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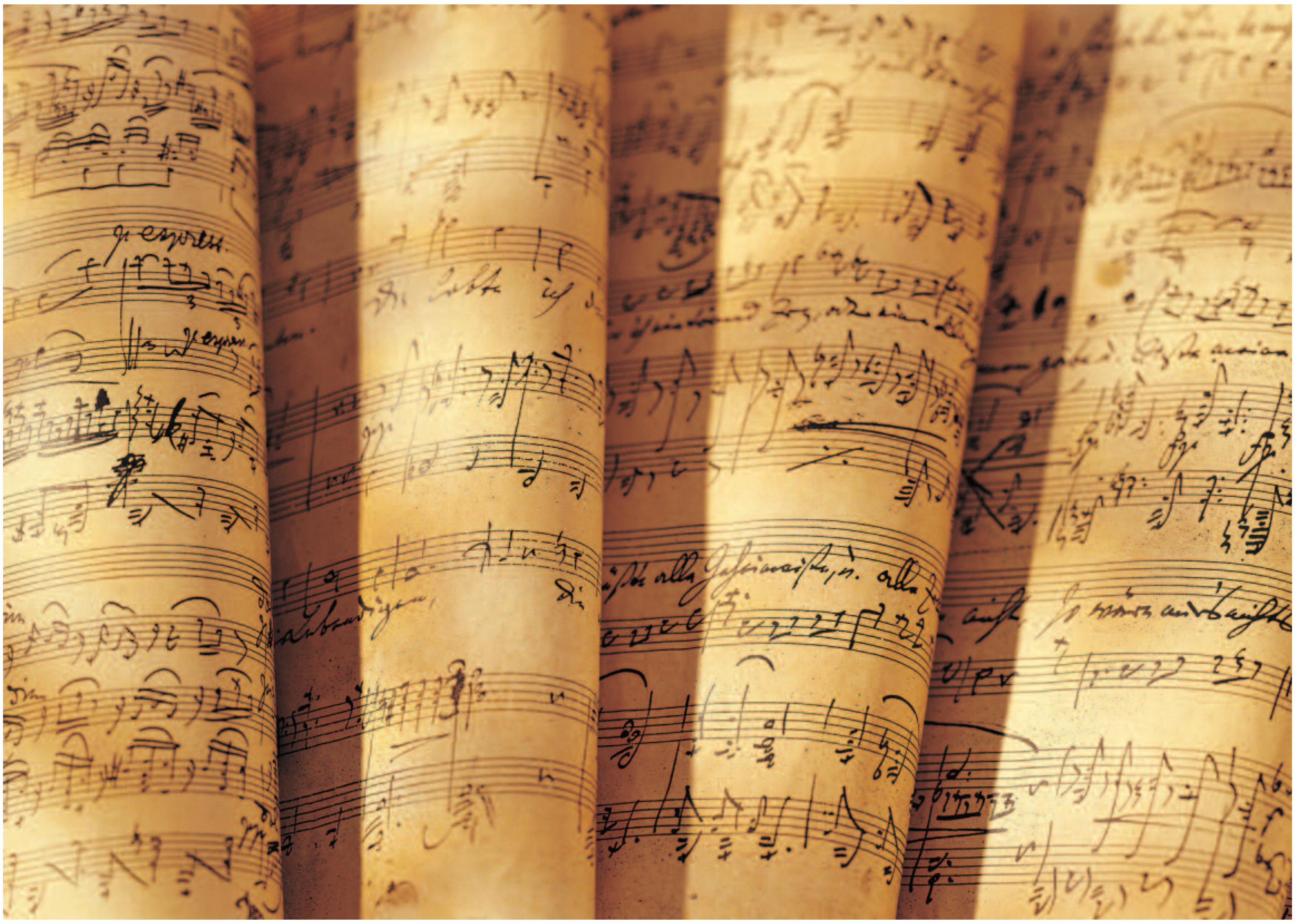
Catalyst

SA's quarterly Private Equity & Venture Capital magazine



Catalyst

From the Editor's desk

Enter shareholder activists

In 1998, when Ethos Private Equity emerged out of FirstCorp Capital Investors, the announcement was met with at best mild interest, from the media and broader financial service community. Not much was known locally, apart from those within a small circle of insiders, about this private equity concept.

Today it's a multi-billion rand industry, attracting increasing institutional allocations and top talent, and vaunting returns that make it an attractive asset class for certain types of investors. In South Africa, 2007 has probably been a seminal year for private equity, being the first time that ordinary investors have become properly aware of it, with the Edcon, Alexander Forbes and (unconsummated) Shoprite deal having garnered national prominence.

The higher profile, together with the quantum leap in the size of the deals, has also attracted attention of a less positive nature, with concerns about high debt levels and generous tax regimes for fund managers. A further issue is that of corporate governance; the fact that when a formerly public company goes private, it is no longer in the public eye, which, it is claimed, enables the private equity owners to commit all manner of gruesome offences.

Enter the spectre of shareholder activism. Brian Molefe of the Public Investment Corporation (PIC) scared the bejeebers out of a number of companies when he started to play an active role in the board composition of some of the companies in which the PIC has a stake, as Barloworld and Sasol will testify. In fact the PIC voted against the Edcon buyout, though that was over concern about losing access to the asset rather than any intrinsic objection to the deal. Furthermore, the Corporation this year published a Corporate Governance and Proxy Voting Policy, with principles based on discipline, transparency, behaviour, independence, accountability, fairness, social responsibility and good stakeholder relations.

The question the private equity houses are no doubt contemplating now is the extent to which shareholder activism is likely to segue into their sphere. The fact that they deal in private entities removes them from the direct shareholder glare faced by public companies, but private equity fund managers might yet find that the activists are increasingly starting to impact on them.

For example, CalPERS (The California Public Employees' Retirement System) has long been a leader in the corporate governance movement and it has investments with at least two South African private equity fund managers. CalPERS is regarded as a founder of shareholder activism stemming from its heightened proxy voting activity at companies in the mid-1980s. And the organisation considers the same issues in both its public investments and its limited partnerships in private equity funds.

In South Africa, Frater Asset Management was probably the first financial institution to take on board the concept of active ownership. Fraters' David Couldridge believes corporate governance is a critical part of reducing downside risk. "Our shareholder activism improves value for all shareholders," he tells **Catalyst**. "Private equity and hedge funds look for a return as quickly as possible. Changes in corporate governance, such as introducing an independent chairman, have been shown to increase shareholder value. We are supportive of activism that improves the overall quality and sustainability of a company's earnings … and is in the interests of <u>all</u> shareholders. We believe the changes that are taking place at the powerful Government Employees Pension Fund and the PIC would be supportive to shareholder activism in South Africa and our early adoption of active ownership."

Fraters was certainly ahead of the game with its position on this issue, but there is no doubt that the wave of activism that started small has the potential to sweep away some of the old ways in which business has always been done.

Signing off

This is the final issue of **Catalyst** I'll be editing as I'm in the process of moving to Abu Dhabi. The last few years have been an exciting time to be watching an industry develop the way this one has. In the months ahead I look forward to keeping an eye on the private equity industry in the Middle East; the Abu Dhabi Investment Authority alone is one of the world's biggest sovereign funds with assets of over $100bn. The Authority has a long history of investing in private equity firms and investing alongside them, so I hope to pick up some interesting tidbits to send back to **DealMakers/Catalyst**. And just up the road from Abu Dhabi, Istithmar, the private equity arm of government-owned Dubai World, is already established as a global player. In South Africa it owns the V&A Waterfront, although it is believed to have a substantial allocation for this country, so expect much more ahead.

Meanwhile, thank you for your contribution to **Catalyst** to date. May all your IRRs be well above average.

Jane Strachan
Editor

All of us at Fabcos Publications recognise the effort Jane Strachan has put into Catalyst and the energy, enthusiasm and valuable perceptions she has brought to the magazine. We will miss her sorely. But we wish her and husband Andrew much good fortune and happiness in their new adventure

David Gleason
Publisher

Contents

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Publisher: David Gleason

Editor & writer: Jane Strachan

Design & Layout: Janine Harms, Gleason Design Studio

Subscriptions: Vanessa Aitken
Subscriptions +27 (0) 11 886 6446
fax +27 (0) 11 886 6448

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Tel: +27 (0)11 886 6446

Fax: +27 (0)11 886 6448

Jane Strachan


WE'LL THINK YOU TO WHERE YOU WANT TO BEE.
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In business, as in life, timing often really is everything - and few appreciate this more than the team that structured the high yield bond offering that funded the R27bn buyout by Bain Capital of Edgars Consolidated Holdings (EdCon) earlier this year. That's because the global liquidity crunch started to take hold just as the deal was being finalised.

Jumbo high yield offering for Edcon buyout - squeezing in before credit crunch

The buyout stands as the largest private equity transaction in the South African market to date, by a long margin, and the second largest local acquisition after Barclays' purchase of Absa.

"The strength of the working partnership that developed between Bain Capital, Edcon's management and ourselves proved critical to enabling the team to execute the transaction as planned and on schedule" says Phil Kelleher, MD of Barclays Capital. "A month later, things could have looked different. But despite the market volatility, investors clearly understood that Edcon was a very good growth story, driven by fundamental shifts in consumer spending, particularly by the emerging black middle class."

Beulah Liebenberg

In fact, when Bain Capital announced its intention to acquire Edcon, there were local and foreign market players that believed the transaction would never close, given its hitherto unseen cross-jurisdictional, regulatory and multiple financial markets complexity, tight timing and the sheer size of debt required. The naysayers were wrong, but there is no doubt that the timing could hardly have been better.

Says Beulah Liebenberg, Head of Global Loans Syndications at Absa Capital: "It is easy to speak from the vantage point of success, but the transaction – a highly structured first of its kind in this market – required significant attention. There is always huge reputational and financial pressure to get it right the first time – there simply is no time, no margin for error and no second attempts. Often, as many as 25 professionals would spend hours on cross-jurisdictional conference calls, running into the early hours of the morning and resuming at the crack of dawn."

In simple terms, the following had to be achieved:

- The early redemption of the listed securitisation vehicle of Edcon's' debtors book, OnTheCards, had to be approved by bond holders and had to be refinanced in the rand debt markets;
- The continuous working capital requirements of the re-rated entity, which changed from a listed corporate to a leveraged entity, had to be secured via placement of a super senior working capital and capital expenditure facilities for the new Edcon;

Stephen van Coller

- High Yield Notes for the remaining R17bn, equating to a €1.81bn, had to be placed in the Euro and US high yield bond markets, the largest Euro placement in the European markets to date;
- US, UK and South African cross-jurisdictional legal and taxation issues had to be run in parallel with obtaining SA Reserve Bank approval for implementing the cross-jurisdictional leveraged financing structure. It was in fact the first major local Rand senior debt and high yield bond financing structure approved by the SARB.

The transaction was, in Absa Capital's words, "a high profile, cross product and geography, jumbo mandate". (*See box Edcon funding: some details)*

There were local and foreign market players that believed the transaction would never close, given its hitherto unseen cross-jurisdictional, regulatory and multiple financial markets complexity, tight timing and sheer size of debt required

When debt market volatility starts to rise, the technical wherewithal of the bookrunners and their market placement depth becomes extremely critical. In this case, the strength of Edcon's management, the robust fundamental Edcon credit story and the reputation of Bain Capital were all key factors that provided investors with the confidence to support and participate in the ground-breaking transaction, according to the deal team.

The buyout was a large scale project and a record-setting debt issue. It moved the debt market to new levels and alerted the domestic banks to the fact that as the size of private equity deals grows, so too will the need for more offshore financing.

"It was one of the most complex transactions to date", says Stephen van Coller, head of Primary Markets at Absa Capital. On a purely practical level, the sheer weight of thousands of megabites of documentation was so enormous it strained servers, so Absa Capital used, for the first time in South Africa, the IntraLinks online workspace service to manage distribution throughout the life-cycle of the loan. This meant that all key loan-related information was stored in a secure, single, central location accessible by all potential investors 24 hours a day from anywhere around the world.

As for the local bank market, this transaction probably served as a wake-up call. "The unprecedented foreign interest and investment in the transaction demonstrated that ZAR debt was no longer the sole domain of the large domestic banks. Also, the structural innovation of the deal caught many by surprise: a solution across the entire capital spectrum instead of individual pockets of solutions," says Van Coller. At the time of the deal, one local banker put it more succinctly: "this is unbelievable."

Subsequently, in the debt placement phase, there was strong support from local players, but the rand debt market has indeed shifted fundamentally. The local debt placement of R10bn was the largest in the South African debt market to date.

Van Coller adds that, with the implementation of Basel II, the buyout market is likely to see more syndication of deal funding, as banks aim to achieve portfolio diversification benefits: "The Edcon deal is an example of a 'new' distribution model for buyout debt. The same goes for the Vodafone deal, done jointly between ourselves and Standard Bank." Absa Capital continues to serve as Facility Agent for both the Edcon and the Vodafone transactions.

Van Coller comments that the relationship between Barclays Capital and Absa Capital, working on the foreign and local placements respectively, proved its value in this transaction. "During the bidding process, when other consortiums were all still in the running, many transaction-specific arrangements between local and foreign banks fell victim to the intensity and complexity of the transaction. It is obviously easier to tackle differences of opinion if you know there is long term intent and benefit, so you have to find a solution together."

By mid-October, when the entire debt team held a closing celebratory dinner for the groundbreaking deal in London, it was, rather predictably, drizzling outside. Inside, however, the deal team was in high spirits, having seen the successful conclusion of the largest private equity transaction in the South African market to date.

Edcon funding: some details

Barclays Capital and Absa Capital provided the initial R18,7bn senior bank and bridge financing used to fund the acquisition. Deutsche Bank AG, Credit Suisse and ABN Amro subsequently joined at senior level, providing a strong arranging and underwriting group across the facilities.

The transaction was funded 27% via equity and the rest via the €1,81bn dual tranche high yield floating rate note offering and the placement of R10bn supporting facilities in the South African market.

The local debt comprised revolving credit facilities and borrowing base facilities benefiting from strong asset coverage. Robust support came from Absa Capital, ABN Amro and Deutsche Bank as mandated lead arrangers, Calyon at senior lead arranger level and lead arrangers Sanlam Capital Markets and First National Bank. Investor participations had to be scaled back due to over-commitments received.

The €1,81bn dual-tranche offshore offering consisted of €1.18bn 7-year non-call 1 (B2/BB-) senior secured floating-rate notes and €630mn 8-year non-call 2 (Caa1/B-) senior floating-rate notes. The senior secured FRNs and senior FRNs each priced at par to yield Euribor +325bps and Euribor+550bps, respectively.

Both tranches were widely distributed to both European and US traditional high yield funds, emerging market funds and hedge fund investors.

Standard & Poor's rates the senior secured notes at BB minus and the senior notes B minus, while Moody's Investors Service put them both a notch lower, at B2 and Caa1, respectively. ◆

Supporters of private equity often counter the negative observations about their industry with claims regarding the performance of private equity-back businesses against that of public companies.

Private Equity-backed companies outperform public companies – report

The problem with these assertions, however, is that they are often made without reference to credible data. One report that will no doubt be used to boost industry claims, is the second annual study by Ernst & Young (E&Y) on the business performance and strategies of Private Equity (PE) firms. The report 'How Do Private Equity Investors Create Value?' analysed largest deals exited in Western Europe and the US in 2006.

Sean MacPhee

The annual rate of growth in enterprise value (EV) achieved last year by the largest PE-backed businesses significantly outperformed equivalent public companies in the same country, industry sector and timeframe. Average annual EV growth rates were 33% in the US and 23% in Europe, compared with public company equivalents of 11% and 15% respectively.

However, while the study specifically focuses on exits by private equity houses in the US and Western Europe, this theme of how private equity companies are able to grow and strengthen businesses under their ownership is also a phenomenon consistent in the ever-growing South African private equity industry, according to E&Y. A relevant example is the Ethos-led consortium's R5,4bn exit from Waco, says Sean McPhee, a director in E&Y's South African Transaction Advisory Services. "Waco was purchased for R2,4bn and, with the introduction of strategies such as new management, growth in the company's footprint and certain disposals, the company developed into a formidable and highly profitable asset."

The study emphasises how the PE industry is consistently able to grow and strengthen the companies under its ownership. The average enterprise value of the businesses studied in the US grew from US$1,2bn when acquired to US$2,2bn at exit. In Europe, the average value grew from US$800m to US$1,5bn at exit.

Employment levels were the same, or higher, at exit versus entry in 80% of US deals. In Europe, employment in businesses owned by PE grew by an average of 5% per annum across the UK, France and Germany, where two-thirds of the deals took place, compared with 3% for equivalent public company benchmarks.

"Private Equity ownership creates value from sustainable improvements in performance and growth," comments Simon Perry, Global Private Equity Leader at Ernst & Young.

"Two-thirds of the earnings growth in PE-owned companies comes from business expansion, with increases in organic revenue being the most significant element. This includes the benefits of investment in sales and marketing, new product launches, acquisitions, investment into attractive industry sectors in the US, and expansion into new geographies in Europe. Cost reduction, including operational efficiencies, is also a very important element of earnings growth in both the US and Europe, accounting for 23% and 31% respectively of the total growth in earnings," Perry adds.

The study shows that PE investors are highly selective and well researched when making the decision to buy a business and have the ability to drive real efficiencies through the business plan under their ownership.

"Three-quarters of investments resulted from proactive deal origination strategies, including company or sector tracking, building relationships with management, or introductions from established contacts," Perry says. "Across almost all deals and ownership strategies, Private Equity investors were actively involved in the business after acquisition, making rapid decisions alongside management, challenging progress and making available specialist expertise. The intensity of engagement between Private Equity investors and management was often stronger than under the previous owners."

"Taking a company private delivers benefits including the inflow of capital, transfer of know-how, synergy enhancement and operation turnaround strategies often resulting in greater profitability and operational results – private equity companies understand this better than anyone," McPhee adds. "Private equity firms typically devote significant effort to improving the businesses they buy, often using a more rigorous and focused approach than other investment styles."

McPhee says that within the South African context some of the private equity strategies outlined in this article delivered exceptional returns. "An example is Ethos' exit of its interest in First Lifestyle Holdings in June 2007. Ethos acquired the business for R492m and held it for six years. Strategic insight, financial and intellectual capital, as well as a firm commitment to retaining the entrepreneurial flair of management, resulted in the generation of important value creation. Over the investment period Ethos contributed to the emergence of a rapidly growing business, culminating in operating profit of about 25% and ending in a transaction valued at R1,2bn."

Recent developments in the credit markets may have cast a long shadow, but Perry remains upbeat about the prospects for the PE industry.

"Private Equity is facing a tougher environment with the recent squeeze on credit undoubtedly putting pressure on the financing of deals," says Perry. "This environment may prompt a more conservative approach with an increasing need for due diligence at acquisition. In Europe, a key challenge will be developing alternative exit routes alongside secondary sales.

"However, market participants view this as a short term dip in activity prior to returning to a more rational climate in 2008. There is widespread solid belief in the PE model and the long-term fundamentals remain strong," Perry concludes. ◆

While at one end of Fricker Road (in Illovo, Sandton), Ethos Private Equity has been gathering quite a diverse selection of investments for its newest fund, at the other end competitor Brait has of late been strongly focused on areas where growth is being driven by cash consumer spending.

Brait goes big on consumer cash spending

Sean Dougherty

The most recent of these is the R1,5bn buyout of privately-held milling and baking group Premier Foods, manufacturer of some of the country's best-known food brands, among them Iwisa maize meal, Blue Ribbon bread and Snowflake flour. The enterprise is being bought jointly by Brait and management from 100% owner, the Foundation for African Business and Consumer Services (Fabcos).

In Premier they will be acquiring (subject to Competition Commission and Tribunal approval) a venerable name that is part of South African history, despite some torrid times in recent years – it reported losses of R1bn from 1999 to 2004, including a "catastrophic" R428m loss on maize futures in 2004.

Since then, however, it has been in turnaround mode, with former merchant banker and derivatives trader Ian Visser at the helm. Last year, it reported an R85m bottom line profit for the year to end April 2006.

Brait Private Equity's Sean Dougherty and Rolf Hartmann agree that despite the turnaround-in-progress, they had to dig deep to see the potential; they assume the recent history may have put off other buyers. "On the face of it, it was quite daunting," Hartmann says. "There were the historic losses, as well as the agricultural risk going forward. But we believe we have found a company with enormous potential here."

Dougherty says Premier is indeed a cash consumer play. "We believe the bread business in particular will benefit from the growing economy. Premier holds big name mass market bread brands which tend to benefit both when disposable incomes are on the increase and in tighter times, when consumers scale back from more premium-priced products and revert to staples with which they are familiar."

Brait's attempted foray into mainstream retail earlier this year gave the team an insight into opportunities in the mass retail market and with Premier they are putting that knowledge to work.

That view also applied earlier this year when Brait Fund IV acquired a substantial minority stake in Nature's Choice Holdings (Pty) Ltd, a perishable food producer specialising in the production and processing of frozen vegetables, frozen French fries, prepared chilled vegetables and prepared meals. The Consol glass business, another Fund IV acquisition, also services the retail consumer market.

> **"On the face of it was quite daunting ... there were the historic losses, as well as the agricultural risk going forward. But we believe we have found a company with enormous potential here."**

Another appealing feature of Premier was the asset weight vested in the company, with its enormous mills and bakeries around the country. These create high barriers to entry for any new aspirant mass market bread brand.

And a further extremely significant attraction was the management, headed by Visser. Brait regarded the fact that he was not a career miller or retail man as a positive. They felt the company needed a creative, thinking leadership group, with an intense focus on detail, and sticking with a financial specialist, someone who had driven the turnaround to date, was a good start.

Visser tells **Catalyst** that he came to head Premier due to his long-standing relationship with Fabcos. "After the derivatives knock they asked me if I thought I could fix it and I thought why not? It was a fundamentally sound business that required some financial engineering. I thought it was fixable." And it was.

He and his team started by stabilising the risk management function. They analysed the numbers in excruciating detail, getting to the core of what made the business tick, and looked at every aspect of the value chain.

"But perhaps one of the most important aspects was getting the culture of the organisation fixed, so this was an area where we expended considerable energy. This included ensuring we had the right people around the table at a senior level, and Brait was part of this.

Rolf Hartmann

"They worked with us to understand the business. They showed courage too, as the global sub-prime debt crisis struck during the transaction process, making the funding trickier."

In Visser and his team and the Premier brands, Brait is convinced they have the right combination of ingredients to ensure that this investment rises to the occasion. ◆

The R1,32bn public-to-private buyout by Ethos Private Equity of Brandcorp snuck in almost under the radar, but it's a sweet deal deserving of more attention.

Brandcorp buyout – hallmarks of a smooth transaction

Brandcorp, which was listed in 1997, distributes value-added niche consumer and industrial products, including power tools for the construction industry, branded handbags and luggage and homewares.

The buyout was concluded at R17,40 a share, a significant premium relative to the share price prior to the cautionary announcement relating to the transaction. Management has a stake, but Ethos has a controlling interest.

Ethos partner Shaun Zagnoev says the deal process went particularly well and highlights some of the important requirements for a smooth transaction. "From the time contact was first initiated to the paying out of shareholders it was about seven months which, given the complexities of a public to private deal, including the need for Competition Commission approval, is very good."

So what was it about the process that smoothed the way? Zagnoev cites several factors:

- From the start, Ethos committed considerable resources to the transaction;
- The firm's relationships with the banks meant the debt funding was handled particularly efficiently. ABSA Capital Leveraged Finance provided financing to secure the acquisition;
- Brandcorp has an exceptionally capable management team in terms of its understanding of the transaction and capacity to provide all of the relevant data speedily;
- Ethos itself is structured for quick decision-making;
- The advisers to the deal offered outstanding input. Webber Wentzel Bowens and Hyde Park Capital were Ethos' advisers, while Fluxmans and

Java Capital acted for the company. The offer price represented fair value.

Looking ahead, Ethos sees future value creation coming through acquisitions, as Brandcorp has not made any meaningful acquisitions for some time now and there are significant areas of opportunity in that regard, says Ethos Partner Christo Roos. He adds that the introduction of industry-appropriate empowerment partners, already underway, will add further value.

"Most importantly, though," Roos adds, "is the relationship between ourselves and management. One of the most significant indicators of success in a private equity transaction is the compatibility of investors and management and we score very highly in this area with the Brandcorp deal."

Brandcorp comprises:

- Matus, a distributor of power tools, welding and safety equipment, compressors, abrasives, hand tools and hardware, servicing the needs of the industrial, building and construction, engineering, agricultural, DIY and mining sectors.
- Interbrand, distributing luggage, handbags, backpacks and accessory products.
- MIC/Prestige/Moto Quip/Leisure Quip, distributing dinnerware, cutlery, tableware, gifting, homewares, kitchen tools, kitchenware, bakeware, paper products, BBQ products, aftermarket vehicle accessories, outdoor and camping equipment, travel aids and accessory products. ◆

Shaun Zagnoev

The R11,4bn buyout of Gold Reef Resorts by an Ethos Private Equity-led consortium looks set to go ahead.

Abe and Solly ride off into the sunset

Ethos is typically tight-lipped about the deal, preferring not to discuss details until the transaction is final. However, this will be the second-largest public to private buyouts in South Africa to date.

As **Catalyst** was going to press the scheme meeting had just been held, with 99,99% of shareholders present and voting (representing 84% of shareholders) voting in favour of the scheme, not unexpectedly, given the irrevocables in hand. In terms of the current timetable, termination of Gold Reef's listing on the JSE will be from January 2, 2008.

The final hurdles for conclusion of the deal now include court sanctioning of the scheme, approval by competition authorities, Gambling Board approval and exchange control approval, before January 31 next year.

In September Ethos Private Equity announced that it was leading a consortium that intended to acquire leading South African gaming and entertainment company, Gold Reef Resorts Limited. The offer of R34 per share was at a 48,5% premium to the March pre-cautionary price of R22,90.

The acquiring consortium comprises Ethos, investment subsidiaries of Goldman Sachs and real estate investment funds sponsored and managed by Goldman Sachs, certain broad-based Black Economic Empowerment groups which currently own an interest in Gold Reef, and members of the Gold Reef management team.

Equity funding will be provided by funds owned and/or managed by Ethos, and by investment subsidiaries of Goldman Sachs, and the real estate investment funds sponsored and managed by Goldman Sachs, by the BEE shareholders and key management; and debt funding will be provided by a group of banks, including Goldman Sachs and Nedbank Corporate. ◆

Gold Reef: How to spend it

Anybody wondering how the Solly and Abe Krok will spend some of the proceeds of the sale of their stake in Gold Reef Resorts should take a look at reports regarding a recent Australian home purchase: the twins have apparently acquired a Hawaiian-style mansion in Sydney's eastern suburbs for an Australian record of just over AUD$29m. The *Australian Financial Review* says the Kroks had been prepared to pay even more.

Discussion over the taxation regime for private equity ignited a storm early this year, but it is clear that, like it or not, the private equity industry in both the UK and the US faces an overhaul to the capital gains tax it currently pays on carried interest.

Changes ahead for tax on carry in USA and UK

As **Catalyst** previously reported, the taxation of the carried interest earned by executives in private equity funds has generated fierce debate in both the US and the UK, and legislative changes now being considered in both. The issue is both whether carried interest ('carry') should be taxed on a capital gains or a revenue basis, with the former attracting a lower tax burden than the latter, and, if a capital gain, what rate that tax should be.

The criticism of private equity's tax treatment in the UK is based on the fact that the partners in private equity firms pay tax on the majority of their income at just 10%, since carry is currently treated as a capital gain.

Since the firestorm started there has been vigorous debate and the UK government now says it plans to make all capital gains subject to a flat 18% charge, rather than the more complex existing system, in which the rate could vary from 10% to 40%, though few pay the higher rate.

In the US, private-equity firms spent at least $5,5m on Washington lobbying in the first half of this year, or almost four times the amount spent in all of 2006. The companies are fighting measures that would, among other things, tax carry at rates as high as 37,9% instead of the current 15%.

The South African private equity industry continues to keep its head below the parapet on this issue.

- Carry is described by the British Venture Capital Association (BVCA) as equivalent to a performance fee, representing the share of a private equity fund's profit that will accrue to the general partners. A minimum return (hurdle rate) to investors must be achieved before a carry is permitted. A hurdle rate of 10%, for example, means that the private equity fund needs to achieve a return of at least 10% per annum before the profits are shared according to the carried interest arrangement. ◆

LPs warming to African Private Equity

Limited Partners (LPs) in North America and Europe appear to be starting to take notice of Africa.

The 2007 Emerging Markets Private Equity Association (EMPEA) survey of LP interest in emerging markets private equity reported that in 2007, 19% of respondents reported they were opportunistically investing, up from only 3% in 2006. Furthermore, only 27% of LP respondents reported having no interest in the region, down from 58% in 2006.

In 2006, African fund managers raised US$2,35bn, a substantial leap from the US$1bn raised in 2005. In the first half of 2007, an additional US$1,6bn was closed and, given the target size of the funds currently in the market, it appears that the 2007 fundraising numbers should exceed those of 2006. While South Africa still represents the largest portion of private equity capital in the region, fresh capital raised in 2006 was evenly split between South African dedicated funds and funds investing regionally or in countries outside of South Africa.

In the last two years, five significant funds representing over US$3bn of capital have been launched for investing in the Africa region, according to EMPEA. "With the region generating significant deal flow, the most experienced managers delivering returns often in excess of 25%, and a new generation of western-trained African talent coming on the scene, LPs are warming to Africa." ◆

First time investors in private equity will encounter the reality of the J-curve effect in the first few years of their investment.

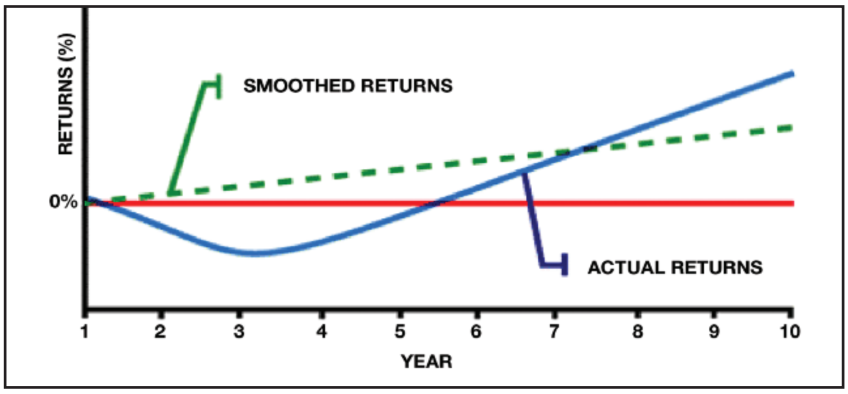
Private Equity 101: The J-Curve effect

And it's the J-curve effect that makes some institutional investors hesitant to invest in the asset class, as a new investor must sit out several years of low or negative returns before showing a positive IRR.

The J-curve effect is the curve realised by plotting the returns generated by a private equity fund against time (from inception to termination). The common practice of paying the management fee and start-up costs out of the first draw-down do not produce an equivalent book value. As a result, a private equity fund will initially show a negative return. When the first realisations are made, the fund returns start to rise quite steeply. After about three to five years, the interim IRR will give a reasonable indication of the definitive IRR. This period is generally shorter for buyout funds than for early-stage and expansion funds. (CalPERS).

Fort Washington Investment Advisors in the US adds that the second major driver of the J-Curve is best explained in the following way: the lemons ripen early, particularly with venture capital funds. Troubled companies tend to be written down or written off much more quickly than successful companies develop. A successful company usually will take longer to reach a positive return such as an Initial Public Offering (IPO) or an acquisition. Most general partners expect that successful companies take four to seven years to reach their positive outcome. Troubled companies, on the other hand, will surface more quickly as it becomes apparent that their business models or management teams are not working. ◆

Source: CalPERS



The challenges around investment in private equity in the South African region will be the focus of February's Private Equity Congress South Africa.

Debating the challenges of Private Equity in South Africa

This one day event will focus on core issues influencing the private equity market, successful competitive strategies and investment potential in this country. Its target market includes institutional investors, venture capitalists, bankers and lawyers to discuss their concerns and the challenges.

Speakers will include Stephen Zide of Bain presenting a case study of its Edcon buyout, George Anson of HarbourVest looking at spinouts and Ivan Missankov of Momentum looking at Limited Partners' misconceptions of South African private equity.

It will be held on February 7 in Cape Town at the SAS Radisson on the Waterfront.

Enquiries to +44 (0)870 240 8859 or conf@incisivemedia.com.