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Catalyst

GOLD MEDAL ISSUE

SA's quarterly Private Equity & Venture Capital magazine

Catalyst

From the Editor's desk

Of mavericks and private equiteers

A private equiteer walks into a pub with a big, beautiful parrot on his shoulder.

"My God! Where did you get that?" asks the barman.

"What? There's flipping millions of them in South Africa right now," the parrot replies.

The point of that little amusement is both to highlight the serious interest in private equity as an asset class right now, and to introduce a new term for practitioners of private equity: no, not asset stripper, locust or corporate raider, but 'private equiteer'.

It's better than the "pack of predators stalking the JSE" with which the February issue of *Maverick* magazine previews its feature on the industry.

The term private equiteer was coined by *Fortune* magazine in an article on private equity prospects for 2007, in which, incidentally, it sounded a note of caution. While describing private equiteers as the current rock-star embodiment of capitalism unfettered, it warned that "these heady days, in which every deal seems like a winner, can't continue". Said one veteran dealmaker: "There is no question that a meaningful number of these deals will crash and burn. I don't know which deals will stumble, because they mostly look fine at the moment. But it would be a complete historical aberration for there not to be reasonably significant default rates on these deals."

And *The Economist* was more forthright, observing that the amount of money pouring into private equity could push up prices and reduce returns. It also pointed to regulator agitation and shareholder concerns about feeling short-changed.

In Washington, private equity firms have formed a lobby group, The Private Equity Council, to deal with the attention their businesses are receiving as a result of soaring deal sizes and massive fund commitments.

While describing private equiteers as the current rock-star embodiment of capitalism unfettered, it warned that "these heady days, in which every deal seems like a winner, can't continue".

This follows the US Department of Justice's antitrust division issuing of letters to some top private equity firms asking about club deals, and the United Nations issued a warning to developing countries about the negative effects of some cross-border private equity sales. These are major image issues for the industry and underscore the need for a trade group. The Blackstone Group, Carlyle Group, Kohlberg Kravis Roberts and Texas Pacific Group are behind the Council.

This comes at a time when in South Africa we are in the midst of what will, if it comes off, be the largest private equity buyout in the country to date, by a very long shot. At the time of going to press, Bain Capital had offered R25bn for Edcon, which is some way above the R14,2bn on the table for Shoprite. And the country's two top third-party private equity fund managers have between them recently announced new funds of more than R11bn which means more big deals must be on the horizon.

The Alexander Forbes deal documentation includes a break fee of R30m for the Actis-led bidding consortium. This figure was thrown into deep shade, however, by the US$720m termination fee payable to Blackstone under certain circumstances in the event of its bid for EOP failing. An interesting – and controversial - issue, this. We'll take a closer look at the concept in the next issue of Catalyst.

We'll also look at the tax implications for private equity of the February 21 Budget, in particular the change to Section 9B of the Income Tax Act, which deals with the taxation of realisation gains for investors. This is has significant implications for the industry and has been the subject of debate and submissions for some time now. The Budget also commits to lowering the current shareholding threshold for foreign direct investment outside of Africa from 50% to 25%, to further enable South African companies to engage in strategic international partnerships. This is also to be welcomed.

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Jane Strachan

Just as Catalyst was going to press, the offer price for Alexander Forbes was increased to R17/share.

The anatomy of an exceptionally complex deal

The Alexander Forbes deal – long hours, sweat and some tears

It's being billed as the most complex private equity transaction in South Africa to date. It is nearly done now, but in the early hours of December 16 2006, it was so touch and go, and had become so stressful for all involved, that some members of the Alexander Forbes buyout deal team must surely have considered just walking away.

John van Wyk

They pressed on, however, to submit their offer for the R8,3bn (US$1,2bn) transaction.

The Alexander Forbes board wanted the deal finalised by the end of the year. The Securities Regulation Panel (SRP) would not give its approval, however, unless signed debt agreements were in place – firm intentions were not good enough.

Meanwhile, holidays were looming, much-needed time-off after an incredibly difficult year. Spouses were threatening to walk out, the odd desk had been punched and various team members – fortunately at different times – had to be brought back from the brink of quitting in frustration.

But finally, some time during the day of Saturday 16 December, the "Firm Intention to make an Offer" was signed.

This was the culmination of a process that, for the Actis team at least, had started nearly 24 months earlier. And it was a deal that, as the finish line loomed, saw the involvement of nine consortium members, including the empowerment partners and management, and six debt providers, to say nothing of huge teams of advisers on all sides.

"We had our first exploratory look at Alexander Forbes about two years ago, really just a sounding out about the business, where it was going and so on," says Actis partner John van Wyk. "There wasn't much interest from Alexander Forbes management at first and things went quiet."

Then, later in 2005, Actis reactivated its interest in the business and went to see VenFin Risk Services (Proprietary) Limited (VenFin), which owned 25.1% of Alexander Forbes, with a presentation on a possible buyout, detailing a proposed mechanism to achieve this. There could be no deal without VenFin. In the midst of this process VenFin had the distraction of it own buyout by the UK's Vodafone group, which stalled further discussion at that point.

More discussions with Venfin followed and the Alexander Forbes board then advised Actis that it had received some other unsolicited interest in the group and had decided, in May 2006, to look at all potential suitors.

It is understood that approaches had come from other private equity investors, as well as some potential trade buyers. "So at the end of May we submitted a formal expression of interest in buying out the group and were selected by the Alexander Forbes board as the preferred bidder," says Actis investment principal Garth Jarvis. Actis had by then already made considerable progress with its investment case and had in principle approval to proceed. "This enabled us to move quickly and definitely put us ahead of the game," they say.

So far so good … until the first hiccup of note, being the resignation from Alexander Forbes of CEO Rael Gordon. "This was unexpected, but something we felt we could deal with," says Jarvis. "The

Garth Jarvis

Natalie Kolbe

Jacob Hinson

bulk of the business was in South Africa and we felt it didn't make sense to have the CE sitting in London. However, this did create uncertainty that we could have done without at that point."

It was a deal that, as the finish line loomed, saw the involvement of nine consortium members, including the empowerment partners and management, and six debt providers, to say nothing of huge teams of advisers on all sides

The biggest problem, however, was yet to come: in June the Actis team heard about the bulking of retirement funds, which broke in the media a day or two later. This meant a R380m provision which was to severely impact the profits for F2006. "And we didn't know what impact the issue would have going forward," says Actis investment principal Natalie Kolbe.

"There were both reputational issues and the potential loss of business; there was a knock-on effect throughout the business. The Actis consortium did as much as it could to get comfortable, but in the end you have to take a view," says Kolbe.

At one point the uncertainties thrown up by bulking and other issues were such that the entire team spent a few weeks 'pens down,' which interrupted the transaction momentum that had been growing before that.

The contagion from the bulking issue added considerable further pressure at a time when the details of the offer should have been the focus of the team's time and energy. One major problem pertained to the funding package: the team had pulled together an over-funded position in terms of both the debt and the equity components, but the bulking shambles saw some large commitment withdrawals.

"We suddenly found that our 'over-funded' position had been wiped out which placed the consortium at considerable risk if another equity partner were to drop out," says van Wyk.

On the debt side, the challenge was that the deal had initially been fully underwritten by international banks. However, it was soon realised that certain structural complexities in the Alexander Forbes business made it impossible to utilise the structures of debt initially planned, so the team had to go into the preference share market.

The negative publicity associated, among other things, with the bulking issue, was a concern for credit committees of the local banks. But luckily three of the local banks were able to get their committees comfortable with the issues and each institution came in taking an equal slug of the prefs, and the problem was resolved, but not before the deal had at one point effectively been pronounced dead.

In the midst of all of this the team was also required to negotiate the complexities of unwinding the existing Alexander Forbes BEE structure with the BEE parties, and structure, negotiate and agree the terms of the reinvestment. Then came the pressure to finalise before the year-end break, so the heat was on.

"We've certainly learnt that while we had always felt that the South African financial markets were very robust, in terms of the big complex deals it is actually quite thin," van Wyk comments. "Without offshore funding packages large transactions are going to be more difficult."

One significant logistical issue was the fact that with some of the major participants being based in North America, the time difference meant that conference calls rarely started before mid-afternoon South African time – and often went on late into the night. And at the start of the process, when there was the prospect of Asian money coming in, work often started long before dawn. Hence the long days and short tempers.

One deal team member describes how at one point, in the early hours of the morning, he heard a colleague in the midst of a long, complex and heated conversation. "I stuck my head around the corner, took one look at his face and knew that if I said anything he would probably come across the desk and rip my head off! I just turned around and walked away quietly."

In the run-up to the 2006 year-end, though, it was all systems go. It is fair to say that the legal team, led on the Actis-advisery side by Kevin Cron of Deneys Reitz, was under enormous pressure. (see 'A legal effort of immense proportions'), as was everyone involved.

By some time on December 16, though, the documentation was complete and submitted and, with a sigh of relief, the participants were able to take a bit of a break.

This is not to imply, of course, that it was all smooth sailing after December 16: the Actis team was well aware that without support from the required 75% of shareholders attending and voting at the shareholders' meeting on February 28 [the day this issue of *Catalyst* will be published], there was always the prospect of an upset.

"Whatever happens, it will have been, without doubt, the most complicated deal in which I have been involved in my career to date," says van Wyk. "There has been a serious opportunity cost for our organisation, as the transaction has absorbed the energies of everyone involved but, at the same time, the creation of intellectual property for the Actis team was immense."

What he doesn't say is that when – or perhaps if – the deal is finally done, the next round of hard work will be about to begin.

- The Actis consortium comprises two other private equity firms, Ethos Private Equity Fund V and Harbourvest Partners LLC, and two Canadian fund managers, Ontario Teachers' Pension Plan Board and Caisse de depot et placement du Quebec as well as Black Economic Empowerment partners the Shanduka Group. ◆

Deal advisers to the Alexander Forbes transaction

Financial adviser and sponsor to Alexander Forbes:	JPMorgan
Financial adviser to the Actis consortium:	Rand Merchant Bank
Legal adviser to Alexander Forbes:	Edward Nathan Sonnenbergs
Legal adviser to the Actis consortium:	Deneys Reitz
Independent adviser to the Alexander Forbes Board:	KPMG
Adviser to the BEE consortium:	AMB Capital
Tax adviser to Actis consortium:	Webber Wentzel Bowens

There were more than 100 legal documents on the debt side alone in putting together the Alexander Forbes transaction. Many of the country's leading legal brains worked on the transaction, as well as some senior legal advisers in New York and London.

An unprecedented legal effort

Kevin Cron of Deneys Reitz, which advised Actis, says that everyone was under enormous pressure. Cron worked on the transaction side with colleague Ross Lomax and comments that the challenges were twofold. First, there was the nature of the Alexander Forbes business, which is diverse with a number of regulatory implications, given its financial intermediary and long and short term insurance businesses and the domestic and offshore components. "It's not exactly a simple manufacturing company," says Cron wryly. "The group took a fair degree of understanding from both the legal and risk analysis points of view."

Then there was the debt team, where the firm's Lionel Shawe, Deseré Jordaan and Gavin Noeth carried the load. With the nature of the debt structure being new to South Africa, it was more complex than has been the case in other buy-out transactions on which they'd worked. It required a high level of financial engineering behind the companies making the bid, with the many contracts having to be interwoven to ensure that the debt and equity contributions and flow of funds "all made sense."

Cron agrees that the pressure on the entire transaction team was at times unusually stressful. "It's gone through phases," he says. "When the workflow was peaking, such as when the push was on to get it all finalised by mid-December, we were all working long hours and under a great deal of pressure.

"Dealing with a consortium that was partly foreign-based made the logistics particularly difficult. The Canadian investors were out for meetings and so on, but much of the work was conducted by email and conference calls well into the night.

"But from a legal point of view these deals are interesting and exciting," Cron concludes. "They are not run-of-the-mill and therefore challenge and stretch one."

Webber Wentzel Bowens partner John Bellew was largely responsible for devising the security structure for the debt aspect of the transaction, with his client being JP Morgan.

> **"For us this has been a big learning curve, as it is to my knowledge the first time that an international leveraged debt structure including senior, mezzanine and PIK debt has been seen in our market place."**

Bellew describes the structure as "extremely complicated," primarily because there are essentially three levels of 'debt': senior, mezzanine and payment-in-kind (PIK).

The rise in PIK debt, or bonds that may pay bondholders compensation in a form other than cash, is a fairly recent development in advanced LBO markets. "The interest on the PIK debt in the Alexander Forbes transaction will not be paid in cash," says Bellew. "It will effectively be capitalised and new PIK notes issued."

Much of the complexity around the security structure arose because the senior 'debt' in the transaction is being provided in the form of preference shares. As a matter of law preference shares are equity and therefore rank behind any form of debt, yet as senior debt it should be first-ranked.

To overcome the problems occasioned by the equity nature of the senior debt, it was necessary to use three security SPVs on an almost cascading basis, with the interrelationship between these, and the circumstances in which each would be called upon in a default situation, causing additional complexity.

The structure also had to accommodate the structural subordination required by the debt providers, which effectively meant that each layer of debt had to be lent into a dedicated ring-fenced company. This resulted in a ladder-like ownership configuration, with different layers of debt being advanced at different rungs of the ladder, with senior debt being closest to the operating level.

More complications were caused by the purchaser being compelled to purchase shares, but wishing to purchase the underlying businesses. This resulted in two tranches of debt – a bridge to purchase the shares and permanent debt applied to finance the subsequent nature of the business. Both tranches had to be accommodated by the security structure.

"For us this has been a big learning curve, as it is to my knowledge the first time that an international leveraged debt structure including senior, mezzanine and PIK debt has been seen in our market place. However, with the size of private equity deals now being undertaken, I am sure that this kind of transaction will become commonplace, and our experience on the Forbes transaction will stand us in good stead," Bellew concludes. ◆

February 28: a crucial date for the Actis consortium and Alexander Forbes. This is the day on which shareholders will vote their approval, or otherwise, of the buyout proposal put together by Actis.

This is also the day on which *Catalyst* hits the streets, which means the crucial final stage of the transaction is not included in our coverage.

At the time it was announced it was the largest private equity deal in South Africa to date (though Edcon appears likely to assume this mantle in 2007).

Private Equity Deal of the Year:

The Alexander Forbes buyout by an Actis-led consortium

Apart from price, this transaction is undoubtedly the most complex of the year: more than 100 legal agreements for the debt alone, the involvement of nine consortium members and six debt providers, to say nothing of more than a year's worth of work and a great deal of blood, sweat and tears. Well, sweat and tears, at least.

The details of the process are outlined in "Alexander Forbes: long hours, sweat and some tears" (see pg 3)

The key criteria adopted by ***Catalyst*** in determining the Private Equity Deal of the Year are:

- Size (though high rand value alone is not enough);
- Status at year end (the likelihood of completion);
- Deal complexity: how strategically clever was it? Did it require innovations in terms of structure? Were there intricate legal issues involved?

The most vexing criterion was that regarding deal status at year end. A number of private equity players suggested a deal should not be considered adequately 'done' until all shareholder votes had been concluded and all regulatory and legal approvals granted, though the money didn't need to have been paid.

The members of the ***Catalyst*** team spent nearly as much time debating the rules as the Alexander Forbes deal team spent structuring their transaction and came to the conclusion that, as with the **DealMakers** M&A Deal of the Year, if the bulk of the work has been done in a particular year, and there is good reason to believe that the bid will be successful, then it should count.

The size of the Shoprite transaction would have given it a significant edge over Alexander Forbes, but by 2006 year end we believed there was too much uncertainty surrounding its conclusion for it to come into contention. Critically, a number of major stakeholders were still adamant that they would not support the deal, although scheme revisions in January managed to swing the vital Allan Gray support.

On the other hand, the R6,2bn Consol deal was looking fairly certain by year end, but the only issue that added greater 'value' and complexity to this one is that the Brait offer that pushed the already-announced Ethos bid off the table. We did not consider this to be sufficient.

Another in the running was the acquisition of Safripol by an ABSA Capital-led consortium, from Sentrachem. It had a deal value of almost R1,3bn and was completed by year end. It was a business carve-out with many intricacies, requiring a complex due diligence in order to understand the long term trends in plastics. It was also a highly sought-after asset contested by a number of private equity investors over the last two years.

Then came the Alexander Forbes transaction. This had reached a point where the acquiring consortium had submitted its firm intention to make an offer, documentation relating to the funding had been finalised (the last condition precedent) and the cautionary withdrawn. Furthermore, there were no out-of-the-ordinary shareholder problems on the horizon.

> **The size of the Shoprite transaction would have given it a significant edge over Alexander Forbes, but by 2006 year end we believed there were too many uncertainties surrounding its conclusion for it to come into contention**

The buyout received unconditional Competition Tribunal approval on January 24, with the shareholders' meeting to discuss the scheme set for February 28.

So, despite that final February 28 hurdle, and the risk it may not win shareholder support, we concluded, nevertheless, that it is deserving of the Catalyst Private Equity Deal of the Year award. ◆

We were thin on the ground in terms of major deals actually concluded during 2006, since much of the industry's activity seemed to be occupied in fund-raising and working on major transactions which will only come to fruition – if at all – this year.

And some other ins and outs of 2006

Catalyst has attempted to compile a table of deals concluded during the year but it is by no means comprehensive. We were reliant on input by the private equity companies themselves – and they are notoriously reluctant to share their information. **It excludes the deals that receive more comprehensive coverage elsewhere in this publication.**

Please note that the information published is supplied entirely by the private equity companies themselves, with no independent verification by *Catalyst*. ◆

ACQUISITIONS 2006

Company acquired	Acquired by	Acquired from	Transaction value
17% of NCS Resins	Medu Capital and Management	Management shareholder	Not available
25.1% of KSB Pumps	Medu Capital	KSB AG	n/a
Al Clad	RMB Corvest/Tandem/ Management	Introduction of BEE parties	n/a
Aluvert	RMB Corvest	Aronowitz Family	n/a
Chemspec	RMB Corvest/Tandem Capital/Management	Dykins Family	n/a
ERP.Com	Treacle Private Equity	Black Information Technology Empowerment Company (Blitec) and Gateway Technologies (Proprietary) Limited	R 79.8m
Fidelity Security Services Group	RMB Corvest/New Seasons/ Management	Introduction of BEE parties	R287m
Filter and Hose Solutions	RMB Corvest/Tandem Capital	Existing management	n/a
Gazelle	RMB Corvest/Tandem Capital	Existing management	n/a
Industrial Cable Suppliers	Medu Capital, Zest and Management	Founder	n/a
Life Healthcare	OMIGSA Private Equity	African Oxygen Ltd	R168.8m
Metcash	OMIGSA Private Equity	Investment via a rights issue	R45m
Molapo Technology	RMB Corvest/Safika Investments	Introduction of BEE parties	n/a
Moresport	Ethos Private Equity and management	Company previously controlled by Vestacor, Nedcor Investments Limited and management	R681m
Outdoor Network	Sanlam Private Equity and ZICO	RMB Corvest	R140m
Plumblink	Ethos Private Equity, management and BEE partner ISS	Control purchased from a consortium of sellers	n/a
Quantum Asset Finance	RMB Corvest	Existing management	n/a
Safripol	ABSA Capital-led consortium	Sentrachem	R1,27bn
Senwes	Treacle Private Equity and Royal Bafokeng Finance	Senwesbel	R123m, of which Treacle's portion was R43m
Servest	RMB Corvest/ Safika Investments / Management	AMB Capital Partners	n/a
Shanduka Resources	OMIGSA Private Equity	Shanduka Resources	R 90m
Venfin	OMIGSA Private Equity	Venfin	R75.15m

EXITS 2006

Company sold	Sold by	Sold to	Transaction value
Azur	Sanlam Private Equity	Management	Not available
Dunlop	An Ethos Private Equity-led consortium	Apollo Tyres (India)	n/a
Foodcorp	OMIGSA Private Equity	Mezzanine Partners and Foodcorp Redemption	R64m
HT Group	An Ethos Private Equity-led consortium	NUMSA	n/a
Kgorong Investments/Alstom	Sanlam Private Equity	Kagiso Strategic Investments	n/a
Lanseria International Airport	Sanlam Private Equity	Management	n/a
Life Healthcare (part disposal)	OMIGSA Private Equity	Docvest	R63m
Medscheme	Actis Africa Fund I	NetPartner	Actis exited its 8.88% stake
Moresport (Pty) Ltd	Nedbank Capital Private Equity & management	Ethos Private Equity Fund & management	R681m
Outdoor Network Ltd	RMB Corvest and management consortium	Zungu Investments Company (Pty) Ltd	n/a
Peermont Global	Sanlam Private Equity	MIC, Brait, Management	n/a
Replication Technology Group	RMB Corvest	Management	n/a
SAVCIO	OMIGSA Private Equity	SAVCIO redemption	R105m
Trans African Concessions (TRAC)	Actis Africa Fund II	African Infrastructure Investment Fund (AIIF), managed by African Infrastructure Investment Managers (AIM), and was composed of existing co-shareholders that exercised their pre-emption rights	Actis sold its 26.9% stake in TRAC, the Public Private Partnership responsible for the R3bn N4 concession
Wade Walker Pty Ltd	Management and Safika Investments	Murray & Roberts	n/a

This was undoubtedly the most controversial private equity deal launched in South Africa in 2006.

If it's up your street, you *can* still invest in Shoprite

When good old Shoprite, that retail chain just up everybody's street, became the target of a private equity buyout, followed closely by talk of an Edcon deal, it was inevitable that the industry would attract the scrutiny of far broader audience than transactions involving less widely-known businesses.

John Gnodde

That the announcement of the proposed Brait-led R13,2bn Shoprite buyout and delisting came at the same time as disclosure and discussion around management remuneration added further traction to the controversy.

At a less emotional level, however, there were three key issues that fuelled the ire of certain major shareholders: Christo Wiese being permitted to vote his substantial holdings in favour of the transaction and the consequent impact on minority rights, the fact that certain shareholders (such as unit trust investors and many retirement funds) were effectively being forced out of Shoprite, and price.

A concerned Allan Gray led the charge, saying it was "prepared to fight the buyout of Shoprite all the way to the courts" because it feared that the way the deal was being handled could set a precedent for future private equity deals in this country. Allan Gray's clients have greater exposure to Shoprite than any other body in South Africa, holding 26,5% of the listed ordinary shares.

The fund manager's key objections were on the basis of:

- Process: "The deal when looked at holistically is structured in such a way as to allow shareholders, some of whom hold high voting shares, and whom are in our view conflicted, to vote and thereby force the proposed transaction through effectively disenfranchising shareholders who hold a majority of the economic interest in Shoprite."
- The company's relative attractiveness, believing that the original offer price undervalued Shoprite and that at current prices Shoprite was attractive relative to both the market and cash; and
- Furthermore, it said the potential buyers were aware that unit trusts and a majority of retirement funds would not, as a result of regulatory restrictions, be able to reinvest in the unlisted entity thereby diluting these funds' current economic interest in Shoprite's profits to the point of extinction in favour of Brait, Shoprite management and the (in their view) conflicted shareholders, Allan Gray's Duncan Artus said at the time.

SHOPRITE HOLDINGS LTD

By using s228 of the Companies Act (as it now stands, though changes are on the way), which facilitates 'internal restructuring,' a company may sell a major asset or its entire business with the approval of only a simple majority (50% plus one share) of shareholders present at a general meeting. This is opposed to the 75% majority required in terms of s311.

The 50% target would have been secured with Wiese voting all of his shares; in terms of the original deal Wiese held 45% of the voting power, including his deferred ordinary shares, against an economic interest in the company of 15,4%.

Opposition to the transaction as it first stood resulted in the notice of January 24 2007, which introduced a structure used in deals of this nature in the US and UK, but apparently not seen in South Africa before. Brait proposed a mechanism to allow Shoprite shareholders to retain exposure to Shoprite (New Retail) via a listed instrument (Listco), provided the JSE agrees to listing of this instrument.

In essence:

- Shoprite in its entirety will be delisted, becoming a private company. Those shareholders able to invest in private companies (whose mandates allow them to do so) will be able to reinvest directly into the private entity;
- Those who cannot invest into a private company or who simply prefer a public vehicle will be able to invest through a JSE-listed company (Listco), which is essentially just an investment vehicle;

- Investors will be able to buy and sell shares and debentures in that company on a see-through basis. Those shares and debentures will flow directly into the private Shoprite company, so the listed instrument will mirror the shares and debentures in the private Shoprite, as if those shareholders had invested directly into the private company.

This mechanism will provide equivalent economic exposure to Shoprite as if shareholders (in the new listed entity) had retained their Shoprite (New Retail) capitalisation instruments, along with commensurate voting rights in respect of the private company. .

At the same time Brait announced an increase in the offer price by 7,7% from R26 to R28/share, adding more than R1bn to the offer, bringing the company valuation up to R14,2bn. In addition, any dividend declared by the Shoprite board for the period to December 31 2006 will be paid to shareholders.

RMB's standby offer went up to R27,40 from R25,50. This standby offer is made to allow shareholders to protect themselves against any uncertainty regarding the STC (secondary tax on companies) treatment on the delisting distribution. It is being assumed that s44 of the Income Tax Act will apply and that the distribution will not incur STC. If, however, SARS rules differently, the cash component of the offer will be reduced by the STC cost. In terms of the RMB standby offer, RMB assumes the risk of the possible tax liability.

The new structure was enough for Allan Gray to provide an irrevocable undertaking to vote in favour of the transaction and to advise its clients to vote in favour, subject to satisfactory implementation of the new scheme.

"In the original transaction shareholders were effectively disenfranchised, having no choice but to accept the cash offer," Artus comments. "Yet Dr Wiese stood to benefit from the transaction to a greater extent than all shareholders, but was able to exercise all of his votes to approve the transaction. This created a situation of potential conflict of interests. The revised transaction terms now provide essentially for equal treatment of all shareholders as certain groupings of shareholders are no longer being effectively forced out of their investment in Shoprite. It removes the difference between underwriters and our clients.

That the announcement of the proposed Brait-led R13,2bn Shoprite buyout and delisting came at the same time as disclosure and discussion around management remuneration added further traction to the controversy

"In addition, one is investing in a vehicle with a better capital structure, where the interests of management and shareholders are aligned and there will be no more high voting shares."

The Allan Gray approval is very much subject to the satisfactory listing of the new listed vehicle, Listco.

The question of reinvestment by existing shareholders was the one that required some real application by the Brait team. "We were not aware of the details of the mandates of some of the Shoprite shareholders and thus did not appreciate the implications of those mandates which effectively precluded some shareholders from investing in a private entity," says John Gnodde, executive director at Brait, who claims his team did not anticipate the level of hostility it received to the initial structure. "We don't have a problem with shareholders reinvesting in our deals. Upon understanding the mandate issue a lot better we tried to address the problem creatively and constructively."

The equity base for the new private entity will be about R5,2bn, with the balance of R9,4bn in debt to be raised both in South Africa and abroad. Brait is putting in R900m which will give it 17%. The transaction will facilitate the introduction of BBBEE up to a 12% shareholding level. A Shoprite Workers Trust will be included in the consortium.

And while Gnodde and his Brait colleagues deny that they've needed particularly thick skin at this time, saying that any financial transaction comes with its own stresses and flak, one can't help but think that, trolley for trolley, this deal has been right out ahead in terms of pressure.

At the time of going to press the new transaction timetable was not yet in place. ◆

Transaction team:

Adviser to Shoprite:	Javelin Capital Limited
Legal adviser to Shoprite:	Jan S. de Villiers Attorneys
Tax adviser to Shoprite:	PricewaterhouseCoopers Tax Services (Pty) Ltd
Independent adviser to Shoprite:	ABSA Capital
Corporate advisers to Brait:	Rand Merchant Bank Bravura
Tax adviser to Brait:	KPMG
Sponsor to Shoprite in Namibia:	Old Mutual Investment Services (Namibia) (Pty) Ltd
Sponsor to Shoprite in Zambia:	Lewis Nathan Attorneys
Merchant bank:	Rand Merchant Bank
Attorneys to Brait:	Read Hope Phillips Attorneys
Independent sponsor to Shoprite in SA:	Nedbank Capital
Independent reporting accountants:	PricewaterhouseCoopers Advisery Services (Pty) Ltd
Attorney to RMB:	Hofmeyr Herbstein & Gihwala Inc.
Transaction co-underwriter:	Old Mutual Asset Managers
Private equity sponsor:	Brait

Its objections to the initial proposed structuring of the Shoprite buyout notwithstanding, Allan Gray, arguably South Africa's most prominent wealth manager, is actually a supporter of private equity.

In support of private equity

"The recent surge in bids by private equity funds for listed companies is, we believe, contrary to many public comments on the matter, a net positive trend for local retirement funds and unit trusts," says Duncan Artus, Portfolio Manager, Allan Gray.

"When we consider selling our clients' holding in a listed company we evaluate the attractiveness of the alternative uses of the potential proceeds of the sale. This entails comparing the value implied by the offer relative to:

1. Other opportunities available in the equity market;
2. Our expected returns from other asset classes (including cash).

"The good thing about private equity is that it increases the number of potential buyers for our client's assets," Artus says. "As an analogy, it is far easier to sell one's house at a good price if there are ten interested buyers rather than two or three. An increased pool of buyers is a clearly a good thing for owners of undervalued assets.

"Accepting a buy-out offer for a listed company is not a pursuit of short-term performance but selling an asset at what we believe to be its intrinsic value and reinvesting the proceeds in alternatives that are trading at bigger discounts to intrinsic value. This is a judgement of relative value that investors make on a daily basis when buying and selling shares on the stock market in the course of normal trade. The latter is just less dramatic and less newsworthy."

Artus notes that the current global excess liquidity looking for a home has resulted in historically narrow credit spreads. "In other words, investors are currently accepting very low returns in compensation for assuming risk. A lot of this liquidity is funding private equity transactions. Private equity players are not blessed with some kind of foresight unavailable to other market participants – they will have winners and losers too. What they have access to is the above-mentioned low cost debt to leverage up (and down?) expected returns. Theoretically this allows private equity funds to pay higher multiples for each Rand of earnings than investors were prepared to for the company in its listed form."

Duncan Artus

Referring to commentary on the pricing of private equity buyouts, he says market participants will all have their own view on the prices being paid to take various companies private. There will always be a healthy natural tension between buyer and seller but the offer will have to be at a price attractive enough to gain the support of a majority of shareholders. ◆

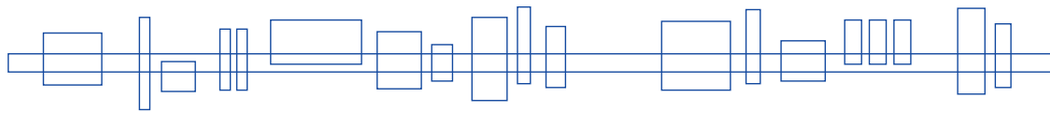
But is it really having such a big impact?

Diminishing the pool of listed companies

One of the arguments brought against the buyout by private equity firms of listed companies is that these deals result in a diminution of the pool of public companies in which to invest.

Certainly, at the time that Alexander Forbes, Shoprite and Consol were joined by Edcon as private equity targets, there was much rumbling in the media along these lines.

Catalyst took the companies that are currently under offer – or rumoured to be 'under threat', and looked at the market capitalisation of each at end-January 2007, as well as that of the JSE, in order to assess the validity of this argument. For the sake of completeness, we also added a couple of unannounced



deals about which there has been speculation and some that have been called private equity transactions but really are not. (While Primedia and Peermont Global might be leaving the exchange after buyouts, the buyouts parties would appear to be viewing their acquisitions as long term investment holdings.)

What is not mentioned in this debate is the re-listing of companies that is often used as an exit mechanism. For example, the Kelly Group was acquired by Brait Private Equity in April 2001 and delisted, but will be coming to the market again this year. It is expected to have a market cap of about R1bn. Some of the current crop of departures may well also find themselves back on the JSE at some point in the future.

The argument that private equity buyouts reduce the diversity of investment offerings may well hold some water – they are undoubtedly taking companies off the public market – but it should be remembered that this criticism would apply equally to other types of M&A activity and corporate shuffling among listed entities. The 2001 $18,7bn buyout and delisting of De Beers, for example, took a giant off the market – and there have been many others in recent years such as Fedsure, Pepkor and African life, to name just three. ◆

Entity	Market cap at 31 January 2007	Percentage of JSE total market cap 31 January 2007
JSE Total Market Cap	R 5,195,318,516,041	
Edcon	R 22,871,995,692	0.44%
Shoprite	R 14,458,043,886	0.28%
Alexander Forbes	R 7,672,422,432	0.15%
Consol	R 5,957,646,269	0.11%
And some potential and non-private equity buyouts		
Famous Brands (+)	R 1,392,764,380	0.03%
Primedia (*)	R 5,605,694,402	0.11%
Peermont Global (-)	R 4,455,000,000	0.09%
Supergroup (#)	R 4,858,117,308	0.09%
TOTAL	**R 67,271,684,369**	**1.29%**

(+) Speculation about this one is still very premature and vague

(*) (though in some places referred to as such, the Primedia buyout is not actually a private equity deal)

(-) Not a proper private equity deal either

(#) Supergroup has apparently been withdrawn from the market, but it was the subject of a potential private equity buyout last year

Ethos Private Equity has been voted "African Private Equity Firm of the Year" in the 2006 Global Private Equity Awards organised by Private Equity International and its sister website PrivateEquityOnline.com.

Ethos voted 'African Private Equity Firm of the Year'

It assumes the mantle from Brait Private Equity, which won last year. The awards are voted on directly by the industry. This year more than 5 000 votes were cast globally.

Ethos notes that it has also been ranked the top private equity firm in South Africa for five consecutive survey periods in the PricewaterhouseCoopers Strategic Banking Survey. ◆

The heat on Fricker Road has been turned up a notch. Actually, it's been turned up by about R600m, with the announcement by Brait of the closing of its US$880m (R6,1bn) Fund IV. This followed the launch in October last year by Ethos of its US$750m (R5,5bn) Fund V.

Hotting up in the Fricker Road kitchen

Word on Fricker Road was that after Ethos launched its fund, billing it "Africa's largest private equity fund", Brait was determined to better its rival's figure. Now *it* claims the title of "Africa's largest private equity fund."

This was announced early February at a function to which Brait managed to lure ANC Head of Presidency Smuts Ngonyama, who had shown his support for their efforts by making himself available to tell international investors the South African story from the view of someone close to the driver's seat.

The capital has been raised from international and South African investors and includes a $200m debt facility underwritten by Investec and RMB. The inclusion of this debt facility in the overall fund size has caused raised eyebrows in some quarters, but Brait's John Gnodde assures ***Catalyst*** that this is conventional practice, and that local debt was more attractive than other international packages offered.

"It is part of the capital pool that is available for private equity investment," he says, adding that the Limited Partners (the pension funds, insurance companies, asset management firms and fund of fund investors that commit capital to a private equity fund) are happy with the debt component.

He adds that the debt funds are, as with other LP commitments, blind pool funds, where the investor does not specify what investment opportunities the general partner should pursue.

Gnodde says commitments come from some of the world's largest private equity investors including US and European pension funds, endowments, family offices and fund of fund investors, and some major South African pension funds and institutions. These include the New York State, HarbourVest, Princeton University, the IFC and, locally amongst others, the Transnet and Eskom pension funds.

The heat is on now for Brait, Ethos and all of the other funds sitting on chunky pools of money to spend their committed funds. ◆

KPMG and the Southern African Venture Capital and Private Equity Association (SAVCA) are in the process of assembling the annual industry performance survey of South Africa (for the 2006 calendar year) and the big question this year is whether or not funds under management will go over the R60bn mark.

Will funds under management exceed R60bn?

At the end of 2005 South Africa's private equity industry boasted a total of funds under management of R43,9bn, an increase of 10% over the previous year. However, 2005 was actually a slow year for fundraising, certainly compared with 2006 when the two 'biggies', Ethos and Brait, hit the road in search of support for new funds. (See 'Hotting up in the Fricker Road kitchen', above)

For the total to go over R60bn, there would have to

Marco Dias

have been a net increase of R16bn after disposal activity. Ethos got to R5,5bn and Brait reached R6,1bn, and there were a few other much smaller funds that also tapped into the market. However, it is not yet known to what extent the captive funds, which at end 2005 accounted for some 67% of the total funds under management, have bulked up their private equity commitments. So it remains to be seen if there are enough new commitments to push the total over R60bn, though given the interest in and performance of the asset class of late, this is likely to be the case.

One other feature to watch out for will be the source of new funds, with the majority of these committed to the independent or third-party players likely to be from the US and Europe.

Another aspect of interest will be the number of deals concluded, with these likely to be down markedly from the previous year, which itself was down 24% on end 2004, from R6,5bn to R4,9bn. What the new survey may not reflect is the considerable amount of work that went into some enormous deals which may reach fruition only in the current year.

Marco Dias, KPMG Associate Director Corporate Finance, says he hopes to release the survey results on May 9. ◆

The Department of Trade and Industry (DTI) submitted the Codes of Good Practice on Broad Based BEE to Cabinet for approval late last year, with gazetting in February this year. For the first time there was specific mention of private equity, but there are now probably even more questions than before.

No real clarity for private equity in BEE codes

It may even be that those private equity fund managers that concluded empowerment deals will find that, in terms of recognition for their efforts, they have wasted their time.

The section in the Codes on 'Key principles' says that in terms of private equity funds, a 'measured enterprise' may treat any of its ownership arising from private equity funds as black-owned and controlled if it meets the following criteria:

- More than 50% of exercisable voting rights are in the hands of black people;
- More than 50% of profits accrue to black people after realisation of investments;
- Private Equity Fund manager must be a black owned company;
- More than 50% of the value of funds invested by private equity fund must at all times be invested in black-owned enterprises that were at least 25% black owned prior to the investment..

The implication of this, the DTI says, will be:

- To encourage the emergence of Private Equity Funds owned and controlled by black people;
- To encourage Private Equity Funds to drive investment in black-owned enterprises.

At the time of going to print no further detail was available and Polo Radebe, Chief Director:BEE at the DTI, told ***Catalyst*** that "stakeholder engagement" had already been concluded.

When asked for clarification on the private equity element of the codes, Radebe said that if private equity funds met the criteria, then "investments by private equity funds will be viewed as being in black hands (in the investee company) So, if a private equity firm does not meet the criteria its investments may have the option of being excluded from measurement in accordance with the new "exclusion principle."

In essence, this provision allows investments by pensions funds, life companies and banks (among others) to be excluded from the ownership of an investee company up to a maximum of 40%. Since many private equity funds

have such investors backing them, the benefits of this principle are likely to be available to most investee companies of the major private equity funds. How beneficial this principle will be to private equity funds depends on the level of actual black ownership already in their investee companies.

The alternative to the "exclusion principle" is to quantify the level of black participation in the private equity fund. This will be no small task and the private equity entity will have to set about proving the extent of economic interest and voting rights attributable to black people (probably an actuary would have to conduct an exercise to determine the extent of value attributable to black people in the funds being managed by the fund manager as well as prove shareholder activism by such black people).

While industry players were reluctant to comment until they had seen the full meat on the bones of the codes, the final point, "more than 50% of the value of funds invested by private equity fund must at all times be invested in black owned enterprises", is likely to prove taxing.

So in fact it appears to benefit the non BEE-managed private equity funds that don't purport to bring BEE to their investees much more than it benefits anybody else

"Whilst I appreciate the intention and direction set by the DTI, it is very demanding as it is so far removed from the reality/private equity opportunities on the ground," said one private equity fund manager.

BEE analyst Kevin Lester of Mohlaleng Transcend Corporate Advisers commented that the implications for private equity were "interesting. "Not so much because of the provisions relating to the special benefit for black-owned private equity managers as the requirements may make this benefit more promise than delivery," he said, "but rather because most private equity funds tend to have mandated investments (or managed investments as per the Code summary i.e. pension funds, long term assurers, banks and the like) sitting behind them.

"However, the real story lies in the fact that, either way, the big victim from a private equity fund perspective are those funds that held themselves out as being black simply because they were black-managed and took 25% stakes in companies having convinced the investees that they would qualify as being 25% black-owned. Because the private equity benefits are largely about excluding ownership, these guys may be in trouble – if the ownership does not hold as being black, then it matters nothing that you can exclude the private equity fund investor as 0 of 100 and 0 of 60 both represent 0%.

"So in a worst case scenario," he concluded, "it appeared to benefit the non BEE-managed private equity funds that didn't purport to bring BEE to their investees much more than it benefited anybody else." Having said that, he hastened to add that the jury was still out on what exactly the 2nd and 4th bullet points in the DTI's definition of black managed private equity fund means.

"There can be no question that the 4th bullet point is limiting in the extreme if we read the targeted companies as being the measured companies themselves. But if we are merely talking about investor higher up in a chain of ownership, that bullet point can be easily met. As regards the 2nd bullet point, unless we understand the term "profits" in a business sense (which could have the effect of limiting them to the profits of the fund manager), this provision is the actual killjoy that will put the benefits of the new provisions beyond the reach of any of our existing players."

As reported in ***Catalyst*** last year, the industry debated at length its view on the contentious issue of the constitution of "black" private equity funds.

The submission of the Southern African Venture Capital and Private Equity Association (SAVCA) to the Financial Sector Charter (FSC) Council looked at the definition of "black private equity funds." The organisation's view was that the definition should rather relate to a "BEE private equity fund manager" (and not to a "black private equity fund").

SAVCA supported the view that investors who committed capital to private equity funds managed by BEE private equity fund managers should score points in terms of the FSC Scorecard. But it disagreed with the proposed definition of "black private equity fund". Its view was that:

- The criteria for determining what constitutes a "BEE private equity fund manager" should be the same as the criteria for determining what constitutes a "BEE company" for the purposes of qualifying as a "BEE transaction" as defined in the FSC; and
- The extent to which investors in both "BEE private equity fund managers" and "BEE companies" score points in terms of the FSC Scorecard should be determined on a sliding scale, with reference to the extent of BEE effected in the relevant "BEE private equity fund manager" and "BEE company."

The organisation said at the time it believed the failure to amend or replace the definition of "black private equity funds" with a definition of "BEE private equity fund managers" could have a number of skewing effects on the venture capital and private equity market. For example, it feared a reduction in the aggregate funds committed to venture capital and private equity investment, since there were few funds that complied with the narrow definition proposed. It was also concerned about the impact it would have on foreign investment in local private equity funds.

SAVCA suggested that by inserting a definition of "black private equity funds" into the FSC, it begged the question why there was not also a definition for "black public equity funds." "There seems to be little logical reason why a BEE company managing capital for private investment should be distinguished from a BEE company managing capital for investment in the public domain."

The same questions of definition apply in the DTI's codes, so it remains to be seen if the final codes address this issue at all and, if not, how the industry will respond. ◆

One of the larger private equity deals in 2006 probably didn't get quite the attention it should, as most of the action happened in sleepy December. That was Consol, which saw a last-minute 'swoop' by Brait after having first announced that it would be going with an Ethos proposal.

More than a Consol-ation prize for Brait

In July last year the listed glass packaging company issued a cautionary regarding a proposed acquisition. On December 4 it announced that it had received a buyout offer of R6,08bn (R19,24/share) from a consortium of investors led by Ethos Private Equity, with the Consol board saying it would recommend the deal to shareholders.

A little more than two weeks later (December 19) the group said it had received a rival bid from Brait, at R19,50/share or R6,2bn, and that it would proceed with that offer instead. The price represented a 62,5% premium to the closing price of R12,00 rand at which Consol shares traded on July 19, before the first cautionary was issued.

On February 6 shareholders present or in proxy representing 92,39% of the shares in issue voted in favour of the scheme. The date for High Court sanction of the scheme is expected to be March 13, with delisting to follow on March 26.

Consol shareholders are being offered 61,33 shares in the new company (Newshelf 809) for every 100 they currently hold. The Public Investment Corporation (PIC) is one of those fund managers whose mandates allow them to hold shares in private companies and which have said they will reinvest in the new unlisted entity. All shareholders, including Brait, management and Consol's BEE group, will hold shares in the same company.

The scheme of arrangement for the Consol transaction is in terms of section 311 of the Companies Act, which requires 75% shareholder support present at a general meeting, as against the proposed Shoprite buyout, which is a section 228 deal and which needs only 50% plus one share support, present or not.

Says Brait's Bruce MacRobert: "Every deal we do is motivated by different facts, patterns, and sets of circumstances. Each deal is different and comparisons between the two are not, therefore, relevant. We provided the Consol board with a number of different structural alternatives and it made up its mind on the structure that, in its view, best suited this particular transaction. It opted for the section 311."

Whether the deal is "devilish" as one publication puts it, or merely clever, no doubt depends on one's point of view. How was it, some observers have asked, that Brait was able to come in with a fully-fledged and finely-tuned offer so quickly – just two weeks after the Ethos offer became public?

Brait chairman Antony Ball says he had, in fact, approached Consol much earlier in 2006, prior to the July cautionary, and been told the company was "not for sale". Brait then went out and secured conditional support for a bid from Public Investment Corporation (PIC), Investec Asset Management, Old Mutual Life Assurance and Old Mutual Asset Managers. It re-approached Consol and was again told it was not for sale.

"Round about August/September, though, a limited bidding process was launched when the Consol board asked interested buyers to put bids on the table," Ball explains. "On 14 November we were selected at the preferred bidder, but then Ethos came in with a higher offer, which was subsequently announced in the early December notice."

Brait then went back about a week later with its new (winning) bid. "It's a fantastic asset and we're very excited about it." Presumably part of the attraction of Consol was its strong operating cash flow – a powerful motivator for an LBO.

MacRobert adds that Brait "always had the support of shareholders. When we submitted our last bid, we had 36% of Consol shareholders undertaking to vote against the Ethos scheme and in favour of the Brait bid. Price aside, this was a strong message from shareholders to the board." ◆

Transaction team:

Investment bank and sponsor to Consol:	Standard Bank
Corporate law advisers to Consol:	Taback & Associates
Independent adviser to Consol:	Nedbank Capital
Lead private equity sponsor and lead transaction arranger:	Brait South Africa
Transaction debt arranger:	Brait South Africa (Specialised Debt Finance)
Attorneys to Newshelf 809 and Brait:	Read Hope Phillips Thomas & Cadman
Financial advisers to Newshelf 809:	Citigroup Global Markets Limited
Joint debt providers to Newshelf 809:	Citibank, N.A. JPMorgan PLC
Tax advisers and legal advisers regarding funding to Newshelf 809:	KPMG Services
Transaction co-underwriters:	Brait IV Investments, LP Brait Private Equity GP IV Old Mutual Life Assurance Company (SA) HarbourVest International Private Equity Partners V HarbourVest Partners 2004 Direct Fund L.P.

GUEST COLUMN

Private equity is an increasingly competitive industry, with huge funds chasing a limited number of deals. In order to achieve acceptable returns in this environment, private equity and LBO firms need a deeper understanding of the strategic attractiveness, key drivers of value and exit opportunities inherent in every potential investment.

Strategic Commercial Due Diligence: Don't be seduced by the thrill of the chase

By Paul Zaloumis of Burlington Consultants (*)

Private equity is an increasingly competitive industry, with huge funds chasing a limited number of deals. In order to achieve acceptable returns in this environment, private equity and LBO firms need a deeper understanding of the strategic attractiveness, key drivers of value and exit opportunities inherent in every potential investment.

It may be trite to remind deal executioners of the following three questions, each of which needs to be answered in assessing a buyout prospect, but it is important:

- Will this investment give me the return I am seeking in deploying my capital to optimum?
- Is this management team capable of ensuring the realisation of the promised return?
- Do I trust these individuals (management?) with our funds?

While all three questions are fundamental to making an investment, the first question should be the focus of commercial due diligence.

Due diligence is, in essence, the process whereby acquirers analyse a potential acquisition. This process is the key tool which allows an acquirer to understand whether the target business can generate the forward revenues, profits and cash flows to justify the purchase price and financing structures.

Commercial due diligence is typically aimed at answering two questions:

- Is the target likely to achieve the sales, profit, and cash flow forecasts in the management/ investment plan?
- What are the key drivers of value for the business and how can these be optimised?

One sees that the due diligence process is evolving and today's sophisticated acquirers are redefining the process and importance of this process, using a structured approach the better to evaluate thoroughly the true opportunity inherent in a potential investment. Are they doing it better because the deal sizes are so huge these days and therefore the risk of loss is more meaningful?

The benefits of a comprehensive due diligence process include:

- Identification of the risks and potential liabilities
- Introduction of a necessary element of neutrality into the evaluation team
- Quantification of items affecting the sale price (revenue/ cost lines)
- Preventing mid-investment surprises
- Basing negotiations on a data-driven platform
- Facilitation of an effective post-investment integration process.

The acquisition of such knowledge is particularly important for financial buyers as they are likely to have less understanding of the industry in which the target company operates than, for example, trade buyers.

However, what is clear from an analysis of many deals is that due diligence is often seen as a second order discipline – one often subordinated by deal professionals for the more exciting 'deal making, deal doing' phases.

Successful serial acquirers build systems and disciplines into the review and acquisition process, specifically identifying and investigating the core drivers and levers underpinning the future operational performance. Six areas of analysis in a competent due diligence stand out:

1. **Market attractiveness**. This is the starting point as it serves to frame the business within the context of its relevant international, country and sector environment. This knowledge grounds a set of assumptions which facilitate the inputs into the revenue forecasts of the valuation model.
2. **Customer evaluation**. This phase enables one to establish the certainty of future revenues from existing customer relationships.

3. **Competitor intensity**. The key investigation areas are identification of the key competitors, establishing their unique weaknesses/ strengths, performance benchmarks and comparators and points of competitive overlap and the intensity of these.
4. **Cost/ overhead optimization**. Establishing the true set of costs requires the co-operation of the target company. The better the quality of management accounts (historic and future), the more accurate the cost base to analyse. The greatest value to the acquiring team is the identification of operational value opportunities – this can enhance the cash flow expectations and therefore widen the valuation parameters.
5. **Industry capability assessment**. A crucial part of establishing ongoing revenues is a frank review and calibration of the business's core capabilities in order to understand if the target has areas of lasting competitive advantage.
6. **Exit options**. As private equity buyers are by implication short to medium term owners, the release of equity is a prime consideration. Experienced strategic buyers consider exit options at the time of purchase – a clear view of the likely source and mechanics of exit can enhance the acquisition thesis. Operational strategy directed to enhance exit can add considerably to the value creation and realization process.

The key rationale for raising the quality of due diligence is that by applying a systematic and disciplined process, investors are less likely to make bad buys. A ready reckoner would include the following:

- Impose checks and balances. Deal discipline is crucial as transactors become seduced by the thrill of the chase – impartial unrelated third party advisers can offset this phenomenon
- Develop rigorous analytical processes to review and test every assumption
- Impose objective disciplines on the financial side of the process
- Strip out unproven revenue contributors ie: cross sell, margin growth, new products, market repositioning, new geographical territories
- Negotiation discipline – setting and observing agreed price parameters
- Plan the purchase with exit in mind

Due diligence practitioners need to remain dispassionate and analytical at all time during the process, exhibiting intellectual scepticism and curiosity. The bottom line is that good due diligence raises the likelihood of making value-maximizing acquisitions … the goal, surely, of any private equity buyout. ◆

(*) Burlington is a strategy advisory firm with a specialty in supporting private equity transactions, having worked on more than 450 such transactions since 1995. Burlington is led by Paul Zaloumis, a consultant with more than 12 years of senior advisery experience in Australia, South Africa, the United Kingdom and Europe. During this time he has advised many organisations on diverse issues around corporate strategy, transaction services, enterprise transformation and mergers and acquisitions.

The proposed buy-out of Equity Office Properties in the US by the Blackstone group for US$39bn would be the largest buyout (of any kind) to date. And that this buyout is of America's largest office landlord has highlighted the significant private equity funds being invested in real estate abroad.

Private equity in real estate – coming to SA?

This phenomenon hasn't yet reached South Africa – though the US$1bn acquisition of the V&A Waterfront in Cape Town may qualify as a private equity transaction – but some of this country's top property execs are certainly keeping any eye on it.

Blackstone is among the most active investors in the global real estate market, investing in the sector through five general real estate funds and two Western European-focused funds. The giant Carlyle group has seven real estate funds focused on investment opportunities in Asia, Europe and North America, while a number of other private equity firms have similar operations. Blackstone and Carlyle are, in fact, both rumoured to be looking at South Africa as a general investment destination.

There's even a magazine published on the subject, *Private Equity Real Estate (PERE)*, launched in the US in 2005, on the basis that "institutional investors are

no longer simply looking to invest in real estate assets directly, nor do they plan just to acquire exposure to the asset class indirectly via the public markets. A growing number are being attracted to private equity real estate—a term that more reflects a style of investing than a particular group of funds."

PERE estimates that private equity real estate funds will raise approximately $55bn in 2006, far surpassing the $37bn raised in 2005, and adds that these record amounts of equity, along with favourable debt financing, has fuelled much of the recent activity in the US public real estate markets.

Furthermore, funds with a global mandate accounted for more than 50% of the capital raised in 2006. Private equity real estate funds targeting Europe and Asia also accounted for a substantial amount of equity, closing on approximately US$5bn and US$2bn respectively. Factoring in debt financing, the funds raised in 2006 have buying power in excess of US$160bn. And 2007 could rival 2006 in terms of fundraising and deal activity. Early in 2007 Blackstone was reported to be raising US$10bn for one of the biggest ever global property funds.

Les Weil, chairman of South African property group JHI, believes private equity investment in the listed real estate sector is certainly a prospect in this country too. "If one looks at the share registers across the board on the JSE now, for the first time one is seeing international investors there, which is evidence of their interest in South Africa. It is inevitable that property will eventually get a look-in too."

He says the returns on listed property in recent years have been excellent. "Then when you get a trophy asset such as the V&A attracting an international buyer, it's only a matter of time before there are more such deals."

Weil notes that the size of a listed vehicle is important in its profile as a target. "One can't imagine any interest in a vehicle of under R1bn. But we do have some quite substantial vehicles, among them Hyprop and Growthpoint, for example."

Then yields would also be key considerations, and yields on South African listed property have come down substantially in recent years and are now more in line with international levels.

Weil says a very attractive aspect of South African property is the structure of leases, with annual escalations built in, as opposed to, say, the UK, with long term fixed rentals. "That's a very positive cash flow aspect for private equity."

He does note, though, that some of the listed property funds are currently trading at a significant premium to their NAV, which might be problematic.

"However, the medium term outlook for South Africa property is very positive at this stage, which makes it a potentially exciting proposition for private equity activity," he concludes.

Malcolm Segal, Director Sasfin Capital, says the prospect of private equity involvement in real estate in South Africa "adds an exciting new dimension to the asset class. At Sasfin, this is a field we have recently engaged in and for which we have set aside capital. This change is being driven by a number of factors, including lower interest rates (which impact on the relative cost of capital), the expansion of the economy, the liquidity of real estate assets, and increasingly sophisticated capital structuring techniques and financial instruments."

"One can't imagine any interest in a vehicle of under R1bn. But we do have some quite substantial vehicles, among them Hyprop and Growthpoint, for example."

The introduction of a uniform Real Estate Investment Trust (REIT) structure in South Africa, in line with international standards, would most likely make it easier for foreign funds to invest here, since it is a form with which they are more familiar.

Les Weil

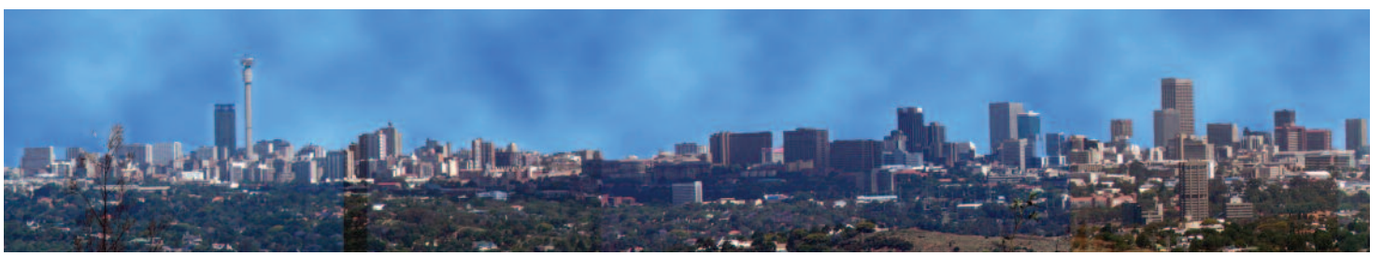
A REIT is an entity, listed or unlisted, that owns and in most cases operates income-producing real estate such as apartments, shopping centres, offices, hotels and warehouses.

South African property today features two primary property fund vehicles, Property Units Trusts and Property Loan Stocks, both of which comprise similar features to REITs.

The property industry, recognising that it is out of line with international norms in this area is driving a process of standardisation into a REIT environment through the Property Loan Stock Association.

The large third party private equity funds such as Brait and Ethos tend to be precluded by their mandates from investing in property, but that doesn't mean we won't see private equity funding into the class.

As the real estate private equity fund market continues to make its mark as one of the most significant sources of equity financing for real estate transactions globally, can South Africa be far behind? ◆



The rapidly expanding exposure of private equity funds in developed economies to emerging markets means that fund managers are increasingly willing to open their ears to the South African message.

SAVCA does Switzerland

The case for investment in South Africa in general and private equity in particular was put to investors in Switzerland recently in events organised jointly by the Southern African Venture Capital and Private Equity Association (SAVCA), the SA Embassy in Switzerland and the Swiss Private Equity and Corporate Finance Association.

SAVCA executive director JP Fourie says the high level of turnout was indicative of interest in the South African "story," with the major Swiss private equity fund of funds managers, private banks and investment banks being represented.

Roy Baumann of the Private Equity Investment Management team for Partners Group, among the largest private equity asset managers worldwide, says his company presently has no direct exposure to South Africa. However, he adds that Partners is currently raising a Fund of Funds for emerging markets, which will have a predominant allocation to Asia, but the opportunity to invest also in other emerging markets, such as South Africa, Russia, or Latin America.

"This fund may or may not make commitments to South African funds in the end," he tells ***Catalyst***. "But Partners Group, either during the course of a due diligence, or for general market intelligence reasons, is likely to visit private equity firms in South Africa in the short to medium term.

Baumann says it is difficult to benchmark the BRIC (Brazil, Russia, India and China) countries against South Africa on a sole risk indicator. "Each country has its different characteristics with respect to political, regulatory, macro-economical and operating risks. We would, however, place South Africa in the same group as the BRIC countries in terms of a risk/return profile, albeit the sources of risk being different."

SAVCA's Fourie also met with Marc-Antoine Voisard, Unigestion's investment Director Private Equity. Unigestion has CHF12bn under management, of which 20% is allocated to private equity.

The firm has no investments in South Africa at this stage, focussing on the US, Europe and Asia. "Nevertheless," Voisard tells ***Catalyst***, "we pro-actively review any emerging market on a regular basis to assess whether it could represent a new geography target in our investment strategy."

Unigestion would consider investing in South Africa if convinced that the risk:return ratio of the market was sufficiently favourable. "For example, if we estimate that the risk of investing in South Africa private equity is greater than in US or Europe, we would need to have a greater target return in order to approve an allocation to this market.

"Moreover, we would need to be convinced that the positive macro-economic environment and the stable political and legal systems are sustainable going forward. Finally, we would have to find professional and solid firms which we could support on a long term basis. As these firms may have shorter track records than other firms in more developed markets such as the US and Europe, our due diligence would focus on the quality of their investment process and their specific knowledge of value-added to their investments."

Asked where he would place South Africa on a risk basis against the BRIC countries, he says South Africa is "probably one of the less risky emerging market due to several favourable elements such as political stability and the Anglo-Saxon influence on business rules. Nevertheless, it does not mean that this is necessarily the most attractive market to invest in. While other markets may include additional risks, their macro-economic situation or the global competitiveness of their economy may be more favourable."

The main impediment to investment in South Africa thus far has been the attractiveness of private equity returns compared to the level of the development of the market. "However, we have the impression that the situation has positively evolved recently and we are going to re-evaluate the market in the month ahead."

Voisard says he was surprised to hear about the pace of growth in South Africa and the sophistication of private equity structures. "I didn't know, for example, that the leverage market was already relatively developed in private equity transactions."

Unigestion targets higher returns in emerging markets compared to the US and Europe, due to the higher risks of investing in such markets. "In general, we would expect gross IRRs in the range of 25-30% in emerging markets compared with 20-25% in developed markets."

Presentations at the two Swiss events were by Ivan Missankov, Manager Momentum Private Equity Fund of Funds, Richard Flett, Executive Director, Horizon Equity, Zenzo Lusengo, Director, AMB Private Equity Partners and Adiba Ighodaro, Principal, Actis.

One-on-one meetings were also held with Pictet & Cie, LGT Capital Partners Ltd and Capital Dynamics. ◆

The acquisition of Equity Office Properties Trust (EOP) by the Blackstone Group for US$39bn is the largest buyout in the world to date. It overtakes the $32bn deal last year for US hospital chain HCA, which itself was the first to surpass the previous takeover record-holder, the $30bn 1988 purchase by KKR of RJR Nabisco.

New barbarians are through the gate

The EOP story may well also prompt a book along the lines of 'Barbarians at the Gate,' if not a movie too, given the bitter saga of offers and counter-offers and twists and turns before the final acceptance of $55,50 share.

Blackstone rival Vornado Realty Trust bowed out saying it had "terminated its fully-financed, definitive proposal to acquire EOP. Vornado concluded that "the premium it would have to pay to top Blackstone's latest bid, protected by a twice increased breakup fee, would not be in its shareholders' interest."

The Blackstone offer – all cash and a speedy completion commitment following EOP shareholder approval – had the support of Equity Office trustees, however, even though it was less than the $56 per share in cash and shares offered by Vornado. The trustees found Vornado's bid too risky because of the length of time it would take to complete and the need for Vornado shareholder approval.

EOP is the largest publicly-traded owner and manager of office properties in the US by square footage. At September 2006 it had a national office portfolio comprising whole or partial interests in 585 office buildings, more than 103m square feet. ◆

International round-up

- Members of the US National Venture Capital Association (representing venture capital and private equity firms) are predicting greater deal flow activity overseas in 2007. The areas of greatest interest are China and India with more than 90% of respondents forecasting increases in investment in these regions. Other global regions where VCs are predicting increases are Eastern Europe (59%) and other Asian countries (61%). The areas where the most VCs are predicting investment declines include Israel (15% of respondents forecasted investment decline there), Canada (13%) and Western Europe (13 %), with no reference to Africa at all.

- The emphasis of private equity deals in 2006 shifted to sectors such as media, technology, and health care. The biggest deal, prior to the EOP buyout by Blackstone, was the acquisition by KKR, Bain Capital and Merrill Lynch Private Equity of hospital company HCA for $33bn.

- A record number of LBOs in the US last year would generate $11bn in fees for banks, according to data compiled by Thomson Financial and New York-based research firm Freeman & Co. Firms logged $699bn of deals in 2006, according to Bloomberg data, fueled by a mix of record fundraising and borrowing costs for sub-investment grade companies near the lowest in 40 years.

  KKR alone was set to pay at least $837m in fees to investment banks for deals in 2006, more than any other private equity firm, in an unprecedented year for LBOs. The firm spent three times more in the first 11 months of 2006 on fees to securities firms than in the whole of 2005.

- Carlyle Group, the Washington DC-based private-equity firm, has raised $3,1 bn to invest in buyouts in Europe. Carlyle plans to raise as much as $5,9bn for Carlyle European Partners III, with a minimum investor commitment of $13,2m. This may overtake the € 4,5bn that KKR raised for European deals last year.

- At the time of going to press, the Blackstone Group, CVC Capital Partners and KKR were considering a joint bid for British supermarket chain Sainsbury's, the third biggest supermarket chain in the UK, in what would be Europe's biggest LBO. Existing investors were believed to want an offer of more than 600 pence a share, or £10.3bn.

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