SWFs move to centre stage

While sovereign wealth funds continue to be a powerful force in financing both natural resources and transportation, there can sometimes be a certain lack of trust between sources of capital and recipients of money. Barry Parker reports

A group of two dozen sovereign wealth funds (SWFs) agreed voluntarily in early September - and, perhaps pre-emptively - on a set of investment principles that will be put before the International Monetary Fund (IMF) at the organisation's October meeting.

Lack of transparency, and possible nationalistic motivations for investment, have aroused suspicions in target countries. At the same time, a parallel effort organised through the developed countries in the Organisation for Economic Development and Co-operation (OECD), has been quietly launched, with those countries establishing their own set of principles and criteria for investment approval.

An uneasy standoff and a certain lack of trust and confidence, exists between sources of capital and recipients of money. Because SWF investment activities have buttressed some of the world's largest private financial institutions, policy makers have wondered aloud, including in US congressional hearings, whether SWF investments should be treated as more than simply cross-border flows of financial capital.

A highly celebrated example of the ramifications for the sector was the 2006 brouhaha in the US surrounding Dubai Ports World's (DP World's) investment in P&O Ports. Ultimately, DP World's investment passed muster, but only after the parties agreed to ring-fence the US ports business, which was ultimately sold to AIG Capital. AIG went on to expand the P&O ports nucleus, re-branding it as Ports America and acquiring other facilities throughout the hemisphere. Around the same time, the Chinese National Offshore Oil Co (CNOOC) abandoned its attempts to acquire Unocal, a mid-tier integrated US oil company.

DP World is not the only international port operator with government backing. Its slightly larger and more Asia-centric competitor PSA is backed by two Singapore-domiciled funds: Temasek Holdings and the larger Government of Singapore Investment Corporation. Port logistics require global reach and terminal networks with local presences. Temasek is also an important investor in Singapore Airlines (SIA), another business with wide geographical reach.

Transport financiers should keep a weather eye on the forthcoming IMF meeting, since SWFs have already intersected with and may continue to exert pressure on transport space.

It is impossible to precisely define SWFs. Edwin Truman, a senior fellow at the Washington, DC-based think-tank Peterson Institute, describes them as "separate pools of government-owned or government-controlled financial assets that include some international assets". Truman, best known for work establishing 'scorecards' for SWF accountability, estimated that SWF assets aggregated some USD8 trillion as of 2Q 2008, with about half invested cross-border.

The transportation sector offers an attractive investment profile for equity investors because of long-term financial contours, sometimes resembling those of bonds. Truman adds: "A substantial proportion, but not all, of SWF assets of industrial countries are in government pension funds."

Although the sector's long-term cashflows attract investors, transport often involves critical infrastructure and, sometimes, as in the case of DP World, real or imagined national security implications. A major inflection point in the SWF debate
occurred in 2Q 2007 when a Chinese state-linked fund - China Investment Corporation (CIC) - which manages China's foreign exchange reserves, placed USD3 billion into US private equity player Blackstone Group (founded by ex-Lehman banker Pete Peterson), which was then in the midst of an initial public offering (IPO). Traditionally, Chinese entities had favoured bonds.

CIC had also looked at investing in Blackstone rivals TPG, Carlyle Group and Kohlberg Kravis Roberts (KKR). CIC invested another USD3 billion to USD4 billion in a fund managed by JC Flowers, which has a stake in HSH Nordbank. Funds managed by Blackstone - although not the funds in which CIC has invested - have invested in a company building US flag tankers for the coastal Jones Act trades.

A current hot topic among Europeans, with aerospace and maritime implications, is the interest of SWFs in European Aeronautic Defence and Space Co (EADS), whose holdings include Airbus. EADS is also involved in radar projects for the US Coast Guard. Not surprisingly, the funds' voluntary move towards investment guidelines comes after considerable ranking within the EU after a 3 per cent investment in EADS was placed during 2007 by UAE-based Dubai Capital and then a 6 per cent stake in the company was taken by Russian bank Vneshtorgbank (VTB).

The domiciles of EADS' new equity investors have not escaped the attention of sceptics in the US Department of Defense (DOD) and in Congress after EADS was awarded a USD35 billion contract for tanker aircraft. In mid-September, the DOD had a change of heart, scrapping the contract that would have resulted in EADS supplying A330 aircraft to be converted into tankers by US partner McDonnell Douglas.

Beneath the veneer of policy discussions is a fear the SWFs might adopt more activist investment styles. Peterson Institute's Truman debunks the myth that SWFs are different from hedge funds. He says: "In effect, SWFs provide the capital to be leveraged to generate the high rates of return."

Another indirect but vital link between the SWFs and shipping investments comes through "resource nationalism", a concept that is gaining steam in some parts of the world, including Bolivia, Ecuador Russia and Venezuela, although raw material prices have abated throughout 2008.

In late 2007, the same CIC, with an ownership stake in large Chinese steel mills, was tied to a bidding contest for a takeover of iron and commodities producer Rio Tinto, a dual-listed company (Australia and the UK) with vast resources in Australia. A Rio Tinto takeover would not have been a play for a conservative investor, with the commodity price curve still rising.

However, some analysts saw a political angle. A CIC takeover would block a possible acquisition of Rio Tinto by Australian ore giant BHP Billiton, which would likely lead to higher ore prices for China's steel-makers. At the same time, the rumour mill had Chinese investors also looking at Brazilian ore giant Vale, which was partially privatised in 1997 and fully privatised in 2002. In early 2008, Chinese state-owned aluminium producer Chinalco teamed up with Alcoa, buying a 12 per cent stake in Rio Tinto worth USD14 billion, effectively creating a roadblock to BHP Billiton's takeover plans.

BHP Billiton's ambitions where further dampened in mid-2008 by EU bureaucracy, which looked at competition issues. Also, the Australian government said that it would not permit Chinalco to increase its stake in Rio Tinto beyond 15 per cent. In late August, Wayne Swan, an Australian treasury minister, announced: "While Australia welcomes foreign investment in our economy, we will carefully examine national interest issues where these arise in relation to foreign sovereign ownership." Many Chinese steel and metals producers are in the process of privatisation but still retain state ownership.

Major iron ore producers and steel mill customers, pounded by high freight costs in 2006 and 2007, have defensively ordered ore-carrying vessels or entered into vessel charters of up to 10 years duration, suggesting that SWF ownership is only one step removed from shipping. Shipping veterans remember the previous commodity peak in the 1970s: an era when the first wave of SWFs was established. At that time, developing nations were clamouring for cargo preference restrictions on foreign flag vessels.

In January 2008 Rio Tinto announced an order for up to five ore carriers to be built in Japan and delivered in late 2012. The company has also taken delivery of the first of six specialised vessels ordered in early 2006 to transport bauxite, the raw material for aluminium production, with the remaining ships to be delivered through 2009. Brazil's Vale recently placed a USD1.6 billion order for 12 very large ore carriers (VLOCs), each with a 400,000 dwt capacity.
Another view of state ownership can be seen with Singapore-based Neptune Orient Lines (NOL), which is 26 per cent directly owned by Temasek, with an additional 40 per cent owned by Lentor Investments, a wholly owned subsidiary of Temasek. In 1997, NOL acquired US-based American President Lines (APL) in a USD825 million deal. With an aim towards building scale in the container shipping business, NOL is in the running to acquire Hapag-Lloyd, now owned by the German conglomerate Tui. Temasek has also recently acquired a 3.1 per cent interest in Fesco, Russia's second-largest shipping company.

Roland Koch, Conservative leader of the regional government in Hesse, has been a vociferous critic of SWFs at a time when a local consortium, including the city of Hamburg, has mounted a defensive effort to keep Hapag-Lloyd in German hands. Koch wrote in the policy journal Europe's World that he supports an assessment "of whether public order or safety might be threatened" if a foreign stake in a German entity exceeds 25 per cent. Ironically, Temasek might also be playing a potential white knight role in the battle for ownership of Germany's bourse. The Singapore fund is rumoured by insiders to have been invited by the exchange to invest, as the bourse fends off activist hedge funds TCI and Atticus, both of which are investors in US-based transportation provider CSX Corporation.

Cross-border investment, although not always through state-owned entities, is an industry mainstay that has gathered steam during 2008. Shipyards had long been considered strategic national assets. The seemingly exponential increase in cross-border money flows has included transactions in the maritime sphere. In recent years, international deals have changed the ownership contours in the sector. Oslo-listed shipbuilder Aker Yards, which had built itself into an industry leader through purchases of Kvaerner, Alistom and others, has recently seen the vast majority of its shares acquired by Korean conglomerate STX Group. In 2006, Aker had acquired Alistom yards in Saint-Nazaire and Lorient in France.

The French government is in the process of acquiring a 34 per cent blocking interest in Aker's French yards. Along with an underlying business motivation for the state to participate in growth in the cruiseship sector, political commitments to maintain jobs in France are a primary motivation.

The resource connection also figures prominently in the continuing plans of oil and gas producers. In 2006, the continued growth in offshore production enabled Brazil to shift from net importer to net exporter. Recent discoveries in the Santos Basin have the potential to ratchet Brazil to the top of the oil exporter league when production comes online between 2011 and 2012.

This energy boom has also brought about a boom in shipbuilding and a revival of Brazilian shipyards. Transpetro, a wholly owned subsidiary of Brazilian energy company Petrobras, with depository receipts listed on the New York Stock Exchange but still 55.6 per cent state-owned, ordered 24 vessels worth USD2.5 billion from a group of Brazilian yards in 2007. Recently, Transpetro issued tender documents to both Brazilian and foreign yards to construct an additional 22 vessels. The new order, worth about USD2 billion, is aimed at partially sating Brazil's export ambitions and consists of refined product carriers, liquified petroleum gas (LPG) carriers, aframaxes and larger suezmaxes. Many of the vessels will be suitable for international trade.

Strategic foreign investment in shipyards is a growing phenomenon. South Korea's Samsung Heavy Industries acquired in June a 10 per cent interest in Estaleiro Atlanticco Sul, a Brazil-based shipyard company, for USD22 million. Samsung is providing tanker expertise that is expected to benefit Transpetro orders.

As Brazil's shallow and deepwater production grew following the start of offshore leasing in the late 1990s, outside investors Sembawang and Keppel brought needed expertise in offshore platform construction. The Aker Group - now in the hands of STX - and the Spanish Elcano Group are also likely to invest, bringing expertise in offshore supply vessels and gas carriers respectively.

Expansion of shipbuilding in Brazil - a major shipbuilding country in the 1970s and early 1980s - has been boosted by loans from government entities. The main entity is the Brazilian Merchant Marine Fund (MMF), which is administered through the Banco Nacional de Desenvolvimento Economico e Social (BNDES), the national development bank within Brazil's ministry of development, industry and foreign trade. The 2007 24-vessel order from Transpetro is being spread over multiple shipyards.

A 10-vessel construction programme at the Atlantico Sul yard will be financed by a BRL2.5 billion (USD1.4 billion) MMF-BNDES credit line, effectively 90 per cent financing, with repayment obligations parcelled out among Transpetro ship-operating companies.

According to BNDES, low interest loans to fund ship construction are provided at rates between 2.5 per cent and 5 per
cent, with terms of up to 20 years after a four-year grace period.

Similar terms are provided to the shipyards themselves. Where Brazilian content exceeds certain levels - typically 60 per cent - the interest rate is reduced by 0.5 per cent. Yards have yet to be announced for the 2008 programme - which may include foreign yards since demand is stretched beyond what Brazil's facilities can handle.

BNDES, which also boasts project finance expertise, is able to structure ship finance in ways that traditional lenders might not. In another 2007 deal for BRL1.8 billion, 90 per cent of the total was provided for a construction programme at the Consorcio Rio Naval yard - formerly known as the Ishibras yard because of a joint venture between Japanese and Brazilian interests - where five aframax and four panamax tankers will be built. During the construction period, in addition to an equity piece of 10 per cent, the finance is shared between Transpetro (36 per cent) and the shipyard (46 per cent), which also kicks in yard credit (8 per cent). As ships are delivered, Transpetro then takes out the yard credit.

In Brazil, one wonders whether oil is more strategic than iron ore, or whether political considerations dictate payback of loyal customers. Vale's 12 ore carriers are coming from Jiangsu Rongsheng, a privately owned Chinese yard where private equity funds controlled by Goldman Sachs own a small stake ahead of a potential IPO in Hong Kong.

In mid-September, a fresh wrinkle was emerging in the relationship between SWFs and natural resources, with potential implications for raw materials transportation. One of the most activist SWFs is the Norwegian Government Pension Fund, sometimes known as the 'oil fund.' The socially responsible fund, which has built up a war chest in excess of USD300 billion since the 1970s, announced it would sell a GBP500 million (USD895 million) stake in Rio Tinto due to concerns about pollution at a copper mine.

SWF expert Brad Setser, an economist and fellow at the Council of Foreign Relations, a Washington, DC-based think-tank, offers the following: "China's quest for resources meets Norway's socially-conscious investing. Maybe Norway's government fund should offer China its mining portfolio in one big block trade? Norway can avoid owning polluting mines and China Inc could increase its resources exposure."

SWFs, along with big strategic investments by non-state entities, will continue to be a powerful force in financing both natural resources and transportation. Insiders have Brazil now looking at establishing an SWF, initially to invest surplus dollars in debt instruments.

After filling in parts of the big investment canvas, SWF links to transport, some circumstantial and some explicit, begin to emerge.