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Opportunity or threat?
Infrastructure investments and Regulation 28

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Michael Kruger, CFA®
Investment Analyst
Morningstar Investment Management
South Africa

Simbarashe Mangwiro
Investment Analyst
Morningstar Investment Management
South Africa

For Financial Advisors and their Clients

On 26 February 2021, National Treasury released a proposal to amend Regulation 28 of the Pension Funds Act to make it easier for pension funds to invest in infrastructure projects. This has raised concerns from certain market participants that government could force pension fund members to invest in infrastructure projects. In this article, we answer some of the key questions that investors may have regarding the proposed amendment.

What are the proposed changes to Regulation 28? Where does infrastructure currently sit, and where will it move to if the changes are approved?

The intention of Regulation 28 is to reduce excessive and concentration risk to member savings and ensures protection by limiting the extent to which retirement funds may invest in a particular asset or asset class. Infrastructure is currently not defined as a specific asset class and is currently split across several asset classes including equity, bonds, loans, and private equity. Current data on retirement funds, therefore, does not record the exact investment in infrastructure. The proposed amendment will introduce a more precise definition for infrastructure to enable better data and measurement.

The proposed amendment limits the amount invested in infrastructure across all asset categories to 45% in respect of domestic exposure and 10% in respect of the rest of Africa. The aggregate exposure per issuer or entity may not exceed 25% of the total assets of the fund.

What are the reasons for the proposed changes to Regulation 28?

The proposed amendment to Regulation 28 is largely due to calls for increased investment in infrastructure, given the low economic growth environment in South Africa. The goal is to increase the amount which pension funds invest in infrastructure assets. The proposed change in legislation should also increase the visibility of the extent to which retirement funds are currently invested in infrastructure.

It will, however, be up to the public and private sector to provide enough lucrative investment opportunities for trustees of pension funds and asset managers to allocate more to this area of the market going forward.

Is this 'prescribed assets' in disguise?

South Africans will be aware of the concept of prescribed assets, which was introduced in the country for the first time in 1956. The level of prescription varied over the 33-year period until 1989, however, at its peak, funds had to invest more than half of their assets in South African government and parastatal bonds.

It is important to emphasise that the intention of the new legislation is not to force people to invest in any particular investment. The proposed amendment does not set a prescribed minimum amount that needs to be allocated to infrastructure, but rather has the intention of making it easier to invest in infrastructure based on the underlying merits of the specific investment.

Will the role of a pension fund's board of trustees or that of asset managers change if the amendments are approved, or will they still have discretion in terms of what investments are made?

The discretion of trustees and asset managers to make investments will be retained. Trustees and asset managers will, therefore, not be forced to invest in a particular infrastructure investment unless they believe that it will be beneficial for the future return prospects of the pension fund. This should allay any concerns about irresponsible investment decisions being made, given that discretion is retained as well as the responsibility to act in the best interests of the members of the fund.

What is infrastructure investing?

Infrastructure assets can be broadly defined as companies that are involved in the construction, maintenance or operating activities of structures, networks and facilities that are widely used by the public. In general, these are unique assets that cannot be replicated due to their nature or government control. A good example would be a bridge or a road, whose construction will naturally be dictated by the existence of space to construct it. Further to this, they might be erected on public land which is controlled by a government.

In general, infrastructure assets are long term, require large capital outlays, and have low running costs once established. The capital intensity and operational efficiency required to establish and run these assets create an opportunity for governments to partner with the private sector. Such partnerships generally result in a transfer of the financing requirements and execution or operational risks to the privately-run entities. A good example would be the Gautrain, which should be familiar to most readers.

Private companies, in turn, will look to finance the large capital outlays by raising capital via debt and equity markets. This can be done through listed or unlisted markets or a combination of both. In the case of equity investments, investors effectively acquire ownership rights to the assets in question whilst debt holders attain contractual claims to cashflows. Equity investors are, therefore, compensated via dividends and capital gains.

Debt holders, on the other hand (depending on the type of debt), assume limited liability in exchange for a pre-determined amount of cashflows and may not fully participate in any capital appreciation from the underlying assets in question.

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In short, if an investor chose to invest in an infrastructure asset, they have the choice of either buying the equity (with long term ownership rights and potential capital growth) or the debt (which yields a fixed coupon and has a finite term).

What are the potential benefits of infrastructure investments?

If managed properly, infrastructure assets can provide significant benefits for governments, investors and the economy. From an investor perspective, institutional investors (like pension funds) benefit from the long-term nature of infrastructure assets as they typically look for assets that can match their long-term liabilities. Governments can also look to offer incentives on these assets such as tax breaks to attract private investors. The economy and society can benefit through job creation and improved infrastructure development. **We discuss below, a few key additional benefits for investors:**

- **Access to a steady and reliable income stream**

  Because infrastructure assets cannot be easily replicated and are generally owned or regulated by governments, they will generally have high barriers to entry. They also tend to be essential and subject to everyday use by society, which (when viewed together with the barriers to entry) create a moat for the businesses that control these assets. The existence of this moat naturally leads to government intervention via price regulation to cap the extent of economic profits to the upside.

  Despite the above-mentioned regulation, the absence of competition creates a floor to the extent of profit erosion for these businesses. This is an extremely valuable characteristic as it underpins revenues and results in a steady and reliable income stream for investors over the life of the assets.

- **Capital appreciation**

  Another source of returns for investors in these types of investments is capital appreciation, which is usually closely linked to their underlying cashflows. Due to the steady and reliable nature of these cashflows, capital values should closely follow the changes in the net present value of the future cashflows. It follows then, that capital appreciation will generally be subject to growth in underlying cashflows and/or a reduction in the cost of capital.

  Cashflows will likely grow due to the increased usage of the assets by the public, without a corresponding increase in capital expenditures. The cost of capital on the other hand will generally follow the interest rate cycle but could also decline if there is an improvement in the risk profile of the underlying business.

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- **Diversification**

  Another attractive characteristic of infrastructure assets is the diversification benefit that they can bring to investor portfolios from a total portfolio point of view. Ideally, one would look to maximize returns and lower risk by adding high returning and uncorrelated assets to their portfolio.

  Infrastructure assets (particularly in the unlisted space) tend to exhibit lower levels of correlation to mainstream assets such as listed equities and listed bonds. This is largely because they are less exposed to market gyrations as a result of changing investor sentiment. Instead, their capital values are generally anchored to their underlying cashflows which are generally stable.

  These characteristics are ever more important to South African investors, who face a very limited opportunity set in a very concentrated market.

Can retail investors access infrastructure in their retirement annuities?

It is still early days and there is limited information on issues such as the ways in which retail investors can participate in infrastructure investing. Currently, it looks like the changes in regulation largely apply to large pension funds whose asset/liability mismatches allow them to participate in such long-term capital-intensive investments.

For the retail investor, current and future participation could either be through direct or indirect investments. Direct investment could be via pooled investment vehicles, such as infrastructure-focused funds whilst indirect investment could be through multi-asset funds that could access direct infrastructure assets as part of their allocations to alternative assets. It remains unclear, however, the extent to which tax benefits will accrue to the retail investor.

As an investor, should I be concerned or happy?

We would encourage investors to see this as an opportunity. With this allowance, investors will be able to invest in a well-established asset class that previously had minimal exposure and/or was completely excluded from pension fund assets.

This increased opportunity set provides the benefits of diversification, a steady income stream and possible capital appreciation. If applied correctly, it could also provide a much-needed economic boost for South Africa through job creation and the construction of vital infrastructure for the country. We, therefore, view this proposal by National Treasury as one that could not only benefit investors and our economy but our country too. M

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+ t: (0)21 201 4645 + e: MIMSouthAfrica@morningstar.com + 5th Floor, 20 Vineyard Road, Claremont, 7708.

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