Emerging Markets in Capital Markets:
BRICs, Sovereign Funds and New Power Brokers

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Abstract: The world is seeing a new share-out of the wealth of nations that benefits emerging markets. The shock waves that have hit the world's financial markets over the last decade are fostering this transition. This article looks at how the new power brokers are establishing new world financial centres and players. We also look at how an economy like Spain's can jump on the bandwagon and to what extent BRICs and sovereign funds may become opportunities for Spanish firms and the nation's economy.

Keywords: Emerging Markets; Sovereign Funds; Spain.

The world continued to recover in 2010. While the financial crisis hit Europe and various rating agencies have continued to lower national ratings for several OECD countries, emerging markets have see improving ratings and rising growth rates.

From China to Brazil, from India to Russia, the BRICs are emerging from the global crisis with hardly a scratch, high growth rates and low debt levels. Meanwhile, many European saw their debt ratings fall and there was even talk of Euro Zone default as Greece and Ireland plumbed the depths[1]. In mid-2010, CDS (Credit Default Swaps), which measure the cost of insuring the debt, revealed the sheer scale on which risks and opportunities were being redistributed. The cost to Greece (both a member of the EU and the OECD) of insuring its debt soared. In fact, Greece's CDS were only a little cheaper (i.e. less risky) than Argentina's and Venezuela's and dearer (that is to say, riskier) than Ukraine, Ukraine, Egypt and Russia. The CDS for OECD nations such as Iceland, Portugal and The Irish Republic showed the markets considered these countries' debts riskier than those owed by Russia, Indonesia and South Africa.

Goldman Sachs, which coined the term BRICs[2], reviewed its forecasts for these economies, bringing forward by several years the date when the economies of China, India, and Brazil would overtake those of the US, The United Kingdom and Germany, respectively. In fact, in 2010, Brazil became the world's seventh biggest economic power in terms of absolute GDP (Brazil still has a lot of ground to make up in per capita GDP terms*)*. This put Brazil ahead of Spain. China, meanwhile, had replaced Japan as the world's second-biggest economy. Goldman Sachs even invented a new category of companies—the so-called Nifty Fifty, which were the big winners in the first decade of the 21st Century. They were precisely those with a big business presence in emerging markets[3].

The shock waves hitting financial markets over more than a decade reflect a great transition in which the world's wealth is being redistributed in favour of emerging na-

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[1] See The Federal Reserve Bank of Atlanta's analysis in *Demystifying Sovereign Debt in Greece: Why It Matters to Us*, available at:

http://easy.bibref.com/**ESADE-0008-AAA**

[2] See Goldman Sachs, *Building better global economic BRICs*, London and New York, Goldman Sachs Global Economics, 2001; Goldman Sachs, *Dreaming with BRICs: the path to 2050*, London and New York, Goldman Sachs Economics, 2003. Available at:

http://easy.bibref.com/**ESADE-0009-AAA**

[3] See Goldman Sachs, The BRIC*s Nifty 50: The EM & DM winners*, London and New York, Goldman Sachs Global Economics, 2001. Available at:

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tions. As Pimco—one of the world's best bond managers puts it, this new balance of economic power is now the New Normal[4]. One of the results of this 'channelling' is that a growing number of investors from both OECD and the rising nations are investing in emerging economies, Pimco being a case in point. It is estimated that institutional funds in OECD countries currently have 6% of their total assets in emerging markets and that this will rise to over 10% in 2020 and 18% in 2030. This means over US $4 trillion[5] will shift to emerging markets. This weakens Lucas' paradox, which states that investments flow to developed countries and that this occurs even in the case of underdeveloped nations—whose need for capital in theoretically greater.

Evidently, assets in emerging economies are very heterogeneous and will continue to be affected by local rises and falls, crises and recoveries. However, what we are seeing is an unprecedented rise in the emerging economies, which is turning these nations into new international financial centres. The BRICs (Brazil, Russia, India, China) and beyond them, economies such as those of the Arab Emirates, Hong Kong and Singapore, are becoming the new financial hubs. In 2030, for example, Goldman Sachs foresees the three main financial centres as China, the US and India, followed by Japan, Brazil and Russia. In other words, four out of the world's six biggest financial centres will be in emerging nations. In global equity markets, emerging countries will account for over 55% of total assets instead of the current 31%.

The sovereign funds of countries with large reserves are increasingly important players that are wooed by all asset managers in OECD countries in their quest for liquidity and customers. Total world reserves came to almost US $8.5 trillion in 2010. Fully 65% of this total covered emerging markets. China alone, with US $2.5 trillion, accounted for over 31% of the world's reserves in 2010. In the summer of 2010, Asian investors in general—and Chinese ones in particular—snapped up over 13% of the bond issues made in early July (of the US $6 billion issued). Here, China played a key role in restoring international confidence in Spain's economy.

In the first part of this article, we shall see how these power brokers (as McKinsey calls them) are becoming key players on the world financial stage and establishing new financial hubs in the process. In the second, we shall focus on Spain's case. To what extent might BRICs and sovereign funds open opportunities for Spanish companies?

BRICs and sovereign funds: new geographies of the wealth of nations

[4] See Mohamed El Erian, "Sovereign wealth funds in the new normal", *Finance and Development*, June 2010, pp. 44-47. Available at:

http://easy.bibref.com/**ESADE-0011-AAA**

[5] Note that all figures quoted follow the US convention (that is, the short scale or *échelle courte*) in which 10^9 is one billion and 10^{12} is one trillion.

See http://easy.bibref.com/**ESADE-0012-AAA**

The 2008 crisis unleashed in OECD countries pushed almost all of the so-called developed nations into deep recession yet hardly affected emerging markets. Although growth dropped in the latter, some hardly drifted into recession in 2009 (for example, Brazil) while others continued to rack up enviable figures (for example, China, India and Indonesia). In 2010, even the worst-hit emerging countries such as Mexico and Russia managed annual growth of over 8%, while Brazil, China and India did much better. While European OECD lands were hit by a financial Tsunami, the emerging economies hardly felt a ripple.

The asymmetry of the crisis is something entirely new. In the past, whenever America sneezed, OECD countries caught a mild cold and emerging economies went down with pneumonia. In such circumstances, developing countries often defaulted on their debts. This time round, it is the OECD economies that are in intensive care. The new power brokers (to use McKinsey's term) have rapidly absorbed the impacts of the crisis. Whereas financial assets in OECD pension funds slumped by almost 20% in 2009 and mutual funds dived by 25% on average, Asian investors saw good growth (+8%) and petrodollar funds hardly fell (-2%), according to data from McKinsey[6]. In 2009, the assets of petrodollar nations reached US $5 trillion and Asian investors assets almost the same again, both far ahead of the whole hedge fund sector in OECD countries (barely US $1.4 trillion at the end of 2008) or the Western private equity sector (scarcely US $3 trillion). While the crisis also affected the new power brokers in the form of emerging economies, these recovered quickly in 2010 as raw material and exports began to surge again.

The case of sovereign funds is particularly noteworthy. These funds, particularly those invested in securities in OECD countries, sustained big losses in 2008. However, according to Deutsche Bank, by the end of 2009 these funds' assets had bounced back to US $3.7 trillion, close to where they stood in 2007 before the global crisis[7]. In 2020, it is estimated that assets in these funds will exceed US $7 trillion—over twice the amount currently managed—turning them into first-league world players. Many readjusted their investment portfolios, Temasek the Singapore sovereign fund being a case in point. It decided to raise its investment in emerging markets to 80% of its portfolio and cut its exposure to OECD markets to the remaining 20%. Put another way, sovereign funds and other international asset managers have sustained substantial losses in the crisis. However, they have weathered the storm and are again investing in every corner of the world. Even so, they are now on another tack, striking a course towards emerging markets and away from the troubled waters of the developed world. For example,

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[6] McKinsey, *The new power brokers: how oil, Asia, hedge funds, and private equity are faring in the financial crisis*, McKinsey Global Institute, July 2009. Available at:

http://easy.bibref.com/**ESADE-0013-AAA**

[7] Steffen Kern, *The role of SWFs: towards a new equilibrium*, Frankfurt, Deutsche Bank Research, June 2010. Available at:

http://easy.bibref.com/**ESADE-0014-AAA**

in 2009, they disposed of around US $40 billion of assets to carry out broad restructuring of their portfolios.

Far from curtailing the growth and proliferation of these funds, the crisis is only spurring them on. New institutions are springing up in Africa, Asia and even Latin America. The debate is also open in Algeria, Tunisia, Iran, Rwanda, India and even Columbia. In Nigeria, a country with over US $45 billion in reserves set up a sovereign fund in 2010. Angola, Ghana, Indonesia and Mongolia also made the leap, setting up their own sovereign funds throughout 2010. Saudi Arabia and Malaysia, which already had such funds, added new ones: Hassana Investment Co. and 1Malaysia Development Berhad, respectively, both for mainly investing in foreign assets. Latin America has joined the rush. Brazil set up one at the end of 2008. This nation has reserves of over US $250 billion. Brazil's recent discoveries of offshore oil are set to boost these reserves even further.

There are over 50 sovereign funds around the world, which together manage some US $3 billion. The biggest ones are based in The Middle East and Asia (especially China and Singapore). Some funds—like those in Central Asia—are still taking their first steps. ADIA (Abu Dhabi Investment Authority) is one such case. It is the world's biggest fund in terms of volume of assets managed and employs almost a thousand staff. In any event, all of these funds are undertaking a far-reaching review of their investment strategies and options. For both these funds and other asset managers worldwide, the crisis is not simply a financial or economic one but is also of a cognitive nature. The investment industry, including sovereign funds, have discovered to their cost that investing in OECD countries can be a riskier proposition than it seems and that goes for the US too (some might say especially for the US).

Until recently, investing in OECD countries was supposedly *low risk, low return* and investing in emerging nations *high risk, high return.* The sub-prime crisis and its global aftermath in 2008 demolished both cosy assumptions in one fell swoop. American companies with Triple-A ratings were either wiped off the map or found themselves bankrupt. Many emerging countries now attract similar risk to their OECD counterparts. The crisis calls on us to rethink facile simplifications, beginning with the 20th Century vision of a world split between developed and underdeveloped countries. The bounds between the two are becoming increasingly blurred. Investing in the 'developed world' of yesteryear can be very risky. Likewise, investing in emerging countries may be less risky that it used to be and yet still offer succulent returns.

For some sovereign funds, this cognitive crisis has led to action. Temasek, as we noted earlier, is one of the leading funds of its kind. It has drastically altered its global investment strategy. In mid-2010 it decided to make an even greater commitment to emerging markets, earmarking 80% of its portfolio for this purpose and leaving a paltry 20% for investments in OECD lands. On virtually the same day it announced this change, Temasek disposed of its stake in Bank of America and Barclays, while it raised its shares in China Construction Bank and Standard Chartered. The signal could not have been clearer: it was full steam ahead for emerging markets whether in the form of direct stakes in local banks and companies or indirectly through OECD-based banks

and firms with big business interests in those countries. Any doubts about Temasek's new strategy were laid to rest in 2009 when it opened investment offices far from its national base in Mexico and Brazil. In 2010, Temasek began making its first investments in Latin America, setting up a fund jointly with a Mexican real estate firm to the tune of US $200 million.

Other funds are now following in Temasek's wake. Thus GIC, another big Singapore sovereign fund, has decided to place two of its top managers in London and New York to foster investment in Europe, Africa and The Middle East. The New York office will mainly invest in Latin America. The Chinese sovereign fund CIC (which manages over US $200 billion) is also on a shopping spree in Central Asia and South-East Asia. In October of 2009 alone, it acquired assets for over US $4 billion, all of them in emerging countries such as Indonesia, Singapore and Kazakhstan. In summer 2009, it set up an international council whose members include Arminio Fraga, former governor of Brazil's Central Bank, now in charge of an investment fund based in Rio de Janeiro—a token of CIC's interest in Latin America.

Sovereign funds in The Middle East, beginning with Abu Dhabi's ADIA, have also bet heavily on emerging economies or are considering investments. It comes as no surprise that Aabar Investments, a subsidiary of the Abu Dhabi's giant IPIC, spent close on US $330 million in October 2010 to buy a 0.6% stake in Banco Santander Brazil. Temasek made a similar move with Standard Chartered.

This strategic repositioning by sovereign funds is not only good news for emerging economies and their companies but also for European firms, especially those strongly committed to such markets. This sea change may be good news for Spanish firms that have bet strongly on emerging markets—especially those in Latin America and Asia—over the last decade. Such companies are highly attractive. That is because while their share capital and offices are based in 'The First World', the firms' investments, income and business are increasingly tied to emerging economies.

Spain and sovereign funds

Over the last few decades, the pace of internationalisation in Spanish companies has speeded up. Evidence of this is not hard to find. In the first half of 2010, the turnover generated from abroad by Spanish companies quoted in the Ibex 35 stocks index exceeded 53% of the total for the first time ever. Several Spanish companies now earn the lion's share of their revenue and profits from abroad: Ebro Foods (93% of total revenue in 2010); Gamesa (80%); Grifols (75%); Inditex (68%); Ferrovial (67%); Telefónica (67%); OHL (66%); BBVA (57%); Repsol (55%); Iberdrola Renovables (55%).

Some companies not only earn most of their revenue abroad but also do so in emerging markets. This is the case of Banco Santander. Here, international business accounted for almost 78% of total revenues in 2010 but emerging countries (particularly

in Latin America) made up close to 40% of the total. In BBVA's case, Latin America generates 49% of total revenue, and Telefónica gets almost 41%, of its income from the region (especially Brazil). Put another way, sovereign funds look for first-rate firms from OECD countries but with strong links to emerging ones. Ideal candidates are to be found among the multinationals in Spain's Bies 35 stock index.

Another way of measuring this internationalisation is to look at the stakes held by foreign investors in Spanish publicly-quoted companies. At the end of 2009, such investors held a record 40% of Spanish firms' equity. However, a darker side to the picture was the dramatic fall in Spanish bank and savings bank stakes, which fell from 15% to 5% between 1995 and 2010. Reform of the savings bank sector and the impact of the Basel III International Regulatory Framework for Banks is accelerating the latter trend. In addition to these developments, many non-finance firms—which boosted their stakes in quoted companies up to 26% of the share capital—now find themselves overburdened with debt.

The next decade may therefore see much of Spain's stock market equity change hands. The Repsol oil company could point the way here. Over a third of its capital is held by banks or finance firms (which are heavily indebted). Repsol also holds a third share in another heavyweight in the Ibex stock index—Gas Natural—in which La Caixa savings bank is the main shareholder. Banks hold between a quarter and a third of the equity of other companies, such as Abertis, Iberdrola, Iberia, Indra, Mecalux, NH Hoteles, Pescanova, SOS Cuétara, and Tecnocom (the list may grow).

In other words, many publicly-quoted Spanish companies may be acquired by their competitors. An alternative is for more financial investors, particularly foreign ones, to take a greater interest in Spanish companies. One possible source of such investment may be the sovereign funds. According to Deutsche Bank estimates, these funds come to US $3.7 trillion and may be twice as large by the beginning of the decade. However, as yet they have little presence in Spanish companies' equity.

The Norwegian fund also increased its interest for Spain. It is the second biggest sovereign fund in the world, with investments of over €18 billion in the Spanish stock market. The fund manages almost €330 billion of investments and has stakes in over 8,300 companies, 77 of which are Spanish. Its biggest stakes in the country are in Santander and Telefónica. However, sovereign funds as a whole have meagre stakes in Spanish firms, despite the fact that 40% of their assets are held in Europe. At the moment, these funds overwhelmingly invest in British, Italian, French and Swiss companies. Spain does not show up among the top fifteen countries for inward investment published by Monitor and Fondazione ENI[8] Enrico Mattei (FEEM).

Yet these funds offer certain advantages. They tend to be long-term investors, much like the private equity industry (which is currently very active in Spain). Unlike private equity firms and industrial investors, sovereign funds are usually financial partners and are not interested in controlling the groups they invest in or preside over. Further-

[8] Note: ENI stands for Ente Nazionale Idrocarburi

more, they seldom demand a strong presence on the Board (only 7% of cases[9]) and when they do, they tend to take a back seat—particularly in firms in OECD countries.

Can one reasonably imagine sovereign funds showing a greater interest in investing in Spain? It has happened before. In 2009, the International Petroleum Investment Company (IPIC), an Abu Dhabi State-owned enterprise, invested over €3.6 billion in Spain's CEPSA oil company, taking a 47% stake in its equity, second only to the shares held by Total, the French oil firm. In 2010, IPIC had four CEPSA Board members, who included Khadem Al Qubaisi and David Forbes, Managing Director and Strategy Director of the Abu Dhabi fund.

The interest of sovereign funds for Spain has been on the rise since. By the end of 2010 and early 2011, this has been changing. Indra, one of the largest technological Spanish companies, signed an agreement with Mubadala, the strategic investment fund of Unted Arab Emirates. Indra along other technological firms obtained contracts in Emirates for 1,4 billion of dollars. The same Mubadala, early 2011, was expected to invest 500 million of dollars in Aernnova, the Spanish aeronautics firm. Also early 2011, after a tour in Middle East by the King followed by trips of the Spanish head of state, Qatar promised to invest 3 billion of dollars in several Spanish companies, including the financial sector. Emirates also promised to invest another 150 million of dollars in the Spanish financial sector.

Latin America plays also a key role in the interest of sovereign funds for Spanish firms. One key example is Banco Santander who sold a 32.5% stake[10] in CEPSA to IPIC, capitalising on its good relations with investors in the Middle East. One of the big attractions of Spanish multinationals now is their strong presence in emerging markets, particularly in Latin America. Sovereign funds seeking investments in Brazil or in the region know that a Spanish company, being based in an OECD land, offers legal guarantees but can tap the high profits found in emerging markets. This is what led Banco Santander (BS) to float its Brazilian subsidiary, part of whose share capital was bought by a Middle East investor. In 2009, Aabar Investments (which happens to be an IPIC subsidiary) invested almost US $330 billion in BS' Brazilian offshoot (the stake has been sold since with a premium). One year later, Qatar Holdings, the arab sovereign wealth fund, invested nearly 2 billon of euros in a 5% equity stake in Brazilian subsidiary of Santander. This strategy is one that Repsol YPF is seeking to emulate with the stock market flotation of its subsidiary in Brazil.

Finance and investor relations director of Ibex 35 companies and other firms have extensive contacts with these funds, especially those in The Middle East and Asia. Lately, the Spanish Treasury has been adept at placing a large slice of its bond issues in Asia.

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[9] According to Bernardo Bortolotti *et al*. "Sovereign Wealth Fund investment pattern and performance", Fondazione ENI Enrico Mattei, 2009. Available at:

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[10] Note: The rest of IPIC's 47% stake in CEPSA was acquired from Unión Fenosa, a utility company that later was acquired by its Spanish rival Gas Natural.

Nevertheless, one can imagine co-ordinated measures such a series of forums arranged for investors in various Spanish cities. Apart from Madrid or Barcelona, these events might also be held in iconic locations such as Bilbao's Guggenheim Museum or Granada's Alhambra.

Successfully wooing sovereign funds takes time. Hence, the need for a strategy to mobilise various States, corporate, national and regional players. Such a concerted approach would pay handsome dividends, putting Spain on these investors' radar screens. Sovereign funds are key players in radically redistributing the wealth of nations and Spain ignores them at her peril.