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Corporate Finance

The South African Private Equity Confidence Survey

April 2007

SAVCA

SOUTHERN AFRICAN VENTURE CAPITAL AND PRIVATE EQUITY ASSOCIATION

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Introduction

Welcome to the fourth publication of the South African Private Equity Confidence Survey (“PECS”), conducted by Deloitte & Touche in conjunction with the Southern African Venture Capital and Private Equity Association (“SAVCA”) amongst a population of over 350 investment professionals in the Private Equity (PE) industry across South Africa.

A Deloitte Perspective on Private Equity

General trends

From both a worldwide and local viewpoint, PE as an asset class had a very big year in 2006. A global glut of capital has provided PE outfits all over the world with the firepower to do bigger deals and the resulting search for returns has spilled over to emerging markets in a manner never before experienced. Deals are being done further and further from home and the globalised nature of targets results in dealmakers being exposed to investment opportunities in far flung economies.

Cheap debt, key factor for PE deal-making

Over the last few years, we have witnessed a surge in the availability of debt, and numerous changes in the types of debt offerings available. The debt market is hugely important. It has for many years dwarfed the equity markets in Europe and North America, but it is now much more innovative. New instruments and debt structures bring flexibility and a range of choices which makes them attractive and accessible to a much wider group of corporates than used to be the case.

This increase in flexibility and liquidity in the debt markets has resulted in increased competition, driving debt spreads lower and allowed leverage ratios to increase. Gearing up a balance sheet has never been easier or cheaper.

Bigger deals than ever

2007 has already provided the biggest buy out to date, Blackstone’s USD 39 billion acquisition of Equity Office Properties Trust which may yet be topped by KKR and Texas Pacific’s offer to buy-out of TXU, a Texan power company for USD 45 billion.

In recent months the asset class has received an unparalleled focus in South Africa. Record size multi-billion rand funds have been closed and the successful Edcon deal, the delisting of Consol and the aborted play for Shoprite are some of the South African mega deals which have vaulted the asset class into the public eye.

Lingering market scepticism – Transparency? Governance? Shareholder vs stakeholder interests?

PE deal-making gets considerable attention in the media – but it's not always positive. Much has been written about PE as asset-stripping by another name, raising corporate risks through massive debt raising and the general fears about "what goes on when a company is removed from the public eye?" Like all aspects of life, there are positives and negatives to any development or change. The PE dynamic is no different.

In fact, very little media attention is given to the following:

- The tight alignment between shareholders, directors and management achieved through PE transactions.
- The removal of expensive public reporting costs and indeed the incongruity between corporate goals, that may have a five year time horizon, and public reporting responsibilities that focus on short term results.
- The capabilities of PE players, through their organisations and networks to contribute to the operational re-engineering and efficiency plans that go far beyond the financial re-engineering for which PE players of the past were well known.

It all boils down to the same question – whether you are a shareholder, director or union representative – "Can I really trust a PE house to serve my interests and those of the broader stakeholders?" The PE players that will succeed and dominate in the future are those that will consistently get a YES answer.

The PE Premium - truth or fiction?

The fact is that public-to-private transactions tend to attract a premium to the prevailing share price, and often a substantial one. In South Africa, our earnings multiples lag many parts of the world. Not so much because our stocks are undervalued, or due to some anomalies in the equities supply/demand relationship, but more simply to do with the scale and growth rates in our economy. Whilst not a direct linear relationship, Asian stocks are typically trading at multiples that are twice as high as their SA equivalents mainly because their economic growth rates are twice as high as South Africa's.

In terms of PE buyouts, there seems to be a natural assumption by many institutional investors that they are "owed" a premium to exit, due to the expectations that, through financial and operational re-engineering, further value can be unlocked. Also, for many institutional shareholders, they may be unable to enjoy these future benefits, as investing in private entities may not be within their investment mandate. The emergence of tradable securities that allow an institutional shareholder to re-invest, after the public company goes private, are necessary to dampen the expectations of an immediate payout and provide additional investment alternatives in cases where the universe of public investment opportunities is limited.

PE transactions are a natural and necessary part of corporate dynamics. Institutional shareholders should carefully evaluate when to press for higher and higher premiums when PE investors have expressed an interest as, in reality, these premiums will represent no more than "corporate fiction," if the current business fundamentals don't support the higher values. We wonder if in the aftermath of a PE foray, whether or not the incumbent shareholders will challenge the board and management to take appropriate action so that this corporate fiction can become a corporate reality.

We anticipate that, with recent equities performance, and the interest from PE players, both local and international, that most publicly-traded stocks are fully priced. We expect that the local PE players may well focus more on the bristling market of private companies in SA, demonstrating growth in a buoyant economic market but whose owners have a strong desire to draw on PE expertise, to help take their business to the next level.

Tax – some good news for PE deal-making?

From a tax perspective, it was announced in the 2007 Budget that the taxation treatment of gains realised on the disposal of shares will be changed. Currently there is little certainty as to whether gains realised on the disposal of shares will be subject to capital gains tax or revenue tax. Extensive guidelines are set out in case law dealing with the capital/revenue nature of gains, however, application often differs and is highly reliant on subjective factors.

In the Budget, the Minister of Finance proposed that all shares disposed of after a period of three years will be subject to capital gains tax and not revenue tax. This move brings South Africa in line with the tax treatment of capital gains realised in other jurisdictions, although the three year period is longer than that applied in the UK for example. Should shares be disposed of within the three year period, one would still need to test whether the gain was revenue or capital in nature. It is therefore still possible that gains realised on shares disposed of within three years from the date of acquisition could be capital and taxed accordingly.

The proposed change should be good news for PE funds as capital gains are taxed at a lower rate. Generally, PE funds acquire shares with the intention of disposing of the shares within a period of between three and five years. The question is often whether the gains realised are in fact capital in nature given that they are usually held by the funds with a dual intention i.e. the shares would be disposed of should a good return be realised at any stage.

It is likely that these changes will be dealt with in the next round of legislative amendments.

Results of the 2007 Mid year PECS survey

Key Findings

- Overall economic sentiment positive supporting a continuation of current conditions.
- Manufacturing, services and retail attract the most investment focus.
- Replacement and buy-out deals find favour.
- Competition for new investments remains high.
- Transaction volumes expected to increase.
- A net buyer position is strongly anticipated over the next twelve months, lending support to expectations of increases in entry multiples.
- BEE influence on dealflow expected to remain strong, providing more opportunities.
- Understanding of the asset class and lack of liquidity remain the largest concerns of investors.

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Summary results

Economic and market climate – more upbeat

Respondents are feeling slightly more upbeat regarding the economic climate since the last survey with an 8% increase in the proportion of respondents feeling bullish about the future and a marked increase to 52% in the number of respondents expecting the current economic environment to remain unchanged over the next 12 months. Negative sentiment has declined from a high of 46% to 16% (chart 1).

Funding - plenty of road to go

The proportion of those planning to raise new funds in the next 12 months is up from 44% to 53% and continues to track the trend commencing in Q1 2006. Given the high level of recent fund-raising activity it will be interesting to see if this trend will continue (chart 2).

Mixed responses regarding the ease of raising new funds continue. 50% of respondents feel that the current conditions will remain unchanged, down from 61% in Q3 2006 and 35% now feel that the conditions will become more difficult, up slightly from 32% in Q3 2006. (chart 3). Availability of debt financing for transactions in the next twelve months is however expected to increase or remain the same by a combined 95% of respondents (chart 15).

The well established trends for sources of funding continue. Government / Developmental Funding Institutions and pension/endowments continue to be the most popular capital sources with insurance, banks and funds of funds still the next most popular sources of funding (chart 4).

The trend in the geographical source of funding continues although the post popular sources of funding, South Africa and Europe, have given up some ground to the US which has increased from 16% to 28% since Q3 2006 (chart 5).

Chart 6 shows that respondents are now anticipating a shorter period will be required to invest current funds with a decline across the various time horizons. 52% of respondents feel that it will now take less than two years. Up from 43% in Q3 2006. Given the ever-increasing levels of competition (chart 10), this may prove to be an overly optimistic view despite the flurry of deals anticipated (chart 12).

Institutional investor sentiment towards the industry remains at a high level, with an increase in the proportion of respondents who feel that relations with institutions are improving. This is juxtaposed against a marked increase in the proportion of those who feel exactly the opposite, up from 3% in Q3 2006 to 17% (chart 7).

Investment - its getting more and more competitive and expensive

Manufacturing, retail and services remain the top three sectors on the industry interest barometer (chart 8).

Replacement and buy-out deals continue to attract attention, up sharply since the last survey. Expansion & development deals are expected to remain high albeit lower than Q3 2006 having declined from a high of 72% to 42% currently. Overall interest in start up & early stage deals and seed capital has declined and can be expected to continue in this vein for some time given the few players who operate in this space (chart 9).

Competition levels for new investment opportunities continue well established trends, not surprising given the funded status of the industry as a whole and the shrinking target pool. Again, no respondents feel that the level of competition will abate in the next twelve months (chart 10).

A combined 95% of respondents feel that entry multiples will either remain the same or increase. This would be seen as a natural progression to the high levels of competition anticipated (chart 11).

In the light of the record levels of fund raising in 2006 and the need to invest these funds, it is not surprising that strong sentiment exists for an increase in transaction volumes (chart 12) and average deal sizes (chart 13) and that a marked increase has taken place in the number of respondents who anticipate being net buyers of businesses over the next 12 months (chart 14).

Exits in the Trade still dominate

Overall sentiment supports an increase in exit valuations with 53% of respondents sharing this view. The proportion of respondents expecting an unchanged environment in this respect is up marginally to 40% from the last survey (chart 16).

Views on exit volumes are mixed and the majority of respondents support either an increase or continuation of current exit volumes with 12% anticipating a decrease (chart 17).

Trade sales remain the most popular anticipated exit mechanism at 47% of respondents. Resales to management and exits to other firms and a distant second and third exit mechanism at 20% and 19% respectively. IPO activity continues to be on the horizon with 14% of respondents anticipating making use of this exit route in the next twelve months (chart 18).

The majority view (68%) on current investments holding periods anticipates a two to five year holding period with little support for a period of less than two years. Given the increased levels of competition anticipated this view would be expected (chart 19).

Strong performance of investments is still expected

63% of respondents expect their investments to perform in line with expectations, down from 79% since the last survey point. The decline in sentiment in the proportion of respondents expecting in-line performance has shifted to expectations of out-performance, up from 18% to 34% (chart 20).

Expectations regarding the combined valuation of all portfolio companies continues its historical trends with 95% of respondents currently anticipating growth in the value of their investment portfolio over the next twelve months (chart 21).

BEE continues to be a vital driving force in local deals

A combined 83% of all respondents expect their funds to have some form of black involvement ranging from black influence to black control with the percentage of respondents anticipating no black involvement remaining largely unchanged at 17% from 15% in Q3 2006 (chart 22).

Dealflow due to BEE continues to be very high (chart 24) and continues to be a requirement in the majority of transactions (chart 23).

New investments still take time

New investments continue to take up the largest amount of respondent's time, with no significant changes in time allocation taking place (chart 25).

Investors are still expecting strong returns but tempered by higher entry multiples

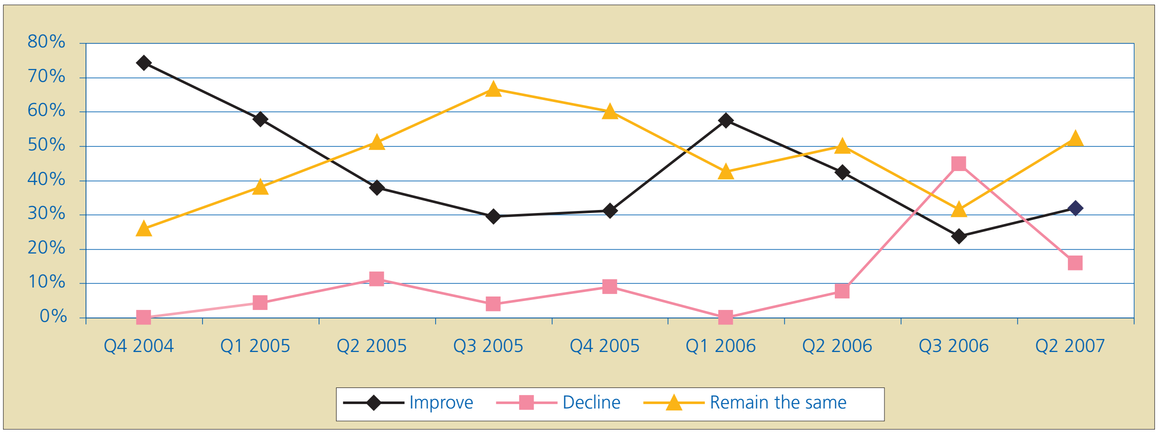
Out-performance of the appropriate JSE index continues to be widely anticipated although the consensus return expectation has now shifted over time from superior risk adjusted returns to adequate risk adjusted returns with the high entry multiples perhaps swaying the anticipated risk return equation (charts 26 and 27). Again, little support exists for the view that performance will be below that of an appropriate JSE benchmark or that the risk adjusted returns to be achieved are going to be inferior.

None of the respondent investors anticipate a decrease in funds to be allocated to the asset class over the next twelve months which is positive, as is the rise in the proportion of investors who anticipate an increase in asset allocation (chart 28). Current allocations of more than 5% of assets have however experienced a decline since Q3 2006 (chart 29).

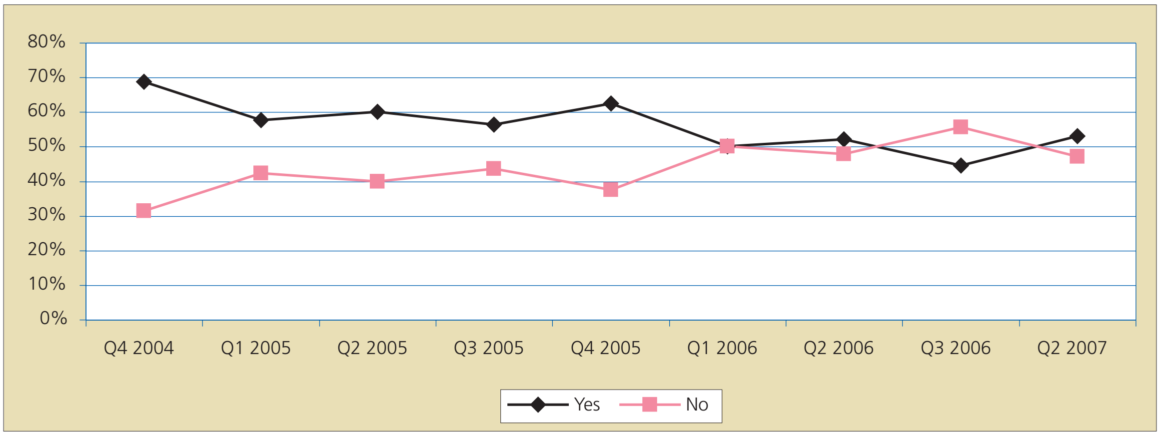
A lack of understanding of the asset class, the lack of liquidity and the lack of appropriate risk adjusted returns remain the top constraining factors and suggest that relationship building with investors and investor education is an ongoing process (chart 31).

General Economic Climate

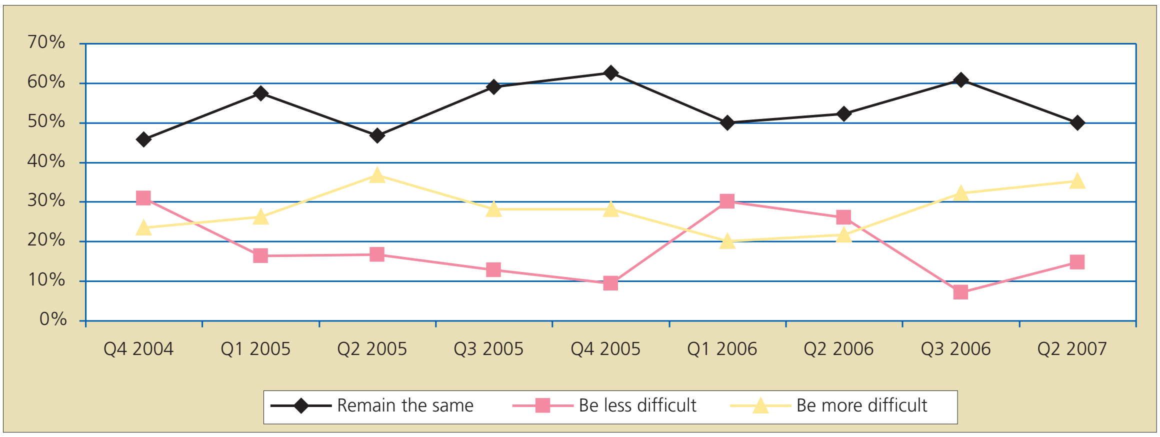
1. During the next twelve months, I expect the overall economic climate to:



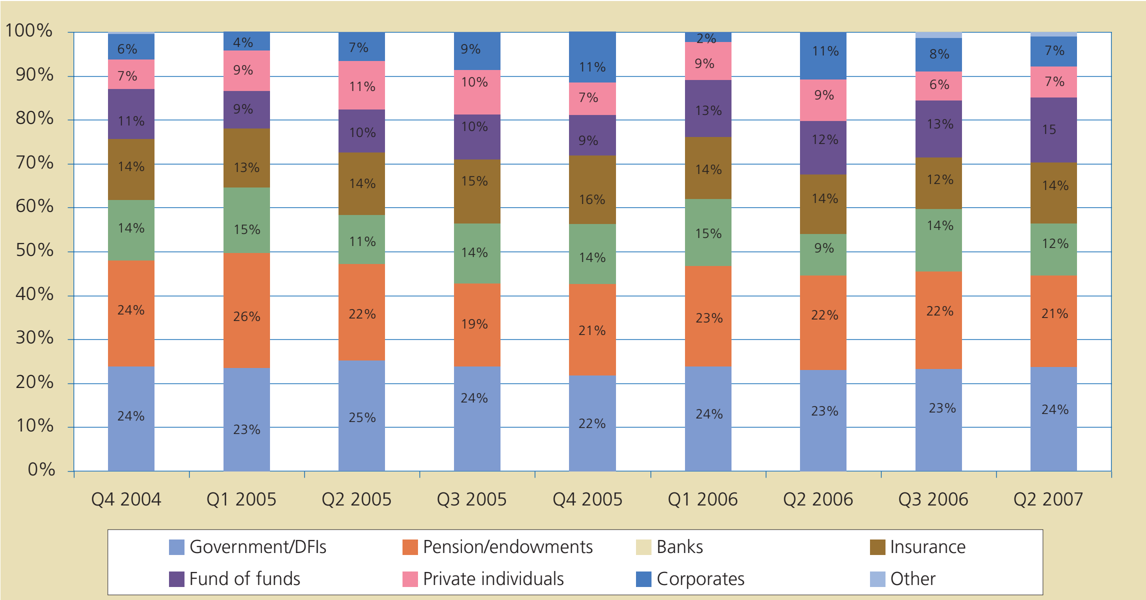
2. Over the next twelve months we plan to raise a new fund:



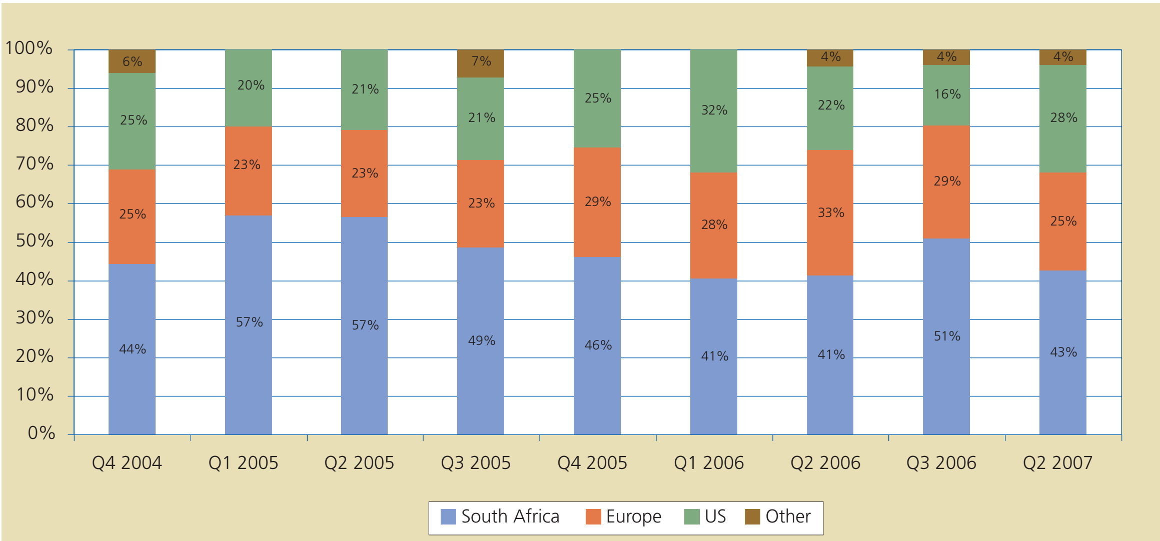
3. Over the next twelve months we expect raising new funds for investment to:



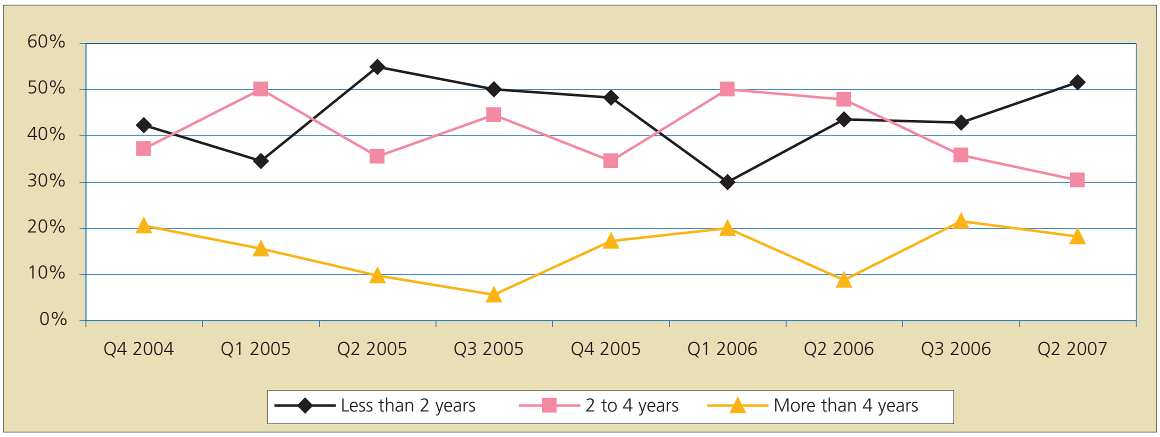
4. If we intended to raise funds within the next 12 months, we would raise capital from the following source of third party funding:



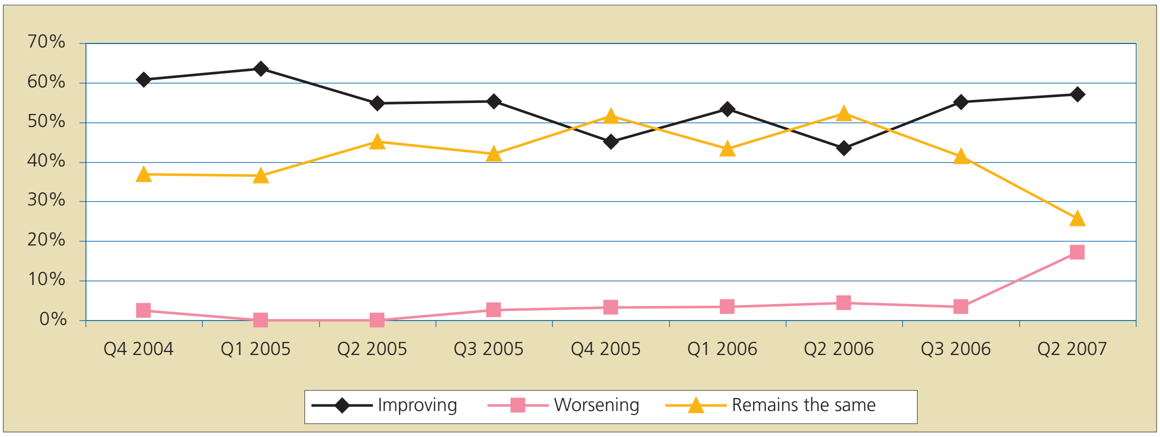
5. If we intended to raise funds within the 12 months, we would raise capital from the following geographical source:



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

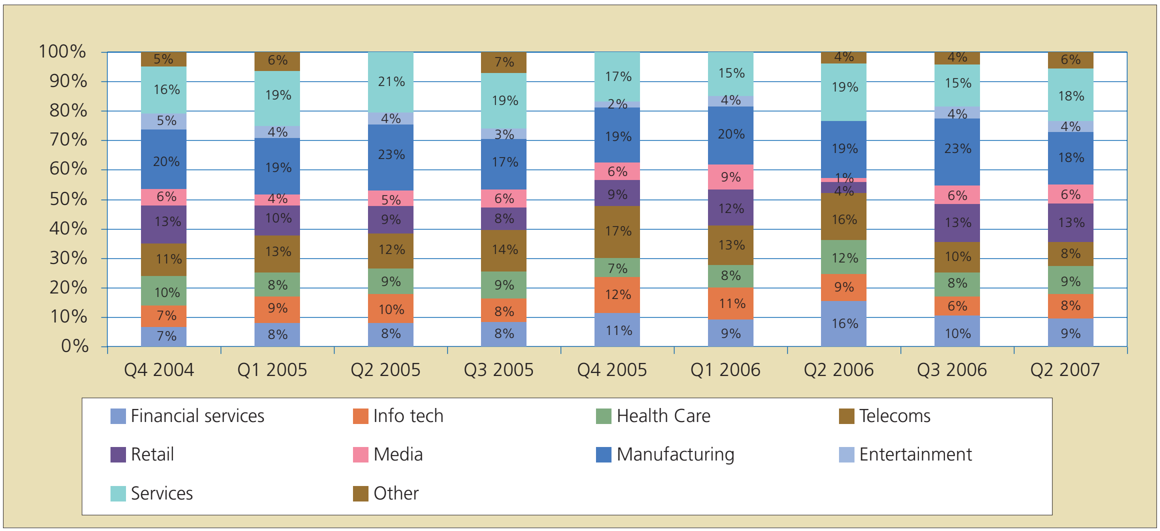


7. Currently, I feel that the understanding and attitude of institutional investors towards the PE / VC industry is:

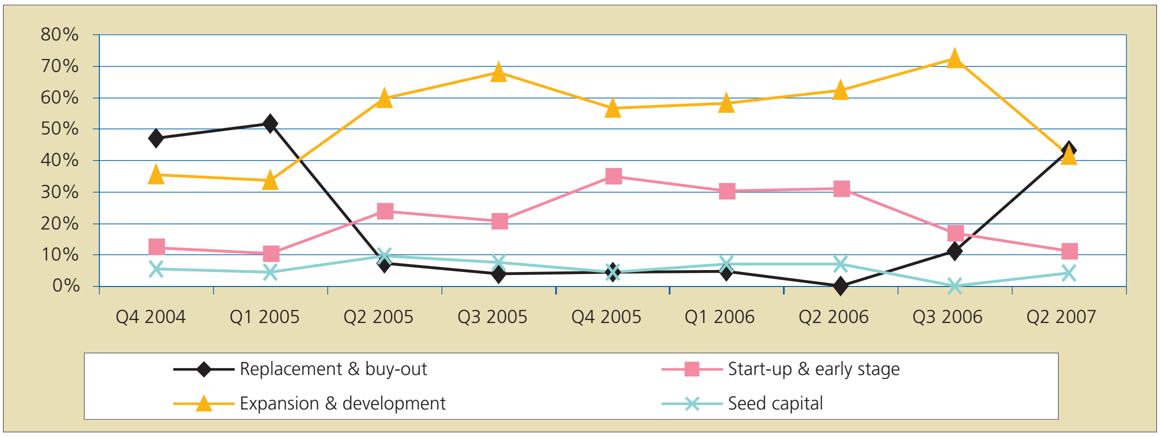


Investments

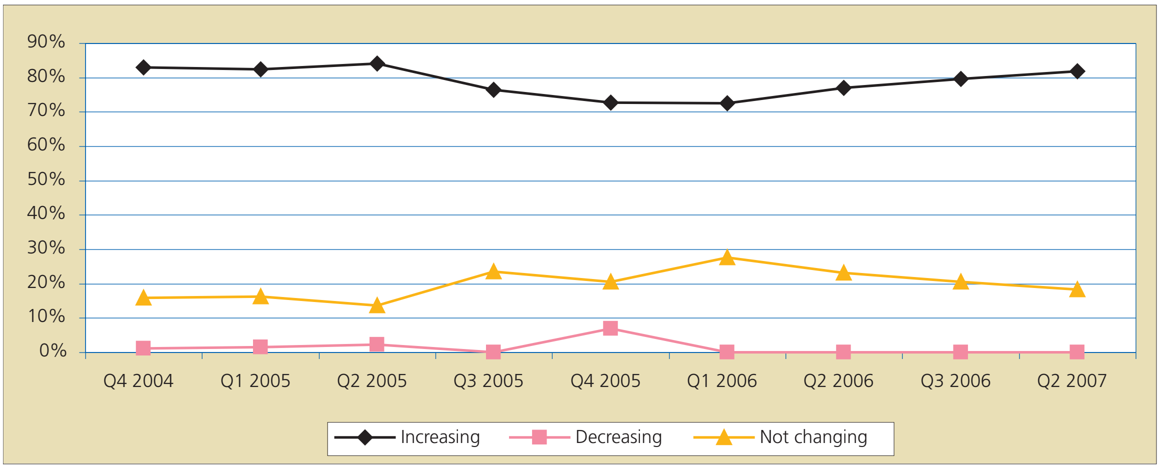
8. Over the next 12 months I expect to focus on opportunities in the following sectors:



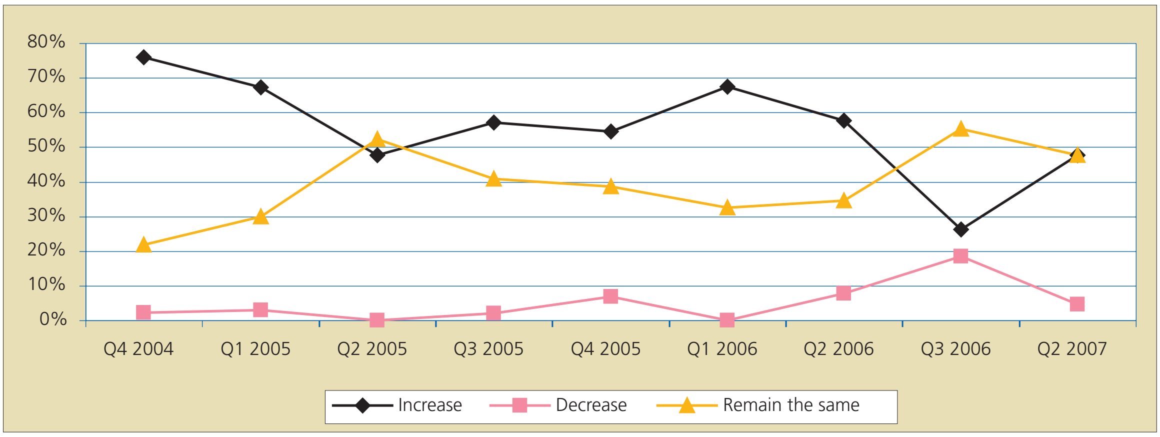
9. I am currently looking at the following types of deals:



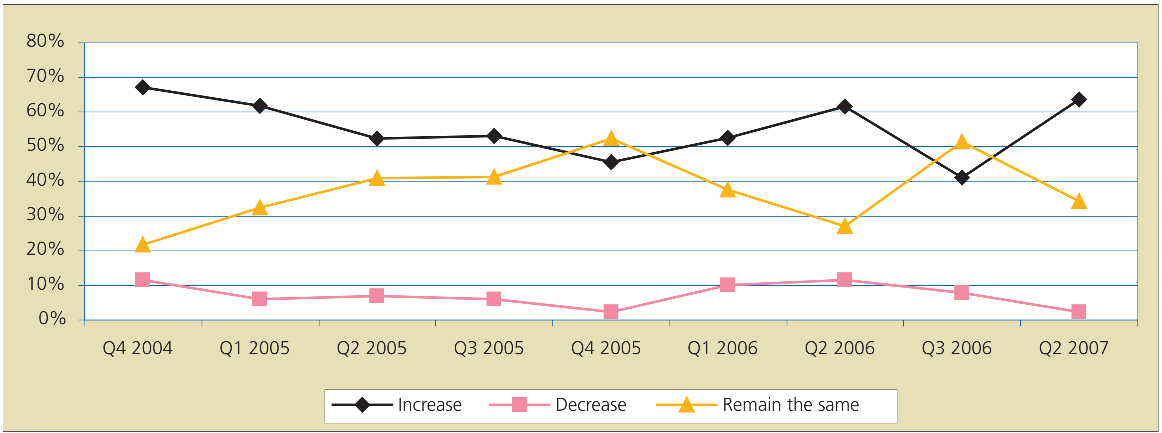
10. At the present time, competition for new investment opportunities is:



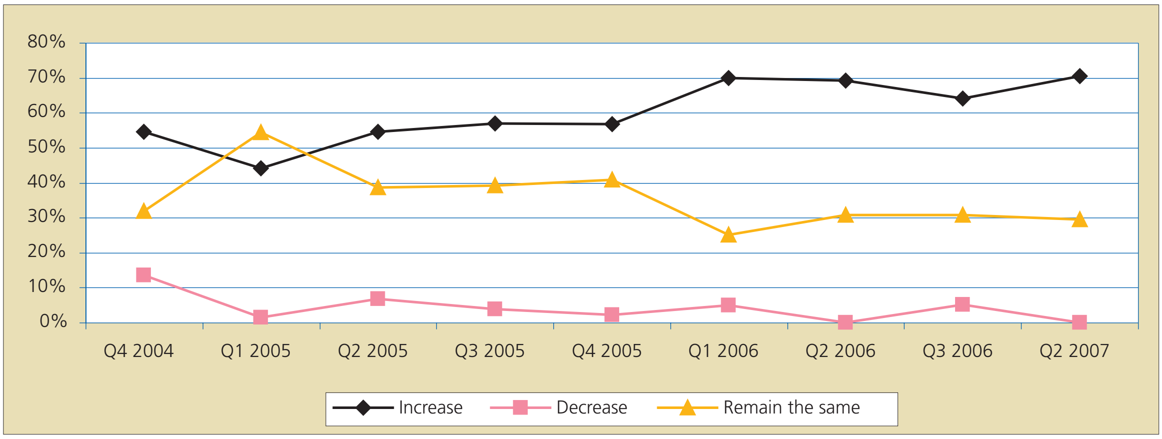
11. Over the next twelve months I expect entry multiples on transactions to:



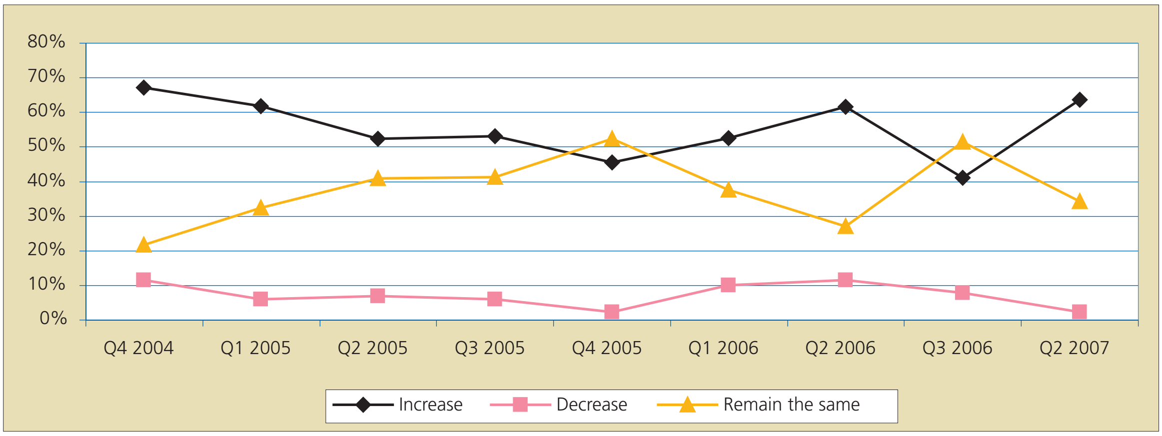
12. Over the next twelve months I expect the volume of transactions to:



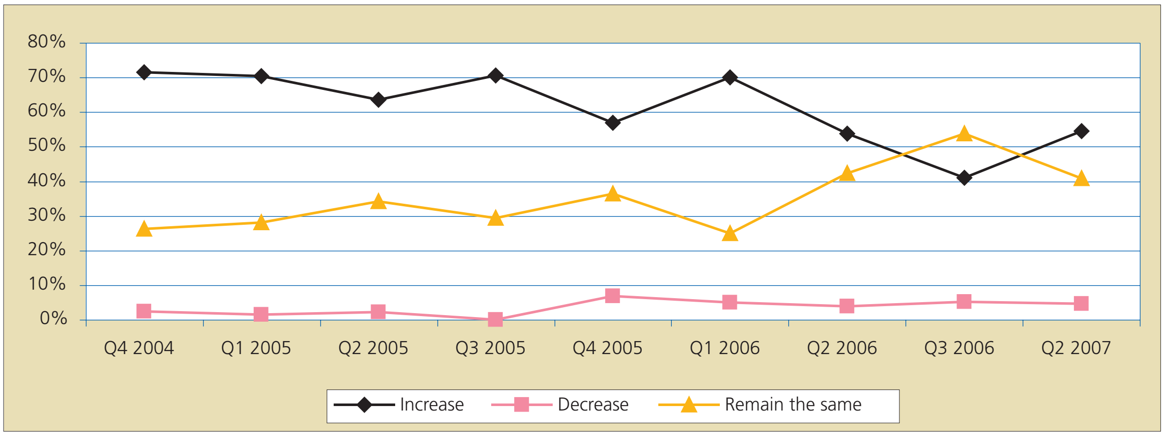
13. Over the next twelve months I expect the average deal size to:



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

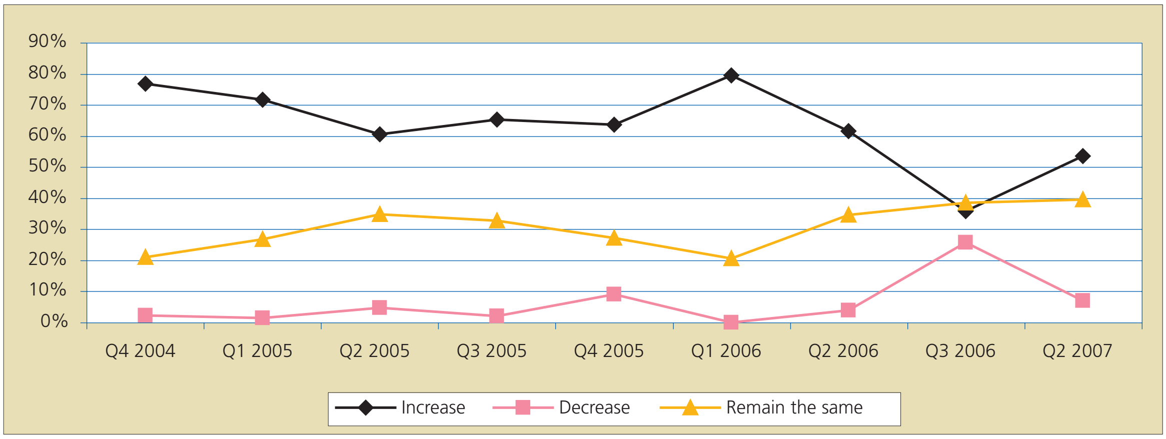


15. I expect the availability of debt financing for transactions to:

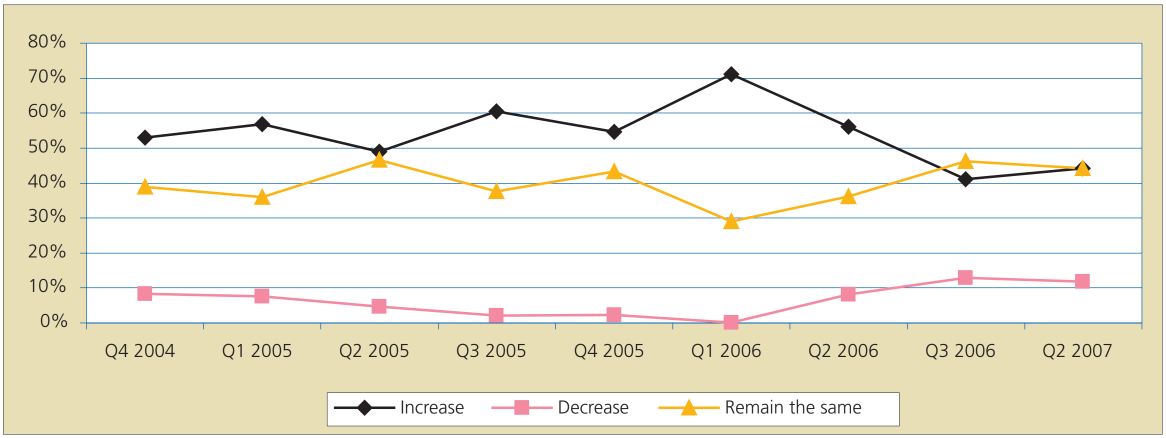


Exits

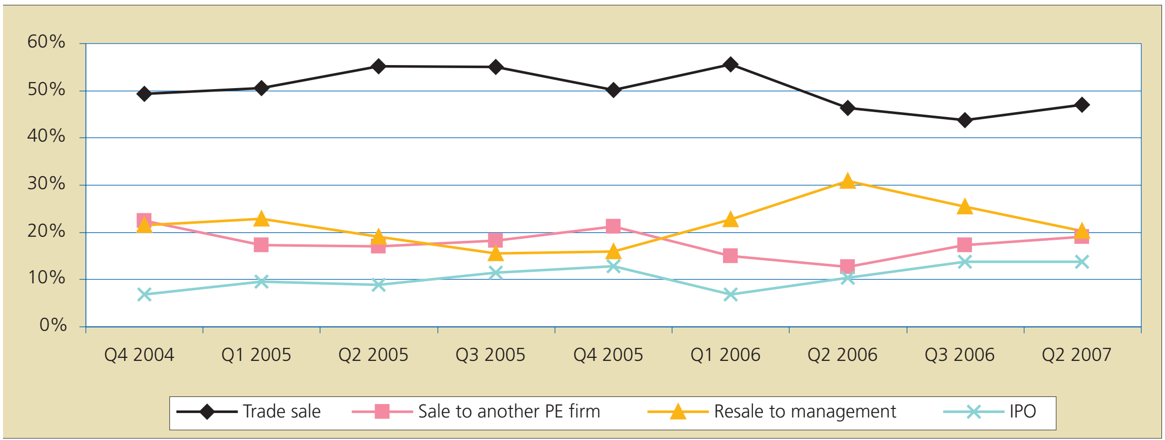
16. During the next twelve months, I expect exit valuations to:



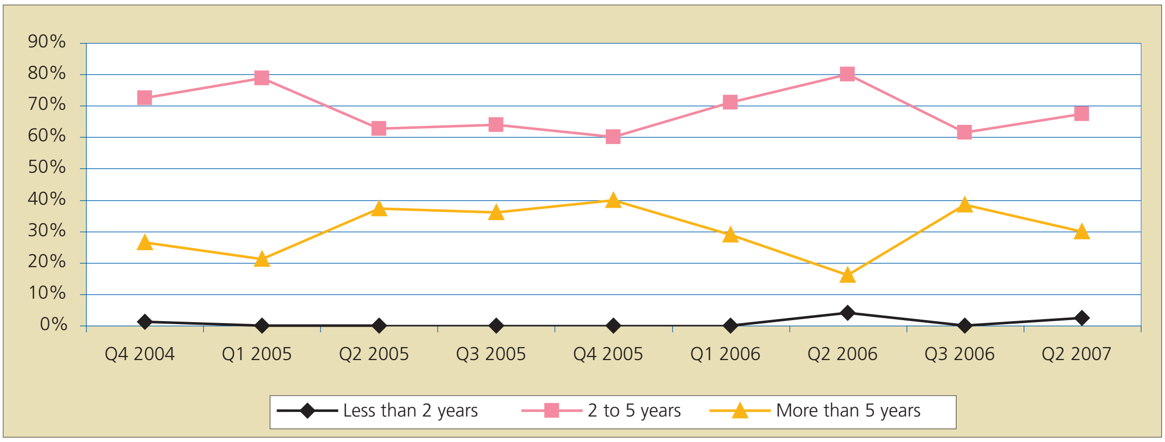
17. During the next twelve months I expect the volume of exits to:



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

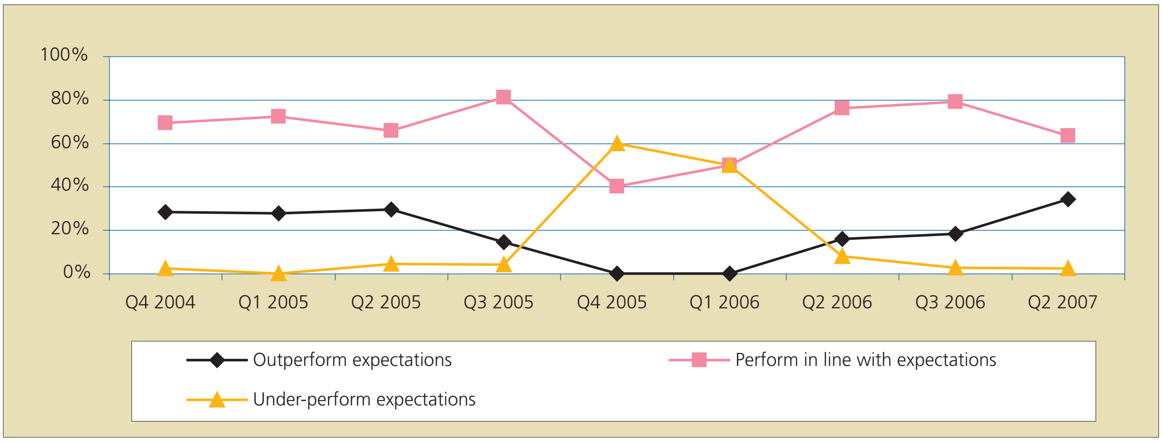


19. I expect the average lifecycle from initial investment to exit for investments made current year to be:

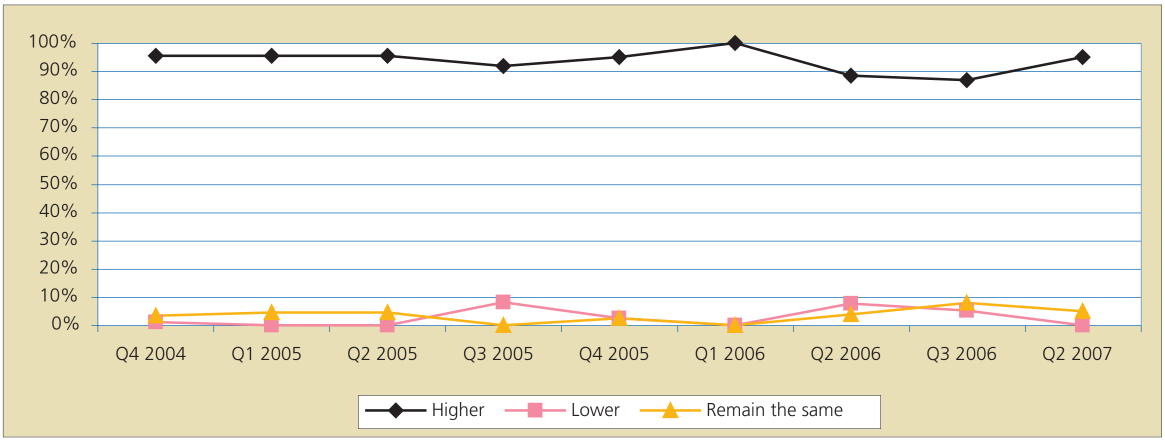


Performance

20. Over the next twelve months I expect the relative financial performance of our investee companies to:

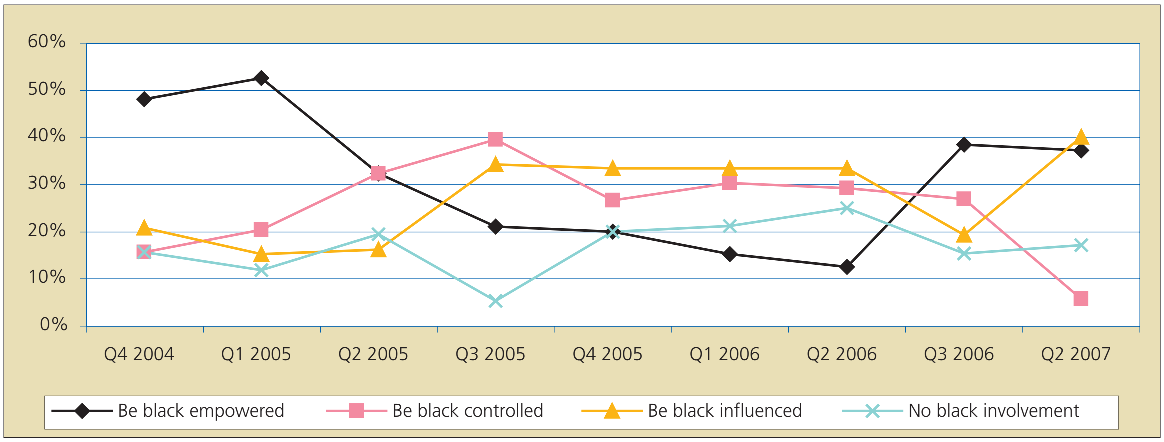


21. Twelve months from today, I anticipate the combined valuation of all portfolio companies in which we are invested today, relative to current value, to be:

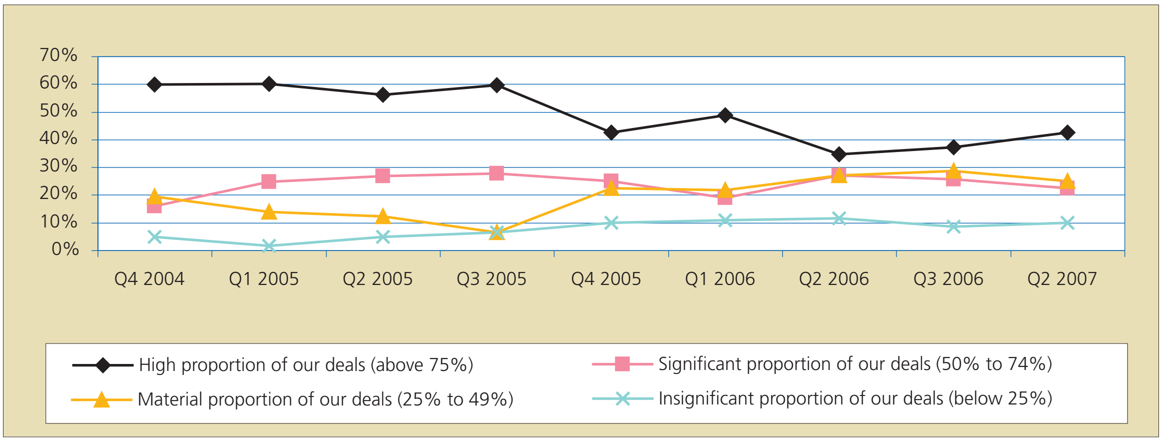


BEE

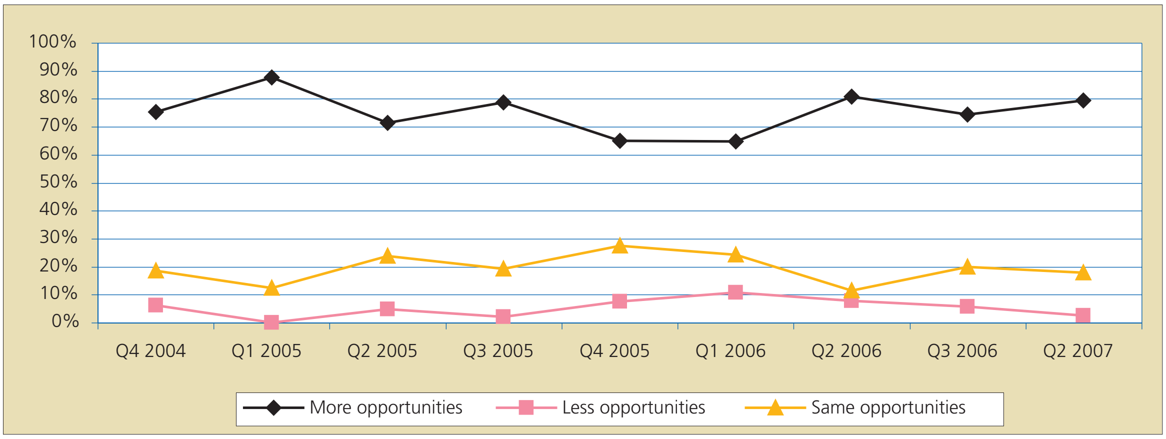
22. During the next twelve months we expect our fund to:



23. During the next twelve months we expect BEE to be a requirement in a(n):

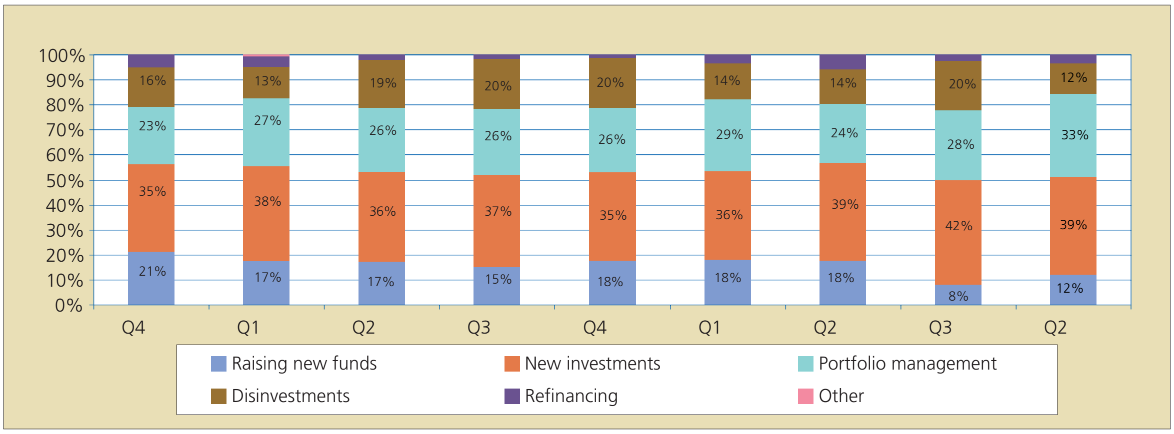


24. For our business, BEE will generate:



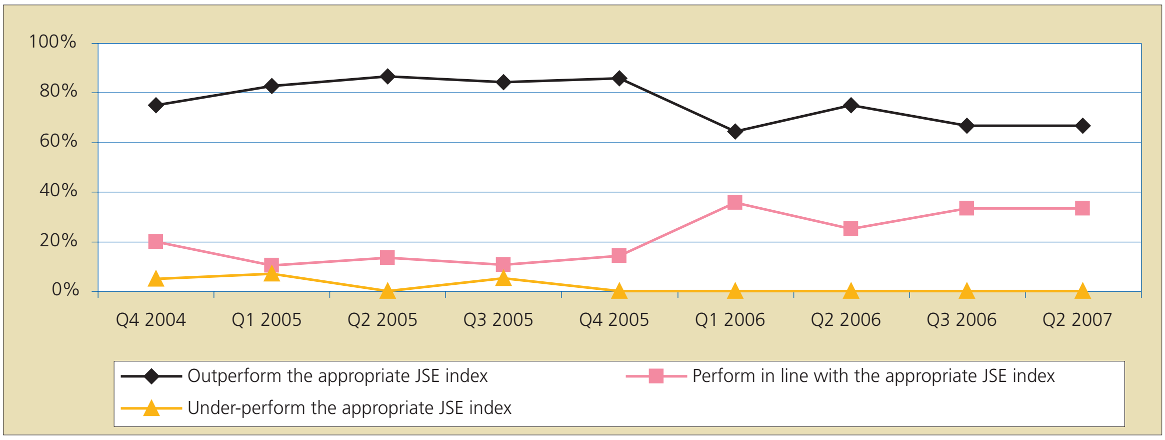
Other

25. During the next twelve months, we expect to spend the majority of our time focused on:

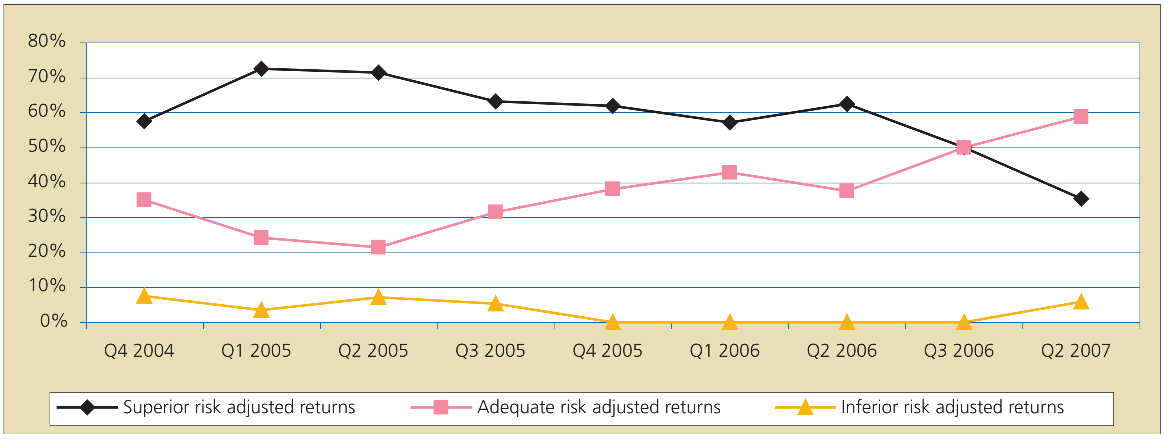


Investors

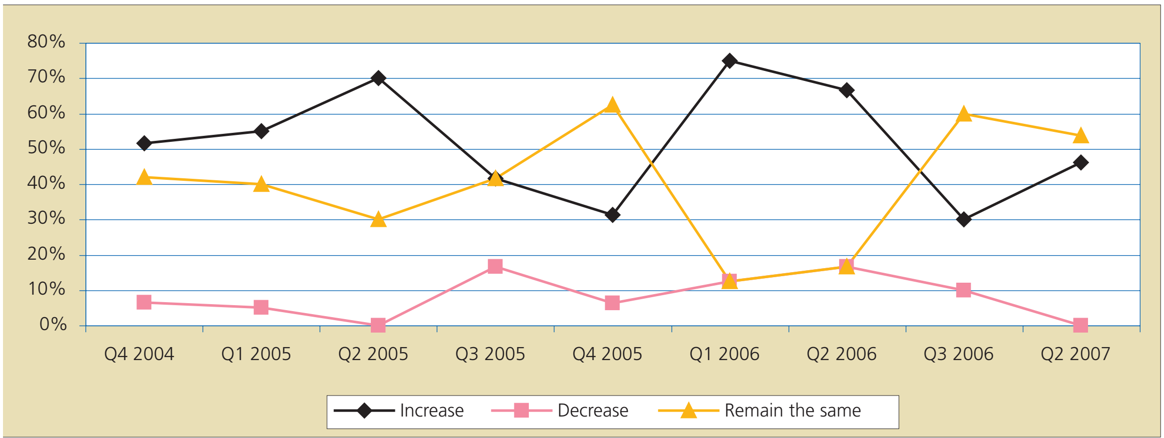
26. My current medium-term view is that PE / VC funds will provide returns that will:



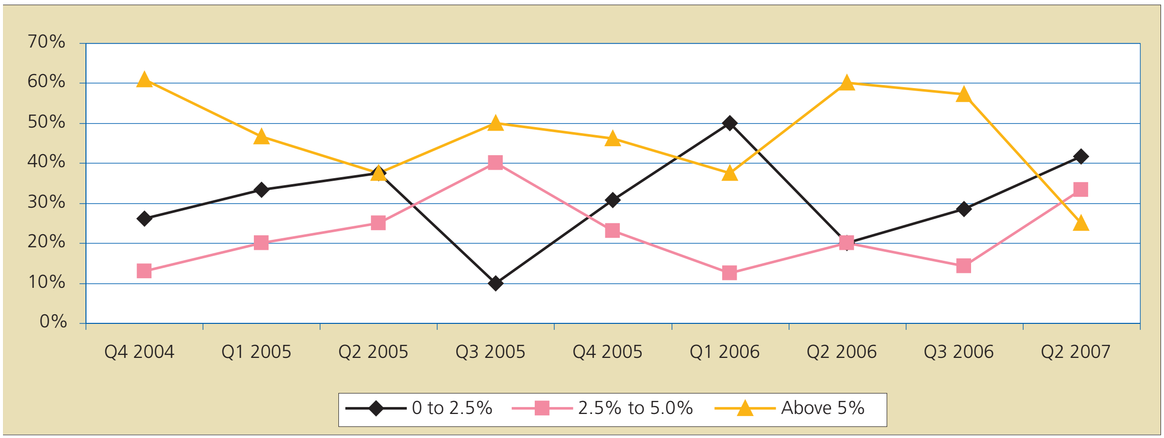
27. My current medium-term view is that PE / VC funds will provide:



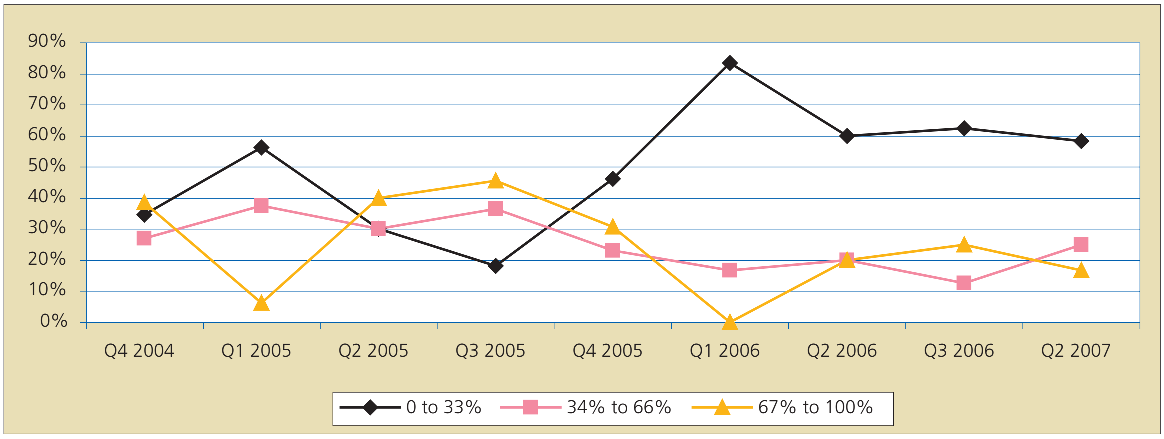
28. During the next twelve months we expect our allocation (% of total funds) to PE / VC funds to:



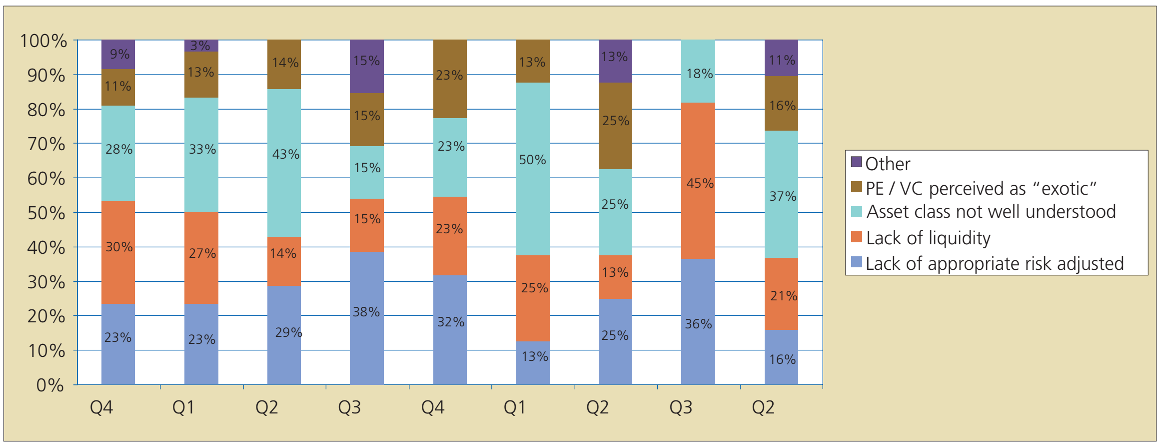
29. Our current allocation to PE / VC funds are:



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



31. I expect the following to be contraining factors during the next twelve months for investing in PE / VC funds:



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 quarterly surveys conducted in 16 other developed and emerging economies and from a South African perspective, was initially conducted on a quarterly basis and published semi-annually, and is now conducted on a semi -annual basis. PECS will further facilitate comparisons of trends and views expressed by the global venture capital community with our domestic marketplace. The surveys were conducted amongst a population of approximately 300 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

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About SAVCA

SAVCA was founded in 1999 and is the industry association representing venture capital and PE firms in South Africa. SAVCA presently has 53 full members and 27 associate members, representing approximately 350 professionals in the industry with over R56 billion of assets under management. For more information, or to become a full or associate member of SAVCA, please contact:

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