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Catalyst

SA's quarterly Private Equity
& Venture Capital magazine



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From the Editor's desk

Ill-informed attacks on private equity underlines need to engage critics

The news that two big-name retail chains, Shoprite and Edcon, are being considered for private equity-backed buyouts has brought this asset class to the fore among the broader public. On top of this, the proposed Alexander Forbes buyout by an Actis-led consortium has focused attention on private equity among a more select financial service audience.

This should be good for an industry that has been notoriously backward in coming forward about itself. Instead, however, it has prompted a string of ill-informed and sometimes alarming comments in the financial media.

Perhaps it's just bad timing that the news of these deals emerges at a time when some extremes of executive pay are being highlighted, Shoprite's Whitey Basson and Edcon's Steve Ross among them.

However, to suggest that those two companies might be taken private primarily in order to obscure from the public their CEOs' earnings is to impute some pretty unsavoury intentions to those individuals, their boards and their shareholders.

Most puzzling, though, was the suggestion (in *Business Day*), that these buyouts would "without question make our democracy poorer." This was followed by the entreaty that "if there is a legal way to stop them then it should be attempted".

The legal way to stop a company changing hands is for its shareholders to vote against the deal. Or for the Securities Regulation Panel, the Financial Services Board or the Competitions authorities to say no. It's that simple. While recognising that minority shareholders sometimes get a raw deal in the markets, any argument that this applies only in private equity transactions cannot be justified.

The criticism also completely ignores the fillip that private equity can provide to a business and an economy. To be fair, this is where the industry's sometimes obsessive desire to shield itself from scrutiny has backfired. *Catalyst* has previously reported on shortcomings in terms of disclosure, and while this is undoubtedly changing, that change has clearly not come quickly enough.

Leave aside the returns that private equity can deliver to its investors, who usually represent huge groups of private individuals,

through their pension fund investments. If critics believe, as does *Business Day*, that a poor populace would in the short term "probably be better off under a socialist regime," perhaps they should take a look at the economic stimulant and job creation aspects of private equity investment. (And ignore the fact that to argue that socialism would be better than the current free market system would surely be to argue that government should nationalise all businesses, including newspapers.)

There are as yet no firm figures in this regard in South Africa, but a Pre-Budget Statement Submission by the British Venture Capital Association to the UK Chancellor of the Exchequer for 2006/2007 in October this year confirmed that private equity-backed companies were a significant driver in the UK economy and its global competitiveness.

It said that 92% of responding companies reported that without private equity the business would not have existed at all or would have developed less rapidly.

Furthermore, "private equity-backed companies create jobs at a considerably faster rate than other private sector companies. Over the five years to 2005/6, the number of people employed worldwide by UK private equity-backed companies increased by an average of 9% p.a. This compares dramatically with FTSE 100 and FTSE Mid-250 companies, at 1% p.a. and 2% p.a. respectively. Furthermore, around three-quarters of companies said their growth was organic, rather than by acquisition, since they had private equity backing.

"Over the five years to 2005/6, on average private equity-backed companies' sales rose by 9% p.a., compared with FTSE 100 companies (7% p.a.) and FTSE Mid-250 companies (5% p.a.). Exports grew by 6% p.a., compared with a national growth rate of just 2.2% and investment rose by 18% p.a., compared with 1.1% nationally."

Half the firms said that their level of investment was higher as a result of private equity backing.

Private equity investments make sense only when the buyers believe they can add value. This does not mean guaranteeing under-performing and overpaid executives their jobs; on the contrary, it is well known that

under-performing management best beware when a private equity fund takes over.

The South Africa industry is structured along similar lines to that of the UK and local players believe this economy derives similar benefits from private equity. Clearly the SA Venture Capital and Private Equity Association (SAVCA) and its members need to move to demonstrate this as quickly as possible.

The departure of John Coulter and others from Brait is covered elsewhere in *Catalyst*. The one issue we don't deal with in that article is whether or not one should be reading anything into the reported sighting of Coulter having a lengthy coffee session in Hyde Park with former Brait CEO Mark Barnes and Wendy Appelbaum.

We had hoped to bring you a review of the Public Investment Corporation's comments and opinions on private equity. However, after trying since March this year to secure an interview with CEO Brian Molefe, we were finally, after many months, referred to Pani Tyalimpi. Schlepped all the way to the far reaches of Pretoria to meet with her, only to be told afterwards that she had "transgressed the policy of the company" in granting me the interview, and that Molefe is "in actual fact ... the only person allowed to grant interviews."

This precludes Tyalimpi, head of the PIC's Isibaya Fund, from discussing the activities within her purview. The Isibaya was established in 1999 and manages a portfolio valued at R13,2bn, making it, in the PIC's words, "one of the largest private equity funds in South Africa".

And now for our usual plug: *Catalyst* needs your support. Please tell us what you would like to see in this publication – 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. We need your input.

Jane Strachan

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Jane Strachan

The most comprehensive, independent actuarial research into private equity conducted so far in South Africa says that private equity has performed “spectacularly well” over the past 13 years - and suggests that there is a clear case for higher levels of private equity investment in pension fund portfolios.

Strong case for more institutional investment in Private Equity

A constructed ‘aggregate’ portfolio of the funds in the sample set produces a return premium of 18% pa, before costs, relative to the FTSE/JSE Africa All Share Index and 16,8% pa relative to the FTSE/JSE Africa Small Cap Index. Calculated Sharpe ratios (a measure of the risk-adjusted return of an investment) and indicates that private equity has produced good risk-adjusted performance relative to other asset classes over the period.

The research also found low correlations, of the order of 0.1, of the investment performance of the private equity funds in the sample set with that of other conventional asset classes.

The release of this report will no doubt be welcomed by the third party fund managers in particular, who not only have to convince some asset managers to invest their particular funds, but often have to “sell” the asset class as a whole.

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fund managers in particular, who not only have to convince some asset managers to invest in their particular funds, but often have to “sell” the asset class as a whole.

The landmark research, entitled “Is private equity a suitable investment for South African pension funds?” was conducted by Ivan Missankov, Riaan van Dyk and Werner van der Veen of the Momentum Group, Andrew van Biljon of Riscura (pension consultants) and Mark Hayes of QED Consultants and Actuaries. It was presented at the Convention of the Actuarial Society of South Africa in October.

The purpose of the study was primarily to introduce private equity in the context of pension fund investment to the actuarial profession in South Africa, examining the historical investment performance of independent private equity managers in the country and discussing asset allocation and the suitability of private equity assets for investment by pension funds. It focused on independent third-party funds, which the authors felt appropriately accommodated the criteria of access and reliability of data, a sufficiently long track record and suitability for access by pension funds.

In noting some of the unique characteristics of private equity – the specific style of active management, particular fee structures, a long investment horizon and limited liquidity – the researchers note that while some of these may represent drawbacks, these drawbacks are mitigated by high investment returns and diversification benefits.

Possible reasons for the existence of a performance premium and a higher expected rate of return are the tech-

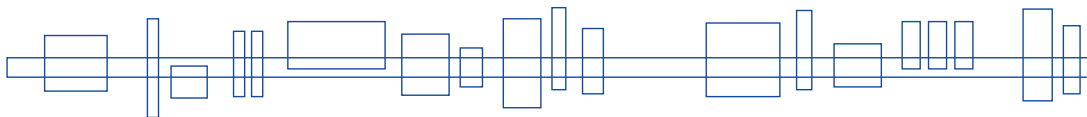
niques used by private equity managers in managing the underlying portfolio companies. The techniques involve due-diligence investigations, the negotiation of low entry and high exit prices, active involvement in the boards and management of the investee companies, the judi-



Riaan van Dyk

cious use of financial leverage and the alignment of investor and management interests through significant stakes in the business for a company’s management team.

“These techniques appear to bring about success, at least as far as our sample set of funds is concerned. From a required return perspective, the long



term and illiquidity of private equity investments suggest that investors should demand a significant liquidity premium from their private equity investments. If such a premium exists, which our study seems to suggest, then it can be said that an investor would be forfeiting a significant return in exchange for immediate liquidity by not investing in private equity."

In terms of costs, private equity investment is expensive relative to other asset classes. Funds charge fees of at least 2% pa on committed capital and a further 20% of performance in carried interest. The investigation suggests that the costs of investment decrease the returns of the funds in the sample set by approximately 6% pa.

With respect to asset allocation, the results led the researchers to conclude that private equity potentially has a significant role to play in a strategy designed to achieve real rates of return.

The impact of costs becomes more significant as funds mature. The level of fees has to be questioned despite the significant performance premiums, and the level of active management which takes place. It should also be noted that existing fee structures potentially result in

misalignment of the interests of investors and managers.

With respect to asset allocation, the results led the researchers to conclude that private equity potentially has a significant role to play in a strategy designed to achieve real rates of return. In particular, based on mean-variance optimisation, private equity could receive an allocation of up to 17% in a balanced long-only, but otherwise unconstrained, portfolio designed to achieve a return of up to 10% pa above inflation.

The results of the optimisation further suggest that in a balanced portfolio with a more conventional investment strategy, e.g. 55% South African equity, 20% bonds and so on, private equity may be held up to its assumed regulatory maximum of 5%, and up to 10%, if there were no regulatory limit. Such an allocation would improve the efficiency of a portfolio and contribute to meeting real return investment objectives.

"While the results of the investigations should not be treated as conclusive, they certainly point to benefits for pension funds which invest in private equity," says van Dyk. "Expected investment performance and diversification benefits should be powerful drivers for the allocation of assets to private equity investment, as should be the opportunity to meet BEE objectives.

The investment horizon of private equity investment, in particular, is especially suited to the long-term nature of pension funds. Liquidity should not be a significant concern, assuming a relatively low allocation of 5% of assets and what appears to be a substantial liquidity premium."

One of the issues frequently cited by pension funds as an impediment to investing in private equity is the difficulty they face in accessing comprehensive information from fund managers. This is

confirmed by the report's authors: "A key obstacle to the wider acceptance of private equity by pension funds has been the lack of definitive analyses of investment performance and an understanding of the nature of investing in private equity," they say. "In addition, in contrast to their colleagues in the asset management industry, private equity managers tend to disclose comparatively little public information about their underlying investments and the valuation of their portfolios.

"Performance statistics are generally not independently verified by, for example, investment consultants, and not easily comparable to those of more widely accepted investment vehicles. We suggest that the industry can only gain by opening itself up to the scrutiny that will necessarily arrive with wider pension fund attention and investment."

Research such as this should provide a foundation for better understanding of private equity as an investment for pension funds.

The authors stress, though, that further analysis is required of the performance of private equity as an industry, rather than just of independent third-party funds. A better understanding of the factors driving the performance of particular managers and any persistence in such factors is important to understanding the sources of return in a private equity investment. In time, this should also lead to a better understanding of the dispersion of returns among SA managers.

Finally, a detailed understanding of the costs of investment and their impact on investment returns is critical if private equity is to become a mainstream investment for pension funds, they say.

The team is expected to continue its work in providing detailed quantitative research into this important asset class.

PERFORMANCE DATA CHANGING PERCEPTIONS

Private equity may not be a new asset class, either internationally or locally, but the trustees of pension funds in this country and their consultants have not included or considered private equity

as integral elements in the design and implementation of pension fund investment strategies. This has been largely due to the lack of suitable performance data, concerns about liquidity and prob-

ably some degree of a general lack of understanding of private equity assets and investing. Such is the premise of this actuarial study, which examines the asset class in considerable detail.

There are indications, however, that perceptions towards private equity are changing. Pension fund

researchers have presented mixed evidence.

the table below. The private equity funds' performance is compared to South African Equity, SA Small Cap

Relative performance of private equity

Fund	Vintage Year	No of Months	Equity	Small Cap Equity	Bonds	Money Market	Property	Foreign Cash	Foreign Bonds	Foreign Equity	Foreign Hedge FoF
Fund 1	1992	132	28.3%	30.0%	24.6%	27.5%	28.2%	27.4%	24.9%	23.9%	22.0%
Fund 2	1995	125	15.9%	14.4%	16.7%	20.5%	13.2%	24.0%	22.5%	19.0%	18.7%
Fund 3	1996	118	13.6%	11.7%	12.7%	17.3%	8.1%	22.4%	20.5%	18.3%	17.8%
Fund 4	1997	103	-3.3%	-3.4%	-1.9%	2.6%	-9.3%	7.6%	5.3%	4.5%	4.0%
Fund 5	1999	87	0.7%	1.0%	8.3%	15.2%	-1.6%	22.0%	20.9%	21.2%	16.4%
Fund 6	1999	85	33.6%	33.4%	41.1%	47.0%	27.6%	54.4%	52.5%	53.4%	48.7%
Fund 7	1999	79	0.9%	-2.7%	6.2%	13.2%	-3.7%	20.0%	17.4%	19.9%	15.1%
Fund 8	2000	69	7.5%	-1.9%	13.8%	20.4%	3.3%	29.2%	25.6%	30.5%	26.0%
Fund 9	2001	54	9.9%	-5.3%	23.6%	27.2%	9.4%	43.2%	38.6%	35.2%	38.0%
Fund 10	2003	33	24.2%	6.1%	50.8%	56.2%	33.9%	71.0%	67.6%	51.1%	64.4%
Aggregate Portfolio	1992	164	18.0%	16.8%	19.2%	22.5%	19.1%	24.7%	22.3%	19.1%	19.3%
Minimum		33	-3.3%	-5.3%	-1.9%	2.6%	-9.3%	7.6%	5.3%	4.5%	4.0%
Maximum		132	33.6%	33.4%	50.8%	56.2%	33.9%	71.0%	67.6%	53.4%	64.4%
Average		88.5	13.1%	8.3%	19.6%	24.7%	10.9%	32.1%	29.6%	27.7%	27.1%

Relative performance of the sample set to other asset classes

consultants are paying increasing attention to private equity assets and managers, while trustees are looking to increase their knowledge of private equity investment. This trend is driven by the international prominence of private equity investments, the high internal rates of return quoted by independent private equity managers and the desire on the part of trustees and consultants, as well as some pressure from members, to find additions to the traditional listed equity, bond and money market assets.

Internationally, the decline in global stock markets after 2000 initially led institutional investors to invest in hedge funds. More recently, private equity investments have attracted significant attention and capital inflows as the latest class of investments to provide superior returns. Investment performance is widely-publicised and return premiums up to 55% pa to listed equity indices are reported. Nevertheless, the investment performance of private equity remains a

The performance premium of the sample set and a constructed aggregate private equity portfolio to conventional asset classes is illustrated in

There are indications, however, that perceptions towards private equity are changing. Pension fund consultants are paying increasing attention to private equity assets and managers, while trustees are looking to increase their knowledge of private equity investment.

Equity, SA Bonds, SA Property, SA Cash, Foreign Equity, Foreign Bonds, Foreign Cash and Foreign Hedge Funds of Funds, using the benchmarks listed above. SA hedge funds or funds of funds were not considered due to the lack of a suitable benchmark.

The maximum private equity out-performance of listed SA Equity is 33.6% pa but the poorest fund underperformed by 3.3% pa. The average premium over the different time periods was 13.1% pa while the Aggregate Portfolio outperformed listed equities by 18.0% pa.

The results relative to small caps are similar - the maximum out-performance of the

FTSE/JSE Africa Small Cap Index was 33.4% pa but the poorest fund underperformed small caps by 5.3% pa. The average out-performance was 8.3% pa and the Aggregate Portfolio outperformed by 16.8% pa.

The maximum out-performance of 71% pa occurred relative to foreign (US Dollar) cash, while the maximum underperformance of 9.3% pa was relative to SA property. ♦

If it comes off, it'll be the largest private equity deal in South Africa to date, though it would be comprehensively eclipsed if the Shoprite and/or Edcon buyouts were to be consummated.



Alexander Forbes

SA's biggest PE deal to date inches towards the finishing line



John van Wyk

It's the proposed buyout of financial services group Alexander Forbes by a consortium led by the international emerging markets private equity firm Actis, and the deal should have been settled, with more detail available, by the time *Catalyst* hits the streets.

The acquiring consortium comprises Actis and two other private equity firms, Ethos Private Equity and the US-based Harbourvest, and Canada's two largest institutional fund managers, Ontario Teachers Pension Plan Board and Caisse de dépôt et placement du Québec (*).

The number on the table when *Catalyst* went to print was R8,3bn, or 16,59/share, including a 59c dividend paid in September. This represents a premium of 18,3% to the closing price on June 6, 2006, the date prior to the release of the first cautionary announcement on the matter, making it very much a "full" price, according to Actis partner John van Wyk.

However, the proposed transaction is so complex – one of the legal firms involved says it is the most complicated set of legal agreements it has yet encountered – that there remain a number of details still to be ironed out. Not least of these is acceptance of the offer by VenFin, which owns 24,5% of Alexander Forbes.

Actis first started looking at Alexander Forbes about 18 months ago. It had already conducted a preliminary analysis of the business and initiated discussions with the board when the "bulking" issues arose, something that "came as a surprise," it admits. A chunky R500m has since been paid in settlement of the group's liability in this regard. A further surprise was the resignation of Chief Executive Rael Gordon.

Neither of these factors deterred the bidders: "There is no doubt that the bulking issue in particular was of major concern to the equity investors and our banking partners and required some modification of the terms," van Wyk says. "It was important for us to get to grips with the problems and form a view over their impact on the business into the future."

This was not an easy task. "But we are in the business of taking considered risks and have the mechanisms and procedures to assist us in understanding and quantifying risks of this nature."

"We remain convinced that the company presents a reasonable buyout opportunity. Among other appealing factors, it is one of the last truly independent businesses of its kind in South Africa. It is a reasonably good cash generator and it is quite well diversified between its Financial Services and Investment Solutions operations. We have a strong focus on corporate governance and will

work with the management team in fulfilling its commitment to set new standards of transparency and openness and reinforcing a customer-centric culture."

This diversification will enable the consortium to introduce "substantial" leverage into the transaction. The funding required will be raised through a combination of equity provided by the Actis consortium and various financing instruments provided by RMB, Investec Bank, Nedbank Capital, JP Morgan Chase Bank, Ontario Teachers' Pension Plan Board and the Actis Africa Empowerment Fund.

"We remain convinced that the company presents a reasonable buyout opportunity. Amongst other appealing factors, it is one of the last truly independent businesses of its kind in South Africa."

The deal also provides for Alexander Forbes' BEE partners, namely Shanduka Group, and the Alexander Forbes Community Trust, which currently own a stake only in the African operations, together with management and staff, to own at least 30% of the holding company, thereby better aligning interests.

The plan is to keep the group together as the consortium believes it has value

Catalyst

in its current form. It is worth noting that the nature of private equity allows for broader mechanisms to accommodate the needs of a human capital business; in other words, it can structure packages that enable it to attract and retain the highest quality management.

* Ontario Teachers' Pension Plan Board is Canada's second-largest fund manager, investing the fund's assets and administering the pensions of Ontario's 163 000 elementary and secondary school teachers and 101 000 retired teachers. The Plan had net assets of CA\$96bn at December 31, 2005.

Ethos did not want to comment at this stage, preferring, as it usually does, to wait until the fat lady has sung, gone home and is tucked up in bed before discussing deal details.

Financial adviser and sponsor to Alexander Forbes is JP Morgan, mer-

The Caisse de dépôt et placement du Québec was created in 1965 to manage the funds contributed to a newly created universal pension plan, the Québec Pension Plan. Other public-sector organisations subsequently became depositors, making the Caisse the largest institutional

chant bank to the Actis consortium is Rand Merchant Bank, legal advisers to Alexander Forbes are Edward Nathan Sonnenbergs, independent adviser to the Alexander Forbes Board is KPMG and legal advisers to the consortium are Deneys Reitz. ♦

fund manager in Canada and one of Québec's leading financial institutions. As at end 2005, depositors' net assets totalled CA\$122.2bn, and the Caisse's total assets under management amounted to CA\$216.1bn.

There are many similarities between wine-making and private equity - both require careful selection of the initial input, a great deal of patience and experience variable returns commensurate with management's skill in maximising the end result. Yet in both cases there are enough players in the market to create concern about surplus capacity.

Fine wine and PE - SAVCA adds Mogase to its blend

The contradiction with private equity, however, is that because the harvest cannot be guaranteed and the mechanisms appear opaque to outsiders, many who could be playing a role in the industry are nervous about investing in it.

This is where the Southern African Venture Capital and Private Equity Association (SAVCA) comes in. As already reported in *Catalyst*, the body has upped its game with the appointment of full-time executive director JP Fourie. At the same time long-standing chairman Malcolm Segal has completed his final term and has now been replaced by Mutle Mogase.

Mogase, in addition to being the new Savca chairman and executive chairman of Vantage Capital, is part of a group of four that earlier this year launched the Epicurean wine label. Mogase and friends Mbhazima Shilowa, Ron Gault and Moss Ngoasheng got into the wine business following an offer from Johann Rupert of certain of his facilities. Production, still limited, is distributed through restaurants and bottle stores in Johannesburg and Cape Town.

Mogase aims to bring the same passion he has for the wine business - and it is

indeed a passion - to his efforts at SAVCA. One of the key challenges, as he sees it, is to enhance the dialogue between the industry on one hand and the institutions and asset managers on the other. Interestingly, while he recognises that the industry has not done enough to further its own cause, particularly with regard to transparency and disclosure, he believes that pension funds and asset managers are not necessarily being honest about their failure to invest more in the asset class.

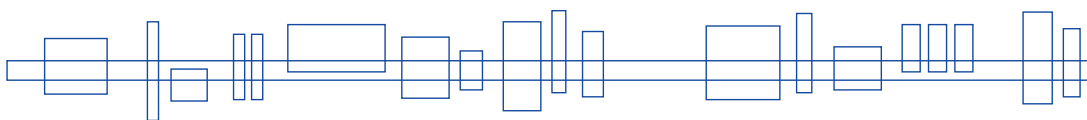
"I'm not sure that they have adequately investigated private equity," he says. "I think it may be easier to stick with the known, rather than spend the time getting to know a relatively new asset class."

He makes it clear in his quietly-spoken but assertive manner that he expects to play a role in SAVCA's drive to address issues such as these. Nor will government escape some serious discussion: "When one considers the role private equity can play in developing business and jobs - just see how many jobs private equity creates in the UK, for example - you see that issues such as tax treatment of the industry require urgent attention."

Mogase observes that venture capital has not received the focus it deserves either, but acknowledges that it is unrealistic to expect traditional third party private



Mutle Mogase



equity firms to move into the early stage space. For one thing, the remuneration models are different ... and the risk appetite of private equity investors is at odds with the risk profile of venture capital. "But there's no reason why we can't work to make this area attractive for other investors." SAVCA itself has not been particularly successful in focusing attention on venture capital to date, but this is one of the association's strategic thrusts for the year ahead.

Mogase (42) was born in Alexandra, Johannesburg, and schooled in Soweto. A scholarship paid for a post-matric year at St Johns College and for his subsequent B Com (Accounting), at UCT, a degree he completed after some sound career guidance from his father, former Johannesburg mayor Isaac Mogase.

A life-changing point came shortly after Mandela's release, the beneficiary of a professional development programme inspired by Mandela's arrangement with David Dinkins, then mayor of New York. It was a programme that gave Mogase six months with Chase Manhattan Bank in New York, a period that "changed his perception" of himself and his capabilities.

A few months after returning from Chase in December 1992, while he was

working for Nedbank, he joined friend Jethro Mbau, with Don Ncube and Oscar Dhlomo, in a consortium that was to purchase a stake in African Life Assurance. The deal came to fruition in November 1993 and Mogase, still employed full time, spent evenings and weekends contributing to the growth of African Life, whose holding company was Real Africa.

Real Africa listed on the JSE in March 1994 and in 1998 Mogase sold his stake and set up a private equity firm with Mbau, later to be joined by Colin Rezek.

An association with Brait in an effort to co-invest in and raise a private equity fund ultimately saw them move on to form what is now Vantage Capital, a black-owned and managed private equity fund manager.

To date, Vantage Capital has invested about R500m in 12 investments in its technology fund and on balance sheet. It also recently launched Vantage Risk Capital, the first South Africa black-controlled, fully independent mezzanine fund.

In addition to his roles at Vantage and SAVCA, Mogase:

- Was closely involved in the drafting of the Financial Sector Charter, having represented all the black interest

groups – in particular the Association of Black Securities and Investment Professionals, of which he was the founding president;

- Chaired the Programme for Technological Carriers (Protech) to secure funding and set up laboratories and user facilities on the peripheries of the townships;
- Is involved in the Thusano Trust, a beneficiary of and shareholder in Vantage, which oversees the Small Enterprise Foundation, a micro-finance programme making loans to poor women in rural areas;
- Chaired the Microfinance Regulatory Council, which helped oversee the new Credit Bill;
- Chairs Gauteng government's Blue IQ programme and is also trustee of Gauteng Partnership Fund, a social housing finance programme, which seeks to catalyse investment by banks in high density housing.

It seems, then, that when it comes to experience, Mogase represents good stock. It is now up to him, SAVCA and its members to ensure that the vintages of the future live up to expectations, ensuring that returns for all are palatable. ♦

Any doubt that sport is big business would have been dispelled by the buyout of sports goods and outdoor activities company Moresport by Ethos Private Equity and management for a total enterprise value of R681m.

On your marks ... Ethos and management buy Moresport

Moresport is the leading nationwide specialist sports goods retailer, trading countrywide through store chains – Sportsmans Warehouse, Outdoor Warehouse and Sportshoe World.

The company was previously controlled by Vestacor, Nedcor Investments and management, who've been through the wringer in trying to sell their investment (See *Competition authorities frustrating business overleaf*).

The value attached to the Massmart

offer for Moresport previously was R403m, but this was for 84.1% of the business, as opposed to 100% in the Ethos deal, and it assumed an effective date 18 months earlier than the current transaction.

Ethos says it saw in Moresport a company that is a leader in its niche, with a strong market position, "visionary" management and a solid track record of profitability. The positive growth indicators in the South African economy in general and

the retail and sporting sub-sectors in particular were additional attractive factors."

Ethos Partner Ngalaah Chuphi comments that Ethos first started looking at the company as soon as it realised there were problems regarding the Competitions Commission. "We spoke to Vestacor earlier this year and told them we would be interested in talking if the Massmart deal fell through."

By the time it became clear that Massmart was going to be out of the pic-



Ngalaah Chuphi

ture, Ethos was ready to move. "By then the company was showing markedly higher earnings than the previous year, and the retail sector had derated. Furthermore, we got the business at a discount to comparable listed multiples."

Chuphi says Ethos took the view that the interest rate upswing was not going to be as dramatic as the last one and this, combined with the fact that the group's customers are largely in the LSM7-10 bracket and therefore quite resilient to moderate interest rate hikes, meant they were not overly concerned about the changing macro-economic environment.

Moresport Chief Executive Kevin Hodgson says Ethos was one of a number of private equity firms and investment bankers to have approached the shareholders after the Massmart acquisition collapsed.

"We had been through an MBO before, so we had a good idea of the challenges faced by investors in a private company – but we were also clear on our requirements; we accept that they need to learn about the business and be involved at a high level, but we need to be able to get on with the business of running it. We were comfortable that Ethos had done enough deals in its time to be able to respect this."

Hodgson says the growing take-up of health and fitness activities in South Africa made prospects for the business look extremely sound, while the 2010 World Cup would further raise awareness of branded quality sporting merchandise.

Commenting on the recent interest rate increase, he says that while interest rate increases are never good for retail business, the type of goods sold through his group tended to be less susceptible to interest rate impact than products at the lower end of the retail market.

The group has 24 Sportmans Warehouse outlets and 13 Outdoor Warehouses and is about to add two more of the former and one of the latter.



Since when are Competition authorities meant to frustrate business?

Moresport has been through the mill when it comes to corporate transactions, having been part of previously-listed retail holding company Moregro, then unbundled as Moresport, subsequently delisted and wholly-owned (by Vestacor), done a management buy-in (with Vestacor and Nedbank), a buy-out attempt by Massmart and now a private equity deal with Ethos.

But out of all of these activities, the one thing that most frustrated management was dealing with the competition authorities over the proposed Massmart acquisition.

Massmart's bid for 84.1% of Moresport for R403m fell through in April this year after competition authorities prohibited it, and the sellers decided not to appeal. It took more than a year for a decision to be handed down, a decision which in the end put paid to the transaction.

The Competition Tribunal said Massmart had become a "significant

national chain of sports and recreational goods" with its offering of sports and outdoor merchandise through its Makro, Game and Dion stores. "The merger would lead to the elimination of rivalry between the two largest, strongest, most committed and experienced players in the sports and outdoor equipment market," it said.

Afterwards Massmart, in an official statement, said that Massmart would like to proceed with the appeal against the Tribunal's decision but, "notwithstanding the accommodation by the Competition Appeal Court to hear the matter on 1 August 2006, the possibility exists that a ruling may only be handed down in September 2006 or later, 16 months or more after the transaction was entered into.

"While the parties respect the competition process as set out in the Competition Act, this passage of time was never contemplated by the par-

ties, presenting the Sellers with a diminution of relative value and with challenges relating to the management and growth of Moresport within the constraints of a sale agreement.

"The Sellers' position is now untenable and they have decided not to proceed with an appeal. In the circumstances the parties have, therefore, agreed to terminate all agreements between them with immediate effect."

Moresport Chief Executive Kevin Hodgson told *Catalyst* that something needs to be done "as there are lots of unhappy people out there."

Yet this frustration with the competitions approval process is not unique to Massmart/Moresport; this debacle only highlights the issues being raised by many in the M&A business.

"It is a disgrace that one has to endure the levels of incompetence experienced with the competition authorities," says one business leader

who has been through this process. "One is happy to accept the verdict provided it is given by people who are informed and competent and provided within a reasonable period of time.

But this was certainly not the case."

He believes the competition authorities "are meddlers who see themselves as omnipotent and who are intoxicated by their own sense of

self-importance. They seem to believe that the best way never to get it wrong is not to make a decision, so they drag out the process beyond all reasonableness." ♦

Johnnic Holdings is moving into the international private equity arena with a commitment of up to US\$43,5m to New York-based private equity firm Blue Wolf Capital Management LLC. Blue Wolf focuses on middle-market investments in companies with complex issues, including government contracting, union relations and financial distress.

Johnnic shakes the market with move into offshore PE

Johnnic, a subsidiary of Hosken Consolidated Investments (HCI), has agreed to commit between \$33,5m and \$43,5m to Blue Wolf to allow it to begin investing. It will make majority stake investments of \$5m to \$30m in companies that generate sales of between \$10m and \$150m. Blue Wolf's IRR commitments to investors "will be defined in a prospectus to potential investors in due course."

Johnny Copelyn, CEO of Johnnic and HCI, describes HCI as "essentially a private equity fund of a special character," and says that the group does not have commitments to other funds in South Africa.



Johnny Copelyn

Blue Wolf, formerly called Partnership Equity, was founded by Adam Blumenthal and Josh Wolf-Powers, who worked together in the comptroller's office of New York City, where they pioneered a private equity programme.

"This investment represents a wonderful vote of confidence from a sophisticated and successful team whose middle-market investment strategy is almost identical to ours," said Blumenthal. He said he had "enjoyed a long-standing, close working relationship" with Copelyn and HCI/Johnnic chairman Marcel Golding, dating back to 1994. "Josh and I welcome Johnny's and Marcel's experience and expertise, and look forward to this new chapter in our relationship."

Copelyn said the role he and Golding had played in their apartheid-era fight for social change had provided unique insights into complex businesses that most investors saw as no-win situations.

"We have used these insights to acquire and build companies in our domestic market. The time has come for us to expand by putting our skills and a portion of our capital to work in the US market."

Domestic private equity players were surprised by the announcement, with several commenting that it was a pity, given Johnnic/HCI's empowerment credentials, that it had not committed to a local pri-

vate equity fund. Copelyn responds: "The USA commitment is a small part of our

Copelyn says the role he and Golding had played in their apartheid-era fight for social change had provided unique insights into complex businesses that most investors saw as no-win situations.

capital base and appears to us to be an appropriate level of diversification."

Another market view was that it was good that the group was seeing value in private equity as an asset class, irrespective of where it was investing. "This may open their eyes and the eyes of other South African institutions to the opportunities and returns within the local private equity market," he commented.

The investment in Blue Wolf is subject to SA Reserve Bank approval.

There's no shortage of *schadenfreude* in the financial services sector - which is why, when a top name such as group CEO John Coulter leaves Brait after less than 18 months in office, the 'phone lines around town are abuzz.

Musical chairs - the reality of the PE industry



John Coulter

In Brait's case this has been compounded by the departure of Brait director and private equity team member Chad Smart and two private equity colleagues, Darshan Daya and Sean Patterson. They've gone off to do their own thing.

There was similar hand-rubbing when Peter Schmid and John van Wyk left Ethos to join Actis, and more recently when that firm's Eugene Stals became a "semigrant" to Australia, moving his family offshore while retaining his ties with Ethos.

Even the departure of Soteris Theorides from AMB Private Equity, with the (unconfirmed) possibility of more to follow, has got the gossips going.

From a private equity perspective, Coulter's "release[d] from his contract" is neither here nor there, though, since private equity wasn't the skill he was expected to bring to the party.

Antony Ball, who moved from his exec-

utive chairman role to become CEO, will be refocusing on private equity, as will John Gnodde, who relinquishes his group deputy chairman responsibilities in the reshuffle. Given that private equity is the main profit generator for the group, shareholders will no doubt be pleased to hear this.

Ball comments that the industry is well-known for the staff turnover that tends to come when firms are raising new funds. This is the time for people to review whether or not they are willing to commit for the relatively long lifespan of a fund, typically five to 10 years.

"Any fund manager expects this," he says. "It is the reality of our business."

And of course the financial services sector has more than its fair share of strong personalities with high income expectations, making it a natural arena for staff turnover.

The increase in interest rates, rising inflation and the weakening of the rand will give some private equity players sleepless nights. Others, however, may be rather pleased with current economic conditions.

Diversify to reduce macro-economic shocks

Various issues will inform a private equity player's views of these factors including, among others, whether it is currently fundraising, negotiating acquisitions or exits, the type of assets in its portfolio and the extent to which debt is hedged.

Either way, given the major deals and big-number fundraising in the private equity industry this year, these three macro-economic factors require ongoing evaluation by the industry.

Mike Donaldson and Stephen Brown at

RMB Corvest note that further increases in interest rates will place cash flow pressure on highly-g geared investments that have not been hedged. In addition, consumer demand may decrease and operating performance could soften. "A combina-



Stephen Brown

tion of the two could result in a double whammy for some companies, particularly those that are highly geared and reliant on cash flows to pay off debt.”

Most large debt deals are hedged as a requirement of senior debt providers, but some of the smaller funds will not have

this protection in place.

In terms of inflation and the weakening of the rand, Brown and Donaldson say that some of RMB Corvest's investments have already experienced sharp increases in their input prices, especially where inputs are sensitive to increases in the oil price and steel prices. “If a company cannot pass these price increases on to its customers quickly enough, it will experience pressure on its margins.”

The upside for existing investments in a rising inflation rate environment, of course, is that where the debt value has been fixed, it leads to higher cash flows and, therefore, quicker repayment. And a weakening of the rand is good news for private equity investments that are strongly export focused.”

The conclusion to be drawn from all of these points is that a well-diversified private equity portfolio helps to mitigate



Mike Donaldson

these macro-economic factors.

Finally, Brown and Donaldson note that equities are (theoretically) lower priced in higher interest rate cycles. “We therefore aren't overly afraid of higher interest rates, since we prefer to make new investments when equities are cheaper.”

South Africa's two independent private equity fund “biggies,” Brait and Ethos, might soon be arguing over the title of manager of “the largest private equity fund in Africa.”

Which is the biggest of them all?

Ethos recently announced that its new Ethos Fund V has capital available for investment of R5,5bn (US\$750m), by far the largest fund in Africa to date, while market talk is that the new Brait fund may well eclipse this. An announcement is expected shortly.

At the end of 2005, according to the KPMG/SA Venture Capital and Private Equity Association annual industry performance survey, there was already some R7,3bn in undrawn commitments available for independent fund managers.

The Brait and Ethos funds referred to are not the only fundraisings this year. This means there will be no shortage of capital in South Africa for very large deals ... but it

There will be no shortage of capital in South Africa for very large deals ... but it also means that there is a vast pool of capital in the market chasing these big-ticket transactions, particularly when combined with the off-shore investment appetite.

also means that there is a vast pool of capital in the market chasing these big-ticket transactions, particularly when combined with the offshore investment appetite.

And as third party funds often operate on a “use it or lose it” principle, there is considerable pressure to invest their funds as soon as possible.

Ethos has already completed three Fund V transactions in South Africa; Kanderlane, Plumbink and the recently-announced MBO of Moresport. Ethos Fund IV closed in March 2000 with close to R2,5bn in commitments.

Brait's Fund III closed in June 1999 with over R3bn in commitments.

There is strong pressure on private equity companies to ensure that their portfolio investments achieve their employment equity targets. Yet smaller and medium-sized businesses in particular find the process of achieving sustainable BEE a challenge.

Treacle hits a sweet spot

"Once BEE ownership has been resolved," says Treacle Private Equity partner Njabulo Mthembu, "the challenge of recruiting and training historically disadvantaged individuals who have the potential to become senior managers in entrepreneurial environments is often challenging. In most cases these companies do not have the know-how, resources or funding avail-

able to achieve this objective."

Treacle, through its support of the Treacle Education Foundation Trust, aims to play a proactive role in this area. It is creating value for its portfolio companies in the pursuit of employment equity and has recently awarded two training scholarships, with two candidates to undergo both classroom and practical training, the latter being

at a Treacle Fund I portfolio company. The Foundation is a shareholder in Treacle Private Equity and, in addition to capitalising the Foundation for the purpose of providing training scholarships, Treacle has also provided additional capital which, with carried interest proceeds in Treacle Fund I, will finance the organisation's co-investment obligations in Treacle's second fund.

The cry in South African business today is about the "challenge" of attracting good black staff; even Reserve Bank Governor Tito Mboweni has controversially complained about the difficulty in retaining black employees.

Attracting - and holding onto - young black professional talent



Njabulo Mthembu

The private equity industry faces a particular challenge given that the big payday comes some years into a fund, when carried interest ("carry") starts to flow. Yet elsewhere in financial services a youngster with a financial bent has the promise of massive guaranteed bonuses from the start.

This, at least, is the common complaint. Yet, argues Treacle Private Equity partner Njabulo Mthembu, private equity provides an excellent environment in which to acquire the skills set that would enable someone ultimately to run their own business – the ambition of many a bright youngster of any background.

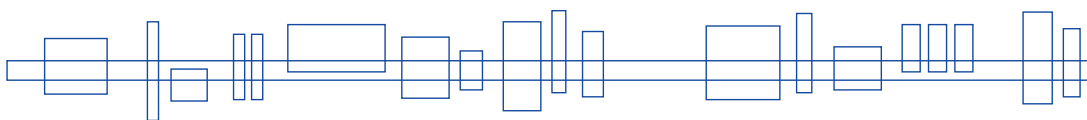
"In private equity one learns about business at the coalface," Mthembu says, "from origination of a transaction, to closing the deal, managing the business –

with all that that entails – and eventually selling it on.

"This is surely more valuable than a quick, short-term buck." So his advice to a young black person considering a career would be to defer the big payday and rather concentrate on doing something that has significant longer-term benefits. "And it's not as if people in private equity are particularly badly paid anyway."

He sees it as the industry's task to educate potential employees about its benefits.

Treacle is a majority black-owned private equity management company focusing on medium-sized businesses (turnover between R50m and R500m). The firm has raised two funds, Treacle Fund I (R244m) in 2000 and Treacle Fund II (R463m) in 2005.



Idion Technology Holdings is to sell its sole operating subsidiary, Vision Solutions International Inc, in the United States, to an affiliate of private equity firm Thoma Cressey Equity Partners (TCEP) for approximately US\$62,5m.

Over and out for Idion

TCEP is a US private equity investment firm that has been around for more than 25 years. Its investment focus is on companies in the software, healthcare, business services and consumer products industries and the firm currently manages approximately \$2bn of equity capital. Idion will be sold to Delaware-based IS Holdings, owned by TCEP.

Idion MD Nicolaas Vlok said the Idion board had believed for some time that the share price on the JSE did not

reflect the true value of the company. "This resulted in the Idion board examining various ways to unlock increased value for shareholders and to this end it engaged a US investment bank to conduct a strategic review of the various options available.

"After evaluating several options, the board concluded that a transaction with Thoma Cressey represented an excellent opportunity to unlock shareholder value."

Vlok is also CEO of Vision Solutions and he, along with the current Vision senior management team, will remain in place post transaction.

Idion originally listed on the Development Capital sector of the Johannesburg Stock Exchange in August 1998, moving in November 1999 to the Information Technology Sector of the Main Board. If all goes according to plan the listing will be terminated on 21 November.

The Business Partners small and medium-sized enterprise financing model is being rolled out to other African countries. To start, Business Partners International (BPI) and the International Finance Corporation (IFC) have launched the Business Partners International Madagascar SME Fund, a €8.5m risk capital fund.

Business Partners' SME model going beyond SA

The fund will provide quasi-equity financing and technical assistance to small and medium-sized enterprises in Madagascar. Alongside the Business Partners fund, the International Development Association has provided a \$2.0m facility to fund a technical assistance component of the fund's activities.

The Madagascar fund is the first BPI fund, with a second due to be launched in Kenya before year-end and a third already in planning.

Business Partners MD Jo' Schwenke says the joint venture is an ideal vehicle in which the Business Partners' way of

investing capital, skill and knowledge into viable SMEs can be rolled out into Africa. "We believe the combination of risk capital and technical assistance (mentorship and consulting) is the necessary catalyst to enable African entrepreneurs to realise their dreams and build sustainable, mainstream, world class businesses."

Says Haydée Celaya, Director of IFC's Private Equity & Investment Funds Department: "Launching the partnership with Business Partners is an important step in demonstrating the viability of this innovative business model for providing risk-capital to small businesses. The suc-

cess of BPI will show that working together in partnership with like-minded investors can bring innovative solutions to have a tremendous impact in developing difficult markets. We look forward to replicating this initiative."

Business Partners is South Africa's foremost specialist investment group providing customised and integrated investment, mentorship and property management services for small and medium enterprises. The IFC, the private sector arm of the World Bank Group, is the largest multilateral provider of financing for private enterprise in developing countries.

The acquisition of the Trellicor Security Group (TSG) by the UK-based SA Investment Opportunities (SAIOL) throws an interesting new player into the South Africa private equity mix.

Trellidor deal opens the gate to an intriguing new player

SAIOL is managed by Hibridge Capital, which is owned and run by two former South Africans, Mark Olivier and Mark Faulkner.

TSG, which owns the Trellicor, Coroma and Roll-up Serranda brands, was acquired by SAIOL for an undisclosed amount, seeded by Fidelity Investments International and Goldman Sachs International. It is the first investment by SAIOL but is unlikely to be the last. The fund has an equity stake in TSG of 69.5%, management 20% and the TSG founders, (Hugh Wimble and Philip Rodwell, who are retiring), have retained 10.5%.

The fund has been established particularly for the Trellicor transaction but as and when further opportunities arise in South Africa it will be used as the vehicle, with funding raised on a case by case basis.

Trellicor's revenue is forecast to reach R410m in the current financial year.

Hibridge MD Olivier told *Catalyst* from London that SAIOL had been established particularly for the TSG transaction but that as and when further opportunities arose in South Africa it would be used as the vehicle, with fund-

ing raised on a case-by-case basis. He said there were "one or two" potential deals on the horizon, and that Fidelity and Goldman Sachs had co-investment rights in the next venture.

Olivier said there were several reasons why Hibridge/SAIOL was acceptable to both management and the vendors: "Firstly, being offshore, we offered a degree of confidentiality they felt they might not have had with local buyers. This was a significant factor for them.

"They also liked it that the transaction was structured as a share rather than asset sale and that we didn't plan to gear the business from the start. As a result, the business now has significant internal capacity to fund future growth including potential acquisitions," Olivier said.

Finally, there was the fact that Olivier and Faulkner could assist in the growth of the business through their extensive network of contacts in the UK, developed over more than 15 years there. For example, while TSG's UK business is relatively small, the person who will chair the UK operation is currently chairman of the Federation of Wholesale Distributors in the UK and until his recent retirement was MD of Costco Wholesale UK Limited, a business with annual sales of over £1bn.

The UK business contributes 7% to TSG's revenue, without significant attempts thus far to grow this. TSG also exports to Australasia, the Middle East and elsewhere in Africa. Manufacturing assembly plants have been established in various countries, including the UK.

"Trellidor is an exportable product and we are able to provide the business with an ability to grow outside of South Africa, which would be more difficult for South Africa-based players." Of course

Ethos might disagree with this comment, given its achievements with Waco.

Olivier, an accountant, previously worked for Hawkpoint Partners (a corporate finance advisory business in London), BoE (on the UK Exco) and KPMG London.

Faulkner has over 20 years' experience in providing financial planning advice to high net worth individuals in

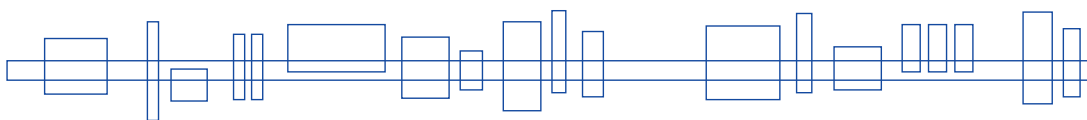


Terry Dennison and Mark Olivier

both the UK and South Africa. He co-owns a UK based independent financial advisory business and co-founded a property company in the UK, which is now one of the largest privately owned property groups investing in council housing in London.

The two Marks (school mates at Michaelhouse) formed Hibridge Capital in 2004, to service wealthy individuals and owners of private companies in both the UK and South Africa. They also service corporate clients whose requirements fall below the level of qualification at traditional corporate finance houses.

"We source proprietary 'off market'



investment opportunities that are not available through traditional investment houses for both South African and UK based high net worth individuals" said Faulkner.

With regard to external investor concerns about South Africa, Olivier said Finance Minister Trevor Manuel had been extremely good in providing the sense of stability and certainty required for investment. He said the concerns regarding a possible Jacob Zuma presidency and reported rifts in the ANC were

points of discussion in investor circles, though he added that "there is political uncertainty pretty much everywhere in the world right now, not just South Africa.

Furthermore, South Africa is an emerging market and investors expect to have to deal with issues such as this from time to time – in fact, quite a few of the emerging markets fund managers are ex-South Africans or have a South African association of some kind, and therefore understand the dynamics of these mar-

kets and build it into their return expectations."

It is worth noting that Hibridge has expertise in the UK council housing market. Olivier said it had looked at affordable housing in South Africa and that "if the opportunity is commercially viable we might look at it more seriously. However, our main focus is on finding South African businesses that produce world class products that are exportable and will benefit from our ability to facilitate growth outside of South Africa."

International round-up

The US Department of Justice has begun an inquiry into potentially anticompetitive behaviour among some of the world's leading private equity funds. The department has reportedly issued letters to a number of the US industry's best known players including KKR, the Carlyle Group, Silver Lake Partners and others. The enquiry pertains to how private equity firms bid for companies in leveraged buyout deals and the questionnaire apparently asks about price changes during a bidding process. At this stage the investigation is understood to be "informal" and cooperation voluntary, but there are no guarantees that it will stay like this or that charges will not be brought.

■ The Blackstone Group has raised its current fund target to \$20bn, according to The Wall Street Journal.

■ The Carlyle Group is planning to raise US\$15bn for its next US private equity fund, according to Bloomberg. It also reportedly is seeking €5bn for its next European private equity fund.

■ KKR is reported to have submitted a \$50bn bid for the French entertainment and telecommunications company Vivendi, following an on-off discussion process. If the deal does come off, it will be the largest LBO in the world to date. This would com-

fortably eclipse the \$31.4bn takeover by KKR in 1988 of RJR Nabisco, the deal that gave rise to the phrase "The Barbarians at the Gate."

■ The Blackstone Group and PAI Partners are to buy the UK's top biscuit and snack maker, United Biscuits, to gain brands including McVitie's cookies and Jacob's crackers, with a purchase price of more than £1.6bn. PAI is an existing United shareholder.

■ South Korea appears to be moving to allow insurance funds in the country to acquire as much as 15% of private equity funds.

India vs. China: No contest

From Asian PE News

"The ongoing war for the hearts, minds and money of private equity and venture capital investors is turning into a rout ... India is raising four times the funds that are being raised in China. The reasons behind this are becoming ever clearer.

"In China, which is preparing to enact stricter regulations for private equity and venture capital activity, the government is in the early stages of completely re-organizing its approach and control over for-

ign private equity investments in this country. In the long-term, having a single policy created and enforced by a half dozen regulatory agencies is no doubt good for the industry and China alike, in the short scheme of things, the introduction of another series of regulations and approvals means more delays.

"In India, on the other hand, the government has put out the "open for business" sign in large print as the government voted to approve KKR's half-billion dollar acquisition of Flextronics' software development arm in India. It was a resounding affirmation that India welcomes the investments of overseas pri-

vate equity and venture firms. Meanwhile, a flurry of new VC and PE funds have been announced for India, including vehicles from Sequoia, Matrix, NEA and Helion, among others.

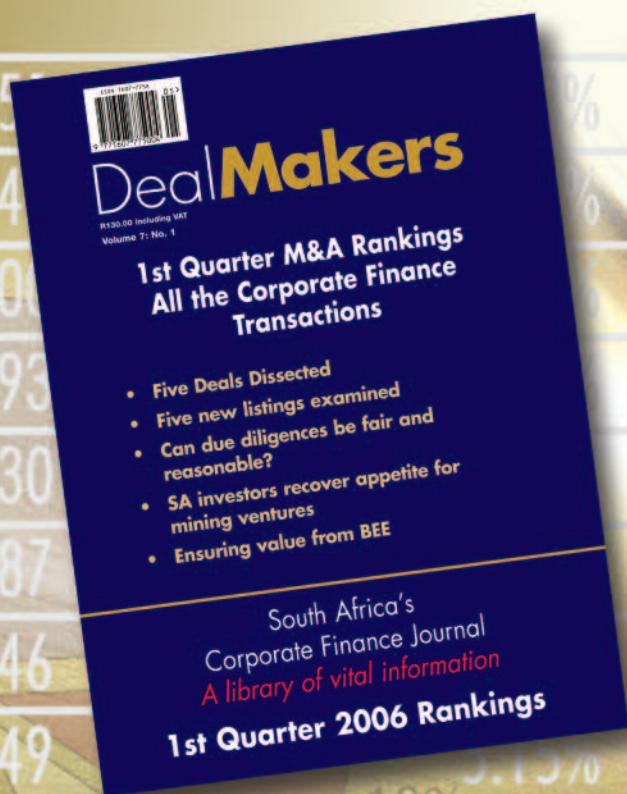
"More importantly there are deals galore as the investment pace in India is on the increase. Warburg Pincus announced two investments in the past week alone, but it's basically putting money back that it took out of its 6X return on its Bharti Telecom investments earlier in the year.

When all is said and done, India is set to fulfil predictions of overtaking China this year."

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