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SOUTHERN AFRICAN VENTURE CAPITAL AND PRIVATE EQUITY ASSOCIATION

REGULATION 28 AMENDMENTS FOR PRIVATE EQUITY

SAVCA Positioning Paper

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2 June 2020

Regulation 28 amendments for private equity

Executive Summary

Private equity and venture capital funds play a crucial role in our economy, investing widely and stimulating growth, innovation and sustainability. As we look to recovering after the Covid-19 crisis, the importance of this role is in stark relief.

Yet, institutional investors, particularly pension funds, are currently constrained in the amounts they can invest in the asset class. Restrictions are imposed by Regulation 28 of the Pension Funds Act, which groups private equity with hedge funds and “other” despite significant differences in the risk/return profiles of these asset classes. These constraints limit the economic impact that private equity and venture capital can have at the same time as limiting the ability of fund managers to fully deliver on their mandates.

We propose two changes to Regulation 28, the first to separate private equity into a specific asset class with a specific ceiling, and secondly over time to increase this ceiling from 10% of assets to 15%. We present evidence in this note that this will improve wider outcomes in the economy while also allowing fund managers to be more effective in their investment strategies.

Introduction

Private equity and venture capital funds play a unique function in the investment marketplace because they are active investors involved in growing companies, alongside the leaders of those companies. This makes private equity quite different from hedge funds, collective investment schemes and other institutional investors which generally play no active role in directing the strategy and growth of companies. Private equity focuses on the real economy, on building successful companies through a combination of capital and strategic know-how, rather than on financial markets where shares and bonds are traded. This means it has much wider exposure than the relatively few companies that are able to list their shares or issue tradeable debt. Private equity investors work closely with management teams to support them through critical aspects such as cash-flow management, credit facilities, supplier management, procurement, ESG and, in growing their businesses.

Most Private equity managers are focused on growing their portfolio companies, including employment and profitability. Private equity is also well known for its ability to support and turn around distressed companies, while improving sustainability and governance standards. This has been extremely important during the Covid-19 crisis and will be vital when the economy begins the process of recovery. A successful recovery of a business requires financial, operational and legal skills. Stressed balance sheets may require restructuring, as well as the reform of client and supplier relationships to cater for disrupted supply chains. Businesses also need to restructure operations to meet new health and economic demands.

This beneficial impact of private equity at times of crisis was demonstrated during the global financial crisis. Several studies after the crisis showed that close monitoring and timely intervention by private equity investors to deal with financial problems in portfolio companies ensured their performances

were not disrupted. For example, one study of the UK economy found evidence consistent with the view of “PE firms both adding more value to portfolio companies and being more actively involved in taking timely action to assist their investees” (Wilson, Wright, Siegel, & Scholes, 2012). This ensured that companies were able to survive and protect jobs.

Private equity also plays a key role in new investments in areas of the economy that will be critical to the recovery process. At least 15% of the funds managed by the industry are invested in infrastructure assets, and 23% of new investments made in 2018 was into infrastructure, energy and related sectors and services (Southern African Venture Capital and Private Equity Association, 2019). Investment also went into start-ups, small businesses, the consumer sector, industrials, information technology, logistics and healthcare. The private equity industry has been key to providing the risk capital that underpins the financing of key industries, without which they would not be viable.

The regulations that currently govern pension funds includes, among others, Regulation 28 of the Pension Funds Act that specifies ceilings for exposures to different asset classes. This has long been a constraint on institutional investors in optimising their portfolios, as well as on the industry in playing the beneficial role it could. The current crisis highlights that it is important to make amendments to this regulation to provide greater clarity for pension funds to be able to direct funding to the private equity industry and manage their investments appropriately. We set out the case in this note.

How do pension funds invest in private equity internationally?

Many pension funds invest in private equity. World leaders like the California Public Employees’ Retirement System (Calpers) and the Ontario Teachers’ Pension Plan allocate a significant portion of their assets to private equity. Ontario Teachers allocates 19.3% of its assets to private equity (Kozlowski, 2020) while Calpers has a target of allocating 8% of its assets under management, equivalent to $10bn, to private equity (Navedo-Perez & Diamond, 2019).

Worldwide, countries generally place a cap on specific asset class exposures in pension funds. A 2018 study by the Organisation for Economic Cooperation and Development (OECD) found that out of 77 countries surveyed, eight provide no ceilings at all: Australia, Belgium, Canada, the Netherlands, New Zealand, the United Kingdom, the United States, and Malawi (Organisation of Economic Cooperation and Development, 2018), several countries do not distinguish between listed and unlisted equity and have a single limit placed on both asset classes, usually quite high. These countries include the largest pension fund sectors in the world, meaning that a large proportion of pension assets globally are not subject to ceilings. Investments in unlisted equities tend to be capped in most countries, though some caps apply only to specific categories of pension funds, often personal plans that are in addition to statutory systems.

Most countries have in place a limit for private equity including Spain (30%), Turkey (20%), Albania (30%), Colombia (5%), Egypt (15%) and Uganda (15%) however only four countries group private equity and hedge funds together under a single limit: Denmark, Germany, Norway and South Africa. This variety of practices suggests that it is far from settled what the correct approach to regulating pension fund exposures should be and that countries should take into consideration their unique development objectives and market infrastructure.

Why do pension funds invest in private equity?

Private equity, is an ideal asset class to include in pension fund portfolios because pension funds need the real returns above inflation that private equity investments offer over a long investment horizon. Most pension funds will need to meet liabilities to members when they retire, which may be many

decades in the future. This long-term liability structure means pension funds require long-term assets. We outline three major motivations for private equity investment below: returns, risk and promoting sustainability.

1. To increase returns

Private equity provides attractive returns to investors. The asset class earns a liquidity premium that is available to investors as a return for the fact that they are usually locked into the investment for five to 10 years, depending on the fund. Given the long-time horizon of pension funds, this premium is easily available to pension funds.

Various studies confirm the existence of superior returns to Private Equity. Globally, Private Equity has outperformed listed equity every year since at least 1988 (Brown & Kaplan, 2019), by at least one percentage point, but in some years as high as 26 percentage points.

Locally, the private equity industry has provided the following returns over various periods compared with major indices of listed equities (measured by compound aggregate growth rate):

Time period	Pooled IRR*	ALSI TRI**	Findi TRI**	Swix TRI**
10 year	12.7%	12.6%	16.5%	13.0%
5 year	10.2%	5.8%	6.8%	5.9%
3 year	3.6%	4.3%	0.4%	3.7%

**Internal rate of return, a standard measure of return for private equity comparable to total return measures*
***Respective total return indices for the All Share Index, Financials Index and Shareholder Weighted Index*
Source: Southern African Venture Capital and Private Equity Association, 2019

These return figures reflect a premium for private equity in most measurement periods and against various listed equity benchmarks.

2. To reduce risk

The investment objectives for pension funds are not just to maximise returns but also to minimise risk. Risk is usually determined as the volatility of returns. Pension funds can absorb short-term volatility if it means higher returns in the long run. The key for any investor in managing risk is to diversify investment exposures. Diversification is achieved by ensuring the assets in an investment portfolio have a low correlation of returns with each other.

South Africa's domestic public capital markets are dominated by a few companies representing a limited number of economic sectors including resources, financials and media (due to the combined influence of Prosus and Naspers). The top three stocks of the JSE Top 40 index account for 53% of the index's market capitalisation and the top 10 stocks account for 79% (as at 7 May 2020). This means it is difficult for large institutional investors to obtain diversification within the domestic listed equity space. Regulation 28 allows funds to have a 75% equity exposure, with a 15% exposure limit to any one large company, within which considerable concentration risk can rise. Internationally, companies

on the New York Stock Exchange have fallen from over 7,000 companies to approximately 3,500 companies.

Private equity allows funds to diversify in two primary ways:

1. Private equity has a lower correlation than hedge funds with listed equity, reflecting the different stages of development and economic drivers of companies that make up most private equity investments. One reason is the size of investments and therefore the breadth of portfolios: the average investment made by private equity funds in 2018 was R68m, while the median market capitalisation of the top 40 index was R268bn.

2. Private equity invests broadly across the economy compared to the listed environment, particularly in high-growth, entrepreneurial businesses in sectors such as fintech and e-commerce, and assets that do not suit the listed environment such as infrastructure and energy. In 2018, 17.4% of investments were in the services sector, 17% in the retail sector and 14.3% in the energy sector[1], which are only available in limited exposures in the listed environment.

These factors mean that by including private equity in a portfolio, pension funds can diversify overall risk by gaining exposure to different economic sectors and different development stages of companies, so reducing the correlation between assets in their portfolios but obtaining access to higher real returns.

Private equity does, however, introduce some new risks. We have already considered liquidity risk above, but an additional risk is funding risk – the risk that an investor may not be able to meet a capital call. A typical private equity investment involves an investor making a commitment of a certain amount in advance. This is drawn down only when the private equity manager requires the funding for investment. Some risk exists that the investor may not have the liquidity available at the time of the capital call. However, in our experience, pension funds are uniquely capable of managing asset/liability matching and are well equipped to manage funding risk. They also benefit from relatively young memberships such that net inflows tend to exceed outflows providing healthy liquidity. The bigger risk comes from retrenchments, which can trigger relatively large outflows.

3. To facilitate sustainable investing

Institutional fund managers have increasingly incorporated sustainability measures into their investment decision-making frameworks. In South Africa, the importance of sustainability was made clear by the FSCA’s guidance note *Sustainability of Investments and Assets in the Context of a Retirement Fund's Investment Policy Statement* which called on retirement funds to include its sustainability practices in its investment policy statement (Financial Sector Conduct Authority, 2019).

The private equity industry has long been a leader in sustainable and impact investing. Private equity firms were among the early signatories to the United Nations Principles for Responsible Investing because private equity can exercise greater control over their portfolio companies (Caplan, Griswold, & Jarvis, 2013). Indeed, several studies show that private equity is particularly well placed to catalyze sustainable investing because private equity firms are active owners that hold their interest over a long period and are also able to gather information rigorously to report to end investors (Alsubaei, et al., 2017). Sustainability, ESG (environmental, social and governance) and impact investing are also

[1] These figures exclude Business Partners which makes a large number of small investments and forms an outlier. Source: SAVCA, 2019

thought to contribute to the management of risk and return, but from a public policy point of view it is important to recognise that sustainability is a public good that private equity uniquely advances. For example, private equity investors were major investors in South Africa's renewable energy programme.

For institutional investors that have factored sustainability into their investment decision framework, demand for private equity assets will naturally increase in order for them to meet their objectives. Public policy should actively support investors to do so by increasing their access to the private equity asset class.

South Africa's development objectives

Private equity and venture capital focus extensively on developing new companies and growing established ones. In 2018, the industry made R35,4bn of new investments, including R20.5bn in follow-on investments to support growth and R14.9bn of new investments (Southern African Venture Capital and Private Equity Association, 2019). This was the highest investment level on record, even though the economy had experienced several years of negative per capita growth. These investments can be divided into the following stages:

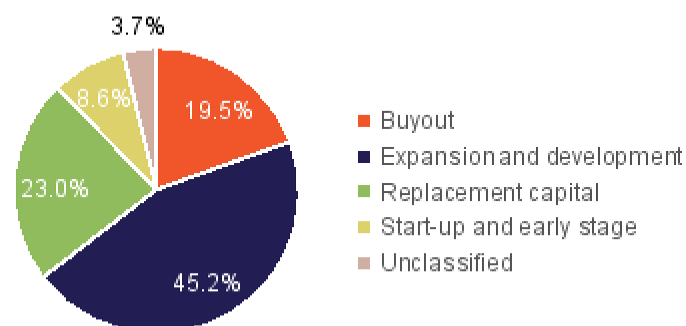

Figure 1: Private equity investments by stage, 2018

The industry also has an outsized impact on the economy and various development objectives. A study commissioned by SAVCA found that private equity-backed companies grow their workforces on average by 22% per year during the investment period. They also improve innovation at companies with 64% of portfolio companies reporting that the speed of innovation improved as a result of the private equity investment and 55% of the number of innovations were commercialised. Private equity portfolio companies are therefore significant job creators and innovators, key areas to improve both employment and productivity in the economy.

Private equity is also a major source of funding for small and medium-sized businesses, which are well recognised as the engine of job creation and competitiveness in the South African economy. The Global Entrepreneurship Monitor reports that in 2019, South African entrepreneurs had a far higher expectation of creating jobs than the global average and regional averages, the latter by about 30% (Global Entrepreneurship Monitor, 2020).

But perhaps the most important developmental impact is through the sectors in which private equity companies invest. Private equity was a major investor in the renewable energy programme, for example, providing the risk capital that allowed developers to then leverage funding through debt. Private equity was therefore the essential catalyst for a significant portion of the R200bn invested in the first four rounds of the REIPPP programme. In 2018, 14.3% of all new investments by private equity firms were into energy and related fields.

Apart from this, private equity was also a significant investor in infrastructure, making up 6.1% of investments in 2018, with a further 2.8% into telecommunications and 2.3% into infrastructure and related services. More than 10% of current portfolio investments are in infrastructure. There are several specialist infrastructure funds in the industry that are well positioned to play an important role in driving private investment into public infrastructure as part of the recovery effort post the Covid-19 crisis.

Private equity has been criticised historically for the use of excessive debt in companies which can increase their financial vulnerability and, in some cases, reduce taxes paid to government. This is largely a problem of the past and the industry has led the way in embracing ESG investment standards, ensuring that their investments have a positive social impact (Southern African Venture Capital and Private Equity Association, 2019). The financial dislocations of the past 15 years have compelled companies to improve financial resilience and private equity firms have often led the way in helping companies to reduce financial risk. To the extent that debt creates opportunities for tax avoidance, this is true of the economy as a whole and must be addressed through tax law rather than prudential guidelines on asset classes.

The current structure of Regulation 28

Regulation 28 as it stands, places private equity into a bucket of alternative investments which is capped at 15% of compliant funds' assets under management (National Treasury, 2011). This bucket includes "hedge funds, private equity funds and any other asset not referred to in this schedule".

With the 15% allocation, the following further caps apply:

<table>
<tr><th></th><th colspan="2">Category of assets</th><th>Maximum per issuer/entity (percent of AUM)</th><th>Maximum exposure (percent of AUM)</th></tr>
<tr><td rowspan="3">a)</td><td colspan="3">Hedge funds</td><td>10%</td></tr>
<tr><td>(i)</td><td>Funds of hedge funds</td><td>5% per fund of hedge funds</td><td></td></tr>
<tr><td>(ii)</td><td>Hedge funds</td><td>2.5% per hedge fund</td><td></td></tr>
<tr><td rowspan="3">b)</td><td colspan="3">Private equity funds</td><td>10%</td></tr>
<tr><td>(i)</td><td>Funds of private equity funds</td><td>5% per fund of private equity funds</td><td></td></tr>
<tr><td>(ii)</td><td>Private equity funds</td><td>2.5% per private equity fund</td><td></td></tr>
<tr><td>c)</td><td colspan="3">Other assets not referred to in this schedule and excluding a hedge fund or private equity fund</td><td>2.5%</td></tr>
</table>

This structure presents several challenges for pension fund investors. Hedge funds, which invest in a wide variety of strategies mostly involving long and/or short positions on listed instruments, have a low correlation with private equity. The fundamental drivers of returns and risk are quite different, yet in consolidating them under a single 15% allocation through Regulation 28, pension funds are unable to manage the two asset classes independently to optimise the risk/return profile of their funds, let alone enhance their overall ESG characteristics.

The intention of asset class ceilings is to limit overexposure to any one source of concentrated risk. This is on the assumption that single asset classes have a degree of correlation.

The standard investment decision framework recognises that asset allocation is the "overwhelmingly dominant contributor to total return" as the seminal paper on portfolio performance put it (Brinson, Singer, & Beebower, 1991). This is significantly more important than security selection within asset classes.

The asset allocation approach originally saw the asset class universe as consisting of essentially four asset classes: equity, bonds, cash (and equivalents) and "other". This historic perspective has contributed to the structure of Regulation 28 as it stands, although it has gone further in creating separate categories for property and commodities, alongside cash, debt and equity. But the "other" catch-all remains, and hedge funds and private equity find themselves in it.

An investor such as a pension fund will use asset liability modelling and a set of assumptions about asset class returns and risk to build a model portfolio that properly balances risk and return to meet target thresholds and liquidity requirements. The decision on hedge funds and private equity allocations would reflect their independent return and risk features within the wider model. However, Regulation 28 acts as a constraint on asset allocation decisions, leaving investors potentially with inefficient portfolios. This is particularly the case when asset classes with uncorrelated returns and risks, stemming from fundamentally different economic drivers, are grouped under a single threshold, as is the case for hedge funds and private equity.

Indeed, to manage their exposures, fund managers may find themselves in the position of reducing private equity exposure because hedge funds have outperformed, or vice versa, such that the combined exposure is within limits. This does not make logical sense. Given the independent risk and return characteristics, the private equity and hedge fund classes should have separate and independent ceilings under Regulation 28.

Our recommendation

We see several compelling reasons that amendments should be made to Regulation 28:

1. Measures that enable pension funds to increase their allocation to private equity would be highly supportive in confronting the unemployment, fiscal shortfall and, economic contraction arising from the Covid-19 crisis and the recovery effort afterwards.

2. Separating hedge funds and private equity would enable investment decision makers to model the asset classes independently in their portfolio construction process, so as to properly accommodate the risk/return characteristics of each.

3. Increasing the private equity cap would enable pension funds to gain a higher degree of diversification, reducing their overall risks. This has positive public benefits broadly by improving the financial security of pension fund savers in the long run.

We therefore believe that two steps should be taken in amending Regulation 28:

1. Separate hedge funds and private equity into independent asset classes, each with their own caps.

2. Over time, increase the private equity cap from 10% to 15%. This can be phased, so allowing the industry and investors to scale up capacity in tandem, possibly by one percentage point

each year. A gradual approach is also low risk as unintended consequences can come to light before full implementation.

The cap increase would effectively allow a pension fund to take a larger exposure to the entire private equity asset class as they are currently allowed to take in a single large listed company. We believe a case can easily be made for a larger increase but respect that regulators should take a gradual approach to not expanding exposure too rapidly, particularly as pension funds will need to develop the skills to analyse the asset class and the supply side may need to increase capacity. The individual fund exposure cap can remain at 2.5% of a single fund and 5% for funds of funds.

SAVCA is available to discuss further any aspects of this note and would welcome feedback and questions on the contact details below.

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This report was prepared with research support by Intellidex (Pty) Ltd

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