Sovereign interest

by Tyson Freeman

Sovereign wealth fund CEOs, such as Mike Burns of the Alaska Permanent Fund, are exploring infrastructure investments

Sovereign wealth funds have earned outsized attention in recent years for their large, often aggressive, private equity deals. They have certainly had solid growth but are still a relatively small portion of the institutional universe, and as they increasingly focus on infrastructure, they are drawing similar attention.

The story of what's driving the growth of certain SWFs has an element of the haves and the have-nots. The United States and Europe, for example, have accumulated massive fiscal deficits in the past decade; countries on the

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other side of the trade have built surpluses. Whether it is from commodity exports — such as oil in the Middle East and Norway, or copper in Chile — or high domestic savings rates in countries such as China, SWFs are flush. And like much of the institutional investment world, they are increasingly targeting infrastructure assets.

"SWF [assets under management] have grown, and they need to invest that capital," says Ashby Monk, executive director, Global Projects Center, Stanford University. "So there is significant cash on the sidelines targeting infrastructure, including capital earmarked for direct investments. Competition for deals is expected to be intense, especially for large income-producing brownfield assets."

Industry watchers say it is difficult to draw neat trends in SWF infrastructure investment, but its activity is still closely followed. Interviewees mentioned pockets of activity rather than broad, distinctive trends. "All of these entities are very different," says Monk. "Most them believe holding real assets is a valuable thing, but how they go about it reflects that variety."

A lot of people also are anticipating investments by the largest SWF in the world — the Government Pension Fund of Norway — as it moves closer to jumping into the infrastructure asset class. The fund has nearly $1 trillion under management between its domestic and global funds. "The Norwegians are talking about ramping up infrastructure investing but have not done it yet," Monk explains. "They are figuring out how they want to do it."

Institutional Investor's Sovereign Wealth Center puts SWF assets under management at $6 trillion, and most of these are active infrastructure investors.

"Sovereign wealth funds, however you define them, have been quite active [in the infrastructure market]," says Georg Inderst, founder of London-based Inderst Advisory. "A number of them have been especially active recently, and we expect more activity in the future."

According to Inderst, 60 percent of the SWF universe by some measures has invested in infrastructure and half of them invest directly and through funds.

SOVEREIGN WEALTH UNIVERSE EXPANDING

Many countries have sovereign investment funds, but East Asian and the Middle Eastern funds make up more than 70 percent of all assets. Their investment goals and strategies vary, but their influence is real. Of this $6 trillion of AUM, the Gulf Cooperation Council SWFs account for approximately 30 percent of global SWF assets.

"There is no doubt that as liquidity tightened in the West, thanks largely to the lingering impact of the financial crisis and, more recently, the euro zone sovereign debt crisis, sovereign wealth funds, particularly Middle Eastern SWFs' influence on the global economy has grown," says Michael Underhill, chief investment officer, Capital Innovations. "Now, more than ever, these SWFs are viewed by the West as an important source of capital."

Despite their growth trend, there are several cautionary points when assessing sovereign wealth funds. Inderst says that, aside from some SWFs and larger public pension funds in Canada, Australia, Norway and the Netherlands, it is very difficult to obtain

Top 10 sovereign wealth funds by assets under management

Rank	Country	Sovereign wealth fund	Assets ($b)	Inception	Origin
1.	Norway	Government Pension Fund – Global	$893	1990	Oil
2.	UAE – Abu Dhabi	Abu Dhabi Investment Authority	$773	1976	Oil
3.	Saudi Arabia	SAMA Foreign Holdings	$757	n/a	Oil
4.	China	China Investment Corp.	$653	2007	Non-commodity
5.	China	SAFE Investment Co.	$568	1997	Non-commodity
6.	Kuwait	Kuwait Investment Authority	$548	1953	Oil
7.	China – Hong Kong	Hong Kong Monetary Authority Investment Portfolio	$400	1993	Non-commodity
8.	Singapore	Government of Singapore Investment Corp.	$320	1981	Non-commodity
9.	Qatar	Qatar Investment Authority	$256	2005	Oil and gas
10.	China	National Social Security Fund	$202	2000	Non-commodity

Source: Sovereign Wealth Fund Institute

data and useful details about many of their investments and strategies. Transparency could be improved in many cases. He also asserts that few SWFs are created alike. Differences of size, maturity and mandate between SWFs can be pronounced, and one must be cautious in drawing too many generalizations.

That being said, it is clear that SWFs, like much of the institutional world, have a clear interest in infrastructure investing. SWFs have built real assets portfolios in recent years on the back of prime commercial real estate and infrastructure markets in developed economies. As those markets have become more competitive, they have shifted focus to more infrastructure and more infrastructure in less developed countries.

EYES ON THE MIDDLE EAST

SWFs in the Middle East are drawing a lot of attention. With more than 10 funds and close to $2 trillion of assets under management, the six GCC countries represent the world's highest concentration of SWFs. With state budgets heavily reliant on commodity prices, these funds have benefited greatly from years of record high oil prices and are driven by the need to achieve long-term diversification from their energy sector.

Brian Chase, an energy and infrastructure specialist at Campbell Lutyens & Co., recently met with several of the larger SWFs in the Middle East and says the teams there did not believe the swoon in oil prices would have a significant effect on their investment pace. "They have experienced these price cycles many times," Chase says. "Most believe that oil prices will remain in the $50 range for the next three years, but few expect that will have a huge impact on their investment plans for private equity and infrastructure."

Much of the activity from Middle Eastern SWFs in recent years has focused on brownfield assets in developed countries, especially in Europe. For example, late in 2014 Kuwait Investment Authority, through its infrastructure unit Wren House Infrastructure Management, teamed up with Macquarie Group on the $3.1 billion purchase of the German power utility E.ON SE's Spanish assets.

But after years of pouring capital into European real estate and infrastructure, as well as in their equities and bonds, many funds are shifting focus. The Qatar Investment Authority, for example, has a large number of assets in Europe and is now looking to diversify its portfolio with more investments in Asia.

In November 2014, QIA's chief executive Ahmed Al-Sayed said that the fund expects to invest between $15 billion and $20 billion in Asia during the next five years. He specifically noted that China's property, infrastructure and healthcare sectors are of interest to the QIA for future investments.

Chase believes some of the Middle East investors are also warming up to North American energy investments. "They are becoming more interested in North America energy infrastructure — coal retirement deals, power transmission and power generation, both renewable and conventional," he says. "Though they also think, with oil prices so low, that it's also a good time to invest in domestic oil storage in the Gulf."

Low oil prices have also stoked interest in distressed energy plays such as Marc Lasry's distressed energy hedge fund, Avenue Capital Group, Chase says.

Despite the capital Middle Eastern SWFs bring to the deal markets, experts caution they also come with unique business risks and challenges. "The SWFs there tend to be less transparent than some of their European and Australian counterparts," Chase says. "There is relatively less publicly disclosed information, whether it is about their commitment levels, deal structures or future plans. And while they tend to have well-developed and highly experienced teams, they are still government-owned and can be cautious and conservative in their decision making."

Chase notes that quite a few SWFs are looking to invest in middle-market energy infrastructure funds in the United States for their proprietary deal flow and strong returns. "It's an interesting dynamic. The smaller funds often have better performance, and are in demand by Middle East sovereigns, but the Middle East can be kind of a black hole for mid-market funds," Chase says. "New relationships are hard to establish in any investor geography, but can seem even more challenging in that environment where such funds are not as well known as they are among U.S. investors."

SWFS DO DIRECT

One distinctive feature of SWFs is that, for those that invest in infrastructure, about half, according to Inderst, have made direct investments.

"These are often very large funds," Inderst says, "So they have the capacity, and necessity in some cases, to go direct." SWFs also have something of a competitive edge in making direct deals work. They often have few, if any, of the short-term liabilities that other institutional investors have, and they also do not have many of the post–financial crisis accounting rules and regulations that require greater transparency and reporting by traditional public pension funds.

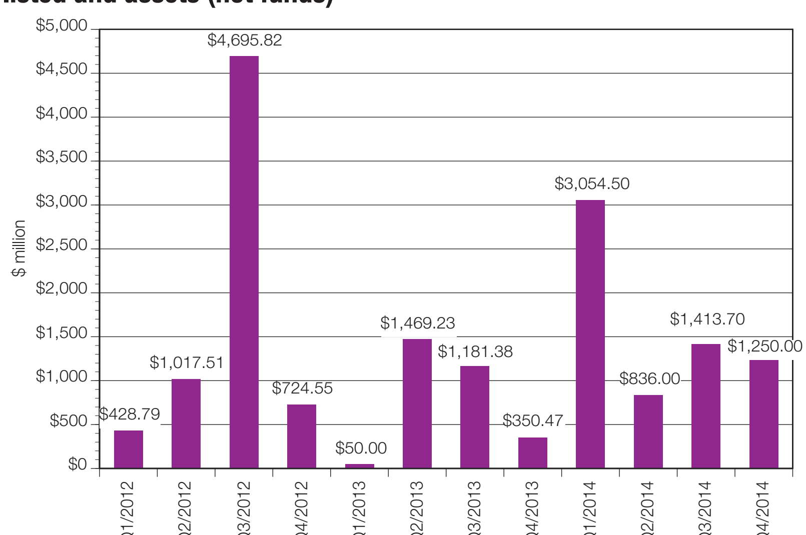
The market is keeping an eye on SWF direct investments in infrastructure in much the same way they observed them strike some of the largest private equity deals in recent years. How SWFs are tackling direct investment is of particular interest to the rest of the market. There are signs that at least some SWFs are teaming up with each other to invest in their respective regions.

Korea's sovereign fund, the Korea Investment Corp., recently signed an agreement with QIA to create a $2 billion investment fund — with equal contributions of $1 billion — to jointly invest in Qatar and Southeast Asia. KIC signed a similar, $500 million "joint investment platform" deal with the Russian SWF, Russian Direct Investment Fund, in 2014.

The RDIF seems to favor this approach. It has made similar platform deals with several countries, including China and India. In India, it agreed to team up with the Indian SWF, IDFC, to invest $1 billion — $500 million committed by each partner — in Indian infrastructure and hydroelectric projects.

Kuwait launched Wren House Infrastructure Management to invest in direct

Direct transactions in the infrastructure sector by SWFs — listed and assets (not funds)



As of Jan. 21, 2015
Source: Sovereign Wealth Fund Institute

infrastructure deals. Soon after, they teamed up with the Canadian pension fund OMERS and the Universities Superannuation Scheme in an unsuccessful $8.2 billion bid for the London-based water utility Severn Trent.

While there are certainly examples of SWFs teaming up with each other, Inderst notes, given their size and objectives, he expects them to make more investments alongside operators, developers, contractors, industrial companies or maybe even a large pension fund. "SWFs typically try to profit from their partners' complementary expertise when they co-invest," Inderst says.

Mike Burns, CEO of the Alaska Permanent Fund Corp., agrees. "We do not plan to co-invest with other SWF-type investors," he says. "Any co-investment will be alongside our existing infrastructure managers or new managers that come on board. Our staff looks for the managers with the best track records and capabilities, and if, in the course of their activities, they come across transactions that require equity investment beyond what they want to take down in their fund, we will evaluate them."

SHIFTING FROM BROWNFIELD

Although SWFs typically target brownfield assets, the current strong competition for large, stabilized infrastructure assets has spurred SWF interest into emerging markets or greenfield assets.

"Many large brownfield assets are considered overvalued," Monk says. "Everyone knows the assets inside and out. The auctions are contentious and some of the valuations have ridiculous forward earnings multiples for infrastructure assets. They leave little room for equity growth. So more SWFs are looking to greenfield project finance deals and emerging markets."

Monk points out that the recent Queensland Motorway sale is telling. "At least some long-term investors are selling brownfield. It is a seller's market when you have QIC, a governmental agency and long-term investor, selling a $7 billion asset."

Monk believes India has a challenging economic environment right now, but he expects it to provide opportunity going forward. And some SWFs are looking to provide project financing alongside operators as a first move in emerging markets such as Africa.

According to a recent KPMG report on SWF investing, the United Arab Emirates, home to one of the largest SWFs in the world, has played a significant role in establishing relations with African countries and has made $19 billion of commitments across 17 infrastructure projects.

FINAL THOUGHTS

SWFs are increasingly becoming a part of the global infrastructure investment market, and while they have traditionally been active in brownfield markets, they appear to be striking out in some different directions than the rest of the institutional infrastructure pack. As their moves into emerging markets and greenfield investing mature, the rest of the market will no doubt benefit. ❖

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