

**THE EFFECT OF PRIVATE EQUITY TRANSACTIONS IN SOUTH AFRICA  
ON THE SOUTH AFRICAN ECONOMY**

**BY**

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**A Mini-Thesis submitted in partial fulfillment of the requirements for the degree  
Magister Legum in the Faculty of Law, University of the Western Cape.**



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**15 NOVEMBER 2007**

## DECLARATION

I declare that *The Effect of Private Equity Transactions in South Africa on the South African Economy* is my own work, that it has not been submitted before for any degree or examination in any other university, and that all sources I have used or quoted have been indicated and acknowledged as complete references.



Rowena Natascha Williams

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November 2007

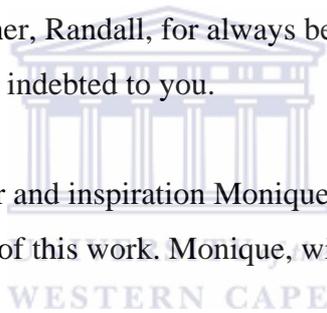
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Special Thanks to my parents for giving me the opportunity to better myself through the valuable lesson of how important education is and for being my pillars of strength throughout my life. I will apply the virtues that you have instilled in me in every aspect of my life and career.

To my sister, Nadia, and brother, Randall, for always being there whenever I needed a helping hand, I will always be indebted to you.

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## GLOSSARY

Developed Countries- These are countries that possess a high income per capita and a very high Human Development Index.

Developing Countries- These are countries with relatively low standards of living, an underdeveloped industrial base and a moderate to low Human Development Index.

Foreign Direct Investment- An international interest in which a resident in one country obtains a long lasting interest in an enterprise resident in another.

Ibid- Ibidem

Investors- Persons or entities that provide the capital to private equity firms which are used to invest in various target companies.



Least developed countries- According to the UN, these are countries which exhibit the lowest indicators of socio-economic development and with the lowest Human Development Index ratings of all the countries in the world.

Private Equity- Refers to any type of investment in an asset in which equity is not freely tradeable on a public stock market. It also refers to the manner in which the funds have been raised, namely on the private markets as opposed to the public markets.

Private Equity Funds- The pools of capital invested by private equity firms. They are generally organised as either a limited partnership or a limited liability company which is controlled by the private equity firm that acts as a general partner.

World Trade Organisation (WTO) - This is a global international organisation which sets the rules for the global trading system of member states that are signatories to its Agreements

Venture Capital- Describes investing in companies that have underdeveloped or developing products or revenue. Venture capital has a particular emphasis on entrepreneurial undertakings and less mature businesses.



## ABBREVIATIONS AND ACRONYMS

AMT	Alternative Minimum Tax
ARD	American Research and Development Corporation
BEE	Black Economic Empowerment
BIT	Bilateral Investment Treaty
DFA	Department of Foreign Affairs
DME	Department of Mineral and Energy
DTI	Department of Trade and Industry
EPZ	Export Processing Zones
FDI	Foreign Direct Investment
FOIA	Freedom of Information Act
GDP	Gross Domestic Product
HDSA	Historically Disadvantaged South Africans
HHI	Herfindahl-Hirschman Index
IPO	Initial Public Offering
LBO	Leveraged Buyout
M&A	Mergers and Acquisitions
MAI	Multilateral Agreement on Investment
MPRDA	Mineral and Petroleum Resources Development Act
OECD	Organisation for Economic Cooperation and Development
PAYE	Pay As You Earn
SA	South Africa
SADC	South African Development Community
SARS	South African Revenue Services
SHD	Sustainable Human Development
SME	Small to Medium Enterprises
SMME	Small Medium and Macro Enterprises
UBTI	Unrelated Business Taxable Income
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
UNI	Union Network International
USA	United States of America

VAT Value Added Tax  
WTO World Trade Organisation



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“Trust in the Lord with all your heart; and don’t lean on your own understanding. In all things acknowledge Him, and He shall direct your way”

Proverbs3:5, 6 The Good News Bible



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## **CHAPTER 1: INTRODUCTION**

### **1.1 Introduction**

Private Equity has long been one of those aspects of trade that was mainly embarked upon by the First World. These developed countries were advantaged by sound and stable economies. This then, enabled them to get involved in investments that would further strengthen the economy which in turn, would secure the financial stability of the country.

Private equity has now infiltrated the economies of developing countries and it is no longer considered to be an aspect of trade only undertaken by developed countries.

Developing economies are currently also actively taking part in these types of transactions.

Private equity investors are taking an interest in the South African economy in the same way that they have taken an interest in the economies of First World countries, as this economy is one of the leading developing economies on the African continent.

This interest will then serve to place South African trade and investment on the world map of International Trade and Investment

### **1.2 Aims of the Study**

This study proposes to have regard to the effect that private equity transactions has had on the South African economy. As tax is a concern that has to be taken into account when structuring private equity transactions, tax considerations will also be evaluated in this study. An analysis of foreign direct investment will also be included as well as a work towards an agreement on the issue under the auspices of the World Trade Organisation (WTO). The structure of private equity funds and private equity deals will also be considered. Private equity in the context of the South African mining sector will also be looked at.

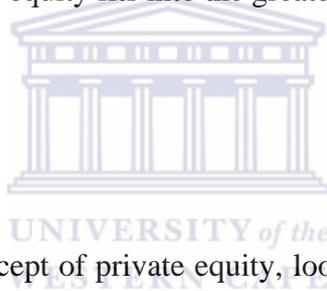
### **1.3 Research Methodology**

The research that will be undertaken for the compilation of this paper will primarily consist of database research, literature reviews and proposed interviews with experts in the field of private equity transactions.

### **1.4 Overview of Chapters**

#### **Chapter One**

Chapter one is an introductory chapter and its purpose is to give the reader a brief overview of the contents of this thesis. It aims to highlight the need for private equity and also indicates how private equity fits into the greater area of international trade.



#### **Chapter Two**

Chapter two explores the concept of private equity, looking at what it entails, private equity funds and fundraising and also the role of private equity in trade. A brief history of private equity is also discussed. The advantages and disadvantages of private equity will also be given as well as the reason as to why one should invest in private equity. Furthermore, due diligence in relation to private equity will be discussed.

#### **Chapter Three**

Chapter three aims at providing an analysis into private equity and tax considerations. The private equity tax situation in the United States of America (USA) will be examined and also how it contrasts with the tax situation in South Africa. The tax debate in the USA will also be discussed.

## **Chapter Four**

Chapter four will be examining the concept of Foreign Direct Investment as a factor that influences private equity in an economy. The chapter will be exploring what FDI is, how countries can attract FDI especially developing and least developed countries, the interrelation between private equity and FDI, FDI and a Multilateral Agreement on Investment (MAI), as well as FDI in South Africa and Africa including the challenges faced by this developing continent.

## **Chapter Five**

Chapter Five will be discussing the legal structure of private equity funds. It will also provide a note on private equity deal structures.

## **Chapter Six**

Chapter six discusses private equity in the context of the South African mining and minerals sector also taking a look at corruption and its effect on the economy of developing countries. The OECD and the United Nation's Conventions regarding corruption will also be discussed

## **Chapter Seven**

Chapter seven is a concluding chapter and it will be looking at the private equity activities over the past year and also its effects on the South African economy.

## **CHAPTER 2: PRIVATE EQUITY**

### **2.1 Private Equity: Defined**

Private Equity is a broad term that commonly refers to any type of investment in an asset in which equity is not freely tradeable on a public stock market.<sup>1</sup> More accurately, private equity refers to the manner in which the funds have been raised, namely on the private markets, as opposed to the public markets.<sup>2</sup> Private equity firms were commonly misunderstood to invest in assets which were not in the public market.<sup>3</sup> Presently, larger private equity firms invest in companies listed on public exchanges and take them private.<sup>4</sup> Passive institutional investors may invest in private equity funds, which are then used by private equity firms for investment in target companies.<sup>5</sup>

Categories of private equity investment include leveraged buyout, venture capital, growth capital, angel investing, mezzanine capital and others.<sup>6</sup> Private funds typically control management of the companies in which they invest, and often bring in new management teams that focus on making the company more valuable.<sup>7</sup>

As they are not listed on an exchange, a private equity firm owning such securities must find a buyer in the absence of a traditional market place such as a stock exchange.<sup>8</sup> The “exit” or “selling out” is often achieved by way of an initial public offering (IPO), i.e. floating the company on a stock exchange, trade sale or secondary tertiary buyouts (i.e. sale to another private equity house).<sup>9</sup>

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<sup>1</sup> < [www.wikipedia.org/wiki/Private\\_equity](http://www.wikipedia.org/wiki/Private_equity) > Assessed on 28/05/2007

<sup>2</sup> Ibid

<sup>3</sup> Ibid

<sup>4</sup> Ibid

<sup>5</sup> Ibid

<sup>6</sup> Ibid

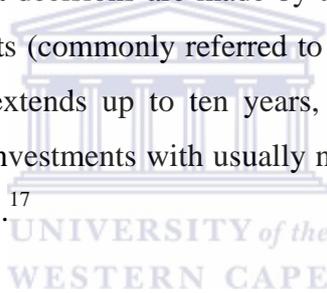
<sup>7</sup> Ibid

<sup>8</sup> Ibid

<sup>9</sup> Ibid

## 2.2 Private Equity Funds

Private Equity Funds are the pools of capital invested by private equity firms.<sup>10</sup> They are generally organized as either a limited partnership or limited liability company which is controlled by the private equity firm that acts as a general partner.<sup>11</sup> The limited partnership is often called the “Fund”, and the general partners are often designated as the “Management Company”.<sup>12</sup> The fund obtains capital commitments from certain qualified investors such as pension funds, financial institutions and wealthy individuals to invest a specific amount.<sup>13</sup> These investors become passive limited partners in the fund partnership.<sup>14</sup> At a time when the general partner identifies an appropriate investment opportunity, it is entitled to “call” the required equity capital at which time each limited partner funds a pro rata portion of its commitment.<sup>15</sup> All investment decisions are made by the General Partner which also manages the fund’s investments (commonly referred to as the “portfolio”).<sup>16</sup> Over the life of a fund which often extends up to ten years, the fund will typically make between 15 and 25 separate investments with usually no single investment exceeding 10% of the total commitments.<sup>17</sup>



General partners are typically compensated with a combination of a management fee, monitoring fees, as well as transaction fees.<sup>18</sup> In addition, the general partner is entitled to “carried interest”, effectively a performance fee, based on the profits of the generated fund.<sup>19</sup> Typically, the general partner will receive an annual management fee of 1% to 2% of committed capital and carried interest of 20% of profits above some target rate of return, which is typically 8% to 10% (called “hurdle rate”).<sup>20</sup> Gross private equity returns may be in excess of 20% per year, which in the case of leveraged buyout firms is primarily due to increasing levels of leverage in the

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<sup>10</sup> Ibid

<sup>11</sup> Ibid

<sup>12</sup> Ibid

<sup>13</sup> Ibid

<sup>14</sup> Ibid

<sup>15</sup> Ibid

<sup>16</sup> Ibid

<sup>17</sup> Ibid

<sup>18</sup> Ibid

<sup>19</sup> Ibid

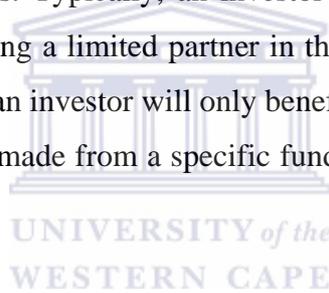
<sup>20</sup> Ibid

portfolio companies, and otherwise due to the high level of risk associated with early stage investments.<sup>21</sup>

Private equity firms generally receive a return on their investment through one of three ways: an IPO (Initial Public Offering), a sale or merger of the company they control, or a recapitalisation.<sup>22</sup> Unlisted securities may be sold directly to investors by the company (called a private offering) or to a private equity fund, which pools contributions from smaller investors to create a capital pool.<sup>23</sup>

### 2.3 Private Equity Fundraising

Private equity fundraising refers to the action of private equity firms seeking capital from investors for their funds. Typically, an investor will invest in a specific fund managed by the firm, becoming a limited partner in the fund, rather than an investor in the firm itself. As a result, an investor will only benefit from investments made by a firm where the investment is made from a specific fund that the investor has invested in.



The majority of investment into private equity funds comes from institutional investors. The most prolific investors into private equity funds in 2006 were public pension funds, banks and financial institutions, which together provided 40% of all commitments made globally.<sup>24</sup> Other prominent groups investing in private equity include corporate pension plans, insurance companies, endowments, family offices and foundations.

Another large investor-group in private equity funds are so-called fund of funds, which are private equity funds that invest in other private equity funds in order to provide investors with a low risk product through exposure to a large number of vehicles of different type and regional focus.<sup>25</sup>

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<sup>21</sup> Ibid

<sup>22</sup> Ibid

<sup>23</sup> Ibid

<sup>24</sup> According to data from London –based Private equity Intelligence Ltd

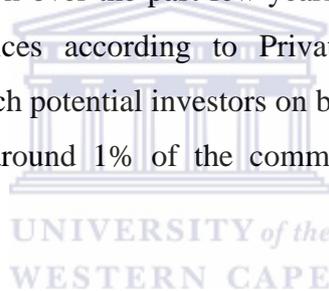
<sup>25</sup> <[www.wikipedia.org/wiki/Private\\_equity](http://www.wikipedia.org/wiki/Private_equity)> Assessed on 28/05/2007

Fund of funds accounted for 14% of global commitments made to private equity funds in 2006 according to Private Equity Intelligence Ltd.<sup>26</sup>

As fundraising has grown over the past few years, so too has the number of investors in the average fund.<sup>27</sup> In 2004 there were 26 investors in the average private equity fund; this figure has now grown to 42 according to Private Equity Intelligence Ltd.<sup>28</sup>

It is also worth noting that the managers of private equity funds themselves will also invest in their own vehicles, typically providing between 1% and 5% of the overall capital.<sup>29</sup>

Often private equity fund managers will employ the services of external fundraising teams known as placement agents in order to raise capital for their vehicles.<sup>30</sup> The use of placement agents has grown over the past few years, with 40% of funds closed in 2006 employing their services according to Private Equity Intelligence Ltd.<sup>31</sup> Placement agents will approach potential investors on behalf of the fund manager, and will usually take a fee of around 1% of the commitments that they are able to acquire.<sup>32</sup>



The amount of time that a private equity firm spends raising capital varies depending on the level of interest among investors for the fund, which is defined by current market conditions and also the track record of the previous funds raised by the firm in question.<sup>33</sup> Firms can spend as little as one or two months raising capital where they are able to reach the target that they set for their funds relatively easily, often through gaining commitments from existing investors in their previous funds, or where strong past performance leads to a strong level of investor interest.<sup>34</sup>

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<sup>26</sup> Ibid  
<sup>27</sup> Ibid  
<sup>28</sup> Ibid  
<sup>29</sup> Ibid  
<sup>30</sup> Ibid  
<sup>31</sup> Ibid  
<sup>32</sup> Ibid  
<sup>33</sup> Ibid  
<sup>34</sup> Ibid

Other managers may find fundraising taking considerably longer, with less popular fund types finding the fundraising process tougher.<sup>35</sup> It is not unheard of for funds to spend as long as two years seeking capital, although the majority of fund managers will complete fundraising within nine to fifteen months.<sup>36</sup>

Once a fund has reached its fundraising target, it will have a final close.<sup>37</sup> After this point it is not normally possible for a new investor to invest in the fund, unless they were to purchase an interest in the fund on the secondary market.<sup>38</sup>

## 2.4 Size of the Industry

Nearly \$135bn of private equity was invested globally in 2005, up a fifth on the previous year due to a rise in buyouts as market confidence and trading conditions improved.<sup>39</sup> Buyouts have generated a growing portion of private equity investments by value, and increased their share of investments from a fifth to more than two-thirds between 2000 and 2005.<sup>40</sup> Private equity fund raising also surpassed prior years in 2005 and totaled \$232bn, up three-quarters on 2004.<sup>41</sup>

Prior to this, after reaching a peak in 2000, private equity investments and funds raised fell in the next couple of years due to the slow down in the global economy and declines in equity markets, particularly in the technology sector.<sup>42</sup> The fall in funds raised between 2001 and 2003 was also due to a large excess created by the end of 2000 of funds raised over funds invested.<sup>43</sup>

The regional breakdown of private equity activity shows that in 2005, North America accounted for 40% of global private equity investments (down from 68% in 2000) and

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<sup>35</sup> Ibid

<sup>36</sup> Ibid

<sup>37</sup> Ibid

<sup>38</sup> Ibid

<sup>39</sup> Ibid

<sup>40</sup> Ibid

<sup>41</sup> Ibid

<sup>42</sup> Ibid

<sup>43</sup> Ibid

52% of funds raised (down from 69%).<sup>44</sup> Between 2000 and 2005, Europe increased its share in investments (from 17% to 43%) and funds raised (from 17% to 38%).<sup>45</sup> This was largely a result of strong buyout market activity in Europe.<sup>46</sup> Asia-Pacific region's share of investments increased from 6% to 11% during this period while its share of funds raised remained unchanged at around 8%.<sup>47</sup>

Private equity fundraising reached new record levels in 2006, with data from Private Equity Intelligence showing that a total of 684 funds worldwide achieved a final close over the course of 2006, raising an aggregate \$432bn in commitments.<sup>48</sup>

The biggest fund type in terms of commitments garnered was buyout, with 188 funds raising an aggregate of \$212bn.<sup>49</sup> So-called mega buyout funds contributed a significant portion of this amount, with the ten largest funds of 2006 raising \$101bn alone-23% of the global total for 2006.<sup>50</sup>

Other strong performers included real estate funds, which grew 30% from the already strong 2005 levels, raising an aggregate of \$63bn globally.<sup>51</sup> The only fund type to not perform so well was venture, which saw a drop of 10% from 2005 levels.<sup>52</sup>

The majority of funds raised in 2006 were focusing on the American market, with 62% of capital raised in 2006 focusing on the US.<sup>53</sup> European focused funds account for 26% of the global total, whilst funds focusing on Asia and the rest of the world account for the remaining 11%.<sup>54</sup>

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<sup>44</sup> Ibid

<sup>45</sup> Ibid

<sup>46</sup> Ibid

<sup>47</sup> Ibid

<sup>48</sup> Ibid

<sup>49</sup> Ibid

<sup>50</sup> Ibid

<sup>51</sup> Ibid

<sup>52</sup> Ibid

<sup>53</sup> Ibid

<sup>54</sup> Ibid

## 2.5 Private Equity Fund performance: Transparency

In the past, the performance of private equity funds has been relatively difficult to track, as private equity firms are under no obligation to publicly reveal the returns that they have achieved from their investments.<sup>55</sup> In the majority of cases the only groups with the knowledge of fund performance were the investors in the fund, and the firms themselves, making comparisons between the various different firms and the establishment of market benchmarks to be a difficult challenge.<sup>56</sup>

With the introduction of the Freedom of Information Act (FOIA) in the United States and other countries such as the UK in the early 21<sup>st</sup> century, has led to new performance data for the industry becoming more readily available.<sup>57</sup> Following the introduction of the FOIA legislation, London-based research and consultancy firm Private Equity Intelligence used the FOIA in order to request data on private equity fund performance from bodies such as pension funds, establishing an online searchable database from FOIA requests and also in a large number of instances, data from fund managers themselves.<sup>58</sup>

It is also possible to view private equity fund performance data directly on the websites of certain investors.<sup>59</sup>

The performance of the private equity industry over the past few years differs between funds of different types.<sup>60</sup> Buyout and real estate funds have both performed strongly in the past few years in comparison with other asset classes such as public equities.<sup>61</sup> In contrast other fund types such as venture have not shown such a strong overall performance.<sup>62</sup>

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<sup>55</sup> Ibid

<sup>56</sup> Ibid

<sup>57</sup> Ibid

<sup>58</sup> Ibid

<sup>59</sup> Ibid

<sup>60</sup> Ibid

<sup>61</sup> Ibid

<sup>62</sup> Ibid

Manager selection in the private equity industry is definitely a vital factor for any investor seeking exposure to the market, with the performance of the top and bottom quartile managers varying dramatically, especially so in the high risk venture capital world , and less so with real estate funds.<sup>63</sup>

## 2.6 History of Private Equity

South African companies have long invested in unlisted businesses.<sup>64</sup> The success in terms of growth achieved by private equity funds in the US and, to a lesser extent in Europe, has resulted in the development of professional private equity firms in other parts of the world, including South Africa.<sup>65</sup>

In SA, the four major commercial banks and their predecessors pioneered leveraged buy-outs. This was largely driven by disinvestments from SA in the early 1980's.<sup>66</sup> These buyouts, encouraged by the international success of private equity, formed the foundation for our private equity market today.<sup>67</sup>

Organised and professionally managed investments in the private equity market can be traced back to 1946 in the US when the American Research and Development Corporation (ARD) was formed to facilitate new business formation and development.<sup>68</sup> ARD's stock persistently traded at a discount to its net asset value, and it had difficulty raising capital on the stock market.<sup>69</sup> This was a negative view of private equity as an asset class.<sup>70</sup>

During the 1950's and 1960's the US Congress introduced legislation to promote the development of small business, with moderate success.<sup>71</sup> An increase in the market for IPO's in 1968-69 resulted in significant profitable realizations of venture capital

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<sup>63</sup> Ibid

<sup>64</sup> KPMG an SAVCA Private Equity and Venture Capital Survey-2003

<sup>65</sup> Ibid

<sup>66</sup> Ibid

<sup>67</sup> Ibid

<sup>68</sup> Ibid

<sup>69</sup> Ibid

<sup>70</sup> Ibid

<sup>71</sup> Ibid

investments made in the 1960's.<sup>72</sup> During the 1970's, many of these venture capital partnerships began leveraging buyouts of divisions of large conglomerates.<sup>73</sup>

During the late 1970's, regulatory and tax changes allowed US pension funds to invest in private equity for the first time.<sup>74</sup> This, together with the success of new leveraged buyout (LBO) firms, resulted in a boom in fund raising.<sup>75</sup> In 1987, Kohlberg Kravis and Roberts raised a record US\$5.6bn LBO fund, which was more than twice the total commitment to all other venture capital firms in that year.<sup>76</sup>

The 1980's and 1990's therefore saw explosive growth in US private equity commitments.<sup>77</sup> In 2000, private equity and venture capital investments in North America increased to a record with a total of \$12bn funds invested.<sup>78</sup> Expansion and early stage investments comprising 60% of this reflecting the strong growth in these subclasses of private equity.<sup>79</sup>

As Europe emerged from the recession in the early 1990's, it too became a fertile environment for private equity.<sup>80</sup> In 1997, a number of private equity firms raised funds of more than \$1bn for the first time.<sup>81</sup> At the end of 2002, the total of European private equity investment portfolios at cost was estimated at \$116.8bn.<sup>82</sup>

The global market is dominated by North America (specifically the US) and Western Europe.<sup>83</sup> Seventy percent of global funds raised from 1998 to 2002 have in fact been raised in North America.<sup>84</sup> Western Europe and Asia Pacific are a distant second and

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<sup>72</sup> Ibid

<sup>73</sup> Ibid

<sup>74</sup> Ibid

<sup>75</sup> Ibid

<sup>76</sup> Ibid

<sup>77</sup> Ibid

<sup>78</sup> Ibid

<sup>79</sup> Ibid

<sup>80</sup> Ibid

<sup>81</sup> Ibid

<sup>82</sup> Ibid

<sup>83</sup> Ibid

<sup>84</sup> Ibid

third with 20% and 7% respectively.<sup>85</sup> The Middle East, Africa, Central and Southern America and Eastern Europe only contributed the remaining three percent.<sup>86</sup>

In SA, the private equity industry was only formalized with the constituting of the South African Venture Capital and Private Equity Association in 1999.<sup>87</sup> The industry in SA is relatively sophisticated by emerging markets' standards and its participants are active in early stage investments through to large LBO's.<sup>88</sup>

## 2.7 Advantages and Disadvantages of Private Equity<sup>89</sup>

The advantages include:

Shorter chain of ownership, with partners taking an active role in the running of the company<sup>90</sup>;

Longer investment horizons<sup>91</sup>;

Fewer reporting requirements<sup>92</sup>;

Ability to provide incentives for managers<sup>93</sup>;

There is a greater ability to create jobs because it is better at creating successful companies with a long-term future<sup>94</sup>.

The disadvantages include:

Conflicts of interest, because private equity partners are involved in the running of the company and may have different priorities from other investors in the private equity fund<sup>95</sup>;

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<sup>85</sup> Ibid

<sup>86</sup> Ibid

<sup>87</sup> Ibid

<sup>88</sup> Ibid

<sup>89</sup> House of Commons Treasury Committee-Private Equity, Tenth Report of Session 2006-07, Volume 1 pg 11. <[www.publications.parliament.uk/pa](http://www.publications.parliament.uk/pa)> Assessed on 19/10/2007

<sup>90</sup> Ibid

<sup>91</sup> See the House of Commons Treasury Committee-Private Equity, Tenth Report of Session 2006-07, Volume 1 paragraph 21.

<sup>92</sup> House of Commons Treasury Committee-Private Equity, Tenth Report of Session 2006-07, Volume 1 pg 11. <[www.publications.parliament.uk/pa](http://www.publications.parliament.uk/pa)> Assessed on 19/10/2007

<sup>93</sup> Ibid

<sup>94</sup> Ibid

<sup>95</sup> Ibid

Shorter investment horizons, because the aim is usually to sell the company after a few years rather than focusing on long term growth<sup>96</sup>;

Lack of transparency making them less accountable to the public and their workforces<sup>97</sup>;

Greater leverage making companies more vulnerable to economic downturns and with the potential to pose risks to lenders and the financial system<sup>98</sup>;

Risk of job destruction through seeking to extract extra value<sup>99</sup>;

Risk to pensions through the selling of assets and loading companies with debt<sup>100</sup>.

## 2.8 Why Invest in Private Equity?<sup>101</sup>

The fundamental rationale for investing in private equity is to improve the risk and reward characteristics of an investment portfolio<sup>102</sup>. Investing in private equity offers the investor the opportunity to generate higher absolute returns whilst improving portfolio diversification<sup>103</sup>.

There are various features that investors may find attractive when deciding to invest in private equity funds. These include:

- a) Long-term historical out-performance<sup>104</sup> -

The long term returns of private equity represent a premium to the performance of public equities. This has been the case in the US for over 20 years and also in Europe, following an increase in the number of private equity funds, for over ten years<sup>105</sup>.

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<sup>96</sup> Ibid

<sup>97</sup> Ibid

<sup>98</sup> Ibid

<sup>99</sup> Ibid

<sup>100</sup> Ibid

<sup>101</sup> Bance, A. "Why and How to Invest in Private Equity" An EVCA Investor Relations Committee Paper <[www.evca.com](http://www.evca.com)> Assessed on 19/10/2007

<sup>102</sup> Ibid, pg 5

<sup>103</sup> Ibid

<sup>104</sup> Ibid

<sup>105</sup> Ibid

b) True stock picking in a low inflation, low growth environment<sup>106</sup> -

A low inflation environment creates a focus on growth stocks as a means of out-performance<sup>107</sup>. One of the core skills of successful private equity managers is to pick companies with growth potential and to actively create the conditions for growth in those companies<sup>108</sup>.

c) Absolute returns<sup>109</sup> -

Excessive volatility and poor investment performance experienced by quoted equity portfolios, many of which have index-tracking strategies or are benchmarked to an index, have led to a swing in favour of strategies that seek absolute returns<sup>110</sup>. Private equity managers do seek absolute returns and their traditional incentivisation structure, the “carried interest”, is highly geared towards achieving net cash returns to investors<sup>111</sup>.

d) Exposure to smaller companies market<sup>112</sup> -

The private equity industry has brought corporate governance to smaller companies and provides an attractive manner of gaining exposure to a growth sector that went out of favour with quoted market investors in the mid 990’s for reasons of liquidity<sup>113</sup>.

e) Access to legitimate inside information<sup>114</sup> -

A much greater depth of information on proposed company investments is available to private equity managers<sup>115</sup>. This helps the managers more accurately assess the viability of the company’s proposed business plan and to project the post-investment strategy to be pursued and expected future performance<sup>116</sup>.

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<sup>106</sup> Ibid

<sup>107</sup> Ibid

<sup>108</sup> Ibid

<sup>109</sup> Ibid

<sup>110</sup> Ibid

<sup>111</sup> Ibid

<sup>112</sup> Ibid, pg 6

<sup>113</sup> Ibid

<sup>114</sup> Ibid

<sup>115</sup> Ibid

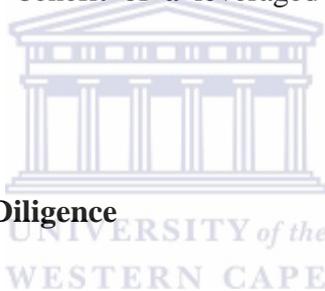
<sup>116</sup> Ibid

f) Influence over management and flexibility of implementation<sup>117</sup>-

Private equity managers generally seek active participation in a company's strategic direction, from the development of a business plan to the selection of senior executives, introduction of potential customers, M&A strategy and the identification of eventual acquirers of the business<sup>118</sup>. This flexibility represents another feature whereby risk can be reduced in private equity investment<sup>119</sup>.

g) Leveraging off balance sheet<sup>120</sup>-

Buyout managers in particular are able to make efficient use of leverage<sup>121</sup>. They aim to organise each portfolio company's funding in the most efficient way, making full use of different borrowing options from senior secured debt to mezzanine capital and high yield debt<sup>122</sup>. By organising the company's funding requirements efficiently, the equity returns are potentially enhanced<sup>123</sup>. Thus the investor has the effective benefit of a leveraged portfolio with less downside risk<sup>124</sup>.



## 2.9 Private Equity and Due Diligence

Due diligence is the term used for a number of concepts involving either the performance of an investigation of a business or person; or the performance of an act with a certain standard of care<sup>125</sup>. It can be a legal obligation, but the term will more commonly apply to voluntary investigations<sup>126</sup>. Some common examples of due diligence in the various industries includes: The process through which a potential acquirer evaluates a target company or its assets for acquisition and also bounding<sup>127</sup>.

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<sup>117</sup> Ibid, pg 7

<sup>118</sup> Ibid

<sup>119</sup> Ibid

<sup>120</sup> Ibid

<sup>121</sup> Ibid

<sup>122</sup> Ibid

<sup>123</sup> Ibid

<sup>124</sup> Ibid

<sup>125</sup> <[www.wikipedia.org/wiki/Due-Diligence](http://www.wikipedia.org/wiki/Due-Diligence)> Assessed on 25/10/2007

<sup>126</sup> Ibid

<sup>127</sup> Ibid

In business transactions, the due diligence process varies for different types of companies<sup>128</sup>. The relevant areas of concern may include intellectual property, real and personal property, insurance and liability coverage, debt instrument review, employee benefits and labour matters, immigration and international transactions<sup>129</sup>.

Due diligence plays an important role in the area of private equity relating to manager selection and investing in a potential fund. The principal criteria for private equity fund selection usually relate to the credentials of management teams<sup>130</sup>. The variation in performance between upper and lower quartile managers in the private equity market is substantially more diverse than in listed equity and bond markets<sup>131</sup>.

Investors should evaluate each manager's credentials by investigating its track record and reputation closely<sup>132</sup>. Research has shown that a manager's track record can be an indicator of future success as the percentage of new funds that become top quartile performers has historically been the highest among managers of previous top quartile funds<sup>133</sup>.

A proposed fund's investment strategy should be clear and very similar to that on which the manager's track record is founded<sup>134</sup>. The track record should demonstrate a disciplined approach and the ability to adhere to the articulated strategy<sup>135</sup>. The amount of money being raised should be clearly justified by the magnitude of the perceived investment opportunity and the extent of the manager's resources<sup>136</sup>. The investment strategy should be attractive in the context of the wider economic landscape, which will impact the market opportunity<sup>137</sup>.

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<sup>128</sup> Ibid

<sup>129</sup> Ibid

<sup>130</sup> <sup>130</sup> Bance, A. "Why and How to Invest in Private Equity" An EVCA Investor Relations Committee Paper <[www.evca.com](http://www.evca.com)> Assessed on 19/10/2007

<sup>131</sup> Ibid, pg 13

<sup>132</sup> Ibid

<sup>133</sup> Ibid

<sup>134</sup> Ibid

<sup>135</sup> Ibid

<sup>136</sup> Ibid

<sup>137</sup> Ibid

Publicly available statistics showing upper quartile rates of investment performance are becoming more accurate as a benchmark for funds by sector and vintage year<sup>138</sup>. Prospective investors need to examine the internal rates of return on investments in conjunction with multiples of original costs realised<sup>139</sup>. Consistent upper quartile returns over an extended period of time and a good number of realised investments are preferred<sup>140</sup>.

Returns are often quoted on a “gross” or “net” basis<sup>141</sup>. The gross return represents the fund’s return on its investments and does not take into account the fees and expenses of the fund or the dilutive effect of holding uninvested cash<sup>142</sup>. The net return represents the investors return and is also referred to as the “cash on cash” return<sup>143</sup>. Returns on realised investments are often also distinguished from returns on unrealised investments<sup>144</sup>. Investors should look for a large proportion of realised investments in the portfolio<sup>145</sup>. In respect of unrealised investments, the investors would want to examine valuation policy<sup>146</sup>. An analysis of the dispersions of the returns on an investment by investment basis illustrates the volatility of returns and risk associated with the investment strategy<sup>147</sup>. For example, buyout returns ought to be less volatile than venture capital returns<sup>148</sup>.

An assessment of the ability of a manager to reproduce previous quartile performance will focus on the individuals comprising the management team, their incentivisation and the past and future continuity within the team<sup>149</sup>. The most important aspect of each individual’s background should be solid experience as a private equity manager<sup>150</sup>. Additional attributes, such as relevant operational, sector or scientific experience, are helpful<sup>151</sup>. It is important that the core members of the management

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<sup>138</sup> Ibid

<sup>139</sup> Ibid

<sup>140</sup> Ibid

<sup>141</sup> Ibid

<sup>142</sup> Ibid

<sup>143</sup> Ibid

<sup>144</sup> Ibid

<sup>145</sup> Ibid

<sup>146</sup> Ibid

<sup>147</sup> Ibid

<sup>148</sup> Ibid

<sup>149</sup> Ibid

<sup>150</sup> Ibid

<sup>151</sup> Ibid

team have already been working as a team for a significant period and departures from this core team have been minimal<sup>152</sup>. This will provide clearer attribution of the investment track record to these individuals and give some comfort as to the future continuity of the team<sup>153</sup>. It is normally very helpful to speak to business counterparts in respect of the individuals, as they may provide some insight into the dynamic of the team<sup>154</sup>.

Further comfort with respect to the future can be derived from the incentivisation structure<sup>155</sup>. Broadly, all the key executives should receive a fair proportion of the carried interest and ideally it would be shared widely throughout the team<sup>156</sup>. This will give comfort as to the strength and depth of the team<sup>157</sup>. It will also evidence planning for the future succession of senior management responsibility within the management team<sup>158</sup>. Personal commitments to the fund by the management team that are meaningful in the context of their net worth are also good indicators of commitment<sup>159</sup>.

Investors will generally look for a coordinated origination strategy and a disciplined procedure for evaluating investments<sup>160</sup>. This should include valuation of a business plan, the likely exit route and expected investment returns<sup>161</sup>. There needs to be proven discipline among the principals of the fund as to the application of decision-making criteria<sup>162</sup>. This will include pricing discipline and it is an advantage for managers to demonstrate transactions declined on pricing grounds<sup>163</sup>. In venture capital, investors may look for evidence on preparedness to cut losses in under performing investments rather than following in on subsequent grounds<sup>164</sup>. In buyout funds, the ability to tap the debt markets efficiently is an advantage<sup>165</sup>.

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<sup>152</sup> Ibid

<sup>153</sup> Ibid

<sup>154</sup> Ibid

<sup>155</sup> Ibid, pg 14

<sup>156</sup> Ibid

<sup>157</sup> Ibid

<sup>158</sup> Ibid

<sup>159</sup> Ibid

<sup>160</sup> Ibid, pg 15

<sup>161</sup> Ibid

<sup>162</sup> Ibid

<sup>163</sup> Ibid

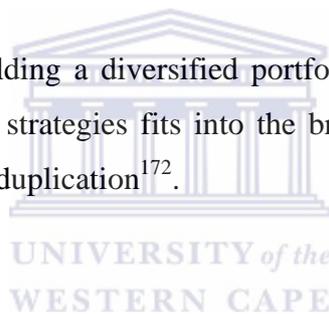
<sup>164</sup> Ibid

<sup>165</sup> Ibid

With regard to monitoring, how the manager uses valuation metrics or milestones in the business plan will be of interest<sup>166</sup>. Having alternative exit strategies is considered to be a strong point in all private equity transactions and the way a manager plans for an exit is a key factor<sup>167</sup>.

The greater the number of underlying investments means that the diversification of the risk will inevitably also be greater<sup>168</sup>. If the investments are very concentrated in number, or focused in one particular geography or field of operation, then the risk becomes more concentrated<sup>169</sup>. However, private equity managers tend to be heavily committed to investments and therefore the number of deals that a team can source, evaluate, operate and realise is strictly limited<sup>170</sup>. So there is also risk if a team spreads itself too thinly or operates in fields or geographies where it has limited prior experience<sup>171</sup>.

Given the importance of building a diversified portfolio, an investor should ensure that the type of fund and its strategies fits into the broader private equity portfolio strategy without unnecessary duplication<sup>172</sup>.



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<sup>166</sup> Ibid

<sup>167</sup> Ibid

<sup>168</sup> Ibid

<sup>169</sup> Ibid

<sup>170</sup> Ibid

<sup>171</sup> Ibid

<sup>172</sup> Ibid

## **CHAPTER 3: TAX CONSIDERATIONS**

### **3.1 Introduction**

When a private equity fund is formed, the fund sponsor must address certain issues. One of those issues, pertinent to this chapter, is that of tax.<sup>173</sup>

This chapter will have regard to Tax Considerations in Structuring a US-Based Private Equity Fund<sup>174</sup> as well as the concern in South Africa in relation to private equity transactions and tax considerations.

The aim of a private equity fund is to improve the performance of the respective businesses and sell at a profit after holding an investment for several years.<sup>175</sup> The target investor group will include local and foreign institutions, individuals, governmental entities and perhaps other private equity funds.<sup>176</sup>

### **3.2 Position in the United States**

Most US investors will share a common tax objective when investing in the fund.

These include:

The fund should not bear tax;

Pass through of capital gains and losses, allowing individuals to enjoy favourable tax rates on capital gains;

The minimisation of “phantom” income (i.e. the allocation of profits to the investor that are included in the investor’s taxable income without receiving cash);

No tax reporting in non-US jurisdictions or, if taxes are incurred, the ability to credit those taxes against US tax on the gain.<sup>177</sup>

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<sup>173</sup> Tax Considerations in Structuring US-Based Private Equity Funds  
<[www.akingump.com/docs/publications/376.pdf](http://www.akingump.com/docs/publications/376.pdf)> Assessed on 24/08/2007

<sup>174</sup> Ibid

<sup>175</sup> Ibid

<sup>176</sup> Ibid

<sup>177</sup> Ibid

In addition, there are certain specific requirements unique to certain classes of US investors, particularly pension plans, private foundations, charitable trusts and other tax-exempt investors.<sup>178</sup>

One of the concerns transmits to Unrelated Business Taxable Income (UBTI).<sup>179</sup> Certain US investors who are generally exempt from tax in the United States are taxable in respect of UBTI.<sup>180</sup> It will not include dividends, interest and capital gains from the fund's investment activities, but will include all or a portion of the income that the fund earns from the investments that are in whole or part financed with indebtedness (called Unrelated Debt Financed Income).<sup>181</sup>

The sponsor will generally be required under the fund's limited partnership agreement to avoid or minimize UBTI, or may be required to give certain investors the right to opt out of UBTI generating investments.<sup>182</sup> This then reduces the amount that is taxable.<sup>183</sup> It could be seen as a loophole in the US tax structure relating to private equity. It also provides investors with a mechanism to reduce the taxable amount of their returns in relation to their investment.<sup>184</sup>

Most non-US investors will share the following common tax objective when investing in the fund. These include:

No US taxation of gains;

By investing through the fund, the investor's tax in the investor's home jurisdiction is not worse than if the investor made an investment in the portfolio company directly; and

Anonymity, i.e. no obligation to disclose the identity of the fund's investors to taxing authorities.<sup>185</sup>

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<sup>178</sup> Ibid

<sup>179</sup> Ibid

<sup>180</sup> Ibid

<sup>181</sup> Ibid

<sup>182</sup> Ibid

<sup>183</sup> Ibid

<sup>184</sup> Ibid

<sup>185</sup> Ibid

In addition there are certain specific requirements unique to certain classes of non-US investors.<sup>186</sup> One of these classes includes Pension Funds. Unlike their US counterparts, there is no special exemption from US tax for non-US pension funds as a matter of US tax law.<sup>187</sup> Treaties may, however, eliminate withholding tax on dividends and interest that otherwise may be applicable.<sup>188</sup>

The basic US tax regime applicable to non-US investors in US-based private equity funds is that they are exempt from taxation on gains arising from portfolio investment activities, making the United States a tax haven of sorts for foreign private equity capital.<sup>189</sup> United States tax law provides that a private equity fund that is investing or trading for its own account is not engaged in a trade or business in the United States, even if the fund is managed in the US, and is therefore not subject to tax on gains.<sup>190</sup>

### 3.3 Position in South Africa

According to South African Tax Law, non-resident investors are subject to South African tax in respect of any South African (SA) sourced income or income deemed to be sourced from SA.<sup>191</sup>

Because of this, foreign investors into SA funds (such as hedge funds, private equity funds) face an enquiry into whether the profits from such investments are derived from a source or deemed source within the country.<sup>192</sup> This is particularly relevant where the foreign investors have a direct exposure to the underlying assets, such as where the fund is a transparent entity such as a partnership.<sup>193</sup>

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<sup>186</sup> Ibid

<sup>187</sup> Ibid

<sup>188</sup> Ibid

<sup>189</sup> Ibid

<sup>190</sup> Ibid

<sup>191</sup> Tax Exposures for foreign investors in South African funds- International Tax Review, February 2007- Peter Dachs, Edward Nathan Sonnenbergs < [www.ens.co.za](http://www.ens.co.za) > Assessed on 31/08/07

<sup>192</sup> Ibid

<sup>193</sup> Ibid

In determining the source of the income from investments into SA assets, it is generally necessary to determine the originating cause of such income.<sup>194</sup> This examines factors such as the place where the capital is employed (SA), where the investment decisions are taken (typically SA), and where the capital raising takes place.<sup>195</sup>

Based on these criteria, there is a real risk that the South African Revenue Services (SARS) could impose tax on foreign investors into SA funds particularly where the foreign investors are directly exposed to the underlying assets of the fund.<sup>196</sup>

Many local hedge funds are set up as partnerships, with the general partners based in SA.<sup>197</sup> Since the general partner has the authority to bind other partners and make partnership decisions on their behalf, this increases the likelihood of exposure to SA tax for the foreign investors.<sup>198</sup>

An investment into a fund that is constituted as a partnership has two additional issues.<sup>199</sup> This means that even if the foreign investors invest from jurisdictions which have double tax agreements with South Africa, the fact that there is a general partner in SA means that the foreign investors have a tax presence (permanent establishment) in SA.<sup>200</sup> This, in theory, gives SA the right to tax the income of non-resident investors.<sup>201</sup>

Even if the non-resident investor's gains are capital in nature, SA imposes tax on non-resident investors with a tax presence in SA.<sup>202</sup> The general partner (in SA) may create such a presence for foreign investors.<sup>203</sup>

Until South Africa's tax provisions are amended to provide clarity on whether it is really the intention of SARS to impose tax on foreign investors investing in SA funds, foreign investors should take advice on their potential SA tax exposures.<sup>204</sup>

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<sup>194</sup> Ibid

<sup>195</sup> Ibid

<sup>196</sup> Ibid

<sup>197</sup> Ibid

<sup>198</sup> Ibid

<sup>199</sup> Ibid

<sup>200</sup> Ibid

<sup>201</sup> Ibid

<sup>202</sup> Ibid

<sup>203</sup> Ibid

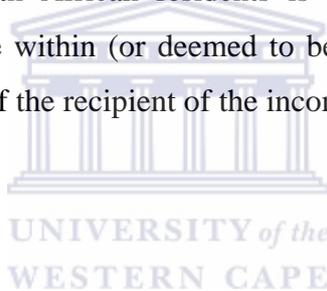
### **3.4 South African Tax for Investors: Types of taxes in South Africa**

South Africa has a well-developed and regulated taxation regime based on international best practice. The tax regime is set by the National treasury and managed by the South African Revenue Service (SARS).

#### **Income tax:**

This is the principal source of direct taxation revenue in South Africa. Individuals are taxed on a progressive basis up to a maximum rate of 42 percent on taxable income exceeding R215 000 per annum. A uniform rate of tax is applied to all individuals, irrespective of gender or marital status, and without child rebates.

Tax on income on non-South African residents is source-based, meaning that all income arising from a source within (or deemed to be within) South Africa is taxed, irrespective of the residence of the recipient of the income.



#### **Value Added Tax (VAT):**

This is the principal source of indirect taxation revenue in South Africa. If a subsidiary or branch of a foreign-owned company sells goods or provides services, it must register as a vendor with SARS and charge and pay over VAT.

The standard rate of VAT is 14 percent. Exports, certain foodstuffs and other supplies are zero rated, and certain supplies are exempt (mainly certain financial services, residential accommodation and public transport).

#### **Capital gains Tax:**

This type of tax is levied on non-residents to the extent that they dispose of immovable property situated in South Africa, or have a permanent establishment in SA and dispose of an asset of that establishment.

These taxes are the main taxes that are applicable in South Africa. Other taxes do apply such as Pay As You Earn (PAYE), this tax is applicable to employees of a company. Regional service council levies on gross revenue and salaries. A skills development levy at the rate of 0.5 percent of payroll is payable. Transfer duty is payable on land and buildings. Stamp duty is payable on transfer and issue of shares, leases and mortgage bonds. Customs and excise taxes are also payable. Compulsory workmen's compensation, assurance and unemployment insurance fund premiums are payable, although these are relatively insignificant.

### **3.5 Tax concerns relating to Private Equity Buyouts in South Africa**

UNI affiliates in South Africa are concerned at the wave of private equity buyout activity in the country.<sup>205</sup> Globally private equity funds have \$500bn to spend and South Africa is in their sights.<sup>206</sup>

The union's main concern is that of employment as there is uncertainty as to what exactly will happen to employees after a company is taken private.<sup>207</sup> There are no commitments on jobs or future investments and they have no idea as to who the ultimate owners will be.<sup>208</sup>

There have been indications that the Ministry of Finance is concerned about private equity activity in South Africa.<sup>209</sup>

Business Day Newspaper reported (21/02/07) that the government has voiced displeasure of how private equity deals rob the country of vast amounts of tax revenue.<sup>210</sup> This concern arose because as in the Edgars case, a large portion of cash flow will be used to repay loans taken out by private equity buyers- loans that are

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<sup>205</sup> Private Equity: Union Concern in South Africa, <[www.union-network.org](http://www.union-network.org)> Assessed on 14/08/2007

<sup>206</sup> Ibid

<sup>207</sup> Ibid

<sup>208</sup> Ibid

<sup>209</sup> Ibid

<sup>210</sup> Ibid

mostly sourced from overseas banks.<sup>211</sup> According to South African tax law, the loans are not income sourced or deemed to be sourced from within the Republic and are therefore not subject to South African tax.<sup>212</sup>

There has however been speculation that a non-resident tax on interest payable to foreign loans made to non governmental organisations is in the pipeline to curb the outflow of cash flow that would otherwise not be subject to tax in South Africa.<sup>213</sup>

### **3.6 The Big Tax Debate: Raise or Reduce**

There is an ongoing debate in the US surrounding tax and private equity firms. Private equity firms are subject to lower tax rates than other companies and individuals.

This is seen as an advantage for private equity firm fund managers who are taxed on profits at a rate of 15 percent.

Private equity firms raise funds from investors, including institutions, pension plans and wealthy individuals, and use the money, combined with loans, to acquire companies in the hope of selling them at a profit.<sup>214</sup>

Fund managers usually get a cut of those profits- often 20 percent- and that cut, known as carried interest, is taxed as capital gain, at a rate of 15 percent.<sup>215</sup> In recent months lawmakers and labour groups in the US have been increasingly questioning whether these profits should be taxed at the 35 percent rate.

Another argument that is in favour of not raising tax rates states that efforts in congress to more than double taxes on managers of private equity firms would generate little or

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<sup>211</sup> Ibid

<sup>212</sup> Ibid

<sup>213</sup> Ibid

<sup>214</sup> “Bill is offered to increase tax on private equity” < [www.nytimes.com](http://www.nytimes.com) > Assessed on 30/08/2007

<sup>215</sup> Ibid

no extra revenue to help pay for middle class tax cuts that many US lawmakers are seeking.<sup>216</sup>

According to an International Herald Tribune article: “Tax change for private equity firms may yield little, study finds”, buyout and venture capital firms would restructure their affairs in order to sidestep the new tax laws. This study was conducted by Michael Knoll, a law professor at the University of Pennsylvania.

It was stated in the study that at most, lawmakers may generate \$3.2 Billion a year in added revenue by raising taxes on the share of profit (carried interest), that executives receive as compensation for managing funds.

The study signaled an uphill battle for lawmakers trying to raise the money needed to pay for eliminating the alternative minimum tax for about 23 million mostly middle-income households.

According to the article, Drew Maloney, a principal at Ogilvy Government Relations stated that “What seems to some folks as an easy fix is not quite as simple and clean and will not generate the kind of revenue they expect”.

The rationale behind the plan to increase tax on fund managers with legislation is to permanently eradicate the alternative minimum tax (AMT) for most families that would benefit 90 million households in the US.<sup>217</sup>

The legislation would therefore tax carried interest as wages, which is currently taxed at a rate as high as 37.9 percent. That income, typically 20 percent of a fund’s profit, is now taxed at 15 percent, the capital gains rate.

In the above-cited New York Times article “Bill is offered to increase tax on private equity”, it is stated that in the bill that was introduced to increase tax on private equity,

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<sup>216</sup> “Tax change for private equity firms may yield little, study finds” <[www.iht.com](http://www.iht.com)> Assessed on 31/08/2007

<sup>217</sup> Ibid

that the US Congress must ensure that the tax code is fair and also that the bill was introduced to address equitable tax treatment and was not an attempt to penalize success.

Matthew Rhodes-Kropf, a professor of finance at the Columbia School of Business, contended that the tax was a bad economic idea. He stated that “private equity is a very important part of our economy” and that raising taxes in respect of private equity firms will discourage private equity activity.<sup>218</sup>

According to the article, it states that the most recent legislation seeks to compromise on this issue, allowing managers to receive capital gains treatment on any of their own money they invest in their funds but requiring that they pay ordinary tax rates for managing money for pension funds, endowments and for the wealthy.

A similar debate has been playing out in Britain. The Financial Times, in the article “Private equity taxation to rise?” (17/08/2007) reported that Alistair Darling, the new UK Chancellor of the Exchequer, is considering an increase from 10 percent to 20 percent in the base rate of capital gains tax for investments classed as business assets—such as holdings in unlisted companies or shares owned by employees.

The US viewpoint is also shared that it is a populist desire to make the rich pay but increasing tax on private equity is, in economic terms, very dangerous. These firms are the most mobile, the most able to move if they come under attack.

In an industry where firms are so mobile and face such low barriers to shifting capital where its treatment will be more favourable this analogy from George Gilder’s *Wealth and Poverty*, seems particularly apt:

“In an increasing competitive global economy, a government can no more raise its revenues simply by raising its taxes than a company can raise its income simply by raising its prices.

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<sup>218</sup> Bill is offered to increase tax on private equity < [www.nytimes.com](http://www.nytimes.com) > Assessed on 30/08/2007

Like a company, a government must constantly lower its prices and improve its services to expand its market (its tax base)”



## **CHAPTER 4: FOREIGN DIRECT INVESTMENT**

### **4.1 Introduction:**

The last decade has seen a dramatic increase in foreign direct investment (FDI) defined as the ownership and control of a business or part of a business in another country<sup>219</sup>. FDI is usually distinguished from portfolio investment, where a foreign actor purchases securities in a domestic company solely to earn a financial return, without the intent to own, control or manage the domestic firm.

FDI generally takes one of three forms: an infusion of new equity capital such as a new plant or joint venture; reinvested corporate earnings and net borrowing through the parent company or affiliates<sup>220</sup>.

While many developing countries have come in recent years to take a more positive view of foreign investment and have moved to dismantle many explicit barriers and disincentives, ownership by foreign investors has become of increasing concern in certain industrialized countries, particularly the United States that traditionally complained about illiberal attitudes elsewhere towards foreign investment<sup>221</sup>.

The issue of foreign investment is closely linked to the role of multinational corporations in the global political economy. Some see such corporations as powers unto themselves, capable of buying or intimidating governments, or at least with the capacity to spread production and other functions around the globe so as to exploit regulatory differences between states- taking advantage of one country's cheap labour, another's tax haven and yet another's favourable rules on intellectual property and perhaps creating a race to the bottom<sup>222</sup>.

It is also widely argued that a country's economic performance over time is determined to a great measure by its political, institutional and legal regulatory environment. These institutions and policies of government form the Governance,

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<sup>219</sup> Trebilcock, M. and Howse, R. (1995) *The Regulation of International Trade* 2<sup>nd</sup> ed. Routledge

<sup>220</sup> Ibid

<sup>221</sup> Ibid

<sup>222</sup> Ibid

whereas infrastructure largely determines the inflow of FDI. The flow of FDI is largely determined by a good and favourable investment climate which is a precursor to economic growth and Sustainable Human Development (SHD). In addition to this, economic governance, infrastructure and other structural infrastructure have a very important role to play in the attraction of FDI. Developing countries in Africa have a primordial role to play in the regulation of FDI, which role among others must include the enhancement, enforcement and judicious maintenance of the rule of law, ensuring accountability and transparency in both private and public management. This regulatory role also extends to the multinational corporations on national institutions. It is a cardinal principle of investment that an investor needs to be secure with his investment anywhere.

This chapter, then, shall be exploring what exactly FDI is; the Factors attracting FDI; the regulation of FDI; the Interrelation between FDI and Private Equity; FDI in Africa and South Africa will be examined; and FDI and the WTO will also be discussed.

#### **4.2 Foreign Direct Investment (FDI): Defined**

Foreign Direct Investment (FDI) is defined as international interest in which a resident in one country obtains a long lasting interest in an enterprise resident in another.<sup>223</sup> It is a situation where a foreign country creates a subsidiary to provide goods and services.<sup>224</sup> Thus, a firm undertakes FDI in a foreign market if it possessed with an ownership advantage over the local competitors.<sup>225</sup> The ownership of the foreign investment usually remains in the investing (home) country. FDI represents the primary means of transfer of private capital (i.e. physical or financial), technology, personnel and access to brand names and marketing advantage.<sup>226</sup>

FDI has the potential to generate employment, raise productivity, transfer skills and technology, enhance exports and contribute to the long term economic development

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<sup>223</sup> The attraction of the Foreign Direct Investment (FDI) by the African countries, Mosima Makola. Biennial ESSA conference, Somerset West: Cape Town.

<[www.essa.org.za/download/2003Conference/MakolaM](http://www.essa.org.za/download/2003Conference/MakolaM)> Assessed on 13/10/2007

<sup>224</sup> Ibid

<sup>225</sup> Ibid

<sup>226</sup> Ibid

of the world's developing countries. More than ever, countries at all levels of development seek to leverage FDI for development<sup>227</sup>

FDI is not only a transfer of ownership from domestic to foreign residents but also a mechanism that makes it possible for foreign investors to exercise management and control over host country firms- i.e. it is a corporate governance mechanism.<sup>228</sup>

Both economic theory and empirical evidence suggests that FDI has a beneficial impact on developing host countries.<sup>229</sup> It is thought to be more useful to a country than investments in the equity of its companies because equity investments are potentially “hot money” which can leave at the first sign of trouble, whereas FDI is durable and generally useful whether things go well or badly.<sup>230</sup>

Economists tend to favour the free flow of capital across national borders because it allows capital to seek out the highest rate of return.<sup>231</sup> Unrestricted capital flows may also offer several other advantages: International flows of capital reduce the risk faced by owners of capital by allowing them to diversify their lending and investment.<sup>232</sup> The global integration of capital markets can contribute to the spread of best practices in corporate governance.<sup>233</sup> The global mobility of capital limits the ability of governments to pursue bad policy.<sup>234</sup>

### **4.3 Factors Attracting Foreign Direct Investment:**

Many investors regard political and economic stability, availability of natural resources and a large and growing market as important factors to attract FDI.<sup>235</sup> In a global environment the following determinants are preferred:

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<sup>227</sup> <[www.UNCTAD.org](http://www.UNCTAD.org)> [Assessed on 22/08/2007]

<sup>228</sup> Foreign Direct Investment <[www.IFEZ.org](http://www.IFEZ.org)> [Assessed on 12/09/2007]

<sup>229</sup> Ibid

<sup>230</sup> Ibid

<sup>231</sup> Ibid

<sup>232</sup> Ibid

<sup>233</sup> Ibid

<sup>234</sup> Ibid

<sup>235</sup> The attraction of the Foreign Direct Investment (FDI) by the African countries, Mosima Makola. Biennial ESSA conference, Somerset West: Cape Town.

<[www.essa.org.za/download/2003Conference/MakolaM](http://www.essa.org.za/download/2003Conference/MakolaM)> Assessed on 13/10/2007

A favourable environment with low and stable rates and effective competition policies;<sup>236</sup> low transaction and business costs for labour and trade regulations, entry and exit rules, location and environment regulation;<sup>237</sup> subcontract services to local firms;<sup>238</sup> support quality assurance and technical extension to Small to Medium Enterprises (SME's);<sup>239</sup> human capital with diverse modern skills;<sup>240</sup> low cost infrastructure such as an effective communications system and transportation links;<sup>241</sup> Mergers and Acquisitions<sup>242</sup> and open policies in export activities-i.e. free trade and free foreign exchange regimes to maximise economies of scale.<sup>243</sup>

#### **4.4 The Regulation of Foreign Direct Investment:**

FDI is regulated through various agreements on an international, national and regional level. Nationally and regionally, FDI is regulated through Bilateral Investment Treaties (BIT's).

A BIT is an agreement establishing the terms and conditions for private investment by nationals and companies of one state in the state of the other.<sup>244</sup> BIT's are established through trade pacts. A trade pact is a wide ranging tax, tariff and trade pact that often includes investment guarantees.<sup>245</sup>

Most BIT's grant investments made by an investor of one Contracting State in the territory of the other a number of guarantees, which typically include fair and equitable treatment, protection from expropriation, free transfer of means and full protection and security.<sup>246</sup>

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<sup>236</sup> Ibid

<sup>237</sup> Ibid

<sup>238</sup> Ibid

<sup>239</sup> Ibid

<sup>240</sup> Ibid

<sup>241</sup> Ibid

<sup>242</sup> Ibid

<sup>243</sup> Ibid

<sup>244</sup> <[http://en.wikipedia.org/wiki/Bilateral\\_Investment\\_Treaty](http://en.wikipedia.org/wiki/Bilateral_Investment_Treaty)> Assessed on 13/10/2007

<sup>245</sup> <[http://en.wikipedia.org/wiki/Trade\\_pact](http://en.wikipedia.org/wiki/Trade_pact)> Assessed on 13/10/2007

<sup>246</sup> <[http://en.wikipedia.org/wiki/Bilateral\\_Investment\\_Treaty](http://en.wikipedia.org/wiki/Bilateral_Investment_Treaty)> Assessed on 13/10/2007

The distinctive feature of many BIT's is that they allow for an alternative dispute resolution mechanism, whereby an investor whose rights under the BIT have been violated could have recourse to international arbitration, often under the auspices of ICSID (International Center for the Settlement of Investment Disputes), rather than suing the host State in its own courts.<sup>247</sup>

On November 25 1959, the first BIT was signed between Germany and Pakistan. In the years after, most BIT's were signed between developed and newly independent developing countries, especially those in Africa. Typically the BIT's were initiated by the developed capital exporting country, with the usual objective being to secure higher standards of legal protection and guarantees for the investments of its firms than those offered under the national laws of the capital importing developing country. African countries signed more BIT's than any other region in the world in the 1960's. According to UNCTAD (United Nations Conference on Trade and Development), the current trend is that there is an increase in the number of BIT's being signed between developing countries.

Over the years, the primary features of BIT's have remained largely the same, especially regarding format, objectives and main provisions. There are typically four or five sets of major provisions. The first set usually outlines the scope and definition of foreign investment. The second set deals with the rules and conditions for admission of investments and focuses on national and most favoured nation treatment and on fair and equitable treatment. In the third set, the parties usually agree on some kind of guarantee and compensation scheme regarding the loss of investment due to expropriation, war or civil disturbances, guarantees of free transfer of funds and repatriation of capital and profits, subrogation on insurance claims and "State-to State" and "Investor-to State" dispute-settlement provisions. Other provisions may deal with the transparency and enforcement of national laws, performance requirements, entry and movement of foreign personnel and general exceptions.

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<sup>247</sup> Ibid

#### **4.5 The Interrelation between Private Equity and Foreign Direct Investment**

Private equity can be construed as a form of Foreign Direct Investment (FDI). They are both a form of investment with a view of providing investors with a worthwhile return on the investment that has been made. Both private equity and FDI is subject to foreign ownership. The investments are usually made in enterprises that are resident in countries other than where the investors are resident.

FDI as an investment in the economy of a country aids in economic growth. This then, in turn, leads to a number of advantages for a country and its citizens. Among the many advantages, these seem to be the most important: The advancement of infrastructure which is of utmost importance especially in a developing country and economy. With the injection of FDI into the economy of a developing country, aimed at improving the infrastructure, other foreign investors could also be attracted to that particular country and invest in other sectors.

More employment opportunities can also be created through investments that support projects which aid in providing skills to people in less developed areas of a country (i.e. rural areas). The skills acquired can then be used to empower communities that would otherwise not have had the opportunities but for the investments.

The above elements then create an increased standard of living. This is the most important factor that emanates from the investment made. An increased standard of living, in my opinion, is the ultimate goal of FDI's. The nature of FDI is long term investments that are advantageous to a country even in dismal and trying times, especially in the economic facet of a country. A higher standard of living not only aids those who initially benefit from it but it also ensures that the standard of living of future citizens will be better than those who were primarily the beneficiaries of FDI.

An increased standard of living in turn leads to the eventual eradication of poverty. This factor is one of the greatest inhibitors of growth in many developing and least-developed nations. Poverty robs a nation of valuable advancement opportunities. It almost single-handedly ensures the stagnation of economic and infrastructural growth.

With projects in place that are supported by FDI, one can work towards a future where poverty will only be known as a ghost of the past.

Hand in hand with poverty are two factors that can cripple a country if it spirals out of control. These factors are disease and corruption. Disease in most cases is mainly prevalent in rural areas and in under-developed and overcrowded urban areas. These areas are also usually not well supported by governments as corruption filters through. The main diseases in developing and least-developed nations are Tuberculosis and HIV-AIDS, which are interrelated diseases. HIV-AIDS is the cause of most adult deaths on the African continent. This then leads to children becoming orphans and also to child-headed households. This demon deprives the children of valuable education opportunities which every child should be afforded and entitled to.

With FDI backed projects aimed at the health and education sectors in developing and least developed nations, both the above-mentioned problems could be substantially alleviated.

Corruption in governments of developing and least-developed countries plays a major contributing role as an inhibitor of economic freedom and growth. The situation in Nigeria is an exemplary example of how corruption hampers growth opportunities. The oil rich nation is home to one of the most poverty stricken people on the continent. FDI is injected into the country but somehow seems to get lost along the way as it falls into the hands of greed and power hungry politicians who's only concern is self-advancement and getting ahead despite the consequences.

Anti corruption measures have been put in place but it is ultimately the government that has to ensure the implementation of those measures which renders the situation even more difficult to overcome.

If FDI's are properly implemented by government and other sectors of a government, the goals and objectives of it can be achieved. Better governmental policies and politicians ensure that funds, aimed at improving the lives of citizens and the economy, are utilised effectively. Corruption free governments lead to stronger

economies and secure a better future for the people of a nation. A strong government and economy encourages a country to be able to advance and take part in a stronger and more efficient global economy.

Private equity and FDI can then be equated as the aims and objectives are similar in nature, with FDI being the more secure option for governments because of the long term nature of Foreign Direct Investment.

#### **4.6 FDI in Africa:**

Globally, the mention of Africa evolves images of civil unrest, war, poverty disease and mounting social problems among the other ever growing problems. For this reason African countries are faced with a great challenge to attract FDI<sup>248</sup>.

Most of the FDI's are found in developed countries, and the emphasis is on manufacturing and finances<sup>249</sup>. The question then is what will happen to less developed countries where the prominence was primarily on agriculture, extractive industries and public utilities<sup>250</sup>.

A number of African countries have been making serious efforts to liberalise external trade to attract FDI<sup>251</sup>. In 1999, there was an estimated stock of \$865 billion worth of foreign direct investment in the world<sup>252</sup>. The developed countries attracted nearly three quarters of the total inflow of FDI<sup>253</sup>. Africa has during the last three decades managed to attract more FDI from 8 dollars to almost 15 dollars per \$1000 of Gross Domestic Product (GDP) during 1970-1997<sup>254</sup>.

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<sup>248</sup> *The Attraction of the Foreign Direct Investment (FDI) by the African Countries*, Mosima Makola. Biennial ESSA conference, Somerset West: Cape Town.

<[www.essa.org.za/download/2003Conference/MakolaM](http://www.essa.org.za/download/2003Conference/MakolaM)> Assessed on 13/10/2007

<sup>249</sup> Ibid, pg 3

<sup>250</sup> Ibid

<sup>251</sup> Ibid

<sup>252</sup> Ibid

<sup>253</sup> Ibid

<sup>254</sup> Ibid, pg 4

#### 4.7 The Challenges in Africa:

The following shortcomings are still found in African countries:

Many countries are still making it difficult to obtain expatriate permits quickly and efficiently<sup>255</sup>. The nature of the granting of investment incentives is variable<sup>256</sup>.

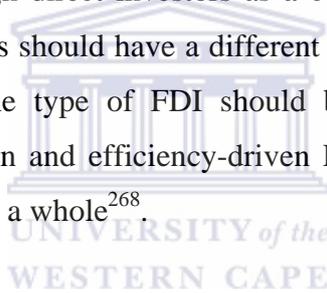
For example, South Africa grants several industry specific incentives and activities<sup>257</sup>. Ghana has abolished tax holidays in favour of low general tax rates<sup>258</sup>.

There are considerable variation in FDI entry procedures and requirements across African countries<sup>259</sup>. Export Processing Zones (EPZ's) are created as incentives but their effectiveness is eroded by restrictive provisions and bureaucratic procedures<sup>260</sup>.

Africa experiences red tape as a main obstacle for investment<sup>261</sup>. Administrative barriers should be liberalised<sup>262</sup>. Most countries became operational<sup>263</sup>.

Africa has a poor reputation among foreign direct investors as a continent marred by starvation, war and high risk<sup>264</sup>. Investors should have a different perception and see Africa as a good place for FDI's<sup>265</sup>.

The type of FDI should be identified<sup>266</sup>. Africa needs resource-driven, market-driven and efficiency-driven FDI's<sup>267</sup>. FDI statistics should cover the African continent as a whole<sup>268</sup>.



#### 4.8 FDI and South Africa: The Economic Strength of South Africa

The success of the first democratic election in 1994 put the economy on the path of growth and development and at the same time created a conducive environment for both domestic, regional as well as for foreign investment that have continued to robust

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<sup>255</sup> Ibid, pg 12

<sup>256</sup> Ibid

<sup>257</sup> Ibid

<sup>258</sup> Ibid

<sup>259</sup> Ibid, pg 13

<sup>260</sup> Ibid

<sup>261</sup> Ibid

<sup>262</sup> Ibid

<sup>263</sup> Ibid

<sup>264</sup> Ibid

<sup>265</sup> Ibid

<sup>266</sup> Ibid

<sup>267</sup> Ibid

<sup>268</sup> Ibid

the economy despite World economic slumps and booms that have weakened some developing economies around the world.<sup>269</sup> Despite this, South Africa remains one of the world's favourite emerging markets, offering investors highly sophisticated financial infrastructures and exceptional investment opportunities and incentives.<sup>270</sup> Coupled to the positive indicators, the government has put in place an investment friendly range of business incentives against a background of robust standardized economic policies regulated by very efficient rules and structures.<sup>271</sup> To this could be added its open business climate with transparent rules and regulations, high standards of corporate governance, one of the most liberal constitutions in the world and a strict observance of the rule of law.<sup>272</sup>

Following the state of things, South Africa is the leading economy in Sub-Saharan Africa and often considered as the gateway to Africa.<sup>273</sup> This fact is supported by the presence of many multinationals based in the country and also by the exporting of local goods and services to the rest of Africa.<sup>274</sup> Even though still considered as a developing economy, its infrastructure and structures far surpass those of other developing economies on the same classification on the World Trade Organisation (WTO). An appraisal of the South African economy reveals its growth and macro stability in the face of a fluctuating world economy.<sup>275</sup>

The South African Trade and Industry Department in implementing government economic policies offer a number of incentives to investors, both foreign and domestic.<sup>276</sup> The Department of Trade and Industry (the DTI)'s primary role is to facilitate access to sustainable economic growth with the main objective of promoting the development of small, medium and micro enterprises (SMME's), increasing Black Economic Empowerment (BEE), reducing inequality and poverty reduction, developing the South African Development Community (SADC) region and strengthening the international competitiveness of South African business internally

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<sup>269</sup> Chesami, ME. The Role of Government in the Attraction of Foreign Direct Investment: A Case Study of South Africa and Cameroon 18-20<[www.uwc.ac.za](http://www.uwc.ac.za)> Assessed on 13/10/2007

<sup>270</sup> Ibid

<sup>271</sup> Ibid

<sup>272</sup> Ibid

<sup>273</sup> Ibid

<sup>274</sup> Ibid

<sup>275</sup> Ibid

<sup>276</sup> Ibid

as well as externally in collaboration with the Department of Foreign Affairs (DFA).<sup>277</sup> In the same framework, these incentives are geared towards increased market access to foreign investment and to usher in an air of fair, efficient and competitiveness in the market place.<sup>278</sup>

#### **4.9 Foreign Direct Investment and the World Trade Organisation:**

The WTO is currently working towards an agreement that would internationally regulate FDI. This agreement is known as the Multilateral Agreement on Investment (MAI).<sup>279</sup>

Much has been written about the MAI that has been negotiated by OECD (Organisation for Economic Cooperation and Development) Countries.<sup>280</sup> Perhaps even more has been said by the critics of those who would like to see an agreement of this kind extended among other countries.<sup>281</sup> There has indeed been a great deal of “toing” and “froing” about the desirability of MAI and even misunderstandings about its merits. The principal question is whether there is any need for an MAI.<sup>282</sup> There are arguments in favour and against. On balance, the positive aspects of a multilateral agreement should outweigh the negative ones.<sup>283</sup>

The arguments for and against the need for the MAI clearly demonstrate that there has not been enough agreement about the need for an MAI, even though the pendulum is swinging towards the ‘multilateralists’.<sup>284</sup> While the need for FDI is generally recognised, the push for an international agreement has rather been lukewarm in some countries.<sup>285</sup> This lack of enthusiasm or even outright hostility could be a serious problem for the international trading system and for capital markets. First, the

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<sup>277</sup> Ibid

<sup>278</sup> Ibid

<sup>279</sup> Drabek, Zdenek “A Multilateral Agreement on Investment: Convincing the Sceptics” WTO Staff Working Paper ERAD -98-05 June 1998. 1-3

<sup>280</sup> Ibid, 1

<sup>281</sup> Ibid

<sup>282</sup> Ibid

<sup>283</sup> Ibid

<sup>284</sup> Ibid, 2

<sup>285</sup> Ibid

question of MAI divides the WTO members into those who support the idea of an agreement and those who are against it.<sup>286</sup> In other words this is a divisive issue which could also hamper progress in other areas of WTO jurisdiction. Second, the division has gone along the lines of important country groupings-developed versus least developed countries (LDC's).<sup>287</sup> This, too, is a serious business because of the interest of developing countries having LDC's integrated into the multilateral trading system.<sup>288</sup> Third, FDI has been growing dramatically over the last decade or so, resulting in a rapid pace of globalisation and a significant contribution of foreign capital to investment in many countries of the world.<sup>289</sup> Unfortunately the growth of FDI has been uneven, with some LDC's benefiting more than others, leading many people in academia and policy circles to fear that the latter countries, or at least some of them, will be marginalised.<sup>290</sup> Fourth, there does not seem to be an agreement on the need for an MAI among international public institutions that give advice on trade and investment policies to countries.<sup>291</sup>

The crucial question of whether an MAI is desirable, therefore, still lingers over the heads of trade ministers and other politicians.<sup>292</sup> But even if one believes that there is an unambiguous need for an MAI, the question remains what kind of agreement should be proposed. Too much regulation can be costly, while too little regulation may be imprudent.<sup>293</sup>

The principal question is whether there is indeed a need for an MAI.<sup>294</sup>

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<sup>286</sup> Ibid

<sup>287</sup> Ibid

<sup>288</sup> Ibid

<sup>289</sup> Ibid

<sup>290</sup> Ibid

<sup>291</sup> Ibid

<sup>292</sup> Ibid

<sup>293</sup> Ibid

<sup>294</sup> Ibid

## **CHAPTER FIVE: THE STRUCTURE OF A PRIVATE EQUITY DEAL**

### **5.1 The Legal Structure of Private Equity Funds<sup>295</sup>**

The providers of the venture capital needed in order to structure a private equity fund include: Business Angels (Private persons), Investment companies, Corporate Venture companies, Private equity funds, Funds-of-Funds and Government-controlled entities<sup>296</sup>.

Private Equity Funds are the preferred vehicle for pooled investments as they are tax transparent, flexible capital rules/procedures as well as flexible organisational rules/procedures apply to them<sup>297</sup>.

In the regulation of limited partnerships, there must be two kinds of partners:

- a) Limited partners with limited liability (the investors in the limited partnership)
- b) General partners with unlimited liability (but it can also be a company with limited liability)<sup>298</sup>.

The general partners shall have managerial or financial powers. Responsibility for day to day operation of the limited partnership can be delegated to a management company (controlled by the management team who also controls the general partner)<sup>299</sup>. Either the partnership or the general partner can make such delegation<sup>300</sup>. There are also additional regulation regarding registration and annual reports can also be undertaken by the appointed management company<sup>301</sup>.

In the organisation, the corporate bodies required include the limited partnership (the “Fund”), the general partner (the “GP”) and the investment manager (the “IM”)<sup>302</sup>.

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<sup>295</sup>“The Legal Structure of Private Equity Funds” <[www.isis.ku.dk/kuser/blob.aspx?feltid=15530](http://www.isis.ku.dk/kuser/blob.aspx?feltid=15530)>

Assessed on 19/10/2007

<sup>296</sup> Ibid

<sup>297</sup> Ibid

<sup>298</sup> Ibid

<sup>299</sup> Ibid

<sup>300</sup> Ibid

<sup>301</sup> Ibid

<sup>302</sup> Ibid

Optional corporate bodies that can be used within the organisation include an Advisory Board, and Investment Committee or an Investor Council (or board)<sup>303</sup>. The Capital needed is derived from commitments from investors, draw downs (also referred to as “Capital Calls”) and reinvestment of proceeds<sup>304</sup>.

Timing issues relating to Private Equity Funds include the lifetime which is about ten to twelve years with a possible extension of one to five years<sup>305</sup>. The closings which are divided into two: one in connection with the establishment and another up to one year thereafter<sup>306</sup>. The investment period, this is four to six years from the first closing<sup>307</sup>. Lastly, the Cut-off date which is the last date at which investors can be required to make payments to the fund<sup>308</sup>.

The general partner or the investment manager can be appointed by a sponsor or management<sup>309</sup>. They will then be authorised to do anything necessary to operate the partnership. There are however various restrictions and limitations regarding the behaviour of the GP/IM which include: Investments outside of the defined investment universe, size of the investment in any one company, use of debt by the fund, co-investment by third parties (including other funds controlled by management) and also the establishment of other funds controlled by management<sup>310</sup>.

The various fees and expenses include the establishment cost (which is 1-2 percent of the total commitment payable once), the management fee (which is 1.5-2.5 percent payable annually) and the transaction costs (which is split between the fund, IM and the portfolio companies)<sup>311</sup>.

There are also various conflicts of interest that should be regulated. These include, among others, the establishment of other funds controlled by the management, co-

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<sup>303</sup> Ibid

<sup>304</sup> Ibid

<sup>305</sup> Ibid

<sup>306</sup> Ibid

<sup>307</sup> Ibid

<sup>308</sup> Ibid

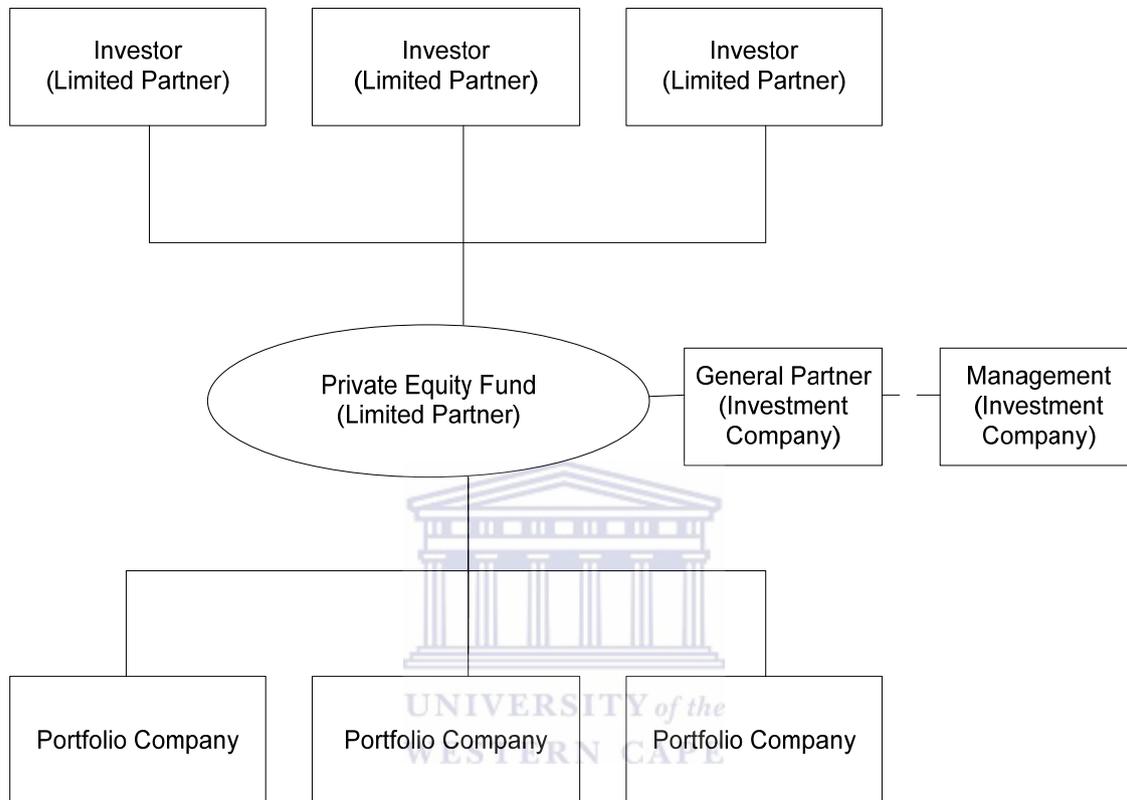
<sup>309</sup> Ibid

<sup>310</sup> Ibid

<sup>311</sup> Ibid

investment by other funds controlled by management and also co-investment by investors in the Fund<sup>312</sup>.

Figure 1. Structure of a typical Private Equity Fund:



## 5.2 Private Equity Deal Structures<sup>313</sup>

Private equity deal structures are formulated in time sheets. These are preliminary documents designed to facilitate and provide a framework for negotiations between

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<sup>312</sup> Ibid

<sup>313</sup> This section of the chapter is taken from the Note on Private Equity Deal Structures as prepared by George Bene under the supervision of Adjunct Assistant Professor Fred Wainwright and Professor Colin Blaydon of the Tuck School of Business at Dartmouth College <[www.seca.ch/sec/private-equity/Deal-Structure-PE.pdf](http://www.seca.ch/sec/private-equity/Deal-Structure-PE.pdf)> Assessed on 19/10/2007

investors and entrepreneurs. A term sheet generally focuses on an enterprise's valuation and the conditions under which investors agree to provide financing.

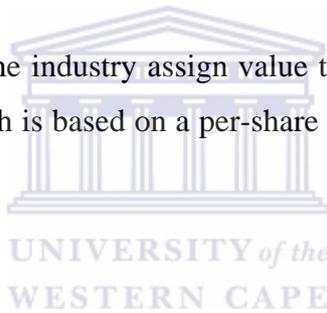
The term sheet eventually forms the basis of several formal agreements including the stock purchase agreement which is a legal document that details who is buying what from whom, at what price and when.

The process of arranging venture financing is challenging. Negotiating deals with terms that are satisfactory to both sides and ensuring that stakeholders' interests are properly aligned is crucial. This process begins with a term sheet.

The paragraphs below describe the key financial items in most term sheets. It also contains additional control provisions.

#### a) Valuation

Traditionally, companies in the industry assign value to enterprises as the result of a financing event. This approach is based on a per-share value and the valuation is on a fully diluted basis.



#### b) Step-ups

This describes the increase in share price from one financing round to the next. They also describe the increase in the value of the company since the last round of financing. Step-ups help motivate all the shareholders to remain engaged in the enterprise's effort to build value.

#### c) Securities

Different investments have varying risk or reward characteristics which call for different types of securities to accommodate investor's goals. The most common type used in venture capital transactions include: Common stock, Convertible preferred stock, Participating preferred stock, Redeemable preferred stock, Convertible debt, Mezzanine debt, Senior debt, Subordinated debt, Warrants, and Options.

#### d) Anti-Dilution

Dilution occurs when an investor's proportionate ownership is reduced by the issue of new shares. Investors are primarily concerned with "down rounds" or financing

rounds that value the company's stock at a lower price per share than previous rounds. Down rounds may occur due to number of factors like economic conditions or company performance. Since investors cannot determine with certainty whether a company will undergo a down round, they negotiate certain rights or anti-dilution provisions referred to as "ratchets", so that they may protect their investment.

#### e) Pay-to play (Play or Pay) Provisions

These are usually used with price-based anti-dilution measures. These provisions require an investor to participate (proportionally to their own share) in the down rounds in order to receive the benefits of their anti-dilution provisions. Failure to participate results in forced conversion from preferred to common or loss of anti-dilution protection. This encourages the Venture Capitals to support the struggling portfolio companies through multiple rounds and increases the companies' chances of survival.

#### f) Other issues

In addition to the key financial provisions described above, the term sheets usually include a number of other important items related to control and a mix of financial and non-financial terms is common. The non-financial terms described below include:

**Voting rights-** Term sheets often address issues of control in order to allow investors in a company to add value and also exercise control if things go wrong. While investors may not want majority board control if things are going well, they may negotiate provisions that give them control if certain events occur. The golden rule often applies: he who has the gold makes the rules.

**Board Representation-** Venture Capitalists may negotiate control of part of the Board of Directors, generally to influence decision making and to protect their investments rather than to run the company. Often, classes of stock holders are allowed to elect a percentage of the board members separately. If venture capitalists invest as a syndicate and board representation is not possible for all of the participating firms, then the board observer rights are an option. These rights allow investors to monitor their portfolio companies and to influence decisions by being present at board meetings, but they are not allowed to vote.

Covenants- Most preferred stock issues and debt issues have associated covenants or things that the portfolio company promises to do (positive covenants) and not to do (negative covenants). They are negotiated on a case-by-case basis and often depend on other aspects of the deal. Failure to comply with the covenants can have serious consequences for the company such as automatic default on payments due.

Vesting- This provision states that a manager or entrepreneur earns ownership of common stock or options only after a predetermined period of time or after the company achieves certain milestones. The most important effect of vesting is that it motivates employees to stay with the company and may prevent them from leaving prematurely to pursue other opportunities.

Bridge Loans- Bridge financing can be used to prepare a company for sale or as a pre-round financing. A bridge is, in essence, short term financing designed to be either repaid or converted into ownership securities. In the sale case, a bridge is useful when a company needs relatively small amounts of capital to achieve its final targets and achieve maximum value in the eyes of potential buyers. A bridge is also useful to pump cash into a company quickly while investors are found to complete a formal round of financing. Bridge investors often insist on warrants or equity kickers to compensate them for the higher risk of lending money to high growth ventures.

Phased financing- A venture capital firm may agree to phased-financing or incremental financing in tranches. In this case, the entrepreneur and his or her team must reach certain milestones in order for the venture capitalist to agree to invest more capital in the startup. This has the additional benefit of allowing startup and the venture firms to trumpet the larger commitment amount, generating positive PR, while limiting the actual cash disbursements until the startup has proven itself.

Staged financing may also cause misalignment of goals, however, since management may be motivated to cut corners to achieve milestones rather than focusing on the long term health of the company, its customer relationships and the value of its products and services.

Much of the success of Private Equity deals and transactions are dependant on negotiations that recognise the needs of both investors and entrepreneurs alike. There has to be equity for both parties in order for the negotiation process to run smoothly. This will in turn lead to transactions that are not only beneficial for investors and entrepreneurs but also for the economy of the country where the transactions will be rooted.



## **CHAPTER SIX: THE EFFECT OF PRIVATE EQUITY IN THE CONTEXT OF THE SOUTH AFRICAN MINING SECTOR**

### **6.1 The Mining Sector of South Africa**

South Africa is particularly rich in mineral resources and is one of the leading raw material exporters in the world<sup>314</sup>. The main raw materials are gold, diamonds, platinum, chromium, vanadium, manganese, uranium, iron ore and coal<sup>315</sup>. These goods make up about sixty percent of the entire export<sup>316</sup>. With platinum, vanadium, manganese and chromium, South African is globally number one, as far as mineral resources as well as the actual mining and export volumes are concerned<sup>317</sup>.

Gold mining still holds a special position<sup>318</sup>. Forty percent of the world's gold reserves are still to be found in the Witwatersrand area<sup>319</sup>. The gold-bearing stone, however, has to be mined with considerable technical expenditure from great depths<sup>320</sup>. To produce one fine ounce of gold, on average about three tons of ore, five thousand litres of water and six hundred kilowatt hours of electricity are required<sup>321</sup>.

Although well over a century old, South Africa's mining industry is far from fully tapped<sup>322</sup>. The country is a treasure trove, with mineral deposits only matched by some countries of the former Soviet Union<sup>323</sup>.

Only two strategic minerals- crude oil and bauxite- are not available in the country<sup>324</sup>. For the rest, the sector spans the full spectrum of the five major mineral categories, namely precious metals and minerals, energy minerals, non-ferrous metals and minerals, ferrous minerals and industrial minerals<sup>325</sup>.

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<sup>314</sup> <[www.southafrica-travel.net/economy/e\\_gold.htm](http://www.southafrica-travel.net/economy/e_gold.htm)> Assessed on 25/10/2007

<sup>315</sup> Ibid

<sup>316</sup> Ibid

<sup>317</sup> Ibid

<sup>318</sup> Ibid

<sup>319</sup> Ibid

<sup>320</sup> Ibid

<sup>321</sup> Ibid

<sup>322</sup> <[www.southafrica-travel.net/economy/e\\_gold.htm](http://www.southafrica-travel.net/economy/e_gold.htm)> Assessed on 25/10/2007

<sup>323</sup> Ibid

<sup>324</sup> Ibid

<sup>325</sup> Ibid

Over the last few years, the price of gold has dropped continuously<sup>326</sup>. The main reason is the reduced demand for gold on the world market, because fewer currencies are being backed up by gold reserves<sup>327</sup>. Also competition from Australia and Russia puts pressure on the gold price because their gold mining is easier and cheaper<sup>328</sup>.

The gold mines in South Africa suffered a heavy crisis temporarily, and in 1995 more than 100 000 workers were laid off (retrenched)<sup>329</sup>. So far, the industry has been saved from ruin by down sizing, establishing cooperatives and the weakening currency, although many mines has reached their limit of profitability and at times even work below it<sup>330</sup>.

The South African economy has, in recent years, succeeded in reducing its dependency on the gold price<sup>331</sup>. In general, the economy is striving to shift away from its one-sided orientation as a raw materials exporter<sup>332</sup>. In future, the proportion of semi-finished and finished products in the entire export volume shall be increased by a capital-intensive modernisation of the industrial structures, which became outdated through the isolation of the apartheid era<sup>333</sup>.

The South African mining industry is continually expanding and adapting to changing local and international world conditions, and remains a cornerstone of the economy making a significant contribution to economic activity, job creation and foreign exchange earnings<sup>334</sup>.

Change strategies adopted by the mining industry since the end of the apartheid era in 1994 have made it more competitive<sup>335</sup>. With new leadership in place, better structure

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<sup>326</sup> <[www.southafrica-travel.net/economy/e\\_gold.htm](http://www.southafrica-travel.net/economy/e_gold.htm)> Assessed on 25/10/2007

<sup>327</sup> Ibid

<sup>328</sup> Ibid

<sup>329</sup> Ibid

<sup>330</sup> Ibid

<sup>331</sup> Ibid

<sup>332</sup> Ibid

<sup>333</sup> Ibid

<sup>334</sup> <[www.southafrica-travel.net/economy/e\\_gold.htm](http://www.southafrica-travel.net/economy/e_gold.htm)> Assessed on 25/10/2007

<sup>335</sup> Ibid

companies, and a more robust operating and financial base, South Africa will continue to be an important player in the global mining industry<sup>336</sup>.

## 6.2 Private Equity and the South African Mining Industry

Historically, private equity houses have taken little interest in the mining sector, with few transaction of note in an industry that has been perceived as inappropriate for financial purchasers<sup>337</sup>. With the ever-increasing buying power available to private equity and the rapidly changing metrics of the mining sector, perhaps it is time for the mining sector to be reconsidered<sup>338</sup>.

The mining sector has not been a private equity target in the past due to various reasons<sup>339</sup>. Empirical evidence suggests it is a cyclical industry, Mining companies have been price takers and not price makers, cash flows has historically been unpredictable, there has been concerns over environmental and other reputational risks, it requires specialist knowledge to succeed, there were concerns over political and social risks in emerging markets and also a lack of possible exit options<sup>340</sup>.

But, the mining industry clearly perceives things differently<sup>341</sup>. Transactions have seen a sharp pick-up since 2005, with global M&A deals spiking from US\$16 billion in 2004 to US\$54 billion and US\$68 billion in 2005 and 2006 respectively<sup>342</sup>.

The last metal price slump in the late 1990's was significantly impacted by the exceptional de-stocking of inventories built up during the cold war by the former Soviet Union<sup>343</sup>. The impact of this was to greatly exaggerate the perception of mining being a cyclical industry<sup>344</sup>. The current higher metal prices are reflecting a

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<sup>336</sup> Ibid

<sup>337</sup> "Mining, is now the time for Private Equity" <[www.ey.com/miningmetals](http://www.ey.com/miningmetals)> Assessed on 25/10/2007

<sup>338</sup> Ibid

<sup>339</sup> Ibid

<sup>340</sup> Ibid

<sup>341</sup> Ibid

<sup>342</sup> Ibid

<sup>343</sup> Ibid

<sup>344</sup> Ibid

very fundamental supply/demand imbalance- the industry may now be out of sync with the macro economic cycle causing a step change in the metal pricing<sup>345</sup>.

World demand for metals is closely related to global GDP, although rapidly expanding economies tend to have a higher intensity of use of some metals, particularly steels, than advanced countries<sup>346</sup>. Current levels of demand strength were not expected nor anticipated<sup>347</sup>. Whilst the western economies grow steadily, the growth of the Chinese and Indian economies continues to surprise, with no sign of abating<sup>348</sup>.

Supply is constrained in ways that cannot be easily corrected and projected growth in demand already discounts substitution, recycling and thrifting<sup>349</sup>. There are various reasons for this. It can take up to ten years to develop a large mine, with current metals prices already taking into account existing projects coming on stream<sup>350</sup>. Outside of existing projects, there is a lack of new mineral discoveries as the most easy to find deposits are already known; exploration has been cut back as the long timescales for projects coming on stream make investment too risky; political risks has eliminated many prospective areas; high-tech and biotech are competing for the same risk capital and there has also been a lack of new exploration technology<sup>351</sup>. There is a major skills shortage relating to mining engineers and geologists<sup>352</sup>. There is a major materials shortage globally: tires and equipment often have three-year lead times<sup>353</sup>.

Metal prices have increased substantially over the last three years, with the nickel and lead hitting record highs in early 2007 and tin enjoying a 22-year high<sup>354</sup>. Copper has

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<sup>345</sup> Ibid

<sup>346</sup> Ibid

<sup>347</sup> Ibid

<sup>348</sup> Ibid

<sup>349</sup> Ibid

<sup>350</sup> Ibid

<sup>351</sup> Ibid

<sup>352</sup> Ibid

<sup>353</sup> Ibid

<sup>354</sup> Ibid

been heavily shorted since its high in May 2006, but is now holding at high price levels and the aluminium is experiencing a physical squeeze<sup>355</sup>.

The knock on effect of this is that mining companies as become cash generative, with predictable and secure cash flows<sup>356</sup>. There are now major mining companies with low gearing and a diminishing pipeline of capital projects despite the acceleration of capital expenditure<sup>357</sup>. Many mining companies are now aggressively returning cash to shareholders<sup>358</sup>. Several of these organisations have unused credit capacity, are consciously “unhedged” and are aggressively consolidating to find growth opportunities through M&A activities<sup>359</sup>.

Continued consolidation amongst the major players is leading to an element of greater pricing power by the producers, after decades during which a fragmented mining industry had little control over its product pricing<sup>360</sup>. Management is behaving more astutely in limiting capacity expansion and future overproduction. As a result, normal supply/demand economies are being established<sup>361</sup>.

The importance of an exit strategy to private equity investors has been a barrier to investment in the mining sector<sup>362</sup>. The changing fundamentals in the industry mean that there are more exit opportunities, whilst the importance to the overall investment return is diminishing<sup>363</sup>. Given the changing fundamentals, a significant element of the required return on investment may be achieved prior to the exit<sup>364</sup>.

Historically, public offerings have not been an option for the mining companies in emerging markets because of the perceived political risks in cross border transactions<sup>365</sup>. Recently, however, there have been many successful offerings from previously unappreciated geographies, such as the most recent offering on the London

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<sup>355</sup> Ibid

<sup>356</sup> Ibid

<sup>357</sup> Ibid

<sup>358</sup> Ibid

<sup>359</sup> Ibid

<sup>360</sup> Ibid

<sup>361</sup> Ibid

<sup>362</sup> Ibid

<sup>363</sup> Ibid

<sup>364</sup> Ibid

<sup>365</sup> Ibid

Stock Exchange of Kazakhmys plc (Kazakhstan), Hothschilds plc (Peru) and GEM Diamonds plc (Africa)<sup>366</sup>.

Short term cash returns are potentially higher than acquisition prices would suggest, making the exit a less critical part of the overall return to private equity investors<sup>367</sup>. Coupled with the availability of IPO, the opportunity for private equity to make a target return on mining investments is greater than ever before<sup>368</sup>.

### 6.3 Government Interference in the Mining Sector

With the implementation of the Mineral and Petroleum Resources Development Act<sup>369</sup> (MPRDA) in 2004, transformation of how business is conducted has become a key priority for the South African resources sector during the last two years<sup>370</sup>. This has presented the local mining sector with a number of corporate mindset challenges as many companies have had to transform their approach to business in order to comply with the requirements of the new legislation<sup>371</sup>. During the last two years, mining companies have had to alter the way they operate their business to meet the requirements of the new legislation which fundamentally changes the way in which mining companies are required to conduct their business<sup>372</sup>. This is evidenced in the fact that, subsequent to 1998, there has been relatively little legislation surviving from the previous regime<sup>373</sup>. As a result, the mindset of the mining sector has had to change to accommodate the emergence of a new legislative environment especially with regard to the ownership of minerals and black economic empowerment (BEE)<sup>374</sup>. The reality is that South African mining companies are operating in a new dispensation in which minerals belong to the State<sup>375</sup>.

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<sup>366</sup> Ibid

<sup>367</sup> Ibid

<sup>368</sup> Ibid

<sup>369</sup> Act 28 of 2002

<sup>370</sup> <[www.engineeringnews.co.za/article.php?a\\_id=93477](http://www.engineeringnews.co.za/article.php?a_id=93477)> Assessed on 23/10/2007

<sup>371</sup> Ibid

<sup>372</sup> Ibid

<sup>373</sup> Ibid

<sup>374</sup> Ibid

<sup>375</sup> Ibid

Before the MPRDA was promulgated, South Africa was one of the few countries in the world that had private ownership of the minerals<sup>376</sup>. However, as all minerals belong to the State, mining companies have had to follow a process of rights conversion in order to continue mining or exploring activities<sup>377</sup>. This is time consuming, and, in some cases, costly for many companies but has contributed to the cementing of BEE in the industry as companies are compelled to have a BEE shareholding in order to obtain mining and prospecting rights<sup>378</sup>.

Although many companies have concluded and embarked on BEE negotiations, a number of mining companies have yet to conclude a successful BEE transaction, which may be indicative of the reluctance to transform under the new legislation but could also be ascribed to the practical, technical and financial challenges facing these transactions<sup>379</sup>.

However, if the mining sector and government wish too have an amicable relationship in the future, it is essential that mining companies speedily embrace and actively pursue all aspects of transformation<sup>380</sup>.

The promulgation of the MPRDA, the act provides that one or the grounds on which the Minister of Minerals and Energy must refuse to grant a prospecting right<sup>381</sup> is where the granting of the right “will result in the concentration of the minerals resources in question under control of the applicant”<sup>382</sup>. Since the commencement of the act, a number of applications for prospecting rights have been declined on this basis<sup>383</sup>. The reasoning, however, as to why it is considered that the application will result in the concentration of the mineral resources is generally not given<sup>384</sup>.

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<sup>376</sup> Ibid

<sup>377</sup> Ibid

<sup>378</sup> Ibid

<sup>379</sup> Ibid

<sup>380</sup> Ibid

<sup>381</sup> Means the right to prospect granted in terms of s17 (1) of Act 28 of 2002

<sup>382</sup> S17 (2)(b)(iii) of Act 28 of 2002

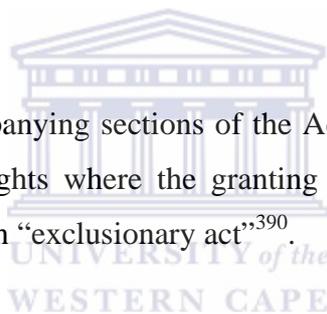
<sup>383</sup> <[www.engineeringnews.co.za/article.php?a\\_id=96092](http://www.engineeringnews.co.za/article.php?a_id=96092)> Assessed on 23/10/2007

<sup>384</sup> Ibid; also see s17 (3) of Act 28 of 2002

There are no guidelines either in the act, its regulations or elsewhere, defining concentration<sup>385</sup>. This is problematic as there is no framework provided by the Department of Minerals and Energy (DME) on which to base its decision<sup>386</sup>. It is suggested that the reason, that Minister must refuse to grant a prospecting right where the granting of the right will result in concentration, may be based on the objective of the MPRDA to “promote equitable access to the nation’s mineral and petroleum resources to all the people of South Africa<sup>387</sup>”.

The legislature could have taken the view that it would not be equitable should the rights of a particular mineral become too concentrated in the hands of any one holder<sup>388</sup>. It seems that the inclusion of the requirements that applicants be declined where they result in concentration of the mineral resource under the mineral applicant appears to be clearly motivated by matters of competition as opposed to equity and access to resources<sup>389</sup>.

This is evident in the accompanying sections of the Act, which prohibit the minister from granting prospecting rights where the granting of the right will prevent fair competition or will result in an “exclusionary act”,<sup>390</sup>



This term is commonly used in competition law and is defined in the MPRDA as “any act or practice which impedes or prevents any person from entering the mineral and mining industry or from entering any market connected with that industry, or from making progress within such industry or market”,<sup>391</sup>. This places an onerous obligation on the Minister or the official delegated by the Minister to make the decision<sup>392</sup>. As the decision is administrative in nature, it is subject to both common law and constitutional safeguards<sup>393</sup>. The decisions should also be taken in a procedurally fair manner<sup>394</sup>.

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<sup>385</sup> Ibid

<sup>386</sup> Ibid

<sup>387</sup> Ibid

<sup>388</sup> Ibid

<sup>389</sup> Ibid

<sup>390</sup> Ibid

<sup>391</sup> Ibid

<sup>392</sup> Ibid

<sup>393</sup> Ibid

<sup>394</sup> Ibid

The subsection cannot be used as a catch-all to prohibit any application which does not find favour with the department for whatever reason<sup>395</sup>. The implementation of competition law is most often the responsibility of the Competition Commission and the Competition Tribunal<sup>396</sup>. These bodies deal with issues such as market concentration on a daily basis and have developed considerable expertise<sup>397</sup>.

It is required that the officials in the DME tasked with implementing the MPRDA incidentally develop the knowledge and expertise necessary to determine the impact of concentration of granting a prospective right but this is seen as a tall order<sup>398</sup>. The concept of concentration is quite commonly used in competition or anti trust law, particularly in the consideration of mergers<sup>399</sup>.

To explain why high concentration is considered undesirable, the “structure-conduct-performance” model of competition law is used<sup>400</sup>. Authors, Bishop and Walker, express this in “Economic of Competition Law”,<sup>401</sup>. It states that the model holds that the more concentrated the market structure, the less competitively firms behave, which in turn leads to both higher prices and higher profits than under more competitive conditions<sup>402</sup>. Unlike the requirements in the MPRDA, the competition authorities are not limited to consider only ‘concentration’<sup>403</sup>. In determining the impact on competition of a merger, the authorities must consider any factor relevant to the market, for example, imports or ease of entry into the market<sup>404</sup>.

If it appears that the merger will substantially prevent or lessen competition, the authority then considers whether there is some technological, efficiency or other pro-competitive gain that may result from the merger which is greater than or may off-set

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<sup>395</sup> Ibid

<sup>396</sup> Ibid

<sup>397</sup> Ibid

<sup>398</sup> Ibid

<sup>399</sup> Ibid

<sup>400</sup> Ibid

<sup>401</sup> Bishop, S and Walker, M-Economics of EU Competition Law: Concepts, Applications and Measurements, Sweet and Maxwell (2002).

<sup>402</sup> <[www.engineeringnews.co.za/article.php?a\\_id=96092](http://www.engineeringnews.co.za/article.php?a_id=96092)> Assessed on 23/10/2007

<sup>403</sup> Ibid

<sup>404</sup> Ibid

the lessening of competition<sup>405</sup>. There is no equivalent provision for this type of balancing of interests in the MPRDA<sup>406</sup>. The necessary preliminary step in calculating concentration in a market is to define the market itself<sup>407</sup>.

This usually includes a product market and a geographical market<sup>408</sup>. However, the MPRDA specifically require that the Minister consider the concentration of the mineral resources in question under the control of the applicant<sup>409</sup>. Therefore, as far as the product market is concerned, the MPRDA simply requires that this be determined with reference to the mineral to which the prospecting rights relate<sup>410</sup>.

Mr. Donovan Smith of Bell Dewar and Hall Attorneys cites the example of determining concentration in an application for the prospecting of gold<sup>411</sup>. The appropriate geographic market to consider may be the global rather than the domestic market<sup>412</sup>. This is consistent with the decisions made by the Competition Tribunal relating to the sale of mineral rights relating to gold<sup>413</sup>. Accordingly, in order to determine whether or not the granting of a mineral right might result in market concentration, it would be necessary to determine the extent of the gold resources held by the applicant relevant to the total global resources available<sup>414</sup>.

Bishop and Walker caution that “serious problems arise with using market shares to make inferences about competition when the definition of the market from which market shares are calculated is inappropriate”<sup>415</sup>. If the relevant geographic area is not properly determined then a prospecting right which might, in fact, decrease concentration might be incorrectly declined<sup>416</sup>.

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<sup>405</sup> Ibid

<sup>406</sup> Ibid

<sup>407</sup> Ibid

<sup>408</sup> Ibid

<sup>409</sup> Ibid

<sup>410</sup> Ibid

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<sup>412</sup> Ibid

<sup>413</sup> Ibid

<sup>414</sup> Ibid

<sup>415</sup> Ibid

<sup>416</sup> Ibid

The MPRDA and its regulations do not provide any guidelines regarding when concentration of the mineral resources becomes unacceptable<sup>417</sup>. Smith notes that, alternatively, in competition law, the common measure of market concentration is the Herfindahl-Hirschmann Index or HHI<sup>418</sup>. Other measures sometimes used are 'concentration ratios', such as the CR4<sup>419</sup>. The US Department Justice has prescribed merger guidelines indicating the manner and levels at which the HHI ratio can be used to determine high market concentration as well as unacceptable increases in market concentration<sup>420</sup>. These guidelines are sometimes also referred to and applied by the South African competition authorities<sup>421</sup>. Smith is of the opinion that there is clearly a considerable amount of information which a decision maker requires at its disposal in order to make a decision regarding whether or not the granting of a prospective right will result in the concentration of that mineral resource<sup>422</sup>. For example, in order to determine the HHI, it is necessary to know the market share of at least the major competitors in that market<sup>423</sup>. He explains that the application for a prospecting right currently require that the applicant submit a table listing existing rights and permits held by the applicant and indicating the region, the location with regard to the land name and the existing right or permit number for each mineral<sup>424</sup>. An application does not require any other information regarding the extent of the concentration of the mineral resource or the possible impact of the application on that concentration<sup>425</sup>. Unless the information requested in the application form is supplemented with considerable data from within the Department of Minerals and Energy, for example, distribution of the mineral resource concerned, then it would simply not be possible for the Minister to properly make a determination<sup>426</sup>.

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<sup>417</sup> Ibid

<sup>418</sup> The HHI is a widely used measure of market concentration which is calculated by summing the squares of the percentages of a market as represented by each competitor. For example, 5 equally sized generators each contributing 20 percent of a market would result in that market having an HHI of 2000 (5 x 20<sup>2</sup>=2000). Federal agencies handling anti trust issues consider a market having an HHI of 1800 or more to be highly concentrated. While useful when handling competition among generators, it is often of limited use when dealing with interacting components (such as generation and transmission) where even a low HHI would not necessarily reveal monopolistic capabilities. <[www.energybuyer.org/glossaryGK.htm](http://www.energybuyer.org/glossaryGK.htm)> Assessed on 27/10/2007

<sup>419</sup> <[www.engineeringnews.co.za/article.php?a\\_id=96092](http://www.engineeringnews.co.za/article.php?a_id=96092)> Assessed on 23/10/2007

<sup>420</sup> Ibid

<sup>421</sup> Ibid

<sup>422</sup> Ibid

<sup>423</sup> Ibid

<sup>424</sup> Ibid

<sup>425</sup> Ibid

<sup>426</sup> Ibid

The final issue which should be considered is whether the requirement of the MPRDA is simply misplaced<sup>427</sup>. In essence; a prospecting right merely grants the holder a limited real right to search for the mineral which is subject to the prospecting right<sup>428</sup>. As the extent of the increase in mineral resources controlled by the applicant is unknown at the time of application there is insufficient information available to determine any impact on concentration<sup>429</sup>.

Another consideration is that, in the event that the prospecting is successful, this increases the mineral resource available<sup>430</sup>. Therefore with the exception of prospecting by the largest existing controller of mineral resources or its near competitors, prospecting will inevitably decrease market concentration<sup>431</sup>.

A decision regarding whether or not to decline a prospecting application where it results in the concentration of that mineral resource under the control of the applicant is not subjective<sup>432</sup>. The decision cannot be made on the basis of existing mineral rights held by the applicant alone and requires a consideration of economic and competition law principles as well as the determination of at least the relevant geographic boundary as well as the pre- and post-prospecting concentrations<sup>433</sup>.

It is not only necessary for the DME to develop policies, guidelines and procedures to ensure the fair application of the 'concentration' requirement in the MPRDA, but the requirement itself may need to be assessed in order to determine whether or not, in fact, it achieves the objectives of the MPRDA<sup>434</sup>.

The newly promulgated minerals rights legislation resulted in the Italian investors in Marlin Holdings Limited and Marlin Corporation Limited and Red Graniti SA (Pty) Limited announcing that their request for compulsory international arbitration against

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<sup>427</sup> Ibid

<sup>428</sup> Ibid

<sup>429</sup> Ibid

<sup>430</sup> Ibid

<sup>431</sup> Ibid

<sup>432</sup> Ibid

<sup>433</sup> Ibid

<sup>434</sup> Ibid

the South African government has been granted by the World Bank's International Center for the Settlement of Investment Disputes (ICSID) in Washington<sup>435</sup>.

The request, under the ICSID additional facility, arises out of the May 2004 entry into force of the MPRDA, which placed previously privately owned mineral resources under state custodianship<sup>436</sup>. The request has been granted and it encompasses a comprehensive statement of the investor's current and projected losses arising from this expropriation, and related damages, amounting to 266 million Euros<sup>437</sup>.

Marlin is part of the Luxembourg incorporated, but privately held, Finstone Sarl group, while Red is a subsidiary of Red Graniti Spa of Italy<sup>438</sup>. The two groups' combined operations employ some two thousand (2000) people<sup>439</sup>. The Finstone and Red groups are engaged internationally in the sourcing, quarrying, marketing and distribution of natural stone for the construction and monumental industries and are generally regarded as global leaders in their field<sup>440</sup>.

Both groups rely to a large extent on volume productions from their operations in SA, principally in the Rustenburg area<sup>441</sup>. Finstone has also invested heavily in the processing of natural stone into finished and semi-finished products in line with the South African government's policy of prioritizing beneficiation, particularly in respect of the countries rich mineral resources<sup>442</sup>.

The request for the international arbitration was made under South Africa's bilateral investment treaties (BIT's) with Italy and the Belgo-Luxembourg economic union<sup>443</sup>. Under the BIT's investors are entitled to "prompt adequate and effective" compensation for the expropriation of their South African investments, which must, in addition, be accorded "fair and equitable" treatment by South Africa<sup>444</sup>.

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<sup>435</sup> <[www.miningweekly.co.za/article.php?a\\_id=102969](http://www.miningweekly.co.za/article.php?a_id=102969)> Assessed on 23/10/2007

<sup>436</sup> Ibid

<sup>437</sup> Ibid

<sup>438</sup> Ibid

<sup>439</sup> Ibid

<sup>440</sup> Ibid

<sup>441</sup> Ibid

<sup>442</sup> Ibid

<sup>443</sup> Ibid

<sup>444</sup> Ibid, also refer to Chapter4 – page 34.

Moreover, the use and enjoyment of such investments under the BIT's must not be subject to "discriminatory" measures<sup>445</sup>.

In addition, under the proposed Mineral and Petroleum Royalty Bill, 2006, the investors will, from 2009, have to pay royalties on mineral rights which they previously owned<sup>446</sup>. The request points out that by extinguishing the ownership of the investors' South African mineral rights without providing prompt, adequate and effective compensation, the entry into force of the MPRDA constitutes an unlawful expropriation of their investments<sup>447</sup>. Likewise, the South African Mining Charter's forced divestiture of twenty-six percent of the investors' investments to historically disadvantaged South Africans (HDSA's), as a condition of the conversion of the investor's old-order rights to new-order rights under the MPRDA, constitutes a violation of the BIT's requirement that the investors receive "fair and equitable" treatment<sup>448</sup>.

The investors did not invest in South Africa prior to 1993 and are not signatories to the Mining Charter<sup>449</sup>. Their South African subsidiaries are likewise not members of the SA Chamber of Mines, which signed the charter on behalf of the mining industry<sup>450</sup>. In the investors view, as set out in the request, the Mining Charter discriminates against foreign investors in favour of HDSA's, and thus violates the BIT's equitable treatment requirements<sup>451</sup>. The investors have attempted since December, 2004, to reach an amicable settlement of their claims with the South African governments<sup>452</sup>. Despite extensive correspondence and numerous meetings with the government over an eighteen month period, involving the diplomatic intervention of the Italian and Belgian governments, no settlement has been reached, leaving the investors with no option but to refer the matter to ICSID for international arbitration<sup>453</sup>.

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<sup>445</sup> <[www.miningweekly.co.za/article.php?a\\_id=102969](http://www.miningweekly.co.za/article.php?a_id=102969)> Assessed on 23/10/2007

<sup>446</sup> Ibid

<sup>447</sup> Ibid

<sup>448</sup> Ibid

<sup>449</sup> Ibid

<sup>450</sup> Ibid

<sup>451</sup> Ibid

<sup>452</sup> Ibid

<sup>453</sup> Ibid

## 6.4 Corruption and its Effect on the Economy

Corruption is a general concept describing any organised, independent system in which part of the system is either not performing its duties as originally intended to, or performing them in an improper way to the detriment of the systems original purpose.<sup>454</sup>

Corruption has become an issue of major political and economic significance in recent years and the necessity to take measures against it has become evident.

It mainly affects the poorer nations such as Bolivia, Cameroon, Kenya, Nigeria, Bangladesh, etc.<sup>455</sup>

The early 1990's witnessed a proliferation of initiatives aimed at fighting corruption on national, regional and international levels.<sup>456</sup> Fighting corruption has engendered a high degree of international co-operation, leading to an armoury of international instruments such as the OECD's Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, and the Council of Europe's Criminal Law Convention on Corruption.<sup>457</sup>

In the long run, no country can afford the social, political or economic costs that corruption entails.<sup>458</sup>

It erodes public confidence in political institutions and leads to contempt for the rule of law; it distorts the allocation of resources and undermines competition in the market place; it has a devastating effect on investment, growth and development. Furthermore, corruption exacts a high price on the poor by denying them access to vital basic services.<sup>459</sup>

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<sup>454</sup> <[www.wikipedia.org/wiki/Corruption](http://www.wikipedia.org/wiki/Corruption)> Assessed on 25/04/2007

<sup>455</sup> <[www.oecdobserver.org/news](http://www.oecdobserver.org/news)> Assessed on 25/04/2007

<sup>456</sup> Ibid

<sup>457</sup> Ibid

<sup>458</sup> Ibid

<sup>459</sup> Ibid

## 6.5 What Corruption Entails:

Corruption involves the improper or illegitimate pursuit of self interest which is improper and therefore corrupt.<sup>460</sup>

It entails a transaction between a corruptor (the person who demands the 'service') and the corruptee (the person who supplies the 'service') that is in contravention of the law.<sup>461</sup>

Corruption exists because there is a supply and demand for this service.<sup>462</sup> Factors impinging on the supply of corruption would include the lack of income and alternative employment opportunities, the absence and/or poor state of detection and punishment mechanisms and the entrusting of significant discretionary powers to the corruptees.

## 6.6 The OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions:

The OECD Anti Bribery Convention is a convention of the OECD aimed at reducing corruption in developing countries by sanctioning bribery in international business transactions carried out by companies based in the convention member countries.<sup>463</sup> Its goal is to create a truly level playing field in today's international business environment.<sup>464</sup>

The convention came into effect in February 1999. Countries that have signed the convention are required to put in place legislation that criminalises the act of bribing a foreign public official.<sup>465</sup>

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<sup>460</sup> <[www.agrifood.info/connections](http://www.agrifood.info/connections)> Assessed on 25/04/2007

<sup>461</sup> Ibid

<sup>462</sup> Ibid

<sup>463</sup> <[www.answers.com/topic/oecd-anti-bribery-convention](http://www.answers.com/topic/oecd-anti-bribery-convention)> Assessed on 25/04/2007

<sup>464</sup> Ibid

<sup>465</sup> Ibid

The OECD has no authority to implement the convention but instead monitors implementation by participating countries. Countries are responsible for implementing laws and regulations that conform to the convention and therefore provide for enforcement.<sup>466</sup>

In Article 1 of the Agreement, bribery of foreign public officials is established as a criminal offence.

Article 3 imposes sanctions for those guilty of bribery in Article 1. It states that the punishment shall be comparable to the punishment imposed for nationals of the member country for the offence of bribery.

Article 5 states that the investigation and prosecution of the bribery of a foreign public official must be objective and not be influenced by any person.

Article 7 incorporates the offence of money laundering into the offence of bribery of a foreign public official.

Article 8 deals with the falsification of accounting records for the purpose of bribing foreign public officials or of hiding such bribery. It states that countries shall impose laws and regulations regarding those types of offences.

Article 9 deals with Mutual Legal Assistance. It states that the parties shall provide other parties with legal assistance if so requested for the purpose of criminal investigations and proceedings.

Article 10 makes provision for the extradition of those found guilty of the bribery of a foreign public official.

Article 12 deals with monitoring and follow-up. It states that the parties carry out a programme of systematic follow-up to monitor and promote the full implementation of the Convention.

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<sup>466</sup> Ibid

The remainder of the articles deal with miscellaneous provisions regarding administrative matters.

The Convention serves to provide for the enforcement of punishment for the offence of bribing a foreign public official in an aim to combat corruption.

The only shortcoming of such conventions and agreements is that it cannot be enforced into the municipal laws of all countries as it only applies to those members that are signatories to the Convention. This shortcoming serves as a hurdle in the fight against corruption especially in developing countries where it is rife.

### **6.7 The United Nations Convention against Corruption:**

This convention is closely related to the OECD convention. It, however, goes further into depth regarding corruption by providing more guidelines when dealing with the corruption of foreign public officials.

It deals with the corruption of national officials of member countries and also provides more guidelines regarding money laundering, the public and private sector, mutual legal assistance as well as all of the provisions dealt with in the OECD convention. The Convention is more comprehensive and provides more enforcement mechanisms when dealing with corruption.

Chapter III of the convention deals with Criminalisation and law enforcement. It goes further than the OECD convention in making provision for the criminalisation of not only bribery but also embezzlement, trading in influence, abuse of functions, illicit enrichment, bribery and embezzlement in the private sector, money laundering, concealment, obstruction of justice, participation and attempt. It also deals with the freezing, seizure and confiscation of proceeds and property derived from corruption. The protection of witnesses, experts and victims are made provision for. It also makes provision for the protection of reporting persons and also provides for the cooperation between members.

As with the OECD convention, the United Nations Convention is only applicable to those countries that are signatories to the convention. This is once again seen as a shortcoming in the fight against corruption.

The convention also deals with technical assistance provisions that aim at training the personnel responsible for the preventing and combating of corruption.

The multitude of provisions is more effective in the punishment of corruption than the OECD convention which makes it more efficient in the fight against corruption.

### **6.8 Corruption and Development:**

Developing societies and their people are not inherently more corrupt than developed ones. Yet, the argument is sometimes made that the lack of development opportunities automatically encourages corruption.<sup>467</sup>

From this perspective, economic growth and development create social opportunities that are of potential benefit to people so that they tend to engage in honest activity to sustain themselves.<sup>468</sup> A prospering economy can also afford to pay its civil servants well, reducing their motivation for corruption.<sup>469</sup>

In contrast, the despair caused by inequality and pervasive poverty may encourage people to break the rules of honesty and decency. Major development related aspects are land, educational opportunities and access to capital.<sup>470</sup>

Educational inequality often translates into broader income inequalities. People's earning power is affected by their low levels of education, whereas higher education levels empower some groups to lobby government more effectively to prioritise their particular needs and requirements.<sup>471</sup>

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<sup>467</sup> <[www.iss.co.za](http://www.iss.co.za)> Assessed on 25/04/2007

<sup>468</sup> Ibid

<sup>469</sup> Ibid

<sup>470</sup> Ibid

<sup>471</sup> Ibid

While none of these factors intrinsically lead to corruption; shortages of resources raise the stakes of competition for those resources that are available and slant the balance of power towards those with access.<sup>472</sup>

Such intense competition may encourage people with access to resources to use corrupt means to hold on to those privileges, or serve as an incentive for the deprived to use corrupt means to improve their own plight.<sup>473</sup>

Corruption cuts across international borders. Many cases of corruption reported in emerging economies involved corporations in the first world.<sup>474</sup> Transnational corruption, for example, is particularly rife in the arms trade. A United State's Commerce Department confidential annexe to a report on international bribery in July 1998, noted that half of the recorded corruption complaints involved arms sales.<sup>475</sup>

The ways of concealing foreign bribes are numerous. One often hears of companies effectively setting up bribery funds to buy favours from the governments of developing countries. For example, the Saudi Ministry of Defence officially bans commissions on arms contracts, but bribes have been channelled via obscure companies in Liechtenstein into Swiss accounts.<sup>476</sup>

Sometimes middleman companies are designated as local subcontractors for 'support' and are lavishly overpaid for their services. For example, middlemen pocketed US \$24 million on a \$1 billion deal for Bell Canada to modernise Morocco's telecommunications industry, despite the fact that the World Bank and the Canadian government were funding it on the condition that commissions were formally forbidden.<sup>477</sup>

Corruption jeopardises development in several ways. It distorts public spending in three ways: from shaping the official priorities of government, by deflecting allocated

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<sup>472</sup> Ibid

<sup>473</sup> Ibid

<sup>474</sup> Ibid

<sup>475</sup> Ibid

<sup>476</sup> Ibid

<sup>477</sup> Ibid

resources away from their original purpose and by undermining the tax base of the government.<sup>478</sup>

In some of the world's most notorious cases, the Philippines lost some 20% of internal revenue through corruption in the 1970's; around 10% of Nigeria's GDP and 25% of Zaire's went lost due to corruption.<sup>479</sup>

In South Africa under apartheid, contracts in the Department of Development Aid; and Education and Training were frequently awarded in nepotistic fashion rather than on the basis of merit.<sup>480</sup>

Because the poor have so little resources, their prospects of influencing the allocation of resources are limited by corrupt regimes.<sup>481</sup> Poor people become primary victims. They are denied services either because their resources are moved elsewhere or because corrupt payoffs make services unaffordable.<sup>482</sup>

In many cases, ill-structured projects, geared towards the wealth of corrupt officials and their co-conspirators, limit the number of jobs and opportunities that are created or cause these benefits of development to be allocated on the basis of favouritism.<sup>483</sup>

When bribery results in public officials turning a blind eye to key risks, the poor are often the ones who suffer the most.<sup>484</sup> Even in perfectly honest systems, public priorities are often shaped by the lobbying power of those with relatively more resources.<sup>485</sup> However, where corruption occurs, distortions become more routine and the public good is generally regarded as being of secondary importance.<sup>486</sup>

Corruption, therefore, is not a critical objective for all governments as many countries are not party to the conventions that deal with combating corruption. Many states

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<sup>478</sup> Ibid

<sup>479</sup> Ibid

<sup>480</sup> Ibid

<sup>481</sup> Ibid

<sup>482</sup> Ibid

<sup>483</sup> Ibid

<sup>484</sup> Ibid

<sup>485</sup> Ibid

<sup>486</sup> Ibid

enact anti-corruption legislation but that does not serve to dissuade public officials from participating in corrupt activities.

As long as there are people who make their self interest a priority, corruption will forever remain a hurdle that will cripple the economies of many nations especially having a profound impact on the economies of developing nations.



## **CHAPTER 7: CONCLUSION**

### **7.1 Conclusion**

South Africa's merger and acquisitions (M&A) environment is never dull, but in 2006, the market was considerably spiced up by the announcement of several major private equity transactions, with the largest of them having a combined value of over R50 billion<sup>487</sup>.

South Africa followed global trends by playing host to a significant increase in the value and volume of private equity deals<sup>488</sup>. According to research, global private equity reached an all-time high in activity levels, with 2354 deals being announced, and the total value increasing 172 percent to \$751 billion compared to 2005<sup>489</sup>. The main surge in private equity activity was due to historically low interest rates in many of the main regions; healthy credit markets that padded the wallets of takeover firms; and wider support from lenders, making it easier for these firms to raise capital for deals via debt<sup>490</sup>.

In the South African market, attention was focused sharply on private equity when a number of different consortiums made a bid for Shoprite, Consol, Alexander Forbes and Edcon<sup>491</sup>. The details of the Edcon offer were only made public after the end of the calendar year<sup>492</sup>. Putting the four deals together the combined price on offer from their private equity suitors is about \$53 billion, or roughly 1 percent of the market capitalisation of the JSE Ltd's main board<sup>493</sup>.

Private equity firms have become popular solutions for company management teams entrusted with growing the businesses and providing sustainable value for the owners<sup>494</sup>. The opportunity arises for private equity firms when they see a gap

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<sup>487</sup> <[www.ey.com/global/content.nsf/South\\_Africa/28\\_Feb\\_07\\_Private\\_Equity](http://www.ey.com/global/content.nsf/South_Africa/28_Feb_07_Private_Equity)> Assessed on 29/10/2007

<sup>488</sup> Ibid

<sup>489</sup> Ibid

<sup>490</sup> Ibid

<sup>491</sup> Ibid

<sup>492</sup> Ibid

<sup>493</sup> Ibid

<sup>494</sup> Ibid

between the markets valuation and their estimation of the real worth of the business<sup>495</sup>. This 'value gap' is exploited by gearing the companies that are taken private and investing considerable time and energy in changing them to make them more efficient and profitable<sup>496</sup>.

The key attributes of a private equity-worthy business include a respected management team, strong market share in a stable but not mature industry, robust cash flows and a well thought out strategy<sup>497</sup>. In a typical private equity transaction, the new shareholder will put debt into the balance sheet to make it more efficient and will ensure that management actions are aligned with the objectives of the new owners<sup>498</sup>. This is accomplished by bringing managers on board as co-owners<sup>499</sup>.

South Africa's domestic private equity firms may face some still competition from the biggest names in the business, with healthy speculation that a number of foreign are considerably establishing a presence in South Africa<sup>500</sup>. Many of the world's largest private equity firms are increasingly looking at merging markets like South Africa for a number of reasons<sup>501</sup>. The value gap in their traditional markets has narrowed considerably, especially as management and shareholders become more aligned; developed markets are becoming 'fished out' with many of the best targets already identified; numerous opportunities exist in non-traditional markets and institutional funders of private equity are giving takeout firms broader mandates to invest in emerging economies<sup>502</sup>.

Private equity, which was a bit of a Cinderella for many years, has come of age<sup>503</sup>. And it is a trend that is likely to continue as long as the value gap remains attractive<sup>504</sup>.

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<sup>495</sup> Ibid

<sup>496</sup> Ibid

<sup>497</sup> Ibid

<sup>498</sup> Ibid

<sup>499</sup> Ibid

<sup>500</sup> Ibid

<sup>501</sup> Ibid

<sup>502</sup> Ibid

<sup>503</sup> Ibid

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