<u>South Africa offers opportunities, despite self-created misconceptions</u>

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South Africa offers attractive investment opportunities for venture capital and private equity. This can be confidently stated because of the country's sound economic foundations and on its current growth strategy. Despite this, South African authorities have recently created unease in the international community in relation to the country's position on issues such as Aids, the Zimbabwean land crisis and the fight against corruption. This chapter reconciles the investment opportunities with these self-created misconceptions. It should be noted at this point that, on the whole, insiders remain confident about South Africa's young and robust democracy.

This chapter is a stand-alone guide intended to help investors identify opportunities created by the country's privatisation programme as well as those that exist in the IT sector and the digital economy in general. The chapter also seeks to help investors understand the background and reasons for the misconceptions that have recently arisen concerning South Africa's official position on the aforementioned controversial issues.

<u>Summary</u>

The groundwork for sound economic foundations was laid between 1994 and 2000. Recently, both President Thabo Mbeki (in his State of the Nation address) and Finance Minister Trevor Manuel (in his budget speech) outlined the growth strategy South Africa is pursuing. This is based on a steady recovery of gross fixed capital formation and on South Africa's continued robust trade performance[1]. Only well-informed investors can see the opportunities that are arising in South Africa despite the initial difficulties inherent in its current economic strategy.

Restructuring State Assets

Table 2 provides a comprehensive summary of the emerging opportunities in South Africa. The main areas of interest are:

- Telecommunications: privatisation, second half 2001, value R18 billion.
- Defence systems: privatising specialized subsidiary companies, value R5 billion.
- South African Airways: additional privatisation, 2002, value R7 billion.
- Airports: additional privatisation, 2002, value R3 billion.
- Railways: privatisation of specific lines, 2003 – 2004, cumulative value R5 billion.
- Electricity: privatisation of generation and distribution, 2003, value yet to be determined.

Technology

Table 4 provides details of some specific opportunities and advantages for investors. The main areas of interest and points to note are:

- Proprietary software: e.g. security systems and banking software.
- Low development costs as a result of a weakening exchange rate.

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[1] Budget 2001/2 speech on 21 February 2001.

- Remote services: e.g. education.
- Internationally proven products for South Africa’s sophisticated market.
- Industry redefinition in specialised niches of business-to-business exchanges.

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’.

Basic Information on South Africa[2]

Financial authorities have complimented South Africa for its determined pursuit of a prudent economic policy[3]. Last year South Africa rose fourteen places in a ranking of the world’s economies in terms of its competitiveness. Its credit rating was also increased by various agencies. The economy continues to grow (GDP rose from -2.2% in 1992 to 3.0% in 2000. Over the next three years an average growth rate of 3.5% is expected[4] despite a predicted slowdown in the international economy); inflation[5] is falling (from an average of 12.5% between 1990 and 1994 to 5.2% in 1999. Although it rose to 7.6% in 2000, it is expected to steadily decline over 2001); the budget deficit is narrowing (from 10% in 1993/4 to 2.4% in 2000/01); and, finally, interest rates have also fallen sharply (the prime rate is now 14.5%). Both President Mbeki and Mr. Manuel stressed a shift in emphasis from creating sound fundamentals to concentrating on micro-economics, projects and delivery.

Table 1: Current structure of the South African economy

GDP (billions of rand) [1]	1997	%	1998	%	1999	%	2000	%
Agriculture [2]	25.3	*4*	25.6	*4*	26.6	*4*	29.8	*4*
Mining and Quarrying	40.5	*6*	44.2	*7*	47.1	*6*	49.7	*6*
Manufacturing	124.6	*20*	128.6	*19*	132.6	*18*	147.7	*18*
Construction	19.4	*3*	20.7	*3*	20.9	*3*	23.3	*3*
Electricity, Gas & Water	20.4	*3*	22.5	*3*	23.8	*3*	25.2	*3*
Transport [3]	57.7	*9*	65.0	*10*	73.1	*10*	81.4	*10*
Trade	85.6	*14*	89.3	*13*	95.2	*13*	105.5	*13*
Business Services	109.6	*18*	124.3	*18*	140.6	*19*	156.6	*19*
Others	142.2	*23*	155.7	*23*	168.2	*23*	187.7	*23*
Total	**625.3**	***100***	**675.9**	***100***	**728.1**	***100***	**806.9**	***100***

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

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

[2] Euromoney, Venture Capital & Private Equity Yearbook 2000/2001, pages 83-86.
[3] Economist October 12th 1996; December 13th 1997; May 29th 1999; February 24th 2001; IMF and World Bank.
[4] Budget speech 21 February 2001.
[5] CPIX inflation (consumer prices excluding mortgage interest).

decisions. Nevertheless last year after buying (net) R14.3 billion worth of bonds in 1999, foreigners sold (net) R20.7 billion worth in 2000. Purchases of equities also fell sharply in 2000 to R17.4 billion (from R40.3 billion in 1999). Direct foreign investments shrank to US$ 492 million from 1,023 in 1999[6].

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 (in its high crime rate, fractious labour relations, weakening exchange rate, Aids epidemic, and worrying levels of corruption) but are manageable.

Successful companies and sectors are easy to spot in South Africa. Thawte, Billiton, De Beers, Didata, Investec and the motor, wine and food industries stand out.

South Africa's privatisation programme

Introduction

South Africa's long awaited privatisation programme gained momentum under the government of President Mbeki[7]. For each state asset the South African government has identified the strategic share it will retain. The privatisation process will be based on modern regulatory frameworks. The government wants the process to reach out to previously disadvantaged communities as well as to take account of general employment considerations, global competitive criteria, relations with trade unions and the need to prevent asset stripping. Table 2 indicates the stage reached by each privatisation process per specific state asset, together with the opportunities for investors, and the expected value and timing of the privatisation.

Table 2: Opportunities arising from the Programme to Restructure State Assets

State Assets	Opportunities	Value[1]	Status[2]	Share[3]	Planning
1. Telkom	1. IPO for additional 40%	18.0	6	70%	Q3-4, 2001
	2. Fixed line license(s)	[4]	3	[4]	[4]
2. Denel	1. Shares in Denel	0.5	5	<50%	Q2, 2001
3. Transnet					
Airways	1. Additional 50%	7.0		70%	2002
Airport	1. Additional 45%	3.0		75%	2003-4
Spoornet	1. Coallink	[4]	3	100%	2003-4
	2. Lux rail	[4]	3	100%	2003-4
	3. Oryx	[4]	3	100%	2003-4
Portnet	1. Port services	[4]	[4]	[4]	[4]
4. Eskom	1. Generation	[4]	2	80%	2003+
	2. Transmission	[4]	2	[4]	[4]
	3. Distribution	[4]	2	[4]	[4]
	4. Local distributors	[4]	1	[4]	[4]
5. Sasria		3.0	6	66%	Q1-2, 2001

[6] National Business Initiative: State of the South African Nation, 4th Quarter 2000 and January 2001, and Business Map research document 22 January 2001.

[7] On 10 August 2000 Jeff Radebe, Minister of Public Enterprises, issued his policy paper entitled 'An Accelerated Agenda Towards the Restructuring of State Enterprises'.

6. Safcol		0.3	6	100%	Q2-3, 2001
7. Aventura			6		
8. Alexcor			6		

1. Billions of rand
2. 1: Strategy, 2: Regulatory Framework, 3: Business Model, 4: Restructuring, 5: Transaction, 6: Iteration.
3. In private hands after completion of the restructuring process.
4. Not yet determined.

The separate state enterprises

Telkom: telecommunications

Telkom's fixed license expires in May 2002. In 1997 30% of Telkom was sold to a joint venture between SBC communications from the U.S.A. and Telekom Malaysia. Of the remaining 70% some 20-30% will be offered through an IPO, while an additional 10% will be split between employees (2%), black economic empowerment schemes (3%) and the National Empowerment Fund (5%). A consortium led by Deutsche Bank and JP Morgan has been appointed to function as global co-ordinators of the deal, while UBS Warburg is leading a group of advisors to Telkom. The regulatory framework is still under discussion. Issues that require final agreement include the number and timing of fixed licenses, the competition framework and the role of the state.

Denel: defence systems

Denel is a high tech company but is too small to survive in a contracting market. Negotiations have started with British Aerospace Systems to establish a strategic partnership during the second half of this year. Soon after its establishment such a partnership may divest from those technology niches that are deemed to be non-core activities of the company.

Transnet: transport

Investments of R9.0 billion[8] in South Africa's traditionally sound infrastructure are a cornerstone of the government's growth strategy. The investments have to clear a substantial backlog in maintenance and development. A number of restructuring activities need to take place within the companies operating this infrastructure in order to achieve commercial objectives, maintain affordability and extend rural coverage.

South African Airways

Swiss Air acquired 20% of SAA in 1999 and has an option till December 2001 to increase its stake to 30%. The SAA IPO is scheduled for 2002. The proportion the state will continue to hold is expected to be around 30%.

Airport Company South Africa

Airporti di Roma acquired 25% of the Airport Company in 1998. The listing of ACSA has been postponed till 2003/4.

Spoornet: railways

The overall model to restructure Spoornet was finalized in March 2001 and is based on a shift from road to rail transport. Some Spoornet subsidiaries (e.g. Oryx and Coallink) and dedicated lines (e.g. to Saldanha) are likely to be sold to the

[8] Expenditure proposals in budget speech of 21 February 2001.

private sector within the next three years. The Spoornet model has international dimensions with its links to the countries in southern Africa.

Portnet: harbours
Portnet is expected to be split into a Port Authority division and a Port Operations division. The latter division is likely to be privatised (e.g. containers). However, port assets are expected to remain in state ownership.

Eskom: electricity

The business plan for the electricity sector distinguishes three business activities: Generation, Transmission and Distribution. Eskom will be incorporated as a limited liability company and split into these three corporate entities. Competition will be introduced in electricity generation and access will be allowed to current Eskom power stations. Although South Africa already enjoys some of the lowest electricity costs in the world, it is considered desirable to attract international investors in order to promote further competition in the market and to develop environment-friendly technologies in the energy sector. Distribution will be restructured into 7 or 8 regional distributors in which private stakes will become available. This model will be rolled out in the next 24 – 36 months. Eskom is considering the use of its transmission grid in competition with Telkom.

Sasria: insurance

Sasria is the South African State Insurance Company and will be totally privatised through an open tender this year. The expected value of the privatisation is R3 billion rand.

Safcol
Transactions involving forest assets in KwaZulu Natal and Eastern Cape North are nearing completion. Offers for the single Northern Forest Package of Mpumalanga and the Northern Province have been invited for late April 2001. Once all these deals have been completed this year only the forest assets of Southern and Western Cape will be left for future restructuring.

Aventura: tourism
Aventura was loss making as a result of its poor marketing. A turnaround management contract has been entered into with the Protea hotel group for a period of three to five years. Disposal will take place once the results have improved substantially.

Alexor: diamond mining
This activity is contracted out to Nebeira and extended yearly.

The technology and digital economy

Effect of the privatisation of the Telecoms Infrastructure

The liberalisation of the telecommunications market next year is likely to drive technological expansion over the coming years. Enhanced competition is likely to see the rates for Internet connectivity falling very rapidly. The Internet Service Provider (ISP) market is already saturated, with both Xsinet and Absa Bank providing free Internet access, the latter through a joint venture with IBM and Affinity of the United Kingdom, costing an estimated R144 million per annum to these sponsors.

Free Internet access, falling prices of computer equipment, and a fall in telecommunications tariffs are expected to see Internet connectivity rise by 200,000 users per annum, a significant 10% increase on the estimated 2 million Internet users at present. The country is expected to increase this impressive rate with connectivity growing by 30%, 45% and 70%, in the next three years respectively, to reach a total density of some 18% of the population by the end of 2004.

Track record

South Africa has a track record in producing exciting technology investments of a world-class nature. Didata, a mere 15 years old, had an R80bn debut as an FT100 company, and armed with a war chest of over US$2bn is looking at expansion opportunities in the US. Like Didata, several other companies, including Softline, Ixchange and Idion, have excelled on the world stage. This track record is sustainable and many more successes can follow in the coming years if the integration with the global economy is pursued. Specific areas and examples of where South Africa has demonstrated leadership are listed in Table 3.

Table 3: South African technological leadership

Areas Of Focus	**Competitive Advantage**	**Deals**	**Valuation in rand**
Wireless Technologies	South Africa's research capacity	Mweb-First ISP at CSIR Cabletron-Laser Broadband technology	1 billion 200 billion
Digital Currencies	Banking Infrastructure	e-Bucs Bluebean	40 million 30 million
Cellular Payment Technology	High cellular density as basis for SIM card payment technologies	MTN experiment project	Many billions
Broadband	Radio frequency Laser and fibre optics	Radio cards Linux-lan	250 million 150 million

Stable maturity in the technology environment

A major part of the stability in South Africa's technology market can be attributed to the fact that South Africa missed the unrealistic euphoric exuberance that drove most world markets to irrational levels. The high demand for seed, start-up and early stage funding was satisfied through more traditional venture capital channels rather than through over-priced stock offerings, as was the case elsewhere in the world. The maturity of the digital economy is an incentive for more traditional companies to develop new strategies to merge the opportunities of the digital economy with their established and proven business practises.

As the consolidation of the first generation of e-Business initiatives takes place, more and more companies are realising the need to benchmark against the best in the world in order to attract international venture capital, to establish potential strategic allies, identify current and future competitors, and explore exit strategies that may be appropriate in these international markets.

South Africa as an emerging region has low IT development costs. However, in order to fully capitalise on this strength, South Africa must retain its skilled IT personnel, slow down the continuing weakening of the exchange rate, and attract foreign investors.

Government and public sector support

The government places a high priority on developing a top class technology sector. This is evident in the establishment of the Technology Task team by the president, a team that includes such luminaries as Carly Fiorina (of Hewlett Packard) and Larry Ellison (of Oracle) amongst others.

Support from local councils is visible in the development of technology parks. Pretoria has established a R280 million Innovation Hub, whilst Cape Town is developing the Bandwidth Barnyard, its own Technopark that will complement the Technopark that already exists in Stellenbosch.

Further evidence of South Africa's commitment to high technology can be found in the Industrial Development Corporation's (IDC) sponsorship of four venture capital funds totalling about R200 million each. The main objective of this totally state-owned corporation is to sustain the growth and employment potential of the manufacturing sector of South Africa.

Opportunities in technological areas

Given such favourable conditions, some of the key areas in which investors could profitably focus include:

- Exploiting projects pilot tested in South Africa in a broader international market (such as security software).
- Developing IT Development services in emerging markets at much lower costs.
- Delivering remote services through the Internet (such as educational products).
- Marketing internationally proven products (such as Digital Subscriber Lines).
- Financing projects whose impact could re-define entire industrial propositions and could aim to totally dominate those markets.

Table 4: Recent deals and activity in technological areas

Project name	**Investment**	**Transaction size**	**Amount invested**
Mtn – Nigeria	Mobile Telecom	R280m	R280m
Ican-online	Consumer finance portal	R30m	R30m
Siemens – 13% acquired by Sekunjalo	Telecoms	R538m	R70m
Zeneca (IDC, Standard Bank & British Aerospace)	Fibre Optics plant (in discussions)	R250m	R250m

Tradeworld	e-Procurement hub	R25m	R25m
Ananzi	Search engine	R30m	R3m
Career junction	On-line recruitment	R50m	R15m
e-Bucks	Digital currency	R40m	R16m

Venture capital & private equity as part of the technology investment community

The Johannesburg Securities Exchange (JSE) has shown remarkable stability in the face of the recent volatile circumstances. The JSE is a modern IT-driven institute that replaced its traditional open outcry trading floor system with the JET electronic system. Today it operates the paper/scrip-less STRATE (Share Trading Totally Electronic) system. It participates in the global drive for integration with the other major capital markets and is likely to consolidate its position as one of the world's top 10 stock markets.

The stock market's reluctance to support small capitalisation public offerings (small cap IPOs) - especially now that the Internet bubble has burst - creates space for venture capital to secure realistic prices in buying into these ventures. Venture capital invested in technology is growing at a rapid pace, and is now approaching 25% of the total private equity market of R27 billion. It is clear from this high level of activity that the technology sector has only paused prior to regaining momentum once international conditions have stabilised.

Accelerators and Incubators are also beginning to emerge given the challenges recently experienced in trying to establish businesses of this nature in South Africa. The general prospects look good in the medium to long term. Businesses and investors that are prepared to look past the short-term volatility are likely to enjoy lucrative returns on investments that are actively maintained on a risk-managed basis.

South Africa's self created misconceptions

Over the last year South Africa has created serious misconceptions about its future in three main areas. Firstly, it took South Africa a very long time to distance itself from the land turmoil in Zimbabwe and find a balance between international diplomacy and managing its own public relations. Although it is true that South Africa is dealing with its own land reforms in a structured way[9], this did not come across to the international investor.

Secondly, South Africa's HIV/Aids strategy, or initial lack of it, is another example of how South Africa managed to confuse the international community, including investors. South Africa's pragmatic defence of poor countries in the face of the pharmaceutical industry's pricing of vital drugs is understandable. However, the academic debate about the relationship between HIV and Aids, and the initial lack of pragmatic measures to combat the epidemic in South Africa, is not.

Thirdly, the present corruption allegations concerning a R43.2 billion arms deal, combined with an apparent lack of official determination in investigating them, is another area in which misconceptions are in the process of being created.

[9] Economist Survey on South Africa, February 24th 2001.

South Africa’s president, Thabo Mbeki, is undoubtedly committed to his country and his continent[10]. His determination to develop a vision is evident in his call for an ‘African Renaissance’ as well as in his recent presentation of plans for African development in Davos. However, in relation to the three ‘misconceptions’ outlined above, he has yet to provide effective leadership. Happily, South Africa’s professional organizations, business community, free press, and, crucially, its opposition parties, have helped to develop vigorous public debate about these three issues. So long as this trend continues the negative misconceptions can soon be dispelled. The strengthening of South African democracy and all that goes with a free and open society are the critical factors in determining what the future holds for the country. South Africa clearly remains a country in transition. This offers both considerable opportunities to investors as well as risks to be considered and managed.

Conclusion

Attractive business opportunities for venture capital and private equity exist in South Africa. However, the interested international investor will benefit from the effort to replace perceptions by facts, and to take decisions accordingly.

South Africa attracted international respect because it ‘signed, sealed, and delivered’ a peaceful transition to democracy. Delivery and achievements at home are the basis for respect and confidence abroad. Investments will follow suit, especially if South Africa presents its achievements, challenges and opportunities consistently, and avoids creating confusing misperceptions. Potential investors only turn into actual investors if they feel comfortable with the perceptions they hold of South Africa and, secondly, if specific opportunities meet their investment criteria.

Given South Africa’s complexity and continuing evolution as a democratic nation, investors are best advised to enter the South African market through joint ventures or a local partner once firm decisions to invest have been taken.

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[10] Africa – the time has come, I am an African; page 31.

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