Trustee Tutor 17:
Investing in private markets

All businesses and governments need money and investment to be able to function and grow. These funds are often referred to as **financial capital**.

For companies, having access to funds means the difference between being able to grow and expand or missing out on great opportunities.

There are two routes available to raise the capital they need

Raising financial capital is the process by which companies raise funds from external sources to be financially able to achieve their objectives.

DEBT

- Take a loan from a bank,or
- Issue bonds.
- In both of these the company or government must repay the lender (or investor) at a set interest after a fixed period.
- The investor earns the interest as well as any growth on the bond value.

EQUITY

- Sell company shares.
- Buyer (or investor) becomes a part owner of the company.
- The investor earns dividends as well as any growth in the value of the share.

Whilst governments only issue bonds to raise capital, companies usually use a combination of both of these approaches.

Where would a company raise capital?

Like most of the things we buy, equity and bonds are bought and sold in a marketplace where interested buyers are connected with interested sellers. These marketplaces can be either:

LISTED

A listed marketplace is known as an exchange. Companies apply to have their shares listed on an exchange. And, in order for them to be listed, they need to meet specific formal requirements on that exchange. While each exchange has their own requirements, these usually focus on financial and governance aspects of the company.

A listed company is known as a public company. And, once listed, the company needs to comply with the laws that apply to all public companies.

In South Africa, our exchange is called the Johannesburg Stock Exchange (JSE). The JSE is the largest stock exchange in Africa and among the 20th largest in the world. The JSE is the marketplace for trading shares and financial derivatives. It sets the listing requirements for South African companies, enforces the trading rules and laws and provides market information on investments.

What does Regulation 28 say?

A retirement fund can invest up to 75% of its investments in shares listed on the JSE.

UNLISTED

Where a listed exchange is a formal marketplace, the unlisted market is an informal one. Some companies are not traded on a public exchange or stock market because they don't meet the traditional listing requirements. These are traded in what is referred to as the private market.

Unlisted shares are usually issued by smaller companies or newer start-ups that can't (or don't want to) comply with the requirements of an official exchange, like market capitalisation or listing fees.

Private market investments give investors access to a different set of companies – usually innovative companies, in their early stages, with high potential. This strategy can complement the investor's portfolio of listed market assets and provide opportunities for higher long term returns.

Before we look into private markets in more detail, let's first consider whether retirement funds are allowed to invest in these types of investments.

What does Regulation 28 say?

On 3 January 2023, Regulation 28 updated the limits to which retirement funds may invest in private investments, as follows:

- The regulations split hedge funds and private equity investments into separate categories to facilitate higher investment into private equity up to 15%, and a limit of 10% on hedge fund investments.
- The aggregate limit for all unlisted equities was increased from 35% to 45%.
- The aggregate sub-limit for all unlisted shares (excluding property shares) and private equity funds was increased from 15% to 20%.

From the above increases in the various limits, you can see that retirement funds investing into private markets is being encouraged.

It is important to remember that both debt and equity for companies and governments can be publicly or privately traded.

The market context ...

South Africa's investment landscape has changed a lot over the last 10 years. The country's economic growth has slowed, there are less listed shared on our stock exchange and it is becoming more and more difficult to deliver real returns (in other words, returns higher than inflation).

This has left investors looking for alternative prospects to find meaningful growth.

Coupled with this, is South Africa's current social and economic difficult reality. High unemployment, crumbling infrastructure and the energy crisis are all negatives that need to be overcome if we are to thrive as a country.

This context presents investors with an opportunity.

What opportunities do private markets present?

Private markets expand the investment range available for retirement funds to invest in. They offer the following benefits:

Diversification – private markets are not highly correlated with public equities or debt. Private markets give investors exposure to stable cashflows backed by real assets whose value does not rise and fall every day with the mood of the market. This presents retirement funds with an effective diversification tool.

Higher potential returns – investors can expect to be compensated for investments which are less liquid and more long term in nature.

Inflation protection – private assets tend to be less vulnerable to inflationary pressure than more traditional assets.

Long term investment time horizon – the investment horizon of private equity investment is well suited to the long term horizon of retirement funds. But the time horizon of the investment is not the only long term benefit. Typically, these types of companies create employment, grow infrastructure and stimulate economic growth. Investments into these therefore contribute to the sustainability of a country.

Choices available – in reality, the number of shares listed on the JSE has dropped from 776 to 334 over the last 30 years. In contrast, private markets worldwide have grown significantly over the same period. Private markets thus present a growing opportunity set for retirement funds.

Social upliftment – there is compelling evidence that a strong private markets industry helps a country create employment and economic growth. These companies often also solve for particular social and environmental issues.

Most often, private market investments go hand in hand with infrastructure development and other economically boosting investments.

These types of investments give trustees the chance to not only diversify the retirement fund's investments to minimise the impact of volatility and seek higher returns, but also to meaningfully impact society and contribute to a sustainable country into the future.

Because of the benefits provided by private markets, there is a growing global trend to invest in these types of assets. In 2022, there was $11.7 trillion invested in these markets in the United States. In South Africa, market is still relatively small at around R150 billion (in 2023) but it is expected to grow quickly.

Let's look at the risks in a little more detail ...

The listing requirements of formal stock exchanges try to ensure that only the highest quality companies trade on these exchanges. Because of this, the perception of some investors is that unlisted investments may be of a lower quality and present bigger risk.

1. **Liquidity** - Liquidity risk is simply that an investment can't be turned into cash quickly enough to meet financial obligations. In a retirement fund investment context, liquidity is important to make sure that the fund can pay claims as they occur. Because private market investments are typically long term in nature, investors need to be committed to the investment for a long period – usually five to ten years.
2. **Funding** – private market investments don't subscribe to the listing requirements of public companies on the minimum levels capitalisation. This leaves investors nervous of losses resulting from inadequate funding.
3. **Operational constraints** – many investors fear that start-ups or infrastructure investments don't have adequate systems and processes to support the company's or project's operations.
4. **Fees** – fees for private market investments are generally higher than for traditional asset classes.
5. **Timing/availability** – historically private market investments have proven difficult to access for investors, who are not sure where to look for these opportunities. The companies and infrastructure projects themselves also have a long timeframe, and typically an investor would want to time their investments to ensure that their monies are indeed invested meaningfully in a project that is already up and running.

Why would retirement funds invest in private markets?

Having considered the risks, why should trustees of retirement funds consider investing in private markets?

The promise of long term returns, meaningful diversification and the importance of social and economic upliftment make a compelling case for these types of investments. The increasing of the Regulation 28 limits to which retirement funds may invest in private markets, signals the Regulator's intention that these types of investments need to be considered with more vigour. This is a major step forward in the development of the infrastructure assets desperately needed, especially in areas such as renewable energy, desalination, the digital economy, water, sanitation and roads.

Private markets have experienced rapid growth over the past few years. It is estimated that assets under management in private markets will reach as much as $15 trillion by the end of 2025 (more than 10% of global assets under management).

Benefits of private markets from three different perspectives

1

Issuer

Non-traditional companies and start-ups are able to access the investment capital they need to operate and grow their businesses. Building a solar farm, for example, is a long term project for which companies and governments need the capital before they can begin. These companies need investors with an investor mindset who are willing to invest their capital for five years or more.

Private market portfolios connect these companies and initiatives with investors. The asset managers who construct these portfolios have the expertise and skills needed to assess the projects/prospects.

2

Investor

Private markets offer the investor exposure to entrepreneurial projects and businesses that fall outside of the traditional listed market environment. These investments are perceived as being "riskier" than listed investments but often mistakenly so. They provide investors access to more reliable, long term cashflows and proportionately higher investment returns.

3

Society

Listed markets are not equipped to deal with the problems facing South Africa and the rest of the world. The challenges include the transition to lower carbon emissions, efficient infrastructure, financial inclusion, education for everyone and modern sanitation. Private markets have the skills, capital and, most importantly, the creative freedom to solve many of these problems.

How do trustees access private market investments?

Most asset managers in South Africa offer private market investment portfolios. These are pooled portfolios with private market mandates. These asset managers have the expertise, knowledge and skills to assess the prospects of the various investment opportunities, in the context of the regulatory, political and market environments.

When looking at these types of portfolios, trustees should consider:

- The investment manager's track record in this space and their network
- The types of projects and companies they invest in – discipline, transparency, governance and accountability.
- Diversification
- Liquidity
- Fees
- Any exit conditions, charges or penalties

To deliver consistent returns in private markets, asset managers need networks in the real economy and the skills to analyse the full range of legal, regulatory, operational and technological risks facing a project.

In addition, the illiquidity of private market assets makes ESG critical for asset managers, where all investments are long term. Asset managers must therefore set high ESG standards for the companies they invest in, and then monitor performance consistently.

And finally, if things don't go to plan, an effective manager must have the skills and strategies to recover as much value as possible for investors.

To sum up private markets

South Africa, like many other countries worldwide, needs investment into infrastructure and other economically stimulating projects if we are to build a sustainable future. Retirement fund assets represent more than R5 trillion of assets and trustees are looking for new investment opportunities to diversify and earn real returns. Private markets are becoming a real option for retirement funds.

It is however, important to balance the approach depending on members' needs and investment objectives. Private markets provider another tool where trustees can help member reach their retirement goals, while also helping wider society and the economy.

If you're interested in reading more about private markets, you can look up the SAVCA.
The South African Venture Capital Association (SAVCA) is a trade association that represents the interests of the private equity industry in South Africa. The association provides networking opportunities, training and research as well as other services to its members.