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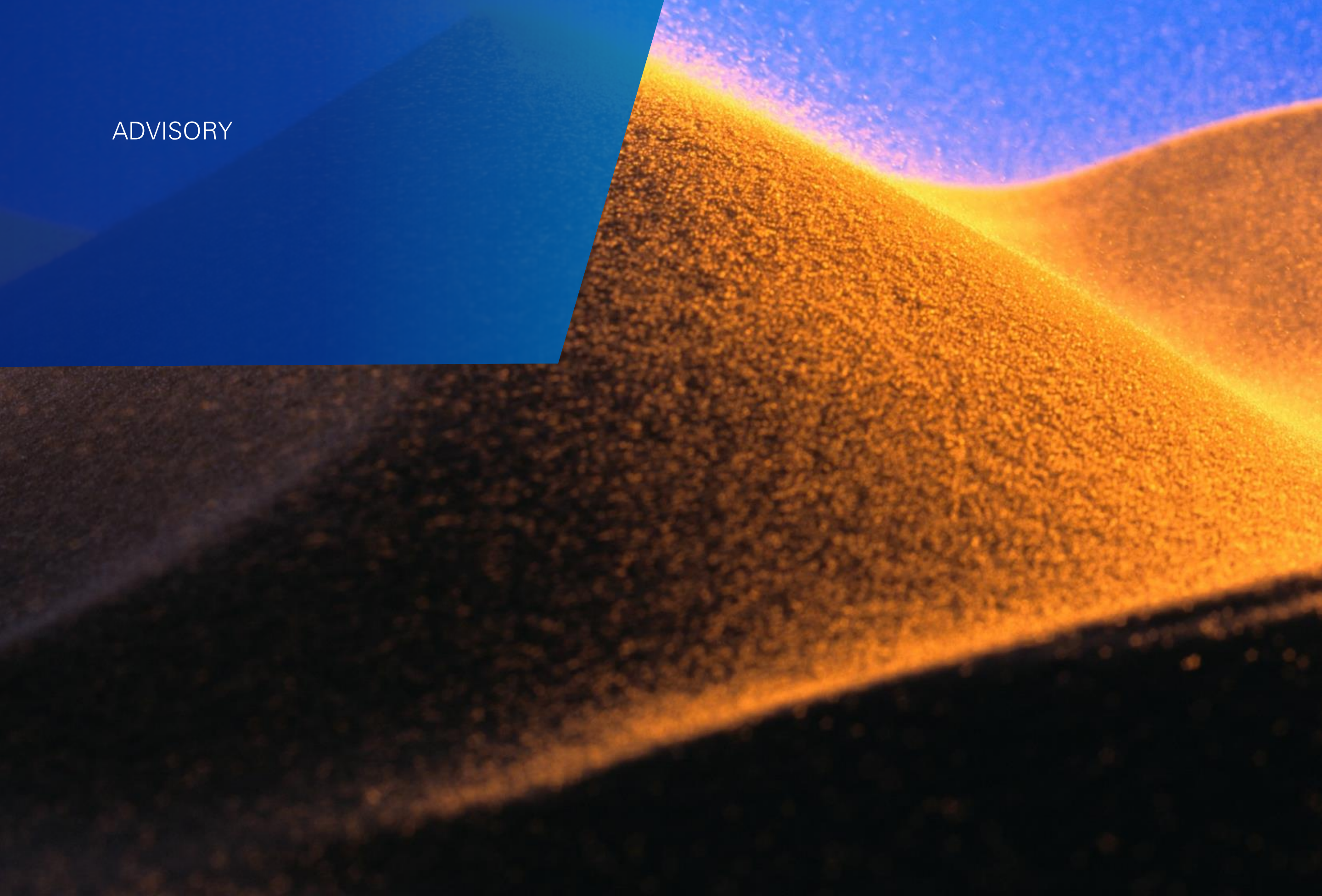
cutting through complexity

Institutional Investor's sovereignwealth CENTER

SWFs – Riders through the storm

November 2014

ADVISORY



Special thanks to the contributors and the KPMG reporting team for their support and efforts in compiling this report.

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FOREWORD

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According to the Institutional Investor's Sovereign Wealth Center, Sovereign Wealth Funds (SWFs) had over US$5 trillion of assets under management at Q3 2014 and undoubtedly have a key role to play in the region, and globally. SWFs are continually evolving and, as part of this, becoming increasingly sophisticated in their operations and execution of their respective investment strategies.

While the majority of SWF funds continue to deploy their funds in bonds and global equities, a relatively low interest rate environment, continually evolving investment strategies and a growing appetite for alternative asset classes are resulting in a shift away from what has typically been a passive investment philosophy for most SWFs during the last few years.

The areas of direct investments for SWFs are generally few and chosen with the majority concentrating on real estate, infrastructure, and increasingly, private equity. It should come as no surprise that SWFs spent US$24.5 billion on mergers and acquisitions in the first half of 2014, the most in any six month period since 2010 (Source: Thomson Reuters). According to the Institutional Investor, SWFs have doubled their allocations to private markets over the past six years at a time when other long term investors (such as public pensions) have dialed back risk to meet outstanding liabilities.

According to the Sovereign Wealth Fund Institute's 'Sovereign Wealth Fund Transaction Database', the first half of 2014 recorded a 21% increase in the value of direct transactions by SWFs from US$42 billion in H1 2013 to US$51 billion in H1 2014. The increase is largely attributable to an increase in the volume and value of SWF real estate transactions (many being larger in size compared to 2013). Based on what are now strong foundations for growth and investment, it is likely that 2015 could prove to be an active and productive year for SWFs.

Through our long term presence in the Middle East region and role in a number of the region's landmark projects, KPMG's global network of member firms have developed a deep understanding of SWFs in the region. This publication includes a selection of thought leadership articles written by KPMG partners and SWF specialists from throughout the region, and globally, and aims to provide an interesting insight into the recent trends seen in SWF investment.

On behalf of KPMG, I would like to convey special thanks and gratitude to Victoria Barbary, and her team at the Institutional Investor's Sovereign Wealth Center, whose contributions and insights towards this thought leadership have been invaluable, and most appreciated.

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Institutional Investor's Sovereign Wealth Center

Middle East sovereign wealth funds, like other institutional investors around the world, have been forced to navigate shifting economic currents at home and abroad, as they seek to invest their oil-fuelled capital to generate the best returns for their stakeholders.

Over the past two years, there has been a shift in how the Middle East's sovereign wealth funds do that. The changes are driven by market forces — the unprecedented low-interest rate environment, for example — but some of the region's biggest investors have also reacted to specific conditions at home.

The region's sovereign wealth funds are taking advantage of their scale and long-term investment perspective by allocating more of their assets to real estate, largely in Europe and the US. While the Abu Dhabi Investment Authority and the Kuwait Investment Authority have been buying property since the mid-1970s, there has been a marked rise in bricks and mortar investments by these funds and their peers from around the Arabian Gulf. During 2014, however, prime commercial real estate markets in developed economies have become increasingly crowded as large pension funds and insurance companies have followed the lead of sovereign wealth funds. As a result, state-owned investors have shifted their focus, investing in other real estate sectors such as hospitality, industrial, logistics and retail, as well as funding infrastructure, where yields are higher.

Some funds face specific challenges. Most obviously, since Qatar's political transition in June 2013, its sovereign wealth fund has shifted its attention and investments to its domestic market, establishing ventures like Nebras Power alongside the Qatar Electricity and Water Company and Qatar Petroleum International, the foreign investment arm of the Emirate's national oil company, to back infrastructure projects. Conversely, Abu Dhabi's Mubadala Development Company is stepping back from its efforts to diversify its home economy and is scouting for investment opportunities abroad, as its initial development projects come to fruition and are privatised.

It is most certainly an exciting time to be working with the Middle East's sovereign wealth funds as they adapt to so many changes.

In closing, I would like to thank Vikas Papriwal for inviting Institutional Investor's Sovereign Wealth Center to contribute to this report and bring some of our market-leading data to bear on KPMG's analysis. On behalf of my team, I hope you find our research interesting and informative.

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An introduction to the regional landscape

> “Looking forward, 2015 is set to be an active year for SWFs in the region. Many funds have increased their headcount significantly during the last couple of years and have strengthened their in-house capabilities.”

Overview

The global SWFs currently control an aggregate of approximately US$5 trillion in assets under management or AUM (Source: Institutional Investor's Sovereign Wealth Center). Of this amount, the GCC SWFs (most notably ADIA, currently the world's third largest SWF behind the Norway Government Pension Fund and China Investment Corporation) account for approximately 40% of global SWFs by AUM.

Top 10 Global Sovereign Wealth Funds (AUM)

No	Country	Sovereign Wealth Fund	AUM (US$ billion)
1	Norway	Government Pension Fund Global	869.0
2	China	China Investment Corporation	652.7
3	UAE	Abu Dhabi Investment Authority	589.0
4	China	State Administration of Foreign Exchange (investment portfolio only)	456.0
5	Kuwait	Kuwait Investment Authority ("KIA")	386.1
6	Singapore	GIC Private Limited	315.0
7	Qatar	Qatar Investment Authority	304.4
8	Saudi Arabia	Saudi Arabian Monetary Agency (investment portfolio only)	210.0
9	Singapore	Temasek Holdings	177.2
10	UAE	Investment Corporation of Dubai	159.8

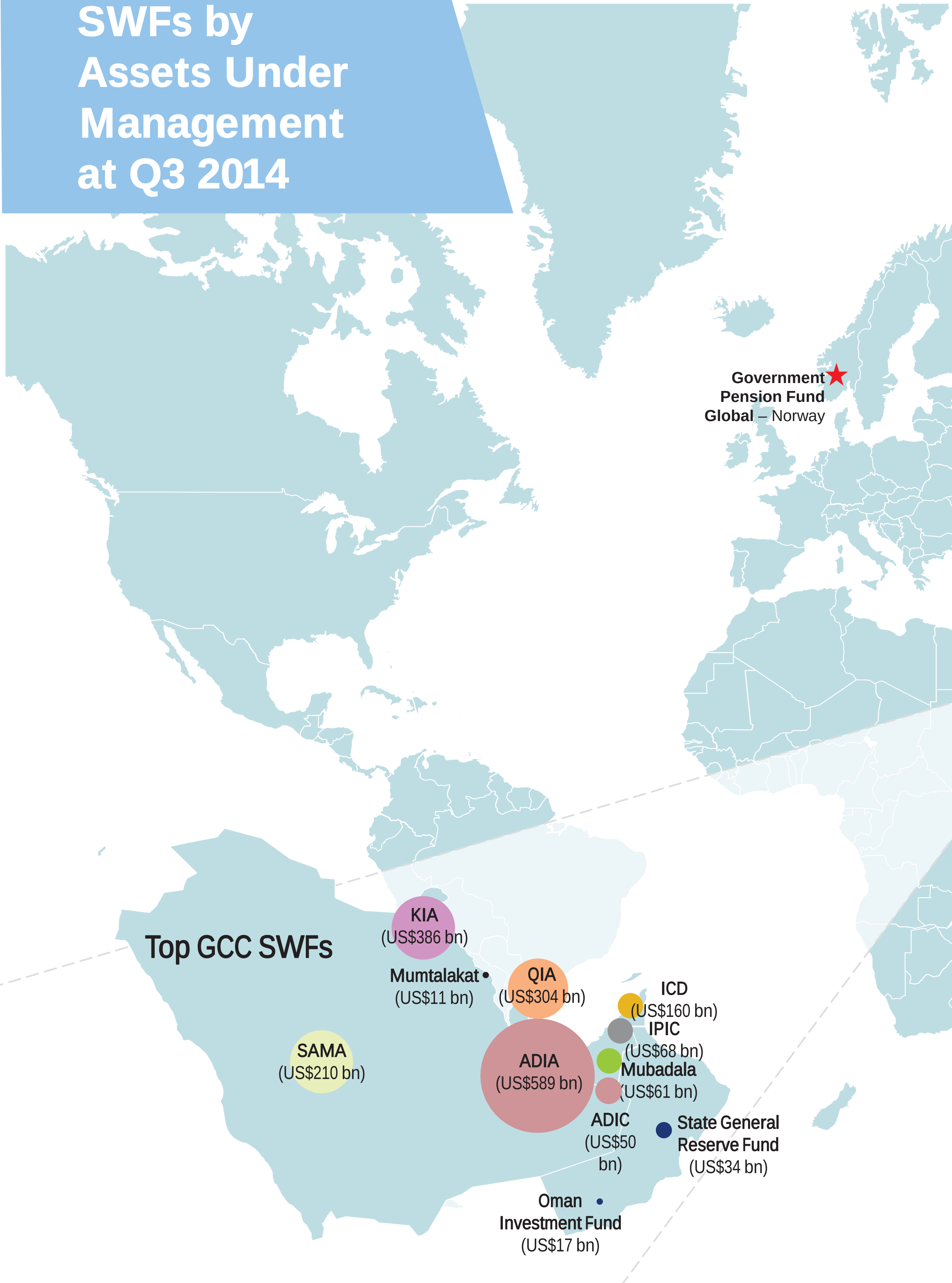
Source: Institutional Investor's Sovereign Wealth Center at Q3 2014

Like the rest of the world, the Middle East was impacted by the global financial crisis which saw SWFs in the region curb their investment activity, and in many cases, reset their investment strategies altogether. While recent years will be remembered for the financial crisis, the impact on SWFs in the oil rich countries was partly mitigated by the increase in the price of oil (while trading below US$80 per barrel during 2014, oil prices were well in excess of US$100 per barrel from 2011 to 2013). Therefore, as the economic world crawled out of the economic slowdown, these organisations appeared to be in the best position to take advantage of the recovery in the global markets.

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, Middle Eastern SWFs' influence on the global economy has grown. Now, more than ever, these SWFs are viewed by the West as a vitally important source of capital. However, despite this fact, SWFs in the Middle East appear to be viewing the West with caution and, as a result, have invested less internationally than they have done in the past. Whether this is due to international forces, such as the Euro zone debt crisis, or as a result of local factors, such as the Arab Spring, it is becoming evident that SWFs are redirecting a portion of their funds from international investments back into the Middle East. Generally speaking, the most common changes within the region can be seen in local wage inflation and increases in major local infrastructure spend - evident in Dubai in preparation for the 2020 Expo and in Abu Dhabi as it seeks to grow into a major global financial centre and true global city (Abu Dhabi's 2030 vision).

Looking forward, 2015 is set to be an active year for SWFs in the region. From our experience, many funds have increased their headcount significantly during 2013 and 2014 and have strengthened their in-house capabilities. While distressed periods are typically times when oil-rich SWFs have taken advantage of 'opportunities' to acquire trophy assets in the West, we expect there to remain a heightened sense of caution, particularly with the recent plunge in oil prices to under US$80 a barrel, as supply outpaces demand. Western governments and organisations looking for capital from the Middle East need to adapt and demonstrate a deep understanding of what is driving the thinking of SWFs in the region, and be dedicated to making a long term commitment to building relationships that add value to their investment policy.

Top 10 Global SWFs by Assets Under Management at Q3 2014



Source: Sovereign Wealth Fund Institute and Institutional Investor's Sovereign Wealth Center – ranked by AUM at Q3 2014

SWFs –Riders through the storm

> Despite collapsing oil and asset prices and reduced trade which caused collateral damage to the economies of many sovereign investors, largely prudent investment strategies, absence of leverage in most funds and crucially a long term outlook resulted in the sovereign funds having what everyone now craved – capital availability.

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SWFs – Riders through the storm?

With Greece having recently returned to the debt markets, many are seeing this event as a milestone marking an end to the financial and banking instability the world has been experiencing since 2008. Certainly the recapitalisation and recovery of the banks and the current generous liquidity in the credit markets also suggest that the current situation is far more stable and we are in a period of recovery. Given where the world is now, we thought it might be an opportune time to have a look back and see how the global financial crisis affected sovereign investors both in financial terms and in the perceptions of others.

> "As sovereign investors found their way onto every investment bankers speed-dial, when the calls were placed most learned that sovereign investors were maintaining investment discipline and that sovereign capital was far from easy to access."

The situation pre-2008

The benign economic environment in the years leading up to 2008 had in the main been good to SWFs with rising public markets, rapidly appreciating oil prices and an OECD consumer boom fuelling trade surpluses in exporting countries and trading hubs. In some respects the perfect storm, however, with seemingly endless liquidity in credit and equity markets, some participants both economic and political began to raise issues regarding sovereign investors. Transparency and, crudely put, 'potential politicisation' of capital were at the forefront of the sceptics' worries. With an abundance of capital, some market participants started to become particularly selective over the sources of their capital. The Santiago Principles were the sovereign investors' response which, whilst being generally well received, did have its critics.

The banking and global financial crisis

Post the collapse of Lehmans, liquidity of course rapidly reduced which very quickly eroded the highly leveraged balance sheets of both investment and retail banks around the globe. Collapsing oil and asset prices together with reduced trade as mature economies went into recession caused collateral damage to the economics of many sovereign investors. Despite the turmoil, largely prudent investment strategies, absence of leverage in most funds and crucially a long term outlook resulted in the sovereign funds having what everyone now craved – capital availability. Perhaps unsurprisingly those raising concerns pre-Santiago fell silent pretty quickly.

A number of sovereign investors made substantial investments in major western banks and financial institutions as well as in some cases providing liquidity to support domestic institutions. Some funds made very substantial returns on these investments and, for the most part, others have done respectably having been able to hold whilst asset values recovered. However, with some of these investments suffering early losses, sovereign investors were uncharitably perceived by some as easy capital. As sovereign investors found their way onto every investment banker's speed-dial, when the calls were placed most learned that sovereign investors were maintaining investment discipline and that sovereign capital was far from easy to access.

Most sovereign funds of course hold very substantial publically quoted equity and debt portfolios and unsurprisingly these came under pressure with falls in public markets. This resulted in considerable pressure, particularly for those funds publishing detailed returns analysis.

The recovery

Sovereign investors for the most part played to their strengths of being longer term investors with access to liquidity. They were able to ride out depressed values in public markets without having to realise investments. Many funds also had the ability to take advantage of depressed pricing of assets, particularly in Europe, and pick up quality assets at reasonable prices.

Lessons learned

Taken in aggregate, sovereign investors have managed the recent turbulent times relatively well, although individually a few funds have had a more challenging ride. Where challenges did arise, some of the characteristics evident were:

- Excessive use of leverage in concentrated portfolios;
- Investing in complex assets that require highly specialist expertise and experience;
- Poor risk management infrastructure; and
- Portfolio concentration.

KPMG member firms have seen that most funds, whether or not directly affected by these factors, realise that positive adjustments can be made to increase diversification within their portfolio. Several funds have geared up their expertise to diversify geographically or across more asset classes. Likewise, as we reported last year, there has been more focus on risk management with upskilling and infrastructure development noted at many funds.

It is important to put these comments into perspective in that sovereign investors generally weathered the storm better than many asset managers and financial institutions.

Effects

The last few years have clearly had major effects on sovereign investors, but we would highlight one in particular which is the change in perception of sovereign investors within the wider business community. It seems that many people's views of sovereign investors have changed from being neutral to slightly sceptical to recognising the particular qualities of sovereign capital.

In particular term, there is a far greater appreciation of the long time horizon most funds consider which, together with their degree of liquidity, provides an attractive capital source against a market of liquidity dependent 'hot capital'. The fact that many sovereign investors 'had a good recession' also demonstrated to the market that sovereign funds are more effective investors than many had given them credit for. The perception of easy capital or poorly disciplined buyers of trophy assets is thankfully now a receding memory.

In the end, it is results that count and looking at the big picture, sovereign investors in aggregate posted increases in AUM every year throughout these difficult years despite pressure on their sources of funds and collapsing markets.

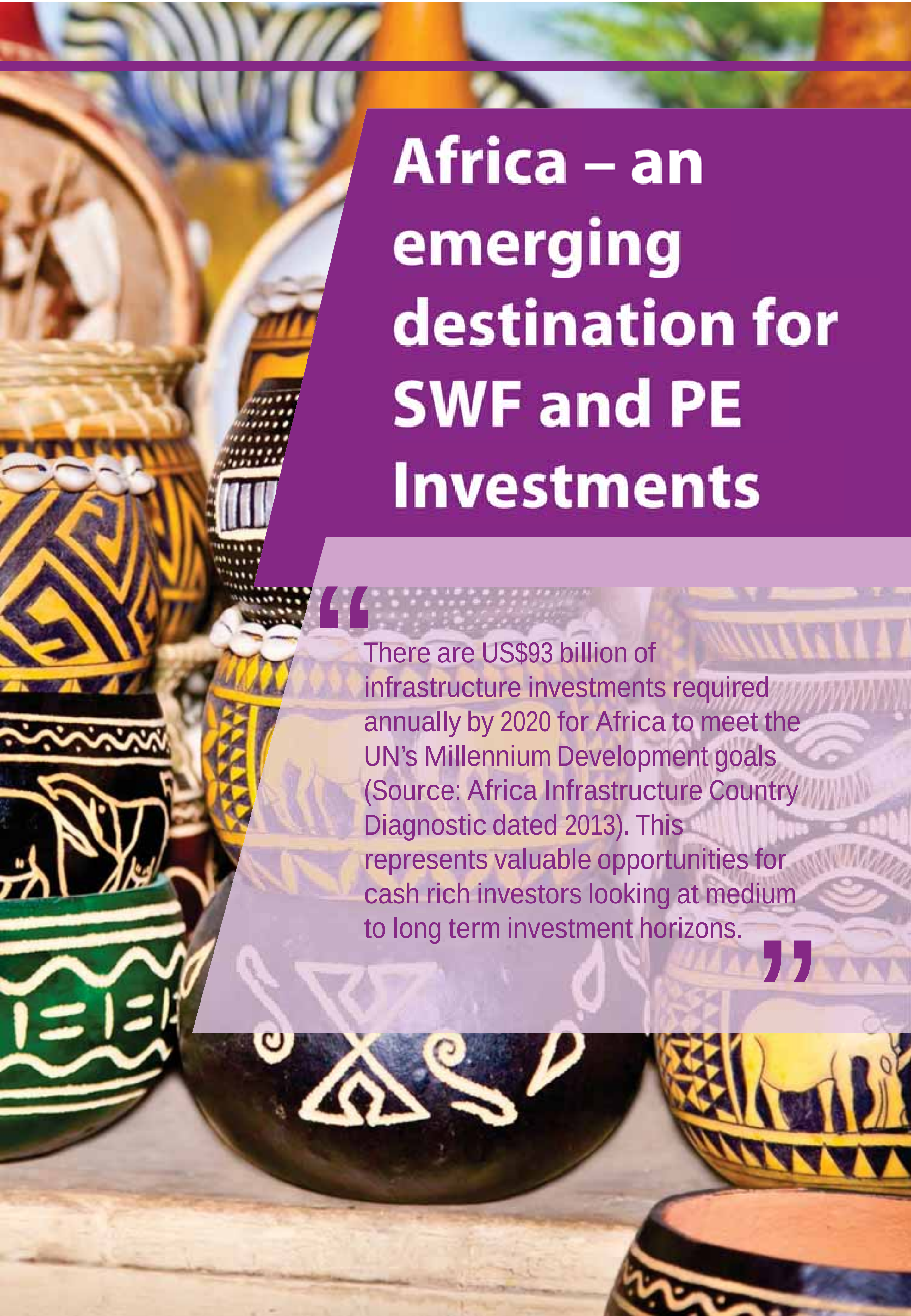
> “From perhaps a mildly sceptical political and financial community pre-crisis, sovereign investors are now far more actively courted by governments, institutions and enterprises alike. This change in perception is welcomed and will surely positively impact the range of investment.”

Conclusion

Recent financial history has provided a stern test for managers of funds and financial institutions. This was a test many failed, however, the sovereign investor community faired better than most.

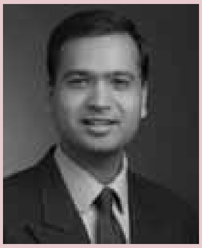
For most sovereign investors the global financial crisis has been a challenging and volatile period but has nevertheless resulted in a broadly positive outcome. This has been made possible by lack of or prudent use of leverage, the ability to take a long term view and disciplined investment.

Undoubtedly the financial crisis and subsequent recession raised the profile of these investors and demonstrated the advantageous characteristics of this source of capital. From perhaps a mildly sceptical political and financial community pre-crisis, sovereign investors are now far more actively courted by governments, institutions and enterprises alike. This change in perception is welcomed and will surely positively impact the range of investment opportunities available to sovereign investors in the future. Many sovereign investors also appreciated the risks inherent in the crisis and reacted via the measured adjustment of asset allocations and further developing risk management capabilities. This should prepare funds well to capture a balanced return on further positive momentum in the economic cycle and boost their ability to cope with future volatility and challenging times.



Africa – an emerging destination for SWF and PE Investments

"There are US$93 billion of infrastructure investments required annually by 2020 for Africa to meet the UN's Millennium Development goals (Source: Africa Infrastructure Country Diagnostic dated 2013). This represents valuable opportunities for cash rich investors looking at medium to long term investment horizons."



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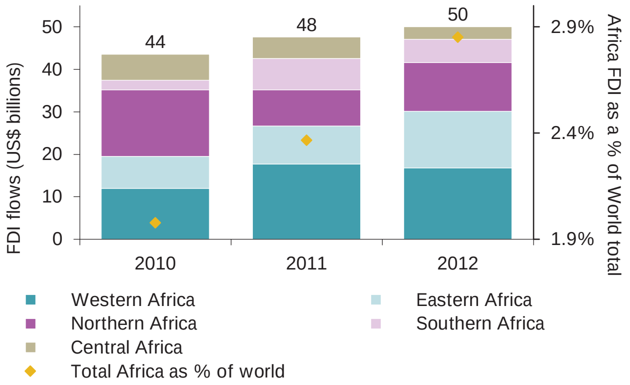
Introduction

According to UNCTAD's annual survey on investment trends, foreign direct investment (FDI) flows into African nations increased 5% during 2013, surpassing US$50 billion p.a. It is interesting to note that this growth took place at a time when global FDIs reduced by approximately 18% over the same period. In the wake of decelerating growth in China, Brazil and India, global investors are warming up to the prospect of investing into Africa. Not surprisingly, we have seen Private Equity firms and SWFs, both globally and in the MENA region, increasing their focus on Africa (particularly Sub Saharan Africa) which is increasingly viewed as a destination of growth and value. While we refer to Africa as "one" in this article, it is easy to forget that the continent comprises of five regions and over 55 countries, each with its unique opportunities and challenges.

Africa's Foreign Direct Investment flows



Source: UNCTAD World Investment Report 2013

- **Eastern Africa:** Energy resources, such as the recently discovered gas reserves in Tanzania and oil fields in Uganda, have driven increased FDI.
- **Western Africa:** FDI continue to be primarily channelled to Nigeria and Ghana for oil and gas related investments.
- **North Africa:** FDIs during 2012 increased 50% on prior year following improvement in political stability across a number of key economies.
- **Southern Africa**: FDI has increased, driven primarily by Mozambique where inflows have more than doubled owing to the nation's large off-shore gas reserves.
- **Central Africa:** FDI have historically been attracted by natural resources, in particular mining opportunities in the Democratic Republic of Congo.

While there appears to be many factors at play, this article discusses some of the key factors driving investment into Africa and the key challenges which remain for investors.

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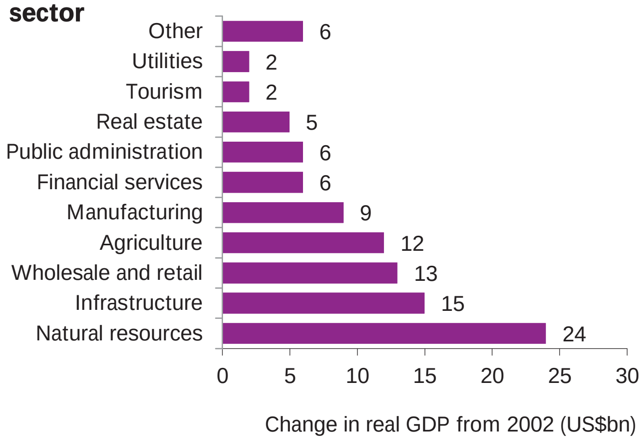
Key sectors of growth

Africa's GDP growth since 2002 - by sector



Source: The Africa Competitiveness Report 2013 - World Economic Forum

Given Africa is amongst the world's richest continents in terms of known mineral wealth, it is only appropriate that natural resources are the largest contributors of GDP growth, contributing US$24 billion in real GDP since 2002.

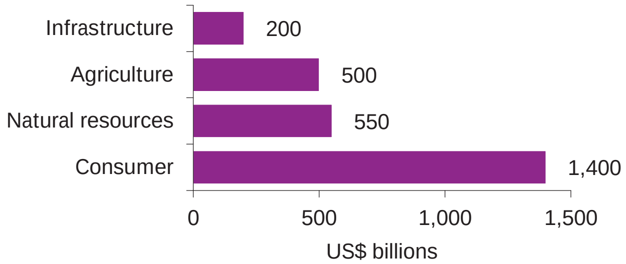
In view of Africa's annual infrastructure spending needs of c.US$93 billion p.a. (Source: Africa Infrastructure Country Diagnostic dated 2013), it is also unsurprising that infrastructure is the second largest contributor of GDP growth since 2002 of US$15 billion (Source: The Africa Competitiveness Report dated 2013), representing Africa's increased focus on improving transport and telecommunication networks.

Amongst others, emerging sectors include wholesale and retail (driven by a growing middle class), agriculture (60% of global uncultivated arable land is found in Africa, Source: Standford FSE), manufacturing (a by product of improvements in human and IT capital) and financial services (follows a period of economic resilience and increased investment).

At a time when Europe continues to implement austerity measures and the US economy comes to terms with rising national debt, the emerging African economy had demonstrated a certain level of resilience.

With an average real GDP growth of 5% during the last three years and one-third of Africa's countries having real GDP growth rates of more than 6% during 2013, the size of the African economy had more than tripled since 2000 (Source: Africa Attractiveness Survey 2013).

Projected revenue growth to 2020



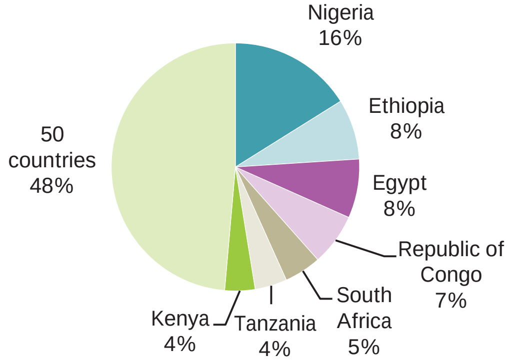
Source: The Africa Competitiveness Report 2013 - World Economic Forum

Evolving legal and regulatory environment

The continent's legal and regulatory environment is in the early stages of its development. That said, there has been a marked improvement in the establishment of necessary frameworks, particularly in the financial services sector. During the past decade, African policymakers have undergone a process of modernising legal and regulatory structures so as to establish more harmonised measures, encouraging greater inter-continental and international investments.

Demographics and improving human capital

Africa - population snapshot by country

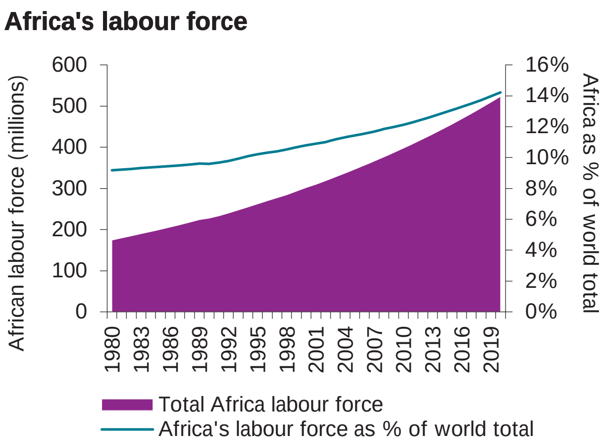


Source: The Africa Competitiveness Report 2013 - World Economic Forum

While differing regulations across African markets remain, regulators continue to align and strengthen measures across the continent in key sectors. This has created a platform for higher economic growth in Africa and is likely to pave the way for greater investments in the medium to long term.

The region's economic prosperity is complimented by an increasing 'middle class' which have more than tripled in population during the last 30 years (Source: African Development Bank). Defined as those earning between US$2 and US$20 a day, the World Bank predicts Africa's middle class to grow from 355 million (34% of Africa's population) in 2010 to 1.1 billion (42% of the population) by 2060, making it the world's fastest growing middle class. The continent's growing consumer class is central to its economic fabric and fuels Africa's strong appetite for basic infrastructure, natural resources, agriculture as well as consumer goods.

Traditionally Africa has been viewed as a geographic and economic link between Europe and the Middle East. However, owing to its strong demographics, large and growing population, and high growth potential, the continent is quickly gaining traction with large investors (SWFs and Private Equity alike) as the new emerging market and destination for investment. The abundance of natural resources as well as human capital bodes well for cash rich and opportunistic global investors given the relatively untapped disposition of Africa's resources. From KPMG member firms' experience, a growing number of investors are keenly looking at countries with a large population (such as Nigeria and Egypt) due to the sheer market size, and therefore, opportunities it presents.



Source: UNCTAD World Investment Report 2013

In KPMG member firms' experience, not only is the African economy on the agenda for regional investors but so too is the hiring of African employees. Investment houses pride themselves on having a local reach and deep understanding of markets. The African human capital market remains nascent and is considered by many to be in the early phases of its development life cycle compared to regions like the Middle East. That said, there has been considerable improvement in the continent's offering as an increased number of Africans are becoming technically equipped through higher education and training at foreign institutions. Given Africa's rapid population growth and hence competitive job market, hiring costs and employee wages are far lower in the continent compared to financial hubs around the world, which can prove to be a significant competitive advantage.

Improved political environment and reforms

Unrest has paved the way for reform and cautious optimism. The region is gradually being opened up to PE investment. As politically volatile countries continue their transition to a relatively stable political environment, we are noticing a pick up in investment activity. The drop in investment and fund raising activity in response to the unrest was only ever likely to be a temporary position as the overall demographics of the region remain strong and robust. Consumer markets are poised to grow as industries and regional businesses expand into new territories, both within and beyond Africa. By and large, in addition to natural resources and consumer goods, infrastructure is viewed as a key sector of growth. According to the Africa Infrastructure Country Diagnostic dated 2013, there are US$93 billion of infrastructure investments required annually by 2020 for Africa to meet the UN's Millennium Development goals. This represents valuable opportunities for cash rich investors looking at medium to long term investment horizons.

SWFs – venturing into Africa

African SWFs still in their formative years

The recently established sovereign wealth funds of Nigeria (US$1 billion), Ghana (US$100 million) and Angola (US$5 billion) are among the smallest in the continent, behind oil producers Algeria (US$77 billion) and Libya (US$65 billion) (Source: Financial Times, October 2013).

While the trend of managing wealth through SWFs is encouraging and opens a new chapter of investment management for Africa, the continent will need to make and demonstrate significant advancement (particularly around governance) before it becomes home to any of the world's largest SWFs.

Africa – on the investment agenda for large SWFs

Although Africa is yet to be home to any of the world's most prominent SWFs any time soon, the continent has been on the investment agenda of some large Middle Eastern and Asian SWFs for quite some time now. Not least because Africa remains underinvested, despite the numerous opportunities, and the investment potential of SWFs remains largely unexploited.

With Middle Eastern SWFs in particular continuing to benefit from government surpluses and increased contributions, and returns in the bond market remaining low owing to the interest rate environment, it comes as no surprise that SWFs are turning their focus to higher-yielding assets in emerging markets such as Africa.

While investment objectives have certainly changed (including geographical and sector focus), diversification remains a key and common objective for Middle Eastern SWFs as countries in the region seek to reduce their reliance on energy, oil and gas prices.

Key sectors of focus for SWFs investing in Africa

The African equity markets have demonstrated strong performance over the past 12 months. SWFs are increasingly viewing economic fundamentals underpinning Africa's recent performance as potential drivers of long term sustainable growth.

Based on member firms' experience, SWFs have historically been keen to build strategic asset allocations rather than investing according to short-term tactical views. This is likely to result in SWFs focusing their investment efforts in Africa towards alternative assets and increasing their appetite for private equity, real estate, agriculture and infrastructure investments. In addition, this is likely to enhance liquidity into Africa's local and regional debt and equity markets.

UAE – a key gateway for Africa

Most recently, the UAE (home to the third largest SWF in the world) played host to the inaugural West Africa Investment Forum in Dubai, welcoming the heads of state of six member countries of the West African Economic and Monetary Union (UEMOA).

The Forum proved to be a success with market estimates of African countries securing commitments worth US$19 billion from UAE investors across numerous infrastructure projects to invest in roads, railways and airports (Source: Khaleej Times).

This followed a US$300 million investment by ICD (a UAE based SWF) in West Africa, and is expected to pave the way for future investments as economic linkages between the Middle East and Africa continue to intensify. Currently, according to market estimates, various Gulf entities together have more than US$30 billion in investments in Africa (Source: Zawya).

What do SWF investments mean for Africa?

The ICD investment in West Africa is seen as the beginning of more investment flows from the UAE and GCC into that region. SWFs may well prove to be good investors for Africa given their long term investment horizons, and relatively stable funding.

According to a study by the OECD, SWF investments may be crucial for African countries to meet the Millennium Development Goals in the build up to 2020.

SWF investments can serve long-term development goals, by bringing long-term and stable funding that is generally lacking in other investors. They can thus invest in illiquid and long-maturity assets that other institutional investors, such as private sector funds, cannot.

However, there remain specific barriers to SWF investments in Africa. Some of them are structural (fragmentation of markets, low sovereign ratings and weak regulatory framework amongst others) requiring long-term changes, whereas others require shorter term adjustments. We discuss barriers to entry more generally opposite.

Key challenges

While Africa certainly presents a significant opportunity to foreign investors, there remains a number of challenges which need to be appreciated before exploring the investment opportunities in the region:

Political environment: While generally improving and stabilising, political instability and volatility remains in a number of key economies which raises concerns over investor protection, enforcement of contractual terms, transparency and abidance to rules and regulations (the term "facilitation payments" is all too common). This increases the perceived political risk, making it more difficult for global investors to deploy funds.

Local relationships: When investing into Africa, there appears to be no substitute for having skilled and experienced people on the ground. Building relationships and forging alliances with domestic investors and regulators is absolutely key for a successful execution. Foreign investors should be prepared to invest in their own local teams in order to capture this critical local expertise and contacts. Furthermore, quite often commercial interests have to be aligned with strategic interests of local players.

Information limitations: Information asymmetry and lack of a proven track record in these geographies makes investor decisions more challenging. As with many emerging economies, quality data is hard to come by and therefore, difficult to get an accurate understanding of investment opportunities, markets and competitive landscape.

Once a presence has been established, an investor needs to be aware of the ongoing challenges including:

Close and regular monitoring of investments: Given the nature of the market and unique risks that businesses in Africa are subject to (from bribery/corruption to embezzlement), investments require close and regular monitoring before, during and after acquisition. Related to the point made above, having a trusted and experienced local presence and team on the ground is crucial.

Limited Successful exit strategies: Some of the traditional exit avenues are not necessarily available or applicable to investments in Africa. Given the regional stock markets are small / nascent and IPOs not prevalent, investors will need to carefully assess, plan and execute exit strategies. Trade and strategic sales are most prevalent and the likely route to disposal across most industries.

Conclusion

Africa is a large and diverse continent which offers a lot of opportunity and avenues for FDI. With mineral wealth, strong demographics, increasing middle / consumer class and improving political and regulatory environments, we expect Africa to continue to attract the interest of international investors.

However, with opportunity comes challenges and Africa is no exception to this. It is clear that there is no substitute for having expertise on the ground. Those looking to invest into the continent must be prepared to invest into their own teams and expertise. Relationships are particularly important and, therefore, an investor needs to demonstrate a commitment to creating and growing relationships which can take time (and investment holding periods may be longer as a result).

The continent does remain somewhat volatile. Once a presence has been established, an investment will require close and regular monitoring. In addition, some traditional exit avenues may not be open (e.g. IPO) and, therefore, there is a greater dependence on strategic exits which require careful planning and execution.

Shifting sands: Middle Eastern SWF investment in Europe

“European assets have long been a mainstay of Middle Eastern sovereign wealth funds’ portfolios as their government owners have sought to diversify away from oil. From the explosion of hydrocarbon prices in the mid-2000s until 2011, sovereign funds from oil-rich Arab countries poured money into Europe. Even during the financial crisis and the subsequent Euro zone credit crunch, they held onto their major European assets, taking advantage of their long-term investment horizons to ride out the downturn and seek out undervalued assets in the region.”

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Shifting Sands: Middle Eastern Sovereign Wealth Fund Investment in Europe

European assets have long been a mainstay of Middle Eastern sovereign wealth funds' portfolios as their government owners have sought to diversify away from oil. From the explosion of hydrocarbon prices in the mid-2000s until 2011, sovereign funds from oil-rich Arab countries poured money into Europe. Even during the financial crisis and the subsequent Euro zone credit crunch, they held onto their major European assets, taking advantage of their long-term investment horizons to ride out the downturn and seek out undervalued assets in the region.

But in recent years these funds, like other investors looking for yield, have turned their attention to emerging markets. In particular they've looked to Asia, where rising demand from China is driving secular growth. As a result, these funds are now looking for different kinds of European assets. They're no longer investing in manufacturing and technology companies that will provide high returns but in real-return investments like prime real estate and infrastructure, which protect their portfolios from inflation.

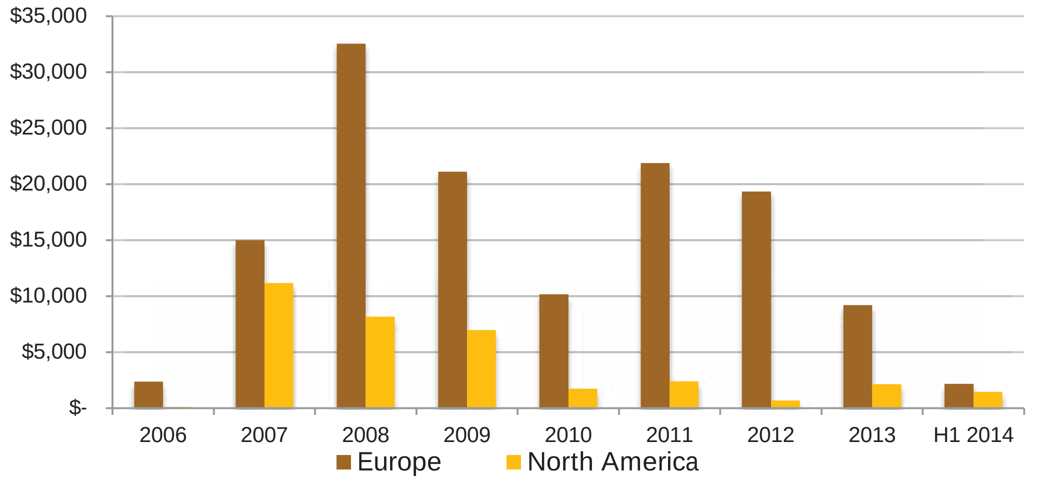
Gulf Sovereigns and Europe: Historic Ties

Sovereign wealth funds from the Arabian Gulf, such as the Abu Dhabi Investment Authority (ADIA) and the Kuwait Investment Authority (KIA), have traditionally been relatively risk-averse investors, concentrating on investment-grade sovereign bonds, prestige commercial real estate, large-cap listed equities and other safe-haven assets in developed markets.

European capital markets have long been the mainstay of their portfolios. This is partly for historical reasons. Many sovereign fund executives were educated in Europe and are well connected to the commercial worlds of London, Paris and Zürich. Moreover, given the UK's colonial history in the Arabian Gulf, the Middle Eastern countries have long managed their excess reserves in London, making Europe an obvious starting point for portfolio diversification.

> "In 2007, Middle Eastern sovereign wealth funds directly invested US$14.3 billion in Europe, a 650 percent increase over the previous year."

European markets have also been more open to Middle Eastern capital than the US. The region's sovereign wealth funds have been wary of negative US public sentiment toward investment from the Gulf in the wake of the September 11, 2001, attacks and the DP World controversy in 2006, when Dubai's state-owned ports operator had to sell six US ports after its acquisition of UK shipping company P&O in the wake of a public backlash. The Abu Dhabi Investment Council, for example, was the subject of considerable public opprobrium in the US following its acquisition of a majority stake in New York's Chrysler Building in 2008. Europe's tax regimes until recently have also been more favorable to foreign investment. For example, KIA sold its direct US real estate holdings in the early 2000s for tax reasons, only re-entering the market in 2011. Between 2006 and 2013 the total value of Middle Eastern sovereign funds' direct investments in Europe were on average four times greater than similar allocations to the US and Canada.



Source: Institutional Investor Sovereign Wealth Center.

The Mid-2000s Oil Boom

Investment from Middle Eastern sovereign wealth funds first started flooding into Europe in 2006. As oil prices skyrocketed and rapidly rising reserves risked generating severe inflationary pressures in a region where currencies are pegged to the US dollar, Middle Eastern governments became more eager to invest their surpluses abroad.

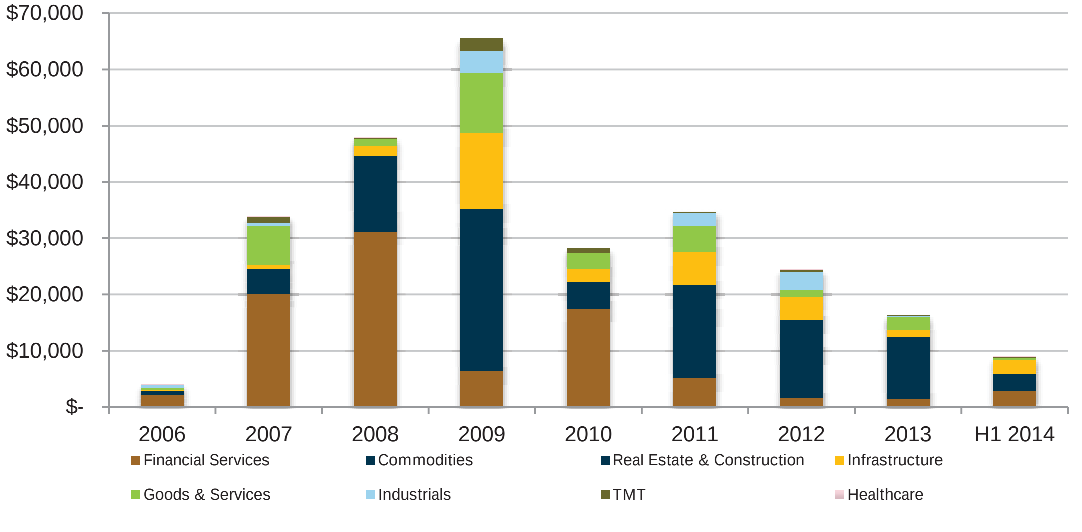
They came up with two solutions. First they expanded the mandates of existing investment vehicles like International Petroleum Investment Co. (IPIC), which had previously invested to develop Abu Dhabi's oil and gas sector, to include diversifying the Emirate's assets. In 2009, IPIC acquired local investment house Aabar Investments and used the firm to purchase stakes in European companies such as German automaker Daimler, the Swiss private banking arm of US insurance giant American International Group and Vienna-based oil and gas multinational OMV.

The second solution was establishing new sovereign investment vehicles. Countries like Qatar established their first funds, whereas Abu Dhabi and others set up additional vehicles to complement existing ones. New funds such as the Qatar Investment Authority (QIA) were less cautious than their older peers: instead of investing passively or through asset managers, they pursued direct investment strategies that raised their public profile. Europe, and particularly the UK, became their focus as they boosted investment volumes and competed for assets.

In 2007, Middle Eastern sovereign wealth funds directly invested US$14.9 billion in Europe, a 630 percent increase over the previous year. Almost half of this total (US$6.4 billion) arose from a bidding war for the London Stock Exchange Group and Nordic exchanges operator OMX between Borse Dubai, owned by the Emirate's sovereign wealth fund, and Qatar Holding, the direct investment arm of QIA. The Qatari sovereign fund spent a further £2.4 billion (US$4.9 billion) on purchasing a 26 percent stake in British supermarket chain J. Sainsbury.

Also, IPIC and Mubadala Development Co., another Abu Dhabi sovereign fund, sought to invest in Europe to bring manufacturing knowledge and technology back to the Arabian Gulf. As part of its US$2.7 billion investment in Daimler, IPIC insisted on developing new automotive technologies with the aid of California-based electric car manufacturer Tesla Motors, in which Daimler is a major shareholder. Similarly, Mubadala invested in Swiss aeronautics company SR Technics as part of its drive to build an aerospace hub in Abu Dhabi, a strategy that also saw it create an alliance with UK aircraft engine maker Rolls Royce.

Middle Eastern Sovereign Wealth Fund Direct Investment in Europe 2006- H1 2014



Source: Institutional Investor Sovereign Wealth Center.

The Financial Crisis

The bailouts of US financial institutions by Middle Eastern sovereign wealth funds in 2007 and 2008 dwarfed those of their European counterparts. However, European institutions also benefited from Middle Eastern sovereign fund capital. IPIC and QIA injected a combined £7.6 billion into British bank Barclays in 2008, while the Qatari fund boosted Swiss lender Credit Suisse Group's balance sheet by Sfr4.9 billion (US$4.4 billion) that year alongside investors including Saudi Arabian conglomerate Olayan Group. Two years later, Aabar bailed out struggling Italian lender UniCredit Group by acquiring a 5 percent stake in the firm for €1.8 billion (US$2.2 billion).

The Middle East's sovereign funds also used the financial crisis to invest counter-cyclically in Europe, capitalizing on dislocations between market values and their underlying assets. QIA purchased stakes in German automotive companies Porsche Automobil Holding and Volkswagen ahead of their ultimately aborted merger, IPIC bought 37.5 percent of Spanish oil producer Compañía Española de Petróleos (CEPSA), and the State General Reserve Fund of the Sultanate of Oman invested heavily in Eastern European retail and real estate.

IPIC and Bahrain Mumtalakat Holding Co., the island kingdom's sovereign fund, took advantage of the global shortage of capital to buy into Formula One motor racing. The governing body of Formula One granted Abu Dhabi and Bahrain grand prix events as European-based teams struggled to raise funds for a notoriously expensive sport. IPIC's Aabar bought a 30 percent stake in new F1 team Brawn GP in 2009; Mumtalakat, which had already purchased 30 percent of UK-based McLaren Group in 2007, provided another capital injection two years later by boosting its position to 42 percent of the company's equity.

The onset of the European credit crisis in 2010 put a brake on sovereign wealth fund allocation to the region as uncertainty about the future of the Euro zone made long-term bets risky. That year Middle Eastern sovereign funds' direct investment in Europe fell to just US$10.2 billion from US$21.1 billion the previous year, its lowest level for half a decade; QIA's purchase of London department store Harrods for £1.5 billion from Egyptian businessman Mohamed al-Fayed accounted for almost a quarter of that value.

As uncertainty became the new normal in 2011, Middle Eastern sovereign funds returned to the market to pick up assets on the cheap and made direct investments in Europe totaling US$21.9 billion during the year, primarily driven by IPIC and QIA's allocations to commodity companies. IPIC bought all of the shares in CEPSA that it didn't already own for €5.6 billion, while its subsidiary Aabar purchased 1 percent of Swiss commodity trader Glencore International at its London initial public offering for US$850 million. QIA acquired 6.2 percent of Iberdrola, another Spanish electrical utility, for €2 billion and 2 percent of French oil company Total for €1.4 billion.

Moving Into the Future

Since 2011, however, Middle Eastern sovereign wealth funds have shifted their focus in Europe. Previously they tended to invest in engineering, technology and consumer-facing companies that would have been considered growth drivers in a portfolio. As the global economy has recovered and economic power has shifted eastward, they've been looking for rapid growth and new technologies elsewhere. Europe now provides them with real-return assets such as prime commercial properties, luxury hotels in London and Paris, and established infrastructure assets with strong capital appreciation and rental incomes that protect their portfolios against inflation. In 2013, real estate investments accounted for US$10.8 billion, 91 percent of Middle Eastern sovereign wealth funds' investment in Europe. The largest investment made by a Middle Eastern sovereign fund into a European company was the Abu Dhabi Investment Council's approximately US$240 million commitment to Platform Acquisition Holdings, a London-listed cash shell founded by American businessman Martin E. Franklin and German financier Nicolas Berggruen to acquire a portfolio of specialty-chemical companies; the company redomiciled in the US following its buyout of Denver-based chemical manufacturer MacDermid.

This shift is striking because it suggests that Middle Eastern sovereign funds see Europe's position in the world economy changing. London and Paris are still places where companies do business — they need swanky offices and plush hotels for visiting executives — but innovation and growth now come from elsewhere. For example, as the US economy recovered last year, Middle Eastern sovereign fund investment in the country climbed to US$1.7 billion from just over US$665 million in 2012. Even more-conservative players like KIA have allocated heavily to Asia to benefit from Chinese economic growth. So although European assets will remain important to Middle Eastern sovereign wealth fund portfolios, they'll play a different role than they did before 2011.

Sovereign wealth funds and Tax

> "At a time where SWFs are managing US$6 trillion (Sovereign Wealth Fund Institute) of the world's assets and striving to reassure the public globally of their integrity, reports of tax minimization can materially undermine the longevity and prosperity of the projected returns for the particular asset."

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Steve has served as Lead Tax Advisor for various high profile clients on secondary market transaction deals in Australia.

Introduction

Sovereign Wealth Funds manage over US$6 trillion worth of assets worldwide[(1)]. In 2013 alone, SWFs engaged in over 300 investments valued at approximately US$60 billion[(2)]. As the growth of SWFs continues and competition for global assets intensifies, the tax implications for SWFs are more significant now than in the past.

This article will explore the trends in sovereign immunity, and examine the current developments in EU withholding tax reclaims. Within that context, this article discusses the tax environment after the recent OECD Base Erosion and Profit Shifting ("BEPS") Action papers, and consider the potential tax risk framework's that SWFs should operate within.

Sovereign Immunity

Broadly, the doctrine of sovereign immunity exempts a sovereign from taxation when operating in another country. While sovereign immunity is not available in all jurisdictions, it does exist and operate in key investment markets. Countries such as the US, UK, Australia, and France all have sovereign immunity rules, and are also key investment markets for real estate and infrastructure. However, the applicability of the doctrine is multifarious. For some countries, sovereign immunity manifests itself judicially, while in other countries it is prescribed by statute. As such, the threshold to obtain sovereign immunity is far from uniform, and must be assessed on a jurisdiction-by-jurisdiction basis.

In recent times, foreign jurisdictions have reconsidered the breadth of sovereign immunity. In Australia for example, the government recently ruled out potential changes to the tax law which would have introduced income tainting rules in relation to commercial income derived by SWFs[(3)]. Australia is now undergoing administrative review of the doctrine, with the aim to achieve a more predictable and consistent treatment of sovereign immunity.

Similarly, the United States is proposing to implement changes to the *Foreign Investment in Real Property Tax Act* that will exempt non-US pension funds from tax on real estate investments. While it is unclear as to whether SWFs will obtain the same tax treatment, this could provide SWFs with a renewed opportunity to invest in the US property market.

With different jurisdictions adopting different approaches to sovereign immunity, it is pertinent for SWFs to consider tax exemptions available when deciding whether to invest in a foreign country.

1. *Sovereign Wealth Funds Surpass 6 Trillion in Assets | Sovereign Wealth Fund Institute. 2014. Sovereign Wealth Funds Surpass 6 Trillion in Assets | Sovereign Wealth Fund Institute. Available at: http://www.swfinstitute.org/swf-news/sovereign-wealth-funds-surpass-6-trillion-in-assets/. Accessed 30 April 2014.*

2. *Sovereign Wealth Fund Transaction Database | Sovereign Wealth Fund Institute. 2014. Sovereign Wealth Fund Transaction Database | Sovereign Wealth Fund Institute. Available at: http://www.swfinstitute.org/tag/sovereign-wealth-fund-transaction-database/. Accessed 23 April 2014.*

3. *Australian Government Consultation Paper, Greater Certainty for Sovereign Investments,(November, 2009).*

4. *ATO ID 2002/45*

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Country	Application of the doctrine	Active/Passive Income	Available for controlled entities?
US	The United States provides an exemption for qualified income of foreign governments pursuant to section 892 of the Internal Revenue Code. Broadly, this includes current income and capital gains from US securities, bonds and other financial instruments.	Passive.	Yes
UK	All income and gains that are beneficially owned by the government of a non-UK sovereign state are exempt from direct taxes under the sovereign immunity rules. Approval is required by HMRC confirming sovereign status.	Passive. Commercial income could be covered upon application to UK tax authorities.	No
Australia	Sovereign immunity applies to any income that is derived from a foreign government when governmental functions are carried out in Australia[4]. Application for a private ruling to the ATO is required to confirm whether the income is exempt from income and withholding taxes.	Passive.	Yes.
France	The French Tax Code provides an exemption from French withholding tax for dividends paid by French companies to foreign states or foreign public institutions. The exemption only applies if the investment is not a direct investment (unless approved by administrative authority), and the securities are held in registered form, or through a credit institution located in France.	Only applies to dividend, interest, and capital gains.	No, generally.

EU Claims

Sovereign Wealth Funds who hold portfolio interests in EU Member States may be able to file reclaims for dividend withholding tax paid on their European investments.

Article 63 of the Treaty on the Foundation of the European Union ("EU Treaty") prohibits any restriction on the movement of capital between Member States, and third countries[5]. This however, has not stopped EU countries from imposing withholding taxes on non-resident investors.

Over the past 6 years, a number of cases before European Courts have extended the operation of Article 63 to investors who are non-resident in the EU[6]. In such cases, it has been held that it is contrary to Article 63 for Member States to impose higher withholding taxes on dividends paid to non-residents when compared to resident investors[7]. In light of these decisions, the Netherlands is currently processing reclaims on withholding taxes and a number of other EU jurisdictions are reviewing their position.
It is important that SWFs review the jurisdiction of their foreign investment to determine the materiality of any refunds, and act promptly to avoid any risk of their rights expiring.

5. *Consolidated version of the Treaty on the Functioning of the European Union - PART THREE: UNION POLICIES AND INTERNAL ACTIONS - TITLE IV: FREE MOVEMENT OF PERSONS, SERVICES AND CAPITAL - Chapter 4: Capital and payments - Article 63 (ex Article 56 TEC)*
6. *Fokus Bank (2004), FIM Santander (2012)*
7. *Ibid.*

The New Global Tax Framework

Today's global tax environment is unparalleled with anything in the past. The tax minimisation strategies used by large multinational corporations have infiltrated mainstream media, with reports of 'shareholder revolts' and 'consumer boycotts' at the forefront. For SWFs in particular, this has caused a paradigmatic shift in tax risk management which now not only entails litigation risk, but also reputational risk. At a time where SWFs are managing US$6 trillion of the world's assets and striving to reassure the global public of their integrity, reports of tax minimisation can materially undermine the longevity and prosperity of the projected returns for the particular asset.

> "The introduction of the OECD's Base Erosion Profit Shifting ("BEPS") Action papers further reflects this new approach towards tax minimisation. Broadly, the BEPs project explores the current rules that allow taxable profits to be located in jurisdictions that are different from whether the business took place."

The introduction of the OECD's Base Erosion Profit Shifting ("BEPS") Action papers further reflects this new approach towards tax minimisation. Broadly, the BEPs project explores the current rules that allow taxable profits to be located in jurisdictions that are different from whether the business took place. Underlying the project is the need to preserve the fairness and integrity of the tax system, with the aim to develop instruments to allow domestic governments to preserve their tax base[8].

Tax Risk Management Strategies

The introduction of BEPS re-emphasises the ideological shift towards appropriate and fair taxation of profits. Base erosion and profit shifting have now become a political issue, where royalties, intra-group loans, and interest rates are increasingly being perceived with suspicion by revenue authorities. This new environment therefore necessitates the need for internal tax teams to develop a comprehensive tax risk framework which sets out the acceptable level of risk the SWF is willing to take in its investments.

While a number of SWFs have sophisticated internal tax functions that have developed such frameworks, others have lagged behind. Because SWFs are not homogenous in asset class and invest in various jurisdictions, it is the beyond the scope of this article to detail precisely how SWFs should manage their tax function. It will be suffice to state that the framework must accommodate the following factors:

1. **Jurisdiction** – Tax risk analysis varies across jurisdictions. Some jurisdictions are inherently more litigious than others, while some have different concepts regarding the rule of law.

2. **Asset Class –** With SWFs investing directly into large assets, there is a need to understand the different tax risks that underlie specific asset classes.

3. **Materiality of the investment -** Broadly, the greater the materiality of the investment, the greater accountability the SWF will have towards that foreign government. It is important that the tax risk management framework differs according to the materiality of the investment.

At its core, the framework must be flexible. The jurisdiction, asset class and materiality factor will inevitably vary with each investment the SWF makes, so too will the risk factor. At the same time however, it is largely impracticable to expect an internal tax team to have specialised knowledge across all these factors. The task is even more arduous when SWFs invest via collective investment vehicles, as the need to understand various risk profiles of member investors is critical.

To deal with this capacity constraint, the SWF should have a team of external advisers to assist the deals team in their investments. These advisers will work within the framework and provide specialised local advice in relation to the above three factors. It is necessary, however, that the external advisers understand the framework. The absence of this understanding could mean that the advice undermines the acceptable level of risk sanctioned by the framework.

It is therefore the role of the internal tax team to establish the tax risk framework of the organisation and the procedures to be adopted in managing those risks. It is for the external advisers to understand the tax risk framework, and provide their advice within that framework.

Whilst the advisers should generally deal with the deals team directly, to the extent that an investment poses a material tax risk for a SWF, this should be brought to the attention of SWF internal tax teams.

Conclusion

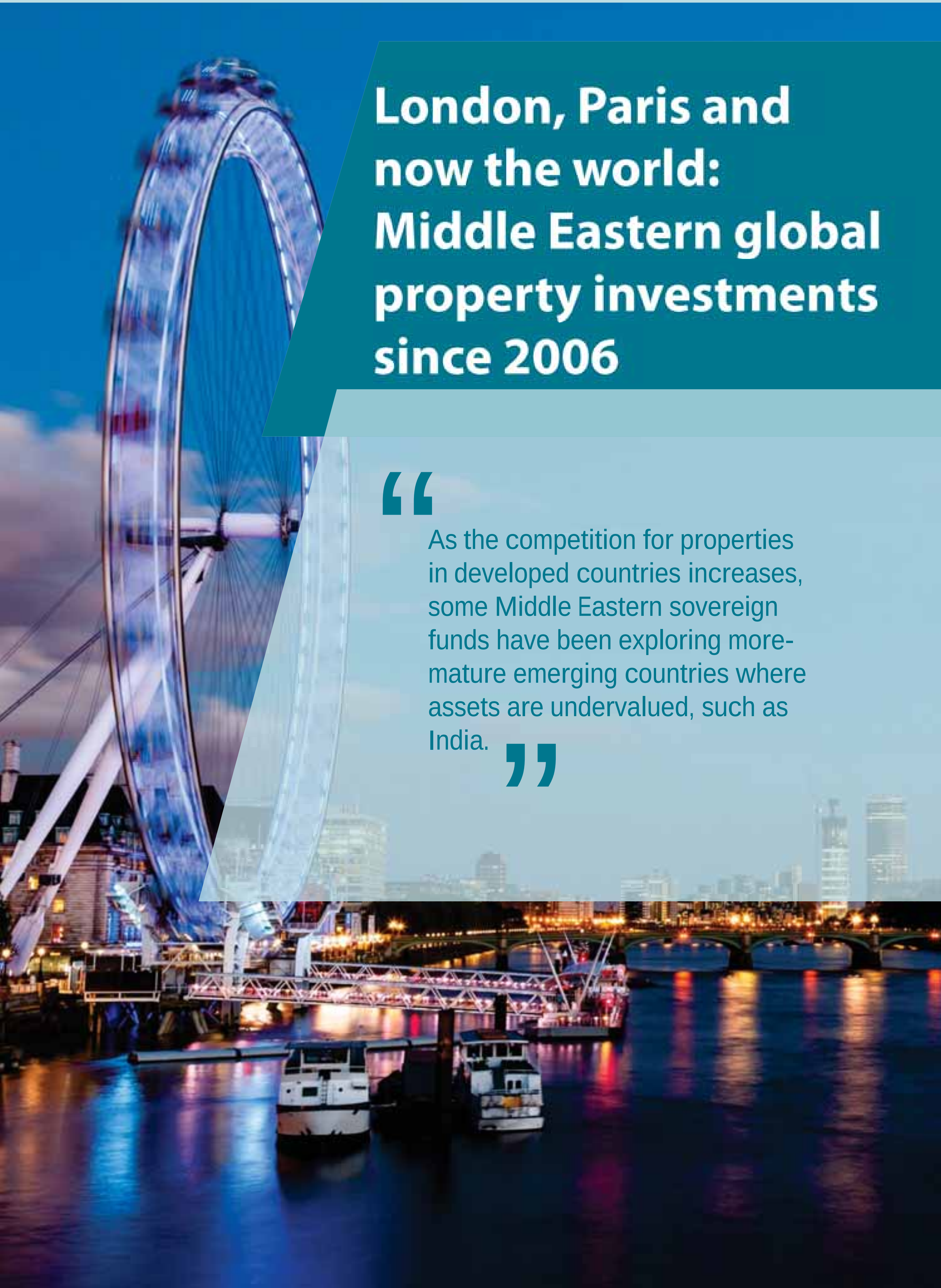
The global tax environment is changing: sovereign immunity has been revised, and EU countries are processing reclaims for WHT. However at a more strategic level, the interplay between tax minimisation strategies and popular media has caused the notion of 'tax risk' to include elements of reputational risk. It is therefore important for SWFs develop a tax risk management framework which is backed by an external panel of advisers, and considers the jurisdiction, asset class, and materiality of the fund's investment.

KPMG member firms have strong track-records of working closely with SWFs with the design and implementation of tax risk frameworks. If you are interested in tailor-made advice for your fund, we encourage you to contact us.

8. *The BEPS Action Papers released to date are available from the OECD website http://www.oecd.org/tax/beps.htm*

London, Paris and now the world: Middle Eastern global property investments since 2006

> "As the competition for properties in developed countries increases, some Middle Eastern sovereign funds have been exploring more-mature emerging countries where assets are undervalued, such as India."



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London, Paris and Now the World: Middle Eastern Global Property Investments Since 2006

Real estate is often the first unlisted asset that sovereign wealth funds acquire as they diversify their portfolios away from stocks and bonds. The Kuwait Investment Authority (KIA) and the Abu Dhabi Investment Board, the forerunner of the Abu Dhabi Investment Authority (ADIA), both started investing in property in the mid-1970s, and newer funds such the Qatar Investment Authority (QIA) have embraced it as an important part of their portfolio.

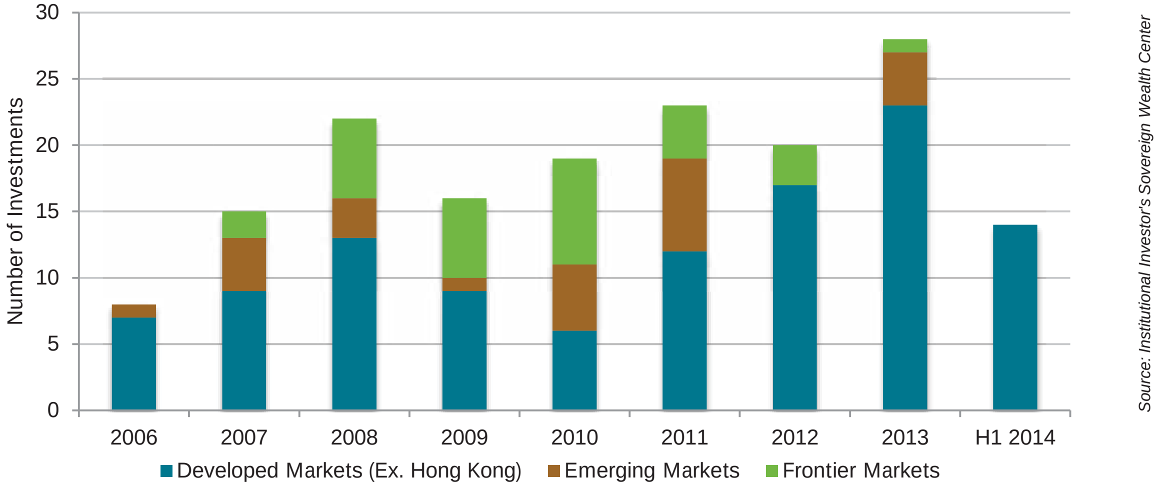
Since 2006, when Middle Eastern sovereign wealth funds started rapidly deploying capital around the globe, these three funds have dominated direct cross-border real estate investments, accounting for 80 percent of the total for Middle Eastern sovereign funds. Although it only launched in 2005, QIA invested US$15.9 billion in foreign real estate between 2006 and 2013 — 40 percent of Middle Eastern sovereign funds combined direct allocation to property abroad during that period — approximately double the US$8.8 billion from ADIA or the US$7.3 billion spent by KIA. Any analysis of how the region’s sovereign wealth funds invest in foreign real estate will largely reflect these funds’ preferences, which largely focus on developed markets.

Developed Markets

ADIA, KIA and QIA favor established real estate assets in developed countries. ADIA and KIA do not tend to invest directly in properties in emerging markets, instead they prefer to gain access to property in the developing world by investing in externally managed funds. QIA, on the other hand, has used its property development arm, Qatari Diar Real Estate Investment Co., to invest more extensively in emerging and frontier markets by undertaking developments in the Middle East and Africa, largely in the hospitality sector. The Qatari fund commenced many of these projects between 2009 and 2011, but has since scaled back its new international projects, to concentrate on building the new city of Lusail just outside Doha.

> “Real estate is often the first unlisted asset that sovereign wealth funds acquire as they diversify their portfolios away from stocks and bonds.”

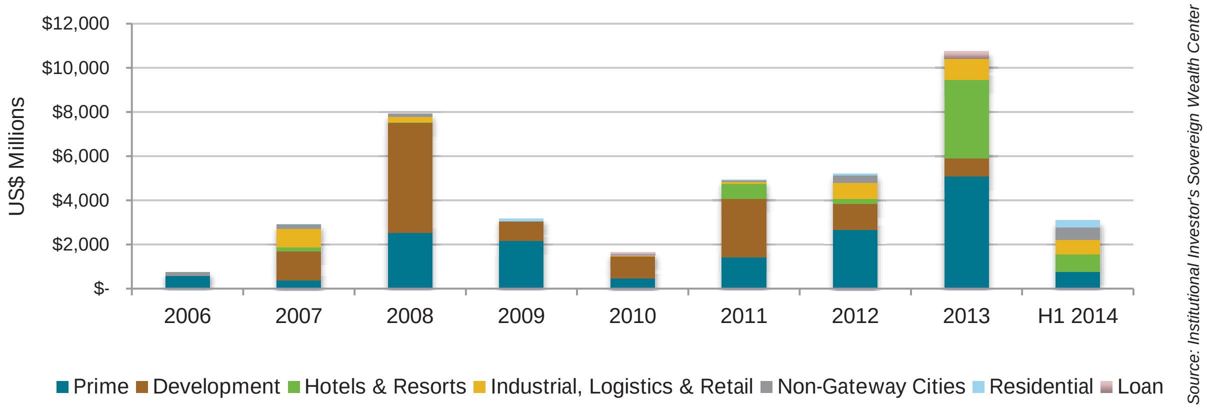
Target Markets of Middle Eastern Sovereign Wealth Funds' Direct Investments in Real Estate 2006-H1 2014



Core Values

Prime office properties in major cities such as London, New York, Paris and Tokyo have traditionally been the focus of Middle Eastern sovereign wealth funds' direct real estate investment strategies. Such so-called core properties benefit from strong rental incomes and capital appreciation over the long term, protecting the funds' portfolios against inflation. Since 2006, Middle Eastern sovereign funds have preferred core property investments in times of economic uncertainty. In 2009, for example, such acquisitions accounted for US$2.2 billion, or 68 percent of the value of their investments in foreign real estate.

Middle Eastern Sovereign Wealth Funds' Direct Investments in Real Estate 2006- H1 2014



But such assets are beginning to lose their luster for Middle Eastern sovereign wealth funds. Over the winter of 2012–'13, low interest rates and growing optimism about the global economy encouraged institutional investors to try to increase portfolio returns by reducing their allocations to publicly traded securities in favor of high-status commercial properties with secure rental incomes in major cities. As competition for premium real estate heated up, valuations rose and yields retreated to pre-crisis levels, on the whole Middle Eastern sovereign wealth funds chose not to buy what they perceived to be overvalued assets.

Even when these sovereign funds do buy core assets, they try to avoid bidding wars. The acquisition of the More London complex by KIA's St. Martins in December 2013 is a case in point. Then-owner London Bridge Holdings, a Bahamas-based company controlled by a group of investors led by Armenian businessman Dikran Izmirlian, planned to put the estate on the market in 2014. But KIA jumped the gun and made an attractive offer while refinancing talks were still in progress, enabling it to lock down a better price.

Avoiding premium assets or taking an inside track to avoid rapidly inflating property prices is a marked contrast to how Middle Eastern sovereign funds handled a similar situation in 2008. Despite valuations rising to bubble-like proportions in major cities, they invested US$2.1 billion in core properties that year, four times their total for 2007. These acquisitions included the Abu Dhabi Investment Council buying a majority share in New York's Chrysler Building and KIA purchasing the Willis Building in the City of London. Each property had a market price of approximately US$800 million.

ADIA Sees Opportunities in Smaller Towns

Since the end of 2012, instead of joining an overcrowded marketplace ADIA and QIA have invested in properties that they perceive to represent better value for money. ADIA has long allocated commercial real estate outside major cities in the UK — for example, it's owned several properties in Reading, England, for more than a decade — but the fund recently started following a similar strategy in continental Europe. In 2012 and in 2013, respectively it acquired the Zuiderpoort office complex in Ghent, Belgium, and large property portfolios in Lyon, France.
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Hotels: Harnessing Spending Power

Another strategy that ADIA has pursued but QIA has positively embraced is purchasing hospitality properties, especially luxury hotels in Europe and the US. Both funds see this kind of real estate as better value than prime commercial properties.

ADIA, which prefers hotels that cater to business travellers, has bought provincial UK and US hotels managed by US-based hospitality giants Hilton Hotels & Resorts and Marriott International. Despite the cyclicality of the hospitality industry, business hotels tend to have consistent revenue streams that are often correlated with economic growth. In 2013, Britain and the US were two of the fastest-growing developed-market economies.

QIA has a different take on the hospitality business. The fund has largely concentrated on plush hotels that provide luxury accommodation for elite travellers, particularly those from the Middle East and Asia. For example, in February 2013, the fund bought four French luxury hotels from Greenwich, Connecticut–based Starwood Capital Group: the Concorde La Fayette and Hôtel du Louvre in Paris, the Grand Hyatt Cannes Hôtel Martinez in Cannes and the Hyatt Regency Nice Palais de la Méditerranée.

> "Smaller and more-conservative funds prefer to access property diversification benefits through privately held funds, real estate investment trusts, as well as listed property management and development companies."

In the past year QIA has also developed a strong relationship with UK-based hotel operator InterContinental Hotels Group, purchasing the InterContinental London Park Lane and entering into a joint venture with the company to redevelop the InterContinental New York Barclay hotel.

Smaller Players

Although ADIA, KIA and QIA account for the majority of international property investments made by Middle Eastern sovereign wealth funds, the region's other state investors are also active in the sector. But rather than invest directly in bricks and mortar, which requires building up internal expertise, smaller and more-conservative funds prefer to access property diversification benefits through privately held funds, real estate investment trusts, as well as listed property management and development companies.

This makes their activities harder to track, but the Saudi Arabian Monetary Agency allocates to such instruments. So does Oman's State General Reserve Fund, which has scaled back its direct property investments since the financial crisis, although it still invests directly where it finds attractive opportunities.

Perhaps the most interesting of the other funds is the Abu Dhabi Investment Council. The Council, which, unlike ADIA, has no liquidity requirements and a long-term investment horizon, invests in a wide range of property assets. Although it's best known for its purchase of the Chrysler Building in 2008, acquiring such high-profile core real estate without a partner has proven to be a relatively unusual move. The Council appears to prefer to partner with industry-leading companies to invest in less-glamorous assets like industrial, logistics and retail properties in developed countries. The fund has also amassed a large portfolio of global real estate fund commitments in developed and emerging markets.

Moving On

To date, the Middle East's major sovereign real estate investors have concentrated on developed markets, particularly core commercial assets. But as competition for properties in these countries increases, some Middle Eastern sovereign funds have been exploring more-mature emerging countries where assets are undervalued, such as India. They may also inject more capital into development projects with trusted partners where the returns are more attractive. Regardless of what property types they favor, real estate will remain a core part of their portfolios.

Sovereign wealth funds and US infrastructure

"Many investors including sovereign wealth and pension funds, have recently displayed a renewed and reinvigorated interest in the US infrastructure market. This is not surprising as infrastructure investments are extremely diverse and span a broad range of sectors including transportation, energy, communications and social infrastructure."

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Dean specializes in tax issues arising in mergers, acquisitions, divestitures and other corporate restructurings for both domestic and inbound/outbound transactions. Dean has over 19 years experience at KPMG's US member firm and several years experience in private industry. Throughout the past 16 years, he has advised on numerous transactions providing both tax due diligence and tax structuring advice for Fortune 100 companies and private equity firms.

An overview of US Infrastructure

The demand for private investment in US infrastructure has existed for several years, but has yet to attract the volume of activity that the market initially anticipated. However, many investors including, sovereign wealth and pension funds, have recently displayed a renewed and reinvigorated interest in the US infrastructure market. This is not surprising as infrastructure investments are extremely diverse and span a broad range of sectors including transportation, energy, communications and social infrastructure, among others. The particular underlying investment can encompass a myriad of assets such as toll roads, court houses, airports, parking facilities, ports, solar and wind projects, biomass facilities, or water treatment plants, to name a few. Further, infrastructure transactions can vary significantly from typical equity style acquisitions to the appealing public, private, partnership or P3 structure. As a result, there is significant opportunity to access a wide spectrum of investment structures and asset classes. In addition, infrastructure investments typically possess very favorable elements to sovereign wealth and pensions fund investors; which are projects that typically enjoy a manageable risk profile, possess long term investment horizons, and contain relatively predicable streams of cash flow.

There is also unprecedented need for investment in this US market sector. It is no secret that the US has a severely aging and inadequate infrastructure. In 2013, the American Society of Civil Engineers (ASCE) graded the national infrastructure a "D+". From schools and ports, to transit and drinking water, many of the infra subsectors could barely achieve a grade level over a D. Undoubtedly an embarrassing grade for a student let alone a nation with the world's largest economy.

The ASCE also estimated that it would take approximately US$3.6 trillion dollars to improve the overall condition at the national level. This staggering amount places an extreme burden on both federal and local governments to obtain the capital required. This begs the necessary question – from where will the essential capital funding for the US's declining infrastructure be derived? President Obama's FY 2014 budget contained only a sliver of the funds needed to address the deficiency in our infrastructure (e.g., US$40-US$50 billion). In addition, many state municipalities and local jurisdictions are fiscally constrained and unable to fund their current and projected liabilities. As a result, with many areas of our US infrastructure being classified as functionally obsolete or structurally deficient, the view towards private investment (particularly in the P3 context) in US infrastructure has increased dramatically.

As background, it is helpful to explore the key differences between traditional infrastructure funding models and the P3 approach to better understand how the latter can provide a powerful source of much needed capital. Traditional infrastructure projects in the US have almost exclusively been funded from governmental sources. The private sector usually acted in a limited capacity, such as a contractor, who would develop the project for a particular fee with no continuing obligation or commitment to the overall project. Such an approach often lead to an emphasis on lowering construction costs to maximize the private sector's profit under the contract without much foresight into the long term maintenance or vitality of the project. These projects often result in cost overruns exceeding budget and a failure to be completed on time. To make matters worse, such inefficiency in contracts and delays was typically borne by the governmental recipient of the project. Furthermore, many times the majority of funding was allocated to new projects at the expense of maintaining and repairing existing projects.

In contrast, the P3 approach seeks to "bundle" the initial investment to include the underlying construction of the project by the private sector with the future maintenance and operation. This creates an overall alignment of incentives and the sharing or off-loading of risk to the private sector investor who has a long term interest in the project. The private sector investor typically has significant upfront investment in the project and receives a return on its investment over a long period of time through user fee revenues or periodic availability payments. This also creates incentives to finish the project on time (or earlier) and on budget since the private sector investor typically starts to receive payments only after completion. Subsequently, after a prescribed period of time, the project would eventually revert back to the control of the municipal or state government.

As one would anticipate, there are a variety of tax issues associated with the P3 and infrastructure investments. To illustrate, let's take a basic P3 concession between the public and private sector for the new construction of a governmental facility. Many of these contractual arrangements are for "DBFOM" services; that is, the private sector concessionaire will be responsible for the design, build, finance and operation/maintenance of the project for the length of the concession period. In return, the municipality will pay periodic payments over the concession term to the private sector investor. As a result of these arrangements, the private sector taxpayer is confronted with numerous tax issues. For example, how is the overall concession agreement viewed for federal tax purposes (e.g., should the agreement be characterized as a lease, should the services be bifurcated)? How should the various costs and expenditures incurred (e.g., construction, financing, maintenance, capital expenditures, etc.) be recovered for tax purposes? In addition, how should the periodic payments, which relate to the various underlying services provided, be accounted for under the tax rules (e.g., which tax accounting methods apply, is there a reimbursement of certain costs, etc.). Further, there is a myriad of state and local tax matters to consider as well, such as franchise/income, gross receipts, sales/use, and real and personal property taxes, to name a few.

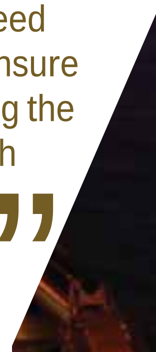
Pension funds and sovereign wealth funds investing in the infrastructure sector will also need to carefully structure their investment into the particular asset. Non US and tax-exempt entities need to consider numerous factors to ensure a tax efficient investment, including the ability to effectively repatriate cash and minimize tax on ultimate exit. One of the critical items to consider is how the overall investment will be funded (e.g., equity, debt, preferred interests). Further, the investor will need to determine whether the investment can qualify for any tax benefits which may reduce the overall effective tax costs. For example, would the investors qualify under a tax treaty or other section of the US tax code (e.g., section 892, portfolio interest exemption, etc.) which may provide substantial tax benefits? To illustrate, qualifying for treaty benefits could lower or eliminate tax withholding on interest and/or dividends distributed from the US in contrast to its statutory rate of 30 percent. Finally, non-US investors must evaluate whether the infra investment will be subject to the US FIRPTA rules (Foreign Investment in Property Tax Act). The FIRPTA rules can create unforeseen US tax filings obligations to foreign investors as well as subject certain gains to US taxation as effectively connected income and seriously diminish returns on an after-tax basis.

As noted above, many investors including pension and sovereign wealth funds have shown renewed interest in the infrastructure sector and its potential opportunities. This interest appears to be fueled in part by the changing economic and political climate. Although the infrastructure market has shown progress during the past several years, the anticipated realization of market potential has been slow. Many feel this has been a result of not only market forces, but the overly cautious and indecisiveness of various US governmental municipalities along with limited support at the national level. Municipalities were hesitant to bind future administrations with long term concessions and many were challenged to fully understand the P3 structure and how the deal could be addressed from a political/constituency perspective.

However, it does appear that the attitude towards infrastructure from a political and legislative perspective is changing. State and local municipalities are more open to P3 projects than ever with many states passing or considering infrastructure legislation. At the national level, there are at least five bills currently working their way through Congress providing a strong indication of a changing attitude in a positive direction. For example, The Water Resources Development Act of 2013 was introduced in the Senate by Barbara Boxer of California (with a similar bill introduced in the House of Representatives). In addition, the Building and Renewing Infrastructure for Development and Growth in Employment Act was introduced in late 2013. Furthermore, there were two bills introduced last year to address the needs for infrastructure financing. Infrastructure has also been named a priority of the current US President. During his most recent State of the Union address, President Obama pushed lawmakers to approve the new funding bills for the nation's roads and ports by "this summer".

Whether any of the proposed legislation will ultimately be enacted is yet to be seen. However, there are several positive factors which are clear when it comes to the infrastructure space which should be highlighted - (1) there is an undeniable need for investment in US infrastructure which cannot be satisfied without private assistance, (2) the investment opportunities are becoming more viable and continue to gain public/private support and (3) with careful tax planning, these investments can provide a tax efficient investment with an ample rate of return.

> "Non US and tax-exempt entities need to consider numerous factors to ensure a tax efficient investment, including the ability to effectively repatriate cash and minimize tax on ultimate exit."



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