SUMMIT AFRICA

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LOOKING AHEAD IN 2019

In 2019 we will see 24 of Africa's 54 countries go to the polls to exercise and in some instances test the democratic framework of their countries. Chief among them are Africa's two giants, South Africa and Nigeria.

Many analysts have gone on to say that for South Africa in particular, this is an election almost as significant as 1994, where we elected our first democratic President. After a tough period of corruption, patronage and general economic regression we need to see the emergence of strong political leadership to helm the ship and guide the nation through the murky waters.

Political analysts predict that Cyril Ramaphosa, our current President who took over from President Zuma after the elective conference of the ANC, will emerge victoriously and become President on a direct mandate. Some have ruled out the possibility of there being a coalition government as the general sentiment is that Ramaphosa has done enough to pull together support from all corners to give him an uncontested mandate.

A clear win will bode well for South Africa as Ramaphosa and his interim government have

skillfully boosted investor sentiment and confidence. The President gave us a taste of what to expect going forward, with his direct and openly strategic approach to restoring the confidence of both the nation and global business in the country. Some of the Government's most positive actions which set the stage for better performance and growth of the economy last year included:

- Cabinet reshuffles
- Commission of Inquiry into State Capture and SARS
- New boards at Eskom, Transnet and Denel
- Finalising the Mining Charter

The government held a successful Jobs Summit in 2018, followed by an investment conference that saw business commit to R290bn worth of investment over the next 5yrs. This amount only includes the pledges that were made public at the conference. In light of this, we anticipate there will be higher spending by more companies as well as a tremendous drive by private equity firms to ride the wave of positive sentiment in 2019.

Fortunately for South Africa, we will not have to wait until after the elections to understand the global thought on the reforms. A South African delegation to the World Economic Forum coupled with the Mining Indaba will provide a stern litmus test of whether we are on the road to recovery.

Large global institutions such as Goldman Sachs, Moodys, World Bank and AfDB all share the same views that we can expect to see a growth of between 1,7% and 1,9% in 2019. These predictions are a vast improvement from the numbers produced in 2018 wherein the third quarter South Africa went into a technical recession.

SO WHY THE OPTIMISM?

Improved Consumer Fundamentals

Consumer fundamentals aren't currently that bad and are likely to grow as confidence improves. It is also in line with a cyclical economic pickup. There is the possibility that investment could rise sharply again leading to growth possibly reaching 3.0% to 3.5% by 2021/2022. We continue to see fuel prices come down, with a second decrease expected in the latter parts of January to early February, which should further ease the pressure on consumers. The government is set to announce the Vat Zero rating of more basic commodities to alleviate the burden on lower income earners and the indigent members of society.

Managing Inflation and Interest Rates

Economists generally hold the view that the deflationary environment is likely to last for a while, with the consensus facing a downside inflation forecast risk. Inflation will likely remain within the target range, and I maintain my 2019 inflation forecast of 4.8%, which is well below the consensus of 5.5%.

A Reformist ANC Taking the Reigns

It will be favourable for the economy should Mr Ramaphosa take an overwhelming majority and

be able to continue with the reforms he started following the elections. The President will have to be decisive in dealing with contentious issues such as land reform. The redistribution of land is a historical and social imperative for South Africans and must happen in a manner that does not threaten or hamper business or investment.

Mr Ramaphosa must also end the culture of patronage and return government departments and SOEs to the business of doing business, curb corruption and prosecute those caught with their hands in the cookie jar.

There should be a resolution on all policy and government operations to move quickly and decisively leaving no room for ambiguity. All of these are traits that the government under President Ramaphosa have shown.

Astute Appointments

The President engaged with parliament and followed a more open process in the appointment of the National Public Prosecutor. This level of accountability to the public is a step in the right direction around the transparency of government. More key appointments are and will be up for grabs in 2019, starting with the CEO of the largest asset manager in Africa, the Public Investment Corporation. A transparent apolitical appointment will be necessary to boost confidence that the economy is on the right track. This year, as a country, we must show we are doing what's required to drive growth and create jobs, starting with robust and functional institutions that support any initiatives we look to implement.

Fiscal Consolidation

The Government has committed to stemming reckless spending, and the Medium-Term Budget Statement as presented by Minister Mboweni reflects this. It is and should remain a government imperative to correct the country's debt to GDP ratio. The government also needs to focus on spending money on infrastructure and actual service delivery, something the current administration has carried out efficiently.

Trump and The US

Finweek's Miriam Isa published an insightful article in December 2018, titled 'Trends that will shape the economy in 2019'. In this article, she reports that US President Donald Trump's extended honeymoon with the financial markets is drawing to an end. Jitters over his trade war with China has knocked confidence coupled with evidence that the spurt of growth triggered by sweeping tax cuts and a spending splurge is waning.

While US stocks have bounced back again, all three major indices – the Dow Jones, S&P 500, and Nasdaq – closed the first week of December more than 4% lower, marking the worst start to December since the global recession in 2008.

However, the recovery is unlikely to last. The outcome of a three-month truce on tariffs between the US and China is still in doubt. A growing number of analysts are warning that the tide is turning in a bull market which has lasted for a decade – the longest in history.

The tariffs which Trump's administration has slapped on imports from China and other countries have done more harm than good. The US trade deficit in goods and services was up by 11% in October of 2018 compared with the same month in 2017.

The deficit reached a record high of $600bn at the end of 2018, which is 20% higher than when Trump took office. Even worse, many US forecasters now believe that the economy will slip into a recession in 2020 – ironically, the year in which he will run for re-election.

Against this backdrop, many financial analysts are suggesting that local investors drop the idea that the US market is their best bet in 2019. They favour putting more money into local shares, which offer better value – especially as the dollar is likely to weaken in the coming months. According to Peter Brook, head of MacroSolutions at Old Mutual Investment Group, "Now is not the time to sell your balanced fund to take the cash and invest overseas – that would be jumping out of the frying pan into the fire."

The Elephant in the Room

However, all is not entirely rosy in 2019 as the financial crisis at Eskom, and other SOEs loom large over any growth. As such, the 2019 budget speech is a key watershed in the story of SA INCs turnaround. The government has muted the idea of absorbing R100bn of Eskom's debt

to which rating agencies, 2 of whom already rate SA as Junk, have responded by saying this would not lead to an automatic downgrade. This decision would need to be supported by a robust and comprehensive turnaround strategy to explain how the government would ensure Eskom does not return to this position.

Also, it would be essential to show how the government intends to make sure there is no compromise on the security of supply of power from the state-owned entity in 2019; another element that could severely curtail growth and productivity of business rendering all efforts mute.

HOW DOES PRIVATE EQUITY FIT INTO THE PICTURE?

Ignoring the data is hard. Several studies conducted by industry bodies, audit firms, investment consultants and others showed that in a depressed 2018 market, private equity still outperformed listed equities in all key matrices such as return on investment, growth in assets under management, and the ratio of local jobs created and retained relative to the investment universe.

Not only did they outperform the listed market but generally delivered inflation bearing numbers.

It is without question that the alternative asset industry in South Africa is ideally situated to help realise the economic stimulus plan. Increasing allocations to private equity, venture capital, and private debt funds have a real transformative effect on the local economy. These funds generally back the country's middle market, stimulating innovation, the job market, improving health care, housing, education, and infrastructure at a market rate of return.

Regulation 28 of the Pension Funds Act limits an institution's exposure in alternative assets to 15%, with a maximum of 10% allowable for private equity. The South African pension fund industry has more than R4 trillion AUM, meaning there is circa R400 billion available for investment into alternative assets. Total investment into alternatives in South Africa currently sits at around 1% or less than R40 billion. The balance of institutional allocations is invested primarily in listed equities. The value of listed company contributions to the South African economy is indisputable, but they have a limited transformative impact within the South African context.

To illustrate, listed JSE shares as a regulated asset class may boost short-term profit-taking, but it diminishes the asset owner's (pension fund) ability to influence the listed investee company's tangible contribution to South Africa's economic and social development, and long-term sustainability.

Even though Regulation 28 stipulates a 30% cap on ex-SA exposure (25% international; 5% Africa), the reality is that the actual ex-SA exposure of current pension funds is substantially higher.

The reason being is that many of the 'local' listed companies are more global in nature due to their push for increased geographic diversification, growth, access to technology, and foreign-currency earnings. Approximately 65% of revenue generated by JSE listed companies comes from abroad. Examples of such companies are Anheuser-Busch InBev, Naspers, Glencore, Sasol, British American Tobacco, MTN, and so on.

Lastly, 60% of South Africa's economic activities and a sizeable portion of the domestic investment, both listed and unlisted, concentrate around the four main cities of Johannesburg, Durban, Pretoria, and Cape Town.

This concentration of investment and risk has increased urban migration at a faster pace than what the system can manage. Many people are coming to the cities looking for opportunity only to find themselves sucked into the social ills perpetuated by high unemployment in the over-burdened centres.

Decentralising domestic investment from the main cities into the secondary towns of South Africa can stimulate the economy to a greater degree than is already the case. There are ample investment opportunities available in these areas which will counter the social burdens experienced in the cities. Consider for a moment, that the membership of the largest South African pension funds spread across South Africa's nine provinces, but their savings are funnelled

into the four main cities as a default because of the high exposure to the highly regulated listed market. In effect, most economic investments made by pension funds that affect the quality of life are taking place outside of the areas many of their members will retire to and where their families live.

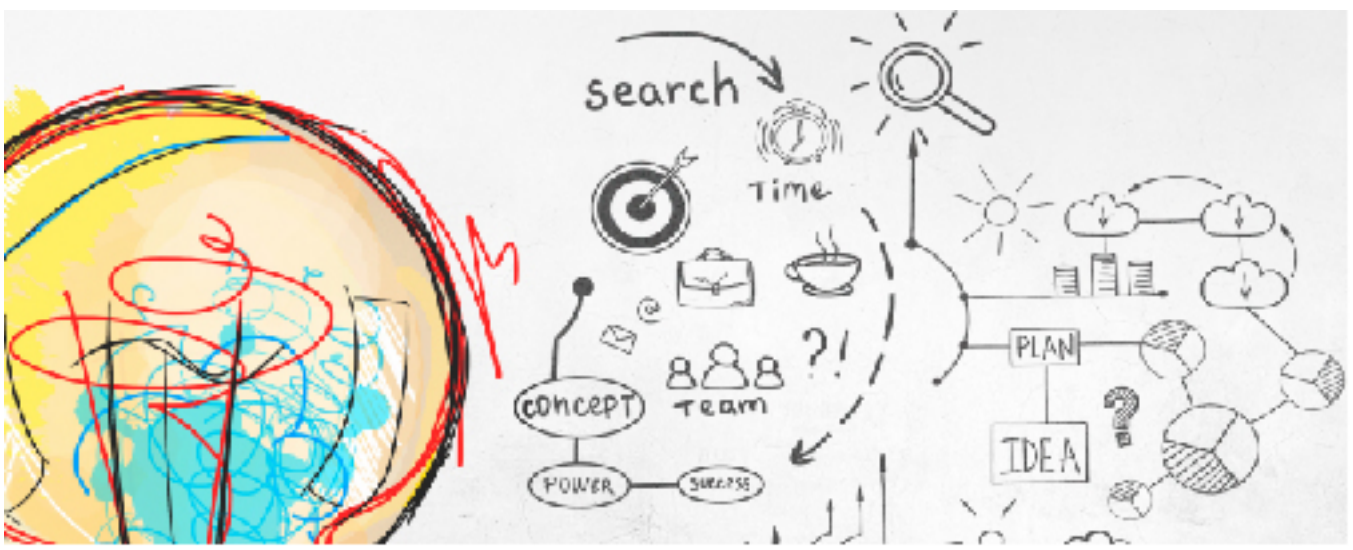
WHAT ROLE CAN PENSION FUNDS PLAY?

While most pension funds have, or are starting to map their portfolio to the environment, social, and governance (ESG) requirements, they are not yet necessarily connecting it to transformation goals and "proudly South African" objectives. Doing so would require accountability and reporting along the investment chain to include details like, "How many jobs did my investment create?" "How did my investment improve South Africa's global competitiveness?" "To what extent did my investment provide economic growth outside of the key metropoles?"

What are the opportunities for pension funds to bolster the economy and drive social change while ensuring a return on investment for its members?

- To start, pension fund owners should see themselves as vital catalysts for change.

- Secondly, they should actively seek opportunities where they can drive investment allocations into asset classes that have a direct local, social, and economic impact at market rate returns. These alternative asset classes include private equity, unlisted real estate, venture capital, and private debt funds focused on the middle market and SME's - the main engines of job creation and growth.



Increasing allocations into alternative assets have a real transformative effect on the local economy, but this kind of change requires pension funds to have a louder voice. There are several steps pension funds can follow to achieve this.

- The trustees of the pension funds should consider expanding their investment policy statement to include the requirement for a portion of the pension funds' assets to be managed by managers who recognise the value of ESG and Transformation and delivering social returns. Doing this will give pension funds an active voice in their investments, channelling their assets into areas that have both local impacts to where their pension members are located and ensuring market-related returns for their members.

- Pension funds can ease this process by creating transparency between the board, the investment committee, the investment consultant, and the investment managers concerning the investment policies and social objectives of the pension fund. These aims could include investments in specific sectors, targeted geographical areas, job creation, and retention.

- Pension funds can also become active participants in fund governance. Unlike listed investments where pension funds generally invest through external fund managers and vote by proxy, investments in private equity, unlisted real estate, and debt give the pension fund an opportunity to participate actively in the governance structures of these funds. Funds nominating an independent investment committee member and, or an advisory board member who has a clear understanding of the pension fund's investment policy objectives can ensure their fiduciary duties to their members are not compromised.

- Pension funds can formulate the alternative asset fund strategy in conjunction with the fund manager(s). Globally, private equity strategy is driven by a coming together of ideas from Government, pension funds and investment managers. In some instances, pension funds even go as far as to co-develop strategies and help formulate a team to execute the strategy. CalPers in the United States is a fund who has successfully used its influence achieving the desired social impact without compromising on financial returns.

The saying, "the whole is greater than the sum of its parts" cannot be more relevant to trustees selecting where to invest the assets of the pension fund. As outlined in Regulation 28, each asset class has its place, balancing and safeguarding assets and protecting member objectives. None the less, the whole is not and cannot be complete unless a part of that selection includes investments in alternative asset classes such as private equity, unlisted real estate, venture capital, and private debts funds. By investing in alternative assets, the pension funds complete not only the whole but more importantly, they become catalysts driving both social and economic change within South Africa.

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Summit Africa is a majority black-owned and managed, Specialist Alternatives Investment Manager with a focus on investing in private equity and unlisted real estate, delivering above benchmark risk-adjusted financial returns. We believe strongly in contributing meaningfully and measurably to the social and economic transformation and development of the local community and South Africa as a whole.

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