Revision to Reg 28 gives private equity a chance to prove its worth

Rory Ord

In December 2010, the National Treasury issued a second take on the revised Regulation 28 of the Pensions Fund Act. Reg 28 sets prudential limits on the allocations that South African pension funds make to different asset classes and has historically restricted investment into unlisted equity to part of a 5% allocation with other alternative assets.

The new draft represents a significant step forward for investment in unlisted companies with a maximum of 10% now allowed to be invested in unlisted equity. This 10% maximum is part of a larger 15% total allocated to a combination of hedge funds and private equity, and an overarching 30% encompassing all unlisted or unrated debt and equity.

The change in the Regulation has two significant implications. Firstly, the fact that private equity has been specifically defined, and has been allowed a significant allocation, means that pension fund trustees must now specifically consider their approach to investment in this area. The previous categorisation, as part of a small "alternatives" and "other" classification, allowed trustees to consider this area insignificant. The increased emphasis and guidance in the Regulation will also give trustees increased confidence that investing in unlisted companies is not only good from a portfolio management point of view, but is specifically sanctioned by the Regulator.

Secondly, the size of the allowed allocation expands the potential pool of pension fund investors into private equity. South Africa has few large pension funds, yet a significant number of smaller pension funds. By virtue of their size, the larger pension funds could make reasonably sized investments into private equity while still complying with the old Reg 28. However, the many smaller pension funds could not achieve sufficient diversification within their alternative asset allocation to make investment worthwhile. The increase to 10% specifically for unlisted equity will allow many of these smaller funds to make appropriate investments into private equity without becoming too concentrated in single investments or with a single manager.

It will no doubt take time for pension fund trustees to come to grips with the revised Reg 28 and revise their asset allocations, however, the door has been opened for private equity managers to begin the conversation with trustees.

Once the Regulation is promulgated (due to happen in March this year), it will be up to South Africa's blossoming private equity industry to state its case to the many new potential investors that the Regulation will create. RisCura is currently finalising research into the historic performance of the country's private equity funds for release in the first quarter of 2011. The results of this research will no doubt form part of the conversation between pension fund trustees seeking to understand how private equity has performed in the past and managers seeking to show their own performance relative to a benchmark.

In the guidance notes to the new Reg 28, the Regulator placed significant emphasis on the potential that private equity has to create a positive impact through its investment activities. Investing in an unlisted company, which has an established, successful business but needs capital to expand operations, can have a significant impact from an economic development point of view. Allocating capital to these companies is more likely to create jobs and boost economic growth than investing in the already well funded listed market. While economic impact is not, and should not be, a pension fund's first responsibility or concern, this aspect of investment into unlisted companies should be acknowledged as a bonus to a private equity allocation.

All of this represents an opportunity to the country's private equity managers, who have found fundraising tough over the last couple of years. The impact of the financial crisis, negative publicity around private equity in developed markets and the uncertainty around regulations created a difficult fundraising environment. With the South African economy pulling itself out of recession, the recovery of the JSE, and the near finalisation of Reg 28, private equity managers will be feeling more confident about approaching potential investors. Now that the pension fund investor pool is about to be increased, it is up to these managers to prove their worth.

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An often-heard criticism from budding small business owners and entrepreneurs is that there is no start-up capital in South Africa – and that infers that there is a lack of venture capital in the country.