Sovereign Wealth Funds and Their Investments in Private Equity

In conjunction with the publication of Preqin’s seventh Sovereign Wealth Fund Review, this month’s Spotlight turns to the community of sovereign wealth fund investors and looks at their level of activity within the private equity space.

**Fig. 1: Aggregate Sovereign Wealth Fund Assets under Management ($tn), 2008 - 2015**

Sovereign wealth funds, despite being small in number and secretive in nature, continue to capture attention as a result of their ever growing assets under management and corresponding influence on global financial markets. Today, the total assets of sovereign wealth funds top $6.31tn (Fig. 1), more than double the capital these entities represented in 2008, the year Preqin launched its first Sovereign Wealth Fund Review.

Since the previous Preqin Sovereign Wealth Fund Review, launched in October 2013, these institutions have grown by over $900bn despite commodity and oil prices, the source of funding for many of the largest sovereign wealth funds, falling over 2014. Instead, the growth in assets of sovereign wealth funds has been driven by continued funding from governments and reserves as well as from investment returns generated by these investors in their continued hunt for long-term yield in a low interest rate environment.

In previous years, growth in the sector has been partially driven by the creation of new sovereign wealth funds; however, in 2014 just a single new sovereign wealth fund was formed. Ireland Strategic Investment Fund (ISIF) was created in 2014 with the mandate to invest its resources in areas that will support economic activity and employment in Ireland. However, future sovereign wealth funds continue to be planned. The Government of Hong Kong has been recommended by a working group within the region to allocate up to a third of its annual budget surpluses into a proposed ‘Hong Kong Future Fund’, in order to meet the growing expenses resulting from an ageing population.

Despite Fall in Oil Prices, Most Sovereign Wealth Funds Grow over 2014

Twenty-nine percent of sovereign wealth funds have seen their assets fall in size since 2013; of those that have lost assets over this time, half derived their capital from hydrocarbons. Falling oil prices over the second half of 2014 have led to significant withdrawals from some sovereign wealth funds by governments highly funded by such assets in order to provide stabilization or prevent recession, and also to fill funding gaps.

For example, the combined assets of Russia’s National Wealth Fund (NWF) and Reserve Fund have declined by over $20bn since 2013. The effect of falling oil prices, as well as the impact of events such as the Ukraine conflict, have caused the Russian economy to shrink, leading to growing deficits in the country and the withdrawal of international funding for projects either as a result of uncertainty in the region or as a result of international sanctions. Russia has withdrawn capital from its sovereign wealth funds to cover deficits and to stimulate the economy through capitalizing banks in order to provide funding for infrastructure investments and lending. Other governments, such as that of Ghana and its Stabilization Fund, have indicated they will also be raiding sovereign wealth funds in order to cover shortfalls in oil revenue.

However, despite the negative impact of oil prices on some sovereign wealth funds’ assets, since October 2013, 59% of sovereign wealth funds tracked by Preqin have accumulated more assets since 2013; of those that have lost assets over this period, 50% have lost assets since 2014.

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by almost $43bn over this period. However, this is a relatively small increase in its total assets compared to the previous year, when it added nearly $180bn in assets under management. The fund was established to safeguard Norway’s assets from oil production for future generations, rather than to provide short-term stabilization for Norway’s economy. Therefore, even though inflows have slowed, and falling oil prices may continue to impact short-term distributions to the fund, it currently looks set to remain a long-term investor in its pursuit to meet the Norwegian Government’s objectives. As the fund’s vast assets under management make it an influential market participant on a global scale, many will be paying close attention to the fortunes of the sovereign wealth fund and the impact of oil prices on this most influential investor.

Alternative Investments

The nature of sovereign wealth funds, with their longer term investment horizons and, in general, lack of short-term liabilities, allows them to take not only significant stakes in the funds and securities in which they invest, but also to maintain investments for longer periods of time. Sovereign wealth funds’ capital allocations both directly to securities or assets, as well as to funds, can be characterized as among the “stickiest” of all institutional investors’ allocations as they seek returns over long periods and have less need to disinvest in times of crisis or turmoil.

Traditional investments, such as equities and fixed income securities, are widely used by sovereign wealth funds and are a relatively stable part of the portfolios of these investors (Fig. 2). Alternative assets have emerged as an increasingly important portion of the portfolios of many sovereign wealth fund investors over recent years, as these investors seek to diversify their portfolios and acquire assets that can generate yield and help them meet their long-term objectives.

Suitability to Private Equity

Preqin’s analysis shows that almost half (47%) of all sovereign wealth funds invested in private equity in 2014. The long-term investment approach and vast pools of capital available to sovereign wealth funds often make them suitable investors in the private equity asset class. The highly illiquid and relatively risky nature of private equity, though unmanageable for many other institutions, is far less of a concern for sovereign wealth funds, which do not need to consider short-term obligations.

Different sovereign wealth funds approach their investments in different ways. Emirates Investment Authority (EIA), for example, invests in private equity through direct and fund investments; the sovereign wealth fund considers investments in vehicles that focus on a diverse range of industries across the MENA region, but it will also consider investing globally. Other sovereign wealth funds access the asset class via separate account mandates. This is the case with the $31bn Texas Permanent School Fund State Board of Education (SBOE), which has its private equity investments managed in four limited partnerships, each with an external investment manager.

A number of sovereign wealth funds choose to invest in private companies directly and therefore avoid fees charged by fund managers. Direct investment in companies allows for greater operational control over portfolio companies, which is especially attractive if the sovereign wealth fund has broader social and economic goals in a particular area. RAK Investment Authority, for example, has a preference for direct investment in domestic companies and has previously entered into joint ventures in order to form partnerships that are of benefit to the local economy of Ras Al Khaimah.

Conversely, there are a notable proportion of sovereign wealth funds that are not as compatible to the private equity asset class; 42% of sovereign wealth funds are known not to include private equity as part of their investment strategy. Funds with their own liquidity concerns and anticipation of economic stress often favour more liquid assets such as public equities and fixed income instruments, as exemplified in the investment strategy of Fundo Soberano do Brasil (FSB).

Sovereign Wealth Funds Investing in Private Equity by Total Assets under Management

The five largest sovereign wealth funds that invest in private equity have combined assets under management of almost $3tn; three of these are based in Asia and two in the MENA region. The largest sovereign wealth fund that invests in the asset class is Abu Dhabi Investment Authority (ADIA), which manages total assets of $773bn.
and has a target allocation to private equity of approximately 8.0%. The largest Asia-based sovereign wealth fund investing in private equity is China Investment Corporation (CIC), which has total assets under management of $650bn. In general, the larger the sovereign wealth fund, the more likely it is to be a private equity investor. Fig. 4 shows that of sovereign wealth funds with total assets under management of less than $1bn, only 13% invest in private equity. There are, however, exceptions; most notably, GPFG (whose $818bn makes it the largest sovereign wealth fund in the world by total assets) is not permitted to invest in private equity due to restrictions imposed by the Government of Norway. Its investments are directed towards public markets and real estate.

Outlook

Despite a reduction in the price of a barrel of oil, sovereign wealth funds’ assets continue to grow in aggregate. Investments made by sovereign wealth funds account for an increasing proportion of aggregate private equity capital raised, with 14% of institutional capital raised by private equity funds coming from sovereign wealth funds. This is a significant increase compared with the levels witnessed in 2013 and 2014. The ability to deploy large amounts of capital and the lack of liabilities when compared with other institutional investors makes sovereign wealth funds well suited to the private equity asset class. The established economies of North America and Europe offer the greatest choice of fund managers and strategies, and a higher deal flow than regions where private equity is still relatively immature. However, there has been a shift towards a global focus for investment in the asset class, with increasing proportions of sovereign wealth funds targeting investments further afield than the traditional markets. The larger sovereign wealth funds are attracted to the long-term returns these markets can provide, and seize the opportunity to diversify risk away from their primary national revenue source. Many of the larger funds do, however, have the resources to source their own deals. With this we see a continued appetite for direct investments, allowing funds to reduce the cost of fees and carry. As sovereign wealth funds grow, data would suggest that they will likely commit more capital to the private equity asset class.
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