

New Barbarians at the Gates

Impact of SWF on M&A in AsiaPac

Not since the advent of PE has a class of investors attracted so much controversy across the Globe. SWF have existed for the last quarter of century. However, their recent rise to prominence following their investments into troubled US financial groups has prompted much debate about their role in the broader global economy. In this article we look at some of the major SWFs in AsiaPac and consider what impact SWFs may have on the Mergers and Acquisition (“M&A”) environment in Asia Pacific (“AsiaPac”).

Summary

The impact of SWFs on AsiaPac M&A market will increase as surpluses continue to accumulate and are put to work seeking higher returns. The conservative mindsets of many AsiaPac governments are rapidly giving way to a race to build ever-larger funds. The additional liquidity these funds provide will undoubtedly support deal activity, and the fund management industry. SWFs from outside the region will also provide further sources of capital looking for growth opportunities. The privileged position of SWFs may displace some private sources of capital, and over time SWFs will develop their own PE teams and dis-intermediate PE funds for some deals.

Despite the storm of controversy and recipient governments’ resistance, SWFs are going to be significant global and regional M&A players. Deal makers cannot afford to ignore the emergence of these enormous new pools of capital and potential competitors, and are already finding ways to work together with SWFs, both as sources of funds, as co-investors, and to provide access to new deal opportunities. In the process, the competitive dynamics of the PE industry in the region is being reshaped. This approach is not without risk, especially with recently established SWFs, whose government owners have also not yet determined what role they want their SWFs to play. Moreover, some of the regional SWFs will be viewed as being more politically motivated/sensitive than others, and PE funds hoping to build strategic relationships will need to consider how to manage the political fall out that could arise should some of these relationships go sour.

Finally, SWFs are susceptible to political interference from the governments who own them, and will encounter political opposition both globally and also intra-regionally. In particular Japan and China, holders of the largest foreign exchange reserves in the world, could be perceived to extend their strategic influence in the region through the activity of their SWFs.

Who and what are SWFs?

What exactly constitutes a SWF is the subject of some debate. SWFs generally exist to invest excess reserves of national governments. Globally, oil-producing nations and major export nations have generated the largest excess reserves (“excess” meaning the reserves in excess of what is required for monetary stability). SWFs generally take 3 forms.

- i. Funds set aside specifically for investments from government reserves. Key SWFs in the region include Government of Singapore Investment Corporation (“GIC”) with approximately US\$150 billion of assets under management (“AUM”), China Investment Corporation (“CIC”) with approximately

US\$200 billion, and Korea Investment Corporation (“KIC”) of South Korea with US\$20 billion. Japan is also reported to be considering establishing SWFs.

- ii. State holding companies that are set up to hold investments in state-owned enterprises and use the accumulated disposal gain and dividend income as PE funds. Regional examples being Temasek of Singapore, Khazanah of Malaysia, and Vietnam’s State Capital Investment Corporation, or a government organ like SASAC in China.
- iii. State-owned enterprises (“SOEs”), both listed and unlisted, where government holds controlling stake, and are perceived as extension of their government. This is the grey area. Most SOEs, especially those listed on stock exchanges and include foreign funds as their shareholders, will argue that they operate independently and act commercially for interests of its shareholders. The efficacy of this argument varies from country to country, and SOE to SOE. However, judging by past events, recipient countries and governments do not always differentiate SOEs from their governments.

In this article, we use the term SWF’s to refer to funds established to manage excess reserves, but also discuss the activity of state holding companies, recognising certain commonalities between the two.

SWF’s from the AsiaPac region wield increasing power due to rising foreign currency reserves and the rapid establishment of SWFs to mobilise those reserves for higher returns. Asian foreign exchange reserves were around US\$3 trillion at the end of 2006, of which slightly more than one-third was held by China, slightly less than one-third by Japan, and the remaining third by other Asian countries. To put this in perspective, the AUM of the Asian central banks exceeds the AUM of the global hedge fund and PE industries combined, although only a small portion of these assets are placed in SWFs. Much of the remainder is invested into US Treasuries and bonds, whose weakening exchange rate and low return create increasing opportunity cost in terms of investment income foregone. A key driver behind the formation of SWFs is to raise returns on these reserves above rates offered by the US Treasuries.

Are Asian SWFs less politically sensitive than petrodollar SWFs?

Apart from the AsiaPac governments themselves, the other major SWFs that will have an impact on the region are the petrodollar SWFs, mainly from the Middle East. The combined AUM of the Middle East SWFs is slightly higher than that of the AsiaPac governments, but the Middle East domestic and regional economies are much smaller. As the oil price has risen, consumers in non-oil producing nations have essentially been paying a “consumption tax” that has flowed back to the oil-producing nations, who in return have sought overseas outlets for their new found wealth. McKinsey estimate that if oil remains at US\$50 per barrel, then the petrodollar SWFs will have an additional US\$1 billion available for investment every day. As well as being a source of funds for the AsiaPac region, the rise of the petrodollar SWFs also signify a potential threat as further increases in the oil price could reduce the surpluses enjoyed by AsiaPac nations who are heavily dependent on energy imports.

The activity of SWFs and government holding companies have attracted much comment in recent months due to high-profile transactions that they have been involved in. The discomfort over the lack of transparency surrounding SWFs drives much of the growing hostility to SWFs in the US and Europe, where calls to regulate the activity of SWFs have been made. The International Monetary Fund has asked SWFs in Singapore, Norway and Abu Dhabi to draw up disclosure benchmarks for SWFs, amid calls by the US Treasury for SWFs to follow yet-to-be defined guidelines governing transparency and investment behaviour. The European Union is drawing up their own guidelines for SWFs.

SWFs from petrodollar countries wield real economic power over western economies as they control the supply of oil and also the investment of the resulting surpluses. Post September 11, there is also greater concern in the US over assets that may have national security implications. For example, Dubai World's GBP3.9 billion acquisition of Peninsular & Oriental Steam Navigation Company ("P&O") met with stiff US objections. As a concession, Dubai World was forced to segregate the operations of the 6 US ports managed by P&O and is in the process of divesting them.

Asian sovereign-linked investors may not have the added "menace" of control of oil supply, but have nonetheless attracted political controversy in larger transactions, as Temasek has found with its acquisition of Shin Corp in Thailand from the then Prime Minister, Thaksin Shinawatra and two telecoms companies in Indonesia from

the government of Indonesia. Further back in time, China National Offshore Oil Company Ltd ("CNOOC"), an SOE, had to withdraw its acquisition offer for US's Unocal Oil Company amidst "unprecedented political opposition".

In general, there is scepticism whether the governments behind SWFs are really only interested in commercial investments, rather than in increasing the cross border reach of their own political power.

AsiaPac SWFs have very different backgrounds and mandates

Most regional SWFs are in their infancy, and hence there are no strong historical precedents to refer to when trying to predict their future behaviour. Motives for establishing SWFs also vary greatly and these different mandates make performance comparisons difficult. On the one hand, you have GIC, the longest established SWF in AsiaPac, formed in an era of oil-shock driven high inflation and in a small country with no geo-political ambitions. It has focused on seeking returns above the rate of inflation in secure developed economies. On the other hand, CIC and the SWF under consideration for Japan, have quite different or as yet undefined mandates (see below) which could include mainly domestic investments. Moreover, initial actions by a new SWF may be a poor indicator of future trends, as the SWFs may have room for considerable flexibility in their mandates whilst their role is being refined.

Countries with the largest SWFs and state holding companies

SWF Greater than US\$100 billion				
Country	Fund Name	Assets (US\$'billion)	Established	Origin
UAE	Abu Dhabi Investment Authority	875	1976	Oil
Singapore	Government of Singapore Investment Corporation	330	1981	Non-commodity
Norway	Government Pension Fund	315	1990	Oil
Saudi Arabia	Various	300	Various	Oil
Kuwait	Kuwait Investment Authority	250	1953	Oil
China	China Investment Corporation	200	2007	Non-commodity
China	Central Huijin Investment Corp	100	2003	Non-commodity
Singapore	Temasek Holdings	100	1974	Non-commodity
Australia	Australian Government Future Fund	51	2004	Non-commodity
US (Alaska)	Alaska Permanent Fund	40	1976	Oil
Qatar	Qatar Investment Authority	40	2000	Oil
Russia	Stabilisation Fund of the Russian Federation	32	2003	Oil
Brunei	Brunei Investment Agency	30	1983	Oil
South Korea	Korea Investment Corporation	20	2005	Non-commodity
Malaysia	Khazanah Nasional	18	1993	Non-commodity
Kazakhstan	Kazakhstan National Fund	18	2000	Oil
Canada	Alberta Heritage Fund	17	1976	Oil
Taiwan	National Stabilisation Fund	15	2000	Non-commodity
Iran	Oil Stabilisation Fund	13	1999	Oil
Total		2764		

Source: *the Economist*, Morgan Stanley

Selected Announced/Reported Transactions of Asian SWFs, 2007-8		
GIC		
TPG Fund	US\$2.5 billion	PE
Westin Tokyo	US\$719 million	Hotel property
Citigroup	US\$6.9 billion	Financial services
UBS	US\$10 billion	Financial services
WestQuay	US\$299 million	Retail property, UK
CIC		
Blackstone	US\$3 billion	PE
China Railway Group	US\$100 million	Transportation
Morgan Stanley	US\$5 billion	Financial Services
Central Huijin	US\$67 billion	Financial Services
Korea Investment Corporation		
Merrill Lynch	US\$2 billion	Financial Services

Source: Media reports

GIC – AsiaPac’s most mature SWF

The most mature SWF in the region is GIC of Singapore. Established in 1981, it publicly discloses AUM of at least US\$100 billion, and claims an annual real rate of return since establishment of 5.3%. Analysts believe the actual AUM to be much higher. It has developed from being a public markets investor to expand its range of asset classes and now has a significant real estate and PE portfolio. GIC has become the only mandatory Asian stop on any fixed income roadshow, and its influence was further demonstrated by its recent investment of US\$6.9 billion into Citigroup, and its intended investment of CHF11 billion in UBS.

These latter investments have aroused some negative comment in recipient nations, to the extent that Dr Tony Tan, GIC’s Deputy Chairman and Executive Director, made public comments in defense of SWFs, whilst acknowledging demands for greater transparency. It is thought that GIC has less to fear from greater transparency as its objectives are primarily financial, not political. GIC, in its role as an agent for the owner of the investments, the government of Singapore, does not publish an annual report, and does not disclose the size of assets it has under management, except to the nearest round US\$100 billion.

CIC – a new heavyweight with an evolving strategy

China was reported to have considered GIC as a model in the establishment of its own SWF, CIC. However, CIC faces different pressures and is under the spotlight, not only in potential recipient nations, but also at home where its coming-out investment in the Blackstone IPO attracted criticism by not making immediate returns – with CIC at one point being US\$1 billion down on its US\$3 billion investment. As it is funded by Rmb-denominated debt which is appreciating in value, implies its expected return rates must be under further pressure.

Two-thirds of its initial capitalisation of US\$200 billion had actually already taken place and was re-allocated to CIC from its predecessors – US\$67 billion to acquire Central Huijin (the state-owned vehicle for stakes in policy banks), and a further US\$70 billion for other recapitalisations of policy banks. The remainder is to be invested abroad, with around US\$30 billion currently being allocated to foreign investment managers. However, following its highly-publicised initial foray into Blackstone, and in view of other Chinese frustrations in purchasing foreign assets such as Unocal, CIC has announced it will avoid strategic industries in foreign countries. However, the opportunity to acquire nearly 10% interest in Morgan Stanley for US\$5 billion was irresistible (described as a ‘big fat rabbit’ by CIC’s chairman), particularly as political barriers were lower at a time when the bank needed capital.

CIC’s mandate seems less focused and may be perceived as more susceptible to political interference when compared to that of GIC. It combines domestic policy bank balance sheet rebuilding, support of domestic companies in their overseas fund-raising (CIC was a pre-IPO investor in the China Railway Hong Kong IPO) and overseas investments. Not all of these activity will necessarily achieve the overall objective of obtaining higher returns on excess reserves.

Japan – fear of being left behind

As holder of the second largest foreign exchange reserves in the world, Japan could establish a fund that could rival CIC in size, and Japanese ministers have disclosed that Japan is considering establishing such a fund. However, reports suggest that the purpose of the fund will be to support the domestic stock market. Given Japan’s rapidly deteriorating demographics, future pension and medical costs need to be covered by a reducing workforce. A natural role for the SWF would be to invest current excess reserves to earn revenues to finance some of those future liabilities. That supporting the domestic stock market has even been suggested as an objective lent weight to criticism that Japan’s SWF could be at the mercy of politicians. Paradoxically, in democratic Japan the political influence over the mandate of the SWF could be even greater.

The timing of Japan’s moves is significant. Japan fears that the formation of CIC could lead to further marginalisation of Japanese interests if China uses CIC as a vehicle to increase its economic and political power in the region and globally. Some commentators in Japan view the takeover battle for Rio Tinto to be a sign of things to come, with Japan (whose key steel industry depends on imports of iron ore from producers including BHP Billiton and Rio Tinto) left on the sidelines as Chinalco, one of China’s major state-owned enterprises, intervened with Alcoa of the US to acquire a 12% stake in Rio Tinto for US\$14 billion, in a bold statement of interest in the deal. Japan would be put in the uncomfortable position of relying on its chief strategic competitor for a key raw material in a seller’s market. In recent weeks Japan has also been mentioned as a target for investment from SWFs including CIC and Russian funds, and in response Japan has been one of the voices calling for restraint of SWF’s.

Calls for Japan’s own SWF to be put to use in supporting the domestic stock market reflect a narrow short term view, but in the longer term competition between the SWFs of China and Japan could be the new stage on which their struggle for strategic leadership of the region is played out.

South Korea – a new dawn

South Korea’s Korea Investment Fund has also recently grabbed headlines with its US\$2 billion investment into Merrill Lynch. This bold investment marked a u-turn for the fund which had previously been limited to investing in bonds and developed markets by its Ministry of Finance. Only at the end of 2008 were some restrictions on its investment activity lifted to include emerging markets and other asset classes, and at the same time it was announced that the fund would increase from US\$20 billion to US\$50 billion by 2010, which is a significant statement of intent.

The impact of SWF's on M&A activity in AsiaPac

The formation of new SWFs in the region will greatly increase liquidity available for M&A. Part of their asset allocation will be into funds such as PE and hedge funds, and in so doing sustain an active and competitive fund management industry. In addition, the SWFs will be direct equity investors themselves. We will also see SWFs co-investing with SOEs in overseas acquisitions to share the risks and increase the SOEs' deal appetite.

In addition, SWFs from outside the region are likely to allocate increasing amounts of capital to developing markets in Asia. Petrodollar SWFs are taking their first steps in investing in China – a recent example being the agreement between Saudi Aramco, by some estimates the world's largest company (although Saudi Arabia does not currently have an SWF, Saudi Aramco fulfils a similar role), Sinopec and Exxon for two oil refinery projects in China with total investment of US\$5 billion.

CIC's initial deal with Blackstone may be the first tentative steps in a pattern that could be repeated – that of PE funds trying to partner with AsiaPac SWFs and other state controlled vehicles to get access to funds and assets. In addition to raising capital, Blackstone may have hoped that having CIC as an investor could help it solve the most problematic issue for all PE investors in China – how to get big deals approved. During 2007, China underwent its own populist backlash against foreign investment, and as a result regulatory approval procedures became even more complex. Based on evidence to date, it appears that Blackstone's pursuit of a partnership strategy may be bearing fruit. An investment of 20% in China Bluestar, a leading domestic chemicals company, has been approved in principle in January, and Blackstone and Bluestar's parent made a joint bid for Nufarm, an Australian agrochemicals group.

A similar case of partnering with China Inc., albeit in a different asset class, is that of Barclays, who accepted an investment of US\$3 billion from China Development Bank prior to Barclay's attempted takeover of ABN AMRO. Barclays now hope that relationship will support their bid to manage some of the US\$30 billion of funds being allocated to global fund managers by CIC.

Other PE funds are seeking partnerships with CIC. JC Flowers, the US fund specialising in the financial services industry, is reported to have made an agreement with CIC to manage US\$4 billion of funds to invest in the US. By partnering with a US fund, it may be that CIC is hoping not only to benefit from the deep experience of JC Flowers in the financial services industry, but also reduce political resistance to direct investments. It appears that Blackstone and JC Flowers are seizing 'late mover advantage' to learn from the experience of others and create partnerships for mutual benefit as platforms which generate further investment opportunities.

Other China investments are following a similar partnering strategy, such as Chinalco's acquisition of an interest in Rio Tinto with Alcoa of the US as a co-investor. The ability to forge and manage these kinds of high-level strategic partnerships could be a key success factor for PE funds and strategic investors alike as China's strength increases.

SWFs pose a challenge to PE investors

The growth of SWFs in the region poses a challenge to PE funds who have been struggling to find and close deals in an environment of high valuation expectations and proliferation of newly set up funds seeking investments. More established SWFs and state holding companies like GIC, Khazanah and Temasek are already in the market for the same investments, and investment managers. Over the medium to long term, newer SWFs are likely to build their own PE teams. However, for the purpose of diversification and to tap into a wider pool of expertise, it is unlikely that SWFs will completely dis-intermediate PE funds. Moreover, PE funds also have another purpose for SWFs, as using the PE fund as an intermediary can reduce some of the political pressure when making overseas acquisitions. Not all PE funds will be equally adept at managing these new types of sometimes conflicting, relationships.

Those funds that have not benefited from such a partnership may follow a strategy of using the political process in the US and Europe to try to force China into granting greater access. US Senators have already questioned whether or not US PE funds enjoy similar level market access into China as CIC does in the US. This approach needs to be carefully managed, but the kinds of questions already being raised by prominent US politicians through forums such as the Congressional Joint Economic Committee and the US-China Economic and Security Review Commission suggest that some funds are already using the US political process to put pressure on AsiaPac SWFs.

SWFs are increasingly competing with each other

Completing the circle, the rise of newer SWFs is also impacting the behaviour of the early movers, like GIC. It was reported that when the Citigroup stake came up for sale, many bankers were surprised at the speed which GIC moved to make its investment. This speed is in part attributed to the speed at which other competing SWFs, like CIC and petrodollar SWFs, had shown they could move. Similarly, GIC will be aware that for many deals, an investment from China, with the promise of further deal flow and market access, could sound more seductive than one from Singapore, with its far smaller, mature domestic market. Increasing competition between SWFs is also likely to be a trend of the future, and GIC's efforts towards greater transparency are partially to differentiate itself and strengthen its competitive position versus both new Asian and petrodollar SWFs.

Japan and China are likely to be competitors for influence through the activity of their SWFs. The assertion so often made by governments that SWFs are driven by purely commercial considerations could be severely tested in the hothouse of North-East Asian politics.