The search for yield in private markets

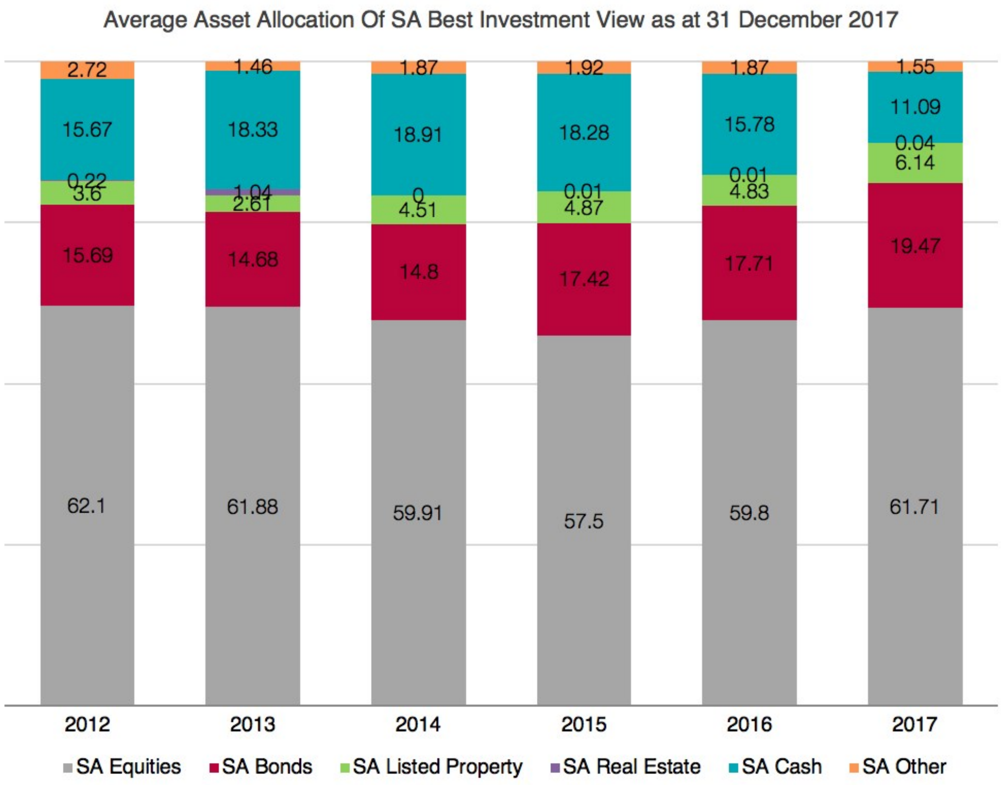
27 February 2019

Increasing concerns around the global economy, the United States (US)/China trade conflict, uncertainty around Brexit and emerging markets risk are pushing investors to look for other sources of return. Global growth seems to have peaked but there is a downside risk to this growth.

On the domestic front, constrained economic growth projections (albeit in the right direction), disappointing stock market performance, lack of business confidence and political uncertainty are leading local investors to look for other sources of return. The market is not expected to improve substantially in the short term.

Therefore, the international factors coupled with local factors have led investors to look beyond the traditional assets for better returns. The alternative markets still provide attractive valuations and offer the potential for alpha while also offering diversification from traditional assets. Investors are also increasing their allocations to alternative investments in search of returns that are not correlated to the traditional market.

However, South African investors allocate about 2% of their assets to alternatives. This is extremely low when compared to the developed world (US and Europe), where allocations are generally over 20%.



Source: Alexander Forbes Retirement Fund Survey 2017

Below we look at the different alternative investment options available. However, please note that the industry data on the alternative assets is not readily available because the market is not as developed and standardised as the traditional assets.

Unlisted credit

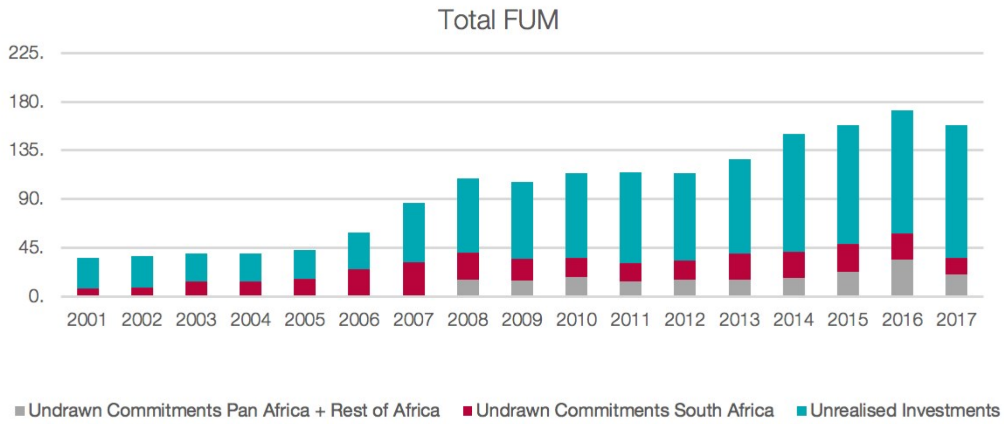
In South Africa (SA), more than 80% of companies fund themselves through the banking system (private markets). This means that less than 20% of companies use the public debt capital markets for their funding requirements. The more developed countries have a lot more companies accessing the debt capital markets for their debt funding (e.g. in the US it is the opposite of the SA scenario). The South African phenomenon has resulted in SA banks having very well-diversified balance sheet portfolios, whereas capital market investors only have access to limited investment opportunities through the debt capital markets. The unlisted credit offering gives investors the opportunity to access this diversified pool of assets that are currently not readily available to investors in

Collective Investment Schemes Control Act regulated funds.

We have seen increased interest and demand for unlisted credit from South African institutional investors in last the couple of years. The revised pension funds regulations (Regulation 28) allow for 15% of the pension fund to be invested in unlisted debt instruments. Most pension funds are below this limit.

The private equity

Southern Africa's private equity industry had R158.6 billion funds under management as at 31 December 2017. Of funds raised during 2017, 49.9% were from South African sources according to the Southern Africa Venture Capital and Private Equity Association 2018 Private Equity Industry Survey.



Source: SAVCA 2018 Private Equity Industry Survey

South African institutional investors have been increasing their participation in the private equity market for many years, as can be seen from the above chart. Investors may include mezzanine debt under the private equity category depending on the way in which the instrument is structured (e.g. some mezzanine structures will include equity kickers).

Real assets

Investor participation in real assets will either be through a debt structure or equity structure. The pension fund allocation limits will be prescribed under Regulation 28. Institutional investor participation in real assets is key, especially for a country like SA with huge infrastructure funding needs.

Real assets offer a great source of inflation hedge for long-term liabilities, particularly for pension funds. The assets' long duration, predictable cash flow and inherent inflation hedge are very attractive. Investors have previously participated in toll road and renewable energy infrastructure funding and have preferred to participate in the post construction phase of the transaction. This is mainly because of a lack of understanding of the construction phase risk.

The policy and pricing uncertainty, because of political meddling, has seen investors scaling back from these assets in the SA market. Jeff Radebe, Minister of Energy has moved swiftly to provide some certainty on the funding of renewable energy projects. We hope that this will lead to increased confidence and funding from institutional investors. The country's fiscal constraints will require institutional investors to plug the infrastructure funding gap.

Conclusion

We believe that any portfolio asset allocation needs to have a meaningful allocation to alternative assets. Alternative investments, when used as part of a multi-asset portfolio, to complement traditional investments, can lead to improved long-term risk-adjusted returns. First time investors in the alternative markets should focus on the overall benefits that alternative investments bring to a portfolio.