

# Taking a step back



Having held up reasonably well until last autumn, the South African economy is now feeling the pinch of the global slowdown. And, while the medium-term outlook for deals is reasonably healthy, the short-term picture is not looking rosy. Vicky Meek reports

**B**ack in the autumn last year, South Africa's private equity houses were pretty sanguine about the market there. Having experienced a year like no other in 2007, which saw a 270% increase in investments by value over the previous year, with a large element of that accounted for by one single deal (the R27bn Edcon acquisition by Bain Capital), they were not too concerned by the fact that the market had returned to something like more normal levels. And indeed, the figures for 2008 show only a slight fall in transaction values, from R26.1bn in 2007 (of which R8.7bn was the equity value of the Edcon deal) to R21.3bn in 2008: strip out Edcon and there was actually an increase.

## Reasons to be cheerful

There were reasons to be cheerful: local banks were still lending and there was talk of a mini-boom surrounding the construction and infrastructure activity in preparation for South Africa holding the football World Cup in 2010. The economy wasn't in that bad shape either: it was still growing, with the major concern being high inflation. There might not have been the mega-deals of the previous year getting done, but there was reasonable activity.

It's very different now. "The picture in South Africa is not currently encouraging," says Warren Watkins, of KPMG in South Africa. "Private equity houses all have at least two to five deals that they are working on, but none of them are in proactive buying mood. Unless a deal jumps out at them in

terms of price, they are reticent. It's a very quiet place and a very different one from this time last year."

## Time lag

In common with most markets, the uncertainty over earnings is holding back deals to a large degree. "South Africa lags the US and Europe," says John van Wyk, partner at Actis. "Until around March this year, the contagion hadn't spread as far as here. It was only then that we started to see the effect on corporate earnings filter through and that has still to happen to some degree – the effect will be quite material. There is a widespread concern about the drop-off in earnings, but many vendors seem to believe that we are at the bottom. I'm not sure that is the case."

After growing steadily for nearly two decades, the South African economy is now witnessing the effects of its first recession for 17 years. To stimulate spending, interest rates have been reduced five times since the end of last year and now stand at 7.5%, markedly lower than the 12% of the autumn 2008, and the money is on further rate falls.

"South Africa is in a tough situation right now," says Sven Soderblom of CDC Group, which has investments in several South African funds. "The economy is not going in the right direction and that is having an effect on private equity. There is a general slowdown in the market and the LBO market, which is quite developed there, is suffering from a lack of debt availability."

Most participants report that, unlike in other more developed markets, banks are lending to some degree, although on much tougher conditions than previously. Having been insulated from much of the financial crisis by South Africa's exchange controls, the banks are in a relatively healthy state, but they are generally highly cautious for the time being. "The banks have tightened their lending criteria and the quantum they are prepared to lend has dropped off," says Warren Hibbert, partner at MVision. "They have not been directly affected by the credit crisis – it's more a case of conservative lending while market and growth prospects remain uncertain. There is liquidity, but the appetite for lending has been stunted. It won't take long to switch back, but it requires broader market confidence."

### Spate of restructurings

And confidence will be in short supply as long as the prospect of restructurings in a number of companies looms large. "I know of quite a few private equity and non private equity-backed companies with high leverage that are being restructured as we speak," says van Wyk.

"There hadn't been much in the way of restructuring activity until recently; companies had been shielded from restructurings as the good months from last year were still filtering through in results," adds Warren van der Merwe, CFO of Vantage Capital. "Now the bad months are starting to come through, the restructurings have started and although we haven't seen debt for equity swaps yet, that may be in the next round." One of the earliest casualties was Brait portfolio company Primedia, which was forced to restructure last summer as the cost of debt started creeping up.

### Death of LBOs?

The market may well even see the development of its LBO market go into reverse. "As a result of the recent crisis, the LBO model has hit a setback," says Nathan Mintah, partner at Kingdom Zephyr. "We will see a pick up, but we won't go back to the racy pace of 18 months to two years ago. It has become lodged very firmly in people's minds that a lot of LBOs have gone pear-shaped. Those LBOs that get completed will be done on the basis adding fundamental value to companies rather than on the expectation that multiples will expand."

It's a trend noted by Hibbert, too. "The large deals are a thing of the past as these

*One of South Africa's oldest and best known private equity firms, Brait has been investing since the early 1990s. Sean Dougherty outlines the firm's fundraising and investment strategy.*



Sean Dougherty, Brait

As one of the most established names on the South African private equity landscape, Brait's latest fundraising will be watched closely by other local players. The firm is seeking a similar size capital pool as for its fourth fund which closed in early 2007 at \$880m including a debt facility.

It is starting its efforts on the local market, says the firm's Sean Dougherty. "We feel it's important to demonstrate local support for the fund before going to international investors," he says.

"We've traditionally had support from local pension funds as well as life companies. Our existing pension fund investors should be supportive, although the life companies may have some maths to do before they can commit."

The firm is expecting broadly the same mix of international investors versus domestic ones for this fund as the last (which was 75% to 25%, respectively).

Part of a broader alternative assets management house that incorporates hedge funds, and mezzanine investing, the Brait private equity business has been in existence since the early 1990s. "We tend to make investments / write cheques of between R100m and R1bn," says Dougherty. "Our sweet spot is the R400m to R600m mark."

Brait IV is now almost fully invested and the fund includes investments in Johannesburg Stock Exchange-listed contract mining and construction business Buildmax, in which the firm acquired a 24% stake last autumn, glass company Consol, food manufacturing business Premier Foods and media business Primedia.

The new fund will look for similar opportunities. "We look at industrial

opportunities as well as services, which account for around 55% of the South African economy," says Dougherty.

"We're also interested in the cash consumer. Even with the downturn, the lower to mid-market part of the economy, the informal sector, is being driven by increasing disposable income."

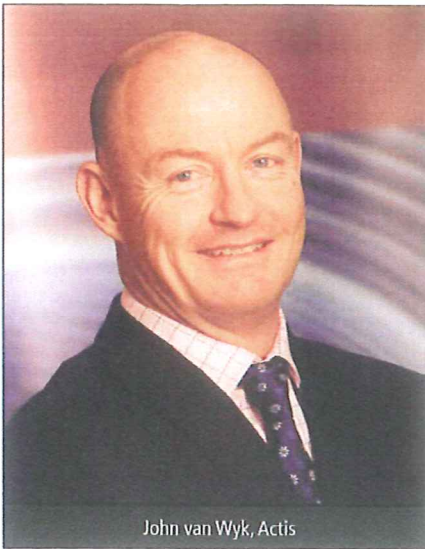
It will also look at the companies supplying services and goods into the infrastructure sector, which is being driven by government spend of nearly R900bn over the next three years, plus some private sector investment.

As with its previous fund, Brait V will be able to invest up to 20% of its capital outside South Africa. But the firm is not currently focused on making a slew of investments elsewhere in the African continent as its 14 investment professionals and most of its operational advisers are based domestically.

"We like to be close to the management team and portfolio company," says Dougherty. "It's not in our DNA to make investments elsewhere without a team on the ground and it takes a lot of time and effort to build these. We'll consider doing this over time, but it's not a short-term plan."

Yet Brait is convinced of the growth other African countries offer.

"There are a lot of very exciting opportunities in Africa," says Dougherty. "Some 20% of the revenue of the portfolio companies in Brait IV comes from outside South Africa and that's what we'd seek to achieve with our next fund. We don't have to make investments on the ground in order to access the higher growth rates that parts of Africa outside South Africa have to offer."



John van Wyk, Actis

*"The picture in South Africa is not currently encouraging. It's a very quiet place and a very different one from this time last year."*

*Warren Watkins, KPMG*

were done when the market had access to the European high yield bond market and local bank credit committees with greater risk appetites," he says. "Buy-out investors are having to demonstrate genuine operational value-add and control over their portfolio companies in order to drive them through this difficult period unscathed. The banks are constantly looking for more equity protection below their senior and mezzanine tranches. The type of deal is also evolving into more of a buy-and-build/growth capital style than typical LBO for obvious reasons."

Nevertheless, some say there is finance on the table for the right deal. "Bank funding really depends on whether the institution is under or overweight in particular sectors as our banks are now adhering to Basel II," says Ngalaah Chuphi, partner at Ethos. "We closed the Idwala deal in December 2008 with debt at about 4x EBITDA [as opposed to the maximum 3.5x EBITDA now seen in the market] because it was a good business in a sector that the bank wanted exposure to. We are finding some banks coming to us looking to fund particular assets or opportunities, so there are pockets that will lend."

### Dry powder needed

Yet it's not just the availability of bank debt that will impede the return of LBOs. Firepower is a big factor. KPMG and SAVCA's annual review of the industry suggests that private equity firms have R29.2bn in uninvested capital. But some believe the figure is actually much lower. Two of the country's major funds, Brait and Ethos, are currently out in the market seeking around the US\$600m to US\$900m mark apiece

and both are believed to have scaled down their original ambitions in response to market conditions. Absa Capital Private Equity, which is understood to be spinning out from its banking parent, is also understood to be on the fundraising trail.

Local LPs may be generally supportive to domestic funds, but there is a question mark over what international LPs will do. "Some are simply focusing on their core markets and so wouldn't invest in South Africa because of that," says Soderblom. "Those that are looking at emerging markets may well take the view that if they can invest in other markets that are still growing, why would they want exposure to South Africa, which is in recession?"

Less established funds will also find the market tough. "One complication in the market is that a lot of funds raised for the first time over recent years and they are now looking to raise successor funds in very difficult conditions," says Fourie. "There will be a shake-out of these."

### Opportunity knocks

Yet it's not all doom and gloom. Some funds do have the firepower and desire to invest. Actis is one. Having raised its near \$3bn fund for emerging markets last December, it is also of the view that it needs to continue investing in South Africa and elsewhere. "There are opportunities now and we would invest now," says van Wyk. "We need to invest across the cycle, and that includes the bottom. We may even invest on the basis of leveraging in a few years' time when the market has improved."

There is a feeling that deal flow may start to return towards the end of the year, even if the economy isn't in better shape. If South Africa sees several bad quarters, as many are expecting, at least price expectations will come down and there will be better visibility about which companies are most likely to weather the storm.

And there are some brighter spots to the market. "People are very cautious and earnings visibility is low," says J-P Fourie, executive officer of the South African Venture Capital and Private Equity Association. "Things are ticking along, but the country

is technically in recession. The positive side is that there is still significant headroom in interest rates, so there is scope for the Reserve Bank to bring these down to stimulate the economy. There is also a lot of infrastructure spend still to happen that is being funded by prudent budgeting on behalf of the government."

Indeed, many firms cite the companies that provide services to the infrastructure companies and projects as being major opportunities for them now and in the future. And it's hardly surprising, given the scale of work involved. The South African government has committed to spending close to R800bn (US\$100bn) over the next three years on infrastructure projects, such as road-building, rail, power plants, ports and airports, not to mention the preparations for the World Cup next year.

Services is another key area. While many may see South Africa as a large resource exporter, it has a reasonably diversified economy, with primary industries only representing around 10% of GDP.

"The tertiary industries are doing reasonably well," says Chuphi. "Even in some mining services, you are seeing good results as infrastructure spend and certain maintenance schedules have been brought forward because it's a quieter time for extractive industries." Many also see greater opportunities in the informal parts of the economy that are driven by ready cash rather than credit. "There is still strong growth in the small scale cash retailers and corner stores in the townships," says Hibbert. "These cash-reliant sectors are showing great resilience, buoyed by the growth in the emerging middle class."

### Smaller but stronger

Once the dust settles, it appears as though the opportunities for investment will be there, albeit on a smaller scale than some have been used to over the last few years. Most people believe that the issue of available capital for both funds and acquisition finance will work through over the short-term, leaving a market that will have been shaken but perhaps even strengthened by the experience of the crisis.