August 2008

# Asia Pacific View

## Inside



UBS Investment Bank

# Welcome

**Welcome to the first edition of the UBS Investment Banking Asia Pacific View, which I hope you will find a useful source of information, news and views on the region. In this edition we focus on the diverse Asian markets.**

The economic impact of the sub-prime crisis, accelerating oil prices and the threat of inflation are creating huge uncertainty across global capital markets. Our greatest challenge is to navigate this uncertainty and identify the opportunities that changes in these markets create. In this first edition we focus on Asia, providing insights into the most important trends and transactions that have impacted these markets in recent months.

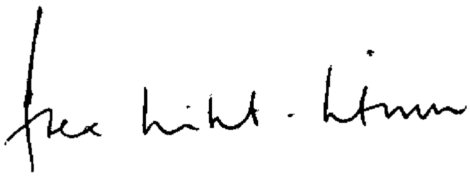
We have responded to the changing market conditions by adapting our structure in ways that more closely unite the expertise and experience of our people. For example, we have integrated our equity and debt capital market groups into the Global Capital Markets Group and we have aligned our global Financial Institutions coverage. In China, with UBS Securities, we are in a strong position to broker domestic debt and equity underwriting and secondary market trading. We now have a presence in 22 locations across Asia Pacific.

> "We now have a presence in 22 locations across Asia Pacific... and we have been named the Best Investment Bank in Asia 2008 by Euromoney."

We have completed more transactions in the region than any other investment bank in the last three years and we have been named the Best Investment Bank in Asia by *Euromoney* for the second successive year.

As Robert Rankin, our Asia Head of Investment Banking, says, "UBS in Asia Pacific is firing on all cylinders".

I hope that you find this – and our future updates – useful. I'd be very interested to hear your thoughts on the topics covered and answer any questions you may have so please do not hesitate to get in touch with me.



**Alex Wilmot-Sitwell**
Chairman and CEO EMEA, UBS AG
Joint Global Head of Investment Banking

# Investment Banking overview

**In this first edition of the UBS Investment Banking Asia Pacific View we aim to provide you with insight on the themes and trends that are influencing the future direction of this dynamic region.**

One such trend is clearly the rise of the region's Sovereign Wealth funds, which have been at the forefront of some of the major activity in the global financial markets over the last 12 months. Their importance is undeniable. In 2007 they accounted for 35% of global M&A activity. They now have more assets under management than hedge funds and private equity funds combined. In this issue, we will provide some analysis as to what is driving them and what future decisions they may take.

> "While in Europe and the US private equity deal-making has slowed as the availability of debt has been reduced this is not the case in Asia."

We also examine three of the region's most active sectors: financial institutions, which will experience further and necessary consolidation across the region; the booming resources market, with particular focus on the opportunities in Indonesia's thermal coal industry; and, finally, developments in the region's telecoms sector as global and local champions go head-to-head in the search for growth.

While we are already well into the second half of 2008, it's important to reflect on the first half of the year and some of the successes achieved by our clients against the backdrop of a very challenging financial landscape. Because, despite the difficulties faced, it's crucial to remember that companies with strong management and clear strategic direction were able – and continue – to execute deals. Benchmark financing deals for UBS clients include Want Want's successful USD 1,047 million IPO, where, despite volatile market conditions, demand outstripped supply by one and half times. This deal was followed by Maoye's USD 345 million IPO.

While the equity markets will continue to offer challenges throughout the remainder of 2008, there will still be windows of opportunity to raise capital. This will especially be the case in those markets where issuers have recalibrated their expectations of valuation in line with the market's views.

Mergers and acquisitions activity in the market remains positive. A review of investment banking data from *Thomson Reuters* shows that, unlike much of the rest of the world, M&A in Asia Pacific and Japan was up 8.7% in the first half from the same period a year earlier. We expect this positive momentum to continue with regional champions, especially Indian and Chinese companies, seeking greater opportunities beyond their borders.

Significant transactions include China Merchant Bank's successful acquisition of Wing Lung Bank for USD 4.7 billion. The deal is one of the most important transactions of the year. In addition to being the largest bank transaction in Hong Kong for several years, it is expected to trigger a wave of further consolidation across the Hong Kong banking industry in the months and years ahead. Other important deals where UBS played a key role include:

- China Telecom's USD 15.8 billion acquisition of China Unicom's CDMA business and network
- the acquisition of Korea Express by Kumho Industrial; and
- Cheung Kong's acquisition of Vector in New Zealand.

In the financial sponsors space dialogue between these investors and companies also remains healthy and we remain bullish on private equity opportunities in Asia. While in Europe and the US private equity deal-making has slowed as the availability of debt has been reduced, this is not the case in Asia. Sponsors have adapted a more flexible approach to investing in growth through equity financings, private placements, block sales and convertible bonds.

For investment banking as a whole for Asia Pacific UBS continues to lead, having successfully consolidated its position as the top ranked investment bank in the region. UBS in Asia Pacific is firing on all cylinders. We would like to thank our clients for continuing to make the partnerships between you and us work so comprehensively and recognizing our abilities in being able to deliver the solutions that you require.

> "It's crucial to remember that companies with strong management and clear strategic direction were able – and continue – to execute deals."

We hope you enjoy this newsletter and look forward to receiving your feedback.

**Robert Rankin**
Head of Investment Banking, Asia

# Recent Awards

**Best Investment Bank in Asia Pacific,** *Euromoney,* 2008

**Best M&A House in Philippines,** *Euromoney,* 2008
**Best Equity House in Philippines,** *Euromoney,* 2008
**Best M&A House in Australia,** *Euromoney,* 2008
**Best Equity House in Australia,** *Euromoney,* 2008

**Best Foreign Investment Bank in China,** *FinanceAsia,* 2008
**Best Foreign Investment Bank in Philippines,** *FinanceAsia,* 2008

**Best Investment Bank,** *Asiamoney*, 2007
**Best Equity House,** *Asiamoney* 2007
**Best M&A House,** *Asiamoney*, 2007

**Best Investment Bank,** *Finance Asia*, 2007
**Best M&A House,** *Finance Asia*, 2007

**Best China Deal,** *Finance Asia,* 2007
**Best India Deal,** *Finance Asia,* 2007
**Best Project Financing Deal – Hong Kong,** *Finance Asia*, 2007

**Best M&A Bank – China,** *Global Finance,* 2007
**Three Deals of the Year,** *CFO Asia*, 2007

# Key trends in Asia's financial institutions sector

**The financial institutions space in Asia is in a state of flux as local champions look to entrench themselves domestically and regionally in the face of further competition from international banks. In addition, changes in legislation across the region are beginning to take effect as governments attempt to push their overcrowded banking sectors to consolidate further. UBS believes this is a trend that is set to continue.**

Taiwan's banking sector has been at the forefront of the story. Over the last two years, four banks have been successfully acquired by foreign and domestic institutions. However, with 39 banks still in operation, the sector remains highly fragmented. With the newly elected Taiwanese government only too aware of the situation, market participants and observers expect further activity.

Following closely on Taiwan's heels is Hong Kong, which stole the headlines in June following a decision to put Wing Lung Bank up for sale. China Merchants Bank was the eventual victor, successfully acquiring the bank for USD 4.7 billion. The high valuation of 3.11 times book value that the selling shareholders, advised by UBS, were able to achieve, suggests the deal could serve as a major catalyst for further M&A transactions in Hong Kong's banking sector.

In Indonesia too, there is similar movement taking place as the country's regulatory requirements develop. The government's Indonesian Banking Architecture policy was introduced in an attempt to reduce the number of banks in the country from its present 130 to between 50 and 60. In addition, the Single Presence Policy has also been rolled out to prohibit the ownership of more than one Indonesian bank by a single entity. This bank legislation will necessitate further stakes being put up for sale.

Conglomerates in the Philippines are making waves in that market's banking sector as they look to consolidate their interests, and the country's mid-sized banks are seeking asset expansion and growth opportunities in an effort to achieve larger scale and better pricing power.

Further north, all eyes will be on Korea from 2009. The introduction of the Capital Markets Consolidation Act next February is expected to enhance competition amongst Korean financial investment companies and trigger sector consolidation as players seek to secure scale to compete with each other and their regional peers.

> "China and India have experienced strong growth on the back of robust and rapidly growing economies."

**Privatization**
As well as consolidation, privatizations will be another key theme throughout Asia for the sector. For example, with the Taiwanese government holding over 50% of the sector's assets in eight banks, the market expects privatization of the government controlled banks to continue in the medium term.

In Korea, the privatization of government-owned banks such as Korea Development Bank, Industrial Bank of Korea and Woori Financial Group, which the new government has repeatedly stated as a priority, will significantly impact the competitive dynamics and industry landscape, given the scale of these institutions.

**Capital raisings**
The banking sectors of the developing economies of the region, in particular China and India, have experienced strong growth, on the back of robust and rapidly growing economies. The "Big 5" Chinese banks have collectively raised USD 45.7 billion from their IPOs since 2005-2007, while recent capital raisings by Indian banks of over USD 19 billion highlight how India's banks have increased their capital base in order to respond to the growing financial services needs of the Indian economy as a whole.

**Financial buyers**
Financial buyers continue to show interest in the region, which has culminated in several M&A transactions in the sector. With the consumer credit crisis in Taiwan coming to an end, private equity firms such as The Carlyle Group, SAC and Longreach have all acted on the reasonable valuations on offer and taken control of a number of mid-sized banks.

UBS acted as financial advisor to Ta Chong Bank on the USD 656 million sale of a 36.6% stake to the Carlyle Group in July 2007.

In Indonesia, UBS advised TPG Capital on its USD 175 million acquisition of PT Bank Tabungan Pensiunan Nasional in June 2007.

**Rising cross-border interest**
With companies looking for greater market diversification driven by the search for greater profitability and growth, there is increasing interest in cross-border M&A transactions within and beyond Asia. Faced with a mature banking market and a stable three-bank system, Singaporean banks are expected to make forays overseas, while in China, there will continue to be outbound M&A transactions by the well-capitalized "Big 5" banks, in order to enhance diversification, profitability and growth.

Recent cross-border M&A transactions of the larger Chinese banks have taken various forms, including ICBC's USD 5.6 billion acquisition of a 20% stake in Standard Bank of South Africa (October 2007), China Merchant Bank's USD 4.7 billion acquisition of Wing Lung Bank of Hong Kong (June 2008) and Bank of China's USD 965 million acquisition of Singapore Aircraft Leasing Company (December 2006).

## UBS transactions

**China**
- Financial advisor and bookrunner on People's Insurance Company (Group) of China's USD 1.1 billion lower tier 2 bank capital issuance (April 2008)
- Sole bookrunner and sole ratings advisor on Shenzhen Development Bank's USD 923 million lower tier 2 bank capital issuance (March 2008)
- Joint financial advisor and sponsor on Huaxia Bank's USD 1.6 billion private placement (March 2008)
- Joint sponsor and bookrunner on China Pacific Insurance (Group) Company's USD 4.1 billion A share IPO (December 2007)

**Hong Kong**
- Financial advisor to the Wu family (selling shareholders) and Wing Lung Bank on the USD 4.7 billion sale to China Merchants Bank (June 2008)
- Joint bookrunner on Wing Hang Bank's USD 400 million upper tier 2 bank capital issuance (April 2007)
- Sole bookrunner on Bank of East Asia's GBP 300 million upper tier 2 bank capital issuance (March 2007)
- Joint bookrunner on Dah Sing Bank's USD 200 million upper tier 2 bank capital issuance (February 2007)

**Taiwan**
- Financial advisor to Ta Chong Bank on the USD 656 million sale of a 36.6% stake to the Carlyle Group (July 2007)

**Korea**
- Lead manager on disposal of a 7% stake in Woori Financial Group held by the Korea Deposit Insurance Corporation (December 2007)
- Joint bookrunner on Industrial Bank of Korea's JPY 60 billion Samurai bond offering (November 2007)

**Indonesia**
- Financial advisor to TPG Capital on its USD 175 million acquisition of a 71.6% stake in PT Bank Tabungan Pensiunan Nasional (June 2007)

**India**
- Joint bookrunner of HDFC Bank's USD 700 million ADS follow-on offering (July 2007)
- Joint bookrunner of IDFC's USD 520 million Qualified Institutional Placement (July 2007)

**Philippines**
- Financial advisor to Philippine National Bank on its USD 608 million acquisition of Allied Banking Corporation (April 2008)
- Sole bookrunner on Philippine National Bank's USD 208 million follow-on offering (July 2007)

**Singapore**
- Financial advisor to DBS on its acquisition of Bowa Bank with a USD 1.4 billion subsidy from the Taiwanese government (February 2008)

**Thailand**
- Joint placement agent on Thai Military Bank's USD 1.1 billion recapitalization (December 2007)

**Malaysia**
- Joint bookrunner on Maybank's USD 300 million subordinated Sukuk offering (April 2007), which was the world's first Islamic USD subordinated Sukuk bank capital

# Asia's Telecoms sector in focus

**Asia's telecommunications market is coming of age. With the industry boasting 1.4 billion mobile customers, but with penetration levels still below those of Western Europe and the US, it's unsurprising that this combination of scale and potential growth is attracting so many global telecommunications operators.**

Over the past five years, inbound M&A volumes have increased dramatically. According to *Thomson Reuters*, announced telecom M&A deal volumes reached USD 23.7 billion in 2007 compared to USD18.8 billion for the entire 2003-2006 period as operators look for regional and local partners and targets that will rapidly enhance profiles and create value. With the rewards on offer so attractive very few, it seems, are being deterred by the unpredictable and less consistent regulatory environments they face when entering such diverse markets.

India has led the telecoms M&A trend from the front, with large market changing deals dominating headlines over the past 12 months. Vodafone, advised by UBS, kicked off proceedings in October 2005 by taking a USD1.5 billion strategic interest in Bharti Airtel. This was followed by its USD11.9 billion acquisition of HTIL's interests in Hutch Essar in February 2007, again advised by UBS. At the time the deal was announced it represented Vodafone's largest ever cash acquisition and was also the largest transaction ever announced involving an Indian company.

Vodafone has not been alone in its increasing level of interest in the Indian market. Other recent landmark deals include: Providence Equity, in a consortium of financial sponsors, acquiring a minority stake in Idea Cellular; Telekom Malaysia's investment in Spice Communications; and Maxis' acquisition of a controlling stake in Aircel. Foreign strategic and financial investors are also showing a keen interest in greenfield licenses that are coming on offer.

India's story is being mirrored to some degree in South East Asia as landscape transforming transactions continue to be executed. In April 2008, Telekom Malaysia, with UBS acting as its financial advisor, demerged its international mobile subsidiary, TMI Berhad, for USD 10.3 billion. With the entity successfully claiming 40 million mobile subscribing customers and a presence in ten markets, it is already one of the largest pan-Asian operators, and the demerger and spin off transaction is attracting a lot of attention from international telecom operators looking to unlock value in their own operations.

In Vietnam too, with its rapidly developing telecoms market, international interest has intensified. Despite there being a lack of clarity on timing, VMS Mobifone is being lined up for privatization with several regional and global operators interested in the potential opportunities on offer.

With the largest mobile phone market in the world, developments in China are being closely scrutinized by all. The recently announced restructuring of its telecom industry is one of the largest industrial reorganizations ever under taken globally. A crucial element of the restructuring includes China Telecom, advised by UBS, purchasing China Unicom's CDMA business and network.

As China's landscape continues to evolve, foreign strategic investors are increasingly looking to gain some exposure to the market. And with potential 3G licenses on offer opportunities for international players to share their expertise with domestic operators look increasingly likely.

But the story is not all about inbound opportunities. Asia's domestic and regional champions are quickly establishing themselves and looking across their borders for their own overseas opportunities. Originally, Asia's players focused on the undersea cable sector, where a number of undervalued assets were shaken free following the bursting of the technology bubble in 2001. Players such as Reliance Communications and VSNL from India and China Netcom built up significant holdings and a strong presence in this area.

In the more technically advanced markets of Japan, Korea, Singapore and Hong Kong there is also plenty of M&A activity. PCCW in Hong Kong and Starhub in Singapore, to name just two, have been at the forefront of the global fixed-mobile convergence trend, offering quadruple plays that combine mobile and fixed telephony, broadband and IP-TV to their customers. The recently announced PCCW reorganisation and potential sale of a minority stake in the telecom and media business, advised by UBS, suggests developed markets in Asia will also generate their fair share of corporate activity.

Further examples of Asia's outbound telecoms M&A activity revolves around deals into other emerging telecoms markets. An example is MTN, which has seen two of India's leading players, Bharti and Reliance, in discussions around a possible tie-up. Not to be out done, China Mobile has already ventured into Hong Kong and Pakistan and has expressed interest in a number of other targets. Singapore Telecom and Telekom Malaysia have ventured beyond their home markets too and built very attractive pan-Asian portfolios. With top lines and bottom lines strengthening, Asia's major operators are not expected to be left on the sidelines and will be major players in the consolidation story.

# Indonesian natural resources – thermal coal heats up

**With its abundant natural resources Indonesia has once again caught the imagination of global investors. On the back of soaring oil prices, its alternative energy supplies are again in demand as its neighbours clamour for its thermal coal to power cheaper coal-fired power plants.**

The price of export thermal coal has risen by more than 125% within the past year and currently trades at USD 142.58/tonne. The bullish sentiment on Indonesian thermal coal is reflected by the rising share prices of Indonesia's companies in this sector. Share prices of the three largest Indonesian listed coal companies, PT Bumi Resources Tbk., PT Tambang Batubara Bukit Asam Tbk., and PT Indo Tambangraya Megah Tbk. have increased over 100% each over the past year. As a comparison, the Jakarta Composite Index has decreased by 7% during the same period.

In line with this, corporate activity in the coal sector has been on the rise. PT Adaro Energy Tbk successfully raised USD 1.3 billion following its IPO in July 2008 and PT Indika Energy Tbk raised USD 297 million in early June 2008, while PT Bayan Resources is looking to raise between USD 500 million and USD 700 million with its expected third quarter listing.

On the M&A front, there is a significant level of consolidation as power companies look to secure Indonesian coal assets either through equity participation, off-take agreements or a combination of both. In June 2007, India's Tata Power invested around USD 1.3 billion to acquire a 30% interest in two coal mines owned by Indonesia's largest coal company, PT Bumi Resources Tbk. In May of this year, India's Reliance Power acquired three Indonesian coal mines for USD 1.0 billion.

UBS has one of the strongest investment banking franchises in Indonesia and has been extremely active in the Indonesian natural resources sector including coal. Notably, UBS acted as the Sole Global Coordinator for the USD 337 million IPO of ITM in late 2007, where UBS was the first international bank to act as Lead Managing Underwriter in Indonesia. Other significant natural resources transactions completed in 2007 include the USD 174 million accelerated placement of PT International Nickel Indonesia Tbk (PT INCO) and the USD 105 million senior secured notes offering for Shining Hope Pte Ltd in its acquisition of Riau Baraharum coal mining in Sumatera, Indonesia.

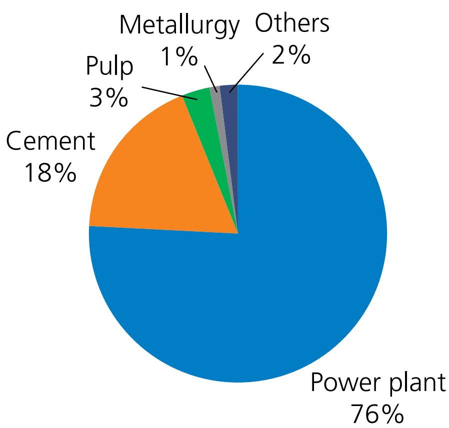
## Overview of Indonesian thermal coal

According to the Indonesian Mining Association, around three quarters of domestic coal is used by local power plants for electricity generation. Indonesian thermal coal has less heat value and more moisture compared to its regional counterparts and as a result is sold at a discount to the regionally used Newcastle price index, thus making it very attractive for regional power plants.

Indonesia is the world's largest exporter of thermal coal. In 2007, Indonesia accounted for roughly 30% of the total supply of globally traded thermal coal with approximately 183 million tonnes. According to UBS Research, Indonesia's coal exports are expected to almost double from 103 million tonnes in 2004 to 201 million tonnes by year-end 2008. Key factors for this big increase are the country's favorable comparative pricing as well as proximity to its regional customer base (North Asia) vis-a-vis other major coal producing countries in the region, such as Australia. Reflecting growing global demand for coal, UBS Research estimates that, average export thermal coal prices will almost triple from USD 55.5/tonne in 2007, to USD 160.0/tonne by early 2009.

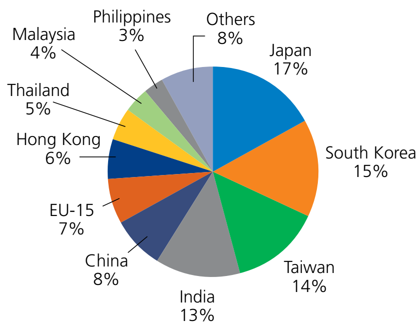
> "Indonesia is the world's largest exporter of thermal coal. In 2007 Indonesia accounted for roughly 30% of the total supply of globally traded thermal coal with approximately 183 million tonnes."

**Indonesia thermal coal utilization mix (2007E)**




Source: Indonesian Mining Association

**Indonesia's top ten thermal coal export destinations (2007)**



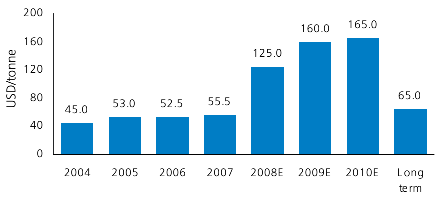

Source: AME Mineral Economics

## Challenges

Whilst both domestic and regional demand for Indonesian coal remains very strong, supply has not been able to catch up with the strong appetite for Indonesian coal. AME projects that coal exports will grow at a slower pace in the short-term. Indonesia has been plagued with supply bottlenecks due to a lack of improvement in its rural infrastructure. Specifically, transportation routes from the coal mines to the open sea are still underdeveloped or non-existent causing transportation delays for customers or new coal development projects being installed.

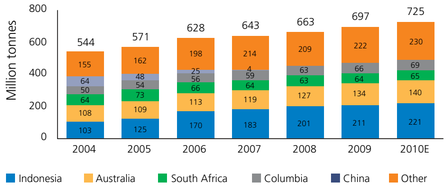
Foreign entities are not allowed to directly own coal mining concessions. The only way to invest in coal mining is by acquiring a local Indonesian entity that already has a coal mining license or by establishing an Indonesian entity which can apply for a coal mining license. This itself can take many months or even years with many regulatory hurdles. There are two types of mining licenses issued in Indonesia, Mining Authorization ("KP"), which is restricted to entities 100% owned by Indonesian nationals and Coal Contract of Work ("CCoW"), which can be granted to foreign entities. The first generation of CCoW only allows a maximum 49% foreign shareholding. The later generation of CCoW can be granted to foreign entities, but there is still a requirement to have Indonesian nationals as the shareholders.

### Price of export thermal coal (JFY)




Source: UBS Research, March year-end

### Global traded thermal coal supply




Source: UBS Research, March year-end

## Outlook

Going forward, demand for thermal coal in Asia is expected to remain strong in the short to medium term. Thermal coal prices are expected to remain high, reaching USD 165.0/tonne by early 2010. with a long term price of USD 65.0/tonne. Amidst this environment, Indonesia will play an even more important role. We expect more Indonesian coal companies to tap the international capital markets to secure funding with the aim of solving existing bottlenecks and expanding their domestic footprint. We also expect Indonesian coal companies to play a vital role in regional utility companies' strategy in their quest to vertically integrate their coal mining operations. We see no end to the current activity and remain optimistic that this sector will continue to boom in the foreseeable future.

# The growing importance of Sovereign Wealth Funds

**Sovereign Wealth Funds have emerged as an important and growing force in the world's capital markets. Their liquid assets have swollen as a result of soaring commodity prices and the ballooning current account surpluses in many of the countries where they are based. At a time of global financial stress and with concerns mounting over commodity prices and inflation, the role that these funds play could not be more important.**

To put SWFs' influence into perspective, according to *Global Insight* SWFs accounted for 35% of global M&A activity in 2007 and 28% of total M&A activity in the United States in January 2008. SWFs have overtaken private equity buyouts as the leading force in M&A, with private equity buyouts falling to below USD 3 billion in the fourth quarter of 2007, from USD 15 billion in the previous quarter. From 2000-07, SWFs made strategic acquisitions and disposals of around USD 115 billion (based on external disclosures). This does not include foreign investments by state-controlled corporations (e.g. Dubai Ports), which are estimated at an additional USD 100 billion over the same period.

Most of the deals involving SWFs centred around the acquisition or disposal of minority stakes in listed or unlisted firms. At a sectoral level, property and financial institutions dominate the figures. Since 2006, SWFs have invested around USD 82 billion in financial services, (e.g. UAE investing in HSBC and Temasek into Standard Chartered).

The financial sector will continue to be a focus area for Asian SWFs as they take key minority stakes in the larger U.S. and European banks, including UBS. With the financial sector under extreme stress, the timing of these investments is highly opportunistic, both financially and politically. However, SWF investment strategies in the first quarter of 2008 have begun to take the form of investments under the guise of private equity, hedge funds, and other closed investment vehicles as the political noise and popular disquiet about SWFs become louder. A number of such deals with private equity vehicles have already been reported in the first quarter of 2008, for example Temasek Holdings' investment alongside KKR in India's Bharti Infratel. This change in investment strategy also insulates SWFs from domestic criticism, as specific investments become more opaque to the public and the media.

**Emergence of new Asian Sovereign Wealth Funds**

While it remains difficult to gauge the total assets under management of SWFs, estimates suggest they amount to around USD 3.5 trillion, making them slightly larger than the combined assets of hedge funds (USD 1.5 trillion) and private equity (USD 1.5 trillion); but this excludes central bank reserves of an additional USD 4.5 trillion.

Against this background, Asia's sovereign wealth continues to expand rapidly, averaging 25% AuM growth per year over the last five years, with China and Malaysia reporting the fastest Sovereign Wealth generation in the region, at over 40% per year. The sources of Sovereign Wealth are principally linked to the generation of current-account surpluses on the balance of payments, allied with strong foreign direct investment (FDI) and portfolio inflows.

In China not only is FDI inflow the largest, but, more importantly, the swelling trade-based surplus has been the principal driver to rising foreign exchange reserves, which now exceed USD 1.5 trillion, the highest anywhere in the world. Inflation is now at an 11-year high, close to 7%, and the pressures on the monetary conditions in China mean that the authorities are increasingly looking at ways to release money out of the system and put it to work overseas. Building inflationary concerns and runaway domestic money supply growth, with the potential to fuel asset-market bubbles in property and stock markets, help to explain the domestic drivers behind the foreign ventures of the newly set-up China Investment Corporation (CIC), as well as the more established state-owned banks and state-owned companies.

The development of CIC in September 2007, Asia's largest SWF, is a major accomplishment. It is mandated to manage over USD 200 billion of central-bank-supplied foreign exchange for more lucrative investments across a broader range of global assets. While taking direct equity stakes itself, such as its USD 5 billion equity investment in Morgan Stanley in December 2007, CIC has also decided to farm out the management of its funds for tender to worldwide professional fund managers experienced in a broader range of global assets, including those in emerging markets, with a view to achieving a higher risk return.

Proposals to set up a Japanese SWF to manage part of Japan's USD 1 trillion foreign exchange reserves have so far been less successful with the Ministry of Finance's proposal meeting with resistance, even from the minister himself. Nevertheless, draft proposals for a Japanese SWF to be set up within the year will be submitted by the end of March and have the endorsement of the former Japanese prime minister, Shinzo Abe.

Not wishing to be left out, Taiwan's government also took a decision at the end of 2007 to set up a SWF that will utilise Taiwan's stock of foreign exchange and other short-term foreign assets, such as triple-AAA-rated government Treasury bills. The Taiwanese government has confirmed that it is finalising details for the creation of an overseas investment fund financed by contributions from the public and private sector. The initial TWD 2 billion (USD 61.5 million) portfolio will be managed by the Council for Economic Planning and Development, with private capital furnishing around 60% of total funding and the government contributing the remainder. Energy projects in the Arabian Gulf region will be amongst those specifically targeted.

Policy developments are also likely to enhance the expansion and more aggressive investment role for South Korea's only SWF, the Korea Investment Corporation (KIC). The KIC is in talks with the national pension service and other pension funds to expand its investment pool. The Korean Finance Ministry said in November 2007 that it planned to expand KIC's assets tenfold to USD 200 billion by 2015 and broaden its investment scope, allowing investment in real estate and private equity funds. The Bank of Korea has also relaxed its investment guidelines for KIC to invest in EM equities and equities more generally, away from traditional OECD government bonds.

Meanwhile, in mid-February 2008 India became the very latest country to discuss setting up a SWF. Indian policymakers are currently debating the possibility of setting aside a portion of the country's foreign-exchange reserves, standing at USD 291 billion, to set up a SWF to invest in local infrastructure and overseas energy resources, as well as overseas financial assets. India's foreign-exchange reserves are up by 57% on last year, despite a trade deficit. There is speculation that an Indian SWF could initially have capital of USD 5 billion and be modelled along the lines of Temasek, the long-established Singaporean SWF.

**UBS and SWFs**

In recognition of the significance of SWFs, UBS Investment Bank and Global Asset Management hosted the inaugural UBS Sovereign Wealth Fund Conference in Abu Dhabi on 21-23 April 2008. The event was a natural evolution of UBS's sovereign relationships that are managed in close collaboration between the two business groups. The conference in Abu Dhabi was attended by 40 senior clients from 25 institutions around the world, creating insightful debate at the highest level.

The largest SWFs were represented at the conference alongside a select handful of countries which have growing reserves. Key decision makers, such as Bob Zoellick, President of the World Bank, also participated. Covering topics such as Best Practices for Sovereign Wealth Funds, Asset Allocation and the Implications of Strategic Equity Holdings, the event was unique in its SWF-only composition. Keynote speeches covered the themes of Public Relations Strategy, the Establishment of SWFs in Georgia, Private Equity and Significant Cross Border Capital Flows.

Within Asia, the UBS Financial Sponsors Team, headed by Stephen Gore, manage the coverage of SWFs for IBD.

**Globally, SWF assets are highly concentrated with the top ten funds accounting for 80% of total assets. The majority of SWFs derive their income from commodities, the single largest contributor being oil, whilst other large SWFs derive their income from current account surpluses and growing fiscal reserves.**

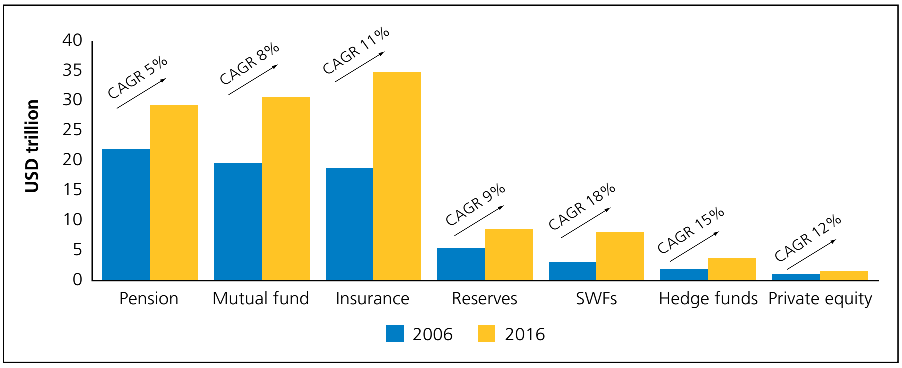
| No | Sovereign Wealth Fund (Country) | Funding source | AuM (USD bn) |
|---|---|---|---|
| 1 | Abu Dhabi Investment Authority (UAE) | Oil | 650-700 |
| 2 | Norway Government Pension Fund (Norway) | Oil | 350-400 |
| 3 | GIC (Singapore) | Fiscal/Reserves | 330 |
| 4 | Saudi Arabia Monetary Authority (Saudi Arabia) | Oil | 300 |
| 5 | Kuwait Investment Authority (Kuwait) | Oil | 250 |
| 6 | China Investment Corporation (China) | Fiscal/Reserves | 200 |
| 7 | Temasek Holdings (Singapore) | Fiscal | 160 |
| 8 | Russia Reserve Fund (Russia) | Oil & Gas | 150 |
| 9 | Hong Kong Monetary Authority (Hong Kong) | Fiscal/Reserves | 140 |
| 10 | Libya Reserve Fund (Libya) | Oil | 50-100 |

Source: Global Insight, UBS estimates

## Growth of Sovereign Wealth Funds

**According to *Global Insight*, over the medium term, SWFs are expected to be the fastest growing institutional investor segment SWF AuM could be more than double that of global hedge funds, and about six times the size of private equity funds. Cerulli and McKinsey forecast that SWFs will grow at a CAGR of 18% between 2006 and 2012.**

**Projected medium-term growth of different asset classes**




Source: UBS, Cerulli, McKinsey

> *"Asia's sovereign wealth continues to expand rapidly, averaging 25% per year over the last five years."*

## Differentiating Sovereign Wealth Funds

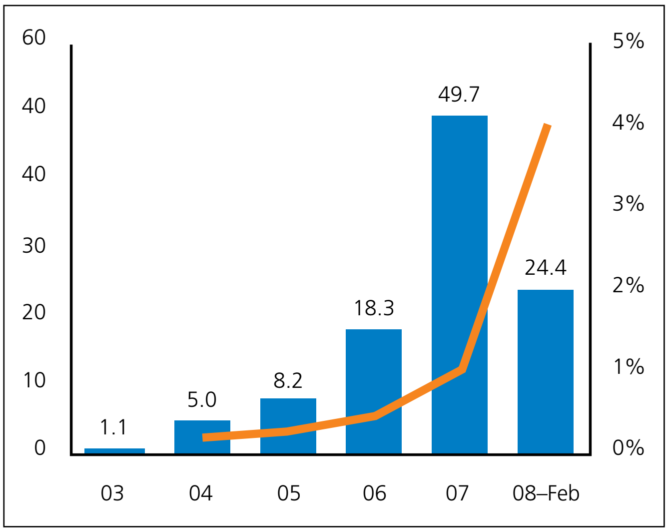
**SWFs are often considered to be a homogenous group of investors. In reality, SWFs include a variety of institutions with different goals, investment approaches and risk tolerance. From an investment style perspective, they are typically distinguished into three fund types – stabilisation funds (e.g. HKMA), savings funds (e.g. Norway Government Pension Fund) and reserve investment corporations (e.g. Russia Reserve Fund).**

**Another useful distinction of SWFs is that between "asset managers" and "strategic investors". The majority of SWFs fall in the category of asset managers. They have a very similar investment approach to conventional institutional investors (i.e. pension funds), rarely take individual major stakes in single companies and mostly invest in publicly-listed financial assets (e.g. bonds and equities). In general, they are passive and long-term investors with no desire to impact company decisions by actively using their voting rights.**

**Strategic investors are more aggressive in their asset allocation. They make individual acquisitions and dispose of strategic assets, operating in a similar fashion to private equity funds. According to UBS estimates, they control c. 20% of the assets managed by SWFs, but their importance is gradually growing. In fact, more assets are being shifted from asset managers to strategic investors. There are several drivers for this. First, the amount of reserves held in the stabilization and savings funds is becoming large enough and new SWFs are being established (in the Middle East, for instance, new SWFs are being established to diversify the fast-growing reserves). Secondly, the asset allocation of existing funds is being revised, to broaden the spectrum of investments considered in the asset allocation. It is the recent activities of these strategic investors which has recently catapulted SWFs into the global spotlight.**

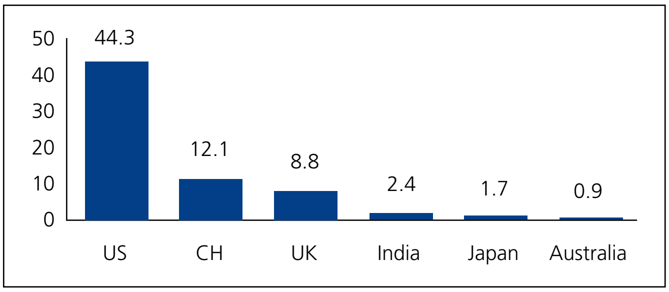
### SWFs as strategic investors

**SWF direct/strategic investments 2003-08 (USD bn)**

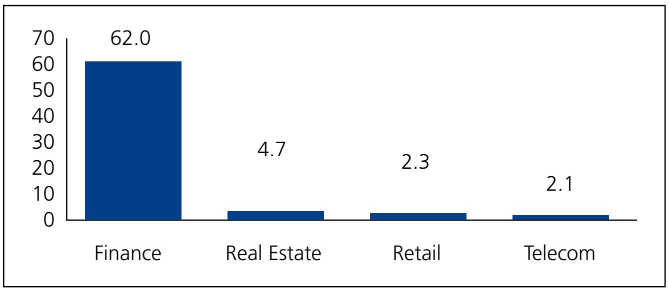



Source: Dealogic

**SWF investment by destination, 2007-08 (USD bn)**




**SWF investment by sector (USD bn)**



# Q&A Key questions on Global Inflation


**Paul Donovan , Deputy Head of Global Economic Research, UBS Investment Bank, gives his views on the issue of global inflation and on the likely impact on the economies of Asia.**

**Q. How long will this slowdown in the world economy continue? Can Asia help prevent a slowdown?**

We believe that the world economy will operate below its trend (potential) rate of growth for all of 2008 and 2009. The world may start to get back towards trend in 2010, but the recovery is likely to be slower than normal.

Asia can, of course, contribute positively to the world economic recovery when it comes. However, there are problems with the idea that Asia will take a strong role. Asia (excluding Japan) is a little more than 20% of the world economy. That is important, but it means that the whole of the Asian economy (including China and India) is the same size as either Europe or the United States. While Asian growth is not too export dependent, and domestic demand in the region can do something for the world economy, exports are still an important part of Asian economic activity, and that growth depends on Europe and America.

More significantly, the causes of this slowdown are rooted in weaker consumer demand in Europe and America. Because European and American consumers are wealthier than Asian consumers, they tend to purchase different sorts of goods. It is unlikely that Asian consumers will buy the same items that European and American consumers used to buy. This means that Asia might generate a different sort of demand in the future, but it is very unlikely to replace the demand that has been lost in Europe and America.

**Q. Do you believe that China's economy will slow down following the Beijing Olympics?**

We do not believe that the Olympics will have a significant impact on the Chinese economy, in a direct sense. The construction and economic activity related to the Olympic project is a tiny part of an economy as large as that of China. Olympics only tend to have a significant direct impact on an economy if the host country is relatively small, and the construction and tourism therefore forms a large proportion of GDP.

There are indirect impacts from the Olympics. It is possible that the Chinese government has been delaying some policy moves until after the Olympic Games, and those policy changes could then alter the economy. However, we do not believe this to be the case, and there seems to be little impact on fiscal or monetary policy. For the longer term, the way in which China presents itself to the world during the Olympic Games can be very important to its international image and longer term growth. It's estimated that around 4 billion people watch some part of the Games. A successful Games (Seoul, Sydney) can bring long term investment through good publicity. Conversely, an Olympic Games that does not present a country in a positive way can damage longer term growth prospects.

**Q. Are we heading into an era of stagflation?**

Stagflation has no formal economic definition. Rising inflation and slowing growth is quite common - because inflation tends to react to growth with a lag. The 1970s, which are commonly referred to as a stagflationary episode, are unlikely to be repeated. In the 1970s the "Carter Misery Index" (inflation plus the unemployment rate) was over 20%. Something like that is very unlikely today. I believe that inflation is likely to come down in most OECD economies over the second part of this year. However, for emerging markets, inflation may be more of a problem - including some economies in the Asian region.

### Q. When will the global economy recover? What are the positive signs to look out for?

We think the world economy will reach a bottom in the third or fourth quarter of this year. The problem is not how far down the economy goes, it is more a question of how long the world economy is likely to take to recover. I think evidence of a stronger recovery will come in late 2009. I would look for a "normalisation" of the banking system, and more normal credit lending practices, as an important signal.

### Q. The outlook for the price of oil shows many variances. Why are there so many differences and is an energy crisis looming?

Essentially there is disagreement over what is causing the oil price increase - supply constraints, demand, refinery capacity, speculation. Most economists agree that speculation has very little to do with the oil price, and so views depend on the other factors. There are wide differences in estimates of supply and refinery capacity in particular, which allow for different price estimates.

A short term crisis in energy is possible - at least one that is caused by rising oil prices. However, chronic energy shortages seem relatively unlikely in the developed economies at least. In the 1970s the world was very dependent on oil for power generation, and a genuine energy crisis emerged (the United Kingdom suffered repeated power cuts, and the debate was of a three day working week). Technological change, energy efficiency and alternative energy sources mean that this sort of power crisis (directly halting economic activity) is less likely. There is, however, already a crisis of sorts in that consumers are (through price effects) forced to choose between whether to buy fuel for their car or whether to buy other things. Of course, some consumers are simply changing their behaviour - Americans are driving less this year than last; Japan has fewer cars this year than last year, for the first time since 1946.

### Q. Food price inflation is also an important issue, what is your outlook for food prices? Will price controls, restrictive export practices, and the provision of subsidies continue in certain countries?

We expect the price of agricultural commodities to remain relatively high for this year - though the percentage change is likely to be lower than it was last year. However, we should remember that not all commodities are seeing increases in price. It is also very important to stress that the price consumers pay for food has little to do with commodity prices. In an OECD economy, only around 20% of the price of food paid for by consumers actually goes on agricultural commodities. Consumers spend around 80% of their food budget on processing, packaging, advertising, supermarket costs etc.

Limits on exports are, generally speaking, a political devise - there is no economic justification for them. It will therefore depend on domestic politics as to when they are lifted. The economic impact of some of these controls is exaggerated. Limits on rice exports, for example, sound dramatic - but less than 3% of rice is actually traded internationally. Nearly all rice in the world is consumed in the country in which it is grown, so export limits are not as dramatic as they sound.

### Q. As the global economy slows are you seeing any protectionist measures being introduced?

Protectionism is a very real threat, and it is already a risk that we are facing up to. There are two forms we need to be sensitive to – current account protectionism – limits on trade – and capital account protectionism – limits on the free movement of capital, investment etc. Both are serious risks.

I believe that the best case scenario will see globalization stabilize, measured by international trade as a percentage of GDP. This is a very different environment to the last 15 years or so, when globalization roughly doubled - trade share of world GDP went from 12% in 1990 to 23% in 2006. Protectionism, and the failure to advance multilateral free trade, is likely to stop trade expanding any more rapidly. Bilateral trade deals, which can harm globalization because they create barriers to anyone who is not part of the exclusive preferential trade agreement, are likely to continue and will prevent trade growth from accelerating.

### Q. While the U.S. now suggests it wants a strong dollar, the market continues to show dollar weakness. What is your outlook for the value of the U.S. dollar?

Longer term I think the dollar is declining. Its use as a reserve currency in the private sector is fading. A Japanese company for example is more likely to invoice a Korean company in yen today, fifteen years ago they would have invoiced in dollars. The current account will continue to be a negative feature for the US dollar as well. However, we should remember that the currency markets never move in straight lines. Although I believe the dollar will tend to weaken in the coming years, I think that in the near term it has overshot its position against the Euro. There is therefore the prospect of some Euro weakening, and dollar strength, over the next few months - before dollar weakness is resumed.

### Q. What is your outlook on interest rates?

We believe that interest rates in Europe, America and the UK have further to fall. In emerging markets, it will vary from country to country, but interest rate increases are to be expected over the remainder of this year. Japan and Australia are likely to keep rates unchanged.

### Q. Do you think there will be increased cooperation between countries in light of the global slow down?

I believe that any future crisis will provoke a coordinated response for example, the coordinated action by central banks to provide the financial markets with liquidity. However, I think that coordinated policy moves in the absence of a crisis are less likely. Governments in Europe, America and Asia are pursuing different objectives, and it is hard to see how common policy goals would be agreed upon.

# UBS's new Global Capital Markets Group

**To improve connectivity for clients and to increase the levels of cross product thinking and cooperation, UBS has brought together its leading equity and debt primary and derivatives business groups to create the Global Capital Markets (GCM) Group.**

In Asia, Steven Barg takes overall responsibility for running the GCM business and reports to the new Joint Global Heads of GCM, Roberto Isolani and Matthew Koder.

**Following his appointment Steven announced his GCM Asia senior leadership team:**

- **Sutha Kandiah and Mark Williams**
  Joint Heads of Asian Equity Capital Markets
- **Ranobir Mukherji**
  Head of Asian Debt Capital Markets
- **Ranobir Mukherji and Michel Lee**
  Joint Heads of Asian Alternative Capital Markets
- **Michel Lee**
  Head of Asian Structured Products (Equity-linked and Capital securities)
- **Sam Kendall and James Fleming**
  Joint Heads of Asian Equity Syndicate and Block/Execution
- **Fergus Edwards**
  Head of Debt Syndicate

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