

Sovereign Wealth Funds:
Real Estate Partners in Growth?



Sovereign Wealth Funds (SWFs), wholly owned government entities that invest a nation's surplus wealth, made a big splash in 2007 and early 2008 with a broad array of investments in the U.S. banking and financial services sector, along with some notable U.S. real estate investments. Certain of these high-profile transactions seem to be fueling speculation about SWFs' potential long-term effect on commercial real estate. Industry experts have advised that the extraordinary growth in SWFs' capital available for investment opportunities, the current political and business environment, and the combination of certain macroeconomic conditions may be creating an environment for SWFs to adjust their investment strategies.

In contrast to their traditionally conservative, passive investment practices, some SWFs are pursuing interests in partnerships and joint ventures with U.S. real estate firms and investors. This shift to broader and more active investment relationships may require that SWFs pay greater attention to increased political, media and public scrutiny, as well as their need for greater operational transparency. Figure 1 shows a listing of major SWFs and key attributes in their investment approach, including whether they actively or passively manage their investments.

Figure 1: Active vs. Passive SWFs

SWFs are commonly either active investors or passive asset managers (quasi-pension funds) as of March 2008

Top 10 Sovereign Wealth Funds by Assets Under Management (AUM)					
Sovereign Wealth Funds	Assets Under Management (AUM)	Transparency	Autonomy	Active Investors	Passive Investors
Abu Dhabi Investment Authority	\$875B	Low	Medium		ADIA
Government of Singapore Investment Co.	\$330B	Medium	Medium		GIC
Government Pension Fund or Norway	\$300B	High	Medium		GPFN
Kuwait Investment Authority	\$250B	Low	Low		KIA
China Investment Corporation	\$200B	Low	Low		CIC
Temasek Holdings	\$159B	High	High	Temasek	
Qatar Investment Authority	\$50B	Low	Low	QIA	
Alaska Permanent Fund	\$40B	High	Medium		Alaska
Australian Government Future Fund	\$40B	High	Medium		Australia
Libyan Investment Authority	\$40B	Low	Low		Unknown

Source: Reuters, Morgan Stanley

As a consequence of media and political attention surrounding recent, high profile transactions (Figure 2), some SWFs may be moving to increased operational transparency.

Figure 2: Examples of Recent Financial Institution Investments by SWFs

Date Announced	SWF	Target	Target Country	Industry	Amount Invested (\$mil)
Jun-08	Govt. of Singapore	UBS	Switzerland	Financial	\$61.3
Apr-08	Istithmar World	Gulf Stream Asset Mgmt.	USA	Financial	N/A*
Apr-08	Temasek Holdings	Merril Lynch	USA	Financial	\$600
Feb-08	Qatar Investment	Credit Suisse	Switzerland	Financial	\$500
Jan-08	Govt. of Singapore	Citigroup	USA	Financial	\$6,880
Jan-08	Korean Investment	Merril Lynch	USA	Financial	\$2,000
Jan-08	Korean Investment	Citigroup	USA	Financial	\$3,000
Jan-08	Korean Investment	Merril Lynch	USA	Financial	\$2,400
Dec-08	Temasek Holdings	Merril Lynch	USA	Financial	\$4,400
Dec-08	China Investment Corp.	Morgan Stanley	USA	Financial	\$5,000
Dec-08	Govt. of Singapore	UBS	Switzerland	Financial	\$9,750
Nov-08	Abu Dhabi (ADIA)	Citigroup	USA	Financial	\$7,600
Sep-08	Mubadala (UAE)	Carlyle Group	USA	Financial	\$1,350

Source: Securities Data Corporation database

Source: Deloitte Research

*N/A Not Applicable

Although only a few SWFs reveal details about their asset allocations, real estate seems to be a key component of many SWFs' portfolios. For example, several major SWFs disclose that they currently allocate between five percent and ten percent of their assets to real estate.¹ There is evidence that an increase in direct real estate

investments by SWFs is becoming a global reality. The Government of Singapore Investment Corp. (GIC) recently purchased The Westin Tokyo in addition to commercial facilities on Japan's Island of Kyusyu. GIC also holds a five-percent stake in a Japanese Real Estate Investment Trust (REIT) as part of its \$80+ billion global portfolio

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¹ Sunil Rongala, "Sovereign Wealth Funds," Deloitte Research, 2008

of commercial real estate.² Similarly, SWFs are taking larger stakes and more controlling interests via outright property purchases, as illustrated in Figure 3.

Figure 3: Recent SWF Investments in Real Estate

Sovereign Wealth Funds	Target	Country	Investment (\$ Value USD mil or % Stake)	Type	Date
Mubadala Development	Kor Hotel Group	USA	(50%)	Hotel	Sep-08
Dubai World	MGM Mirage	USA	(20%)	Hotel	Aug-08
Kuwait Investment Authority, JV with Boston Properties	125 West 55th St., N.Y.	USA	444	Office	Aug-08
Kuwait Investment Authority, JV with Boston Properties	2 Grand Central Tower, N.Y.	USA	427.9	Office	Aug-08
Kuwait Investment Authority, JV with Boston Properties	540 Madison Avenue, N.Y.	USA	277.1	Office	Aug-08
Dubai Investment Group, JV Kennedy-Wilson	Avalon Bay	USA	81.2	Apt	June-08
Abu Dhabi Investment Authority	Chrysler Building	USA	800	Office	June-08
Boston Property, Meraas Capital, Kuwait Inv. Authority and Qatar Inv. Authority, Goldman Sachs	NY General Motors Building	USA	2,800	Office	June-08
Nakheel Co PJSC (Dubai)	Fountainbleau Resorts	USA	375	Hotel	Apr-08
Mubadala Development	John Buck Co.	USA	(24.9%)	Real Estate	Mar-08
Kuwait Investment Authority	Willis Building	UK	582	Office	May-08
Dubai World	MGM Mirage Inc./ City Center Holdings	USA	2,700	Hotel	Feb-08
Mubadala Development Company, Olayan Group and other unidentified SWFs	Related Companies	USA	1,000	Capital Infusion	Dec-07
Infinity World Investments	Holiday Inn City Center	USA	85	Hotel	Nov-07
State General Reserve Fund (Oman)	Heron Tower (London)	UK	900	Office	Sep-07

Source: Securities Data Corporation Database

Focus on U.S. Real Estate

Recent moves by SWFs into U.S. real estate companies and properties include an investment by Abu Dhabi Investment Authority, in the Related Companies, a U.S. commercial real estate developer,³ and GIC's investment in several U.S. hotel properties.⁴ In early 2008, Kuwait's \$225 billion SWF, the Kuwait Investment Authority, also announced its plan

to invest in real estate companies in the U.S. and Europe to capitalize on lower asset prices.⁵ It has subsequently followed through, and between May and August of 2008, it was involved in four transactions in the U.S. as a joint venture participant, and one in the U.K. in which it was the sole acquirer.⁶ Despite the turbulence in the U.S. and global

² "Sovereign Wealth Funds Emerge as Key Buyers in Slumping REIT Market," *Nikkei Report*, March 6, 2008

³ "Related Receives Dollars 1.4bn Injection," *Financial Times*, December 18, 2007

⁴ Securities Data Corporation database, Real Capital Analytics, 2008

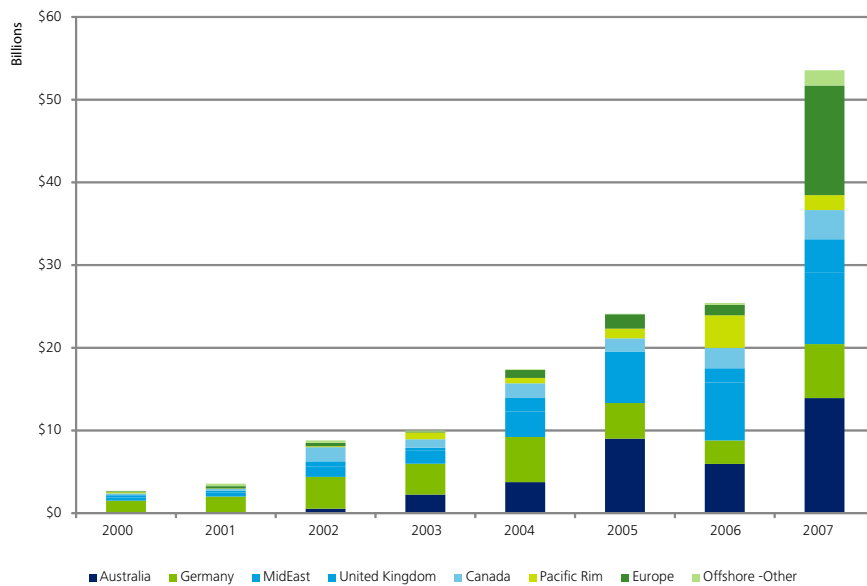
⁵ "Kuwait Fund Seeks Bargains in the U.S.," *Financial Times*, January 2, 2008

⁶ Securities Data Corporation database, Real Capital Analytics, 2008

financial markets that developed in September, 2008, U.S. commercial real estate may have both near- and long-term appeal to SWFs, perceived to be a quality investment in a mature and sophisticated market. Figure 3 demonstrates the increasing size and visibility of SWF investments in U.S. real estate, including a focus on five-star hotel properties and Class A office buildings in gateway cities.

Two recent deals strongly suggest that increased SWF investment in U.S. commercial real estate is fast becoming reality. In June 2008, it was announced that the Abu Dhabi Investment Authority acquired a 75 percent stake in the Chrysler Building for \$800 million.⁷ This transaction came within weeks of the sale of the GM Building and three other Macklowe properties for \$3.95 billion to a group of investors that included Boston Properties, Goldman Sachs and the SWFs of Qatar and Kuwait.

Figure 4: Increased investment in U.S. Real Estate



Source: Real Capital Analytics

⁷ "Chrysler on the Block, Sovereign Arab Fund to Pay \$800m," *New York Post*, June 11, 2008

While there currently is limited data available on the total annual dollar volume that SWFs invest in U.S. commercial real estate, Figure 4, on page 5 shows that the U.S. market seems to have become an increasingly popular destination for foreign direct investment in recent years.

Converging Trends Create Opportunity

Many industry observers believe that U.S. commercial real estate is an attractive long-term investment for SWF managers, and view it as a hedge against currency depreciation with potential for capital appreciation when the markets recover.⁸ Specifically, current economic uncertainty, U.S. REITs trading at a 34.3 percent discount (as of October 31, 2008) to net asset values (NAV), and private equity investors' curtailed activity due to lack of available debt financing, may provide opportunity for SWFs to pursue U.S. real estate investments.⁹

Conversely, other current macroeconomic conditions may be causing a dampening of SWFs' appetite for investing in U.S. real estate. Exchange rate fluctuations which have relatively strengthened the U.S. dollar in the short-term, combined with decreased oil prices affecting some SWFs ability to invest, may have impacted the appeal of U.S. assets in the near-term. In addition, due to the recent market downturn (including significant dislocation in the U.S. Financial Services sector), SWFs are taking inventory of their own needs to balance investment portfolios and address short-term liquidity needs.

Despite the potential for reduced short-term SWF investment activity, the long-term outlook may see SWFs pursuing larger, more active and more strategic U.S. real estate investment opportunities via:

- Joint ventures, co-investments, or "club" deals, either with commercial real estate operators/managers or with private equity investors

- Controlling or non-controlling equity investments in real estate developers and real estate operators (including REITs)
- Development capital commitments to real estate operators and developers to expand platforms domestically and internationally
- Hybrid debt financing or alternate investment commitments to private equity and other real estate investors to fill the void created by the stagnating public and private debt markets (e.g., co-invest, bridge equity, bridge financing, and convertible debt securities).

Several recent transactions may indicate that SWFs are looking to acquire controlling interests and deploy more capital in U.S. real estate firms. Mubadala Development Co., an Abu Dhabi government investment vehicle that manages over \$10 billion of assets, recently purchased a stake in Chicago-based John Buck Co., with which it will develop regional projects in Abu Dhabi. Mubadala's representative stated that it established a real estate firm with John Buck to build projects in Abu Dhabi and across the Middle East. John Buck International, in which Mubadala holds a 51 percent stake, will be based in Abu Dhabi and will focus on real estate development, leasing and management services.¹⁰

In another significant partnering of a SWF with a U.S. firm to develop projects outside the U.S., GIC and U.S.-based Host Hotels & Resorts, Inc. ("Host") have announced a joint venture with up to \$600 million of equity funding to invest in real estate in Asia and Australia.¹¹ (Host is one of the world's largest owners of upscale hotels, with 119 properties and approximately 64,000 rooms.) GIC and Host will employ leverage to build a property portfolio of up to \$2 billion. Host will take a 25 percent stake in the venture while an affiliate of GIC Real Estate will hold the remaining 75 percent. "Combining Host's core skills in hospitality

8 Dave Keating, "State Capitalism," *Private Equity Real Estate*, November 2007

9 SNL Real Estate, accessed on November 6, 2008 http://www.snl.com/real_estate/Sector_Premium-Discount_Nav.asp

10 "Mubadala Joins Forces with Chicago Property Developer," *Middle East Economic Digest*, March 14, 2008

11 Carolyn Cummins, "Singapore Checks in for Hotel Fund," *The Age*, March 27, 2008

investment and asset management and GIC's regional presence and network, we believe that the joint venture is well positioned to build up a substantial portfolio of hospitality-related assets in Asia," GIC Real Estate President Seek Ngee Huat said in a statement.¹²

Although SWFs may have an abundant supply of capital in a market where leverage is increasingly scarce, many seek critical, on-the-ground resources and operational expertise to manage and operate real estate in U.S. markets. Therefore, partnering with established real estate operators and investors may be a logical approach for SWFs to manage risk, build expertise and develop long-term investment relationships. In addition, purchasing a controlling interest in an established real estate firm with a quality track record and a performance-driven management team may provide an appropriate platform for developing expertise and further deploying capital for global investment opportunities.

Regulatory Restrictions and Political Sensitivity

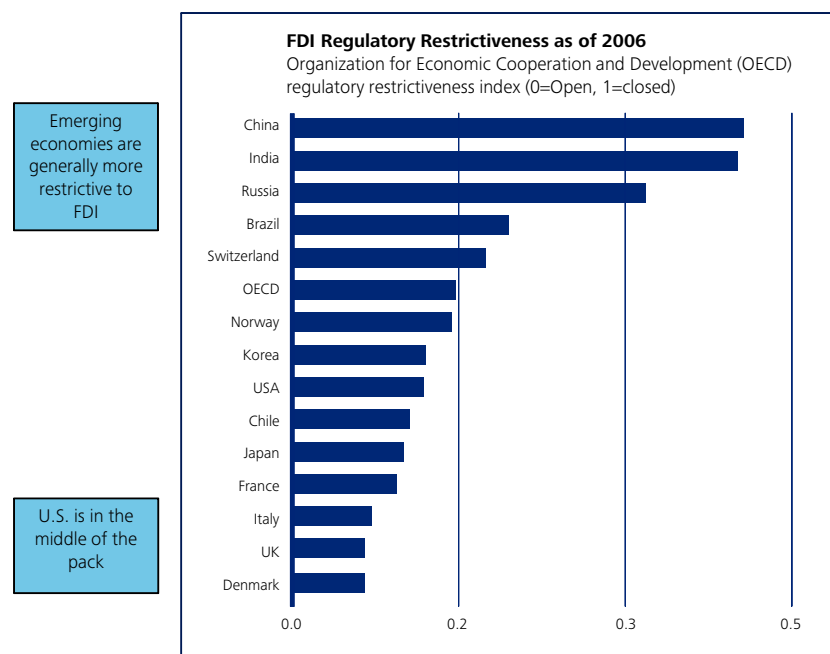
Certain high-profile foreign investments have come under some political scrutiny. Most notably, in 2005, Dubai Ports World announced plans to acquire a U.K. firm, P&O, which had a contract to operate several major U.S. ports, including the ports of Los Angeles, CA, and Newark, NJ. Initial approval of the transaction met with a flurry of grass-root and media objections. In response, certain members of Congress objected to allowing significant points of entry into the U.S. to fall under certain foreign control for a variety of reasons, including the argument that the transaction may have placed strategic assets at risk. Ultimately, Dubai Ports World agreed to divest the U.S. interests of P&O North America, which included the sensitive port operations, to a U.S. entity.¹³

The U.S. government is vigilant in its efforts to protect

the country from foreign control of key industries and assets. In 1975, Congress established the Committee on Foreign Investment in the United States (CFIUS) to monitor and evaluate the effect of foreign investments. As these investments began to increase, Congress enacted the Exon-Florio legislation in 1991. This legislation empowered the United States to act to protect national security and also established a system to support voluntary reviews of foreign deals – usually initiated by the acquiring party – for national-security considerations. For example, the intent to purchase 10 percent or more of a financial services firm with a national charter triggers a Federal Reserve review.¹⁴

While baseline regulations have been in place for years, the United States is just now instituting more comprehensive oversight of foreign investments. In contrast, many other nations already impose restrictions of varying intensity. Figure 5 highlights the regulatory environment facing SWFs as they search the globe for investment opportunities.

Figure 5: Restrictions to Foreign Direct Investments



Source: OECD

12 Carolyn Cummins, "Singapore Checks in for Hotel Fund," *The Age*, March 27, 2008

13 Jim Abrams, "A Year after Dubai Port Deal, Congress Sends Investment Bill to House," *Associated Press*, July 11, 2007

14 "Exon-Florio Legislation," *Sovereign Wealth Fund Institute*, accessed on May 30, 2008 <http://www.swfinstitute.org/research/exonflorio.php>

Note that the U.S. is in the “middle of the pack” relative to the regulatory restrictions imposed on SWFs.¹⁵

The current trend in foreign investment regulation is to encourage the establishment of voluntary guidelines and agreements with specific funds, which generally does not block SWFs’ investments. Many view this as preferable to more rigid guidelines and regulations, which could have the unintended consequence of causing SWFs to look outside the U.S. for investment opportunities. Some SWFs are responding by reshaping their images and internal policies, and by ensuring greater operational transparency. For example, in November 2007, after Abu Dhabi’s investment arm bought a 4.9 percent stake in Citigroup Inc. for \$7.6 billion, Abu Dhabi officials were quick to point out how uninvolved they would be in Citigroup’s day to day management. They would neither receive a board seat nor have any ongoing say in the bank’s operations.¹⁶

On March 20, 2008, officials from the U.S. Treasury, the governments of Abu Dhabi and Singapore, and the SWFs ADIA and GIC met to develop policy principles/leading practices for SWFs, which were detailed in a joint news release issued by Abu Dhabi, Singapore and the United States.¹⁷ The policy principles were established for both SWFs and for countries receiving SWF investment. For example, the policy principles for SWFs extend to ensuring the absence of geopolitical motivation and the requirement for investment solely on commercial grounds, as well as enhanced public information disclosures and internal governance structures by SWFs.

The “Santiago Principles”

In an important recent development, the International Working Group (IWG) of Sovereign Wealth Funds, with the assistance of the International Monetary Fund, promulgated a set of 24 Generally Accepted Principles and Practices (GAPP) for SWFs. These are commonly referred to as the “Santiago Principles,” after the city in Chile where the final drafting took place.

The Santiago Principles, which were made public on October 11, 2008, seek to establish a framework for SWFs that promotes operational independence in investment decisions, transparency and accountability. Twenty-five SWFs participated in the drafting process. The Santiago Principles cover practices and guiding principles in three key areas:

- legal framework, objectives, and coordination with macroeconomic policies
- institutional framework and governance structure
- investment and risk management framework.

The overarching theme for these three areas is to provide assurance to the recipient country about the funds’ investment strategy. An in-depth Deloitte article, “Minding the GAPP: Sovereign wealth, transparency, and the Santiago Principles,” can be found at www.deloitte.com/mindingthegaap.

It should be noted that the Organization for Economic Cooperation and Development is well advanced in the development of a set of principles for recipient nations of sovereign wealth investment, which will be complementary to the Santiago Principles.

¹⁵ “Sovereign Wealth Funds – State Investments on the Rise,” *Deutsche Bank Research*, September 10, 2007

¹⁶ “Citi of Arabia,” *Wall Street Journal Europe*, November 30, 2007

¹⁷ “Treasury Reaches Agreement on Principles for Sovereign Wealth Fund Investment with Singapore and Abu Dhabi,” *U.S. Treasury*, March 30, 2008

Conclusion

One possible outcome of the trend toward increased transparency by SWFs may be their continued elimination of barriers to increased investment in U.S. real estate. To date, there has been limited scrutiny of SWFs' investments in U.S. real estate properties and real estate firms. In September of 2008, DLA Piper released a survey of U.S. commercial real estate executives which found that the majority (51 percent) of respondents expect foreign investors to be the most active investor class in 2009. Consistent with that conclusion, nearly one in five respondents had engaged in a transaction involving sovereign wealth funds.¹⁸

Notwithstanding current U.S. and global macroeconomic conditions, which will likely have an impact on short-term investment strategies and activities of SWFs and other global investors, SWFs appear to be here to stay and may present significant opportunities for new flows of capital into U.S. commercial real estate and the overall U.S. economy. Real estate firms that strive to understand and build relationships with SWFs may benefit from these new capital flows and expanded opportunities for growth. In many respects, SWFs represent a new and significant participant in the capital structure of U.S. real estate investments, and could be important partners in growth. However, SWFs operate differently from other participants in the real estate investment arena, and so understanding their individual investment philosophy, criterion, goals and timeline may be critical to securing and building these relationships. Adopting a collaborative approach to SWFs may be the best way for real estate investors, developers and operators to build successful relationships with those who manage these significant pools of capital.

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¹⁸ "DLA Piper State of the Market Survey," *DLA Piper*, September, 2008

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