Value Creation in Private Equity: The South African Context

A Research Report
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University of Cape Town

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of the requirements for the
Masters of Business Administration Degree

by

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Supervisor: Dr. Francois Toerien
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Also, thank you to all of the industry professionals who participated in this Research and who, because of the anonymous nature of the research design, I cannot thank specifically. I remain humbled at the broad response in particular in the given short time frame and, notwithstanding, the extent of your generosity and willingness to contribute.

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Master of Business Administration

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- I know that plagiarism is wrong. Plagiarism is to use another’s work and pretend it is one’s own.

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______________________________

Name: Marlene Miller

Exam Number: FT443

Date: December 2010
ABSTRACT

The recent “financial crisis” continues to reshape the private equity investing landscape, prompting private equity (PE) practitioners to re-think their value-creating strategies and academics to revise enquiry into the subject of PE’s asserted “superior returns” relative to public equity markets. Despite the fact that “the scale of [South African PE] continues to outperform most of the major international economies,” seemingly absent from local PE debate is similar investigation. The purpose of this report is not to prove causality but to capture context-specific, practitioner perspective. This study seeks to address a gap in the existing literature by documenting, from a South African fund practitioner perspective, the “determinants” of improved returns and/or factors that influence PE returns.

Using a Likert-type scale questionnaire, complimented by 7 in-person interviews, a survey population of 40 South African private equity fund managers were asked, in the context of their fund experience, to rate and to indicate the extent of their agreement with various identified and hypothesized sources of private equity value creation identified in the literature. A 55% survey response rate was achieved. Data analysis follows with a descriptive presentation of both the survey and interview results.

Key findings confirm global trends in the belief that operational engineering will increase relative to that of financial (83% of PE managers surveyed), and that credit markets will remain restricted for the foreseeable future. In particular, findings specific to the South African context include the opinion that capital overhang could increase future competition for PE deals (56% of PE managers surveyed “strongly agree” with this); the perception of greater domestic opportunity relative to PE abroad as afforded by a relative lack of competing intermediaries; the unique scope of domestic investment opportunity provided by a historically entrepreneurial market; the positive effects to PE returns of BEE, of Multi-lateral Development Finance (MDFI) association and increasingly, of a regional African investment focus. However, this report ultimately finds that PE is too interdisciplinary and heterogeneous to definitively distil the sources of return into a few concise elements.

Keywords: IRR, Value creation, Returns, Private Equity, South Africa

1 Kaplan (2009); Campbell & Legere (2009, p. 6); Matthews, Bye & Howland (2009); 2 SAVCA (2009, p. 4)
4 Intermediaries who advise entrepreneurs/ investees/ act to dilute PE firm-advantage in their knowledge of deals on the market
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GLOSSARY OF TERMS

“2 and 20” - Private equity fund managers charge at least 2% per year on committed capital and a further 20% of performance in “carried interest”.

Black Economic Empowerment (BEE) - The economic empowerment of all black people, including women, workers, youth, people with disabilities and people living in rural areas, through diverse but integrated socio-economic strategies.

Emerging markets private equity (EM PE) - uses SAVCA/ Coller Capital (2010) convention to refer to private equity in the emerging economies of Africa, Asia, Central and Eastern Europe, Russia/ CIS, Latin America and the Middle East.

Private equity investment stages:

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<th>Stage of business development</th>
<th>Typical application</th>
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<td>Venture Capital</td>
<td>Prototype development - pre start-up (seed capital)</td>
<td>Funding for research, evaluation and development of a concept or business before the business starts trading. Funding for new companies being set up or for the development of those that have been in business for a short time (1 to 3 years).</td>
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<tr>
<td>Development Capital</td>
<td>Expansion and development</td>
<td>Funding for growth and expansion of a company which is breaking even or trading profitably.</td>
</tr>
<tr>
<td>Buyout Capital</td>
<td>Leveraged buy-out or buy-in</td>
<td>Funding to enable a management team or empowerment partner - either existing or new - and their backers, to acquire a business from the existing owners, whether a family, large corporation or other entity. Unlike venture capital and development capital, the proceeds of a buy-out are generally paid to the previous owners of the entity. Buy-outs are often leveraged through the use of debt capital. Funding for the purchase of existing shareholding in a company from other shareholders, whether individuals, other venture-backers or the public through the stock market. Similar to buy-out capital, the proceeds of replacement capital generally are paid to the previous owners of the equity.</td>
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(Source: SAVCA & KPMG, 2009, p. 12)
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<td>Black Economic Empowerment</td>
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<td>CGT</td>
<td>Capital Gains Tax</td>
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<tr>
<td>GSB</td>
<td>Graduate School of Business, University of Cape Town</td>
</tr>
<tr>
<td>DBSA</td>
<td>Development Bank of South Africa</td>
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<tr>
<td>DFI</td>
<td>Development Finance Institution</td>
</tr>
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<td>EBITDA</td>
<td>Earnings before interest, tax, depreciation and amortization</td>
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<td>EM</td>
<td>Emerging markets</td>
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<td>EM PE</td>
<td>Emerging markets private equity</td>
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<td>EV</td>
<td>Enterprise value</td>
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<td>EVCA</td>
<td>European Private Equity and Venture Capital Association</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>GP</td>
<td>General Partners (private equity fund managers/ firms)</td>
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<td>IPO</td>
<td>Initial Public Offering</td>
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<td>IRR</td>
<td>Internal Rate of Return</td>
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<td>LBO</td>
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<td>MBO</td>
<td>Management Buy-Out</td>
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<td>MDFI</td>
<td>Multilateral Development Finance Insitution</td>
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<td>PE</td>
<td>Private Equity</td>
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<td>PPP</td>
<td>Public Private Partnership</td>
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<td>SMME</td>
<td>Small Medium and Micro Enterprises</td>
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<td>SSA</td>
<td>Sub-Saharan Africa</td>
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<td>UK</td>
<td>United Kingdom</td>
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<td>US</td>
<td>United States of America</td>
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<td>USD</td>
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1. INTRODUCTION:

Research Area, Context, Research Problem, Purpose and Significance

1.1. Research Area

Broadly defined, private equity investment refers to the acquisition and financing in return for an equity stake of companies (either publicly listed – “take privates” – or private businesses owned by founders, families, trusts or indeed other private equity funds) by professional managers of investment funds (Arnold, 2005). The South African Venture Capitalists Association (SAVCA) specifies that private equity can be broadly classified into three sub-classes; venture capital, development/expansion capital and buy-out (Leveraged buy-out or buy-in/Replacement Capital) funding (SAVCA & KPMG, 2010, p. 9, 10; Diagram 1, p. 6). The two main categories of private equity (PE) investment are venture capital (VC), which refers to a much earlier stage of financing of newer companies and typically does not obtain majority control; and buyouts, which focus on later stage financing of mature businesses that have a more established customer base and business model and in which the private equity fund typically buys majority control of the firm.

Adopting SAVCA convention, late-stage private equity deals can be further segmented into two main categories; development capital and buyouts (see: Glossary). Development capital generally applies to businesses in the “expansion or development” stage of business development and typically involves “funding for growth and expansion of a company which is breaking even or trading profitably.” Buyout capital includes investments at that stage of business development that includes “leveraged buy-outs or buy-ins and replacement capital.” (SAVCA, 2009, p. 12). The term “leveraged buyouts” (LBO) is more commonly used to refer to those investments financed using a relatively small portion of equity and a relatively large portion of debt financing issued in the form of bonds and loans under the companies name (Kaplan & Stromberg, 2008). Replacement capital involves “funding for the purchase of existing shares in a company from other shareholders, whether individuals, other venture-backers or the public through the stock market. Development and buy-out investment firms today refer to themselves (and are generally referred to) as private equity firms4.

Dominate the profile of South African PE; notably, leverage-sensitive buyouts represented 39% of all unrealised PE investments in 2009.

In South Africa (SA), late-stage PE investments such as buyout and expansion/growth capital dominate the profile of PE; leverage-sensitive buyouts represented 39% of all unrealised PE investments in 2009.

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4 This report follows convention (Kaplan & Stromberg, 2008) and SAVCA (2009), in using the term “private equity” to refer to late stage investments including growth/replacement capital, development capital, mezzanine funds, buyouts or equity investments in mature companies by equity limited partnerships; it excludes early-stage, “venture capital” investing.
- an exception to the rest of Sub-Saharan Africa, where underdeveloped debt markets and the relatively smaller scale of opportunity to invest (USD 3-10 million typical deal sizes) translate into a still quite nascent buyout market (Evaluserve & SAVCA, 2010, p. 13). In 2009, of 81 LPs (limited partners) surveyed globally, while most “overwhelmingly favored growth equity across the BRIC (Brazil, Russia, China, India) emerging markets” the majority “found buyouts [relatively] more attractive in South Africa” (EMPEA, LP survey, 2008, p. 6). This report focuses specifically on late-stage PE investments (see: Diagram 1).

The reasons for this report’s focus on late-stage private equity is two-fold:

1). The profile of private equity in South Africa is dominated by later stage investments such as buy-out and development capital (see: Diagram 2). This inferably renders this report of greater and broader relevance to various PE stakeholders, including investment practitioners and academia.

2). Late-stage PE-backed companies have typically already reached a mature state; data access hence generally makes it easier to analyze the impact on returns for such established companies than for those that are in a continuous state of flux (as is common of seed/ VC). (Bengtsson, Nagel, & Nguyen, 2008).
1.2 Context: Background: The SA private equity market

PE’s relevance in South Africa as an alternative asset class both locally and internationally remains undisputed: “the scale of [South African PE] continues to outperform most of the major international economies,” (SAVCA, 2009, p. 4). At the end of 2009, funds under PE management in South Africa totalled R106.6bn, representing a 14% annual compound growth rate of 14% since 1999 and measuring 3% of GDP as compared to an international norm of 2.7%. While capital overhang implies increased competition for deals in the future, it has on closer examination been decreasing year-over-year: (R. 40.5bn to 32.9bn, and R28bn to R23.2bn from 2008 to 2009 respectively, reflecting total and independents undrawn commitments, respectively). Notwithstanding Emerging Asia’s prominence among emerging markets, South Africa’s PE penetration as measured by total PE investment to GDP ratio outperformed that of the BRIC countries (2006-2008). In 2009, of 30 countries surveyed South Africa’s PE investment to GDP ratio (0.38%, which ranked the country 10th) was notably ahead of the 2 preeminent emerging market PE investment destinations, China and India (0.14% and 0.07%, ranking these countries 22nd and 26th, respectively) - (Evaluserve & SAVCA, 2010, p. 6; SAVCA & KPMG, 2010, p. 34 ). Notably, South Africa’s aforementioned 0.38% PE GDP penetration was marginally higher than the 0.37% recorded in the USA, which is thought-provoking, considering that the U.S is “the world’s largest private equity market” (Apax Partners Ltd/ The Economic Intelligence Unit, 2007, p. 9).

From 2006 to 2008, Africa’s perceived risk premium fell from 8.9% to 6.7%, while 31% of global LPs surveyed by EMPEA judge South Africa with a risk premium of [relatively] “less than 5%.” (EMPEA, 2008, p. 4)5. The proportion of global LPs investing in the continent increased by one of the largest levels witnessed by emerging markets, climbing seven-fold to 31%, up from 4% in 2006 (2008, p. 8). Of global LP investment in Africa in 2008, SA represented 40% of all funds raised, over 70% of all capital invested and 56% of the number of transactions (Evaluserve & SAVCA, 2010, p. 3). While in value terms PE investment fell 63% (in line with the general dip in large global deals), it is noteworthy that actual number of new investments – i.e. 457 in [South Africa] in 2009 was in line with 2008 levels – i.e. 458, and in fact outweighed follow-on investments in 2009 - i.e. 147 deals.

South Africa ranks 13th among 20 countries ranked globally by PE funds raised and by investments made since 2007. Further, it is the only African country that is represented amongst that group (SAVCA & Evaluserve, 2010, p. 6).

Of the R 5.6 bn funds raised by the South African PE industry in 2009, as a proportion of third-party funds the US’ allocation increased significantly to 51% (from 18% in 2008). Domestic fund-raising was similarly significant; of that R5.6bn South Africa’s contribution was 36% (up from 22% in 2008)

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5 Ibid footnote 5 (EMPEA, 2008, survey of 81 Limited Partners (LPs) investors balanced across institutions.)
(SAVCA & KPMG, 2010, p. 23, 25). Haarmeyer (2008) further confirms that “an important indicator of private equity’s legitimacy and long-term success is firms’ ability to raise successive funds - in other words, to return to the market to raise capital from new and existing investors.” (p. 255). This continued willingness of both local and global LPs to invest in South African PE suggests investor confidence in the continued ability of local PE fund managers to create value.

Assuming that the asset market is rational, and that the institutions and individuals who invest in PE supply their capital competitively, it follows that they would only provide capital to PE firms until their risk-adjusted expected returns (net-of-fees) equaled the expected returns they could earn elsewhere (Ljungqvist & Richardson, 2003b). This finding further suggests that South African PE are able to optimize returns, making it interesting to investigate local PE perspective on the subject.

1.3 Research Problem

This report’s research problem is to uncover new insights and to attempt to identify, as rated in importance by PE practitioners and in the context of their funds, the “determinants” of improved returns and/or factors that influence the optimization of PE returns.

1.4 Research Purpose

The overall purpose of this report is to enhance knowledge for PE stakeholders on the interventions and/or determinants that help South African PE practitioners aim to maximize returns relative to the public market (SAVCA; DBSA, 2009, p. 3; Missankov, Van Dyk, Van Biljon, Hayes, & Van der Veen, 2006). The purpose of this report is not to prove causality but to capture context-specific, practitioner perspective. Methodologically, its purpose is to construct an interpretative narrative from the data in an attempt to capture the complexity of the “phenomenon” under study.

1.5 Significance of this study

There seems to be a general consensus in the literature that “the outperformance [of PE] is lower in larger and more developed markets compared to developing markets.” In a 2008 study, 81 global LPs expected their emerging market PE commitments to yield “net returns on average of 23%...reflecting a 6.7% premium over US buyout funds.” (EMPEA, 2008, p. 8).

Emerging markets (EM) are widely recognized as the next frontier for driving growth in private equity (Diagram 3). In 2008 the BRIC (Brazil, Russia, India, China) countries and South Africa procured the highest investments in terms of total number and amount of [global PE] deals (or over 50 percent of total EM deals (755 as per EMPEA, SAVCA & Evaluserve, 2010, p. 6).
Political instability and economic risk are the two most conventionally cited barriers to investment by global investors in emerging markets. Yet from 2007 to 2008 these two apparent deterrents actually declined collectively for emerging and specifically—as it pertains to this report—for African markets (EMPEA, 2008, p. 5). Instead, a 2008 study of 81 global LPs, revealed the most important barriers to investing in emerging markets (cited by 66% LPs) to be a “lack of experienced private equity fund managers” and a “lack of access to the best GPs” (cited by 39% of GPs) - (EMPEA, 2008, p. 10).

The significance of this study in light of these revelations becomes clear in two aspects: 1) It is clearly not unreasonable to infer then that the principal explanatory variables for the current lack of LP investment in emerging markets are not merely traditonally cited political and economic risk-aversion: i.e. there perhaps then is a returns-based premise. 2) LP restraint can be deduced as more likely a function of limited insight into the profile of value-adding interventions and ability of emerging market PE practitioners (which, significantly hence, this report attempts to uncover).

The South African PE industry has grown at a pace equalled by few, if any, classes: it eclipsed R100 billion of funds under management in 2009 and beyond a market investment, plays a critical role in the economy’s development. Yet relatively little research has been done on South African PE to date.

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6 “Emerging Markets” refers to Emerging Asia (excluding Japan, Australia and New Zealand); Central & Eastern Europe/Russia; Latin America & the Caribbean; Africa; and the Middle East. – (EMPEA Annual Limited Partner (LP) survey of 81 LPs, 2008, p.2)

This study, while not pretending to give a comprehensive picture not least due to sampling bias, nonetheless attempts to fill a research gap and contribute to existing studies by enlisting the direct input of practitioners themselves. In its methodological approach, it attempts to capture and present a rich set of - contextually relevant - insights that can enhance stakeholder knowledge of how and/or what determinant help South African GPs to optimise returns. That insight subsequently, and for the below reasons, has significance for the following private equity stakeholders:

1. **Investors:** In particular with regard to South Africa’s pre-eminence as a gateway to regional African investment – particularly for international investors – this research can help investors to gain further understanding of South African private equity and to assess potential socio-economic impacts to their existing investment portfolios.

2. **Private Equity firms:** Local GPs can gain new insight, in the context of the financial crisis, of the relative importance of the attributes that may be influencing the effectiveness of their interventions.

3. **Government and/or policy makers:** Private equity plays a crucial role in meeting South Africa’s socio-economic/developmental policy objectives (SAVCA; DBSA, 2009, p. 1)

4. **The Corporate domain:** many private equity practices, from operational processes to incentive structures, are relevant to the corporate domain. These interventions have thus been increasingly adopted by corporates in an attempt to mimic private equity’s value creation.

5. **The General Public:** The re-ignited public hostility and debate with regard to private equity’s asserted value creation stems in no small measure from the opaqueness and enigma imbued in the asset class by it’s policy of non-disclosure. This proposal therefore has broader ramifications in addressing general public interest in understanding how private equity firms achieve superior investment returns.

Given the significance of South African private equity and yet the relative lack of research thereof due to the lack of data, this proposal should therefore be of interest to a broad range of private equity stakeholders.

Following this introduction the report is structured as follows; Chapter 2 describes the hypotheses and questions to be answered, the research assumptions and ethical considerations. Chapter 3 covers the Literature Review in respect of this area of study and the research problem. Chapter 4 details the methodology applied in undertaking the research herein. Chapter 5 presents this study’s findings and accounts for its limitations. Chapter 6 concludes while Chapter 7 indicates possible areas for further research.
2. **AREA OF STUDY**

2.1 **Research Questions & Scope**

The data collection and analysis undertaken herein has been focused on answering the following questions which form the core of the research topic:

1. What are the mechanisms and/or determinants that can influence or help South African PE fund managers to optimise or improve their returns?

2. Are there any additional mechanisms or determinants of value-creation that may have particular relevance or are unique to the South African context? (if so, what might they be?)

**Scope:** The scope of this proposal, while it references the determinants and sources of return as identified in similar studies abroad (mostly the U.S and U.K markets\(^8\)), is limited to an analysis of the current interventions, determinants and or/attributes that help PE managers to optimize returns, as rated by South African PE fund managers. The results of the research are not necessarily restricted to the current economic context. However, in its interpretivist and context-specific approach, this report attempts to capture the distinct personal insights of SA PE fund managers in *this specific* time and *country* setting, rather than seeking to identify any generally applicable rules. Consequently, it will likely only be applicable to the current South African context.

2.2 **Hypotheses: sources and determinants of returns inferred from the literature**

The literature review highlighted factors that prompted the following hypotheses which are tested in this report. These are related to the core objective of this study because they pertain to sources or determinants that can influence or improve PE returns. For the reader’s ease, they are organised as either a) particularly relevant to the profile of SA private equity or b) inferred by the author as possibly unique to the South African context (detail: Chapter 3);

A. **Drivers of value creation (i.e. returns) particularly relevant to the profile of SA private equity**

1. **Operational engineering (A):** will increase relative to financial engineering as a technique for optimising returns; **Hypothesis (B):** as the PE value creation model becomes more internally focused on extracting value from portfolio companies, private equity firms will prioritize hiring teams (i.e. investment professionals) that have more “operational”, industry-based experience or skillsets than more financial/valuation-related skills (Palter & Kehoe, 2009; Achleitner et. al, 2010)

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2. **Deal flow: Capital overhang in SA:** resulting increased deal competition will lead to less favourable (marginal) acquisitions: since most funds operate on a “use it or lose it” basis, “there is an ongoing drive by fund managers to invest their funds as soon as possible”: will hamper PE’s attempts to optimise returns in the future (SAVCA & KPMG, 2010, p. 16; Axelson, et. al., 2010).

3. **Investment strategy (PE business segment):** PE investment strategies of growth/development (which generally rely less on leverage) will increase in focus as means to optimizing returns relative to leveraged buyout strategies: The current economic context will mean a permanent decrease in the availability of leverage (Kaplan & Stromberg, 2008; Achleitner et. al, 2010) and hence constrain the use of leverage as a value-creation mechanism (a traditional driver of superior returns in particular LBOs). Further evidence supporting this hypothesis: buyouts as a proportion of investments made decreased significantly to 41% in 2009 (13%: 2008), reflecting the sharp drop-off in buyout activity in 2009. (SAVCA & KPMG, 2010, p. 29).

B **Drivers of value creation (i.e. returns) possibly unique to the context of SA private equity**

4. **Leverage** will remain a relatively key mechanism of SA private equity value creation (i.e. returns) as compared to PE in other markets: Lower levels of gearing in local deals, historically low net-debt-to-equity ratios in South Africa (about 7% compared to 32% in the USA and 45% in Europe: SouthAfricaInfo, 2007) and given that the SA economy has been “relatively shielded …and not suffered the general toxic debt exposure.” This implies that financial engineering (i.e. the use of leverage) will remain of greater relative importance as a driver of PE returns in South Africa relative to more credit constrained, international markets (SAVCA & KPMG, 2010, p. 4).

5. **Deal flow: MDFIs:** large MDFI presence and funding support of SA PE might mean lowered risk perceptions and related risk premiums: greater global LP investment helps PE to optimise returns by increasing related ability to invest for value-added PE returns: (Evaluserve & SAVCA, 2010, p. 22; SAVCA & KPMG, 2010, p. 9; Settel, Chowduhury, & Orr, 2009). DFI presence might have a particularly context-specific impact on local PE returns.10

6. **Deal Flow & Leverage: BEE (Black Economic empowerment)** – BEE can potentially help PE managers to optimise returns by improving deal flow (i.e. due to preferential opportunities to do business due to better BEE credentials; access to cheaper debt; access to cheaper/discounted investments; improved fund-raising) -(SAVCA & KPMG, 2010, p 4; Dada & Thayser, 2007; Van Niekerk & Krige, 2009)

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9 Multi-lateral development financial institution
10 In SA there is a large contribution from Governments, aid agencies and DFIs to the local PE industry (24%), whereas in Europe the contribution is smaller (11%) – (SAVCA & KPMG, 2010).
7. **Operational engineering: Organic growth versus acquisitions:** South African private equity practitioners tend to use organic rather than growth by acquisitions as a means to maximising returns: South African survey by DBSA & SAVCA (2009) of 327 PE-backed companies across PE investment segments suggests that unlike their overseas counterparts, local PE generally prefers organic growth – cross all PE investment stages (p 6, 16; ) - (detail: Chapter 3).

8. **Investment strategy: (Geographic focus):** SA private equity practitioners will increasingly view Sub-Saharan/ regional geographic investment strategies as a source of enhanced returns: The existing PE value creation model will be aligned to reflect emerging regional investing preferences by MDFIs and global LPs investing in Africa, in order to capture a competitive share of such LP fund participation. (EMPEA, 2008; Evaluserve, 2010, p. 3)

### 2.3 Research Assumptions

This study documents interviews with 7 PE practitioners in SA, balanced across fund size, investment strategy, PE segment and regional focus. While the sample size would be considered small, academic South African and international studies on the industry broadly have targeted a similar number of interviews with research success (Fourie, 2002; Roodt, 2004; Jones 2009; Kaplan, Mitchell, & Wruck, 1997). In the case of renown PE academic Kaplan and his co-researchers (et. al, 1997) of the 4 companies the authors approached, only one finally agreed to participate. This study hence shares Kaplan et. al’s (1997) assumption that while such smaller sample selection likely suffers from selection bias, its strength is that it “facilitates the study of phenomenon [i.e the South African context] that cannot be examined through large sample approaches….but can then be applied to large-sample contexts” (p. 4). These interviews are supplemented with Likert-type scale online survey questions, which minimises any possible bias in using interviewing techniques. The author is confident that the design of research in using both interviews and surveys “triangulates” and, hence, balances the strengths and weaknesses of both techniques.

This report further assumes and relies on the honest response of the private equity participants to the survey and interview questions, which past research has shown can be problematic (Van Niekerk & Krige, 2009, p. 7). While the author cannot guarantee that this assumption was met, by offering research participants anonymity via a secure website, any incentives toward positive bias in reported data are limited.

The author assumes the reliability of the research instruments used to gather data and of a limited order effect: the questions were randomised within the defined categories of return (see: Chapter 3) and hence not presented in any perceived order of importance.

In undertaking this research, the author also assumed that the survey and interview participation rates would be at levels robust enough to provide adequate insights. In line with prior similar studies, the
author originally aimed for a survey response rate of 30% and to secure 5 interviews. This assumption was more than met by a survey response rate of 40-55% \(^\text{11}\) (a peak of 22 out of 40 targets) and in securing 7 interviews (of an initial target of 5). Surveys are renowned for low participation rates and past similar studies typically achieved average response rates of 30% and secured between 1-5 interviews (n.p., practical survey, ; Kaplan et. al, 1997; Fourie, 1999; Hollander & Schirnig, 2001; Roodt, 2007).

Several experienced qualitative researchers offer as one of the standards that might be used to evaluate a qualitative study the criteria of “coherence” (i.e. “multiple data sources converge onto consistent conclusions (triangulation).”) (Glaser, 1992; Creswell, 1998, 2009; Eisner, 1998 in Leedy & Ormrod, 2010, p. 157). Triangulation in this study was effected through the use of a mixed methodology of instruments and technique (i.e. closed and open questions; surveys and interviews). Coherence is assumed by the overall consistency of online survey results relative to data gathered in interviews, which participation rates moreover were statistically adequate, as benchmarked by research standards on average response rates for the instruments and by academic precedent.

However, notwithstanding the author’s above-mentioned efforts to counter weaknesses in the report’s assumptions, risks to the results gathered persist. Readers should bear in mind that because the gathering of data herein is retrospective and subjective - notwithstanding the anonymity extended to participants - PE practitioners may still be inclined to overstate/emphasize successful and understate unsuccessful aspects of their fund experience in generating returns.

2.4 Research Ethics

A detailed cover email (Appendix 1) made clear to potential participants the purpose and intent of this study. This email was sent to targeted research participants, detailed the area of study and included a request to participate. Sent via the Graduate School of Business (GSB) email network, the email further confirmed the purpose of this research and guaranteed the confidentiality of responses. Participants’ consent to participate in the project was therefore indicated by their completion of the survey. Responses published in this study remain anonymous, given that the idea, in particular with respect to the open-ended interview questions, is to use “content analysis” to identify common themes in the responses and then resolve these as SA-specific drivers of return, or to match commentary to existing sources of return identified in the literature – rather than to identify the specific participant responses, per se.

Whatever practitioner-specific information that was included in the research instruments such as fund size, team size, sector or geographical coverage was neither personal, nor did it enable explicit identification of the participants. The exception to this was an invitation to participants of voluntary

\(^\text{11}\) i.e. 16-22 responses; variation occurred but only 1 category of a total of 12 categories received 16 responses; all others received 18-22. Variation occurs for those respondents who chose to skip questions as relevant to the context of their experience)
inclusion of an email address for later correspondance of the final report. Data was requested and intended only so far as it was identified in the literature or hypothesized by the author as specific to the South African context; its purpose was to yield richer insights into the sources of value creation in South African private equity.

Regarding the interviews, the author contacted 7 individuals who were identified as representing a layered and varied sample of PE firms (Appendix 3). The research purpose and semi-structured design, as well as the confidentiality of the responses received was similarly explained to participants prior to the interviews. By way of preparation interview participants also received by email and in advance, the survey questionnaire, which exposed them to the themes to be discussed in the interviews, and provided reassurance that proprietary metrics would not be required. However, to limit bias inherent in studied responses, the interview questions were not made available to interviewees in advance (Appendix 5). All research questions in both instruments related only to factual responses concerning the fund and views expressed as to current industry themes.

The author consequently does not foresee any ethical issues emerging in either research instrument with regard to breaches of confidentiality or invasion of privacy.
3. LITERATURE REVIEW

Preface: Overview of the literature on PE returns

Apart from Van Niekerk & Krige (2009) who quantitatively analysed sources of return in private equity and perhaps, correspondingly, Missankov, Van Dyk, Van Biljon, Hayes, & Van der Veen (2006), who studied the investment performance of a sample of PE funds, there is scant evidence in the literature of research into the attributes of private equity value creation in South Africa. To this point, it is telling that industry-driven reports appear to dominate what little there is of literature on the local PE industry. The bulk of academic work on private equity returns focuses on PE’s performance at the fund level (Ljungvist & Richardson, 2003; Kaplan & Schoar, 2005, Lerner, Schoar & Wong, 2007, Van Niekerk & Krige, 2009). However, aspects that influence returns or the mechanisms used by PE fund managers to optimise returns (IRR) at the investment (i.e. company) level are still largely unexplored. The reason for this gap in the literature is that little is known about the detail of PE transactions, as most studies rely on publicly available data or confidential data, often from a single buyout fund (Groh & Gottschalg, 2006; Caselli & Garcia-Appendini, 2009; Van Niekerk & Krige, 2009; Chapman & Klein, 2009). Chapter 4 (4.2) of this report includes a critical analysis specific to the methodologies used in past similar studies in the literature, and substantiates the merits of this report’s particular methodological approach.

There is evidence in the literature that PE in South Africa has achieved “good risk-adjusted performance relative to other asset classes” as suggested by calculated Sharpe Ratios. (Missankov et al., 2006). These authors studied a representative sample of 11 South African PE funds over a 13 year period. Key findings included that PE in South Africa outperformed the FTSE/JSE All Share Index by 18% before fees, and approximately 12% per year - after fees. That finding is a key differential, since a healthy literature on PE abroad criticizes its performance for the fact that, net-of-fees, average PE returns are only comparable or even underperform those of public equity markets by some 3% – irrespective of the datasets used (Kaplan, 2009; Phalippou & Gottschalg, 2007; Phalippou, 2010, p. 1)

Further attesting to the positive performance of South African PE, a DBSA (& SAVCA, 2009, p. 6) survey of 327 PE-backed companies in South Africa shows that they achieved:

- average turnover growth of 20% compared to 18% for JSE companies and 8% for UK PE-backed companies.

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12 A quantitative study of a sample of 46 large, individual completed buyouts over the period 1992 to 2007 that regressed the relationships between identified sources of return and reported internal rate of return (IRR)
13 A study of the investment performance of a representative sample of 11 South African private equity funds over a 13-year period
14 This number represents “an extremely significant proportion of extant PE-backed SA businesses” (SAVCA & DBSA, 2009, p. 5)
Pre-tax growth of 16% per year compared to 14% for JSE companies and 11% for UK PE-backed companies.

Van Niekerk and Krige (2009) argue that all arguments on the drivers of PE returns can be reduced to earnings growth: if that is the case, the above statistics would suggest that, at least as far as the sample in question can allow for inferences, South African PE managers have unique competencies that enable them to optimise returns and in some case outperform the local public market.

Most closely related to this report’s investigation in South Africa is that of Van Niekerk & Krige (2009), who used a sample of 46 individual completed and exited investments representing a number of large buyouts in South Africa from 1992 to 2007. The analysis used multiple regressions to quantitatively investigate the relationship between some identified sources of return in the literature and the realised internal rates of return (IRR) in the case of each investment. The regression suggested that only earnings growth and earnings multiple increases displayed a significant relationship with the returns achieved by the PE fund managers on the investments included in the sample (p. 10).

While Van Niekerk and Krige’s study provides a useful benchmark, in the author’s opinion it suffers a number of limitations. First, the model’s fit was not particularly convincing: it explained only 49% of the variability in the reported IRRs (2009, p. 10). Secondly, like several of the previously cited quantitative studies it relies on IRR in determining its findings, which for reasons later discussed is shown to be problematic (Chapter 4). Thirdly, it relies exclusively on quantitative methodology to solve a research problem that it concedes is “as much an art as it is a science.” (p. 10). The wide disparity in IRR achieved globally by PE funds suggests that in aiming to maximise returns, PE fund managers apply techniques as individualised as each investment is unique.

Findings in the literature review on overseas PE also suggest that growth by acquisitions of PE-backed investments achieves higher rates of return on invested capital than organic growth. However, the author found new evidence in local literature which suggests that, unlike their overseas counterparts, South African PE fund managers use organic rather than add-on transactions as a technique in maximising growth and returns in their investment companies. The author inferred the apparent differential as a technique that is possibly unique to the SA context. The hypothesis was tested within the survey questionnaire, which conclusions can be found in the findings section of this report (Chapter 6).

Even when controlling for alternative explanations such as differences in IRR calculation or risk, there
is significant heterogeneity in global PE performance (Achleitner, Braun, Engel, Figge, & Tappeiner, 2010), Consequently, it is unreliable to generalize the existing results in the literature on PE value creation to the South African context: that research is based on selected samples and markets (predominantly the U.S and U.K) which differ not least in terms of regulatory frameworks, governance, levels of corporate gearing (i.e. company debt levels) and in access to liquidity. This provides further merit to this context-specific study of returns from the diverse perspectives of South African PE fund managers.

A further merit of this particular study relative to the focus of past similar studies is that it is not restricted to buyouts. Although buyouts are a foundational segment of local PE, expansion/development and replacement capital now form a relatively significant part of the SA industry, not just in number but also in cost of investments. The layered typology of survey and interview participants recruited for this report was designed to be as reflective of this varied activity as possible: (40-55% response rate; 7 interviews including prominent PE industry participants)

Following this introduction, there follows a discussion of the quantitative and qualitative sources and determinants of optimal returns identified in the literature.

**Qualitative and Quantitative sources of value creation in private equity**

**3.1 Financial Engineering**

(Financial engineering 1) Leverage and Free Cash Flow

Financial engineering through the use of leverage is traditionally regarded as the principal means by which private equity, especially LBO, fund managers maximise returns - and this, regardless of the proportional increase in risk (Millson & Ward, 2005; Kaplan & Stromberg, 2008; Achleitner et. al, 2010). Financial models show that the benefits from leverage could exceed any operational synergies, even if this does always appear commercially sensible. (PricewaterhouseCoopers, 2009, p 6). Leverage can be described as the Debt to Equity ratio of the investee (portfolio) company. PE managers can decide to change the investee company’s leverage in a number of ways, including for example by selling off some of the company’s assets or by refinancing existing ones. However, this method of value creation has also generated the most controversy and scrutiny by critics of private equity, who call PE managers’ aggressive use of debt and cost-cutting “asset-stripping.” Some PE firms (particularly larger ones) also pay dividends to themselves after completing a purchase: they use new debt to fund the dividend.—(n.p., ssrn-id1409699, 2010, p. 4; n.p., Bartlett & Poulsen, 2010).

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16 The South African PE market emerged in the 1980s led by the major commercial, merchant and investment banks of the time. Wide spread disinvestment from South Africa by multinationals in response to apartheid led to the pioneering of leverage buyout and management buyouts by these banks. (SAVCA & DBSA, 2009, p. 11)

17 Expansion & Development; Replacement and Buyout capital as of 31 Dec, 2009 based on cost of investments (38%: 17%: 39%); based on number on investments (51%: 9%: 17%) (SAVCA & KPMG, 2009, p. 31)
Internal rate of return (IRR) is the most common method by which PE investment returns are measured. Increased debt can be used to improve IRR (Fraser-Sampson, 2007 in Van Niekerk & Krige, 2009). First, IRR depends on the timing of cash flows; the quicker the cash is returned to the investor, the higher the IRR. Basically, the PE fund managers can increase the investee company’s debt and then use the free cash flow generated by the company to pay off the debt sooner (i.e. early repayment) – thereby increasing the IRR in the process. Leverage can also be used to reduce the amount of own funds that the PE fund needs to raise, for the same amount of ownership. Third, leverage disciplines entrenched managers, increasing incentives to add fundamental value to the firm, thereby increasing overall company (and PE) returns.

Extensive literature counters that PE practitioners apply several mechanisms beyond a simplistic use of leverage to create value and optimize returns (Ernst & Young, 2008; Kaplan S. N., 2009; Colvin, 2010). In South Africa, 46% of 327 PE-backed companies surveyed attested that it was precisely PE’s ability to make contributions beyond financial engineering that made them choose PE over alternative forms of financing (DBSA & SAVCA, 2009, p. 9).

It is interesting to note that while the predominant view in the academic literature is that the economic context has restricted access to leverage, thereby fundamentally and permanently changing the model of PE value creation; other literature asserts that while leverage may be more expensive, it is nonetheless still available and– apparently - currently in line with the long-term historical cost of debt (BCG and IESE University of Navarra, 2008).

**Financial engineering 2) Earnings increase**

While increasing earnings is not intuitively a “source” of returns since it relies for its result on many interdependent techniques, the relevant issue as suggested in the literature is that earnings in PE-backed companies tend to outperform their public benchmarks. These superior earnings increases can help PE managers to optimise relative returns on invested capital. (Kaplan 1989a; SAVCA & DBSA, 2009; Guo, Hotchkiss, & Song, 2009). Adopting Caselli & Garcia-Appendini’s (2009) definition in their study of Italian PE-fund returns, sales growth is understood as the growth in gross sales between the entry and exit of the PE investment. The earnings-multiple method, the simplest and yet probably the most popular technique used to value companies in the PE industry, relies on an earnings figure called EBITDA (earnings before income, tax, depreciation and amortization). (n.p., ssrn1409699, 2010, p. 4).

\[ \text{EBITDA} = \text{Operating income (EBIT)} + \text{Depreciation and Amortization}^{18} \]

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\(^{18}\) Operating income equals operating revenues less operating costs. Operating costs include costs of goods sold, SGA (selling, general and administrative expenses) and depreciation and amortization. The latter two are added back to EBIT
PE funds buy companies (private or public) at a multiple of their EBITDA value. By achieving improvements in the company’s performance by, for example, improving its compensation plan, marketing methods and other areas of weakness, the PE firm can increase the company’s revenues, while its costs decrease; consequently, the company’s EBITDA increases. The PE firm profits through optimised returns when it sells the company, since the firm’s value rises along with its EBITDA.

In the introduction to this literature review the author highlighted that 327 PE-backed companies across a spectrum of industries grew pre-tax profit by 16% per annum compared to 14% for JSE listed businesses and 11% for UK private equity backed businesses (SAVCA & DBSA, 2009, p. 4). These results, to this report’s credit in recruiting direct PE perspective, suggest that South African PE fund managers are able to apply a unique set of individual competencies to maximise returns through superior earnings increases.

(Financial engineering 3) Valuation: EBITDA growth, Entry Value and Multiple Arbitrage

As mentioned above, a common metric used in private equity is EBITDA. A further metric often used is enterprise value (EV). Enterprise value is also the metric most readily gauged against public company benchmarks (Ernst & Young, 2008). Building business value is, of course, the ultimate goal of all profit-oriented business owners. This holds for public and private companies, as well as for private equity. Enterprise value has many components. While profits, productivity and valuation multiples are three significant metrics on their own, they are also important drivers of EV (2008).

According to Van Niekerk & Krije (2009), the latter metric can be broken down as follows;

\[
\text{Enterprise Value} - \text{Net Debt} = \text{market value of Equity} \quad (2)
\]

\[
\text{Enterprise Value} = \text{EBITDA} \times \frac{P}{\text{EBITDA Multiple}} \quad (3)
\]

Increases in either EBITDA or the multiple expansion (equation 3) raise enterprise value, which after the repayment of debt increases the firm’s equity value (equation 2). It follows that by selling the investee portfolio company at a multiple that is higher to that at which it was initially acquired, PE managers can increase the market value (i.e. the enterprise value) of their initial investment and, as a result, increase their returns.

In their proposed model used to explain PE returns in Italian private equity funds, Caselli & Garcia-Appendini (2009) calculate IRR as “the difference between exit and entry value divided by the entry value” (p. 13). As such, the authors assert the importance to optimising realised PE returns of relative under-valuation of the PE target at the point of investment (i.e. scope to achieve valuation multiple expansion to be realized on exit/sale of the investment). Ernst & Young’s (2008) also confirmed PE’s

because they are non-cash expenses which are available for use by the private equity firm. (n.p., ssrn.com, SSRN-id1409699: The Private Equity Myth, p. 3)
ability to sell businesses for much more than their original investment. Exits in their study grew EBITDA “33% faster than public company benchmarks” (p. 2). EBITDA grew at 16% for PE portfolio companies compared to 10% for public benchmarks (p. 8). Further, the PE firms grew enterprise value at 24%, “double that of public company benchmarks” (p. 2). Critics of private equity argue however that such multiple expansion is merely the case of a “rising tide that raises all ships” that is, merely the result of contemporaneous and overall increases experienced by the rising market (and multiples) as a whole (2008, p. 10; Kaiser & Westarp, 2010). However, several studies abroad find that PE has driven successful outcomes across market fluctuations in the past (2008; Kaplan & Stromberg, 2008).

With respect to multiple growth, Ernst & Young’s 2008 study further concluded that “more than half of all multiple growth charted for the top exits was attributable to the success of strategies implemented under private equity ownership…it is clear that private equity investors sold better businesses than they had acquired.” Notably, in a Spring 2010 roundtable survey of PE fund managers on value creation drivers in Indian private equity (Rajan, 2010), practitioner Archana Hingorani also referenced the afore-mentioned figures reported by Ernst & Young (2008), saying that it makes one “sit up and understand that besides leveraging and cost-cutting, PE investors actually create value” (p. 70).

3.2. Operational Engineering

Productivity and Cost-Cutting

A dominant view in the literature is that beyond leverage, PE uses aggressive cost-cutting at their portfolio companies as a key means to increase earnings, and hence, returns. Productivity can be measured by the ratio of production inputs to revenue, profits or other inputs (Van Niekerk & Krige, 2009; Kaiser & Westarp, 2010). Similar to findings with EV and EBITDA, the literature broadly attests to the ability of PE managers to increase productivity levels in their investment companies relative to public benchmarks (Rajan, 2010). In the afore-mentioned Ernst & Young study (2008), PE investments were found to have achieved 33% higher levels of productivity than public companies (p. 2). These PE practitioners managed to increase headcount (contrary to some popular claims that optimising PE returns (Cressy, Munari, & Malipiero, 2008) must include cutting jobs), while improving the relative ratio of EBITDA. It follows that by achieving such superior relative earnings increases, PE managers can achieve relatively superior returns to their public company benchmarks.

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19 The first global study of the year’s 100 largest private equity exits (Asia, North America and Europe
Recent empirical studies of PE firms by both Chapman and Klein (2009, p. 22) and Nikoskelainen & Wright (2007) found that transactions across sectors involving value-increasing add-on transactions (i.e. acquisitions) performed significantly better than investments that relied on organic growth (IRR of 50% and 33%, respectively in the case of Chapman and Klein). However, in South Africa PE practitioners seem to use organic growth as a dominant route toward growth and returns.

PriceWaterhouseCoopers (PwC) assert that add-on or so called “buy and build” strategies will be an important part of the PE value creation model in the future.(2009, p. 6). They argue that with their ability to leverage companies reduced, the advantage that PE had over trade buyers in pursuing deals has been eroded: PE must instead now use their skills to consolidate fragmented markets. While on previously financed deals this might not be as attractive as it requires debt (which could lead to repricing), on new investments PwC says that add-on transactions may offer an opportunity for PE to optimise returns by creating value and competing with trade buyers (2009, p. 6). Nikoskelainen & Wright (2007) also showed that return characteristics of LBOs and the probability for a positive return also related to the size of the buyout target and other acquisitions carried out during the holding period.

Chapman and Klein used a sample of 13 PE firms to study 288 exited transactions across sectors. In their study, “buy and build” strategies were found to have half the debt pay-down and to generate higher increases in revenues, profit margins, employment and capital expenditures. Interestingly, between acquisitive or organic strategies the authors found no appreciable differences in leverage (65.4%), numbers of club or solo deals, equity splits to either the PE firm or the management, or exit multiples. As the authors conclude, these findings support the thesis that consolidating acquisitions can, when executed properly and access to leverage permitting, enable PE fund managers to achieve substantially higher returns on the investment.

However, in SA, a study of 327 PE-backed companies showed that while 33% had been “allowed” by their PE funds to make acquisitions, 82% had since achieved the majority of their growth through organic means (+DBSA & SAVCA, 2009, p. 6, 16). This phenomenon held true not just for buyouts, or for early stage ventures (which given their smaller size would intuitively be less likely to grow by acquisition) – but notably, also for expansion and development capital deals (which typically do not rely as much on the use of leverage in financial engineering as do buyouts).

3.3 Governance

In their study on corporate governance criteria as applied in PE investments in SA, South African researchers Millson and Ward (2005, p. 79) found that having appropriate management is a key
requisite for successful value creation by private equity managers. PE firms place great emphasis on having the “right” people in place and will retain those managers capable of adding value while replacing those who they do not perceive as up to the task (Morris, 2010). Further, “buying well” continues to be a “key element of PE success.” The Ernst & Young study cited previously (2008) also found that 82% of the PE-backed companies in their sample were sourced by PE firms by proactive origination through relationships with the target’s management (p. 12). Establishing a structure in which both the PE fund managers and the key managers of the investee company agree and share a common ownership vision and are motivated to create value is “more critical than any one business intervention” (p. 12).

(Governance 2) Incentives: Agency theory

Agency theory (Jensen, 1989) asserts that a key source of private equity’s value creation lies in its ability to incentivise managers to behave like owners. PE firms also optimize returns through the managerial discipline (typically, through the use of leverage) that they impose on their investee companies. Attractive incentives packages enable top PE firms to hire and learn from some of the world’s best corporate managers. Kaplan and Stromberg in their (2008) analysis of LBOs assert (as found in much of the literature) that heavy debt financing reduces the incentive for company managers to invest in projects that could have negative returns (i.e., NPV\(^{21}\) negative). This is because heavy debt acts as a disciplinary tool since it forces the investee managers to view cash as a scarce resource.

(Governance 3) Active Ownership

PE firms also view themselves as owners together with the investee managers (Jensen, 1989; Kaiser & Westarp, 2010). They adopt a strong shareholder-centric focus that allows them to make business decisions with a relative lack of sentimentality and instead with a view to maximizing value creation (as measured by returns). To this point on the general lack of sentimentality of PE fund managers in terms of doing what is viewed as best for maximizing ultimate enterprise value, the Ernst & Young study (2008) reports that the most common thread among PE investors when reflecting on lessons learned was “we should have changed the management sooner.”(p. 12).

Further influences on PE returns

A review of the literature revealed the following additional factors that influence investment returns generated by PE fund managers:

3.4. Deal flow

(Deal Flow 1) Syndication: Syndicate deals (also called “club deals) are those in which a PE firm partners with other PE firms or co-investors (Chapman & Klein, 2009, p. 19). In 2007, 80% of

\(^{21}\) Net present value
the 10 largest PE transactions undertaken in South Africa were done by PE syndicates (2008, p. 31).

In their study on syndication of private equity investments in South Africa Bent, Williams and Gilbert (2004) concluded that syndicated investments generally have higher rates of return than stand-alone PE investments, implying that the involvement of multiple firms in the management of an investment can help PE firms to optimise returns (p. 39). Lockett and Wright (2001 in Bent et al., 2004) found three primary rationales for syndication:

The finance-based rationale stipulates that PE firms can improve returns by reducing the unsystematic risks of their portfolios by sharing the financial risk with other PE investors.\textsuperscript{22}

The resource-based rationale stipulates two assertions of maximizing returns through syndication. First, that in deciding whether to invest, syndication can reduce risk (and optimise returns) by providing access to a greater set of skills and experience to analyse the opportunity: the PE firm is better able to select a good investment, thereby reducing firm-specific risk in the process and consequently enhancing the ultimate returns that can be realized from the investment. Secondly, in the “ex-post management” of investments, the syndicate can select from the differentiated skillsets and resource capabilities of the investing group to provide and so extract maximum value to the investee..

The deal-flow rationale asserts that syndication helps to optimise PE returns given the potential for “future reciprocity” (Bent et al., p. 40). This is because by involving another firm in the investment and in working together successfully, PE firms increase the likelihood of being asked to participate in investments in the future by their industry peers. For firms with a good reputation, this may consequently increase the amount of deal opportunities available, (Lerner, 1994)

\textbf{(Deal Flow 2) Reputation of the PE firm}

Gompers (1996) found that young venture capital (VC) firms take companies public earlier than older VC firms in order to establish a reputation and successfully raise capital for new funds. Gomper’s argument is premised on two further factors identified in the literature that support the idea that across all investment stages PE fund reputation can help fund managers to maximise returns by 1) its effect on attracting capital, which is important to accessing debt and equity markets (Diamond, 1989) and 2) by acting as a strong indicator to potential PE investment recipients of the fund’s ability to attract other investments and investor (i.e. LP) commitment (Chevalier & Ellison, 1995). Axelson (et. al, 2010) also highlights the role of GP’s personal reputations as critical to raising of future PE funds;

\textsuperscript{22} The unsystematic risk relates to the individual investment (in this case, the investee company) and concerns such firm-specific factors as the industry in which the company operates, the company’s growth profile and the management skills of the entrepreneur. Systematic risk refers to market-related risks. Syndication allows PE firms to have more diversified portfolios which leads to the risk of the investment consisting almost entirely of systematic risk. Liquidity risk is similarly reduced by sharing spreading the risk on a deal-by-deal basis, since PE investments have at least 4-5 year investment horizons before returns can generally be realized.
with ultimate implications for optimization of returns since this in turn dictates the ability to pursue value-creating investment opportunities (p. 38). Smith, Pedace and Sathe (2010) further find that generic firm reputation also is positively related to PE performance.

**Deal Flow 3**  
**Proactive origination of PE investments**

As cited previously, Ernst & Young (2008) found that 82% of their 2007 survey sample of PE-backed investments were originated proactively by PE funds who sought to establish relationships with the target’s management (p. 12). Many private companies do not have the managerial competencies to perform optimally. Furthermore, they are often relatively unknown, few objective valuations of the company exist, and if there is mispricing in valuation it is likely to be more pronounced in illiquid private rather than public companies (Anson, 2007 in Van Niekerk & Krige, 2009). PE fund managers can use their unique skills to proactively seek out these unknown investments, possibly acquiring them at an otherwise underpriced rate as they work to establish relationships and incentivise entrenched management into investment participation.

**Deal Flow 4**  
**Black Economic Empowerment (BEE)**

In a 2007 survey of South African PE fund managers, Deloitte found that 80% of the respondents believed that BEE would generate more opportunities for their PE businesses. BEE policy requires changes to intra and inter-firm relational patterns such as capital and control, promotion and development, supplier selection and enterprise development. (Andrews, 2007, p. 4). Organizational theory further argues that these kinds of intra and inter-firm relational structures (and the networks they establish) influence who participates in the economy, what new ideas enter the market, what products are produced and who benefits from the growth opportunities that exist (2007, p. 4). This report hypothesizes (and tests) that this argument could also be used to view BEE as a potential means to helping PE practioners optimise returns: among other things it presumably will facilitate deeper networks and financial connections, including potential bidding partners to find new deals (deal flow).

Although difficult to prove empirically, role players argue that BEE can help PE optimize returns by 1) improving deal flow (i.e. affording PE fund managers greater access to more potentially returns-enhancing deals due to expanded networks to source such deals, and through preferential opportunities to do business due to better BEE credentials); 2) giving practioners access to more sources of debt at lower prices; 3) potential access to cheaper/discounted investments than in ordinary transations and 4) enabling fund managers to better access fundraising (i.e. 80% of the R32.9 bn in undrawn commitments in 2009 – which reflect the significant pool of funds raised in SA from 2005 to date –

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23 BEE calls the private sector to restructure itself and create opportunities for previously disadvantaged individuals (PDIS) - Andrews (2007). *Is Black Economic Empowerment a South African growth catalyst? (Or could it be...)*. Harvard University/ The Government of South Africa.
are managed by “black influenced” or by government funds. (SAVCA & KPMG, 2010, p 4; Dada & Thayser, 2007; Van Niekerk & Krige, 2009)

(Deal Flow 5) **Multi-lateral/ Development Finance Institutions (MDFI/DFIs)**

MDFI presence in PE funds is an increasingly important catalyst to mobilize other LP investment and to build LP loyalty (Greenberger, 2007; Settel et. al, 2009). This can help PE practitioners to optimize returns by enabling them to pursue more potentially value-creating investments. The importance of MDFI funding to enabling PE to pursue such returns-enhancing investments can be inferred in the fact that many local PE practitioners argue that overstating the level of local PE activity is a “disservice to the industry as this could possibly reduce the appetite of DFIs and foreign investors to commit funds to South Africa in favour of other under-funded emerging markets.” (SAVCA & KPMG, 2010, p. 9).

In 2009, DFI funding/participation represented 67% of all third party funds raised in SA, further underscoring its importance to funds inflows into local PE. In line with the **syndication** thesis of PE returns, MDFIs can also help to optimise PE returns since, the association reduces perception of political and economic risk, in particular by global LPs, who are a key source of funding for local PE. (SAVCA & KPMG, 2009). In line with the PE fund **reputation** thesis of returns, DFI funding can also act as a proxy signal for PE reputation: the literature finds that MDFIs prefer to rely on proven fund managers with a track record of successfully investing capital and with a tried-and-tested strategy (Settle (et al., 2009, p. 70). To this point, 66% of global LPs investing in emerging markets (EM) cited the lack of experienced GPs as a leading reason for not investing more in EM private equity (EMPEA, 2008, p. 10).

(Deal Flow 6) **Capital Overhang and Deal competition**

Gompers and Lerner’s (2000) ‘money chasing deals’ analysis shows that current valuations of investment portfolio companies are high when there is significant competition for deals or when too much investment capital flows into the PE sector. As a testament to this, an examination of 9 major global PE buyout deals in the recent market peak (2005-2007) show that PE sometimes paid premiums approaching 50% (Appendix 6). Ljungqvist & Richardson (2003b) stress the importance of the competitive environment faced by GP: they argue that there are a limited number of good investment opportunities in the PE market at any one time, and that due to increased competition for investment targets, GPs come under pressure the less available favourable targets are - with ensuing negative implications for PE returns. To avoid overpaying, PE managers will take longer to invest, find it more difficult to extract rents from entrenched managers, screen investments less diligently and tend to make more marginal investments which require more nursing prior to exit and arguably have higher mortality rates (Bengtsson, Kaplan, Martel & Stromberg 2002 in Ljungqvist & Richardson, 2003b, p. 7). Increased deal competition therefore can negatively impact PE returns.
Axelson (et. al., 2010) present a model that also has predictions for the investment behavior of PE practitioners as it relates to the competitive state of the PE market: it implies that a ‘capital overhang’ of un-invested capital should affect the willingness of GPs to accept marginal projects (p. 35) – as explained in the previous paragraph. In South Africa, SAVCA reported capital overhang in 2009 of R32.9bn (R23.2bn of that is PE independents, 2009, p. 18). SAVCA also mentions that since PE funds often operate on a “use it or lose it” principle, notwithstanding overhang SA funds are therefore incentivized to invest their funds as soon as possible. This report tests, as part of its online survey, the hypothesis that capital overhang in SA will increase competition for deals. In light of SAVCA’s assertion, the author further seeks to understand in the findings (Chapter 6) whether this might affect the willingness of SA GPs to accept marginal projects (with related negative implications for returns).

3.5 Exit Type

Ljungqvist & Richardson (2003b, p. 21) suggest that competition and investment opportunities may affect the investment exit decisions taken by PE funds. Another major challenge for PE funds in optimising IRR is being able to find value-preserving exit vehicles for their investments. Larger funds may have a comparative advantage in seizing favorable exit opportunities -with positive implications for PE returns (perhaps by virtue of having stronger relationships with top IPO underwriters). Also, larger investments potentially have more of an impact on a fund’s profitability and IRR, and so may be exited sooner all else being equal (2003b). IPO’s have been shown to be the most profitable exit, since they maximize the returns to PE, but are currently less likely given the constrained credit markets (Ljungqvist & Richardson, 2003b; Smith et al., 2010). Although an IPO is now more likely an option for the largest buyouts with growth prospects, most buyout investments are harvested either through sales to other companies or, increasingly, other private equity firms. The latter transactions, known as secondary buyouts, now account for a significant share of new funds invested by private equity firms across Europe. (Wright, Simons, Scholes, & Renneboog, 2006). This phenomenon is seemingly reflected in the exit strategies of South African PE managers: of 327 PE-backed South African companies of the 108 companies where there was a disposal in South Africa last year, 72% involved a sale to management (buyback), 11% were the result of a trade sale and 8% of portfolio companies were sold on to another PE firm. Only 5% of businesses were exited via IPO or other listing/offering (SAVCA & DBSA, 2009, p 22).

3.6 Firm Size (PE deal-assessment capacity & Diseconomies of scale)

Jensen (1989) argued that the small scale and the lean and specialized management of PE firms were important reasons why they were able to add value to the companies they acquired. But the PE industry has concentrated since then, creating larger PE firms of sometimes several hundred
employees.\textsuperscript{24} The concept of diseconomies of scale argues that as a firm scales up, it benefits from an increased “utilization rate of knowledge”, but its larger communication needs come at the cost of a trade-off between communication and knowledge acquisition costs (Lopez-de-Silanes, Phalippou, & Gottschalg, 2009, p. 2). To this point, Lopez-de-Silanes (et. al, 2009) found that scope, workload-per-employee and firm scale growth influences PE returns: firm scale hurts investment returns and explains around a fifth of PE fund performance persistence. The authors studied the largest dataset to date: 7500 investments of 250 PE firms over the last 30 years. Their findings, which survives several robustness tests,\textsuperscript{25} found that PE investments held at times of high number (or value) of parallel investments substantially underperform.\textsuperscript{26} They find that related to the growth of the firm, firms fail to proportionally scale up resources: a doubling of investments is only matched with a 60% increase in the number of employees. The authors hypothesize that higher workload-per-employee could lead to lower productivity, or to strain, since only certain decision makers at some PE firms can ultimately decide to invest. This could lead to lower productivity and so explain the negative relationship between PE returns and professionals’ workload. Also important to note is that they find that it is the effect of the number (or value) of projects in a PE firm’s hands during rather than at the time of investment so much at the time of investment that influences returns - which suggests that the problem is most acute during the PE value-adding process. The authors conclude that PE performance suffers when the value-added capacity of a management team (i.e. especially after the initial “accounting”/financially-related assessment work is complete) is shared across too many investments, and communication of “soft” operationally-based information becomes more important and more difficult – more so in large firms also probably because they tend to be more hierarchical (2009, p. 6). Constrained operational arbitrage (i.e. limited as the number of parallel projects, hierarchy of larger firms or restricted initial deal assessment capacity hamper the ability of the firm to assess and/ or add value throughout the life of the investment) is consequently expected to have negative impact on PE returns.

3.7 Limited Partner (LP) sophistication

The question of the heterogeneity in investment strategies and sophistication across different types of LPs has not attracted much scrutiny in the literature, but what research does exist shows that the returns that LPs\textsuperscript{27} realize from PE investments differs dramatically across institutions. (Lerner, Schoar, 2007). Giants at the gate: Diseconomies of scale in PE.

\textsuperscript{24} Jensen contrasted the 16 PE “professionals” of PE firm Kohlberg Kravis (KKR) with the 470 people employed by its investment target, RJR Nabisco, at the time of the deal.

\textsuperscript{25} Their results survive across sub-samples, time periods, investment location, scale levels, proxies related to the supply of PE capital and survivorship bias of unsuccessful PE firms out the sample. Lopez-de-Silanes (et al 2009, p. 4)

\textsuperscript{26} The average (median) IRR of investments in the highest scale decile was 17% (19%) compared to 47% (36%) for those in the lowest decile. And those results survived a number of robustness tests (footnote). Lopez-de-Silanes (et. al, 2009, p. 2).

& Wong, 2007). GPs typically have to rely on external capital provided by LPs (i.e. PE investors) to finance their investments. Because GPs have limited liability and so take less of the downside risk in any deal, they can have an incentive to overstater the quality of potential investments when they try to raise financing from uninformed investors. Shleifer and Vishny (1997 in Lerner et. al, 2005) show that information asymmetries between GPs and their investors can affect LP portfolio allocation strategies, and eventually, the returns of the latter. Phalippou (n.p., 2008) goes so far as to claim that “investors are fooled” (p. 2). Also illustrating the differential competencies of LPs in their ability to select high-performing PE funds, Lerner (et. al, 2007) finds for example that the performance of follow-on PE investments in which U.S endowments and (to a lesser extent) public pension funds decide to reinvest show much higher performance than the PE funds in which they opted not to reinvest. Other LP classes are not found to display these same performance patterns. What this means for how PE can optimize returns is as follows: unsophisticated LPs can inadvertently influence (i.e. lower) the overall PE returns posted by the industry, since such LPs can fund underperforming GPs (Myers & Majluf, 1984, in n.p., Axelson et. al, 2010, p. 38).

3.8 General Partner (GP) sophistication

Axelson (et. al, 2010) assert that GPs not only have skill in identifying and managing potentially profitable investments, they have better information about deal quality than potential investors (p. 38). Kaplan (2009) stresses the importance of relative GP sophistication within the industry in his revised finding that PE funds in the top industry quartile—as opposed to the suggestion of average PE returns were able to persist in their repeat outperformance (net-of-fees) of the public market (p. 9). This implies that PE returns do have some demonstrated correlation to the level of GP sophistication: Sorensen (2007) also challenges the view that PE returns are due to luck (“home-run” deals). Other researchers find that GP skills, including sector expertise, accumulated experience through deal exposure and access to networks to exploit value creation in their investments companies are all means by which PE managers maximize returns. (Diller & Kaserer, 2007; Smith, Pedace and Sathe (2010), p. 4). Further, as mentioned previously, the fact that PE-backed companies’ earnings tend to outperform those of public companies would suggest that is it by applying their unique knowledge and skills that PE managers are able to achieve superior earnings, so maximizing their returns.

Gompers, Kovner, Lerner and Scharfstein (2008) conducted an extensive study (30000 PE firms over 20 years) and found that the greatest agility in exploiting market-timing was demonstrated by specialized PE firms that had considerable experience (i.e. relative GP sophistication). Gompers (et. al, 2008) found that only those PE firms with the most experience, industry-specific knowledge and superior human capital resources were able to maximize returns by using public market signal for investment timing purposes. However, in their 2004 paper examining whether market timing mattered
to realized PE returns, Schmidt, Nowak, and Knigge, found that investment timing affected VC fund performance - but that later-stage buyout fund returns were driven not by market timing but instead significantly related to the experience of the individual fund manager (p. 19). Smith (et al., 2010) found that while PE performance persistence is due partly to the propensity of entrepreneurs and LPs to want to partner with experienced PE firms, such preferences are “warranted by the differential value added by such firms.” (p. 5). However, Diller and Kaserer (2007) caveat in their findings that returns are driven by GP skills – as well as stand-alone investment risk. Lastly, Smith (et. al, 2010, p 4) find that the IRR of a PE fund with a given sector focus positively correlates to the PE firm’s experience (i.e. sophistication) in that sector. Given that PE is moving to an asserted more operationally-focused model of value creation, this report also tests the related hypothesis that PE funds will begin to hire/ augment operational expertise to gain this sector sophistication – with related positive effects to IRR (PricewaterhouseCoopers, 2009; Matthews et. al, 2009; SAVCA & KPMG, 2009).

3.9 Investment Strategy

(Investment strategy 1) Market Timing and State of the Overall market

The literature suggests that overall market cycles and state of the economy influences PE returns: Kaplan and Schoar (2005), Kaplan and Stromberg (2009), Ljungqvist and Richardson (2003a, 2003b) and Lopez-de-Silanes (et al., 2009) all show that changes in public equity valuations during the life of a PE investment has a large impact on IRR, evidencing a close link between private and public equity. That said, Diller and Kaserer, (2007) find no evidence that PE returns are correlated with stock market returns: they find a negative association that instead attests to PE’s asserted portfolio diversification effects (p. 4). However, the majority of the literature, as previously mentioned, finds the contrary to be true: i.e. that the state of the markets impact on returns and and influences how PE can optimise the former.

Market timing refers to efforts by PE funds to optimize returns by selecting deal-by-deal investment timing (within the fund’s lifetime) of investing and selling investments in such a way as to try and optimize returns achieved (Gompers & Lerner, 1999; Schmidt, Nowak & Knigge, 2004, p. 3). If a PE fund can buy companies when general valuations are lower and then select to sell them at times when general valuations increase, market timing will help PE managers optimize returns.

Whether deals will be financed at all depends on the state of the economy — in good times, where the average project is positive NPV, there is overinvestment, and in bad times there is underinvestment. (Axelson, et. al 2010, p. 4). To this point, casual observation tells that during the years of the technology bubble, many PE funds destroyed money because they invested too late, at unreasonable

28 i.e. persistency of returns over different funds at the same PE firm
valuation levels, and were too slow to exit their investments.\textsuperscript{29} Axelson’s (et al) model predicts that returns on PE investments should be negatively related to overall deal activity: in bad times, some good investments are ignored and in good times, some bad investments are undertaken. Hence, the average quality of investments taken in bad times will tend to exceed that of those taken in good times (2010, p. 35). Gompers and Lerner (2000) proposed a complementary idea with their “money chasing deals” argument: higher investment level growth rates increase target company prices but not, correspondingly, available investment opportunities. Therefore, in peak market states some capital must go to mediocre investments, contributing to lower performance of overall PE returns. This further suggests the significant impact of the overall state of the market on PE returns.

\textbf{(Investment Strategy 2)  PE Investment stage & Deal size}

Of 327 PE-backed South African companies recently surveyed, expansion and development capital was highest by type of investment received (40%; relative to 30% for buyouts/ins and venture capital, respectively). Around 39\% of the expansion/development capital companies received financing in the “\textit{mid-market range} of between R50m to R1bn.” - SAVCA & DBSA (2009, p. 16, 21,23)

Lopez-de-Silanes (et. al, 2009, p. 4) studied the most extensive PE dataset to date (7500 investments, 250 PE firms, 30 years): although they do not specify whether size is associated with higher PE returns, their data suggests that the majority of PE investments globally are in fact quite small. The median (average) size of investments in their sample is US$15 (US$36) million dollars (2006). The authors highlight that the multi-billion dollar deals covered in the press are in fact a tiny majority of all deals made: only 10\% of investments are above US$100 million of equity while over 20\% are below US$5 million.

\textbf{(Investment Strategy 3)  PE Geographical focus}

A PE fund’s regional focus can impact PE returns by influencing access to funding and to (possibly) more returns-enhancing deals in less competitive and higher growth markets. This implication follows from Gomper and Lerner’s (2000) “money chasing deals” thesis, which suggests that competition can increase deal acquisition prices, thereby negatively impacting on PE’s ability to optimize realized returns. Regional markets may, being potentially less competitive, also reduce PE propensity to overpay or to otherwise make marginal acquisitions, thereby improving PE’s ability to optimize returns. From 2007 to 2008, South African PE funds underwent the most dramatic preference shift relative to other emerging markets\textsuperscript{30}: LPs preferring regional funds to access South Africa over

\textsuperscript{30} “Emerging Markets” refers to Emerging Asia (excluding Japan, Australia and New Zealand); Central & Eastern Europe/Russia; Latin America & the Caribbean; Africa; and the Middle East (EMPEA, 2008: survey of 81 global LPs investing in emerging markets)
country-dedicated funds rose from 16\% to 51\%.^31 (EMPEA, 2008, p. 6). The literature shows that economic growth is the primary driver of increased GP commitments: 67\% of a representative sample of 151 global GPs surveyed cited greater exposure to high-growth PE markets as their primary motivation. A further 58\% cited an improved risk-return profile in these markets over the last 12 months.

The above findings imply that geographical focus will become a factor in helping PE fund to maximize their returns. For South African PE, this suggests an increasing trend toward Pan-African PE focus. Notably, in terms of its implications for local PE’s ability to capitalize to the benefit of returns on South African PE’s strong image relative to pan-African PE generally, only 30\% of the 151 GPs cited “limited scale of opportunity to invest” as a deterrent to investing in Africa, while 60\% cited “a shortage of access to experienced GPs” as the greatest barrier to investing (2008, p. 10). This pan-African regional trend has also been confirmed as a key emerging trend as observed in both PE fund raising and investment activity in Sub-Saharan Africa, such as the dominance of funds raised for regional strategies (SAVCA & Evaluserve, 2010, p. 3). This report tests and reports as part of its findings (Chapter 6) the hypothesis that SA private equity practioners will increasingly view Sub-Saharan/ regional geographic investment strategies as a source of enhanced returns.

**Investment Strategy 4) Holding Period**

Lopez-de-Silanes (et. al, 2009) studied, as detailed previously, the largest dataset to date and found complementary evidence on the PE holding period debate: that long-lived^32 investments are not the ones delivering high returns. The authors documented a strong negative association between performance and duration: PE investments held less than 2 years have an average IRR of 79\%, those held between 2 and 4 years average 35\%, and those kept beyond 4 years only reach a 10\% average (2009, p. 3). Although their data did not allow them to specify what kind of PE actions are associated with higher returns, it suggests that high-return PE deals may be the result of a quick short-term financial or operational therapy treatment by the PE firm (Rappaport, 1990, in Lopez-de-Silanes et. al, 2009), or the ability of PE firms to buy low and sell high quickly either because they have good bargaining abilities or because they are able to time the debt-equity market (see above: 3.9:1, market timing, for detail). This report tests and presents as part of its findings (Chapter 6) the relevance of this determinant to PE returns from the perspective of South African PE fund managers.

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^31 EMPEA/ Coller Capital 2010 survey: 151 institutional investors based in North America, Western Europe, Central & Eastern Europe, Asia, Africa, the Middle East and Latin America. They form a representative sample of EM PE investors.

^32 The median duration of the investments in our database is four years, suggesting most investments are indeed relatively long-lived.
3.9.1 Literature Review: Conclusions

The literature review revealed a number of factors that are sources or that impact on value creation by private equity fund managers. (Appendix 7) contains the draft of factors outlined by the author during the process of the literature review.

Notwithstanding the low net-debt-to-equity ratios of South African companies, the literature review led to the expectation that operational engineering would be shown to be of greater importance to traditional leverage as a mechanism to help PE managers optimize returns. Given the heterogeneity of private equity, it was further expected that a number of value-creation drivers as identified in this section of the report could all have similarly impacted the optimization of IRR currently in South Africa, and that possibly some aspects of returns unique to the SA context would emerge. Therefore these areas formed the focus of the research in order to identify which of them play a part or are more important/unique to the SA context. Ultimately, it was expected that any consensus as to the factors supported in the literature would be caveated by the finding of past similar studies that PE is too interdisciplinary to distil the sources of return into a few concise elements (or hence to hold robust to any universally transferable methodology).
4. RESEARCH METHODOLOGY

4.1 Research Design:

This study adopts a qualitative methodology and a cross-sectional design that aims to incorporate positivist rigor by “triangulating” data sources and techniques (i.e. both secondary and primary data sources; both a survey questionnaire and interviews). Research literature advocates this approach as a way to balances the strengths and weaknesses of purely positivist (i.e. quantitative) or constructionist (i.e. qualitative) designs (Abrahamson, 1983).

Much of the existing research on PE returns is restricted to quantitative attempts to establish relationships between some identified sources of return and the realised IRR returns achieved by PE fund managers. These studies rely for their deductions on secondary data provided in completed and exited buyout investments (Kaplan & Schoar, 2005; Groh & Gottschalg, 2006; Phalippou & Gottschalg, 2007).

The design adopted in this research deviates from prior research methodology for two main reasons. First, data on exited PE investments is very difficult to obtain: even abroad where the literature on PE is more extensive, researchers concede as much and, in the majority, only managed to adopt their quantitative methodology because they managed to access proprietary fund data (Caselli et. al, 2009 sample database access provided by an “anonymous” Italian PE fund; Chapman and Klein (2009) regressions given “confidential” transaction-level data on 288 exited transactions; Van Niekerk & Krige, 2009, proprietary access to South African exited-transactions database).

Secondly, IRR is a flawed measure of performance, open to manipulation by PE practitioners (Phallipou, 2007). Since this report’s design seeks to capture subjective opinion, rather than to determine absolute PE performance, the author is confident that such a design averts the shortfalls of prior designs, problematic in their singular use of statistical technique and reliance on reported IRRs.

According to Leedy and Ormrod (2010), qualitative research provides an understanding of the problem setting (i.e. local SA context) and is especially appropriate when seeking to capture or understand people’s beliefs, experiences, behaviour and interactions. The advantage of a qualitative approach is that it affords in depth study and the extraction of more nuanced information about a much smaller number of people.

Quantitative research Quantitative research seeks to quantify data by typically applying some form of statistical analysis; it is the appropriate method to use when seeking to identify causal relationships. While it answers questions like “how much”, it fails to adequately answer questions like “why or how” or to capture nuanced opinions, aspects that this study attempts to address (Bryman & Bell, 2007).
4.2 Research Philosophy:

Ontology is defined as the “philosophical assumptions [one has] about the nature of reality” (Easterby-Smith, Thorpe, & Jackson, 2008, p. 60). Ontology of social science can be representationalism, relativism or nominalism. The relativist position assumes that “truth is determined through consensus between different viewpoints” and that facts “depend upon the viewpoint of the observer” (p. 62). Epistemology is defined as the “general set of assumptions about the best ways of inquiring into the nature of the world” (Easterby-Smith et al., 2008, p. 60).

Relativist epistemology asserts that “different observers may have different viewpoints and that ‘what counts for the truth can vary from place to place and from time to time’ (Collins, 1983 in Easterby-Smith, Thorpe, & Jackson, 2008, p. 62). Consequently, it concedes that the ‘difficulty of gaining access to ‘reality’ means that multiple perspectives will normally best be adopted through a ‘triangulation’ of methods and the surveying of views and experiences’ (p. 63).

This report adopts a relativist ontological and epistemological perspective for the following reasons:

1. “There is a reality which exists independently of the observer” (Easterby-Smith et al., 2008, p. 60): That is, there are empirically-tested and broadly identified methods of value creation by PE globally identified in similar studies abroad in the literature.

2. Different observers may have different viewpoints and that ‘what counts for the truth can vary from place to place and from time to time’ (2008, p. 62): The financial crisis is “reshaping the landscape of private equity investing” (Matthews, Bye, & Howland, 2009, p. 21), arguably hence from a relativist perspective this is changing “what counts for truth…from time to time,”

3. “The difficulty of gaining access to reality”: limited access to statistically significant data imposed by PE’s exemption from public disclosure renders getting to the “truth” through strictly positivist, statistical experiments problematic. There is also the further issue posed by sampling and selection bias (Leedy & Ormrod, 2010).

4. Triangulation of methods and the surveying of views and experiences of …samples of individuals” (2008, p. 63). IRRs are empirically shown to be inherently problematic both in their calculation and in their inadequacy as a measure that accurately captures the diverse value-creating competencies of private equity managers. Moreover, as Leedy and Ormrod (2010) concede, statistics can summarise but “cannot capture all the nuances” of a particular phenomenon (p. 30). A relativist perspective acknowledges these positivist shortcomings.
4.3 Pilot Study

A pilot study of the online survey questionnaire was conducted with 2 industry participants to pre-test the compiled questions. This enabled the author to attempt to limit interpretation bias and to test what questions would (or would not) be effective in helping to solve the overall research problem. (Leedy & Ormrod, 2010, p. 111). The pilot population could be considered small, but circulating the questionnaire more widely would have reduced the report’s already limited ultimate population, since such input must then be excluded from findings of the final report – and this moreover, in view of the risk of traditionally low survey response rates.

4.4 Data Collection Methods and Research Instruments

4.4.1 Data Collection Methods

Secondary data in the form of similar past studies abroad and various sources of academic literature were consulted as a first measure in identifying the relevant sources of and/or influences on optimal PE returns (Leedy & Ormrod, 2010). Primary data was collected through an anonymous online questionnaire survey which used a unique url link to permit direct access to the survey on the secure, web-hosting GSB website. (see Appendix 4 & 5). Further, 7 in-person, semi-structured interviews were conducted contemporaneously with the online questionnaires. Robson (2002) supports semi-structured interviews as a technique to reveal “what is happening and to seek new insights” (p. 59). While the interview sample size could be considered small, it has precedents broadly in PE literature. (Kaplan, Mitchell, & Wruck, 1997).

The questionnaire and interviews contained both closed and open-ended questions; the close-ended questions referred to the specific mechanisms used and other aspects (as most conspicuously identified in similar studies in the literature) that influence the optimization of returns by PE fund managers. Open-ended questions were used in the interviews to offer participants an opportunity to provide greater primary data (and detail) on specific factors and themes identified in the literature or that may have a particular context-specific (South Africa) impact. As advocated in research literature, the number of questions was limited to ensure that potential respondents were not deterred by seemingly having to write a lot, or to participate in unduely lengthy interviews (Bryman & Bell, 2007).

The questionnaire asked participants, using Likert-type scale questions, to rate the importance of various aspects of value creation as identified in the literature review. Respondents were also asked to rate the extent to which they agreed (or disagreed) with questions related to an attempt by the author to test hypotheses set forth in this report to uncover possible influences on PE returns unique to SA. The number of targeted respondents and PE confidentiality challenges make a questionnaire a particularly cost and time effective strategy for data collection (Bryman & Bell, 2007).
4.4.2 Research Instruments: Questionnaire Design

The literature review\(^{33}\) provided the point of departure in identifying aspects that impact on PE returns (see: Appendix 7 for mind map). They were then converted into closed-ended, clear and concise sentences to enhance clarity and so avoid confusion (Easterby-Smith et. al, 2008).

To capture a broad set of subjective PE perspectives, ranking questions were designed by using a **Likert-type scale type of questionnaire** that asked South African PE fund managers to rate, in the context of their funds, various aspects identified in and hypothesized from the literature as influencing the profile of PE returns. A Likert-type design facilitates asking a bulk of standard questions since it merely requires a rank response on a scale of 1 to 5 (i.e. “very important” to “very unimportant”). The bulk of new information was gathered during the interviews, designed to shed light on any emerging themes identified from the surveys.

The key areas for exploration were divided into 3 main categories as identified in the literature: Financial Engineering, Governance Engineering and Operational Engineering. Other categories, which included alternative, less apparent factors that impact on PE returns were randomised in the rest of the survey. Hence, to start off, the respondents were asked to rank the relative importance of the 3 main categories that typify PE value creation literature. In this way, it was hoped that first making clear the key identified issues would later facilitate data analysis regarding consensus on the key theories. The randomised design of the other questions helped to limit any perceived order effect and to extract new and/or future insights most relevant or possibly unique to the SA context. The broad categorization represented in the diversity of questions asked recognized the diversity of the target population and the fact that the instruments were designed to capture subjective opinion (i.e. that different fund/interest groups within the respondent population would likely have differing views.

4.4.3 Research Instruments: Interview Questions Design

The Likert-type scale questionnaire design was complemented by interviews that included open-ended questions that explored the same themes as the online survey. Also included were more expansive topics intended to allow more detailed discussion of influences to PE returns, and any additional methods or aspects that influence returns inconspicuous in the literature or unique to the South African context. The author attempted to target a differentiated typology of interviewees, including such factors as funds that have a pan-African strategy, fund size by gauges of assets under management, focus by PE investment stage and geographical focus (all aspects identified during the

\(^{33}\) Literature prominent in originating the author’s hypotheses on SA context-specific influences on PE returns include; Millson & Ward, 2005; Ernst & Young, 2008; EMPEA, 2008; Settel, Chowduhury, & Orr, 2009; SAVCA; DBSA, 2009 Evaluserve & SAVCA, 2010; SAVCA & KPMG, 2010.
literature review as potential influences on PE returns). This layered typology in fund selection is deemed appropriate, given this study’s aim to fill a research gap by documenting direct practitioner perspective, as well as by adopting the “multiple perspectives” approach espoused by relativist philosophy. The open-ended questions were designed to complement themes explored in the online survey: this was intended to facilitate later comparison of data and in order to improve consistency of data capture for final analysis.

The inclusion of interviews is particularly relevant given the “highly subjective [nature] of private equity investments’ valuations” (SAVCA and KPMG, 2010, p. 40), and that most of the generally applied methods for measuring the importance of different value creation drivers “do not comprehensively account for all relevant aspects” (Achleitner et al, 2010, p. 17)

4.5 Data Analysis techniques: Online Questionnaire

The survey was hosted on the Graduate School of Business’ (GSB) secure online survey-hosting website, which enabled the author to track response rates and pace follow-up calls to the original target sample population. The GSB survey tool also generated a series of simple analytics that enabled the author to sense-make trends and identify emerging themes from the closed-ended questions. The author then re-grouped the raw-data of the survey questions into their relevant categories (see: section 4.6) once the survey results were downloaded. Any perceived order effect of rankings was limited during the survey by ordering the questions randomly and not in any perceived order of importance. Also, the questions were tailored and presented in an equal manner to all participants, which facilitated later comparison of the data.

In seeking to understand and analyse the rankings, statistical analysis was decided as inappropriate: the aim of the research is not to prove causality or to establish absolute importance but to capture and document as broad a set of views as possible within the given time for the report and selected interest group - and to achieve as high as possible a response rate from them. The analysis technique adopted to present the report’s findings therefore uses descriptive statistics (pictorially) present the proportion of respondents indicating specific answers to the closed-ended survey questions. Where there is consensus, such a technique allows the author to easily identify and document for speed and ease of reader comprehension, areas of agreement or of divergence from the existing literature.

4.6 Data Analysis techniques: Interviews

The interviews were typically 30-45 minutes long; They consisted of open-ended questions designed to shed light on any emerging themes in the online surveys and, pointedly, to enable interviewees to elaborate on possible SA context-specific influencers on PE returns. As such, interviewees were also able to add any additional factors or issues of their own that may not have been addressed in the
closed-ended survey questions. Since the themes of such responses were in the majority identified by the author in advance through the literature review and surveys, the short written answers in notes taken by the author during the interviews were made easier to analyse post-interviews. The technique selected by the author to analyze the content of these interviews follows the analytical approach proposed by Creswell (1998). This approach comprises the following 4 steps; 1) Organising the data and breaking down large bodies of text into smaller units; 2) Perusing the entire data set several times to get a sense of what it contains as a whole; 3) Identifying general categories and themes and classifying each piece accordingly and 4) Integrating and summarizing the data.

The above technique used to analyze the open-ended interview questions is known as “content analysis.” (Leedy & Ormrod, 2010). Content analysis involves cross-referencing “raw” interviewee commentary with “codes” (i.e. common themes or facts identified in the literature) to reduce any bias that may be introduced by the author “as participant” integral to the interpretation of the informants’ responses. This systematic approach enhances the objectivity with which the author “sense-makes” during the qualitative process, and enabled the author to pick up where key themes emerged or where new information was provided.

4.7 Sampling: Questionnaire and Interviews

The online questionnaire sample is based on The Southern African Venture Capitalists Association (SAVCA) list of 2010 members (excluding associate members). The SAVCA database lists both full and associate memberships (the latter includes intermediaries such as accountancy and law firms). This approach in identifying sample populations has precedents in the literature (Van Deventer & Mlambo, 2009). The population sample targets only late-stage PE segments. Like the online survey, the interviews were designed to be as representative of late-stage PE as possible, targeting a cross-section of firms balanced across firm and fund size, regional focus and investment strategy (Appendix 8 – in green).

The author consolidated both lists and identified a core list of 40 late-stage firms specifically identified via cross-internet searches of their respective websites as dealing in various stages of late-stage PE investment (i.e. definition per SAVCA & KPMG, 2010). In defining this ultimate list, the author also consulted with SAVCA director, Mr. JP Fourie in order to further validate whether the sample adequately represented a balanced typology of the late-stage investment profile of this report. Remaining firms on the SAVCA membership list were left out of the survey (Appendix 8 – in white): their websites either did not specify their specific investment rationale; were under construction, or did not meet the reports investment profile (e.g. law firms/associate members). All potential participants were first emailed a letter of invitation to participate in the survey (Appendix 1). They were subsequently emailed to confirm receipt and as a means of following up/ to permit a more formal
Introduction by the author. Several follow-up calls also allowed the author to directly attempt to incentivise participation in the survey by offering potential respondents a copy of the completed report. Given the anonymous nature of this report’s design, a letter of thanks (Appendix 2) was broadly emailed to the original target survey population, thanking those who had participated and importantly, reiterating confidentiality with respect to the information disclosed. As detailed prior (see: 4.3), a pilot study was trialed over two weeks toward the end of September, 2010 to a maximum of two private equity funds (buyout and growth focused; Africa and domestic in distinct regional strategy).

The original shortlist of interviewees targeted is detailed in (see: Appendix 3). The attempt in selecting the interview sample was to try and reflect the quantitative research concept of “purposeful sampling”: i.e. as diverse a selection as possible yet individuals/firms likely to yield the most information of the topic under investigation (Leedy & Ormrod, 2010, p. 147). The list includes the 7 ultimate interview participants who because of the anonymity afforded to participants, cannot be otherwise specified. The original interviewee list targeted 15 funds in order to accommodate possible rejections or schedule conflicts. Further, to facilitate a cost and time-effective interview schedule, the majority of interviews were located in Johannesburg, where most South African PE firms are located.

4.8 Research Criteria: Reliability and Validity

Leedy and Ormrod (2010) explain that the “validity of an instrument is the extent to which the instrument measures what it is intended to measure”. Past studies have analysed the sources of value creation in private equity principally from a quantitative perspective, relying on secondary financial data and reported IRRs. As a measure of return, IRR’s “validity” has been empirically shown to be problematic; relying not just on the accuracy of reported data but facing inherent challenges to do with its varied calculation (Kaiser & Westarp, 2010, p. 10; Phalippou, 2010, p. 4). Hence, there is clearly ample room for an alternative methodology that might yield higher “validity.” The relative ranking measurements of the Likert-type scale used in the online survey arguably does not suffer the same issues of IRR-related validity, since it minimises any issues of positive bias or reporting inaccuracies by a) the anonymity of its design and b) the fact that it seeks to understand the relative, rather than absolute importance of the various identified sources of value creation and c) because it does not rely on any - self-reported - secondary financial data for its analysis.

Reliability is the “consistency with which a measuring instrument yields a certain result when the entity being measured hasn’t changed”. This study is limited in focus to SA and private equity. Given that different markets have specific and unique characteristics, and given the heterogeneity of PE, the replicability of this study is difficult – as is the case for most qualitative research. However, given that the sources of value creation identified in the literature are in the majority factual, rather than
economically-sensitive (i.e the current financial context), those attributes and their relative importance
could feasibly be re-tested in the future (albeit that the respondents may change positions and hence no
longer provide the same sample basis). Concepts such as validity and reliability are most easily
applied to quantitative research. (Guba & Lincoln, 1994) propose two other criteria instead;
trustworthiness and authenticity. Bryman & Bell (2007) state that trustworthiness is further made up
of 4 criteria; namely 1) credibility 2) transferability 3) dependability and 4) conformability.

Internal validity (i.e credibility) relies on the quantity and quality of responses garnered in terms of
enabling the researcher to construct a “true” picture of the factors that may be influencing the market
(re: relativist “multiple perspectives” philosophy – Leedy & Ormrod, 2010). However, the relativist
philosophy that underlies the methodology adopted by this study uses “triangulation” of instruments as
a way of adding to the validity of the ultimate findings. As far as transferability, this study faces an
issue in that regard since it is limited to a specific context (South Africa) and segment of the private
equity industry (late-stage). Consequently, and not least given the hetrogeneity of the PE practitioners
themselves, the subjective perspectives herein contained should not be used to make generalizations to
other markets. Neither, for that matter, is that the aim or purpose of this study.

In terms of dependability, since clear procedures were set out for the participants in terms of
requirements and guidelines, the author is satisfied that this study’s results should be dependable. In
terms of conformability, the majority of the information was lifted from the online survey rankings
(where the author is not present). Further, the author has taken great care to avoid any subjective bias
that could be introduced by author-interpretation of the raw interview data and open-ended questions.
Consequently, “content-analysis” of this qualitative data has been used as a technique to facilitate
more objective involvement by the author.
5. RESEARCH FINDINGS, ANALYSIS & DISCUSSION

This section details the comprehensive findings from the online survey responses: because respondents could skip certain questions as relevant to the context of their fund, questions answered varied from 16-22 in number of repondents to each segment (i.e. this equates to a 40%-55% reponse rate from a sample total of 40) and the 7 interviews (46.6% of a “purposeful” target of 15), which were both used to conduct the below analysis. The findings are divided into 3 main sections. The first section (5.1) addresses characteristics of the industry participants as derived from the survey sample. The second section (5.2-6.0) is split into sections reflecting the questions and responses of the survey as they relate to the identified categories of aspects that influence PE returns as chronologically covered in the literature review. This section also integrates results from the interview questions, where relevant, to enhance insight or to present new information. It also highlights results of the survey as they relate to the hypotheses outlined in Chapter 2. The third section (5.1) concludes with a discussion of the limitations of the study.

The data depicted below primarily represents the data exported from the GSB’s secure survey-hosting website.

5.1 Characteristics of the Respondents (survey sample)

This section reviews the characteristics of the PE companies who particpated in the online research. Of the 40 PE participants emailed, a total of 22 responses were received to the survey by the cut-off date (10 November, 2010). The pie chart below depicts the breakdown of respondents:

The quality of responses received (46% of responses either private equity CEO or Director) - not least by average survey response-rate standards – confirms satisfactory achievement of this study’s prime research objective; to try and capture PE practitioner perspective, in a “purposeful” representation (i.e. a sample that represents those repondents most likely to meaningfully inform the research topic).

34 The attempt in “purposeful sampling” is to try and capture as diverse a selection as possible yet of key individuals/firms likely to yield the most information of the topic under investigation (Leedy & Ormrod, 2010, p. 147).
Namely, these survey results suggest that significant practitioner opinion, including a number of prominent late-stage PE representatives in SA, was captured among the responses. Hence, while the survey responses were mostly rendered anonymously, the similarly high quality of participants represented in the interviews increases confidence that the survey findings are adequately representative, and can therefore be used to make valuable inferences.

A total of 22 firms answered this question. The PE investment sectors represented display a varied typology of respondents that is reflective of the most recent SA PE industry survey (SAVCA & KPMG, 2009, p. 17): Generalists represented over two thirds of the R106.6bn under PE management. Within “Other”, 3 funds identified themselves as other, specifying Technology, Financial Services and a final fund, to preserve report anonymity, cannot be more clearly identified.

22 firms opted to indicate their fund type in answering this question, and even only within those who elected to do so the survey reflects successful capture of a similarly diverse representation by typology of PE fund type. Within “Other”, 3 funds specified themselves as non-fund, listed and family office.

As expected, the above dispersion in the composition of funds under management reflects that of the
SA industry’s SAVCA 2009 survey respondents: 50.6% independents; 31.4% Captive: Financials, 14.5% Captive: Government and 10.1% Captives: Other. (2009, p. 14).

Of the 22 answers to this question, 3 funds (14%) adopted a multiple regional investment focus covering Global, Sub-Saharan Africa and SADC. While, as expected, the dominant geographical focus is South Africa, it is interesting to note that a substantial percentage (32% combined) of respondents in this sample are investing in regions outside of South Africa as well: this is a key emerging theme identified by recent industry surveys by Evaluserve (& SAVCA, 2009); as well as global LP EMPEA/Coller capital surveys (2008/2010).

The above percentages by PE investment stage of the 22 responses received to this survey question represents overlap for those firms who operate in more than one sector. Notably, these results provide further confidence that this survey successfully captured a representative typology of PE funds, since the dispersion of the respondents closely reflects that of the most recent SAVCA survey (2009), i.e.
investments by stage (based on number of investments).  

A total of 19 respondents ranked the importance of the broad categories identified in existing literature as those typically known to influence the optimization of PE returns (results are as depicted above).

What is important to note here is that the differences in the average rankings is not statistically significant. Given the evidence in academic and popular literature abroad as documented in Chapter 1 of this report, the expectation going into the survey was that PE fund managers would now either a) possibly rate operational engineering as more important than financial engineering or b) in a testament to PE’s alleged “evolved model of value creation” and that PE managers will be more focused on extracting value from their existing portfolios, that the statistical difference between the two categories would at least be more pronounced. (PricewaterhouseCoopers, 2009, p. 1, 2; SAVCA & KPMG 2009, p 4; Palter & Kehoe, 2009). That said, the limited statistical dispersion provides some new evidence that confirms SAVCA’s assertion that the ongoing infrastructure development programme, coupled with traditionally lower relative levels of company gearing, may mean that SA private equity is unlikely to see distressed debt situations as dire as compared to other PE markets, and that SA has perhaps suffered relatively less from the reduced availability of debt witnessed in PE markets abroad. Fundamentally, the results (notwithstanding constrained credit markets) underline not only the relative importance of operational, governance and financial engineering, it is noteworthy that financial engineering remains a cornerstone and ideal tool used by PE to try and maximise returns.

Following this overview of the findings and analysis of the characteristics of the survey respondents, the following sections re-group (as chronologically covered in the literature review: see Chapter 3), the survey questions and answers by category of influence on PE returns;

5.2 Financial Engineering: In each instance of the following diagrams, the survey participants were asked to rate the questions highlighted in the diagram headings; (5 ranks: very

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35 1% seed capital; 22% Start-up & early stage; 51% Expansion & development; 9% Replacement; 17% Buyout (SAVCA & KPMG, 2009, p. 31)
important - very unimportant, as detailed below):

1. In the context of your fund, how important to optimising returns (IRR) do you rate the following:

   Notwithstanding debate in the literature regarding an evolving, more operationally-focused model of value creation in PE given reduced access to credit, responses as to the relevance of leverage as a tool to helping PE managers optimize returns would seem to indicate that debt remains a key premise of PE’s differential value-creation, and a mechanism used broadly by PE practitioners to improve returns. 20 responses were received to each of the above survey questions: in each instance, the combined percentage weightings affirm the importance of leverage either as a general tool to enhance IRR, or in terms of the degree of leverage of the target at the point of acquisition as “very important” or “important” (combined 65% and 55%, respectively). This result “triangulates” the results of the broad, initial categorical rankings, whereby leverage still came ahead of operational engineering, albeit only slightly (2.74 average rankings vs. 2.53 of a total of 22 responses received to that question).

These results suggest that from the perspective of the PE respondents currently surveyed, financial engineering still appears to lead in terms of interventions that help PE managers to optimize their returns. Further indication of the former is provided in the notable dispersion in the above responses: over half (i.e. 55%) of the survey population consider “very important/important” assessing as part of their due diligence on potential investments the leverage of the target at the point of acquisition, which implies that PE managers assess leverage prior to the transaction to ascertain its potential to help them add and deliver on value creation (i.e.returns) afterwards, which clearly suggests the importance of leverage as a prime tool used by PE managers to maximize returns.

The report made one of the following, leverage-related hypotheses. Discussion on findings follows:

Drivers of value creation (i.e. returns) possibly unique to the context of SA private equity:

Leverage will remain a relatively key mechanism of SA private equity value creation (i.e. returns) as
Leverage overall, as affirmed in Diagrams 10, 11 (prior page) and A (above), is rated of particularly high importance by PE practitioners in helping them to optimize returns. Of 18 respondents (see: Diagram A), 14 respondents or a combined majority of 78% ranked very high the influence to maximising returns of debt as an “agency” tool to discipline and incentivise entrenched target management. However, these results appear to contradict the not insignificant number of dissenters in the survey, who as per Diagrams 10 and 11, surprisingly rate either “unimportant” or “neutral” the general use of leverage, or the degree of target leverage. These combined findings prompt the following possible explanations for the seeming contradiction:

First, the results may perhaps be such less because leverage is not perceived to be a significant tool to optimising returns than because access to such leverage is currently (and will be for the foreseeable future), restricted (see the majority results to this effect in Diagram B). Certainly, the interviews confirm as much: of the 7 interviewees, all believed that constrained credit markets will remain a fixture of the future PE investing landscape, with resulting implications for how PE firms organise themselves to create value and optimise PE returns going forward. Secondly, the “neutral-unimportant” results of the leverage findings simultaneously suggest the emergence in SA PE - as advocated in the literature - of a more “active involvement”, internally focused and operationally-led model of PE value creation that is less dependent on financial engineering to generate returns.

Van Niekerk and Krige (2009, p. 10) argue that in the end, all arguments that explain the “source” of optimal PE returns can be reduced to earnings growth. The results of the survey complement that finding. Since 20 responses were received to both the questions asking PE managers to rank the importance to optimising returns of leverage (Diagrams 10 & 11), as well the questions on the importance to optimising returns of earnings (Diagrams 12 & 13), the findings to each of the

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36 (i.e. Lower levels of gearing in local deals, historically low net-debt-to-equity ratios in South Africa (about 7% compared has been “relatively shielded ….and not suffered the general toxic debt exposure.” (SAVCA & KPMG, 2009to 32% in the USA and 45% in Europe: SouthAfricaInfo, 2007) and given that the SA economy , p. 4)
Consistent with Van Niekerk & Krige’s _quantitative_ analysis (regression) findings on the importance of EBITDA to IRR, this _qualitative_ survey’s results indicate that a majority of PE practitioners (i.e. 70% or 20 respondents: Diagram 13) rate “very important” the scope to increase earnings at the target investment. Further interpretation of this result as compared to the findings on the importance to IRR of the degree of target leverage (see: Diagram 11) yield an interesting finding: SA PE managers appear to rate of more importance the scope to grow or improve EBITDA at a target firm than the scope to simply “leverage-up” profits (only 20%: Diagram 11), as critiques of PE typically assert (Farzad, 2007; Jackson, 2010; Morris, 2010). This finding hence lends support to the fact that PE managers create and add differential value in maximizing returns through their unique professional expertise.

5.3 **Operational Engineering:**

Of 20 PE respondents to this question, a majority rated more important to optimizing IRR the ability of the PE firm to adopt a _multiplicity_ of mechanisms to increase the overall productivity of their target investments, rather than of cost-cutting initiatives, _per se_ (combined 85% or 17 firms, Diagram 15 vs. combined 45% or 9 firms, Diagram 14).

These findings are notable in that they provide evidence consistent with recent findings of a significant extant of PE-backed SA companies: 56% (sample: 327) of companies surveyed cited the positive contribution made by PE beyond financing that includes “increased profitability…efficiency and [other] benefits conferred from ownership” (SAVCA/DBSA, 2009, p. 36). Clearly, PE applies a _multiplicity_ of efficiency-enhancing tools rather than necessarily and solely “harsh” cost-cutting measures to improve performance. The reason for the separate survey questioning of PE practitioners as to the importance to optimizing IRR of cost cutting, and to overall improved productivity, was an attempt by the author to unearth any differentiation within SA PE opinion as to the relative importance
3. **In the context of your fund, how important to optimising returns (IRR) do you rate the following:**

![Diagram 14: Cost-cutting Initiatives at the Investee](image1)

- Very important: 5%
- Important: 15%
- Neutral: 30%
- Unimportant: 50%
- Very unimportant: 15%

![Diagram 15: Ability of the PE firm to increase the productivity of the investee](image2)

- Very important: 15%
- Important: 35%
- Neutral: 50%
- Unimportant: 15%
- Very unimportant: 50%

of cost-cutting measures: there is considerable literature that criticizes PE efficiency gains (and related increased returns) as primarily related to PE’s apparent harsh cost-cutting measures (characterized as “easy” gains typically deriving mostly from “cost-cutting” headcount cutbacks at the target), (Phalippou, 2008; Cressy et. al., 2008). These results are also notable for the fact that they complement the findings of an emerging literature that emphasize a new model of PE value creation premised on returns driven through operations rather, *per se*, than leverage or “harsh” cost cuts (Apax Partners/The Economic Intelligence Unit, 2006; PwC, 2009; Campbell & Legere, 2009; Hevizi, 2009).

4. **In the context of your fund, how important to optimising returns (IRR) do you rate the following:**

![Diagram 16: The PE firm grows the investment by acquisitions](image3)

- Very important: 25%
- Important: 20%
- Neutral: 55%
- Unimportant: 20%
- Very unimportant: 30%

![Diagram 17: The PE firm grows the investment “organically” (i.e. rather than by acquisitions)](image4)

- Very important: 20%
- Important: 30%
- Neutral: 50%
- Unimportant: 20%
- Very unimportant: 50%

The above survey results (20 respondents) complement the findings of SAVCA & DBSA’s 2009 analysis, the first of its kind in SA to attempt to measure PE’s economic contribution to industry. In that report, 82% of SA PE-recipients were found to achieve the majority of their growth organically rather than by acquisitions.\(^{37}\) However, the extent of this complementary finding is tempered by an almost equal and significant number of respondents (i.e. 55%) who rate investee acquisitions as “important”. Consequently, the findings lead the author to conclude that a majority of PE practitioners

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view add-on acquisitions as equally important a tool as organic growth in optimizing PE returns. The report made the following, acquisitions/growth-related hypothesis. Discussion on findings follows:

**Drivers of value creation (i.e. returns) possibly unique to the context of SA PE:**

**Operational engineering:** South African private equity practitioners tend to use organic rather than growth by acquisitions in maximizing returns.

Contrary to the significant dispersion of the Development bank of South Africa (DBSA) 2009 survey results, the findings depicted in Diagrams 17 and 18 are instead consistent with an alternative strand of the literature that finds that value-adding, add-on acquisitions are rated as equally important tool of returns optimization by PE practitioners relative to organic growth, (Nikoskelainen & Wright 2007; PricewaterhouseCoopers, 2009 Chapman and Klein 2009, p. 22). However, an alternative explanation for the almost equal rankings of add-on acquisitions and organic growth strategies to optimizing PE returns could be the fact that smaller firms within the survey perhaps lack the financial clout or access to leverage of the larger, more established firms within the sample. As such, those firms in the sample with easier access to leverage may have rated acquisitions relative to growth as “very important/important.”

Alternatively, it may be that regardless of access to credit or firm/fund size, respondents view both strategies as equally “important”. Constrained credit has heightened the fact that PE firms can no longer rely on financial arbitrage or on previously arcane financial instruments like debt derivatives in order to optimize returns. Accordingly, for PE firms to now use their skills to consolidate fragmented markets through acquisitions might not be as attractive as the choice of organic growth – regardless of their financial clout or access to credit - particularly since acquisitive operational engineering requires debt (which especially on previously financed deals might not be as attractive, since this could lead to repricing of prior debt). This report made the following hypotheses related to the financial and operational engineering findings previously reviewed. Discussion on related survey findings follows:

**Drivers of value creation (i.e. returns) particularly relevant to the profile of SA private equity:**

**Operational engineering (A):** will increase relative to financial engineering as a technique for optimizing returns (Palter & Kehoe, 2009; Achleitner et. al, 2010) - (see: Diagram 18)

**Operational Engineering (B):** as the PE value creation model becomes more internally focused on extracting value from portfolio companies, PE firms will prioritize hiring more “operational”, industry-based experience or skillsets than more financial/valuation-related skills (Palter & Kehoe, 2009; Achleitner et. al, 2010) – (see: Diagram 19)

The results of the survey suggest that PE practitioners in SA will increasingly rely on operationally-led

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value creation mechanisms relative to financial engineering in their attempts to positively impact PE returns. Namely, of the 18 respondents questioned on whether operational would increase relative to financial engineering in the foreseeable future (i.e. with regards to interventions used by PE to maximize returns), a combined 83% either “strongly agreed/agreed” with this statement. While dissenters to these results surfaced, the resounding “yes” of the majority is inferably more telling of the relative importance to IRR of operational versus financial engineering, at least for the foreseeable future given strained credit. These findings further confirm assertions in the literature as to an “evolved” model of, operationally-based, PE value creation going forward (Matthews et. al., 2009).

Interestingly, the previously cited majority findings also make it interesting to ask whether this would translate into increased demand and/or hiring of “operationally” experienced hires or increased partnerships with consultants/industry (i.e. as opposed to hires conducting initial due diligence of transactions, e.g. financial/accounting-related skillsets). While not strictly unbiased in terms of comparability given that this question received 16 versus the 18 responses to Diagram 16 and 17, nonetheless there is a notable disparity in the neutral rating to this versus the prior, related question: i.e. 31% (5 firms in Diagram 18) relative to 11% (2 firms in Diagram 19), respectively.

Detractors to the majority in the survey results of Diagram 19 found company in the interviewees; almost 43% (3) of the 7 interviewees did not believe that operational hiring or use of industry experts would necessarily increase in the context of a PE value creation model evolved to manage restricted credit markets by becoming more operationally focused. Instead, those interviewees asserted that financially-related competencies were equally important to returns, since PE value creation prior to a transaction (i.e. competent due diligence) is just as important to IRR as is operational expertise/experience. That said, a relatively larger 57% (4 interviewees) “agreed” with Operational B hypothesis, not necessarily to the extent that operational hiring would increase per se, but that value-creation in PE was ultimately moreso found “soft” managerial skills than in core financial competency (which was perceived to be more of a “commodity” skill, and so easier to recruit). Consequently, the
survey appears to suggest that while the majority of PE firms either strongly agree/agree that operational will, for the foreseeable future, eclipse financial engineering in optimizing returns, a contrarian contingent of respondents do not believe that their ability to attract operational expertise to the investee is any more relatively important to how they will continue to aim to optimize returns.

A possible explanation for the above finding can be traced to a related finding in the literature: the above disparity in survey results appears to complement Lopez-de-Silanes’ (et. al, 2009) assertion that some PE firms may hurt returns by failing to proportionally scale up resources as they grow or, in this case, as the PE value-creation model evolves (and, hence, warrants related adaptation in resource capabilities) – (Chapter 3). That said, the key finding, as inferred by the majority of respondents who either “strongly agree/agree” with the two prior statements (i.e. Diagram 18 & 19: 83% and 69% combined, respectively) provides new evidence from the SA private equity practitioner perspective that confirms findings in the literature that operational will likely increase in importance as a value-creating intervention relative to financial engineering. In tandem, the industry may likely witness a related increase in operational hires or in industry-expertise led partnerships.

5.4 Governance Engineering:

The diagrams below indicate the governance-related survey results for questions which asked respondents (as specified in the diagram headers) to either rate the importance of the issue in question to how they optimize returns – or, to rate the extent to which they agreed with the given statement:

4. In the context of your fund, how important to optimising returns (IRR) do you rate the following:

An interesting disparity in the governance-related survey results emerged: notwithstanding the higher average ranking of “use of incentives” relative to “active involvement in the investment by the PE fund” in the initial broad categorical ranking at the onset of the survey\(^{39}\), only 90% of these same 20 respondents rated “use of incentives” as important to IRR, while 100% rated “active involvement” as such. Further, a notable 10% rated the importance of incentive packages as “neutral” to returns.

\(^{39}\) (i.e. 2.47 vs. 2.26 average rankings, respectively, on a scale of 1-4)
5. Please indicate the extent to which you agree (or disagree) with the following

This is curious finding because agency theory⁴⁰, like the use of leverage, is widely regarded in the literature as cornerstone tool applied by PE to optimize target returns.

When assessed with the findings depicted in Diagram 22, which shows that a majority of the 18 respondents to that question highly rate the importance to IRR of “common strategic vision…”, the disparity in the previously-cited governance ratings between “active involvement” versus “incentives” is perhaps not as pronounced. These findings suggest that in terms of relative importance, the SA PE perspective captured in the survey sample rates “active involvement” as marginally more important than incentive packages in optimizing PE returns.

An explanation for the discrepancy in the above-mentioned ratings may be attributed to the fact that the constrained credit environment may be causing South African PE managers to become, as asserted by the SAVCA, more “internally focused” on their portfolio companies as a means to extracting IRR-enhancing value (SAVCA & KPMG, 2009). Interviewees further confirmed this finding; a majority underscored the relatively greater importance and impact of active involvement in optimizing returns.

A further interesting finding of the survey as it pertains to possible influence on returns optimization in the future is depicted in Diagram 23. This question sought to capture the opinion of SA PE managers as it relates to governance of the PE firm itself (i.e. as opposed to the traditional view of governance engineering as applied by the PE firm to target management). Namely, as PE firms, particularly overseas, have grown in size and subsequently even elected to publicly list on an exchange, an emerging literature has critically hypothesized that in so doing, such PE firms are unravelling a fundamental advantage and the very premise of PE’s “source” of returns”: i.e. that PE is “private” and so not subject to the agency-related conflicts typically imposed by shareholder-focus or

⁴⁰ i.e. governance engineering through the use of incentives packages that minimizes the typical conflict in listed/ public companies of the conflict between entrenched managers as self-serving agents rather than as accountable “owners.” (Jensen, 1989)
information disclosure, (Jensen, 2007, p. 3, 31). Interestingly, a combined 38% of respondents concur with this statement while 44% (7) indicated neutrality.

A possible explanation for the significant number in the survey who indicated neutrality may well be because public listing of PE firms has been an overseas rather than SA phenomenon, and so is perhaps less contextually relevant to any impact on optimizing of local PE returns. currently or in the near future. That said, these findings suggest that a significant number of local PE managers in the sample believe the lack of disclosure requirements is a significant, and differentially important “source” in optimizing PE returns.

5.5 Deal Flow:

The diagrams that follow re-group the deal-flow-related survey questions specified in the diagram headers (and organised chronologically, for ease of reader reference, as per the literature review: see Chapter 3). Related survey results are depicted. The section is organised as follows; deal flow aspects of reputation, capital overhang; entry valuation, BEE and MDFI influence on LP risk perceptions.

(Deal Flow 1) - Reputation

6. In the context of your fund, how important to optimising returns (IRR) do you rate the following

20 (and 18) responses were received to the questions posed in Diagrams 24 (and Diagrams 25, 26), respectively. A majority of respondents rated as highly important to optimizing IRR the reputation of the PE firm in terms of securing credit or (leverage) financing. These results were “triangulated” by the author by randomising (and asking a similar question later in the survey) in order to limit any perceived order effect bias of question rankings (see similar question: Diagram 26). “Coherence” in the findings to questions posed on reputation in both Diagram 24 and 25 is evidenced in the almost equal statistical dispersion in results (70% and 72% of respondents, respectively). Importantly, this demonstrates successful achievement of this report’s design objective: to “triangulate” findings for robustness of any inferences made. None of the respondents were “neutral” or “disagreed” that PE
7. Please indicate the extent to which you agree (or disagree) with the following:

![Diagram 25: The reputation of a PE firm influences access to deals/deal flow]

- 44% Strongly Agree
- 56% Agree
- 22% Neutral
- 11% Disagree
- 11% Strongly Disagree

![Diagram 26: The reputation of the PE firm influences access to leverage]

- 50% Strongly Agree
- 22% Agree
- 11% Neutral
- 11% Disagree
- 5% Strongly Disagree

firm reputation can affect IRR optimization by influencing access to deal flow. Conversely, disparity surrounded opinions on the effect of PE reputation on fund access to leverage. This finding implies that while SA PE managers in the sample rate PE fund reputation as significant to optimizing IRR, it is less significant in terms of access to leverage than in access to deal flow. This finding is also consistent with the literature; Ernst & Young (2008) found that 82% of their 2007 survey sample of South African PE-backed investments were originated proactively by PE funds who sought to establish relationships with the target’s management (p. 12). This underscores the relatively greater significance to IRR optimization of unique PE firm relationship and networking competencies.

The above results were triangulated through the interviews, which conversely placed equal importance to IRR of reputation for access both to leverage and to deal flow. Interviewees explained that particularly in SA, the PE community is small. Also, now more conservative lenders prefer only the perceived “safest” of clients, generally taken to be the bigger or leading PE houses who have longer track records and a larger geographical or deeper footprint (geographical or otherwise). That said, interviewees stressed that they consider relationships (and networks) a particularly contextually-relevant feature of IRR optimizaion in the SA market. As one interviewee confirmed;

“deals take longer to do in South Africa: it is much more relationship-driven and one has to take the time to establish a relationship and win the confidence of the [investee] management”. (interviewee, 2010).

The survey results (20 respondents) depicted in Diagram 27 further trianguate and confirm the above-mentioned findings; PE firms rely on their reputations to attract entrepeneurs and investors. Reputation becomes a means to optimise returns because a) it can help a PE firm attract deal flow (and so potentially gain access to more/returns-enhancing investment opportunities) - and b) it can help PE firms to optimise IRR by differentiating themselves from the competition.
8. In the context of your fund, how important to optimising returns (IRR) do you rate the following:

<table>
<thead>
<tr>
<th>Proactive deal origination by cultivating relationships with the target investee</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>-------------------------------------</td>
</tr>
<tr>
<td>Deal Flow 2) - Capital Overhang</td>
</tr>
</tbody>
</table>

9. Please indicate the extent to which you agree (or disagree) with the following:

<table>
<thead>
<tr>
<th>Capital overhang could increase competition for deals in the future</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strongly Agree</td>
</tr>
<tr>
<td>----------------</td>
</tr>
<tr>
<td>22%</td>
</tr>
</tbody>
</table>

**Drivers of value creation (i.e. returns) particularly relevant to the profile of SA private equity:**

**Deal flow: Capital overhang in SA:** will increase deal competition & will lead to less favourable (marginal) acquisitions, since most funds operate on a “use it or lose it” basis. This will hurt PE returns and hamper PE’s attempts to optimise returns in the future.\(^41\)

SAVCA/KPMG (2009) industry survey asserts that the SA PE industry has “an expectation of lower competition for assets, [which] must represent future buying opportunities.” (p. 4). However, the findings of the survey, as further confirmed by the interviews, appear to contradict that statement: the majority of the respondents “strongly agree/agree” that capital overhang could in fact increase the competition for deals in the future. Notably, none of the respondents disagree. This report set out to test the related hypothesis: the findings of both research instruments appear to confirm the author’s hypothesis that capital overhang within SA PE will, in fact, likely negatively impact PE returns, and on PE’s ability to optimize returns going forward. Of the 18 respondents to this question, 78% (14)

\[^41\] EMPEA, 2008; SAVCA/KPMG, 2010, p. 16.
agreed that capital overhang could increase competition for PE deals in the future.

These findings are notable, not just because they appear to contradict recent positive industry assertions, but because to the author’s knowledge it presents new evidence not otherwise found in recent local PE literature on a critical influence on SA-specific PE returns. Further, the results confirm prior findings in PE literature abroad: Axelson (et. al., 2010) assert that a ‘capital overhang’ of uninvested capital should affect the willingness of GPs to accept marginal projects (p. 35): due to increased competition for investments, GPs come under pressure the less available favourable targets there are. GPs may screen investments less diligently and tend to make more marginal investments which require more nursing prior to exit and have higher mortality rates. (Bengtsson, et. al, 2002 in Ljungqvist & Richardson, 2003b, p. 7). It may therefore be the case that capital overhang in South African PE could have a similarly negative impact local PE returns, and on how local PE managers are able to optimize their returns in the future.

(Deal Flow 3) - Entry Valuations

10. Please indicate the extent to which you agree (or disagree) with the following:

A majority of the 16 respondents (62%) agreed that the recent recession has reduced target/deal valuations. This finding is curious, given that prior-mentioned related survey findings that capital overhang would increase competition for deals in the future (see Diagram 28). The literature on PE finds that this should translate into higher investment valuations (hence, presumably, would be the negative effect to IRR of the competitive effect of capital overhang within SA PE): Gompers and Lerner’s (2000) ‘money chasing deals’ analysis asserts that current valuations of targets are high when there is significant competition for deals. One interviewee shed light on these survey results regarding possible, context-specific impact to optimizing IRR (i.e., in a PE environment made more competitive by capital overhang); “There is still quite a disconnect between the prices sellers are requesting and what buyers are prepared to pay” (PE interviewee, November, 2010).

If a majority of GPs expect capital overhang to increase competition for deals, yet a further majority (albeit smaller) believe that the recent recession reduced target valuations, it would follow that the
negative implications for PE returns implied by an expected increase in competition (which the literature shows should, in fact, *increase*, deal valuations), would be tempered.

However, a number of alternative explanations (inferred by the author from the interviews, and some of which may be *unique* to the SA context) may explain this seeming anomaly in survey results. There are a limited number of good investment opportunities in the PE market at any one time: GPs may expect increased competition for deals due to overhang and may agree in the majority (62%) that deal valuations have since decreased – but that does not necessarily mean that the *quality* of such deals, notwithstanding that they might appear cheaper than before, has increased proportionately.

The interviews confirmed results of the survey that deal origination in SA PE is particularly characterized by a cultural predisposition to cultivate long-term relationships and to proactively seek out networks that build over time in sourcing investments. This may account for the fact that while capital overhang is expected by respondents to increase competition for deals, cheaper valuations may not necessarily translate into increased opportunities, also because entrepreneurs/ “entrenched” management may prioritize considering aspects such as PE reputation, incentive packages or personal relationships (which according to the findings of the interviews, is a particularly context-specific marker of PE in SA).

Finally, the survey sample suffers from selection bias and does not pretend to represent the full spectrum of local PE opinion on the matter: that half of the 7 interviewees felt that there was still a disconnect between buyers and sellers supports those in the survey (i.e. 6%: Diagram 29) who disagree with the assertion that the recent recession has reduced investment/deal valuations.

**(Deal Flow 4) - Black Economic Empowerment**

Findings to the hypothesis below made in this report are also presented in these deal-related results:

*Drivers of value creation (i.e. returns) possibly unique to the context of SA private equity:*

**Deal Flow & Leverage: BEE (Black Economic Empowerment)** – *BEE can potentially help PE managers to optimise returns by improving deal flow: preferential opportunities given BEE credentials, improved fund-raising, cheaper debt/discounted investments.*

The results of the survey appear to indicate that Black Economic Empowerment is a SA, context-specific aspect that can indeed impact and help PE managers to optimize returns (see: Diagram 30 & 31), but not necessarily by providing preferential access to cheaper debt or favourable terms of leverage (see: Diagram 31). Only 22% of the 18 respondents to this survey question agreed as much.

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Interviwees confirmed these findings: most managers severely doubted whether BEE accreditation would actually help to optimize IRR by translating into preferential access or leverage terms.

A possible explanation for the 22% “neutral” ratings (4 respondents: Diagram 31) may be that it reflects those respondents in the sample, as was the case in some interviews, indicated neutrality less because they discounted the impact of BEE in optimizing IRR than because, in the context of their funds, they had not been exposed to BEE.

However, this survey’s findings present new evidence consistent with Deloitte’s 2007 survey of South African PE fund managers (which found that 80% of the respondents felt that BEE would generate more future opportunities for their PE businesses). 56% of survey respondents (of 18 total) “agreed:strongly agreed” that BEE can improve IRR by helping access to dela flow: investment opportunities. A further 44% (of 16 total respondents to the question: Diagram 32) agree that BEE can improve returns by enabling PE funds to acquire ownership at a discount to ordinary transactions. However as the diagrams depict, and as confirmed in the interviews,.opinions vary on the subject and any perceived BEE “benefits” to IRR seems proprietary. For example, when elaborating on this subject interviewees seemed in aggregate to downplay the core impact of BEE to helping them optimise their returns, and outrightly and across all interviews indicated doubt as to whether BEE would translate into cheaper or preferential debt. However, most interviewees conceded that BEE status improved deal flow through expanded networks/networking opportunities and especially in

**Diagram 30: BEE can improve earnings of the investee due to BEE credentials in sectors which sometimes get preferences to do deals**

- Strongly Agree: 17%
- Agree: 17%
- Neutral: 20%
- Disagree: 39%
- Strongly Disagree: 22%

**Diagram 31: BEE can improve returns by giving access to cheaper debt (leverage)**

- Strongly Agree: 6%
- Agree: 11%
- Neutral: 50%
- Disagree: 22%
- Strongly Disagree: 11%

**Diagram 32: BEE can improve returns by enabling PE funds to acquire ownership at a discount to ordinary transactions**

- Strongly Agree: 13%
- Agree: 44%
- Neutral: 25%
- Disagree: 19%
- Strongly Disagree: 13%

11. Please indicate the extent to which you agree (or disagree) with the following
improved perceptions of PE firm reputation. Interviewees agreed, albeit to a lesser extent, that BEE could enhance returns in sometimes providing them leverage for price negotiation or through possibly being able to acquire investment ownership at a discount or preferable rate to ordinary transactions.

(Deal Flow 5 & 6) - Multi-Lateral Development Finance Institutions (MDFIs), & Syndication

Findings to the hypothesis below made in this report are also presented in these deal-related results:

Drivers of value creation (i.e. returns) possibly unique to the context of SA private equity:

Deal flow: MDFIs: large MDFI presence and funding support of SA PE might mean lowered risk perceptions and related risk premiums: greater global LP investment helps PE to optimise returns by increasing related ability to invest for value-added PE return.43

12. Please indicate the extent to which you agree (or disagree) with the following:

MDFI presence might have a particularly context-specific impact on local PE returns: in South Africa there is a large contribution from Governments, aid agencies and DFIs to the local PE industry (24%), whereas in Europe the contribution is smaller (11%), (SAVCA & KPMG, 2010). The literature hypothesizes that MDFI’s can help those PE funds in which they invest to improve returns by acting as a catalyst to attract other LP funding, particularly EM-investing global LPs, since it can act as an inadvertent device to signal confidence in the PE fund (MDFIs are shown in the majority to prefer investing with “tried and tested” PE managers: Settel et. al, 2009). In Africa, where global GPs may be less privy or sophisticated given distance to the market and related factors regarding selection of local PE funds, such MDFI association can hence enable the PE firm to differentiate itself from its competition, so attracting more funds and being able to pursue more, potentially IRR-enhancing deals.

The results of the survey suggest that a not insignificant number of the PE respondents would concur:

of 18 total respondents to the question, 44% agreed that the presence of MDFI funding in a PE fund can lower (in particular, international) GP investment-risk perceptions (see: Diagram 33). A possible explanation for the .33% (6 respondents) who indicated a “neutral” stance is perhaps because, in the context of their fund, they did not receive MDFI funding and so could not comment.

Related to the above results is the idea that the author came across during the literature review that syndication can potentially hurt (rather than help) PE managers to optimize returns (see: Diagram 34), since those deals that are syndicated tend to be those that not only warrant breadth of expertise or depth of funding, but also are often those that are the riskiest (i.e. finance-based rationale. See: literature review). The idea is that syndication, hence, can actually hurt optimization of PE returns, since it can raise the overall risk profile of the PE firm’s investment portfolio. However, in terms of the context of SA, this appears to be a non-issue to IRR optimization: only 6% of respondents agreed, while 56% were neutral, which indicates the relatively limited number of syndicated deals in SA PE.

13. Please indicate the extent to which you agree (or disagree) with the following:

The findings of the survey suggest that syndication is overall a means by which PE firms can potentially optimize their returns: of the 16 respondents to the question of whether syndication raises the overall risk profile of a PE firm’s investment portfolio (see: Diagram 34), none agreed. Instead, a substantial 38% (6) indicated that they “disagree.” A further and significant 56% (9) indicated neutrality, which speaks to their lukewarm reaction to the assertion that syndication may pose a negative to PE returns. Consequently, these findings are consistent with the literature, which finds overall that syndication can be a mechanism that can help PE managers to improve returns.

5.6 Exit Type

The interviews and survey results related to the profile of exit types in SA PE are consistent with an emerging literature that finds that the available exit strategies at the end of the investment has widened. IPOs (empirically shown to be most profitable exit by realized returns to PE) or sale to a trade buyer have traditionally been the exit routes used by PE to realize the highest returns - but the secondary market (whereby a PE fund sells to another PE fund) increasingly presents a popular exit option. This means that the secondary market can still help managers to optimise returns, and in
view of restricted credit markets, likely increasingly will be used to effect as much. As one interviewee confirmed, a smaller business can instead given credit markets be grown and then perhaps sold to a larger PE firm (with optimal IRR results ultimately, thus, still realised vis-a-vis an IPO or trade buyer.

14. Please indicate the extent to which you agree (or disagree) with the following:

Prior-mentioned survey findings (see: Diagram 34) are triangulated and reinforced by findings depicted in Diagram 35 (with ensuing implications for how PE firms continue to optimize returns in the future. Of the 18 respondents to this question, a telling 72% agreed that secondary market sales will increase in the future. Notably, none of the respondents indicated any level of disagreement with the assertion. Interviewees explained this survey trend by mostly attributing it to restricted credit access. This finding is significant in terms of IRR, since it predicts that realizing optimal returns will perhaps be less likely through the market or trade buyers than it is perhaps using PE fund themselves.

5.7 Firm size: Diseconomies of scale & Capacity of the PE firm to assess deals

The survey results resoundingly confirm findings in the literature abroad that adequate capacity to assess potential investments can help PE managers to optimize their returns (with the reverse being true). However, the interviewees offered contradictory findings (discussed in more detail below) with regards to the literature on “diseconomies of scale”, which argues that as a firm scales up, firm scale hurts investment returns (Lopez-de-Silanes et. al, 2009).

Of 20 total respondents to the question, 85% rated “very important:important” to optimizing IRR that there be sufficient capacity at the PE fund to assess potential deals efficiently: almost half of those 45% rated this factor as “very important”, which attests to the importance of this variable in helping PE managers to optimize their returns. Further evidence to this point is in the fact that none of the respondents indicated any level of disagreement. However, as to the concept of “diseconomies of scale” (i.e. that as firm scale increases, it can hurt PE returns) interviewees provided contradictory opinions: almost 50% felt that firm scale can negatively impact PE returns and offered the following
reasons; potentially greater politics and/or slower communication in larger firms (given that they
typically have greater levels of hierarchy); that smaller teams potentially enable agility in
communication and assessment of deals, or the family “intimacy” factor of smaller PE firms can be a
differentiator from larger competitors in attracting potential entrepreneurs/target management). Other
interviewees felt that scale came as a benefit, helping to optimise returns through higher profile,
established reputation and related access to greater resources and network capabilities.

5.8 Limited Partner (LP) Sophistication.

The question of the heterogeneity in investment strategies and sophistication across different types of
LPs has not attracted much scrutiny in the literature, but Lerner (et. al, 2007) and Myers & Majluf,
(1984, in n.p., Axelson et. al, 2010, p. 38) argue that unsophisticated LPs can inadvertently lower the
overall PE returns posted by the industry, since such LPs can fund underperforming GPs. The survey
results, of which the author knows of no similar evidence in the literature, provide new evidence that
confirm that a majority of SA PE practitioners in the sample concur with these findings abroad: Of the
18 respondents to this question, 72% “agreed/strongly agreed”. This influence on IRR optimization is
particularly compelling given that, unlike most work on PE value creation, it captures rare GP opinion
on LPs – feedback which is more often shared or recruited in reverse (i.e. LP opinion, instead).

16. Please indicate the extent to which you agree (or disagree) with the following
5.9 General Partner (GP) Sophistication.

A key premise used in the literature to explain the differential excess in IRR aimed for by PE relative to the markets is the value-add in superior investment skills and related industry networks of PE managers. Axelson (et. al, 2010) assert that GPs not only have skill in identifying and managing potentially profitable investments, they have better information about deal quality than potential investors (p. 38).

17. Please indicate the extent to which you agree (or disagree) with the following:

It was interesting to the author that while the (anonymous) survey results indicated resounding agreement (and included no dissenters) on the matter, interviewees were much more modest and less forthcoming in their confidence as to their differential (and value-creating/returns-optimizing) skills-set. Of the 18 respondents to this question, 94% (17) indicated (anonymous!) agreement. Conversely, none of the interviewees were so bold; “I would like to think that is the case” (PE interviewee, 2010). That said, the survey results indicate that PE managers generally strongly attribute their unique deal information and professional competence as a significant means by they optimize returns.

6.0 Investment Strategy

The diagrams that follow re-group the investment strategy-related survey questions (categorized chronologically as per the literature review: Chapter 3). Related survey results are depicted. The section is organised as follows: strategy (market timing & overall market state; PE investment stage & deal size; geographical focus and holding period).

(Investment Strategy 1) – State of the Overall Market & Market Timing:

The survey results (see: Diagram 39) overwhelming confirm, as found in the literature, that overall market cycles and the state of the economy influence the profile of PE returns. Of the 20 respondents to this question, 75% indicated that the state of the overall financial markets was a significant factor to optimizing PE returns. 25% indicated “neutrality.

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44 Kaplan & Schoar (2005), Kaplan & Stromberg (2009), Ljungqvist & Richardson, 2003a, 2003b and Lopez-de-Silanes (et al., 2009).
18. In the context of your fund, how important to optimising returns (IRR) do you rate the following
OR to what extent do you agree (or disagree) with the following:

A possible explanation for those 25% who indicated neutrality in the face of the contrarian majority might be confirmation of other empirical findings in the literature that show that there is, in fact, no correlation between PE returns and the market (Diller and Kaserer, 2007). However, the majority results suggest that there is, in fact, a close link between private and public equity – with related cyclical implications for and impacts on PE returns. The results of the survey similarly confirm the importance in the literature of market timing (see: Diagram 40) as a technique used by PE funds to help optimize returns (Gompers & Lerner, 1999; Schmidt et al, 2004). Of the 16 respondents to this question, 88% indicated agreement. These results suggest that provided a PE fund has the skill and can buy companies when general valuations are lower, and then select to sell them at times when general valuations increase, market timing can be used and is highly rated as a tool to maximize PE returns.

(Investment Strategy 2) - PE investment stage and Deal size

Findings to the hypothesis below made in this report are also presented in these deal-related results:

Drivers of value creation (i.e. returns) particularly relevant to the profile of SA private equity

Investment strategy (PE business segment): PE investment strategies of growth/development (which generally rely less on leverage) will increase in focus as means to optimizing returns relative to to leveraged buyout strategies: The current economic context will mean a permanent decrease in access to leverage (Kaplan & Stromberg, 2008; Achleitner et. al, 2010) - (see: Diagram 43 & 44)

Given strained credit markets and the findings in the literature, particularly that of the PE industry (SAVCA, Evaluserve, Coller Capital, EMPEA), it became interesting to ask whether, as a means of optimizing IRR, this might mean focusing on certain PE investment segments.
19. Please indicate the extent to which you agree (or disagree) with the following;

Of the 18 respondents, 83% “agreed/strongly agreed” that the mid-market/mid-cap space (i.e. mid-size investments)\(^{45}\) offers the most attractive opportunities in South Africa (Diagram 41). In trying to make a related inference as to whether this mid-cap size preference for optimizing returns is perhaps related to the use of leverage, the results depicted in Diagram 42 become interesting; respondents were asked to rate the extent to which they agreed on whether the size of the target determined whether leverage was used. Of the 16 respondents to this question, 44% agreed as much. On the surface, this would suggest a link to Diagram B (earlier on in the findings) in hypothesizing that part of the reason for the relative attractiveness of the mid-market space may be because its smaller deal focus relies less on the extent of leverage required for bigger deals. However, the interviewees better shed light on the possible reasons for why 31% (5) of these 16 respondents “disagree” that target investment’s size determines the use of leverage (Diagram 42).

Namely, a number of the interviewees pointed out that the mid-cap space can be more attractive to PE investment, not necessarily because of the use of leverage as compared to other investment segments of PE – but moreso because mid-market companies are often those firms that present the best

\(^{45}\) The definition of mid-cap varies but the SAVCA& DBSA define “mid-market range” as between R50million to R1bn (2009, p. 16, 21, 23)

\(^{46}\) Gompers & Lerner, 1999; Schmidt, Nowak & Knigge, 2004, p. 3
opportunities for PE to really add value: larger firms may already have implemented various operational improvements and efficiency-enhancing measures whereas it is often the smaller, “under-the-radar” opportunities that allow PE to acquire an investment at a valuation that can truly allow for scope to restructure, and hence realize optimal returns. Also, some interviewees indicated that the midcap market presents less competition, since they may be too small for the investment profile of larger firms, and is a segment that may rely more on propriety PE firm networks.

In terms of PE investment stage, the survey results suggest that growth capital will offer better opportunities/means to optimize returns (see: Diagram 43). These findings, much like the premise for PE preference of the mid-cap space, suggest that certain investment sectors can help PE managers to better optimize returns. Further, in line with the literature that asserts that the overall state of the markets can impact on optimization of PE returns⁴⁵, certain investment sectors can be more attractive at different times in the economic cycle and accordingly, this can impact PE returns. Of 18 total respondent, 100% “agreed/strongly agreed” that growth capital in PE investments will increase (see: Diagram 43). Those findings are related to the survey findings depicted in Diagram 44, which show that an overwhelming majority of respondents expect buyouts to decrease relative to growth/expansion capital for the foreseeable future (i.e. of 16 total respondents to this question on buyouts, 44% (7) indicated agreement). What these findings appear to confirm is this report’s hypothesis that growth/development capital will witness an increase for the foreseeable future (given constrained credit markets) as a preferred investment stages of focus by PE managers in their aim to optimize PE returns.

However, added to those that disagree (see: Diagram 44) is a notable contingent who are “neutral”: this disparity may be explained by further findings in the survey results below;

20. Please indicate the extent to which you agree (or disagree) with the following;

![Diagram 45: Relative to the rest of the world, South Africa offers favorable scope for buyouts as a PE category in the next few years](image)

Of 16 total respondents, a majority 56% agreed that, relative to the rest of the world, SA offers favorable scope for buyouts as a PE investment category going forward. Recalling prior survey findings (see: Diagram B, p. , in which 72% of respondents agreed that access to leverage will remain restricted for the foreseeable future), the 19% (3) who here disagree may simply reflect Diagram B’s findings. Hence, the combined findings of this section and Diagram B indicate that buyouts may well
resurface in popularity as access to leverage improves, but that at least for the foreseeable future, PE practitioners rate as more significant (or likely) to optimising IRR an investment strategy focused on growth capital.

(Investment Strategy 3) - PE Geographical focus

Findings to the hypothesis below made in this report are also presented in these deal-related results; Drivers of value creation (i.e. returns) possibly unique to the context of SA private equity Investment strategy: (Geographic focus): SA private equity practitioners will increasingly view Sub-Saharan/regional geographic investment strategies as a source of enhanced returns: The existing PE value creation model will be aligned to reflect emerging regional investing preferences, especially by MDFIs and global LPs investing in Africa, in order to capture a competitive share of such LP fund participation (EMPEA, 2008; Evaluserve, 2010, p. 3).

The findings of the survey provide further, context-specific evidence in support of an emerging industry literature that suggests that pan-Africa/regional investment strategies will become a driver of value creation and IRR optimization in SA going forward. This finding also compliments earlier survey findings of this report (―deal flow‖: section 6.5), heightened competition for deals can negatively impact PE returns.

19. Please indicate the extent to which you agree (or disagree) with the following:
Of 18 total respondents to the question, a majority 56% agreed that the rest of Africa offers less competition for deals than South Africa (see: Diagram 46); The 28% (5) respondents who indicated neutrality could be explained that perhaps, in the context of their fund or PE experience, they are unable to comment as such.

However, in terms of the risk (see: Diagram 48), 81% of the 16 respondents to this question agreed that Africa presents greater investment risk relative to investing in South Africa. Of that 81%, 31% (5) indicated that they “strongly agree” with the statement, which makes it interesting to ask what the aggregate findings mean for how importantly SA PE rates a pan-African investment strategy to optimizing returns. Diagram 47 depicts the findings to that question: 100% of the 18 total respondents to the question agreed that the rest of Africa will increase as a focus sector of SA PE fund managers in the future. Interviewees also confirmed these survey findings, which therefore confirms this report’s hypothesis that in terms of mechanisms: influence on optimizing PE returns, SA PE managers will increasingly pursue SADC/Sub Saharan/regional investment strategies. This finding is clearly a trend to optimal IRR, set to continue and context-specific to SA PE.

(Investment Strategy 4) - Holding Period

Empirical studies abroad on the determinants of PE returns find evidence of a strong negative association between performance and duration.46 The diagram below depicts survey findings related to the relevance of this determinant to optimizing PE returns in the SA context. Results are consistent with those of PE markets abroad: of the 18 respondents to this question, 83% agreed that the investment holding period could influence the ultimate profile of realized PE returns.

These findings suggest that a majority of the PE respondents inferably consider shorter holding times ideal to optimal returns, and overwhelming rate such a strategy as a significant intervention.

46 PE investments held less than 2 years have an average IRR of 79%, those held between 2 and 4 years average 35%, and those kept beyond 4 years only reach a 10% average (Lopez-de-Silanes, et. al, 2009, p. 3). Detail: Lit. Review, section 3.9
5.1 LIMITATIONS

This study is limited to PE fund managers in South Africa who invest in the broad categories of development and buyout PE as defined by the SAVCA (see: Glossary). Because the study examines only late-stage PE, the sample is biased to some degree and cannot be used to make generalizations about the industry in aggregate, since it is not representative of the entire population.

The author recognizes that the inclusion of only the acquiring firms’ opinions does not fully cover all aspects of the debate, since not all parties involved have been heard. (i.e. since this study recruits only the opinions of the PE firms rather than also those of the recipients of PE investment).

The final report’s ultimate success has been predicated on the quality and number of insights that were able to be gathered from the relevant parties. Similar past academic studies on average have relied for their deductions on between 1 to 5 interviews and 30% survey response rates: this report has achieved a peak 55% survey response and secured 7 interviews - (n.p., practical survey [online]; Fourie, 1999; Hollander & Schirnig, 2001; Roodt, 2007). Renown private equity scholar Steven Kaplan in one case derived conclusions from just one case study participant (Kaplan et. al, 1997). In view of the resulting adequate response rates to the survey and interview requests, the author is confident that this report has generated a layered typology of respondents from whom valuable insights and inferences can be drawn.

Likert-type scale questionnaires, while closed-ended, provide a systematic way to obtain data. Also, they help to balance any weaknesses of ambiguity or bias that could result from the open-ended questions and from data retrieved in the interviews.

An additional consideration in survey research is that we are relying on “self-reported” data: people are telling us “what they believe to be true or, perhaps, what they think we want to hear.” (Leedy & Ormrod, 2010, p. 188).

The sample size of interviews may be considered small but had to be limited in number given the need to meet the report’s deadline in a cost, travel and time-effective manner. The author is confident that this potential shortcoming has been limited by achieving a varied typology of interviewees.

Finally, the report limits any potential bias in participant input by seeking to understand the relative rather than absolute importance of the characteristics of PE returns. In building toward solving its appointed research problem, it is designed to approximate reality rather than establish any absolutes. (Leedy & Ormrod, 2010, p. 147).
6.0 RESEARCH CONCLUSIONS

This research study set out to analyse the drivers of value creation in late-stage PE in South Africa (i.e. what those factors are that can determine, impact or help PE fund managers to optimize their returns on invested capital). The adequate number of interviews achieved (7 relative to a benchmark average of 3 in past similar academic studies)\(^{47}\) and similarly adequate survey response rates (40 to 55% relative to a survey average of 30%; 16 to 22 respondents and an average of 18 respondents\(^{48}\) in aggregate) captured the opinions of senior practitioners and some of the leading PE firms in South Africa.

This research set out to answer a number of hypotheses which are set out below and are respectively addressed in detail with supporting findings. The author has drawn the following conclusions based on the qualitative data gathered from the online surveys and interview participants:

A. **Drivers of value creation (i.e. returns) particularly relevant to the profile of SA private equity**

1. **Operational engineering Hypothesis (A):** will increase relative to financial engineering as a technique for optimising returns:

   The author found evidence to support the hypothesis and as such can conclude that PE firms in SA will increasingly adopt operational engineering as compared to financial engineering in seeking to optimise returns.

   **Operational engineering Hypothesis (B):** as the PE value creation model becomes more internally focused on extracting value from portfolio companies, private equity firms will prioritize hiring teams (i.e. investment professionals) that have more “operational”, industry-based experience or skillsets than more financial/valuation-related skills.

   The author found evidence to support the hypothesis and as such can conclude that PE firms in SA will increasingly prioritize “operational” hiring or partnerships in seeking to optimize returns.

2. **Deal flow: Capital overhang in SA:** resulting increased deal competition will lead to less favourable (marginal) acquisitions: since most funds operate on a “use it or lose it” basis, “there is an ongoing drive by fund managers to invest their funds as soon as possible.” This will hampering PE’s attempts to optimise returns in the future.

   The author found evidence to reject this hypothesis and as such can conclude that PE returns in SA will not be hurt by capital overhang.

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\(^{47}\) GSB research as well as some similar studies abroad: (re: Rosholt, 2006; Roodt, 2007; Jones, 2009; Kaplan, et. al, 1997)

\(^{48}\) i.e. 16-22 responses: variation occurred but only 1 category of a total of 12 categories received 16 responses: all others received 18-22. Variation occurs for those respondents who chose to skip questions as relevant to the context of their experience)
3. **Investment strategy (PE business segment):** *PE investment strategies of growth/development (which generally rely less on leverage) will increase in focus as means to optimising returns relative to to leveraged buyout strategies:*

The author found evidence to **support** this hypothesis and as such can conclude that PE firms in SA will increasingly focus on investment strategies of growth/development capital in seeking to optimise returns.

**B. Drivers of value creation (i.e. returns) possibly unique to the context of SA private equity**

4. **Leverage** will remain a relatively key mechanism of SA private equity value creation (i.e. returns) as compared to PE in other markets:

The author found evidence to **support** the fact that SA PE practitioners continue to regard financial engineering as an important tool to optimizing returns, but evidence that 89% of the PE survey respondents believe that leverage availability will remain constrained for the foreseeable future provides a basis to **reject** the hypothesis that PE firms in SA will, relative to PE in other markets and because of traditionally lower gearing of SA companies, continue to make relatively more use of leverage in seeking to optimize returns.

5. **Deal flow: DFIs:** *MDFI presence and funding support of SA PE might mean lowered risk perceptions and risk premiums: greater global LP investment helps PE to optimise returns by increasing related ability to invest for value-added PE returns).*

The author found evidence to **support** this hypothesis and as such can conclude that MDFI funding can help local PE firms to optimise returns by enhancing deal flow. Such association can act as a catalyst to attract other LP investment (particularly of global LPs investing in emerging markets): as the literature finds, MDFIs prefer to rely on proven fund managers with a track record of successfully investing capital.

6. **Deal Flow & Leverage: BEE** (Black Economic empowerment) – *BEE can potentially help PE managers to optimise returns by improving deal flow (i.e. due to preferential opportunities to do business due to better BEE credentials; access to cheaper debt; access to cheaper/discounted investments; improved fund-raising).*

The author found evidence to **support** this hypothesis and as such can conclude that BEE influence can help PE managers to optimize returns.

7. **Operational engineering: Organic growth versus acquisitions:** *South African private equity practitioners tend to use organic rather than growth by acquisitions as a means to maximising returns.*
The author found evidence to **reject** this hypothesis and as such can conclude that PE firms in SA view both add-on transactions and organic growth as equally important means to optimize returns. The author caveats this conclusion with the fact that this observed trend may be influenced (and, so, biased) by currently constrained credit markets.

8. **Investment strategy: (Geographic focus):** SA private equity practioners will increasingly view Sub-Saharan/ regional geographic investment strategies as a source of enhanced returns.

The author finds evidence to **support** this hypothesis and as such can conclude that PE firms in SA will increasingly adopt African regional investment strategies in seeking to optimize returns.

Ultimately, the key theme to emerge from the findings can be reduced to the fact that the deals that emerge in an environment (for the foreseeable future) without cheap credit will mark a return to the fundamental purpose of PE: namely, seizing opportunities when a combination of assets can create value for shareholders by driving out real inefficiencies and benefiting from scope or scale. This next “wave” of PE deals in terms of optimizing PE returns will therefore emphasize proprietary PE competences that permits PE firms to better distinguish themselves from competitors, favouring those PE buyers with good deal execution (i.e. timing) and depth of experience and of networks.

It emerges that private equity is fundamentally an inherently labour-intensive, skills-based business; extracting value from deals in the form of returns will emphasize strategies of even more intense “active involvement” by PE firms in their respective portfolio companies.
7.0 FUTURE RESEARCH DIRECTIONS

Given the suggestion in the introduction that relatively little work has been done on the drivers of value creation in private equity in South Africa so far, there is ample opportunity for further research on the subject.

The possible sources/determinants of return and factors that can otherwise influence PE returns mentioned in this report by no means implies that such interventions or factors that otherwise impact PE returns are limited to these attributes. More work could be done to explore other “sources” of return including synergies that different portfolio companies might unlock amongst each other (Barber & Goold in Van Niekerk & Krige, 2009) or on the effect of the holding period - shown in the literature to have a critical correlation to PE returns that survives several tests for robustness (lopez-de-Silanes et. al, 2009).

The findings of this study demonstrate the emerging importance of the secondary market as an exit mechanism by which PE firms can realize returns: it would be interesting to explore the impact of this trend as it particularly relate to the South African PE context (where, as confirmed during the course of the interviews for this report, IPOs have traditionally been less prevalent as an exit strategy than in PE markets abroad). (thesis PE interviewee, 2010; HarborVest, 2008, p. 1).

The PE survey and interview population of this report, while adequate by benchmarks of both survey response statictics and similar past academic studies, suffers from selection bias: further work could be done to explore the topic with a larger population that would further improve the reliability to the findings. This report focuses on late stage PE, which dominates the profile of the local PE industry, but future studies could also incorporate the opinion of venture capitalists, so enlarging the survey population and even perhaps, as such, allowing for comparative data between value creation in early versus late stage private equity in SA.

Given the particular importance to PE firms in SA of active involvement in their investments as a mechanism to optimize returns (as evidenced in the online survey results to this report), more work could be done on examining how PE firms actively involve and add value in the management of investments. A case study approach using PE firms may be especially useful in this regard.

A comparative study of value creation practices in South Africa and the U.S/ U.K (markets to which most the existing work on the drivers of PE returns is currently restricted) would yield further insights as to any contextually-specific or different practices/influences that help to explain how PE managers in South Africa optimize returns, and better highlight any reasons for the homogeneity of private equity returns in South Africa as compared to other markets.

Finally, it would be interesting to consider value creation from the side of the investee firm: such study would expand on the first ever such study in PE in SA, which was recently jointly conducted by the Development bank of South Africa (DBSA) & SAVCA in 2009.
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APPENDIX 1  Cover Email:  Survey Questionnaire Participation

PRIVATE EQUITY SURVEY
MBA 2010– UNIVERSITY OF CAPE TOWN, GRADUATE SCHOOL OF BUSINESS

“How SA private equity fund managers aim to achieve superior returns: The SA Context”

Dear SAVCA member,

I am currently a full time MBA student set to graduate December 2010 from the University of Cape Town Graduate School of Business. The reason that I am contacting you is to request your kind participation in an entirely confidential and anonymous online survey that will take you no more than 10-15 minutes to complete. We will provide all respondents in the survey with a full electronic copy of the complete research report by mid-December, 2010.

Given my background in investment banking in New York, Milan and London, which ignited my interest in private equity and specifically back on home turf in Africa, I have chosen to undertake my thesis (which forms a majority of the MBA final assessment) on “The Drivers of Value Creation in Private: The South African Context.”

The financial crisis sweeping global markets is reshaping the private equity investing landscape, yet in contrast to markets abroad, little research has been done in South Africa to re-examine the drivers of value creation, in the financial context– not least given the industry’s heterogeneity. Your insight and contribution will greatly assist in gaining a better understanding as to the relative importance of these sources of value creation, and highlight why South African private equity remains the compelling investment that it is.

Your response will be completely anonymous. The final analysis will illustrate the overall trends of the respondents; no specific company or individual will be identified at any stage.

Online Survey link: XXXXXXX
Please complete the Survey by October 31st

The survey should take no more than 10-15 minutes to complete.

I appreciate that your time is precious and have vigorously attempted to minimise the questions required.

Your time and effort is much appreciated.

Yours faithfully

Marlene Miller

UCT GSB MBA Fulltime 2010

Any queries, please contact Marlene Miller on 0761- 324- 615

APPENDIX 2  Survey & Interview Thank you Letter (emailed)
PRIVATE EQUITY SURVEY

RE: MBA 2010 - THESIS:
“How SA private equity fund managers aim to achieve superior returns?: The SA Context”

Dear SAVCA member,

To all those who participated in the survey, which because of it’s anonymous nature I am unable to thank specifically, an earnest thank you for your participation in the Graduate School of Business MBA 2010 survey considering the relevance of the sources of the superior returns (value creation) in private equity buyouts in South Africa. Your time and input is much appreciated. We will provide all respondents in the survey with a full electronic copy of the complete research report by mid-December, 2010.

The aim of this study is to understand how buyout fund managers are able to achieve superior returns. Your insight and contribution greatly assisted in respect of understanding a broad spectrum of practitioner-specific opinion on the subject.

The information in the final report will focus on the overall results and no specific responses or identities will at any stage be revealed.

Your time and effort is much appreciated.

Yours faithfully,

Marlene Miller

UCT GSB MBA Fulltime 2010

Any queries, please contact Marlene Miller on 0761- 324- 615
APPENDIX 3  Interview Population List (includes 7 ultimate interviewee participants)*

* Because of the anonymity extended to interview participants as a premise of limiting incentives to positive bias in reporting and to incentivise participation, these participants cannot be otherwise specified.

<table>
<thead>
<tr>
<th><strong>Interviewee Firm</strong></th>
<th><strong>Description</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Act.is</td>
<td>One of the largest private equity firms; broad strategy; 2008 major fund raiser (SAVCA &amp; KPMG, 2009) invest: US$50mln-$250mln</td>
</tr>
<tr>
<td>Emerging Capital Partners</td>
<td>UK/ Africa based firm with a pan-Africa, multiple sector and strategy focus. Launched US$613 Africa buyout fund in 2010,</td>
</tr>
<tr>
<td>Ethos private equity</td>
<td>Large firm, broad-based sector/ strategy, SA focus: invest R100-800mln</td>
</tr>
<tr>
<td>Horizon Equity Partners</td>
<td>2008 major fund raiser (SAVCA &amp; KPMG, 2009); various PE stages; growth capital focus; mid caps; invests R20mln-R100mln</td>
</tr>
<tr>
<td>Mecene Investments</td>
<td>Have a proprietary “value creation” PE model, all stages incl. buyouts invest US$500K-US$5 mln</td>
</tr>
<tr>
<td>Nedbank Private Equity</td>
<td>large firm, no excluded industries; Nedbank Capital PE invests R30mln-R120mln</td>
</tr>
<tr>
<td>Shanduka Fund Managers</td>
<td>Excludes a few industries but still broad; invest R20-75mln but not for start-up investments</td>
</tr>
<tr>
<td>Kingdom Zephyr Africa Management</td>
<td>Broad sector, various including buyouts, pan-Africa focus; invest US$20mln – US$60mln</td>
</tr>
<tr>
<td>Vantage Risk Capital</td>
<td>BEE deals, mezzanine LBOs, recently adopted pan-Africa; invests R40mln –R350mln (with co-investment)</td>
</tr>
<tr>
<td>Medu Capital</td>
<td>2008 major fund raiser (SAVCA &amp; KPMG, 2009) incluces mid stages</td>
</tr>
<tr>
<td>Leaf Capital</td>
<td>2008 major fund raiser (SAVCA &amp; KPMG, 2009); includes mid markets investments; in Cape Town</td>
</tr>
<tr>
<td>Standard Bank</td>
<td>Large, PE captive, broad sector; min invest R50mn, max: n/a</td>
</tr>
<tr>
<td>Lereko Metier</td>
<td>includes growth focus, BEE empowerment; invest R50mln- R750mln</td>
</tr>
<tr>
<td>Basileus Capital</td>
<td>broad sector; investment strategy; includes mid-stages, in Cape Town</td>
</tr>
<tr>
<td>Brait</td>
<td>Large, broad-based sector/ strategy, SA focus, invests R5mln-R1bn</td>
</tr>
</tbody>
</table>
Optional Information

1. Email Address (Optional): if you would like to receive a final copy of the report

General Information

2. Position in company*
3. Investment sector*
   You may select multiple answers.
   - Generalist
   - Communications & Technology
   - Infrastructure
   - Mezzanine
   - Real Estate
   - Mining & Resources
   - Energy
   - Other, please specify

4. Fund type*
   - Independent
   - Captive - Financial Services
   - Captive - Other
   - Other, please specify

5. Geographical focus*
   You may select multiple answers.
   - South Africa
   - Rest of Africa
   - Other, please specify

6. Private equity category*
   You may select multiple answers.
   - Expansion and development capital (Growth)
   - Buyouts
   - Replacement capital
   - Other, please specify
This survey follows private equity convention and uses IRR (internal rate of return) to measure the "returns" generated by private equity investments. "PE" refers to "private equity."

The sources of return (IRR) theoretically attributed to private equity investments are divided into 4 categories below.

Please rank the relative importance you assign to each category by ranking them from 1 to 4.

7. Please rank the following, selecting a number 1 through 4*
   Please refrain from using the same number more than once.
   Rank the items below, using numeric values starting with 1.

   Financial Engineering (i.e. Leverage)

   Governance Engineering (a) - Active involvement by PE fund managers in the investment

   Governance Engineering (b) - Use of incentives to motivate the investee management

   Operational Engineering (i.e. Cost-cutting; improving productivity; improving operating margins and cash flows)

8. In the context of your fund, how important do you rate the following in terms of how you optimise returns (IRR)? *

<table>
<thead>
<tr>
<th>1 Very Important</th>
<th>2 Important</th>
<th>3 Neutral</th>
<th>4 Unimportant</th>
<th>5 Very Unimportant</th>
</tr>
</thead>
<tbody>
<tr>
<td>Active involvement in the investment by the PE fund</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>The PE firm grows the investment by using acquisitions</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>Relative under-valuation of the target at point of investment (i.e. scope to achieve valuation multiple appreciation that can</td>
<td>□</td>
<td>□</td>
<td>□</td>
<td>□</td>
</tr>
</tbody>
</table>
then be realized on exit/sale of the investment)

Reputation of the PE firm in terms of securing a loan/financing

<table>
<thead>
<tr>
<th></th>
<th>1 Very Important</th>
<th>2 Important</th>
<th>3 Neutral</th>
<th>4 Unimportant</th>
<th>5 Very Unimportant</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost-cutting initiatives at the investee firm</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sufficient capacity at the PE fund to assess target deals efficiently</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Leverage</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Proactive deal-origination by cultivating relationships with the target investee</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>State of the economy and/or financial markets</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

9. In the context of your fund, how important do you rate the following in terms of how you optimise returns (IRR)? *
Incentive packages that motivate investee managers to behave like owners

The scope to increase earnings of the investment (i.e. to grow EBITDA: earnings before interest, tax, depreciation and amortization)

The PE fund grows the investment "organically" (i.e. rather than by acquisitions)

10. Please indicate the extent to which you agree, disagree to the following;*

<table>
<thead>
<tr>
<th>Strongly Agree</th>
<th>Agree</th>
<th>Neutral</th>
<th>Disagree</th>
<th>Strongly Disagree</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leverage availability will remain limited for the foreseeable future (2 or more years)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The demand for growth capital in PE investments will increase</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The use of Operational Engineering will increase relative to Financial Engineering</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Capital overhang could increase competition for deals in the future.
The reputation of a PE firm influences access to deals/deal flow.
BEE (Black Economic empowerment) can improve earnings of the investee due to BEE credentials in sectors which sometimes get preference to do deals.
Unsophisticated investors in PE funds can mistakenly fund poor PE performers, so lowering average PE industry returns.
The mid-cap space offers the most attractive opportunities in South Africa.
Common strategic vision between the investee and PE fund management is important.

11. Please indicate the extent to which you agree, disagree to the following;*

<table>
<thead>
<tr>
<th>Strongly Agree</th>
<th>Agree</th>
<th>Neutral</th>
<th>Disagree</th>
<th>Strongly Disagree</th>
</tr>
</thead>
<tbody>
<tr>
<td>The rest of Africa offers less competition for deal flow than South Africa</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
</tbody>
</table>
The superior investment skills and knowledge of PE managers is a source of superior returns.

The rest of Africa will increase as a focus sector of South African PE fund managers in the next few years.

Secondary market transactions (PE to PE fund sales) will increase over the next years.

Leverage disciplines investee managers, causing them to treat cash as a scarce resource.

The holding period of the investment (years) impacts the realized returns of the investment.

BEE (Black Economic Empowerment) can improve returns by giving access to debt at lower prices.

The reputation of a PE firm influences access to leverage.

The presence of development funding in a PE fund can lower its perceived investment risk, especially by international PE investors.
12. Please indicate the extent to which you agree, disagree to the following;*

<table>
<thead>
<tr>
<th></th>
<th>Strongly Agree</th>
<th>Agree</th>
<th>Neutral</th>
<th>Disagree</th>
<th>Strongly Disagree</th>
</tr>
</thead>
<tbody>
<tr>
<td>The rest of Africa offers less competition for deal flow than South Africa</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>Buyouts will decrease as a PE category relative to growth/expansion capital</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>PE firms will increasingly deepen their pool of operational expertise either by new PE hires or through partnerships with industry experts</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>The size of the target investment determines whether leverage is used or not</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>BEE (Black Economic Empowerment) can improve returns by enabling PE funds to acquire ownership at a discount to ordinary transactions</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
</tbody>
</table>
The rest of Africa presents greater investment risk than South Africa.
Relative to the rest of the world, South Africa offers favorable scope for buyouts as a PE category in the next few years.
The recent recession has reduced investment target/deal valuations.
Distressed debt will increase as a private equity category.
Public (exchange) listing of a PE firm dilutes the shareholder-focus advantage enjoyed by PE firms that maintain non-disclosure, private status.
Market timing (investment entry and exit) impacts the realized investment returns.
Syndication raises the overall risk profile of the PE firm’s investment portfolio since co-investors generally share the riskiest deals.
APPENDIX 5 Interview Questions

In the context of your fund;

How important to optimizing returns do you rate financial vs. operational vs. governance engineering? Is any one more important to optimizing returns than the other going forward?

Where do operational improvement comes from when you work to improve productivity or efficiency of the investee?

What is your view on the availability of leverage to PE going forward?

How important to optimizing returns do you rate reputation of the PE firm? Further, how importantly do you rate the reputation of a PE firms in terms of access to leverage? In access to deal opportunities? In attracting investee management?

How important to optimizing returns do you rate the capacity of the PE firm to assess deals efficiently?

How important to optimizing returns do you rate an investment focus that includes Africa (i.e. regional African areas outside of South Africa)?

What are your thoughts on Black Economic empowerment in terms of its influence to optimizing returns?

Does BEE offer cheaper access to debt?

Does BEE offer the opportunity to acquire investments at a discount to ordinary transactions?

What are your views on capital overhang in SA private equity as it relates to influence on PE returns?

What are your views on current investment target valuations?

Are there any aspects, in your experience, that are unique or especially relevant to South African PE that influence PE returns in South Africa?
## 9 Major Private Equity Deals (2005-2007)

<table>
<thead>
<tr>
<th>Company</th>
<th>Year</th>
<th>Premium to Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>SunGard</td>
<td>2005</td>
<td>44%</td>
</tr>
<tr>
<td>Kinder Morgan</td>
<td>2006</td>
<td>27%</td>
</tr>
<tr>
<td>Clear Channel Communications</td>
<td>2006</td>
<td>30%</td>
</tr>
<tr>
<td>Harrah’s Entertainment Inc.</td>
<td>2006</td>
<td>36%</td>
</tr>
<tr>
<td>Petco Animal Supplies Inc.</td>
<td>2006</td>
<td>49%</td>
</tr>
<tr>
<td>TXU</td>
<td>2007</td>
<td>25%</td>
</tr>
<tr>
<td>First Data</td>
<td>2007</td>
<td>26%</td>
</tr>
<tr>
<td>Hilton</td>
<td>2007</td>
<td>32%</td>
</tr>
<tr>
<td>Equity Office Properties</td>
<td>2007</td>
<td>37%</td>
</tr>
</tbody>
</table>

APPENDIX 7  Drivers/ Attributes of Value Creation -Literature Review

PLEASE NOTE (very rough in presentation but left as such from thesis proposal stage because authentically shows exact methodology and process behind the thinking regarding how the author captured sources of value creation during the literature review and broad inferences for alternative, less conspicuous sources)

1. Financial engineering
2. Operational engineering
3. Governance
4. Strategic redirection

Factors as aforementioned include;

1. Leverage
2. Black Economic Empowerment (BEE)
3. Valuation Multiples
4. Earnings Increase
5. Corporate Governance
6. Company management
7. Market Timing (exits and purchase prices)
8. Competition for assets
9. Superior Knowledge, insider knowledge and Skill of GP practioners
10. Advantages (and disadvantages) of public vs. private company disclosure requirements
11. Operational: i.e productivity, efficiency and cost-cutting measures
12. Sources of acquisition: i.e private companies with inefficiencies vs. public companies which might already be implementing these value-creation methods and so leave less room to create value?
13. Investing in secondary investments: i.e given the credit market constraints and
subsequent rise in private equity-to-private equity firm sales (so-called “secondary market”).

14. **Syndication**

Additonaly;

15. Lack of LP sophistication – (INSEAD) – Also Phallipou (2010, p. 25)

16. Size of teams – (Jensen)

17. Listing: Private vs being a publicly-listed PE firm (like abroad, which dilutes the agency argument) – (Jensen)

18. Sector – ie (Ernst & Young, 2008) says Tech & Telco =highest growth in EV BUT ALSO: related to geography there is no restriction on the geog’s or countries of PE funds so unsophisticated LPs/ investors can end up with UNDIVERSIFIED portfolios (Phallipou, 2010, p. 29) ??

19. Geography: re: less competition for deals (re: Sub-Saharan Mandate – SAVCA/KPMG & Also EMPEA: LP prefer regional for Africa)

20. Deal size - $500 - $1 bn (bigger can use more leverage?) – (Achleitner)

21. Number of deals: the more investments, the worse the IRR (Phallipou, p. 32);

22. Size of teams: i.e. PE capacity to assess deals efficiently/ strained resources (i.e. ultimate investment “go-ahead” decision makers; loseout on deal opportunities; inability to efficiently assess opportunities etc)

23. Reputation of PE firm: get better loan access (Kaplan)

**Draft Hypotheses:**

1. **2006-2008 deals: Leverage impact will be higher bc credit was easier then; what about leverage less impact in SA bc lower gearing traditionally??**

2009-2011 – Operational will be more important value driver

2. Proportion of leverage to operational & market effects will be less than 1/ & 2/3 (re: Achleitner) bc SA is lower debt-to-equity and was less impacted
3. **Biz teams as a value driver: will be more operational hires than before?** Will this crisis mean a permanent decrease in the availability of leverage for the PE market as a whole?

4. **Capital overhang (R32.9 billion) could increase competition for deals?**

5. **Capital overhang could lead to less than favourable acquisitions, since most funds operate on a “use it or lose it” basis?**

6. **Emerging markets LPs rate capital overhang as a key concern when investing in emerging markets?** (re: EMPEA, 2008)

   PE thoughts for how this issue, given the R32.9 billion in undrawn commitments of PE funds, to the SA market?

7. **Most of the deals completed between 2006-2008 aren’t yet realized- how will PE extract value from these existing portfolios?**

8. **Will there be lower competition for assets as earnings stabilize?** (SAVCA, KPMG, 2009, p. 4. 5)

9. **The number of investments the PE fund is holding at the time** (Phalippou, 2010, p. 1)

10. **Market timing – deals in recessionary environments yield better returns?**

    also, GPs ability to time markets as a technique to achieve better returns?

    (Phallipou, 2010; Acheleitner, 2010)

11. **Syndication actually RAISES risk of investments and isn’t value-adding: ie co-investors want to share risk of the riskiest assets therefore raises profile of risk for other passive investors?**

    **MFDIs in SA: lowered risk premiums; catalyst to mobilize deal flow/ attract funds**

    (EMPEA 2008, SAVCA/KPMG, 2009…also see Settle et. al, Journal of PE, Spring 2009,p. 70)
# APPENDIX 8 Sample (in white): FULL membership list from SAVCA

<table>
<thead>
<tr>
<th>Company</th>
<th>Contact Person</th>
<th>Address</th>
<th>Contact Information</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABSA Capital Private Equity</td>
<td>Mr. Wouter Viljoen</td>
<td>15 Alice Lane Sandton South Africa 2196</td>
<td>Tel: +27 11 895 6000/ 895 6896 Fax: + 27 11 895 7812 <a href="mailto:wouter.viljoen@absacapital.com">wouter.viljoen@absacapital.com</a> <a href="http://www.absacapitalprivateequity.com">http://www.absacapitalprivateequity.com</a></td>
</tr>
<tr>
<td>Acorn Private Equity</td>
<td>Mr. Pierre Malan</td>
<td>Unit A 3, The Beach Head 10 Niblick Way, Somerset West Cape Town, South Africa 7130 P O Box 3360 Somerset West Cape Town, South Africa 7129</td>
<td>Tel: + 27 21 852 2887 Fax: + 27 21 852 3161 <a href="mailto:pierre.malan@acornequity.com">pierre.malan@acornequity.com</a> <a href="http://www.acornprivateequity.com">http://www.acornprivateequity.com</a></td>
</tr>
<tr>
<td>Actis</td>
<td>Mr. Patrick Helson</td>
<td>1st Floor, Cradock Heights 21 Cradock Avenue Rosebank 2196 P O Box 2396 Saxonwold South Africa 2132</td>
<td>Tel: (011) 778 5900 Fax: (011) 327 7407 <a href="mailto:phelson@act.is">phelson@act.is</a> <a href="http://www.act.is">http://www.act.is</a></td>
</tr>
<tr>
<td>Adlevo Capital</td>
<td>Mr. Greg Voigt</td>
<td>P O Box 783953 SANDTON</td>
<td>Tel: +27 11 502 6940 Fax: + 27 11 444-0690</td>
</tr>
</tbody>
</table>
African Infrastructure Investment Managers (South Africa) (Pty) Ltd

Johannesburg 2146
Building 2, Commerce Square 1st Floor, 37 Rivonia Road Sandton, South Africa 2146
info@adlevocapital.com http://gprtgort/www.adlevocapital.com

Collinton House, The Oval 1 Oakdale Road, Newlands Cape Town, South Africa 7700
P O Box 23777 Claremont Cape Town, South Africa 7735
Tel: +27 21 670 1234 Fax: +27 21 670 1220 andrew.johnstone@macquarie.com

Aureos SA Advisers Mr Ron den Besten

2nd Floor, Fountain Chambers Sandown Village Office Park Aureos Central America does MBOs, MBIs; SA site
Cor Maude St & Gwen Lane, Sandton 2196 Suite #209 Private Bag X9916 Sandton 2146
Tel: +27 11 884 2066 Fax: +27 11 884 2067 dscott@aureos.co.za http://www.aureos.com

Biotech Venture Partners (Pty) Dr Heather Sherwin

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11 Lansdowne heather@bioventures.co.za
Roa  
Claremont, Cape Town  
7701  
GR 05 Brookside  
Office Park  
11 Lansdowne Road  
Claremont, Cape Town  
7701

Brait Private Equity  
Mr John Gnodde  
9 Fricker Road  
Illovo Boulevard  
Illovo, Sandton  
2196  
Private Bag X1  
Northlands  
Johannesburg  
2116  
Tel: +27 11 507 1000  
Fax: +27 11 507 1001  
jgnodde@brait.com  
http://www.brait.com

Brighthead Investments (Pty) Ltd  
Mr Manie Wessels  
1st Floor, Block G, Wedgewood Office Park  
3 Muswell Road  
Bryanston, South Africa  
P O Box 71931  
Bryanston  
South Africa  
2196  
Tel: +27 11 244 8400  
Fax: +27 11 244 8416  
manie@brighthead.co.za

Business Partners Limited  
Mr Nazeem Martin  
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Houghton Estate  
Johannesburg, South Africa  
P O Box 4300  
Johannesburg  
South Africa  
Tel: +27 11 713 660  
Fax: +27 11 713 6657  
enquiries@businesspartners.co.za  
http://www.businesspartners.co.za
<table>
<thead>
<tr>
<th>Company</th>
<th>Name</th>
<th>Address</th>
<th>Phone</th>
<th>Fax</th>
<th>Email</th>
<th>Website</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capitalworks Equity Partners</td>
<td>Mr. Chad Smart</td>
<td>24 Central Building, 3rd floor Cnr Gwen Lane &amp; Fredman Drive Sandown, Sandton 2196 P O Box 653088 Benmore South Africa 2196</td>
<td>Tel: +27 11 301 3000/1</td>
<td>Fax: +27 11 883 5560</td>
<td><a href="mailto:chad@capitalworksip.com">chad@capitalworksip.com</a></td>
<td><a href="http://www.capitalworksip.com">http://www.capitalworksip.com</a> growth</td>
</tr>
<tr>
<td>Capricorn Capital Partners</td>
<td>Mr. Gavin Chadwick</td>
<td>Capricorn House 32 Impala Road Chislehurston, Johannesburg 2196 P O Box 652090 Benmore Johannesburg 2010</td>
<td>Tel: +27 11 666-0700</td>
<td>Fax: +27 11 666 0702</td>
<td><a href="mailto:gavinc@capricornsa.com">gavinc@capricornsa.com</a> equity BEE stakes</td>
<td></td>
</tr>
<tr>
<td>Coast2Coast Investments</td>
<td>Mr. Gary Shayne /Cris Dillon</td>
<td>Unit C7, Westlake Square Westlake, Cape Town South Africa 7945 Cape Town Unit C7, Westlake Square Westlake, Cape Town South Africa 7945</td>
<td>Tel: +27 021 701 2232</td>
<td>Fax: +27 021 701 3343</td>
<td><a href="mailto:info@coast2coast.co.za">info@coast2coast.co.za</a></td>
<td><a href="http://www.coast2coast.co.za">http://www.coast2coast.co.za</a> R20mln – R300mln</td>
</tr>
<tr>
<td>Collins Private Equity Holdings</td>
<td>Mr. Bruce Chelius</td>
<td>164 Springfield Road Morningside, Durban</td>
<td>Tel: +27 31 208 6266</td>
<td>Fax: +27 31 208 6014</td>
<td><a href="mailto:bruce@collinsprop.co.za">bruce@collinsprop.co.za</a></td>
<td></td>
</tr>
</tbody>
</table>
Convergence Partners
Mr. Idan Segal
33 Fricker Road
Illovo
South Africa
2196
Tel: +27 11 550 5320
Fax: +27 11 550 5321
investment@convergencepartners.co.za
http://www.convergencepartners.co.za
BEE, SA, Africa, Mid East, minority interest, growth & development

Decorum Capital Partners
Mr. Neil Gardyne
37 Peter Place
Bryanston
South Africa
2191
Tel: 011 706 1442
Fax: 011 706 1593
neilg@decorumsa.co.za
http://www.newafricanminingfund.co.za
early stage

Development Bank of Southern Africa
Mr. Emile du Toit
1258 Lever Road
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South Africa
1685
Tel: +27 11 313 3935
Fax: +27 11 206 3935
emiled@dbsa.org
http://www.dbsa.org

Development Partners International LLP
Mr. Eduardo Gutierrez-Garcia
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LONDON, SW0 0QJ
UK
Tel: +44 (0) 207 349 5030
Fax: +44 (0) 207 349 5038
Clodagh.bourke@dpi-llp.com
http://www.dpi-llp.com
UK
Does not explicitly state – but invest in Africa
from the UK; include for diverse regional
perspective

Edge Growth
Mr. Daniel
Hatfield
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Offices
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Sandton, South
Africa
2010
Postnet Suite 539
Private Bag X9
Benmore, South
Africa
2010
Tel: +27 11 292 7971
Fax: +27 11 292 7911
dhatfield@edgegrowth.com
http://www.edgegrowth.com
enterprise development

Emerging Capital Partners
Alex-Hendrah
Aime, Zain
Laher
8th Floor, The
Forum
Cnr Fifth and
Maude Street
Sandton, South
Africa
2196
P O Box 785789
Sandton
South Africa
2146
Tel: +27 11 685 0830
Fax: +27 11 784 9112
aimea@ecpinvestments.com
http://www.ecpinvestments.com
multiple sectors
and pan African and all sizes, strong growth prospects

Enablis
Mr Paul
Lamontagne
1 Plein Street
Darling Street
Parkade
Cape Town
8001
P.O. Box 2287
Cape Town
South Africa
8000
Tel: +27 21 422 0690
Fax: +27 21 422 0744
paul.lamontagne@enablis.org
http://www.enablis.org
non profit
<table>
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<th>Email</th>
<th>Website</th>
<th>Notes</th>
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</thead>
<tbody>
<tr>
<td>Ethos Private Equity</td>
<td>Ms Chelsea Wilkinson,</td>
<td>35 Fricker Road Illovo, Sandton</td>
<td>+27 11 328 7400</td>
<td>+27 11 328 7420</td>
<td><a href="mailto:cwilkinson@ethos.co.za">cwilkinson@ethos.co.za</a></td>
<td><a href="http://www.ethos.co.za">http://www.ethos.co.za</a></td>
<td>growth replacement public to private, buyouts mid buyouts $750 to $3bn, multi-sector</td>
</tr>
<tr>
<td></td>
<td>Corporate Affairs</td>
<td>South Africa 2196</td>
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<td></td>
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<td>Freetel Capital</td>
<td>Mr. Enos Banda</td>
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<td>+27 11 263 7904</td>
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<td><a href="http://www.freetelcapital.com">http://www.freetelcapital.com</a></td>
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<td>Glenhove Fund Managers</td>
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<td><a href="http://www.wpef.co.za">http://www.wpef.co.za</a></td>
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http://www.intelcapital.com
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<td>International Housing Solutions (Pty) Ltd</td>
<td>Ms Soula Proxenos/Pamela Lamoreaux</td>
<td>1st Floor, North Wing 269 Oxford Road, Illovo, South Africa 2196</td>
<td>Tel: +27 11 215 8300</td>
<td>Fax: +27 11 268 5166</td>
<td><a href="mailto:info@inthousingsolutions.com">info@inthousingsolutions.com</a></td>
<td><a href="http://www.intlhousingsolutions.com">http://www.intlhousingsolutions.com</a></td>
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<td>InVenfin</td>
<td>Ms Ronelle Cloete</td>
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<td>Tel: +27 21 888 3355</td>
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<td><a href="http://www.invenfin.com">http://www.invenfin.com</a></td>
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<td>Investec Principle Investments</td>
<td>Ms Arlene Lubbe</td>
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<td><a href="mailto:principalinvestments@investec.co.za">principalinvestments@investec.co.za</a></td>
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<td>Kagiso Ventures (Pty) Ltd</td>
<td>Mr Afzal Patel (MD)</td>
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<td>Fax: +27 11 537 0530</td>
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<td>Kingdom Zephyr Africa Management</td>
<td>Mr Panos Voutyritsas</td>
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<td>+27 11</td>
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<td>Leaf Capital (Pty) Ltd</td>
<td>Mr. Paul Leaf-Wright</td>
<td>28th Floor, 1 Thibault Square Long Street Cape Town, South Africa 8001</td>
<td>+27(0)21</td>
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<td><a href="mailto:info@leafcapital.co.za">info@leafcapital.co.za</a></td>
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<td>Median Fund Managers</td>
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<td>Mezzanine Partners (Pty) Limited</td>
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<tr>
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<td>RMB Corvest</td>
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<td>RMB Leveraged Finance</td>
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<td>RMB Private Equity</td>
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<tr>
<td>RMB Ventures SA</td>
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<td>+27 11 282 8242</td>
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<tr>
<td>Sabvest</td>
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<td>Mr. Pieter Kriel</td>
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<tr>
<td>Company</td>
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<tr>
<td>Sasfin Private Equity Fund</td>
<td>29 Scott Street, Waverley, Johannesburg 2090</td>
<td>(011) 445 8001</td>
<td>086 638 6729</td>
<td><a href="mailto:msegal@sasfin.com">msegal@sasfin.com</a>, <a href="http://www.sasfin.com">http://www.sasfin.com</a></td>
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<tr>
<td>Shanduka Fund Managers</td>
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<td>+27 11 305 8900</td>
<td>+ 27 11 305-8999/16</td>
<td><a href="mailto:rgovender@shanduka.co.za">rgovender@shanduka.co.za</a>, <a href="http://www.shanduka.co.za">http://www.shanduka.co.za</a></td>
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<th>Company</th>
<th>Name</th>
<th>Address</th>
<th>Contact Details</th>
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<tr>
<td>Triumphant Venture Capital</td>
<td>Ms. Joan Rangwaga</td>
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<td><a href="http://www.triumphvc.co.za">http://www.triumphvc.co.za</a></td>
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<tr>
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<td><a href="mailto:info@vantagecapital.co.za">info@vantagecapital.co.za</a></td>
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