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Asian SWFs in Europe: much ado about nothing?

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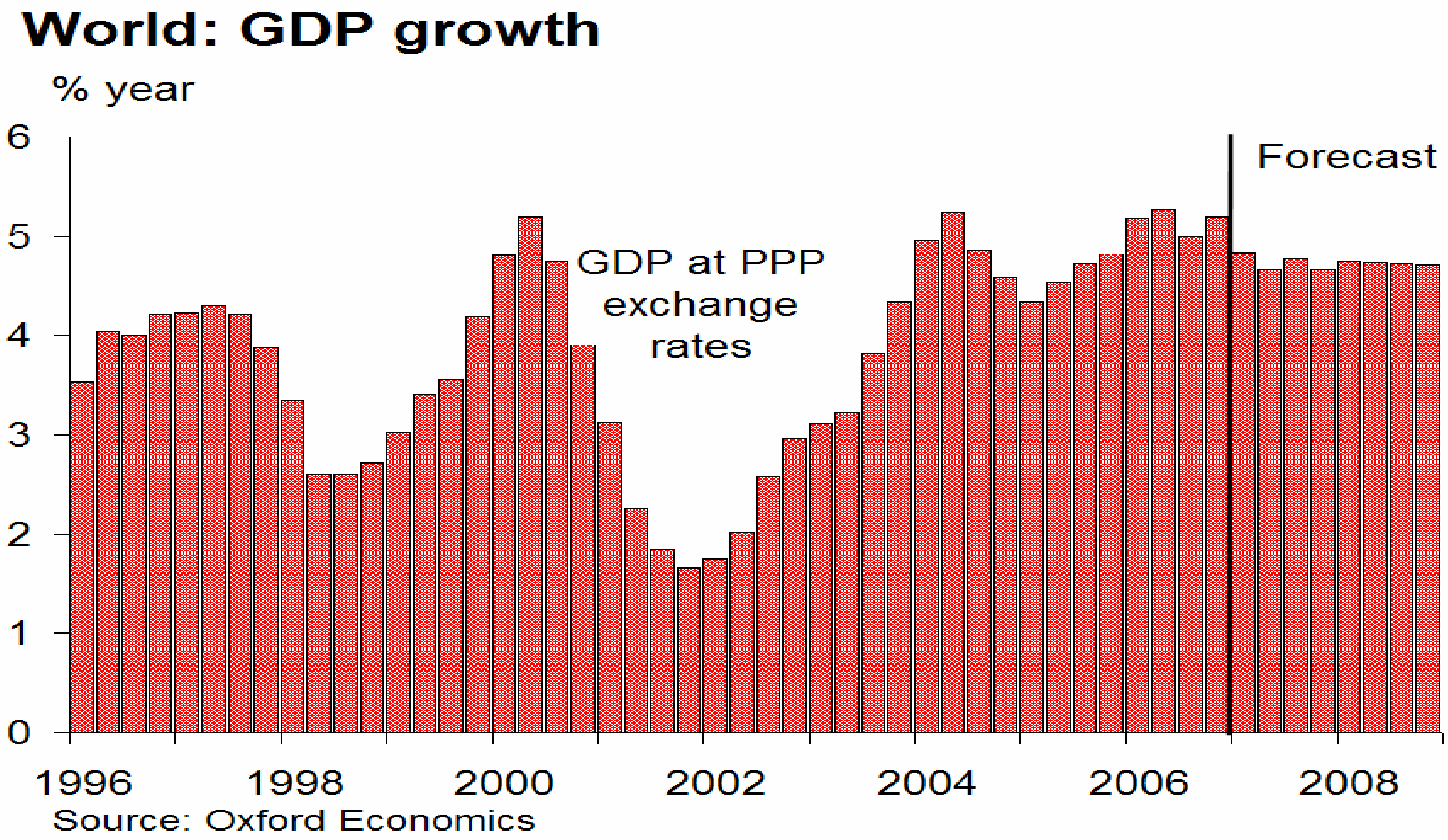
Outline

- Setting the scene: global capital flows and new players
- SWFs: definition and size
- Europe's target sectors: where are the "national champions"?

Section 1
Setting the scene: global capital flows

World economy strongest for 30 years



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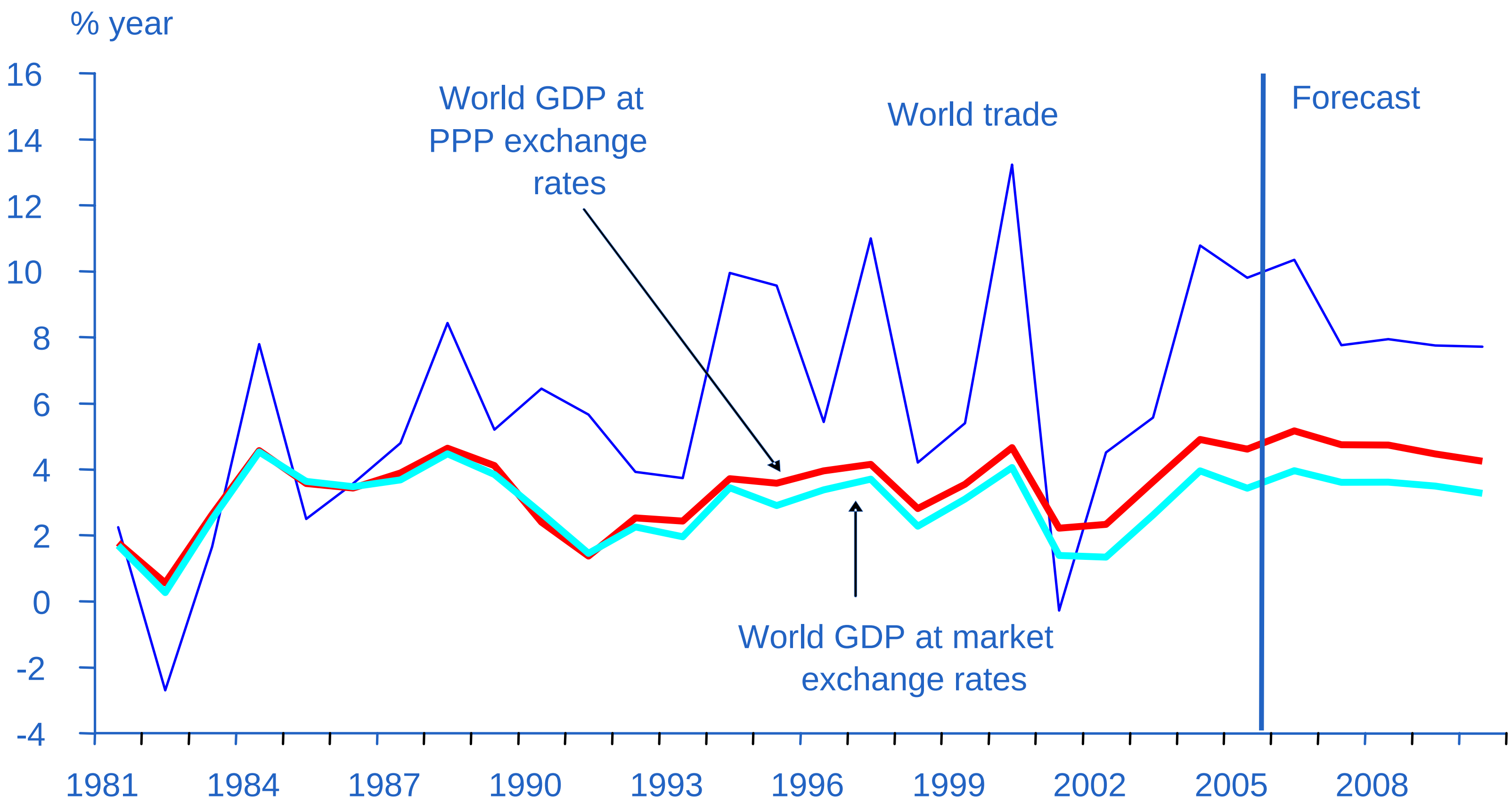
World: GDP and trade



Source: Oxford Economics

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Globalisation driving activity

- Global trade imbalances are one of the key drivers of capital flows
- Both trade and capital account flows are rising sharply – creating an ever greater need for financial market development around the world
- FDI, M&A and portfolio flows are all growing
- Asia and the Gulf are at the heart of the new boom

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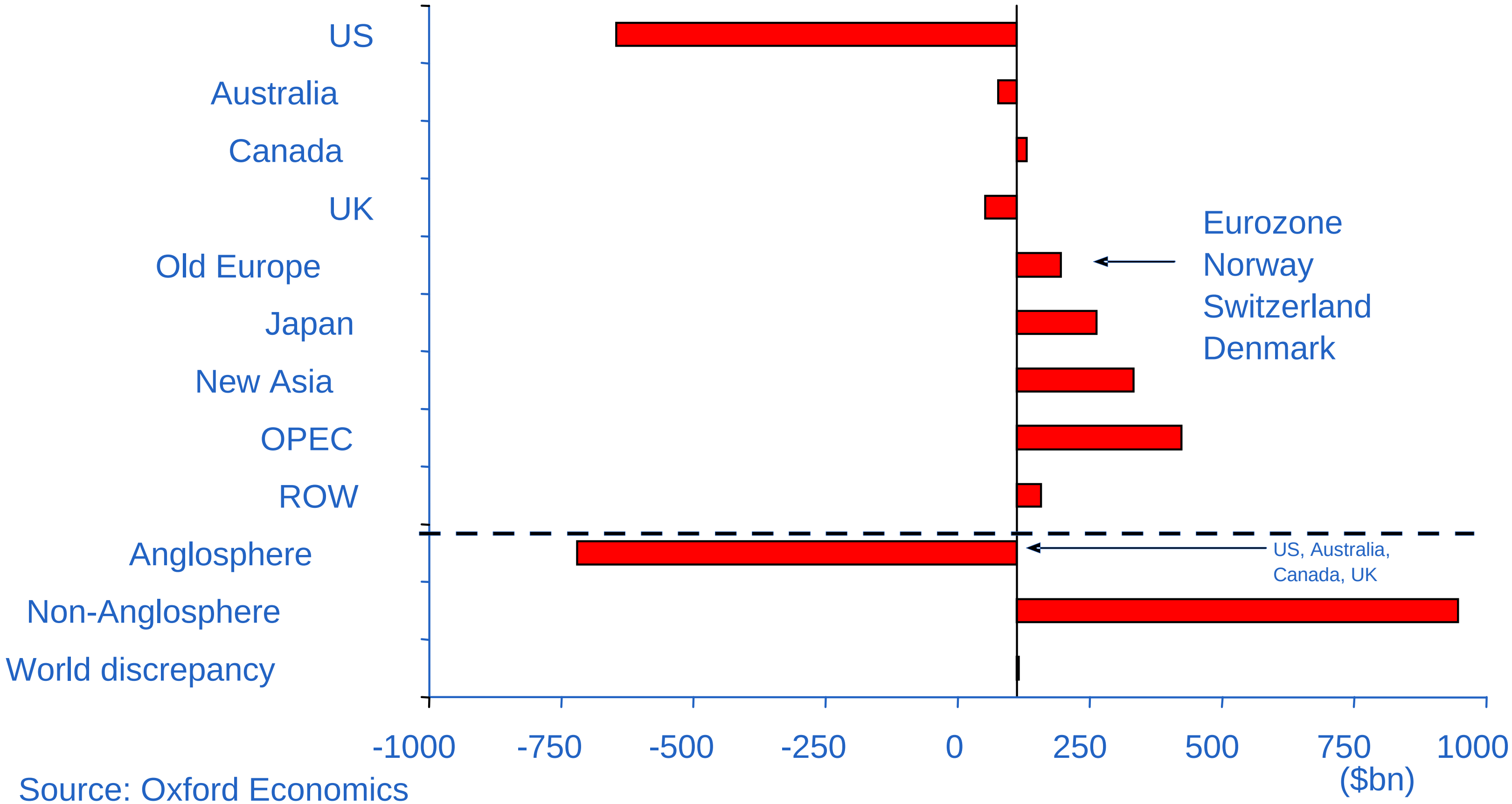
Capital flows and trade imbalances

- Global trade imbalances are one of the key drivers of capital flows
- Net capital flows out of Asia, Russia and OPEC combined now amount to about $1trillion per annum, reflecting their combined current account surplus – and the US current account deficit
- In addition both in and outflows have increased - so total market activity is much higher
- The US alone had a capital outflow of more than $1trillion last year, although its inflow was larger at $1.7trillion

Global current account balances 2006



Source: Oxford Economics

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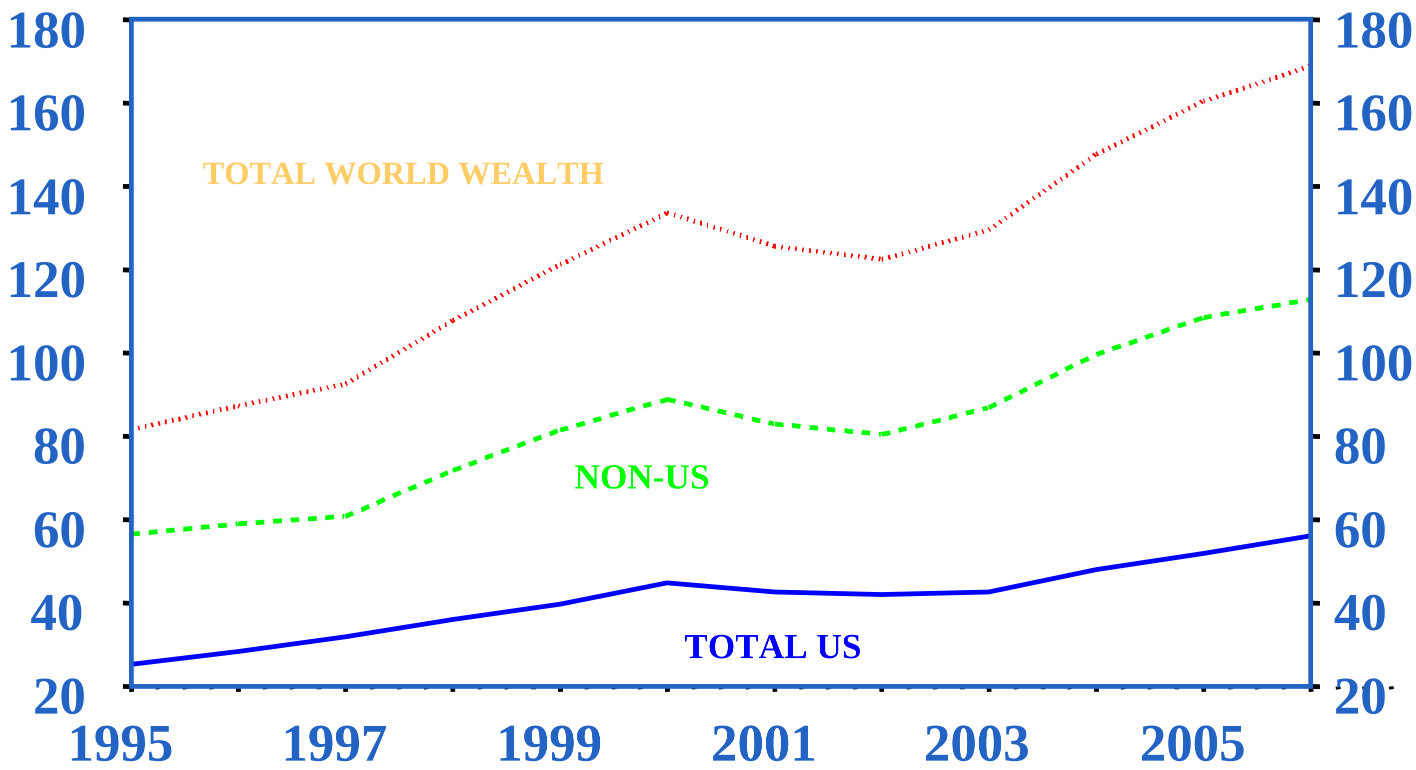
What capital flows?

- **Capital account transactions are about a third portfolio flows, a third FDI with the rest mostly banking operations and FX management**
- **The background to this is the rise in GLOBAL WEALTH and the increase in the proportion of this wealth that each country invests abroad**
- **Major change from 20-30 years ago**

World financial wealth is growing (US$tr)



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World financial wealth estimates for 2005

EQUITY HOLDINGS
Listed $37 trillion
+ Non-listed approx $15 trillion

BOND MARKETS
Corporate $35 trillion
Government $25 trillion

CASH
MONEY = $50 trillion

TOTAL FINANCIAL WEALTH $162 trillion
WORLD GDP $40 trillion

US wealth is $53 trillion
EZ is $35 trillion
Japan is $32 trillion
Rest of World is $42 trillion

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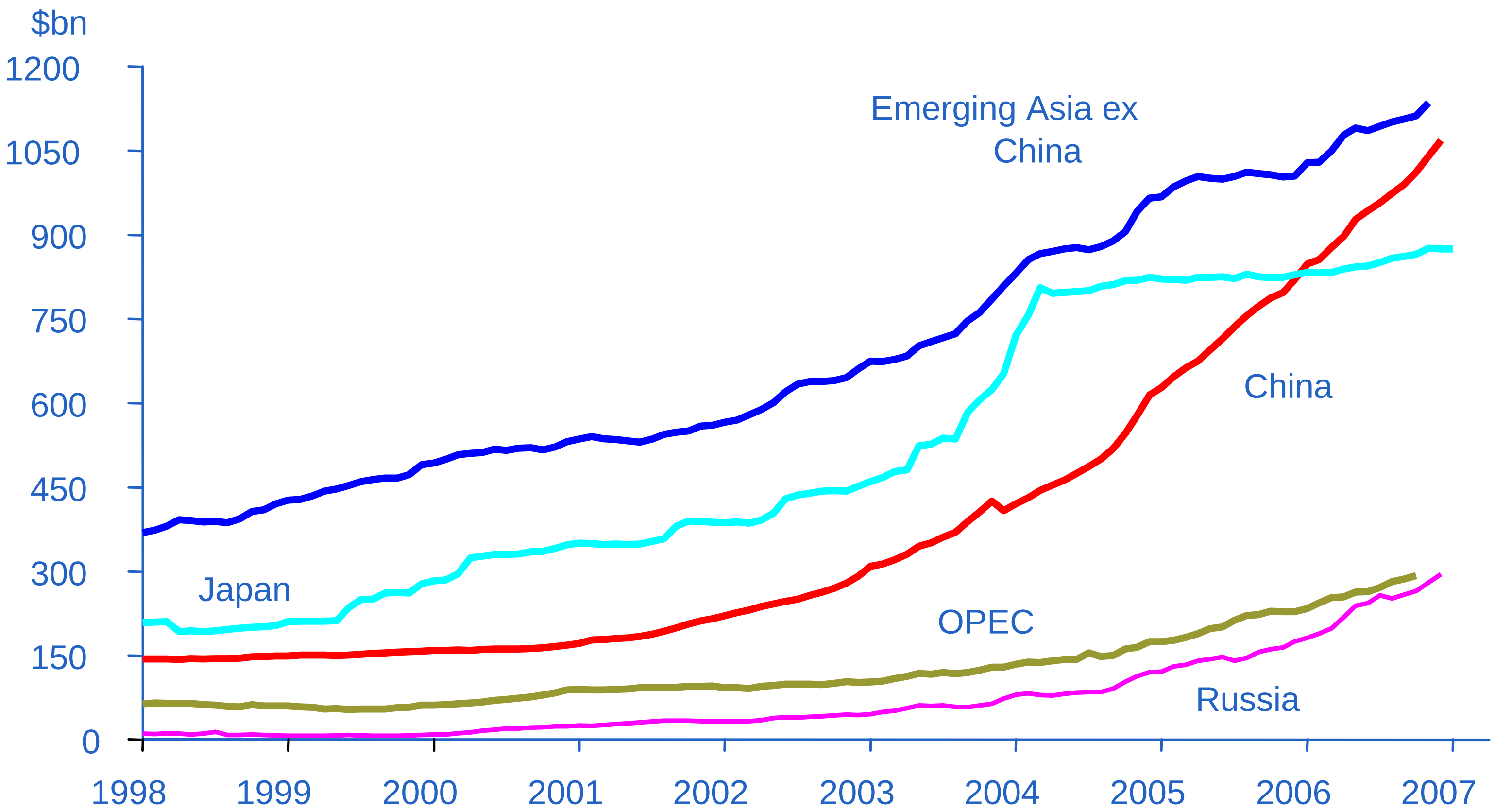
Official reserves holdings



Source: Oxford Economics / Haver Analytics

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Section 2
SWFs: definition and size

SWFs: a bit of history

- SWFs are not new: the first was established in 1953
- Of the 20 largest SWFs, 7 were in existence before 1990, 6 started in the 1990s and 7 since 2000
- A number of smaller funds have started in recent years, their success may encourage other countries to establish their own
- <u>But</u> only recently SFWs have become a big issue, particularly in policy circles

SWFs: a definition?

- There is no universally agreed definition of SWFs
- "A government investment vehicle which is funded by foreign exchange assets, and which manages these assets separately from official reserves", *Clay Lowery, Acting Under Secretary for International Affairs*
- They need:

  Sovereign; High foreign currency exposure; No explicit liabilities; High risk tolerance; Long investment horizon;

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SWFs: growth rates and future size

- Over US$2 trillion currently held by SWFs
- Oil SWFs can easily grow by US$200-300 bn a year
- China's SWF can grow by US$120-150 bn a year
- A total US$500 bn a year: SWFs bigger than the world's total official reserves* in 5 years?

- * currently at US$6 tr

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Growing Government Investment Funds

Country	Fund name	US$ million
Total		*2,279,866*
UAE	ADIA	625,000
Norway	Gov Pension Fund - Global	322,000
Singapore	GIC	215,000
Kuwait	Kuwait Investment Authority	213,000
China	CIC	200,000
Russia	Stabilization Fund	127,500
Singapore	Temasek Holdings	108,000
Qatar	Qatar Investment Authority	60,000

Source: Morgan Stanley

SWFs: issues at stake

- Increasing strategic nature of these funds: a case of State Capitalism? (*Standard Chartered*)
- The surge in size and the likelihood that they will continue to grow
- Lack of transparency of most of them
- No ground rules regarding how SWFs should behave and what they can buy
- Risk of protectionism and market instability

SWFs: need for ground rules

- Level playing fields
- Best practice
  - Learn from Norway
- Avoiding collision between SWFs and host nations
- Code of conduct: western countries may need to accept the rise of SWFs as a further sign of a shift in the world economy and should seize this as an opportunity to work with economies such as China, Russia, the GCC etc

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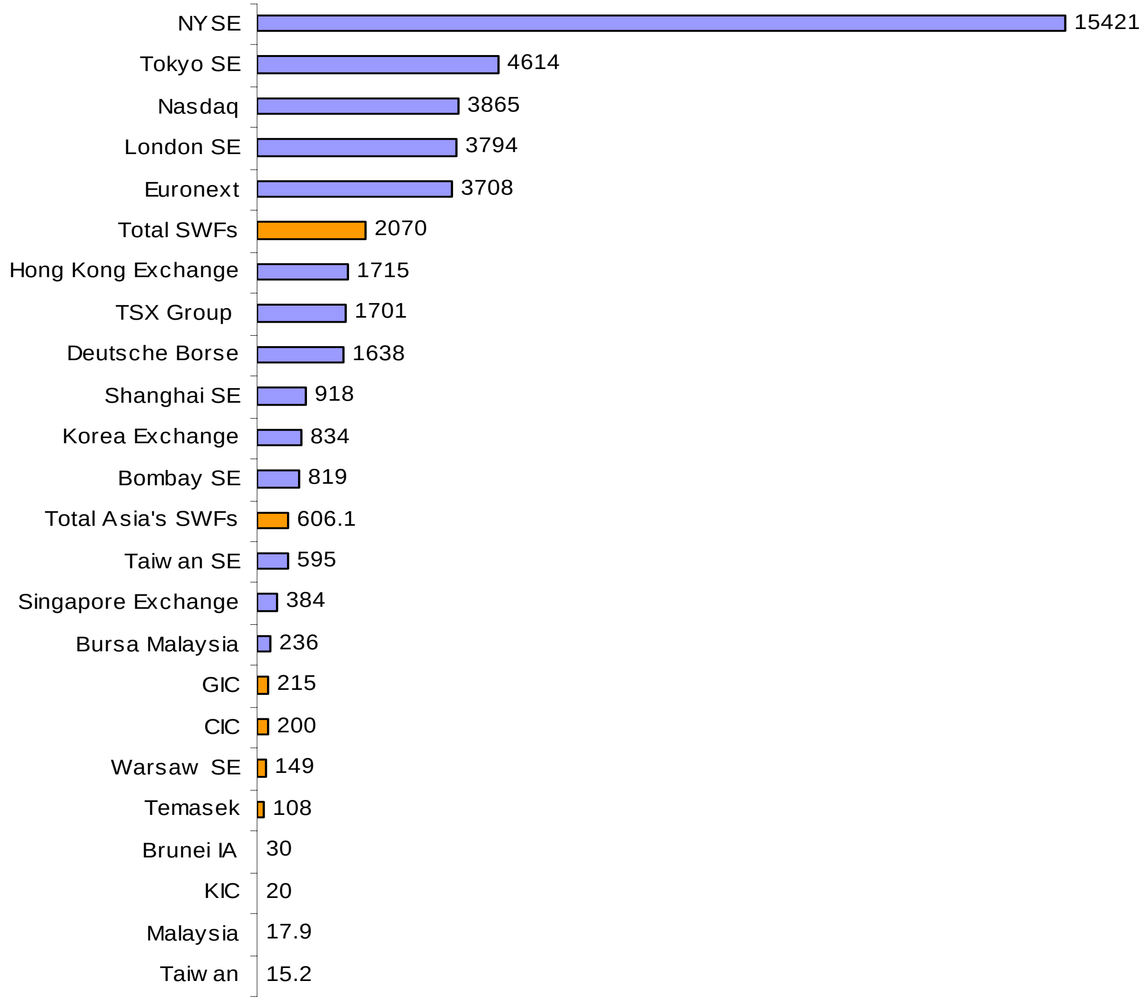
Section 3
Asia's SWFs: targeting Europe?

Is "everything up for grabs?"

Asia's SWFs: source and scale

- All non-commodities funds
- Only the funds of Singapore (both GIC and Temasek) and China have assets in excess of US$100 bn
- As a proportion of domestic GDP, the most important funds are those of Brunei and Singapore (both GIC and Temasek)
- The total assets of SWFs exceed the market capitalization of Asia's stock exchanges (exc. Tokyo SE)
- The assets of the two Singaporean funds exceed the market capitalization of their domestic stock exchange
- The assets of CIC are 23% of the market capitalization of the Shangai stock exchange

Size of SWFs compared to the market capitalization of selected stock exchanges



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Sources: Oxford Analytica, Standard Chartered

Estimated size of Asia's SWFs (US$ bn)*

Country	Fund Name	Launch year	US$ bn	% of 2006 GDP
Singapore	GIC	1981	215.0	169.0
China	China Investment Corporation (CIC)	2007	200.0	8.0
Singapore	Temasek	1974	108.0	84.9
Brunei	Brunei Investment Authority	1983	30.0	309.4
South Korea	Korea Investment Corporation (KIC)	2005	20.0	2.2
Malaysia	Khazanah Nasional BHD	1993	17.9	12.3
Taiwan	National Stabilization Fund	2001	15.2	4.0
Total			**606.1**	

* Non-commodities SWFs

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Is China the problem?

- The two Singaporean funds have been around long enough: medium transparency (GIC), high (Temasek), known investment policy and asset allocation
- CIC: New kid on the block, potential expansion of fund size, low transparency, guesses on investment policy and asset allocation

The economics of CIC and GPF

CIC

- ‘hurdle rate’: 8-10%
- Investment policy and asset allocation not disclosed
- Aggressive approach
- Wider focus by country (G20), asset class (PE funds, hedge funds, infrastructure funds), strategic investment

GPF

- No ‘hurdle rate’
- “high return subject to moderate risk”
- Since 1997: 4.58% NRAR
- Conservative approach
- Focus on developed countries, 50-70% of overall portfolio in fixed-income securities, 30-50% in equities

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FDI inflows, 2007-11 average

	US$ bn	Rank	% world total
EU27	570.1	1	38.06
US	250.9	2	16.75
Asia	244.3	3	16.31
UK	112.9	4	7.54
China	86.8	5	5.79
France	78.2	6	5.22
Belgium	71.6	7	4.78
Germany	66.0	8	4.41

Sources: EIU, author's calculations

New FDI projects, top recipient countries

	2005		2006		
	No.	% world total	No.	% world total	% change yoy
EU27	3237	30.98	3848	32.56	18.9
Asia	2611	24.99	3272	27.68	25.3
China	1237	11.84	1378	11.66	11.4
India	590	5.65	979	8.29	65.9
US	563	5.39	725	6.14	28.8
UK	633	6.06	668	5.65	5.5
France	489	4.68	582	4.93	19.0

Sources: EIU, author's calculations

FDI and M&A (1)

- The growth in global FDI in 2006, as well as in 2004-05, was in large part the result of very strong M&A activity, including cross border deals (which are the main form of FDI in the developed world)
- The increase in FDI inflows in 2006 was especially strong in developed economies – by more than 50%
- Growth in FDI flows to emerging markets was more modest – by 20% in 2006, similar to the growth rate in 2005
- The share of emerging markets in global FDI inflows declined to 38% in 2006 from a peak of 48% in 2006

FDI and M&A (2)

- FDI inflows in 2007 should be sustained by a strong global economy and the continued boom in crossborder M&A that occurred in H1 2007
- However, growth in 2007 in the global FDI total will be modest – USD1.5tr, representing 10% growth on 2006
- M&A activity will slow from 2005-06 levels. There will also be fewer privatisation opportunities in emerging markets compared with recent years

FDI and M&A (3)

- Completed crossborder global M&A surged by more than 50% yoy in the first half of 2007
- PE funds were willing to inject capital into all kinds of deals
- However, volatile financial markets will have a dampening impact on M&A activity in the second half of 2007 and into 2008
- Much of the M&A activity continues to be undertaken by strategic investors with healthy balance sheets and strong cash flows

Who invests in Europe

- Mainly US and Japan
- Significant increase in investment originated from the BRICs (from 102 in 2005 to 153 in 2006, +50%), *Ernst & Young*
- India: among the top 10 investors into Europe for the first time in 2006 (78 projects), most in UK
- China more beneficiary of FDI than investor
- Brazil and Russia: irrelevant
- Chinese investors set to increase their investment in Europe in 2008-09 *(InterLink Survey of 200 investors from Asia-Pacific)*

FDI: Europe's top destinations (1)

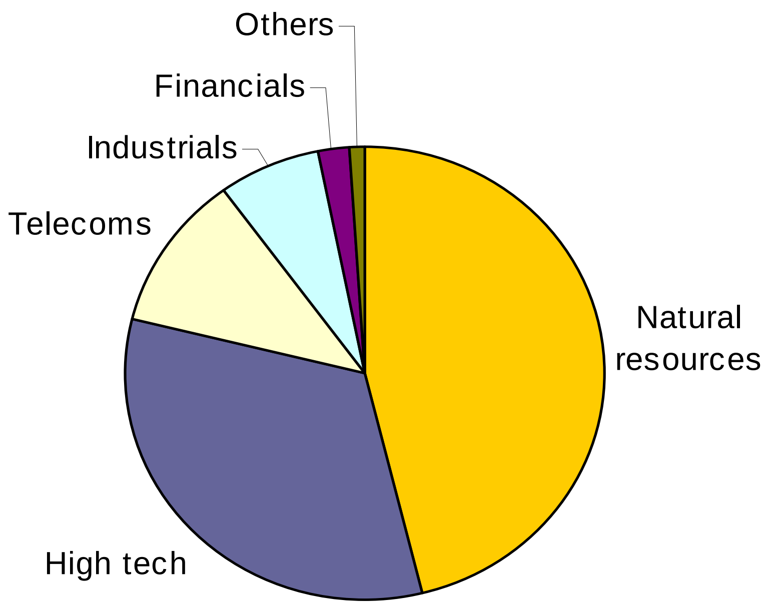
	Destination	No FDI, 2006	Market share, 2006	No FDI, 2005	change, 2005-06
1	UK	686	19.4%	559	+22.7%
2	France	565	16.0%	538	+5.0%
3	Germany	286	8.1%	182	+57.1%
4	Spain	212	6.0%	147	+44.2%
5	Belgium	185	5.2%	179	+3.4%
6	Poland	152	4.3%	180	-15.6%
7	Romania	140	4.0%	86	+62.8%
8	Switzerland	136	3.9%	93	+46.2%
9	Czech Republic	113	3.2%	116	-2.6%
9	Sweden	113	3.2%	95	+18.9%

Source: Ernst & Young

FDI: Europe's top destinations (2)

- UK and France at the top of the list
- Investment in other countries fell behind these market leaders
- Decline of the relative position of CEE because of (1) shift in importance between manufacturing and service sector investment; (2) limited appeal of CEE for service sector investment to date
- Western Europe features a large number of less labour-intensive projects

China outbound M&A, by sector in 2005



Source: Deutsche Bank/EIU

Chinese investment in Europe

Date	Target	Acquirer	Deal value (US$ml)	Sector
July 2007	Barclays (2.64%, UK)	China Development Bank (CDB)	3000	Banking and finance
July 2007	British Gas (0.46%, UK)	CIC-PBOC	110	Energy
July 2007	Schwerin-Parchim Airport (100%, Germany)	Link Global Logistics	130	Infrastructure
March 2007	Monterrico Metals (89.9%, UK)	Zijin Mining Group Co	94.6	Minerals
2007	Ridge Mining (29.9%, UK)	Zijin Mining Group Co	15.93	Minerals
July 2005	MG Rover (100%, UK)	Nanjing Automobile group	93	Automotives
2005	Thomson SA (joint-venture, France)	TCL Corporation		Consumer electronics

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Chinese banks targeting foreign banks

Date	Target	Acquirer	Deal value (US$bn)
23 July 07	Barclays (2.64%, UK)	China Development Bank (CDB)	3.0
24 August 07	Bank of America (Asian business Hong Kong)	China Construction Bank (CCB)	1.2
29 August 07	Seng Heng Bank (79.93%, Macau)*	ICBC	0.6
8 October 07	UCBH (9.9%, US)*	China Minsheng Banking (CMB)	0.3
19 April 00	Union Bank of Hong Kong	ICBC	0.3

* Pending

Source: Dealogic

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Major European banks

Bank	Country	Market value US$bn
HSBC	UK	202.0
UBS	Switzerland	124.4
Royal Bank of Scotland	UK	122.5
Santander Central Hispano	Spain	111.2
Unicredito Italiano	Italy	99.0
BNP Paribas	France	97.0
Intesa SanPaolo	Italy	96.6
BBVA	Spain	86.9
Credit Suisse	Switzerland	86.7
ABN Amro	Netherlands	83.0
Societe Generale	France	79.4
HBOS	UK	77.1

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Possible targets: countries

- Germany: manufactures and location, SMEs
- France: good, but obsession with ‘national champions’
- Italy: difficult, mainly financial sector, SMEs
- Netherlands: critical mass of firms in a number of sectors – notably telecoms, media, IT – resulting in ‘positive externalities’ that are likely to attract more investment in the sectors concerned
- Sweden: some key companies in key sectors, strong potential including competitive corporation tax
- UK: one of the world’s most attractive location
- CEE: not really attractive for Asia’s SWFs – too small mkts, no much technology transfer etc – but some exceptions like Poland

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Concluding remarks

- SWFs are not a homogenous group
- Concerns in Europe and the US triggered by China's activities
- CIC: 'aggressive' approach, most of assets in portfolio holdings, 10-15% in strategic stakes
- Limited targets for strategic investment in Europe: banking and finance, mining and metal, and the UK