FUTUREGROWTH
/ ASSET MANAGEMENT

What to ask your asset manager: Investing in Infrastructure
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Why does investing in infrastructure matter?

The macroeconomic benefit of investing in infrastructure has been well researched and documented over the past century. Such investment bolsters a country's economic growth, while simultaneously providing both intended and unintended social benefits. These include reducing income inequality, poverty and unemployment, amongst many others. Experience has shown that capital providers of these investments can, at the same time, earn sound risk-adjusted returns.

Infrastructure is defined as the basic physical structures and systems for the provision of utilities or services for public use or enjoyment. Expanding on this, a consensus view has emerged: that infrastructure development is *fundamental* to economic growth and poverty reduction, given that the availability of infrastructure (or lack thereof!) affects production costs, employment creation, access to markets, and – ultimately - investment. In the context of South Africa, it can be seen as an important catalyst to improve our economic growth trajectory, while addressing the urgent need for job creation.

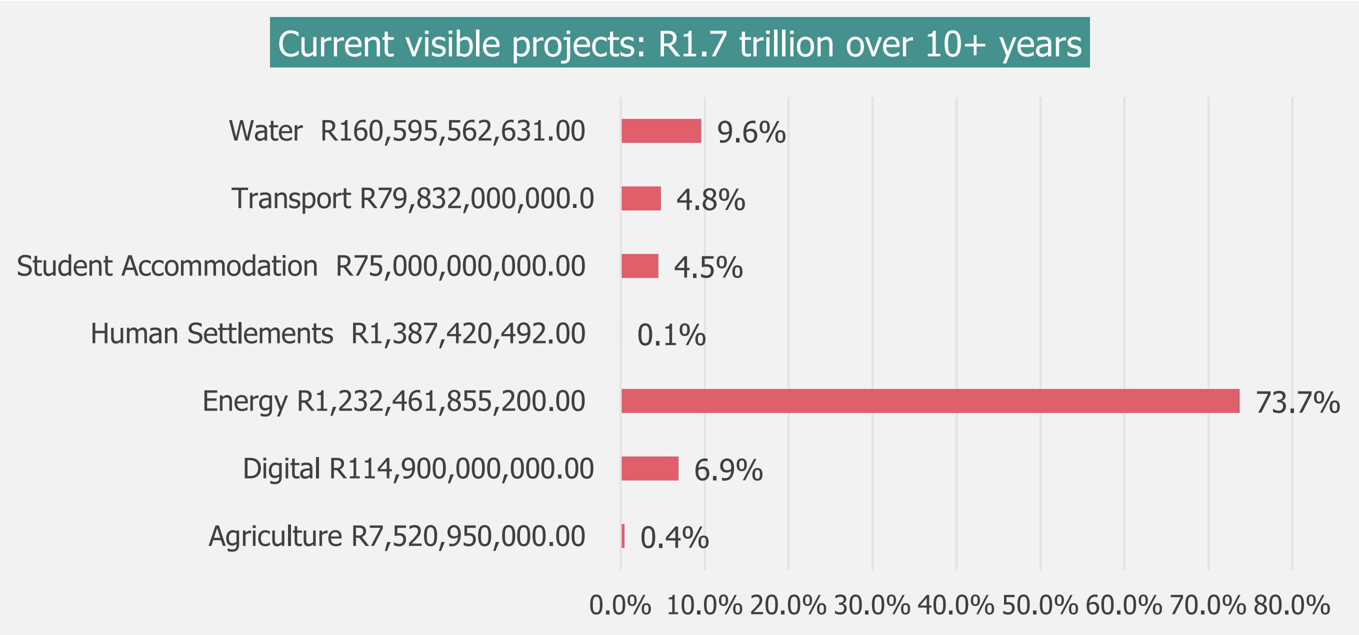
Infrastructure development has the following knock-on benefits:

- It allows for easier access to markets, and is an enabler for the development of other sectors and industries. This is specifically important in the African context, where a vast portion of the population live and work in rural areas. Thus infrastructure development gives these communities improved access to the formal economy and markets.
- It has positive impacts on transaction costs. Investment in infrastructure development and maintenance can improve production costs and business competitiveness.
- The link between appropriate and adequate infrastructure and poverty alleviation efforts has been seen in many areas. Research shows, for example, that access to electricity improves literacy, healthcare and nutrition. Conversely, where infrastructure development is not addressed, the cycle of inter-generational poverty is entrenched.

South Africa faces a growing infrastructure funding shortfall

Over the next 10 to 15 years, it is expected that there will be an infrastructure funding shortfall of approximately R1.7 trillion - to fund approximately 276 identified initiatives. This is based on the government's own infrastructure drive and, apart from the public-private partnerships such as the renewable energy programme, the bulk of these would normally be funded by government and its various branches in the form of the State-Owned Enterprises (SOEs). However, given the expectation that the net debt to GDP will increase over time (and be further exasperated by contingent liabilities in the form of guarantees provided to various SOEs such as Eskom) our government will not have the means to play a big role. The onus will therefore fall on the capital markets (i.e. banks and pension funds) to fund these opportunities. Nevertheless, *bankability* remains the key consideration: that there will be sufficient sustainable cashflow to **both** service debt **and** provide adequate returns for equity investors.

South Africa's infrastructure funding gap
Estimated totals: 276 projects, R2.3trn total value



Updated: 17 November 2020

Regulation 28 draft amendments elicit some considerations
In February 2021, National Treasury released its draft amendments to Regulation 28 of the Pension Funds Act, which aim to make it easier for pension funds to invest in infrastructure. Please refer to our recent article: Draft Reg 28 amendments – supportive but some concerns

Although attempting to create a greater impetus for investments in infrastructure, the proposed changes have suggested a very narrow definition of infrastructure, which only considers investment in public infrastructure as "infrastructure" and thereby ignores infrastructure investments by the private sector.

Furthermore, in our view, infrastructure assets should not be seen as a different asset class, which this additional classification suggests. These assets need to fit within an already defined asset allocation strategy, be they in debt, equity or property. They are typically long term in nature, and act as a natural asset/liability match for retirement funds. As alluded to above, the returns afforded to retirement funds need to be on full commercial terms, giving investors sound risk/return characteristics.

Retirement funds can play a meaningful role
Over the past two decades - through various specialist managers - the retirement fund industry has invested in many private sector initiatives that have ensured tangible returns for both the country and members of pension funds.

Due to the expected infrastructure funding shortfall over the next two decades, pension funds can play a meaningful role in that regard - but this needs to be done in manner that doesn't put retirement funds at risk due to sub-optimum investments.

Investment fundamentals need to prevail, with a need for a pipeline of bankable transactions driven by:
- Cashflows to support debt and equity;
- Sound public and private sector partnerships;
- Reputable and experienced developers;
- An enabling environment and legislation;
- Municipal infrastructure that works;
- ESG considerations; and
- Suitable impact reporting, to meet the needs of investors.

Here are some questions to consider when reviewing infrastructure investments

These questions are collated from a combination of Futuregrowth's own experience in managing these complex (predominantly unlisted) alternative investments, together with a range of frequently asked questions based on client interactions over the past few years.

1. How experienced is the service provider?

Infrastructure investments require a specific skill set bolstered by a deep understanding of project finance and its associated risks – as well as how to mitigate against (and adequately price for) both construction and operational risks. It is of utmost importance that trustees of pension fund money apply proper due diligence in this regard.

2. How important is liquidity?

Investors often think that if an asset is more liquid it is less risky. However, if you were invested in African Bank shares or bonds (for instance) you would know that liquidity does not take away business risks and that liquidity would only be beneficial in exiting an investment before it completely sinks and probably doing so at a deep discount.

Whilst unlisted assets in infrastructure might not be liquid, investors in these projects generally have more insight into the business on a regular basis. Equity holders in an unlisted business may, for example, have board representation (depending on their shareholding), which would keep them appraised of the activities and performance of the business. In the case of investors that provide debt funding directly in the unlisted market, protections for investors can be negotiated, such as access to financial information (such as monthly management accounts) or by taking security over the asset being funded.

3. What is the investment horizon?

Investments in both unlisted and listed infrastructure assets require a relatively long-term view; more so for unlisted assets, because of the often illiquid trading nature of these. When making the decision whether to invest in traditional or alternative asset classes, clients' income requirements and level of risk tolerance need to be carefully considered.

4. What types of assets should be considered?

The entire market has access to listed assets on an exchange, and access to investments in specific economic sectors is limited to what is available on the exchange.

The unlisted market can provide investors with access to a wider selection of infrastructure assets across various sectors. Some of these businesses can be in a niche market, be difficult to replicate, and have little competition – such as renewable energy, toll roads and broadband infrastructure. Therefore, opportunities for investment in these assets should not be overlooked.

5. How should risk and return on the investment be measured?

The risk and return assessment on a listed or an unlisted infrastructure asset would largely be the same. The only difference might be a higher liquidity premium for an unlisted asset, in order to compensate for reduced liquidity and tradeability the asset (versus being on an exchange).

Conclusion: protections and bankability are key

Investing in unlisted assets can appear to be more risky than investing in traditional listed assets, but there are a number of tools at investors' disposal (some of which we have highlighted above) to ensure that they are rewarded for the risks taken. An investment in an unlisted asset can be protected by having numerous "belts and braces" in place, which the borrowing company or entity would need to comply with over the life of the investment.

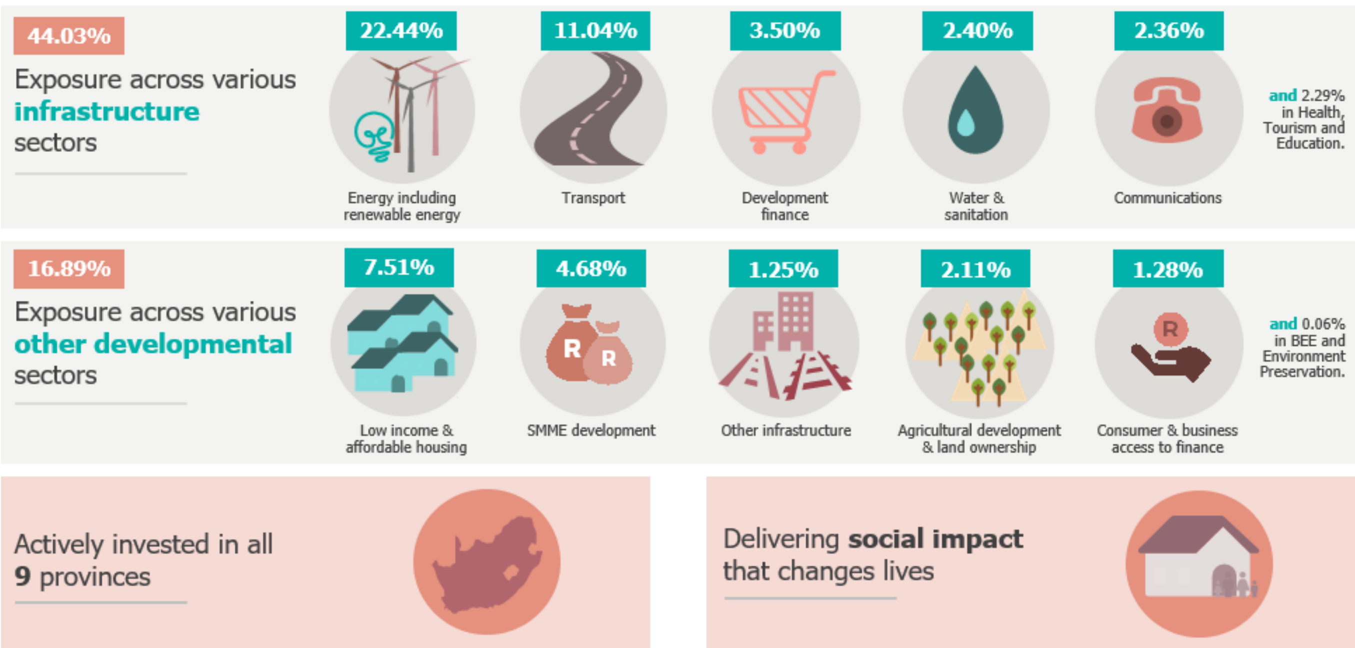
As we have indicated above, investing in unlisted assets is complex - due to the additional layers of work involved - and requires highly specialised skills. Therefore, we recommend that investors who include alternative assets as part of their portfolio allocation invest with partners that have a proven track record in managing investments in infrastructure.

Infrastructure spending continues to be seen as an important driver of economic development and growth, as well as job creation. We are all aware of the infrastructure backlog that plagues South Africa, with the government having launched various initiatives over the past few years to try to address this concern. Given government's rising debt to GDP levels, and therefore limited ability to fund these initiatives, the role of the private sector becomes ever more important. The bankability and sustainability of such investments is key. While developmental finance institutions can play a subsidised financing role and thereby take on more risk, banks and institutional investors can only fund on the basis of bankability - and should expect to earn commercial returns.

FUTUREGROWTH INFRASTRUCTURE & DEVELOPMENT BOND FUND

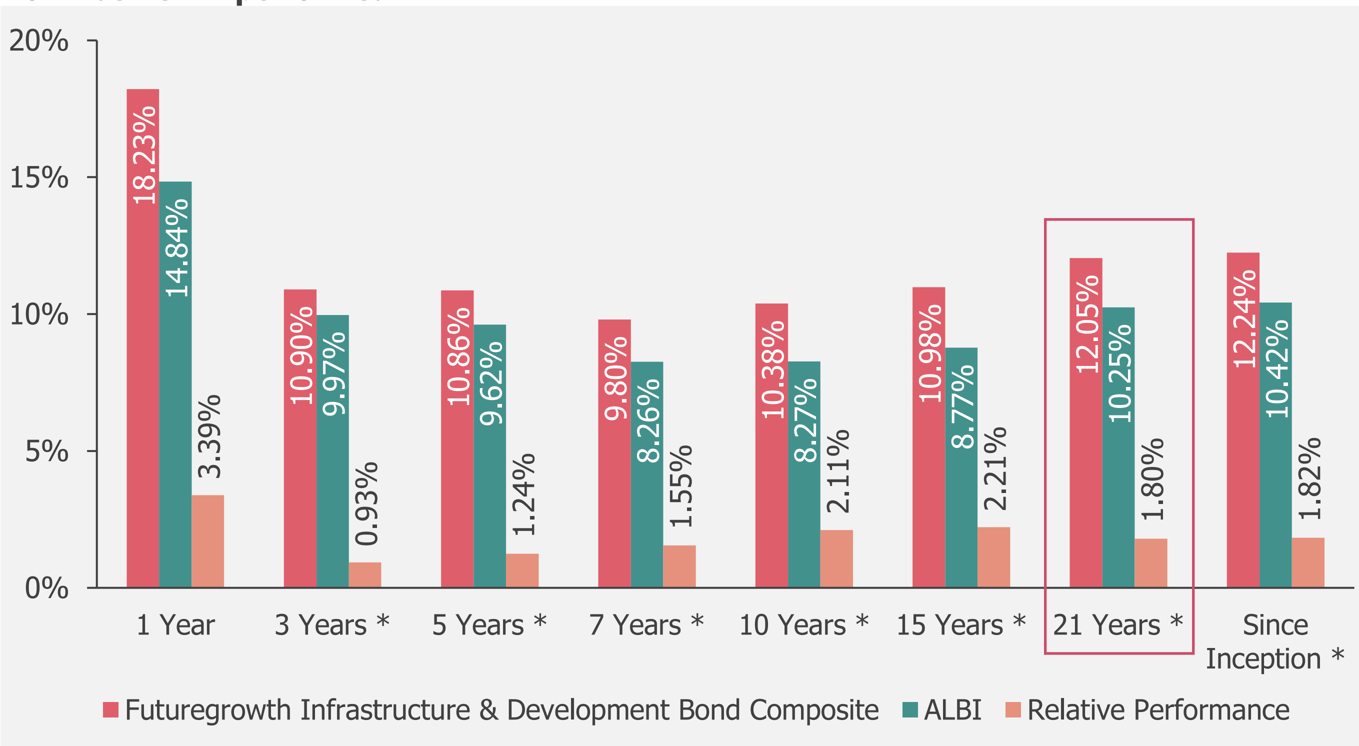
The Futuregrowth Infrastructure & Development Bond Fund (FGIBF) has continued to play an integral part in infrastructure funding since its launch more than two decades ago, funding various initiatives in the infrastructure and developmental space, gaining exposure to sectors such as power, transport corridors, healthcare, transport, education, SMME development and affordable housing. Diversity plays an important role in terms of the management of the Fund - echoing our credit ethos – which has exposure to over 154 issuers and 37 economic sectors.

Which sectors does FGIBF invest in?



Updated: 30 June 2021

How has FGIBF performed?



Performance as at 31 August 2021 / Fund start date: January 1995 / Since inception date (GIPS Composite): January 2000
*Annualised/Source: Futuregrowth

Key features of FGIBF

Updated: 30 June 2021

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