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Catalyst

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SA's quarterly Private Equity
& Venture Capital magazine

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From the Editor's desk

Look at the leading companies in the United States. Of the 100 largest companies at the beginning of the 20th century, all but 16 are gone today. The survivors succeeded because they changed to remain relevant to their market place. They knew they could not stand still and live to tell about it.

As we enter 2008, there are clear signs the private equity market has altered – albeit temporarily. Recent years have seen the establishment of many new funds, including a number of one-man operations dedicated to a single sector. As deal flow slows, will these funds find the business to survive? If your practice is wholly dependent on private equity, you're likely to struggle this year. Better take Business Partners' Jo' Schwenke's advice and work a lot harder.

With the cost of borrowing higher and the terms of borrowing tougher, there'll be less money available to do deals. The nature of deals may well change during 2008 from acquisitions to restructurings and debt repackaging.

There is still much changing in this industry, where the ability to do big deals is inextricably linked to economic performance and the attractiveness of South Africa as a foreign investment destination. With political change in the air, power cuts, economic uncertainty and high interest rates, the attraction is faded.

Indeed, when it comes to big-ticket private equity deals, we wouldn't be surprised to see those deals experience difficulty getting exchange control approval in the coming months. Such is the changed risk environment.

It will be a tougher year for the industry to unlock value in their portfolios, especially if deals are highly leveraged and GDP growth falters. Black economic empowerment may be one of the first casualties. It is likely to be a year of consolidation, in which portfolio managers will have to get creative in adding value to their existing underlying investments – if they want to show the level of return that private equity has become accustomed to.

The first quarter of 2008 has so far been a tale of two trends: the cost of capital has hurt deal flow, but when asset prices come down, it's a good feeding ground for private equity.

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Catalyst

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It's not just because it is the largest private equity transaction in the South African market to date, and the second largest local acquisition after Barclays' purchase of Absa that this deal stands out: its complexity and the fact that it entails one of South Africa's best-known brands also add weight.

All the right ingredients produce a worthy winner

When Bain Capital announced its intention to acquire Edgars Consolidated Holdings (Edcon), many local and foreign market players believed the transaction would never happen, given its previously unseen cross-jurisdictional, regulatory and multiple financial markets complexity, tight timing and the sheer size of debt required.

To succeed, the following needed to be dealt with:

- The early redemption of the listed securitisation vehicle of Edcon's debtors book had to be approved by bond holders and had to be refinanced in the Rand debt markets;
- The continuous working capital requirements of the re-rated entity, which changed from a listed corporate to a leveraged entity, had to be secured via placement of a super senior working capital and capital expenditure facilities for the new Edcon;
- High Yield Notes for the remaining R17bn, equating to a €1,81bn, had to be placed in the Euro and US high yield

bond markets, the largest Euro placement in the European markets to date;

- US, UK and South African cross-jurisdictional legal and taxation issues had to be run in parallel with obtaining SA Reserve Bank approval for implementing the cross-jurisdictional leveraged financing structure. It was in fact the first major local rand senior debt and high yield bond financing structure approved by the SARB.

On top of this, the global liquidity crunch started to take hold just as the deal was being finalised, putting pressure on the team that structured the high yield bond offering.

Members of the deal team attribute their success in part to the strength of the working partnership that developed between Bain Capital, Edcon's management and the Absa Capital team, but also to the fact that investors clearly understood that Edcon was a very good growth story, driven by fundamental shifts in consumer spending, particularly by the emerging black middle class. In addition, the technical strength of the bookrunners and their market placement depth was critical.

"It was one of the most complex transactions to date", Stephen van Coller, head of Primary Markets at Absa Capital, told *Catalyst* at the time.

As for the local bank market, this transaction probably served as a wake-up call, as the foreign interest and investment in the transaction demonstrated that ZAR debt was no longer the sole domain of the large domestic banks. Also, the structural innovation of the deal caught many by surprise: a solution across the entire capital spectrum instead of individual pockets of solutions.



Steve Ross

The local debt placement of R10bn was the largest in the South African debt market to date. It moved the debt market to new levels and alerted the domestic banks to the fact that as the size of South African private equity deals grows, so too will the need for more offshore financing.

The buyout by Bain Capital of Edcon scored high on all fronts: size, complexity innovation and broad market influence, making it the clear winner of the *Catalyst/DealMakers Private Equity Deal of the Year* for 2007.

Some debt detail:

- Barclays Capital and Absa Capital provided the initial R18,7bn senior bank and bridge financing used to fund the acquisition. Deutsche Bank AG, Credit Suisse and ABN Amro subsequently joined at senior level, providing a strong arranging and underwriting group

Edcon was a very good growth story, driven by fundamental shifts in consumer spending, particularly by the emerging black middle class

We're bullish about Africa



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We believe in the potential of well positioned businesses in Africa. Ethos is willing to invest in regions with good growth

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The PricewaterhouseCoopers Banking Survey has ranked Ethos South Africa's leading private equity firm for five consecutive years.

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across the facilities.

- The transaction was funded 27% via equity and the rest via the €1,81bn dual tranche high yield floating rate note offering and the placement of R10bn supporting facilities in the South African market.
- The local debt comprised revolving credit facilities and borrowing base facilities benefiting from strong asset coverage. Robust support came from Absa Capital, ABN Amro and Deutsche Bank as mandated lead arrangers, Calyon at senior lead arranger level and lead arrangers Sanlam Capital Markets and First National Bank. ♦

Jane Strachan

Financial adviser to Edcon:	Caliburn
Legal adviser to Edcon:	Werksmans
Transactional sponsor and equity markets adviser to Edcon:	Merrill Lynch
Namibian sponsor to Edcon:	IJG Securities
Independent advisor to the Edcon Board:	PricewaterhouseCoopers Corporate Finance
Financial advisers to Newco:	Citigroup, Credit Suisse and Standard Bank
South African legal adviser to Newco:	Webber Wentzel Bowens
International legal adviser to Newco:	Kirkland & Ellis International LLP
Private equity sponsor and transaction arranger for Newco:	Bain Capital LLC
Debt arrangers and providers to Newco:	Barclays, ABSA Capital

The year 2007 was without doubt South Africa's Year of Private Equity. Notwithstanding a weakening in the final quarter, it boasted a record number of deals, complemented by the entry of US foreign equity giants.

Rising cost of capital takes a bite out of the top end of the market

The striking feature of the Edcon deal was that three global private equity houses were prepared to spend considerable resources on it. Having devoted to South Africa so much time, and millions of dollars, they'll be looking for further opportunities.

Not for the moment, however. Sub-prime, which initially seemed so distant and inconsequential in the South African context, has now become a dominant feature – and has driven off the global private equity houses. Six months ago the local private equity market was apprehensive about the arrival of bell-curve international private equity firms like Blackstone Capital and Kohlberg Kravis Roberts (KKR) driving up the cost of deals and cherry-picking the best – now they're relishing the opportunity to do deals while their international rivals are preoccupied back home.

From late 2006 to the final quarter of 2007, private equity deal flow was healthy,

with everyone expecting more of the same into 2008. The three big guns of the local industry – Brait, Ethos and Actis – had mounted a record fundraising drive in 2006, causing funds under management to surge to R56,2bn from R42,5bn in 2005, according to KPMG's latest annual survey of the industry.

Despite the availability of all these funds, the reality is that deal flow at the very top end of the market is already drying up, because any deal bigger than about R4bn, needs debt capital, usually from offshore.

Since the sub-prime crisis, anyone with money to invest in the US and Europe has become risk averse – and South Africa chose this moment to raise its risk profile.

Slowing economic growth, rising inflation, political uncertainty, Eskom and a ravenous current account deficit points to a highly vulnerable currency, which could be poised for significant weakness in 2008. No

wonder many private equity practitioners are anticipating there will be few – if any – mega deals in 2008.

Investment capital continued to flow into South Africa as long as the country offered a risk premium, and conditions looked stable. However, economic circumstances over the past few months have shifted. The current account deficit has widened to more than 8% of GDP, and at the same time evidence of a slowdown in the South African economy has become tangible. Vehicle sales are in recession and retail sales for November came within basis points of moving into contraction.

Christopher Hart, Head: Market and Economic Research at Investment Solutions, says: "Economic growth of around 5% over the past few years looks set to slow to the 3% mark in 2008. The risk-reward equation has, therefore, shifted in a highly unfavourable direction when



John Gnodde

examined from a growth and current account deficit perspective.

"A further unfavourable risk-reward shift has taken place when growth and inflation is taken into account. Inflation is still rising while growth is slowing. Inflation is now well above the growth rate compared with the recent past where the inflation rate fell below growth. Hence the risk-reward matrix has shifted from being attractive from an investment point of view, to being unattractive," he adds.

**Mike Donaldson,
director of RMB
Corvest, says
once prices drop
below a multiple of
ten times, it
becomes easier to
do deals**

Besides an unfavourable comparison between the risks of inflation and current account deficit with the reward of economic growth, the trends are also problematic and the risk-reward matrix is likely to deteriorate further.

"Political uncertainty has also made an inconvenient arrival. The rising perceived tension between the ANC executive and Presidency creates further risk from an

investor point of view. Economic policy along with macroeconomic management has provided a great deal of confidence over the past ten years and has helped to lay the platform for South Africa's economic success. Both foreign and domestic investors have placed much confidence in both the stability and continuity of economic policy and have taken comfort in that it is highly credible and in line with global best practice.

"However, the political uncertainty means that this regime is now in question. Should economic policy retain continuity and direction, then no serious problems should arise. However, there are elements within the new guard of the ANC that view certain aspects of economic policy with a jaundiced eye. The consequential risk is capital flight of both domestic and foreign capital," says Hart.

"As if these problems were not enough, South Africa now also faces a period of investment sanctions - imposed by Eskom. The electricity shortages mean that the country's ability to absorb further investment faces structural limitations," says Hart.

Almost every industry in South Africa is to some degree affected by power cuts, and it is unlikely any foreign private equity player would be interested. Any deal would be highly geared with a consequent need to sweat the assets - something simply not possible if plant is down for any length of time.

The current account deficit needs to be financed. This means capital inflows equivalent to 8% (and rising) of GDP is required. Stop the flow, and the rand weakens. An outflow and the rand faces a crash.

Mega-deals, of R4bn and more, which typically exceed the prudential limits of local financial institutions and, therefore, require foreign capital to sustain the deal, will most likely not happen for four to six months, unless the assets being acquired are of sufficient quality to override foreign risk aversion.

The foreign private equity players, who might otherwise have been interested, are currently pulling in the reins, post subprime.

This creates an opportunity for the local banks to recover ground lost to foreign markets over the past 18 months. A growing appetite for raising money on foreign markets, where capital could be raised cheaper, has stalled. Foreign investors are no longer interested in emerging markets, and where there is interest they now want

a risk premium, making foreign capital as expensive as local capital - thereby defeating the purpose.

Mid- and small-cap deals will continue, and may even pick up, as asset prices have become on average 20% cheaper since the JSE peaked in October last year.

John Gnodde, executive director at Brait Private Equity, believes growth will still be good in 2008, notwithstanding the rising interest rate cycle. "Our deal flow remains good, and this is a positive for the industry going forward. We continue to exceed 30% internal rate of return (IRR) in dollar terms, and 2007's performance was better than 2006.

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deals," says
Donaldson**

"Deals have been getting bigger each year, and this trend should continue into 2008. The big difference for 2008 is that market volatility creates more opportunity," says Gnodde.

Mike Donaldson, director of RMB Corvest, says once prices drop below a multiple of ten times, it becomes easier to do deals.

"With realistic pricing, we expect more deals, and the further prices drop the easier it is," he says.

He's noticed a flurry of deals by people who were waiting for the market to peak, and waited too long. "They've now lost out because of the crash, and are keen to do deals before prices worsen. These are now more do-able deals," says Donaldson. ♦

At a time when private equity was experiencing one of its best runs ever, the recent turmoil in the credit markets has thrown a spanner in the works. Deal flow in 2008 has clearly slowed. The sub-prime crisis, even though not a South African issue, has affected the settlement of many deals. However, no matter what happens to the JSE and cost of capital, Brait, Ethos and Actis will be sifting deep to find the nuggets among corporate South Africa.

Sub-prime spanner in the works

Lance Williams, MD of i capital, says: "There was a bubble in the global credit markets and it has burst. This will slow down private-equity activity as their transactions over the past few years have tended to be highly leveraged and funded with lower cost offshore money. The ability to use these cheap funds came to an abrupt halt following the sub-prime crisis in the US.

"Private equity's ability to carry out large transactions is likely to be curtailed, and the prices they are able to offer may well be lower."



Mike Donaldson

The cost of capital has a significant effect on deal flow and if interest rates rise, equity markets tend to drop.

Though the pace of private equity activity has picked up in recent years, the sub-prime crisis in the US and UK has prompted investors to take a more cautious approach to emerging market risks.

According to Werksmans' Kevin Trudgeon commercial department: "The Edcon deal proved that foreign buyers were willing to accept South African country risk, but the sub-prime crisis curtailed the expected flood of foreign private equity investment into the country. Another factor weighing on foreign buyers' perceptions of the local market is the lack of available deals at acceptable valuations and with sufficient critical mass.

"These are hopefully temporary setbacks and we would expect to see a resumption of large-scale foreign private equity investment over the next two to three years."

Debt packages are taking strain. Not only have rates now increased but the terms of repayment are also less favourable. This is bad news for private equity

RMB Corvest director Mike Donaldson says that debt packages which used to consist of 10-year duration, with an interest roll-up for two to three years and a bullet payment at the end, are now back to six-year packages, with regular monthly interest payments.

However, the credit crunch offshore may well be good news for local banks whose risk profiles are not significantly affected by sub-prime issues. The banks may be able to continue to fund the debt for the smaller deals that are likely to be announced.

Overseas, the credit squeeze has been shaking markets since August and has managed to put the brakes on some enormous private equity deals.

While the impact is being felt on megadeals, which typically require a level of international funding to be viable, the global credit squeeze will not affect the mid-cap deal flow that is the bread-and-butter of the domestic South African private equity industry. With private equity firms in South

Africa having raised about R30bn since the beginning of 2006, that's not going to happen any time soon.

"The credit squeeze is affecting the megadeals – the ability to syndicate debt is getting more difficult," says John Gnodde, CE of Brait's private equity business, which runs the largest private equity fund in Africa, "but the model will evolve to reduce the level of gearing. I expect to see the level of debt used coming down and potentially more equity."

However, the credit squeeze has arguably created fresh opportunities for the domestic private equity firms with third-party funds. If anything, they like market turmoil because it reduces the cost of assets.

Brait is handling the Brait IV fund with more than \$880m of investors' money, and Gnodde says its private equity team is busier than it has been for the last six to seven years.

"We may see some debt underwriting returning to South Africa. Debt is expensive offshore, and the market even closed for a while. This has led to a standstill in private equity overseas, and as a result pricing is very high. More people will be raising more debt in South Africa, but it too may be more expensive. The overall level of debt in a transaction will therefore have to come down," says Gnodde.

Companies that have already raised debt offshore will not be affected, he says: "They're all fundamentally good companies, and were well received on those markets. The debt is also hedged, so there will be no impact at all."

Despite global turmoil, Actis Private Equity says it was not affected, being "very active" according to CEO Peter Schmid, doing deals during 2007 valued at \$500m. It did the R2bn buyout of Fuel RTT, as well as Alexander Forbes, Diamond Bank in Nigeria, Egypt's Sinai Marble and bedding

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company Mouka in West Africa.

"We paid aggressive multiples for our South African acquisitions, and especially with the environment of high interest rates and lower current valuations, we expect some tough times in 2008. Portfolio management and value add will be key to companies where we paid full price before the correction," says Schmid.

"The first two years of a buy-out are critical, especially where the acquisition was highly leveraged. All of us in the industry have the challenge of being innovative in finding value to compensate for the prices paid, especially where the margin may reduce as GDP growth shrinks in South Africa this year. This will be especially the case in the consumer space, where many of the deals were done," he says.

It will be a year of consolidation in private equity and portfolio management. The advisory side of private equity has seen a "quite considerable reduction" in activity, says James Formby, head of Rand Merchant Bank corporate finance.

"This is a trend we have seen in other markets: the demise of the mega public-to-private transactions since August last year, with private equity firms instead operating below the radar on smaller listed companies and in the unlisted space," he says.

But funds like Ethos and Brait that still have capital are unaffected, except in the

mega-deal space. They will continue to invest, as buying opportunities abound as prices come down. Cheaper prices create conflicting emotions: on the one hand, sellers are often unwilling to sell at the lower multiples, but on the other there tend to be more distress sales involving over-capitalised companies.

As a result of the credit squeeze, some M&A deals have fallen through, says Schmid, particularly those where deals were struck subject to raising capital in foreign markets. "That opportunity for foreign funding has now dried up, and these deals are having to be refinanced. They have to be innovative about finance, and one solution is to come to private equity funds," he says.

That's the theme he expects for 2008: more mid-sized deals than ever taking place. Liquidity may not be a problem in South Africa, but Schmid believes that access to local debt will still become more difficult as pricing is increased.

"The credit crisis is becoming more evident even in South Africa, and the various local investment banks' risk committees are becoming more and more cautious," he says.

However, the sub-prime crisis wasn't enough to dent the activity level during 2007, as Ethos and Brait were able to continue doing deals, being less dependent on international debt finance. Smaller than their international peers, they are able to



James Formby

be served by domestic debt to continue driving their investment strategy.

Some of the big deals we have seen last year include Ethos Private Equity's R11.4bn offer for Gold Reef Resorts (since cancelled) and its R1.32bn buyout of Brandcorp.

There has also been Brait's acquisition of Premier Foods for R1.5bn; the purchase of a substantial minority stake in Nature's Choice Holdings; and its R6.2bn buyout of glass maker Consol. ♦

At the same time as foreign private equity players look to South Africa for better returns than they can get in their domestic markets, for the same reason South African private equity firms are looking to Africa.

The last untapped market

Until the recent JSE correction, South African companies had become expensive, and debt relatively pricey, making returns in resources-rich African countries begin to look more attractive. This comes on the back of a super-resources cycle that continues unabated. But it is far from just resources companies being targeted: Ethos bought a Nigerian bank, and Actis bought a bank and bedding manufacturer in Nigeria, as well as a marble company in Egypt, and a Nigerian oil and gas

subsidiary from Shell.

According to Peter Schmid, partner at Actis, a number of leading African countries are experiencing "strong consumer growth," which is attracting not only South African private equity firms, but the major global players as well.

Actis is a leading emerging market private equity fund with US\$3.5bn (R26.3bn) assets under management, the majority of which is invested, and will soon be looking to raise more.

Its four teams in Johannesburg, Lagos, Nairobi and Cairo give it a deep understanding of African conditions. Its total value of deals during 2007 is \$850m (R6.4bn), of which \$320m (R2.4bn) is direct investment by Actis with the balance co-financed with partners.

"Indigenous private equity operations are also beginning to emerge – it's growing strongly," he says. "However, with the global downturn in 2008 we are expecting to witness some tough times this

year, particularly in the consumer and retail markets in South Africa.

An additional concern for investors could be a further weakening of the rand, which may impact private equity returns for investors."

And it is not as dependent on conditions in South Africa as are many of the other funds. Schmid says "We continue to see a wealth of opportunity in Africa, which we view as the last untapped market in emerging markets. We're seeing growing interest on the back of the resources cycle, attracted to Africa's petroleum and mineral resources that is resulting in strong cash flows, GDP growth and wealth in the regions. Nigeria, East Africa, Egypt and South Africa are the big markets that are attracting interest.

"In terms of volume of deals, the key growth area is West Africa and North Africa which are both benefitting from the high oil price. Another emerging region is the Maghreb countries in North Africa, where economic liberalisation is leading to above-average growth in excess of 7% a year. These economies are benefiting directly or indirectly from the high oil price, their economic liberalisation and privatisation, plus strong demand for raw materials out of the east, and the opening up of trade opportunities with Europe," explains Schmid.

With strong resources demand and political stability, there is growing interest in the economy of Africa, and a clampdown on corruption in countries such as Nigeria is having a real impact on perception and investor appetite. Schmid believes there

has never been a better time to invest in Africa. He cites as an example American analysts who predict that in the near future West Africa will provide a quarter of all US oil needs.

Germien du Plessis, a senior financier at Bravura Corporate Finance, says while returns in South Africa are still good, "better returns are to be made in oil and resource-rich neighbouring countries such as Angola and DR Congo.

"Africa as a whole is beginning to see a lot of political stability. Other public finance institutions such as the World Bank and IFC are active in funding deals, and putting systems and corporate governance in place to ensure things are managed properly. Oil and resources revenue is flowing into these countries, acting as a stimulus for the entire country," says Du Plessis.

"Many sectors of the economy are feeling the benefit of this revenue, and there will be substantial venture capital opportunities for some time to come, while returns are higher than one could expect from an increasingly mature South African market," she says.

During the final quarter of 2007 Ethos announced its first ever deal in outside Southern Africa, the investment in Nigeria's Oceanic Bank.

Ngalaah Chuphi, Ethos's "man in Africa," says: "We're an emerging market fund, and our third party investors have mandated us to invest in sub-Saharan Africa, including South Africa. We think that as opportunities tighten up in South Africa through

increased competition and cyclical slow-down, private equity firms will look harder at the rest of Africa."

"We've been looking strongly at East Africa, but the current turmoil in Kenya is putting a halt to that," adds Ethos partner Bill Ashmore.

That sums up the risk associated with



Peter Schmid

Africa – its potential for sudden conflict. Because private equity deals are of longer duration than an equity investment, special attention has to be placed on the likelihood of the country remaining stable not just at the time of the deal, but throughout its lifecycle. ♦

Two major asset management firms launched their second retail multi-manager private equity funds during 2007.

Moving into the retail end of the market

In effect they took the gap to capitalise on the fact that, while other investors are becoming increasingly fond of private equity as an asset class, the retail and smaller pension funds were excluded as a result of high barriers to entry.

Old Mutual Multi-Manager Private Equity Fund 2, launched in the second half of last

year, attracted about R400m in investments from institutional and retail investors.

To capitalise on growing demand for private equity investment, Momentum Wealth launched the Momentum International Private Equity investment on 1 October 2007 with a R1m entry level. This new product is aimed at pension funds, high net

worth individuals, trusts and companies, says Ivan Missankov, manager of the Momentum fund.

The product will invest internationally in a diversified selection of top-quartile private equity opportunities, including both primary and secondary funds in both developed and emerging markets.



Mark Gevers

Old Mutual Investment Group SA head of private equity Mark Gevers, says South Africa offers higher medium- to long-term growth prospects than many developed markets, and had largely offset the decreased lending appetites of many offshore lenders, thereby defying the slowing private equity trend seen abroad in the

wake of the subprime crisis.

"Though funding costs for private equity deals have risen somewhat, the expected returns have helped convince many investors to continue to participate in them. As a result, we have seen good inflows into our private equity products.

"Demand for our new fund has been even stronger than we expected, and we anticipate the fund's capacity will be filled shortly," Gevers said.

"Taking into account its gearing facility, the fund now has almost R800m under management that is directly exposed to private equity. Investors particularly like its multi-manager structure, which diversifies risk across at least four well-established managers and many different private equity investments."

The underlying investments in the fund include stakes in Consol Glass, South Africa's largest glass manufacturer; Nature's Choice Holdings, a frozen food wholesaler; Pepkor, one of the largest retail

chains; Life Healthcare, a leading hospital group; Oceanic Bank, a fast-growing Nigerian commercial bank; IT company Vox/Datapro; Plumblink, a plumbing and sanitaryware merchant; retailer Moresport, which owns Sportsman's Warehouse and Outdoor Warehouse; Kanderlane, dominant in the independent deployment of ATMs; and financial services broker Alexander Forbes.

By investing in Momentum's new product, individual investors and many pension funds will, for the first time, be able to access international private equity assets, with the associated returns and currency diversification benefits.

The International Private Equity product may be accessed via two products administered by Momentum. These include the Flexible Endowment Option (R1m minimum) or the RMB Investment Services Personal Portfolio (\$150,000 minimum), the latter being for investors wishing to make use of their R2m offshore allowance or

There has been a noticeable increase in transaction volumes over the last two years, and some of the biggest deals have involved foreign private equity players, such as Bain Capital.

Reserve Bank puts its eye on foreign transactions

Quite apart from this year's major deal involving Edcon, Alexander Forbes was bought and delisted from the JSE Securities Exchange by a consortium led by foreign private equity fund Actis, while local IT company Idion was bought and delisted by IS Holdings III, a wholly-owned subsidiary of US-based private equity fund Thoma Cressey Equity Partners, for nearly US\$65m.

According to Kevin Trudgeon, a director in Werksmans' commercial department, foreign buyers confront a number of legal issues when entering the local market: "One of the biggest issues is exchange control. The Reserve Bank wants to make sure that the inter-

est rates charged on these heavily geared transactions are market-related to avoid exporting capital from South Africa. Another issue is black economic empowerment (BEE), and foreign buyers need to be educated as to the necessity of an outcome which is BEE-compliant."

John Gnodde, partner at Brait Private Equity, says foreign players will remain interested, but will be more selective. "Pricing in the equity market was quite high until the end of last year. With prices having come off a bit, they'll continue interested, but most likely more interested in their own markets for now." ♦



Kevin Trudgeon

The rate at which black economic empowerment (BEE) transactions have been concluded has been on a roller coaster rise of late. During the latter half of 2007, the rate slowed, primarily driven by the rising cost and availability of debt, but those same reasons have, ironically, been the cause of a dramatic rise so far in 2008 - albeit far smaller deals.

The BEE roller coaster

The big funders of BEE – and there are only five – have been the major banks and life companies. The banks typically transact at rates linked to Jibor, but this rate has been increasing faster than the rate of growth of the underlying businesses – affecting legacy and new deals alike.

This is one area where the increasing cost of money and rising prices of assets has impaired the ability of many BEE groups to finance deals, because many BEE players do not have their own capital and need to borrow substantially.

Ross Randall, director and joint head of private equity at Standard Bank, says: “There are BEE companies that have realised earlier investments and are coming to the market for a second or third time, this time with their own funding.”

Cora Fernandez, deputy chief executive of Sanlam Private Equity, says: “A bank with a number of BEE-financing instruments on its books, will have experienced an increase in the coupon of their BEE financial instruments, assuming they haven’t hedged it out. The increasing coupon

would give rise to a deterioration in the “equity value” of the BEE vehicle, being the issuer or holder of the instrument. This deterioration is further exasperated by fluctuations – given recent developments in the stock market – in the valuation of the underlying asset, being listed shares. These factors could reduce the banks’ appetite for BEE finance.

“On the other hand, there are still many vendors ready to sell their business to black investors or introduce BEE partners, but the striking of deals depends on those BEE parties being able to obtain finance, and also depends on the credit rating of the entity.”

Apart from acting as a co-investor with the mega private equity firms like Sanlam Private Equity specialises in the BEE component of the mega (R5-R7bn) buy-out deals.

“Where a buy-out is taking place, and there is typically a requirement for a 25% BEE partner, we would finance that component subject to the return profile of the transaction and our return expectations being met. In other cases, where there is already an incumbent BEE party, we would consider bringing in another consortia of black investors. We have 13 black-owned investment companies we’re strategically allied with, and either we introduce one of them to a deal, or just as likely they supply the introduction,” says Fernandez.

Explaining the “huge increase” so far this year, Fernandez attributes this to the switch in focus from mega-deals to mid cap and small cap transactions.

“We believe it’s a consequence of the sub-prime issue. Foreign debt is no longer available for the mega-deals, with some exception in superior quality assets with good credit ratings, but local debt finance is still available for a conventional private

equity buyout valued at less than R4 billion.”

Ross Randall, director and joint head of private equity at Standard Bank, says there are still plenty of BEE deals being done, albeit more selectively



Cora Fernandez

“There are BEE companies that have realised earlier investments and are coming to the market for a second or third time, this time with their own funding. This is our target market because we usually require equity participants to come up with a degree of cash - and we’re now finding them,” he says.

While some people believe this defeats the purpose – it is not growing the total pool of BEE participation – Randall disagrees, saying true BEE is about converting opportunity into cash, “so selling one investment to do another is part of the deal.

“Private equity has, to a considerable degree, facilitated this process. Because of its use of leveraging, it’s a catalyst for BEE.

Catalyst

The model is a highly leveraged one, buying an equity stake with as much debt as possible in the company rather than in the BEE structure," explains Randall.

The private equity model for BEE requires the buy-in of the business owner, by selling a part shareholding today to realise greater value tomorrow.

Jacques Fourie, director and also joint head of private equity at Standard Bank adds: "Most deals we do have a BEE component, so we're constantly selling this model. Often, the owner will realise that a 75 percent stake of a bigger company is worth more than his current 100 percent."

Randall adds current market conditions

do not affect a deal, though it may impact on viability: "For us, we're seeing a very active market at the moment with a number of businesses for sale. Private equity is about investing for the long term – so our appetite for deals is related to our view as to what business conditions will be like for the next five years." ♦

At the venture capital end of the market, the current Eskom power farrago plays a greater role than the sub-prime crisis or even high interest rates. Business start-ups are all about confidence, and that takes a terrible drubbing when a small business' power can be cut at any moment.

Tough times ahead



Jo Schwenke

Small business financier Business Partners is in a league of its own, dominating deal numbers by far, but its total value is small within the total private equity industry.

MD Jo' Schwenke says if last year was a tough year in this market, 2008 will be tougher still. "Though we met our (challenging) budget for the year 2007, it required a lot harder work."

Among the funds at this end of the market are: Business Partners, HBD, Triumph

Venture Capital, BioVentures, Median Fund, Enablis and GroFin.

Schwenke adds: "With the consumer downturn, we had to be a lot more discerning in the deals we backed, and there were naturally fewer deals in sectors involved in retail, entertainment and franchising, and more manufacturing deals in the industrial heartlands such as the East Rand. We're being a lot more careful in any sector exposed either to the consumer, or to high gearing.

"Even good businesses, well run, are having difficulty meeting their repayments, where they're highly geared. When structuring deals in this environment, we're introducing a higher level of capital in order to reduce the gearing," says Schwenke.

"We met our targets in 2007, but it was a credit to our sales team, because it was far harder to achieve than in 2006. This year is yet another story. This time round the Eskom power is an added factor that will enter people's thinking, another reason not to start a new business, or expand an existing business, as they may not be able to power additional plant.

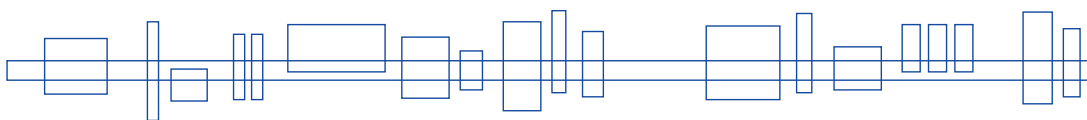
Business Partners has introduced a scheme to provide small business with loans to finance a generator, but Schwenke points out that the cost at up to R1m (average R50 000) a business, multiplied by 600 000 SMEs would finance a power station.

On average, small business needs to add 15% to its capex for co-generation, assets which are not productive to the bottom line, but simply a defensive measure.

"Some people will use this as an excuse to get rid of marginal operations, potentially destroying jobs, in addition to those not being created.

"I am nonetheless confident that, as with 2007, if everyone in the industry works harder this year the deals are there to be had," adds Schwenke

"Inflation is another concern. With CPIX having reached 8,6% this will inevitably fuel demands for wage increases. This year will consequently be a tough one. However, I am nonetheless confident that, as with 2007, if everyone in the industry works harder this year the deals are there to be had," adds Schwenke. ♦



The final quarter of 2007 was relatively quiet for most private equity funds, with the exception of the 'big guns.'

Tip-toeing out of 2007

Further to four exits during the quarter (First Lifestyle, Tsebo and two divisions of IST), Ethos made a US\$130m consortium investment into Nigerian-listed Oceanic Bank International plc. and have three other works in progress: Tiger Automotive (which will be paid out during the first quarter of 2008); Gold Reef Resorts (the scheme has since lapsed); and House of Busby, which awaits shareholder approval.

Ethos has received sufficient shareholder votes for the Tiger Automotive public to private deal to go ahead, while a substantial number of investors have already given irrevocable commitments to the Busby deal. A shareholders meeting is to be held shortly.

Actis Private Equity acquired a 2.0% stake in Nigerian bank, Diamond Bank, and has introduced additional expertise to assist the local management in its expansion plans. It next acquired Egyptian commodity business Sinai Marble, which is the leading marble exporter to Europe; and Nigerian bedding

company Mouka, which distributes mattresses across West Africa. One of Actis' biggest acquisitions was the buy-out of South Africa's Fuel RTT – the country's largest independent logistics firm, and the R3.8bn buy-out of Alexander Forbes. Finally, it invested in a marginal Nigerian oil and gas firm alongside a local partner, an acquisition from Shell. This is over and above the five exits achieved in Africa.

Brait Private Equity is poised to announce two deals, effectively concluded in December last year. Its five deals during 2007 mean it has now invested 45% of its \$880m fund.

Not all were acquisitions: Brait has invested R1.4bn in plant expansion at Consol. Before the sub-prime crisis fully impacted on the raising of debt in Europe, Brait raised a flexible package for Consol that permits the expansion and growth of the company.

RMB Corvest executed two deals in the final quarter of 2007. Through one of its earlier investments, Servest, the fund has now expanded into the UK. It financed

an MBO in 2006, and from October 2007 launched a strategy to globalise the firm.

Mike Donaldson, a director at RMB Corvest, which was a co-investor with Servest, says: "We moved the chairman to London, and with the acquisition of retail outsource cleaning company Ecocleen, we struck our first deal in the UK. This strategy takes the company into a different dynamic with more sustainable growth, plus the ability to leverage off their expertise."

"This was a very important acquisition both for Corvest and Servest."

Its second deal of the quarter was the co-investment with Safika (Corvest: 23%), in Micros SA, the Southern African agent for Micros International, which is one of the leading restaurant and hotel system providers in the world.

"It's an attractive deal because the restaurant/franchise and hotel industries are among the fastest growing in South Africa," says Donaldson. ♦

Most miss prime time

Ethos Private Equity timed to perfection four exits in three deals at the end of 2007, just ahead of the current market correction at a time when the JSE was at an all-time high.

Ethos partner Bill Ashmore says in the context of the past three years 2007 probably represented a cyclical high in the exit market.

"While there are always company specific factors that represent the primary driver of exits, it is always ideal if these can be timed to coincide with benign market conditions."

"It started with the sale of Dunlop in 2006 to Indian tyre manufacturer Apollo, followed by the disposal of First Lifestyle to Foodcorp for R1.2bn. In mid-2007 we then sold two businesses out of IST –

one to the JSE-listed Powertech (Altron) for R505 million, and a nuclear power business to Westinghouse a couple of months later. Our most recent exit was the sale of our controlling stake in hospitality and facilities management firm Tsebo Outsourcing Group to a consortium led by Absa Capital."

The transaction was for an undisclosed amount.

Tsebo CEO Clive Smith said Absa Capital had acquired 49.95% of Tsebo, which boasts an annual turnover of more than R2bn, while management of Tsebo had increased its stake to 20%. Black-owned companies Nozala Investments and Lereko Investments had each acquired 15% in the company. Vantage Risk Capital had contributed R200m in

mezzanine financing towards the acquisition of the company.

Smith said Tsebo's "track record" was testimony that empowerment linked with private equity deals worked. "Our partnership with Ethos Private Equity and Nozala Investments afforded us the space and flexibility to concentrate on developing new contracts and markets."

Tsebo is the largest player in SA's catering and facilities sector and owns Fedics, Equality Food Services, Tsebo Cleaning Services, Tsebo Retail Services and the Drake & Scull businesses.

There were few other private equity exits during this time, with the other deals being only Brait's listing of Kelly Group, and Standard Bank's sale of Defy to an offshore buyer. ♦