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# Sovereign Wealth Funds' Internationalization Strategies: The Use of Investment Vehicles

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ABSTRACT

In this paper, we examine the strategies used by sovereign wealth fund (SWF) investments in their cross-border investments. We investigate *how* SWFs internationalize their activities, specifically whether the use of investment vehicles as signal of passive investment approach to access foreign markets is influenced by SWF- and deal-specific characteristics and the presence of bilateral trade agreements between the SWFs and the target country. Our probit and multinomial logit estimates show that fund opacity, fund politicization, strategic industry targets, and majority ownership choices lead to a more likely use of vehicles, while bilateral trade agreements negatively affect such investment strategy. We also find that fund opacity increases the likelihood to use SWF-controlled vehicles, while fund politicization, strategic industry targets, and majority ownership choices increase the likelihood to use a corporate vehicle. Bilateral trade agreements reduce the use of corporate vehicles. Our results also indicate that politicized foreign SWFs are more likely to invest through vehicles located in third countries. On the other hand, when strategic industries are targeted, investment vehicles are likely to be located in the target country. Our results control for SWFs' strategic goals, SWF experience (reliance on external managers or advisors, fund size), type of funding sources, crisis period, deal-specific effects, and legal and institutional differences across countries and over time.

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> *"Globalisation has not only disturbed the balance of power between the US and the rest of the world, it has also altered the balance of power between the public and the private sectors. One channel through which the public sector will gain influence over the financial markets is Sovereign Wealth Funds* (*SWF*)*."* (Jen 2007: p. 1).

## 1. Introduction

Sovereign wealth funds (SWFs) are funds owned and/or controlled by sovereign states aimed at reinvesting sovereign wealth assets in both domestic and foreign markets (Johan et al., 2013). Although SWFs have existed for six decades, it is only in recent

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years that their increasing presence as global equity investors has attracted scholarly attention (e.g. Aguilera et al., 2016; Al-Hassan et al., 2013; Butt et al., 2008; Megginson and Fotak, 2014; Vasudeva, 2013) in international economics and finance (e.g. Carrington, 2015; Hovlan, 2015; Johnson, 2015). According to the Sovereign Wealth Fund Institute, the market size of SWF investments has doubled from September 2007 to September 2014, with a growth rate faster than any other institutional investor (Aizenman and Glick, 2008). After the 2008 crash in financial markets, SWFs have been one of the major funding sources for corporations worldwide, with assets under management estimated at over $4 trillion (Bernstein et al., 2013) — more than the value of all private equity or hedge funds.

Bernstein et al. (2013) highlight the controversies surrounding SWFs and their international investments, and explain the fear of developed economies toward the changing global power imbalances. Such fears are based on the active presence of politicians inside SWFs which might lead to the pursuit of strategic objectives, and finally to financial and political destabilization (Gieve, 2008; Johnson, 2007; Johnson et al., 2000; Knill et al., 2012a; Summers, 2007).[1] The risk of destabilization is higher when the investment target is a strategic infrastructure (Chhaochharia and Laeven, 2009; Karolyi and Liao, 2010; Knill et al., 2012a).[2]

The ability to take large stakes, the lack of short-term cash needs, the large size, and the potential presence of long-term horizons would make SWFs the ideal investors to monitor target firm managers and engage in effective corporate governance activities (Shleifer and Vishny, 1986; Chen et al., 2007; Ferreira and Matos, 2008). However, the active presence of politicians might lead to investment behaviors that do not maximize shareholder value (Shleifer and Vishny, 1994; Megginson and Netter, 2001), because of political and strategic objectives. From a macroeconomic perspective, there are also concerns about the expansion of governments in the global capital markets (Bortolotti et al., 2015; Summers, 2007). Among other forms including foreign exchanges reserves and state-owned enterprises (Keller, 2008), SWFs represent, in fact, a strategy employed by governments to invest and expand across borders (Cohen, 2009).

Suspicions and controversies surrounding SWF investments are also related to their structure and behavior, which are usually opaque. Such opacity leads to a higher perceived risk in the target country (Gieve, 2008; Johnson, 2007; Summers, 2007). Additionally, the interaction between SWFs and the government's political agenda is one of the crucial elements that needs to be considered when analyzing their investment strategies, especially in the international setting (Bortolotti et al., 2015; Knill et al., 2012a). In fact, some foreign SWF investments might be driven by home-country governments' ambition to gain international political influence or access key assets located in the host country (Chhaochharia and Laeven, 2009; Keller, 2008). Drawing insights from the international business (IB) and finance literature, this study analyzes how entry mode strategies can be used by SWFs to overcome or mitigate such concerns. More specifically, we explore the determinants of SWFs' investment strategy in cross-border acquisitions, i.e. the choice to use an intermediate investment vehicle - in the form of financial or corporate companies, or SWF-controlled firms/subsidiaries. Thus, the key question addressed by the present work is: *Why do SWFs use investment vehicles in cross-border acquisitions*?

Several studies have investigated the impact of investment vehicles on the corporate ability to access external assets, markets and technological opportunities (e.g. Tong and Li, 2011). In the case of SWFs, we claim that direct investments and investments by means of vehicles can be viewed as alternative governance strategies, which can be used to exploit business and market opportunities under different circumstances. SWFs may in fact use vehicles to signal a "hands-off" passive investment approach toward the home-country governments.[3]

Using a new dataset on SWF investments, whose size is comparable with the datasets used in the most popular SWF studies (Avendaño and Santiso, 2011; Bernstein et al., 2013; Bortolotti et al., 2015; Dewenter et al., 2010; Fernandes, 2014; Knill et al., 2012a; Kotter and Lel, 2011), we focus on the internationalization strategies of SWFs, analyzing *how* SWFs invest cross-border through acquisitions. In particular, we investigate whether the likelihood to use a vehicle in cross-border SWF investments is influenced by SWF- and deal-specific characteristics, and by the presence of bilateral trade agreements between the SWFs and the target country. Our probit results show that fund opacity, fund politicization, strategic industry targets, and majority ownership choices lead to a more likely use of vehicles, while bilateral trade agreements negatively affect such investment strategy. When we disentangle the different types of vehicles and their geographical location, multinomial logit estimates show that fund opacity increases the likelihood to use SWF-controlled vehicles, while fund politicization, strategic industry targets and majority ownership choices increase the likelihood to use a corporate vehicle. Bilateral trade agreements reduce the use of corporate vehicles. As to the geographic location of the vehicle, politicized foreign SWFs are more likely to invest through vehicles located in third countries, i.e. countries which are different from the home and the host ones. Instead, targeting strategic industries leads to invest in vehicles located in the target country.

[1] The economic and financial distortions associated with foreign SWF investments are well explained by Megginson et al. (2013) and include "*the risk of equity price bubbles arising from the sheer size of SWF investments and the related decline in demand for Treasury bonds*; *the risk of an increase in volatility of financial markets*; *the possibility that SWFs might have a detrimental effect on corporate governance because of political motives or lack of sophistication*; *and the risk of the emergence of a new form of financial protectionism as a reaction to SWFs*" (p. 541).

[2] Some examples of regulatory/enforcement efforts aimed to hinder foreign SWF investments are provided by Fernandes (2014): "*The first SWF, the Kuwait Investment Office, ran into trouble in the U.K. in 1987 when it acquired a stake of more than 20% in British Petroleum (recently privatized). The U.K. government, headed by Margaret Thatcher at the time, did not like the idea of an important national asset being owned by a foreign government. In the end, the Kuwaitis had to sell more than half their stake.* […] *The German government, for example, has announced that it would introduce controls on investments by SWFs, especially if they seek stakes in strategic sectors. French President Nicolas Sarkozy has announced that he would use his country's state-owned bank (Caisse des Depots et Consignations) to help protect French companies against potential takeover threats posed by SWFs*" (p. 6–7). Other examples are provided by Knill et al. (2012a).

[3] The authors are grateful to an anonymous reviewer for this suggestion.

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