

MANAGING the opportunities for Venture Capital & Private Equity in South Africa¹

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Introduction

Venture capital and private equity opportunities in South Africa have been largely ignored by international investors. To date their investments in South Africa have been liquid and portfolio-based. This chapter provides information needed by investors to reach a considered opinion on the medium to long term opportunities for venture capital and private equity in South Africa (US\$ 4.5 billion; 3.7% of 1999 GDP). Private equity funds are well rooted in South Africa's solid banking system, but venture capital is relatively new to the country.

Summary

Opportunities for venture capital in South Africa exist in niche markets related to Internet technology (WAP, infra red and security) and in the spin-offs from the government's privatisation programme. Foreign analysts consider South Africa to be a world leader in some areas and, in general, competitively priced.

Opportunities for private equity exist in the disposal of non-core assets, black economic empowerment and in improving the competitive position of the manufacturing sector.

Successful companies and sectors are easy to spot in South Africa. Thawte, Columbus Steel, Saldanha Steel, Didata, Investec and the motor, wine and food industries stand out.

South Africa has been complimented by financial authorities for its determined pursuit of a prudent economic policy². The economy is growing (GDP rose from -2.2% in 1992 to an expected 3.8% for 2000 and 4.0% in 2001³); inflation is falling (from an average of 12.5% between 1990 and 1994 to 5.2% in 1999); the budget deficit is narrowing (from 10% in 1993/4 to an estimated 2.6% for 2000/01); and interest rates have also fallen sharply (the prime rate is now 14.5%).

South Africa's strengths are its banking and legal systems, (communication) infrastructure, mineral resources, business community, strategic position in the global economy, climate and, not least, its track record in negotiating practical political decisions.

South Africa's weaknesses are its high real interest rates, uneven income distribution, high unemployment, commodity based economy, poor competitiveness, and inadequate education system.

Risks exist (crime, labour relations, exchange rate, aids, corruption) but are manageable.

Conclusion: South Africa offers a sound platform on which to launch successful ventures. Strong management is a prerequisite, which is exactly what venture capital and private equity can offer. However, as Alec Erwin (Minister of Trade and Industry) concluded in his speech at the Investment Conference, held in the Hague on 20 April 1998: 'Do not come to South Africa if you have a nervous character, but only if you enjoy managing the opportunities and risks of a country in transition'.

1: South Africa

1.1 Political stability: a track record in negotiating practical decisions

South Africa owes its political stability to the constitution it adopted in 1996, which is one of the most progressive of its kind in the world. This stability stems as much from the process of the negotiations as from the result. Because the relationship between Mandela and de Klerk

¹ Leverage research document, 1 July 1996. Leverage was founded by Adriaan Brouwers in 1995 to facilitate joint ventures between South African and Dutch, European or other foreign companies financed, where appropriate, by venture capital or private equity.

² Economist October 12th 1996; December 13th 1997; May 29th 1999; IMF and World Bank.

³ IMF's World Economic Outlook, April 2000.

broke down in July 1991⁴, Cyril Ramaphosa⁵ and Roelf Meyer⁶ became the key negotiators. Other individuals also made vital contributions, such as Joe Slovo⁷, who proposed the unilateral suspension of the armed struggle (6 August 1990) and General Viljoen, who prevented intervention by the armed forces. The process was supported by the majority of the country, including the whites, of whom 85% voted in a referendum on 17 March 1992 with 68.7% voting in favour of the transition process.

Mandela appreciated the high price the Boers had paid for their desire for self-determination during the Anglo-Boer War of 1899-1902. Apartheid was their misconceived attempt to entrench the power they acquired in 1948 in an effort to ensure that they were never dominated again⁸. Mandela successfully conveyed this critical insight to his fellow prisoners and to South Africa as a whole⁹. As a result, all sides were convinced of the need to negotiate a common future. Mandela led this visionary yet pragmatic approach¹⁰ and became its symbol.

Indeed, few political processes of the twentieth century are likely to be judged by history as more stable than the emergence of democracy in South Africa. Today the country pursues an active but prudent regional role, and President Thabo Mbeki is committed to what he has termed the African Renaissance¹¹. It should be noted that South Africa's experience differs sharply from that of Zimbabwe. Following its democratic change, South Africa immediately instituted a process of land reform. Furthermore, South Africa already has its second elected president and has a very active political opposition, independent judiciary and free press (a very critical debate is in progress on Mbeki's approach to Zimbabwe). South Africa's experience is also highly respected internationally as evidenced by the Irish Republican Army's recent request for Cyril Ramaphosa to oversee its arms decommissioning process.

1.2 The economy

1.2.1 Structure, strategic direction and opportunities

The present structure of the South African economy is reflected in the table below:

GDP (Rand billion) ¹	1996	%	1997	%	1998	%	1999	%
Agriculture ²	23.7	4	25.3	4	25.6	4	26.6	4
Mining and Quarrying	38.8	7	40.5	6	44.2	7	47.1	6
Manufacturing	114.1	20	124.6	20	128.6	19	132.6	18
Construction	17.6	3	19.4	3	20.7	3	20.9	3
Electricity, Gas & Water	18.1	3	20.4	3	22.5	3	23.8	3
Transport ³	51.8	9	57.7	9	65.0	10	73.1	10
Trade	79.5	14	85.6	14	89.3	13	95.2	13
Business Services	94.1	17	109.6	18	124.3	18	140.6	19
Others	<u>128.3</u>	<u>23</u>	<u>142.2</u>	<u>23</u>	<u>155.7</u>	<u>23</u>	<u>168.2</u>	<u>23</u>
Total	566.0	100	625.3	100	675.9	100	728.1	100

1. South African Reserve Bank, GDP by sector. 2. Including forestry and fishing. 3. Including communication.

In 1990 South Africa opened its almost totally closed economy and is now in the process of adjusting to the global competitive environment. Distinct successes are not hard to find (for

⁴ Anatomy of a Miracle, by Patti Waldmeir, correspondent of The Financial Times, 185; F. W. de Klerk the autobiography, 207-211.

⁵ Former leader of the Union of Mine Workers, Secretary General of ANC and present captain of industry; see F. W. de Klerk the autobiography, 238; Anatomy of a Miracle, 208-209.

⁶ At the time Secretary General of National Party; see F. W. de Klerk the autobiography, 358; Anatomy of a Miracle, 142.

⁷ Member Communist Party, Opponent of Apartheid from 1948, Chief Commander Umkhonto We Siswe, Negotiator, Minister of Housing, married to Ruth First who was blown apart by letter bomb in Maputo 1979.

⁸ Business Day 11 October 1999, Carl Niehaus Ambassador of South Africa to The Netherlands, 9.

⁹ Mandela, the authorised biography; Anthony Sampson, 283-300; Anatomy of a miracle, 83.

¹⁰ No future without forgiveness, Desmond Tutu, 24-36.

¹¹ Africa, the time has come, Thabo Mbeki, 31, 296.

example, increasing car exports, IT expansion, and the wine and food industries). Foreign listings have also broadened international horizons (for example, Anglo American, SA Breweries, Billiton and Old Mutual, with Didata and Investec to follow soon), and there has been important industrial restructuring (for instance in the gold and car industries, and by Sanlam). Current priorities include job creation, achieving global competitiveness, adding value to the mineral base and developing a high tech sector.

1. 2. 2 Policy framework

Since its inception in 1996 the Growth Employment and Redistribution (GEAR) policy has been consistently applied in South Africa. As a result, the country survived the Asian financial crises reasonably well. Improved tax collection has enabled social expenditure to increase without compromising the government's commitment to reduce the budget deficit (down from 10% in 1994/5 to 2.6% in 2001/2). Inflation has fallen from double digits to its present level of around 5%. Nominal interest rates have dropped from 25% in 1998 to their present prime rate of 14.5%. However, reduction in real interest rates remains to be achieved. The rand exchange rate is in a controlled process of finding its stable level¹². Exchange controls only apply to local companies. These controls were further relaxed in this year's February budget¹³. Corporation tax was reduced in 1999 from 40% to 35%, and in 2000 to 30%. A package of tax incentives and tax holidays is under revision. It is expected to be more comprehensive because the original GEAR targets of 6% economic growth with 400,000 jobs created annually have yet to be achieved. Black economic empowerment continues to be a cornerstone of government policy. The consistent application of the policy framework outlined above is guaranteed by the continuing service of Trevor Manuel and Alec Erwin as Ministers of Finance and Trade of Industry, respectively, together with the shift in emphasis from reconciliation during the Mandela era to delivery and performance under Thabo Mbeki.

1. 2. 3 The strengths of the South African economy

Availability of raw materials

South Africa has abundant mineral resources¹⁴ and is a world leader in mining.

Communications network and infrastructure

South Africa has a sound transport and communication infrastructure that functions well.

Financial and legal system

South Africa's banking and financial system are as good as any in the world. This protected South Africa from the worst of the Asian financial crises. South Africa has a developed legal system based on Roman Dutch law with an admixture of English law. A substantial legislative programme focusing on constitutional, land and educational reforms is being carried out.

Business community

The existence of black entrepreneurial talent is evident in the successful growth of business during the apartheid period. Ethnic or culturally defined business networks exist, and are supportive and highly successful.

Labour unions

Unions are strong and share responsibility for developing national economic policy.

Geographical position in global economy

South Africa is strategically positioned between Asia, Europe and South America.

1. 2. 4 Weaknesses

¹² Its present value against the US dollar is 7.00R=1US\$; it had a stable value for a year of 6.2 to the dollar. In 1995 its average value was 3.65 to the US dollar.

¹³ Budget speech, 23 February 2000.

¹⁴ It has 88% of the world's platinum resources, 83% of its manganese, 72% of its chromium reserves, 45% of its vanadium, 39% of its gold reserves and a large proportion of its gem diamonds.

In 1994/5, Monitor Company, Inc. carried out a full review of the South African economy¹⁵. Besides confirming the strengths outlined above, the review identified the following weaknesses: South Africa lacked an outward looking industrial policy and applied no cluster thinking to its economic sectors; its long isolation meant that its economy was heavily protected and thus lacked healthy internal and external competition; fundamental policies such as developing long term strategies and being more customer-oriented were largely absent; shortages existed in machinery, engineering, maintenance and design services. Subsequent efforts to remedy these weaknesses have focused on the review's recommendations.

1. 2. 5 Risks to be managed

Crime

The crime rate is high and the police are largely ineffective. However, recent civil and business initiatives (in co-operation with the police) are beginning to reduce crime rates in some areas quite considerably¹⁶.

Labour relations

Labour unions are strong, well organised, and protected by the 1997 Labour Law. Although privatisation policies and MBOs conflict with their immediate interests they continue to take a pragmatic position in this critical South African economic debate.

Markets

Export markets will only develop if South African products become competitive. In October 1999 South Africa concluded a trade accord with the European Union which will improve South Africa's export position. Similar agreements are being negotiated with India and Brazil. Domestic suppliers have enormous potential access to other countries in the region such as Zimbabwe, Namibia, Mozambique, Swaziland and Angola.

Exchange rate

The Central Bank's exchange rate policy is to let the rand find its free market value¹⁷. Increased international confidence is a precondition for real interest rates to fall to international levels. Exchange controls only apply to South African citizens, not to foreign companies. These controls are in the process of being phased out.

Corruption

Isolated cases of corruption occur in South Africa, but identified cases are thoroughly investigated and dealt with.

HIV / Aids

South Africa has a rapidly increasing infection rate. Controversial differences of opinion exist about the best prevention strategy to adopt.

2: The Venture Capital & Private Equity sector in South Africa

2.1 Opportunities for venture capital in technology niche markets

There are particularly exciting opportunities in niche markets related to Internet technology, an area in which South Africa is considered to be world leader. Due to its isolation South Africa was forced to develop advanced research capabilities and some extremely innovative businesses have resulted. In addition, South Africa has a strong entrepreneurial ethos because it lacks any form of social security. Examples include Thawte Technologies, who developed a garage on-line start-up involved in digital certification that was recently sold for US\$600 million, and Automated Identification Technology, who developed a unique wireless tracking product and are in the process of extending their technology to wireless keyboards. Further

¹⁵ The review focused in particular on these sectors: motor vehicles, clothing and textiles, sugar, fruit juices, metals, tourism, and low budget housing.

¹⁶ International Herald Tribune 16 May 2000, 2; up to 80% in central districts of Johannesburg and Cape Town; television news 11 April 2000.

¹⁷ Mr. Tito Mboweni, Governor of Central Bank, April 2000.

innovative developments can be found in South Africa's food processing, broad band, WAP and E-commerce technologies. Compared to trading centres in Korea, Taiwan, India and even Brazil, the Johannesburg Stock Exchange has a very slim technology portfolio. However, individual success stories like Comparex, Dimension Data and IxChange exist.

Recent information technology deals

Thawte	US\$ 0.3 (sold for US\$ 600 million)
AIT	US\$ 22.0
eGolf	US\$ 3.0

1. US\$ millions

Investments at cost¹

2.2 Opportunities for venture capital in spin-offs from privatisation

The spin-offs of the privatisation process are likely to offer very attractive opportunities for venture capital. Resistance from the unions delayed the programme, but it is once more on the agenda. Besides South African Airways, which already acquired Swiss Air as a private partner, the privatisation of Eskom, Transnet, Telkom, and Denel, with an estimated combined worth of some 200 billion rand, has been announced. Illustrative examples of spin-offs include:

SPIN-OFFS

<u>Sector</u>	<u>Value</u> ¹	<u>Planned privatisation programme</u>			
		<u>Sector</u>	<u>Company</u>	<u>Share</u> ²	<u>Year</u>
Airport Retail	150	Air transport	S.A. Airways	20%	1999
Pebble bed	115	Electricity	Eskom	20-49%	2000/2
Rotek Engineering	75				
Construction	³ -	Railways, ports	Transnet	20-49%	2003/4
Blue Train	-				
Airport Services	-				
Mobile phones	-	Telecommunication		20-49%	2000/2
Internet	-				
Infotechnology	5-100	Defence	Denel	20-49%	2002/3
Communication	5-100				
Infra Red	5-100				

1. In millions of South African rands

2. It is expected that the privatisation process will be in two phases. An initial sale of 20%-30% will improve the performance of the company concerned; a subsequent sale of up to 29% of the stock will then yield a far higher return for the government.

3. (-) No reliable figures are available as yet.

2.3 Opportunities for private equity in the divestment of non-core assets

When sanctions increased in the period 1970-1992 various companies divested from South Africa. Their businesses were acquired by existing South African conglomerates (such as Anglo American, Old Mutual, Liberty Life, Rembrandt, Anglovaal and Sanlam). As a result, these conglomerates spread their activities into almost every conceivable economic sector. The lifting of sanctions has enabled them to seek out international opportunities for their core business and to divest themselves of non-core assets. Many such deals have already been completed and further opportunities in this area can be expected to arise, as shown in the following table:

<u>Company</u>	<u>Sector</u>	<u>Disposing Co.</u>	<u>Value</u> ¹	<u>Funding</u> ¹	<u>Year</u>
Reunert	Engineering products	Barlow Rand	1.76	0-0,3	1997
Wacco	Conglomerate	Trencor	1.5		1999
Murray and Roberts	Construction	Sanlam			1998
Several Co's	Financial Services	Several	N.A.	0-0,5	1999
Tongaat Group	Diversified Industrial	Anglo American	3.4	1	future

1. Estimated South African rand billion

2.4 Opportunities for private equity in black empowerment

Several groups were excluded from mainstream economic activity until 1990. After 1990 substantial business empires were developed by empowered groups, some of which were financed with special purpose vehicles and/or preference shares. Although some transactions failed miserably (for example Mzi Khumalo of JCI) others have flourished (for example Kunene Bros and Kasigo Investments). Now that lessons from the first wave of

empowerment schemes have been learned future schemes are expected to be more realistic. The chief lesson to be learned is that empowerment is not enough; real added value must be achieved too. This lesson is likely to be reflected in the National Empowerment Council's report. Venture capital and private equity can be suitable instruments for refinancing some first generation empowerment schemes, as well as for funding future schemes. The following opportunities are expected in the near future:

<u>Opportunity</u>	<u>Sector</u>	<u>Value</u>¹	<u>Funding</u>¹	<u>Year</u>
Third Cellular	Mobile telephone	12	3	2000/1
Rebhold	Conglomerate	3	0.3	2000
Casinos	Leisure	³ -	0.2	future
Outsourcing	Business Services	-	0.1-0.5	2000
e-ETV	Media	-	0.5	future
Amka	Cosmetics	-	0-0.1	2002
Microlending	Financing	-	1	future

1. Estimated value in South African rand billion.

2.5 Additional opportunities for private equity

In addition to those described above, opportunities for private equity exist in the following economic activities:

Adding value to the mineral base

In an effort to reverse the practise in South Africa of mainly exporting minerals, Columbus Stainless Steel, Saldanha Bay Steel, Hulett Aluminium and the Alusaf smelter at Richardsbay produce metal which is now used for further manufacturing of half and final metal products.

Improving competitiveness

The motor industry sector has been revitalised through the 1995 Motor Industry Development Programme. Daimler-Chrysler, Volkswagen and BMW invested an estimated US\$ 500 million in 1999 alone. This has created employment, and stimulated the growth of and integration with local component suppliers (from 0% to up to 50% in 2000), who have been forced to meet international quality standards. More industrial sectors are expected to follow the motor industry's example.

Stimulating ecotourism

The natural beauty of South Africa coupled with its good infrastructure offers visitors a unique experience. Ecotourism combines profitability with high employment potential.

Of course, opportunities in all of the above areas can only be fully exploited if a sound professional and manufacturing skill base exists. This in turn offers yet another opportunity for investments in the education and development of human resources.

2.6 Structure of the venture capital and private equity industry

Venture capital is relatively new to South Africa. Some funds (for example, Wizcorp, Archway Venture Partners, Horizon Equity Partners, TribeOne Capital, Cycad SMC Technology Fund and WebCapital) focus on technological opportunities.

Private equity has developed within the existing banking system and has grown rapidly in the last few years. AMB Private Equity Partners raised 740 million rand, Brait Capital Partners 3.25 billion (of its 5.0 billion target), and Ethos 3.5 billion rand.

The table below summarises the main players in the market¹⁸:

<u>Main Players</u>	<u>Type of Fund</u>	<u>Total</u>¹	<u>Average</u>²
Ethos, Brait, NAA, AMB	Independent Private Equity	12 000	850
Nedcor, Absa, Standard Bank	Captive Banks	4 000	800
IFC, US Aid, SAEDF, CDC	Government Agencies	7 000	1 400
Didata, Mitsubishi, others	Other Captive Funds	<u>4 000</u>	<u>250</u>

¹⁸ 1999 Private Equity Survey by KPMG and South African Venture Capital Association.

Total

27 000

675

1. Funds available in million rand. 2. Size of fund in million rand.

To date, private equity has allocated 26% of its funds to manufacturing, 19% to the IT sector, 15% to media, telecommunication, entertainment and leisure, 11% to financial projects, 8% to services, 7% to retail businesses with the remaining 14% distributed to other sectors. Expansion and development capital accounted for 61% of the funding, Management Buy Outs/Ins 20%, Replacement Capital 12%, Early Stage 6% and Seed Capital 1%. The impressive early successes of almost a third of private equity managers, who achieved returns of over 40%, resulted in many new entrants in the mid to late nineties. The South African Venture Capital Association was formed in 1999 as a self regulating body.

2.7 Outlook of the Private Equity & Venture Capital industry

Factors such as the dynamics of the new e-economy, globalisation pressures, relaxation of exchange controls, privatisation policies, the empowerment imperative, divestment of non-core assets by major corporations, volatility in public financial markets, succession funding and the need for funding associated with mergers, acquisitions and joint ventures, will continue to act as a major catalyst driving growth by at least 25% p.a. for the next three years in the private equity market.¹⁹

3: Conclusion

Since 1990 South Africa has achieved distinct successes in opening its economy but the legacy of isolation has left severe problems that have still to be remedied. South Africa has created a sound platform on which to base future economic development. In turn this means there are numerous opportunities for venture capital and private equity in a range of key areas including technology niche markets, spin-offs from privatisation, the disposal of non-core assets, and improvements in manufacturing competitiveness. It seems prudent to invest in partnership with local fund managers taking into account the phases which reflect the growth and transitional dynamics of the South African economy.

The recent Merrill Lynch Fund Manager Survey found that 52% of fund managers favoured South Africa over Asia (29%) and Latin America (19%). All the South African fund managers who took part in the survey expect the economy to perform better in 2000. 58% were very confident about the macro-economic policy framework, with no one expressing no confidence in it at all.

Strong management is a prerequisite, which is exactly what venture capital and private equity can offer.

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¹⁹ HBR ref-economics of venture capital in developing economies.

²⁰ Wizcorp is establishing an incubator to promote Internet-based ventures between South Africa and other developed countries.