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Catalyst

Regulation 28 in the dock

Newcomer Trinitas stalking the mid-cap's

PE survey makes for sombre reading

Venture Capital loves the New Companies Act

SA's quarterly Private Equity & Venture Capital magazine

Catalyst

From the Editor's desk

How much longer can the lull in private equity deal activity continue? Unfortunately, there's no foreseeable end in the short-term to the global recessionary induced coma that the sector has slipped into on the dealmaking front. It's still a case of tending the investee business as a priority and waiting for the market to recover from an exit and purchase perspective.

The KPMG/SAVCA Private Equity Survey for calendar 2009, released in the second quarter, confirms the cautious approach being adopted by most within the industry. However, the report also points to some positives and the possibility of a rebound in 2011.

SAVCA's J-P Fourie, the man with his finger firmly on the comatose patient's pulse, believes that "the scale of activity in our industry continues to outperform most of the major international economies, which bodes well for South Africa's Government stated growth targets, as local and international research confirms that private equity investment is a key driver of entrepreneurial activity and growth in any economy."

Positive sentiments indeed during such gloomy times.

Another tonic comes in the form of a government policy that is still criticised by some high profile captains of industry as creating faux ownership, though the private equity and corporate advisory sectors will be breathing huge sighs of relief that BEE is still part of the prescription medication for the ills of Apartheid.

The fact that private equity's role in BEE has risen from R68,6bn in 2008 to R81,7bn in 2009, as highlighted by Warren Watkins in the Survey, demonstrates just how important this policy has become as a defensive hedge during economic downturns.

Private equity is especially effective in BEE deal mechanisms as it enables higher gearing. A combination of private equity investment and bank loans introduce sufficient leverage to facilitate the inclusion of management to acquire a significant stake in the company. This model also creates opportunities for the involvement of other BEE parties in the ownership and management of an investee company.

In the Trinitas profile on page 2 Cheryl Carolus, CEO of Peotona Group, the newly launched private equity fund's BEE partner, makes the point that many mid-cap companies have failed to take BEE as seriously as their larger peers. It is clearly an area that Trinitas and many others intend on targeting while the industry braces itself for an awakening. ◆

Catalyst

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Pension funds carry the responsibility of providing a means to a comfortable retirement for their members. To fulfil this responsibility, pension fund trustees must make appropriate allocations to asset classes in order to grow the fund's assets to satisfy the liabilities created by the payouts to retiring members.

Proposed regulations will pull the rug out from under private equity funds

Rory Ord

This asset allocation should be done by modelling the fund's assets and liabilities, taking into consideration the fund's risk profile, in an effort to determine an allocation with the highest potential to meet the fund's liabilities over the long term, thus ensuring an avenue to comfortable retirement.

Regulation 28 of the Pension Funds Act 1956 legislates the limitations on the percentage of a fund's portfolio that may be invested in specific asset classes. These regulations have been in place for many years and seek to give structure to asset allocations in an effort to prevent misallocations by pension fund trustees and their service providers. The Regulator has recently put forward draft amendments to Regulation 28 in an effort to update this legislation – to align with current investment practices.

Unfortunately, the draft regulation has created a large degree of uncertainty in South Africa's steadily growing private equity market. These sentiments are echoed by the Southern African Venture Capital and Private Equity Association (SAVCA). Under the existing Regulation 28, private equity is classified into either the "unlisted securities" bucket with a maximum allocation of 5% or the additional 2,5% earmarked for "other assets", which is generally interpreted as allowable for private equity investment. Though this total of 7,5% is considered a small allocation, the regulation is relatively clear and allows investors to plan their allocations and in turn private equity fund managers to plan their funds.

However, the current draft amendments to the regulation do not appear to consider private equity specifically, which leaves it as part of the "other assets" category thus limiting its allocation to 2,5%. Should this draft legislation go ahead, this would effectively reduce the allocation that pension funds can make to private equity by two thirds.

Another way to interpret the draft amendments to the regulation is to include private equity as part of "unlisted securities." However, assets in this category must now, according to the draft amendment, fall into a credit rating band. It is generally accepted that private equity investments cannot be ascribed credit ratings because of the equity nature of these investments.

> **The move to limit pension fund investment into unlisted assets may have the unintended consequence of hindering economic growth**

Furthermore, the proposed legislation does not consider "unlisted investments" outside of South Africa in its categorisation. Many South African pension funds see investing in the rest of Africa as a way to capture growth from these rapidly developing markets. Private equity is a likely avenue for investment into many African countries where stock exchanges are not as developed as South Africa's, and where few companies are listed.

Private equity as an asset class is a valuable part of a pension fund's portfolio as it allows the fund to invest in assets that have a low correlation to listed markets, as well as premium returns**. This value has been recognised by the world's largest pension funds. Many North American pension funds including the California Public Employees' Retirement System, have allocations of more than 10% to private equity, while others have more than 20%*. The Organisation for Economic Co-operation and Development (OECD) surveyed the limits that pension funds are allowed to allocate to private equity in 22 countries. Nine of these countries had no limit, while only 3 had limits as low as 5%. None of the countries surveyed had limits below 5%. Therefore, on a relative basis, the proposed limitation of 2,5% is very low.

Ord

The move to limit pension fund investment into unlisted assets may have the unintended consequence of hindering economic growth, as private equity is a key avenue of financing for small to medium sized companies looking for expansionary capital. A recent survey performed by SAVCA in conjunction with the Development Bank of Southern Africa (DBSA) showed that private equity investment into unlisted companies had an overwhelmingly positive impact on these companies, both in terms of profitability and job creation. The survey showed that more than 50% of the companies surveyed said that private equity investment had facilitated Black Economic Empowerment in their business, while almost half said that private equity finance was actually responsible for the survival of their business. A further, 64% of respondents felt that their companies would have grown less rapidly without private equity investment.

Private equity funds also have several attributes that make them favourable for long-term investments such as infrastructure, which may take many years to develop. Over the last 15 years, private equity investments have funded many such projects, including toll roads, mines and water provision projects.

In addition, the trend in pension fund investment towards sustainable investment, developmental finance and socially responsible investment may be hindered by the proposed regulation changes. The investment base of companies listed on the JSE is simply too small for South Africa's pension funds to invest significantly more in companies that adhere to these ideals. In order to allow pension funds to invest in this way, greater access to unlisted companies must be allowed.

South Africa's private equity industry has grown rapidly over the last 10 years, and now has assets under management of over R100 billion, much of which comes from institutional investors. Reducing the allowed contributions of institutions such as pension funds to private equity will be detrimental to pension funds and their members through lower risk adjusted returns and particularly threatening to the South African economy by reducing the access that small to medium sized companies' have to capital. ◆

Rory Ord is Head of Valuation and Pricing at RisCura Analytics

Even though deal activity in the private equity industry has been muted over the last 18 months the market has welcomed a new player into the mid-market space with the launch of Trinitas Private Equity in the second quarter.

Trinitas looking for mid-cap meals

The independent third party private equity fund was established by three experienced private equity executives Andrew Hall, Soteris Theorides and John

Stipinovich, are the funds Principals, with JSE-listed specialist banking and financial services group Sasfin Holdings as a partner and anchor investor.

Peotona Group Holdings, the women's' investment organisation headed by Cheryl Carolus, is the fund's BEE partner.

"Trinitas is a black-empowered, independent private equity advisor, formed as a joint venture amongst the Principals, Sasfin and Peotona Group," explains Hall. "The Principals have worked together as a private equity team since 2001, having previously managed two other independent private equity funds. The Principals' collective private equity experience of thirty-two years, and integral involvement in the majority of the twenty-one deals undertaken in two previous later-stage private equity funds, is the reason that the Fund is promoted as the Principals' third later-stage fund, albeit through the new platform of Trinitas."

Hall says that, despite raising funds in difficult conditions – it was initiated in 2008, coinciding with the collapse in glob-

> "It was a particularly difficult raising environment, but there continue to be pockets of interest locally for the mid-market space where Trinitas operates, and where there is use of lower gearing, and opportunities are deemed to be more favourably priced..."
>
> – Andrew Hall

al markets – the market's reaction was favourable. He puts this down to the collective experience of the team, coupled with two credible brands in Sasfin and Peotona, which provided the market with a convincing story and new entrant, in the mid-market space.

"We successfully raised R430m at our first close date of 1 March 2010. The fund will remain open for further commitments until the final close date of 31 August 2011, at which point we hope to have raised a total fund size of R750m – R1bn.

"It was a particularly difficult raising environment, but there continue to be pockets of interest locally for the mid-market space where Trinitas operates, and where there is use of lower gearing, and opportunities are deemed to be more favourably priced, than in the large cap sector."

It is this keen focus on the often neglected mid-market that lies at the heart of Trinitas's strategy.

"The [Fund's] mandate will take cognisance of Trinitas's perception of the value proposition offered by the mid-market sector," says Hall. "This mid-market sector, which is widely recognised in the local context as that market segment comprising companies with enterprise values of R100m to R1bn, is typically defined by larger private companies and smaller listed companies. A major benefit of the relative smaller size of companies in this sector is that prices are typically lower than larger listed comparables. These transactions would translate into an average investment size of R70m by the Fund per portfolio company."

At the upper end of the investment range, Hall says the Fund would look to syndicate transactions with other equity partners or Fund investors.

"The predominant rationale for the Fund's focus on the mid-market sector, other than the Principals' track-record and experience in this sector," explains Hall, "is the multitude of factors that drive value creation and superior investment returns. Whereas in many large private equity deals, the primary value driver is the use of high levels of gearing, the mid-market provides for a number of other value drivers, such as capacity for significant growth or expansion capital strate-

> ...."[M]id-cap enterprises have lagged the big corporates in BEE – an arena in which Peotona has a depth of skills and experience which management can tap into." –
>
> Cheryl Carolus

gies, the implementation of platform consolidations and favourable pricing parameters. These, together with the corporati-

Andrew Hall

sation of these companies, and the attainment of critical mass, typically result in the realisation of these investments at a premium to entry pricing parameters."

And the premium that Trinitas is hoping to achieve is at the upper end of expectations in this market with a targeted internal rate of return (IRR) of between 25 and 30 percent over the life of the Fund. Ambitious targets indeed in such tortuous economic times.

BEE, or perhaps the lack of focus by mid-market players on empowerment, will play a large part in the Fund's strategy and the link with Peotona should provide Trinitas with access to quality deal flow and place it in an advantageous position to achieve its stated IRR.

Outlining Peotona's involvement and role in the new fund, CEO Cheryl Carolus, says that it was decided some time ago to add private equity to Peotona's investment mix because of the "incredible business opportunities" it offers.

"Furthermore, mid-cap enterprises have lagged the big corporates in BEE – an arena in which Peotona has a depth of skills and experience which management can tap into," adds Carolus.

Many other private equity funds will be watching the developments at Trinitas unfold with great interest to see whether the strategy of accessing development finance institutions for funds and tapping into the underdeveloped mid-cap BEE space will prove successful. If it does, and there's a good chance it will, then this space could become the next big thing.

Values in the South African markets remain higher than international norms and while the industry is still cautious about 2010, it is expecting an increase in activity in 2011.

Down, but far from out

Despite a decrease of 2,6% in the volume of funds in the South African private equity sector from 2008 to 2009, the funds under management (excluding undrawn commitments) remained above the R100bn for the second year in a row at R107bn. This represents 3% of GDP value, despite the global recession of 2008, and remains unchanged from the 2008 percentage. In real terms, this is a drop from the R109bn in December 2008. However, this is still higher than the international norm of 2,7%.

These were some of the findings of the 11th annual private equity survey conducted by KPMG and the South African Venture Capital Association (SAVCA).

"The private equity market in Sub-Saharan Africa over the past two years has been characterised by caution," observes Warren Watkins, head of Private Equity for KPMG in South Africa and the Africa. "As a result, the appetite for deals has been reined back significantly. But while market participants remain cautious about 2010, a consensus is building that 2011 is likely to show a robust increase in activity."

BEE and emerging markets

Despite these challenges, some highlights from the survey show that a positive role is being played by private equity in market activities. In the Black Economic Empowerment (BEE) space, for example, the fact that R82bn of the total R107bn of funds under management is under the control of empowerment entities (R69 bn in 2008) is a positive development, showing an increase of 19,1% and illustrates the importance of this sector to the economy.

BEE-compliant fund managers have undrawn commitments of R23,4bn (the equivalent of 70% of the total of R33bn in undrawn commitments). The private equity sector significantly supports the BEE influence in the South African economy.

While funds to the value of R33bn in undrawn commitments remain available for future investment, most private equity houses believe that acquisitions made or likely to be made in 2010/2011 will yield returns well in excess of 20%. The 2009 survey clearly shows that the industry is down, but it is certainly not out.

Gazing into his crystal ball, J P Fourie, Chief Executive of SAVCA, maintains that, as an asset class, private equity has a proven track record for strong performance. "With its evolved business models focused on active value management, the industry is in a position to take on new challenges," says Fourie. "With the worst of the financial crisis hopefully over, emerging markets present an attractive case for investment. Local fund managers will be looking to increase activity on the continent."

The shrinking global market

Some additional findings from the survey show that fundraising was down by almost half with R6bn raised in 2009, significantly down from R11bn in 2008. Foreign investment, which is often termed sticky capital due its longer term nature when compared with volatile flows into listed stocks on the JSE for example, accounted for R4bn of the R6bn.

Watkins notes that "this foreign direct investment is encouraging as private equity is a longer-term investment of usually eight to ten years for the investor."

Investment in new or existing portfolio companies accounted for R7bn during 2009, showing a significant decrease from R19bn in 2008.

"This can be contextualised within the overall downturn of 43% in the South African mergers and acquisitions market," said Watkins. A further compounding factor was a shrinking global market in which

JP Fourie

the United States saw a reduction in 2009 to US$52bn from US$113bn in 2008, while the United Kingdom saw a drop to US$12bn from US$113bn in the same period and Germany saw a contraction to US$3bn in 2009 from US$20bn in 2008.

"It is also interesting to note, in these difficult economic times, that write-offs in South Africa increased from R31m in 2008 to R80m in 2009," said Watkins, "this is a very small percentage of the total R3,3bn in funds returned to investors in 2009. In contrast, European private equity funds wrote-off approximately R32bn of investments in 2009, representing 33%of all exits."

Watkins was particularly encouraged by the relatively strong performance displayed by emerging markets during the economic downturn.

"Many Private Equity funds globally see emerging markets as a significant growth area and it is inevitable that South African fund managers, with their particular understanding of the region, will look for investment opportunities in Africa as a whole to harness that growth," said Watkins. ◆

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Venture capital in South Africa - renowned for its high risk, high return investments - will benefit substantially from the new Companies Act, which will come into effect in 2010.

New Companies Act reduces the risk for venture capital

According to Eben van Heerden, portfolio and investment manager of Mark Shuttleworth's venture capital company, Here Be Dragons, venture capital companies are exposed to enormous risk as they focus on fast growing businesses – often without being involved in the day-to-day management of the companies. Major changes to the companies act including raising the bar on financial reporting and greater accountability for directors go a long way in helping manage this risk.

"As we have to rely hugely on executive directors to make best possible use of the finance, the new Companies Act gives us protection in that it ensures that directors carry out their responsibilities. It also provides a clearer framework to directors – which in the case of venture capital are often fairly new to the role – on what is expected of them.

"As we work with many young companies, it has always been a challenge to quickly get the standard of financial reporting to a very professional level." - Eben van Heerden

"Without accurate financial reporting, it is very difficult for a venture capitalist to identify problems in the business and know when to intervene. As we work with many young companies, it has always been a challenge quickly to get the standard of financial reporting to a very professional level. The new Companies Act helps us achieve this, as it has raised the bar on what is required from a legal perspective in terms of financial reporting," says van Heerden.

"Likewise, the new legal framework in the new Companies Act around well-structured and regular board and other committee meetings creates a healthier forum for group wisdom. It again provides the opportunity for the venture capital company to intervene more constructively in the strategy of the company.

"We have always encouraged our portfolio companies to adopt good corporate governance and compliance practices, since young companies tend to apply their energy elsewhere," highlights van Heerden.

"Corporate governance has for a while been seen as a purely compliance orientated procedure, but it is far more than that. It encourages good management of companies if followed correctly.

"As a result, the Act is expected to impact positively on the business environment for growing companies. It will 'force' younger companies to comply with matters that they should be complying with on their own volition. This has to improve the overall standard of business engagement.

"There are fairly few aspects of the new Act that impose unreasonable compliance orientated obligations on younger companies."

In fact, the act works in favour of young companies when it comes to business rescue. The new Act provides for a company in financial distress, in that it must go through the complex process of business rescue before it is liquidated. An individual will be appointed to manage the company's affairs and attempt to resurrect it. This will encourage both the entrepreneur and the venture capitalist to save a new business with potential, rather than exit a non-profitable company too quickly.

Growing businesses wanting to get to grips with the new Companies Act can start with the internet, which is a great resource with many summaries of the key aspects of the Act. ◆

Eben van Heerden

***Catalyst* caught up with venture capital firm Invenfin, which, since its launch in the third quarter of 2008 (*Invenfin hopes to reinvigorate the venture capital market, Catalyst Vol 5 No.3, 2008*) has reported that companies in which it has invested have enjoyed some good early successes, vindicating CE Brett Commaille's belief in South African innovation.**

Invenfin start-ups make global inroads

As a result, this wholly-owned subsidiary of investment group Remgro is taking a decidedly bullish view on further investment.

On a tour of three cities this month, Invenfin Commaille said the company's first two investments, in contextual advertising firm Ad Dynamo and gaming platform ChessCube, have fared encouragingly well in global markets.

Ad Dynamo currently delivers more than 300 million pay-per-click ads per month in a lucrative and expanding market made famous by search giant Google. The company is the first vendor globally to be certified by Microsoft to serve rich media interactive Silverlight advertisements, and recently debuted the first Silverlight advertising campaign for EA Games in the UK market.

Commaille says while it is far too early to draw conclusions, the development of Invenfin's investments so far have the company excited about future investment potential in the country's entrepreneurs

More than 15% of Ad Dynamo's revenue is generated abroad, and the company is being readied for expansion in the US and Europe. On the strength of Invenfin's investment, Ad Dynamo has been developing compelling digital marketing innovations and is aiming at winning a sizeable share of the valuable international market.

Invenfin's other internationally focused venture, ChessCube, the versatile gaming platform, has thus far attracted more than 1 million users in over 200 countries; making it one of the most successful chess platforms in the world. The platform is focused on live, online tournaments, which it recently launched successfully. The launch of its second game is in the pipeline for later this year.

Invenfin's third investment, in the development of a media property for a feature film has recently entered a joint venture with a leading international executive production company, to develop and sell these rights to a studio.

An additional two investments have been made recently. The first is an internationally patented tyre maintenance system, which is currently in the industrial design and development phase. The second represents a solution to the pressing crisis of acid mine drainage plaguing many of South Africa's mines.

Invenfin director, Joe Kieser, stresses the importance of a well packaged business proposal underpinned by thorough research including the required intellectual property rights attached to the business concept

Quality innovation, quality backing

Commaille says while it is far too early to draw conclusions, the development of Invenfin's investments so far have the company excited about future investment potential in the country's entrepreneurs. "The ratio of ideas presented to us versus ideas accepted is another proof point, as it is within global norms. It compares especially favourably with other emerging markets, such as Israel," he notes.

Joe Kieser

Invenfin director, Joe Kieser, stresses the importance of a well-packaged business proposal underpinned by thorough research including the required intellectual property rights attached to the business concept. "It must be patentable or otherwise capable of being legally protected," advises Kieser. "Even though we look at early stage development, we do require proof-of-concept or beta stage development."

In return, Kieser say that Invenfin will provide, "strategic support that combines focused expertise with access to substantial early-stage venture capital, as well as the international business networks and experience of Remgro, one of South Africa's most respected investment groups." ◆

Brett Commaille

SOUTH AFRICA PRIVATE EQUITY DEALS Q1 & Q2 2010

NATURE	PARTIES	ASSET	ADVISERS	VALUE	DATE
Acquisition by	Agri-Vie	equity stake in Dew Crisp	Bowman Gilfillan	not disclosed	Feb 3
Sale by	Link Private Equity to Aurora Empowerment Systems	45,7% stake (90 106 335 shares) in Labat Africa	Vunani Corporate Finance; Arcay Moela; Eversheds	R4,5m	Feb 9
Sale by	Labat Africa to Link Private Equity	all assets, subsidiaries and liabilities	Vunani Corporate Finance; Eversheds	R6,6m	Feb 9
Sale by	Pamodzi Investments to BlueBay Asset Management, Capitau SA Partnerships and management and staff	77% stake in Foodcorp	Capitua; Nedbank; J.P.Morgan; Rand Merchant Bank; KPMG; Cliffe Dekker Hofmeyr; Paul Weiss; Shearman & Sterling	R637,43m	Mar 10
Acquisition by	Investec Africa Frontier Private Equity	7% stake in OK Zimbabwe	Webber Wentzel	$4,4m	Apr 15
Acquisition by	Trinitas Private Equity	a stake in Le-Sel Research		R50m	Jun 17
Acquisition by	Mayibuye	64.9% of Blue Financial Services via a specific share issue plus debt financing	NM Rothschild & Sons(South Africa); Grindrod Bank; Garlicke & Bousfield; PricaewaterhouseCoopers Corporate Finance; Cliffe Dekker Hofmeyr	R163m plus R300m	Jun 21

International round-up

SAIL Group, a niche investment holding company, focusing on private equity investments in various companies within the marketing, sport and entertainment industry, has been renamed MARC Group Limited.

MARC Group will remain focused on private equity investments within the marketing, sport and entertainment industry and will also serve as the group's shared-services hub.

Two of the Group's wholly owned operating brands, CIRCA Hospitality and Navitute will be trading as SAIL. The refreshed SAIL brand will consolidate MARC Group's rights commercialisation business, focusing on sport and entertainment commercialisation; incorporating broadcast structuring, sponsorship structuring, stadium advertising, corporate hospitality, event rental services and event creation. The company looks for opportunity within South Africa, Africa and internationally. ◆

Bloomberg reports, citing London-based research firm Preqin Ltd., that private-equity firms saw quarterly fundraising decline 81 percent from the peak in 2008 forcing them to extend deadlines and scale back the amounts they seek from investors. Preqin data show it's taking almost four times longer to conclude commitments for funds of more than $1 billion than it did in 2004. At the same time, investors are becoming more discriminating. ◆

Business Wire reports that private equity-backed companies in the US weathered the "Great Recession" significantly better than comparable businesses, citing a new study released in the second quarter by the Private Equity Council (PEC).

The study found that the annualized default rate for the more than 3,200 private equity-backed companies acquired between 2000 and 2009 and held through 2008-2009 was 2.8 percent during the two-year recession. That compares to a 6.2 percent annualized default rate for similarly-financed businesses. ◆

According to ***Arab News*** the region's key players in the private equity industry are united in saying that Saudi Arabia is considered the next big market for private equity and venture capital investors. In fact, it is being projected that the Kingdom may become the center for private equity in the Middle East.

The region's key players made the announcement during the opening of the four-day "Outlook Saudi Arabia - Investment and Private Equity Summit. ◆

Investment blog ***AltAssets*** cautions that private equity firms could face a potentially huge drain on their profits as a result of proposals by the International Monetary Fund to help offset the cost of the bail-out and stock up reserves for any future shocks, according to reports.

The IMF has proposed a levy on banks, insurers, hedge funds, private equity funds and asset managers, which could include "a flat tax on the liabilities on their balance sheets and levies on profits and pay." The IMF has suggested that each country raise two to four per cent of its GDP through the taxes.

The new measures could cut into firms' pre-tax profits by as much as 20% according to the report, despite the fact that the private equity industry has long protested that it has had no part in the financial crash. ◆

Goldman Sachs' came out on top of ***Private Equity International's*** latest list of the largest private equity firms, supplanting last year's winner, TPG. PEI calculated that the Wall Street firm had raised nearly $55 billion for direct private equity investment over the past five years, up from the $49 billion that earned Goldman the No. 2 spot on last year's list.

Private Equity International's annual list ranks buyout shops by the amount of capital they have managed to raise over the last five years, as opposed to the size of their buyout deals. ◆