



**KPMG and the South African Venture
Capital and Private Equity Association
2000 Private Equity Survey**

April 2001

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Glossary

IRR	– Internal Rate of Return.
BVCA	– British Venture Capital Association.
Gross IRR	– Internal Rate of Return before deduction of management fees and carried interest.
Gross realised IRR	– Gross IRR on total realised portfolio of investments.
Draw down	– A draw down or capital call occurs when third party investors (called limited partners in the United States) provide cash to the private equity fund for investment into a portfolio company. The draw down reduces the outstanding commitment due from the investor.
Carried interest	– This represents a fee enhancement for the private equity fund manager for achieving a benchmark return or ‘hurdle rate’. The fee is often set at 20% of the value of returns achieved in excess of the benchmark return.
Independent fund	– Those private equity companies, managers or funds raising and disbursing capital raised from third party investors.
Captive fund	– Those funds making investments solely on behalf of a parent or group, typically an insurance company, bank or institutional asset manager, often from an indeterminate pool of money.

Foreword

This is the second survey of the South African venture capital and private equity industry.

I am happy that KPMG and the South African Venture Capital and Private Equity Association are living up to their undertaking to making the survey an annual event.

My thanks to all the venture capital and private equity funds that participated in the survey. Thank you Nick Matthews, John Geel and everyone at KPMG for conducting this year's survey under such tight deadlines.

I hope the findings of the survey are of value to -

- ☐ the individual venture capital and private equity funds;
- ☐ the venture capital and private equity industry;
- ☐ South African and foreign investors in South African venture capital and private equity funds;
- ☐ academic and all other interest parties.



Jo' Schwenke

Chairman: South African Venture Capital and Private Equity Association

5 April 2001

Jo' Schwenke

Following the great success of last year's inaugural Private Equity Survey it gives me great pleasure to present the 2000 KPMG and SAVCA Private Equity Survey.

The feedback from the 1999 Survey was greatly appreciated and where possible we have included additional requested statistics. This year we are providing better information on funds raised, undrawn commitments and exits.

We trust that the expanded survey will be of interest to all industry players.



Richard G Carreira

Managing Partner: KPMG Corporate Finance

5 April 2001



Richard G Carreira

Sources of information

The sources of information for this survey include a survey questionnaire, SAVCA's directory of members, interviews with and presentations by private equity industry leaders as well as public information on listed private equity funds.

KPMG's background research identified 56 companies that could potentially be classified as private equity firms or involved in the management of private-equity funds. Questionnaires were delivered to all 56 companies. Thirty of them (representing 41 funds) completed the questionnaire. In addition, alternative sources were used to obtain information on a further 16 private equity firms that did not complete the questionnaire. Although these alternative sources did not provide us with as much information as our questionnaire, we nevertheless believe the information we present provides a fair reflection of the state of South Africa's private equity industry. We do not believe that those funds for which we were unable to get information are material to our survey results.

Although care has been taken in the compilation of the survey results, KPMG does not guarantee the reliability of its sources or of the results presented. Any liability is disclaimed including incidental or consequential damage arising from errors or omissions in this report.

Introduction to private equity

Private equity provides equity capital to enterprises that are generally not quoted on a public stock exchange. Private equity can be used to develop new products and technologies, to expand working capital, to make new acquisitions or to strengthen a company's balance sheet. It can also resolve ownership and management issues, a succession in a family owned business or the buy-out or buy-in of a business by experienced managers.

Investment stages

Private equity can be broadly classified into three sub classes, namely venture capital, development capital and buy-out funding.

Because the definitions of the terms 'venture capital' and 'private equity' vary from country to country, **Figure 1** sets out the terminology used in this survey to avoid confusion.

Figure 1: Private equity investment stages

Venture capital	Seed capital	Funding for research, evaluation and development of a concept or business before the business starts trading.
	Start-up and early stage	Funding for new companies being set up or for the development of those which have been in business for a short time (one to three years).
Development capital	Expansion and development	Funding for the growth and expansion of a company which is breaking even or trading profitably.
Buy-out	Management buy-out (MBO) or buy-in (MBI)	Funding to enable a management team, either existing or new, and their backers to acquire a business from the existing owners, whether a family, conglomerate, or other. Unlike venture and development capital, the proceeds of a buy-out generally go to the previous owners of the entity. Buy-outs are often leveraged.
	Replacement capital	Funding for the purchase of existing shares in a company from other shareholders, whether individuals, other venture-backers or the public through the stock market. Unlike venture and development capital, the proceeds of a buy-out are generally paid to the previous owners of the entity. Buy-outs are often leveraged.

History of private equity

South African companies have long invested in unlisted businesses. Why then has private equity become such a popular catch phrase of late? The answer lies in the development, internationally, of a professional private equity management industry. The success in terms of growth achieved by private equity funds in the United States and to a lesser extent in Europe has resulted in the development of professional private equity firms in other parts of the world, including South Africa.

In South Africa, the four major commercial banks and their predecessors pioneered leveraged buy-outs. This was largely driven by disinvestments from South Africa in the early 1980's. These buy-outs, encouraged by the international success of private equity, formed the foundation for our private equity market.

Organised and professionally managed investments in the private equity market can be traced back to 1946 in the United States, when the American Research and Development Corporation (ARD) was formed to facilitate new business formation and development. ARD's stock persistently traded at a discount, and it had difficulty raising capital on the stock market. During the 1950's and 60's, the United States Congress introduced legislation to promote the development of small business, with moderate success. An increase in the market for initial public offerings in 1968-69 resulted in significant profitable realisations of venture-capital investments made in the 1960's. During the 1970's, many of these venture capital partnerships began leveraging buy-outs of divisions of large conglomerates.

During the late 70's, regulatory and tax changes allowed US pension funds to invest in private equity for the first time. This, together with the success of new leveraged buy-out (LBO) firms, resulted in a boom in fund raising¹. In 1987, Kohlberg Kravis, and Roberts raised a record US\$5.6 billion LBO fund, which was more than twice the total commitment to all other venture-capital firms in that year. By 1998, US private-equity firms had US\$84 billion under management².

The 1980's and 1990's therefore saw explosive growth

in private equity commitments. In 1999 commitments to earlier stage venture capital funds exceeded commitments to buy-out funds for the first time, reflecting the strong growth in this sub-class of private equity³.

As Europe emerged from the recession of the early 1990's, it too became a fertile environment for private equity. In 1997, a number of private equity firms raised funds of more than US\$1 billion for the first time. By the end of 1997, the total of European private equity investment portfolios was estimated at ECU32.7 billion⁴.

Types of private equity firms

A distinction needs to be made between captive funds and independent funds⁵. Many private equity firms exclusively manage assets off their own balance sheet or that of their parent company. These funds are referred to as captive funds.

Independent funds raise cash commitments from third party investors⁶. Generally, in terms of the agreement between the third-party investors and the private equity fund manager, the private equity firm draws down on the commitments as and when investments are made. The independent funds are the dominant type of firm in the UK, Europe and in the US where these funds are structured as limited partnerships. Private equity firms typically act as the general partner of the limited partnership, whilst institutions and other investors become limited partners.

Unlike captive funds, independent funds are usually closed ended. This means that once a fund has been raised, it is closed out, following which no further commitments are accepted from third parties. Typically, third parties commitments expire, often according to a time schedule based on a 'use it or lose it' principal, once a maximum draw-down time period expires. Professional private equity managers usually earn income from a combination of a management fee based on total commitments plus an enhanced 'carried interest', which is based on the performance of the fund relative to a benchmark. Captive fund managers usually do not charge any management fee.

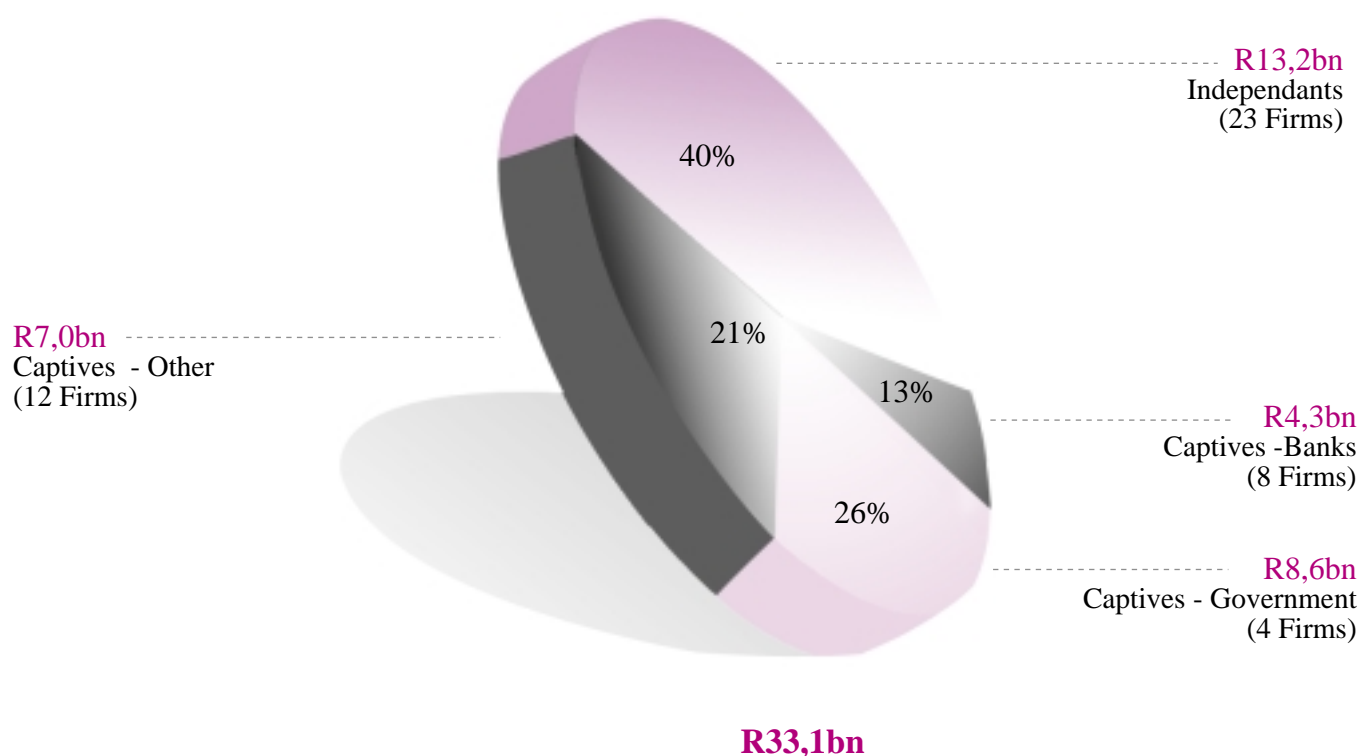
Funds under management and commitments

Our research shows that South Africa's private equity industry now boasts total funds under management of R33,1 bn¹⁵ (inclusive of undrawn commitments of R7,5 bn) up from R31,5 bn (inclusive of R8,9 bn undrawn commitments) in 1999⁷. The number of investment professionals has also grown to 319 (1999: 293).

Significant players in the private equity industry include the captive funds of South Africa's larger banks as well as the captive funds and private equity investment portfolios of government and aid agencies. Examples of these include the Industrial Development Corporation, CDC Capital Partners (previously the Commonwealth Development Corporation), the Southern African Enterprise Development Fund (which is funded by the US agency for international development) and the International Finance Corporation (a division of the world bank).

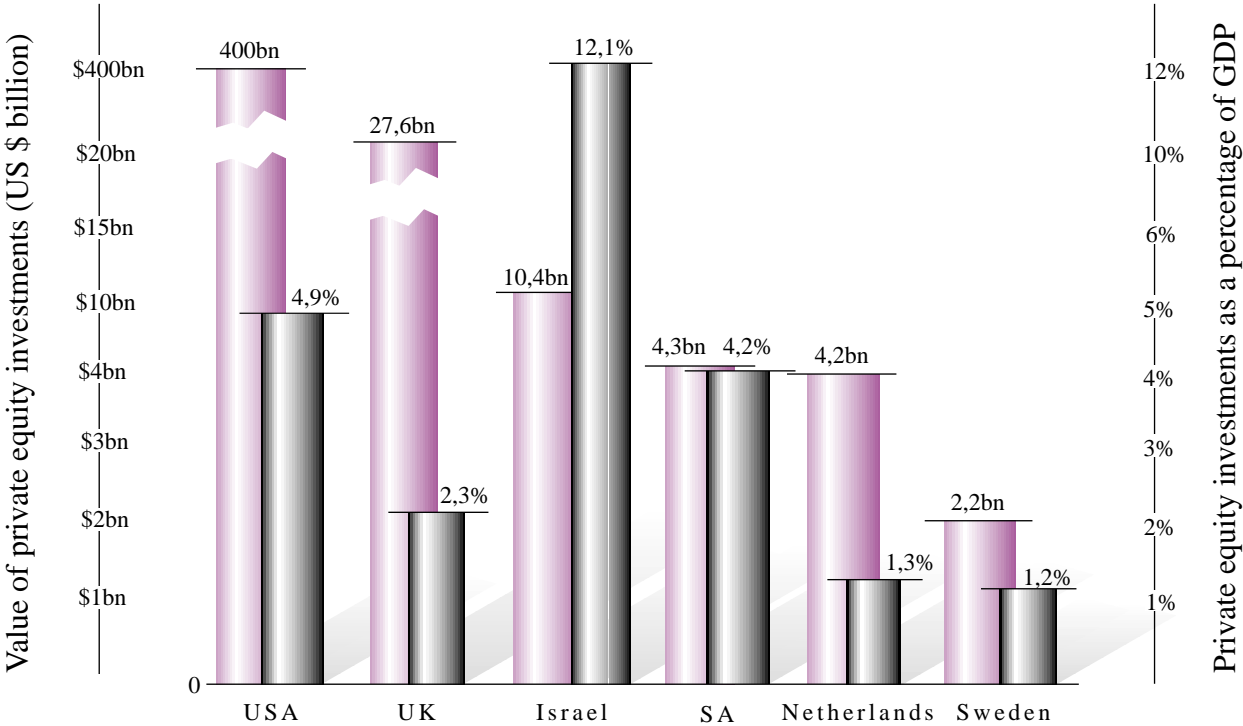
Independant funds, those funds which generally manage third party funds, are becoming an increasingly important segment of the South African private equity landscape. Although this sector is dominated by the larger buy-out focussed funds of Brait Private Equity and Ethos Private Equity, there is an increasing prevalence of second tier private equity fund managers including an increasing amount of earlier stage venture capital funds.

Figure 2: Total funds under management at 31 December 2000



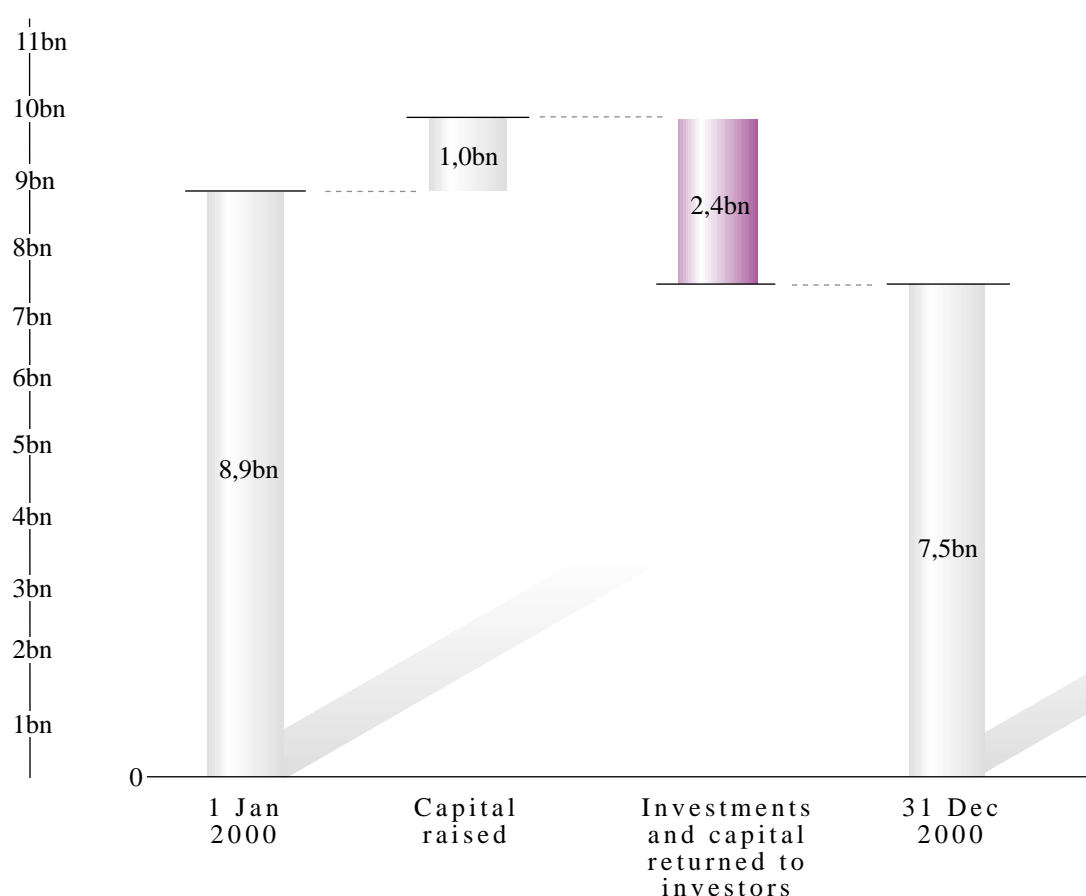
Although our industry is tiny in comparison with that of the United States, it is larger than those of many European countries including Sweden and the Netherlands. In terms of size relative to GDP, South Africa's private equity industry is more significant than most of Europe's, but still some way off Israel's (12,1% of GDP), and the USA (4,9% of GDP)⁸. The relatively large size of South Africa's private equity market (as a percentage of GDP) may indicate that the recent strong growth in private equity may begin to slow.

Figure 3: Relative size of international private equity markets



Despite the growth in the amount of new capital committed to earlier stage venture capital funds, there has been a net decline in the undrawn commitments of the larger buy-out focussed funds. This is largely as a result of large fund raising activities undertaken by the larger buy-out funds in 1998 and 1999 and the subsequent large draw downs in 2000. This is reflected by the R3,4 bn invested during the course of the 2000 calendar year (1999: R2 bn).

Figure 4: Undrawn commitments from third parties.¹⁶

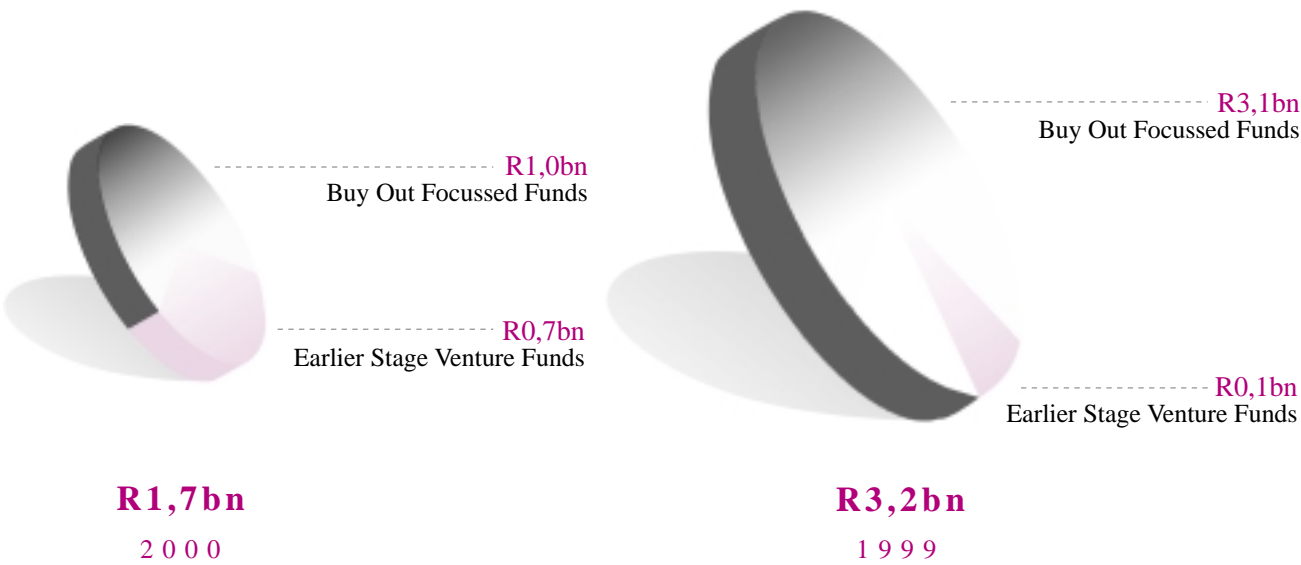


Although slightly down on 1999 there still appears to be a considerable amount of undrawn commitments. Although buy-out funds have been net disbursers of commitments, this has been partly off-set by significant new commitments raised by first time early stage focussed funds. This bodes well for entrepreneurs, as these funds often work on a ‘use it or lose it’ principal meaning that there will be an incentive for fund managers to invest their funds as soon as possible.

Figure 5 highlights that there has been a drop off in the amount of third party funds raised from a total of R3,2 bn in 1999 to R1,7 bn in 2000. Despite this overall drop-off it is exciting to learn that the early stage venture capital funds were able to raise significant amounts of committed capital for the first time. This is no doubt partly as a result of successes achieved in the United States as well as early successes of funds such as the Archway Fund I (a Gensec managed fund) and the Brait Technology and Innovation Fund.

It is interesting to note that a total of five new independent private equity fund managers raised at a total of R565 million of commitments for their respective first funds.

Figure 5: Third party funds raised analysed by fund stage



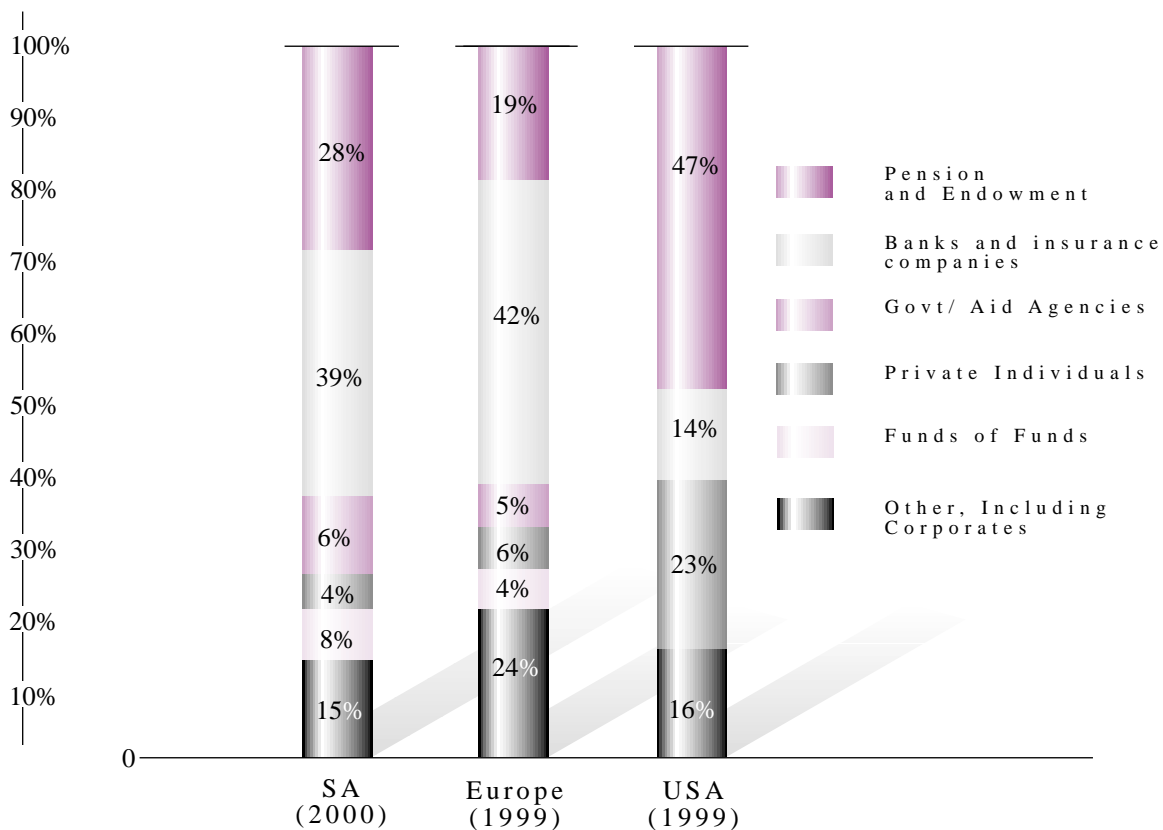
As previously highlighted a significant proportion of funds raised in 2000 was for earlier stage venture capital funds. This capital was sourced mainly from South African financial institutions as well as the IDC which has recently committed significant funds to venture capital.

In the United States the retirement funding industry has proved to be the single largest contributor to the private equity market with US domestic pension funds and endowment funds contributing 47% of all funds raised in 1999.

In the UK, as in South Africa, institutional investors have generally been reluctant to invest into private equity. A large reason for this has been the reluctance of insurance companies, and pension fund actuaries to allow much investment of this type because returns are hard to measure and investments may be unsaleable for several years. US pension funds have consequently been significant investors into non US private equity funds. In terms of cumulative funds raised in South Africa more than one third of funds raised from Pensions/Endowments has been sourced in the United States.

In South Africa as in Europe, the larger investors remain banks.

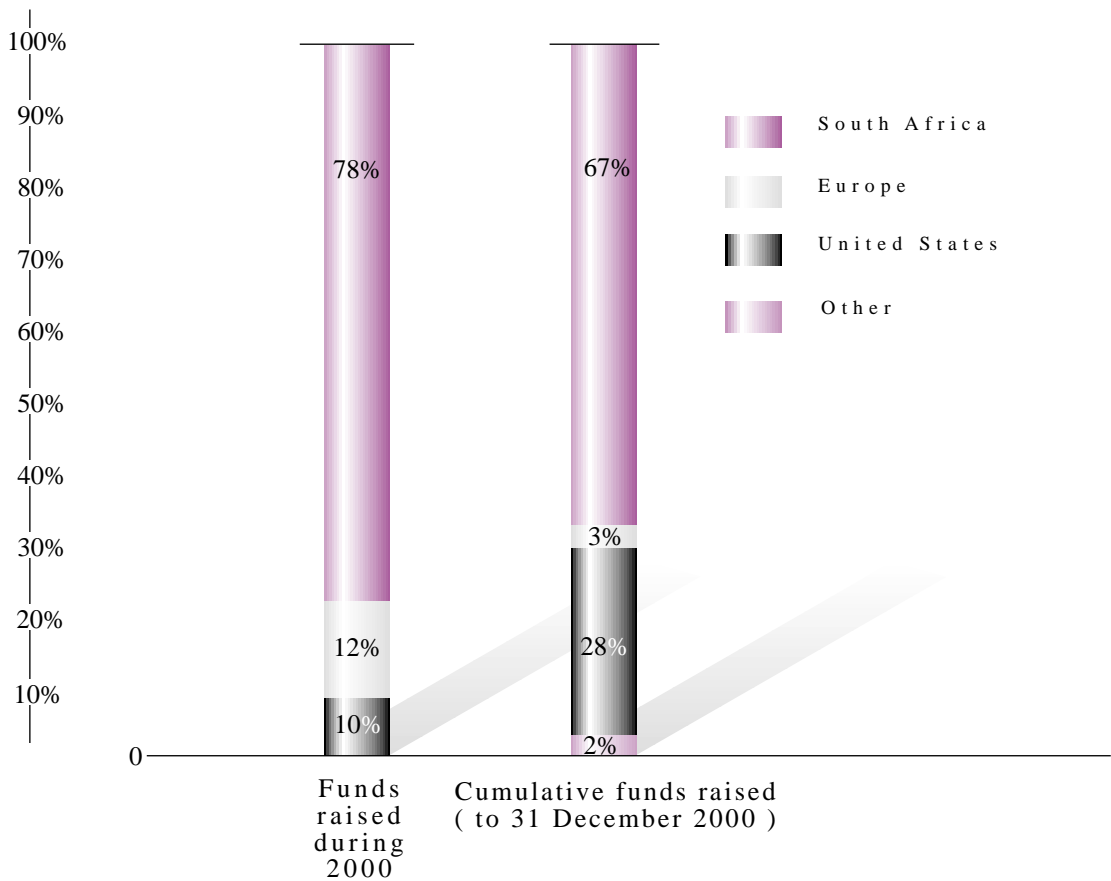
Figure 6: Sources of third party funding¹²



An interesting observation is that in the United States a significant amount of commitments (21% of 1999 total) are also received from endowments and charitable foundations. In South Africa and Europe, however, funding from these sources has not been separately measured, but it is believed to be negligible. For foundations and endowments, whose liability maturity profile is very long and often indefinite, private equity represents an appropriate asset class by matching the maturity profile of assets to liabilities.

The continuing challenge facing the private equity industry in South Africa is not the lobbying of institutional investors but rather the convincing of pension fund trustees that private equity represents a suitable asset class for long-term sustainable growth. Ultimately, the responsibility for the preparation of investment-policy statements lies with the pension-plan sponsors and not the professional money manager.

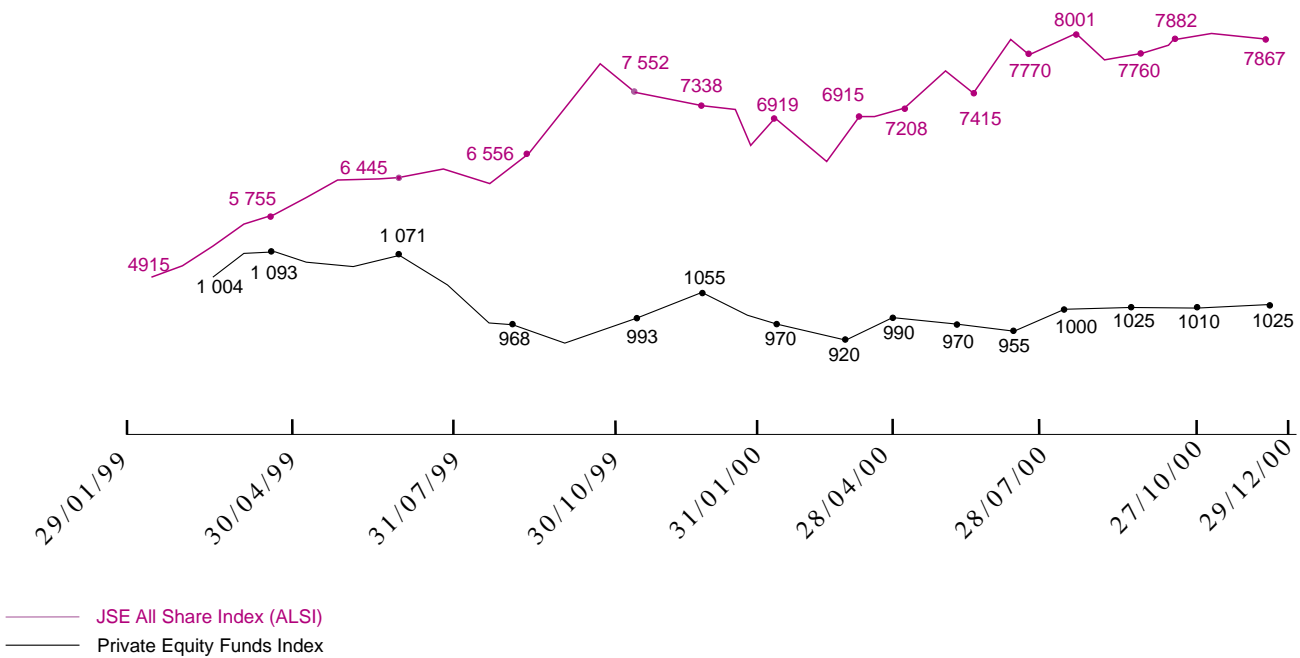
Figure 7: Geographic Source of third party funding



A number of funds have raised capital through listing. This was considered an easier and quicker alternative to raise local funding. Although funds have been successfully raised, the share performance of these listed private equity vehicles has generally been poor and they often trade at a significant discount to net asset value. This adds credence to the view that the listed private equity vehicle may not be appropriate given the long-term nature of private equity investing, especially under current market conditions⁹.

2000 saw no further listings of private equity funds and some private equity funds have commenced buying back their own shares because of the discounts to underlying net asset value at which these funds trade.

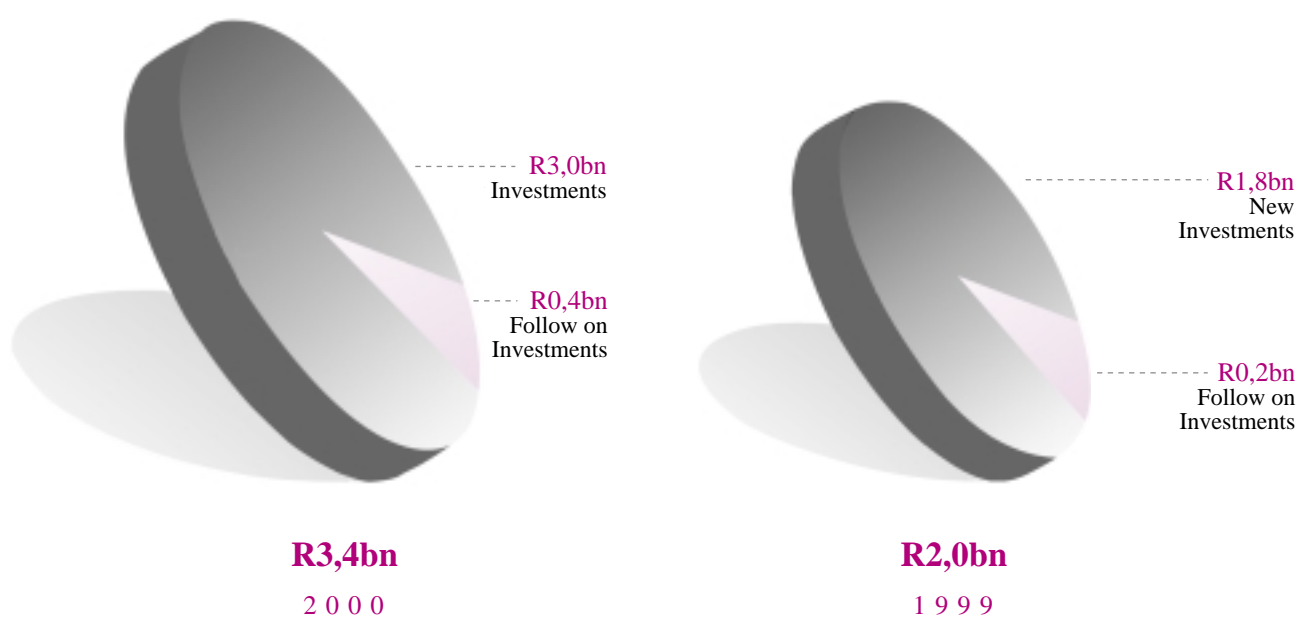
Figure 8: JSE venture capital index



Investments

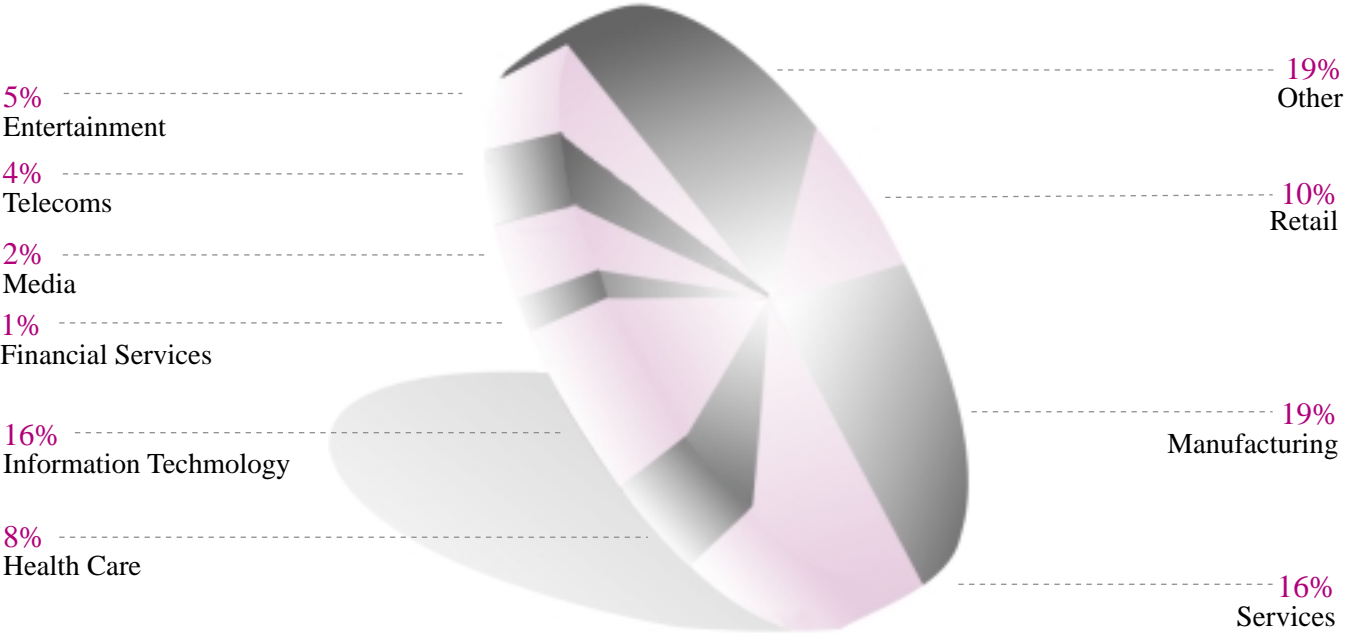
Private equity investments in portfolio companies grew from R2,0 billion in 227 companies in 1999 to R3,4 bn in 264 companies in 2000. The average deal size has increased from R9,7 million to R14,5 million for new investments reflecting the growth in the number and value of larger buy-out transactions. In analysing the data returned it is interesting to note that the private equity firms that focus on larger transactions concluded 33 new investments at an average deal size of R60,6 million, compared with 36 transactions in 1999 at an average size of R25,4 million. Follow on investments are investments into companies into where first round funding has already been made.

Figure 9: Number and value of investments made



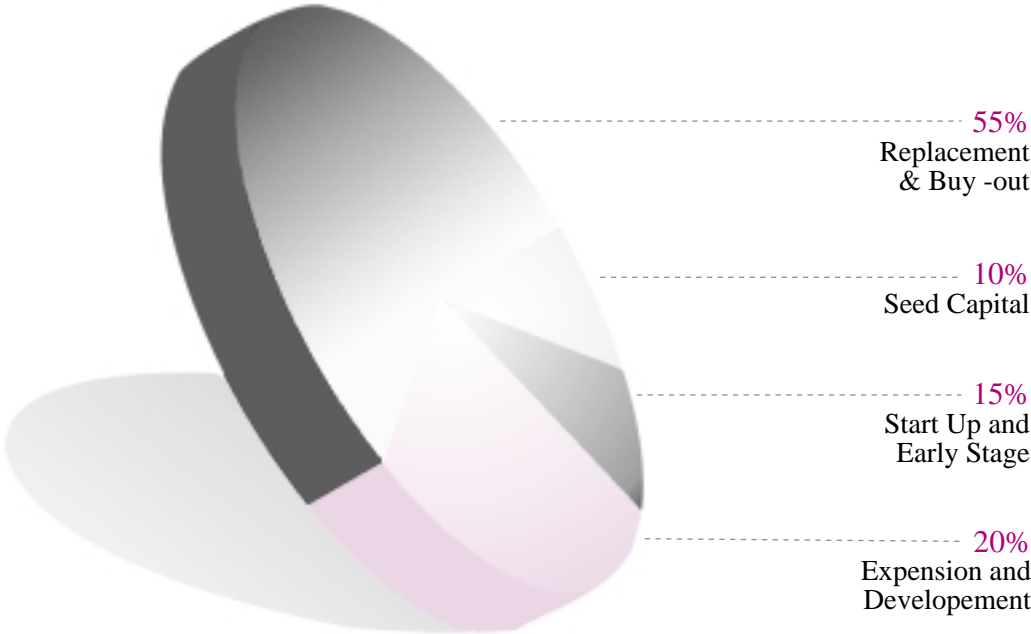
It is interesting to note that much of the value (19%) of private-equity investments is in the manufacturing sector. Information technology attracted 16% of total investments, which is relatively small in comparison with the figures in the United States where 80%¹⁰ of investments in 1998 were into information technology.² The comparative figure for Europe was 65% in 1998.⁴

Figure 10: Sectoral analysis of investments in 2000



An encouraging observation is the growth in the value of investments into seed capital and start up/early stage businesses. Whilst our 1999 survey reported that these two sectors (which together constitute venture capital) totalled 6,1% of cumulative investment to December 1999, in 2000 25% of all private equity investments by value were into seed, start up and early stage businesses.¹⁴

Figure 11: Investments in 2000 - by stage



Buy-out transactions nevertheless still constitute the largest sub-sector by value constituting 55% of all private equity transactions. This sector continues to be characterised by a number of large transactions and during the year we saw a number of those being the take private of listed entities. Given the continued depressed values of some of the sectors on the JSE, especially the Telecoms, Media and Technology sectors, we believe this trend will continue if not accelerate. **Figure 12** below provides an analysis of larger publically announced private equity transactions.

**Figure 12: Table of large private equity deals
(total enterprise value)**

		<i>R mil</i>
WACO International	Public to private LBO	2400*
OTK	Replacement Capital	1300
Southern Mining	Replacement Capital	560
Fedics	Public to private LBO	507
Smartcall	Replacement Capital	500
First Lifestyle	Public to private LBO	492
Tissue Link	Replacement Capital	300*

* These transactions were syndicated with a number of private equity funds.

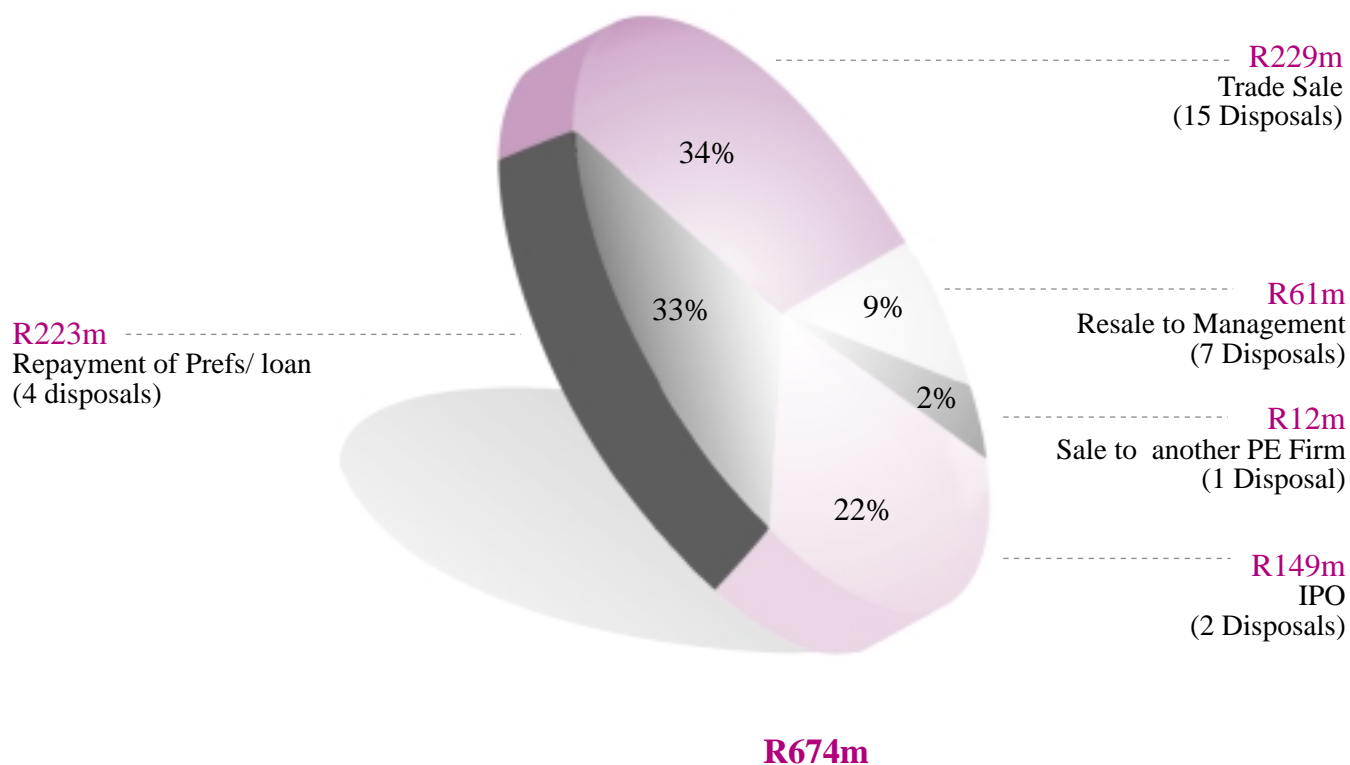
Exits

A concerning trend is the continuing low number and value of exits. Of those firms which completed our questionnaire, a total of only 29 investments were exited (excluding write-offs).

The most prevalent method of exit during 2000 was the trade sale. The current poor environment for new listings has no doubt contributed to the low number of exits via IPO's. Research in Europe and in the US has indicated that one of the strongest growth factors in private equity is a healthy institutional appetite for new listings. The Nuer Mark in Germany and NASDAQ in the US have been a favourite form of exit for many venture capitalists. In the UK some 40% of all LSE flotations are represented by private equity exits. These companies have generally performed better than their peers who have not come to market via private equity.¹¹

In the United States IPO's accounted for 37% of all exits by value as opposed to 23% in South Africa. In the United States 270 venture backed IPO's were achieved during 1999 representing 50% of all IPO's (by number) in 1999. This clearly demonstrates the importance of a healthy IPO environment for the private equity industry. In the long term, sustained growth in the South African private equity market will not be achieved unless there is an uptick in the appetite for new listings.

Figure 13: Disposals in 2000



Performance

Measuring the performance of private equity funds is always difficult. Private equity valuations are, by their very nature, highly subjective. In an attempt to overcome this weakness, SAVCA has developed a set of guidelines that is intended to provide a framework for the valuation and disclosure of private equity portfolios. The overriding principle of the SAVCA guidelines is to show a fair valuation of investments to the investor. It is promising that a total of seven funds claimed compliance with the SAVCA's valuation guidelines. A further six funds claimed compliance with the British Venture Capital Association (BVCA) valuation guidelines on which SAVCA's guidelines are based.

In reviewing the IRR's reported in this survey, a number of issues need to be considered:

- The IRR's reported reflect the returns achieved from the inception of the funds. As the funds are all at different ages, the IRR's are not directly comparable;
- The IRR's reported were gross IRR's and therefore reflect returns prior to the deduction of management fees and carried interest. Although net IRR's are the more relevant performance measure to a third-party investor, we believe that few fund managers would have calculated their returns on this basis;
- The IRR's of independent funds are based on drawn-down funds. As such, there is no cash drag element. Third-party investors have to maintain sufficient liquidity to meet the capital calls made by fund managers. Consequently, they experience an element of flow drag on their investment portfolios. The IRR's calculated by fund managers would exclude this effect;
- When assessing the performance of private equity it is important to focus on long term returns. Initial results over the first two or three years of a fund can be misleading if viewed in isolation. A high short term IRR can be achieved through a few attractive divestments, while low rates may result from new funds only just beginning their investment activity. Any consideration of returns over the short term must be done in combination with scrutiny of the general level of investment and divestment activity.
- Funds with a history of less than one year were excluded from the survey with regard to IRR's; and
- Captive funds generally do not calculate or report IRR's. Their fee structures are not usually linked to the achievement of prescribed IRR's. In short, most of the funds that reported IRR's were independent private equity funds.

In view of the factors discussed above, it was decided that the most appropriate way to present the results is as a table, from which readers can draw their own conclusions regarding the performance of the South African private equity industry. **Figure 14** shows the results of our survey.

Figure 14 presents both total and realised IRR's. Whilst the total IRR presents the total return of the fund since inception including unrealised investments, the realised IRR only presents the returns of funds deployed and subsequently realised and returned to investors. This therefore presents a less subjective picture of fund returns (although it would exclude the negative effect of investments that are difficult to exit).

Figure 14: IRR's reported by respondents to survey questionnaire

	2000		1999	
	<i>Total Gross IRR since fund inception</i>	<i>Realised Gross IRR since fund inception</i>	<i>Total Gross IRR since fund inception</i>	<i>Realised Gross IRR since fund inception</i>
Number of funds reporting	14	10	9	10
IRR below 15%	4	2	3	3
IRR between 15% and 40%	4	1	2	2
IRR in excess of 40%	6	7	4	5

Internationally the net returns achieved by private equity investments have outperformed the public equity markets.

In the UK private equity returns have outperformed public equity returns by 5,4% per annum over the last ten years. Over the last five years the outperformance increases to 7,4% per annum.¹³

In the United States the uptick in the venture-backed IPO market in 1999 resulted in remarkable short term performances (1999 yearly IRR's – 62% net IRR for venture capital, 15,3% for buy-out funds, 28,7% for all private equity). Disregarding these short term factors, the US private equity market has still shown strong returns over five years (22,3%) and over 10 years (22,7%).

In South Africa the returns generated by the independent private equity fund managers have also been healthy, with the large established buy-out funds generating gross IRR's (both realised and total) in excess of 40% since fund inception.

References and footnotes

- 1 The economics of the private equity market, Ice Millar Donandio & Ryan.
- 2 Venture Economics.
- 3 Myners Survey.
- 4 EVCA.
- 5 In the United States, independent funds are normally structured as Limited Liability Partnerships (“LLP’s”).
- 6 Referred to as limited partners in the United States.
- 7 Although the 1999 KPMG & SAVCA survey reported total funds under management of 27,56 bn (with undrawn commitments of R5,9 bn), the 2000 results now include certain private equity funds which were excluded last year. The 1999 figure of R31,5 bn includes R12,8 bn in respect of independents, R8,2 bn in respect of government captives, R4,0 bn in respect of bank captives, and R6,5 bn in respect of other captive funds.
- 8 For UK, Sweden and the Netherlands, information has been sourced from EVCA (1999 numbers). For Israel and the USA information has been sourced from the National Venture Capital Association (NVCA) (1999 numbers). EVCA numbers exclude undrawn commitments.
- 9 The distinction needs to be made between listed private equity vehicles and private equity fund management companies that form part of listed financial services groups. Many of these have performed exceptionally well.
- 10 World almanac.
- 11 Private equity: Examining the New Conglomerates of European Business, Peter Temple.
- 12 European data from EVCA, US and Israeli data from NVCA. NVCA does not separately measure contributions from fund of funds and government institutions and aid agencies.
- 13 WM/BVCA, Venture Capital and Private Equity Performance Measurement Survey.
- 14 Seven of the eight seed capital investments which totalled R50 million related to just one captive private equity fund.
- 15 This number reflects investments made, at cost, plus undrawn commitments. Captive funds, which make up a large chunk of the South African private equity market generally have no fixed commitments, although this is not indicative of their capacity to make new investments.
- 16 Although figure 4 reflects R1,0 billion being new commitments raised, an additional R700 million has been raised by captive funds. These funds have correctly reported that they have no undrawn commitments from third parties and we have therefore excluded the effects of captives. For the same reason, investments made by captive funds have also been excluded from figure 4.

