FUTUREGROWTH
/ ASSET MANAGEMENT

Futuregrowth's Development Equity Fund diversification strategy starts to yield results
Author: Sarah de Villiers, Portfolio Manager @ Futuregrowth
Published: February 2022

Futuregrowth's Development Equity Fund (DEF), an open-ended private equity fund with a focus on South African infrastructure, development and social upliftment, reported a 24.5% return for the year to December 2021.

Background on the DEF
DEF was established in September 2006 and has grown to over R3 billion in assets under management. The DEF is an open-ended private equity fund which clients access via a policy of insurance. The fund is suitable as part of the alternate asset class category for Reg 28 retirement funds and is considered a medium-risk investment with a long-term investment horizon.

This is a positive absolute performance and represents outperformance of 9.05% over the DEF's benchmark of the South African Consumer Price Index (CPI)+10% which was 15.47% for the period. While this performance is partially attributable to a recovery from the previous year's COVID devaluations, the data indicates strong performance emanating from the team's strategy over the past several years to add exposure into early-stage assets.

The DEF is a unique private equity proposition in that:

a. It is open-ended with an unlimited lifespan, and investors buy units in the DEF. Therefore, it is well matched to be part of the alternative asset class allocation for Regulation 28 (Reg 28) retirement funds.
b. As part of Futuregrowth's suite of developmental assets, alpha is sourced across the various Futuregrowth teams; and therefore, while unlisted equity deals comprise the bulk of the assets, there are also investments in listed equities and high-yielding debt instruments, as well as interest rate view overlays.
c. The DEF holds some level of cash exposure. This is due to its open-ended nature, where capital from asset realisations (as well as income received) is retained in the fund for redeployment into new deals, rather than being distributed back to unitholders.
d. As a developmental fund, the assets mostly comprise those investments that have a developmental and social upliftment impact. While infrastructure is a key focus of the DEF, the fund is well diversified for a private equity fund - with investments across 29 sectors and 56 different issuers, ranging from early-stage to late-stage businesses.
e. The DEF has a flat-fee model, reflecting the long-term, open-ended nature of the fund.

Strategy of diversification into early-stage assets
Over the past eight years, the DEF has been expanding its exposure into early-stage assets and market disruptors in appropriate position sizes (for this higher-risk asset class). This strategy has evolved due to the tightening of the returns available from pure infrastructure assets - with a limited number of investable assets locally and an increasing pool of equity capital chasing these assets returns.

The DEF has a 26% exposure to original early-stage assets across 10 investments (two initial early-stage investments having subsequently moved out of this classification as their business models have matured, reducing the exposure to 6% currently). Since 2013, when our first investments into early-stage assets were made, this category has delivered an estimated 32% internal rate of return (IRR) on a capital-drawn-and-repaid basis (including realised gains and losses, and mark-to-market revaluations to date)*.

When looking at the recent performance figures, it is clear that the strategy is starting to pay dividends. Of the 24.5% one-year performance to December, 70% of this was attributable to the unlisted equity assets, with almost 80% of that coming from the early-stage assets (including the two initial investments). Specifically, the strategy with the early-stage assets will be to realise liquidity events, as opposed to the DEF's traditional infrastructure assets which tend to have a project investment life-cycle. Early-stage investments are distinct in that some failures are expected, with those losses more than offset by the potential substantial successes. We have seen this outcome in the DEF, where an initial R15 million investment recently realised a liquidity event with an offer received at a price of 34 times the initial investment over an eight-year holding period. Over the intervening eight years on this investment, the Futuregrowth debt team has also provided debt funding to the investment, while the DEF team has provided strategic input via a Board seat representation.

Diversity remains the key hallmark of the DEF

With a long-term focus, a core element of the DEF's character lies in its layers of diversity. This is reflected in diversity across:

- a number of sectors – from pure toll road infrastructure to fintech market disruptors;
- types of investment – from project finance all the way to owner-manager/entrepreneurial/Venture Capital funding;
- the various stage-of-life investments (early-stage through to more mature, established market players); and
- various asset classes – with the DEF allowed up to 20% in debt instruments.

While the early-stage investments provide additional performance, these are considered the "sweeteners" for the DEF and are limited (in aggregate) to 10% of the fund exposure. These encompass typical venture capital series A to series C investment rounds but will not preclude seed funding in select instances. While the risk/return profile of newly issued infrastructure assets are under pressure, the historic infrastructure assets currently comprise 36% of the DEF exposure. We see some growth prospects in mid-market private equity investments that are somewhat decoupled from the growth prospects of the South African economy. Fintech and entrepreneurial companies who are creating their own growth paths fall into this category as well as the early-stage assets category.

Undoubtedly, we still have some COVID recovery to come through in the underlying assets in the portfolio. Just a little over 10% of the one-year performance was attributable to a claw back of the COVID devaluations in 2020.

Looking ahead, diversification continues

As we move into the start of 2022, with the apparent waning virulency of the COVID virus, the DEF is expecting to make new investments of close to R180 million in this first half of 2022. With a gross deal pipeline of R2.9 billion (probability weighted R500 million) in a mix of investments across stage of life and some exciting new sectors, we anticipate that the DEF will continue to deliver solid results, with performance generated across the various alpha sources attributable to not only the early-stage asset strategy, but also a COVID recovery and diverse sector performance.

For more information on the DEF and its impact, please see the Fund's latest Bi-annual Report.

*Note: This is not GIPS compliant data, but rather a calculation of returns, gross of fees, on the DEF's subset of assets which are deemed early-stage or venture-capital investments. The returns are based on cash-on-cash Internal Rates of Return.

Published on www.futuregrowth.co.za/insights.