Increasing diversity in South African strategies

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The South African alternative strategy industry is populated with some of the best emerging market investment talent in the world. Yet, with equity-based strategies by frequency already dominating the domestic league tables, is it still viable for new managers to keep adding to this increasingly crowded category?

Looking at this ever-lengthening list of names in the hedged equity categories, it's difficult to tell how many of these recent additions are motivated by the so-called incentive fee pull-factor. A fair proportion to be sure.

What is clear though is there appears to be a growing number of new launches in the South African equity categories struggling under a glass ceiling of mediocrity. Not only do they appear to have difficulty in differentiating themselves from competing funds in their category, there also is much visible overlay in their investment theses. Most recently there appears to be an abundance of quant-esque strategies of the 'we-have-a-multifactor-model' variety. This is, indeed, a frustrating area to occupy in 2008, making traction in asset growth difficult and placing pressure on business viability of emerging domestic funds.

A cursory view of the people behind the funds reveals that many established equity managers in South Africa ground away their institutional time in the late 1980s and 1990s, now having privatised their talents. They, as a group, have been to date the primary feedstock of skills to the domestic hedge fund industry. The list of names is, however, a finite one and, possibly it's fair to say that the domestic hedge fund industry has already extracted the rump of talent from that generation of managers.

From where then did the newer vintages of South African equity managers originate, notably the launches of the past year or so? Could it be that latent talent has been locked away in the investment banks for all these years, seemingly unaware of the expanding industry outside that has been so receptive to such talent? Not likely, since much of the best individual talent in equities have dislodged themselves, or been dislodged by sponsors.

A more likely scenario is the alluring pull of a 2% and 20% remuneration package for an adaptation of a long-only process sprung from an institution. As the domestic industry has matured over the past five or seven years so, too, have the allocators. An invoice of 2 and 20 for cash-plus-a-bit performance, and a one-page monthly report is not likely going to cut it for domestic and international allocators going forward. This by no means suggests there is poverty of talent remaining in equities; rather it suggests a shift in the generation of equity managers and a growing appetite for other strategies.

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strategies? This is an important question if the industry is to deepen and provide adequate diversity in strategies to allocators. Equity strategies, with low correlation of performance to some index, still load on some common shared economic risk factors, whatever their identity. What is needed are new strategies in the South African alternatives market that provide diversity in their actual sources of economic risk.

Truly enterprising alternative strategy managers should be seeing opportunities abound, and these do not lie in the hedged equity space in 2008. For example, investment offices in Europe are actively hunting for alternative funds trading in hardwood timbers. Where are the skills that trade timber from the Eastern Cape into Europe and why have they not been sponsored to collapse their businesses into limited partnerships? When farmers in Indonesia began diverting rice acreage in favour of palm oil, Asian soft-commodity funds appeared in anticipation of rising grain prices. Why did agricultural futures funds in South Africa appear only after the wheat price doubled?

There are more examples that are testament to the enterprise of alternative strategy managers. As oil and gas networks in Eastern bloc countries took on an increasingly political dimension, an explosion of Russian-focused energy trading funds emerged to profit from pricing anomalies. When options prices across the pan-Asian region began a structural decline years ago implying no risk was priced into their boom-bust financial systems and no economics for option writers, volatility trading funds appeared.

Sure, the dynamics and opportunity set differ in an antiquated exchange-control environment, but why is there only one small fund even attempting to trade volatility in South Africa? When the Chinese banks first hinted at the possibility of opening their books and selling off limited non-performing loans, every distressed debt fund in the world set up Chinese operations. And this was long after the feeding frenzy of alternative credit funds on the fallout of the Asian financial crisis. Why in the domestic market was the lag so long in creating credit funds and distressed funds, and still there are only three out of 160 funds?

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Notwithstanding the sluggishness of the South African alternatives market in adopting non-equity strategies, there are increasingly positive developments in that direction in 2008. News is that sponsors are lined up to provide seed funding for at least another two off-market credit funds, one dealing primarily with true distressed assets. There are also developments in new funds involved with trade financing, operating in niche areas where banks find small and high-frequency deals too much work for relatively small payoff. There are also emerging CTA (commodity trading adviser) strategies devoted to actual commodities rather than commodity stocks. The list is happily getting longer.

Domestic managers are also actively drumming up foreign interest in their fund management abilities in the hope of finding investors for their newly formed offshore funds. Akin to the master-feeder structures used to segregate US and non-US investors, similar structures for domestic managers enable them to deploy their skills over a larger emerging market opportunity set. It is entirely true that a large portion of blame for the narrowness of domestic hedge fund strategies lies at the feet of draconian 1960s exchange control laws. Forcing South Africa-based hedge fund managers to produce a Rand NAV (net asset value) is not only unappealing to potential foreign investors, it has demonstrably stymied development of capabilities in alternative areas of return.

In spite of the above hindrances to development, the industry has demonstrated a vigorous level of enterprise, albeit on a comparatively delayed schedule with regards to other markets of similar sophistication. Often it is in adversity that alternative funds find their prosperity; such is the environment for alternative strategies in South Africa. For certain, the more non-economic cogs are inserted into the South African financial machinery, so will the hedge funds continue to prosper and the strategy net widen. In just a few short years, the categories in the league tables are likely to be unrecognisable from the present.

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Private equity and the best approach to investing

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South African private equity in 2007 will go down as the year of the 'mega deals', with Bain Capital's acquisition of Edcon for R25 billion and the R37.5 billion investment by Industrial & Commercial Bank of China in Standard Bank being the two largest. Indeed, foreign private equity groups are finding the South African market increasingly attractive, stemming from the growth rates being experienced, access to resources in Africa and opportunities in infrastructure development. Private equity in South Africa now makes up 10% of all merger and acquisition (M&A) transactions, with the South African Venture Capital & Private Equity Association (SAVCA) reporting over 60 full members managing 95 different funds with more than R86 billion under management, a 40% increase from 2006.

So with private equity having come of age in South Africa as a significant asset class, what is the best approach to investing in it?

To answer this, one needs to consider the knowledge level and experience of the investor concerned. Sophisticated investors with a long track record in private equity may well find that the best approach is by investing directly into the underlying portfolio companies. However, this is a very difficult skillset to acquire and requires years of experience. This skillset is, therefore, outsourced to a private equity fund, whereby the investor commits capital to a fund, which in turn invests into the underlying portfolio companies on the investor's behalf.

So how do these private equity funds go about finding the best portfolio companies to invest in? What are their selection criteria and strategies for creating value in those companies? To answer these questions let us look at the various stages in the investment process.

The investment process: commitments, drawdowns and distributions

A private equity fund raises money from investors in the form of 'committed capital', that is money investors have legally promised to invest in the fund. The fund will then invest that committed capital into (typically) unlisted companies by way of 'drawdowns'. Drawdown capital is the amount of the investors' committed capital that has actually been paid to the fund for investing into companies, and for covering fees and expenses.

The private equity fund will then aim to create value in the underlying company by implementing an active investment strategy, which can be realised through trade sales or listing on the stock market. These 'realisations' involve selling their equity stake in the company and returning the proceeds to the investor in the form of 'distributions'.

Private equity investing is, therefore, medium to long term in nature, targeted at (typically) unlisted companies with growth potential. It is a transformational, value-added, active investment strategy. Private equity capital is used to develop new products, expand working capital, make new acquisitions or strengthen a company's balance sheet. It can also be used to resolve ownership issues, or the buy-in or buy-out of a business by experienced managers.

For a private equity fund to be successful, a broad range of skills is required. These range from deal sourcing, screening and 'forensic' due diligence, through to financial engineering, deal execution, company management and exits. Of these, accessing proprietary deal flow, strategic vision, the ability to manage company boards and experience in managing difficult situations and complex exits throughout the cycles are critical success factors.

Investors looking to get exposure to private equity will, therefore, try to invest in an underlying fund that has demonstrated the above. That fund will, in turn, typically invest in around 8-12 underlying portfolio companies.

Diversification

The next task involves achieving the right degree of diversification across companies, fund strategies and time.

Investors need to realise that private equity funds employ different investment strategies, ranging from:

- Buyout Funds: private equity funds that look to acquire control of an established and profitable business with the use of acquisition debt by way of leverage.

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- Development Capital Funds: private equity funds providing expansion capital for an already established company, with control typically not taken (although some voting rights may be pledged).
- Venture Capital Funds: private equity funds looking to provide either seed, start-up or early-stage capital for research, evaluation and development of new cost-effective applications to address commercial problems that would have large-scale appeal.

A balanced blend of these strategies across both industry sectors and through various economic cycles (time) becomes critical in order to ensure good diversification.

How then does the investor choose between different private equity funds? Successful investing requires a well thought out private equity programme with well-developed evaluation criteria to assist in the manager selection process.

This is why the bulk of institutional investors globally have used the fund of funds approach to investing into private equity. In addition, the dispersion of returns between 'top quartile' and 'bottom quartile' funds are wide and it is, therefore, important to ensure selection of the top-performing funds.

By way of example, the KPMG SAVCA 2007 Survey on South African private equity shows that less than 25% of the 35 funds analysed had gross internal rates of return (IRRs) above 40%, with just over 30% producing gross IRRs below 20%.

Rapid participation

The challenge to successful private equity investing is how to combine the unknown drawdowns and realisations from private equity funds in order to get your money to work quickly and keep your money at work.

The drawdown profile of a private equity fund shows that on average it takes three to five years to achieve full participation and, unless the investor has a cashflow management programme to re-invest the realisations as they are paid back, participation in the asset class rapidly drops off.

There are various ways one can address these challenges. Let's deal with the first of these – the unknown drawdowns.

Unknown drawdowns

In order to be able to meet the capital calls made by the underlying private equity funds, the investor needs to have money available at short notice, typically within 10 business days. Undrawn capital is, therefore, held in liquid assets. This leads to another issue of 'cash drag', that is dilution of overall private equity returns by the need to keep undrawn capital in cash or similar short-term assets.

Management of liquidity forms a critical component of total return. The internal rate of return for a private equity fund will not be the same as the total return on the 'block' of capital committed to the fund. Liquidity management is, therefore, a tool that some private equity fund of funds managers offer in order to minimise the cash drag.

Achieving a high total return for the overall investment programme is a complex task that requires not only quantitative modelling and financial engineering skills, but also a high degree of judgement and management discipline. The first task is to understand the various drawdown profiles of the underlying funds and then optimally combine them to avoid the cash drag and achieve rapid participation. This is achieved by being very close to the underlying managers and by a technique of tranching up the various liquidity buckets and investing these in alternative high-yielding assets that match that particular liquidity profile.

By drawing down 100% of the committed capital from the investors on day one, a fund of funds can invest the proceeds in assets such as a fund of hedge funds, credit and mezzanine funds, and alternative fixed income assets, all of which have different liquidity profiles that match the forecasted drawdowns of the underlying private equity managers. In this way, a yield-enhanced return can be achieved, with risk-adjusted returns better than private equity or public equity alone.

Another method of avoiding the cash drag is by adopting what is called an 'over-commitment' strategy. This is a method of committing more capital to the underlying private equity funds than you actually have available, in order to minimise the opportunity cost of the 'non-productive' investment. For a diversified private equity fund investment programme, drawdowns follow a predictable pattern and, therefore, fund of funds are in a good position to implement an over-commitment strategy in which more available resources are committed in order to achieve a target investment level.

Unknown realisations

The final challenge to investing in private equity is the need to be fully invested throughout the cycle. This requires re-investing realisations from funds back into private equity as soon as possible in order to stay fully invested through time. A continuous proactive due-diligence process is therefore required on both existing funds and new funds coming to market. A fund of funds manager's job is to continually evaluate funds and apply their evaluation criteria consistently in order to build an optimal portfolio that stays invested through time.

The key to private equity investing is a sustainable investment programme throughout the cycle. The fund of funds approach provides the investor with the ability to address all the challenges as well as avoiding the burden of research, due diligence, ongoing monitoring and reporting and administration.

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