Catalyst

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Venture Capital Ecosystem Unpacked

Section 23M's Anomalies Explained

Secondaries Market Heating UP

Q3 PE Deals Inside

FROM THE EDITOR'S DESK

Private equity in South Africa, and the rest of the sub-Saharan African region, continues its steady roiling boil, so much so that some are even warning of a possible bubbling over. Bubbles are usually created when a flood of capital flows into a sector, chasing yield, and inflates asset prices to a level so far removed from their fundamentals that there is an eventual bursting of the bubble.

According to research out of UK-based international think tank, Overseas Development Institute, a bubble may be forming in sub-Saharan Africa's emerging private-equity market. This is because too many overseas funds are targeting a small number of companies capable of absorbing international investment.

Private-equity firms in sub-Saharan Africa have an excess of $4bn which they are seeking to invest, according to ODI researcher Judith Tyson. Purchase prices for companies are rising as private-equity firms compete to buy them.

Tyson, a former banker at Deutsche Bank AG, warned in the report published in October that: "In sub-Saharan Africa, many private equity funds wish to engage in 'value investing'–that is in medium-sized companies. For these firms, current policy has focused on providing seed capital for the funds themselves. However, there are barriers to further growth. The region is suffering from an 'overhang' of unused capital. This is because of the lack of suitable companies for investment."

Tyson explains that PE funds have responded by investing in smaller scale companies employing a "build not buy" strategy.

She goes on to write that these approaches do not tackle the demand problem of the lack of companies of the scale and quality sought by private equity funds and speculates that it may even be adding to the problem of 'capital overhang'.

This, in her opinion, could contribute to emerging asset bubbles in relation to company valuations.

When I approached SAVCA CE, Erika van der Merwe, about the issue, she said there has clearly been an uptick in interest in the region over the past few years.

Van der Merwe explained that at the large end of the fund and deal-making spectrum, players from developed markets were looking to execute deals of the size to which they are accustomed to in developed markets, and naturally it has been more challenging to find the right deals at the right price.

However, Van der Merwe doesn't agree with the thesis that this is leading private equity into bubble territory.

"In the total scheme of things, the statement is not true," she says. "Most deals will be in the mid-sized to small scale, and there most certainly is not a glut of capital for these deals. The private equity industry is still young and underdeveloped in sub-Saharan Africa, business owners are still in the early phases of recognising private equity as a funding or exit option, and the need for funding is enormous."

This is also the overwhelming congruency with Tyson's conclusions:

"More usual in the region is to inject new capital into the company through both equity and debt. This is because financial resources are needed in order to grow the company –the goal of private equity funds. Importantly, this is risk capital. This means that, if the business fails, the loss is incurred by the private equity fund . . . Moreover, the key advantage for development of private equity funding is their willingness to finance 'high risk 'countries, sectors and projects which, by definition, are also those facing financing constraints. Because of this private equity funds can be an important source of relieving financing constraints [in sub-Saharan Africa]."

The upshot is that international private equity offers an unprecedented opportunity to accelerate economic development in sub-Saharan Africa. It has been the fastest growing capital flow to the region with more than $50bn annually and a 20% of cross-border capital flows.

Something that is also starting to develop in the South African market is the area of private equity secondaries. As discussed with Juan Coetzer, head of Alternative Investments: Private Equity at Ashburton Investments on page 4, the secondaries market, which refers to the buying and selling of pre-existing investor commitments to private equity and other alternative investment funds, is starting to attract smaller pension funds and this can only be a positive for the asset class and new trustees are introduced to its powerful growth appeal. ◆

Michael Avery

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Gleason Publications

Mineworkers Investment Company (MIC) aims to become more actively involved in the value creation activities of its investee companies. Additionally, MIC intends taking larger stakes in companies where this active mindset can be best leveraged to create sustainable, long-term value, while contributing to the creation of Black industrialists in South Africa.

MIC's aspirations to create black industrialists

By MIC Executive Director for Investments, Nchaupe Khaole

The strategy of creating Black industrialists cannot be left to government alone and MIC's hope is that the pipeline of Black Economic Empowerment (BEE) deals vesting over the coming years could kickstart the creation of a pool of Black Capital, which could be used for this purpose. MIC will be doing what it can to spearhead this drive within the private sector, while accepting that other BEE firms may have liquidity constraints requiring them to cash in their stakes, or different objectives for that unlocked value. The avenues through which this ambition will be realised include partnering with like-minded Black investors to take up controlling positions in entities, or creating platform companies to be controlled by MIC, and actively seeking bolt-on acquisitions to further enhance MIC's value in these entities.

MIC continues to have cash available for new acquisitions. MIC is a long-term investor whose policy is not to realise its investment in companies within a pre-determined timeframe but to rather consider investments with a long-term horizon in mind. That said, if MIC were to be presented with a very compelling offer for one of its assets, an exit would be contemplated. Additionally, MIC reviews its portfolio periodically and to the extent that any of its existing portfolio companies no longer fit with its long-term strategic objectives, optimal investment realisation avenues will be considered.

With a 24% increase in Net Asset Value last year, and with R6bn of assets under management, MIC is under no liquidity pressure and indeed is looking to deploy a minimum of R150m per new investment, typically in companies in the mid-market space with enterprise values of R600m or more.

MIC celebrates its 20th anniversary this year, prompting a review of its experiences and of where it is headed over the next 20 years. Management has learned a lot, made a few mistakes along the way, but essentially built a sustainable business model that has positioned the company to make a step change to the next level in its development.

Given challenging macro-economic headwinds, MIC is increasingly finding that some of its investee companies are struggling to deliver year-on-year growth rates in excess of inflation. To boost its own performance MIC is looking to get more actively involved in the value-creation activities of its investee companies to unlock additional value. This will be accomplished by adopting a more active value-add mindset which seeks to drive growth strategies within investee companies and involves taking controlling positions in entities where having MIC as a controlling shareholder will result in a competitive advantage for the entity concerned.

MIC has already unpacked its existing portfolio in an effort to identify low hanging fruit in companies it is familiar with. A number of interesting opportunities exist to either consolidate MIC's position within the entities concerned and to even increase MIC's shareholding to greater than 51% in one or two entities where this makes sense. However, nothing is yet decided. MIC is also in the process of looking at new acquisitions with majority stakes in mind, though it is important to note that taking controlling stakes is not its only strategy. All that can be confirmed is that MIC will in time start to have investee companies in which it has a controlling stake.

"With a 24% increase in Net Asset Value last year, and with R6bn of assets under management, MIC is under no liquidity pressure and indeed is looking to deploy a minimum of R150m per new investment, typically in companies in the mid-market space with enterprise values of R600m or more."

It is not MIC's intention or strategy to interfere in the management of those companies in any way, other than to bring to the table more of what it in fact already brings, namely: strategic guidance; access to its broad network of contacts; sound corporate governance principles; BEE credentials; its base of solid M&A skills, which can be leveraged in the identification of acquisition opportunities aimed at consolidating the investee company's market position and/or achieving geographic expansion; and finally, capital structure reorganisation skills where the company concerned needs balance sheet strengthening.

The MIC runs a 'tight ship' by design and will not increase organisational capacity unnecessarily to accomplish this new strategic arrow in its quiver. That said, in instances where specialist skills which don't currently reside within MIC are required in order to conclude or maximise value in an acquisition, it will leverage the competencies of suitably qualified service providers in order to do so, with an outlook towards building this competency in-house over time.

MIC's strategy is to build a diversified portfolio that will include making investments in sectors it does not currently have exposure to, such as Telecommunications, Education, and ancillary services aligned to these industries, as well as additional investments in sectors it's already well positioned in, such as Healthcare and Industrials.

This investment strategy is not simply about returns, but social impact as well. Education is one such sector, as is Healthcare, where investment has a multiplier effect on society. To this end, MIC has to date declared dividends in excess of R400m to its sole shareholder, the Mineworkers Investment Trust (MIT), which has a number of beneficiary programmes which seek to make a meaningful difference to the lives of mineworkers, their dependants, and their communities. The abovementioned dividends have been applied towards awarding over 3 000 bursaries, putting 924 graduates through the national education system, improving the potential of nearly 18 000 individuals through short courses ranging from labour law to computer skills, and putting nearly 1 900 individuals through a programme aimed at encouraging food security in communities where these beneficiaries reside.

Nchaupe Khaole

The key learnings and experience which MIC has garnered over the past two decades have positioned the company to play a role in the formation of Black industrialists in line with current government policy. MIC's investment philosophy, which is long-term focused and incorporates a value creation mindset, complements the policy intentions.

Aspirant Black industrialists will require patient capital and like-minded shareholders in order to realise their ambitions, which by necessity will be of a long-term nature. DFIs and state-owned entities cannot be the only suppliers of capital and commercial opportunities required to realise the policy ambitions - Black-owned enterprises have a role to play in this regard as well. Their contribution can be of a financial nature but could also take the form of support (for instance, mentoring Black entrepreneurs).

As an example, MIC is involved in a business incubator programme, which has faced numerous challenges and has not had the impact it initially sought. Be that as it may, the support provided through this programme has had an impact on a few entrepreneurs who stand to create sustainable businesses as a result. The Black industrialist policy thrust should amplify the efforts of such programmes in order to make a real impact

MIC would hope that at its 40th anniversary it could say it has made such an impact on the South African economy. ◆

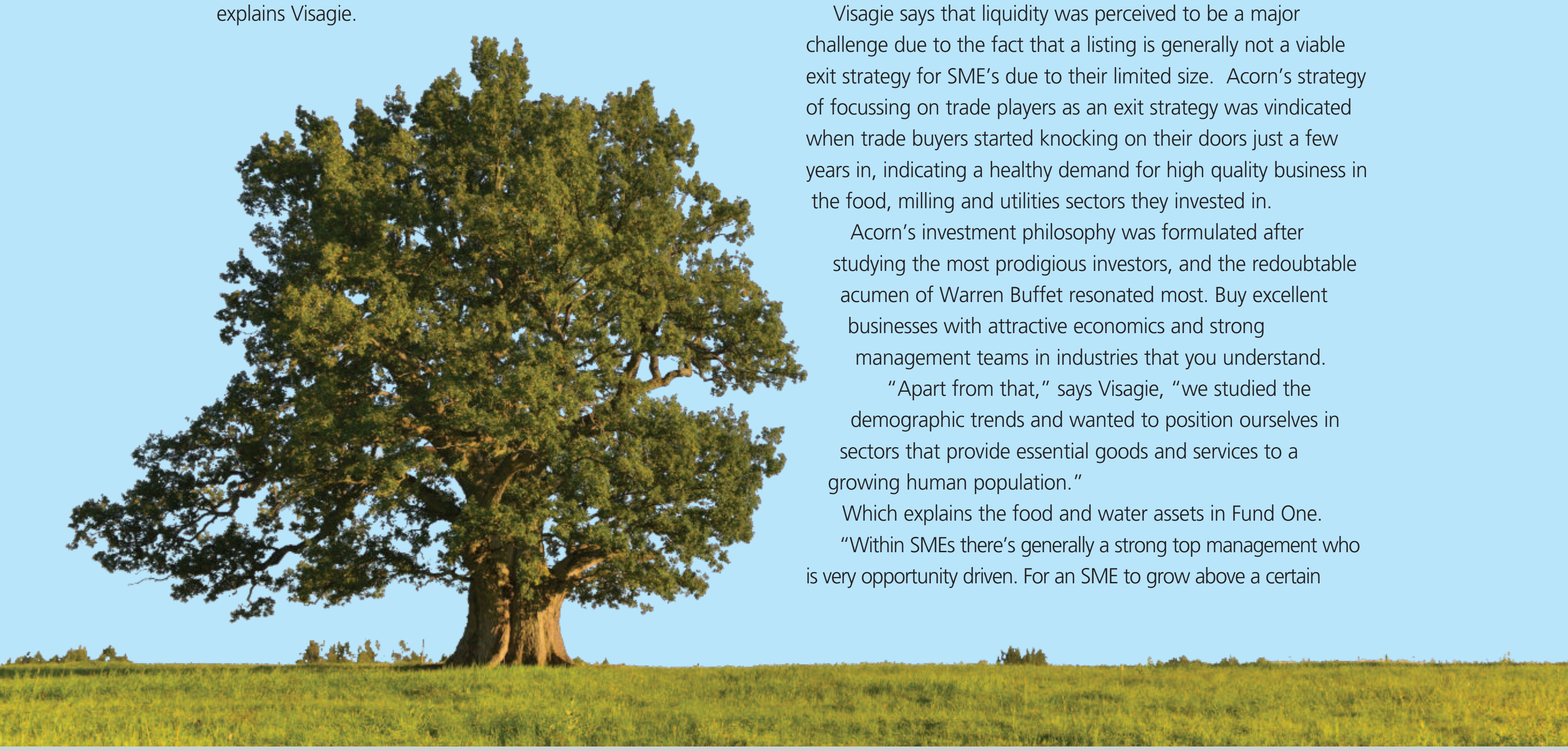
American essayist, poet and leader of the transcendentalist movement, Ralph Waldo Emerson, famously observed that "[t]he creation of a thousand forests is in one acorn". And equally Acorn Private Equity's first private equity fund managed to create an impressive growth in wealth for its investors in a span of time an oak tree would be envious of.

Mighty oaks from little acorns grow

Acorn Private Equity was founded in June 2009 by Pierre Malan, following his tenure as the CEO of PSG's private equity vehicle, Paladin Capital. Malan was also instrumental in establishing Zeder, PSG's agri-focussed listed vehicle through which it consolidated its diverse holdings in the broad agribusiness industry.

Gerhard Visagie, Investment Director at Acorn Private Equity, and involved since inception says the vision of Acorn is to be a partner of choice in its investee companies. It aims to take minority stakes between 25 and 49% and add value to allow for the business to reach its full potential, while allowing the entrepreneurs to do what they do best.

"We started out focussing on SME's with our first fund [Acorn General Fund One] and chose to target High Net Worth Individuals and Family Offices to establish our track record," explains Visagie.



Acorn identified the opportunity to invest in very promising Small and Medium Sized Enterprises (SMEs) that fall outside the mandates of the larger institutional private equity investors. This relatively untapped market has arisen due to the focus of most private equity firms in South Africa on larger transactions (in excess of R100m). Fund One focused on deals below R100 million and, as a result, had limited competitors and was more likely to negotiate favourable prices with target companies with significant growth potential.

"We reached first close in January 2010 and made five investments by August 2011. Harvesting began in January 2014 and we achieved final exit on the 30th of September this year."

That's a rapid lifecycle for an asset class that some investors turned down initially due to illiquidity fears.

Visagie says that liquidity was perceived to be a major challenge due to the fact that a listing is generally not a viable exit strategy for SME's due to their limited size. Acorn's strategy of focussing on trade players as an exit strategy was vindicated when trade buyers started knocking on their doors just a few years in, indicating a healthy demand for high quality business in the food, milling and utilities sectors they invested in.

Acorn's investment philosophy was formulated after studying the most prodigious investors, and the redoubtable acumen of Warren Buffet resonated most. Buy excellent businesses with attractive economics and strong management teams in industries that you understand.

"Apart from that," says Visagie, "we studied the demographic trends and wanted to position ourselves in sectors that provide essential goods and services to a growing human population."

Which explains the food and water assets in Fund One.

"Within SMEs there's generally a strong top management who is very opportunity driven. For an SME to grow above a certain threshold and succeed, it has to develop the necessary human capital (especially middle management) and become more strategic without losing its entrepreneurial flair. The implementation of good corporate governance, a risk management framework and timeous reporting is also critical. And according to Visagie, that's what Acorn has contributed through its active involvement in its investee companies. Investing in SME private equity requires very hands on approach to capitalise on opportunities and pro-actively manage risks.


Gerhard Visagie

A gross return of 3.5 Times Money and 3.1 times (net of fees and carry) speaks to the undoubted success of this strategy at a time when economic growth in South Africa has been hard to come by. That's a gross IRR (internal rate of return) of 46.2% per annum and net IRR of 39.4% per annum (net of fees and carry).

Attention now turns to Acorn Private Equity's current fund, Acorn Agri, which is focused on the Agriculture and Food sectors in Southern Africa. It's been structured as a company and not a limited liability partnership with a view to an eventual listing or other "liquidity" event, says Visagie.

As at October 2015 the fund had five investments and total assets in excess of R800m, with the largest being in Overberg Agri, one of the largest service providers to the country's wheat farmers.

Visagie says the fund is targeting three verticals in the agri sector, being protein, grain and fruit. It is not focused on the primary sector due to its unique risks and particularly the uncertainty about government's land reform programme.

A recent parliamentary portfolio committee meeting on public works, set up to discuss the Expropriation Bill currently before the House, saw tensions rise as the ANC argued for the concept of just and equitable compensation to be removed from its central place in the tenets of the Bill.

The Bill allows for expropriation in the public interest (for instance as part of land reform) or for a public purpose (for instance to construct a road or a power line), and covers both rural and urban private property.

But Visagie says that while this is a concern, it hasn't been an issue for local investors who better understand the nuances and complexity of the seemingly endless debate. And that was also part of the reason to focus on the areas of the value chain outside of the primary sectors.

"We understand the imperative for land reform and support the process provided it's done in a responsible manner," says Visagie. "So far it hasn't been a deal breaker for us."

So where to from here?

Visagie believes that critical mass for the Agri Fund will be around R2bn and exit opportunities will be examined when that time arrives, although he doesn't rule out a listing.

The Acorn team has now demonstrated its proven ability and experience in being creative and innovative when it comes to the structuring of acquisitions, the growing of investee companies and the disposals of investments. Investors will be watching eagerly to see where the next mighty oak is coming from. ◆

The private equity secondaries market in South Africa is quite small and still poorly understood by small and mid-sized pension fund trustees and asset consultants. This is starting to change, to the benefit of the industry, and one asset manager leading the way is Ashburton Investments with its hybrid private equity fund offering.

Ashburton hitting all the right notes playing the secondaries fiddle

Juan Coetzer, responsible for Private Equity at Ashburton Investments, explains why this has been the case and why the Ashburton Private Equity Fund 1 hits the "sweet-spot" for its investors.

"Private equity is a niche asset class, typically only accessed by highly sophisticated investors due to its high barriers to entry, daunting legal structures and agreements, requiring a lot of expertise and attention. This is unusual for investors used to the ease of investing into traditional assets classes only. Locally, public equity performed very well for many years providing little incentive to diversify to alternatives, even though private equity has outperformed public equity over the long term. Recent volatility and uncertainty in our markets have persuaded some investors to consider diversification to alternative assets, like private equity, that are poorly correlated to the rest of their portfolio."

Secondaries refers to the buying and selling of pre-existing investor commitments to private equity and other alternative investment funds. Given the absence of established trading markets for these interests, the transfer of interests in private equity funds as well as hedge funds can be more complex and labour-intensive but there are numerous benefits that the local market is starting to realise.

"We like secondaries, because the assets of a secondary fund investment are known to us and we can look all the way through into what we are buying," says Coetzer.

"The SA private equity market is relatively small with only R171bn assets under management (according to the KPMG-SAVCA Private equity industry survey), yet very sophisticated. There is a lot of competition for attractive deals. Secondaries on the other hand are not actively traded in the local market, mostly due to the size of our market, challenges around valuation and pricing, and pre-emptive rights that often exists where other existing investors in a fund have the option to buy these assets first. These factors make it extremely difficult to find and conclude secondary deals," explains Coetzer. According to the RisCura - SAVCA South African Private Equity Performance Report (2Q 2015): "Previous studies have shown fund vintage year to be an important determinant of private equity returns. Our findings are consistent with these studies and show a dramatic difference in returns by vintage grouping."

"Secondary private equity fund investments provide investors with vintage year diversification, with the intention to achieve a more stable return over time," says Coetzer.

The Ashburton Private Equity Fund I is a hybrid fund providing diversified exposure to South African private equity opportunities with some exposure to Africa. The fund will co-invest in direct private equity transactions (alongside a leading private equity firm), acquire secondary fund investments and could also make commitments to new private equity funds. Ashburton Investments is spearheading the change towards investors' portfolio re-allocation needs.

The Ashburton private equity team with Key Investment Professionals Jake Archer and James Pullinger has already concluded three secondary transactions with a fourth in the pipeline.

"Our fund is nimble and can act quickly when these opportunities arise. We crafted mandate that would allow us to deploy capital to private equity as fast and efficient as possible," says Coetzer.

The first three deals started with a stake in CapitalWorks Fund I (the GP that invested in Rhodes and successfully exited last year), Carlyle's first Sub-Saharan Africa fund and Thierry Dalais' Lereko Metier Capital Growth Fund.

Coetzer explains that the investment process Ashburton employs generally sees them investing in secondaries for several reasons.

First, the fund has track record and assets that one can assess and make an informed decision on NAV and pricing.

Second, during the first few years of a funds' life you are paying management fees of 2% so when one enters a later stage fund these funds are generally paid up so you're getting returns net of fees.

Third, if you enter fund quite late and there are exits on the cards there's the carry interest at play which ensures that fund managers are sufficiently aligned to extract the best possible value form the investment.

> "Considering the benefits its unsurprising to note that private equity research company Preqin, which has been tracking the global secondary market since 2009, reckons there's been a three-fold growth over the five-year period to the end of last year from an estimated $12bn to $42bn in 2014."

Juan Coetzer

Secondaries also provide improved liquidity due to the assets being more mature and closer to the point where the fund manager needs to exit them.

Considering the benefits its unsurprising to note that private equity research company Preqin, which has been tracking the global secondary market since 2009, reckons there's been a three-fold growth over the five-year period to the end of last year from an estimated $12bn to $42bn in 2014.

Preqin notes, "Implicit in a bigger market is the increased participation of the limited partner universe. No longer a last resort for distressed investors seeking liquidity, the secondary market now serves as a viable tool for the active management of alternative asset portfolios. The nature of transactions being completed is becoming more sophisticated and innovative to fit the needs of sellers; a key theme that has emerged more recently is the market's viability as a solution for GPs and LPs seeking end of life solutions for funds, be that in the sale of interests in tail-end funds or more complex GP restructurings. As the markets mature, real estate, infrastructure and private debt secondaries transactions are steadily increasing their contribution to overall market volume."

What this also signals for Coetzer is the opportunity to bring in the small and mid-size pension funds. A market that has been slow to capitalise on regulation 28's increased allocation to alternative asset classes.

"As an industry we still have to do quite a bit of education and promoting of the asset class," explains Coetzer. "Trustees are inherently conservative, as they should be. Unfamiliar territory and investments not fully understood are avoided especially in times when traditional markets have been performing as well as they did. The Ashburton Private Equity Fund 1 is ideally suited for small and mid-sized pension or provident funds looking to gain access to private equity for the first time. Our fund is a perfect and a cost-effective start where they will gain access to a well-diversified mix of private equity assets and get exposure to some of the top private equity managers in the country. They will also gain access to secondaries which offers a far more matured portfolio immediately, and could potentially harvest returns much sooner" Coetzer says.

That's the attractive element, especially for High Net Worth Individuals (HNWI) where lack of liquidity is often a discouragement. Coetzer says although investors are locked in for the duration of the fund, realisations are paid out when assets are harvested (exited) which due to the maturity of secondaries in their fund, could be much sooner than the traditional private equity model. Having a clear line of sight through the fund manager, their track record, the assets in the fund and the performance thereof are all key critical ingredients that lead to the attractiveness of the secondary market.

And secondary transactions are often priced at a discount to fund manager's valuation, depending on the quality of the remaining assets and negotiations between buyer and seller. ◆

The South African VC industry shows an encouraging rise in the number of new fund managers, an increase in deal flow and in profitable exits, while deal size declines.

Venture Capital growing but still not turbocharged

The South African venture capital (VC) industry now represents almost R2bn in assets under management, with healthy confidence levels that are commensurate with reported rising deal activity, a pleasing exits record and a significant increase in VC fund managers and industry professionals.

These findings are encapsulated in the SAVCA 2015 VC Survey, which covers VC-type transactions that took place between January 2011 and July 2015, and follow two previous VC studies produced by the Southern African Venture Capital and Private Equity Association (SAVCA), in 2010 and 2012.

The latest survey reveals that in the 2011-2015 period, 21 public and private VC fund managers and angel investors completed 168 new deals amounting to a total value of R865m. As at July 2015, total VC assets under management were valued at R1.87bn, comprising 187 deals.

"The survey results confirm that the South African VC industry continues to expand in line with the increase in entrepreneurial high-tech activity in the market, a deepening pool of skills and experience, a growing exits track record, and lower barriers to entry for VC-type deals," says SAVCA CEO, Erika van der Merwe, "especially for those that target businesses that involve the use of digital technology (such as online, e-commerce and new media) to expand service offerings."

Uptick in deal flow activity, a decline in per-deal values

The survey indicates an uptick in the number of VC deals done, from the 11 deals struck in 2012, to 18 in 2013, 34 in 2014 and 43 annualised in 2015 to date.

In line with international trends, the average deal size has declined in recent years: The average transaction value has reduced from R9.3m over the 2009-2012 period, to R7.3m during 2011-2015, a decline of 22%. Lean approaches to starting new businesses, which translates into smaller quantities of capital required for transactions, is a key reason for this development. Another reason is the dwindling deal activity by public fund managers and public-funded entities, given that these entities in the past typically have done larger transactions than private sector managers.

Pleasing exits performance

The survey shows that 56% of fund managers with deals on their books had exited from at least one investment during the 2011-2015 survey period. The average rate of return on investments, for all declared deals that were exited with a gain, is 20% (compound annual growth rate).

The amount declared as write-offs over the survey period totals R187m, compared with the total value of profitable exits of R438m.

"The trends highlighted in this survey are positive, in that they signify the advancement of a still-emergent industry that is an integral component of a vibrant and healthily functioning economy – and which is considered a critical enabling mechanism for new high-growth and entrepreneurial sectors and technologies that have the potential to transform the South African economy," van der Merwe says.

VC needs visionary public-sector backing

However, findings from the survey that public-sector VC funds are reducing their activity are a concern.

Stephan Lamprecht from Venture Solutions, who conducted the survey, stresses the importance of government involvement in the sector as a catalyst.

"Evidence from other markets is that sensible government backing and enablement of seed-stage and early-stage VC activity are vital in ensuring not only the development of the VC asset class, but, more importantly, the growth of high-tech, high-growth entrepreneurial activity," explains Lamprecht.

This is backed up from data out of that global leader in VC and innovation the US.

According to William Gaslton, who holds the Ezra K. Zilkha Chair in Governance Studies and senior fellow at the Brookings Institution, government is a good venture capitalist

Stephan Lamprecht

Writing in the Wall Street Journal (Aug 27, 2013) Galston explains that two economic sociologists, Fred Block and Matthew Keller, decided to ask a simple question: Where did these award-winning innovations come from?

For more than four decades, R&D magazine in the US has recognized the top innovations –100 each year – that have moved past the conceptual stage into commercial production and sales.

Messrs. Block and Keller randomly selected three years in each of the past four decades and analyzed the resulting 1,200 innovations. About 10% originated in foreign entities; the sociologists focused on the domestic innovations, more than 1,050.

The data indicated seven kinds of originating entities: Fortune 500 companies; small and medium enterprises (including startups); collaborations among private entities; government laboratories; universities; spinoffs started by researchers at government labs or universities; and a grab bag of other public and nonprofit agencies.

One of their findings that stand out is "the number of top innovations originating in federal laboratories, universities or firms formed by former researchers in those entities rose dramatically, from 18 in the 1970s to 37 in the 1980s and 55 in the 1990s before falling slightly to 49 in the 2000s. Without the research conducted in federal labs and universities (much of it federally funded), commercial innovation would have been far less robust."

Erika van der Merwe

> "The survey results confirm that the South African VC industry continues to expand in line with the increase in entrepreneurial high-tech activity in the market, a deepening pool of skills and experience, a growing exits track record, and lower barriers to entry for VC-type deals," says SAVCA CEO, Erika van der Merwe.

And Lamprecht agrees.

"Without visionary and consistent government backing for VC, the industry will at best continue to grow at average and organically driven rates, subject to market pressures and the high risks associated with being an emergent asset class. It is therefore imperative for the transformation of the entire economy that VC in South Africa is harnessed to support improved, more diversified and more sustainable economic growth." ◆

Section 23M, which became effective on 1 January 2015, and applies to interest incurred on or after that date, was recently included in the Income Tax Act, as an additional measure by National Treasury to limit the deduction of interest paid to persons not subject to SA tax.

The curious case of section 23M and the deduction of interest

Graham Viljoen & Brian Dennehy

In summary, s23M, in terms of a prescribed formula, limits the deduction of interest incurred by a South African borrower in favour of a foreign lender, or local lender who is not subject to SA tax, if there is a 'controlling relationship' between the two entities. A controlling relationship exists when the lender who is not subject to SA tax, directly or indirectly, owns at least 50% of the equity shares or voting rights in the SA borrower, or vice versa.

Graham Viljoen

Brian Dennehy

S23M is an addition to existing provisions which limit the deduction of interest, including s31 which contains the SA transfer pricing and thin capitalisation legislation, and s23N which limits the deduction of interest in respect of reorganisation and acquisition transactions. It is therefore an ultimate capping provision which limits the amount of interest paid to a foreign lender or local lender who are not subject to SA tax, even if the local thin capitalisation and transfer pricing provisions have determined the amount of debt and rate of interest to be arm's length.

As is often the case with new legislation, a number of issues currently reside in the enacted wording of s23M. S23M only applies where the lender is not subject to SA tax. In addition to SA income tax, SA withholding tax on interest, which became effective on March 1, 2015, represents a qualifying SA tax. However, as interest is only subject to withholding tax when such interest is due and payable this means interest which is incurred during a year of assessment may still be subject to the s23M limitation, despite the fact that such interest will be subject to interest withholding tax when such interest ultimately becomes due and payable. The anomaly is that this could result in a disallowance of the deduction of interest in terms of s23M, with no relief for the fact that withholding tax on interest will be recovered when the interest becomes due and payable. The net effect (assuming treaty relief does not apply) is a cost of R43 to the taxpayer for every R100 of interest incurred.

In addition to this example, another issue is that the interaction of s23M with s23N is not clear when one considers the wording in s23M(3) which states that adjusted taxable income must be "reduced by so much of any amount of interest incurred by the debtor in respect of debts other than debts contemplated in subsection (2) as exceeds any amount not allowed to be deducted in terms of s23N".

This is best illustrated by an example:

Company A borrows R60m from Foreign Co, a non-resident company which owns 100% of Company A. Company A also borrows R40m from a local bank. Company A uses the R100m to purchase the assets of Company B pursuant to an intra-group transaction contemplated in terms of section 45 of the Income Tax Act. In the year following the acquisition Company A incurs R6m interest to Foreign Co and R3m to the local bank. The *"adjusted taxable income" of Company A determined in accordance with s23N is R15m, interest income of Company A is R1m, and third party interest incurred on working capital facilities is R0.5m. The percentage calculated in accordance with s23N is 40%.*

Based on the above, in terms of ss23N, interest of R3.5m would be disallowed. However, as the interest is incurred to a Foreign Co which is not subject to SA tax, and is in a 'controlling relationship' to Company A, the provisions of s23M must also be applied.

The provisions of the s23M formula are similar in all respect to the s23N formula, except that the s23M formula is only applied to the year of assessment in question (i.e. there is no choice between years as stipulated in s23N). However, a complication arises when interpreting the provision in s23M(3) which states that the result of the formula must be *"reduced by so much of any amount of interest incurred by the debtor in respect of debts other than debts contemplated in subsection (2) as exceeds any amount not allowed to be deducted in terms of s23N"*.

Does this mean:

- the interest incurred on the local bank s23N debt i.e. R4m less R3.5m, the result of which is that R6m of s23M interest would be deductible; or
- you apply a ratio to the s23N interest to determine what portion of the s23M interest and s23N interest is disallowed under s23N and then apply the result of this in the formula.

Whatever illogical result is produced above, one would assume that, where the foreign interest in question is incurred wholly for purposes of a reorganisation transaction or acquisition transaction contemplated in s23N, s23M should simply produce the same result as s23N i.e. that interest disallowance under s23N should simply apply.

In summary the s23M calculation should only be necessary where interest is incurred on debt which is used other than for purposes a reorganisation transaction or acquisition transaction contemplated in s23N. ◆

Viljoen & Dennehy are directors in the Tax Practice at Webber Wentzel.

The supply of capital for large cap opportunities in Africa is outstripping the demand for capital. At the same time, small and mid-caps are underfunded across the continent, with the exception of North Africa. This keeps the price within a lower range, as competition among investors is lower.

Africa: Supply and demand of private equity funding capital skewed

"Smaller sized transactions are priced similarly to global levels, while large transactions are priced lower in Africa," says Rory Ord, head of independent valuation at RisCura.

For the period 2006 to 2014 there was an average of 32 African private equity deals per year at a generally steady level of pricing over time. This is according to the 2015 Bright Africa report.

In general, it can be seen that African deals in the 2.5x-5x price grouping significantly outnumber global deals; while 79% of global deals and 62% of African deals occur in the more expensive price groupings (5x+).

"This lower pricing of African deals is the result of many factors, including higher risk perceptions and lower debt availability in African markets," says Ord.

Interestingly, there is a relatively small range of prices between sectors, from the Energy sector with a pricing multiple of 4.72x to the Consumer Staples sector with a multiple of 6.6x.

The average size of transactions that are executed in the Healthcare, Consumer Staples and Information Technology sectors, are relatively small in contrast to large transactions in the Energy and Telecoms industries.

The supply and demand for capital in the Real Estate and Extractives industries is relatively balanced, preventing undue upward or downward pressure on pricing. Infrastructure is still demanding more capital than is being supplied, keeping prices low.

Debt in deals

The area where African deals differ markedly from other parts of the world is the lower use of debt as part of the financing of deals. Unsurprisingly, African debt markets are relatively underdeveloped, with the exception of South Africa, which results in difficulty sourcing debt funding for deals. Consequently, African private equity deals have used an average of approximately 1.2x earnings in debt financing over the past four years, compared to approximately 5.3x in the US.

The use of debt across all deal sizes in Africa is far lower than globally, with the largest deals averaging only 3.24x Debt/EBITDA. Even deals involving companies with enterprise values of over $250m are only 37% debt-financed compared to the global average of 60%.

This is due to a number of factors, including poor access to debt markets in parts of the continent, the relative risk aversion of South African banks and generally high interest rates across the continent.

"This very low level of debt means that these deals do not rely on leverage for returns," says Ord.

The use of debt in Africa was higher in 2007, when large deals were still being done with debt in South Africa. In the interim, however, debt levels have declined and have not fully recovered. In contrast, debt multiples in the US have recovered significantly since the global dip in 2009, and appear to be the main driver behind increased purchase price multiples in 2013.

"Interestingly, in 2014 the use of debt in US transactions has declined, causing a decline in US deal prices, while at the same time, Africa's pricing has increased despite using even lower levels of debt funding," Ord says.

The balance between the supply and demand for both debt and equity funding remain one of the driving factors behind investment into Africa. The increase in interest in the continent has definitely resulted in an increased inflow of capital; however the matching of investment opportunities to investor needs remains a challenge.

The low access to debt in Africa inhibits the equity returns that could be earned on the continent, but in turn also results in significantly lower financial risk, which could prove attractive in a post global financial crises world where high levels of debt are viewed with much more caution. ◆

Local and International news

National news

KPMG in South Africa announced the appointment of Michael Rudnicki as the head of Private Equity (PE), effective 1 September 2015, following Warren Watkins' decision to pursue other interests within the firm.

Trevor Hoole, CEO of KPMG in South Africa, said: "Warren has made an invaluable contribution to KPMG throughout his 28 years with the firm. Undoubtedly, his experience and collaborative approach has strengthened our PE business in South Africa. We thank him for his support and we look forward to Michael taking the business forward."

Rudnicki is a partner in KPMG's Corporate Tax practice and heads the Financial Services and Mergers and Acquisitions Tax and Legal practice in South Africa. He advises a number of the key local and international banks and many of the dominant local and international PE houses. He also advises many of the PE houses' portfolio companies.

In the PE sector, Rudnicki has assisted many players in establishing their local and offshore funds. His experience also extends to assisting PE houses with buy and sell side due diligences, tax structuring of acquisitions and disposals, and modelling optimal gearing levels and interest deductions.

"I am delighted to be appointed head of KPMG's PE business in South Africa. I hope that my experience in providing tax advice coupled with my technical expertise will be instrumental in helping the firm deliver the full potential from our business," says Rudnicki.

While lecturing at many universities, Rudnicki has also had numerous TV and radio appearances. He was nominated for the ABSA Jewish Achiever Awards in 2014, and he co-authors the journal, Business Tax and Company Law Quarterly.

Rudnicki holds a BCom (Rhodes University), Hons BCompt (UNISA), BCom (Hons) Taxation (UCT), MCom in Taxation (University of Johannesburg) and is a Chartered Accountant (SA). ◆

Actis, a leading pan-emerging market investor with $7,6bn assets under management, announced the acquisition of a significant minority stake in Coricraft Group, one of South Africa's leading home furnishings retailers. The deal affirms the strength of Coricraft Group's cash value home retail model and Actis says it will act as a substantial enabler of future growth. The firm is investing alongside majority shareholders Westbrooke, a local investment group, and Coricraft Group management.

Actis focuses exclusively on investments in emerging markets across Africa, Asia and Latin America. The firm has a strong track record of backing high-quality, consumer-focused businesses in Africa including South Africa's leading independent sports retailer, Tekkie Town, fabric design company Vlisco Group, and snack food group, Edita. To date Actis has invested $1.6bn in the consumer sector. ◆

In August **Investec Asset Management** acquired a significant shareholding in wiGroup, South Africa's only interoperable point-of-sale mobile transacting network. Investec Asset Management will partner with wiGroup's founder management and existing shareholder Capital Eye Investments (CEI) to support the Company's growth and development both domestically and in new markets outside South Africa.

Founded in 2007, wiGroup has integrated more than 50 mobile transacting issuers, and in excess of 55,000 point-of-sale lanes to its network. The network enables widespread mobile transacting acceptance to wiGroup's corporate client base and their customers. From its head office in Cape Town, wiGroup also offers cutting-edge technology solutions that enable its clients to run integrated mobile-based payment, loyalty, coupon, voucher, reward and gift programmes.

Five large retail chains, over 10 restaurant/hospitality chains, over 50 FMCG brands, and 8 mobile payment / mobile money issuers utilise the wiGroup platform in South Africa. Outside South Africa, wiGroup has established a joint venture with Nigeria's leading switch and payment processor, in order to expand the wiGroup technology platform into West Africa. WiGroup's proprietary mobile transacting technology is well-suited to emerging markets in Africa and beyond where mobile-based transacting is poised to leapfrog traditional, card-based payment, reward and loyalty solutions. ◆

South African based independent alternative asset management firm, **Capitalworks**, has acquired a majority share of South Africa's premier boat builder, Robertson and Caine. The investment of an amount of $25m has been made alongside the original entrepreneur and co-founder of the company, John Robertson.

With 4 manufacturing facilities in Cape Town and over 1 300 staff in its employment, Robertson and Caine is South Africa's largest boat-builder and the second largest manufacturer of blue water cruising catamarans globally, having delivered in excess of 1 300 boats to destinations across the globe.

Robertson and Caine has a strong design and innovation competence reflected in its award winning Leopard product range, which currently consists of 4 sailing catamarans and 2 power catamarans. ◆

International

The **Abraaj Group**, announced the final close of its second dedicated North Africa private equity Fund at $375m in August. The new Fund brings the total amount closed by Abraaj for the African continent in 2015 to $1.37bn, having raised $990m in April for its third Sub-Saharan Africa Fund.

Abraaj North Africa Fund II ('ANAF II' or the 'Fund') targets well-managed, mid-market businesses in the core geographies of Algeria, Egypt, Morocco and Tunisia that have demonstrated robust growth and the ability to become regional leaders in their field. ◆

Investec Asset Management successfully closed the Investec Africa Credit Opportunities Fund 1 at $226.5m in August.

The Dutch development bank, FMO, and the UK's Development Finance Agency, CDC, played an instrumental role in anchoring the fund. The investor-base includes insurance funds, pension funds, fund of funds, endowments and development finance institutions from across the US, Europe and Africa.

The Fund is managed by Investec Asset Management's South Africa and Frontier Credit team, which pioneered the development of this asset class in Africa back in 2008. It is designed with the aim of giving investors high yields, the ability to access the African public and private markets across all sectors, US$ exposure and lower volatility than other risk assets. The Fund's strategy has three main aims – to develop and catalyse the development of African debt capital markets; to generate a high running yield and capital gains from investing in African credit opportunities; and to invest in sustainable businesses that have a high standard in managing ESG risks. ◆

PRIVATE EQUITY DEALS Q3 2015 – SOUTH AFRICA

NATURE	PARTIES	ASSET	ADVISERS	ESTIMATED VALUE	DATE
Acquisition by	Silvertree Capital	stake in Faithful to Nature	U-Start	undisclosed	Jul 8
Disposal by	Minemakers to Spearhead Capital	remaining legacy assets in South Africa		R10,86m	Jul 16
Acquisition by	Investec Asset Management	minority stake in wiGroup	Bowman Gilfillan	undisclosed	Aug 17
Acquisition by	Actis, Westbrooke and management	stake in Coricraft Group	Cliffe Dekker Hofmeyr; Webber Wentzel	undisclosed	Sep 1
Acquisition by	Old Mutual Alternative Investment	African Infrastructure Investment Managers and African Infrastructure Investment Fund 2 General Partner	Cliffe Dekker Hofmeyr	undisclosed	Sep 2
Acquisition by	Capitalworks	majority stake in Robertson & Caine	Cliffe Dekker Hofmeyr; Werksmans	$25m	Sep 2
Acquisition by	Marlow Capital	Just Batteries		undisclosed	Sep 14
Acquisition by	Mondi and Mondi plc from Schloss Neugattersleben	Ascania nonwoven Germany	UBS	€54m	Sep 18
Acquisition by	Paean Capital	Stake in Ralo Cosmetics	Xigo	undisclosed	not announced Q3
Acquisition by	Private Equity Partners from Herbert Martin Teubner	Sinetech	Werksmans	R35m	not announced Q3
Acquisition by	Acorn Agri from Acorn general Fund One	37% stake in Grassroots		undisclosed	not announced Q3

PRIVATE EQUITY DEALS Q3 2015 – REST OF AFRICA

COUNTRY	NATURE OF DEAL	DETAILS	ADVISERS	ESTIMATED VALUE	DATE
Africa	Investment by	Investec Asset Management of an additional equity investment in IHS Towers		undisclosed	Jul 31
Africa	Disposal by	AfricInvest, FMO, FinnFund, Bank of Africa Group and Gras Savoye of a 59.34% stake in Alios Finance S.A. To TLG Finance		undisclosed	Sep 21
Africa	Disposal by	Emerging Capital Partners and its investment partners of C-Re (which holds a 53.6% stake in Continental Reinsurance) to Saham Finances	LiquidAfrica; Stanbic IBTC Capital	undisclosed	Sep 22
Benin	Disposal by	Cauris Croissance to Les Eaux Minerales d'Oulmes of its stake in ETE		undisclosed	Aug 24
Cote d'Ivoire	Acquisition by	Investisseaurs & Partenairs (I&P) of a minority stake in Enval Laboratoire		undisclosed	Sep 25
Egypt	Acquisition by	Valeant Pharmaceuticals International of Mercury (Caman), the holding company of Amoun Pharmaceuticals from Citi Venture Capital, Capital International and Concord International	Baker & McKenzie	$800m	Jul 17
Egypt	Partnership	The Abraaj Group and Tiba Group : Education Management Company		undisclosed	Sep 30
Ethiopia	Investment by	The AAF SME Fund (managed by Databank Agrifund) in Norish		undisclosed	Jul 26
Ghana	Investment by	Injaro Agricultural Venture Capital in Agricare		undisclosed	Jul 15
Ghana	Acquisition by	Adenia Partners of a stake in Cresta Paints		undisclosed	Aug 2
Ghana	Acquisition by	Investisseaurs & Partenairs (I&P) of a minority stake in PEG Africa		undisclosed	Sep 25
Kenya	Disposal by	AfricInvest and other shareholders of their stakes in Brookhouse Schools to Educas		undisclosed	Sep 7
Mali	Investment by	Injaro Agricultural Capital in Comptoir 2000		undisclosed	Sep 10
Morocco	Acquisition by	TPG and Satya Capital of a minority stake in Ecols Yassamine - a group of private schools		$25m	Sep 17
Nigeria	Acquisition by	Abraaj Group of a majority stake in Mouka from Actis	Stanbic IBTC Capital	undisclosed	Jul 7
Nigeria	Acquisition by	Convergence Partners Communications Infrastructure Fund of a strategic, minority stake in Venture Garden Nigeria		$20m	Aug 11
Nigeria	Investment by	440.ng (L5Lab and 88mph JV) in online video learning platform, DavtonLearn		undisclosed	Sep 8
Tanzania	Acquisition by	Fanisi Capital of a significant minority stake in Kijenge Animal Projects		$6m	Jul 9
Uganda	Acquisition by	Ascent Africa of a stake in Chims Africa		undisclosed	Sep 17
Zambia	Investment by	Kukula Capital and eVentures Africa Fund in Dot Com Zambia, through a combination of debt & equity		$500 000	Sep 8