Futuregrowth Infrastructure & Development Bond Fund

Development & Social Impact Bi-annual Report
31 March 2023

FUTUREGROWTH
/ ASSET MANAGEMENT

PHOTO: LHWP

OUR FLAGSHIP FUND CONTINUES TO PERFORM WELL

We remain concerned about the impact of a low-growth environment on the performance of our economy, and especially so in the context of the low level of investment in infrastructure and our ability to source sufficient risk-adjusted opportunities.

PHOTO: Khobab wind farm

Futuregrowth Infrastructure & Development Bond Fund

Welcome to the eighth semi-annual report on Futuregrowth's flagship Infrastructure & Development Bond Fund (IBF/Fund). With a fund size of nearly R17.5 billion, it is one of the largest dedicated funds of its nature - with the longest track record - in Sub-Saharan Africa.

The Fund continues to play an integral part in infrastructure funding. Since its launch more than two decades ago, it has funded various initiatives in the infrastructure and developmental space, gaining exposure to sectors such as power, transport-corridors, healthcare, education, SMME development and affordable housing. Diversity continues to play an important role in terms of the management of the Fund - echoing our credit ethos - with exposure to 147 issuers and 39 economic sectors.

The Fund continues to perform well, particularly from a comparative (relative to benchmark) point of view. Given the sub-par performance of the Index as a whole, absolute performance remains below the level of inflation in the short term. Sub-par local economic growth, marred by a dysfunctional state-owned energy provider, prevents large-scale gross fixed capital formation which is also impacted by rising input costs. We reiterate that a normalised level of long-term return for this Fund, based on its mandate and risk appetite, remains at around 1.75% to 2.15% over the benchmark.

In this report

Our concerns about the lack of infrastructure investment in South Africa are further addressed in this report, with a focus on the successes and failures of our Public Private Partnership (PPP) investment framework and the devastating results of underinvesting in Fixed Capital Goods.

We continue to scour the deal landscape to ensure that we can fulfil our mandate to provide sound risk-adjusted capital to invest in opportunities in the infrastructure and developmental space, thereby meeting our return obligations and at the same time creating economic wealth for the greater South Africa.

Senior Portfolio Manager

Sector insight

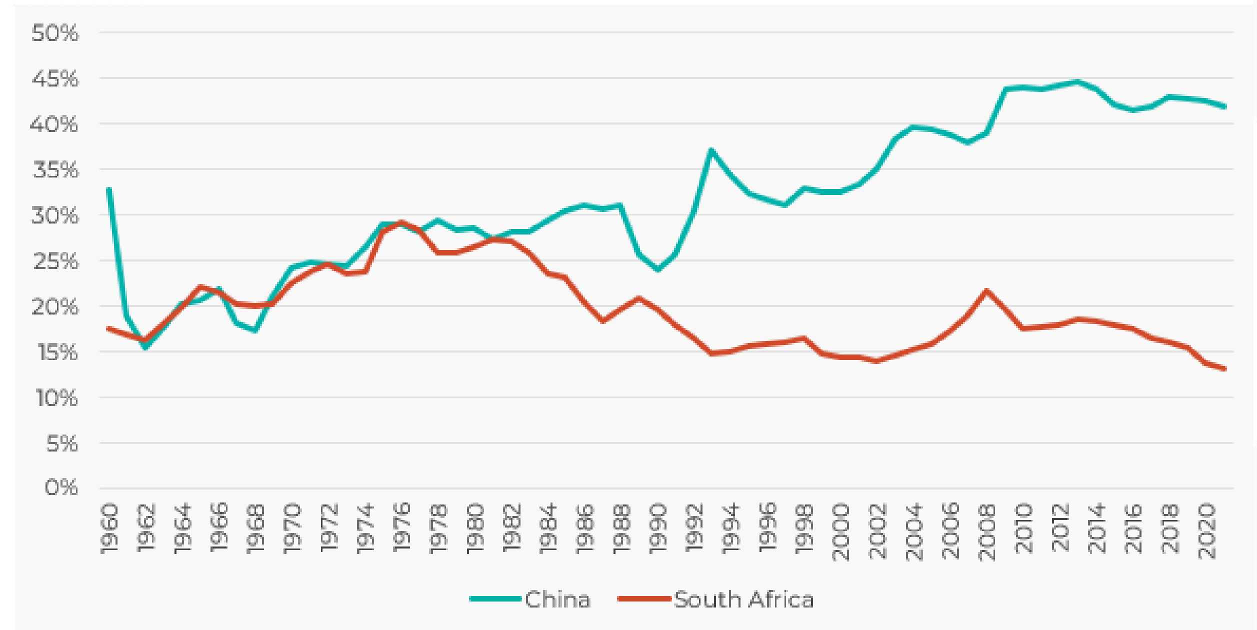
The disastrous consequence of failing to invest in fixed capital goods

Gross fixed capital formation (GFCF) is the net increase in fixed assets used in the production of goods and services. This includes investments in public infrastructure, roads, bridges, power plants, water and sewage systems, and other similar projects. It is an important aspect of a country's economy since it provides the backbone for increased productivity, raised living standards, and creating and maintaining jobs.

Since South Africa's return to democracy in 1994, the rate of investment in our GFCF has been declining, contributing to sluggish economic growth, and impeding our country's capacity to address poverty and inequality. South Africa's share of GFCF to Gross Domestic Product (GDP) in 2021 was a modest 13%, relative to the exceptional 42% contribution of GFCF to China's GDP over the same period. The reasons for the low annual growth rate in GFCF are multifaceted, including political and economic instability, low business confidence and a lack of foreign direct investment.

The growth in China's GFCF, on the other hand, has followed a markedly different pattern. In China, GFCF has grown incredibly fast over the past few decades, contributing to the country's economic growth and development, despite being on a similar path to us up to the early 80s. Since the early 1980s, this has resulted in an average GDP rate of 9.23% for China and 2.10% for South Africa, demonstrating the importance of infrastructure investment.

China is leading the race in terms of GFCF as a % of GDP



Source: World Bank national accounts data

Sector insight

What has gone wrong in SA and worked in China?

South Africa

One of the key reasons for the absence of GFCF growth in South Africa is a lack of private investment, despite recent rays of light, such as investment in the Renewable Energy Independent Power Producer Procurement Programme (REIPPPP). If it wasn't for renewable energy, it is likely that we would have endured much higher levels of loadshedding. Continued investment is essential for growing and modernising existing assets as well as establishing new ones. However, private investment in South Africa has been declining for several years, leading to the fact that actual GFCF has been barely adequate to even outpace the depreciation of existing assets.

Another element contributing to South Africa's lack of GFCF is the state of public infrastructure, which is critical for economic growth and development. In recent years, South Africa's public infrastructure has been neglected, with little investment in maintenance or new construction. This has led to a reduction in the quality and dependability of public infrastructure, making it more difficult for the economy and residents of the country to function, as well as inhibiting real investment by business. Eskom and Transnet are unfortunate examples of how the inability of state-owned entities to fulfill their constitutionally mandated responsibilities has harmed economic activity and growth.

China

One of the main reasons for China's strong GFCF growth is the government's commitment to investing in infrastructure. The Chinese government has made substantial investments in public infrastructure, such as roads, bridges, power plants, and water and sewage systems, which have improved the quality of the country's infrastructure and have attracted private investment. The government has also implemented policies to encourage private investment, such as tax incentives and subsidies, which have helped to stimulate GFCF growth.

In contrast to South Africa, China has benefited from a stable political and economic environment, which has encouraged investment. The government has implemented policies to reduce corruption and improve accountability, which has helped to create a more favourable investment climate. In addition, China's access to finance is deeper than South Africa's, with a more developed financial sector. However, it must be said that China's handling of the COVID-19 pandemic was problematic. The economic shutdown had substantial financial and social effects, creating widespread economic suffering, and emphasising the need for better government openness and responsibility in crisis circumstances.

Sector insight

Where are we now?

The marginalisation of public investment in infrastructure (and likewise for developmental assets) has been a result of South Africa's high levels of poverty and inequality, as well as a heavy debt load that includes expensive interest and debt-service expenses.

With the diversion of limited resources towards ever-expanding social issues, addressing poverty and inequality has hampered our government's ability to invest in public infrastructure. This is demonstrated by consolidated social security spending, which reached R356 billion in the fiscal year 2021–2022, or 17.7% of total spending. The R210 billion, or 10.5%, of total expenditures devoted to economic affairs pales in comparison and serves as a reminder of our economy's insufficient capital investment.

The lack of GFCF investment in South Africa in the past decade has had serious implications for the country's economic growth and development. The low level of private investment, poor maintenance of public infrastructure, high levels of corruption, and high levels of poverty and inequality have all contributed to this trend. While our administration has worked to address these difficulties via different reforms, their implementation has been hampered by a variety of hurdles and a general lack of ability to execute. The consequence will undoubtedly be devastating for all South Africans unless our government takes urgent action and implements its various bold plans to solve these challenges and we see some discernible outcomes.

Vandalism and theft between the Durban and Johannesburg railway corridor is continuing to impede growth

Image Source: Blomberg/Dean Hutton

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Breaking free from the shackles of low growth

The history of South Africa's Public Private Partnership (PPP) framework has been marked by a series of challenges, highlighting the need for the government to reflect and take heed of these shortcomings. Failure to do so may condemn the nation to a prolonged period of stagnant growth, thus necessitating urgent action to break free from this cycle.

Can South Africa's PPP Framework Be the Key to Unlocking Prosperity?

Fortunately, the Renewable Energy IPP Procurement Programme (REIPPPP) framework has managed to overcome the limitations of the previous framework, laying the ground for a better way of establishing and implementing projects that unlock the economy's full potential and contribute to inclusive growth.

What are PPPs, and why are they so crucial for economic growth?

A PPP refers to a collaborative arrangement or agreement between government bodies or the state and private entities to jointly execute a project or deliver a service that is traditionally within the domain of the public sector (e.g., a toll-road concession). This collaboration entails the public and private sectors sharing resources, risks, responsibilities, and rewards.

Governments have used PPPs all over the world. The first PPP goes back as far as the Roman Empire, which first employed the basic framework to create a network of postal stations[1] to serve the empire's expansion under its brigade more than 2 000 ago. Although much has changed since the Middle Ages, the basic concept of a partnership between the public and private sectors to fund, plan, build, and run projects remains a critical tool to promote investment and boost economic growth. Ultimately, however, the success of PPPs rests on government's ability to successfully manage the partnerships and protect the public interest.

Breaking free from the shackles of low growth continued

What are the factors that determine a successful PPP framework?

There are numerous well-defined international guidelines[2] that aid in determining the soundness of a given PPP framework. These include:

- Assessing whether the legal and regulatory structure put in place to oversee PPPs is clear, open, and predictable – and prevents conflicts of interest and corruption.
- Ensuring there's a level playing field for public and private sector partners.
- Building in guarantees for PPPs to meet environmental, social, and governance requirements.
- Evaluating the government's institutional capability to play a meaningful role in PPPs, including whether it has skilled legal, financial, and technical professionals with the necessary understanding to handle PPP projects.
- Ensuring the government has the financial means to cover their share of the project expenditures and any required guarantees or subsidies to attract private sector participation.
- Where necessary, drawing on Development Finance Institutions to provide credit enhancement for the senior lenders through a first loss debt tranche.

A government's political will and dedication to PPPs are also vital to its success in this sector. To achieve this, government needs to:

- Articulate a clear vision and plan for PPPs that aligns with its overall development objectives and priorities.
- Create an enabling environment that encourages the development of PPP projects by promoting private sector participation – and offer incentives to private sector partners.

Stakeholder participation[3] is an important determinant in assuring a government's capacity to participate meaningfully in PPPs. Government needs to guarantee that PPPs are transparent, responsible, and responsive to the demands of all stakeholders by effectively engaging with stakeholders, including civil society, the private sector, and impacted communities. Government also needs to provide the stakeholder engagement mechanisms to safeguard the public interest during the PPP process, such as consultation and feedback channels.

N3 toll concession between Johannesburg and Durban

Breaking free from the shackles of low growth continued

How does South Africa's PPP framework stack up?

Now that we have a basic framework for formulating, constructing, and operating successful PPPs, does South Africa's framework meet these requirements? Our PPP framework has been in place since the late 1990s and has been used to implement various infrastructure projects. However, several deficiencies in the current PPP framework have been identified.

These deficiencies include:

- A lack of regulatory clarity resulting in inconsistent development and implementation of PPP projects.
- A shortage of skilled experts in the PPP space leading to difficulty in successfully designing, constructing, and managing PPP projects.
- Stakeholder engagement is limited, which can lead to key stakeholders opposing PPP initiatives.
- Political and economic uncertainty has failed to create an enabling environment for these projects to thrive.

Why has the REIPPPP been more successful?

In contrast, the REIPPPP is a great example of how these partnerships should be established and operated, and it offers many learnings for other PPPs that have not been as successful.

The REIPPPP was launched in 2011. It revisited previous PPP processes to improve on the outdated and ineffective components of those partnerships and built in the technical, financial, and legal aspects specific to a developing renewable energy space.

The initiative has been highly successful in attracting private sector investment, creating jobs, and increasing renewable energy capacity in the country. The PPP framework used in the REIPPPP is based on international best practices and includes clear guidelines for project selection, bidding, contract negotiation, and risk allocation. Since its launch, the REIPPPP has attracted over R209 billion of private sector investment, which has resulted in the construction of 117 (as of 2021) renewable energy projects across South Africa.

The following features have contributed to the success of REIPPPPs:

- The bidding process has been straightforward and open to all.
- Policy frameworks have been clear and consistent, which has created a stable investment climate.
- Social and economic growth have been centralised.
- A high value has been placed on sustainability.
- They have built up a proven track record of success.

Breaking free from the shackles of low growth continued

Why have these successes not been incorporated into other PPPs?

One should then ask, why have these lessons not been applied across the general PPP framework? Is it perhaps related to the political and institutional challenges that exist in South Africa?

The country has a complex governance structure with multiple levels of government and numerous regulatory bodies. The lack of coordination and cooperation between these entities has made introducing and implementing reforms in the PPP framework difficult.

How are these deficiencies being addressed?

During the latter half of 2022[4], National Treasury underwent a detailed review process that identified several issues with the current infrastructure policy framework for public investments in PPPs meant to deliver on strategic infrastructure projects, including a lack of centralised screening, capacity constraints, and rigid processes that hindered progress. On a positive note, several aspects of the legal and regulatory framework were identified as sound compared to international benchmarks.

National Treasury's findings culminated in various proposed changes, namely:

- Amending legislation;
- Streamlining strategic and critical processes;
- Upskilling staff;
- Improving the PPP Unit's regulatory and advisory functions;
- Simplifying Treasury's approval process; and
- Giving responsible offers specific accountability to ensure project completion, which has been a hindrance in the past.

The proposed legislative changes involve amending the Public Financial Management Act and the Municipal Finance Management Act and making regulatory changes for PPP project management. Critical actions at a provincial and municipal level were identified as simplifying processes, adhering to deadlines, and upskilling employees in provincial and municipal offices.

On the face of it, these initiatives seem praiseworthy, especially because they fall under the umbrella of Project Vulindela, which was introduced in 2020 specifically to expedite PPPs in the country. Nonetheless, we should question whether these initiatives are truly gaining the required momentum to achieve their intended outcomes. Much like a freshly paved road built over an unstable foundation, the lack of implementation in our government's past may result in the eventual collapse of these initiatives if there is no real change to the foundation on which these PPPs are built.

Breaking free from the shackles of low growth continued

Conclusion

The situation in South Africa is grave and infrastructural investment critical if we are to escape the country's low-growth trap. To do so, the PPP framework needs to be robust and effective, incorporating the learnings from the REIPPPP.

However, there is a deep-rooted concern that the government's history of crafting well-thought-out plans, only to fall short in their execution, will once again stand in the way of making any progress. Despite its best intentions, in the past the government has failed to follow through on many initiatives, resulting in widespread public disillusionment.

This time around, it is imperative that the government follows through on its commitments to streamline the PPP process, improve transparency and accountability, incentivise investors, and build capacity within the public sector. Only then will government turn around its history of failed execution and ensure that the PPP framework is implemented effectively and efficiently, unlocking the full potential of the South African economy, and laying the ground for a brighter future for all.

1. Source: Overview of PPP experience, Toolkit for PPPs in Roads and Highways by the PPIAF, 2008
2. Source: Competitive Neutrality – Maintaining a level playing filed between public and private business by OECD, 2012
3. Source: Engaging Stakeholders for Successful PPPs – David Baxter - International Sustainable Resilience Center, 2021
4. Review of the Public-Private Partnership Regulations to deliver on strategic infrastructure projects; with Deputy Minister Public Works and Infrastructure – Parliamentary Monitoring Group, 2022

Comparison between PPP & REIPPPP frameworks

Key criteria	South Africa's PPP Framework	REIPPPP Framework
Regulatory clarity	Lacks clarity	Based on international best practices
Skilled experts	Shortage of experts	Success in respect of the IPP Office
Stakeholder engagement	Limited engagement	Strong engagement across all impacted parties
Political and economic uncertainty	Creates challenges	Clear and consistent policy frameworks
Project selection	Inconsistent	Clear guidelines for project selection
Bidding process	Inconsistent	Straightforward and open bidding process
Contract negotiation	Inconsistent	Clear guidelines for contract negotiation
Risk allocation	Inconsistent	Clear guidelines for risk allocation
Sustainability	Inconsistent	Places high value on sustainability
Success record	Inconsistent	Proven track record of success

Fund facts

Invested in a wide range of debt instruments

Portfolio manager	Jason Lightfoot
Benchmark	All Bond Index (ALBI)
Performance target	ALBI + 1.25%
Current weighted average credit quality (Internal rating)	A+
Average yield enhancement	2.53%
Listed yield enhancement	0.71%
Unlisted yield enhancement	4.71%
Current structure	Pooled
Fund start date	January 1995
Total Fund assets	R 17.43 billion
Termination period	1 calendar month (size dependent)

The Futuregrowth Infrastructure & Development Bond Fund (IBF/Fund) is a specialist yield enhanced bond portfolio and forms part of Futuregrowth's suite of developmental funds.

The Fund targets commercial risk-adjusted returns through a combination of moderate credit concentration limits, active interest rate risk management and active off-benchmark bets.

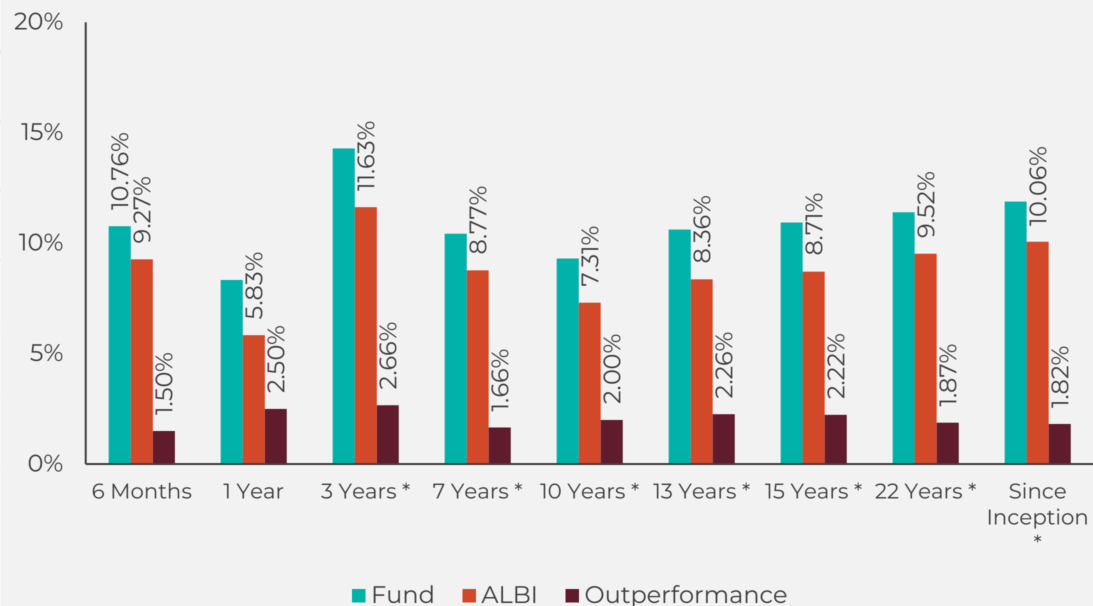
The Fund may invest in a wide range of debt instruments, including those issued by government, parastatals and corporates, as well as securitised assets. The inclusion of assets is subject to credit committee approval.

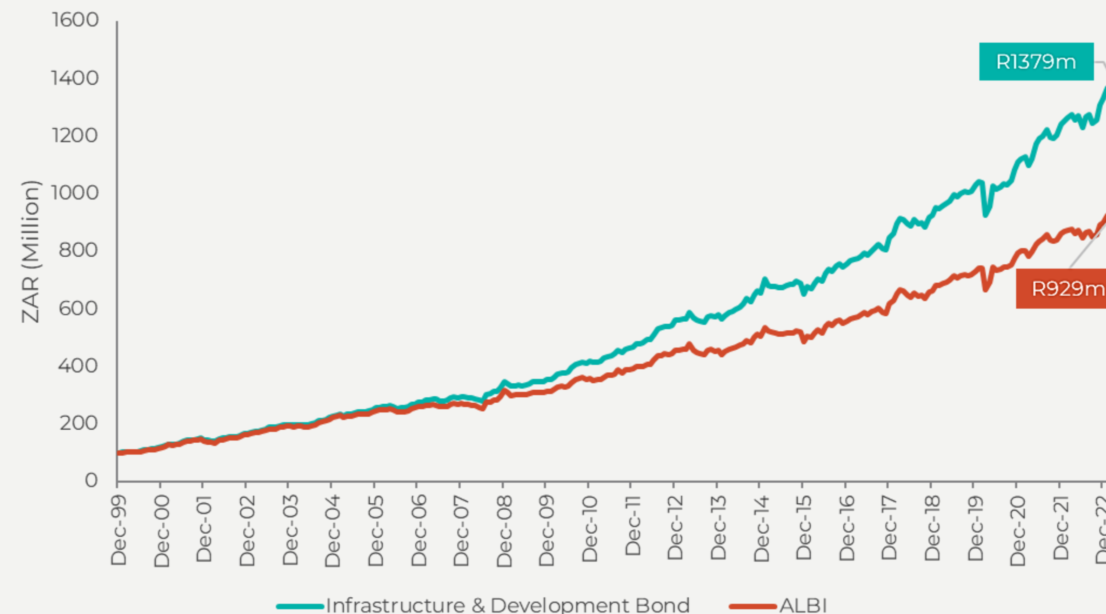
The Fund is allowed to invest up to 50% in unlisted credit and up to 5% in equity assets, primarily through the Development Equity Fund (DEF) subject to investment committee approval. The outcome is good risk-adjusted alpha generation over time. In order to retain adequate liquidity and flexibility, and in the course of managing new investments, asset maturities and sales and fund flows, the Fund usually maintains a high degree of liquid and/or non-developmental assets.

The Fund aims to provide investors with a vehicle that facilitates infrastructural, social, environmental and economic development in southern Africa and delivers on a variety of social impact outcomes such as job creation, affordable housing, access to services and healthcare.

Investment performance

Credit spread accrual continues to be the main contributor





Data as 31 March 2023 // Since inception date (GIPS Composite): 1 September 2006
Fund start date: 1 July 1999 // Source: Futuregrowth // *Annualised

The Fund outperformed its benchmark for the quarter. Credit spread accrual continues to be the main contributor to performance, through a combination of exposure to both unlisted and listed credit counters. On the interest rate side, and specifically from a yield curve positioning perspective, the Fund's overweight modified duration position and yield curve tilts boded well given the downward shift in nominal bond yields over the period, but more so from a base accrual perspective. The Fund's investment in the Futuregrowth Developmental Equity Fund also acted as a positive contributor given its stellar performance for the quarter.

Our developmental investment philosophy

Developmental product suite

Futuregrowth has a 25-year-plus track record of investing in developmental assets. Our funds provide finance to institutions that may not typically receive support from the traditional banking or lending process. In addition to providing finance (credit), we also invest in equity and retail property with a developmental nature.

Our developmental funds are part of our broader responsible investment strategy and reflect the intention of our clients to do good by investing consciously to make a positive impact on society and the broader environment, and thereby to safeguard our collective future.

Our suite of developmental funds consists of:

- **Fixed Income** (Infrastructure & Development Bond Fund, Power Debt Fund, Inflation-Linked Debt Fund);
- **Unlisted equity** (Development Equity Fund, Agri Funds);
- **Unlisted retail property** (Community Property Fund); and
- **Fund of funds** incorporating our suite of development funds as building blocks (Developmental Balanced Fund).

Futuregrowth is dedicated to the development and empowerment of South Africa and its people. We are constantly looking for opportunities that will yield optimal financial returns for investors while making a meaningful difference. As such, we have become a reliable channel for investor savings and promoting national development.

We define developmental investing as financing that a) provides investors with commercial returns and b) produces a social and developmental impact. In South Africa the primary focus is on the provision of basic services and improvement of infrastructure development.

In order to achieve sustainable, long-term, benchmark-beating performance, we apply a responsible investment filter when screening and analysing new deals for our developmental funds. This is supported by a robust credit process that considers both financial and non-financial risks.

Global contribution

We are also aligned with the UN's Sustainable Development Goals (SDGs), thus contributing to this global "blueprint to achieve a better and more sustainable future for all". The SDGs are covered in detail later in this report, where we link the activities of each deal featured to these global targets.

(See:www.un.org/sustainabledevelopment/sustainable-development-goals/)

How we measure and manage impact

Futuregrowth actively measures and manages for impact. Our impact measurement and management approach is aligned with both global and local development frameworks.

National Development Plan (NDP)
This is a long-term development framework for the elimination of poverty and reducing inequality in South Africa by 2030.

UN Sustainable Development Goals (SDGs)
These goals represent the globally agreed 2030 agenda and are a call to action to end poverty, protect the planet and ensure that all people enjoy peace and prosperity.

Principles for Responsible Investing (PRI)
Futuregrowth is a signatory to the Principles for Responsible Investment (PRI), which is an international network of signatories contributing to developing a more sustainable global financial system by incorporating six defined Principles for Responsible Investment into investment practice.

Futuregrowth Infrastructure & Development Bond Fund

Making a meaningful impact

Impulse Biomed: Providing affordable healthcare to under-serviced communities

Gauteng Partnership Fund: providing funding to entrepreneurial property developers of affordable rental accommodation and student housing

Mobiz: providing affordable access to leading-edge technology to micro-, small- and medium-sized enterprises

Inseco: Facilitating food security through the innovative production of protein meal from insects

Impact Innovation Bond Fund: equipping children in under-resourced communities with ECD resources

CIVH: Providing fibre to homes in lower LSM areas

Infrastructure & developmental sectors

A diverse range of investments

42.42%

Exposure across infrastructure sectors

21.63%

Energy including renewable energy

8.62%

Transport

4.09%

Development finance

3.95%

Communications

1.79%

Water & sanitation

and 2.34% in Health, Tourism and Education.

11.79%

Exposure across other developmental sectors

6.92%

Low income & affordable housing

2.71%

SMME finance

1.10%

Agricultural development & land ownership

0.62%

Consumer & business access to finance

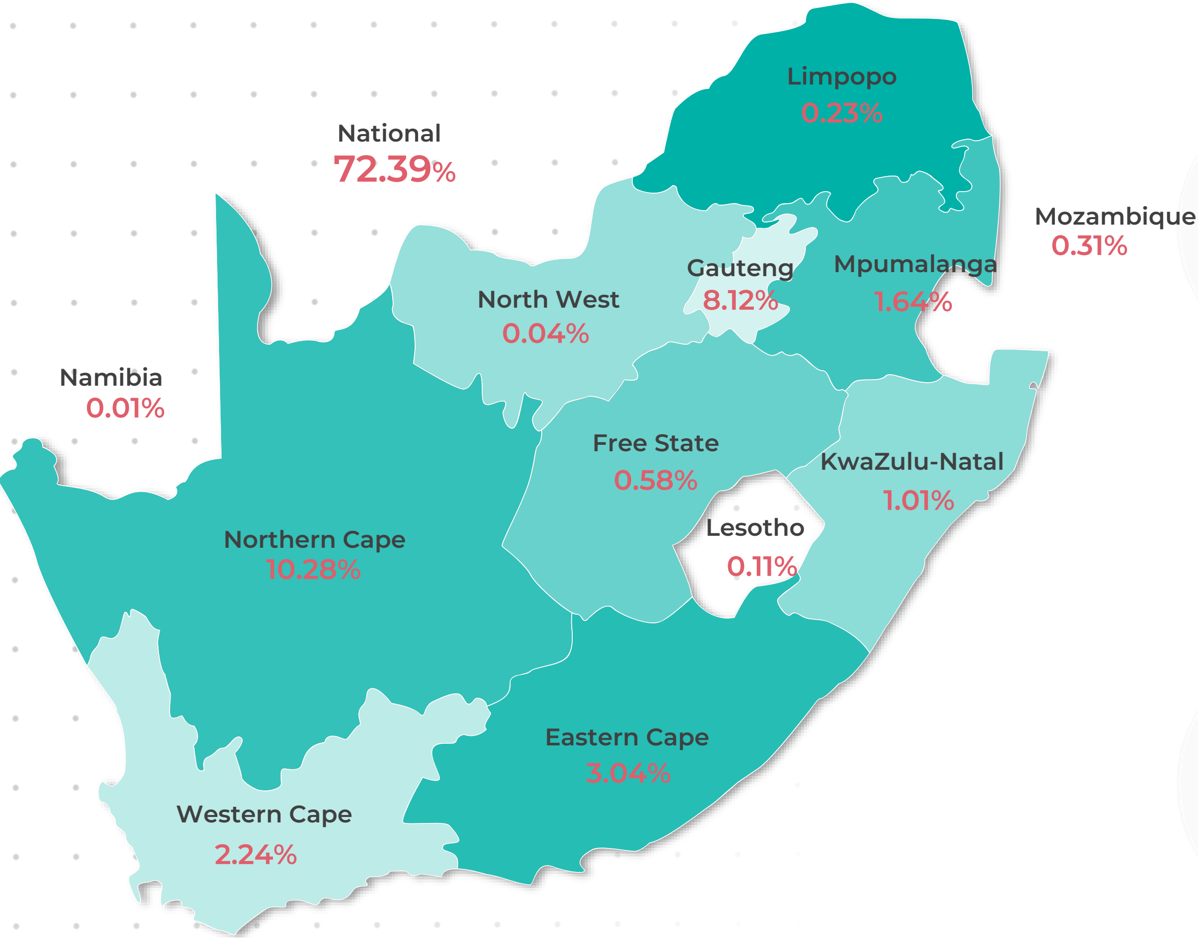
0.37%

Other infrastructure

and 0.06% in BEE finance.

Source: Futuregrowth

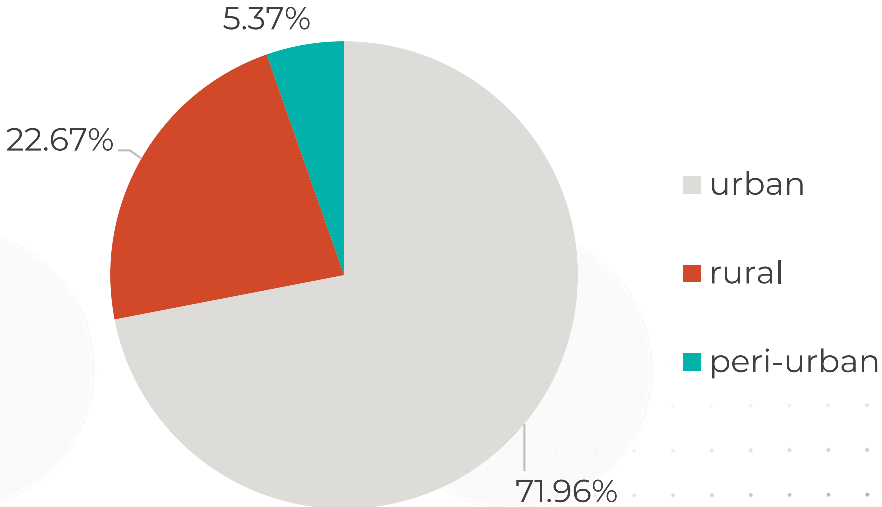
Geographical diversity & rural footprint



Source: Futuregrowth

The Fund has geographical diversity across South Africa, with investments held in 9 provinces. The Fund has over 72% exposure to assets with a national footprint.

Nearly 30% of the Fund's investments impact **rural** and outlying **peri-urban** areas.



Futuregrowth Infrastructure & Development Bond Fund

Key features

R17.43bn
Fund size

25 years+
of consistent long- term performance

Commercial **risk-adjusted** returns

Active in all **9 provinces**

Tangible social & developmental **impact**

Exposure to **147** issuers and **39** economic sectors

Investing in **infrastructure development**

Supports **10 Sustainable Development Goals**

Nearly **60%** of the Fund in medium-to-high developmental impact sectors

Futuregrowth Infrastructure & Development Bond Fund as at 31 March 2023

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