



SOVEREIGN WEALTH FUNDS

by Michael Haddock, Director, EMEA Research & Consulting, CB Richard Ellis



FOREWORD

While much has been written about Sovereign Wealth Funds (SWF), CB Richard Ellis is the first to provide an insightful analysis of how the SWF's might impact the commercial real estate market in the longer term. Our latest global report focuses on the amount of money that could flow into the commercial real estate sectors of direct equity investment, indirect investment and debt if the SWFs proceed, as one would expect, to build global portfolios of assets that are both diversified and deliver good returns.

The report estimates SWF allocations across different types of real estate and concludes that for them to achieve their allocations in the direct market they will have to exploit wider geographies and emerging sectors. However, only by also capitalizing on the growth of the indirect market and the opportunities in the debt market, will they be able to fully accommodate their objectives in the real estate sector.

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EXECUTIVE SUMMARY

The potential impact of the Sovereign Wealth Funds (SWFs) on the real estate market is significant. They already control nearly US\$4 trillion in assets of all types, and are expected to treble that in the next seven years. Real estate's long-term investment characteristics match quite well with SWF's requirements and so their allocation to the sector should grow significantly. Even fairly conservative estimates suggest net investment of US\$ 725 billion by 2015. This will make them significant investors in most of the world's major property markets, with more of them establishing specialist real estate arms.

Although their direct investments are likely to be concentrated in core product in major markets, their influence will be felt throughout the world through indirect investment in unlisted property funds. These unlisted funds will attract a growing proportion of their real estate allocation.

In addition to unlisted funds the SWFs will also need to access smaller markets and niche sectors through joint ventures and other forms of partnership.

Although SWF investment in real estate equities will grow, the sector is not large enough to absorb much of their new investment in real estate. It is possible, however, that we will see outright acquisitions of certain property companies (listed or unlisted) as a way of assembling a significant direct real estate portfolio rapidly as well as the management infrastructure to go with it.

One of the more immediate effects of the SWFs' investment in real estate may be to stimulate a recovery in the secondary market for real estate debt. The factors that are currently depressing that market may attract opportunistic investment from the SWFs.

	Annual net investment (US\$ billion)
Direct Real Estate	40-50
Unlisted Property Funds	20-30
Listed Property Companies	5-10
Debt	20-25
Derivatives	Negligible

INTRODUCTION

Although Sovereign Wealth Funds (SWFs) have been around since the 1950s, the real estate sector has paid only limited attention to them until recently. It is only really since mid 2007 that their potential as investors in real estate has become evident.

As other groups of investors have withdrawn from the property market due to the credit crunch, increasing attention has been focussed on alternative sources of investment. Three qualities make the SWFs obvious candidates:

- They already control nearly US\$ 4 trillion¹ of assets;
- The value of their funds under management is growing rapidly; and
- They typically make their investments with low levels of leverage.

This last quality means that they are relatively unaffected by the credit crunch in terms of their spending power. Their continued ability to transact big deals despite the credit crunch has been well illustrated in recent months by the strategic stakes that have been taken in some of the world's largest banks².

So far, the SWFs' investment strategies have largely focussed on the bond and equities markets. A few have a long track record in real estate. GIC³, for example, is thought to be one of the top ten property investors worldwide. However, historically the majority have only had a limited exposure to direct real estate. The lack of transparency in their corporate governance means that it is difficult to be confident about SWFs' investment strategies, but they are reported to be paying a lot more attention to the real estate sector at the moment and the evidence – in terms of high profile deals – backs up the commentary.

The potential impact on the sector if the SWFs significantly increased their weighting to real estate is significant. A 7% allocation of their current capital would mean worldwide investments totalling US\$ 280 billion. To put this number in context, we estimate that the German Open-ended Property Funds⁴ currently own real estate assets with a total value of around US\$ 165 billion.

Looking to the longer term, their potential for future property investment is perhaps even more interesting. It has been estimated⁵ that the SWFs could reach total assets of US\$ 12 trillion by 2015, implying a further US\$ 560 billion of net property investment over the next seven years to maintain an allocation of 7%.

WHAT/WHO ARE THEY?

Remarkably – given that it is a phrase that now trips easily off the tongue – the term 'Sovereign Wealth Fund' was only coined as recently as 2005⁶. However, while the term is new, some of the funds themselves are not. The oldest⁷ were established in the 1950's as ways to invest government revenues from sales of natural resources, saving for the day when those resources ran out. Since then there have been two other boom periods for the founding of SWFs: The mid to late 1970s, coinciding with the sharp rise in oil prices, and the late 1990s.

There is no universally accepted definition of a Sovereign Wealth Fund. However, one of the most useful is that used by the US Treasury Department:

"... a government investment vehicle which is funded by foreign exchange assets, and which manages those assets separately from the official reserves of the monetary authorities."

¹ Source: Sovereign Wealth Fund Institute. The precise total depends a great deal on the definition used. If the definition were widened to include state pension funds such as Japan's Government Pension Investment Fund, it would add another US\$ 7 trillion.

² For example: Government of Singapore Investment Corporation \$12 billion investment in Union Bank of Switzerland, Abu Dhabi Investment Authority \$7.5 billion investment in Citigroup, Temasek \$5 billion investment in Merrill Lynch, China Investment Corporation \$5 billion investment in Morgan Stanley.

³ Government of Singapore Investment Corporation

⁴ The Offene Immobilienfonds only, not including the Spezialfonds

⁵ Morgan Stanley – "How big could sovereign wealth funds be by 2015?" – May 07

⁶ In an article titled "Who holds the wealth of Nations?" by Andrew Rozanov of State Street Global Advisors.

⁷ The Kuwait Investment Authority is the oldest of the current Sovereign Wealth Funds, having been founded in 1953.

Key distinguishing features of a Sovereign Wealth Fund are, therefore, that the capital is ultimately controlled by the government or state and that it is principally invested abroad. In addition, SWFs are limited to those countries with a substantial long-term trade surplus with the rest of the world.

This definition also leads us to another important feature of a SWF, that it is managed separately from the official reserves of the country. This is important because official reserves are normally only invested in a very narrow range of assets – gold, other precious metals and sovereign debt (mainly dollars and euro). As the main purpose of foreign exchange reserves is as a stabilising factor in the country's exchange rate it is important that they are in highly liquid assets. The SWF has a much broader investment remit, being able to invest in all sorts of real and financial assets.

There are broadly three categories of SWF. The majority of assets are in the first two: those where the source of the trade surplus is natural resources (mostly oil and gas) and those where it derives from a surplus in trade in goods and services. The third category is pension reserve funds.

LARGEST SOVEREIGN WEALTH FUNDS

Commodity Based Funds		
Country	Fund Name	(US\$ bn)
Abu Dhabi	Abu Dhabi Investment Authority	875
Norway	Government Pension Fund	396
Saudi Arabia	SAMA Foreign Holdings	365
Kuwait	Kuwait Investment Authority	264
Russia	National Welfare Fund	163
Qatar	Qatar Investment Authority	60

Non-Commodity Based Funds		
Country	Fund Name	(US\$ bn)
Singapore	GIC	330
China	SAFE Investment Company	312
China	China Investment Corporation	200
China – HK	Hong Kong MAIP	173
Singapore	Temasek Holdings	159
China	National Social Security Fund	74

Source: Sovereign Wealth Funds Institute¹³

Commodity based SWFs: These commodity based funds are currently dominated by countries in the Middle East. Looking forward, however, the exploitation of oil and gas fields in Central Asia mean that funds from countries such as Russia, Kazakhstan, Azerbaijan and Mongolia will be of growing importance.

Non-Commodity based SWFs: These are nearly all in the Asian tiger economies. In terms of fund size the list is dominated by Singapore and China, but there are also substantial SWFs in Malaysia, South Korea and Taiwan. An interesting aside is the fact that Japan, despite its long-term structural trade surplus, foreign exchange reserves of more than US\$ 1 trillion, and a state pension fund with assets of around US\$ 1.3 trillion, has not created a SWF. Its foreign exchange reserves are invested in traditional reserve assets – in particular US government securities. The growing prominence and success of SWFs from other countries, however, has resulted in increasing pressure on the Japanese government to establish one of their own, with a broader investment remit. Such a fund could quickly become one of the largest in the world, initially with assets of up to US\$ 750 billion.

Both categories of SWF are growing rapidly at the moment. In 2005 State Street Global Advisors⁸ estimated the total assets of SWFs to be less than US\$ 1 trillion. Three years later SWF assets are around four times as much and Morgan Stanley⁹ has estimated that the assets of Sovereign Wealth Funds could reach US\$ 12 trillion by 2015. The high price of oil means that oil rich countries are benefiting from even larger revenues and the Asian economies have benefited from the rapid growth in world trade in recent years. China, in particular, has maintained a very high trade surplus as a result of its highly competitive wage rates and continues to be a huge net exporter of goods.

Pension Reserve Funds: These are the national (or in some cases regional) pension reserve funds. Even though they are funded from government surpluses, it is questionable whether such funds¹⁰ are truly Sovereign Wealth Funds. Given that their remit is to act as a pension fund, it is also likely that their investment strategy will follow that of a more traditional institutional investor, rather than the other SWFs. However, this group are a relatively small proportion of the whole and so the differences between them and the other SWFs do not have a material effect on the overall observations in this report.

The scope for growth in the size of the SWFs is also a function of the continuing growth in official reserves and other funds under government control. To an extent, the differentiation between SWFs and official reserves is an artificial one. This is especially true of command economies where official reserves could be transferred to the control of a SWF at very short notice. The world's foreign exchange reserves currently total some US\$ 5.2 trillion¹¹, the majority of which (62%) are controlled by just seven countries¹². This was clearly illustrated by China's decision to found the China Investment Corporation in September 2007 with US\$ 200 billion of initial capital taken from its foreign exchange reserves. Brazil, Japan, Mongolia

and Thailand are all reported to be considering the creation of SWFs from their foreign exchange reserves.

In discussing SWFs, their approach to investment and their likely impact on the market, another key feature is the lack of transparency in their management. One might think that a public agency, investing money on behalf of the state would be held to very high standards in terms of transparency and corporate governance. However, this cannot be said of most of the world's SWFs. Although transparency is improving, with a few exceptions, they are generally unwilling to disclose details, such as the total value of funds managed, investment strategy and significant holdings (except where they are required to do so by regulations in the country where they are investing). For example, Sheikh Khalifa, ruler of Abu Dhabi, recently denied that the size of the ADIA fund was as much as the US\$ 800+ billion that had been reported, but was not prepared to give the true figure.

This lack of transparency has a significant impact on the way in which investments are made. It is very common for SWFs to make investments via holding companies or in joint ventures and investments in listed companies are frequently kept below the level at which it is required to disclose holdings. It also has an impact on the attitude of countries where the investments are made, with considerable suspicion of the motives behind strategic acquisitions, a subject that is discussed in greater detail later in this report.

⁸ "Who holds the wealth of Nations?" – May 05, Central Banking Journal

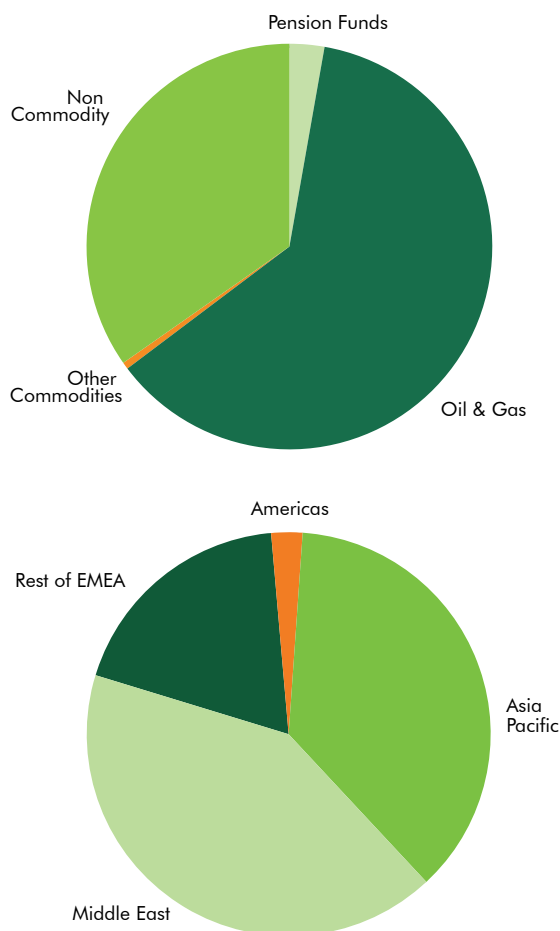
⁹ Morgan Stanley (May 2007) – How big could sovereign wealth funds be by 2015?

¹⁰ This group of funds would include the Australian Future Fund, New Zealand Superannuation Fund, and Ireland's National Pensions Reserve Fund.

¹¹ Source: Peterson Institute for International Economics – "Sovereign Wealth Funds: The Need for Greater Transparency and Accountability" – Aug 07

¹² In order, China, Japan, Russia, Korea, India, Singapore and Brazil, all of which have foreign exchange reserves of more than \$100 billion.

BREAKDOWN OF SOVEREIGN WEALTH FUNDS (BY TOTAL ASSETS)



Source: Sovereign Wealth Funds Institute¹³

HOW DO THEY INVEST?

The approach the SWFs take to investment is driven by their 'raison d'être', which is to invest 'excess' foreign exchange reserves. The implication is that these excesses are temporary and that at some point in the future – when whatever is creating the excess stops – the revenue from the investments made will replace it.

Ultimately, although we do not currently know when, the revenues from the oil or gas will start to diminish. When that happens, it will be important that the country has other resources to fall back

on. The same is true of the non-Commodity based SWFs. Although there is no physical 'good' that can run out, as their national wealth and standard of living grows, the balance of trade between them and the rest of the world should equalise.

SWFs should therefore be investing in assets with long-term growth potential outside their home country and without particular regard for current income or liquidity¹⁴. These investment criteria will change when the build-up phase of the fund is drawing to a close, but all of the main SWFs are currently within their build-up phases and will remain so for quite some time. This combination of a long-term outlook and indifference with regard to liquidity will tend to favour investment in emerging markets and SWFs do appear to have a greater allocation to India, China and the MENA region than would be the case in a balanced global portfolio.

There is also the further consideration of diversification: the majority of the traditionally managed foreign exchange reserves is invested in US government debt¹⁵ and both oil and gas are priced in dollars¹⁶. This means that there is an enormous exposure to the dollar in the existing assets of the country. Conventional investment theory, therefore, would suggest that there would be a strong bias against inclusion of dollar denominated assets in the portfolios of the SWFs.

To an extent this appears to be the case. The remit of most SWFs allows for investment across a much wider range of currencies than is the case for foreign exchange reserves. The desire to diversify away from the dollar means that SWFs do tend to hold investments in many more countries that would be expected of foreign exchange reserves. The SWFs' diversification is therefore to the benefit of assets priced in significant world currencies that are not generally considered reserve currencies – such as yen and sterling – as long as this can be done tax efficiently.

¹³ A complete list of the SWFs recognised by the Sovereign Wealth Fund Institute is included in an appendix to this report.

¹⁴ This is in sharp contrast to foreign exchange reserves, for which liquidity is extremely important.

¹⁵ Globally, around 65% of all foreign exchange reserves is held in dollars, with a further 25% in euros.

¹⁶ Although there have been hints dropped by certain oil producing countries that they may drop the dollar peg. While he was president, Vladimir Putin suggested that Russia might establish an oil and gas exchange priced in roubles and the Iranians have announced plans to sell oil for euros, although these have yet to be implemented.

“In 2009 we predict Sovereign Wealth Funds will enter the Japanese property market with some large acquisitions. The well known players are already active here. Others are beginning to look although they prefer to stay below the radar, which is very much the Japanese way.”

Reid Mackay, Executive Director CBRE
Institutional Investment Properties, Greater Asia

In discussing the investment strategy and tactics of SWFs it is also worth mentioning their frequent use of subsidiaries, JVs and indirect investments, particularly as these feature very strongly in their approach to real estate. With their global outlook and wide remit in terms of sectors and investment types it is obviously difficult for SWFs – particularly the larger funds - to be experts in all the markets that they are investing in. SWFs therefore use a number of different approaches to tap into local specialist management capabilities.

Indirect Investment Vehicles: The simplest of these is to use indirect investment vehicles, either listed or unlisted. Although most SWFs claim to already have a significant weighting to real estate, much of this is in the form of investments in listed property companies. For instance GIC have substantial holdings in Brixton Estates (10%), Liberty International (5%) and Great Portland Estates (5%).

Joint Ventures: JVs also represent a way for SWFs to leverage their financial muscle, while taking advantage of the specialist skills of their JV partner. This is well illustrated, for example, by the JV between GIC and Campus Apartments Inc to develop student housing in the USA. Student housing is a particularly specialist sector and one which also requires substantial on-the-ground management, and it would be very difficult for a SWF to invest in it directly.

Wholly Owned Subsidiaries: The third option is to use a wholly owned subsidiary that specialises in a particular type of investment activity. For example St Martins Property Group, which is a (mainly UK) property investment vehicle of the Kuwait Investment Authority, or Qatari Diar, the real estate investment arm of the Qatar Investment Authority. Nearly 40% of SWFs have a separate specialist real estate arm¹⁷.

POLITICS AND THE SWFs

As the amount of capital they control has grown and their influence in all types of asset market has increased, the investment strategies of SWFs have come under increasing scrutiny from politicians.

Most governments take an inconsistent attitude to inward investment in its different forms. That from corporates tends to be welcomed as creating jobs and reducing trade deficits. That from foreign financial investors tends to be criticised as selling off the national silver. However, inward investment from Sovereign Wealth Funds attracts a double criticism as not only selling off the family silver, but also putting it under the influence of foreign governments whose objectives may not be to maximise performance. The concern is compounded by the lack of transparency in the management of SWFs, which makes it difficult to identify why investments are being made and how decisions are made about how to manage assets owned.

In their defence, SWFs claim independence from political influence, that their investment objectives are the same as any other financial investor and that they, like any other investor, are interested only in the long-term success of their investment target.

The fact that the majority of countries with substantial SWFs also have strict regulations regarding foreign investment in their own countries is a further source of friction. However much the country where the investment is being made welcomes that particular injection of capital, public

¹⁷ Source: Private Equity Intelligence Ltd – “Sovereign Wealth Funds Review: Activity in Private Equity and Private Real Estate” – Apr 08

opinion can be swayed against it if there is no reciprocal arrangement. It is seen as unfair if (for example) a Chinese SWF can invest in an American bank, or a British water company, but US or British investors are not able to invest in the equivalent assets in China.

The possibility that political influence may come to bear on the management of the asset appears to be the main area of concern. The European Commission has been particularly outspoken in this regard and European Commission president Jose Manuel Barroso has been quoted as saying "We cannot allow non-European funds to be used as an implement of geopolitical strategy." Americans, while less vocal have also sought to prevent certain SWF investments, as is shown by the block on the Dubai Ports acquisition in 2007.

SWFs themselves have recognised the potential problem that political resistance to their investments may cause and have generally been prepared to contribute to groups that are looking to establish codes of conduct for SWF investments. These include the International Monetary Fund, which established its working group on SWFs in April of this year¹⁸. The European Union are also calling for a code of conduct, with Commissioner for External Trade, Peter Mandelson, arguing that it was needed to "integrate these huge new players into the global financial system in a way that reassures the recipients of investment without casting the funds as potential villains".

It is interesting to note the recent transaction in which CIC (China Investment Corporation) agreed to purchase a 10% stake in Blackstone. Remarkably, although a voting stake was available, CIC chose to take a non-voting stake. The motivation behind this decision was almost certainly to deflect political opposition to their investment in Washington. It needs to be remembered that China's last attempt to make an acquisition in the USA (energy company Unocal) failed in the face of political pressure.

Actually, the recent stakes taken in major financial institutions by SWFs have attracted very little political opposition. The fact that these investments were welcomed as adding stability to the banking system, may have been a factor in stifling such opposition.

The combination of the credit crunch and the growth in SWF capital is likely to increase the levels of political friction caused by SWF investments. Not only will the number and value of strategic acquisitions grow over the next few years, but so also will the perception that 'foreigners' are buying up important national assets 'on the cheap'.

As far as the real estate sector is concerned, it is unlikely that either this political tension, or any of these codes of conduct will have an impact on direct investments. Foreign ownership, even of trophy real estate assets, is well established in most developed countries¹⁹. Therefore, unless the transaction has security implications²⁰ it is unlikely to attract as much attention as significant holdings in major companies.

WHAT HAVE THEY DONE IN REAL ESTATE?

The lack of transparency in the world's SWFs, means that it is difficult to be precise about the existing real estate exposure of the SWFs. Most claim to have a significant exposure to real estate, although a substantial amount of this is in the form of indirect investments through listed and unlisted vehicles. However, more than half are thought to have at least some direct real estate holdings.

"With the high price of oil the Middle East SWFs are seeing huge inflows of capital and it is easy to see from their behaviour in their home countries that they are serious about allocating a significant proportion of it to Real Estate. Tax efficiency will have a significant impact on their choice of target locations."

Nick Maclean, MD CBRE Middle East

¹⁸ SWF representatives from Australia, Azerbaijan, Bahrain, Botswana, Canada, Chile, China, Equatorial Guinea, Iran, Ireland, South Korea, Kuwait, Libya, Mexico, New Zealand, Norway, Qatar, Russia, Singapore, Timor-Leste, Trinidad & Tobago, UAE, USA and Vietnam are represented on the working party.

¹⁹ A recent example is the acquisition of the Chrysler Building in New York by ADIA that has attracted very little negative comment.

²⁰ Which was the reason given for blocking the acquisition of a number of US ports by Dubai Ports World.

CASE STUDY – GOVERNMENT OF SINGAPORE INVESTMENT CORPORATION

GIC serves as an interesting case study as, if the other large Sovereign Wealth Funds choose to invest much more heavily in direct real estate, it is likely that the pattern of their investment will be generally similar. The objectives of Singapore's GIC are similar to those of the other major SWFs, with the exception of ADIA it is of similar size to the other major SWFs and GIC's obviously successful track record will encourage the other funds to use its approach as a model.

GIC Real Estate has around 150 employees worldwide and six offices outside Singapore, but with investments in 30 different countries clearly they must rely heavily on others' expertise for stock selection and management. This is even more the case when one considers that they invest across a wide range of sectors. In addition to shops, offices and industrial premises, GIC also invests in hotels, residential property, student and senior housing, and sports and medical facilities. To do this they rely on structures such as joint ventures to give them access to expertise in particular property sectors. Recent examples include their JV with Campus Apartments to develop student housing in the USA, with HEI Hospitality to acquire a number of hotels and with Mexico Retail Properties to invest in shopping malls in Latin America.

Despite these investments in emerging markets, it remains the case that a significant majority of the value of the GIC portfolio is in high quality, core assets – such as CBD offices or modern shopping centres. For example, last year in the UK GIC acquired the Merrill Lynch HQ in the City of London and a significant stake in the Metro Centre, Europe's largest covered shopping and leisure centre. Other recent purchases in Europe include the Roma East shopping centre for around €400 million, the Kungshuset office building in Stockholm for €123 million and Iso Omena (a 61,000 sq m shopping centre in Helsinki) for which they paid €132 million for a 40% stake – another example of a JV with a local specialist, this time with Citycon. However, GIC will also get involved in development, but again with a bias towards prime locations.

One of the biggest SWF investors (probably the biggest) in direct real estate is GIC. GIC ranks itself among the top ten global real estate investment firms²¹, and it "... manages a multi-billion dollar portfolio of direct and indirect property investments worldwide, with over 200 investments in more than 30 countries". It is worth noting, however, that GIC's real estate investments include not only direct real estate, but also holdings in listed property companies and REITs, unlisted property funds, and real estate debt.

At the other end of the scale is the Norwegian Government Pension Fund, which despite being the second largest sovereign wealth fund, with assets totalling US\$ 400 billion, has no direct real estate.

In fact until the middle of this year the fund was not permitted to invest in direct real estate either in its own right or through unlisted funds. However, a recent decision by the Norwegian parliament has changed this and the fund now intends to make a 5% allocation to real estate (both direct and indirect).

The other large SWFs have also shown an increased appetite for exposure to the real estate sector over the last couple of years. Initially this was being driven by the very strong performance of property relative to other asset classes. Since the credit crunch and the decline in the real estate market their motivation has been more opportunistic – to take advantage of their high

²¹ Source: Quote by Dr Seek Ngee Huat, president of GIC Real Estate, taken from the GIC web site (www.gic.com).

levels of equity and long-term investment horizon to buy good quality real estate at attractive prices.

The largest of the Sovereign Wealth Funds, ADIA, is an excellent example of this. They currently have a stated target weight to real estate of between 5 and 10% – to include all forms of exposure to real estate²². They are thought to have an actual exposure that is well below the lower end of this range at the moment, with a bias in favour of direct real estate, which is estimated to make up around 65% of their current exposure²³. Their preference for prime (in some cases trophy) assets is also illustrated by the recent acquisition of the Chrysler Building in New York, one of the most recognisable buildings in the city, although this was actually done through the ADIC (Abu Dhabi Investment Council) vehicle.

“Sovereign Wealth Funds have become an active part of the capital stack in New York City transactions, obtaining a number of globally recognised assets. In nearly every case they have cleverly done this in partnership with a top rank US investor, enabling them to combine their own robust liquidity with established local market expertise.”

William M. Shanahan, Vice Chairman CBRE Investment Properties Institutional Group, New York

Over the next 3-5 years, it is their intention to increase their real estate weighting to close to 7% of the total fund value. Based on their current asset value this would require an additional US\$ 30 to 40 billion in real estate exposure. However, the fund is also expected to grow rapidly over that time, so the actual growth in their real estate holdings in dollar terms will actually be much greater.

In geographic terms, the SWFs have shown a somewhat unusual bias to their direct real estate investments, given their investment remit. Local properties – either in their home or neighbouring countries – form a significant part of their portfolios, especially for the SWFs that are based in the GCC countries²⁴. The SWFs also have very extensive holdings in the USA (with a strong bias to New York) and the UK (with a strong bias to Central London). This would not seem to fit in with the objectives identified earlier in this report, which would imply that SWFs should be investing out of their home countries²⁵, and with a bias against dollar denominated assets²⁶.

A number of the SWFs are very intensive users of investment in unlisted real estate funds, particularly the most transparent SWFs and those that have a profile similar to that of a private pension fund²⁷. Initially it might seem odd that the more transparent pension and Sovereign Wealth Funds would make greater use of relatively opaque unlisted property vehicles rather than listed property companies. However, the answer lies in the fact that these transparent funds are also those most likely to measure their performance annually. The annual performance characteristics of a listed property company are much closer to those of non-property equities than they are to direct real estate and so for investors who are measuring performance annually, they do not deliver the necessary diversification.

A number of the more typical SWFs also have extensive investments in unlisted funds²⁸. Such funds have obvious advantages for a SWF in enabling them to access real estate markets in many more countries than they would be able to directly, taking advantage of the specialist investment and management expertise of the fund manager. There are also less obvious advantages. For instance, the SWF's involvement is typically a minority stake in the fund and so does not attract the sort of political

²² Direct holdings, joint ventures, indirect holdings in listed or unlisted vehicles, real estate debt and derivatives.

²³ Source: Private Equity Intelligence Ltd – “Sovereign Wealth Funds Review: Activity in Private Equity and Private Real Estate” – Apr 08

²⁴ Gulf Cooperation Council – made up of Bahrain, Qatar, Kuwait, Oman, Saudi Arabia and United Arab Emirates

²⁵ To avoid Dutch Disease.

²⁶ To diversify away from the strong dollar bias in traditional foreign exchange reserve holdings and in the case of commodity funded SWFs to further diversify away from their country's reliance on income calculated in dollars.

²⁷ The various US funds invested on behalf of states such as Alaska and New Mexico, the Irish National Pension Reserve Fund and the New Zealand Superannuation Fund are particularly big users of this type of vehicle.

²⁸ GIC and Temasek of Singapore, Kuwait Investment Agency and the State General Reserve Fund of Oman.

attention that has been discussed above. Listed property companies and REITs have also attracted a significant amount of SWF investment, either as part of a specific real estate allocation, or just as part of their general investment in equities. In a number of cases they have taken strategic holdings (such as GIC's 10% holding in Brixton Estates), but more commonly their stakes are well below the reporting threshold.

WHAT WILL THEY DO IN REAL ESTATE?

It is evident that the largest of the SWFs are planning to increase their weighting to real estate over the next few years²⁹. The sector matches the long-term nature of their investment horizon and adds to the diversification of their portfolios away from the strong equities bias that they currently have and the strong bonds bias in foreign exchange reserves. The smaller SWFs are also likely to follow suit for the same reasons.

Judging from what has been said publicly by the managers of the larger SWFs their target allocations are likely to be in the range 7 to 10% of total assets. However, it needs to be remembered that this will be the allocation across the full range of real estate exposure – direct, indirect, debt and derivatives.

Quantifying the extent of the additional real estate investment by SWFs that this implies is difficult because their lack of transparency means that we do not know where they are starting from³⁰. However, the rate of growth in SWF assets means that it is the allocation from future growth that will contribute most to their net increase in real estate investment. Assuming a target of 7%, that they are starting from a current allocation of around 4% and that Morgan Stanley's projections³¹ of the future growth in SWF assets is correct, their net investment

in the real estate sector over the next seven years will total US\$ 725 billion. However, this target may be tempered by the practicality of sourcing such a high level of real estate transactions.

The allocation of this money to the various types of real estate exposure available may well have to differ from what they have done in the past. The historic bias has been towards (in order of importance):

1. Direct investment in prime locations in major world cities and GCC countries
2. Indirect investment in listed property companies/REITs
3. Indirect investment via unlisted property funds

The scale of the future investment implied by a 7% real estate allocation would be enough to move prices in these markets significantly. The total turnover of the global real estate market in 2007 was around US\$ 1.1 trillion³², and that was a record by a substantial margin. Even assuming that they did not sell any of the real estate that they purchased, the SWFs would have to acquire between 15 and 20% of all property investments transacted between now and 2015 to achieve their target weight through the direct market alone.

As a result their future investment will need to be more widely spread across geographies, sectors and investment vehicles. The SWFs will also be looking to exploit the difference between the risk/return profile of the capital that they invest and that of the market as a whole to exploit their almost unique position. However, tax efficiency will also have a significant impact on the shape of SWF investment.

²⁹ ADIA have a declared intention of increasing their real estate allocation to around 7%, Norway's Government Pension Fund have announced their intention to have a 5% real estate allocation and the China Investment Corporation announced in Feb 08 its intention to start investing in real estate.

³⁰ Although it is known that some of the largest SWFs have no allocation to direct real estate and only have exposure to the sector through real estate equities. The funds with no real estate exposure include: Government Pension Fund (Norway), China Investment Corporation, Hong Kong Monetary Authority and Reserve Fund (Russia), all of which are in the top ten SWFs by total assets.

³¹ Morgan Stanley – "How big could sovereign wealth funds be by 2015?" – May 07

³² Source: CB Richard Ellis and RCA

DIRECT INVESTMENT

There is every reason to suppose that the pattern of direct real estate investment by the SWFs going forward will be similar to that so well modelled by GIC. There will remain a bias in favour of prime assets in major cities, although as the SWFs are able to take on more duration risk than most other investors, their focus will be prime locations rather than prime properties. However, the range of cities targeted will need to broaden. Japan is one of the countries most likely to benefit from the broadening of this investment horizon. Few foreign exchange reserve assets are held in Yen, so as well as a wide range of high quality buildings the Japanese markets offer diversification away from the dollar. However, other European capitals should also see more Sovereign Wealth Fund investment than has been the case in the past and SWFs will also leverage their long investment horizon to continue to invest in the markets of developing nations.

Their long-term investment horizon and relative indifference to liquidity mean that SWFs are also in a position to target potential growth sectors of the real estate market. This applies in particular to those that are being favoured by demographic changes. SWFs should therefore be significant investors in sheltered accommodation and nursing homes in Europe, the USA and Japan that will benefit in the long-term from the aging population profile of those areas. As has been seen from GIC's activities, however, they are most likely to make these investments by way of indirect exposure (investing in the companies that own and manage the properties) or in joint ventures with local specialists.

Direct investment will still make up the largest portion of their real estate exposure, but as the SWFs venture into more locations and more sectors,

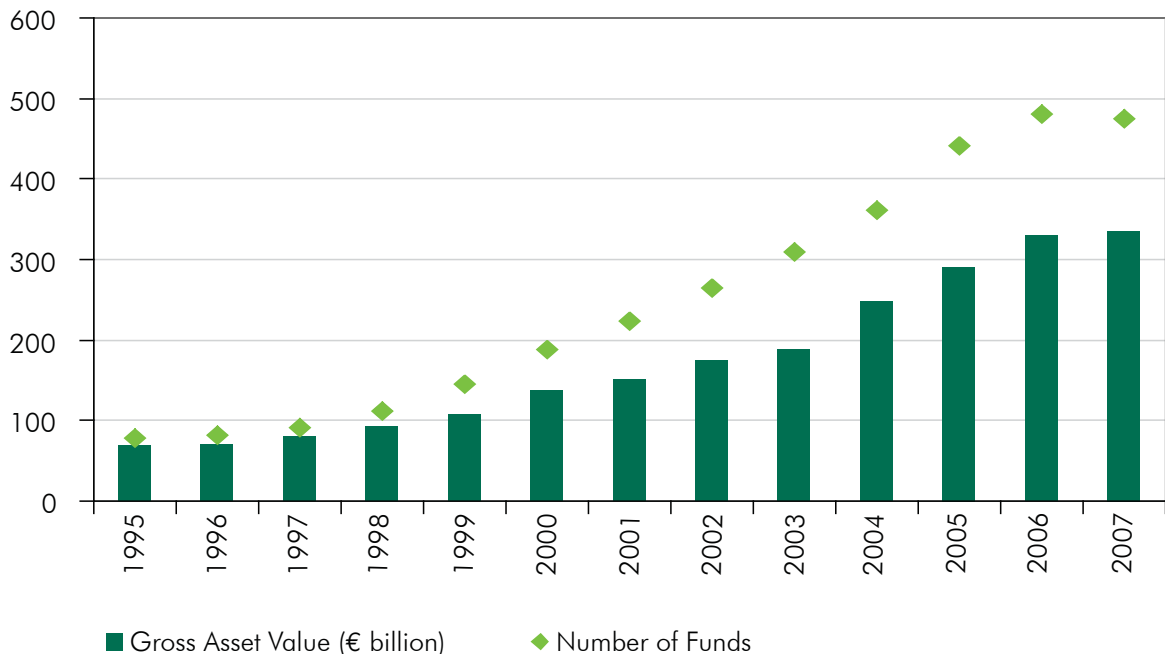
the use of alternate routes into those markets will grow. Direct real estate investment may, therefore, make up less than half of the increased real estate exposure that we have identified, with unlisted property funds attracting a growing proportion.

UNLISTED PROPERTY FUNDS

The unlisted property fund sector has been experiencing an extraordinary rate of growth over the last ten years. A high proportion of the capital invested in unlisted property funds has come from institutional investors and has been part of a larger trend of these funds outsourcing their direct real estate exposure to specialist investors and managers. For the institutions the unlisted funds give them the advantage of being able to invest in a wider range of real estate than they are able to get exposure to on their own and also an opportunity to use leverage in ways that they might not be able to within a directly held portfolio. It is no coincidence that this growth in unlisted real estate funds has happened over a time when the real estate market have become much more international³³ and over a time when the use of leverage has been particularly advantageous to real estate returns.

³³ As the potential investment universe for institutional investors gets bigger it becomes harder and harder for them to have a representative portfolio of direct real estate.

GROWTH IN UNLISTED REAL ESTATE FUNDS IN EUROPE



Source: INREV

It would appear that the SWFs have used unlisted real estate funds in much the same way as institutional investors. This accounts for the higher presence of such investments in the SWF that most closely resemble traditional pension funds.

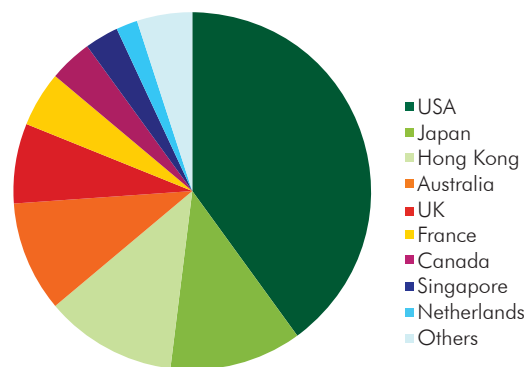
Looking forward, it is probable that the SWFs will make increasing use of unlisted property funds. Only the very largest of the SWF have the size to develop truly global real estate exposure through direct investments. They are also unlikely to want to establish the global infrastructure that would be necessary to support such portfolios. Again GIC are a good example of how even one of the largest global real estate investors, with 150 staff in 6 offices around the world, still make extensive use of funds, in particular to gain access to smaller and emerging real estate markets.

Unlisted property funds are therefore likely to attract a significant proportion of the new net investment in the real estate sector and will therefore continue to grow in importance in the property market. It is worth noting that in terms of the impact on the real estate prices it matters very little whether SWF investment is made directly or through indirect funds. The net new investment capital in the market remains the same.

LISTED PROPERTY COMPANIES/REITS

The total market capitalisation of the global listed property sector is around US\$ 650 billion. However, the 'free float' of this sector is lower; property companies are notorious for having significant proportions of their shares in the hands of owners that very rarely trade them. For SWFs to invest a significant proportion of their real estate allocation in the listed property sector would therefore have the potential to move the market.

DISTRIBUTION OF LISTED PROPERTY MARKET CAPITALISATION



Source: EPRA

The listed property sector will undoubtedly attract a proportion of the additional SWF investment. However, it is likely that most investments will be kept below the reporting threshold so that the SWFs can maintain their anonymity if they wish.

One distinct possibility, however, given the enormous purchasing power of the larger SWFs and the discount to NAV at which listed property companies are currently trading, is the outright purchase of some property companies by SWFs. Such outright acquisitions will serve the dual purpose of gaining rapid exposure to a direct real estate portfolio, whilst at the same time acquiring the infrastructure to maintain it. Buying in expertise will also be attractive as these skills could also be applied to managing their existing domestic development portfolios.

REAL ESTATE DEBT

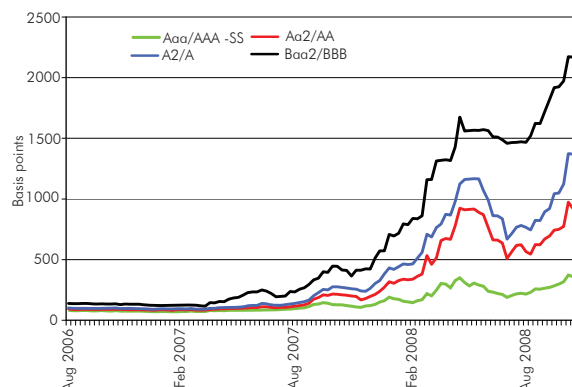
The real estate debt market is an area where SWFs have a particular opportunity to exploit their unique capital structure. It is fairly clear that the pricing of real estate debt at the moment – as illustrated by the spreads on RMBS and CMBS – is reflecting not just the default risk on that debt, but also a big premium to compensate for the liquidity risk due to the lack of turnover in that market.

The 'spread' over 10-year bonds offered by BBB rated US\$ CMBS is currently over 1500 basis points³⁴. Although they are the most risky of those in issue, this means that they are yielding nearly 20% per annum. The spread on BBB Euro CMBS is somewhat lower, but at over 800 bps³⁵ still offers a very high return.

The RMBS and CMBS sectors are being shunned by investors who are required to 'mark to market' because of the possibility that they would be required to take further write-downs. It is also being avoided by investors for whom liquidity is important, as the very low turnover of the market at the moment means that a forced seller would have to take a significant loss on apparent market

value in order to exit the market quickly. Therefore, investors who are prepared to ride out what should be a short-term loss of liquidity in the RMBS and CMBS markets (or if necessary hold the securities to maturity) are able to obtain an attractive return.

CMBS SPREADS TO TREASURYS: AUGUST 2006 TO SEPTEMBER 2008



Source: CMSA

The SWFs have not yet made a significant move into the real estate debt market. However, once they do move into this sector it could be in substantial amounts. There is over US\$ 1 trillion³⁶ of current CMBS issuance and although the majority is denominated in dollars, over US\$ 250 billion of European CMBS has been issued in the last five years. The RMBS market is much larger and, although comprehensive statistics for the total amount of outstanding RMBS are not available, is certainly more than US\$10 trillion. Moreover, this is just part of the debt market into which the SWFs might invest.

DERIVATIVES

In theory there is no reason why SWFs should not make use of derivatives in order to manage their exposure to the real estate sector. In practice, however, there are a number of reasons why this is unlikely:

- As it stands, the derivatives market is just not liquid enough to cope with the extraordinary size of the SWF sector. Even in the UK – the

³⁴ Source: Commercial Mortgage Securities Association – "Compendium of Statistics" – June 08

³⁵ Source: CB Richard Ellis EMEA Debt Advisory – "Market Watch" – 14 July 08

³⁶ Source: Commercial Mortgage Securities Association – "Compendium of Statistics" – September 08

largest of the derivatives markets – the total value of all derivatives contracts currently outstanding is less than £10 billion (US\$ 20 billion).

- The tenor of the derivatives market is also too short to suit their requirements. A SWF should consider investment in terms of time horizons of five to ten years at least. The majority of derivatives contracts have a duration of three to five years at most.
- Most importantly, derivatives are more a tool for managing returns than a store of wealth. In the most common type of derivatives trade – a contract for difference – no capital actually changes hands. As storing wealth for the future is the *raison d'être* of the SWF, the derivatives market does not, therefore, achieve their key aim.

CONCLUSIONS

Even fairly conservative estimates based on a 7% allocation to real estate suggest net investment in the global real estate sector by SWFs of US\$ 725 billion over the next seven years. This investment will be spread across all different types of real estate exposure, direct, indirect, listed, debt and derivatives. However, it would still make them significant investors in most of the world's major property markets.

Based on their existing approach to investment, the profile of the more established SWFs in the real estate sector and the experience of other major real estate investors this net new investment is likely to be distributed as follows:

	Allocation	Total Net Investment by 2015 (US\$ billion)	Annual Net Investment (US\$ billion)
Direct Real Estate	40-50%	290-360	40-50
Unlisted Property Funds	20-30%	145-220	20-30
Listed Property Companies	5-10%	35-70	5-10
Debt	20-25%	145-180	20-25
Derivatives	negligible	n/a	n/a

Their direct investments are likely to be concentrated in prime locations in major markets, and a desire to diversify away from the currencies in which official reserves are held should mean that Japan and the UK attract a higher proportion of this than would otherwise be the case. However, this scale of investment can only be achieved by putting capital to work in wider geographies and emerging sectors. As a result their influence will be felt throughout the world through joint ventures with local and sector specialists and indirect investment in unlisted property funds. These unlisted funds will attract a growing proportion of their real estate allocation.

SWF investment in real estate equities will grow, but the sector is not (as it currently stands) large enough to absorb much of their new investment in real estate. The total market capitalisation of the sector is currently only US\$ 650 billion. It is possible, however, that we will see outright acquisitions of certain property companies (listed or unlisted) as a way of assembling a significant direct real estate portfolio rapidly as well as the management infrastructure to go with it.

In the debt market SWF has the potential for a significant impact. The factors that are currently depressing that market (in particular lack of liquidity) are such that it could attract opportunistic investment from the SWFs. Moreover, with around US\$ 1 trillion of CMBS and more than US\$ 10 trillion of RMBS it is a market with sufficient depth to absorb substantial amounts of SWF capital.

“Some commentators are viewing Sovereign Wealth Fund investment as a trigger to start the recovery of the property market. However, they are very well advised and the expansion of their property exposure will be measured, biding their time before entering the market.”

Richard Womack, Senior Director London Capital Markets, CB Richard Ellis

APPENDIX 1 EXISTING SOVEREIGN WEALTH FUNDS

COUNTRY	FUND NAME	FOUNDED	TOTAL ASSETS (US\$ billion)	SOURCE OF FUNDS
UAE	Abu Dhabi Investment Authority	1976	\$875.00	Oil & Gas
Norway	Government Pension Fund – Global	1990	\$396.50	Oil & Gas
Saudi Arabia	SAMA Foreign Holdings		\$365.20	Oil & Gas
Singapore	Government of Singapore Investment Corporation	1981	\$330.00	Non-Commodity
China	SAFE Investment Company		\$311.60	Non-Commodity
Kuwait	Kuwait Investment Authority	1953	\$264.40	Oil & Gas
China	China Investment Corporation	2007	\$200.00	Non-Commodity
China - Hong Kong	Hong Kong Monetary Authority Investment Portfolio	1998	\$173.00	Non-Commodity
Russia	National Welfare Fund	2008	\$162.50	Oil & Gas
Singapore	Temasek Holdings	1974	\$159.00	Non-Commodity
China	National Social Security Fund	2000	\$74.00	Non-commodity
Qatar	Qatar Investment Authority	2003	\$60.00	Oil & Gas
Australia	Australian Future Fund	2004	\$58.50	Pension
Libya	Libyan Arab Foreign Investment Company	1981	\$50.00	Oil & Gas
Algeria	Revenue Regulation Fund	2000	\$47.00	Oil & Gas
USA - Alaska	Alaska Permanent Fund	1976	\$39.80	Oil & Gas
Ireland	National Pensions Reserve Fund	2001	\$30.80	Pension
South Korea	Korea Investment Corporation	2005	\$30.00	Non-Commodity
Brunei	Brunei Investment Agency	1983	\$30.00	Oil & Gas
Malaysia	Khazanah Nasional	1993	\$25.70	Non-Commodity
Kazakhstan	Kazakhstan National Fund	2000	\$21.50	Oil & Gas
Canada	Alberta's Heritage Fund	1976	\$16.60	Oil & Gas
USA - New Mexico	New Mexico State Investment Office Trust	1958	\$16.00	Non-Commodity
Chile	Social and Economic Stabilization Fund	1985	\$15.50	Other Commodities
Taiwan	National Stabilisation Fund	2000	\$15.00	Non-Commodity
New Zealand	New Zealand Superannuation Fund	2003	\$13.80	Pension
Iran	Oil Stabilisation Fund	1999	\$12.90	Oil & Gas
Nigeria	Excess Crude Account	2004	\$11.00	Oil & Gas
Bahrain	Mumtalakat Holding Company	2006	\$10.00	Oil & Gas
UAE	Mubadala Development Company	2002	\$10.00	Oil & Gas
Botswana	Pula Fund	1966	\$6.90	Other Commodities
Saudi Arabia	Public Investment Fund	2008	\$5.30	Oil & Gas
China	China-Africa Development Fund	2007	\$5.00	Non-Commodity
Azerbaijan	State Oil Fund	1999	\$5.00	Oil & Gas
USA - Wyoming	Permanent Wyoming Mineral Trust Fund	1974	\$3.90	Other Commodities
USA - Alabama	Alabama Trust Fund	1986	\$3.10	Oil & Gas
East Timor	Timor-Leste Petroleum Fund	2005	\$3.00	Oil & Gas
Vietnam	State Capital Investment Corporation	2006	\$2.10	Non-Commodity
Oman	State General Reserve Fund	1980	\$2.00	Oil & Gas
UAE	RAK Investment Authority	2005	\$1.20	Oil & Gas
Venezuela	FIEM	1998	\$0.80	Oil & Gas
Trinidad & Tobago	Heritage and Stabilization Fund	2000	\$0.50	Oil & Gas
Kiribati	Revenue Equalization Reserve Fund	1956	\$0.40	Other Commodities
Mauritania	National Fund for Hydrocarbon Reserves	2006	\$0.30	Oil & Gas
Angola	Reserve Fund for Oil	2007	\$0.20	Oil & Gas
UAE - Dubai	Investment Corporation of Dubai	2006	n/a	Oil & Gas
UAE - Federal	Emirates Investment Authority	2007	n/a	Oil & Gas

Source: Sovereign Wealth Funds Institute

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