

Chapter 5

The Major Role of Sovereign Investors in the Global Economy: A European Perspective

Diego López

Global Sovereign Wealth Funds Director
PricewaterhouseCoopers

05

THE RISE OF SOVEREIGN INVESTORS

The global economy has witnessed the emergence of a new set of key actors over the last two decades. Sovereign Wealth Funds (SWFs) and Pension Funds (PFs) – or Sovereign Investors – have become pivotal players in global financial markets thanks to their liquidity, and continue to grow rapidly in number and in size. This group of highly heterogeneous funds has different backgrounds, structures, and missions, but shares an ultimate goal: to preserve capital and maximize the return on investments.

While the economic crisis and subsequent cash constraints in developed economies quickly brought these investors to the forefront, the global economic recovery is intensifying the competition for high returns. The Asset Management industry is expecting a number of fundamental shifts; hence the way many asset managers operate in 2020 will be significantly different from the current model (PwC 2014). Similarly, sovereign investors keep adapting their investment strategy and focus, and this will condition the performance of the global markets over the next five years.

A Global Playground

Most of the wealth sitting on the books of these investors has its origins in public budgetary surpluses fueled by commodities exports, foreign exchange reserves, or pension contributions. The location of the fund is therefore not necessarily correlated with the GDP or purchasing power of its country in the global context. Of the G8 economies, only Canada, the US, and Russia have sizeable sovereign investors.

In fact, the majority of these players are located in the so-called emerging markets. 70% of the funds in terms of both number and size are headquartered in the Middle East, North Africa, and Asia-Pacific regions. This is unlikely to change in the near future, as most governments having conversations to set up new investment vehicles are from Africa and Latin America.

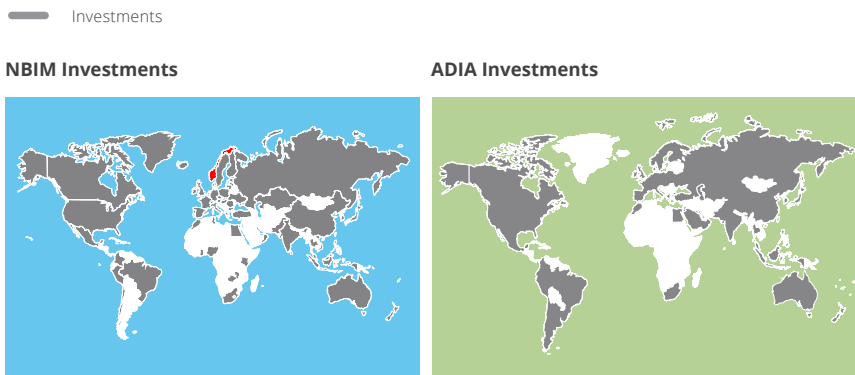
* Diego López is based in Abu Dhabi and works closely with most Middle Eastern SWFs. Diego is a prominent alumnus of the London School of Economics (LSE), where he sits on both the UAE and Global Committees, and a fellow of Tufts University - SovereignNet and Bocconi University - Sovereign Investment Lab.

Europe is not a significant player when it comes to sovereign wealth. Norway's NBIM is considered the world's largest SWF, but it sits outside the European Union. If it weren't for the Dutch pension funds and for the incipient French and Italian vehicles, the EU would not have any significant sovereign investor. In fact, the French and Italian funds only emerged as a solution to attract other foreign players to co-invest with them in the irrelative domestic economies. Other European countries, such as Spain, are showing signs that they will soon follow (COFIDES 2015).

Sovereign investors have generated an unprecedented flow of capital from emerging economies to developed markets and subsequently heated up numerous policy debates in Europe. On the one hand, some of these funds come from non-democratic states and the recipient countries may consider the inward investment an issue of national security if there are objectives beyond the economic and financial goals. On the other hand, it is argued that the presumption of innocence should apply, and that these equity investments are just an issue of economic governance, which, if well managed, can ultimately be beneficial to Western countries (Thatcher 2012).

In any case, political considerations aside, these funds continue to invest in search of long-term returns, leading their investments to expand not only to Western economies but also to emerging markets around the world. The maps below (see Figure 1), showing the current holdings of two of the world's largest SWFs - Norges Bank Investment Management (NBIM) and Abu Dhabi Investment Authority (ADIA) - are proof of their truly global mandate.

Figure 1: ADIA and NBIM: A Truly Global Mandate



Source: Norges Bank

Source: ADIA

Megatrends Matter

Given their typically global mandate and long-term horizon, sovereign investors should build their portfolio based on major future trends, rather than on short-term market movements. Observers have defined the following five megatrends that will shape the global economy in the long run: the shift in global economic power, demographic and social change, rapid urbanization, climate change and resource scarcity, and technological breakthroughs (PwC).

Figure 2: Megatrends



Source: PwC

The shift in economic power to the East is especially meaningful when it comes to sovereign investors. Southeast Asia and the Middle East hold some of the largest funds and are the most active outbound-capital regions. China's assets under management alone almost equal the wealth of all the rest of the sovereign investors combined, when including the almost \$4 trillion of foreign reserves in the books of China's State Administration of Foreign Exchange (SAFE). As economic power shifts to the East, it is crucial for sovereign investors to grant an equal importance to investments in both developed and developing countries.

Demographics will draw a line between Sovereign Wealth Funds, which do not have obvious liabilities, and Pension Funds, whose obligations will become more evident in the next few years. Unless open migration policies are enacted, developed markets like Japan and Canada will face significant pension obligations due to their aged and relatively larger populations, and this will certainly affect the investment policies and risk-aversion of their funds.

Accelerating urbanization and the rising number of megacities in countries such as China and India will drive large infrastructure needs. From hospitals to roads and

airports, the performance of the infrastructure asset class will depend on bodies like the Asian Infrastructure Investment Bank. Others, like the African funds, are dedicating part of their allocation to domestic infrastructure. Sustainability and responsible investments will be on the investors' agendas too.

Climate change and resource scarcity have traditionally inspired a large number of cross-border acquisitions. China has long invested in soil and agribusinesses in Africa and Latin America to offset its unparalleled economic growth and increasing urban population. Food security is also a main concern for Middle Eastern states, who, irrespective of the risk and logistical issues, will continue to invest in land and resources in more fertile lands elsewhere.

Lastly, technological breakthroughs are difficult to ignore. Institutional investors are increasingly focusing on venture capital and incipient Internet companies, which may lack tangible assets and enjoy inflated valuations. Though the dot-com bubble is still on everyone's mind, funds cannot afford to be out of the technological game. Southeast Asian funds, for example, have recently opened new offices overseas in the San Francisco Bay Area, signaling their interest in technology.

Meet the Greeks

Regardless of the differences in their missions and taxonomies, the ultimate goal of most sovereign investors is to preserve their capital and maximize the returns of their investments for future generations. By nature, however, superior returns are not sustainable over time and the funds must be flexible and seek the optimal strategies at each point in time.

One of the most common strategies has been the replication of equity indexes. Investors like to keep a reasonable level of "beta,"¹ or even better, seek "smart beta" that allows them to follow indices while taking into account the volatility of their portfolio. This approach, however, is not as passive as it seems and may present some flaws. In the midst of the financial crisis, it was of little comfort that losses were smaller than the benchmark index's, and most funds started thinking in terms of absolute returns and aiming to achieve consistently positive earnings over time.

¹ Beta, in investment terminology, is understood as a factor revealing the volatility of a portfolio or security when compared to the market in general.

In this context, it appears that what sovereign investors are really after is “alpha,” i.e., earning a return in excess of the benchmark index, while maintaining a similar risk profile. But given their demographic and operational constraints, very few sovereign investors can afford to be truly active investors, and in addition to their in-house investment teams, most try to leverage the unique skills and experience of external asset managers to generate alpha. Today, some of the largest and most successful institutional investors maintain a high proportion of their assets managed externally.

$$\text{portfolio return} = \text{risk free rate} + \text{beta} * \text{equity market premium} + \text{alpha}$$

However, as sovereign investors mature and grow in size, their dependency on index-replicating strategies and external asset managers will likely decrease, thus they will have to be able to generate superior “Greeks” on their own.

Shifts in Asset Allocation

Sovereign investors are generally risk-averse - especially the Pension Funds, whose liabilities will become more evident in the next few years as their pension obligations are realized. The latter have traditionally invested in developed markets and liquid assets, in search for high returns with a tolerable risk level.

However, the current investment landscape, characterized by sluggish economic growth, low interest rates, and frequent quantitative easing, makes it more challenging to achieve superior returns. One possible answer is to increase the allocation to alternative assets - including real estate, infrastructure, and private equities. Investing in these asset classes increases the diversification and balance of the portfolio, and offers potentially higher returns. Needless to say, investors expect very different internal rate of returns (IRRs) from each of these three asset classes; some experts talk about a target IRR between 8% and 12% for real estate and infrastructure and 20% plus for private equities (Clark 2014), but the truth is that returns depend on a variety of factors such as sub-product, sub-industry, geography, and timing.

Nevertheless, building an uncorrelated portfolio is not an easy task. Real estate, infrastructure, and private equities require a deep knowledge of local markets, which can only be attained through external managers or in-house specialists in the different

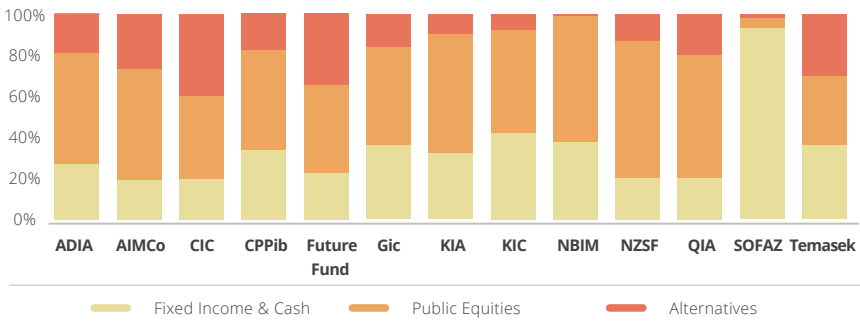
asset classes, industries, and geographies. It also requires an internal strategy team that defines the strategic asset allocation and adapts it over time. In short, building an uncorrelated portfolio requires sovereign investors to grow in size and sophistication.

Recent developments in oil prices have made the shift to alternatives even more challenging. Over 60% of SWFs are oil and gas-related (Sovereign Wealth Fund Institute), and tighter government budgets may translate into a reduction or removal of the annual cash flow into the fund. Though this should not be a problem in the short term given the accumulation of wealth in their balance sheets, it may require a level of dividend yield that is usually harder to find in alternative assets.

Lastly, the size of the fund may be an advantage, but also a weakness. The theory holds that the larger the fund and the allocation, the cheaper it is to enter into the asset class. However, very large funds, also known as Leviathans (Bortolotti et al. 2010), may face difficulties in moving and adapting their strategies. The best example is Norway's massive SWF, NBIM, which has decided to increase its allocation to real estate from 1% to 5% through the acquisition of properties in very specific locations (Norges Bank Investment Management 2013). This 4% increase will require NBIM to deploy a large amount of capital in a relatively short period of time in already overcrowded cities, probably at the expense of high premia.

Below is a representation of some of the sovereign investors' reported current asset allocations (see Chart 1), which change over time due to internal or external factors, such as macroeconomic and geopolitical changes, monetary policies, oil prices, budget balances, and pension contingencies.

Graph 1: Sovereign Investors' Asset Allocation



Source: Funds' websites, news releases, and other public sources

SOVEREIGN INVESTORS AND ALTERNATIVE ASSETS: AN OPPORTUNITY FOR EUROPE

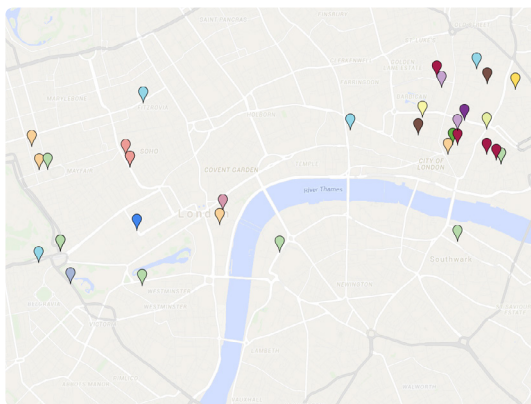
Real Estate

The first dive into alternative asset classes is typically real estate. Sovereign investors are not necessarily experts in brick-and-mortar, but they do have the liquidity to build a diversified portfolio of properties around the world. Most funds have developed specialized teams of in-house experts drawn from the main real estate developers and operators, and tend to leave the operations of the properties to external managers.

Funds have initially focused on high-quality assets in prime locations in London, New York, or Paris. Over the last few years, most of the large real estate deals in these cities have involved a sovereign investor. Though their low cost of capital gives them an advantage in price auctions, the supply cannot meet the rising demand and competition is increasingly fierce, so acquiring a high-quality asset in a prime location most often results in paying a high premium.

Real estate is a local business and investors apply a very granular method. They not only look at specific cities but at specific areas within those cities. Price and availability of properties can vary significantly in a matter of meters. The best example is London, where funds continue to compete for the few prime properties left in the city center.

Figure 3: The Big London Takeover



- Qatar Investment Authority
- Abu Dhabi Investment Authority
- GIC
- State Administration of Foreign Exchange
- Kuwait Investment Authority
- Libyan Investment Authority
- Government Pension Fund Global
- China Investment Corp.
- Abu Dhabi Investment Council
- Brunei Investment Agency
- China Investment Agency
- Future Fund
- Hong Kong Monetary Authority
- Korea Investment Corp.
- Oman Investment Fund
- State General Reserve Fund of the Sultanate of Oman
- State Oil Fund of the Republic of Azerbaijan

Source: Sovereign Wealth Center

As prices rise, funds are beginning to look at different options in search of higher returns. One alternative is industrial and retail properties and another is hospitality assets - sovereign investors invested over \$5 billion in luxury hotels and resorts in 2013. Another possibility is to invest in development projects or in secondary cities with an acceptable level of risk. In all these, relationships with managers and developers are increasingly important in securing access to off-the-market opportunities and keeping a reasonable risk-return balance.

What's in it for Europe?

Since the mid-70s, sovereign investors have poured over \$65 billion into the European property markets, half of which was invested in the last three years (Sovereign Wealth Center). Aside from the UK, which was allocated almost \$40 billion, these funds have acquired numerous properties and real estate portfolios in France, Italy, Germany, Switzerland, and Spain, amongst others.

The largest investors are the usual suspects in the Sovereign Wealth Fund space: ADIA, Qatar Investment Authority (QIA), and Kuwait Investment Authority (KIA) from the Middle East; Government of Singapore Investment Corporation (GIC) from Singapore; NBIM from Norway; and China Investment Corporation (CIC) and SAFE from China. Some of these funds still generate anxiety among European politicians and businessmen alike, but they are making efforts to improve corporate governance and transparency (e.g., Santiago Principles²) that should minimize these fears over time.

Sovereign investors will likely continue to focus on developed locations, but given the overcrowded status of London and Paris, they have started to eye European secondary cities such as Manchester, Barcelona, or Milan, in an effort to gain the “first-mover” advantage.

From the inbound perspective, this may represent a great opportunity for some of the European financial institutions holding large portfolios of non-core real estate assets and/or those in need of liquidity. Depending on the investor's risk profile, it may also scope out additional options such as distressed commercial properties, industrial and logistic portfolios, hospitality assets or developments in peripheral European cities.

² The Santiago Principles is a voluntary set of principles and practices that members of the International Working Group of SWFs support and either have implemented or aspire to implement in order to “identify a framework of Generally Accepted Principles and Practices (GAPP) that properly reflect appropriate governance and accountability arrangements as well as the conduct of investment practices by SWFs on a prudent and sound basis.”

Infrastructure

Real estate may not provide enough diversification and dividends in times of uncertainty. Sovereign investors must diversify further, and the timing is ideal for infrastructure assets. Governments of the developed world face an increasing pressure to reduce debt levels, which has pushed them to privatize some of their prime assets. Growth and urbanization trends are generating large infrastructure needs, and recipient countries have no choice but to welcome foreign direct investments.

Sovereign investors present a natural fit with this asset class, given their long-term view and passive management, and their potential need for a stable cash flow. Infrastructure is in fact the most popular alternative asset class, with 60% of SWFs investing in it (Preqin 2015b). Just as in real estate, the funds entered this asset class by targeting prime assets; and they now own some of the most iconic airports, hospitals, and water managers in the developed world (Santiso 2014). In addition, leverage is cheap and abundant again and some of these investors have managed to achieve impressive returns with certain assets.

Being a direct investor in infrastructure requires expertise and bulky investment that few funds are keen to face alone. This has generated an unprecedented level of collaboration - and competition - between all major types of Sovereign players: Middle Eastern and Singaporean SWFs, Chinese State-Owned Enterprises, Japanese Trading Houses, Canadian PFs, American and British University Funds, and Australian Superannuation schemes. Today, any bid for a prime asset in the developed world is likely to involve five or six bidding consortia formed by these investors and led by infrastructure specialists such as Macquarie, Brookfield, UBS, or Goldman Sachs.

The increasing rivalry for the few remaining top-end projects has driven valuations up significantly, and sovereign investors have had to adapt their strategy. Infrastructure investment teams can no longer afford to be picky, and are expanding their targets into greenfield assets and developing markets around the world.

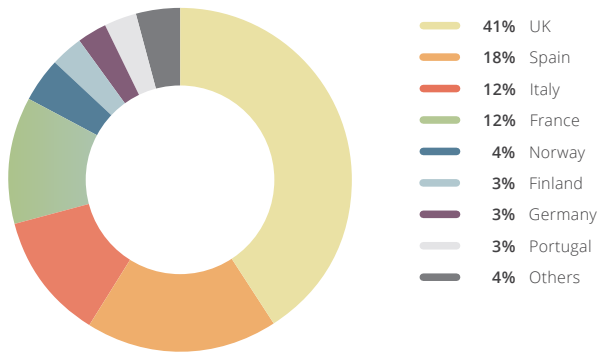
What's in it for Europe?

Infrastructure assets have long been considered of strategic interest for a country. Foreign investors were banned from acquiring European airports, ports, and highways until very recently. In fact, the first foreign acquisition of an infrastructure asset in Europe took place as recently as 2006 - with DP World's takeover bid for the British

shipping and logistics company P&O - creating considerable controversy on both sides of the Atlantic Ocean.

The financial crisis changed it all. Governments from the UK first, followed by continental Europe, started to raise money from the partial sale of their national champions. In fact, it has not been uncommon since then for European heads of state to lead roadshows to the Middle East, Singapore, and China. Non-European Sovereign entities now own (but do not operate) some of the main European structural assets, including airports (Heathrow, Gatwick, Budapest, Rome, and Aena), power and utilities conglomerates (Iberdrola, GDF Suez, EdP, Enel, Gassled, Kelda, Madrilena Red de Gas, and E.On), nuclear energy companies (Areva and Hanhikivi-1), highway operators (Atlantia), and telecoms (Eutelsat and Telecom Italia).

Graph 2: Recipients of Infrastructure FDI in Europe



Source: Sovereign Wealth Center

Sovereign investors are setting up direct infrastructure investment vehicles (sometimes with a different name, like Canadian pension fund Ontario Municipal Employees Retirement System or OMERS' Borealis and Kuwaiti KIA's Wren House) with strong teams of in-house experts that scan global opportunities on a daily basis. As they turn their attention to greenfield projects, there will be great opportunity for European governments, not only to raise money from the privatization of established companies, but also from developing infrastructure projects where the financial muscle of sovereign investors and the operational expertise of their partners can add an even greater value. This asset class may also transition into a subset of real estate, where a combination of properties and infrastructure can present great long-term value propositions.

Private Equities

For an even deeper reach into different industries and higher targeted returns, sovereign investors are transitioning into private equities. A large number of investment specialists have moved in from leading private equity houses, allowing SWFs to evolve from fund investing to co-investments and direct investments in virtually every industry.

Private equity funds (PEs) are quite successful on their own, with \$3.8 trillion of assets under management and over \$530 billion raised in 2014 by circa 1,100 funds (Preqin 2015a). In fact, the buyout industry continues to be dominated by corporations and private equity houses: from 2009 to 2013, only 15% of the buyout deals over \$1 billion involved an institutional investor, either as Limited Partner (LP)³ or as a direct investor (Bain & Company 2015). Only a handful of sovereign investors have the capabilities and appetite required to compete directly with the top-tier private equity funds for buyouts on a standalone basis.

Sovereign investors are the largest group of LPs, co-investors, and sometimes even competitors of PEs for the same targets. Alignment, in terms of horizon and risk-return profile, remains the key issue between both groups of investors, although the liquidity of SWFs has made them attractive co-investors for which PEs are willing to adapt their offer. In November of 2014, the private equity firm CVC announced the launch of a new \$4 billion fund dedicated to SWFs, with a lifespan of 15 years and a targeted IRR of 12%-14% (Chassany and Sender 2014). Earlier that month, Blackstone and Carlyle had announced they would consider takeover deals outside their existing funds if it meant a better alignment with their LPs.

Just as in real estate and infrastructure, strategic allocation is still biased towards developed markets, but as high-quality assets become more pricey and scarce, new options are also being considered. Private equity activity continues to be centered in the US (both buyout and venture capital) and in Europe (mostly buyout). The industries with the highest activity are financial services, healthcare, commodities, and consumer goods - as compared to venture capital deals, where over 70% of the businesses acquired are related to telecoms and Internet activities.

³ Limited partners are usually institutional or high net worth investors interested in receiving the income and capital gains associated with investing in the private equity fund and that do not usually take part in the fund's active management.

In fact, it seems that venture capital is enjoying a rejuvenated relationship with institutional investors. Thanks to their long-term horizons and significant financial capacity, SWFs are great candidates to invest in technological start-ups. In 2013, Alberta Investment Management Corporation (AIMCo), New Zealand Superannuation Fund, and ADIA created the *Innovation Alliance* to collaborate with Venture Capital (VC) firm Kleiner Perkins. Since then they have injected capital into two growth capital opportunities on both coasts of the US. Abu Dhabi Investment Council (ADIC) is also developing its VC footprint, and has invested in the open-source document database MogoDB, in the mobile messaging service Whatsapp and in the music player Spotify in the past few months.

This trend has translated into a larger physical presence of sovereign investors in the Bay Area. At the end of 2013, Malaysian SWF Khazanah Nasional Berhad chose San Francisco as the location of its first office outside Asia. Last year it was Singaporean Temasek Holdings' venture holdings subsidiary Vertex who, following the footsteps of GIC, hired an executive from Facebook to launch a subsidiary in Silicon Valley.

The New Co-investment Model

The strategy of sovereign investors is shifting rapidly from fund investments to a new direct investment and co-investment model. For new fund commitments, a large number of LPs now request co-investment rights, which are usually granted. And while some SWFs consider co-investments separately, others include them as part of their broader private equity fund allocation (Preqin 2012).

The LP has several reasons to co-invest. First, it gains influence over the transaction and gives direct exposure to its investment executives, while reducing management fees and carry⁴ by half. Second, it leverages the access and knowledge of the General Partner (GP) of the country, industry, and of the mid-market in general. And lastly, the liquidity provided early on in the transaction mitigates the J-curve effect⁵ associated with private equity deals and may help to outperform the returns of traditional fund investing.

⁴ Carry is the performance compensation that the limited partners of a private equity fund receive if they exceed a specific threshold return.

⁵ The J-curve effect occurs when funds experience negative returns for the first several years due to capital drawdowns and an investment portfolio that has yet to mature. A J-curve is formed after the fund recovers from its initial losses and shows profits above the initial level.

The GP, however, faces competing views about this new trend. It can use the capital to target larger deals or stakes and “punch above its weight” - thus benefiting from offering high quality co-investment opportunities to LPs. But it is also tempted to keep these highest quality deals in traditional fund structures, in order to maximize management and transaction fees.

The co-investment model is in its early stage, and most players are still seeking to tap and maximize its potential. In November of 2014, the Korea Investment Corporation (KIC) hosted the first Co-investment Roundtable of Sovereign and Pension Funds (CROSAPF) in Seoul, with thirty of the top tier global investors - twelve of which entered into a non-binding memorandum of understanding to facilitate deals and co-investment opportunities going forward. A session solely focused on private equity opportunities was chaired by Providence Equity Partners, whose investors include KIA and GIC.

The relationship matrix between sovereign investors and private equities is growing in size and complexity. A sample of these interactions is included in the table below.

Table 1: Sovereign Investors and Private Equity Funds Matrix

PE	SWF/PF	ADIC	AIMCo	bclMC	CIC	CPPib	Future Fund	GIC	KIA	QIA	Temasek
3i Group	LP, Co	LP		LP	LP			H, LP, Co	LP	LP	Co
Advent International	LP, Co	LP	LP	LP		Co	Co	LP, Co	LP		
Apax Partners	LP	LP	LP		H, LP	LP	H, LP, Co	H, LP			
Apollo Management	H, LP		LP	LP	Co	LP			LP	LP	
Bain Capital		LP						Co			
BC Partners		LP			LP	LP		Co	LP		LP
Blackstone Group			LP	LP	H, LP, Co		LP, Co	LP, Co	LP		Co
Carlyle Group	LP	LP	LP	LP	Co	LP	LP	Co		LP	Co
Cinven			LP	LP		LP			LP		
CVC Capital Partners	LP		LP	LP		Co		H, LP, Co	H, LP		
KKR	LP, Co					LP		LP, Co			Co
Onex Partners				LP		LP					
Permira			LP					Co			
TPG Capital	LP, Co	LP	LP	LP	Co	LP		LP, Co	H, LP		Co
Warburg Pincus	LP, Co							Co			Co

H= Stake in PE firm LP= Limited Partner Co= Co-investor

Source: Sovereign Wealth Center

In the current market conditions, sovereign investors are very valuable partners and private equity funds appreciate the importance of aligning interests with them. The accumulated dry capital, the rejuvenation of the venture capital, and the new co-investment model are signs of the increasing relationship between both groups of investors.

Sovereign investors will continue to boost their allocation to private equity and buy stakes of buyout and venture capital funds, but more as an active long-term stakeholder and partner than as a purely passive investor. Most partnerships will include co-investment rights, and as a result of a continuous and more open collaboration, investment “clubs” will arise.

What's in it for Europe?

Private equities are generally associated with Small and Medium Enterprises (SMEs), i.e., the backbone of the European economy. 99 out of every 100 non-financial businesses in Europe are SMEs, as are two of every three employees, and 58 cents in every euro of value added (European Commission 2014). These companies continue to face difficult economic conditions: their value added in 2013 was just 1% above 2008 levels and employment in 2013 was still 2.6% below levels registered in 2008. For a full recovery based on economic growth, Europe needs its SMEs to grow and reach full speed.

However, it is not only about SMEs. Larger companies on a stand-alone basis can also be classified as private equity investments. In fact, the single largest holding of a sovereign investor in a foreign country is not a property or an infrastructure asset, but a Spanish private company called CEPSA, which was fair valued at almost \$11 billion when it was fully taken over by Abu Dhabi's IPIC in 2011 (Institute of Management Technology).

In addition to the efforts of the European Central Bank and the European Commission, and of several national SME funding programs, sovereign investors and private equity funds will continue to provide the market with liquidity. Given the restrictions of bank lending and the problematic access to finance for smaller businesses, this may represent an optimal short-term solution for such a meaningful and crucial piece of the economy.

In terms of industries, the acquisitions of sovereign investors in European healthcare are still relatively small. However, judging from the megatrends and demographic prospects of the continent, this could be one of the main industries of focus in the next few years, in addition to the always-preferred industrial products and consumer-related European companies.

The Human Side

Sovereign investors typically have a global mandate and need to be close to their target markets. The shift in the investment strategy into alternative asset classes and into direct investments poses some challenges in the short and the long term. One possibility is to hire bespoke foreign professionals, as one of the funds' main strengths. The better the fund's investment team, the more likely it will achieve superior returns. Still, several demographic characteristics drive sovereign investors' human capital needs and policies:

- **National talent:** Some of the largest sovereign investors face demographic challenges. Norway is a country with a population of 5 million that hosts a \$890 billion fund. There are just 1.4 million Emiratis, 1.2 million Kuwaitis, and 0.3 million Qataris in the world, who own almost \$2 trillion in combined assets. GIC and Temasek, which together manage over half a trillion in assets, are owned by only 3.3 million Singaporeans. Despite having ambitious programs in place to nurture local talent, most funds look for the best talent around the world. Today, between 30% and 75% of their workforce are non-nationals, who do not usually hold executive positions, however.
- **Reverse brain drain:** The contrary is true for the Chinese funds. It is difficult to ascertain how many foreigners work for China's CIC, SAFE, National Social Security Fund (NSSF), or Hong Kong Monetary Authority (HKMA), but they probably represent less than 5% of the total workforce - and the same could probably be said of the Russian funds. Given the enormous population and the increasing number of Chinese and Russian nationals studying in Ivy League colleges and working for top-notch investment banks, these funds don't need to recruit foreigners, but rather need to lure their own people back to their country.
- **Challenging attractiveness:** The typical locations of their headquarters make it more challenging for sovereign investors to attract talent. Oslo, Beijing, and Kuwait are not necessarily first choices for top graduates or investment professionals. This issue has been covered by Bachher and Monk, who believe that sovereign investors are almost exclusively successful at hiring the "green" (early career individuals looking for a fast track career), the "gray" (experienced professionals escaping fast-paced cities) and the "grounded" (people with ties to the region) (Bachher and Monk 2012).

Faced with these challenges, several sovereign investors are choosing to open additional offices in the main international financial centers (IFCs), which can be a win-win situation: it allows a closer interaction with external asset managers and is a temporary solution to attract international talent.

Kuwait's KIA is known not only for being the first Sovereign Wealth Fund to be set up in 1953 - before the emirate had gained independence from Great Britain, but also for having opened the first ever overseas office of a sovereign investor: the Kuwait Investment Office (KIO) in London, in 1965. KIO is now the largest sovereign investor's overseas office with well over 100 professionals; it receives 10% of the country's budgetary surplus and manages some of its alternative investments including real estate and infrastructure assets.

KIA is not alone. In spite of not hosting any of their headquarters, London and New York combined have over 1,000 professionals working for 28 sovereign investors' overseas offices. NBIM is an excellent example, with 44% of the manpower working in five offices outside Oslo (Norges Bank Investment Management), as are Temasek and GIC, with 12 and 10 international offices respectively. The Singaporean funds are pioneers in their approach to new markets, and have tentacles in all major IFCs as well as in emerging countries of their focus within Asia and Latin America. GIC and Temasek combined have 30 professionals based in Sao Paulo, who speak the language and understand the local market - and manage a portfolio of over 20 and 10 investments in Brazilian private companies, respectively.

Abu Dhabi's Mubadala has also put its feet on Brazilian soil, after investing \$2 billion in Brazilian EBX group and acquiring stakes in its companies Porto Sudeste and IMX. However, this "asset management" office in Rio de Janeiro will probably be different than the Singaporean funds' branches in Sao Paulo, which primarily focus on new business development. Earlier this year, Oman's State General Reserve Fund (SGRF) announced the opening of its first office abroad in Tanzania - a country the Sultanate has blood relations with - "in order to capitalize on the growing opportunities in Sub-Saharan countries" (State General Reserve Fund Ministry of Finance). It is now the first and only non-African sovereign investor to have a physical presence in the African continent.

Another interesting case study is CIC. Many will remember the fierce opposition that made Chinese State-Owned Enterprise CNOOC withdraw its \$18.5 billion takeover bid for California-based Unocal in 2005, and the general trade tensions between China and the US. Not surprisingly, when CIC decided to open an international office at the beginning of 2011, it initially chose Toronto to "ramp up its Canadian holdings" particularly in the resource sector (Hoffman and Perkins 2011). Two years later, CNOOC acquired Calgary-based Nexen for \$15.1 billion in the single largest foreign takeover by a Chinese company. Due to the investment losses faced in Canada and to the substantial US rebound, the Chinese fund has considered moving its North American headquarters to New York, next to SAFE and HKMA, but is still reported to be based in Toronto.

All in all, and depending on the definition, it is estimated that sovereign investors employ around 20,000 staff. Eight percent of them work in one of the 72 overseas offices shown in the table below. We expect this number to increase further over the next few years as these institutional investors mature and focus on new and unfamiliar markets.

Table 2: Sovereign Investors' Offices Overseas

SI	HQ	Operational branches and Representative offices overseas																						
		Amman	Beijing	Brussels	Chennai	Dar es Salaam	Hanoi	HCMC	HK	Istanbul	London	Lux	Mexico DF	Mumbai	New York	Paris	Rio de Janeiro	San Fran	Sao Paulo	Seoul	Shanghai	Singapore	Toronto	Tokyo
AIMCo	Edmonton									✓														
APG	Amsterdam		✓					✓						✓										
Aust Super	Melbourne	✓																						
BIA	Brunei								✓						✓									
Caisse	Montreal	✓												✓	✓							✓		
CIC	Beijing																						✓	
CPPib	Toronto							✓	✓				✓				✓							
GIC	Singapore	✓							✓		✓	✓	✓			✓	✓	✓	✓				✓	
HKMA	Hong Kong												✓											
Khazanah	Kuala Lumpur	✓						✓	✓			✓				✓								
KIA	Kuwait	✓							✓															
KIC	Seoul								✓				✓											
LIA	Tripoli								✓															
Mubadala	Abu Dhabi															✓								
NBIM	Oslo								✓	✓			✓								✓	✓		
NPS	Seoul								✓				✓									✓		
OMERS	Toronto								✓				✓											
PIF	Ramallah	✓																						
QIA	Doha	✓							✓			✓												
SAFE	Beijing								✓				✓									✓		
SGRF	Muscat				✓																			
SOFAZ	Baku								✓															
Teachers'	Toronto							✓	✓			✓												
Temasek	Singapore	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓

Source: Funds' websites, news releases, and other public sources

High rent for office spaces is not usually an obstacle for sovereign investors. However, some funds are starting to consider buying out these offices. Last January, Norway's NBIM acquired Queensberry House, the offices they had been renting for years in Mayfair (London) for almost \$300 million. Others, like QIA, lend the space they own to their sister organizations: Al Jazeera has recently moved its London offices from Harrods to The Shard, both owned by QIA (Norman 2013), while Qatar Airways' ticket office remains in Harrods.

Sovereign investors will keep acquiring properties that create a long-term value proposition and it would not be surprising if some of them are used to establish new presences overseas. Similarly, the OECD has exerted a renewed pressure on tax matters lately, through the Base Erosion and Profit Shifting (BEPS) - which may accelerate the establishment of fully operational offices overseas.

What's in it for Europe?

It is undeniable that the financial crisis has been a game changer for Europe's human capital. While policymakers have focused on saving the banking system and the common currency, thousands of skilled professionals – especially young graduates - have left the continent since 2008. If we look at the financial sector, many of those resigning (or fired) from European investment banks have flown into emerging markets and joined SWFs. This brain drain may be a blessing in disguise for Europe if, as in the case of China and Russia, it is reversed, luring these executives back to their home countries after having gained an invaluable experience investing in the global markets.

At the same time, the new focus of sovereign investors on direct investments, alternative assets, and new geographies can represent an opportunity for European economies. Four institutional investors have opened offices in Brazil in the last few years to focus on Latin American investments, and SGRF opened an office in Tanzania to look at deals in Sub-Saharan countries. It is a shame that the presence of sovereign investors' offices in continental Europe is still insignificant, as this could drive a significant number of investments if promoted properly. Javier Santiso of ESADE has long suggested that an office in Spain could be used by funds as the base for their Latin American and European portfolio (Santiso 2013).

Other countries are one step ahead. Based on the Russian Direct Investment Fund (RDIF) model, France and Italy have set up collaborative investment platforms to attract foreign investment to their countries. The Caisse des Dépôts' objective is "to make a major

contribution to attracting foreign capital to multiple asset classes in order to provide long-term finance for the French economy and improve its competitiveness.” Similarly, Italian FSI has scored some important goals by signing co-investment agreements with top funds like QIA, KIA, CIC, KIC, and RDIF, and by joining the International Forum of Sovereign Wealth Funds (IFSWF), which will host its seventh annual meeting in Milan this September.

To sum up, there are a number of measures that European countries can adopt to ensure the increase of activity and investments of sovereign investors in their countries. Hosting some of their international offices or signing collaborative investment agreements may be a good start.

CONCLUSION AND CHALLENGES AHEAD

Since the start of the decline of oil prices in June of 2014, analysts and journalists alike have been asking the same question: what is going to happen to Sovereign Wealth and Investment Funds? There is no doubt that for some of the crude-rich states, low oil prices will translate into a lack of budgetary surplus to be transferred to their investment vehicles, but this is unlikely to be a game changer in the short term. Most sovereign investors have accumulated large stocks of capital on their balance sheets that still need to be deployed, and they will keep investing in opportunities in all asset classes.

There are, however, a number of other challenges that may condition the strategy of these investors going forward:

- **Achieving superior returns in an environment of low interest rates and a “new normal”:** asset allocation is moving towards alternatives, and most funds are now trying to invest directly and seek alpha on their own - delivering a great deal of implications and challenges.
- **Lack of familiarity with new investment grounds:** competition for prime assets is fierce and funds have no choice but to start looking at new options, such as greenfield assets and emerging markets. These are new grounds for them that may require revisiting the risk-return profile.
- **Corporate governance, transparency, and commitment to open markets:** sovereign investors have come a long way with steps like the Santiago Principles and

they should make sure to continue down this path, especially when markets pick up again and the need for selling assets becomes less pressing in developed economies.

- **Talent attraction and retention:** human capital is crucial for investment businesses and sovereign investors are transitioning into a model with fewer external asset managers and more in-house experts. Offices overseas at IFCs or generous packages may be their only competitive advantage when financial markets pick up again.

Sovereign investors are still relatively new players in the global markets. When Michael Douglas characterized Gordon Gekko in the 1987 film *Wall Street*, only 15 funds were in place and their holdings were rather domestic or relatively small. Today, the average age of these investors is not yet 20 years old. The industry will keep facing challenges, and evolving with them.

For Europe, it is important to understand the role of these new players in the global economy. Policymakers have placed a lot of attention on their investment strategy or focus, i.e. where and especially why they are going to invest next. But fundamentally, Sovereign Wealth Funds are a highly heterogeneous group of institutional investors, and no two funds are the same. While corporate governance and transparency are treated as the main issues, a step back must be taken to fully appreciate the funds' missions, visions, and values.

If something has become clear it is that sovereign investors are here to stay, and European countries should make them feel welcome, more than they have in the past. At the end of the day, both Sovereign Wealth Funds and Pension Funds can represent a great opportunity for the global economy in general, and for the European recipient countries in particular, in these times of uncertainty.

BIBLIOGRAPHY

- Bachher, Jagdeep Singh, and Ashby H. B. Monk. *Attracting Talent to the Frontiers of Finance*. The Sovereign Wealth Fund Initiative. The Fletcher School at Tufts University, 2012. <http://fletcher.tufts.edu/~/media/Fletcher/Microsites/swfi/pdfs/2012/ Monk%20SWF%20Human%20Resources.pdf>
- Bain & Company. "Global Private Equity Report 2015." *Insights*. March 10, 2015. <http://www.bain.com/publications/business-insights/global-private-equity-report.aspx>
- Bortolotti, Bernardo, Veljko Fotak, William L. Megginson, and William F. Miracky. *Quiet Leviathans: Sovereign Wealth Fund Investment, Passivity, and the Value of the Firm*. BAFFI Center on International Markets, Money and Regulation at Università Bocconi, 2010. http://www.baffi.unibocconi.it/wps/ allegatiCTP/SWF-paper-RFS-Final-oct25_2010.pdf
- Caisse des Dépôts. "Caisse des Dépôts is to Develop its Subsidiary CDC International by Dedicating it to Investment Partnerships with Sovereign Wealth Funds." News release. September 30, 2013. http://www.caissedesdepots.fr/fileadmin/ Communiqu%C3%A9s%20de%20presse/cp/ cp_cdc_international_eng.pdf
- China Investment Corporation. *Annual Report 2014*. Beijing. <http://www.china-inv.cn/china-invTheme/themes/html/ztnb/2014EN/index.html>
- Chassany, Anne-Sylvaine, and Henry Sender. "CVC Finds Creative Ways to Attract the Biggest Investors." *Financial Times*, November 14, 2014, Financial Services. <http://www.ft.com/cms/s/0/c9e24148-6a6a-11e4-bfb4-00144feabd0.html#axzz3QLgQRtK5>
- Clark, Simon. "Blackstone, Carlyle Consider Takeover Deals Outside Their Existing Funds." *The Wall Street Journal*, October 6, 2014. <http://www.wsj.com/articles/blackstone-carlyle-may-consider-takeover-deals-outside-their-existing-funds-1412592776>
- COFIDES. "COFIDES and the State General Reserve Fund of the Sultanate of Oman Signed an Agreement to Establish a Fund for the Internationalisation of Spanish Companies." News release. April 29, 2015. https://www.cofides.es/en/noticias_detalle.php?id=593
- European Commission. *A Partial and Fragile Recovery: Annual Report on European SMEs 2013/2014*. 2014. http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/performance-review/files/supporting-documents/2014/annual-report-smes-2014_en.pdf
- Hoffman, Andy, and Tara Perkins. "China's Sovereign Wealth Fund Sets Up Shop in Toronto." *The Globe and Mail*, January 12, 2011. <http://www.theglobeandmail.com/report-on-business/chinas-sovereign-wealth-fund-sets-up-shop-in-toronto/article562162/>
- International Forum of Sovereign Wealth Funds. "Seventh Annual Meeting of the IFSWF to be Held on 29-30 September 2015 in Milan." News release. February 3, 2015. <http://www.ifswf.org/pr/pr24.pdf>
- International Working Group of Sovereign Wealth Funds. *Sovereign Wealth Funds: Generally Accepted Principles and Practices*. Santiago Principles. 2008. <http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf>
- Kansabanik, Soumitra. *Cia Española de Petroleos SAU Acquisition by International Petroleum Investment Co*. Institute of Management Technology (IMT-Nagpur). <http://www.slideshare.net/soumitra88/cepsa-acquisition-by-ipic>
- Norges Bank Investment Management. *2014 Government Pension Fund Global Annual Report*. <http://www.nbim.no/contentassets/0ff9cd1d5c8e4737a7b7262d3ec167d4/norges-bank-investment-management-annual-report-2014.pdf>

- Norges Bank Investment Management. "Real Estate Management." Last modified June 17, 2013. <http://www.nbim.no/en/investments/real-estate-management/>
- Norman, Paul. "Qatar and Sellar Buy New London Bridge Quarter Site." *CoStar UK*. April 18, 2013. <http://www.costar.co.uk/en/assets/news/2013/April/Qatar-and-Sellar-buy-new-London-Bridge-Quarter-site/>
- Preqin. 2015 *Preqin Global Private Equity & Venture Capital Report*. 2015. <https://www.preqin.com/docs/reports/2015-Preqin-Global-Private-Equity-&Venture-Capital-Report-Sample-Pages.pdf>
- Preqin. *Preqin Special Report: LP Appetite for Private Equity Co-Investments*. 2012. https://www.preqin.com/docs/reports/Preqin_Private_Equity_Co-Investor_Report.pdf
- Preqin. *The 2015 Preqin Sovereign Wealth Fund Review*. 2015. <https://www.preqin.com/docs/samples/The-2015-Preqin-Sovereign-Wealth-Fund-Review-Sample-Pages.pdf>
- PwC. *Asset Management 2020: A Brave New World*. 2014. <http://www.pwc.com/gx/en/asset-management/publications/pdfs/pwc-asset-management-2020-a-brave-new-world-final.pdf>
- PwC. "Five Global Megatrends Continue to Advance." *Global Annual Review 2014*. <http://www.pwc.com/gx/en/issues/megatrends/index.jhtml>
- Santiso, Javier, ed. *Sovereign Wealth Funds 2013*. ESADE, KPMG, and Invest in Spain, 2013. http://itemsweb.esade.edu/wi/Prensa/ESADEgeo_SWF_Report_2013.pdf
- Santiso, Javier, ed. *Sovereign Wealth Funds 2014*. ESADE, KPMG, and Invest in Spain, 2014. http://itemsweb.esade.edu/wi/Prensa/SWF2014_ENG.pdf
- Sovereign Wealth Center. "SWF Investment in UK Real Estate." Google Maps. https://www.google.com/maps/d/u/0/viewer?authuser=0&hl=en&mid=zuY6a_6cRoWE.kr1r38sHxnA4
- Sovereign Wealth Fund Institute (SWFI). "Largest Sovereign Wealth Funds by Assets Under Management." *Sovereign Wealth Fund Rankings*. <http://www.swfinstitute.org/fund-rankings/>
- State Administration of Foreign Exchange (SAFE). "Forex Reserves." Data and Statistics. <http://www.safe.gov.cn/wps/portal/english/Data/Forex>
- State General Reserve Fund Ministry of Finance. "SGRF Opens an Office in Tanzania and Appoints Mohamed Al Tooqi as the Country Manager." News release. <http://www.sgrf.gov.om/news9.html>
- Thatcher, Mark. *Western Policies Towards Sovereign Wealth Fund Equity Investments: A Comparison of the UK, the EU and the US*. Policy Brief, Kuwait Programme on Development, Governance and Globalisation in the Gulf States. The London School of Economics and Political Science, 2012. <http://www.lse.ac.uk/middleEastCentre/kuwait/documents/thatcher-policy-brief.pdf>

