

Leader of the pack

It is Africa's most developed private equity market by far. And in the past 18 months South Africa, with a slew of high profile leveraged buyouts and increasing interest from international PE firms, is seen by many to have come of age. But how will it fare in the new credit reality? Lisa Bushrod reports.

In 2006 South Africa chalked up several private equity-related firsts. "Local funds in South Africa have ZAR56.2bn (US\$8.6bn at current exchange rates) under management and raised ZAR11.2bn (US\$1.7bn) last year; equal to the cumulative amount in the previous five years. PE Funds currently have ZAR26bn (US\$4bn) in undrawn commitments," says Warren Watkins, partner at KPMG in South Africa. Investments were up too, by 33%, from ZAR4.5bn (US\$690m) in 2005 to ZAR6bn (US\$924m) in 2006 and capital returned to investors was up by 60% on 2005 and surpassed the previous record year of 2004.

Garry Boyd, Ethos partner, says: "The market has changed appreciably in the last couple of years as a consequence of the liquidity flood but also because of the investment grade rating South Africa received, along with the general integration of the South African economy into the global market."

And then this spring Bain Capital flew into town and offered ZAR25bn (US\$4bn) for Edcon, the Johannesburg-listed fashion retail group otherwise known as Edgars Consolidated Stores Ltd. This was a headline-making deal for being the largest private equity transaction in the country's history to date, although it was not particularly notable for being a public-to-private transaction, given that these have long been a source of deal flow for domestic private equity players. There appears to be some surprise, and perhaps a tinge of disappointment, that Bain did not choose to bring in one of the firms on the ground – Actis, Brait or Ethos, all operating at the larger end of the market appear obvious partners – to co-

invest alongside them.

"Bain Capital's ZAR26bn (US\$3.5bn) acquisition of Edcon was financed with €1.8bn of high yield notes, but because of the credit crunch, you would be unlikely to get that financing away at all today and certainly not at the same price," says Warren Watkins at KPMG.

Debt gets sophisticated

Debt financing for leveraged transactions has changed markedly in the past couple of years. More than two years ago the local banking market was offering up a pretty conservative and fairly inflexible 3x EBITDA. Then the private equity investor community was introduced to the Eurobond market, which was willing to provide finance at much higher multiples. Faced with a loss of business, the domestic banking market responded with more aggressive multiples and more layering to the debt package, rather than just straight senior debt.

"The debt market in South Africa is fairly sophisticated. At the low risk end of the market there is significant appetite from the local banks. They typically take the senior debt themselves and lay off the higher risk subordinated tranches into the global debt market," says Warren Watkins at KPMG.

He goes on to say: "It has become the norm in the last two years to use slugs of mezzanine in the debt package. And in the last two years as deal prices of companies have come up, there have been more PIK notes and high yield bonds issued to fill the funding gap on larger PE deals. The average deal has about 50% equity, 50% debt, which is still fairly conservative in terms of

international norms. For the larger PE deals, the debt proportion is increasing because the target companies have very little or no debt at the outset."

Warren Hibbert, partner at MVision, which acted for Brait on its latest fundraising (IV), says: "Pricing seems to have stabilised somewhat at the upper end of the market, having risen over the past decade from the 3-4x EBITDA levels towards 8-10x EBITDA, which in any market is nearing the top end. But when you have 30-40% [investee company] growth it's not that expensive."

Part of the reason there is so little corporate debt in South Africa is due to the National Credit Act, which aims to ensure the affordability of debt is a key part of any financial assessment. And another part, according to those in the market, is that finance directors, remembering that the cost of debt spiraled to around 20% in the late 1990s and the impact this had on their businesses, are not predisposed to gear their company's balance sheet. One estimate puts the debt to equity ratio of Johannesburg-listed companies at 7%, compared to the 40% average in Western Europe, and this goes some way to explaining why the Johannesburg stock exchange has been such a vibrant hunting ground for public-to-private investment opportunities.

One example of a public-to-private deal is Ethos Private Equity's consortium bid for Gold Reef Resorts Limited, the South African gaming and entertainment company, announced this September in a post credit crunch funding environment. At ZAR11.4bn (US\$1.75bn), this deal is right at the top end of that achievable by the country's domestic





Warren Hibbert, MVision

private equity funds. Goldman Sachs is part of the consortium and is putting equity plus real estate financing into the deal as well as providing the bank financing alongside NedBank Corporate, a division of Nedbank. Black Economic Empowerment groups are also part of the consortium. Like the public-to-private opportunity, the Black Economic Empowerment objective is another important driver of deal flow in South Africa.

The Black Economic Empowerment Act of 2004 provides for a balanced scorecard, which measures companies' empowerment progress of black people (African, Indian and coloured people) in four areas. Firstly, direct empowerment through ownership and control of enterprises and assets. Secondly, management at a senior level. Thirdly, human resource development and employment equity. And finally indirect empowerment through; preferential procurement, enterprise development, and corporate social investment. The codes are binding on all state bodies and public companies, and the government will be required to apply them when making economic decisions on; procurement, licensing and concessions, public-private partnerships, and the sale of state-owned assets or businesses. Private companies must apply the codes if they want to do business with any government enterprise or organ of state.

Mezzanine hits town

Although investors have been able to access the Eurobond market at competitive terms until the recent credit crunch, the depth of the local funding market should not be underestimated. This includes the emergence

of two independent mezzanine finance providers over the past couple of years.

In November 2005 Mezzanine Partners was created. It is a joint venture between Brait South Africa Limited, Old Mutual Asset Managers and its management. Mezzanine Partners first fund has committed capital of US\$45m. And almost a year later in October 2006 Vantage Mezzanine Fund launched onto the market. By July 2007 its fundraising had reached ZAR603m (US\$93m). Vantage is a black-owned mezzanine fund created by Mutle Mogase and Colin Reze. Its fund manager, Vantage Risk Capital, belongs to the Vantage Capital Group, which was founded in 2001 and holds a number of investments in South African businesses and manages a ZAR125m (US\$19m) technology fund, which is fully invested.

Beyond South Africa

Faced with all this money to put to work and a finite number of investment opportunities, it seems logical that at least some investors will begin to look outside South Africa for deals. Namibia, Zambia, Swaziland and Nigeria are among those most mentioned. Although not everyone is looking beyond South Africa just yet: "With Brait IV we are quite confident we can invest it all in South Africa; there is enough opportunity," says Sean Dougherty, director of Brait's private equity business. Ethos has a 25% carve out of its fifth fund that can be invested outside South Africa and this was a key strategic aim during the fundraising.

"[South Africa] has first world market infrastructure: all the major head hunters are there; global banks with significant operations, Goldman Sachs, Morgan Stanley, JP Morgan, HSBC, Barclays are all on the ground; and the JSE is the sixth largest emerging market exchange," says Warren Hibbert at MVision. And of course, ABSA Bank, NedBank, Rand Merchant Bank, Standard Bank and Standard Chartered all have a strong presence on the ground.

Once you move outside South Africa the picture is very different. Hibbert goes on to say: "Further north [of South Africa] the risks are completely different. And the risk at the transaction level is that you have not got the infrastructure; due diligence, transaction and DCM professionals have to be flown in, typically from Johannesburg or London."

But this is starting to change. Emerging markets banks like Standard Chartered, Standard Bank and more recently Renaissance Group, having seen the way the pen-



Warren Watkins, KPMG

dulum is, to a degree, swinging in favour of emerging markets are leveraging their emerging markets credentials and committing significant resources (highly skilled professionals and offices on the ground) and investment capital into markets like sub-Saharan Africa (Renaissance Group excludes South Africa from its remit).

But it's not just the infrastructure on the ground elsewhere that concerns South Africa's investment professionals. "In private equity you have got to be on the ground; you have got to know what is happening in your world," says Sean Dougherty of Brait.

Of course, Actis, Brait and Ethos are all fishing at the larger end of the market, which naturally limits the number of opportunities of interest to them and perhaps their willingness to consider deals outside South Africa, (Actis has a regional fund and so is already committed to a wider playing field). Below them you have whole raft of players occupying the mid market; firms like Capricorn Capital Partners and Horizon Equity Partners who are likely to remain on home territory for a while yet.

If the private equity/buyout market in South Africa has come of age, the same cannot be said of venture in the country. Although improving, it is a long way off where it needs to be in order for the economy to successfully foster young and innovative companies. This is being addressed by the South African Venture Capital Association, which is already an active advocate of the industry, and for the time being is the most active and has the largest membership of all the individual country associations that presently operate on the continent.