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From the Editor's desk

Hiatus in deal announcements won't last long

There were no surprises in the private equity industry during the first quarter of 2008 – everyone predicted there would be few deals, and sure enough barely a handful was announced.

The House of Busby and Tiger Wheels deals were finalized by Ethos in the R1 to R2 billion price range, and RMB Corvest executed a smaller deal with SA Dye and Pattern Company, but these were much smaller than the level of deals we became used to last year. Since the first quarter, the private equity sale of Tourvest to Guma Tourism has been announced.

Since last year, most private equity houses have been saying they are busy as ever and continue to say so, with some optimism that the number of deals for the year will not be lower than last year, though clearly the value will be substantially down.

It may also be a difficult time to exit investments. Last year's listing of Kelly Group, the first such listing from private equity since 2004, now looks more like an isolated occurrence than the start of a new trend.

While there are hints from abroad that credit is becoming slightly easier, locally it may yet get tougher still for completely different reasons. In Europe, Basel II has already been in force for some time, but the local banks are only now starting to implement its risk assessment policies. Each investment will now be assessed according to more serious thinking than in the past, especially concerning its impact on the bank's capital reserves.

One trend gaining ground in the local market is that of specialised private equity funds. There are already three funds dedicated to the property sector, and the emergence of Pamodzi Resources Fund is a classic example of the direction the industry will take in the coming years. A number of Savca members are currently known to be looking at raising funds dedicated to sub-Saharan Africa, where a great deal of interest – and deal-making – is currently occurring.

One reason why private equity will continue to do deals irrespective of the credit situation, is the extent to which target companies benefit. The successful listing last year of Kelly was the first ever case of a target company going full cycle through the stages of a private equity investment, from delisting to value-add and back to a listing.

Most funds have capital available, capital that can be used to expand businesses out of the public eye, and without the need to report short-term profit increases.

As RMB Corvest's Mike Donaldson explains: "That's where private equity really adds value – the strategic long-term input to the board, and directing the company to where it should be."

Eamonn Ryan
Editor

Catalyst

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Contents

According to the just-released KPMG/Savca Venture Capital and Private Equity Industry Performance Survey 2008 (reporting on the year 2007), South Africa's private equity industry was in buoyant mood last year. There was a massive 46% increase in funds under management to R86,6bn, inclusive of undrawn commitments of R31,7bn (up from R14,4bn in 2005).

Private equity comes of age in SA

The industry has enjoyed annual growth of 14% since 1999, and has leapfrogged to 11th in the global rankings from 12th.

As a percentage of GDP, the South African private equity industry accounted for 2,8% in 2007, compared with 1,7% in 2006 and a global average of 2,1%. In many other respects, South Africa now ranks on a par with the global average, and in some cases better. From a relatively lowly position in 2006, last year the local industry tracked the global trendline of fund raising to be ranked 18th globally in value.

At R15,3bn, last year recorded the highest ever level of fund raising, dominated by the R10bn raised by Pamodzi Resources Fund 1. Of this total, 64% was sourced from the US, which is now the highest contributor of all funds raised to date and not yet returned to investors. But if Pamodzi, which raised almost the entire fund in the US, is excluded then 92% of the remaining R5bn came from South African sources, signifying a greater understanding of the asset class by local pension funds and private investors.

Another change during the past year, was that two-thirds of the inflows came from fund of funds, whereas in previous years most capital was sourced directly from pension funds and public finance institutions both locally and abroad.

In presenting the KPMG Savca report, KPMG associate director for private equity markets, Gareth Druce, said the capital raised by private equity last year compared favourably with that raised on the JSE.

With R25,5bn of equity deals announced, activity levels were 270% up on the previous year, dominated largely by mega-deals, such as the Edcon deal (total funding, including debt: R27,1bn); Alexander Forbes (R8,9bn); Primedia (R7,3bn); and Consol (6,6bn).

Reflecting the larger deals last year, Savca says the average equity cheque increased more than threefold to R95m from R28m in 2006 (excluding the deals by venture capital firm Business Partners, whose 577 deals, or 69% of the total number, average about R1m).

As a percentage of GDP, the South African private equity industry accounted for 2,8% in 2007, compared to 1,7% in 2006 and a global average of 2,1%. In many other respects, South Africa now ranks on a par with the global average, and in some cases better

"Private equity now accounts for 10% of total M&A activity, and while this has grown, it is barely half of the level in Europe, indicating the industry still has some room to grow," says Druce.

Described as a percentage of total

Gareth Druce

GDP, the activity level of private equity leapt from 0,4% to 1,3%. Druce says this is another statistic where South Africa now matches the international norm, in this case 1,4%, where previously it lagged.

In terms of sectors of investment activity, Retail was the largest sector, attracting 43% of all investment, followed by Infrastructure which surged from just 1% last year to 9% this and with more anticipated to come, and Mining & Resources, which was the big loser, falling to 4% of the total from 27% last year.

Druce expects the contribution of Mining & Resources to recover in the current year, with resources fund Pamodzi having now raised its Fund I and looking to invest.

In the business lifecycle, private equity targeted Expansion & Development last year, where 42% of all investment capital went (compared to 52% in 2006). Druce says this is typical of a developing economy, and compares with 21% in Europe, which is more typical of a developed economy.

As a result of Edcon, Alexander Forbes and others, there was a surge in buy-out activity, from 14% in 2006 to 36% last year. Seed capital, at 4% by value, was as usual minimal, though not representative of the number of transactions, 22%.

A total of R56,9bn was invested by private equity in the largest 10 deals last year, though this figure includes the debt component of deals.

Private equity has long boasted of its 'virtuous cycle' with black economic empowerment (BEE) and this year's Savca figures reflect that boast. Fully 69% of all funds under management are managed by at least black-influenced companies or above (according to the Department of Trade and Industry definitions within the Codes), or government captives. This figure increased 35% last year to R59,7bn, largely due to the fund raising by Pamodzi.

There was a 118% increase in funds returned to investors by exits, to R9,6bn. The most common means of exit was by sale to another private equity institution (R3,5bn) followed by trade sale (R2,8bn). The year also produced the first exit via a listing since 2004 – that of Kelly Group. Druce says there were no IPOs during the year.

Thirty-five of the 38 respondents reported on their profitability. Their realised disposal proceeds of R8,3bn came from a cost of R2,7bn, implying a more than threefold return. On the unrealised R57,3bn, the cost of investment was R35,7bn for a multiple of 1,6 times. Druce says most private equity firms are being conservative in their accounting policies, and there remains plenty scope for further profit on realisation.

Captives appear to be the most profitable, with 10 of 15 reporting internal rates of return (IRR) over 30%, whereas only eight of 20 independent funds achieved the same level of return.

Of the 35 funds, only 11 earned IRRs of less than 20%: this compares with an average 16% return from the JSE over the past 10 years. Four independents and four captives each reported an IRR in excess of 40%.

Druce notes that these are gross returns, before management fees.

"This is what has come to be expected of private equity, and is the reason that pension funds and private investors are increasingly interested in getting involved in the asset class," says Druce. ◆

The cheap and easy debt of this time last year is gone, and this has affected the structure of deals. In fact, very few deals have been announced, but that does not mean capital is impossible to find – it just means the viability of deals is being looked at much more closely, given that capital is more costly and comes with more stringent terms.

Goodbye (for now) to the easy life

Ngalaah Chuphi

Whereas deals were once financed with huge balloon payments at the kill, now they require regular monthly instalments throughout the term.

It is thought unlikely that the larger deals can currently be structured as highly leveraged as was the Edcon deal last year. However, few deals and certainly no large deals have been announced, to prove this point.

Ngalaah Chuphi, a senior executive at Ethos Private Equity, explains the dilemma. Before the credit crisis, the spread of deals that Ethos would look at was R1-R20 bn. Of those, on deals above R7bn, Ethos would have to look to the European high yield market for capital.

"That's now completely dried up," says Chuphi. Depending on the quality of the assets, local banks will still look at a deal, but on far different terms.

"The rate in recent months has increased 450 basis points (bps), and the margin charged by the banks has also increased. They used to charge 170 bps above the repo rate, but now charge 345 to 400 bps above.

"For a good asset, you can still get local funding, but it's more expensive. For a poor asset, you will not get debt at all, and will have to fund the deal entirely through equity, which is not the most cost-effective model," adds Chuphi.

Sean McPhee, director of Ernst & Young Transaction Advisory Services, says he expects to see more equity injected into

The rate in recent months has increased 450 basis points (bps), and the margin charged by the banks has also increased. They used to charge 170 bps above the repo rate, but now charge 345 to 400 bps above

such large deals or perhaps more club deals.

"We're not likely to see any of the big public to private deals using the same debt structures for a while as a result of the higher cost of debt, unless the transaction structure is changed. In addition, in some of the deals concluded last year using the high yield bond markets to raise capital – such as Edcon and Consol – we see the bonds trading at significant discounts and as a result the high yield bond market has dried up.

Stephen Brown, director of RMB Corvest, explains that whereas over the past few years a deal could be leveraged almost 100%, that's no longer possible.

"Structuring a target company's balance sheet was one of the major benefits we used to offer a target company, but in this environment what we bring is limited to the cash we can invest," says Brown.

Fellow director Mike Donaldson adds: "We're struggling to raise senior debt on some of our transactions, and the terms have changed significantly."

Peter Schmid, CEO of Actis Private Equity says it is a matter of being selective: "Local banks will still fund a deal if it is in the right sort of business, involving a business with the right market position and track record, with strong cash flows and operating margins."

Finding those businesses is harder, he agrees, because the environment is tougher, "and any business exposed to the retail cycle will be coming under enormous pressure from interest rates, except food retailers and anyone who sells for cash."

Unlike some who claim they see an end to the sub-prime issue – however distant that end might be – Schmid warns "there is still a long way to go, and international debt markets will be closed for a long time."

In the latest quarter there has been a spate of losses reported by investment banks, as well as retrenchments announced by major international investment bankers such as Merrill Lynch.

"It will take at least 12 months before we see light at the end of the tunnel, and until then there is very little debt available from international banks," says Schmid.

Warren Watkins, KPMG head of private equity markets: Africa region, is a little more optimistic though cagey about the time frame. He says: "There's a sense internationally that the attitude among international banks is changing slightly – and there is more activity in the investment space."

He argues that the large private equity houses have raised massive funds, and the money "has got to go to work. Whether it's still this year or next, I don't know, but the cycle will swing back," says Watkins.

He lists one major attraction for banks to invest in private equity: "Globally, the average bad debt in private equity is about 1%, whereas the average global bad debt level for corporates right now is about 4%. Given that, it has to gain in favour." ◆

Catalyst Deal of the Year

DealMakers, *Catalyst's* sister publication, unveiled the Deal of the Year for 2007 at a Gala banquet held at the Sandton Sun Hotel on February 27. This was the eighth annual gathering and the event was attended by approximately 450 guests. At the same function, *Catalyst*, the private equity and venture capital magazine, announced it had selected the buyout of Edcon by US private equity giant Bain Capital, as its Private Equity Deal of the Year. The deal was valued at R25bn and stood head and shoulders above the competition for 2007. Mark Bower accepted a specially minted Gold Fields' gold medal on behalf of Edcon. ◆

Deal of the Year: Mark Bower (Edcon) receives the award from David de Mardt (Chivas)

European governments and unions are taking a critical look at private equity, with last year's February 27 conclave of private equity heavyweights having been characterised as 'locusts' and 'asset strippers' by union protesters brandishing placards .

Better communication will reduce angst associated with PE

In contrast, government and the unions in South Africa are big supporters of, and indeed investors in, private equity as an asset class. Many of the public finance corporations such as the Industrial Development Corporation, the Development Bank of Southern Africa and the Public Investment Corporation have key private equity or venture capital units.

> **National Treasury has no special focus or committee looking into the private equity industry, and there has been no noticeable fall-out on the scale of Europe**

The demonstration at last year's annual Super Return Conference in Frankfurt was just the latest protest against the growing clout of private equity in Europe. Inside the hall the talk regularly turned to why private equity's image has gotten so tarnished and what participants could do to restore a bit of lustre to their industry.

Much of the overseas grumbling about private equity stems from the growth and sheer economic impact of private equity, where massive $22bn deals brought the industry onto the radar screen of 'the public interest'. A similar pattern emerged in South Africa last year following the R27bn Edcon deal.

Even in Britain, which boasts the most active private equity market in Europe, muttering by trade unions over job cuts escalated into a public outcry. The controversy arose at a time of unease in Britain over record numbers of corporate takeovers, huge bonuses and salaries in the financial sector. Politicians criticised the industry for its lack of transparency and the amount of debt foisted on takeover targets.

Similar concerns have been expressed in South Africa as a number of listed companies have been taken private in recent years – but the local private equity industry remains far smaller than that in Britain. With R86,6bn of funds under management, that's a smidgen under 1,4% of the total market cap of the JSE.

"It's seen in South Africa, not as a threat to financial markets but as a facilitator of listings," says Warren Watkins, KPMG head of private equity markets: Africa region. That there have been so few initial public offerings (IPOs) as an exit strategy from private equity investments is more a reflection on the economic merits of a listing compared with alternatives than any hostility to the stock market, he says. There was not a single IPO as an exit from a private equity investment last year, according to the May 2008 KPMG Savca report.

Jon-Pierre Fourie, executive director of the South African Venture Capital Association (Savca) says his organisation is in regular contact with government, and especially the National Treasury, on the contribution of the industry to the national economy, as well as on tax and other regulatory issues such as 'carried interest.'

"At this time there is no special focus or committee looking into the private equity industry, and there has been no noticeable fall-out on the scale of Europe," says Fourie.

He claims the South African industry has been in the fortunate position of having learned from the experiences of their North American and European counterparts, "and as a result our Savca members have learned to consider the views of their wider stakeholder base, and to communicate to them," he says. "But private equity firms still need to be diligent in their reporting."

The European industry is making moves to get out in front of the issues and to stay one step ahead of regulators who might seek to rein it in.

Fourie says Savca is doing the same. "One initiative we have under way is to quantify the private equity impact on GDP numbers, in terms of exports, job creation, management development and listing of businesses. We need to do a better job explaining what we do." ◆

Warren Watkins

The South African legal profession is unlikely to become a target of private equity, as is currently starting to happen in the UK. There, Lyceum Capital has become the first investment house openly to target legal services ahead of sweeping deregulation of the UK profession.

SA law firms aren't about to be PE targets

In South Africa there are still too many statutory impediments to make law firms attractive targets, with significant restrictions on ownership, voting and profit sharing in law firms placed on non-attorneys. It follows that any acquisition in this county would have to be along the same lines as the original deal between Nedbank and Edward Nathan Friedland (today called Edward Nathan Sonnenbergs, though no longer owned by Nedbank). To implement that transaction the practice was split between reserved and non-reserved work and the latter housed in a separate company, which was then sold to Nedbank.

Michael Katz

Lyceum aims to use its fund to finance mid-tier UK law firms doing bulk work and looking to expand. The economies of scale for large firms have been adequately demonstrated in the local market where there has been something of a wave of mergers in recent years: most recently with several of the large firms – Werksmans, Edward Nathan Sonnenbergs and Webber Wentzel Bowens – each having executed mergers.

However, it is more than a year and a half since the merger of corporate law firms Edward Nathan and Sonnenberg Hoffmann Galombik. Many firms then questioned the viability of such a merger, but Michael Katz, chairman of the merged entity Edward Nathan Sonnenbergs, believes their experience has put the case to rest.

"The merger has proven itself from both the financial and professional perspectives. Our expense-to-turnover ratio has improved dramatically. There are certain facilities every law firm needs irrespective of size - a library, human resources department, marketing and others, and the larger the firm the lower the unit cost of these. It is borne out in our improved profitability," says Katz.

"The benefit is even more marked in the professional space, where a major M&A deal can require working teams of as much as 10 different disciplines, including M&A, tax, competition law, financial structuring, employment law, IT pension law and a number of other specialist areas such as telecommunications, depending on the particular business of the client," says Katz.

"This demonstrates that if you want to compete in this space, you need to be a large corporate law practice that can service all the requirements of the client."

The Edward Nathan Sonnenbergs merger remains the biggest in the industry. Katz says he remains convinced of the benefits of scale, and the fact that the industry has not been caught by merger mania does not imply others have not bought into the philosophy.

"Once you're persuaded as to the rationale of scale, that's only half the challenge: you next have to find the right partner. We were fortunate in finding in each other the perfect match, complementing each other in terms of geography, professional skills, management, transformation and value systems," says Katz.

Most private equity houses, though they try not to take over the operations of a target investment, certainly like to have a say in the running of the business. That's difficult in the case of a law firm, because they typically have a very flat structure and operate by consensus between directors

The Webber Wentzel Bowens-Mallinicks merger also joined a Johannesburg with a Cape Town firm.

Kevin Trudgeon, a director in Werksmans' commercial department, says he does not anticipate any immediate private equity interest in the legal profession, "as long as the regulations restrict non-attorneys from sharing profits, voting and the like."

There are several other reasons why private equity is unlikely to be interested, he says: "Most private equity houses, though they try not to take over the operations of a target investment, certainly like to have a say in the running of the business. That's difficult in the case of a law firm, because they typically have a very flat structure and operate by consensus between directors. It is, therefore, much harder for a third party to come in and direct affairs than in a typical company. There are also legislative restrictions on voting rights placed on non-attorneys."

As Nedbank also found when exiting Edward Nathan Sonnenbergs, a transaction on which it lost substantially, the exit strategy is also difficult. Private equity typically prefers to exit by a trade sale or listing, neither of which is likely in the case of a law firm.

"I don't know if there will be trade buyers, and under current regulations it is not possible to list a law firm – so how do they exit?" asks Trudgeon. In the absence of a viable exit strategy, a buyer will want the sellers to underwrite their profits, and Trudgeon believes most attorneys are too conservative to do that.

From the profession's point of view, Trudgeon believes there may be interest in an outside investor if a private equity firm produces a big enough cheque, but business would thereafter become a balancing act for the attorneys.

The thing that keeps attorneys in practice as opposed to joining commerce and industry, is their independence, and this would most likely be lost in a private equity transaction, says Trudgeon. "I think loss of independence would be one of the main fears in such a deal – and it is not the way of private equity to leave a target firm independent."

That balancing act may be tipped in favour of private equity involvement, should regulations be passed permitting non-attorneys to participate in the profits of law firms. There is a push in that direction, says Trudgeon, but not from the perspective of private equity.

"What's driving this idea is a desire by many firms to become multi-disciplinary practices. If a firm wants to specialise in tax, for instance, it needs accounting as well as legal expertise, and not allowing non-attorneys to be shareholders in the firm makes it difficult to operate in such fields. If the regulation on the issue of ownership was to change, it might also permit a law firm to list, and private equity might then be more interested.

Kevin Trudgeon

"But for the moment, they would probably to put off by how to incentivise management to continue to deliver profits, and how to exit their investment," says Trudgeon.

The tax treatment of private equity profits has unleashed a debate both here and in the UK and US. It is now often said that private equity has become the sport of the super-rich in London and New York, which has prompted the British and American public to express their outrage at the way private equity profits are taxed in those countries.

The Private Equity Debate

Cornwell Dauds

The governments of both countries are facing severe political pressure over the issue and lawmakers have begun to look into reforming the favourable tax treatment enjoyed by private equity fund managers on their profits.

As an emerging economy, SA is very dependent on investment and, like all economies, the SA government uses various levers at its disposal, including tax measures, to encourage investment. Though National Treasury has acknowledged the benefits of private equity by stating in the 2008 Budget Review that private equity transactions can contribute to economic growth in various ways, the tax benefits thus far enjoyed by private equity fund managers have come under attack.

Private equity funds are often set up as partnerships which in turn comprise a number of investors, mostly institutional, such as pension funds, etc. If set up offshore, the fund will typically be organised as a limited liability partnership (an LLP) and, if set up onshore, it is legally known as an en *commandite* partnership. Often the limited partnership will have a general partner (GP) who is responsible for the management of the affairs of the partnership. The GP is rarely an individual – in fact, in most cases it is itself a partnership consisting of a number of individual partners.

Alternatively, the funds of the partnership (the investors) may be managed by an investment management company (though this may be unwise as the same profits will

> **" . . . the tax treatment of management carried interest (reward for fund managers in the form of shares/equity) will be investigated. Given the complexities involved, a discussion document will be developed to raise options and elicit public comment"**

be taxed twice – when they are earned and again when they are distributed). The brief of the GP or investment management company typically includes the identification, evaluation and negotiation of investment opportunities, and the monitoring and realisation of those investments on behalf of the fund. For this the GP or management company earns a management fee, typically of 2% of the fund value.

To align the interests of the fund manager with those of the investors, the GP or investment management company may be required to co-invest with the investors in the fund. This requisite co-investment is typically as little as 1-2% of the total capital in the fund. In return, the fund manager typically becomes entitled to up to 20% of the total growth of the fund.

However, 18 – 19% of this entitlement (the 20% of fund growth) is only triggered once the fund manager has achieved a certain agreed level of performance and the ordinary investors have received their specified return. Since the fund manager only contributes 1-2% of the fund's capital, yet gets a 20% share of fund growth, 18-19% is what is often referred to as carried interests (the carry).

The fund manager does not receive the carried interests in return for any corresponding capital contribution. Instead, the carry is based solely on the fund manager's performance which has thus far, in SA, the UK, US and Canada, enjoyed favourable tax treatment in that it has attracted tax at the capital gains tax (CGT) rates instead of the ordinary rates with a maximum of 40% for individuals. Fund managers often organise themselves into partnerships so that the carry is taxed in their hands as individuals at the effective CGT rate of 10%. This favourable tax treatment has unleashed vigorous debate worldwide with commentators taking very strong positions on both sides of the spectrum.

National Treasury's reaction to the debate is encapsulated in the Explanatory Memorandum on the Revenue Laws Amendment Act, 2007 where it said that:

> *"It has come to Government's attention that a number of private equity deals involve management carried interests. These carried interests represent a form of services which should be taxed at ordinary rates"*

Having thrown down the gauntlet to the private equity industry, National Treasury promptly back-tracked and sounded a more conciliatory note in the 2008 Budget Review acknowledging the positives of private equity deals, but also noting that:

> *"... the tax treatment of management carried interest (reward for fund managers in the form of shares/equity) will be investigated. Given the complexities involved, a discussion document will be developed to raise options and elicit public comment"*

Are the carried interests which fund managers earn capital or revenue?

There appears to be agreement that the growth in the investment of the ordinary investors represents a capital gain and should be taxed as such since the shares purchased on behalf of these investors are typically held as capital assets. However, it is contended by some commentators (a view seemingly shared by National Treasury) that when 18-19% of these shares/equity (which appreciated in value) are transferred from the investors to the fund manager as reward for the latter's performance, these shares change character and become ordinary income in the hands of the fund manager and should accordingly be taxed as such. This treatment is supposedly supported by the argument that the shares, held as capital by the investors, actually represent compensation for services rendered by the fund manager, more specifically, they represent performance fees.

A counter-argument is that these shares should not change character when they flow from the investors to the fund manager – even if the fund manager provided services rather than capital. To do so would be to impose an artificial re-characterisation on the shares. What was capital in the hands of the investors should remain capital in the hands of the fund manager, unless the latter clearly makes the decision to acquire and hold the shares as trading stock.

The tax treatment of interest payments

Interest deductions in relation to debt are generally an allowable expense. Private equity transactions tend to involve a significant degree of debt. The deductibility of interest payments in these deals is now under attack. In the 2008 Budget Review, National Treasury made it clear it believes that some private equity deals, particularly highly leveraged buy-outs, have the potential to undermine the tax system. Treasury has also noted that the deductibility of interest payments in highly geared transactions will be investigated.

This approach is not unique to SA. On

Cornwell Dauds

March 8 2007, the UK economic secretary to the Treasury, Ed Balls, announced at London Business School that a review would be undertaken of the rules on interest deductions for private equity backed acquisitions[1]. It seems the global credit crunch has made some national governments jittery as they fear a decline in tax revenue and now wish to make up for this by increasing the tax take from private equity deals. ◆

Dauds is Tax Manager, Edward Nathan Sonnenbergs

This article first appeared in the May 2008 issue of **without prejudice**

1 June 2007, International Tax Review, p.1

Banks may have lost their appetite for lending, but there's no shortage of capital in the world looking for a home. The higher cost of capital has skewed buying patterns of businesses, favouring those with cash.

No lack of rivals to private equity

Current market conditions favour trader buyers over private equity, says Sean McPhee, director of transactional advisory services at Ernst & Young Advisory Services.

"In the past, when an asset becomes available, trade buyers were typically outbid by private equity in an auction process, because of the latter's cheaper and easier access to capital. But with capital now more expensive, affecting the margin of many private equity houses, and because valuation levels are so much more reasonable, this creates a lot of opportunity for trader buyers," he says.

Sean McPhee

Another potential rival to private equity is the recent emergence of sovereign wealth funds (SWFs), which are reputed to have trillions of dollars to invest. These have been quiet in South Africa in the first quarter of 2008, but they were previously active, says McPhee.

SWFs have fostered new alliances with private equity to avoid scrutiny. SWFs already account for approximately 10% of private equity investments globally and should grow further in the next few years.

The 20% stake in Standard Bank bought by Chinese financial institution CBC is most likely backed by a SWF, and the consortium that acquired the Victoria & Alfred Waterfront in Cape Town was certainly led by one.

"They've probably not been evident in the South African market in recent months, but I have no doubt they're sniffing around emerging markets, particularly Africa. That's because they appear to have a specific attraction for mineral extraction, power and infrastructure projects.

"The demand for such investments is coming largely from the East, especially China, and some from the Middle East," says McPhee.

The other fast-growing economy is India, which is not a substantial player in SWFs, but is as a source of direct, corporate investment.

According to Global Insight's new Sovereign Wealth Fund Tracker report, SWFs now represent the most powerful sector of global investors with a combined sovereign wealth reaching US$3.5 trillion in 2007. Global Insight is a leading economic and financial analysis and forecasting company.

The report found that SWFs have been growing at a healthy 24% annually for the past three years. Nigeria has grown its sovereign wealth the most rapidly over the last five years, followed by Oman and Kazakhstan. The largest player remains China, followed by Russia and Kuwait.

Armed with such large amounts of debt-free cash, SWFs are becoming the new financial power brokers, replacing the combined financial muscle of hedge funds and private equity.

According to the Tracker report, in 2007 SWFs injected up to $80 billion into bank shares or bank equity stakes in the US alone and are expected to provide even more capital in 2008 and 2009.

Riding the wilting dollar, together with the energy and commodities boom, SWFs will continue to be the key players in the changing financial landscape of a global economy thrown into stagnation by the credit crunch.

The push factor behind this growth is believed to be record inflation in SWF countries China, U.A.E, Saudi Arabia, Russia and Kuwait, creating pressure to invest domestic money abroad.

Another potential rival to private equity is the recent emergence of sovereign wealth funds (SWFs), which are reputed to have trillions of dollars to invest. These have been quiet in South Africa in the first quarter of 2008, but had previously been active

In January 2008 alone, worldwide acquisitions by SWFs totalled $20,6bn or nearly one-third of the total $60bn that SWFs made in mergers and acquisitions (M&A) for the whole of 2007. SWFs accounted for 35% of world M&A activity in 2007, exceeding the average 20% M&A activity from private equity buyouts. ◆

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

Catering to the retail end of the market

Paul Boynton

Their purpose was 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.

Of Old Mutual Investment Group SA (Omigsa)'s almost R20bn invested in alternative investments, about R8bn is invested in private equity of which R1,5bn is in two multi-manager products.

According to Omigsa head of the alternative investment boutique, Paul Boynton, of its two multi-manager tranches the first R500m was launched in April 2006 and the second, Old Mutual Multi-Manager Private Equity Fund 2, was launched in September last year, ultimately attracting about R700m in investments from institutional and retail investors.

Boynton says: "Although funding costs for private equity deals had risen somewhat by the end of last year, 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.

"Investors particularly like its multi-manager structure, which diversifies risk across at least four well-established managers and many different private equity investments."

The two funds are invested in two of Omigsa's own private equity funds, as well as with funds of the major players in South Africa: Ethos, Brait, Actis and black empowerment firm Lereko Metier.

The above-average returns earned by private equity are well documented – it has consistently outperformed equity investments – but its twin challenges have been poor liquidity, and high risk through concentration within a single fund.

The multi-manager approach, at least as offered by Omigsa, addresses both those problems, says Boynton.

"A private equity investment is a concentrated bet, and we rather recommend that investors go with a multi-manager product that diversifies the risk across five or six funds," he says.

Private equity is also a riskier bet than listed equities, and Boynton recommends that investors should only invest at most 10 percent of their portfolio in the asset class. With Omigsa, the minimum investment is R100 000 and, because it is a complex investment to market, it is only available through the Fairburn life wrapper.

"Ordinarily with private equity, the investor is locked in for as long as 10 years. Our investment period is also 10 years, and it should be emphasised these are not short-term investments, but Old Mutual has agreed to make a price and buy back units at a 5% discount to the latest valuation. This addresses the second major drawback of private equity," he says.

Momentum Wealth launched the Momentum International Private Equity investment on October 1 last year with a R1m entry level. ◆

Migration to the Cape

Cape Town, the traditional home of fund management in South Africa, has largely lost out as the home of private equity. Except where it is an adjunct to fund management, as in the case of Old Mutual and Sanlam, the major private equity houses are all to be found in Johannesburg.

That may be starting to change. Two new and as yet unannounced private equity funds in the R750m to R1bn range, are said to be about to open in Cape Town.

Might this be the beginning of a new geographical realignment?

For example, Santam CE, Ian Kirk, attributes at least a part of the success of its business to its Cape Town location. "Quite apart from any other attraction of the business," he says, "our people are not generally keen to move. It is a factor." ◆