INFRASTRUCTURE FUNDING

The financing of infrastructure development is becoming a major challenge in a post-financial crisis world

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Stricter regulations and liquidity constraints on banks, the main source of debt funding to projects, mean that infrastructure projects can no longer be funded by traditional debt alone.

Historically, investors have accessed infrastructure projects largely through equity investments as part of their alternative investment portfolios. This investment strategy has been driven in part by the lack of opportunities in the capital structure of project finance transactions.

In many jurisdictions - and not only in emerging markets - eyes are now turning to the insurance and pension fund sectors as a way of mobilising funds for long-term investment into infrastructure.

Governments can and do play their part through infrastructure bonds; but the vehicles are not necessarily ideal. According to the UK's *Telegraph*, the UK government is missing out on billions of pounds of funding from British pension funds for infrastructure projects because its proposed investment vehicle for pension funds is badly constructed and too small.

It is clear that governments and the banks cannot go it alone. I believe there is a place for fund managers in the wider infrastructure investment story, and not just in regard to private equity. There is scope for fund managers who manage specialist debt funds to come to the fore with debt funding to established, mature businesses that make a direct impact on communities and the economy or infrastructure projects. Sovereign wealth funds are beginning to invest directly into infrastructure projects, so why not those fund managers that have the specialised skills to do the same?

On the spectrum of expected returns, debt funds lie higher up the curve than other income assets, but below growth assets - somewhere between mortgage and corporate bonds in terms of risk and capital liability. They thus provide a useful diversification opportunity.

Impact investing

Impact investing is an emerging investment trend which at Mergence we believe is ideally suited to Africa's infrastructure needs. In a vulnerable world buckling under "structural issues" in areas ranging from housing, education, income disparity and unemployment to energy shortages, a new paradigm is emerging. Most people have the unmet need to make a difference in society, yet through impact funds individual pension fund members can make a contribution to their country's development.

In essence, impact investing aims to deliver a measurable environmental, social and governance (ESG) impact whilst simultaneously targeting an acceptable market related financial return. It provides participation by way of various asset classes, including private equity, structured notes, bonds, loans, and loan guarantees.

The term 'impact investing' is rapidly gaining currency. The G8 UK Social Impact Investing Forum on 6 June 2013 launched the concept of Development Impact Bonds. These bonds are a new financing instrument that could bring together investors, governments, the private sector and civil society to provide public services in developing countries.

In South Africa, impact investing provides an answer to the new Code of Responsible Investing (CRISA) and changes to Regulation 28 of the Pension Funds Act which have increased awareness of incorporating ESG factors into fund managers' investment processes.

Impact investing is still in its infancy but, driven by initiatives in the United States, it is rapidly becom-

ing formalised through an international rating system and reporting standard. The highly regarded MIT Press Journals' Innovations series on entrepreneurial solutions to global challenges dedicated its entire Spring 2011 issue to impact investing.

Mergence's experience

In June 2010, Mergence Investment Managers launched a suite of impact funds which includes the Mergence High Impact Debt Fund. The fund has key investments in South Africa, among others, in the Trust for Urban Housing Finance (TUHF), Lendcor, SA Taxi Finance Solutions and Eduloan.

Mergence's impact funds have been designed to be aligned with South Africa's infrastructural and growth needs, seeking to address structural issues in areas ranging from housing, education, income disparity and unemployment to energy shortages.

The Mergence High Impact Debt Fund was successfully rated in May this year by the Global Impact Investing Rating System (GIIRS). The GIIRS is a worldwide ratings system for impact investing, analogous to Morningstar investment ratings or S&P credit risk ratings. The GIIRS methodology rates both the investment fund and the underlying investments on their ESG impact. Impact investing is rapidly becoming formalised through the GIIRS system. Investors can now get analytics on the underlying investments and measure the positive contribution that projects are making to addressing social needs.

In conclusion, institutional investors may wish to consider the advantages of debt funds as a long-term investment alternative. The main difference is that by linking funds to prime mortgage rates and adequately negotiated covenants, for example, more security and stable returns can be achieved over the long term than the higher volatility that can be seen in private equity — while allowing overall ownership to stay in the hands of founders. It is a concept expected to take off across Africa as business owners look for more efficient ways to raise capital, while retaining ultimate control of their businesses. ■

DEBT VS EQUITY FUNDING

Source: Mergence Investment Managers

Characteristic	Private equity	Debt funds
Returns	• Start-up and middle-market private companies have more risk and lower returns than investments in established companies via buyout funds.	• Depends on skill-based strategies. Can earn higher returns due to required legal skills and the fact that some investors cannot invest in them. • Returns are based on the interest rate agreed, resulting in income to Investors
Risk	• High volatility	• More stable/ mature entities • Security to Investors • Higher in the waterfall of payments of the company
Stage/Types	• Different stages of the business life cycle, depending on the type of private equity fund. • Start-up or formative-stage companies are those that have not yet or have just begun selling a product. • Middle-market private companies are established, have significant revenues, and may even be preparing for an Initial Public Offering (IPO). • Private investment in public entities (PIPEs) refers to private equity investors purchasing or privatizing a public company, purchasing an established private company, or purchasing a division of an established company.	• More mature business. Can be in different sector types.
Exit	• Different strategies to sell shares (eg. seven years, 10 years)	• Self-liquidating (returns and capital repaid by revenue generated by company)
Diversification	• Private equity returns typically move with stock market returns. • Low diversification	• Debt fund returns do not move with stock market returns. • Good for diversifcation
Liquidity	• Less liquid	• More liquid
Due diligence costs	• High	• High/medium
Valuation risk	• High (earnings multiple of the earnings)	• Medium (based on recoverability of the loan)
Investment Universe	• Limited to sellers of private equity	• Investment
Benchmark return	• CPI + 10 (before fees)	• CPI + 3 or CPI + 4 (before fees)
Fees	• 2% of AUM • 20% outperformance	• Varies (but less than private equity)

MERGENCE HIGH IMPACT DEBT FUND IMPACT ANALYSIS

Source: Mergence Investment Managers