

Private equity and venture capital in South Africa:

Assessing the case for institutional investment



Commissioned by





About this report

This report was commissioned by the Southern African Venture Capital and Private Equity Association (SAVCA) and independently researched and developed by Intellidex. It aims to analyse South Africa's private equity and venture capital asset class and the case for investment by domestic institutional investors.

About Intellidex

Intellidex is a leading research and consulting firm that specialises in financial services and capital markets. Its analysis is used by companies, investors, stockbrokers, regulators, policy makers and companies in South Africa and around the world. It has offices in Johannesburg, London and Boston.

About SAVCA

SAVCA is a non-profit industry association, representing 180 members in Southern Africa, who collectively manage in excess of R205bn in assets.

SAVCA promotes Southern African private equity and venture capital by engaging with regulators and legislators on a range of matters affecting the industry; providing relevant and insightful thought leadership and research on aspects that impact the industry; offering training and capacity building opportunities to stakeholders in the ecosystem; and by creating meaningful networking opportunities for industry players, investors and capital seekers.

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Abbreviations and definitions

AIC	American Investment Council
CPPIB	Canada Pension Plan Investment Board
CalPERS	California Public Employees' Retirement System
DCF	Discounted Cash Flow
ESG	Environmental, Social and Governance
ETF	Exchange Traded Funds
EU	European Union
FSCA	Financial Sector Conduct Authority
GDP	Gross Domestic Product
GFC	Global financial crisis
GP	General Partner
GSIA	Global Sustainable Investment Alliance
GSIR	Global Sustainable Investment Review
IPEV	International Private Equity and Venture Capital Valuation board
IRR	Internal Rate of Return
LBO	Leveraged buyout
LDI	Liability-driven investment
LP	Limited Partner
OECD	Organisation for Economic Co-operation and Development
OTPP	Ontario Teachers Pension Plan
PE	Private equity
PEI	Private Equity International
REIPPP	Renewable Energy Independent Power Producer Programme
SADC	Southern African Development Community
SRI	Sustainable and responsible investments
S&P 500	Standard and Poor 500
VC	Venture Capital

Introduction

Born out of the industrial revolution, private investment emerged as wealthy families contributed money to encourage innovation and infrastructure development on a larger scale (Falat-Kilijanska, 2021). The asset class has evolved to include a wide range of investment strategies including private equity, real estate, infrastructure, securitised credit, and microfinance. It offers important opportunities for investors to diversify their portfolios while driving several other objectives including improved sustainability.

Private equity and venture capital funds play a crucial role in the economy, investing widely and stimulating growth, innovation and sustainability. For an emerging economy like South Africa these are critical public policy objectives and we have seen these translate into a positive environment for institutional investors and private equity, including infrastructure investment. Investor allocation to private equity has broad economic benefits because of the long-term investment horizon and the provision of equity to firms at different stages of their development. It also helps in building better businesses (due to its active management approach) resulting in knock-on effects such as job creation, a wider tax base, and sustained economic growth.

Crucial for institutional investors, private equity can generate significant returns (López-Villavicencio & Rigot, 2013), while diversifying portfolios into sectors and company development stages that are difficult to access through listed markets. Private equity and venture capital tends to back new and highly innovative companies operating in disruptive industries that are very different to the profiles of large, listed companies. This is increasingly the case as listed markets have become more consolidated, with fewer, larger, listed companies. The superior expected returns from private equity are due to the liquidity features of the asset class, in that investor capital is usually tied up in a fund for five to 10 years. This “illiquidity premium” is earned in return for the loss of liquidity but means the asset class is inappropriate for investors who require consistent short-term access to their funds. But for investors with a long time horizon, the illiquidity premium offers a potential source of returns and diversification that would be optimal for end clients.

For this reason, globally there has been significant growth in pension fund exposure to private equity. Yet, institutional investors, particularly pension funds, are constrained in the amounts they can invest in the asset class. In making their strategic portfolio allocations, pension funds must ensure they can meet their liabilities,

Key concepts in private equity

General partner

The “GP” is the fund manager of a private equity fund, they charge a management fee but also gain a share of profits (see “carried interest”). The term “general partner” is internationally accepted and reflects that most fund structures are partnerships.

Limited partner

Limited partners, or “LPs”, are the investors in a fund. The term indicates that they are liable only for the capital they initially commit. They also do not have responsibility for making the investments of the fund or managing them.

Carried interest

Carried interest is the share of fund returns earned by the private equity manager. It is usually taxed as a long-term capital gain rather than income, which would incur a significantly higher marginal tax rate. It is typically 20% but can vary.

Hurdle rate (or preferred return)

The minimum return LPs must earn before GPs can collect carried interest.

Buyout

A transaction involving buying a company from its shareholders. This often involves delisting a company from a stock exchange.

Internal Rate of Return

A common measure of returns in private equity. It is the discount rate that makes the present value of future cash flows in the transaction zero. It is a form of yield measurement.

Committed capital

This is funding that an investor has committed to making to the private equity fund. This will only be called on when the fund makes investments.

Drawdown

This is when the fund draws on the committed capital, requiring an investor to transfer funds to it in order to facilitate an investment by the fund.

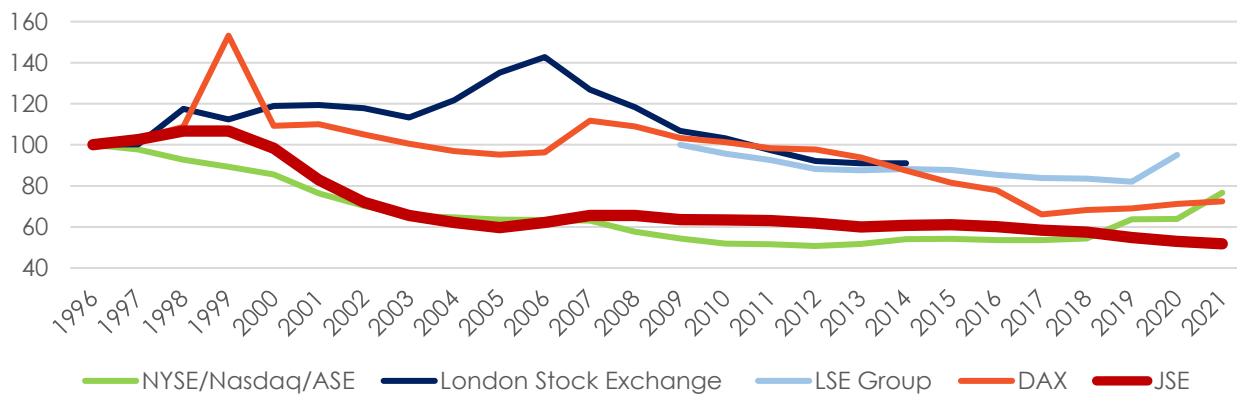
which are subject to real interest rate risk and inflation risk (Hoevenaars et al., 2008). A study by Bonizzi & Churchill (2017) found that listed equities are not a good fit for "asset-liability matching" purposes, given the uncertainty of their cashflows, imperfect sensitivity to interest rates and their vulnerability to asset price changes. Private equity, on the other hand, provides long-term investments that can match the long maturity of pension liabilities. Thus, investments in private equity often make sense for pension funds as they can assist asset-liability matching and provide duration hedging (Real, 2014). This complements the illiquidity premium motive for holding private equity.

Until the early 2000s, most pension funds kept a portfolio of listed shares and debt securities to meet their long-term pension obligations, but this has shifted. Until recently, government bond yields have been at historic lows in most developed and developing countries, particularly during the peak of the Covid-19 pandemic, when quantitative easing dominated monetary policy. With low government bond yields, institutional investors have diversified their portfolios by allocating capital to less-liquid alternative investments such as private equity, in search for higher yields (Bonizzi & Churchill, Jennifer, 2017; OECD, 2021), high risk-adjusted returns (Franzoni et al., 2012; Qian & Liu, 2012; Sadka, R, 2010) portfolio diversification (Jacobs et al., 2014), and long-term asset-liability management (Broeders, Dirk et al., 2021; Croce, Raffaele Della, 2012; Hoevenaars et al., 2008).

Public capital markets have also experienced a decline in the number of listings over the past three decades increasing concentrations, both in large developed markets and in South Africa (see Figure 1). Several studies including Ljungqvist et al., (2016) note that the high delisting rate is explained by an explosion of mergers and acquisitions, including private equity buyouts. This is true of the JSE as well, which has tracked other markets in hosting fewer listed companies.

Figure 1: Number of listed companies per market

(based to 100 at start)



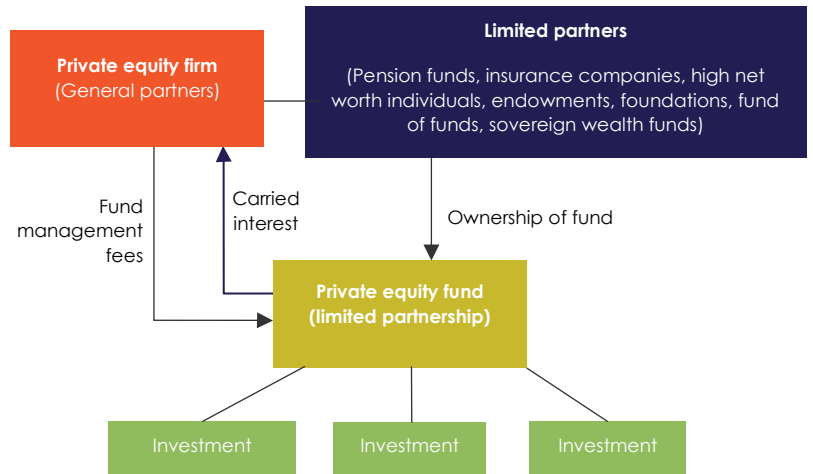
Source: World Federation of Exchanges Statistical Portal

**The LSE group was formed after the merger of London Stock Exchange with the Milan Stock Exchange (Borsa Italiana)

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. Private equity investors also work closely with management teams to support them through critical aspects such as cash-flow management, credit facilities, supplier management, procurement, sustainability 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 means that South Africa's private equity market enables access to a sizable and expanding marketplace of privately held businesses and opportunities compared with a shrinking and concentrated listed public market.

At the sector level, renewable energy projects continue to see significant activity, including the renewable energy independent power producer programme (REIPPP) and the secondary sales of existing project assets. The telecommunications infrastructure sector also receives significant growth and expansion funding. One of the biggest trends in South Africa's private capital sector recently is the surge in venture capital activity, especially investments in fintech. The industry benefits from increased enthusiasm from global venture capital for South African start-ups. The local venture capital market will have greater liquidity as foreign investors get increasingly interested in the business potential that these tech-enabled high-growth companies are providing.

Figure 2: Typical private equity structure



Some small businesses in South Africa suffered losses as a result of the Covid-19 pandemic and the riots in Gauteng and KwaZulu-Natal in July 2021. Even though these unfavourable events put a strain on working capital, they created investment opportunities since small businesses require financial and operational support to recover. Private equity was able to invest and help companies navigate the challenges thrown up by the pandemic and other disasters. Private equity firms also helped their existing portfolio companies manage through the Covid crisis with financial and strategic support.

This report revisits the case for the role of pension funds investing in private equity in South Africa. We research key features, returns history, risk elements of private equity and provide evidence why it is an appropriate investment strategy for pension funds. With the changing nature of the investment universe, we also analyse the ESG/sustainability features of the asset class and how due diligence and assessment of private equity opportunities are undertaken. To conclude, we investigate the international experience of pension funds (and other institutions) investing, to identify industry-wide trends, strategies, as well as best practice that may be adopted domestically.

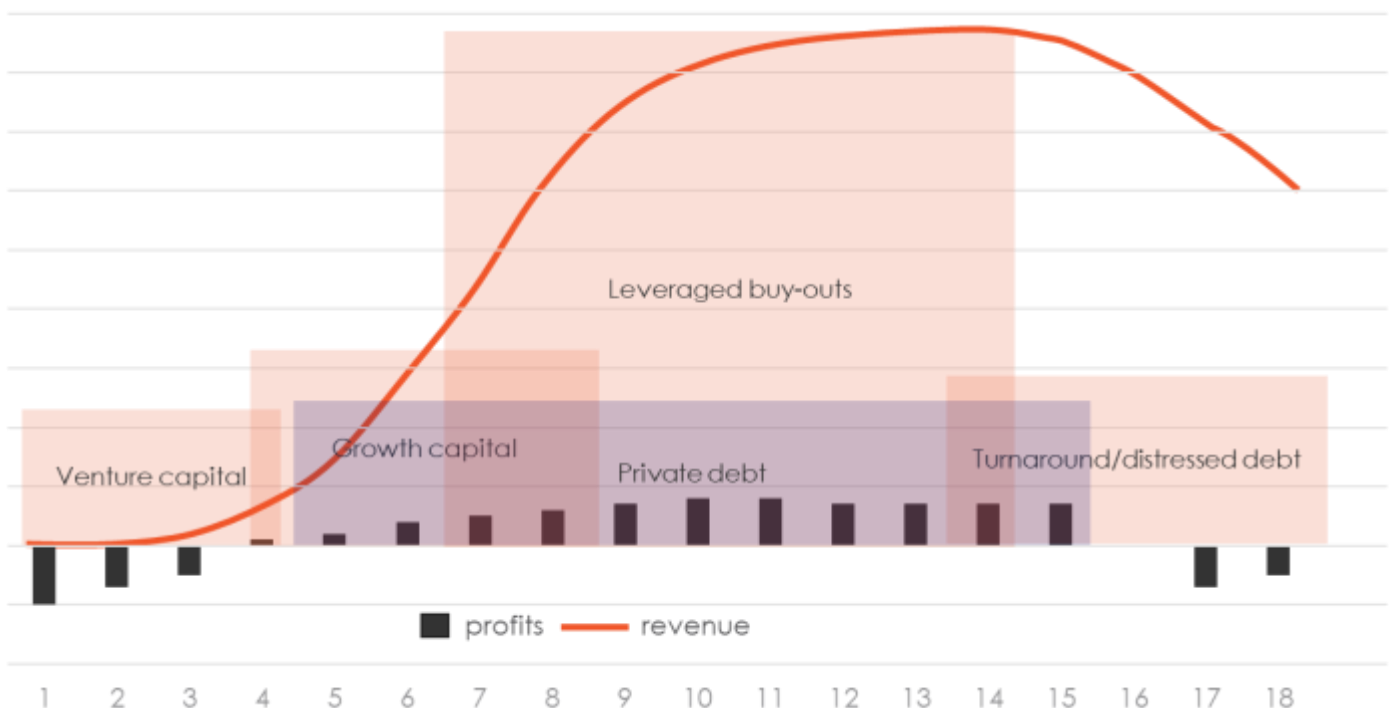
What is private equity and venture capital?

Traditional portfolio theory divides the investment universe into listed equity and debt, and then "alternative" asset classes which include infrastructure, real estate, private equity, and hedge funds (Chowdhury et al., 2018; Gilligan, J & Wright, M, 2020). Within the alternative asset class, private equity is unique in that capital is invested in private companies in exchange for equity, which brings with it rights of ownership and a share in the profits of the company. Private companies are not listed on a stock exchange though may often technically be "public" companies in that they have public shareholders. Private equity offers investee firms more than just capital, combining long-term capital with managerial and governance support. Investors take an active role in monitoring and creating firm value using tools such as operational reforms, corporate governance enhancements and sustainable development strategies. This is enabled by the fact that private equity investors have a large interest in the company and therefore direct access to decision-making. Investors often take seats on the boards of directors to provide advice and support at the highest level of the company.

Private equity key investment strategies comprise venture capital, growth capital, buyout and turnaround (see Figure 3). These focus on different points of the lifecycle of a company, with venture capital focused on early phases before companies are generating profits, through to turnaround specialists focusing on late stages when companies are mature or in decline. Other strategies include funds of funds and secondary funds.

- **Venture capital (VC)** – capital for early-stage companies that may be without profit but that possess innovative ideas or technology.
- **Growth capital** - capital provided to expand established private businesses often by taking a minority interest.
- **Buyout capital** (leveraged buyouts, or LBOs) - in which the private equity firm buys the entire private company or a particular division of an existing company. Sometimes, the buyout target is publicly traded, so the private equity fund performs a public-to-private transaction, removing the target firm from the stock market.
- **Turnaround** - targets companies with poor performance, or those experiencing trading difficulties. The basic concept is to buy cheap and sell high, with the difference between the depressed price at purchase and improvements at the time of sale creating a return on investment.
- **Funds of funds** - vehicles raised by managers with a mandate to invest in the funds of other managers. This is a good option for pension fund teams with small or inexperienced investment teams who would not be able to carry out the allocation process in-house. Funds of funds also offer a diversification benefit, as investors allocate to funds which invest in a variety of companies. As a result, investors have access through these funds to various industry sectors within private equity as well as various geographic locations.
- **Secondary funds** - specialised funds that seek to purchase other investors' stakes in private equity funds. These funds will capture a portion of the anticipated growth in value of an investor's fund stake.

Figure 3: Private equity investment strategies and lifecycle of the firm



Source: (Gilligan, & Wright, 2020)

Globally, leveraged buyouts constitute the largest of the private equity investment strategies by value at 42%. They account for the majority of international primary deal value and when secondary strategies are included, they represent over 40% of the private equity market value (see Figure 4) (Gilligan, & Wright, 2020). That does not align with South Africa, where expansion and development investment dominates, accounting for 51% of investment, while buyouts accounted for 35% of investment in 2021 (see Figure 5).

Over the last four years, expansion investment has averaged 48% of annual investments and buyouts 36%. Startup investment has averaged 14% (SAVCA, 2022).

Figure 4: Relative size of different private equity strategies globally

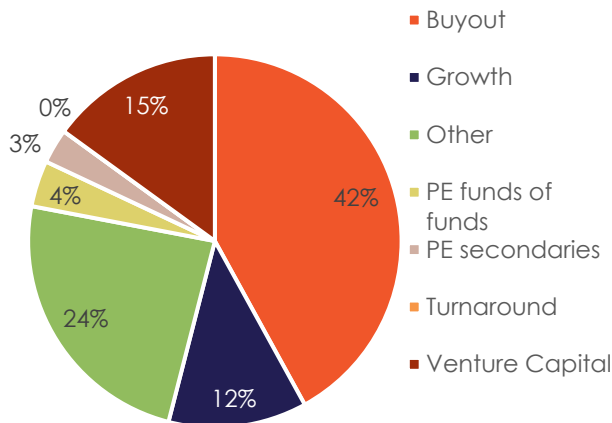
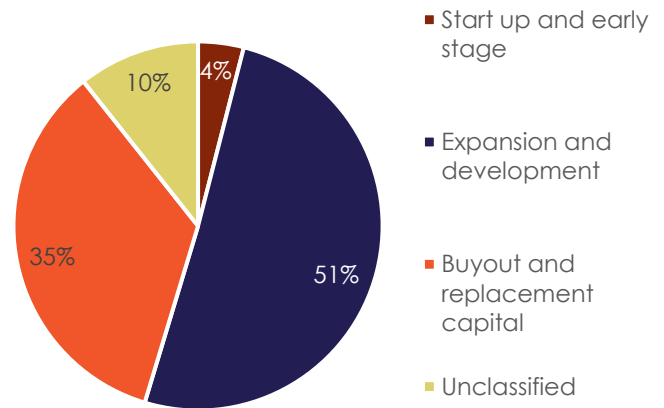


Figure 5: Value of investments by stage in South Africa (2021)



Source: Preqin

Source: (SAVCA, 2022)

Institutional investors including pension funds, sovereign wealth funds, endowments and foundations, and insurance companies, who either invest directly in businesses or through funds managed by fund managers, are the main sources of private equity funding. Many family offices and high-net-worth individuals also invest directly or through fund-of-funds intermediaries. Venture capital investors include government agencies and corporations seeking to promote regional investment or gain insight into, and possibly control of, emerging businesses and technologies.

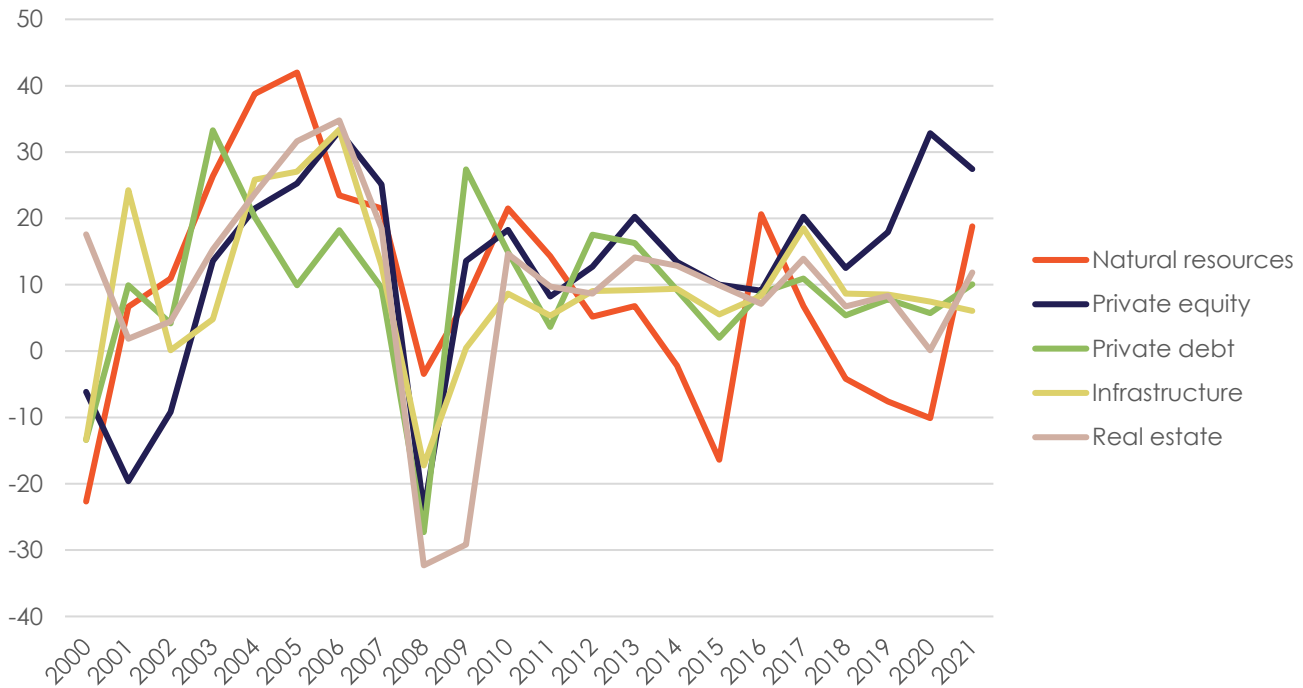
Private equity returns history and the size of the asset opportunity

As with public equities, investors in private equity are subject to market risk, credit risk, and operational risk, but they also carry additional risks due to the long-term nature of underlying assets. The limited regulatory oversight of management and reporting conventions is seen as additional investment risk in private equity. Thus, private equity investors expect superior long-term risk-adjusted returns (Franzoni et al., 2012; Qian & Liu, 2012; Sadka, 2010), compared to traditional stock and bond investment vehicles due to the illiquidity risk (Garay, & ter Horst, 2009; López-Villavicencio & Rigot, 2013).

Private equity investment is characterised by a buy-to-sell strategy. The idea is to buy equity stakes in businesses, actively manage those businesses, and then realise the value created by selling or floating the business on a public market. Thus, the appetite and incentives of most private equity investors is firmly focused on achieving capital growth and increasing shareholder value as opposed to just earning income (from fees, interest or dividends).

A recent report by Popescu (2020) found that alternative assets are always an option for institutional investors as they experience a solid delivery of returns during good and bad cycles. These findings are confirmed in the latest report by EDHEC*infra* (2021) which notes that since 2020, the average projected return for private equity exceeded 8% - they also note similar spikes during the 2008 financial crisis, Eurozone debt crisis, and Brexit. Globally, private equity has been the highest performing private market asset class since 2017 (see Figure 6). Private equities' in-year returns for 2020 and 2021 exceeded those of all other years following the global financial crisis (GFC) showing resilient performance during the Covid-19 pandemic and lockdowns. The alternative investment industry is expected to grow over \$14trn by the end of 2023, owing to alternatives' track record and the ability to deliver superior risk-adjusted returns to investors (Praqin, 2020).

Figure 6: Global fund performance by alternative asset class, 2000 -2021 (%)



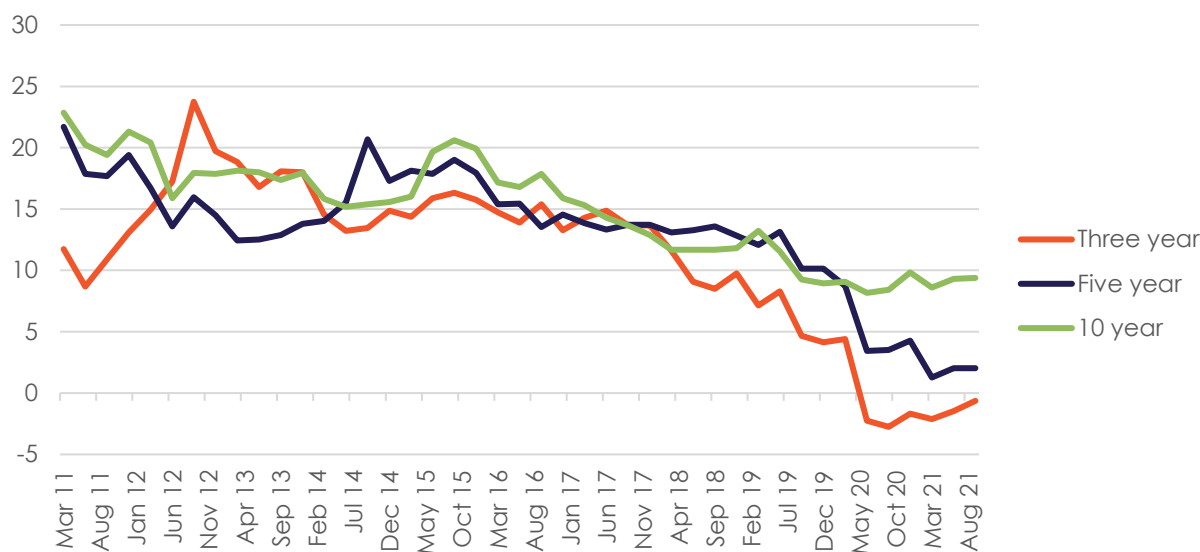
Source: (McKinsey, 2022)

* Fund performance assessed using IRR calculated by grouping performance of funds.

* IRR for 2021 is for the first 9 months (YTD as of Q3 2021)

This returns history has not been followed by the South African market. Returns generated by private equity have been declining during the last few years (see Figure 7). The Covid-19 pandemic and its economic impact, lacklustre GDP growth, political unrest and unreliable electricity supply have had an adverse impact on certain private equity portfolio companies. However, returns have stabilised in the latest 18 months, as managers adapt to the complex environment.

Figure 7: SA private equity pooled rolling IRR year on year returns (% annualised)



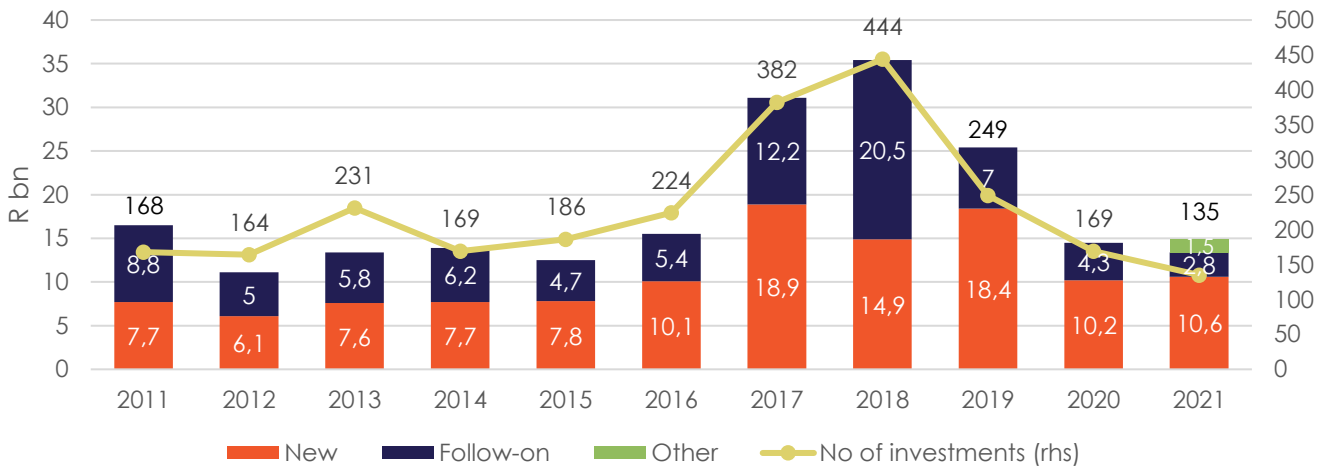
Source: RisCura (2022)

There are several drivers of the relatively poor South African private equity returns performance reflected in the RisCura data on South Africa's performance. The data is weighted by the size of fund and several larger funds have dominated the negative performance while smaller funds who have out-performed are swamped in the returns figures. Larger funds tend to focus on leveraged buy-outs, which have significantly underperformed over the last decade, largely because of domestic economic conditions and the high level of exposure of these companies to the domestic economy. These funds were able to raise commitments from clients in the run up to 2008 and exits have often occurred relatively late with IRRs facing the steady decline in GDP growth that has been locked in since 2010, exacerbated by the electricity crisis in the last three years.

This strategy has shifted in recent years as funds have focused more on the mid-market and start-ups. This has marked something of a regime change in the industry as funds now deploying capital have quite different strategies, focused on earlier stage companies and smaller scale. Such companies exploit niches and are able to benefit from new opportunities rather than being exposed to legacy business models that are tied to the macro performance of the economy. There is more diversification in the mid market with companies more focused on innovation and with potential to scale. There has also been a shift toward more defensive companies that are not exposed to macro themes like loadshedding and consumer distress. Market conditions have, however, meant that deal pricing has come down and entry prices are low. The returns opportunities now stem from companies that can be acquired at low valuations, operating in niches that private equity firms are able to act as growth catalysts.

In volume terms, new investments by the industry have continued at a robust pace. Private equity investments increased to R14.9bn in 2021, up from R14.5bn, while the volume of investments dipped by 20.1% to 135 (2021) from 169 (2020) (see Figure 8) – the volume of new and follow-on investments, excluding business partners, decreased to 53 and 82 respectively in 2021 (vs. 73 and 96 in 2020 and 132 and 117 in 2019). Infrastructure continued to attract the largest portion of capital, albeit down from 2020 and 2019 levels. Funds raised from South African sources declined in 2021 largely due to a drop in fundraising from pension and endowment funds, although this drop was offset by a sharp increase in allocations by insurance companies and institutions. The drop in allocations from pension funds in part reflects the environment of the time, with member withdrawals picking up during Covid, requiring funds to conserve liquidity. However, the increase in allocation from insurance companies shows the growth in confidence of insurers in South African private equity, particularly its ability to reduce concentration risk and improve asset-liability matching. Funds under management increased to R206.2bn in 2021, up from R195.1bn in 2020.

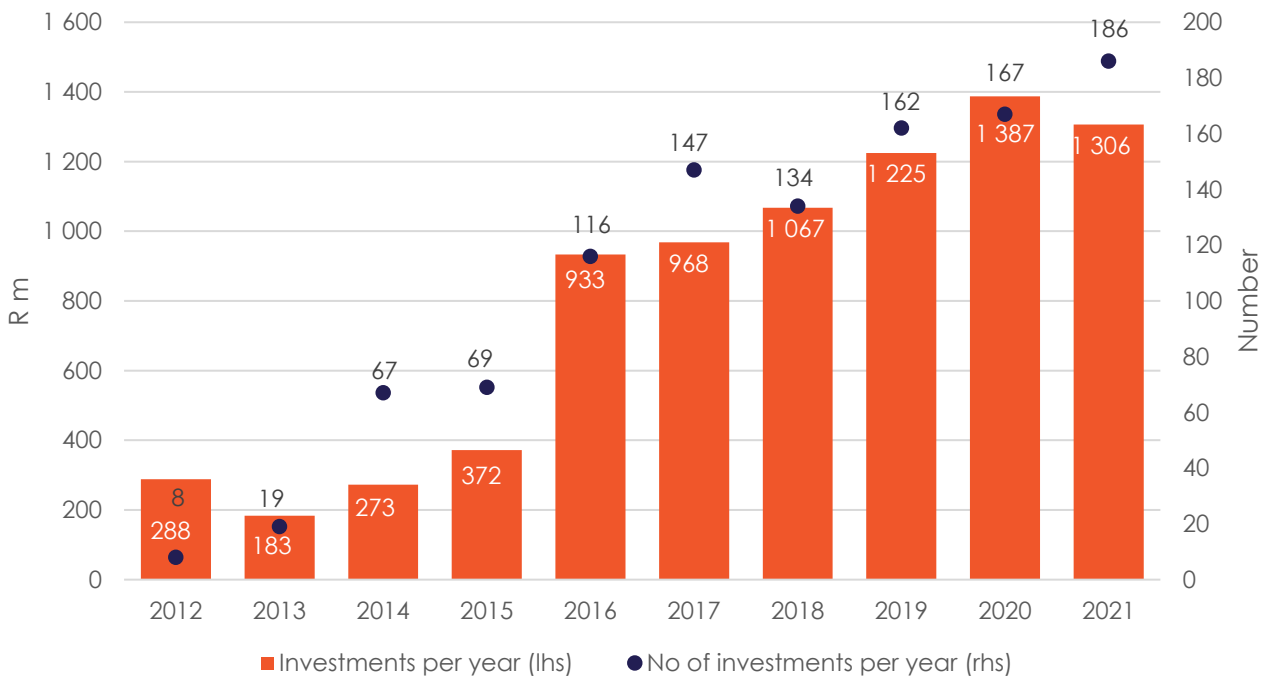
Figure 8: Private equity investments split by new & follow-on (R bn) and by no of deals



Source: (SAVCA, 2022)

Despite a generally difficult global and local economic climate, where fund managers were subjected to trade limitations, ongoing impact of the Covid-19 Pandemic, loadshedding and political unrest, South African early-stage fund managers continued to invest, channelling capital into portfolio companies during the difficult climate. The number of deals increased by 11.4% in 2021 (186) from 167 in 2020. However, the investment activity by value of deals decreased slightly from record levels reported in 2020, amounting to R1.31 billion in 2021, down from R1.39 billion the previous year (see Figure 9).

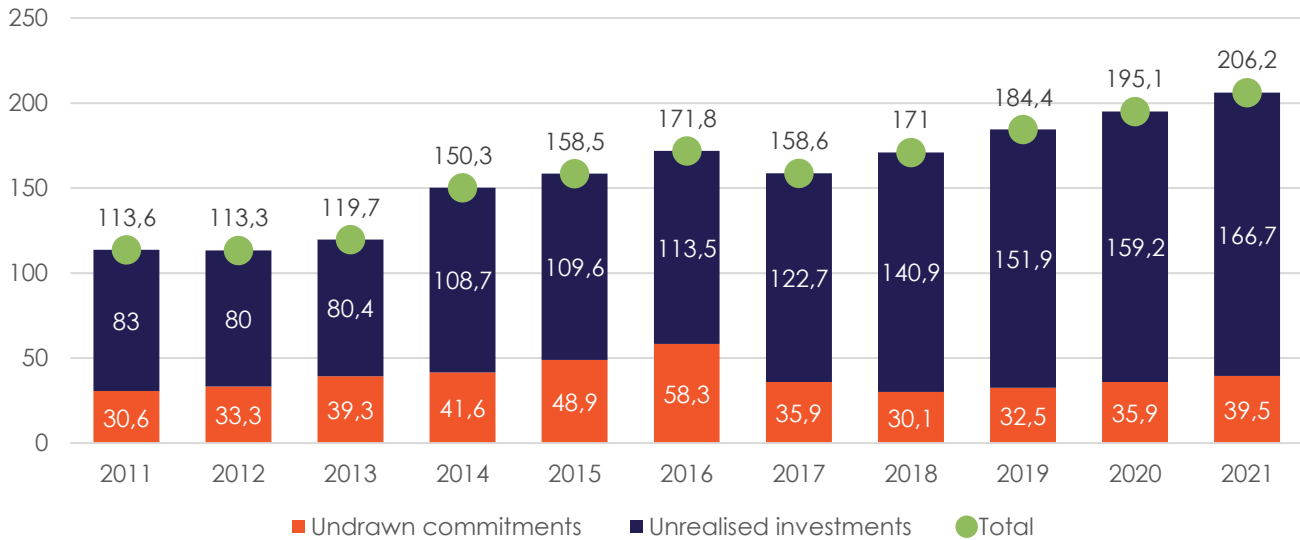
Figure 9: Venture capital investments by number of deals & by value (R m)



Source: (SAVCA, 2022)

The industry now manages R206bn of funds, a figure that has grown consistently for five years. Of that, almost 20% is undrawn commitments, representing funds that can still be deployed into investments (see Figure 10).

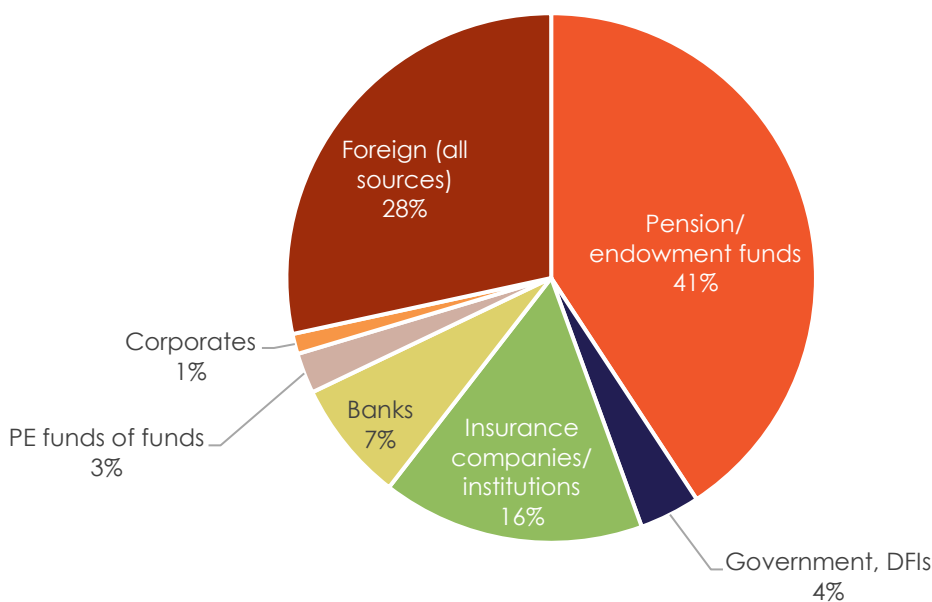
Figure 10: Composition of funds under management by amount invested and undrawn commitments, Rbn



Source: (SAVCA, 2022)

The industry has been actively fund raising from institutional investors. In 2021, R16.2bn was raised, while R16,9bn was raised in 2020 (SAVCA, 2022). Despite the decrease in allocations from 2021, pension funds remained the largest source for the amount raised(see Figure 11), followed by foreign sources which consisted mostly of foreign governments, aid agencies and DFIs (R3.2bn). While the funds raised from pension funds is a small proportion of over R3.2trn managed by pension funds (FSCA, 2023), investment by pension funds has been growing and is set to grow more following the Regulation 28 amendments to allow up to 15% of assets to be held in private equity. The amended regulation also allows pension funds to hold up to 45% of their assets in infrastructure, subject to all of the other respective asset classes including that for private equity.

Figure 11: Sources of new funds raised in 2021



Source: (SAVCA, 2022)

What are the risk features of the asset class and how can they be managed?

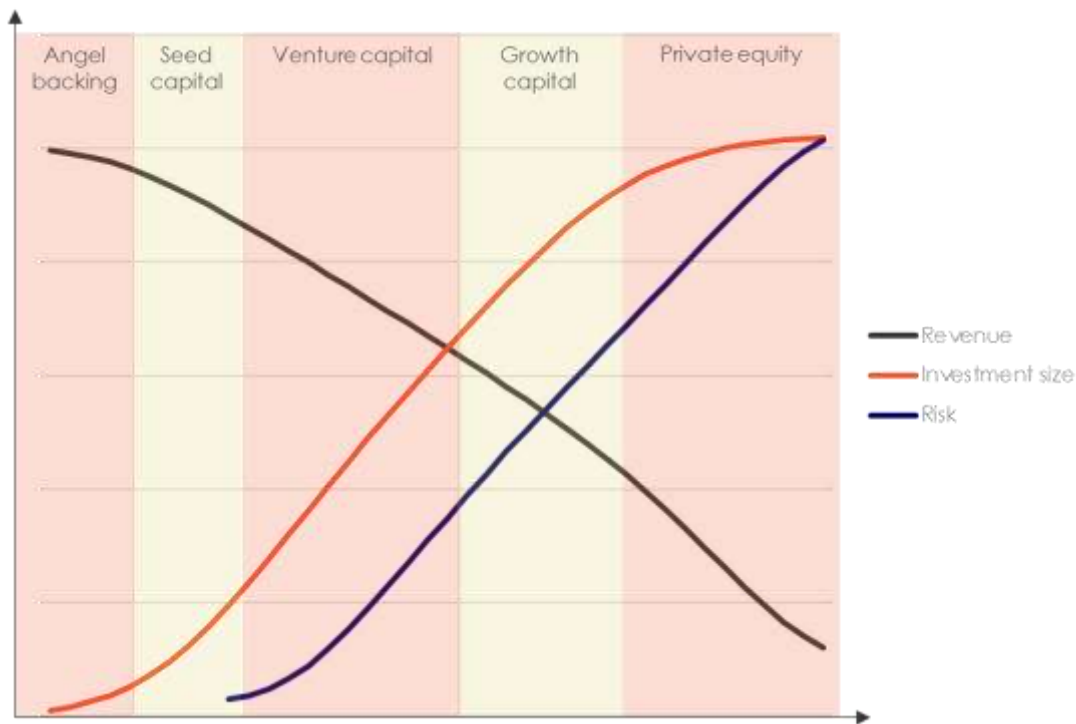
While private equity often delivers superior risk-adjusted returns on the private capital spectrum, it is one of the riskiest equity investment strategies (see Figure 12 and Figure 13), primarily due to the nature of the assets – illiquid, long-term assets with greater market risk. We consider the key risks below.

- **Liquidity risk** is a great concern for investors. Liquidity measures the ease at which investors can buy or sell investments. Private equity investors typically anticipate holding their investments for three to seven years, with the fund typically having a life of 10 years. Some investments are held for longer lengths of time before any profits are realised and managers usually have the ability to extend tenure built into contracts. In contrast, investments in other asset classes, such as stocks, mutual funds and exchange-traded funds (ETFs) are highly liquid and can be sold on the same day if necessary.
- **Market risk:** private equity investors also face greater market risk (changes in the realisable value of their investments) with their investments compared to traditional investments since there's no certainty that any of the companies in which private equity firms invest will grow at all, and, for early stage and venture capital investment, many of the companies invested in are unproven. The success rate of early-stage companies is highly variable, with some experiencing phenomenal growth and others failing altogether. This creates a wide variation in outcomes for investors in the strategy: less than 20% of venture capital investments deliver positive returns. Later-stage private equity investments carry lower risk as they are further along in their development, but this makes the potential returns lower too. Private equity investors may suffer substantial losses as a result of a weak management team, an unsuccessful product launch, or new technology that becomes obsolete as a result of competitors.
- **Drawdown risk:** private equity investors commit to providing investment which is usually called a "committed capital". However, the private equity fund manager only calls on the money to be contributed when it has identified a new investment that it will make. In such events it issues a drawdown notice to investors, requiring them to transfer funds on a certain date. This creates some cash flow risk for the investor, as this liability must be managed to ensure funds will be available when required. In practice, most investors ensure any drawdown potential is covered by liquid funds, which can then be replenished post a drawdown through portfolio rebalancing.
- **Reinvestment risk:** When a private equity fund matures, it begins to exit investments (sometimes called the "harvest period"). This results in large cashflows for the end investor. This will usually happen gradually as the fund exits investments, but there may be large amounts of cash in specific repayments. This creates reinvestment risk for the investor, who must find alternative investments for the realised proceeds.

The extent of risk decreases with the size of investment, so small scale angel investments tend to be highest risk, with larger private equity transactions relatively lower risk (see Figure 12). These risks are managed in many different ways by institutions across the world. Risk appetite and capacity is naturally key – funds with long time horizons, such as many defined benefit pension funds, can absorb liquidity risks. The liquidity risks of drawdown and reinvestment risks can be managed through an asset-liability framework that matches cash flows to the payments that funds make and receive.

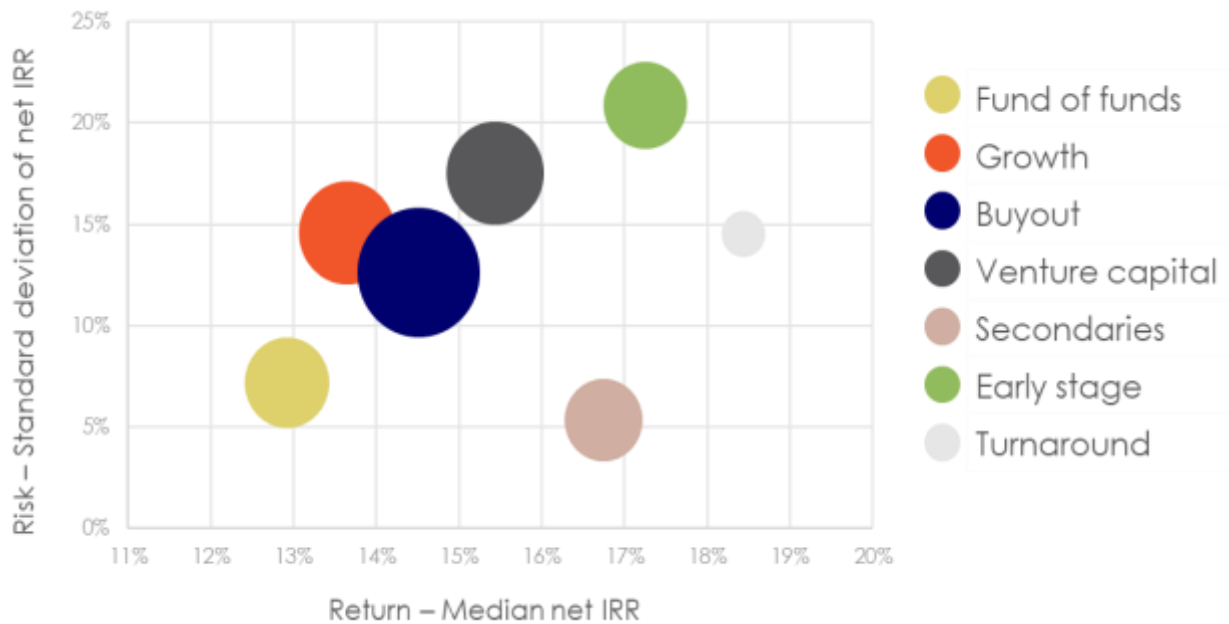
Return risks depend on the strategy of the particular fund. As Figure 13 shows in respect of international industry trends, risk varies by the type of fund strategy, from low risk fund of funds, to high risk early stage funds. This allows pension funds to calibrate their risk appetite and ability to the private equity and venture capital funds they invest in. While we expect the general risk and return trend shown in Figure 13 will hold in the South African context, the fund sizes will be different with more allocated to growth funds and less to early stage and venture capital.

Figure 12: Private capital: risk/return and investment size by fund type



Source: Preqin

Figure 13: Private equity: risk/return by fund type



Source: Preqin

*** The size of each circle represents AUM as of March 2020

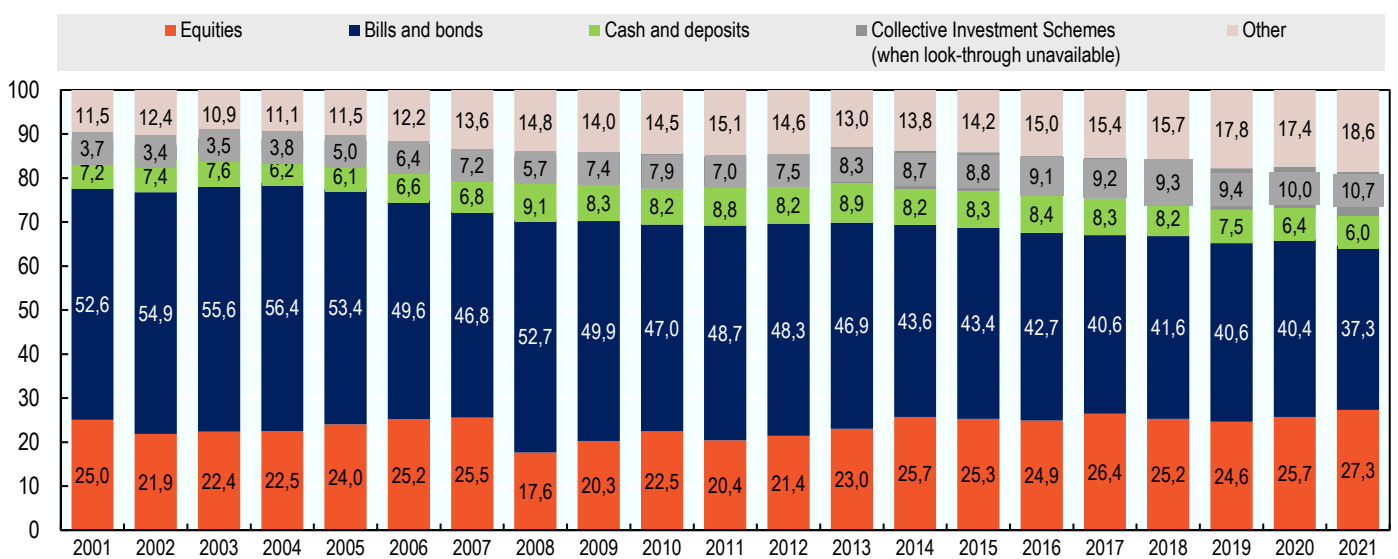
International experience of pension funds (and other institutions) investing in private equity

Pension funds are natural investors in less liquid, long-term assets such as infrastructure, real estate, and private equity, which are often included under the “alternative” or “other” investments segment of portfolios due to their long-term investment horizon (Attig et al., 2012; Broeders, et al., 2021; Croce, 2012). Therefore, private equity is an ideal asset class to include in pension fund portfolios because many pension funds need the real returns above inflation that private equity investments offer over a long investment horizon. The extended holding period is attractive to institutional investors, as fund managers can also avoid the volatility that negatively affects public equities (Bédard-Pagé, Guillaume et al., 2016; Burdel, 2009).

Given the nature of their investments, pension fund managers need to be able to rely on long-term capital commitments, as they have a fiduciary duty to meet their members’ liabilities when they retire, which may be many decades in the future. Thus, the time horizon of private equity makes the asset class a particularly well-suited investment for pension funds. International regulatory and political discussions have also focused on directing institutional capital toward longer-term investments. For example, the UK’s Patient Capital Review highlights that “the lack of patient capital is a significant impediment to UK entrepreneurs’ success” (HM Treasury, 2017), while in the European Union, Long Term Investment Funds are intended to increase investment into infrastructure projects, real estate and SMEs (listed and unlisted) (EU, 2020). The “long term” terminology reflects recognition that liquid capital markets are suboptimal for financing illiquid assets like infrastructure. And, in the context of underdeveloped capital markets, private equity is an attractive option for companies in search of growth capital (López-Villavicencio & Rigot, 2013).

Today, private equity is a small but important part of most pension fund portfolios in both developed and emerging markets. According to a recent OECD report, investments in alternative asset classes have increased over the last 20 years. The study finds that the asset allocation into the “other” category increased from 11.5 % in 2001 to 18.6% in 2021 (see Figure 14) (OECD, 2023).

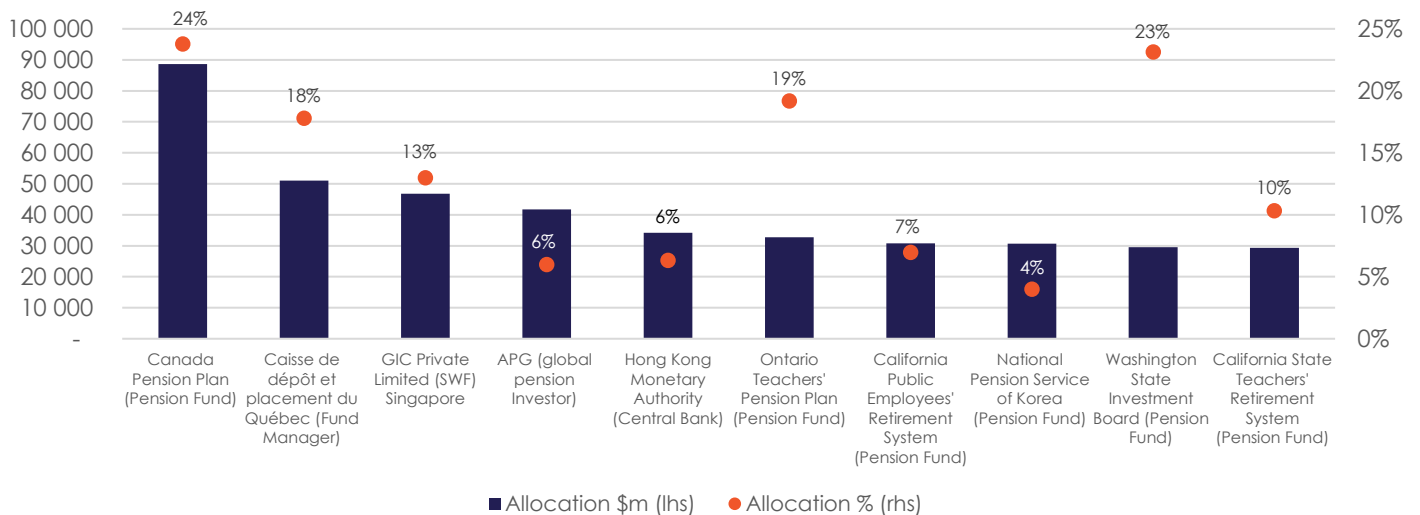
Figure 14: Pension fund average allocation in asset classes, selected OECD countries 2001-2021



Source: (OECD, 2023)

In recent years, most institutional investors, particularly pension funds, endowments and foundations, and insurance companies have steadily increased their portfolio allocations to private markets in a bid to achieve greater returns and to diversify their portfolios. Globally, the top ten institutional investors allocated on average 13% to private equity in 2020 (see Figure 15)¹. Canada and the United States are the leading nations globally, whose pension funds devote a significant amount of funding to private equity.

Figure 15: Top 10 Institutional investors allocation to private equity (2020)



Source: Private Equity International (PEI) Investor Report (2021)

Canada

Canada has a mature private equity market, and its public pension funds lead in private equity investments globally, both through their investments in funds managed externally and their direct investment activity. In 2021, Ontario Teachers' Pension Plan (OTPP), increased allocation to private equity from \$41.8 billion to \$55.1 billion (23% of assets), while decreasing the allocation to public equities from \$42.4 billion to \$27.2 billion (11% of assets). OTPP's private equity portfolio produced a return of 29% (local return 31.1%), outpacing its benchmark return of 17.5% (19.5% local benchmark). This outperformance was driven by solid financial performance across the private equity portfolio including funds, as well as increased valuations for private companies (OTPP, 2021).

Other pension funds are also switching their asset allocation from public equities to private markets. For instance, a study by the Bank of Canada carried out between 1998 and 2018 found the following:

- As the level of interest rates declined, 64% of pension funds in a sample of 128 federally regulated, Canadian private, defined benefit pension plans, shifted away from the traditional stock 60/40 bonds mix, increasing their overall risk exposure in private equity to achieve their return target (illiquidity premium for not being in the public markets).
- These plans shifted their portfolio to private equity, and real assets particularly private infrastructure and real estate.
- The study also found that the portfolio size was an important determinant for the decision to invest in private equity i.e. large pension funds were more likely to invest in private equity than smaller pension funds.

Increased pressure from limited partners, obligatory solvency laws, accounting reforms, and the search for higher yields are the primary causes of the increase in pension funds' commitment to private equity in Canada. Overall, the Canadian pension industry has been successful because it often has internal teams with expertise that implement a range of strategies, including fund investments, co-investments, and direct

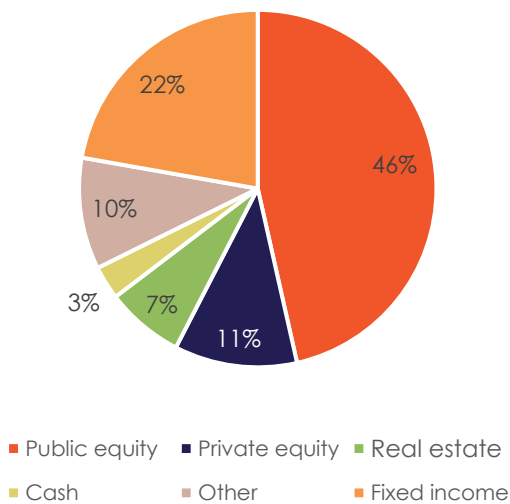
¹ The ranking is based on the market value of investors' private equity investment portfolios both through direct investments and third-party managed investment vehicles. Capital invested through the following structures is included: private equity funds, separately managed accounts, co-investment vehicles and direct investments into private companies.

deals. Most public pension plans target private equity investments in industrials, telecoms and technology, power and energy, healthcare and financial services (S&P Global Market Intelligence, 2022).

United States

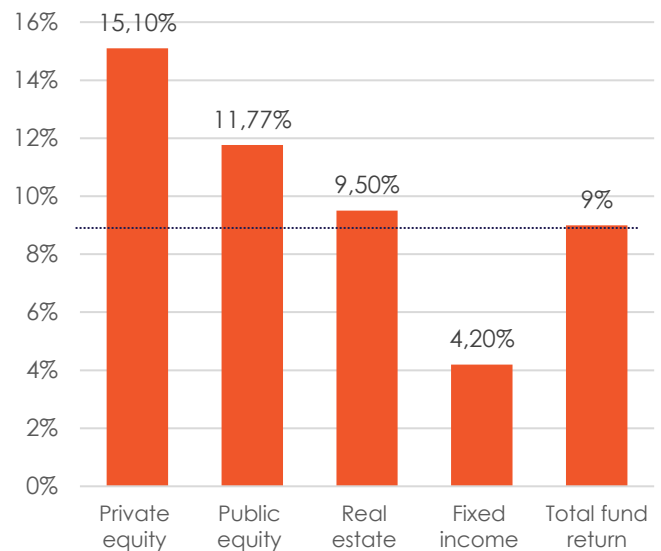
In the US, private equity directly employs over 11.7 million workers, and over 86% of current private equity investments are in small businesses. According to the American Investment Council (AIC), US public pension funds invested 11% of their portfolios in private equity on a dollar-weighted basis as at June 2022 (see Figure 16). The asset class provides strong return on investment, with a median annualised return of 15.1% over a 10-year period, outperforming other asset classes (see Figure 17)(AIC, 2022).

Figure 16: US pension fund asset allocation



Source:(AIC, 2022)

Figure 17: US pension fund asset returns (Based on 10-yr median annualised returns)



Source: (AIC, 2022)

California's Public Employees' Retirement System (CalPERS), the nation's largest fund, increased its private equity allocation from 8.3% in 2021 to 11% as at June 2022 – this follows its November 2021 strategic asset allocation announcement to increase the domestic private equity portfolio from 8% to 13% of total assets (CalPERS' private equity and real assets do not have a target allocation for international investments). CalPERS' private equity investments fared better than most other assets, with its private equity investments returning 21.3% as at 31 March 2022. Private equity holdings include fund and co-investments with existing CalPERS general partners, direct secondary investments, and fund of funds (CalPERS, 2022).

Australia

Unlike Canada and the United States, Australia's pension allocation to private equity remains very low (less than 5%), as there are limits to how much pension funds can solely allocate to the asset class. Large Australian superannuation funds have historically managed most of their mainstream portfolios in stocks and bonds in-house (mostly domestic markets), while outsourcing their smaller specialised allocations (such as private equity) to big US and European fund managers. However, the market is starting to shift as pension funds are now either buying private equity teams in-house or partnering with private equity firms to complete transactions. In partnership transactions, the private equity firm handles most of the operational aspects of the transaction.

Emerging markets

Despite the growing interest in alternative investments globally, the uptake by institutional investors in most emerging markets has been slow. This has been inter alia due to (i) the lack of a transparent and stable regulatory framework (ii) negative experiences with earlier investments, and (iii) a lack of government facilitation (Croce & Gatti, 2014). In Africa, pension funds are largely invested in debt assets, followed by listed equities. Pension fund managers on the continent cite the difficulties in allocating assets to economic-enhancing investments such as infrastructure or private equity because of an inability to meet regulated investment criteria (Sanusi and Kapingura, 2021). Moreover, African countries with well-developed pension systems, including South Africa, Namibia, Botswana and Zambia, constrain the funds that institutional investors typically invest in to meet certain liquidity standards – most countries cap exposure to unlisted equities (OECD, 2019). For example, the maximum permitted allocation to private equity in Namibia is capped at 3.5% of total asset portfolio allocation, Botswana (2.5%), Lesotho (10%), Zambia (10% public funds and 15% private funds) and Zimbabwe (10%) (see Table 1). In South Africa, recent amendments to Regulation 28 increased the permitted asset allocation ceiling for private equity from 10% (shared with hedge funds) to 15% specifically for the asset class. While most institutional investors applauded this positive move, South Africa's pension fund allocation to private equity remains low, regardless of its growing relevance globally – this presents an opportunity to reset the case for private equity in South Africa and the rest of the continent.

An earlier study on pension funds, private equity and private debt in Southern Africa found that there is no clear taxonomy and lexicon in emerging markets. As a result, most national statistical agencies do not collect data specifically on private equity assets, but the data is grouped together under “alternatives” or “other assets”. The different options available to investors to gain exposure means that information is often buried under different categories (FSD Africa & SAVCA, 2022).

Table 1: Snapshot of pension market context of selected countries in Southern Africa

	Botswana	Lesotho	Namibia	South Africa	Zambia	Zimbabwe
Pension Market State	Developed	Emerging	Developed	Mature & advanced	Developed	Developed
No of active pension funds	86	100	135	5,294	243	614
Permitted allocation to PE	2.5%	10%	Min 1.75% Max 3.5% (GIPF exempted, can invest up to 7.5% in unlisted equity)	PE 15% (recently increased from 10% Reg 28 review)	Public: 10% Private: 15% (recently revised from 5%)	Prescribed assets: 10%
Largest Fund	Botswana Public Officers Pension Fund (BPOPF)	Public Officers Defined Contribution Pension Fund	Government Institutions Pension Fund (GIPF)	Government Employees Pension Fund (GEPF)	National Pension Scheme Authority (NAPSA)	Zimbabwe Electricity Supply Authority (ZESA)
Current PE allocation by largest fund	Local: 0.4% Foreign: 3.49%	Local: 1% Foreign: 2.4%	5%	Alternatives: 2% (incl private equity, unlisted debt & unlisted property)	0%	Prescribed assets: 7%
Hindrance to PE allocation	Small market with limited investment opportunities	Political instability, lack of trust in government	Restrictive private equity market	Deteriorating economic environment, political uncertainty	Informal market, dominated by SMEs	Political instability, hyperinflation & valuation dilemma

Source: Annual reports of selected pension funds

What are the ESG/sustainability features of the asset class?

Environmental, social and governance (ESG) factors are more salient than ever, as corporations are increasingly experiencing external pressure to change their behaviour and focus on ESG factor integration

into their business activities. ESG is earning the attention of a wide audience, and many are aware their institutions are accountable for their impact on the environment and society.

Institutional fund managers have increasingly incorporated sustainability measures into their investment decision-making frameworks. A recent study by Zaccone & Pedrini (2020) found that private equity firms, large asset managers and hedge funds have integrated ESG factors into their investment decision-making to reduce long-term risks and ultimately enhance returns. The Global Sustainable Investment Alliance (GSIA) estimates the market for sustainable investment strategies to be about \$35.3 trillion in 2020 (\$30.6 trillion in 2018) of assets under management. Global sustainable investments as a percentage of total assets under management have also increased from 27.9% in 2016 to 35.9% in 2020 (see Table 2) (GSIR, 2020).

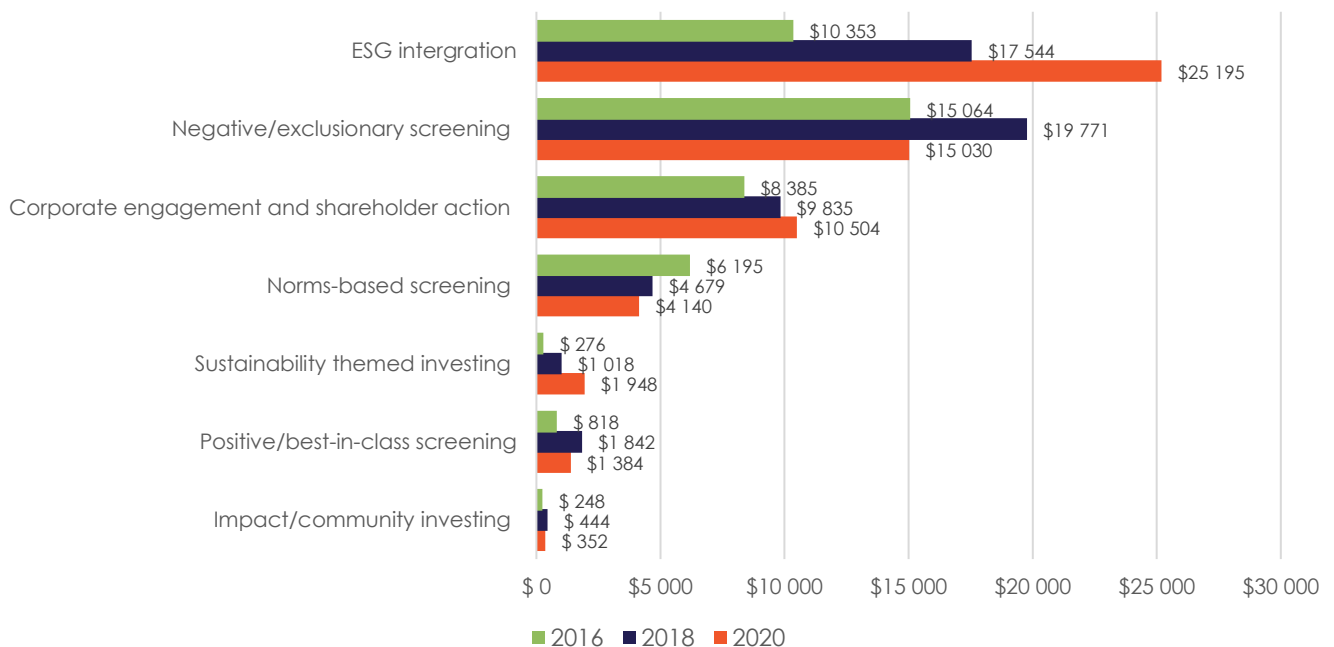
Table 2: Snapshot of global AUM, 2016-2018- 2020 (\$ billions)

	2016	2018	2020
Total AUM	81,948	91,828	98,416
Total sustainable investment only	22,872	30,683	35,301
% Sustainable investments	27.9%	33.4%	35.9%

Source: (GSIR, 2020)

The growth of sustainable investment strategies globally is depicted in Figure 18. ESG integration is the most popular sustainable investment strategy, followed by negative screening, corporate engagement and shareholder action, norms-based screening and sustainability-themed investment (GSIR, 2020). Researchers have highlighted that in the early days of ethical investing, the focus was on using negative screens to exclude companies in certain industries or sectors for moral or ethical reasons (Crifo & Forget, 2013). Over time, partially due to concerns about reliance on negative screening, ethical and socially responsible investing evolved into ESG integration (Zaccone & Pedrini, 2020).

Figure 18: Global growth of sustainable investing strategies 2016-2020 (USD billions)



Source: (GSIR, 2020)

In South Africa, the importance of sustainability was made clear by the Financial Sector Conduct Authority's (FSCA) 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 (FSCA, 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 catalyse 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 and impact investing are also 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. A survey of private equity funds last year found that 94% consider ESG factors when making investment decisions, while 82% intend to increase efforts to manage and track performance against ESG metrics (SAVCA, 2022). For institutional investors that have factored sustainability into their investment decision framework, demand for private equity assets will naturally increase 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.

How is due diligence and assessment of private equity funds done?

Listed capital markets provide an institutional architecture including listing rules and disclosure standards that substantially reduce information asymmetries for investors. This is not true of private equity, and the due diligence requirements for investors in the asset class are therefore different. Institutional investors need to assess fund managers before allocating capital and doing so requires a skill set that is not necessarily present in most pension funds and other institutions used to portfolios of listed instruments. Many will draw on advice from their asset consultants, but increasingly private equity decisions are made in house by larger pension funds. Given the change in Regulation 28 and potential private equity exposure of up to 15% of assets, more funds may well choose to develop in house management capacity. The requirements for pension funds to assess the suitability of private equity funds was set out by the FSCA in its board notice 1 of 2012².

An engagement with a private equity firm usually starts with a fund-raising call from a firm. General partners (GPs) will approach potential investors to become limited partners (LPs) in a fund. This stage can take a few years – funds will set a target for fund raising and will continue seeking funds until it is reached. For potential investors interested in considering an investment, the next step is to assess the opportunity. The GP will provide comprehensive offering materials that will detail the strategy and features of the fund including a “private placement memorandum” that details the fund structure and commitments the LP is making. GPs are used to engaging in a due diligence process with potential LPs and will often have folders of material prepared to support the due diligence and in some cases data rooms that allow investors easy access to all material documents.

As a minimum, an investor considering a private equity investment should aim to:

- assess the firm, including track record of previous funds and the individuals who will be responsible for the current fund;
- assess the fund structure, including tax risks, authority LPs have to intervene in the management of assets, any liability the LP incurs (most South African funds are partnerships, though some are companies or trusts);
- assess the costs and fees charged by the GP and the structure of waterfalls for returns;
- assess the strategy – (does it fit economic expectations and views on tactical sectors and development stages?);
- assess the valuation methodology and determine who will be responsible for the undertaking and reporting of valuations; and
- assess the ESG features of the opportunity.

² Which is available to download at <https://www.fsc.co.za/Notices/Notice%20no%201%20of%202012.pdf>

This can be done through site visits to the manager and one-on-one meetings with key individuals. It is often done at different levels with an initial "prequalification" stage to determine key information that can inform an early decision on whether to reject the opportunity or proceed further to a "qualification" stage for more detailed due diligence.

These steps should lead to a comprehensive assessment of the opportunity in the context of a pension fund's wider objectives, including asset/liability management strategy.

If the decision is made to invest, all legal documents require review. Finally, post investment, there needs to be monitoring of the exposure including oversight of underlying investment to ensure they are within mandate and appropriately managed.

How does one assess the performance of private equity investments?

Private equity market performance can be analysed in several ways. This includes making comparisons against the public markets, capturing average returns earned by limited partners portfolios based on the amounts invested, or analysing fund internal rate of return (IRR). While there are several ways to value private equity assets, doing so has proven challenging because the majority of widely used models ultimately rely on public markets to calculate the required return. Nevertheless, not all models are dependent on publicly traded markets. Models based on stock market correlations tend to be biased downward and models based on risk-adjusted returns (alphas) are biased upward. Bias arises because the period over which the buyout or venture return is measured is not the same as the period over which the stock market returns are measured. The lack of synchronicity results in low estimated correlations (Woodward, 2004). The correlation of returns between private equity and public market classes remains widely debated, as some research suggests that private equity investments are procyclical (Axelson et al., 2009), follow the same fundamental risk outlined in Modigliani and Miller (Axelson et al., 2013) and provide economic exposure similar to equity markets (Franzoni et al., 2012). On the other hand, historical analysis states that the price of alternative assets is not correlated with equity price movements (Bonizzi & Churchill, 2017).

The many valuation methods used in private equity transactions are briefly summarised below, including multiples, net assets, and unlisted infrastructure models. These are usually chosen by funds in consultation with clients and auditors with the optimal approach determined by asset strategies and local regulations. Best practice is set out by the International Private Equity and Venture Capital Valuation (IPEV) board and the FSCA has determined in board notice 1 of 2012 that pension fund policies and procedures for determining fair value of assets must comply with the IPEV guidance.

Multiples:

- Private Equity is valued as an asset class by institutional investors both for its potential above-average performance and for its power to diversify a portfolio beyond what is available in traded securities. Many institutional investors believe that both venture capital and other private equity funds, held as limited partnerships, have returns that exhibit low correlations with returns on traded equities.
- This valuation technique involves the application of an earnings multiple to the earnings of the business being valued to derive a value for the business.

Net assets

- This valuation technique involves deriving the value of a business by reference to the value of its net assets.
- This valuation technique is likely to be appropriate for a business whose value is mainly derived from the underlying fair value of its assets rather than its earnings, such as property holding companies and investment businesses (such as fund-of-funds). This valuation technique may also be appropriate for a business that is not making adequate return on assets and for which a greater value can be realised by

liquidating the business and selling its assets. In the context of private equity, it may therefore be appropriate, in certain circumstances, for valuing Investments in lossmaking companies and companies making only marginal levels of profits.

Discounted cash flows or earnings (of underlying business)

- This valuation technique involves deriving the value of a business by calculating the present value of expected future cash flows (or the present value of expected future earnings, as a surrogate for expected future cash flows). The cash flows and 'terminal value' are those of the underlying business, not those from the investment itself.

Discounted cash flows (from an investment)

- This valuation technique applies the DCF concept and technique to the expected cash flows from the investment itself. Where realisation of an investment or a flotation of the underlying business is imminent and the pricing of the relevant transaction has been substantially agreed.

Valuation of unlisted and illiquid equity investments

There has been a shift in valuations post the 2008/2009 global financial crisis, with a surge in the value of unlisted infrastructure. In fact, the realised volatility of unlisted infrastructure investments is partly due to the asset class's development and increased number of valuations, which reflects a systemic increase in demand for these assets and thus a significant one-off shift in the price of unlisted infrastructure equity risk between 2009 and 2016 (EDHEC*infra*, 2021). The private infrastructure asset price volatility is mostly driven by a mix of interest rate and risk premia movements, which have a far larger magnitude than changes in future dividends. It is important to take duration into account when investing in infrastructure to anticipate changes in the market values of unlisted infrastructure equity. The duration of unlisted infrastructure equity (its sensitivity to interest rate changes) is the most informative forward-looking measure of risk. Duration presents the advantage of combining the impact of changes in the risk premia (which is systematic but firm specific) with that of interest rates (which is country specific).

With the use of a multi-factor approach, the valuation of unlisted and illiquid equity investments can be measured by combining future cash flows, interest rates and a firm-specific risk premia defined by the investment's exposure to key risk factors like size, leverage or profitability. The risk premia of individual private infrastructure companies are driven by a combination of microeconomic and macro-economic factors including:

- The **leverage factor premium** is the largest contributor to the discount rate and in line with financial theory, higher leverage commands a higher premium.
- The **size factor premium** exhibits more short-term volatility and can be considered a proxy of the relative liquidity of infrastructure investments: *ceteris paribus* larger assets command a higher premium. Large sought-after infrastructure companies also tend to be highly profitable.
- The **profit factor premium** is the only negative contributor to aggregate risk premia: higher profits lead to lower risk premia (higher valuations). This factor can be interpreted as a sign of greater risk aversion amongst buyers of unlisted infrastructure. Negative profits (leading to a higher premium) are also a contributor to the so-called 'greenfield' premium which characterises early development projects.
- The **investment factor premium** exhibits the most stability over the past 20 decades. High investment (capex) in infrastructure companies is related to the life cycle of the firm, including the greenfield phase during which sinking larger amounts of capex commands a higher premium. Investment also contributes to a greenfield premium.
- **Country risk (term spread)**: a steeper yield curve indicates greater long-term uncertainty which, in the case of infrastructure can be associated with country risk and tends to increase the risk premia.
- A range of **control variables** including a business model and industrial activities (EDHEC*infra*, 2021).

Because there is no market that prices private equity daily like listed markets, private equity valuations are lagged, thus the value of private equity investments may not reflect current movements in the public markets. Previous research identifies a lagged beta effect for up to four quarters of returns, which means up to a year of past returns could influence current returns (CFA Institute Journal Review, 2014). Therefore, since private equity funds are valued and reported on a quarterly basis, this leads to smoother valuations and less short-term volatility (Munich private equity partners, 2021).

Conclusion

For decades, most pension funds maintained a portfolio of listed shares and debt securities to meet their long-term pension obligations. However, the opportunity set has shifted in recent years as the investment universe has widened to include alternative investments, particularly private equity. This is now even more the case in South Africa, following amendments to Regulation 28 of the Pension Funds Act to enable pension funds to hold up to 15% of their assets in private equity. This change, in effect since 2022, means pension funds should reassess their asset allocation strategies particularly in respect of their exposure to private equity (and other asset classes including the new category for infrastructure).

The international literature on private equity has established several reasons that the asset class is appropriate for institutional investors:

High risk-adjusted returns. The effect of adding private equity into a portfolio is - as always - dependent on the portfolio itself. However, a plethora of research studies find that including private equity in a portfolio of pure public equity can unlock excess returns ("alpha").

Active, value-adding ownership. When an investor buys shares in a public company, the level of control they acquire is marginal. When a private equity firm invests, they usually become active owners. This ranges from advisory and assistance to fully restructuring and running the company. Private equity firms have specialist value creation teams that are dedicated to a singular aim: actively adding value to increase the return as much as possible in the long run.

Alignment of interests. When an investor (the "principal") hires a public fund manager to take control of their capital (as an "agent") they delegate control to the manager while retaining ownership of the assets. The fund managers earn a fee no matter how the fund performs, while the investor retains liability for any losses. In the case of private equity, the general partner doesn't just earn a management fee, the carried interest is based on their role rather than an initial investment in the fund. As a performance fee, carried interest aligns the general partner's compensation with the fund's returns, thus mitigating the "principal-agent problem".

Portfolio diversification. Investments in private equity funds add diversification to an investment portfolio whereby they can improve their risk-return profile. Private equity provides access to investments and market segments that are impossible to reach through public markets, which have become increasingly concentrated. Private equity thus enables investors to diversify risks and improve the efficient frontier of their portfolios.

Long-term perspective. Investments in private equity funds take a long-term perspective, avoiding tactical and behavioural errors. For investors, holding these assets for 10 to 15 years allows for lower volatility and transaction costs, generating meaningful compounding returns on capital while enabling company management to focus on running their businesses. It also allows for a longer horizon for these businesses to benefit from secular tailwinds, which tend to be more difficult to time correctly within a traditional private equity holding period.

With over R206bn in assets under management, the South African industry is a material component of the wider investment opportunity set. The proportion invested in private equity funds is set to grow given the larger available pool of capital that can be invested by pension funds.

The recent private equity returns performance has not been consistent with expectations, with negative returns on three-year view (though over 9% annualised on a 10-year view). This performance reflects the momentum of an investment strategy focused on large scale buyouts that has been maturing over the last few years. The industry has since become more focused on mid-market opportunities which offer greater potential for growth. The performance outlook depends on the specific strategy of a fund, and pension funds and other institutional investors need to assess funds directly and find comfort with their strategies. On the whole, however, the case for private equity is clear.

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