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Catalyst

SA's quarterly Private Equity & Venture Capital magazine

Catalyst

From the Editor's desk

Quiet quarter for private equity – but some big deals may be in the wind

It's been a quiet quarter for news in private equity: the two largest third party fund managers, Brait and Ethos,

> **With four cautionaries out in the market, the next few months might brings some interesting announcements. Watch Alexander Forbes, Illovo, Shoprite and Consol**

have been focusing on tying up their very big new funds – both successfully, one hears – but no major new deals have been announced by anyone. However, with four cautionaries out in the market, the next few months might brings some interesting announcements. Watch Alexander Forbes, Illovo, Shoprite and Consol.

The most interesting news, perhaps is the rumour that some of the world's major private equity funds are looking at South Africa with a view to opening up shop here in some form or another. While the local players are inevitably commenting publicly about this being "good for competition" and so on, behind the scenes there must be a measure of consternation. The arrival of the likes of Carlyle and/or Blackstone will put further pressure on their efforts to source good deals at acceptable prices, at a time when there is already concern on this issue. Then of course there is the question of staff poaching in an industry where skills are highly specialised. See our story on this on page 3.

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The Southern African Venture Capital and Private Equity Association (SAVCA) has its roots in the mid-1980s as the modest Johannesburg Venture Capital Association, then reborn in the late 1990s with the aim of gathering and disseminating industry information, creating a code for self-regulation, providing training and lobbying.

Since then it has grown into a body with a meaningful role in the industry – but with much more work still to be done. Two SAVCA-related issues highlight where the industry is today. One is the appointment of new full-time executive director J-P Fourie (see page 4), a move which should give new impetus to the association.

The other is the release of the KPMG/SAVCA annual private equity survey for 2005, which has grown in breadth and stature over the years and is today an authoritative body of reference for anyone wanting to assess private equity in South Africa. See page 7. The SAVCA committee will shortly elect a new chairman, after a successful four-year stint by Malcolm Segal. It's not clear who the frontrunners are for this post, but it is to be expected that this person will complement Fourie in his efforts.

Finally, *Catalyst* needs your support. You will notice that the publication is now printed on its own, instead of as a run-on part of **DealMakers**. This is in the hope of attracting more of a response, both editorially and in terms of advertising. Please tell us what you would like to see in a publication such as this – more about the people in the industry, the issues, the companies or whatever – and we'll cover it. Send any suggestions, comments or criticisms to Jane Strachan at jstrachan@palimpsest.co.za or David Gleason at david@gleason.co.za.

This magazine, the only one covering this industry in South Africa, won't survive unless we get you involved.

Contents

Catalyst

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Jane Strachan

While neither firm has confirmed it, private equity giants Carlyle and Blackstone are rumoured to be looking at entering the South African market. Whether true or not, the speculation has certainly got the local industry atwitter.

Shhh . . . are the really big boys coming?

The talk suggests that international heavyweights are either looking at opening their own offices here, or are contemplating some kind of joint venture with local operators. One is understood to have approached a recruitment agency already.

Catalyst approached both firms for comment on the rumours.

- David Rubenstein, co-founder and MD of the Carlyle Group: "Our plans are not formed sufficiently for me to say anything meaningful. When that changes I will certainly let you know".
- Sophia Harrison, Blackstone European Corporate Communications: "I am unaware of any intention for us to come to SA. Therefore all of the pertaining questions are somewhat redundant I am afraid. We are, however, in India, as I am sure you are aware."

Carlyle's mission is to be "the premier global private equity firm," yet at this point has offices in 14 countries "to uncover superior opportunities in North America, Europe, Asia and Australia". So nothing there about Africa yet.

The Carlyle Group is one of the world's largest private equity firms, with more than US$39bn under management. With 39 funds across four investment disciplines (buyouts, venture & growth capital, real estate and leveraged finance). While it says it is open to opportunities wherever they can be found, Carlyle focuses on investments in : aerospace and defence (so controversially referred to by Michael Moore in *Fahrenheit 9/11*), automotive and transportation, consumer and retail, energy and power, healthcare, industrial, real estate, technology and business services and telecommunications and media.

Since its foundation in 1987, the firm has invested $18,1bn in more than 460 transactions.

Blackstone describes itself as "a leader in the field of private equity investing since 1987, managing more than $14bn through its Blackstone Capital Partners I, II, III, and IV, and Blackstone Communications Partners funds."

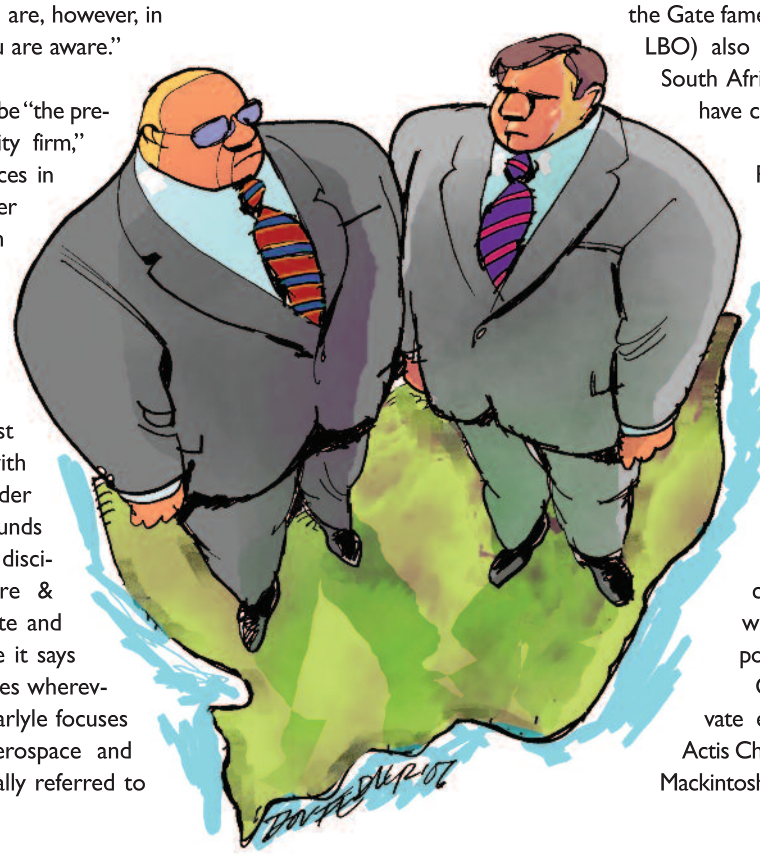
The firm has invested in more than 87 companies in a variety of industries, geographies and economic environments. North America and Western Europe are primary markets, although the firm has invested in Latin America and emerging European markets. After years of investing in Europe, Blackstone opened a London office in 2000, a Hamburg office in 2003 and an office in Mumbai in 2005.

The Blackstone Group recently closed its fifth general fund with $15,6n in capital commitments. It is the largest private equity fund raised to date and it already has committed to a number of deals.

Carlyle was represented at the Emerging Markets Private Equity Association (EMPEA) conference in Washington DC earlier this year, though there was no obvious sign of Blackstone.

Several years ago, the major US private equity firm KKR (of Barbarians at the Gate fame, following the RJR-Nabisco LBO) also poked its nose around in South Africa, but nothing appears to have come of that … yet.

Ethos Private Equity's Andre Roux believes it is inevitable that global heavyweight private equity players will become more active in the South African market. He says "private equity activity probably only represents 2% of the total SA M&A market, whereas in developed offshore markets this penetration is much more like 15 to 25%. As a consequence global players will be attracted the growth potential of the SA market."



Commenting recently on private equity in emerging markets, Actis Chief Investment Officer Alistair Mackintosh noted that five years ago, the emerging markets private equity industry was dominated by a small number of local investors. "Today, particularly in China and India, one sees the same names as in Europe and North America. That means the local players have a choice: either they stay small and niche, or they develop an international network, delivering all the benefits that it can bring. There is little room for the middle-ground." It may be that some of the smaller South African players will soon have to consider this advice.

It should also be noted that the potential foreign interest comes at a time when some of the larger local firms are raising significant sums of money for new funds, and have plenty of fire power in their own right. It is understood that Brait is seeking US$500m for its newest fund, and market speculation is that Ethos is expected to raise even more than that.

In addition, Actis held a final closing of the Canada Investment Fund for Africa in June, with commitments from leading institutions around the world. This brings the total fund size to $212m and bring the total funds raised by Actis for investment in the emerging markets to $1,4bn.

There is in fact a global liquidity glut in private equity, so it is inevitable that the larger fund managers will be looking to new markets.

One area of concern for South African fund managers will presumably be that of staff poaching. The domestic industry has invested considerably in recruiting and training quality people and the prospect of losing staff to newcomers with large chequebooks is unlikely to please them.

Southern African Venture Capital and Private Equity Association (SAVCA) Executive officer J-P Fourie says SAVCA welcomes new entrants to the local market, adding that they "would contribute to the development of the South African industry.

"Perhaps they will use their South African presence to move elsewhere in Africa – which is good for South African and the rest of the continent;" Fourie says.

"South Africa has a well-established private equity industry and it is well-developed (on a par with its international peers in important aspects - governance, sophistication and so on) and a good learning ground for funds that want to move into Africa. However, a local presence is seen as key by many fund managers when they enter new markets, given the need for local industry and regulation understanding/knowledge, networks and so on." ◆

The Southern African Venture Capital and Private Equity Association (SAVCA), represents the industry but it has not, until recently, had the infrastructure to do justice to its role.

SAVCA on the march

This is set to change with the appointment of J-P (Jon-Pierre) Fourie as Executive Officer of the organisation, a full time position.

Fourie comes from the JSE, where he was most recently Senior Manager in the Strategy Department. His work there ensured the development of his skills in strategic modelling, project management and business analysis, communication, the listed and general business environment, planning methods and techniques and negotiation techniques/conflict management. It also exposed him to business and economic global trends and nurtured a nascent entrepreneurial spirit.

Prior to that he was Head of the Emerging Enterprise Zone (EEZ, an initiative that aimed to match capital seekers with potential providers of capital) managing all aspects of this subsidiary company of the JSE, including the facilitation of potential transactions between various parties, the negotiation of all contacts for EEZ and the trade sale of the business.

While at the JSE he represented the exchange as a committee member of SAVCA and it is in part this role, together with the development of his passion for entrepreneurship, that made him the top candidate for the SAVCA position.

"I could see the value this industry had to add and the amount of positive energy there was around the asset class," he tells *Catalyst.* "Therefore, while it still took a lot of soul-searching for me to make the decision to leave the JSE, the chance to become involved in the active promotion of private equity and venture capital seemed too good an opportunity to pass up."

He concedes that there is a lot of work to be done in raising the profile and perceptions of the industry domestically , but says private equity's international profile is so high at the moment that local institutional fund managers appear to be catching some of the buzz.

As measure of the current profile of the industry in this country, Fourie points to the number of approaches SAVCA is receiving from parties looking for information or wanting to discuss various kinds of initiatives. That's apart from the international players believed to be sniffing around here. *(See page 3).*

On the international front he finds it fascinating that private equity is so 'hot' that, in some cases, placement agents are knocking on private equity fund managers' doors on behalf of the institutions, looking for allocations, instead of the


J P Fourie

other way around. This of course means that there is a vast amount of uncommitted capital floating around internationally, but he sees this is a possible opportunity for South Africa, with this country able to serve as a possible 'home' for some of these funds .

Then again, there is a great deal of uncommitted capital here too, but perhaps this means the larger funds will have to extend their horizons both geographically (north) as well as in terms of deal size. "If there aren't enough big acquisitions in the market, maybe they'll rather have to do smaller – but more - acquisitions," he muses.

Commenting on the much smaller end, he recognises the lack of seed investment activity and believes SAVCA needs to play an enabling role in terms of fostering a more VC-friendly environment. "We have to work smarter in this regard to stimulate this arena."

This is, in fact, one of the major challenges he sees for the association. Others challenges include the formulation of a clear, workable position on the thorny issue of black economic empowerment and generally promoting the asset class, be it through exposing performance data to a broader audience, working on industry concerns regarding the asset allocation limits of the Pension Funds Act or, internationally, "selling" South Africa and differentiating the country from competitors such as Brazil, Russia, India and China.

Fourie is a dynamic individual and it is his energy to which many people refer. He quite casually cites triathlon as one of his interests and notes that he completed the March 2006 Iron Man in Port Elizabeth. What he doesn't amplify, however, is how well he did in the 3,8 km swim, 180 km cycle and 42 km run event. He demonstrated the kind of tenacity, endurance and energy that will see SAVCA move up to the next level.◆

Some more background on J-P Fourie

- Schooled at CBC Pretoria
- Represented South Africa as a Rotary exchange student in the US
- B.Comm. Communications - Rand Afrikaans University (RAU)
- B.Comm. Honours in Economics - RAU
- Diploma in Investment Management - RAU
- Various courses on strategy, management and emerging markets
- Alexander Forbes, Assistant Consultant in the Actuaries and Consultants Department
- Joined the JSE's Graduate Programme in 1998
- Moved through Corporate Marketing and Listings to the EEZ and Strategy.

Talking to Terrence Chauke

Confirming private equity as a worthy asset class

Terrence Chauke

When South Africa's large private equity houses are out there fundraising, they know that among the key institutions they really need to talk to are the likes of the PIC and the Eskom Pension and Provident Fund (EPPF). Terrence Chauke, head of the EPPF and chairman of the retirement industry forum the Principal Officers' Association (POA), is not only a willing listener but is also a fan of the asset class. He believes Principal Officers and Trustees should study the asset class closely and consider supporting it more than they currently do.

Alternative investments such as private equity and venture capital have a unique opportunity to better support economic growth and job creation than, for example, listed equity investments, Chauke believes. Infrastructure development can create many jobs and skills development while boasting long-tem economic growth. Private equity managers would do well to look at areas of this nature, he comments.

The EPPF, a defined benefit fund, has funds under management of about R32bn (as at year end of 30 June 2005), of which some 5% is allocated to private equity and 'socially desirable investments'. This makes the EPPF a significant player in the South African private equity market. Actual commitments of the EPPF and other such funds that already support the asset class are well below the 5% limit for alternative investment as provided for in terms of Regulation 28 of the Pension Funds Act, so interests in the sector are likely to rise in time to come.

The EPPF currently has 31 commitments in private equity funds.

"Our experience of private equity at EPPF is that it performs well, in some cases better than listed equities," Chauke says. "Our required 7% real return is not onerous. In fact, since the EPPF started investing in private equity in about 1999 we have achieved average returns well in excess of 25%, so we can confidently advise other pension fund managers that this is a worthy asset class. It has its risks which must be acknowledged, eliminated and /or managed, but it should form part of a sound portfolio diversification strategy."

Chauke urges the private equity industry to enhance its own empowerment credentials and government to find ways to boost private equity market growth

That's not to say that he doesn't have any issues with private equity: he has two particular concerns. One is the question of deal flow and pricing in a competitive market. "There are clearly still many reasonable deals out there, but there is a concern that as we see more private equity fund managers fighting over the juicier deals, prices rise. This is particularly worrying if the likes of Carlyle and Blackstone enter our market, as a broader global strategy might mean that they are willing to pay even more than local players."

His second concern reflects something that is perhaps an intrinsic aspect of private equity – investors' access to detailed information about a third party private equity fund manager's portfolio companies. "While this is obviously in part mitigated by ensuring that one has selected the best fund managers, it is difficult to assign risk if there is no see-through to the underlying asset," Chauke says.

He is not, however, concerned about the levels of disclosure by the fund managers themselves. "It is important for investors to monitor these investments by, for example meeting (as the EPPF does) formally twice a year, examining in detail how everything is going in relation to agreed targets, as well as engaging informally whenever necessary. Furthermore, you need to structure your agreements with them to ensure easy access to various specific types of information."

His concerns are offset not only by the returns achieved through private equity but also by the fact that he sees private equity as a grower of business, a stimulator of the economy. It contributes to black economic empowerment (BEE) and facilitates international investment.

He urges government to recognise the potential of private equity to contribute to the country's economy development. "There must be some way of boosting the further growth of this asset class, incentivising people to invest in businesses that create jobs, as private equity has been proven to do. Government has various instruments at its disposal in this regard, with tax being one of the most obvious avenues."

Part of the problem in convincing government to "give" a little more, he says, is that the private equity industry itself has not as a whole done enough to transform itself, both in terms of the shareholding structures of the management companies themselves and in ensuring transformation at portfolio company level. "They can ensure that that the companies in which they invest are properly committed to the full gamut of meaningful BEE, not just a box-ticking compliance with codes. It is only in this way that private equity investment becomes sustainable and has a long-term impact – it's no use if after a private equity firm exits an investment the company is not able to continue profitably.

"And once government sees real commitment to South Africa's growth and general support for the Accelerated and Shared Growth Initiative for South Africa (Asgisa), it is more likely to be sympathetic to calls for stimulatory measures."

The POA provides a forum for retirement funds to share notes on best practice in areas such governance, investments, costs and skills development. Members have an opportunity to debate and share experiences in a variety of issues affecting the industry and funds. The principal purpose is to ensure that all funds, irrespective of their size, improve the way in which they look after their members.◆

The EPPF's most recently-reported domestic external asset managers were African Harvest Asset Managers, Coronation Asset Management, Frater Asset Management, Investec Asset Management, Oasis Asset Managers Limited, Old Mutual Asset Managers, RMB Asset Management, Real Africa Asset Managers and Sanlam Investment Management.

The international external asset managers are RMC Global Investors, Merrill Lynch Investment Managers, Morgan Stanley Investment Management, Frank Russell and SEI Investments Management.

In the most recent published EPPF report, for the 2004/2005 year, Chauke said the fund had reported its best investment year to date, with an overall investment return of 31,8% for the year, against a CPI rate of 2.8% year-on-year for the same period. "Considering that we follow a conservative asset allocation approach to minimize risk, this is an excellent result," he said. This return was significantly above the three, five and ten year returns.

The annual Venture Capital and Private Equity Industry Performance Survey highlights the growth in size and sophistication of the sector over the years.

Annual industry survey captures the ups and downs of private equity

From a fairly unrepresentative document in its first issue in 1999, when only about 29 players contributed information about their businesses, today the KPMG and SAVCA (Southern African Venture Capital and Private Equity Association) survey is regarded as an authoritative, albeit purely quantitative, reflection of the state of the industry, with data on about 80 locally-based funds obtained either directly from fund managers or from a range of other sources. These days, when international companies want to know about private equity in South Africa, they look to this body of research.

The latest survey, covering the 2005 calendar year, shows an industry with almost R44bn under management, up 10% on the previous year. The R44bn figure includes committed but as yet undrawn capital of R15,6bn at year end. However, only R14,4bn of the total, or 33%, was attributable to independent or third party fund managers, the rest being under the control of captive funds (for the most part the private equity arms of banking groups and government).

The independent fund managers raise cash commitments from third party investors in typically closed-ended funds. The financial institutions in South Africa, more so than is the global norm, make direct private equity investments of their own more rather than only providing independent funds with investment, though they do also fund independents.

And while the survey's primary compiler, KPMG Associate Director Marco Dias, says he is disappointed with the stagnation of funds raised during 2005 at approximately the same level of 2004's (around R2,2bn each year), he notes that some of the country's major independents are currently fundraising, which means that the figures for 2006 are likely to be significantly up. 2003 was a record fund-raising year with R4,9bn raised, R2,6bn of which was raised by Actis alone.

The cost of investments made during the year amounted to R4,9bn, down from R6,5bn during 2004, a record year for South Africa. This number has raised concerns about the amount of investment being made against the funds available and the consequent increasing value of committed but undrawn funds available in the market.

Dias says this was one of the important findings of the research, "especially when we expect fundraising to be significantly up in 2006, Though of course perhaps the people raising funds are not the same as those with the undrawn commitments."

There is the concern that the failure to spend committed funds will lead to negative perceptions of the industry and create difficulties down the line in fundraising. Any investor who has committed funds to a fund manager has to ensure that the committed allocation is readily available for draw-down. This means that these funds can only be invested in very short-term instruments while they await the draw-down from fund managers.

A disappointing aspect of the findings is the paucity of seed, start-up and early stage investment, though this did not come as a surprise. Funds for these investment stages have generally been very low in South Africa.

Investment in entities that are black-owned or empowered was up 78% from R1,8bn to R3,3bn.

Total funds under management of participating fund managers that are themselves black owned, empowered or influenced companies increased by 46% from R18,7bn to R27bn, mainly as a result of transactions undertaken by previously not empowered fund managers, though for the first time fundraising by empowered fund managers also contributed to the increase.

Dias says the area of BEE is the one area where there is possibly a lack of understanding among the foreign private equity players who are looking at the South African market. "It's something they haven't dealt with before and so we need to run them through the rationale, explaining why BEE is driving the industry. However, once they have that information they tend to be more comfortable with it."

Meanwhile, work on the 2006 report has already started; Dias' colleague John

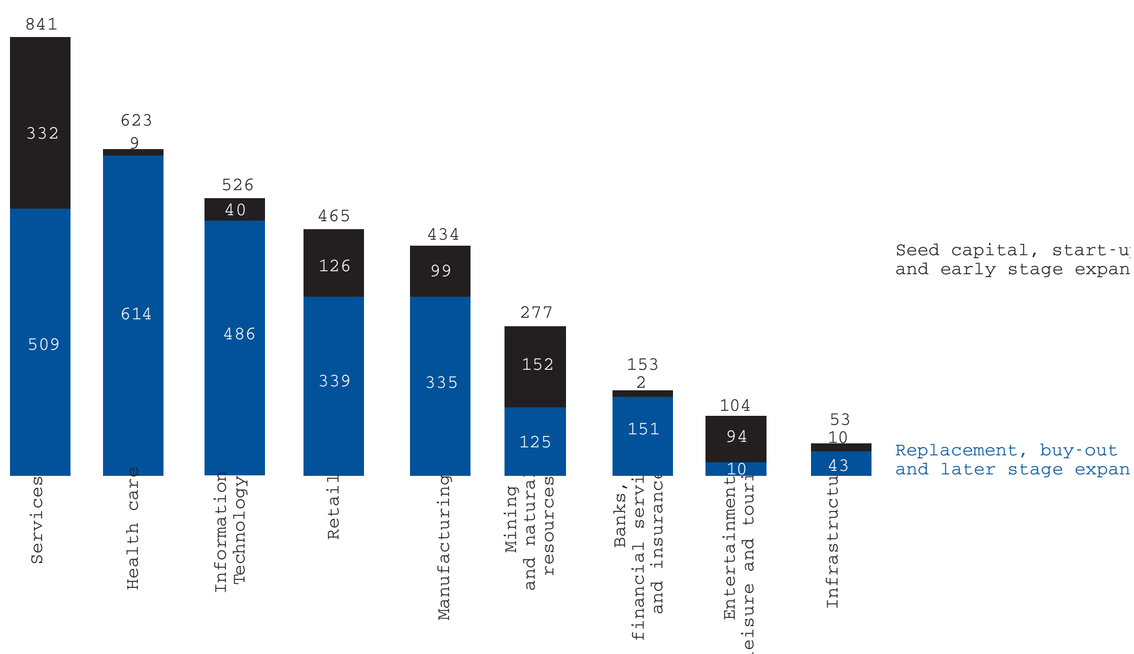
Marco Dias

Geel (MD of KPMG's Corporate Finance practice) said that the survey sub-committee has produced the first draft of the questionnaire, which will be refined over the next few months for circulation in the first week of January 2007. ◆

Note: the surveys going back to 1999 can be downloaded from www.savca.co.za

SOME HIGHLIGHTS OF THE SURVEY

Investments at cost made during 2005 analysed by sector and stage (Rm)



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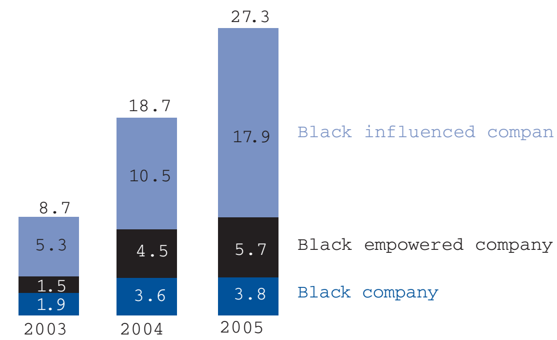
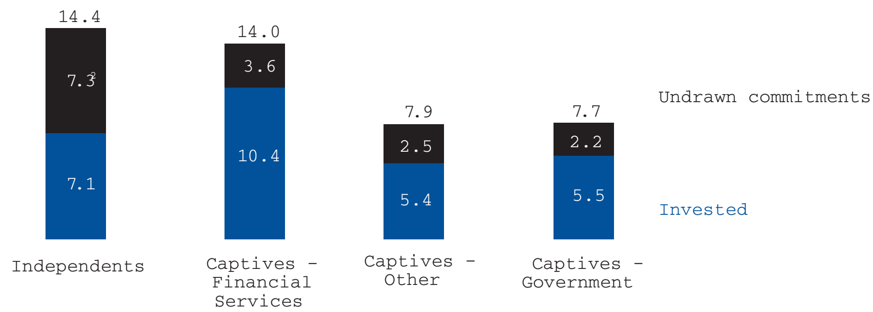
Funds under management by BEE fund managers at year end (Rbn)



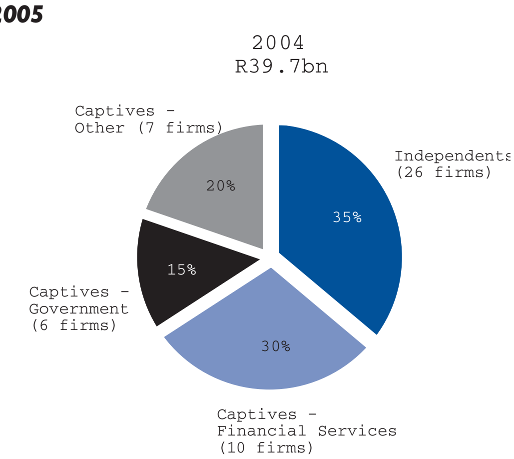
Total funds under management at 31 December 2005 split by undrawn commitments and investments (Rbn)

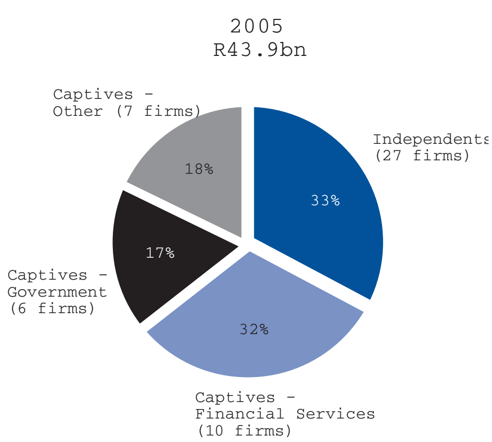


Realised gross IRR since fund inception

	0 - 5 years included in IRR calculation		5 - 10 years included in IRR calculation		> 10 years included in IRR calculation	
IRR	2005 No. of respondents	2004 No. of respondents	2005 No. of respondents	2004 No. of respondents	2005 No. of respondents	2004 No. of respondents
Below 10%	3	4	1	1	—	—
10% — 19.9%	1	1	—	1	—	—
20% — 29.9%	1	1	1	—	—	—
30% — 39.9%	3	2	2	3	—	—
> 40%	2	4	1	—	2	2

Total funds under management at 31 December 2005

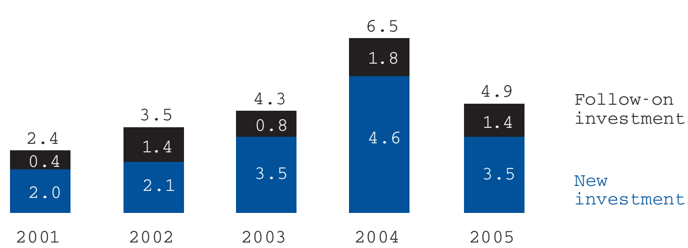




Measuring and reporting on the performance of private equity funds has always been a tricky area for the industry, due both to a reluctance on the part of the managers to disclose returns, but also a problem in achieving uniform valuation mechanisms. Two factors have enabled a move towards better reporting in this regard: the adoption of international valuation guidelines by the domestic industry, and a change in KPMG's approach in the way in which it asks for this information, which saw greater participation on this question.

Private equity returns are, for the purposes of the survey, reported on the basis of their internal rate of return (IRR), with Gross Realised IRR being the Gross IRR on the total realised portfolio of investments and thus excluding investments made that have not yet been realised/sold. Captive funds, especially those classifying themselves as Government Captives, do not always calculate IRRs since many have their own performance measurement criteria, such as job creation or social contribution. They are thus not well represented in the survey's performance reporting.

Cost (Rbn) and number of investments made during the year analysed by new and follow-on investments



Private equity may well be experiencing unprecedented interest in some sectors of the global market, but Warren Buffett isn't one of those singing the praises of the asset class.

Oracle of Omaha not exactly crazy about private equity

In his 2005 Chairman's Letter in the group's annual report, in a section entitled "How to minimize investment returns," he describes a scenario in which private equity managers form one of the vulture-like breed of expensive "Helpers" (wearing sewn-on sexy names like Hedge Fund or Private Equity) whose sole purpose seems to be to separate people and institutions from their money.

His longtime sidekick Charlie Munger elaborated on this theme at this year's Berkshire Hathaway AGM, when he said "at Berkshire, we are trying to welcome partners. With so many Helpers in the world today, they only talk about doing deals.

"Something like half the graduates from our elite schools want to go into private equity or hedge funds. They judge themselves by their same-age earners at Goldman Sachs. We have so many deal flippers in the game that I don't think there is enough to go around."

This reference to "deal flippers" is pure Buffett: he really got up the noses of the private equity industry this year when he charactised private equity firms as deal flippers that did nothing to create value. In fact, he said, whenever he gets a call from a private equity firm he puts the phone down.

He told the AGM that he would never buy a company from private equity investors.

Warren Buffett

"They invariably auction the business and are looking for strategic buyers," he said. "A strategic buyer is just someone who pays too much."

"We have so many deal flippers in the game they're going to get in each other's way," Munger added. "How will private equity firms continue to make money by just flipping and flipping and flipping and flipping?"

"They'll make it on fees, fees, fees," Buffett responded, adding that when he receives an offer from a private equity group he puts the phone down "even faster than Charlie."

At least the two men are consistent; in the 2002 letter to shareholders, Buffett said: Berkshire acquired some important new businesses – with economic characteristics ranging from good to great, run by managers ranging from great to great. Those attributes are two legs of our "entrance" strategy, the third being a sensible purchase price. Unlike LBO operators and private equity firms, we have no "exit" strategy – we buy to keep. That's one reason why Berkshire is usually the first – and sometimes the only – choice for sellers and their managers." ◆

Kagiso 'refining' its investment strategy, Tiso phasing out of private equity

The challenges of life for a BEE private equity company

Kagiso Ventures, the private equity arm of Kagiso Trust Investments (KTI), is facing up to the realities of life for an empowered private equity firm. As a result, it is refining its investment approach and undergoing a shift in focus away from the classical private equity model towards a more strategic investment holding approach.

"We frequently see a conflict in the alignment of interests between a fully-empowered private equity investor and other investors, usually corporate partners and sometimes management," says Kagiso Ventures CEO Afzal Patel.

Most often, says Patel, this conflict arises when the time arrives for the (BEE) private equity player to exit its investment in the normal course of a fund's lifecycle. Yet more often than not the purchasers – and indeed management and the corporate partner (if applicable) too – want the BEE firm to stay on. This enables the company to retain its BEE credentials and ensures the ongoing participation of the BEE private equity player in new business acquisition and so on. But for the private equity investor, it complicates the exit.

As a rule the BEE pressure to retain its stake in an investment is at odds with the medium term exit requirements of a private equity stake

It does of course provide some attractive reinvestment opportunities, as was seen with the sale of Waco International. Kagiso Ventures was the 25,1% BEE partner of Waco Africa, the South African business of Waco International. It sold its stake, realising several hundred million rand, but then the Kagiso group acquired a new 25% stake as a long-term investment proposition.

Nevertheless, as a rule, the BEE pressure to retain its stake in an investment is at odds with the medium term exit requirements of a private equity stake. This conflict is exacerbated where a BEE private equity firm is part of a larger empowered investment holding group. "What happens, then, is that we frequently find ourselves dealing with people who, given a choice between working with our parent and having a long-term partnership in an investment, or dealing with us, a private equity player with a shorter investment horizon, will prefer to deal with the parent."

Industry commentators are speculating that this is what has also led to the Tiso Group's decision to phase itself out of private equity in order to focus on proprietary investing. It may be noteworthy that the group did not want to discuss this decision with *Catalyst*.

Many other BEE groups are also grappling with the issue of on-balance sheet investments versus their private equity commitments. Issues around the 'cherry picking' of lucrative (often vendor-financed) deals for the group and doing riskier deals via their private equity funds present ongoing conflicts of interests for most established BEE groups.

Patel believes it is inevitable that BEE private equity firms are increasingly going to find themselves in this bind – private equity versus long term investment. Kagiso is now working on building a business model that will ensure the continued success of the business beyond BEE, codes and charters.

"The Kagiso group needs to create a long-term view that ensures our viability without the benefits of BEE as a driver of our business and so we are reassessing the appropriateness of the classic private equity model for our overall business philosophy. We need to be clear on our competitive advantage. It is not, for example size, or an ability – or appetite – to outbid all comers for a deal," Patel says, referring to the high prices being paid for acquisitions in the private equity sphere.

Patel notes that "there will always be LBOs and other opportunistic deals that lend themselves to the shorter term view, but our focus now is on building a sustainable base for the future. Private equity is perhaps the most 'pure' form of investment model, with every deal having to stand on its own merits, so we have learnt a lot from our experience with the asset class. Our challenge will be to retain the discipline of this investment philosophy in a longer term strategic investment model."

Private equity is perhaps the most 'pure' form of investment model, with every deal having to stand on its own merits

Afzal Patel

He says ad hoc private equity deals might still provide Kagiso's 'in' to an industry, enabling it to see if it wants to be in a particular space before committing to playing a more strategic long term role.

The dilemma facing Patel and his team is not exclusive to Kagiso Ventures, so while, as Patel says, "it is a pity for the industry," there are likely to be more BEE private equity firms reassessing their strategies.

"Pursuing a long-term strategic investment holding philosophy appears to be more in line with the spirit of BEE. It would, over the longer term, ensure that black companies have a more hands-on and influential role in their investments," he continues. He believes that the current strategy "is moving Kagiso closer to a more sustainable business model." ◆

HBD Venture Capital has recently launched a second fund with which it aims to fill a gap in South Africa for early stage funding. Fund 2 sees HBD offering substantially increased minimum and maximum investment levels per deal.

Change of focus at HBD

However, while it may indeed be filling a gap, there is some concern in the market that one of the active players in this arena is moving out of the bottom end of the VC market.

HBD is a captive fund, with Mark Shuttleworth as the sole investor.

HBD Venture Capital CEO Julia Long says that HBD Fund 2, has an investment mandate of:

- Minimum of R10m and maximum of R25m investment per deal;
- SA-based management team;
- Minimum of six months' trading history (no requirement for a profit, only initial customer adoption);
- A few industries excluded (typically real estate, agriculture, gambling, insurance, tobacco armaments and finance (fund of funds)); and
- Global potential

This is opposed to the now closed Fund 1, which had a mandate of:

- Maximum of R10m investment per deal;
- Innovative / breakthrough technology;
- SA-based management team; and
- Global potential.

Julia Long

Says Long: "A few of our current investments from Fund 1 are actually at the stage which we will be looking for in our Fund 2 investments. As you can imagine, it must be very frustrating for a start-up company to receive venture capital, work for a number of years to get to the point of acquiring its first customers, and then not be able to access further funding. So this is where we are now aiming to fill a gap.

"We see our Fund 2 as post seed funding but still in the very early stages of a business."

Long says HBD has also started to see more funding from government and angel investors at the real early seed stage – from quarters such as the Innovation Fund, IDC and so on.

The firm is also still managing its Fund 1 investments with a normal exit period of seven years, which is onerous in terms of HBD management time. "Our strategy, however, is to remain a small focused team and we have therefore chosen to target investments that would have a shorter exit period, more likely in the range of three to five years."

A further rationale for the shift in focus to Fund 2 is that HBD's current investments are all in the customer adoption and expansion phase. "If HBD continues to invest in companies that are focused on R&D, the set of skills required by us, as the investor, are different. It, therefore, complements our current portfolio to focus rather on investments that are at a similar stage to those we already have."

Long says she is aware that the obvious question regarding HBD's shift in focus is whether the company has upped its minimum investment level after having discovered that the returns do not justify the effort at that end of the market – in other words, if it has found that start-up VC is just not sufficiently profitable to be worthwhile on a commercial basis.

She concedes this could ultimately prove to be the case, "but the fact of the matter is that we haven't proved this either way. We still are shareholders of all the investments we have made to date. This means we haven't closed down any of them and of course we have sold any of them.

Mark Shuttleworth

"After five years into the investing of Fund 1 we are now starting to focus on the exiting of Fund 1. So, I guess you would need a patient investor like Mark Shuttleworth who is prepared to wait for over seven years for the return. Will it justify the effort? All I can say is time will tell."

Shuttleworth, while not involved in the operation on a day-to-day business, meets regularly with the HBD board.

The Medu Capital Fund has made a follow-on investment in Industrial Cable Supplies, a leading supplier of electric cables and wire, bringing its co-investment in Industrial up to 100%. It is invested along side Zest Electric Motors, in which Medu has a strategic 26% shareholding.

Medu powers up

The value of the acquisition has not been disclosed, says Medu's Nhlanganiso Mkwanazi. Medu is a majority black-owned and managed business with a R250m private equity fund.

Medu's other investments include:

- A 49% shareholding in VitalAire, a dominant provider of respiratory products and services;
- A 70% shareholding in Capital Outsourcing Group, a leading provider of temporary and permanent staff to a wide range of industries including FMCG, industrial, oil and gas, construction, printing and publishing, packaging, pharmaceuticals, logistics and retail;
- A 30% shareholding in Ampaglas Holdings, a leading manufacturer and supplier of thermoplastic and translucent roof sheeting and sanitary ware;
- A 3,75% shareholding in Pepko; and
- A 27% shareholding in NCS Resins, the largest manufacturer of unsaturated polyester resins in South Africa.

To what extent does gut feel play a role in assessing potential acquisitions? Quite a lot, says *New York Times'* chief mergers and acquisitions reporter Andrew Ross Sorkin, who believes this accounts for the significant differences in valuations reached by various bidding groups when a company is on the block.

Investing on gut feel

Writing on *PE Week Wire,* he refers to the auction for Spanish media company Univision, in which more than a half-dozen private equity shops all come up with significantly different valuations.

Univision, Spain's largest Spanish-language media company, was sold to a consortium of private equity firms that included Madison Dearborn Partners, Providence Equity Partners, the Texas Pacific Group, Thomas H. Lee Partners and media investor Haim Saban for $12,3bn, or $36,25 a share. The group beat out a rival "club" that at one point included Televisa, Blackstone Group, Carlyle Group, Kohlberg Kravis Roberts, Bain Capital and Cascade Investments.

"In the final days of bidding, the Televisa-led consortium all but fell apart, mostly over valuation issues. Carlyle was the first to drop out. It wasn't prepared to pay anymore than $32 a share. K.K.R. and Blackstone then bailed, unwilling to bid more than about $34 a share. The remaining group ultimately bid $35,75, which clearly wasn't enough. Bain was said to be against bidding much more than $36 a share, but its group never got the chance because Univision went with the other offer.

"So back to the question at hand. Isn't it odd that everyone came to such differ-

Isn't it odd that everyone came to such different valuations? Maybe that's what differentiates them, but that's probably not the complete answer

ent valuations? Maybe that's what differentiates them, but that's probably not the complete answer. After all, PE shops often come to different valuations – someone has to win these auctions – but the differences are usually only slight. And many of the valuation models and input metrics come from the same place – the McKinseys, BCGs and Bains that consult on so many of these transactions.

"Is it that these PE shops have different rates of return goals? That's possible, but most of the big firms in this top tier of the league are aiming for the same high watermark. Is one firm willing to take much more risk than another? Not really. Is it industry expertise? Could be. Providence knows a lot more about media deals than Carlyle. But that can't be it entirely either, because Carlyle was hooked up with Televisa, which knows this business better than anyone and ostensibly had synergies.

"At the end of the day, the answer may be that it's still all about gut. For all of the number crunchers and brilliant analytical minds with MBAs in private equity, it's really always been a game of who has the better instincts and a bit of luck. It's a metric that's too hard to put into a DCF model, but may be the most important." ◆

At the end of the day, the answer may be that it's still all about gut

Those who believe emerging markets private equity is just about pricing arbitrage are in for a shock, says Alistair Mackintosh, Chief Investment Officer of Actis.

Think local act global

"If we want to be successful; if we want to be seen as contributors to the emerging markets, we have to focus on business improvement and business transformation," Mackintosh comments.

"We have to show that capital, invested well, really does make a difference."

Actis is a leading private equity investor in emerging markets, investing globally in many emerging markets; although it is most active in Africa, China, Malaysia and South Asia.

Mackintosh points to the latest Emerging Markets Private Equity Association survey, which showed that the amount of money raised by private equity firms for emerging markets in 2005 more than tripled compared to 2004 (US$21.2bn in 2005 vs US$6.1bn in 2004). It also indicated that three quarters of the limited partners surveyed are already investing in emerging markets and 64% of them expect to increase their commitments over the next five years.

"Investors believe in the emerging markets' ability to deliver – and they are right to do so. There are huge opportunities to invest in good businesses and add value; to produce great returns for investors; and opportunities for quality private equity firms to make a real difference in the markets in which they operate."

Mackintosh says the firms that demonstrate consistent returns will be those that combine a particular range of skills and clearly add value to the companies and industries they invest in. They will have local knowledge that comes from a presence on the ground and experience of investing in these markets over an extended period. This echoes comments in *Catalyst* earlier this year by Actis's South African-based Africa-man Peter Schmid.

Mackintosh adds that private equity firms have to show they are not just about buying cheap and selling expensive, but about delivering real, sustainable business improvement. Firms need to know how to work with investee companies' management to best effect to demonstrate the value of change. An entrepreneur who has created a company sees making changes as a 'cost'. But show them how a similar business has been transformed by change and suddenly you are speaking the same language.

International round-up

Biggest buyout to date

The sale of US hospital chain HCA Inc. to a group of private investors for $32,5bn is set to become the largest leveraged buyout to date, just eclipsing the $31bn deal for RJR Nabisco in 1989. The buyers plan to borrow $16bn to pay for the deal and market commentators believe as much as $5bn may be raised in high-risk, high-yield ('junk') bonds.

The buyers include private equity firm Kohlberg Kravis Roberts & Co (KKR), which so famously engineered the Nabisco deal, Bain Capital and Merrill Lynch Global Private Equity. HCA co-founder and former chief executive Thomas F. Frist Jr, who owns an estimated 4,4% of the company, is also part of the consortium.

The chain offers its buyers substantial and relatively stable cash flow. Nashville-based HCA, the largest for-profit hospital chain in the US, owns 176 hospitals and 92 surgery centres.

IPOs as an exit route for PE firms in the UK

A recent report prepared for the British Venture Capital Association and the London Stock Exchange highlights some interesting stats about the use of stock exchange listings as a mechanism for exiting private equity investments. It showed that:

- Over the period 1998–2004, approximately half of the UK companies (excluding collective investment vehicles) that floated on the LSE's Main Market were backed by PE firms;
- PE-backed companies floating on the Alternative Investment Market (AIM) constitute a smaller proportion (around one-tenth) of total IPOs. However, the relative importance of AIM has been increasing in recent years, and in 2004 about half of all PE-backed IPOs were on AIM;
- When measured at original cost, divestments by PE firms at IPO, or by subsequent sale of quoted equity, average around 20% of the total amount divested over the 1998–2004 period;
- Trade sales are the most important exit route, constituting around 35% of divestments;

■ Since the public equity markets tend to be used for the most successful portfolio companies, the relative share of IPOs and subsequent sale of quoted equity would be higher if measured at market value.

Permira and Barclays Capital reportedly have raised their offer for UK-based retirement home builder McCarthy & Stone PLC to £1,06bn, or £10,30 per share. The firms originally received approval for a £10 per share bid, but then faced a rival £10,30 per share bid from a group that included Tom Hunter and the Reuben brothers. *PE Week Wire*

Western private equity firms might well be viewing places east as the new, new thing, but some of the signals from that part of the world will no doubt be setting off alarm bells.

In China, the government has again seemingly confirmed its opinion of control or majority buyout deals in that country. A government-aligned publication has reported that two largely government-owned and controlled companies would be bidding for Hong Kong's PCCW against two groups of foreign bidders. This follows an earlier announcement that only domestic firms should control "strategic companies," referring particularly to heavy equipment manufacturer XCMG.

Goldman Sachs reportedly is planning to raise around $10bn for its next private equity fund. This is lower than the $14bn or $15bn effort some were expecting, but still higher than its current $8,5bn fund.

Pantheon Ventures is looking to raise upwards of $2bn for its seventh US-focused private equity fund-of-funds, according to a regulatory filing. It already has secured $107,9m in commitments from limited partners like The New York Times Co's Pension Trust, the worker Benefit Plans of the Lutheran Church-Missouri Synod and the Ohio Highway Patrol Retirement System. *PE Week Wire*

The Carlyle Group has confirmed that it has raised $1,9bn for its Japanese buyout fund, Carlyle Japan Partners II. Carlyle's seven funds for Asia now manage $4,5bn in buyout, real estate, venture and growth capital investments. Carlyle has also reportedly cleared at least one regulatory hurdle in its bid to control Taiwan's Eastern Multimedia Group, moving it closer to completing one of Taiwan's largest buyouts to date.

Cabot Square Capital Partners of London is reported to be raising up to $1bn for its third private equity fund. It already has secured over $500m in capital commitments from limited partners like Princeton University.

Fifty US-based venture capital firms raised around $50bn during Q2 2006, the highest quarterly tally since Q1 2001. For more see the National Venture Capital Association at www.nvca.org.

The UK's Universities Superannuation Scheme reportedly is considering a reallocation of £6bn from public equities into alternative assets such as private equity and infrastructure. USS is the UK's second-largest pension system after BT Group, and represents university faculties and staff.

LPs speak out

Comment on private equity issues tends to be generated mostly by the private equity fund managers, which is why it's good to hear the thoughts of the institutional investors in private equity (the Limited Partners) from time to time.

Coller Capital's Global Private Equity Barometer is a snapshot of worldwide industry trends in private equity, with an overview of the plans and opinions of institutional investors based in North America, Europe and Asia-Pacific.

The most recent issue reports that investor demand for private equity shows no sign of slowing, despite record fundraising in 2005. Nearly half of LPs (48%) plan to increase their allocations to the asset class in the next 12 months (compared with 44% who were planning an increase six months ago).

Investors are becoming less tolerant of poorly performing GPs (General Partners – the third party fund managers). Within the last year, the proportion of LPs that have declined to re-invest with some of their existing GPs has increased from 45% in (European) Summer 2005, to 56% six months ago, to almost two thirds (64%) in this *Barometer*.

LPs' total historic returns from private equity have improved in the last 18 months (since the *Barometer* in Winter 2004-05). Nearly three-quarters of investors (73%) reported returns of at least 11% in this *Barometer*, compared with just over half of LPs (52%) previously. This improvement in performance is attributable in large part to the strong performance of buyout funds throughout the world over the last couple of years.

Unsurprisingly, satisfaction with *buyout* returns from Europe and North America is high – 63% and 58% of LPs respectively declare themselves *very pleased* with their returns from these areas.

LPs think Asia-Pacific buyouts will provide the most attractive opportunities for GP investment in the next 12 months. Asia-Pacific buyouts have knocked European buyouts into second place in the league table for the first time since the *Barometer* was launched in Winter 2004-05. This enthusiasm for Asia-Pacific buyouts is shared by LPs worldwide, with around 40%-50% of investors from each region declaring the opportunity to be *very attractive*.

Three quarters of investors expect an increase in the numbers of 'take-privates' (the purchase of quoted companies by private equity funds) over the next three years. This is true for LPs based in all regions of the world.

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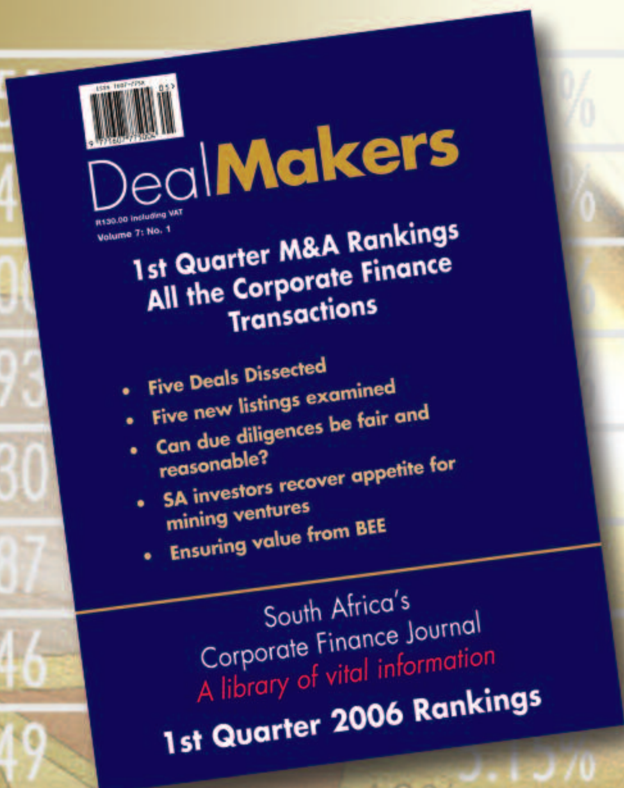

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