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The South African Private Equity Confidence Survey

October 2008

Testing market sentiment

SAVCA
SOUTHERN AFRICAN VENTURE CAPITAL
AND PRIVATE EQUITY ASSOCIATION

Audit.Tax.Consulting.Financial Advisory.Corporate Finance.

Foreword

Deloitte is proud to continue to collaborate with SAVCA for the 2008 Private Equity Confidence Survey ("PECS").

This forward looking survey is important to Deloitte and we are thrilled to provide practitioners with insights into how fellow private equity and venture capital participants are viewing markets and trends and most importantly where future expectations lie.

We would like to take this opportunity to thank all the practitioners who took part in the survey and assisted us in presenting personal views on the private equity ("PE") and venture capital ("VC") landscape.

Subsequent to respondents providing their opinions on the future of the private equity and venture capital industry in South Africa, there have been major international and local events that could have significantly altered the answers given.

The US financial sector has been struck numerous and bruising blows since the start of the US sub-prime crisis. The latest casualties which have rocked international markets and reintroduced concerns over the liquidity recovery period since Freddie Mac and Fannie Mae are Lehman Brothers who announced their bankruptcy, Merrill Lynch who were bought in a fire sale by Bank of America and AIG who were the beneficiaries of a government bailout.

On the local front, Thabo Mbeki has been recalled by the ANC as president of the Republic of South Africa and has been succeeded by Kgalema Motlanthe until the April 2009 general elections. Investor sentiment towards South Africa may not change dramatically and immediately but this political uncertainty will surely result in the country being put under the spotlight as developments on policy are monitored in the short term. Any concern over a volatile changeover or major policy change could have swift and dire consequences.

These events are bound to have a major impact on the local PE and VC industry over the next 12 months as global economies battle liquidity issues and falling asset prices. We live in exciting times and we look forward to our next survey to determine the impact of these factors on market sentiment.

Karin Hodson
Due Dilligence Leader
Deloitte Corporate Finance

Greg Benjamin
Deloitte Corporate Finance

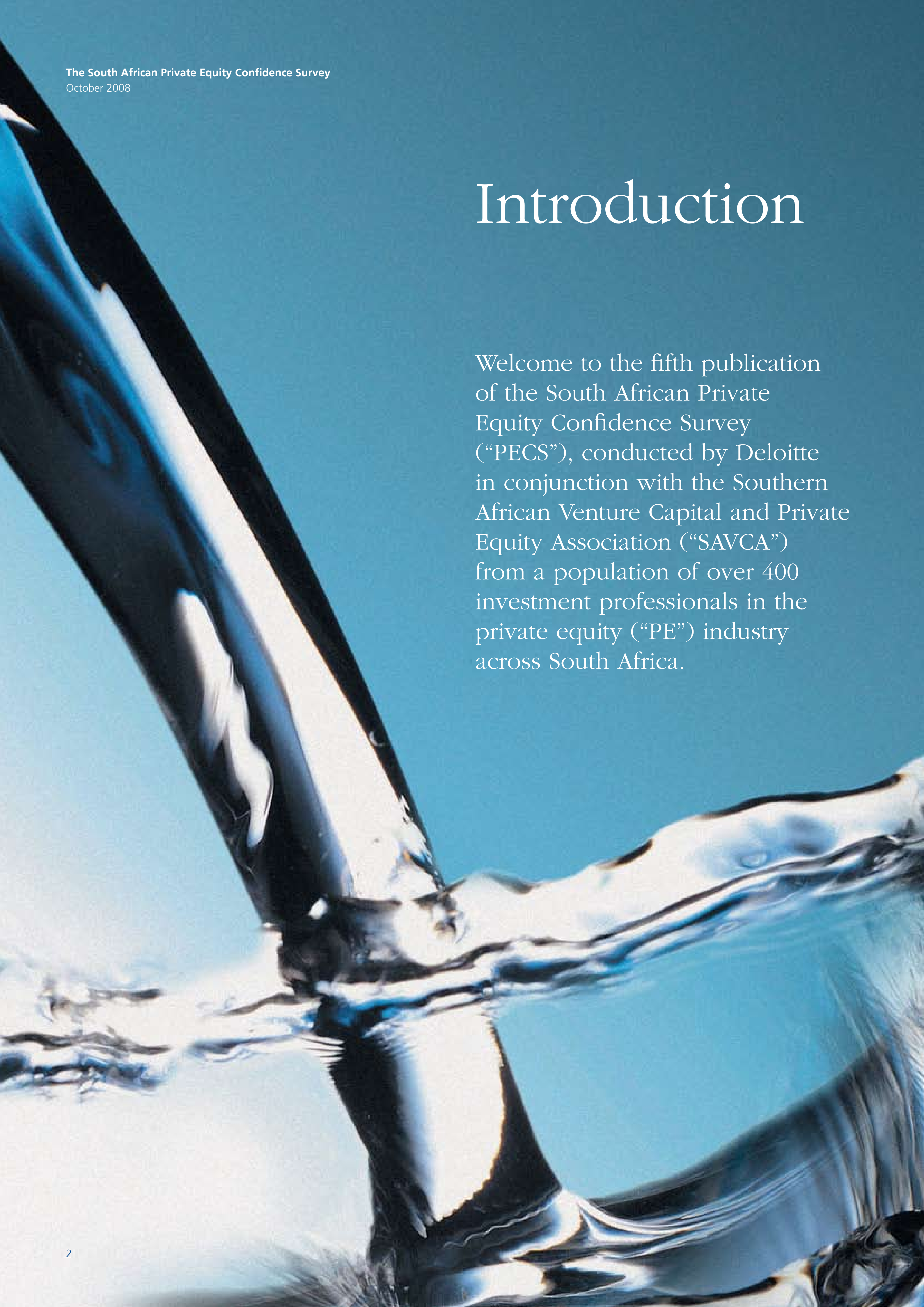
With ten data points for the various questions we pose to PE practitioners for this survey, meaningful trends in responses are beginning to develop and changes in sentiments and opinions become more apparent. This is especially relevant for the views of the industry on fund raising and investment patterns, which makes this survey a significant tool for the industry and our stakeholders.

Notably there has been more activity in the VC section of our industry, with National Treasury releasing draft tax incentives legislation for VC and SME investment; respondents sentiment showing an increase in interest in early stage and seed capital investment coupled with a larger amount of funds that have been raised recently for VC investment. These are important developments for our industry.

As important are the trends which we discuss below for deployment of capital, the performance of portfolio companies, competition and exit strategies for the industry going forward.

I hope that you find this data useful for your future planning and wish to thank the team at Deloitte for their considerable efforts in collection, collating and commenting on the data, all of which results in a valuable reference point for the industry going forward.

J-P Fourie
Executive Officer
SAVCA



Introduction

Welcome to the fifth publication of the South African Private Equity Confidence Survey ("PECS"), conducted by Deloitte in conjunction with the Southern African Venture Capital and Private Equity Association ("SAVCA") from a population of over 400 investment professionals in the private equity ("PE") industry across South Africa.

Key findings of the Q3 2008 PECS Survey

General sentiment

- An overwhelming majority expect the economic climate to deteriorate before improving due to both global and local pressure factors

Fund raising

- A significant proportion of respondents are looking to raise funds in the next 12 months as the poor economic climate is not expected to continue in the long term
- The sources of these funds are shifting as private equity ("PE") and venture capital ("VC") funds look to test the appetite of Middle East and Asian investors
- Lack of liquidity is a major constraining factor

Deployment of Capital

- The manufacturing and services sectors appear to be the most favoured investment sectors over the next 12 months with the telecoms sector experiencing a renewed interest
- 85% of respondents intend to be net buyers of businesses over the next 12 months
- Global liquidity pressure is expected to continue having a negative effect on the debt component of transaction funding
- A decrease in competition for assets and entry multiples is also expected

Exits

- Exits may be delayed in order to extract higher values

Investors

- The expectation of PE and VC funds outperforming the comparative JSE sector remains
- Liquidity pressures will result in a smaller amount of funds being available for investment into PE and VC funds

Results of the Q3 2008 PECS survey

Fundraising (Figure 1 to 5)

The global economy is slowing down. Ignited by aggressive credit extension (the US sub-prime crisis is one) which has resulted in a global liquidity squeeze, the local economy is feeling the effects. Many believe that South Africa will not slip into a recession but will rather experience a period of lower economic growth. However, should the US enter a period of recession, the South African economy may well follow suit.

Further to the global pressures, South Africa is also dealing with internal obstacles that are increasing investor scepticism and having a negative effect on the all important market sentiment. The main internal obstacles are:

- The high crime rate
- The uncertainty surrounding the political transition in South Africa
- The provision of power and related infrastructure
- The current high inflationary environment
- Increased interest rates, and
- The global liquidity squeeze

Respondents (73%) overwhelmingly expect the overall economic climate to deteriorate in the next 12 months. This negative sentiment is significantly up from a previous high of 45% in Q3 2006 and is more than likely as a result of the pressures mentioned above.

An increase in respondents will be raising new funds in the next 12 months (60%) even though 47% expect fundraising to be more challenging than in the recent past. Of particular interest is that there seems to be a shift in the sources of those funds as respondents look to the Middle East and Asia to close the gap left by the liquidity pressures being experienced in the local and US market. These markets could prove to be a significant contributor to private equity funds in the future as the Middle East and Asia continue to find resource rich Africa an attractive investment destination.

This increase in fundraising highlights sentiment that although the economic climate is expected to deteriorate in the short term, there are opportunities expected to yield value in the medium to long term.

Figure 1

During the next 12 months, I expect the overall economic climate to:

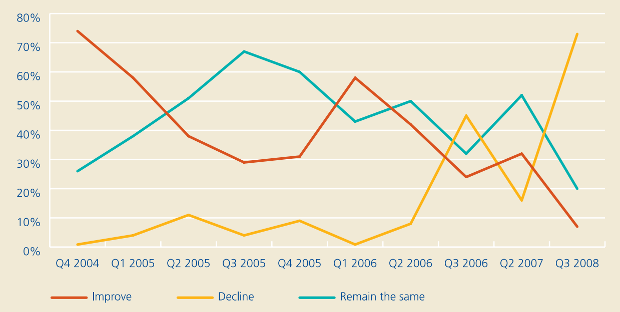


Figure 2

Over the next 12 months we plan to raise a new fund:

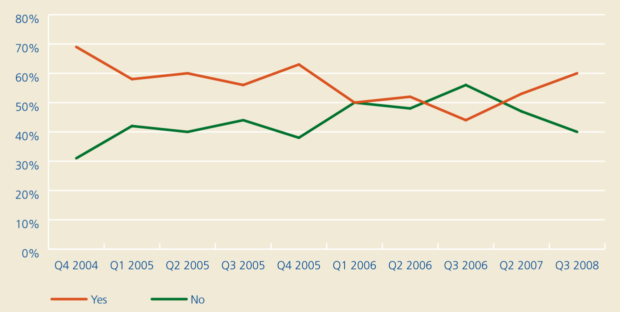


Figure 3

Over the next 12 months we expect raising new funds for investment to:

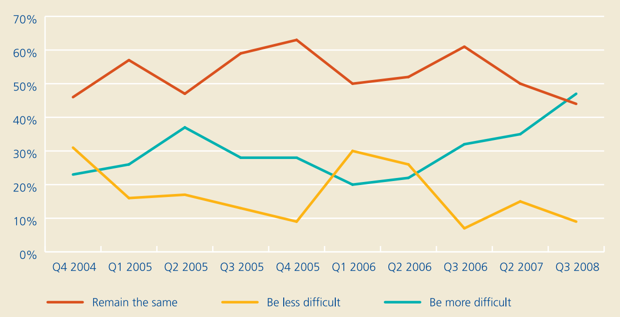


Figure 4

If we intended to raise funds within the next 12 months, we would raise capital from the following source of third party funding (participant allowed to select only 3 options):

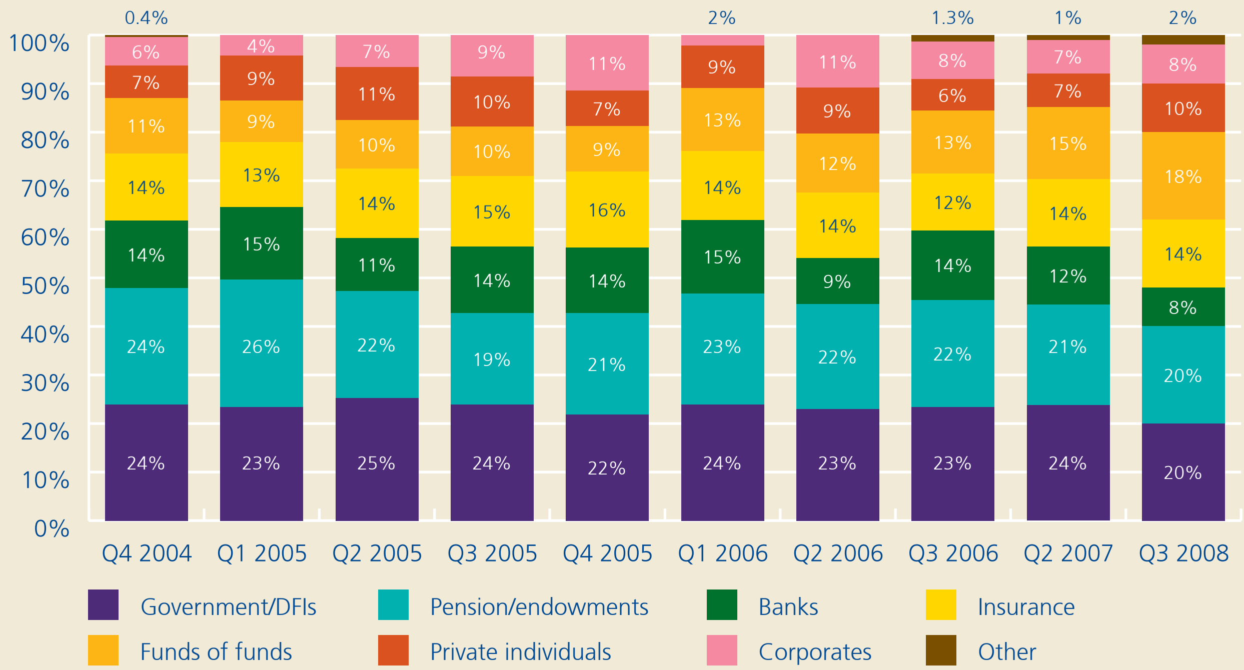
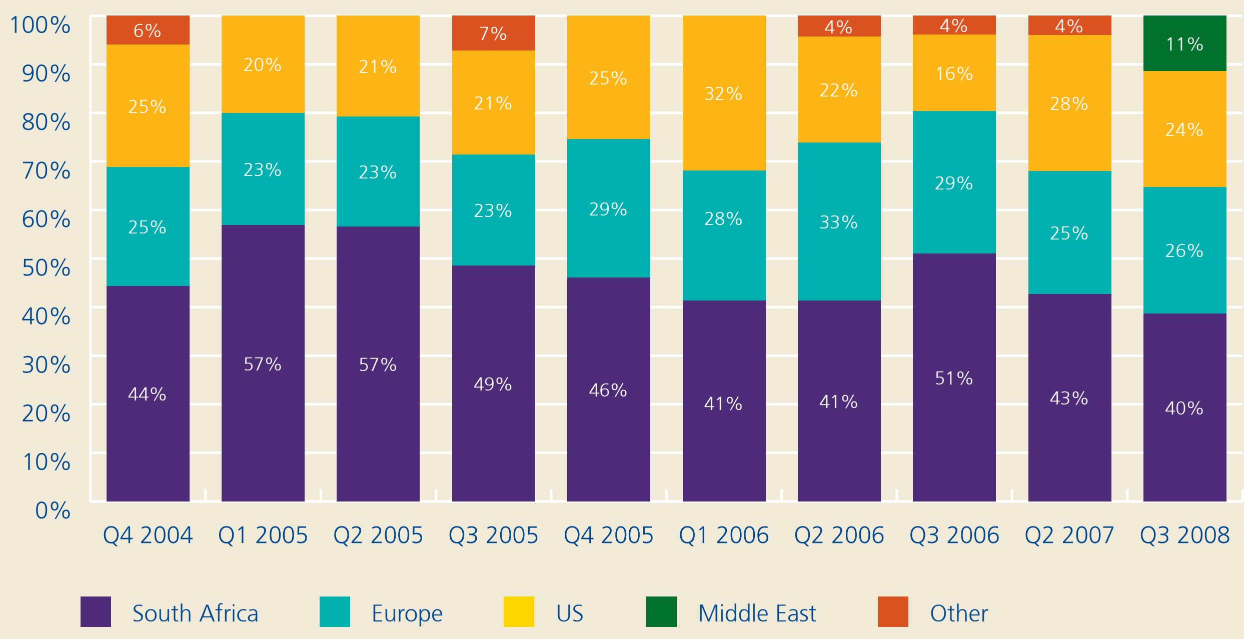


Figure 5

If we intended to raise funds within the next 12 months, we would raise capital from the following geographical source:



Deployment of Capital (Figure 6 to 9)

The “hot” sectors for the next 12 months appear to be the manufacturing, services and telecoms sectors at the expense of the healthcare sector. The appetite for healthcare sector assets appears to be waning due to the regulatory advances and uncertain future government intervention. The manufacturing sector has certainly suffered substantially due to the electricity shortages experienced and the pressure on the consumer due to inflation and increasing interest rates. This could represent significant opportunities for investments in cash trapped manufacturing businesses at very attractive prices in relation to maintainable earnings multiples.

Figure 6

I expect the time it will take to invest my current fund to be:

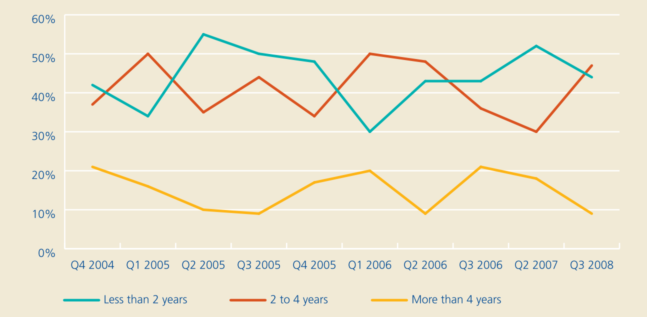


Figure 7

Currently, I feel that the understanding and attitude of institutional investors towards the PE/VC industry is:

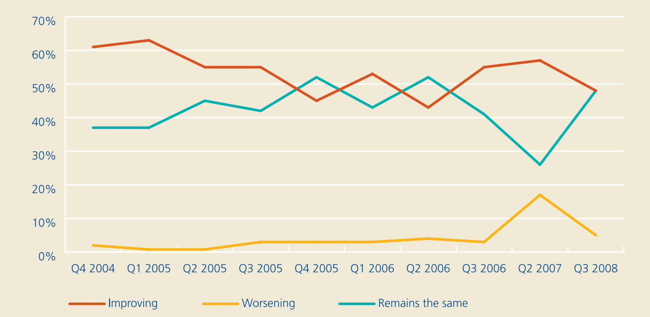
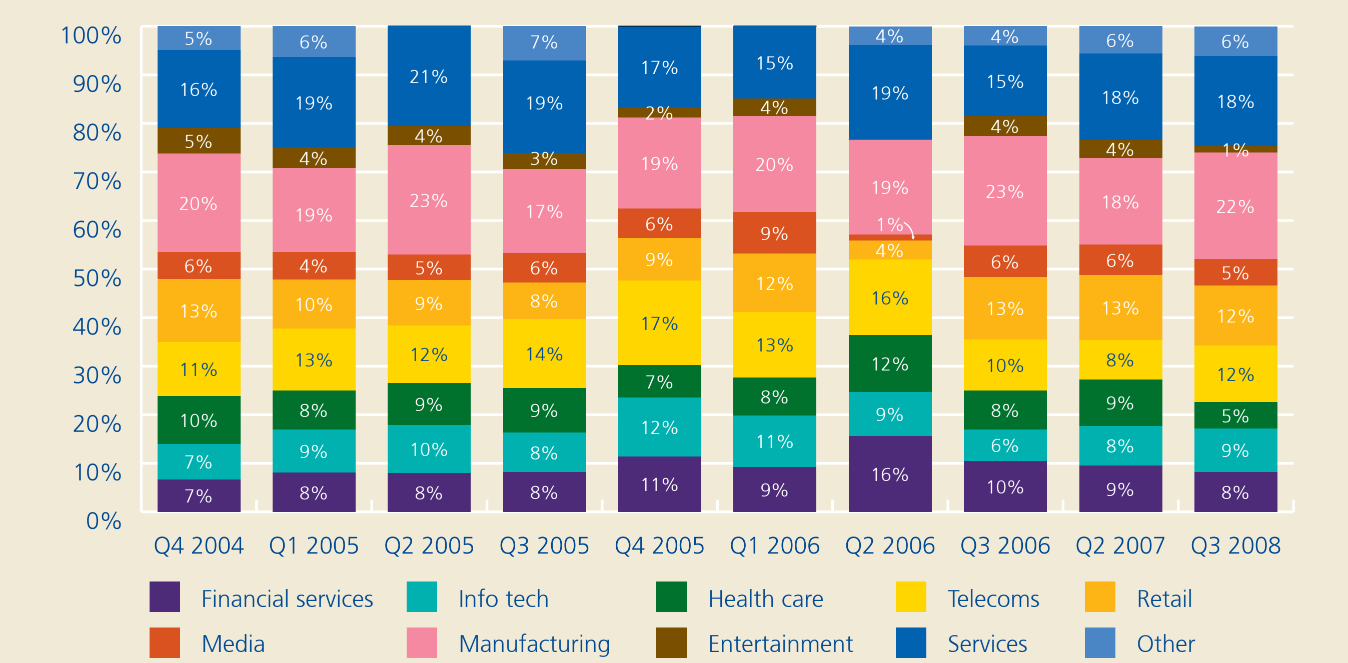


Figure 8

Over the next 12 months, I expect to focus on opportunities in the following sectors (participant allowed to select only 3 options):

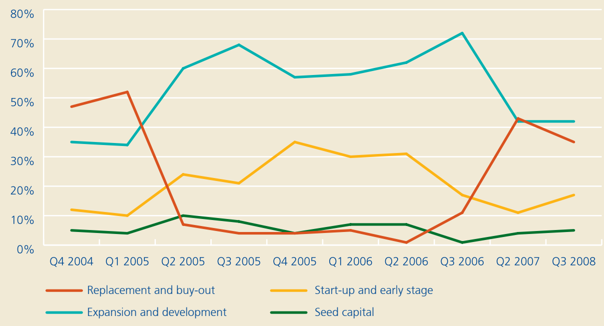


South Africa is again going through a period of significant loss of management skills as a portion of the population is packing their bags in search of countries to reside that offer more certainty in their futures. The increase in businesses for sale in South Africa due to immigration has certainly been noticed by the investment community but the particular impact on the private equity arena will be interesting due to the investment model relying on strong management teams to assist in extracting value from investee companies.

Another interesting move in respondents sentiment is the increase in interest in early stage businesses and seed capital most notably due to the larger amounts of funds that have been raised recently by this part of the industry and the proposed venture capital and SME tax incentives that National Treasury are developing.

Figure 9

I am currently looking at the following types of deals:



Competition for Assets (Figure 10 to 15)

Although the majority, 58%, of respondents expect debt to be more difficult to raise for transactions due to the decrease in global liquidity and funders concerns over falling asset prices, 85% of respondents still see themselves as being net buyers of businesses. These net buyers will be looking to take advantage of the decrease in competition for assets and entry multiples even though the funding of these transactions may have to be less aggressive in the form of lower debt to equity ratios and higher costs of debt.

Deal sizes are expected to decrease on the back of the liquidity shortages and 54% of respondents feel that deal volumes will increase to ensure funds are put to work. The times of the "mega deals" like Edcon and Alexander Forbes may be leaving us until liquidity re-enters the world markets.

Figure 10

At the present time, competition for new investment opportunities is:

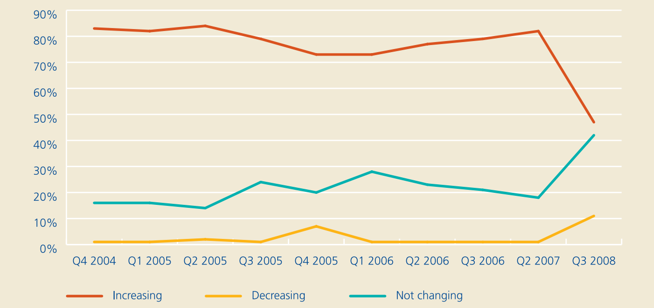


Figure 11

Over the next 12 months I expect entry multiples on transactions to:

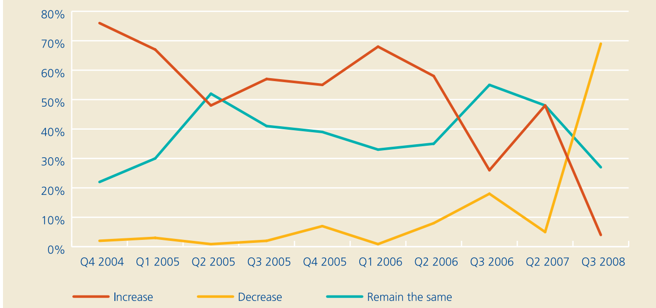


Figure 12

Over the next 12 months I expect the volume of transactions to:

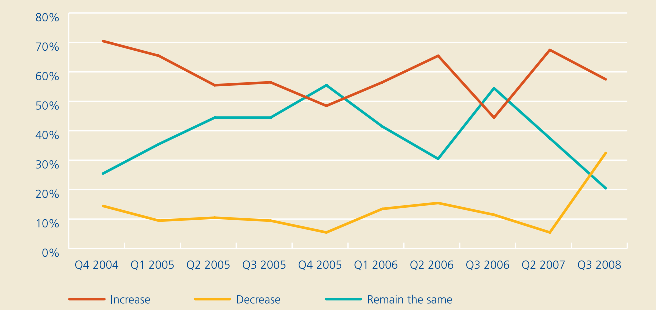


Figure 13

Over the next 12 months I expect the average deal size to:

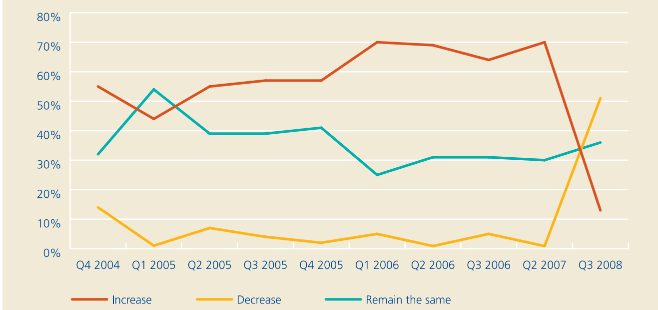


Figure 14

In the next 12 months I expect to be a net buyer or net seller of businesses:

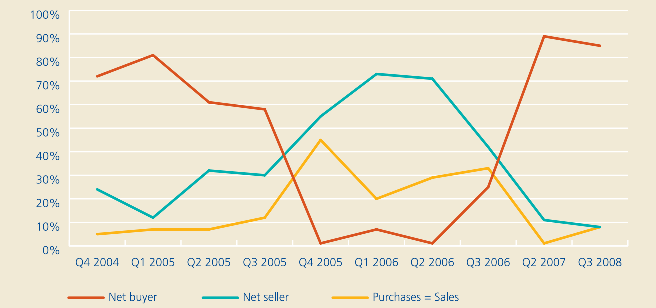
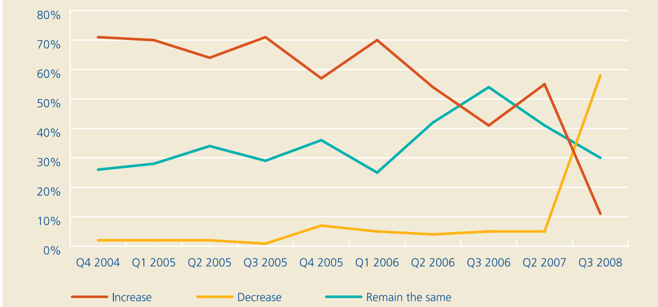


Figure 15

I expect the availability of debt financing for transactions to:



Exit strategies (Figure 16 to 19)

In line with respondents expectations of decreased entry multiples, exit multiples are expected to decrease and as a result force asset holders to delay exit strategies to extract higher values. This again points to respondents expecting better economic conditions in the medium to long term although conditions are expected to deteriorate before improving.

Of particular interest in exit strategies is that only 4% of respondents may exit via listings which is a substantial decrease on Q2 2007 and the lowest it has been since the inception of this survey. This is a sure sign of the end of the listings boom that we have just endured and could point to opportunities for funds to take public companies private.

Figure 16

During the next 12 months, I expect exit valuations to:

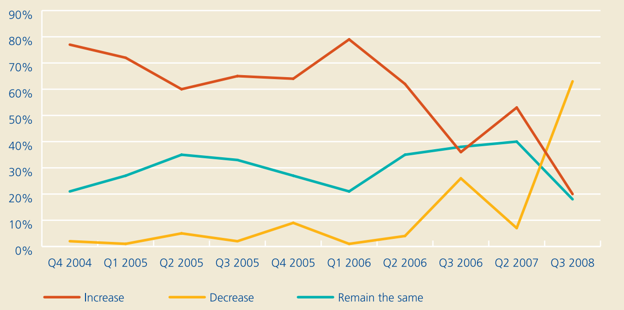


Figure 17

During the next 12 months I expect the volume of exits to:

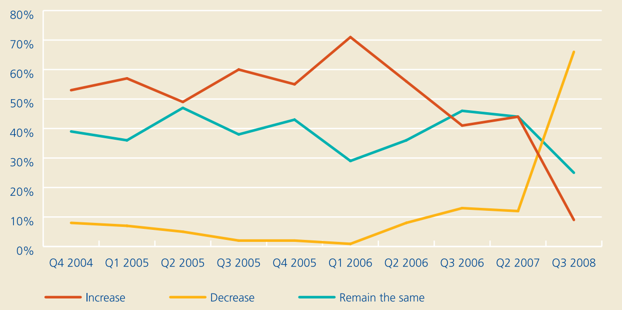


Figure 18

During the next 12 months, we expect to exit investments by:

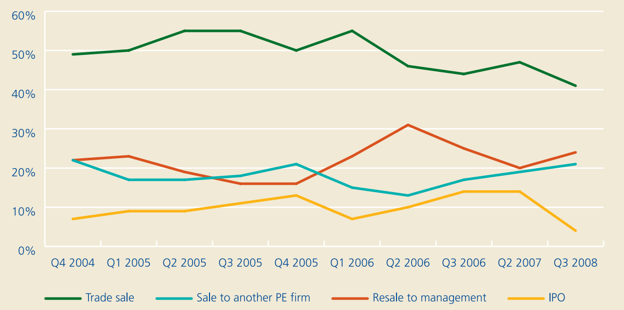
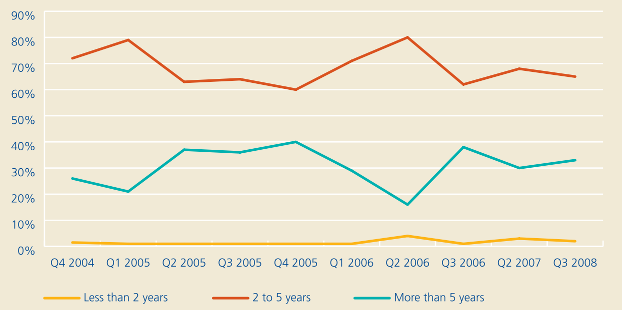


Figure 19

I expect the average lifecycle from initial investment to exit for investments made in the current year to be:



Financial Performance of Assets (Figure 20 to 21)

Although respondents do not see their portfolios outperforming their expectations in the next 12 months, 61% remain confident that their investments will perform in line with expectations and 58% believe that their investments will be worth more in twelve months time than they are currently.

Although respondent's general economic outlook for the next 12 months remains bleak, business earnings expectations are less than they were a year ago but are still upbeat.

Figure 20

Over the next 12 months I expect the relative financial performance of our investee companies to:

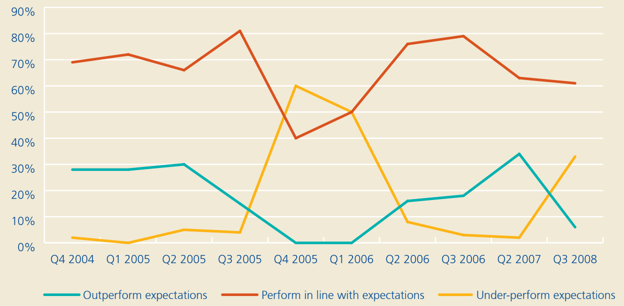
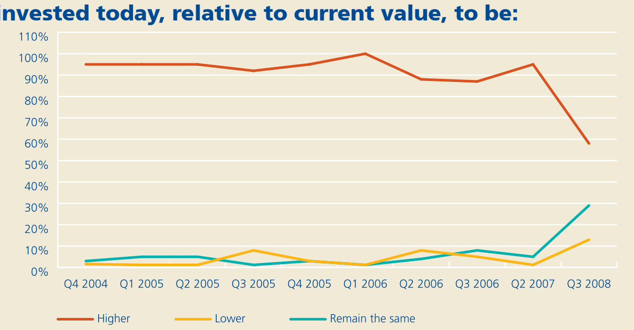


Figure 21

Twelve months from today, I anticipate the combined valuation of all portfolio companies in which we are invested today, relative to current value, to be:



BEE (Figure 22 to 24)

BEE has been a major driver of M&A activity in South Africa in the recent past and various empowerment transactions have been done together with private equity. Sentiment towards BEE transactions being backed by private equity appears to be decreasing as although 57% of respondents believe that BEE will generate more opportunities, this is off the Q2 2007 level of 80%. The other respondents now feel that BEE will only generate the same opportunities.

Furthermore, respondents do not feel that the empowerment criteria for effecting transactions is as important now as it was a year ago and in fact 17% of respondents feel that BEE criteria play no role in these transactions.

Nevertheless, BEE will no doubt remain a driver of M&A activity as 83% of respondents feel that BEE will play some role in future transactions.

Figure 22

During the next 12 months we expect our fund to (funds and captives only):

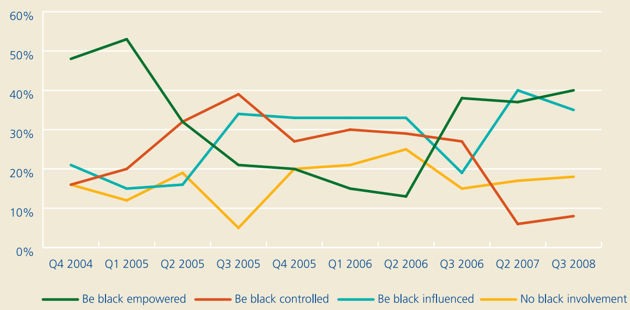


Figure 23

During the next 12 months we expect BEE to be a requirement in a(n) (funds and captives only):

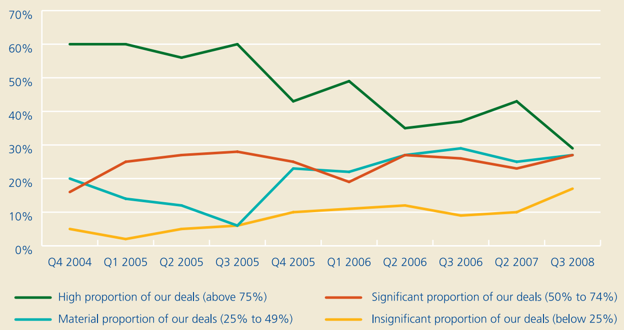
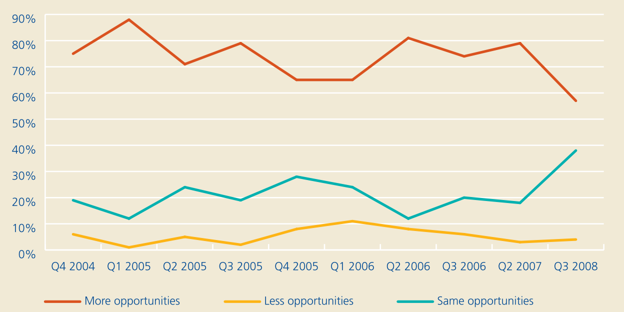


Figure 24

For our business, BEE will generate (funds and captives only):

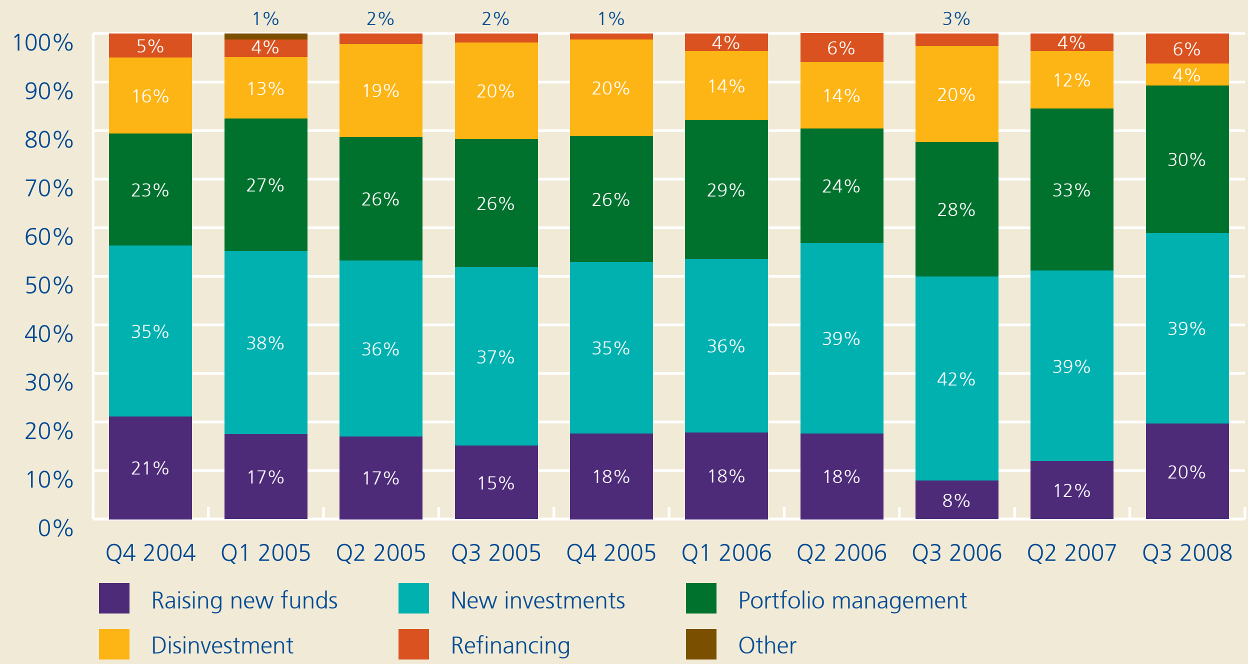


Time allocation and returns (Figure 25)

With the expectation of a decrease in the overall economic climate and respondents expecting capital to take longer to deploy than historically (refer to Figure 6), it would appear that a significant amount of respondents are moving into capital raising mode (refer to Figure 25) so as to be able to deploy capital and take advantage of opportunities as the market starts to turn for the better. Minimal time is expected to be spent on disinvestments in the next 12 months as exit multiples are expected to remain under pressure.

Figure 25

During the next 12 months, we expect to spend the majority of our time focused on (participant allowed to select only 3 options):



Investors (Figure 26 to 31)

The JSE has experienced significant downward pressure during 2008 as a result of a new wave of risk averse sentiment and a flight for quality assets from emerging economies. Foreign investment into the bourse has decreased significantly from a net investment in 2007 of R66 billion to a net disinvestment in 2008 of R15 billion (Source: JSE). To compound these pressures on values, local inflation has spiralled to over 10% which is well outside of the South African Reserve Bank's target range of 3% to 6% and as a result has raised concerns over future earnings. This has resulted in a "double wammy" for values as earnings expectations and multiples have decreased.

Investor respondents (83%) remain firm that returns generated by PE funds will outperform the comparative JSE sector and 58% expect returns to be adequate in relation to the additional risk taken with an alternative asset class.

With the global liquidity pressures (refer Figure 28) it stands to reason that smaller amounts of cash will be allocated to alternative asset class investments as 11% of respondents estimate that their allocation to PE and VC funds will decrease in the next 12 months.

Figure 26

My current medium-term view is that PE / VC funds will provide returns that will:

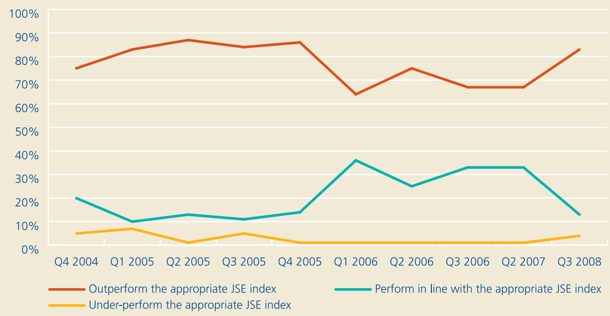


Figure 27

My current medium-term view is that PE / VC funds will provide:

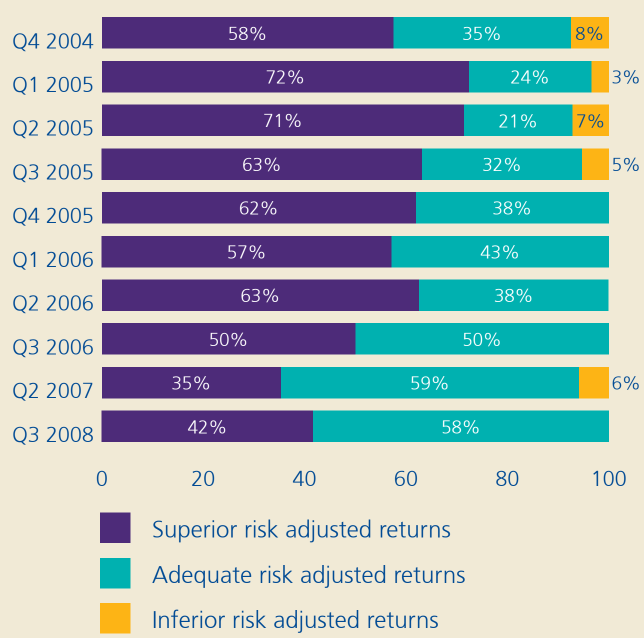


Figure 28

During the next 12 months we expect our allocation (% of total funds) to PE / VC funds to:

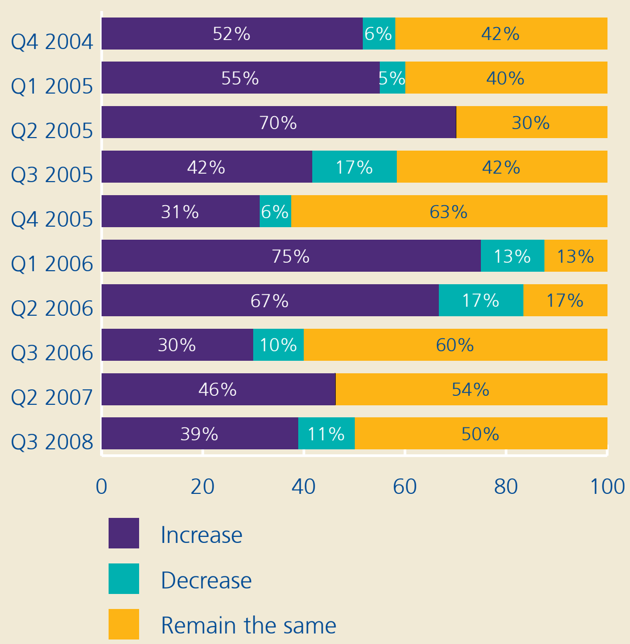


Figure 29

Our current allocation to PE / VC funds are:

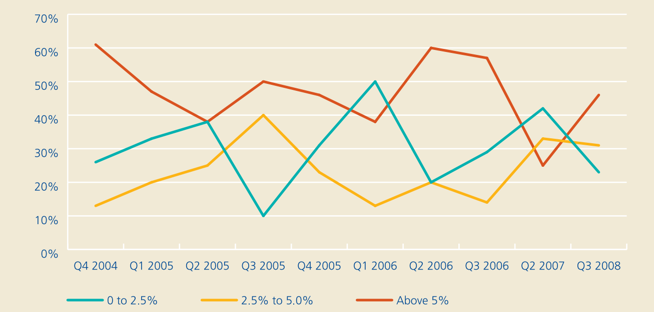


Figure 30

Of our funds committed to PE / VC funds during the next 12 months, investment in BEE funds will be:

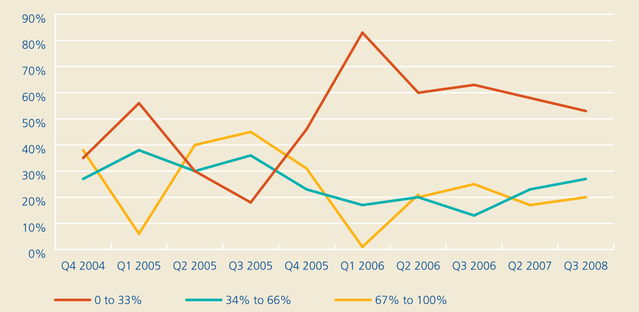
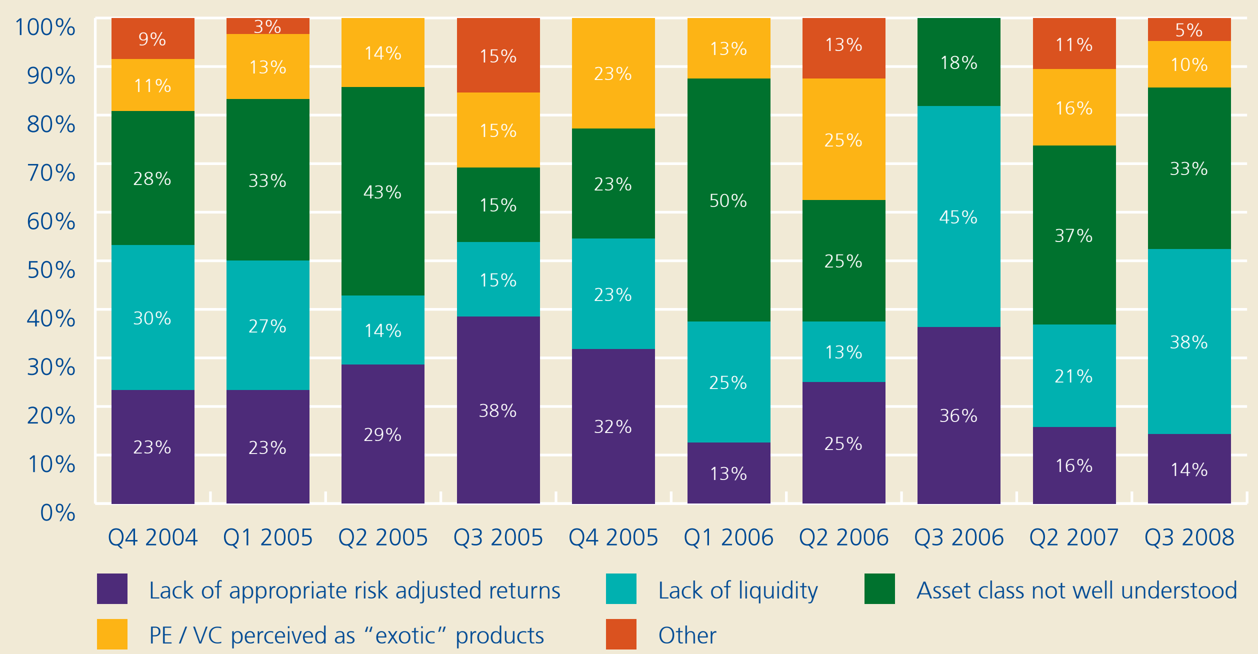
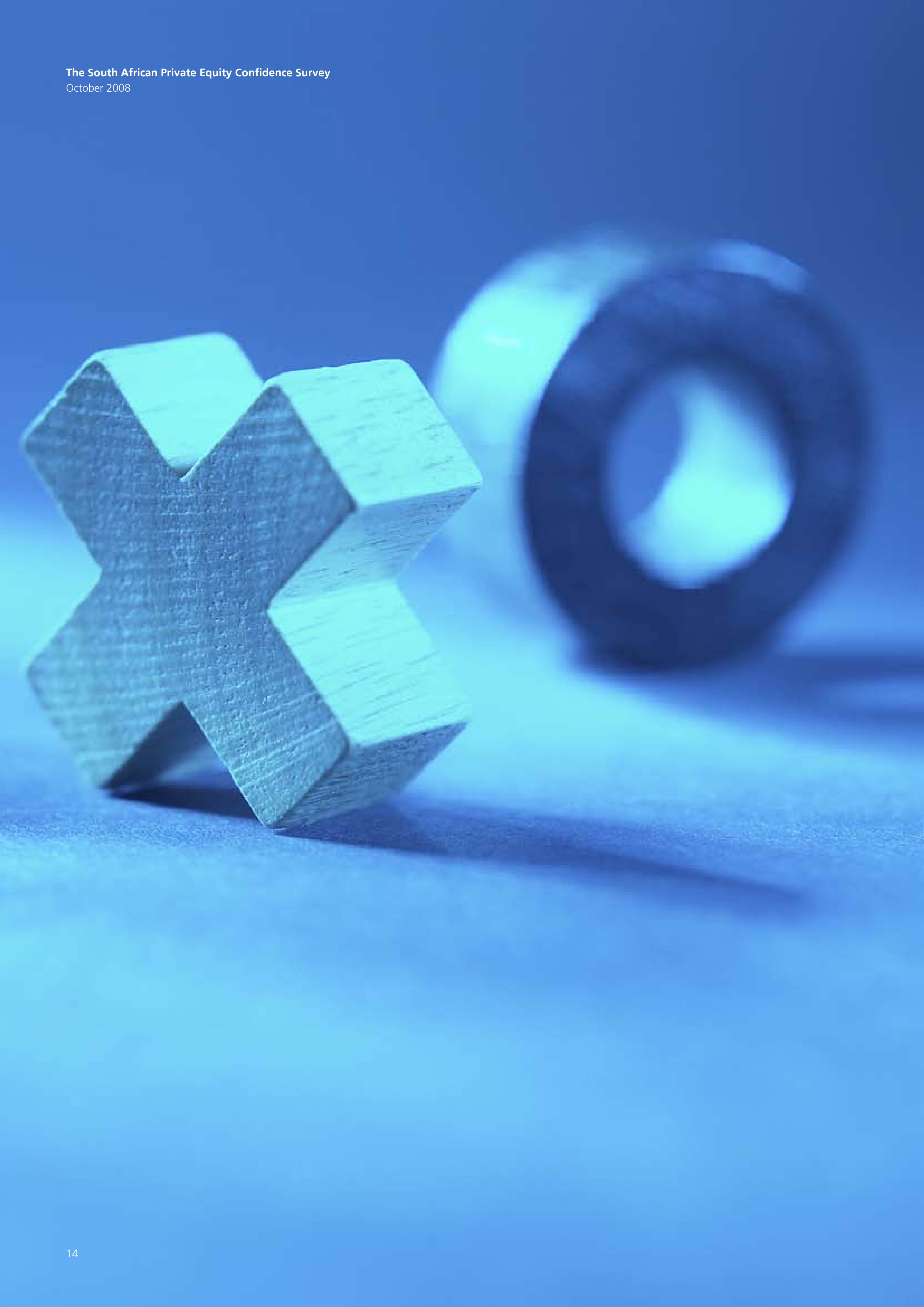


Figure 31

I expect the following to be constraining factors during the next 12 months for investing in PE / VC funds (participants were allowed to select more than one):





About PECS

The Deloitte PECS provides a comprehensive snapshot of the venture capital and private equity industry's expectations for the next 12 months, and acts as an indicator of changing confidence levels in:

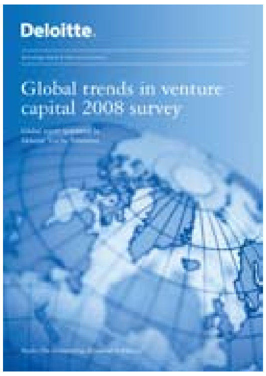
- economic climate,
- deal activity, and
- availability of funding and investment focus.

The results produce a forward looking measure of the overall sentiment in the South African Venture Capital and Private Equity community, which is extremely relevant to immediate deal flow. This survey is modelled on similar surveys conducted in 16 other developed and emerging economies. PECS will further facilitate comparisons of trends and views expressed by the global venture capital community with our domestic marketplace. The survey was conducted amongst a population of more than 400 private equity investment professionals in South Africa.

Other countries and regions where Deloitte has run PECS include:

United Kingdom	Germany/ Austria/ Switzerland
France	Canada
Australia/ New Zealand	Israel
Benelux Countries	Czech Republic
Slovakia	Hong Kong/ China
India	Turkey
Central Europe	United States of America
Russia	

In June 2008, Deloitte Touche Tohmatsu also released a report focussed on venture capital in the Telecommunications, Media and Technology industry. The report was entitled, *Global trends in venture capital 2008 survey*.



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The Southern African Venture Capital and Private Equity Association ("SAVCA")

SAVCA is the industry association representing over 60 fund managers in the venture capital and private equity industry in South Africa.

The industry has over R86 billion (US$ 11 billion) in funds under management and approximately 400 professionals.

SAVCA was formed in 1998 and its mission is to play a meaningful role in the Venture Capital and Private Equity industry by:

- Promoting the interests of the industry
- Lobbying on behalf of the industry
- Disseminating information
- Arranging training for the staff of its members
- Researching the industry in SA

For more information visit www.savca.co.za

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