



THE BOSTON CONSULTING GROUP

SOVEREIGN WEALTH'S HUNT FOR THE NEXT UNICORN

By Markus Massi, Alessandro Scortecchi, and Pratik Shah

AS DIGITALIZATION TRANSFORMS THE way people live, work, and play, the organizations that power this shift will generate significant value for their customers, investors, and the economy as a whole. The rapid growth of the technology sector provides ample evidence. At the end of 2016, six of the top ten revenue-generating companies in the world were technology companies—compared with just one at the end of 2006.

Once focused exclusively on mature industries—such as health care, consumer and retail, energy, and financial services—sovereign wealth funds (SWFs) are becoming increasingly active in the digital and technology sectors, backing innovative businesses that have the potential to become powerful value generators.

These funds are not only actively looking to capitalize significantly more deals, but they are also engaging with targets far earlier in their growth curves. In some cases, they are even serving as an alternative form of IPO.

The benefits of this relatively new investment strategy are bilateral. SWFs gain access to technology life cycles that may lead to larger and more rapid returns as well as insights that can inform both their national strategic agendas and the growth strategies of their existing portfolio companies.

At the same time, with their longer-term investment horizons, relatively deep pockets, and access to key markets, SWFs have become a major source of strategic capital for businesses in the digital and technology sectors—and an important partner for those that are actively looking to expand into growth markets.

Investing in emerging digital and technology businesses, however, is different from investing in other sectors and requires fundamental adjustments to a fund's investment model. To succeed, SWFs need to articulate the value they hope to achieve, adapt their operating model to enable early-stage investing, calibrate the risk-reward thresholds they're willing to accept, and acquire critical skills and expertise.

SWFs Are Increasing Their Stake in Digital and Technology Businesses

Since 2012, the number of SWF-funded technology deals has grown by 38% and now represents 27% of total deal flow. (See Exhibit 1.) In addition to the technology sector’s basic investment appeal, deal growth has benefited from the build-out of direct-investing capabilities by major limited partners and the increasing costs of participating in funds run by top-quartile venture capital (VC) or private equity (PE) managers. SWFs are structuring their participation in a variety of ways, such as through sole directs, cosponsorships with other SWFs and PE funds, co-investments, and limited partnerships.

Much of the momentum is coming from investors in Asia and the Middle East. (See Exhibit 2.) China contributes more in technology-focused VC than most European countries combined, and Far Eastern heavyweights—such as Huawei, Lenovo, and Samsung—are acknowledged world leaders in their respective sectors. The impetus from the Middle East is slightly dif-

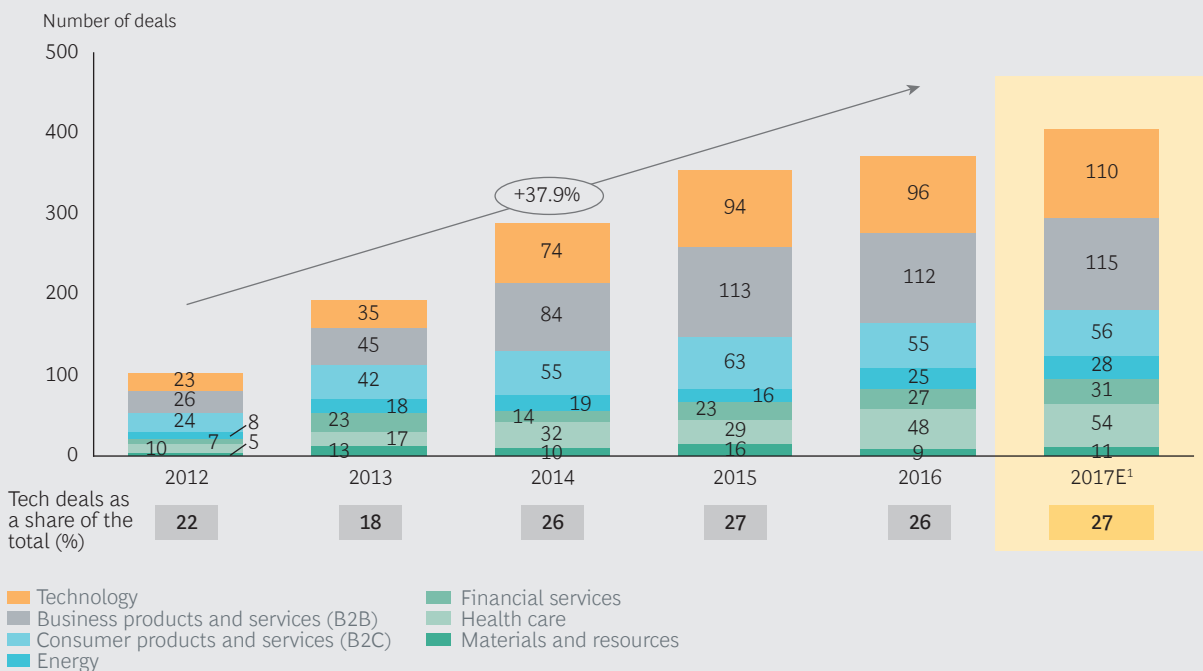
ferent. Many countries in that region are requiring their SWFs to adopt a domestic economic-diversification agenda that moves them away from their traditional commodities focus. This will effectively “future-proof” these countries’ economic systems by accelerating the digital transformation of their domestic industries.

The Rise of Investment in Digital, Technology, and Disruptive Innovation

Digital and technology businesses used to view SWFs as an option of last resort—a view arising from what was perceived to be SWFs’ lack of understanding of those sectors, inexperience in high-growth scaling, and limited global reach. But that perception has completely changed. With few exceptions, young technology and digital businesses now consider SWFs to be on a par with the world’s leading global VC and technology-focused PE funds.

Because SWFs typically have longer investment horizons than VCs, and tend to be less aggressive than PEs, they have earned

EXHIBIT 1 | Deals by Sector

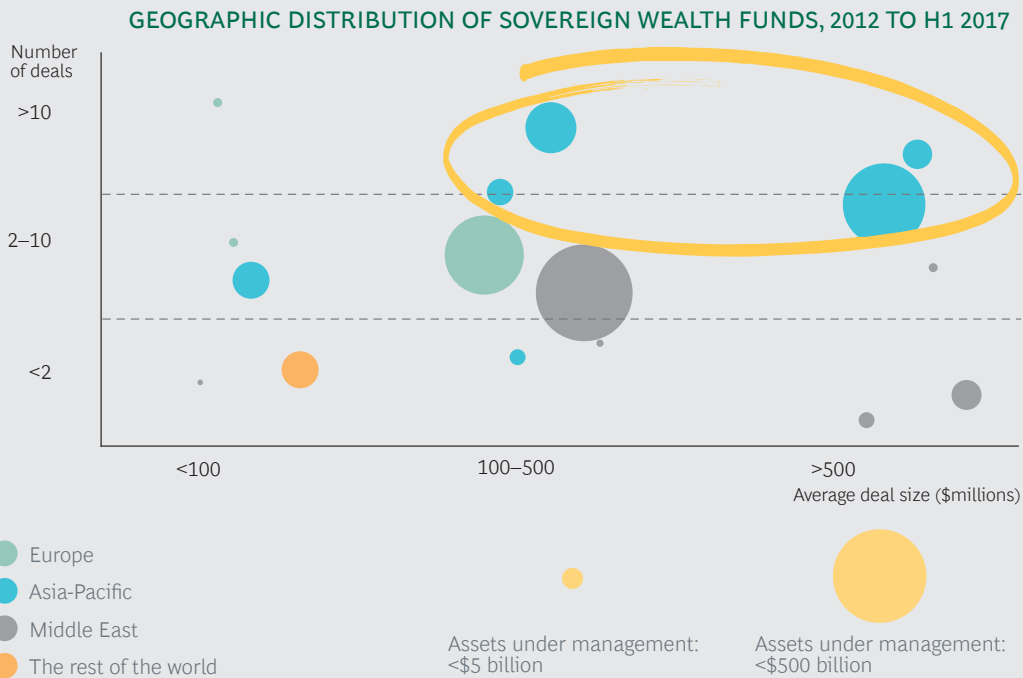


Sources: PitchBook Data; Preqin; BCG analysis.

Note: Deals for which size was not disclosed, or completion was uncertain, were excluded.

¹The estimates for the number of deals in 2017 were made on the basis of BCG analysis.

EXHIBIT 2 | Funds in Asia and the Middle East Dominate the Landscape



Sources: PitchBook Data; Preqin; Sovereign Wealth Fund Institute; BCG analysis.
Note: Deals for which size was not disclosed or completion was uncertain were excluded.

a reputation for providing long-term capital, offering better access to emerging and growing markets, and having more realistic returns expectations. These qualities suit the general culture of high-growth technology businesses that value an incubation period during which they can test and experiment without the pressure of meeting the aggressive growth and cash-out expectations that are typical of VC funds. What's more, some high-growth digital and technology businesses see SWF involvement as a way to provide an alternative, risk-adjusted private form of IPO. SWF capital—often a combination of Series B and Series C funding—can help these businesses maintain (and in some cases, upgrade) their valuations and avoid the volatility and costs of transparency associated with a public listing.

While the relative-risk-adjusted returns for classic investment sectors have declined over the past few years as a result of modest global economic growth, macrostructural imbalances, and continued geopolitical instability, the digital and technology sectors are thriving. Typical digital and tech-

nology life cycles, along with their associated rapid returns profiles, allow SWFs to offset the relatively higher risk of investing in still-unproven business models and channel those returns into new early and (mostly) growth-stage investments.

Qualitative benefits are equally important. An active digital and technology investment strategy and business portfolio creates an innovation pipeline that can provide SWFs with advanced insights into emerging trends. These trends can inform future investment decisions and potentially uncover hidden pockets of value in other, more mature portfolio companies, especially those in classic investment sectors.

Those insights can also help SWFs rebalance their portfolios in order to channel resources toward high-growth opportunities and exit businesses and technologies that seem less promising. In addition, SWFs that maintain an active role in the digital and technology sectors are more likely to attract the right grade of talent and gain the knowledge and network needed to grow their skill base.

Many countries, especially those in growth markets, see investment in digital and technology as a means to diversify and future-proof their economies. For instance, Saudi Arabia, through its Public Investment Fund (PIF)-supported Vision 2030 plan, has used investments in Uber, the e-commerce firm Noon, and the SoftBank Vision Fund as a way to accelerate technology transfer, skills, and productivity upgrades to different sectors and industries. Similarly, Bahrain’s SWF, Mumtalakat, used its 2016 investment in Envirogen Technologies to help serve the country’s growing domestic demand for effective water treatment solutions.

SWFs Are Pursuing a Mix of Entry Points

Insights gained from proprietary research and interviews suggest that, for most SWFs, choosing the right mode of entry is critical. In making the choice, SWFs generally look at alignment, access, cost, and the current stage of the sector’s technology and operational life cycle.

Given their lack of deep expertise in the technology sector and low presence in key technology hubs, the majority of SWFs tend to make early-stage digital and technology investments through limited partnership positions in established VC funds. They then evolve these investments into more direct positions once the digital and

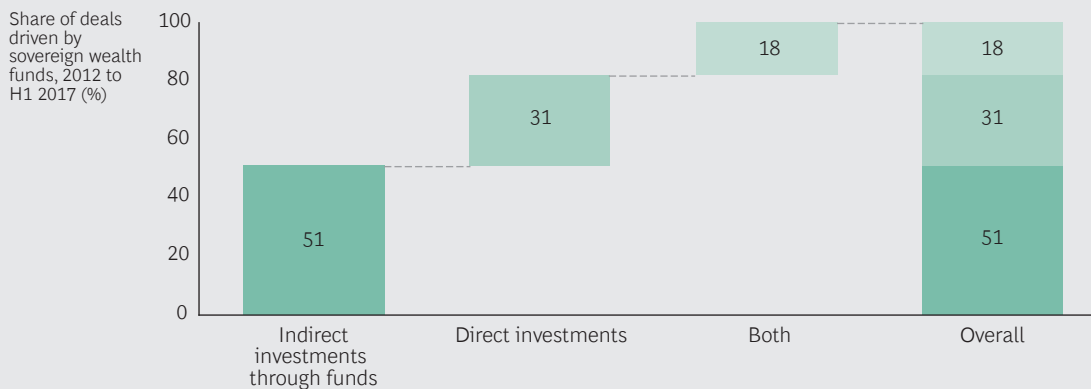
technology businesses become classic growth capital plays—situations in which the underlying business model is effectively proven. This approach tends to suit current SWF investment operating models.

Each mode of entry has tradeoffs. Indirect participation through funds yields a deal flow that is diversified and often of higher quality. It can also provide SWFs with access to specialized technology expertise during the origination and due diligence phase. For these reasons, indirect participation remains the most common mode of entry into the digital and technology sectors. (See Exhibit 3.) But SWFs that choose indirect investment must factor in their fee exposure, which can be significant, and recognize that accessing the most influential managers can be difficult. In addition, participating as a limited partner (unless as an anchor) in a recognized fund may not yield the desired strategic benefits of learning and knowledge transfer that we’ve described.

Direct participation, on the other hand, has the advantage of a lower fee platform and can give SWFs a deeper and more hands-on role with their investment target. But direct investments require greater, and highly specialized, in-house expertise, which can take time and money to cultivate effectively. Investing in digital and technology businesses, often at earlier

EXHIBIT 3 | Indirect Investment Through Funds Remains the Dominant Mode of Entry into the Digital and Technology Sectors

DIRECT INVESTMENTS VERSUS INDIRECT INVESTMENTS THROUGH FUNDS



Source: PitchBook; Preqin; BCG analysis.

stages in their growth curves, is fundamentally different from traditional defensive investment strategies in classic, mature sectors. Accounting for those differences requires changes to the SWF's operating and governance models—including, for example, a more specialized approach to due diligence, multifaceted growth planning, and a comprehensive understanding of scaling a high-growth business. These changes drive the overall complexity of doing deals in these sectors and are often why many SWFs, such as Kuwait's Impulse International and Oman's IDO Investments, look to establish separate units to focus on digital and technology investments.

Some SWFs have opted for a third, hybrid approach that calls for an SWF to hold a significant anchor position as a limited partner in a specific fund and leverage that position for a deeper role in portfolio governance development and value creation after the acquisition. While the general partner still serves as the overall lead, the SWF effectively participates as an equal partner. PIF's commitment of \$45 billion over five years to the \$93 billion SoftBank Vision Fund is one example of this type of model.

Key Steps for Capitalizing on the Digital Opportunity

The classic investment playbooks for traditional sectors cannot be applied effectively to investments in the digital and technology sectors. Approximately 25% of digital and technology businesses in the growth stage fail to return their initial investment; and the risk-reward dynamic, coupled with the potentially rapid and outsize returns profile, is fundamentally different. To navigate these challenges, SWFs need to recalibrate their investment value chains and adapt their broader operating models in the following ways:

- **Develop a strong value narrative and clear objectives.** SWFs must have a clear strategy for entering the digital and technology sectors. Key elements of such a strategy involve articulating

realistic objectives for returns, thoroughly understanding sector risk, and being comfortable with variable hold periods. SWFs also must consider how the digital and technology investment program will contribute to the fund's core domestic strategic-development agenda.

Among the questions to consider is, How does one balance an opportunity that generates an internal rate of return of at least 25% versus one that yields much less and with far greater risk—but which provides insights with regard to future digital and technology trends and informs best practices for technology transfer? Global imbalances in supply and demand make having a compelling value narrative especially important: leading SWFs, pension funds, and family offices are all seeking access to the same top-quartile VC and PE funds, and their direct teams are chasing the same cutting-edge, high-growth businesses. Simply contesting through price premiums is no longer adequate. Investors need to demonstrate why they are the best choice and impress upon the potential target their commercial and strategic expertise to create value and scale.

- **Have the right, experienced team and analytics in place to help predict the technology life cycle.** Winning digital and technology investment programs require teams with deep digital, technology, and innovation backgrounds; exposure to companies across the development curve; and, ideally, experience in principal investing. These teams then require access to cutting-edge analytics solutions and platforms that allow teams to iteratively model a particular innovation's life cycle, from adoption to acceptance to maturity to eventual decline. Of course, acquiring or building such teams is expensive and takes time. Companies that understand this challenge and are able to move quickly to secure the right makeup of experienced industry professionals will be at a distinct advantage relative to the competition.

- **Prime the operating and risk models by developing internal knowledge infrastructure.** In addition to the broader investment model, a digital and technology investment program requires adjustments to a fund's governance and risk management models to succeed. SWFs need to spend time up front designing the right protocols, performance metrics, incentives, and dashboards to monitor progress. These funds also need to develop nuanced risk management models that blend nicely with existing processes but that take into consideration the macro risk characteristics of this sector. To truly maximize efficiency, an SWF also needs to create an effective knowledge transfer infrastructure and sharing mechanism. Major global investors, from the largest global buyout funds to the most powerful limited partnerships, are actively using proprietary knowledge of digital, technology, and disruptive innovation trends to inform broader strategic decision making across the portfolio and help their portfolio companies successfully navigate their own digital transformation journeys. Future-proofed businesses always command a higher multiple than digital laggards.
- **Invest throughout the cycle.** Although the digital, technology, and disruptive innovation sectors are relatively cycle agnostic, SWFs need to avoid the temptation to pull back on their investment activity during recessions. Maintaining a steady investment stream allows SWFs to capture the most attractive valuations and build up their reputations with top venture funds and potential investment targets alike.

BY INVESTING IN digital, technology, and disruptive-innovation businesses, SWFs can gain valuable insight into the practices, tools, and trends that are likely to shape the global economy for years to come. Such knowledge can help SWFs accelerate their domestic development agendas and help future-proof their portfolios. Success, however, requires a fundamentally different investment approach: SWFs need to articulate a clear value narrative, recalibrate their internal operating and risk models, create an internal knowledge infrastructure, and develop the skills and capabilities to compete effectively against other principal investors. Those that successfully follow these steps have the potential to gain significant long-term advantage.

About the Authors

Markus Massi is a senior partner and managing director in the Dubai office of The Boston Consulting Group. He is also the global leader of the sovereign wealth fund topic in the Principal Investors & Private Equity practice. You may contact him by email at massi.markus@bcg.com.

Alessandro Scortecci is a principal in the firm's Dubai office and a core member of the Principal Investors & Private Equity practice. You may contact him by email at scortecci.alessandro@bcg.com.

Pratik Shah is a fund strategy knowledge expert in BCG's London office and a core member of the Principal Investors & Private Equity practice. You may contact him by email at shah.pratik@bcg.com.

The Boston Consulting Group (BCG) is a global management consulting firm and the world's leading advisor on business strategy. We partner with clients from the private, public, and not-for-profit sectors in all regions to identify their highest-value opportunities, address their most critical challenges, and transform their enterprises. Our customized approach combines deep insight into the dynamics of companies and markets with close collaboration at all levels of the client organization. This ensures that our clients achieve sustainable competitive advantage, build more capable organizations, and secure lasting results. Founded in 1963, BCG is a private company with more than 90 offices in 50 countries. For more information, please visit bcg.com.

© The Boston Consulting Group, Inc. 2017. All rights reserved. 9/17