Mergence upbeat on pension access to infrastructure, despite limitations

Kasief Isaacs, Mergence's head of private markets, says infrastructure investing acts as a catalyst for stimulating long-term economic development and growth

South African pension funds can now allocate up to 45% to infrastructure investments yet they face limitations particularly in the listed space, which lacks diversification, says Kasief Isaacs of Mergence Investment Managers.

Recent changes to Regulation 28 of the Pension Funds Act allow pension funds to allocate up to 45% to infrastructure investments. This can comprise up to 15% in unlisted infrastructure private equity funds, 15% to unlisted infrastructure debt through direct exposure or private infrastructure debt funds, and 15% exposure to listed infrastructure assets.

"The investment universe is not keeping pace with the opportunity set, particularly in the listed space," says Isaacs, who is Mergence's head of private markets. He adds that infrastructure investments can bring many portfolio benefits, including diversification, reduced volatility (particularly from infrastructure debt allocations) and more resilience in changing market conditions.

"Importantly, infrastructure investing can act as a catalyst for stimulating long-term economic development and growth and is a vital element of a country's economic growth strategy," he says.

Isaacs notes that in larger, more mature markets, like the US, Canada and Australia, pension fund allocations to infrastructure average from 8-12%. By comparison, South Africa's domestic pension fund allocations are still hovering at less than 1% of total assets.

While some of the reluctance to increase allocations is linked to factors such as limited insight into the asset class on the part of trustees and liquidity constraints often associated with this asset class, he believes the relatively small investible universe in South Africa plays a significant part. "We are able to continue deploying capital in areas such as digital infrastructure where companies are less reliant on government to unlock opportunities. However, infrastructure sectors such as rail, ports, water and transmission grids require government intervention including regulatory changes to unlock these segments and facilitate private-sector investment into these areas," Isaacs says.

Kasief Isaacs

On the listed equity side, Isaacs notes that the only dedicated infrastructure investment vehicle listed on the Johannesburg Stock Exchange has a market capitalisation below R250 million. A few more counters have listed on the Cape Town Stock Exchange but market caps are similarly below R250 million.

"The limited number of listed entities includes Mahube and Telkom," says Isaacs. "Majority state-owned Telkom, for example, controls vast tracts of communication infrastructure across South Africa, but it comes with broader operational risks that make it difficult to classify as pure infrastructure."

The domestic bond market is also constrained from an infrastructure point of view. As of July 2022, the total SA bond market was estimated at R5.6 trillion, yet of the three designated impact bond categories defined by the JSE (ie: green bonds, sustainability bonds and social bonds, some of which may comprise infrastructure-type bonds), total bond issuance in these categories amounts to just R46 billion since 2014.

Of particular concern is that total issuance so far in 2023 amounts to R6.3 billion, down 67% from 2022. "Green or developmental bond issuance seems sporadic at best with no clear trends emerging," said Isaacs.

Direct investments into infrastructure assets are an option but require an inhouse team, excluding all but the biggest pension funds such as the Eskom Pension & Provident Fund and the Government Employees Pension Fund, through the PIC.

For Isaacs, private market allocations offer investors access to a more diversified and broader universe of infrastructure debt and equity investments. This includes economic infrastructure in exciting new areas such as clean energy, digital infrastructure, water infrastructure, and social infrastructure (such as healthcare, affordable housing, and student accommodation).

"Private markets offer the widest variety of managers with both debt and equity products," he says. "Coupled with attractive financial returns, these investments also offer pension funds the benefit of making a meaningful impact and important socio-economic contributions with their members' savings."

As infrastructure sectors evolve, so do the risks, notably in areas such as digital infrastructure and climate change, which includes water assets and energy generation (coal versus renewable resources, and electric charging networks versus traditional motorways).

"While private markets offer the most accessible route to infrastructure investments, investors do need to proceed with caution and ensure that they appoint credible and experienced asset managers with a demonstrable track record and a deep understanding of the risks in the sector."

Mergence Investment Managers manages infrastructure assets of R4 billion out of total AUM of R37 billion, with a diverse product range across both public and private markets, spanning specialist equity and fixed income, multi-asset, infrastructure, debt and private equity funds.

Since 2010, it has launched five funds, featuring both debt and equity investments in sectors like renewable energy, affordable housing, water, financial inclusion (via SSME support), transport, and health.

"When we think about assets that will be resilient to large macro changes, we look for long-term mega-trends. Urbanisation is one of those and we expect a further 10% of the population to migrate to urban areas by 2035," he says. "With that in mind, we invest in assets that support urbanisation such as affordable housing, digital infrastructure and water."

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Its portfolio holdings include several renewable energy projects, digital infrastructure (rolling out fibre networks) and affordable inner-city rental housing in Johannesburg and Pretoria. It is the sole institutional shareholder in two of South Africa's largest water concessions, in Ballito and the Mombela local municipality, which supply water to more than 500,000 customers, including around 300,000 indigent customers.

"We spend a lot of time and effort getting deals right upfront, focusing on origination, structuring, impact and due diligence, with a seven- to nine-year holding period," says Isaacs. "Sourcing and implementing the deal is only part of what we do. Post-investment, we focus more effort on value creation through, for example, working with portfolio companies to unlock synergies and help them expand their markets."

Its infrastructure equity funds offer a CPI + 7% hurdle, with a minimum investment of R100 million, and the debt portfolios target CPI + 4%, with a R50 million minimum.

"It is very rewarding to help deliver change in communities where many pension fund members will retire into. It is about creating sustainable shared value through balancing financial returns with tangible impact," Isaacs says.

Mergence has 12 people on the infrastructure team (of whom 75% are black women), with a presence in South Africa, Namibia and Lesotho. It targets significant further growth in private market assets in the next few years, and will further grow to support the increase in AUM.