Proposed Reg 28 amendments make Private Equity no longer an "Alternative"

Alternative Investments/Private Equity

Kevin French

Business Development Executive

Jacci Myburgh

Private Equity Portfolio Manager

Quinton Dicks

Private Equity Portfolio Manager

"The Fund has delivered an exceptional 29.6% return p.a. ...more than any unit trust over the same period..."

"As interest in alternative investments has grown, and as such investments have become more mainstream, the phrase 'alternative investments' itself is beginning to sound like a contradiction in terms. What were once considered fringe investments are now deemed essential components of many institutional investors' portfolios."[1]

As Old Mutual Private Equity, we have been on a journey for the last five years to increase appreciation for private equity as an investment class among institutional and retail investors alike, by raising its profile and providing attractive products through which they can gain this exposure.

As private equity managers, we have come to know and have experienced the attractive returns offered by the asset class – our existing clients have benefited handsomely from these over the years. However, the challenge in South Africa has been that private equity has not been well understood, regulations governing it have been unclear, and investor access has been limited by both the high minimum investment required (usually R50m) and long periods of lock-in.

Innovative and lucrative funds for smaller investors since 2006

In order to provide retail and smaller institutional investors with direct access to private equity, we launched our first private equity fund of funds in 2006, the Old Mutual Multi-manager Private Equity Fund 1 (OMMMPEF1). In order to ensure ease of access to a broad array of investors, the unique design of this fund included a low minimum investment of R100 000 and a liquidity option should investors need to exit before the fund matured. The OMMMPEF1, which reaches its fifth anniversary in April 2011, has delivered an exceptional annualised return of 29.6% after tax and fees, substantially more than any unit trust in South Africa over the same period. Through the launch of this fund and our following two funds, the Old Mutual Multi-Manager Private Equity Fund 2 (October 2007) and the Old Mutual Private Equity Secondary Fund (October 2009), we have seen growing investor interest, with our total assets under management reaching R12.2bn as of the end of 2010 (of which R1.2bn is invested in these three retail funds). Most of the interest has come from astute wealthy individuals and a few progressive institutional investors who looked to gain first-mover advantage.

One of the biggest challenges for institutional investors in the private equity space has been the lack of clarity in the regulations that govern how pension funds are managed. Regulation 28 of the Pension Funds Act is decades old, and makes no mention of what allocation pension funds can make to private equity. Most investors who have included private equity in their portfolios included it

[1](Russell Investments 2007-2008)

under the Act's guidelines for either "Other Assets", which allowed a 2.5% allocation, or "Unlisted Equity", which allowed a 5% allocation. However, many trustees and consultants were not prepared to allocate any funds to private equity because legislation was not clear on its categorisation.

Internationally, pension fund allocations to alternative assets (unlisted equities, private equity, hedge funds, etc) range from around 5% to 30%, with some regions applying no restrictions at all to private equity (see table below).

Country	Private Equity limit for Pension Funds
Australia	No limit
Austria	70%
Belgium	No limit
Brazil	20%
Canada	No limit
Colombia	5%
Denmark	10%
Finland (statutory plans)	15%
Germany	5%
Ireland	No limit
Italy	20%
Mexico	10%
New Zealand	No limit
South Korea	10%
UK	No limit
US	No limit

Furthermore, research indicates that pension fund allocations have steadily increased over time (see table below).

Interestingly, as international markets started to show early signs of recovery in 2009, a number of pension funds announced their intention to introduce alternative asset allocations or significantly increase previous allocations. For example:

- *South Korea's sovereign wealth fund (Korea Investment Corporation), with $30 billion in assets, announced in July 2009 it was looking to increase its exposure to private equity, ramping up its allocation to 20%.*[3]
- *The UK's Pension Protection Fund (PPF) — 20% of its £3.9billion in assets for alternative investments.*[4]
- *Yale Endowment Fund — Yale boosted its fund's private equity target to 26% from 21% at its June 2009 investment committee meeting.*[5]

In December last year, following a period of consultation with industry stakeholders, National Treasury released draft amendments to Regulation 28 which go a long way towards clarifying pension fund allocations to private equity, by specifically allowing up to a 10% allocation to private equity.

While, when compared to international standards the South African allocation may still be a little low, we believe it is a good first step for South Africa and should remove the uncertainty that exists surrounding the current regulations. We expect this to clear the way for more investors to allocate investments to private equity given its strong return and diversification benefits. In so doing, this should make private equity a more "mainstream", rather than "alternative" asset class.

The current private equity industry in South Africa manages in excess of R100 billion; however, a large proportion of that exposure is owned by individuals and foreign investors. We estimate that the average pension fund exposure to private equity in South Africa is less than 1%. This is a very low percentage by international standards, as highlighted by the tables.

Given the scarce nature of private equity, in the coming years pension funds will need to build up their exposure by allocating a portion of their portfolios to proven private equity managers and funds with solid track records, excellent diversification, ease of exit and accessible minimum investments.

Given the depth of experience of the Old Mutual Private Equity team, its successful track record and innovative products, we believe we are well placed to assist clients who wish to diversify their portfolios into this attractive asset class. The Old Mutual Private Equity Secondary Fund is currently open to investors, with R300m of capacity available. This is an attractive fund which is fully invested and has returned 26.4% for the 12-month period ended 31 December 2010. It provides investors with a diversified portfolio of 12 quality companies and a competitively-priced liquidity option should the investor need to exit.

For further information, please contact Kevin French on 021 509 4326 or at kfrench@omigsa.com.

Investor name	2005 Allocation		2009 Allocation	
	($bn)	(% of AUM[2])	($bn)	(% of AUM[2])
California Public Employees' Retirement System	9.8	5.1	24.3	12.1
California State Teachers' Retirement System	6.9	5.4	15.9	12.1
CPP Investment Board	2.9	3.6	14.1	11.4
Michigan Department of Treasury	5.9	11.0	8.2	17.6
Oregon State Treasury	5.1	7.6	9.2	14.1
University of Texas Investment Management Company	1.2	8.4	3.5	22.0
Washington State Investment Board	6.9	5.4	11.5	16.3
Wellcome Trust	2.7	11.5	4.5	20.5

[2]Assets under management | [3]Source: (Witkowsky 2010) | [4]Source: (Witkowsky 2010) | [5](Bloomberg 2010)