.4	Accor S.A.	Oxford Properties Group, Inc.; Kingdom Holdings Company; Qatar Investment Authority	September*	Cayman Islands
Portfolio of hotels in Hong Kong: Grand Hyatt Hong Kong, Renaissance Harbour View, Hyatt Regency TST	1,411.9	Abu Dhabi Investment Authority & Mega Fortune Company Ltd.	Mega Fortune Company Limited; Sunfield Investment Ltd.; Park New Astor Hotel Ltd.	April	Hong Kong
Jurys Inn Group Ltd.	1,042.3	Lone Star Funds	Westmont Hospitality Group, Inc.; Ulster Bank Ireland Limited; Avestus Capital Partners; Oman Investment Fund; Mount Kellett Capital Management LP	January	Ireland
The London NYC	382.0	Abu Dhabi Investment Authority	The Blackstone Group L.P.	November	USA
Portfolio of Hilton hotels in Germany (2), Paris, Zurich, Strasburg, Luxemburg and Barcelona.	380.0	Oman Investment Fund	Westmont Hospitality Group, Inc.; The Baupost Group, LLC	December	EU
New York Edition	372.3	Abu Dhabi Investment Authority	Marriott International	April	USA
InterContinental Paris – Le Grand	360.9	Constellation Hotels (Qatar Investment Authority)	InterContinental Hotels Group	June	France
Westin Excelsior Rome	251.0	Katara Hospitality (QIA)	Starwood Hotels & Resorts	September	Italy
Miami Beach Edition	230.0	Abu Dhabi Investment Authority	Marriott International	February	USA
InterContinental Hong Kong	200.0*	Korea Investment Corporation; Gaw Capital; others.	InterContinental Hotels Group		Hong Kong
Hyatt Regency La Jolla in Aventine	118.0	Walton Street Capital, L.L.C.; JMA Ventures Inc.	Strategic Hotel Funding, LLC; GIC Real Estate Pte Ltd.	April	USA
Renaissance Raleigh North Hills Hotel	79.9	Abu Dhabi Investment Authority	Concord Hospitality Enterprises Company; Kane Realty Corporation	May	USA
Paris Marriott Opera Ambassador	54.0*	State General Reserve Fund (Oman)	-	August	France
Kim Lien Tourism Joint Stock Company	44.4	-	State Capital Investment Corporation (Vietnam)	November	Vietnam
Hyatt House Raleigh North Hills Hotel	23.0	Abu Dhabi Investment Authority	Concord Hospitality Enterprises Company; Kane Realty Corporation	May	USA
Portfolio of hotels in Sudan	51%	Kuwait Investment Authority	Sudanese-Kuwaiti Hotels Company (Government of Sudan)	March	Sudan
W Washington DC Mandarin Oriental NYC One&Only Cape Town	100% 68% 30%	Investment Corporation of Dubai	Istithmar Hotels	April	USA USA South Africa
Total (purchases & sales)	**11,215**				
Total (purchases by sovereign wealth funds)	**7,113****				

Source: The author, with data from Capital IQ, Sovereign Wealth Center and the funds.
* Own estimate
** Sum of investments (purchases) by sovereign wealth funds.

Westin Excelsior in Rome in 2015. This was the latest in a series of investments that has built up a portfolio of 35 luxury hotels worldwide, following the acquisition of the Le Grand hotel in Paris in 2014 from the Intercontinental Hotel Group (IHG) for €330 million. A year earlier, it bought the Park Lane hotel in London from IHG for €472 million. The divestment strategy of larger hotel groups to bolster their capital is opening the door for fresh investment in single assets. In 2013, Katara gained control of five IHG hotels, in Cannes, Rome, Amsterdam, Frankfurt and Madrid.

ADIA has also been an active buyer. The Abu Dhabi giant was involved in six deals in 2015 - five acting on its own - investing US$2.76 billion in hotel assets in Hong Kong, France and the US. The deal in Hong Kong was noteworthy, as it was ADIA's largest investment in China's special administrative region. This involved the acquisition of 50% of a holding company controlled by Chinese magnate Cheng Yu-tung, the owner of New World Development. This gave ADIA control of 50% of three luxury hotels in Hong Kong. The mass influx of tourists from continental China gives this market enormous medium- and long-term potential. A few months earlier, Qatar, through QIA, bought 20% of the famous Sogo shopping mall, which is highly popular among tourists from continental China. This business is similar to Harrods in London, which is also owned by the Qataris. Once again, the seller was the Cheng family, one of the most important in Hong Kong[17]. ADIA's close cooperation with Marriott International is also noteworthy. In 2013, ADIA undertook to buy three hotels under development to support the expansion of its new Edition brand. Two years later, two of these acquisitions were completed, with the purchase of hotels in Paris and New York. In New York, ADIA has also positioned SWFs in the purchase of trophy assets, with the acquisition of the historic MetLife Tower, and its famous clock, at 5 Madison Avenue.

The Oman Investment Fund has also been very active, investing US$380 million in the purchase of a portfolio of seven Hilton hotels in Europe. The Omani fund is the owner of a joint venture between US hedge fund Baupost and Canadian hotel operator Westmont Hospitality Group (WHG), through which it acquired seven Hilton hotels, in Germany (Dresden and Düsseldorf), France (Paris and Strasbourg), Zurich, Luxemburg and Barcelona[18]. It is worth noting that OIF had sold 50% of Jurys Inn to US private-equity fund Lone Star Funds at the start of the year[19] (see Table 1). This all leads to the conclusion, as already mentioned with regard to Qatar, that the funds obtained from one deal are being reinvested in the same sector a few months later. OIF took a stake in the Irish hotel chain Jurys Inn for £172 million in 2009 and sold it six years later, at the start of 2015, for £340 million. And a few months later, when the proceeds were received following approval of the deal by the competition authorities, OIF bought this portfolio of Hilton hotels in six European countries.

Korea Investment Corporation led a deal to acquire the InterContinental in Hong Kong, with the private equity group Gaw Capital as a local partner. This iconic building was sold by IHG, which is continuing to manage it. The deal was valued at US$938 million, split evenly between equity and debt with local financiers. KIC is continuing its commitment to investment in real estate, having acquired a shopping mall in Berlin and, more recently (2016), taken a controlling stake in six luxury hotels in the USA. KIC's main interest in both cases is to diversity its portfolio, following in the footsteps of the Norwegian fund to which it is often compared because of its conservative investment profile.

Meanwhile, another Omani fund, the State General Reserve Fund, acquired 90% of the Marriott Opera Ambassador in Paris. The price paid has not been disclosed, but it is likely to be around US$60 million (in line with the price paid for other Marriott hotels with similar characteristics, at an estimated $200 thousand per room). There is an interesting connection in this August 2015 deal: the remaining 10% of the hotel remained in the hands of Canada's WHG group[20], which sold its portfolio of Hilton hotels to OIF - the other Omani sovereign wealth fund - a few months later. The connection between the two deals displays a degree of coordination in the activities of the Sultanate's two SWFs, revealing the nature of these sovereign funds, which share the same owner and the same objectives aligned with national strategy.

Finally, deals involving the Kuwait Investment Authority and the Investment Corporation of Dubai (ICD) have put Africa on the global hotel map. These involved two transactions with hotels in Sudan and South Africa. KIA bought 51% of the joint venture it had set up with the government of Sudan. This collaboration dates back to 1972, and has served to boost the country's tourism industry. The Hilton chain abandoned its operations in Sudan in 2007, with the joint venture taking control of the hotels. As a result of this deal, KIA now controls 100% of the assets. Meanwhile, ICD acquired ownership and control of various hotel assets managed by the Emirate's other major investment group, Dubai World. Dubai is the

[17] Information from the Wall Street Journal: http://www.wsj.com/articles/qatar-buys-into-hong-kong-department-store-operator-1413784229 and http://www.wsj.com/articles/abu-dhabi-sovereign-wealth-fund-buys-stake-in-hong-kong-hotels-1430379896

[18] For more information visit: http://www.thomas-daily.de/en/news/item/id/46932/t/Oman-sovereign-wealth-fund-buys-Hilton-package-for-%E2%82%AC400mn

[19] Information on approval of the deal in March 2015 is available at: http://www.irishtimes.com/business/transport-and-tourism/lone-star-funds-completes-900m-jurys-inn-deal-1.2141436

[20] Details at: http://dhow.com/2015/08/18/oman-wealth-fund-sgrf-acquires-90pc-stake-in-paris-hotel/

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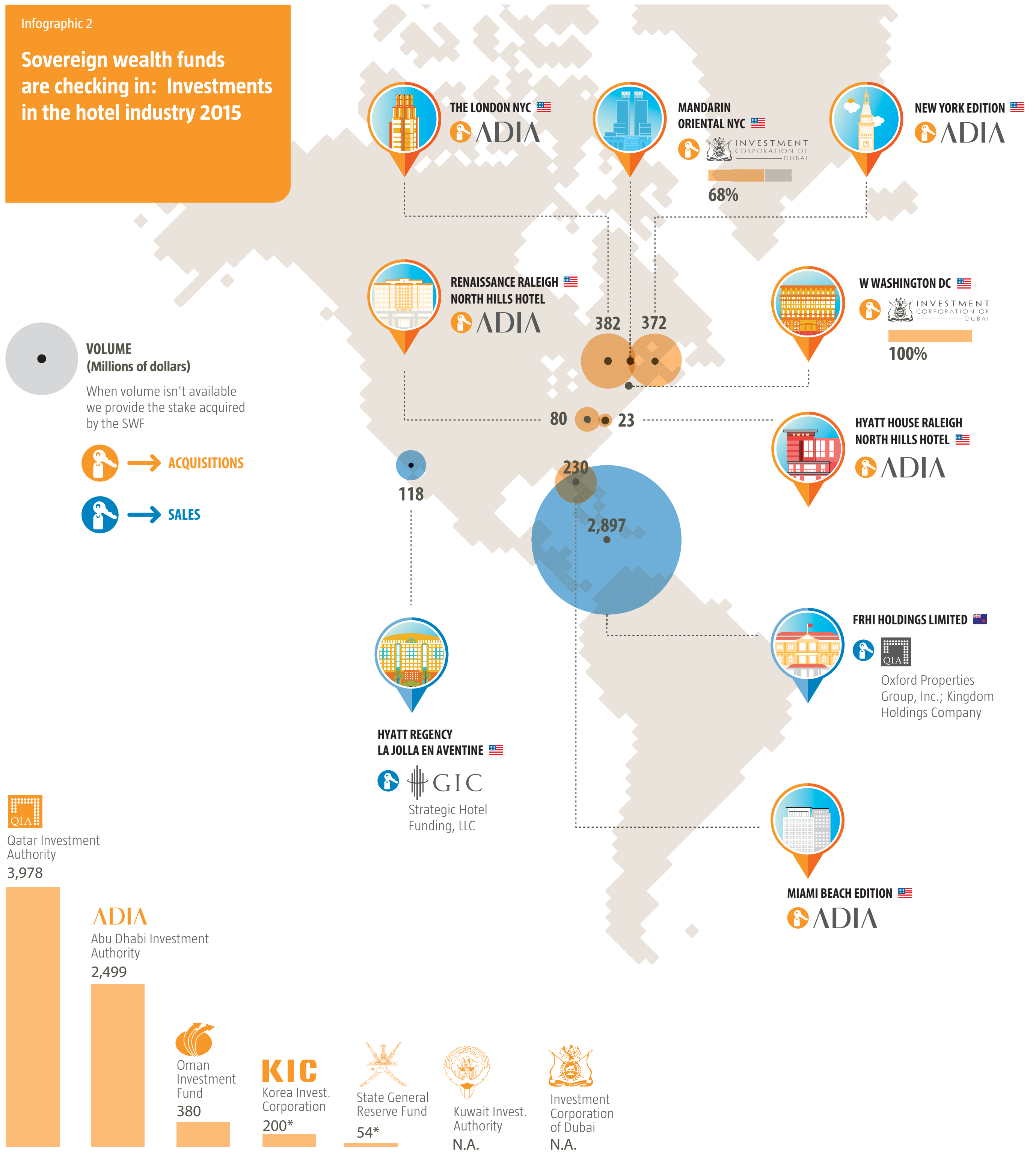
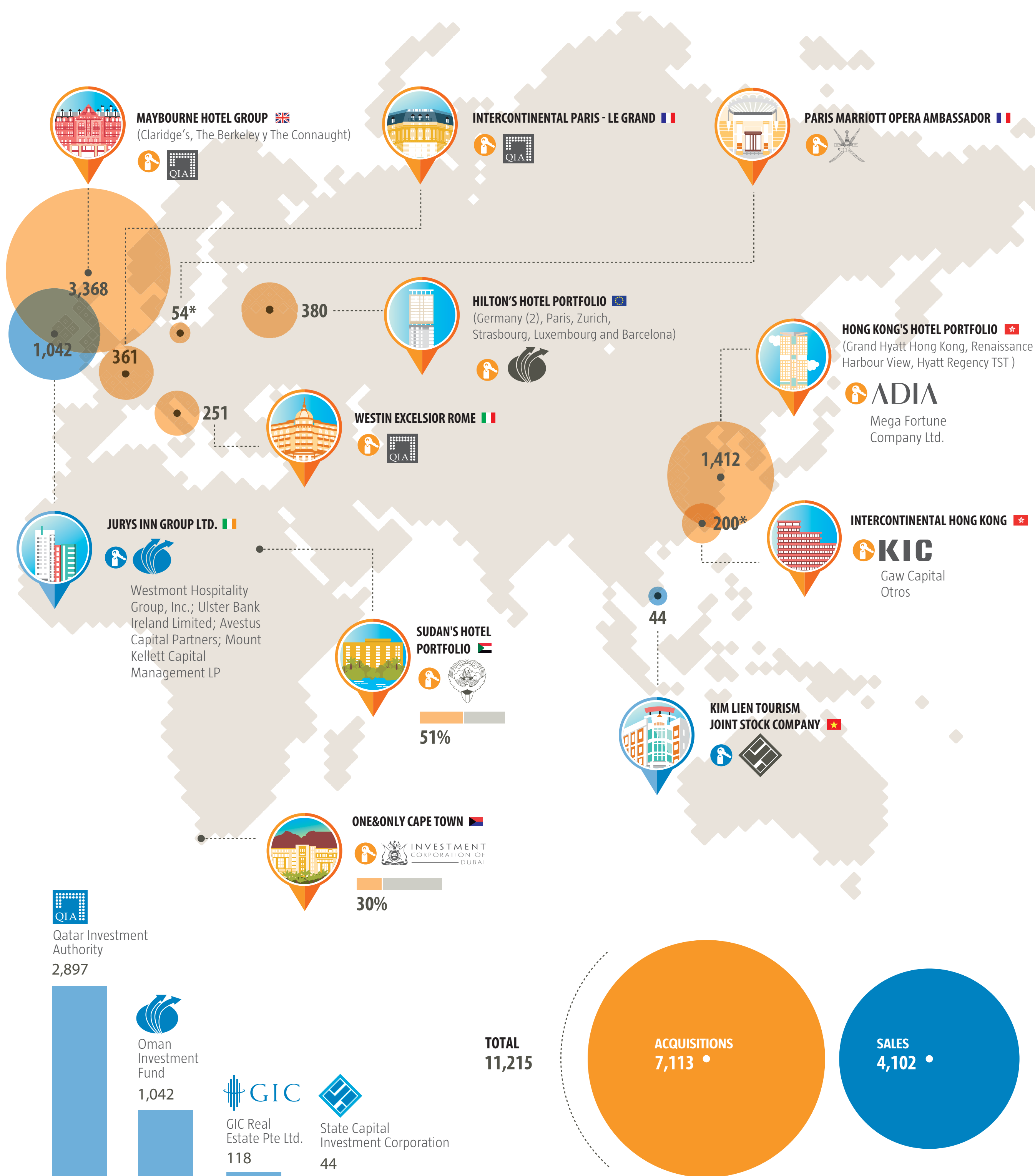


Source: Author's elaboration from Capital IQ and various sources. *Author's estimation.



MAYBOURNE HOTEL GROUP
(Claridge's, The Berkeley y The Connaught)
QIA
INTERCONTINENTAL PARIS - LE GRAND
QIA
PARIS MARRIOTT OPERA AMBASSADOR
3,368
1,042
54*
361
380
HILTON'S HOTEL PORTFOLIO
(Germany (2), Paris, Zurich, Strasbourg, Luxembourg and Barcelona)
HONG KONG'S HOTEL PORTFOLIO
(Grand Hyatt Hong Kong, Renaissance Harbour View, Hyatt Regency TST)
ADIA
Mega Fortune Company Ltd.
251
WESTIN EXCELSIOR ROME
QIA
1,412
200*
INTERCONTINENTAL HONG KONG
KIC
Gaw Capital
Otros
JURYS INN GROUP LTD.
Westmont Hospitality Group, Inc.; Ulster Bank Ireland Limited; Avestus Capital Partners; Mount Kellett Capital Management LP
44
SUDAN'S HOTEL PORTFOLIO
51%
KIM LIEN TOURISM JOINT STOCK COMPANY
ONE&ONLY CAPE TOWN
INVESTMENT CORPORATION OF DUBAI
30%
QIA
Qatar Investment Authority
2,897
Oman Investment Fund
1,042
GIC
GIC Real Estate Pte Ltd.
118
State Capital Investment Corporation
44
TOTAL
11,215
ACQUISITIONS
7,113
SALES
4,102

financial capital of the Middle East, not to mention a regional power in the real-estate sector. Based on this knowledge, it is continuing to develop this long-term relationship with the sector. For instance, the Cape Town hotel was bought from Kerzner International Holdings, an international developer with which ICD is developing a new luxury resort in Palm Jumeirah, valued at US$1.5 billion. Once again, these equity deals are strategic national economic development projects.

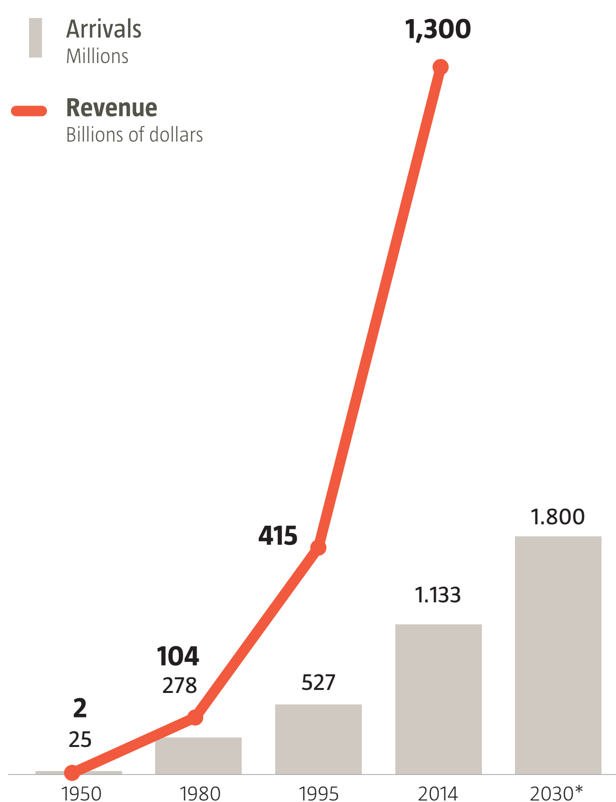
Trends and conclusions

The most significant deals over the last year reveal a number of trends. First, a continuation of the divestment policy of large hotel groups (an "asset-light" strategy). Global hotel chains have been reducing their hotel ownership for decades, concentrating instead on management. To illustrate, five years ago IHG only owned 1% of its rooms, Marriott 2%, Starwood 7% and Hyatt 17%. The groups that have followed this asset-light strategy have reaped higher profits, reduced revenue volatility and, as a result, increased the value of their companies. Second, in relation to the specific investments of sovereign funds, some countries have improved their international positions by acquiring hotels and hotel brands. In the case of Katara Hospitality (Qatar Holding), it is interesting to note the alignment of objectives between the Qatari government and its hotel-investment arm. Katara has said that it is "proud of its role in the national economic plan to attract the best [hotel] brands to Qatar." This attraction and positioning function is typical of sovereign wealth funds seeking a strategic national interest, more than financial returns on the investment.

Third, in addition to positioning, the hotel sector is a source of economic diversification and knowhow. The possibility of interacting with major international players enables the acquisition of management models that can then be replicated in the domestic economy and abroad. Katara Hospitality has been in the industry for over 45 years. It currently has a portfolio of 35 hotels, owning 22 hotels in 10 countries, operating four under the Murwab Hotel Group brand in Doha and developing nine projects in three countries. These 35 hotels that are already in operation or under development will have swollen to 60 within 10 years. Future hotel developments will be possible because of the experience gained in recent years through its relationship with brands such as Raffles, Sheraton, Ritz-Carlton and Westin. Katara is now getting more involved in developing its own hotel products, including one on Lake Lucerne in Switzerland and the transformation of an old palace in Morocco[21].

Chart 1

Key trends in international tourism (1950-2030)



* Forecast

Source: Global Tourism Report 2015, World Tourism Organization

Fourth, the hotel sector enables institutional investors to diversify their investment portfolios. The asset-light strategy means that ownership of many hotels has passed to large investors: institutional investors (including pension and sovereign wealth funds) are the largest buyers of single assets, while private equity groups are usually the purchasers of entire portfolios of hotel assets. With interest rates at such low levels and the outlook for increases still very weak in the US due to uncertainty over the global economic recovery, the search for returns in the real-estate sector seems to be a safe haven for institutional investors. SWFs are well aware of this trend.

Last, but not least, hotels are linked to international and domestic tourist movements. Global tourism is a dynamic sector that has been experiencing exponential growth for decades.

[21] For more information on Katara Hospitality visit: www.katarahospitality.com

Box 1

Sovereign wealth funds in the hotel industry in Spain

Spain is a global power in tourism. It received 68.2 million international tourists in 2015, and this figure is expected to rise to more than 70 million in 2016. Spain is ranked number three in the world by tourist arrivals and receipts (US$56.5 billion in 2015). This massive flow of visitors has enabled the country to develop a robust hotel industry. Hotels and hotel chains in Spain are attractive assets for international institutional investors, including sovereign wealth funds. Since 2013, SWFs have invested at least €300 million in Spanish hotel assets. Moreover, revenues per room - the metric most widely used in the sector - still have plenty of scope for growth in many hotels in Spain, boding well for more deals in the coming years.

One of the most significant deals took place in 2013, when Qatari Diar, a QIA subsidiary, bought Hotel W in Barcelona from a consortium comprising ACS, OHL, Comsa Ente and BCN Godia, for US$200 million. In 2014, Katara Hospitality, another QIA subsidiary involved in investing in hotel assets, bought five InterContinental hotels in Europe. These included an asset on the Castellana in Madrid for €60 million purchased from its previous owner, which was also Qatari.

The most important deal in 2015 was also in Barcelona, with the €60 million sale of the Hilton hotel to the Oman Investment Fund. This was the first real-estate deal involving this Omani fund in Spain.

In addition to SWFs, other Gulf-state investors have bought luxury hotel assets in Spain, but even these investors are in some way related to sovereign wealth funds. For example, in 2014 a public-sector investor representing the Qatari armed forces (QAFIP) bought the Renaissance hotel in Barcelona for €78.5 million. The hotel had been owned by the US Marriott brand since it bought 50% of the Spanish AC Hotels group in 2011. In 2015, another luxury asset in Madrid was sold when the private Saudi Olayan conglomerate acquired Madrid's historic Ritz hotel, in a joint venture with Mandarin Oriental, for €130 million. In 2016, Turkey's Dogus group, in partnership with Spain's BBVA bank, bought the emblematic five-star Villa Magna hotel in Madrid from Portugal's Queiroz Pereira family for €180 million. This latter deal is noteworthy because this effectively priced its 150 rooms at €1.2 million, the highest rate in the Spanish hotel sector.

Interest on the part of SWFs in the Spanish hotel sector in hardly new. In 2006, an investment conglomerate including Singapore's GIC bought the Arts hotel in Barcelona for €417 million. The Arts hotel held the record for the "most expensive hotel per room" for 10 years, until the recent purchase of the Villa Magna.

Barceló Hotels has also been working with sovereign wealth funds for more than a decade, through Tamweelview European Holdings, a subsidiary of ADIA, the largest sovereign fund in Abu Dhabi. This group was the investment partner of Playa Hotels and Resorts, an investment vehicle founded in 2006 by what was then the Barceló Group, to spearhead the acquisition of hotel assets in Mexico, the Caribbean and Latin America.

There is a particular bias in sovereign wealth funds that regularly acquire real-estate assets in prime locations, towards high spending tourism in urban locations in major European and US cities. Being well positioned in these mature markets, SWFs are now building their exposure to emerging markets, knowing that there is a clear trend: tourist arrivals in emerging destinations are expected to grow at twice the rate of traditional destinations between 2010 and 2030. The market share of emerging destinations will also increase to 57% of arrivals over this period. The deals we have seen by sovereign wealth funds in Hong Kong and Vietnam reflect this trend. More deals can therefore be expected in these markets: in 2014, tourist arrivals in the Americas increased by 8% (with Mexico experiencing a significant surge), while Asia-Pacific and Middle East arrivals grew by 5% and Europe arrivals by 3%. This trend continued through 2015, with a slowdown in the Middle East due to geopolitical instability and terrorism in the region.

This trend will be enhanced over the medium term for one single reason: China. China is now the top tourism source market by expenditure: Chinese tourists spent US$165 billion in 2014, compared to US tourists spending US$111 billion and German tourists US$92 billion. As the figures illustrate, four out of five tourist destinations are within the same region: this explains spending on destinations such as Hong Kong and Macao (which for these purposes is classified as international tourism from China). Other countries poised to benefit from this burgeoning Chinese tourism include Myanmar, Malaysia and Cambodia to the south east, India and Sri Lanka to the south, and Japan and South Korea to the north east. Political unrest is the main reason for the 7% fall experienced by Thailand, a traditional destination for Europeans and North Americans.

Traditional destinations, such as France, the United States and Spain - the top 3 by tourist arrivals - are now competing with emerging markets such as China (4), Turkey (7), Russia (9) and Mexico (10). International tourism receipts show that some emerging destinations have high tourist spending: China (3), Macao (5), Thailand (9) and Hong Kong (10).

It would not come as a surprise if Chinese government companies and SWFs became involved in this global strategy of capturing their own international tourist assets. The purchase by the HNA Group (a

private conglomerate) of Carlson Hotels and Anbang's deal to take control of Starwood (where it "competed" with the China's CIC sovereign wealth fund) both follow this approach: seeking to capture returns generated by global Chinese tourism. In the case of HNA, in addition to controlling Spain's NH Hotels, it has also owned the specialist cargo-handler Swissport since 2015, and Hainan Airlines, the China's fourth largest airline. Will we see a Chinese hotel-investment arm linked to CIC? Or will it continue its strategy of selective support for Chinese companies in their global adventures? Only time will tell which of these two strategies China will follow.

There are also myriad examples relating to the Middle East and Africa. Perhaps the most remarkable case is Morocco, which has created its own SWF for developing the tourism sector (similarly to the deal mentioned above by Katara in the country). Morocco set up the Moroccan Fund for Tourism Development (FMDT, for the French acronym) in 2011, as part of its Vision 2020 project. Its strategic objective is to develop new destinations and guarantee the funding required to develop the tourism infrastructure needed to host 20 million tourists by 2020 (up from 10.3 million in 2014), taking it into the global top 20. In addition to providing this finance, FMDT also acts as a catalyst for international investment in tourism. In 2011, it coordinated the creation of Wessal Capital, a unique vehicle owned by five sovereign wealth funds, which have earmarked €2.5 billion to foster the country's tourist sector. Each of the funds - Al Ajial Holding (Kuwait Investment Authority), Qatar Holding (Qatar Investment Authority), Public Investment Fund (Saudi Arabia), Aabar (owner of the Emirates sovereign fund IPIC) and Morocco's FMDT - contributed €500 million. Among the most recent developments is the €530 million Wessal Casa-Port,[22] which includes the refurbishment of historic buildings in Casablanca and a total redesign of the area with the construction of a new cruise-liner terminal, a marina and a number of hotels.

To conclude, the hotel sector is an important investment destination for sovereign wealth funds. First, the sector closely reflects trends in international tourism, helping to anticipate emerging medium- and long-term socio-demographic trends (e.g. rising middle classes, new poles of economic activity in Asia). Second, purchasing buildings can protect the value of investments by indexing rents to inflation. Third, the medium-term returns offered by such buildings in emerging markets that are not yet saturated are an increasingly attractive investment option, at a time of low interest rates and stock market volatility. Fourth, the visibility and international positioning achieved by aligning a country's brand with prestigious "western" locations and institutions enhances the legitimacy of the governments of countries with sovereign wealth funds, most of which are "emerging economies". Finally, the useful lives of these investments explains their interest to SWFs, which have long-term investment mandates and need to find assets that combine returns with moderate risk.

[22] For more details visit: http://www.thenational.ae/business/property/uae-backed-wessal-capital-begins-work-on-portion-of-530m-casablanca-revamp

Luxury and trophy assets: Losing its shine for the sovereign wealth funds

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6. Luxury and trophy assets: Losing its shine for the sovereign wealth funds

Overview

The luxury industry grew again. In 2015, the luxury market exceeded €1 trillion in retail sales value, representing a growth rate of 5 percent year-over-year (at constant exchange rates). Three segments, including luxury cars, luxury hospitality, and fine arts, are the key drivers of the growth[1]. Personal luxury, one of the leading segments in the luxury industry, reached €253 billion in sales, representing real growth rates of 1-2 percent.

The Chinese consumer remains powerful in 2015. Chinese nationals account for 31 percent of global luxury purchases. Americans follow in second, responsible for 24% of luxury purchases, and Europeans in third, accounting for 18%. Meanwhile Japan remains relevant thanks to a strong local market and the influx of Chinese tourism.

As we look into the future of the sector, we can identify three main, interrelated forces that have an impact on the dynamics of the luxury goods industry. The first is the impact on the changing values and expectations of younger generations, specifically the millennials. The second force is the development of a digital economy that is transforming every market sector. E–commerce, social networks, social media, and platforms have had a deep impact on how businesses compete including luxury. The third driver is a growing desire for memorable experiences which is connected to the generational change in expectations and the influence of digital.

These three forces can then be translated into three important, interrelated issues for the sector: new generations of consumers to please, the rise of internet and technology, and the need and the challenge to create meaningful experiences.

Main issues affecting luxury goods industry today

While economic, social, and technological changes both affect and define opportunities in all business sectors, some have had a special impact on the luxury industry. We can identify ten specific issues that are key for the evolution of luxury sector as described below:

First, the challenge of growth as China's rapid economic development has slowed. Although most projections indicate that Chinese consumers continue to make up the largest portion of luxury purchases globally, the Chinese market is no longer the locomotive for the luxury goods industry it once was. The market in China has been hurt by slower economic growth, as well as by measures taken by the government to control corruption. As a result, in 2015 we saw luxury brands make the decision to shrink their networks in China and Hong Kong. As an example LVMH has closed 3 Louis Vuitton stores in China, including the first outlet in Guangzhou. Burberry and Coach have scaled down in Honk Kong where rents are rising and Chinese visitors are decreasing.

Second, the management of price as currency fluctuations and different taxations systems generate disparity in prices. Pricing in the luxury goods industry has become increasingly challenging as a result of price transparency, currency evolution, and the importance of global tourism. Price harmonization is a challenge faced by luxury brands.

Transparency of international price differentials (a result of the growth of e-commerce and global tourism), has provided new challenges for the traditional pricing system that priced items sold in Hong Kong and China between 25% and 40% higher than in Europe, excluding taxes.

With the euro falling by about 20% against the yuan in 2015, this price gap has widened to as much as 60%. Reducing price gaps should discourage gray market trading and protect branding. In 2015, Chanel took a leadership role and decided to harmonize pricing of some key products worldwide, reducing prices in China for several key items, while simultaneously increasing them in Europe. Other companies are rolling out more affordable luxury items for the Chinese market in an effort to reduce price differentials without impacting existing merchandise.

Third, creating memorable experiences is vital for luxury strategies. Being successful at providing a memorable experience is the main area of focus for luxury executives today. Polarization of choices is the result of abundant information, broad access to luxury products, and the aim to be unique and differentiate. While economic slowdown has caused customers to become more price and quality conscious, they are less so when provided with customized service and meaningful experiences. Affluent consumers spend more money and give a far greater share-of-wallet to experiential luxury – trips and visits – as an alternative to luxury products[2]. Today's luxury consumer are "highly digital, mobile and social" and have extremely high expectations for a seamless, digitally enabled, multi-channel shopping experience[3].

[1] Currency fluctuations and luxury globe-trotters boost global personal luxury goods to over a quarter trillion Euros, Bain & Company (2015).

[2] According to research conducted by The Boston Consulting Group and Business of Fashion on luxury experiences and Deloitte's report on Global powers of luxury goods 2014.

[3] According to Altagamma-McKinsey Digital Luxury Experience Observatory global study.

Technology and digital, personalization & customization, physical human contact and "wow moments" as the four pillars for building a memorable experience of luxury[4]. Particularly personalization, customization and the result on protecting exclusivity remain at the core of the luxury business strategy.

Fourth, 2015 was the year of digital luxury disruptors when luxury startups achieved valuations of unanticipated size, such as Farfetch, valued at over $1billion in its last financing round becoming a fashion-tech unicorn. Conversely, some start-ups experienced a hit in their valuations. Gilt Group, has agreed to sell for $250million, much lower than its formerly achieved $1.1 billion value. The growth of online retailers has impacted the way luxury firms compete in the market.

Notable events in 2015 include the merger of the largest e-commerce sites, Yooxs and Net-a-Porter, as well as Chanel's decision to sell online, starting with eyewear and sunglasses categories.

Fifth, overall urban tourism accounts for more than half of total luxury turnover. In Europe more than 60% total sales of personal luxury are to tourists. The evolution of urban tourism trends is particularly important due to the geographical concentration of luxury consumption. There is a competition among cities to become luxury capitals. The top 25 cities account for about one-third of total luxury point of sales, while the top 10 cities account for 20 percent[5].

As tourism grows so does travel retail that is increasingly capturing luxury consumers on the move. Airport retail now accounts for 6 percent of the global luxury market, a growth rate of 29 percent in current exchange rates (18 percent in constant exchange rates). Extensions, improvements, and the launch of new airports contribute to the development of this channel.

Sixth, polarization is driving consumer and retailer success at both ends of the economic spectrum. While luxury good digital clients grow substantially at one end of the economic spectrum, we see value-driven marketers and mass-market retailers serving consumers at the "extreme value" end[6]. On one hand low-income families are focused on family-budget management, while high-income households are more concerned about time-management and convenience, and laying less regard to price. Polarization impacts behavior on social media, mobile, and the Internet.

The number of luxury consumers worldwide has more than tripled over the past 20 years and is expected to reach 400 million consumers by 2020. Luxury goods price increase above inflation rates for the last decade as the result the arrival of new companies to the most selective part of the market as well as the more intensive development of products at high end (personalized, limited edition, etc.).The arrival of new companies to the most selective part of the market can also be indicative of this polarization and, above all, of more demanding customers.

Seventh, digital business was reaffirmed as a key component of business strategy for luxury brands. E-commerce grew to 7 percent market share of luxury in 2015, nearly doubling its penetration of luxury distribution since 2012 and growth is only expected to continue, with forecasts suggesting that 50% of Chinese luxury consumption will be made online by 2020, according to Bain report. The value of luxury products and services searches grew in 2015. In terms of product category, watches was confirmed as the most popular within personal luxury. Also, the search for fashion items increased beyond the search for handbags and accessories. Omnichannel is the buzz world as 78 percent of shoppers use two or more channels during their path to purchase. These multichannel shoppers have been found to be worth up to 208 percent more than single-channel luxury shoppers and 78% of luxury clients would check online before making their purchase, according to Deloitte research and the study by IE Premium Observatory respectively[7].

Social media also saw new innovative initiatives in 2015. Burberry joined forces with Mario Testino for a Snapchat initiative. Instagram strengthened its position as a key social network for fashion and luxury. Instagram models (instamodels) has been highly successful based on visibility. This is exemplified by the success of Kendall Jenner, who has 44 million followers, and of 17-year old Lucky Blue Smith, a leader among male instamodels. Luxury firms are heavily promoting branded mobile apps, iPad catalogs, and mobile web sites in order to maintain customer relationships and to keep clients connected to their brands 24/7.

Eighth, innovation in processes and products in luxury. 2015 was also the year of wearable technology also in luxury. The iWatch was launched with a price range between $350 and $10,000. The premium position was reinforced by a collaboration between Apple and Hermès, to create a product that combines new technology with artisan tradition. Many believe this is a positive sign for the future of the sector as it brings to the pool of clients the millennial generation not heavy users of luxury watches up to now.

4 As identified by Research IE Premium and Prestige Business Observatory. "Keys to memorable experiences".

5 According to research by Luca Solca for the Exane BNP Paribas Luxury Report (2015).

6 Polarizing Economics: Sell to the masses, dine with the classes?, Catterton Investments (2014).

7 The Importance of the Internet for Consumers of Premium and Luxury Products, IE Premium & Prestige Business Observatory (2012).

6. Luxury and trophy assets: Losing its shine for the sovereign wealth funds

Regarding process of development of luxury products, 3D technology is here to stay and is finding new applications in luxury fashion beyond customized jewelry and watches. Until recently, 3D printing was limited to conceptual items, such as those produced for Iris Van Herpen's haute-couture show. Chanel's use of 3-D printing for tweed pieces in their latest haute couture show suggests that the technology is beginning to impact the modus operandi on a larger scale and making its way into more wearable pieces.

Ninth, strategy and management in luxury companies have acquired a different dimension. On one hand as creativity has enhanced the value proposition of luxury brands and remains at the heart of any luxury organization.

On the other hand fashion and luxury are beginning to take their digital propositions more seriously, hiring Chief Digital Officers to better integrate digital strategy thinking into their core. For example, LVMH hired Ian Rogers, a Senior Director from Apple to lead their digital strategy. Alibaba also poached an Apple employee, bringing him onboard as their head of global intellectual property enforcement in an effort to fight counterfeiting. More professionalized digital developments have led to an abundance of data and challenges luxury brand managers to find the "sweet spot" that reconciles management based on analysis with that based on creativity. The role of talent and creativity is reinforced in the strategy of luxury companies, and with it comes the need to keep a well-designed balance between management of data and creativity.

Tenth, as new clients of luxury bring their new values with them, sustainability and responsible innovation has become increasingly important when making a purchase decision. Luxury's newest generation of clients are global, educated, and discerning, and will demand that luxury brands be exemplary citizens, demonstrating both environmental and social responsibility. Corporate Social Responsibility (CSR) continues to gain relevance. In fact, this is the topic with the most significant increase in importance in 2015 for luxury brands according to IE Luxury Barometer 2015.

Millennials' desire for authenticity is increasing. The trend began with local music and hospitality, but has since gone mainstream. Millennials increasingly prefer function and practicality over brand names is causing major shift retail, a shift in which many retailers are winning. While their parents derived status from brand names and product ownership, the millennial shopper distastes logos, prefers to spend on food, technology, and vacations, and favors brands with meaning and a purpose to improve the world[8].

Corporate activity and M&A transactions

In terms of luxury industry corporate activity, M&A transactions in the luxury sector over the last two years reveal three major trends[9]. Deals taking place to regain control of elements of the value chain, particularly design, product development and distribution. Puig, Spanish, Barcelona based fragrance company taking control of Jean Paul Gautier business is an example. A second trend is luxury goods companies acquiring digital knowledge and competitiveness by integrating cutting edge technology start ups. Luxottica Group acquisition of glasses.com from Wellpoint falls in this category. Additionally, a continued interest of private equity in the sector, eager to capture growth opportunities. Varenne purchased Florentine maison Roberto Cavalli in a MBO transaction, Partners Group bought a 25% in Spanish jewelry brand Joyeria Tous or Investindustrial acquisition of Sergio Rossi Spa from Kering are all examples.

In 2015, 141 deals were made within the luxury perimeter, 51 focused in hotels, 33 in apparel and accessories and 19 in cosmetics and fragrances. The average turnover of acquired companies was $425M and large size deals were concentrated in apparel and accessory sector and hotels.

Qatar is already an investor of Tiffany, Porsche, LVMH or Annya Hindmarch as well as Paul Zileri or Harrods. Qela was started in 2013 by Qatar Foundation as the first local luxury brand. Regarding acquisitions in the fashion space Valentino was first and now the French fashion brand Balmain was acquired in 2016.

The slowing economic development worldwide, including China and oil based economies, creates a new landscape where firms need to work to identify new sources of growth for the luxury sector. The fact that the number of high net worth individuals has decreased for the first time since 2007, adds to the challenge of reinvention for luxury brands that had relied on sales increased of super expensive products and categories.

Growth in the luxury sector has to be based on fostering digital growth, providing memorable experiences and targeting new clients that demand new values. The focus on digital growth calls for leaders to rethink how they will achieve a seamless experience and how they can build synergies between digital and brick-and-mortar, including how they tailor product collections for online and offline retail.

8 Millennials are rejecting a strategy Coach, Abercrombie & Fitch, and Michael Kors have relied on for years, Business Insider (2015).

9 Global Fashion & Luxury market: Private Equity and Investors Survey, Deloitte (2016).

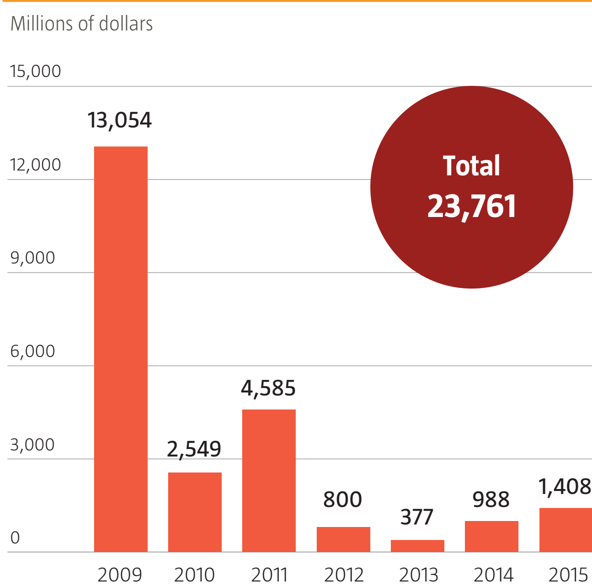
Sovereign wealth fund investments in the luxury industry

Despite the growth experienced in 2015, the luxury industry is showing signs of flattening out. 2016 has been marked by three factors suggesting a degree of caution is required in forecasting the behavior of investments in this sector over the short- and medium-term: a) a slowdown in global economic growth and international trade to 3.1% and 2.8% respectively, according to the IMF and the WTO, levels very similar to those recorded by these bodies in 2014; b) the number of people worldwide declaring assets of US$30 million or more - UHNWIs [10]- has fallen for the first time since the start of the financial crisis in 2007, down 3% on 2014, meaning there are 5,500 fewer members of this select club[11]; c) a marked decrease in demand for luxury goods and services, as reflected in the 12% fall in sales of apartments in Manhattan for over US$10 million compared to 2014[12], the terrible results of major auctions in London, with sales down by more than 30% at both Christie´s and Sotheby´s, and the 15% decline in sales of collectors cars (following a 490% increase in value over the last 10 years[13]).

There are a number of reasons for this situation, including the dramatic falls in oil and gas prices, expectations of higher interest rates in the USA, the weak recovery in western economies and the sharp economic slowdown in China and other emerging markets, such as Russia and Brazil. These factors have all impacted adversely on sovereign wealth funds, many of which are from emerging countries that devote a large share of their funds to mitigating the problems of their domestic economies through countercyclical policies. These have seen their incomes from commodities and budget surpluses contract significantly, while also being hit by substantial depreciations in many of their assets. Taken together with the prevailing geopolitical uncertainty, these factors have served to undermine the investment capacity of some of these vehicles.

Against this backdrop, sovereign wealth funds have decided to go back to focusing on seeking returns, such as those currently offered by the realty sector, the corporate bond market and safe haven securities, such as US fixed income, leaving riskier investments and acquisitions of trophy and iconic assets until conditions improve. This has not always been the case. During the commodities super-cycle, non-realty trophy assets[14 15] - strongly related to the luxury industry - were on the radar of sovereign wealth funds. Such assets were acquired as part of a clear investment strategy, in which the funds were seeking attractive returns and, in some cases, protection against inflation, while at the same time also trying to attract luxury companies and brands to their home countries and position themselves as "world-class investors"[16] (see Chart 1).

Chart 1
Sovereign wealth fund's investments in the luxury industry (2009-2015)



Source: Author's elaboration, 2016.

The first major investments by sovereign wealth funds in the luxury industry took place in the 1970s and early 1980s in the automotive industry. In 1974, the Kuwait Investment Authority sovereign wealth fund bought 14% of the Daimler Benz group, the owner of marques such as Mercedes and Maybach, for US$1 billion. In 1983, its London-based UK subsidiary, the Kuwait Investment Office, bought 10% of the Volkswagen group, currently the owner of marques such as Porsche, Bentley and Lamborghini, for US$141 million. With these investments, the fund was seeking returns from the burgeoning European automotive industry of the 1980s, and also to associate itself with marques such as Mercedes and Volkswagen, which at the time were considered luxury brands, with few models aimed at the mass market.

[10] Ultra high-net-worth individuals.
[11] The Wealth Report, Knight Frank (2016).
[12] CityRealty (2016).
[13] The Wealth Report, Knight Frank (2016).
[14] It has also purchased trophy assets in the realty sector. Noteworthy deals include the 2008 purchase of 75% of the Chrysler building by Abu Dhabi Investment Council for US$800 million, and, more recently, its contribution of 95% of the US$705 million needed for construction of the Shard in London.
[15] See the chapter on investment by sovereign wealth funds in the hotel sector.
[16] See the chapter analyzing the investments of sovereign wealth funds in the art sector in the 2015 Sovereign Wealth Fund Report.

Infographic 3

Qatar's main investments in the luxury sector 2009-2016

PERCENTAGE OF TOTAL INVESTED CAPITAL
(2009-2016)

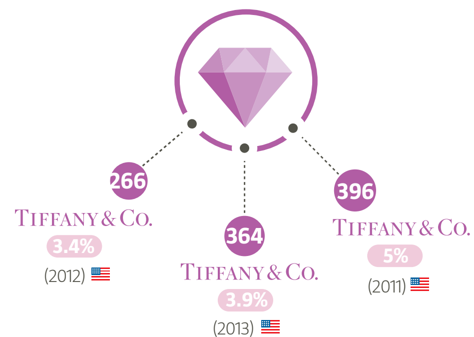
AMOUNT OF INVESTMENTS
(Millions of dollars)

STAKE XX%
YEAR OF PURCHASE (XXXX)

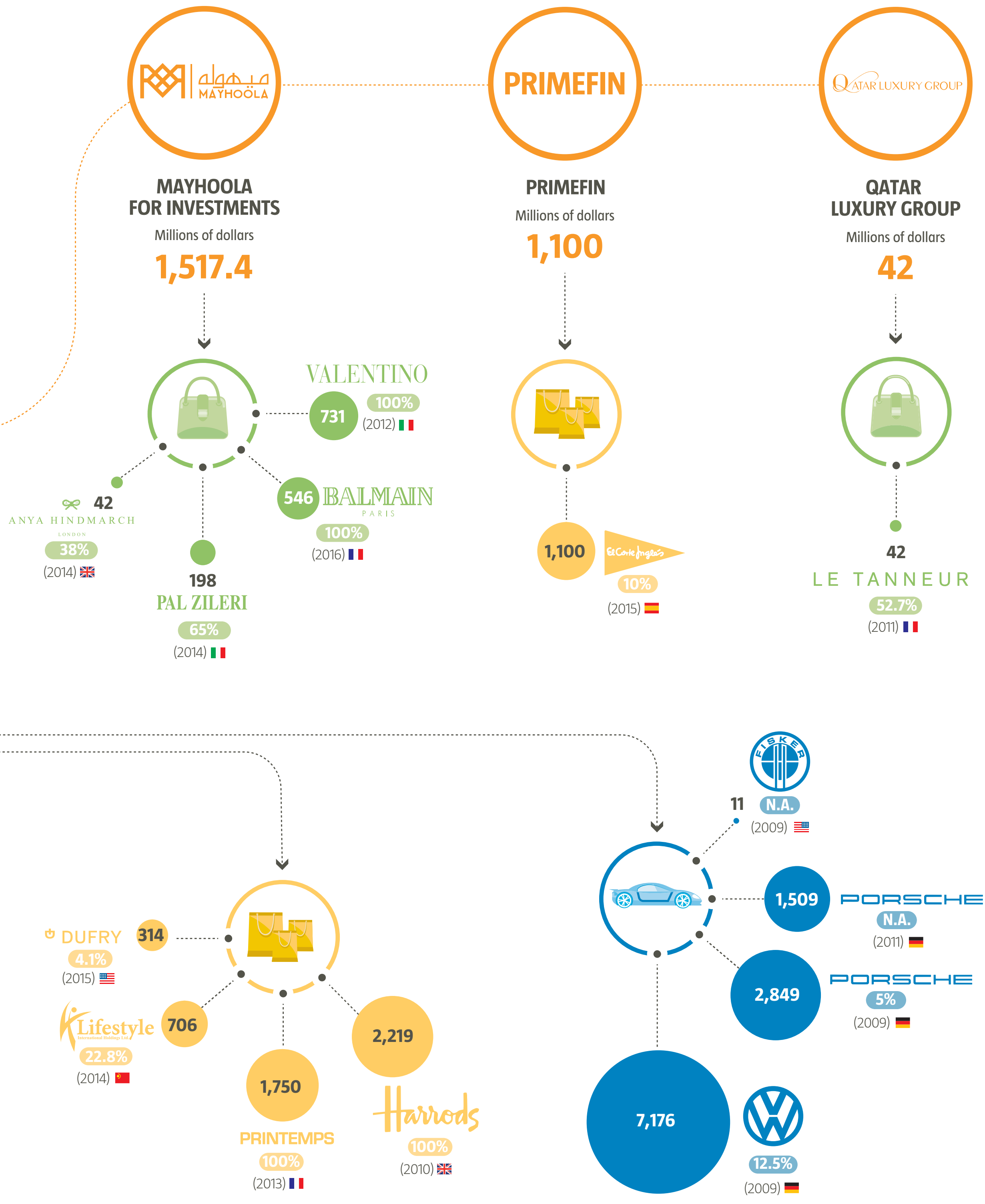
INVESTORS

QATAR INVESTMENT AUTHORITY
Millions of dollars
18,280

720
LVMH
1.1%
(2011)



Source: Author's elaboration, 2016


MAYHOOLA
PRIMEFIN
QATAR LUXURY GROUP
MAYHOOLA FOR INVESTMENTS
Millions of dollars
1,517.4
PRIMEFIN
Millions of dollars
1,100
QATAR LUXURY GROUP
Millions of dollars
42
VALENTINO
731
100%
(2012)
546
BALMAIN PARIS
100%
(2016)
42
ANYA HINDMARCH LONDON
38%
(2014)
198
PAL ZILERI
65%
(2014)
1,100
El Corte Inglés
10%
(2015)
42
LE TANNEUR
52.7%
(2011)
11
N.A.
(2009)
1,509
PORSCHE
N.A.
(2011)
2,849
PORSCHE
5%
(2009)
7,176
12.5%
(2009)
DUFRY
314
4.1%
(2015)
Lifestyle
706
22.8%
(2014)
1,750
PRINTEMPS
100%
(2013)
2,219
Harrods
100%
(2010)

6. Luxury and trophy assets: Losing its shine for the sovereign wealth funds

The Qatar Investment Authority fund has pursued such investments to such an extent that they have become its trademark. Qatar's sovereign wealth fund has invested over US$16.5 billion in acquiring non-realty trophy assets[17] over the last fifteen years. This has made it a real specialist and set the bar for this sector (see Infographic 3). As in the Kuwaiti case, its initial investments were in companies in the automotive sector. In 2009, it took an US$11.3 million stake in the leading manufacturer of hybrid vehicles, the USA's Fisker[18], and, through its subsidiary Qatar Holding[19], invested US$7.176 billion in the Volkswagen Group[20] and US$2.848 billion in Porsche, taking stakes of 12.5% and 10% in their capital, respectively, as part of the merger of the two companies. Two years later, in 2011 it invested US$1.509 billion in a rights issue by Porsche, so as not to see its holding diluted[21]. It currently has 14.6% of the shares of the world's second largest car manufacturer, having at once stage controlled 17% of the shares of the Group resulting from the merger.

The Qatari fund has not limited itself to investing in the automotive industry. Over the last decade it has concentrated a lot of its efforts on acquiring trophy assets in the fashion, jewelry and department-store sectors. It carried out its most audacious investment in 2010, when it paid US$2.219 billion for London's iconic Harrods store. The investment was carried out by Qatar Holding, which has seen its investment rewarded with substantial dividends, exceeding £100 million over recent years[22]. And the investment has also resulted in the opening of branches of the exclusive store in the tiny Emirate's capital, one of which is in the spectacular Hamad International Airport. Three years later, repeating its Harrods strategy, it put up more than US$2 billion to acquire 100% of the luxurious Printemps store in Paris - beating Galeries Lafayette, which was also interested in acquiring the asset - from Deutsche Bank (with a 70% stake) and the Borletti Group (30%). More recently, the fund, and some of its executives, have been taking stakes in the capital of other major stores, such as China's Lifestyle International Holdings, which operates the Sogo malls in Hong Kong, in which it bought a 22.7% stake for US$705 million in 2014, and el Corte Inglés, where the former prime minister of Qatar and ex-CEO of the Qatari sovereign wealth fund acquired a 10% holding in the stores of the Areces family, for US$1.1 billion in 2015. In 2015, it also spent US$313.7 million on acquiring 4.1% of the airport retail operator Dufry, helping the Swiss company to take over its closest competitor, Italy's World Duty Free, in concert with Singapore's two funds, GIC and Temasek. In the first two cases, the plan is to use the Qatari fund's holding to foster international expansion, opening both stores in the Middle East.

The fund has also been very active in the high fashion and jewelry sectors. Its portfolio includes: 1.1% of the French luxury-goods conglomerate LVMH Moët Hennessy, which owns brands such as Louis Vuitton, Loewe and Christian Dior, which it acquired for US$719.6 million in 2011; and Tifanny, in which it has invested over US$1 billion in various deals[23], making it the largest shareholder with a holding of 12.8%, ahead of The Vanguard Group (7.9%), JP Morgan (6.9%) and BlackRock (5.6%). In addition, we should also include the deals carried out by Mayhoola, a vehicle of Qatar's royal family and closely connected to the Emirate's sovereign wealth fund, including its purchase of Valentino in 2012 (for US$731 million), its holdings of 38% of Anya Hindmarch and 65% of Pal Zileri (acquired for US$42.4 million and US$137[24] million, respectively, in 2014) and the acquisition of Balmain in 2016 (for around US$546 million).

Other sovereign wealth funds in the region were infected by the same bug and, driven by imitation and excess liquidity from their hydrocarbon resources, embarked on a search for their own trophy assets. Thus sovereign wealth funds from the Emirates - in direct competition with the Qatari fund to see which could acquire the most prestigious trophy assets - have acquired holdings in companies such as Ferrari (of which Mubadala acquired 5% in 2005 for US$137 million[25]), Mercedes-Benz Gran Prix (in which Aabar, the non-oil branch of IPIC, invested US$1.691 billion to purchase a further 10% of the F1 team, taking its holding to 40%) and the McLaren Group (in which Bahrain's Mumtalakat fund achieved control of 50% of the shares in 2013, having invested US$13 million to acquire an additional 8%). These investments in F1 must have fostered the construction of the Abu Dhabi circuit and the holding of the F1 grand prix there in 2009. They must also have been the catalyst for development of the Ferrari World amusement park in 2010, and the consolidation of the Bahrain grand prix, which was held for the first time in 2004[26]. This clearly reveals that there was a much more ambitious strategy behind these investments than just

[17] It invested over US$26.6 billion in trophy realty assets in Europe and North America over this period. Sovereign Wealth Center (2016).

[18] It participated in the funding round (Series C) through its subsidiary Al Gharrafa Investment, together with Quantum Fuel Systems Technologies, Kleiner Perkins Caulfield & Byers, Palo Alto Investors and Thomas Lloyd Capital. Venture Beat (2009).

[19] Following the most recent restructuring of the fund, Qatar Holding's international investments will pass to the Qatar Investment Authority, with the subsidiary through which the fund had carried out its main acquisitions ceasing to exist. Bloomberg (2016).

[20] The investment in Volkswagen has been less successful than anticipated. The emissions-fraud scandal led to the fund - the third largest shareholder, with 14.6% of the capital - losing around US$5 billion in just three months. Bloomberg (2016).

[21] Following the merger of Volkswagen and Porsche, the fund sold 10% of Porsche to the Porsche and Piëch families in 2013. Bloomberg (2013).

[22] Companies House (2015).

[23] Tiffany annual report (2015).

[24] Including a package of the Italian company's debt, valued at €61 million.

[25] It sold the holding to the Fiat Group for €167 million, five years later, in 2010. Financial Times (2010).

[26] Mumtalakat also took a 9.1% holding in Daimler, the parent company of Mercedes, in 2009, for US$2.654 billion.

achieving returns or linking the image of these brands to the funds and, therefore, their countries, as has subsequently been demonstrated. This rationale could also have been behind IPIC's 2010 investment in multi-millionaire Richard Branson's space company, Virgin Galactic Ventures, of which it acquired 32% for around US$280 million. Will we see the first commercial space flight take off from Abu Dhabi in the next few years?

Acquisitions of trophy assets in Asia have so far been led by Singapore's sovereign wealth funds, GIC and Temasek. GIC's investments in high fashion and jewelry companies include its acquisition of 2.3% of Tod's, it's 2001 acquisition of 4% of Bulgari and its US$48.9 million investment in Jimmy Choo in 2015, giving it a 5.4% stake un the Malaysian designer's company[27]). Other noteworthy investments in luxury retailers include the joint purchase by GIC and Temasek of 14.2% (7.1% each) of the Swiss airport retail operator Dufry for US$1 billion, and, in 2011, GIC's US$170 million capture of 10% of the company that operates the 17 luxury stores of China's Intime chain, the base for some of the main brands of the LVMH Moët Hennessy and Kering groups in the Asian giant. Despite being awash with liquidity, Chinese funds have been very timid in their approach to non-realty luxury assets, concentrating instead on building positions in the financial, energy and industrial sectors. For the moment, we can only point to CIC's investments in Diageo (investing US$364.4 million in 2009 for 1.1% of the producer of spirit drinks such as Zacapa and Johnnie Walker) and L'Occitane (acquiring 1.9% of the French cosmetics company in 2010 for US$50 million), and SAFE's 2014 investment in Fiat Chrysler, in which it acquired 2% of the manufacturer of iconic marques such as Ferrari and Maserati, for US$241.6 million.

It seems certain that we will see more investments by these funds in non-realty trophy assets over the coming years, but not at the pace we saw in the golden decade for commodities and global trade. These assets have - to an extent - lost some of their sparkle, for sovereign wealth funds at least.

[27] Jimmy Choo, annual report (2015).

Sovereign venture funds 2.0

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7. Sovereign venture funds 2.0

Introduction

Sovereign wealth funds (SWFs) continue to bet on innovation and technology. As we discussed in our previous edition, this is a new trend that is becoming more firmly established over time. Investments are multiplying, spreading beyond major tech companies listed on the Nasdaq and other stock market indexes. We are now seeing SWFs investing in startups, even in their earliest stages.

Investments are no longer limited to the major listed tech giants, known as GAFA (Google, Amazon, Facebook and Apple), but have now moved on to Uber, in which the Saudi Public Investment Fund recently invested $US3.5 billion, and Airbnb, into which Temasek injected US$150 million of the US$1.5 billion invested in the 2015 round led by General Atlantic, Hillhouse Capital Group and Tiger Global Management. Some SWFs have even opened offices in Palo Alto from which to invest in US startups. These include Malaysia's Khazanah, which has invested in General Fusion, and GIC, which has invested in Ancestry. It is becoming increasingly common to see these funds investing in "unicorns," unlisted companies owned by venture capital funds that joined the US$1 billion club in record time. These bets and their pay offs often happen at dizzying speed. For example, Malaysia's Khazanah fund earned over US$1 billion on its US$400 million investment in China's internet giant Alibaba in less than two years. Other SWFs have also acquired holdings in Alibaba, such as China's CIC (which invested over €2 billion for a 5.6% equity interest) and Singapore's Temasek.

Meanwhile, the proliferation of unicorns in China is driving the ecosystem: the founders of these startups are then reinvesting in other tech companies, feeding a virtuous circle. In mid-2015, Joseph Tsai, one of the founders and the vice-chairman of Alibaba, with an estimated fortune of over US$6.5 billion, decided to create a family office in Hong Kong[1]. Just like Jack Ma, the founder of Alibaba, and Lei Jun, the founder of Xiaomi, another Chinese unicorn, he is now helping more startups thrive in the Asian giant.

We are witnessing a new trend. The large state funds of emerging countries have thrown themselves into the technology race. We are experiencing an acceleration in the re-balancing of the world. The first decade of this century featured massive re-balancing of wealth from western nations towards emerging markets. Trade and capital flows were redirected towards emerging markets, giving them greater prominence as sources and destinations for investment. This re-balancing has now spread to innovation and technology. But this is not all, the second decade of the century is seeing the rise of emerging economies as tech powers. China now invests more in venture capital than the whole of Europe, and has become the world's second largest hub for startups and venture capital. Israel has more Nasdaq-listed startups than Europe as a whole.

And this is not all, capital from emerging countries is now moving towards high added-value investments. From China to Singapore, passing through Qatar and the Emirates, wagers on US and European startups by sovereign wealth funds have mushroomed in recent years. As have bets on Asian startups. This is not a new phenomenon: the states have (always) been active in tech investments. Silicon Valley and Tel Aviv were largely the creation of the US and Israeli states, as Harvard University's Josh Lerner argues in a masterly book[2]. Many of the innovations we take for granted today - such as the internet, cloud computing and virtual reality - were fostered by state seed capital or driven by government agencies. And this continues to be partly the case: in 2014, the Pentagon, the US Defense Ministry, teamed up with the CIA to invest in cyber-security startups. The CIA has been running its Q-Tel venture capital fund since 1999, with extensive investments in tech companies. This state-military link is particularly important for understanding the rise of startups in Israel and its famous Yozma program, which unleashed the technical miracle Start-up Nation.

What we are seeing is nothing more and nothing less than the rise of sovereign venture funds, i.e. sovereign wealth funds, and therefore public capital, investing in technology, innovation, startups and venture capital. As we will see later on, these funds have two approaches: some invest directly in startups, while others set up funds of funds to invest in private venture capital funds, which in turn invest in startups.

Emerging markets 3.0

While Europe's tech icons are being chipped away one by one - with Nokia the latest to fall and now embarked on a difficult attempt to re-invent itself through its 2015 acquisition of Alcatel Lucent - emerging markets are becoming ever stronger in innovation and technology. Some of their companies are now global leaders in their respective sectors.

* This article was written in May 2016. The author is responsible for all opinions, errors and omissions.

[1] The family office will be managed by Oliver Weisberg, one of the managing directors of Citadel, the Chicago-based hedge fund, and Alexander West, the founder of Blue Pool Capital, a Hong Kong hedge fund set up by Tsai. The management model for the family office will be similar to that of the prestigious Yale University (where Tsai studied) endowment, heavily involved in alternative investments and venture capital in particular. This model has also been followed by other Silicon Valley icons, such as Mark Zuckerberg, who backed the creation of Iconiq Capital, a multi-family office in San Francisco that manages accounts for him and Facebook's chief operating officer, Sheryl Sandberg. Tsai is very familiar with the world of family offices, having worked in Asia for Investor AB, the investment vehicle of Sweden's Wallenberg family, with investments in technology giants such as Ericsson and holdings in startups such as the German group Rocket Internet.

[2] See Josh Lerner, Boulevard of Broken Dreams: Why Public Efforts to Boost Entrepreneurship and Venture Capital Have Failed – and What to Do About it, Princeton, Princeton University Press, 2009.

This is the big story: emerging markets are, partly at least, no longer low-cost and low-technology countries. Now they are no longer just sources and recipients of trade and financial flows: they have developed into countries committed to innovation and technology. And their commitment far exceeds common European perceptions.

The four BRICs (China, Brazil, Russia and India) alone accounted for 43% of the world's population and 21% of global GDP in 2015, as well as 20% of foreign direct investment (almost US$205 billion). And trade between these countries has taken off, multiplying ten-fold in a decade to more than US$200 billion. These four countries are now the first (China), third (India), sixth (Russia) and seventh (Brazil) largest economic powers. In 2015, China had as many companies in the FT Global 500 - an index of the 500 companies with the highest market capitalization worldwide - as the UK, with 33.

Other countries, such as Singapore, are unseating some of the major western financial centers, particularly those in Switzerland. In fact, Singapore is the first emerging economy to join the select club of "triple A" countries, with the highest international credit ratings. Chile, Turkey and Mexico are now OECD members. Qatar has the highest concentration of millionaires in the world, ahead of Switzerland, not to mention the highest GDP per capita. And the airlines connecting the most countries are now from emerging countries, with Turkish Airlines, Qatar Airways, Emirates and Egyptair among the top 10 airlines. They are all seeking trophy assets and knowhow to help them provide services in their own countries. In 2015, the Fosun group bought Cirque du Soleil to flesh out its entertainment offering for China's middle classes, having bought Club Med earlier that year and taken a stake in the Thomas Cook travel agency.

We are witnessing a technological expansion wave. We are no longer (just) talking about countries with cheap labor and abundant commodities, but economies that are downloading killer technological apps at breakneck speed. In 2015, the largest global tech industry supplier was not American, French or Swedish, but China's Huawei. The largest global producer of PCs is no longer American, it is now Chinese - Lenovo, in which the GIC sovereign wealth fund invested US$700 million in 2014. South Korea's Samsung is now one of the world's biggest R&D investors, having outstripped its Finish and US competitors in the production of mobile devices and phones since 2013. We are witnessing unprecedented tectonic shifts. The spread of technology is accelerating like never before, in both space and time, as Diego Comín[3] argues.

[3] See Diego Comín, Mikhaeil Dmitriev and Esteban Rossi-Hansberg, "The spatial diffusion of technology", Harvard University, Boston College and Princeton University, March 2013 (not published). http://www.dartmouth.edu/%7Edcomin/files/SDT.pdf

South Korea is an excellent example. In 1963, Korea's exports of goods were worth just over US$600 million (at today's prices) and involved mainly agricultural and fishery products. By 2015, it exports of goods and services exceeded US$600 billion and included mainly electronics, machinery, chemical products and naval technology.

The giant Samsung comprises more than 80 companies and employs over 380 thousand people worldwide. In 2013, it even overtook Apple, selling more smartphones and generating more profits than the Californian giant. Samsung currently has 23% of the global smartphone market, followed by Apple, with 14.8%. The next three are all Chinese manufacturers: Huawei, with spectacular growth over the last year (8.3%); Oppo, which doubled its market share in a single year (4.6%); and Xiaomi (4.3%), according to figures from leading tech consultancy Gartner.

Business innovation in particular was a western story until very recently. Innovative products were conceived, produced and sold by multinationals from OECD countries. This was gradually supplanted by a different model, in which innovation took place in the west, but production was in emerging countries. This is the model Apple uses for its iPods and iPads, which are partly manufactured in Taiwan, South Korea and China. We are now seeing the emergence of a third model, where innovation not only takes place in, and is sold by, emerging markets, but it is also conceived in emerging markets. Smartphones are a case in point: these enormously important products show that consumer electronics and technology are now dominated by the 'East'.

This movement is causing a rapid re-ordering of global business rankings - such as those of the Boston Consulting Group (BCG) and Forbes - of the most innovative companies in the world. The BCG's top 10 is led by Tencent, and also includes one Taiwanese company (Mediatek), a Mexican company (América Móvil), another Chinese company (China Mobile), two Indian companies (Bharti Airtel and Infosys) and one South African company (MTN). The Forbes Top 10 is also topped by Tencent - ahead of Apple and Google, once again - and also includes Brazilian company Natura Cosmetics and India's Bharat Heavy.

Emerging market multinationals are even starting to take on the Internet, a world traditionally dominated by US multinationals. Tencent's stock market capitalization stands at US$45 billion, higher than eBay's and Yahoo's. Meanwhile, in Moscow, Russia's Yuri Milner is revolutionizing the rules for digital risk capital, which had always been dominated by Californian funds. His company, Digital Sky Technologies (DST), owns mail.ru, one of the most successful Russian startups, which is listed on the London Stock Exchange with a capitalization of over US$8 billion. His venture capital fund is one

of the few to have stakes in Facebook, Zynga and Groupon. In 2011, Milner launched a second fund, DST Global 2, with a value of US$1 billion, a size unheard of in western Europe.

China's Tencent (which holds 10% of DST and has bought startups such as Riot Games in the USA, for US$400 million) launched its Tencent Industry Win-Win Fund in 2011 to accelerate the purchase of startups, with a value in excess of US$750 million. Alibaba Group Holdings, one of China's largest internet companies, launched its fund through its Taobao subsidiary, for US$46 million. Legend Capital, one of the owners of Lenovo (holding over 42%), started another tech fund in 2011, with assets of €500 million. Singtel, Singapore's telecommunications operator, launched its own venture capital fund in 2011 with more than US$250 million, to accelerate the acquisition of technology startups. These initiatives show how Asian emerging economies are committed to carving out an ever larger place for themselves in the world of startups and venture capital.

This is not just an Asian phenomenon. Another example is Naspers, a South African digital multinational, which generates over 70% of its revenues in Africa, but has also multiplied its acquisitions in emerging markets. It owns 45% of Tencent, which it bought in 2011. Since then, the value of its holding has increased by over 3,100%: as a result, the biggest hit in the history of the internet world is in South African - not Californian - hands. It has also invested US$390 million in Russia's mail.ru and owns 91% of the Brazilian startup Buscapé, which it acquired for over US$340 million. In eastern Europe, it bought Tradus for over US$1 billion in 2008. Since 2010, it has been gobbling up companies in Latin America, acquiring Argentinean startup DineroMail - the largest online payment company in the continent - and Olx.com, in 2011 for around US$145 million. Naspers currently has operations in 129 countries, with annual revenue of nearly US$4 billion and around 12,000 employees, making it one of the largest investors in emerging economy startups.

There is a generalized view that Silicon Valley is the almighty focal point for innovation and technology worldwide. However, China has been the second largest global venture-capital hub since 2013. Meanwhile, there are more startups per head in Israel than any other country, venture capital there stands at US$140 per capita. double the US$70 in the USA.

Brazil also has a more robust ecosystem of startups and venture capital funds than some OECD countries: in 2015, there were a number of venture capital funds with over US$100 million exclusively for investment in the country. Media groups, such as Brazil's RBS, have launched e.Bricks, a fund with over US$100 million to invest in local internet companies. And the large Californian funds have already started heading for this new El Dorado: for example, Redpoint e.ventures has created a US$130 million fund for investing in Brazilian startups. European funds are also being attracted: in 2012, the London-based venture-capital fund Atómico started investing in Brazil.

In 2013, another large European fund, Amadeus, created a US$75 million fund to invest in emerging-country startups (including Africa, where things are starting to stir in countries such as Kenya and South Africa). For its part, Telefónica has also made a massive commitment to emerging markets, particularly in Latin America, with a network of accelerators (Wayra) in eight countries, and venture capital funds (Amerigo) in three of these. Mexico's América Móvil also invested in startups in 2013. One of these was the UK's Shazam, in which it acquired an 11% stake for around US$40 million, seeking to expand it throughout the region.

Spanish groups have not been sitting by idly. BBVA in particular has created a US$100 million venture capital fund to invest in the USA and, occasionally, Latin America. The now defunct BBVA Ventures, currently known as Propel Venture Partners, valued at US$250 million and operated out of London and San Francisco, acquired Simple for US$117 million in 2014, also investing US$67 million in Atom: in 2015 it bought a Finish online business bank, for an estimated US$100 million. Santander has not been sitting still either, buying Sweden's iZettle in 2013. More recently, its investment arm, Santander Innoventures, led the US$50 million round for Silent Circle, an encrypted-communications company, and took a share in the US$150 million round for Kabbage, a unicorn for automated online loans to SMEs. Both of these banks are working with these European startups on their international development, paving the way into the emerging markets of Latin America.

Sovereign venture funds: SWFs 3.0

Asia has become the main tech and innovative epicenter on the planet. We have already discussed the rise of Asian technology companies. China's Alibaba is perhaps the most spectacular case, with the largest IPO in the internet world, even ahead of California's Facebook. And this trend will only get stronger. Asia is not only home to huge digital companies, it is also seeing the rise of sovereign wealth funds, powerful investment arms that are getting involved in the world of new technologies.

Traditionally, SWFs did not get involved with technology, but they have now started to invest massively in tech companies and startups. As we will discuss in more detail below, the most active has been Singapore's Temasek, which has invested in more than 40

startups in the last three years. It is also one of the main supporters of the country's leading companies (including the telecommunications operator, SingTel). In 2016, it led various funding rounds, including one to inject US$110 million into Farfetch, a British startup founded by Portugal's José Neves, and one of US$145 million to invest in the Indian startup CarTrade.

The most active sovereign venture funds – SWFs that invest in new technologies and innovation, startups and venture capital – are in South East Asia, particularly Singapore and Malaysia. Malaysia's Khazanah sovereign wealth fund opened an international office in Palo Alto in 2014, in a groundbreaking development clearly seeking to identify and tap into innovation. This has served as inspiration to others, such as the Kazakhstan fund Samruk-Kazyna, which showed interest in setting up a subsidiary in Silicon Valley (Samruk Innovation) in April 2015, initiating contacts with Stanford and Berkeley, and iconic startups, such as Tesla Motors.

In 2015, SWFs made more than 30 significant investments in startups. There can be no question that the most active sovereign venture funds have been from Singapore. GIC was involved in the US$400 million funding round for the Indian startup Ola, which is now valued at US$5 billion. A few months earlier it also invested in the US startup Snapchat. If we combine the investment in startups by Singapore's two SWFs - GIC and Temasek - from 2014 to 2016[4], our estimates show that we would have one of the most active sovereign venture funds on the planet, with 66 investments in tech startups.

Temasek's activity is particularly eye-catching. With a portfolio of US$196 billion, Temasek is not just one of the world's largest SWFs, it is also one of the market makers for investment in startups and venture capital funds. Everything it does - or stops doing - is watched with interest by other public investors, which tend to monitor the strategic movements of this historic and sophisticated Asian fund in great detail.

Temasek's main investments are described in Infographic 4. Temasek has invested in 43 startups since 2014, covering various vertical businesses, such as e-education (in 2015 it took a stake in China's 17zuoye, in a US$100 million funding round), e-commerce (such as the startup Jet.com founded by Marc Lore, in which it took a stake with Bain Capital Ventures, in a US$140 million round), the media, online travel and health (where it has recently made several investments, taking part in funding rounds for startups, such as China's Innovent Biologics and the US's AccuraGen Holdings). It has also invested in a range of countries, with investments in American and European startups, but also Chinese, Indian and even Latin American startups (in 2014 it took part in a funding round to inject US$140 million in the Brazilian startup Netshoes, specializing in selling sneakers. Temasek also led the US$700 million investment in the Chinese taxi app Didi Dache, in a funding round completed in December 2014, together with DST Global and the fund of Russia's Yuri Milner.

In June 2015, Temasek led a US$40 million funding round in Hello, a manufacturer of sensors for drowsiness in drivers. This US$250 million company was founded by a 23 year old British prodigy based in San Francisco. The investment arrived at an exceptionally low point in the normal investment cycle for an institutional investor such as Temasek, confirming the level of sophistication that has been achieved by sovereign venture funds.

The strategic dimension of some investments is also noteworthy. For example, in the case of startups in the financial sector (fintech), Singapore is aspiring to become one of the main global financial hubs, which explains its investments in fintech startups such as Markit and Funding Circle in London, at US$500 million and US$150 million, respectively. In April 2015, Temasek acquired SVB India Finance, an Indian company that lends to venture capital-based startups, for US$48.1 million. This followed another fintech investment in December 2014, in Adyen, a tech startup focusing on payment systems. It took part in a US$250 million funding round together with venture capital funds, including General Atlantic, Index Ventures and Felicis Ventures.

GIC, Singapore's other SWF, has also been active, making 23 investments in startups over the last three years. In 2014, it took part in a US$200 million funding round for Square, a fintech payment startup. In the same year, it also invested in iParadigms, a US startup in the educational sector, taking part in a funding round worth over US$750 million; the Brazilian company Lynx; India's Flipkart and China's internet security company Cheetah Mobile. Recently, it participated together with Temasek in a US$1.5 billion funding round to take a stake in Cainiao Logistics, Alibaba's logistics subsidiary.

South-east Asian funds are not the only ones investing in startups. The telecoms and media sector became the second most important focal point for investment by SWFs in 2011-12. This sector is now the largest in terms of the percentage of total investments for Khazanah (because of the weight of the telco operator), the second largest for Temasek and the third largest for China's CIC and the Emirates' Mubadala. As shown in Chart 1, the combined telco and tech sectors have weightings of 26%, 23%, 16% and 8%, respectively, in

[4] Figures as of July 2016.

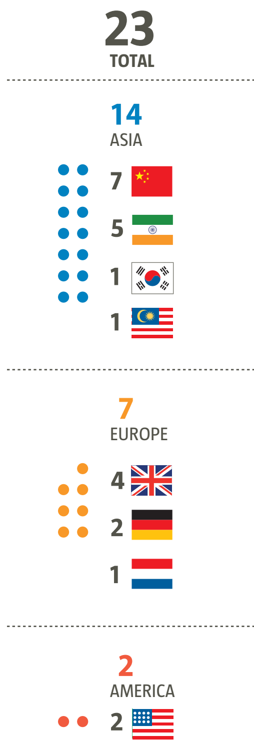
Infographic 4

Temasek: Sovereign Venture Fund Market-Maker

COMPANIES BY COUNTRY OF ORIGIN

23
TOTAL

14
ASIA



INVERSIONES EN STARTUPS
(Millones de dólares)

2016
2015
2014
2013

TOTAL
ASIA 4,905
EUROPE 1,946
AMERICA 80

TEMASEK
TOTAL INVESTMENT 2013-2016
6,931 MILLION DOLLARS**

CarTrade.com
145* (INDIA)

一起作业
17zuoye.com
100 (CHINA)

svb India
47 (INDIA)

滴滴打车
(Didi Dache)
700* (CHINA)

snapdeal
100 (INDIA)

TutorGroup
100* (CHINA)

VANCL
100* (CHINA)

yatra.com
23* (INDIA)

GRABTAXI
10 (MALAYSIA)

HEALTHCARE CELLTRION
129 (SOUTH COREA)

Cloudary
110* (CHINA)

EROS
41 (INDIA)

markit
500 (UK)

EVONIK INDUSTRIES
600 (GERMANY)

Lazada
250* (GERMANY)

adyen
250* (NETHERLANDS)

hello
40* (USA)

AccuraGen
40* (USA)

Funding Circle
150* (UK)

FARFETCH
110* (UK)

Virgin mobile
86* (UK)

* Other co-investors in the same financing round.

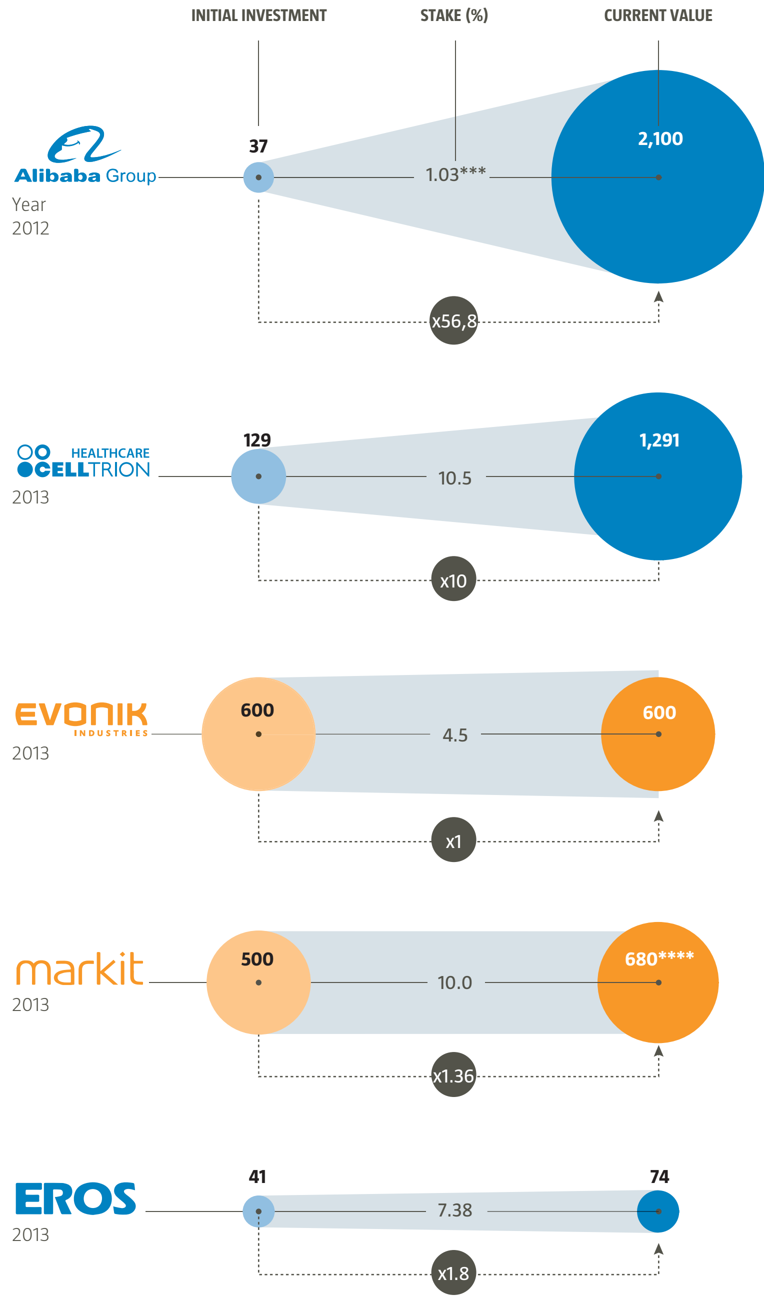
** Valuations based on individual investments, as well as later financing rounds.

Source: Temasek Annual Reports (2016)

美团 meituan.com | 大众点评 dianping.com

3.300* (CHINA)

BIG RETURNS (SELECTED COMPANIES)
(in millions of USD)



***November, 2014

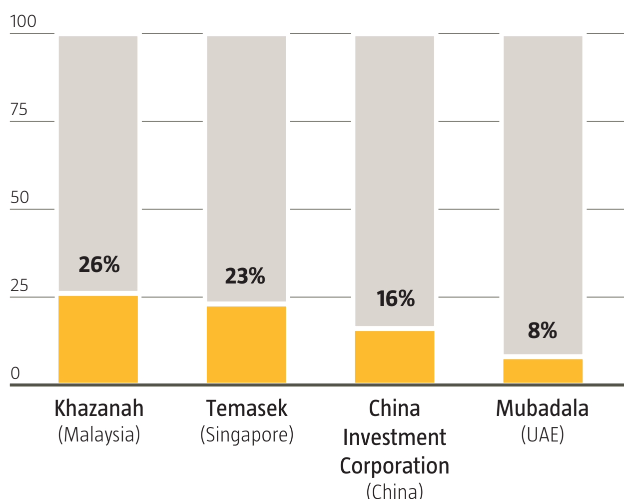
****Value before the merger with IHS in July 2016

7. Sovereign venture funds 2.0

Chart 1

Sovereign Venture Funds' Investments in Telecommunications and Technology (2015)

Percentage of total investments



Source: Latest available Annual Reports

the portfolios of these funds. Many SWFs have significant stakes in their local telco operators, such as Etisalat for the Emirates. Historically, Temasek has been the major backer of Singtel, Singapore's operator, and Khazanah has been the biggest supporter of Malaysia's operator, Axiata. Both have supported their international development.

On top of this, these telco groups have also created their own venture capital funds, which in turn invest in other startups. For example, SingTel has set up a US$160 million venture capital fund, which has invested in more than 25 startups worldwide, with offices in Singapore, Shanghai and San Francisco. Temasek has also created a specialist venture capital subsidiary, Vertex, which invests directly - in more than 35 startups to date - and also in other venture capital funds. In 2014, it launched a special US$100 million fund for investing in startups throughout Asia.

And we now have to add the general frenzy for investing in all types of startups to this. Abu Dhabi's ADIC announced in 2015 that it had invested in the Swedish music streaming startup Spotify, which had carried out an investment round raising over US$400 million, catapulting its valuation to US$8.4 billion. In 2014, this fund invested in the US startup Coupons, which was listed in March that year. Mubadala, another sovereign wealth fund from the Emirates, has stakes in the American cyber-security startup Damballa (5.4%), the US semi-conductor multinational AMD (19.4%) and the US digital services startup Prodea Systems (5%). It also recently set up a joint venture with IBM Cognit Technology Solutions to sell the US multinational's Watson computing system in Africa and the Middle East.

Before the Saudi Public Investment Fund got involved, the Qatar Investment Authority invested in the Californian startup Uber. It was also involved in a US$1.2 billion funding round with the venture capital fund New Enterprise Associates at the end of 2014. Uber's capital reads like a "who's who" of Californian venture capital funds (Kleiner Perkins Caufield & Byers, Google Ventures and Menlo Ventures), the largest investors in debt (Goldman Sachs, Citigroup and Stanley) and some of the giants of global asset management (Fidelity Investments, Wellington Management and BlackRock Inc). The Qatar Investment Authority also invested in Blackberry in November 2013 (US$200 million); Flipkart, in December 2014 (as part of a US$700 million round); and the French internet company Vente-privée, in December 2014 (unknown amount).

As we can see, more and more SWFs are getting involved with such companies, and they are investing in more and more countries. Recent new entrants includes the South Korean sovereign wealth fund KIC (which started investing in Tesla Motors in September 2013) and US sovereign wealth funds (Alaska invested in a US biotechnology startup in 2013). The world of innovation and technology is becoming less and less focused on the United States.

This enables us to glimpse three emerging trends for the future. The first is that this increase in investment is going to continue: we will see more and more SWFs becoming active in venture capital and startup ecosystems, fostering direct investment, investment in venture capital funds and even startups accelerators. The second is a direct consequence of the first: the world of startups will no longer be restricted to the United States. The advent of unicorns in Europe and, in particular, Asia has become a constant. As Chart 2 shows, unicorns are appearing beyond Palo Alto, Boston and New York: they are being created in London, Stockholm, Helsinki, Berlin and Paris, and even Madrid and Barcelona. And unicorns are also emerging in India, China and Russia, and it won't be long before we see some in Brazil, South Korea and Indonesia.

Chart 2
Unicorns: beyond Silicon Valley (2016)

Number of Unicorns: Tech startups valued at $1 billion or more

Source: Fortune, 2016.

The third trend is that this will present an opportunity for countries that know how to position themselves in this 3.0 world. Perhaps this is where Europe will find a place for itself, based on increased interest from SWFs in the continent's startups. This is already happening, as we have seen, with investments by Temasek in British startups, Khazanah in Scotland's Skyscanner, Abu Dhabi in Sweden's Spotify and Qatar in France's Vente-privée.

Europe now has more than a dozen unicorns, as can be seen from Chart 3. The UK is the best placed, with eight unicorns. Other leading players include Germany (5), Sweden (2) and France (1). Spain has created two unicorns (Jazztel and Odigeo), and has attracted interest from sovereign wealth funds: a subsidiary of the Kuwait Investment Authority invested in the Madrid startup Tyba in 2014.

We will also see changes in the investment strategies of sovereign venture funds. In the past, the strategy of the funds has often been to invest in collaboration with venture capital funds that they themselves fund. However, SWFs are now forming alliances with other SWFs to invest in venture capital. The Abu Dhabi Investment Authority, Alberta Investment Management (Canada) and the New Zealand Superannuation Fund created the Innovation Alliance in 2013 to provide growth capital to the startups presented, both through venture capital funds in which they have stakes and through other companies in which they previously had no stake.

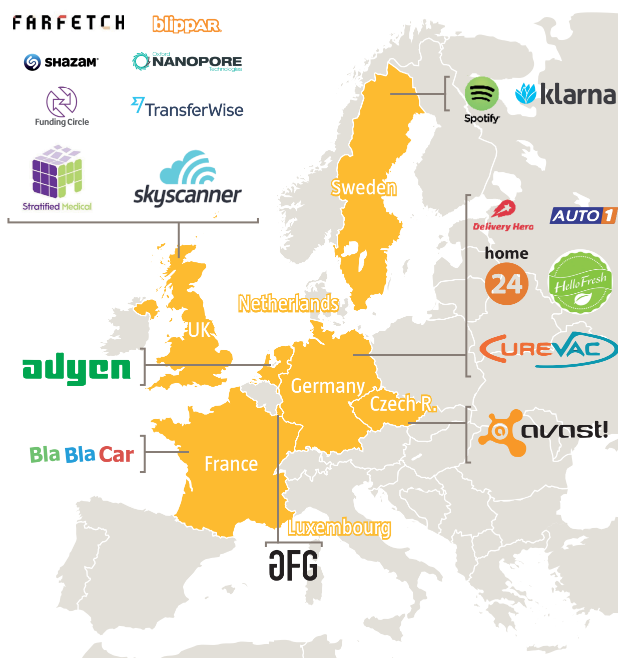
It would also be no surprise to see sovereign funds in the future entering earlier funding rounds than the traditional series D, E and F in which they have usually got involved to date (i.e. the rounds proceeding an exit: a stock market flotation or acquisition by a larger competitor). Temasek is a good example of this entry in early investment rounds: in 2014 it invested relatively "small" amounts of US$17.2 million in JD.com, the second largest Chinese e-commerce site, and US$12.8 million in the Chinese cyber-security company Cheetah Mobile. These deals show an increasing appetite for earlier investment by major SWFs, which are now competing with large venture capital funds in the search for returns from startups.

Conclusion

The bets placed by public funds on startups are not limited to emerging markets. We have underlined how US government agencies are investing in new technologies. Many countries in Europe have funds of funds for investing in venture capital.

7. Sovereign venture funds 2.0

Chart 3
The boom of technology and startups in Europe



Source: CB Insights, Wall Street Journal and Fortune, 2016

For example, Spain has launched the FOND-ICO fund, backed by ICO and Axis. This €1.2 billion initiative is being supported, in part, by venture capital funds for new technologies and biotech. Ireland's Strategic Investment Fund is seeking investments in the fintech sector, particularly in peer-to-peer financing platforms, occupying the brokerage role usually played by banks. Meanwhile, New Zealand's sovereign fund, with funds of US$19.3 billion, has begun investing in the tech world, with a US$60 million investment in the renewable-energy startup LanzaTech (which has also attracted investment from Californian fund Khosla Ventures, the venture capital investment arm of Siemens and the Malaysian Life Sciences Capital Fund). In addition, Canadian sovereign wealth funds set up the US$300 million Northleaf Venture Catalyst Fund in 2014.

We are also seeing government collaborations for investment in startups and venture capital funds. The Irish and Chinese governments have created a US$100 million joint venture capital fund for investment in Irish and Chinese startups. Switzerland has entered into a similar arrangement with China, creating the Sino-Swiss Venture Capital Fund, headquartered in Beijing, backed by the China Development Bank and the Swiss State Secretariat for Economic Affairs (SECO). Canada's public pension fund, the Caisse de Dépot et Placement du Québec – with US$248 billion of assets under management - has set up a fund to invest in Israeli startups[5].

Emerging countries are leading the way in these initiatives, significantly increasing funds of funds to further bolster the venture capital ecosystem. In 2015, the government of Taiwan, through its National Development Fund, launched a new US$50 million fund, in conjunction with eight private corporations, to invest in Asia (AppWorks Fund II) and big data, mobile apps and the internet of things startups[6].

The Chinese government was undoubtedly responsible for the most spectacular initiative: in 2015, it announced the creation of a US$6.5 billion public venture capital fund. There are currently 83 venture capital funds in China today, with a capacity of US$6.7 billion, more than the whole of Europe. And while China is launching a mega-fund of venture capital funds, in Europe we are still twiddling our thumbs. Perhaps we need to learn something about ambition and vision from the emerging economies. The closest we have come in Europe to these two initiatives is the European Investment Fund, which is linked to the European Central Bank. However, it is difficult to imagine a €6.5 billion European fund of funds to foster a single digital market for high growth companies, positioning Europe at the forefront of the 3.0 world. Perhaps we need to return to the spirit of the continent's first venture capitalists and entrepreneurs, when an adventurer and the Queen of Castile joined forces to realize what had until then been only a dream: discovering a new route, that led to a new world. Perhaps we need to (re-) learn from their audacity, which was not so long ago.

[5] The investment manager is Claridge and will be headed from Tel Aviv by Oded Tal, Claridge's Chief Investment Officer from 2000 to 2008. The manager for Caisse is Andreas Beroutsos, the vice-president responsible for private equity investments. See http://www.asiaasset.com/news/La_CaisseDS1302.aspx

[6] The fund is managed by Jamie Lin, the founder of the local incubator and investor in AppWorks Ventures.

Annex 1.
IE - Sovereign Wealth Lab Ranking 2016

Annex 1. IE - Sovereign Wealth Lab Ranking 2016

Table 1

IE - Sovereign Wealth Lab Ranking 2016*

Ranking	Sovereign Wealth Fund	Assets under Management ($bn)	Country	Established
1	Government Pension Fund Global	860.87	Norway	1990
2	China Investment Corporation	813.76	China	2007
3	Abu Dhabi Investment Authority	773.00	UAE	1976
4	SAMA - Foreign Holdings	668.37	Saudi Arabia	1952
5	State Administration of Foreign Exchange	599.51	China	1997
6	Kuwait Investment Authority	592.00	Kuwait	1953
7	Hong Kong Monetary Authority	401.63	Hong Kong (China)	1993
8	GIC	344.00	Singapore	1981
9	National Social Security Fund	294.85	China	2000
10	Qatar Investment Authority	256.00	Qatar	2005
11	Investment Corporation of Dubai ^	196.00	UAE	2006
12	Temasek Holdings	170.36	Singapore	1974
13	Abu Dhabi Investment Council	110.00	UAE	1999
14	Future Fund	95.60	Australia	2004
15	Korea Investment Corporation	91.80	South Korea	2005
16	National Wealth Fund	71.26	Russia	2008
17	National Development Fund	64.80	Iran	2011
18	Mubadala Development Company	63.50	UAE	2002
19	Samruk-Kazyna ^	62.80	Kazakhstan	2008
20	National Oil Fund of Republic of Kazakhstan	61.03	Kazakhstan	2000
21	Libyan Investment Authority	60.00	Libya	2006
22	International Petroleum Investment Company	58.04	UAE	2000
23	Alaska Permanent Fund	56.28	USA - Alaska	1976
24	Silk Road Fund	40.00	China	2014
25	Brunei Investment Agency	39.30	Brunei	1983
26	State Oil Fund of Azerbaijan	35.82	Azerbaijan	1999
27	Khazanah Nasional	34.89	Malaysia	1993
28	Texas Permanent School Fund	34.53	USA - Texas	1854
29	Reserve Fund	31.30	Russia	2008
30	New Zealand Superannuation Fund	22.62	New Zealand	2001
31	Revenue Regulation Fund ^	19.25	Algeria	2000
32	Timor-Leste Petroleum Fund	16.20	Timor-Leste	2005
33	New Mexico State Investment Council	15.61	USA - New Mexico	1958
34	Emirates Investment Authority	15.00	UAE	2007
35	Fondo de Estabilidad Económica y Social	14.38	Chile	2007
36	Alberta Heritage Savings Trust Fund	13.88	Canada	1976
37	1Malaysia Development Fund	13.87	Malaysia	2009
38	State General Reserve Fund	13.00	Oman	1980
39	Dubai International Capital	13.00	UAE	2004
40	Bahrain Mumtalakat Holding Company	10.43	Bahrain	2006
41	Russian Direct Investment Fund	10.00	Russia	2011
42	China-Africa Development Fund	10.00	China	2007
43	Fondo de Reserva de Pensiones	9.14	Chile	2006
44	Quebec's Generations Fund ^	8.52	Canada	2006

Ranking	Sovereign Wealth Fund	Assets under Management ($bn)	Country	Established
45	Strategic Investment Fund	8.10	Ireland	2001
46	Fondo de Estabilización Fiscal ^	7.90	Peru	1999
47	Permanent Wyoming Mineral Trust Fund	6.84	USA - Wyoming	1974
48	Oman Investment Fund	5.79	Oman	2006
49	Arab Petroleum Investments Corporation	5.66	Saudi Arabia	1975
50	Pula Fund ^	5.66	Botswana	1994
51	Heritage and Stabilization Fund	5.65	Trinidad and Tobago	2000
52	Sanabil Investments	5.33	Saudi Arabia	2009
53	Cdp Equity ^	5.30	Italy	2011
54	Gulf Investment Corporation	5.09	Kuwait	1982
55	Fundo Soberano de Angola	4.75	Angola	2012
56	Fondo de Estabilización de los Ingresos Petroleros ^	4.46	Mexico	2015
57	North Dakota Legacy Fund	4.03	USA – North Dakota	2011
58	Fundo Soberano do Brasil	4.02	Brazil	2008
59	State Capital Investment Corporation	3.27	Vietnam	2006
60	Alabama Trust Fund	2.54	USA - Alabama	1985
61	Fonds Gabonais d'Investissements Stratégiques	2.40	Gabon	1998
62	Idaho Endowment Fund	1.87	USA - Idaho	1969
63	Fonds Marocain de Développement Touristique ^	1.50	Morocco	2011
64	Fondo de Ahorro de Panamá	1.43	Panama	2011
65	Louisiana Education Quality Trust Fund	1.30	USA - Louisiana	1986
66	Nigerian Sovereign Investment Authority	1.25	Nigeria	2011
67	FONSIS	1.00	Senegal	2012
68	CDC International Capital	1.00	France	2014
69	Palestine Investment Fund	0.80	Palestine	2003
70	National Investment Corporation	0.80	Kazakhstan	2012
71	Revenue Equalization Reserve Fund	0.65	Kiribati	1956
72	Western Australia Future Fund	0.64	Australia	2012
73	Government Investment Unit ^	0.45	Indonesia	2006
74	Future Generations Fund	0.40	Bahrain	2006
75	Fiscal Stability Fund ^	0.30	Mongolia	2011
76	Ghana Heritage Fund ^	0.07	Ghana	2011
77	Ghana Stabilization Fund ^	0.06	Ghana	2011
78	Agaciro Development Fund	0.06	Rwanda	2012
79	National Fund for Hydrocarbon Reserves ^	0.04	Mauritania	2006
80	Permanent Fund for Future Generation	N/A	São Tomé e Príncipe	2004
81	Human Development Fund ^	N/A	Mongolia	2008
82	Fondo para la Estabilización Macroeconímica^	N/A	Venezuela	1998
83	West Virginia Future Fund	N/A	USA - West Virginia	2014
84	Dubai World	N/A	UAE	2006
85	Fonds de Stabilisation des Recettes Budgétaires ^	N/A	Democratic Republic of the Congo	2005
86	Mauritius Sovereign Wealth Fund	N/A	Mauritius	2010
87	RAK Investment Authority	N/A	UAE	2005
88	Colombia Sovereign Wealth Fund	N/A	Colombia	2011
89	Oil Revenue Stabilization Fund	N/A	South Sudan	2008
90	Fund for Future Generations ^	N/A	Equatorial Guinea	2002
91	National Investment Fund ^	N/A	Syria	2012
92	Turkmenistan Stabilization Fund ^	N/A	Turkmenistan	2008
93	Papua New Guinea SWF	N/A	Papua New Guinea	2011
94	Public Investment Fund	N/A	Saudi Arabia	1971
	Total ($bn)	**7,286**		

Source: IE - SWLab (2016) with information obtained from funds' annual reports and websites. In their absence we relied inter alia on the estimates of SovereigNet (The Fletcher School-Tufts University), Sovereign Wealth Center, Ashby Monk (Institutional Investor) and Preqin.

* This list contains the 94 active sovereign wealth funds as at December 2016. The IE - Sovereign Wealth Lab Ranking uses the most updated information available, some figures may differ from data shown in other parts of the Report.

^ Using a stricter definition (see Capapé and Guerrero, 2013), these sovereign wealth funds would be excluded from the ranking. For example funds dedicated exclusively to stabilisation, with 100% domestic portfolios, or those investing just in fixed income.

Note: Sovereign wealth funds in bold are members of the International Forum of Sovereign Wealth Funds (IFSWF).

Annex 1. IE - Sovereign Wealth Lab Ranking 2016

Table 2

Potential new funds

Ranking	Sovereign Wealth Fund	Assets under Management ($bn)	Country	Established
95	Slovenia	N/A	Slovenia	N/A
96	Northwest Territories	N/A	Canada	N/A
97	Japan	N/A	Japan	N/A
98	India	N/A	India	N/A
99	Israel	N/A	Israel	N/A
100	Philippines	N/A	Philippines	N/A
101	South Africa	N/A	South Africa	N/A
102	Lebanon	N/A	Lebanon	N/A
103	Bolivia	N/A	Bolivia	N/A
104	Georgia	N/A	Georgia	N/A
105	Sierra Leone	N/A	Sierra Leone	N/A
106	Tunisia	N/A	Tunisia	N/A
107	Kenya	N/A	Kenya	N/A
108	Uganda	N/A	Uganda	N/A
109	Zambia	N/A	Zambia	N/A
110	Mozambique	N/A	Mozambique	N/A
111	Namibia	N/A	Namibia	N/A
112	Zimbabue	N/A	Zimbabwe	N/A
113	Tanzania	N/A	Tanzania	N/A
114	Liberia	N/A	Liberia	N/A
115	Guatemala	N/A	Guatemala	N/A
116	Taiwan	N/A	Taiwan	N/A
117	Saskatchewan	N/A	Canada	N/A
118	Bahamas	N/A	Bahamas	N/A
119	Amlak	N/A	Egypt	N/A
120	Future Heritage Fund	N/A	Mongolia	N/A
121	Kuwait	N/A	Kuwait	N/A
122	West Midlands	N/A	United Kingdom	N/A

Note: These 28 funds were not active when this edition went to press. Their establishent is currently being discussed in the various States.

Annex 2.
Sovereign wealth funds strategies in Spain, 2011-2015

Annex 2. Sovereign wealth funds strategies in Spain, 2011-2015

This synopsis reviews the investments by sovereign wealth funds (SWFs) in Spain between 2011 and 2015. SWF investment helps explain the performance of the Spanish economy over the last five years, with emergence from a prolonged crisis through to the current recovery in growth. SWFs acted counter-cyclically in Spain when the economy was in its worst shape, and have built on their presence since then, adding an increasing number of sectors to their investment portfolio in Spain.

In the first report in this series, we highlighted that Europe was the leading recipient of investment by sovereign wealth funds in 2011. And within Europe, Spain and its companies were the main destinations, with US$8.34 billion of investment, ahead of France, the UK and Germany. One of the largest deals in the history of SWFs was completed in 2011, with Spain as the recipient. Abu Dhabi's International Petroleum Investment Corporation (IPIC) completed the acquisition of Cepsa, securing control of 100% of the company's shares for €3.65 billion.

The number of deals accelerated between 2010 and 2011. Some were major deals, contributing to the increase in foreign direct investment recorded in 2011. Qatar Holding's investments in Spain are particularly noteworthy and are the largest to date from an Arab country. In less than two years, China, Qatar and Abu Dhabi invested €18.5 billion to acquire stakes in leading Spanish multinationals, in an on-going process that has led to the increasing internationalization of the shareholder structure of the country's largest companies.

Also, since 2012 SWFs have become heavily involved in European soccer (with sponsorship exceeding US$300 million a year), and Spain's two great clubs have been fully involved in this: Madrid signed a strategic agreement with IPIC in 2014 and is sponsored by Emirates airline, which is owned by Dubai's SWF; meanwhile, FC Barcelona started displaying jersey sponsorship featuring the Qatar Foundation in 2011, and now displays the logo of Qatar Airways, which is owned by Qatar's SWF, the Qatar Investment Authority (QIA).

Another factor that has put Spain on the radar for sovereign wealth funds is the presence of its multinationals in Latin America. This explains recent deals involving SWFs and companies such as Santander Brazil, Cepsa, Iberdrola and Repsol.

Deals by SWFs in Spain in 2013 - such as QIA increasing its stake in Iberdrola, Temasek (Singapore) upping its holding in Repsol, and the first major real estate deal, the purchase of Barcelona's Hotel W by Qatari Diar (a QIA subsidiary) - demonstrated that Spain and its companies remain a focal point for leading sovereign wealth funds.

The rise of SWFs presented Spain with both a financial and an industrial opportunity. The industrial holdings of Spanish banks and savings banks and the need for many Spanish multinationals to deleverage, provided an excellent opportunity for funds to take equity stakes in Spain's industrial entities, which needed fresh capital for their development or restructuring.

Direct investment by SWFs in Spain between 2007 and 2014 amounted to over €13 billion, 10% of total investment by foreigners in real assets, demonstrating the counter-cyclical investment capacity of these long-term investors.

The most active investors in 2014 included SWFs such as QIA (through its direct investment arm, Qatar Holding), IPIC and Mubadala (UAE), and Temasek and GIC (Singapore). The 2014 Report, covering the period from January 2013 to June 2014, identified over €2.7 billion of investment flows in the equity of Spanish companies. A key highlight was the renewed confidence by giant Norwegian Government Pension Fund Global (GPFG) in Spain, increasing its holdings of Spanish shares by 15%. There was also an upswing in confidence in Spanish debt, with GPFG multiplying its positions by nearly five-fold to €3.323 billion at the end of 2013, putting Spain in 12th place by volume of investment in its sovereign debt, ahead of Canada, Russia and Australia. This positive trend continued into 2015, with Spanish debt rising to seventh place in the Norwegian fund's fixed income portfolio, with almost €4.7 billion invested in Treasury bills, ahead of France and Italy.

Attracted by the country's economic recovery, in 2014 the funds once again bet on Spanish assets as a destination for their investments in Europe. Spain received €4.6 billion in investment between January 2014 and June 2015. Many of these investments were in the real estate sector, such as the stake acquired by Singapore's GIC in the GMP real estate group, and QIA's investment in Colonial and its French subsidiary SFL. Both deals confirm the return of confidence among investors in the sector. 2014 also saw the return of the Kuwaiti fund (KIA) to Spain, when it bought 40% of E.ON's Spanish assets for €1 billion, acquired a stake in Global Power Generation (the international generating subsidiary of Gas Natural Fenosa), for €485 million, and led the funding round for the Spanish startup Tyba, through its technology arm, Impulse International.

The volume of investments and the sectors that benefited show that Spain continues to offer excellent investment opportunities. The top five investments in Spain also included Mubadala's recent investment in Matsa (estimated at €447 million), and the €417 million investment by China's State Administration of Foreign Exchange in Madrileña Red de Gas.

The funds continued investing in Spain in 2015. In addition to Spanish debt rising to seventh place in the Norwegian fund's portfolio, there were two other noteworthy deals. Singapore's GIC increased its exposure to the real estate sector by investing in the Axiare REIT (Real Estate Investment Trust), demonstrating the benefits of this format for attracting international investors into the sector. There were also two major investments in strategic sectors for the source country of the investment, namely: the acquisition of 38% of Miquel Alimentació Grup by China's CIC, in the food and beverage sector; and the investment by Bahrain's Mumtalakat in the Aleastur aluminum company, of which it controls 49%. The stock market flotations of AENA and Euskaltel attracted investment from ADIA and GIC, respectively. The Oman Investment Fund acquired Barcelona's Hilton hotel for €60 million. Spain's hotel sector has received €300 million in investment from SWFs since 2013.

In this five years, the investment strategies of SWFs have become more sophisticated. The funds have invested in a range of sectors, particularly energy, infrastructure, real estate and, especially, hotels, while not forgetting fixed income and the financial sector. The funds investing in Spain have also diversified, with capital inflows from Kuwait, Oman, Bahrain and China, joining investment from Spain's traditional partners, such as Singapore, the UAE and Qatar.

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