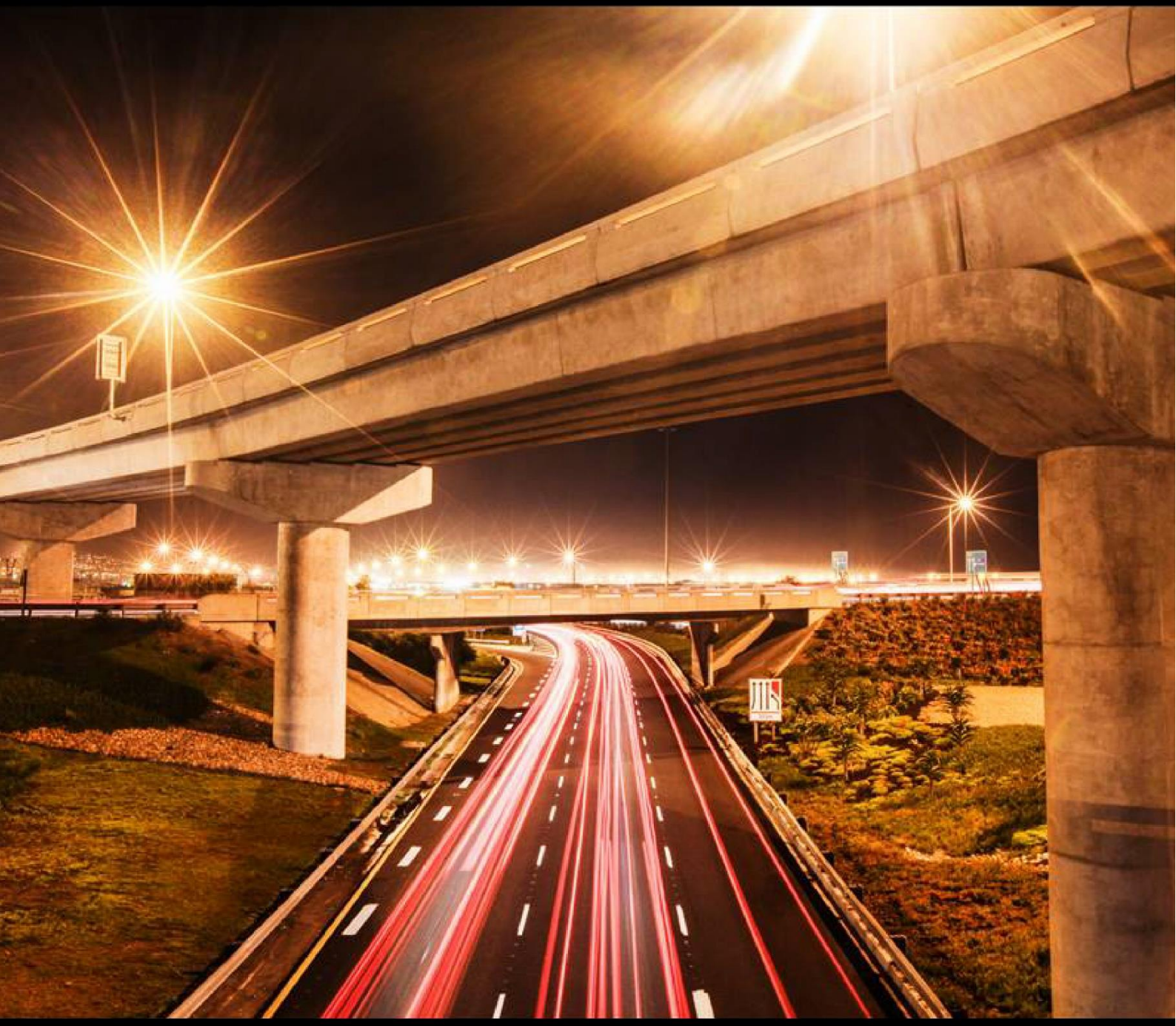
BAYAKHA

INFRASTRUCTURE PARTNERS



REGULATION 28 AMENDMENT –
THE BAYAKHA INFRASTRUCTURE PARTNERS POSITION

REGULATION 28 AMENDMENT – THE BAYAKHA INFRASTRUCTURE PARTNERS POSITION

Written by Ngoku-Sakhile Mazwi, 06 July 2020.

EXECUTIVE SUMMARY

The development of a nation is measured by the size and sophistication of its economy, the state and extent of its physical infrastructure and perhaps most importantly, the quality of its human capital. This paper seeks to articulate the place of physical infrastructure in South Africa's development story, with a specific emphasis on the regulatory framework that governs infrastructure finance for pension funds. In doing so, this submission will make a case for Infrastructure to be understood as a separate asset class, with higher permitted pension fund allocations per the regulatory framework. Making the proposed amendments to Regulation 28 (the regulation governing pension fund investments in private equity investments), will unlock an estimated ZAR 120[1] billion for infrastructure investment. The associated increase in infrastructure stock will then result in a proven, equivalent growth in GDP[2], which makes infrastructure investment the surest path to economic recovery. By way of enriching what is already a lively discourse on the topic, this paper thus also serves as a response to the South African Venture Capital and Private Equity Association's ("**SAVCA**") positioning paper dealing with 'Regulation 28 amendments for private equity' published on June 2, 2020.

INTRODUCTION

Bayakha Infrastructure Partners ("**Bayakha**") agrees with SAVCA in its assertion that traditional private equity and venture capital play a crucial role in the economy by directing investment towards small and mid-sized companies that are critical for job creation, innovation and growth. As a composite piece of the private equity sector, infrastructure investments have been specifically proven to have an empirical, simulative effect on economic growth and to also reduce inequality across a variety of global studies[3]. In South Africa ("**SA**"), Ndlovu[4] examined the influence of infrastructure Public-Private Partnerships ("**PPP**") on Gross

[1] Using estimates from ASISA in South African National Treasury. (2020). Financing A Sustainable Economy. 49

[2] Calderón, C., & Servén, L. (2004). The Effects of Infrastructure on Growth and Income Distribution. Central Bank of Chile Working Papers, 270.

[3] Ibid; Aschauer, D. A. (1990). Why is infrastructure important? Industry Week, 21–68; Kumari, A., & Kumar Sharma, A. (2017). Infrastructure financing and development: A bibliometric review. International Journal of Critical Infrastructure Protection, 16, 49–65. https://doi.org/10.1016/j.ijcip.2016.11.005

[4] Ndlovu, T. (2019). Examining the influence of Public-Private Partnerships on Economic Growth in South Africa. SSRN Electronic Journal, 5(564), 1–19.

Domestic Product ("**GDP**") and argued that the economic growth effects of infrastructure require more private sector involvement as a means of enhancing efficiency in project implementation.

The thesis for private participation in infrastructure investment has been hastened, in some respects, by South Africa's weak fiscus and the compounding effects of COVID-19. COVID-19 has had an adverse impact on the economy, reducing the government's ability to play a larger role in direct infrastructure finance. Real GDP is expected to drop by 7.2 percent in the 2020 calendar year, requiring the Government to enter a 'new social compact; present decisive action to stabilise debt and narrow the budget deficit; implement structural reforms in order to improve both growth; and the structure of the economy'[5].

The recently held Sustainable Infrastructure Development Symposium ("**SIDS**") and attendant Sustainable Infrastructure Development Methodology ("**SIDS Methodology**") are thus a recognition, on the part of government, of the requirement for an infrastructure-led growth plan. What SIDS asserts is that South Africa needs a Gross Capital Formation target of at least 30% in order to transform into an 'investment-led economy'[6]. Stimulating private sector infrastructure investment then, forms part of this strategy.

From a policy making perspective, Regulation 28 of the Pension Funds Act ("**Reg. 28**") governs the asset allocation of pension funds in South Africa. SAVCA's paper rightly indicates that, 'as it stands, Regulation 28 places private equity into a bucket of alternative investments which are capped at 15% of compliant funds' assets under management'[7]. This same bucket includes, Hedge Funds, Private Equity (of which Infrastructure is composite) and 'any other asset not referred to in the schedule.' In opposition to this classification method, SAVCA argues that grouping Private Equity with Hedge Funds is not appropriate as it does not resolve the challenge of diversifying away from listed market exposure by investing in uncorrelated private market asset classes. In other words, for a true unlisted, alternative asset classification, Hedge Funds ought not form part of the same bucket as Private Equity. We agree with SAVCA's position in this respect. In addition, however, we seek to argue for greater stratification within the Private Equity category, enabling a view of Infrastructure as a separate asset class. This paper thus presents supplementary evidence for the additional classification of Infrastructure as a distinct, separate, asset class in Regulation 28 of the Pension Funds Act.

---

[5] National Treasury of South Africa. (2020). Supplementary Budget Review 2020.

[6] Investment and Infrastructure Office South Africa. (2020). Sustainable Infrastructure Development Symposium South Africa (Vol. 1). Vol. 1. Retrieved from https://sidssa.org.za/wp-content/uploads/2020/06/SIDSS-Editorial-V10.pdf

[7] South African Venture Capital Association. (2020). SAVCA Positioning Paper: Regulation 28 Amendments for Private Equity

THE CASE FOR INFRASTRUCTURE AND ITS CLASSIFICATION AS A SEPARATE ASSET CLASS

THE VALUE OF INFRASTRUCTURE INVESTMENT

It is increasingly accepted that infrastructure investments contribute immensely to economic growth[8]. Aschauer's seminal paper[9], published in 1989, triggered a voluminous amount of research into the sector by noting strong links between infrastructure investment and economic growth in the United States. Belloumi & Achour[10] later proved a causal relationship between transport infrastructure, energy consumption and gross domestic product (GDP) in Tunisia. Perhaps the most compelling contribution to this body of work has been World Bank's proof[11] that a 1% increase in infrastructure stock is directly correlated to a 1% increase in GDP.

South Africa has historically under-invested in infrastructure, achieving an investment level of 4.7% of GDP [12]. In comparison, India and China, its bigger BRICs associates, have been investing 8%-13% of GDP in infrastructure consistently since the 1990s[13]. Thus, while South Africa is a regional leader in infrastructure stock relative to the rest of Sub-Saharan Africa, it has inadvertently hurt its growth and development prospects by failing to consistently invest in infrastructure.

DEFINING INFRASTRUCTURE

Although proven to be an essential component of economic growth, there is no dominant, singular understanding of what infrastructure is. However, most definitions share an overlapping view of infrastructure as a reference to: power plants, power distribution networks, oil and gas pipelines, roads, bridges, railways, harbours, airports, water purification and treatment plants, water pipelines, potable water supply, dams, telecommunications and communication networks, sewage facilities, housing services / human settlement, urban

[8] Chong, S., & Poole, E. (2014). Financing Infrastructure : A Spectrum of Country Approaches. Reserve Bank of Australia Bulletin, (September Quarter), 65–76.
[9] Aschauer, D. A. (1990). Why is infrastructure important? Industry Week, 21–68.
[10] Belloumi, M., & Achour, H. (2016). Investigating the causal relationship between transport infrastructure, transport energy consumption and economic growth in Tunisia. Renewable and Sustainable Energy Reviews2, (October).
[11] Kumari, A., & Kumar Sharma, A. (2017). Infrastructure financing and development: A bibliometric review. International Journal of Critical Infrastructure Protection, 16, 49–65. https://doi.org/10.1016/j.ijcip.2016.11.005
[12] McKinsey Global Institute. (2016). Bridging Local Infrastructure Gaps. McKinsey & Company, June (2016).
[13] Chong, S., & Poole, E. (2014). Financing Infrastructure : A Spectrum of Country Approaches. Reserve Bank of Australia Bulletin, (September Quarter), 65–76.

services, and irrigation networks[14]. The Organisation for Economic Cooperation and Development **("OECD"**) definition for infrastructure is simply "the system of public works in a country, state or region, including roads, utility lines and public buildings."

In the investment industry we typically group and differentiate between *economic* infrastructure and *social* infrastructure assets. Economic Infrastructure being power, transport, water and Information and Communications Technology (**"ICT"**) assets and Social Infrastructure typically referring to student housing, schools, human settlements, clinics, hospitals and wellbeing.

INFRASTRUCTURE INVESTMENT CHARACTERISTICS

Investors, including the Bayakha team, typically identify quality infrastructure assets based on their economic and financial investment characteristics, which include high barriers to entry, economies of scale, inelastic demand, lower volatility/correlation to economic swings and listed markets, predictable cash-flow yields based on long-term agreements as well as public-goods attributes linked to a tendency towards monopoly[15].

It is because of these public-goods attributes that government regulation is required to ensure that infrastructure is appropriately priced. Not all infrastructure sectors are like this, however. ICT as an example, has sufficient attributes to incentivise competitive private participation and therefore does to not require *too much* government involvement. Nevertheless, infrastructure projects typically have network effects benefits and address spatial inclusion. Thus, the net public benefit or economic gross value add ("**GVA**") from infrastructure investments exceeds their private sector return. For this reason, some infrastructure sub-sectors, such as social housing, get underprovided for by the private sector.

IS INFRASTRUCTURE AN ASSET CLASS?

Having defined infrastructure and determined its value, the next logical question is whether it deserves to be understood as a distinct asset class? The answer to this question is important as it dictates how asset allocators will view these assets from an asset-liability modelling perspective. This will also influence the final investment amounts allocated directly to infrastructure projects as well as to infrastructure fund managers by pension funds.

---

[14] Kumari, A., & Kumar Sharma, A. (2017). Infrastructure financing and development: A bibliometric review. International Journal of Critical Infrastructure Protection, 16, 49–65. https://doi.org/10.1016/j.ijcip.2016.11.005

[15] Inderst, G. (2010). Infrastructure As An Asset Class. EIB Papers, 15(1), 70–104.

Some scholars have struggled to back the proposition that infrastructure is a separate asset class[16]. However, alternative theory suggests that infrastructure can be understood as distinctive if different from traditional equities, properties, bonds, and cash[17]. Additionally, there is extensive research[18] that suggests that an asset class is ***a set of assets that have similar risk-return characteristics, and are subject to similar regulatory structures, and react to the same factors.*** This perspective on asset-class definition enables a more applied approach, responsive to the specific context that the investor operates in.

In accordance with this approach, we would like to outline key differences between Private Equity and Infrastructure, that necessitate a clear distinction within Regulation 28. Unlike private equity, infrastructure is typically financed through project finance and not corporate finance, with the former having greater sensitivity to interest rate movements due to higher levels of senior debt. Additionally, the cashflow profiles of private equity investments are different, with the bankability of infrastructure projects depending more on predictable, long-term cashflows. Finally, where private equity deals are typically beyond the direct involvement of government, infrastructure projects involve government not only as a regulator but as a partner.

INTERNATIONAL STUDIES & EXAMPLES

Some of the largest pension funds in the world, like the Ontario Teachers' Pension Plan and California Public Employees' Retirement System ("**CalPERS**"), allocate to Infrastructure and Private Equity as separate asset classes. Ontario Teachers' Pension Plan's asset allocation as at December 2019 showed an allocation of 19.3% and 9.3% for Private Equity and Infrastructure investments respectively[19].

A study by Probitas[20] found similar differences amongst investors, claiming that the majority of investors surveyed separated allocations between infrastructure and private equity. However, confusion reigns for others who instead classed infrastructure under private equity (27%); under real estate (13%); under alternatives portfolios (12%) and others yet, under inflation-hedged strategies (7%). While infrastructure can act as cousin to other asset types, the impetus to amend Regulation 28 must come from an appreciation of the South African

[16] Inderst, G. (2010). Infrastructure As An Asset Class. EIB Papers, 15(1), 70–104.
[17] Bacon, R. (2018). Introduction to Asset Allocation. Strategic and Tactical Asset Allocation: An Integrated Approach, 1.
[18] Nieuwoudt, M.; Snyman, H.; Gower, D. (2017). Infrastructure-Risk-and-Return-White-Paper-2017.pdf. Retrieved from www.gaiap.com.
[19] Kozlowski, R. (2020, 3 31). Ontario Teachers returns 10.4% in 2019. Retrieved from Pensions & Investments: https://www.pionline.com/pension-funds/ontario-teachers-returns-104-2019
[20] Probitas (2009). "Infrastructure Market Review and Institutional Survey". Probitas Research, November

context. Specifically, there is a requirement to use the regulatory framework to provide clearer guidance to the Pension Fund market on its role in the nation's infrastructure-led growth strategy and more generally, the national development plan.

CONCLUSION: AN ASSET ALLOCATION PROPOSAL FOR SOUTH AFRICA

In addition to the conflation of Private Equity and Infrastructure, there exists an overlap between Infrastructure and Unlisted Real Estate that must be clarified. Indeed, certain social infrastructure projects such as student and social housing qualify as property assets. However, as articulated above, infrastructure assets overwhelmingly fall outside of the real estate grouping and must be understood as such. Energy, Transport, Water, ICT, Health and Education are not real estate. We thus reiterate the point that Infrastructure is distinct and separate from Private Equity and indeed, Unlisted Real Estate.

We thus recommend the following changes to Regulation 28:

1. Infrastructure should be treated as a distinct asset class. This means it is to be separated from Private Equity and Unlisted Real Estate.
2. A specified list of defined, qualifying economic and social infrastructure assets must be included in the regulations to ensure that Pension Funds apply standardised definitions to their classification.
3. We support SAVCA's proposal to have a 10%-15% regulatory limit on Private Equity investments.
4. In addition, we propose that infrastructure investments also be granted a regulatory limit of 10%.

We believe the above changes will serve the economic growth imperative as a ten percent (10%) infrastructure asset class inclusion in **Reg. 28** has the potential to unlock over ZAR 120 billion[21] of much-needed private pension fund investment into infrastructure through public-private partnerships and direct investment.

It is important to note that infrastructure investments are not only critical for growth, but play a catalytic role in improving the wellbeing of society. Working in tandem with investments in human capabilities, infrastructure unlocks the productivity of society, ensuring that all citizens are empowered to participate in the social, political and economic life of the country.

[21] Using ASISA estimates from ASISA found in South African National Treasury. (2020). Financing A Sustainable Economy. Pg. 49

In addition, we believe that changes to Reg. 28 will complement the commercially viable or blended finance projects from the SIDS Methodology process. Specifically, SIDS presents a healthy pipeline of projects for pension funds to either invest in directly or indirectly, through infrastructure fund managers that are qualified and licensed under the Financial Services Conduct Authority.

In sum then, this paper has presented evidence for the classification of Infrastructure as a distinct, separate, asset class in Regulation 28 of the Pension Funds Act. This amendment will significantly increase the financial capital that exists in local capital markets to fund and support South Africa's infrastructure-led growth and recovery plan. Importantly, we believe this amendment to the Act will achieve policy congruence by enabling greater private participation in infrastructure within a regulatory context that protects the savings of pensioners. In doing this, the amendments will breathe life into the National Development Plan, the goals of which remain relevant for the attainment of a stable and growing economy and the wellbeing of society in general.

Ngoku-Sakhile Mazwi is the Managing Director of Bayakha Infrastructure Partners.

Email: sakhile@bayakha.co.za

REFERENCES

Aschauer, D. A. (1990). Why is infrastructure important? *Industry Week*, 21–68.

Bacon, R. (2018). Introduction to Asset Allocation. *Strategic and Tactical Asset Allocation: An Integrated Approach*, 1.

Belloumi, M., & Achour, H. (2016). Investigating the causal relationship between transport infrastructure, transport energy consumption and economic growth in Tunisia. *Renewable and Sustainable Energy Reviews2*, (October).

Calderón, C., & Servén, L. (2004). The Effects of Infrastructure on Growth and Income Distribution. *Central Bank of Chile Working Papers*, *270*.

Chong, S., & Poole, E. (2014). Financing Infrastructure : A Spectrum of Country Approaches. *Reserve Bank of Australia Bulletin*, (Septermber Quarter), 65–76.

Inderst, G. (2010). Infrastructure As An Asset Class. *EIB Papers*, *15*(1), 70–104.

Investment and Infrastructure Office South Africa. (2020). *Sustainable Infrastructure Development Symposium South Africa* (Vol. 1). Vol. 1. Retrieved from https://sidssa.org.za/wp-content/uploads/2020/06/SIDSS-Editorial-V10.pdf

Kumari, A., & Kumar Sharma, A. (2017). Infrastructure financing and development: A bibliometric review. *International Journal of Critical Infrastructure Protection*, *16*, 49–65. https://doi.org/10.1016/j.ijcip.2016.11.005

McKinsey Global Institute. (2016). Bridging Local Infrastructure Gaps. McKinsey & Company, June (2016).

National Treasury of South Africa. (2020). *Supplementary Budget Review 2020*.

Ndlovu, T. (2019). Examining the influence of Public-Private Partnerships on Economic Growth in South Africa. *SSRN Electronic Journal*, *5*(564), 1–19.

Nieuwoudt, Mich; Snyman, Hendrik; Gower, D. (2017). *Infrastructure-Risk-and-Return-White-Paper-2017.pdf*. Retrieved from www.gaiap.com

Probitas (2009). “Infrastructure Market Review and Institutional Survey”. Probitas Research, November

South African Venture Capital Association. (2020). *SAVCA Positioning Paper: Regulation 28 Amendments for Private Equity*.