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**A CRITICAL ANALYSIS OF BLACK ECONOMIC EMPOWERMENT FUNDING  
STRUCTURES AND THEIR IMPACT ON BEE EFFECTIVE OWNERSHIP**

by

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**ABSTRACT**

In this study it is argued that Black Economic Empowerment is very important as a way of creating stable socio – economic stability in South Africa. We note that we are now at the stage where both the government and corporate South Africa have accepted that BEE is an economic imperative. This has resulted in policy adoption by the government and the private sector driven Sector Charters. Agreeing that 25% of the economy should be in black hands by 2014.

It is argued in this research that reliance of BEE investors on debt funding, creates serious doubts about the attainability of this objective. We also argue that as far as reliance on very high leveraged structures, BEE is similar to leveraged buyouts (LBOs) and management buyouts (MBOs). However, we noted out that most of the characteristics which make LBOs successful are absent in BEE transactions, a factor which increases the probability of failure rate. It has been proven that after MBOs, companies perform better, resulting in double digit returns to investors. This is difficult in BEE transactions because little changes as far as management and the adoption of new strategies are concerned.

We investigated some popular funding structures that have been used in BEE funding. We use these structures to determine what is likely to come out of them. The unsettling truth is that all our research shows that the Net Equity Value that will vest with BEE investors at the maturity of these structures is far below the 25% policy objective. Case studies of ABSA and Metropolitan empowerment structures, which happened in a period of abnormally high equity returns, confirm our suspicion that it will be unlikely to achieve the government objective of 25% BEE ownership in the long term. If South Africa wishes to ensure future political, economic and social stability, we need to revisit these BEE funding structures and ensure that the national BEE objective is attainable.

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## **Acknowledgements**

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## TABLE OF CONTENTS

1.	Chapter 1	7
1.1.	Introduction	7
1.2.	Problem Statement and Research Questions	9
1.3.	Limitations	11
1.4.	Case study research	11
1.4.1.	The choice of case study	12
1.4.2.	Strengths and Weaknesses of the Case Study Research Methodology	12
2.	Chapter 2	14
2.1.	The BEE Scorecard and Net Equity Value	14
2.1.1.	Leveraged Buyouts (LBOs) and Black Economic Empowerment transaction	19
2.1.2.	Free Cash Flow	20
2.1.3.	Modigliani-Miller Theorem	21
2.1.4.	Trade-Off Theory	22
2.1.5.	Agency Cost Theory	23
2.1.6.	Managerial Myopia versus Market Myopia	24
2.2.	Leveraged buyouts and BEE transactions	25
2.3.	Comparing Leveraged Buyout Success Factors and BEE	27
2.4.	Equity Returns in RSA	29
2.4.1.	Determining Market Equity Returns	30
2.4.2.	Capital Asset Pricing Model (CAPM)	31
2.4.3.	Historical Performance of RSA Equities	32
2.4.4.	PWC Survey	35
3.	Chapter 3	36
3.1.	BEE Funding Structures	37
3.1.1.	Special Purpose Vehicles (SPVs)	37
3.1.2.	Interest rate analysis	44

3.1.3.	Improved BEE Funding Structure	48
4.	Chapter 4	51
4.1.	Metropolitan and Kagiso Trust Investments	51
4.2.	ABSA and Batho Bonke Consortium	52
5.	Chapter 5	55
5.1.	Findings, conclusion and policy implications.	55
6.	Bibliography	58

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# Chapter 1

## 1.1. Introduction

South Africa is in the process of economic transformation to correct economic deprivation visited upon black South Africans by successive apartheid laws and government. The policy which has been adopted by government to deal with this historical imperative is called Broad Based Black Economic Empowerment, which will henceforth be referred to as BEE. This policy attempts to correct the skewed distribution of income, wealth and skills and also aims to specifically ensure that black people are the owners of capital and control a meaningful share of the South African economy. In pursuance of this policy state owned enterprises and private business are encouraged to sell parts of their businesses to black people.

The government promulgated the Broad-Based Black Economic Empowerment Act No. 53 of 2003 and this led to the strategy paper issued by the Department of Trade and Industry (DTI) in 2003 on economic transformation in South Africa and Broad-Based Black Economic Empowerment (DTI, 2003)

BEE is defined by the Department of Trade and Industry (DTI) as, "*an integrated and coherent socio-economic process that directly contributes to the economic transformation of South Africa and brings about significant increases in the number of black people that manage, own, and control the country's economy, as well as significant decreases in income inequalities*", (Government of South Africa, 2003:9). This strategy is expanded upon in the DTI's Codes of Good Practice on Black Economic Empowerment which were finally gazetted by government on 9 February 2007 (Government of South Africa, 2007). The Codes of Good Practice includes a detailed scorecard giving details of the components of the BEE strategy and their weighting in measuring Broad-based Black Economic Empowerment.

The elements of the Codes and the generic scorecard are ownership, employment equity, skills development, preferential procurement, socio-economic and enterprise development. These elements are set out in Code Series 000 to 800. The scorecard is aimed at encouraging and rewarding those companies which are supporting BEE to access business opportunities, especially from government, state owned enterprises and private sector companies who do business with government. Also, different sectors of the economy have voluntarily adopted sector charters which guide businesses in those sectors into implementing BEE policy. For instance there is the financial services charter and, mining charter.

This study will only be concerned with the equity ownership element which is set out in the code, Measurement of the Ownership Element of Broad-Based Black Economic Empowerment (Code 100) of the generic scorecard. Vuyo Jack, CEO of Empowerdex, an independent economic empowerment rating agency, states that "*the objective of the ownership element is to increase the number of Black people who own, control and manage the economic resources of the country*", (Jack, 2007:(116).



The ownership element is given a weighting of 20% by the government in the BEE scorecard. The government, through BEE policy, has set itself the task of transferring at least 25% of the economy to black hands over the next 10 years. Kingston, the then CEO of Deutsche Bank in South Africa, aptly summarizes this when he states, "*The principles underlying BEE in South Africa are simple: transfer approximately 25% of the economy's wealth to black shareholders through the sale of equity or assets within a specified timeframe*", (Kingston and Chiume 2006: 25). It is interesting to note that Deutsche Bank estimates that approximately R1.3 trillion will be needed to finance empowerment transactions if the 25% target of wealth transfer is to be achieved. The objective of this study is to study current BEE funding structures to determine whether this objective is attainable.

It becomes critically important to ensure that the deals that are entered into today are structured in a way which will assist in this process. Thus the Net Equity Value in a company which will be transferred to the intended BEE beneficiaries should be clearly understood upfront. Otherwise the country may find itself, come 2014, having again to embark on a second round of empowerment deals because the current wave of empowerment transactions would have failed to yield the desired results. Further, the failure to meet these targets of black ownership of the economy may have political ramifications and create a backlash against current ownership structures.

The importance of Net Equity Value is recognised in the Codes. It is seen as ensuring the real transfer of wealth as it constitutes 7 points of the 20 points of the ownership element. A company will earn the full 7 points when the black participants have been released from all third-party rights arising from the financing of the transactions or if all black participants in the company have never been subject to any such third-party rights.

An objective of this study is to critically analyse current BEE financing structures in relation to achieving a 25% share for black participants over the longer term as well as comparing the expected realisation of equity ownership to the equity ownership that is likely to occur given likely equity returns over the longer term. For example, in the banking sector, a company may indicate that 10% of its equity has been sold to a BEE entity. Yet, over a period of 10 years, what is the expected net value or net equity ownership to be achieved given the requirements of any financing transaction? Is a stated 10% transfer of ownership expected to be realised over a period of 10 years or will there be dilution of equity ownership due to the terms of the transaction? Further, how does this relate to the government's target that 25% of the South African economy should be under black ownership within a period of 10 years?

The focus of this study will be on the Net Equity Value which must be transferred to black participants, hence the focus on the funding structures. Yet the study endeavors to pierce the veil of BEE structures to analyze whether the target ownership rates are likely to be achieved within a realistic timetable. Due to the lack of access to capital resources, BEE transactions are subject to high levels of financial leverage. In this respect, BEE transactions reflect leveraged buyout transactions and this study will evaluate the similarities and differences between BEE transactions and leveraged buyouts (LBOs).

The objective is to evaluate whether the transfer of equity ownership achieved in an LBO may offer insights about the structuring of BEE transactions. Private equity transactions may also involve high levels of financial leverage and aspects of private equity funding may be comparable to BEE funding structures.

## 1.2. Problem Statement and Research Questions

Net equity ownership by BEE companies is critical if RSA is to achieve its objective of transferring 25% of the economy into black hands by 2015. There are many factors which may either enhance or hinder this process. However, the purpose of this study is to investigate the effect of the funding structure on net equity ownership and to evaluate the impact of interest rates and changes in interest rates and dividend streams on the final net equity ownership after the stipulated period. In terms of the Sector Charters and BEE Codes, it is expected that BEE ownership in sectors should be at stated levels within stated periods. Although, currently BEE transactions are stated to be at certain levels, effective BEE ownership over a period of 10 years may differ due to the funding structure(s) used in a BEE transaction. For example, the Financial Sector Charter indicates that BEE ownership in the financial sector should be at 25% black ownership by 2010. "*A minimum of 10% of the target .... Must be satisfied by way of direct ownership by black people ...*" (Government of South Africa, Financial Sector Charter, 2007: 14).

However, the consequences of the funding structures used to finance the BEE transactions may result in effective BEE ownership that may be significantly less than the stated (nominal) ownership level required in terms of the sector charters.

A major challenge of BEE transactions has been the fact that black buyers do not have capital to buy these assets or businesses. This has led to the reliance on debt to fund these transactions. Therefore, in most cases these businesses will be found to be highly leveraged and geared either directly or indirectly. Needless to say, movements in interest rates may have a marked impact on these transactions. In this study we shall analyse BEE transactions and compare them to corporate restructurings found in leveraged buy-outs and in private equity transactions. In this regard the following will be undertaken:-

- Analysis of BEE transactions in relation to stated ownership targets.
- Analysis of the probable effects of BEE funding structures on equity ownership and equity dilution taking into account interest and dividend flows and equity returns over the longer term.
- Analysis of leveraged buyouts (LBOs) and Private Equity investing.
- Investigation of critical success factors of LBOs and a comparative analysis to indicate in which ways are BEE transactions similar and in which ways do they differ from LBOs.

The rationale behind these studies is premised on the fact that both LBOs and BEE transactions rely very much on borrowed money. It is thus assumed there are lessons which can be learned from understanding LBOs.

To further elucidate the BEE funding phenomenon, in particular to look into effective BEE ownership after the expiry of the stated period, we shall attempt to answer the following questions:-

- What are the funding structures common to BEE transactions?
- What are the required ownership levels in the sector charters?
- What is the level of stated (nominal) equity ownership indicated by the BEE transactions evaluated in this study?
- What is the effective BEE ownership expected from the transactions based on expected ordinary dividend growth rates, interest/preference dividend costs and the expected share price performance over a stated period?
- What is the range of effective ownership to be achieved if we analyse changes in the expected dividend rate and equity prices and changes in interest rates?

In order to answer these questions, we will firstly use an example of a typical structure and calculate the probable difference between the stated and probable BEE equity ownership over a 5-year or 10-year period. Then we will use selected case studies of actual BEE transactions to evaluate whether the stated transfer of equity ownership is likely over a period of 10 years.

After a period of falling interest rates, South Africa has experienced a significant increase in interest rates since 2005. As discussed above, BEE transactions are mainly funded by debt or debt equivalents such as preference share financing. The nature of debt funding involves contractual commitments to pay interest and capital. In terms of preference share financing, there is a commitment to pay a fixed dividend to the financiers prior to any payment of ordinary dividends to black participants. However, any deficits between the ordinary dividend and required financing costs as measured by interest costs or preference share dividends may be rolled up if the contract with the vendor so permits; otherwise additional financing is required to be arranged to finance any shortfalls. Despite the prospects of higher returns, this exposes the company to financial risk, both interest and capital risk.

We shall further investigate what the impact of interest rate changes on effective BEE ownership is expected to be, given the current financing structures used to fund BEE transactions? In answering this question we need to answer the following questions:-

- What are the funding structures?
- What are the interest rates or preference dividend rates charged to BEE structures over time, including varying assumptions of the growth in equity prices, interest rates and dividend rates?

This study hopes to answer all these questions. This will help BEE practitioners and white companies who are considering undertaking BEE transactions. It will also assist government to understand the outcome of these BEE transactions at the specified future date. What is important here is for BEE companies to know what to expect when their structures mature. Also, government should know whether its policy objectives will have a high probability of being achieved over time.

### **1.3. Limitations**

The Final Codes on Black Economic Empowerment were enacted only in February 2007, and whilst the topic is highly topical, the fact is that there are very limited peer-reviewed publications on the topic of Black Economic Empowerment financing structures. The topic is highly specific and access to the contracts of BEE financing structures is restricted. Although this places constraints on the ambit of the study and limits the literature review, the study makes a meaningful contribution to the understanding of BEE financing structures and their likely impact on net equity ownership of black participants in such BEE transactions.

### **1.4. Case study research**

The methodology that will be used in this investigation is the case study methodology. It is critical to briefly discuss this methodology in order to understand what it is. Also, we shall investigate what it can achieve and the conditions under which it is most appropriate to use. We shall in the same vein look at its strengths and weaknesses so that we can appreciate the robustness of whatever conclusions we reach.

Yin defines a case study as, " an empirical enquiry that investigates a contemporary phenomena within its real – life context, especially when the boundaries between phenomena and context are not clearly evident, (1994:13). Stake says, "Case study is the study of the particularity and complexity of a single case, coming to understand its activity within important circumstances, (1995:xi).

It is also very important to realize that case study cannot just be used under all circumstances. There are situations which lend themselves to this type of research. Other methods like regression analysis and economic models may be suitable for other types of research. What is critical about case study research is that it provides insights from what has been observed from experience from a particular occurrence. This is different from generalization which other forms of research are most appropriate.

Tellis, maintains that "selecting case study must be done to maximize what can be learned, in the period of time available for the study", he further says , "case studies tend to be selective, focusing on one or two issues that are fundamental to understanding the system being examined", ( 1997: 6).

#### 1.4.1. The choice of case study

Briefly it is important to investigate the appropriateness of the case study methodology in our research. Steve Curry mentions instances where this approach should be used. We must therefore test our research topic to see whether it satisfies these conditions. He argues that the case study should inform about the actual events or policies, (1993: 4). In our research we are looking at the policy decision of Black Economic Empowerment on particular cases in a specific period. We therefore satisfy this requirement.

It is further argued that, "a case study will be oriented to actual problems or decisions, depicting the way in which they were approached, and opening up the possibility of improved approaches." (1993:4). In our research we are looking at the funding structures and we would like to see whether policy objectives are attainable. We shall take a different route if we find out that the current approach is inappropriate. Again our proposed research satisfies this requirement.

In countries where there are major policy changes case studies may give more insight into economic events. Also, in instances where that particular economic event is influenced by policy changes of government. Again in this research we are particularly looking at the consequence of this government policy directive, and its consequence. It can be safely concluded that our chosen research methodology is appropriate for this type of research, and it will be able to provide answers to our research problem statements.

#### 1.4.2. Strengths and Weaknesses of the Case Study Research Methodology

Case study is not different from other research methodologies. It also has its strengths and weaknesses. It is thus important for a researcher to appreciate these upfront so as to mitigate the weaknesses and exploit the strengths. Naidex 2009, page 2 in "How to do Case Study Research" identifies the following strengths of a case study based methodology:

- Can provide insight into issues that may need to be explored in great depth.
- Enables a depth of understanding.
- Enables in-depth probing into the case, which helps to develop a descriptive picture or, depending on the nature of the research, facilitates explanations and predictions.
- The researcher considers a real event.
- The researcher is more likely to become aware of important factors that did not form part of his or her preconceived ideas.

- Uncovers detail in complicated situations.
- Uses few resources.
- Is relatively inexpensive

As mentioned above, every research methodology has its own weaknesses. Naidex in the same writing identifies the following as weaknesses:

- The study may become merely an extended anecdote, without evaluative relevance.
- It may be biased, as a result of the researcher becoming too involved in the collection and analysis of data.
- Case studies – particularly single case design – are not general, so they cannot represent a population

Understanding these strengths and characteristics is critically important for a researcher so that he takes an extra effort and be particularly cautious about conclusions that can be drawn or not drawn from case study research methodology. This therefore sets a good platform for us to continue and use this approach for our research.

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## Chapter 2

### Literature Review

BEE is a recent phenomenon and is specific to South Africa. As indicated in Chapter 1, this creates challenges as there are few peer reviewed published research studies on the topic. Therefore, in relation to the BEE component of this study we will analyse legislation, reviews of legislation and analyse actual case studies.

In this chapter we will also study in particular the BEE Scorecard which companies are expected to comply with. Also we investigate the LBOs functioning and economic theories which explain why they occur in the first place. Secondly, what makes them succeed and fail? We do that to see whether those factors will have a similar impact on BEE funding structures. We also want to know how the LBOs risks are mitigated. Again we do that to understand whether similar strategies can be employed by BEE investors, and if not, why. All this is premised on the understanding that both LBOs and BEE funding structures are highly leveraged.

### 2.1. The BEE Scorecard and Net Equity Value

It was indicated above that there is a BEE Scorecard whose purpose is to indicate the contribution of an enterprise to BEE. The government gazetted the generic scorecard as part of the Codes of Good Practice. It is called generic because it can be used in all industries. Other industries have got sector specific charters, like the Financial Sector Charter, the Mining Charter, the Agriculture BEE Charter, etc.

The elements of the scorecard and their weightings are as follows:-

- Equity ownership - 20%
- Management – 10%
- Employment equity – 10%
- Skills development – 20%
- Preferential procurement – 20%
- Enterprise development – 10%
- Residual /Corporate social investment – 10%

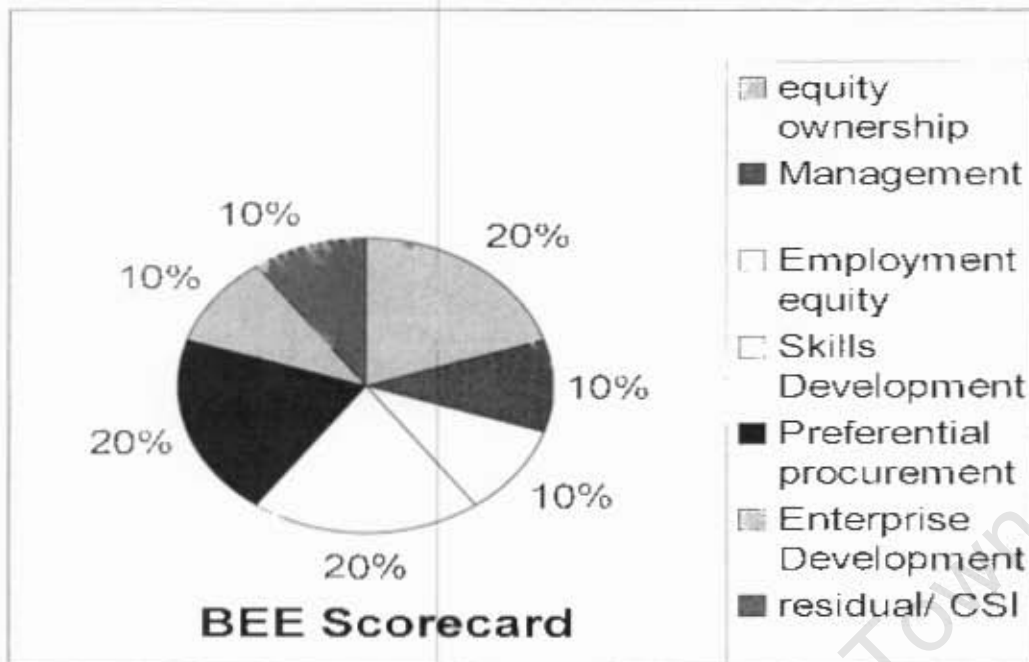


Exhibit 1 Components of the BEE Scorecard

For the purposes of this study we shall only be focusing on the equity ownership element of the scorecard. It is called Statement 100. "The objective of statement 100 is to provide a scorecard for measuring an entity's contribution to the ownership element of BEE", (Jack and Harris etc 2007:187). The ownership element consists of four indicator groupings, i.e. voting rights, economic interest, realization points and bonus points.



Criteria	Weighting Points	Compliance target
Ownership Element (20 points + 3 bonus points)		
Exercisable voting by black people	3	25%
Exercisable voting by black women	2	10%
Economic interest in the enterprise to which black people are entitled	4	25%
Economic interest in the enterprise to which black women are entitled	2	10%
Economic interest in the enterprise to which black designated groups are entitled	1	2.5%
Ownership fulfillment	1	No restrictions
Net Economic Interest (Net Equity Value)	7	20% of target (years 1-2) 50% of target (years 3-5) 75% of target (years 6-8) and 100% of the target (years 9-10)
Ownership by broad-based BEE schemes or new entrants (bonus)	3	Bonus per each level of 5%

*Exhibit 2 Ownership Element of the Scorecard (Statement 100)*

Source Balshaw T and Goldberg J, 2005

Briefly let us look at some of the sub-categories of Statement 100 and understand what they exactly mean. In particular our interest is in the economic interest in the enterprise to which black people, black women and designated groups are entitled to. In total this amounts to 7 points although with different weightings. In the Codes Economic Interest is defined as, "...a claim against an enterprise representing a return on ownership of the enterprise similar in nature with a dividend right, measured using the Flow Through and, where applicable, the Modified Flow –Through Principles", (Government of South Africa 2007:24). The Flow Through Principle is intended to ensure that value accrues to natural persons and not complicated legal structures. Generally speaking economic interest will be that percentage which entitles you to dividends of the company from the first day. It is thus different from the Net Equity Value which always takes debt into consideration.

Economic interest points are calculated as follows:-

**Economic Interest points = (economic interest held by the participants of that indicator as a total of economic interest/compliance target of the indicator) x weighting points for that ownership criterion**

What should be noted here is that economic interest points are different from net equity value which in most cases will be known at the end of the period which is covered by the structure.

However, our investigation is on the Net Equity Value (NEV) section of the ownership scorecard. Therefore we will not be taking the discussion around the other elements of statement 100 any further. Our focus is on Net Equity Value segment of the realization points of the ownership scorecard. As can be seen above the total equity ownership points, including bonus points is 23 points. 7 points are allocated to NEV, the highest score in the whole scorecard. This signifies the importance given by government to NEV.

Net Equity Value "is defined as the value of the instruments to which a black participant's equity interest attaches in a measured enterprise (including without limitation, the value of economic interest received since date of acquisition of the instruments) after deducting the value of any third party rights or claims that may exist against the black participant rights or claims that may exist against the black participant (including without limitation, the value of all interest payable in respect of such transactions) measured as a percentage of the total value of the Measured Enterprise (all valuations must be undertaken in accordance with an Acceptable Valuation Standard)", (Balshaw et. al. 2005:101). Jack defines Net Equity Value as "the market value of the Black participant's equity above acquisition debt specific to ownership of that equity (deemed net value), reflected as a percentage of the targeted BEE ownership of the measured entity against preset annual targets, (Jack and Harris etc 2007: 196).

The NEV of BEE which measures unencumbered black shareholding can be calculated as follows:

**NEV = (Market value of the equity instrument) – (Capital balance of the acquisition loan) / Market value of the measured enterprise (Jack, V, (2007):196).**

## BEE Ratings and Ownership

The Financial Mail publishes with Empowerdex every year the top BEE 200 companies ranked on the basis of the generic BEE Scorecard. Exhibit 3 presents the top 75 companies from the 2007 survey published by the Financial Mail. Empowerdex is an independent BEE ratings agency which calculates company BEE scores based on company information. The total score includes scores for each component and equity ownership counts for 20 points (%). Exhibit 3 depicts the scores the total BEE score per company and the total points earned for the equity ownership component, which is the focus of this study.

In Annexure A to this study we have presented the financial ratios of each BEE rated company based on information extracted from the FA Macgregor data base.

It will be noted from Exhibit 3, that whilst some companies score quite highly in terms of the total BEE score, the ownership score may be low. Companies such as Primedia (63.14:5.58) Harmony Gold (53.98:7.00) Foschini (45.98:4.95), Standard Bank (50.72:5.60), and First Rand (50.38:3.75) score low on ownership but have a total BEE score above 50%. Of the top 75 BEE rated companies in South Africa, there are 22 companies with an ownership score less than 10 and there are 44 companies with a score of less than 15. There are 23 points in the generic BEE scorecard for the ownership component subject to a maximum score of 20 points. Therefore, the indicated ownership scores indicates the distance that some of the most highly rated BEE companies in South Africa must still travel to achieve the target BEE ownership set by government.

Rank	Company	BEE Score	Ownership	Rank	Company	BEE Score	Ownership	Rank	Company	BEE Score	Ownership
		%	%			%	%			%	%
1	Enaleni	79.28	18.00	26	Exxaro Recources	54.93	19.00	51	Comair	45.45	9.18
2	Adcorp	73.22	18.56	27	Harmony Gold	53.98	7.00	52	SABMiller Pic	45.04	5.60
3	The Don	70.89	15.00	28	Group Five	53.15	14.35	53	Impala Platinum	44.77	6.96
4	Oceana	70.29	18.14	29	Aveng	53.11	17.64	54	Coronation Fund	43.81	6.77
5	Hosken	70.12	20.00	30	African Rainbow	52.28	17.80	55	Brimstone Investm	43.17	15.39
6	Sekonjalo	68.87	18.00	31	Sun International	52.31	15.47	56	Mvelaphanda Gr	43.08	15.32
7	Cadiz	68.35	18.74	32	Absa Group	52.20	12.68	57	Compu-Clearing	42.95	3.12
8	Bytes Tech	66.90	18.02	33	Mutual and Federal	52.03	15.84	58	Omnia	42.83	-
9	Metropolitan	66.59	18.49	34	Jasco Electronics	51.87	19.00	59	Lewis Group	42.48	2.32
10	Bidvest Group	65.01	20.00	35	Faritec	51.33	16.87	60	Anglo GoldAshanti	41.78	7.00
11	Glenrand MIB	64.80	20.00	36	Aspen Pharmacy	51.12	18.52	61	GrowthpointProp	41.44	5.99
12	Phumelela	63.51	15.57	37	STD Bank	50.72	5.60	62	The Spar Group	41.41	0.42
13	Primedia	63.14	5.58	38	Mustek	50.62	5.24	63	African Oxygen	40.46	15.43
14	Trans Hex	63.14	15.00	39	First Rand	50.38	3.75	64	Network Healthcare	39.88	4.20
15	Old Mutual Pic	62.01	13.30	40	Imperial	50.14	11.54	65	Investec	39.17	16.00
16	MTN Group	61.95	13.05	41	Edcon	49.35	16.66	66	Tiger Brands	39.14	10.85
17	Paracon	61.60	12.00	42	Alexander Forbes	49.25	15.95	67	Massmart	38.68	4.34
18	Peermont Global	60.57	18.30	43	Santam	48.06	11.30	68	Kagiso Media	37.99	10.96
19	Sanlam	60.27	16.20	44	Enviroserv	47.53	13.87	69	African Bank	37.84	10.96
20	Telkom	58.08	12.28	45	Super Group	47.00	15.00	70	BHP Billiton	36.80	1.57
21	GijimaAst	56.29	12.60	46	Distell Group	46.38	13.21	71	Investec	36.38	12.00
22	Barnard Jacobs Mel	55.97	11.14	47	Advtech	46.25	10.83	72	Sappi	35.91	-
23	Nedbank	55.81	13.85	48	Foschini	45.98	4.95	73	Sasol	35.16	11.00
24	Business Conn	55.71	15.34	49	Merafe Resources	45.94	7.00	74	Command	35.14	15.00
25	Gold Fields	55.13	13.21	50	Distribution& Ware	45.50	15.00	75	Control Instruments	34.32	-

Exhibit 3 Top 75 BEE Companies in 2007: ratings by Empowerdex (2007)

In Annexure A to this study, we have set out the top Empowerment companies as indicated by Empowerdex as well as the financial ratios extracted from BFA Macgregor. Whilst not directly relevant for this study it depicts an area for future research and indicates the net profit margins and Return on Equity ratios for the leading BEE companies in South Africa.

As indicated above, it will be argued in this study that BEE transactions are in many cases a form of leveraged buyout. Therefore understanding what LBOs are, and how they work, is critical for understanding the problems and challenges faced by BEE transactions. Further, this study investigates similarities and differences between the LBOs and BEE transactions. To accomplish this, a brief literature review will be undertaken to better understand why and how LBOs work. We will continue to evaluate BEE transactions, which are generally highly leveraged in terms of the critical features required to ensure that LBOs are successful.

### 2.1.1. Leveraged Buyouts (LBOs) and Black Economic Empowerment transaction

A leveraged buyout is a process whereby an investor or group of investors gains control of a majority of a target company's equity using borrowed money or debt. This is also referred to as "bootstrap" transaction. This is using other people's money to gain control of another company. Olsen defines a leveraged buyout, or LBO, as "*an acquisition of a company or division of another company financed with a substantial portion of borrowed funds*" (Olsen, 2000: 1). Fox and Marcus state, "*LBOs take place when a firm is "taken private" – the company's equity is bought up and removed from publicly traded security markets*", (Fox and Marcus 1992:63). The most common form of an LBO is the Management Buyout, commonly known as an MBO. This occurs when management of the target company acquires the majority of equity of that company, again mainly using debt financing. Vuyo Jack quotes an American MBA student who described the entire BEE funding mechanism as, "*one big leveraged buyout (LBO) of the economy in South Africa*". Jack continues and states, "*This is somewhat true because there is not much black capital to purchase most of these stakes in established companies. Therefore, debt is the most accessible capital that can be utilized for BEE deals*", (Jack 2006: 20). This provides support for the objective of this study in trying to understand LBOs with an aim of gaining more insight into the BEE funding structures and their likely outcomes

In an LBO, the range of own capital to debt ranges from 30% to 70%, up to the most aggressive structures of 5% of own capital to 95% of debt. It is agreed now that LBOs result in higher debt levels. The observation by Fox and Marcus in this regard is instructive. They observed, "*In companies subject to LBOs, debt goes up dramatically. In 76 buyouts that occurred between 1980 and 1986, the median book value of debt to total capital jumped from 18% to 88,4%*", (Fox and Marcus 1992:63).

There are certain critical success factors or characteristics that apply to most LBOs. Unfortunately these have been ignored by investors who in certain instances are too eager to acquire the business. In the early years of LBOs, from the late 1950's and up to the 1990's the main driver of this was the belief by the acquirer that it could introduce efficiencies once the business had been taken over. It has been argued that, initially LBOs concentrated in extracting efficiencies from their operations. Olsen argues that "*LBO firms today are seeking to build value in acquired companies by improving profitability, pursuing growth including roll-up strategies (in which an acquired company serves as a "platform" for additional acquisitions of related businesses to achieve critical mass and generate economies of scale), and improving corporate governance to better align management incentives with those of shareholders*", (Olsen, J, 2000:1). However it is argued that in most cases this type of restructuring has been exhausted, more reliance today is placed on complex financial engineering, capital structure and a focus on revenue and profits. (a reference or justification is required for this argument)

Many theories have implications for various aspects of LBOs and should therefore be examined. These include Free Cash-Flow Theory, the Modigliani – Miller Theorem, Trade-off Theory and Agency Cost Theory. This list is by no means exhaustive, but these will elucidate research and studies which have been conducted in this regard.

### 2.1.2. Free Cash Flow

This theory argues that a company with the ability to generate sizable amounts of free cash flow from operations is a good candidate for a leveraged buyout. Put differently, the existence of free-cash flow is a necessary, although not sufficient condition for the LBO. Free-cash flow is defined as, "*cash in excess of that required to fund all of firm's projects that have positive net present values when discounted at the relevant cost of capital*", (Fox and Marcus 1992:66). It also means that firms with free cash flow need to be restrained from investing the free cash flow in high risk investments. A high level of debt ensures that management is highly focused and disciplined. "It replaces discretionary expenditures and forces management to focus on profitability and cash flows", (Fox and Marcus, 1992:64).

In most cases the debt will be posted in the acquired company's balance sheet and the acquired company's free cash flow will be utilized to pay the debt. It is critical to realize that there is much reliance on the company's free cash flow, or the ability of the management to generate that cash. It can already be seen that if anything, be it economical or managerial, were to make that impossible, the seeds of failure will be sowed already. An obvious factor may be changing interest rates. Increasing interest rates no doubt will put a squeeze on the company's free cash flow, and thus on the company's ability to service the debt. A concern has been raised by some analysts arguing that, "*Bond investors worry about LBOs, which are financed with debt added to*

*a company's balance sheet. LBOs of investment grade-rated companies tend to trigger downgrades to the high yield market", (Simensen, 2005:41).*

Edcon's acquisition by a private equity firm resulted in a rating downgrade and affected the securitization of its card debtors. Laughlin (2006) counters this argument by stating that today companies are willing to sacrifice their ratings if the LBO transaction makes economic sense. She states that, *"We've noticed that weak investment grade companies are happy, for strategic reasons, going into Baa rated land if there was a strategic transaction that made sense. Whereas before, culturally, the concept of an investment grade company accepting the idea of going into junk would not have made sense", (Laughlin, K, 2006:1).* Free Cash Flow theory therefore suggests that a company which is able to generate sizable amounts of free cash flow from operations remains a target for LBOs. Fox & Marcus stress the attractiveness of cash by saying, *"The occurrence of LBOs is positively related to the existence of target firms that have free and stable cash flows", (Fox & Marcus 1992:67).*

### 2.1.3. Modigliani-Miller Theorem

The Modigliani-Miller (MM) theorem examines the effect of capital structure on the value of the firm. As an LBO results in a change to the capital structure of the firm being bought, the findings of M&M may be relevant to LBOs in terms of value changes, as might the implications of the modified M&M Theory. The gist of the theory is better summarized in the following quote, *"In their path breaking article on the cost of capital Modigliani and Miller(1958) demonstrated that in the absence of bankruptcy costs and tax subsidies on the payment of interest the value of the firm is independent of the financial structure", (Jensen, M et al. 1976:332).* MM initially stated that there is no optimal capital structure and changing a firm's capital structure will not change the value of the firm. The MM theory argues strongly that it is the assets of the firm which determine its value, and not the way it is financed. Therefore, a firm's weighted cost of capital will not change. *"This occurs because, as the company increases its debt (which is cheaper than equity), it is increasing its risk"* (Correia et. al. 2007:14-7). However this theory is based on many strict assumptions, including the assumptions that there are no taxes, no transaction costs, no costs associated with financial distress and no agency costs.

#### 2.1.4. Trade-Off Theory

There is evidence which refutes the strict assumptions of Modigliani and Miller. For instance, when the assumption of no taxes is relaxed the picture changes. Interest on debt is tax deductible, therefore making debt cheaper, and the value of a geared firm will be higher by the discounted value, or present value, of the tax saved. This implies that the optimal debt ratio is 100%. The aggressive financing of some leveraged buyouts and private equity transactions may reflect an application of this theory. However, the more plausible approach over the longer term will be the Trade-off Theory. This theory argues that the cost of equity and cost of debt will increase as leverage is increased, but only after a certain level of debt financing due to the costs of financial distress. Initial increments of debt financing will reduce the cost of capital and increase the value of the firm but as the probability of failure increases with further increases in debt levels, then the cost of debt and the cost of equity will rise due to the increased risk of bankruptcy and financial distress.

It is called trade-off theory because companies are seen to *"trade-off the advantage of debt financing with the costs of taking on increasing levels of financial leverage, such as higher interest rates and potential bankruptcy"* (Correia et al.2007: 14-10).

In the context of BEE transactions, it will be important to analyse what the impact of rising interest rates will be, especially on the value that will finally vest in the BEE parties. Bankruptcy or financial distress is indeed a possibility but we shall deal with this later in our investigation. However, BEE financing structures may include provisions which in effect protects the firm from bankruptcy but ensures that the black equity ownership is effectively diluted to zero and the shares revert to the vendor.

Another reason cited for LBOs, is the desire of the company to be shielded from the scrutiny of being a public company. Remember that in many LBOs, a public entity will be delisted, particularly when linked to a private equity transaction. In case of an MBO, this gives an opportunity for managers to be significant owners of a firm's equity, thus aligning the interests of shareholders with those of management. Also it has been found that using leverage in acquisitions control debt. Jensen argues, "Many of the benefits in going private and leveraged buyout (LBO) transactions seem to be due to the control function of debt,(Jensen1986:325). Managers realize that they must pay high interest charges and repay the principal amount. *"This can force management to focus on certain initiatives such as divesting non-core businesses, downsizing, cost cutting or investing in technological upgrades that might otherwise be postponed or rejected outright"*, (Olsen, J 2000, 3). It can be seen that here LBOs can be used to completely change managements philosophy and behaviour.

### 2.1.5. Agency Cost Theory

Agency Costs have been cited as one of the reasons why there will be LBOs and MBOs. This theory is based on the divergent interests sometimes between managers on one hand and shareholders on the other. " We will say that an agency relationship has arisen between two (or more) parties when one, designated as the agent, acts for, on behalf of, or as representatives for the other, designated the principal, in a particular domain of decision problems", (Ross 1973:134). Managers can therefore be defined as agents because they are designated by the shareowners (principals), to manage the business on their behalf. This theory argues that "the maximization of utility of the agent is not congruent with the maximization of the utility of the principal." "...in addition there will be some divergence between the agent's decisions and those decisions which would maximize the welfare of the principal", (Jensen and Meckling 1976:308). In other words managers will not always act in the best interest of the shareholders. It is also argued that this problem will be more severe where there is a lot of free cash flow. This problem is well captured by Smith, 1776, as cited by Jensen and Meckling, 1976 when he says, "*the directors of such (joint-stocks) companies, being the managers rather of other people's money than their own, it cannot be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own*", (Jensen, 1976: 305).

The conflict between management and shareholders "*arise over the optimal size of the firm and the payment of cash to shareholders*", (Jensen, 1986:323). It is argued that managers will always have incentives to grow the firm beyond its optimal size because of the power they attain due to the resources under their management and the ability to increase managerial remuneration is related to firm size. Mann and Sichernman argue that, "Specifically, managers have incentives to use unencumbered funds to benefit themselves rather than shareholders" (1991:2140). On the other hand increased payouts to shareholders reduce resources under their control and therefore curtail their power. In short, agency costs theory states as long as there is this divergence between management interests and equity owners' interest, LBOs and MBOs are likely to occur. Jonathan Olsen argues that to mitigate this agency cost problem "private equity firms typically invest alongside management", (2003:3).

The objective function of the firm should be firm value maximization. We have indicated that agency costs may make the attainment of this objective difficult if not impossible. Leveraged buyout therefore is an attempt to reach the equilibrium position where firm value is maximized. Jensen (1986) describes this as the point where "*the marginal costs of debt just offset the marginal benefits*" (Jensen C, 1986:4).



Lehn and Poulsen (1989) advance an argument which says going private increases shareholder value. In their research they say, "*We find support for the hypothesis advanced by Jensen (1986) that a major source of stockholder gains in going private transaction is the mitigation of agency problems associated with free cash flow*", (1989:771).

What we have showed above with the agency costs theory is that as long as these costs are there, these may be an incentive for management and leveraged buyouts.

#### 2.1.6. Managerial Myopia versus Market Myopia

One of the major criticisms of LBOs is short - termism of management. This short term focus may be due to the desire of management to generate cash so as to pay off the LBO debt as quickly as possible. This is what Michael Jensen refers to as managerial myopism. This suggests that managers are interested in increasing accounting earnings and not the value of the firm. For instance management may compromise spending on research & development and maintenance (where maintenance may be necessary) again as a way of trying to generate cash to pay off the debt. This then shows that management in LBO may focus on short term cash generation to the detriment of the long term objectives.

The myopic market hypothesis argues that "*security markets are shortsighted and undervalue future cash flows while overvaluing near – term cash flows*". Jensen (1988) argues that there is little or no evidence supporting both managerial and market myopia. He says managerial myopia occurs when management holds little stock in their companies and when they are oblivious to the forces that determine stock values. He cites many examples which prove that market myopia does not exist. He argues, "*The mere fact that price-earnings ratios differ widely among securities indicates the market is valuing something other than current earnings*", (Jensen, M.C. (1988). He also shows that the market will always respond positively to announcements of increased investments.

The above argument is a clear indication that LBOs are here to stay because they have consistently delivered value to the shareholders. Obviously this does not suggest that there are no risks associated with them. A major risk arises when the economy weakens and therefore financing dries up. Kate (2007) states that, "*Companies exposed to commodities prices, like chemicals or oil and energy, are facing substantial margin squeezes ....Their larger, less leveraged competitors can deal with a cyclical downturn, [but] when you're as leveraged as some of these companies are, there isn't a capacity to absorb a cyclical margin squeeze and deal with heavy competition*"(Kate, 2007:1)

## 2.2. Leveraged buyouts and BEE transactions

In a leveraged buyout and particularly in a management buyout, the firm will be highly leveraged with up to 90 percent of the cost of acquisition being financed with debt. In a BEE transaction, debt ratios may exceed this level, with more than 95 percent of the cost of shares in the firm being financed with debt. Therefore in both LBO and BEE transactions, this results in very high financial leverage ratios.

However, in an LBO the high financial leverage occurs within the firm so that the firm's assets are subject to high levels of debt and interest is tax deductible. The tax deductibility of interest is important to any LBO transaction, particularly in relation to the senior tier or first tranches of debt finance. Fox and Marcus make the point when they say, "Tax savings provide a strong incentive for LBO's, (1992:71).

In many BEE transactions, the financial leverage is not within the firm but outside the firm in the investment holding company. This means that the BEE investment holding company is highly leveraged with debt or with preference share financing. Recently, BEE transactions are resulting in high debt ratios in the firm as a BEE transaction will require the transfer of the assets and business to a new operating company which will raise debt finance to fund the acquisition of the business from the vendor. The BEE party will acquire a direct holding in the shares of the operating company. This is more akin to the normal LBO transaction and will be described in greater detail in the study.

LBOs and MBOs that are subject to highly leveraged financing structures include varying layers of debt financing involving senior secured and unsecured loan finance, and mezzanine finance which represents subordinated debt that ranks after senior debt for repayment. Mezzanine finance will result in higher rates of interest and will involve acquiring a share of the company's equity by the mezzanine finance provider at a nominal cost. Senior debt will be provided by the commercial banks. Olsen says, "Bank debt is the most senior claim against the cash flows of business, and is repaid first with its interest and principal payments taking precedence ....", (2002:4).

In many of the traditional BEE transactions, the financing involved mainly vendor financing and limited senior debt financing and the security for any such financing was the equity in the underlying company. Due to the tax consequences of borrowing for the purchase of shares, which resulted in the non-deductibility of interest, vendors and banks provided financing in the form of preference share funding with the dividend rate set at around 70-74% of the bank prime overdraft rate. The bank or vendor would obtain the STC credits arising from preference dividend income and such preference dividend income was not taxable for the bank enabling the bank to effectively reduce the cost of borrowing by transferring effectively some of the tax shield to the BEE investors. However, the prime rate is set at significant premium to the risk-free rate and resulted in a higher effective cost of financing for the BEE investors.

However, recent BEE financing structures which involve the transfer of assets and business to a new company increasingly reflect the type of structures involved in a leveraged buyout. (The Hulamin BEE structure is a typical example). Also see Exhibit 17 to see how this structure operates.

The discussion on LBOs puts us in a better position to identify and discuss briefly critical success factors for a leveraged buyout and to relate these to a BEE transaction. They can be summarized as follows:

- (i) The target company should have excellent free cash flow generating capability to sustain interest and capital repayments as well as stable cash flows. Fox et al concludes, "*The occurrence of LBOs is positively related to the existence of target firms that have free and stable cash flow*", (1992:67).. The target company should have quality assets which can be used as security for loan finance.
- (ii) The target company should have low capital spending requirements in the future to enable the company to focus on repaying debt
- (iii) The target company should be able to offer high returns on operating assets.
- (iv) The target company should have a very low debt ratio and significant borrowing capacity.
- (v) Timing of an LBO is critical. This is even more so in cyclical companies. It has been proven that managing a highly leveraged company during recession may prove to be a mammoth task. Therefore cyclical businesses should be approached with caution.
- (vi) LBOs that occur in periods of low interest rates have a higher probability of success. It is also highly recommended to invest with management. This will ensure the alignment of management and shareholder interests, thus reducing agency costs. Lehn et al. support this view when they argue that, "*We find support for the hypothesis advanced by Jensen (1986) that a major source of stockholder gains in going private transactions is the mitigation of agency problems associated with free cash flow*" (1989:771). Management will be highly incentivised from a financial perspective and will obtain a high degree of control over the operating assets and direction of the firm.
- (vii) High debt levels should be reduced to reasonable levels within a period of five to ten years from operating cash flows or the sale of non-core assets or divisions.

Although, LBOs in the USA and Europe have been successful, the reality is that there were many LBOs from the 1980s that went into bankruptcy in the recession of 1991-92. The expected failure rate was about 50 per cent at the time. However, in a recent study undertaken by Lerner and Gurung (2008), it was found that 6% of buyouts ended in bankruptcy.

In a normal LBO, it is the company that will fail whilst in the traditional BEE financing structure; it is the BEE entity that will fail. Recently, in BEE transactions involving the transfer of the business to a new company, it is the company that may fail and this means that BEE transactions will be similar to a normal LBO situation. However, there may be qualifications to this. We shall deal with that in the later chapters.

## 2.3. Comparing Leveraged Buyout Success Factors and BEE

Now that we understand the success factors of LBOs, we are proceeding to see how these compare with BEE. In other words we want to see to what extent are these conditions likely to occur in BEE transactions. Will the factors applying to BEE transactions increase the probability of succeeding or failure?

- (i) Free- cash flow generating capability is critical for LBOs survival as indicated above. Unfortunately this is not always the case with BEE transactions. Companies are required by law to enter into BEE transactions, especially if they hope to do business with government or state owned enterprises. In fact the inability of the company to generate excess free cash-flow may be the main driver for the company to do BEE transaction because it wants to have access to lucrative government business. This will then make it difficult for the company to pay preference dividends, interest on debt, let alone the repayment of capital. This will then increase the possibility of BEE transaction to fail.
- (ii) As indicated many white companies accept now that they should do BEE transactions for their own survival. The quality of assets to secure loans is therefore not a consideration for these companies. Didata for instance is an IT company which does not have the quality assets we are referring to, yet it had to do an empowerment transaction. This means that even companies with poor quality assets will continue with BEE transactions. This again will raise the chances of bankruptcy and failure for the BEE Company.
- (iii) Do companies which have done BEE transactions postpone capital expenditures so as to focus on debt repayment for BEE? There is no empirical evidence to support this proposition. Companies continue with their programmes. Remember if shareholders of white companies were to be told that the "cost" of BEE is to postpone capital expenditure for the business, they will mostly likely resist it. So for the company it becomes business as usual. Whether the BEE Company is able to pay or not, is less of their concern. In any case that just increases BEE partners' indebtedness. This will either be capitalized or be postponed to the maturity of the lock-in period, where the BEE investor will have to refinance this or sell it to the white company. That is what happened with Bidvest, where Dinatla BEE partners had to sell part of their shareholding back to the company, (at a huge discount to Bidvest) and pay the debt. Although this did not lead to Dinatla's bankruptcy, it did reduce their announced shareholding substantially. It is however safe to conclude that this important element of LBOs success is not always there in most BEE transactions.<sup>1</sup>

<sup>1</sup> This occurs when BEE is structured in the form of the sale of the business so that the debt is due by the operating company.

- (iv) With LBOs and MBOs management which has either been brought in or in case of an MBO, management who are now equity holders ensures that they generate higher returns from operating assets. What happens in a BEE is that in most cases BEE partners will not have any management involvement. At best they will have a Board seat. Even in instances where companies are willing to give a management position, BEE parties are reluctant to take them because they are seen as ceremonial. Also BEE partners do not want to be locked in management of the company which will only mature in 10 years. Whatever the reason of not being involved in management, the fact of the matter is that there is no guarantee of higher returns for a BEE partner. Thus again increasing the probability of failure for the BEE company.
- (v) It is argued that the target company should have a low debt ratio to allow it to be able to borrow should it want to. The leverage ratio of a target company is in most cases not a consideration. It may be low, which will be more coincidental than design.<sup>2</sup>
- (vi) Timing is critical for successful LBOs. This is even so for cyclical businesses as indicated above. However, this is not a consideration for BEE transactions. This is so because the established company decides when it is opportune for it to do an empowerment transaction. This is more driven by BEE requirements for the company. BEE companies then go and bid for that BEE opportunity. The BEE Company does this without considering the cyclical nature of the business. So if the opportunity came at the wrong time, no doubt that this could increase the chances of bankruptcy.
- (vii) BEE companies like LBOs are highly leveraged. The LBOs are mostly likely to occur when the interest rates are low and equity values are high. In South Africa the interest rates have been on the rise for some time now, with prime rate rising to 14% from the low of 10%. There is no indication that BEE transactions which are highly leveraged are slowing down. On the contrary the Codes of Good practice and other Sector Charters have been adopted in the rising interest rate climate. The point is that BEE transactions are not waiting for interest rates to start decreasing. We indicated above that high interest rates put more burden on BEE investors. High interest rates increase the probability of BEE failure. We will also indicate in the later chapter that high interest rates reduce net equity value for BEE investors.

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<sup>2</sup> This presupposes that the BEE company bought the operating company, and therefore the debt ratio becomes an issue.

- (viii) MBOs ensure that agency costs risks are mitigated. With BEE investors it is difficult to invest with management because most companies are managed by white managers who do not qualify for BEE points. The advantages of investing with management are thus lost for BEE investors. This again does not help the course of BEE investors. They continue relying on old managers and therefore nothing new can be expected.
- (ix) Contrary to what happens to LBOs where high debt levels reduce in a period of 5 to 10 years because management focus on cash generating activities like selling of non-core assets, downsizing, amongst others, BEE transactions may increase debt levels during that time. BEE investors have no control over the assets. The increased debt levels could increase risk failure for BEE investors.
- (x) BEE investors often help to create post BEE value by representing the firm to some clients, and enabling the company to qualify for lucrative opportunities that require doing business with empowered companies. That created value will be shared by all the shareholders. However the share price that BEE investors are paying may include BEE created value. It is common for companies to announce that they will be doing a BEE transaction before they fix the price. The share price in most instances will increase around the time of the announcement<sup>3</sup>. The BEE partner then finds itself paying for the value they have created.

## 2.4. Equity Returns in RSA

We shall demonstrate in the next chapter that the success of BEE transactions by and large depends on the equities market performance. It will be shown in some of the sensitivity analysis that the NEV to BEE is so much dependent on the performance of equities. However to understand and measure equity performance it is important to understand the equity risk premium concept since it is very critical to intelligently project the future performance of a particular stock. Dimson defines equity risk premium as "*the incremental return that shareholders require from holding risky equities rather than risk-free securities*", (Dimson et.al. 2002:1). Correia defines it as "*the additional return that investors will demand for investing in ordinary shares rather than government bonds*", (Correia 2007: 3-19). In short, the equity premium can be defined as the difference between the return on risky stocks and return on safe bonds.

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<sup>3</sup> When the intended Sasol BEE deal became public knowledge Sasol Share was trading at R265. ("Star 15/06/07) and when Sasol deal was finally executed the price was R442. ("Star 05/05/2008).

Equity risk premium may be calculated using many approaches, including Capital Asset Pricing Model (CAPM)<sup>4</sup> and Dividend growth model. Based on CAPM approach and assuming a Beta of 1, market risk premium is equal to expected rate of return on equity capital less risk free rate of return.  $E(R_p) = E(R_e) - R_f$ .

On the other hand Dividend growth rate model says:

Cost of Equity =  $D/\text{Market Value} + g$ , where

$D/\text{Market Value}$  = dividend yield, and  $g$  expected growth in dividend.

What is evident from the definitions above is that investors know and expect equities to be more risky than government bonds and securities. That being the case it should be expected that investors will require higher returns from equities. The risks are mainly economic risks and the volatility of the stock market. The corporate disasters of Barings Bank and Enron are a living examples of the risks associated with equity markets. It is thus not unreasonable for investors to expect higher returns when they invest in equities market.

#### 2.4.1. Determining Market Equity Returns

The success of BEE transactions are significantly affected by market equity returns. In this section, we will evaluate market equity returns over the long-term and in a later chapter we will relate the likely performance in equities will have on the BEE ownership in the net equity of companies. We now know that investors expect higher returns from equities than government bonds and other securities. The question is how big those returns should be. We need to establish that if we are to forecast the future performance of the equities. To do this we shall be looking at how JSE-listed equities have performed over a long time period and look at the survey conducted by PricewaterhouseCoopers (2005). Based on insights obtained, it will be possible to analyse the potential impact of future market changes on BEE transactions. The reason we do this is to get as close as possible to the net equity value that is likely to transfer to BEE partners at the expiry of lock in periods we will be investigating.

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<sup>4</sup> See pages 40 and 41 for the exposition and explanation of CAPM

## 2.4.2. Capital Asset Pricing Model (CAPM)

It is important to understand what CAPM says before we use it. This is so because CAPM continues to be a popular approach to pricing of capital assets. CAPM holds that, " a certain level of risk applies in a market to all capital assets and must be borne by the investor, while other risk is peculiar to the specific asset and can be eliminated through diversification", (Correia et. al. 2007: 1-25). Simply put, CAPM says that the expected return that the investor hopes to get, will be equal to the rate on a risk free security, (like a government bond) plus a risk premium.

CAPM says risk is both systematic risk and specific risk. Specific risk is the risk associated with the chosen asset. Systematic risk on the other hand, " is the risk of a firm that contributes to the overall market portfolio – a portfolio that contains a weighted average of all capital assets" (Dowjones 2001:1). CAPM holds that the marketplace compensates investors for taking systematic risk of holding the market portfolio.

Consider the following CAPM Equation:

$$E(R_e) = R_f + \beta \times E(R_p)$$

Where:

$E(R_e)$  = Expected rate of return on equity capital - is the expected annual return as a percentage on this specific asset, (f). This represents what an investor hopes to achieve by taking the risk.

$R_f$  = Risk-free rate of return – This is the return expected from government bonds. It is said to be risk free because the probability of government to default on their bonds is close to zero.

$\beta$  = Beta - This is a measure of the extent to which an asset's expected return can be expected to change given some change in the market portfolio. In other words Beta measures volatility of a share in relation to the rest of the market. It should be noted that the market portfolio has a Beta of 1. The Betas greater than 1 are riskier than the market portfolio. On the contrary Betas less than 1 are less riskier than the market portfolio.

$E(R_p)$  = Expected market risk premium – This is the return that includes risk adjustment for risks that the investor takes by investing into a particular stock.

CAPM therefore says the market will give returns to investors who take systematic risks, but there will be no returns for taking specific risks.



Although CAPM is widely used by many analysts, it does have its drawbacks. Some of the assumptions it is based on are herculean, and are difficult to obtain in the real world.

Amongst the assumptions that it makes is that investors are risk averse and they maximize the expected utility of their end period wealth. This makes a one period model. It also assumes symmetric distribution of information to investors. This is not always true, usually we encounter skewed distribution of information. It also assumes that borrowing rate is equal to the lending rate. It also assumes there are no taxes, regulations or restrictions on short selling, i.e. it assumes a perfect market. This may be difficult to find in the real world.

### 2.4.3. Historical Performance of RSA Equities

When looking at equity risk premium it is important to take a long term view. Short to medium term view can be very erratic. For instance before the technology bubble burst in the late nineties investors expected long-run stock market returns to deliver double digit percentage returns. Dimson et. al therefore argues, *"To understand the risk premium,...., we need to examine periods that are much longer than one or two years, or even a decade. This is because stock markets are volatile, with much variation in year – to- year returns"*(Dimson et al 2002: 2).

Below is the table which shows what Dimson found as far as the performance of equities over a 102 year period. He found that over this period the annualized equity risk premium, relative to bills was 4.5% for the UK, 5.6% for the USA. South Africa's equity risk premium was higher (because of higher equity returns over the period), when compared to most of the countries under review. RSA's equity risk premium was found to be 6.1%.

Taking the arithmetic mean to forecast the equity premium for different countries, he concludes that they will be lower than the historical performance. Obviously South Africa's risk premium should be higher because of perceived higher risks. Therefore based on historical performance of South African equities and a risk premium of say, 5%, the expected annual equity return is approximately 14% if we use a risk-free rate of 9% (which in late 2007 reflected the risk-free rate), then the expected return from investing in ordinary equities is;

In South Africa it has been found that investors have shifted from the RSA R153 Bond (R153) to RSA R157 as a proxy for the risk-free rate. This was confirmed by the 2008 PWC Survey. R157 provides a longer term to maturity. This is also in line with many BEE transactions which has long term horizon. R157 therefore matches BEE investments terms. We assume Beta to be 1, as elaborated above. Then equity Returns will be:

**Equity Returns = Bond Yield + equity risk premium**

$$9\% + 5\% = 14\%$$

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## Equity risk premia (percent per year)

EQUITY RISK  PEMIA AROUND  THE WORLD  1900- 2001	Country	Relative to bills			Relative to bonds		
		Geo- metric	Arith- metic	SD	Geo- metric	Arith- metic	SD
	Australia	7.0'	8.5	17.2	6.3	7.9	18.8
	Belgium	2.7	5.0'	23.5	2.8	4.7	20.7
	Canada	4.4	5.7	16.7	4.2	5.7	17.9
	Denmark	1.6	3.2	19.4	1.8	3.1	16.9
	France	7.1	9.5	23.9	4.6	6.7	21.7
	Germany*	4.6	10.0'	35.3	6.3	9.6	28.5
	Ireland	3.4	5.3	20.5	3.1	4.5	17.3
	Italy	6.6	10.6	32.5	4.6	8.0'	30.1
	Japan	6.4	9.6	27.9	5.9	10.0'	33.2
	The Netherlands	4.8	6.8	22.3	4.4	6.4	21.5
	<b>South Africa</b>	<b>6.1</b>	<b>8.2</b>	<b>22.4</b>	<b>5.4</b>	<b>7.1</b>	<b>19.6</b>
	Spain	3.1	5.2	21.4	2.2	4.1	20.2
	Sweden	5.3	7.4	21.9	4.9	7.1	22.1
	Switzerland*	4.0'	5.8	19.6	2.4	3.9	18.0'
	United Kingdom	4.5	6.2	19.9	4.2	5.5	16.7
	United States	5.6	7.5	19.7	4.8	6.7	20.0'
	World	4.6	5.9	16.5	4.3	5.4	14.6

*Germany\* excludes 1922-23, Switzerland commences in 1911.*

*Source: Dimson, Marsh and Staunton, Triumph of the Optimists, Princeton University Press, 2002*

We will not study the relative merits of using arithmetic and geometric means but business practitioners tend to use a market risk premium determined on a geometric basis and comparing the equity return to the performance of Government Bonds rather than short-term Treasury bill yields which can be volatile.

In a recent survey by Dimson et al (2007), and published in the ABNAMRO /LBS Global Investment Returns Yearbook, it was found that South Africa recorded a real return of 7.5% over the period from investing in equities and a return of 1.8% from investing in bonds. The long-term market risk premium is estimated to be 5.7%.

#### 2.4.4. PWC Survey

In 2005 PWC Corporate Finance undertook a survey to determine which were the most used valuation methodologies in South Africa. This survey included 24 financial analysts and corporate financiers. Our interest on this survey is on the views of these analysts on equity risks premium required by RSA investors. It was established that most respondents use Capital Asset Pricing Model (CAPM) to estimate cost of equity. CAPM estimates the required rate of return of an equity investor in the target company.

The outcome of the survey was that over 50% of the respondents use expected market risk premium of between 5% and 6%.

This is an interesting equity risk premium because it is consistent with our conclusion on the risk premium arrived at when using the historical approach. For the purposes of our research, it is thus safe to expect nominal equity returns of  $15\% = (9\% + 6\%)$ . This assumes a 6% MRP. In the following chapter we would use this equity market return expectation to estimate what NEV is likely to vest with BEE partners at maturity of these structures. We would like to see what does this mean for the attainment of BEE targets set? Also we would like to establish how long it will take for the stipulated targets to be attained, given the equity market return of 15%.

## Chapter 3

### Black Economic Empowerment Transactions

Now that we understand how leveraged buyouts work, we can proceed and look at BEE ownership and the typical BEE funding structures that are used. As we do that we shall be drawing similarities, where they exist, between these BEE funding structures on one hand, LBOs and Private Equity Investments on the other. One glaring similarity is that they are all very much dependant on debt to fund their transactions. However, the biggest difference between the two is that the power relations are different.

In a typical LBO the buyers of the business or assets will have bigger negotiating power and a plan of what they will do when they get the business. They will be having clear plans what they want to do with free-cash flow, how long they want to be in that business and who they will be putting in management position to drive their strategy. In an LBO, there will be a transfer of control as there is normally a transfer of more than 50% of the shares in the company. In Private Equity, the private equity investor may not have a controlling interest but will have board representation and will have a shareholders agreement setting out what management may or may not do prior to investing in the company. Whilst there has increasingly been competition between private equity investors thereby pushing up the prices of private equity transactions, the requirements set out in the shareholder agreements will remain stringent in regard to management decisions regarding expansion, investments and capital expenditure decisions as well as financing decisions.

BEE parties are increasingly being required to set indicative values for any off-market transaction and due to competition between BEE parties, this is pushing up the prices of transactions. Secondly, BEE parties are required to sign restrictive and wide-ranging shareholders' agreements.

In most cases BEE companies do not have strong negotiating power because it is the white company which will have initiated the process, and having to choose amongst many BEE companies who would have shown an interest in the said company. This is commonly known in BEE circles as "*beauty parade of BEE companies*". Also the BEE Company in most cases does not take over the management of the business, and has no or little say as to what happens with free-cash flow. Although this is similar to a private equity transaction, in that the private equity investor does not take over the management of the company, private equity investors do place restrictions on operating, capex and financing decisions.

In short the BEE Company continues to be at the mercy of the white companies, who in most cases embrace BEE in order to comply with government requirements and legislation. This has a bearing on the value that will finally accrue to the BEE partners. Also, the lock in period for a BEE partner is determined by the target

Company, whereas in a typical LBO, the new investor will decide when to sell, list or delist, depending on what maximizes returns on their investments. Even if the BEE partner, in its own considered view, thinks that it has maximized its value and the business can only go down, it cannot sell its shareholding. The opposite is true for an LBO. An example is the ABSA-Batho Bonke deal. The share price hit R140 per share in 2007, now it is at R103, (Sunday Times 20/01/2008). Batho-Bonke could have sold some of its equity, paid the debt, and remained with unencumbered equity. This would have definitely reduced exposure of the BEE to interest rate risk. We will analyse the effects of the ABSA share price movements on BEE ownership levels and relate this to the Financial Sector Charter requirements.

### 3.1. BEE Funding Structures

In this section we turn our focus to some of the mostly used BEE funding structures. It should be remembered that the biggest challenge of these funding structures is to sell businesses or assets to black entrepreneurs who do not have capital. Development Finance Institutions like Independent Development Corporation (IDC) and National Empowerment Fund (NEF) have been the champions of funding BEE transactions. Needless to say, they have limited capacity themselves. Private sector, as part of the financial sector charter commitments, pledged to work together with government towards funding BEE deals. This is a clear indication that government and private sector should co-operate for BEE objectives to be attained.

We want to investigate the feasibility of government's target of transferring 25% of Net Equity Value (before any changes in the business as a result of BEE) of the economy to black people by 2014 with the structures that have been employed so far. Jack stresses the point that, "*in a BEE context, ownership and financing are inextricably linked*". He continues to argue that, "*While financing provides opportunity, it can also come with a sting in the tail, as debt hanging over a BEE party undermines ownership*", (Jack and Harris, 2007:382). Therefore it is critically important to understand this sting and see how it can be mitigated by using of BEE friendly funding structures. To further elucidate this point we shall be looking at some case studies.

#### 3.1.1. Special Purpose Vehicles (SPVs)

This is a mechanism which has been used to facilitate the financing by funders of BEE transactions. Although white shareholders would like to do BEE transactions as a business imperative, they are not prepared to be exposed to the risks associated with this process. An SPV can be defined as, "*a vehicle formed specifically to facilitate financing of a BEE party where the party needs a combination of bank, vendor and equity finance. The BEE Company acquires the voting rights, but the financier enjoys the performance of the underlying shares up to a certain hurdle rate*", (Jack 200: 383). Underneath we shall critically analyze this SPV structure. We want to see the risks and benefits associated with it.

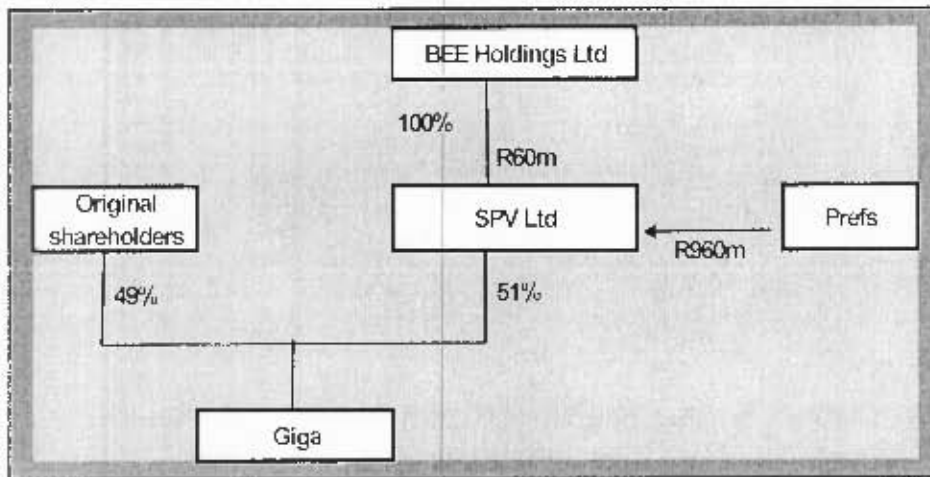


Exhibit 5 BEE Ownership and Financing Structure

The features of this structure are:-

- o GIGA Ltd originally owned 100% by original shareholders and it would like to make a 51% BEE deal with BEE Holdings Ltd; BEE Holdings Ltd does not have funds and therefore it goes to the bank to raise finance;
- o The consideration amount is R1020m for 51%, and BEE Holdings Ltd contributes R60m as equity;
- o SPV Ltd is formed, and Preference shares of R960m are issued to the bank at a dividend rate of 74% of the prime rate; the current Prime rate is 14.5% (December 2007);
- o After this deal SPV Ltd "owns" 51% of GIGA Ltd and the original shareholders hold 49%;
- o R82m ordinary dividends were paid prior to this transaction with a dividend cover of 3.12 (i.e. R82m dividend on earnings of R255.6m = 3.12). GIGA would maintain a constant dividend payout ratio or dividend cover of 3.12 over the duration of the transaction.
- o Preference shares are redeemable in 5 years in a bullet payment and the value of ordinary shares is expected to grow at a long term rate of 10% per year.

- o interest rate is based on the long term historical market premium of 5% medium term 5. 14% is a reasonable return in the current interest rate environment and based on the long term historical market premium of 5%.
- o We are therefore going to model this scenario and determine possible outcomes, especially for BEE Holdings Ltd. We need to see what the Net Equity Value accruing to the BEE Company is after 5 years.

Ordinary dividends - given info	Dividends		Market cap increase	
	R 82,000,000	SPV	R 2,000,000,000	SPV
Yr 1	88,788,271	45,797,112	2,190,231,729	1,117,002,882
Yr 2	88,338,164	50,152,484	2,398,491,807	1,223,230,822
Yr 3	107,890,209	54,822,005	2,526,580,452	1,339,561,130
Yr 4	117,931,640	60,145,137	2,876,391,474	1,466,954,652
Yr 5	128,147,041	65,884,991	3,148,577,839	1,606,463,138

Exhibit 6 Dividends and Market Capitalisation growth for BEE Holdings over 5 years

In the first year after the transaction, SPV Ltd will receive R45.80 million from the ordinary shares held in the operating company, GIGA Ltd. The total dividend payable by GIGA to its shareholders is R89.80 million. The market value of the SPV's holding in GIGA will amount to R1,606,4 million at the end of five years with the expected equity return in GIGA of 14% per annum for five years.

We will assume that the bank is willing to finance any shortfall between the ordinary dividend receivable by the SPV and the preference dividend payable each year by subscribing for further preference shares in the SPV. Therefore, the net deficit is financed by the issue of preference shares in the SPV.

In terms of voting control, BEE Holdings owns 100% of the SPV which owns 51% of the ordinary shares and therefore BEE Holdings controls the operating company, being GIGA Ltd. However, such control may be subject to the terms of shareholder agreements and the terms of such shareholder agreements are often highly restrictive in relation to the BEE Company exercising effective control.

<sup>3</sup> The 5 year period is in line with the BEE scorecard and it is also considered to be medium term referred to. 50% of the original stated BEE ownership can be taken as meaningful compared to situations where after the period may have close to zero ownership.



Preference debt	Opening balance	Interest	Payments	Closing balance
Yr 1	R 960,000,000	103,008,000	-45,797,119	R 1,017,210,882
Yr 2	R 1,017,210,882	109,146,728	-50,152,464	R 1,076,205,146
Yr 3	R 1,076,205,146	116,476,812	-54,922,006	R 1,136,759,952
Yr 4	R 1,136,759,952	121,974,343	-60,145,137	R 1,198,589,158
Yr 5	R 1,198,589,158	128,608,817	-65,864,991	R 1,261,332,783
		570,214,499	-276,887,716	

Exhibit 7 Preference Share Funding Balance over 5 years

In the first year, the SPV will owe the bank a preference dividend of R103 million (R960 million x 14.5% x 74%). The SPV will pay over to the bank the ordinary dividend of R45,8 million in ordinary dividends received and will issue the balance of R57,2 million in preference shares, thereby increasing the preference share balance to R1 017 million at the end of year one.

At the end of five years, the balance owing to the bank will amount to R1 261 million whilst the market value of the equity investment in GIGA will amount to R1 606 million.

Summary	
Market cap of SPV	1,606,463,198
Preference share	-R 1,261,332,783
	<u>R 345,130,415</u> 10.96%

Exhibit 8 Net value of BEE shareholding in the operating company

The net value of the BEE shareholding will amount close to R345 million which amounts to 10.96% of the operating company, GIGA. The above analysis shows that, unless the dividend payable by GIGA is at least equal to the preference dividend payable by the SPV to the bank, the debt to the bank will increase. Repayment of dividends and capital must occur if the BEE partner is not to be in a position, after 5 years, where the capital amount owing has increased. Growth in the NEV via growth in the equity value (even if such growth exceeds the growth in debt) is of little use as the equity cannot be sold by the BEE entity to reduce or settle debt.

At the maturity date of the preference shares, GIGA LTD owes R1 261 million. What has happened to market capitalization of GIGA LTD and by definition to BEE Holdings? The SPV market value has increased to R1 606 million. This then results in a NEV for BEE Holdings (via SPV) of:

$$BEE\ HOLDINGS\ NEV = R1\ 606\ 463\ 198 - R1\ 261\ 332\ 783 - R345\ 130\ 415$$

This outcome represents 10.96% Net Equity Value ("NEV") for BEE SPV. It is interesting to note that after five years, that this is a mere 10.96% of the deal which was announced as a 51% BEE deal.

If one explores this issue further, it is apparent that an annual dividend of R201.9 million would have to be paid by GIGA just to cover the preference dividend payment by the SPV (i.e. R201.9 million X 51% = Pref. dividend on R960 million at 10.73%). In year 1 this would require a dividend cover of R280m / R201.98m – 1.39. This is high for a growing company, but could be accepted for a mature company.

To take the analysis further, an annual dividend of R505.9m would be required if the preference share debt plus dividend were to be repaid in five equal annual instalments (this represents the annual annuity payment required of R254.9m, divided by 0.51). As GIGA at no time during the five years has earnings of R505m per year, this analysis shows just how unrealistic the five-year payback period is, given the parameters stated in the model. It also highlights in clear fashion the particular difficulties surrounding the financing of BEE deals.

This analysis could lead into a discussion of the ways and means by which the desired objectives could be achieved, e.g. by changing dividend policy by GIGA for the five year period (so that, if not all of the debt is repaid within the first five years, it is at least reduced significantly). A discounted share price to the SPV could also be considered, although the extent of the discount may at present be limited by JSE requirements.<sup>6</sup> These restrictions may in fact apply to all share sales, including BEE deals.

What would happen to the NEV if the BEE deal is announced as a 25% transfer of equity ownership? In terms of the BEE Codes of Conduct, the DTI set a target of 25% equity ownership. However, there are Sector Charters which require a lower target of ownership such as 10% BEE ownership in the Financial Sector Charter.

We will evaluate a BEE transaction which has announced a 25% transfer of ownership. This is more in line with the government proposition to transfer 25% of the economy to Black people by 2014. This has prompted corporate South Africa to aim at selling 25% stake of their businesses to empowerment companies. We would like to see how this scenario pans out in 5 years time. We assume that BEE Holdings will invest R30 million in equity capital.

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<sup>6</sup> According to JSE regulations, a discount of more than 10% requires shareholder approval.

Ordinary dividends - given info	Dividends		Market cap increase	
	R 82,000,000	SPV	R 2,000,000,000	SPV
Yr 1	89,799,771	22,449,568	2,190,201,729	547,550,432
Yr 2	98,328,164	24,584,541	2,398,491,807	599,622,952
Yr 3	107,890,209	26,922,552	2,626,590,462	656,647,613
Yr 4	117,931,640	29,482,910	2,876,381,474	719,096,369
Yr 5	129,147,041	32,286,760	3,149,921,639	787,481,960

Exhibit 9 Dividends and Market Capitalisation growth for BEE Holdings over 5 years

Preference debt	Opening balance	Interest	Payments	Closing balance
Yr 1	R 470,000,000	50,431,000	-22,449,568	R 497,961,432
Yr 2	R 497,961,432	53,433,406	-24,584,541	R 526,830,299
Yr 3	R 526,830,299	56,528,891	-26,922,552	R 556,436,636
Yr 4	R 556,436,636	59,735,651	-29,482,910	R 586,659,379
Yr 5	R 586,659,379	62,948,551	-32,286,760	R 617,321,170
		293,047,501	-135,726,331	

Exhibit 10 Preference Share Funding balance after 5 years

If we deduct the closing balance of the preference share funding from the market value of the SPV holding in the operating company we obtain a Net Equity Value of R170 million which amounts to 5.40% of the market capitalisation of the operating company at the time. This is depicted in Exhibit 11.

Summary	
Market cap of SPV	787,481,960
Preference share	-R 617,321,170
	<u>R 170,160,790</u>

Exhibit 11 Net Equity Value of BEE Shareholding in the operating company

If we extend the period to 2014, to reflect government's target that 25% of the economy should be owned by BEE entities, then the net equity value will rise to R265 million which represents about 8.42% of the market capitalisation of the firm. This is a long way from the government target of 25% BEE ownership by 2014. The current structure will result in government failing to meet its objective in relation to BEE ownership based on a reasonable assumption about equity returns in the future.

Summary	
Market cap of SPV	944,384,514
Preference share	-R 679 034,833
	<u>R 265 349,682</u> 8.42%

*Exhibit 12 Net Equity Value of BEE shareholding in the operating company*

We will summarise the situation for a 25% BEE transaction over five years. Exhibit 10 illustrates the situation where there is a shortfall of preferential dividend payment from the ordinary dividends received. Looking at year 2, we see there is a preferential dividend of R28.8 million which must be paid to funders. However there is only R24.6 million ordinary dividend received by the BEE Company to pay the preferential dividends. We see that the shortfall will be carried forward and capitalized. A bullet payment which involves the capital and shortfall on preferential dividends will be paid at maturity.

Looking at Exhibit 11 we also realize that market capitalisation for BEE Holdings has grown to R787.4 million. However, we still need to deduct R617.3 million which is owed to the funders. Therefore NEV that will vest with BEE Holdings at maturity is:

$$\text{BEE HOLDINGS NEV} = R787\,481\,960 - 617\,321\,170 = R170\,160\,790$$

Again we find a very discomfoting result as far as the achievement of 25% transfer of the economy to black hands by selling businesses to BEE partners. This deal which started as a 25% deal to BEE holdings was only able to transfer a mere 5.40% Net Equity Value to the BEE partner.

There is no doubt that this BEE has resulted in transferring of value to this BEE Company. The argument is that in this case where there was such a favourable economic climate it still did not come out to be 51%, but 10.96%, and not 25% but 5.4%.

In our model we carried out sensitivity analysis to try and understand the impact of these changes in the Net Equity value to BEE. We mainly used sensitivity analysis in a situation where BLL Holdings buys 25% of GIGA LTD. This is so because that is the target most companies set themselves to comply with government's requirements. It is also the target that the government has set itself to achieve by 2014. The following sensitivity analysis were done on changes in interest rates, and market capitalisation growth rates:

### 3.1.2. Interest rate analysis

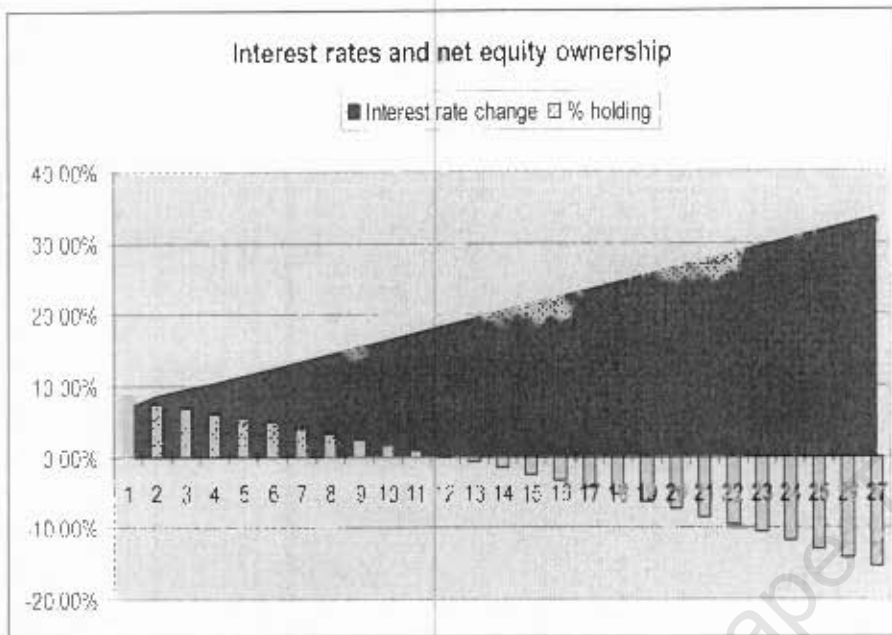


Exhibit 13 Net Equity Value and changes in interest rates

The prime interest rate has increased from 9.5% to 14.5% in a few years. This is a 5% increase in the base financing rate used to determine the preference dividend rate payable by the BEE Company. Obviously this has increased the BEE interest liability. If interest rates were to increase to 20%, as it happened in the nineties, BEE NEV will dramatically fall to less than 1%. This clearly illustrates sensitivity of BEE NEV to interest rates changes. This is because of the high leverage of these BEE funding structures. There is thus clear negative correlation between interest rates changes and BEE NEV. Please note that this only raises the red flag about some of the risks that are faced by these structures.

Exhibit 13 above illustrates graphically that there is a negative relationship between Net Equity value and prime interest rates. We realize that beyond a prime interest rate of 20.5% there is absolutely no benefit for the BEE partner. However, this assumes that interest rate changes are independent of market capitalisation changes. It is expected that the growth in market capitalisation would be reduced by increases in interest rates and we test the combined sensitivity to these two variables later in the study. Market Capitalization growth rate analysis



Exhibit 14 Market Capitalisation and Changes in Net Equity Value Ownership

Assume a market capitalization growth rate of 10% p.a. As indicated before, the effect of this is a drastic decrease in the BEE Holdings Net Equity value to 5.4%. Again this deal was supposed to be a 25% deal. This outcome is disappointing, because it is much lower than what was announced 5 years ago. In the above exhibit we see a positive correlation between equity market growth rate and NEV for BEE investors. However, even a 25% growth in market capitalisation will result in a 15% Net Equity Value ownership. This growth in market capitalisation is not sustainable in the long term but may occur for some years such as in the period 2004 to 2006.

The graph above shows that there is a positive correlation between Net Equity Value to BEE investors and growth in market capitalization. Although this deal was announced as a 25% BEE deal, the reality is that the final outcome is much dependent on, amongst other things, growth rates in market capitalization during the period under consideration.

However, in order to achieve a 25% equity ownership, the announced BEE transaction needs to be in the order of 85% if we assume a market capitalisation growth of 10% per year and 8% growth in dividends per year until 2014.

We established in the previous chapters that expected equity market growth is 15%. Based on this we can say that NEV that will finally transfer to the BEE partner at most will be 7%. This is far below the 25% announcement at the commencement of this deal.

### 3.1.2.1. Analysis of the Growth Rate in Ordinary Dividends

The expected growth rate in Ordinary dividends payable by the operating company to the BEE Company (SPV) will affect the Net Equity Value and this is depicted in the following exhibit.

A dividend cover of 3.1 per year will result in a 3.4% net equity value equity ownership at the end of year 5. Although NEV growth is not as significant, debt reduction is maximized as dividend growth is increased.. A change in dividend policy is required for the BEE Company to be able to service its debt and once the debt has been paid off, the desired NEV will be achieved. A change in dividend cover to 1.4 per year which is very demanding, will increase the NEV to only 3.9% under the current situation which indicates that NEV is less sensitive to ordinary dividend growth than to the growth rate in market capitalisation and a higher cost of funding.

Change in dividend cover	Net value	% holding
1.00	88,219,042	4.4%
1.40	95,780,563	3.9%
1.90	101,071,956	3.7%
2.40	104,279,203	3.5%
2.90	106,429,849	3.4%
<b>3.10</b>	<b>107,103,882</b>	<b>3.4%</b>
3.60	108,472,931	3.4%
4.10	109,518,443	3.3%
4.60	110,342,945	3.3%
5.10	111,009,796	3.3%

*Exhibit 15 Changes in dividend cover and Net Equity Value Ownership*

We will now evaluate the sensitivity of changes to NEV to combined changes in the prime interest rate and dividend cover changes.

### 3.1.2.2. Simultaneous Changes in both the Equity Market Growth Rate and Interest Rates

Up to now we have held all variables constant and have allowed only one variable to change at a time. We now combine the effect of changes in the prime interest rate and changes in dividend cover.

The following exhibit indicates what happens to NEV as we change both the prime rate and the dividend cover. At a dividend cover of 3.1 and a prime rate of 14.5%, we would expect that the NEV of the BEE Company would amount to 3.4% as calculated above and this is what is indicated in the Exhibit 16.

Dividend cover	Change in interest rate						
	10%	10.5%	11%	11.5%	12%	12.5%	13%
10	88%	81%	72%	63%	54%	44%	34%
14	78%	73%	65%	56%	48%	39%	30%
19	71%	68%	60%	53%	45%	37%	28%
24	68%	65%	58%	50%	43%	35%	27%
29	67%	63%	56%	49%	42%	34%	27%
<b>31</b>	68%	63%	56%	49%	42%	<b>34%</b>	28%
36	65%	62%	55%	48%	41%	34%	26%
41	64%	61%	54%	47%	40%	33%	26%
46	64%	61%	54%	47%	40%	33%	25%
51	63%	60%	53%	47%	40%	33%	25%

Exhibit 16 NEV and changes in interest rates and Market Capitalisation growth rates

In the above sensitivity analysis we did always allow one economic variable to change, and held others constant. However that assumption may be violated when changes occur simultaneously. What happens when dividend cover changes to 3.6, and interest rates increase to 15.5%? Here you have economic factors working against BEE investors. But what is the impact? Based on our model we can see that the NEV to BEE of GIGA LTD decreases further to 2.6%. Needless to say, this is a far cry from the 25% deal which was announced when this transaction was announced. This is not an unlikely scenario because it is quite common that economic factors may work against the value of shareholders. The increase in interest rates in the late 1990s resulted in the unwinding of BEE transactions such as Johnnic, Real Africa and Ucingo.



This structure has been criticized as having benefited more the banks, and not the intended beneficiaries. This is mainly because of very high hurdle rates which are set. Unfortunately the BEE partners have very little option and end up accepting unfavourable terms. On the other hand the white company continues to enjoy BEE benefits. This model came under heavy criticism especially towards the end of the last decade because the stock market did not perform. Global stock markets crashed, and companies' performance fell short of the cash flow required to pay preference dividends or interest. It was reported that banks may capitalize the deficit which would result in the BEE party holding onto more debt than equity.

The SPVs were found to be working under conditions of a bullish stock market performance. Being empowered definitely gives the white company a competitive edge over its competitors. This is true especially for those companies which do a lot of business with government. It is also particularly true for companies which need government permits and licences for them to operate. To show the appreciation of this BEE value-add, white companies need to facilitate these deals by giving a discount for the value that BEE partners bring to the company and for giving the company a competitive advantage<sup>7</sup>. This will lessen the burden on BEE companies, especially when market conditions are difficult. Unfortunately the advantage brought about by the BEE partner is in most cases downplayed or denied by these companies. Yet in such industries as mining or in industries that rely on government contracts and for companies that supply such sectors, the value created by the BEE partners is significant. It would be incorrect if such value was not recognised in terms of the transaction.

### 3.1.3. Improved BEE Funding Structure

It has been shown that the SPV structure above is very volatile and presents major risks to a BEE company. The government policy of transferring 25% of the economy to black people by 2015 may end up being wishful thinking. We saw that in some instances 51% announced ended up with a NEV of 8.42%. There have been attempts to improve the funding structures in order to mitigate risks for both BEE and the established white company.

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<sup>7</sup> A company can give up to 10% discount without any prior shareholder approval. Anything above 10% discount the company needs shareholder approval. This happened when Cadiz Holdings Ltd gave Makana a 40% discount for their BEE deal.

Let us consider the following BEE funding structure:

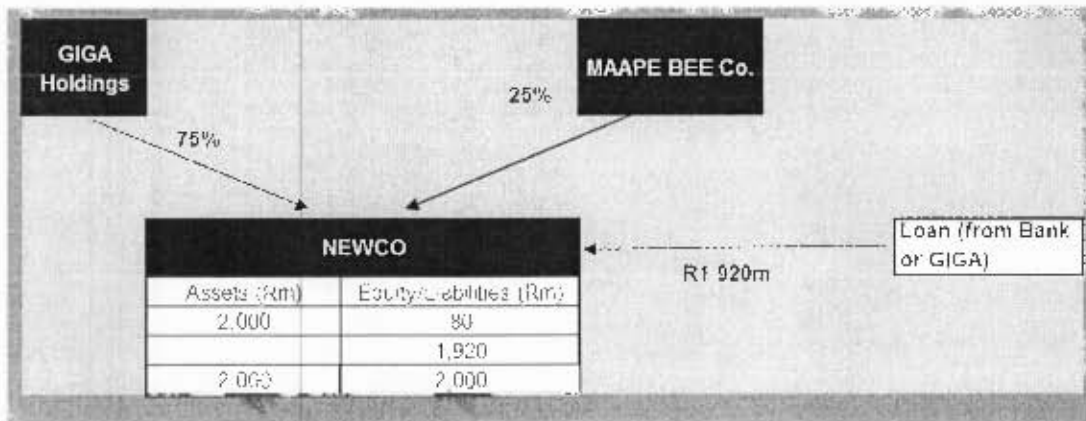


Exhibit 17 BEE Financing Structure (transfer of assets)

The BEE transaction will involve the following steps:

- GIGA Holdings wants to do a 25% deal with Maape BEE Company.
- GIGA Holdings sells 100% of the operating company to NEWCO and GIGA retains 75% ownership in the operating company and sells 25% to the BEE Company for a nominal consideration.
- The market value of NEWCO's equity is very low due to the very high loan financing used by NEWCO to purchase the business from GIGA Holdings.
- GIGA and Maape BEE now hold 75% and 25% respectively in the NEWCO.
- NEWCO pays R200 million for this business.
- The equity contribution by GIGA Holdings and Maape BEE in NEWCO is R60m and R20m respectively.
- R1920m is borrowed as a loan from the bank
- We will assume an interest rate of 10%
- EBIT = R240m

Before we consider what outcomes we get from this improved BEE financing structure, let us look at some theoretical arguments for its usage compared to the SPV structure discussed earlier. This is a creative way of allowing the white established company to help fund the BEE transaction, thus circumventing Section 38 of the Companies Act<sup>8</sup>, although it is now allowed with the recent amendments to that Act. This allows the white company to sell at most 30% of its equity in NEWCO without incurring the tax consequences relating to capital gains. This is in

<sup>8</sup> Previously the company from which shares are bought was not allowed to use its financial resources to buy its own shares. However with the amendment of the Act, that can now be done provided the company passes both solvency and liquidity tests

line with current BEE objectives of transferring 25% of businesses and economy to black people. This approach does not therefore violate Section 45 of the Income Tax.

This structure is not subjected to capital gains tax and the tax effects of recoupments.

The loan that is raised by the NEWCO is tax deductible because it is used to acquire the business and not equity. It should be noted that any loan to buy equity is not tax deductible, thereby explaining the use of preference shares in our prior example. The tax deductibility of interest acts as an incentive for white companies to do BEE deals on the basis of a transfer of assets and liabilities. This structure also enhances the BEE credentials of NEWCO because from the first day this company will be able to earn all 7 realisation points of Statement 100 of the Scorecard. This is so because the BEE Company itself does not have debt. On the contrary the debt is in NEWCO. This will therefore give NEWCO an advantage when it bids for new business from the government, state owned enterprises and even from the private sector companies who are required to be BEE compliant.

This high leverage of NEWCO may instil management discipline, like in a typical LBO transaction. This is so because they want to repay the debt. This will also encourage BEE partners to be more involved with the company, again so that the debt should be repaid sooner rather than later. This will allow the company to start paying dividends sooner. The downside of this structure is that the NEWCO may be constrained to fund future expansion programmes since it has a very high gearing ratio. Further loans for expansion may require the white company to take a further risk by subordinating future loans. We know that these companies are in most cases reluctant to take that risk. This is the same downside we find in LBOs. Further, any economic downturn or increases in interest rates may mean that the company is not able to meet its interest obligations. Further, the company may be at risk in relation to renewing loans later on and management and the BEE partners need to focus on reducing debt levels to reasonable levels as is the situation in an LBO.

These results, particularly in relation to the transfer of equity, are both profound and daunting. They are profound because we now know what to expect after the expiry of the term. It thus gives all the role players time to rectify some of the glaring problems which may accompany this outcome. It is indeed daunting because this may lead to social and political unrest if the intended beneficiaries discover what underlines these BEE transactions. No wonder some commentators have referred to these transactions as "*smoke and mirrors*".

## Chapter 4

### Case Study of BEE Funding Structures

In this section we intend to look at the funding structure(s) that have been employed in the real BEE transactions that have taken place. We would state what the relevant charter is hoping to achieve in 5-10 years; look what has happened to Net Equity Value so far, and how the picture is likely to pan out when these financial structures mature.

#### 4.1. Metropolitan and Kagiso Trust Investments

Metropolitan is a leading financial services company and in June 2004 agreed to transfer 10% of the ordinary equity in Metropolitan to Kagiso Trust Investments (KTI) which was a leading broad based BEE company. The BEE structure set out in our example in Exhibit 5 reflects the BEE financing structure employed by Metropolitan to transfer 10% of the equity ownership in the company with some adjustments.

KTI (via a wholly owned subsidiary) incorporated a private company to be the vehicle to finance the transaction. KTI subscribed for the shares in the SPV for a consideration of R30 million. The SPV was required to issue redeemable preference shares amounting to R510 million to a consortium of banks. The proceeds were used to purchase 75.84 million convertible preference shares issued by Metropolitan at a subscription price of R7.12 per share. The preference shares in Metropolitan were convertible on a one for one basis after year three and if not converted would be compulsorily redeemable at the end of year five after issue. The benefit of this structure would be that the preference dividend income stream to the SPV would more or less match the preference dividend payable by the SPV to the banks.

Note that the capital amount achieved can be redeemed by the either partial sale of equity or refinancing of the debt, and continuing with preference dividend payment.

This resulted in a lower level of equity dilution as compared to the immediate subscription for ordinary shares in Metropolitan.

Kagiso further subscribed for 12.7 million convertible preference shares in July 2005 and this was followed by a further subscription for 47.1 million shares in December 2005. The shareholding by KTI amounts to about 17% but this will be subject to dilution when the preference shares are required to be converted.

If we analyse the first subscription for convertible preference shares, then we estimate that the NEV will be approximately 6%. This is relatively favourable due to the share price doubling from a conversion price of

R7.12 to R14 during the period as well as the structure avoiding ongoing deficits during the period prior to conversion.

The share price performance over 3.5 years represents a growth in market capitalisation of about 21% per year. This high growth will have resulted in a favourable effect on NEV but such share price growth is unlikely to be sustained over the long term.

This means that the conclusions reached in our analysis remain valid as we have analysed likely share price performance over the long term and its likely effect on BEE equity dilution. The share price performance of Metropolitan is unlikely to be sustained in the long term but has been very positive for BEE equity ownership in the period under review.

## **4.2. ABSA and Batho Bonke Consortium**

In 2004 ABSA concluded a BEE transaction with a Mvelaphanda-led consortium. An SPV called Batho Bonke was formed. The salient features of the deal are:

- The creation of a new class of share – a redeemable cumulative option – holding preference share with par value of R2.00.
- 73 152 300 redeemable preference shares were issued to Batho Bonke with voting rights equal to an ordinary ABSA share
- Holders have the option to subscribe for ABSA shares between 2007 and 2009
- Preference dividends to be paid at 72% of the prime rate
- A lock – in provision for 50.1 % of the ABSA ordinary shares arising from the exercise of options until 31 March 2011
- Each redeemable preference share allows its holder to subscribe for one ABSA share based on the 30 day volume weighted average trading price of an ABSA ordinary share:
- If weighted average share price is  $\leq$  R70 then the option strike price = R48;
- If weighted average share price is  $>$  R70,00 and less or equal R100 , then the option strike price will be R48,00 plus 70 cents for each complete R1,00 increment in the share price over R70,00;
- If the weighted average share price is  $>$  R100, then the option strike price will be R69,00
- The price of ABSA shares was R100,50 as on the 7<sup>th</sup> of February, 2008, (Business Report 07/02/2008). However, the share price had previously reached a level of over R140 per share.

The issue of 73.152 million option-holding redeemable preference shares amounted to 10% of the issued share capital of ABSA. However, in terms of this BEE transaction, ABSA valued these options using a standard option pricing model and the value of the options amounted to R858.6 million at the time. This represented 2.8% of the market capitalisation of ABSA at the time.

The share price of ABSA has performed strongly though the share price has retreated recently partly due to the global effects of the sub-prime crisis as well as higher interest rates and a weaker outlook for the local economy.



Exhibit 18 ABSA Share Price Performance

We will analyse the value of the options at expiry in 2009 and compare this to an option price of R69 per share assuming that the share price will remain over R100 per share. As ABSA is trading at a Price-Earnings ratio of 8.5, it is highly probable that the share price will be above R100 at the expiry date.

Exhibit 19 indicates the share prices and the effective BEE net equity value at each share price. At a share price of R140 per share, the effective BEE equity ownership will amount to 5.5% whilst at a share price of R260, the effective ownership is 8%.

A future share price of R100 in 2009 will mean that the option will have a value of R31 at expiry date. At a share price of R120, the value at expiry will be R51 and the total value of the options is plotted in relation the market capitalisation of ABSA at the time.

As the share price was trading at R58 in 2004, if the share price is R100 in 2009, then the growth in market capitalisation will have amounted to 12% per year. A share price of R140 per share would reflect a growth rate of 19% per year in market capitalisation whilst a share price of R260 implies a share price increase of 35% per year<sup>9</sup>. This represents compound growth rates. Whilst these growth numbers are demanding, the reality is that the share price has doubled in the last 3 years and based on its current Price-Earnings ratio, the share remains attractively priced.

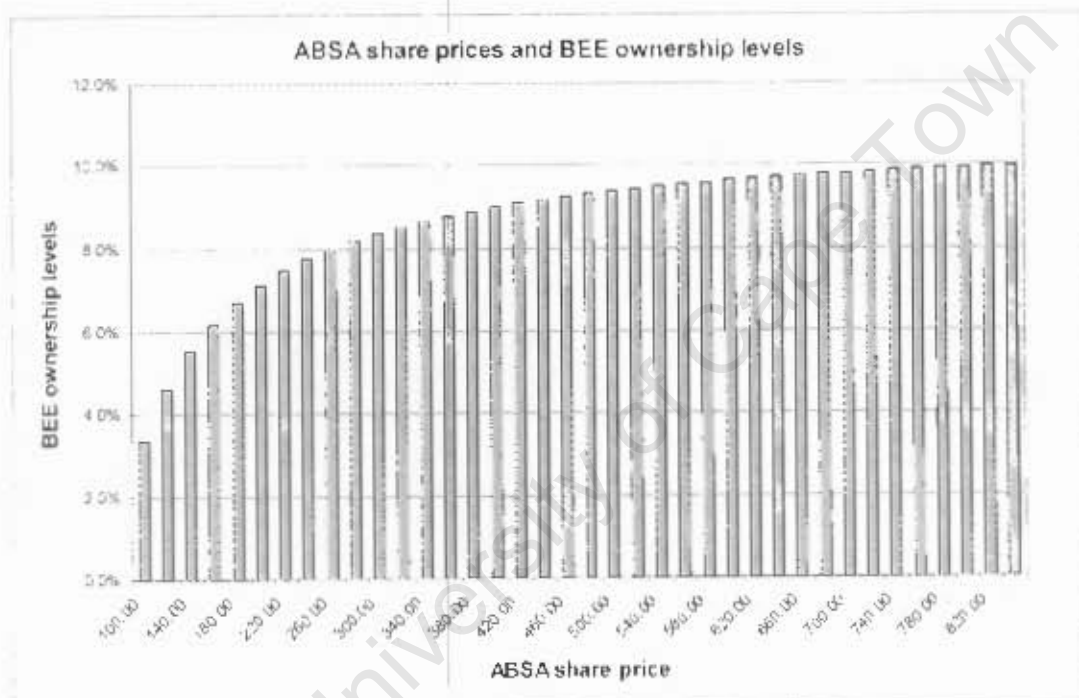


Exhibit 1819 ABSA Share Prices and Net Equity Value

It is estimated that the BEE Company in ABSA will achieve a Net Equity Value of between 6% and 8% in ABSA before the option expiry date in 2009. Although this is less than the announced deal of 10%, there will have been a significant increase from 2.4% NEV at the time of the announcement of the transaction.

A relatively strong equity market offering equity returns between 30 to 40 % per year in the years 2004 to 2006 has enabled BEE transactions to obtain higher Net Equity Values than would be expected to occur in a period of normal equity returns.

<sup>9</sup> Note that the doubling of the share price over a period of 3 years represents a compound growth rate of 26% per year

This study has evaluated two case studies in a period of abnormally high equity returns and very low interest rates. Yet in the longer term, the examples set out in Chapter 3 indicate how fragile BEE is in a normal equity market and in a market subject to higher interest rates. In order to plan for a future equity market which will offer returns closer to the long term average and an environment of relatively high interest rates, it is imperative that the issues arising from Chapter 3 are examined in relation to the long term effect on BEE equity ownership in South Africa.

## Chapter 5

### 5.1. Findings, conclusion and policy implications.

This study has revealed some less than satisfactory outcomes as they relate to the future of BEE and its intended policy objectives. There is no doubt that the objectives set by government and corporate South Africa are noble and necessary. In this section we therefore summarize what we found and also try and understand the implications for the policy objectives. It should be remembered that BEE policy was adopted as one of the ways of dealing with apartheid legacy which denied black people access to economic opportunities. We make the following findings about the funding structures and their impact on effective ownership;

- There are major similarities and differences between LBOs and BEE funding structures. The major similarity is that both LBOs and BEE funding structures are highly leveraged. They both rely on some form of debt financing to acquire equity in operational companies. The principal difference is that after the transaction, LBOs have more control on management and strategic direction of the company, while such control is very much curtailed in the case of BEE structures.
- This makes the investors to be very vulnerable to the changes in the economic environment. Increasing interest rates pose risks to both LBOs and BEE structures.
- We discovered that in LBOs transactions, interest rates risk and other risks can be mitigated by ensuring that you have high quality managers, who in many cases can outperform the equity markets. However, BEE investors are in many cases unable to put in their people in companies. It continues to be business as usual with no slightest chance of mitigating agency costs and other problems. Shareholder agreements which normally are a product of intense negotiations in LBOs are imposed on BEE parties. We mentioned above that the power relations between BEE investors and white companies tilt in favour of established companies.
- Therefore in BEE deals the investors are not able to come in with new strategies to mitigate risks associated with highly leveraged companies and have little influence over dividend policy and asset sales.



- Although LBOs are long term investments, the investors there can decide to sell if they are of the view that they have maximized returns on their investments. This is not the case with BEE investors. They are expected to sign agreements which prevent them from exiting their investments before the expiry of a certain period, usually seven to ten years. This has resulted in BEE investors losing a lot of value. The ABSA experience with Batho Bonke is a case in point when the share price fell from over R140 to R101.
- Based on the funding structures that are mostly used, Net Equity Value for BEE investors may end up being much lower than what was announced when the transaction was entered into, assuming normal equity returns. We saw in an example of GIGA LTD, where a BEE transaction started at 51% but with favourable conditions ended up only transferring 12% of NEV to BEE investors when the structure matures after 5 years. This picture deteriorated significantly when economic conditions changed. In fact when two variables changed at the same time for worse, probability of bankruptcy increased for BEE investors.
- The ABSA case study was instructive because it showed that despite the Financial Sector Charter objective of transferring 10 % effective ownership of Financial assets to black people by 2010, it was unusually high equity returns that will result in a NEV of between 6% and 8% when the structure matures.
- The research proves that the objective that government set itself to transfer 25% of the economy by 2014 to black people will be difficult to achieve, with the current BEE funding structures, and under normal economic conditions. This means that with equity market returns of around 14%, and interest rates at their current levels, reaching 25% government objective is very difficult. If the economic conditions deteriorate, then the target becomes even more difficult to achieve. This will put BEE policy and funding structures under severe criticism from the intended beneficiaries. We have already seen that the economic melt- down of the late nineties resulted in many BEE failures and structures were unwound.
- We said earlier that failure of BEE policy to deliver on its promises may lead to political instability, with negative consequences to established business performance and Foreign Direct Investment. Government, private sector, economists and financial practitioners need to re-strategize to avert political instability which may create problems akin to those of our neighbour, Zimbabwe.
- We hope this research will at best stimulate debate timeously to try and avert acrimony and instability when these structures do not deliver on their expected outcome. This may cast doubt to the ability of the market to deliver on the expectations of the majority of South Africans.

**Annexure A: Empowerdex Rankings and Profitability and Return Ratios**

Company	NP Margin	OP Margin	ROA	ROE	
	2006	2006	2006	2006	2006
1 Enaleni Pharma	13.55	24.07		47.26	10.72
2 Adcorp Holdings	4.22	4.59		24.11	36.65
3 The Don Group	-10.86	7.51		2.35	7.68
4 Oceania Group	5.4	6.97		16.63	16.7
5 Hosken Consolidated	12.6	18.94		6.3	15.19
6 Sekunjalo	15.85	21.65		16.49	18.45
7 Cadiz	45.66	50.31		11.74	27.02
8 Bytes technology	4.99	8.13		24.01	29.52
9 Metropolitan	26.23	4.47		3.9	29.09
10 Bidvest Group	2.9	4.78		15.54	30.0
11 Glenrand MIB	10.1	-10.99		-0.28	44.84
12 Phumelela	2.85	3.96		28.19	27.48
13 Primedia	8.67	14.91		21.36	35.83
14 Trans Hex	-11.1	-11.64		-9.22	-12.58
15 Old Mutual Plc	8.6	8.6		2.65	12.46
16 MTN Group	20.56	32.51		31.68	27.42
17 Paracon	6.94	8.52		32.44	22.33
18 Peermont Global	17.70	33.92		7.95	19.44
19 Sanlam	N/A	N/A		3.43	29.03
20 Teikom	19.6	30.8		25.6	31.48
21 GijimaAST	1.19	3.68		9.28	8.81
22 Barnard Jacobs Mel	20.11	23.58		2.64	20.88
23 Nedbank	N/A	N/A		5.85	18.05
24 Business Connexion	3.86	5.05		9.98	10.05
25 Gold Fields	9.51	16.74		8.58	7.58
26 Exxaro Resources	126.63	128.03		132.6	213.78
27 Harmony Gold	-6.53	-0.45		0.26	-2.26
28 Group 5	2.45	4.4		5.35	21.07
29 Aving	3.66	3.82		10.26	16.69
30 African Rainbow	16.32	39.33		0.16	11.1
31 Sun International	15.69	25.23		22.13	30.26
32 ABSA Group	N/A	N/A		7	25.44
33 Mutual & Federal	10.13	15.57		20.87	25.34
34 Jasco Electronics	5.46	8.46		22.05	16.96
35 Faritec	3.4	4		6.4	16.7
36 Aspen Pharmacare	18.48	25.9		21	50.9
37 Standard Bank	N/A	N/A		5.44	24.61
38 Mustek	1.93	3.36		7.52	12.33
39 FirstRand	N/A	N/A		5.28	27.77
40 Imperial	4.15	7.88		12.69	22.47
41 Edcon	8.54	11.89		35.85	42
42 Alexander Forbes	1.06	15			15
43 Santam	14.58	14.6		14.9	28.02
44 Enviroserv	8.96	12.55		13.83	23.51
45 Super Group	3.33	6.62		13.43	23.48
46 Distell Group	7.96	12.24		17.09	16.34
47 Advtech	10.4	14.73		25.24	26.38
48 Foschini	18.28	14.14		26.64	37.66
49 Merafe Resources	13.5	14.88		7.31	12.58
50 Distribution & Ware	7.37	11.68		20.86	38
51 Comair	3.99	6.75		14.17	21.41
52 SABMiller	9.69	16.82		26.6	11.38
53 Impala Platinum	24.83	37.19		30.29	31.37
54 Coronation Fund	27.82	46.34		7.15	15.72
55 Brimstone Investment	290.89	383.61		53.99	69.92
56 Mvelaphanda Group	37.06	35.84		25.61	25.12
57 Compu-Clearing Out	19.08	23.89		25.8	18.8
58 Omnia	3.55	6.68		14.77	15.1
59 Lewis Group	15.69	23.09		23.66	19.56
60 AngloGold Ashanti	2.81	7.03		2.82	-2.81
61 Growthpoint Prop	0.04	66.23		6.42	1.55
62 The Spar Group	2.4	3.54		18.99	45.67
63 African Oxygen	23.81	28.16		31.85	41.46
64 Network Healthcare	13.23	13.64		5.2	68.72
65 Investec	N/A	N/A		5.1	41.07
66 Tiger Brands	13.75	18.96		38.41	50.78
67 Massmart	2.75	4.22		16.73	43.56
68 Kagiso Media	18.19	34.11		64.69	40.5
69 African Bank	N/A	N/A		28.1	44.86
70 BHP Billiton Plc	32.5	34.03		31.14	43.15
71 Investec Plc	N/A	N/A		5.21	26.05
72 Sappi	-0.08	2.61		2.81	0.29
73 Sasol	12.59	25.16		20.83	19.81
74 Command	6.69	12.39		25.69	34.37
75 Control Instruments	7.35	10.54		14.63	16.19

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