

# THE INTERRELATIONSHIP BETWEEN THE SOUTH AFRICAN PRIVATE EQUITY INDUSTRY AND BLACK ECONOMIC EMPOWERMENT

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## Abstract

This paper investigates the relationship between the South African private equity industry and government's black economic empowerment (BEE) legislation. As the private equity industry of South Africa was formalised only in 1999, literature and data regarding the industry is limited. The research is therefore more qualitative in nature, and is based on a combination of media and journal articles, domestic as well as global surveys, personal communication with experts in the industry and other relevant research. The study suggests that the need to earn black economic empowerment credentials is one of the major driving forces behind the growth experienced in the South African private equity industry, and at the same time this growth leads to an accelerated BEE transformation process, resulting in an interrelationship between the industry and BEE.

**Keywords:** private equity, South Africa, economic legislation

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## Introduction

BEE is one of the most frequently used phrases in South Africa and has increased in popularity during the last few years. According to the government's BEE strategy document (2003: 4), South Africa requires an economy that can meet the needs of all its economic citizens in terms of people and their enterprises, in a sustainable manner. Government's objective is to achieve this vision of an adaptive economy characterised by growth, employment and equity by 2014. A BEE scorecard was developed to determine the extent to which an enterprise complies and supports government's BEE strategy. The scorecard is used to rank and categorise enterprises according to their level of compliance for the purposes of future governmental support. Equity ownership and enterprise development are two core components of the scorecard, and aggregates to 40% of the total score.

Private equity provides equity capital to investors or companies that are not listed on a public stock exchange. South Africa's private equity Industry was formalised in 1999 (KPMG and SAVCA, 2000: 5) and experienced substantial growth since then. In terms of total funds under management, an increase of almost 40% was experienced since 1999, while the annual amount invested in private equity deals show growth of approximately 145% during the same period. Some of the uses of private equity include starting up new enterprises, developing new businesses, growing and expanding existing companies as well as acquiring equity ownership of a business. These uses are directly in line with two of

the BEE scorecard components namely equity ownership and enterprise development.

## Objective and outline

The objective of this paper is to determine whether companies and investors are using the private equity industry as a vehicle to become BEE compliant, leading to the substantial industry growth experienced, and the effect thereof on the BEE transformation process.

This objective will be addressed by first looking at BEE, followed by the definition of private equity, the history of the industry and the growth in South Africa's private equity industry since it was formalised in 1999. The interrelationship between BEE and the private equity industry will be explored next while the last two sections will address the managerial implications of this interrelationship and the concluding remarks.

## 1. Black Economic Empowerment

One of the objectives of the South African government is an economy that meets the needs of all the economic citizens in a sustainable manner (DTI, 2003: 4). Subsequently, government has outlined broad economic strategies to transform the economy by 2014. Government's BEE policy forms an integral part of this strategy.

Black Economic Empowerment is the empowerment of all black people, meaning all Africans, Coloureds and Indians who are South African Citizens, including women, workers, youth,

people with disabilities and people living in rural areas, through diverse but integrated socio-economic strategies (DTI, 2003: 4). In addition to this definition, it is also defined as an integrated and coherent socio-economic process that directly contributes to the economic transformation of South Africa and brings about significant increases in the numbers of black people that manage, own and control the country's economy, as well as significant decreases in income inequalities (DTI, 2003: 12).

According to the BEE strategy document (DTI, 2003: 12) government aims to, *inter alia*, increase:

- i. the number of black people who have ownership and control of new and existing enterprises;
- ii. the number of new black owned enterprises (where more than 50% is owned and controlled by black people), black empowered enterprises (where more than 25% is owned by black people) and black influenced enterprises (where between 5% and 25% is owned by black people)

In order for the government's BEE strategy to be implemented successfully, it is necessary for them to form partnerships with the private sector (DTI, 2003: 14). One form of such a partnership is sector- and enterprise-based charters. Such charters should include detailed methods of achieving BEE objectives in that specific sector or enterprise as well as measurement indicators and targets. Government's BEE scorecard, which was developed to measure the extent to which an enterprise or sector complies with and supports their BEE strategy (DTI, 2003: 14 – 15), should be used as a guideline in the development of a charter. Therefore a sector charter can be seen as a refined BEE scorecard, outlining the strategy to be followed by the specific sector in becoming BEE compliant as well as measurement indicators to determine the progress thereof. The scorecard will be

used to measure each enterprise within the specific sector who is a signatory to the charter. Using the scorecard as a guide, government will rank and categorise enterprises for the purposes of preferential procurement, restructuring of state-owned enterprises, financing and other kinds of support (DTI, 2003: 14-15).

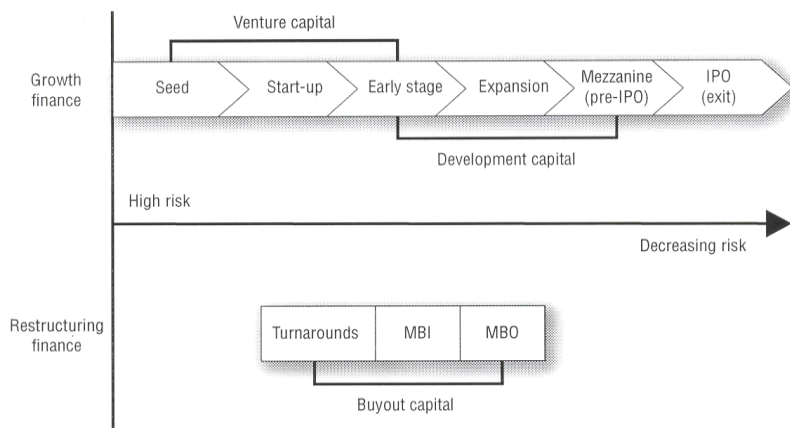
In August 2002, the financial sector committed itself to the development of such a BEE charter. The Financial Sector Charter (FSC) was released on 17 October 2003. A scorecard was developed to measure financial institutions' BEE progress. Equity ownership, enterprise development and empowerment financing are core components of the FSC scorecard. Therefore the extent to which an institution has encouraged these components will be measured and used by government and the private sector in the negotiation and awarding of contracts to the financial institution.

## 2. Private Equity

### 2.1 Defining Private Equity

Private equity provides equity capital to investors or companies that are typically not quoted on a public stock exchange (KPMG and SAVCA, 2005: 8). The uses of private equity include the financing for the development of new products and technologies, expanding working capital (a company's current assets minus its current liabilities), making new acquisitions, strengthening a company's balance sheet and the buy-out or buy-in of a business. Additionally it is used to resolve ownership and management issues and for the succession in a family owned business (KPMG and SAVCA, 2005: 8). The definition can further be refined by categorising private equity finance into different stages. Graphically these stages can be presented as follows:

Figure 1



(Abbreviations used in the figure refer to initial public offering (IPO), management buy-ins (MBIs) and management buyouts (MBO).)

(Source: Nieman, Hough and Nieuwenhuizen, 2003)

According to KPMG and SAVCA (2000: 4) Venture Capital refers to the type of equity capital

that is used to start up a new enterprise (i.e. seed capital, which refers to the initial equity capital that is

used to start a new business). It can also be used for the development of those companies that are in their infant or early stage. Equity capital used for expanding a business is known as development capital, which is the next stage of private equity investment. The capital provided to a management or empowerment partner that is used to acquire a business from its existing owners, or to purchase existing shares in a company from other shareholders is called buy-out capital. An “exit” refers to the method by which a private equity fund manager intends to get out of an investment that he or she has made. Examples of an exit include an initial public offering (IPO), where the firm sells its stock to the public for the first time, resulting in the end of the private equity cycle for the specific firm, or where the manager is being bought out by another player in the industry.

**2.2 History of Private Equity**

The earliest form of organised and professionally managed investments in the private equity market was perhaps when the American Research and Development Corporation (ARD) was formed during 1946 in the United States of America (USA) (Hsu and Kenney, 2004: 3). ARD’s focus was on the formation and development of new businesses. The market was sceptical of private equity as a new asset class, resulting in ARD’s stock constantly trading at a discount to its net asset value. During the 1950’s and 1960’s, the US Congress introduced legislation to

encourage the development of small businesses, but without much success (KPMG and SAVCA, 2004: 9). It was only with the increase in the market for IPOs in the late 1960’s that venture capital investments resulted in significant profits. During the 1970’s, many of these venture capital firms began financing buy-outs of divisions of large companies, and regulatory and tax changes allowed USA pension funds to invest in private equity (KPMG and SAVCA, 2005: 9). The 1980’s and 1990’s experienced continued growth in the USA private equity industry.

The success in terms of growth achieved by private equity funds in the USA has resulted in the development of professional private equity firms throughout the rest of the world, including South Africa. The private equity industry was formalised in South Africa with the constituting of the Southern African Venture Capital and Private Equity Association (SAVCA) in 1999. The industry has shown significant growth since then.

**2.3 Growth in the South African Private Equity Industry**

According to PWC’s global rating (2005: 9-11), South Africa’s private equity industry was ranked 15<sup>th</sup> based on annual amount invested, which consists of new as well as follow-on investments (i.e. where first-round investments has already been made). In terms of compound average growth rate South Africa was ranked 9<sup>th</sup>. Table 1 represents the top 20 countries in each respective category.

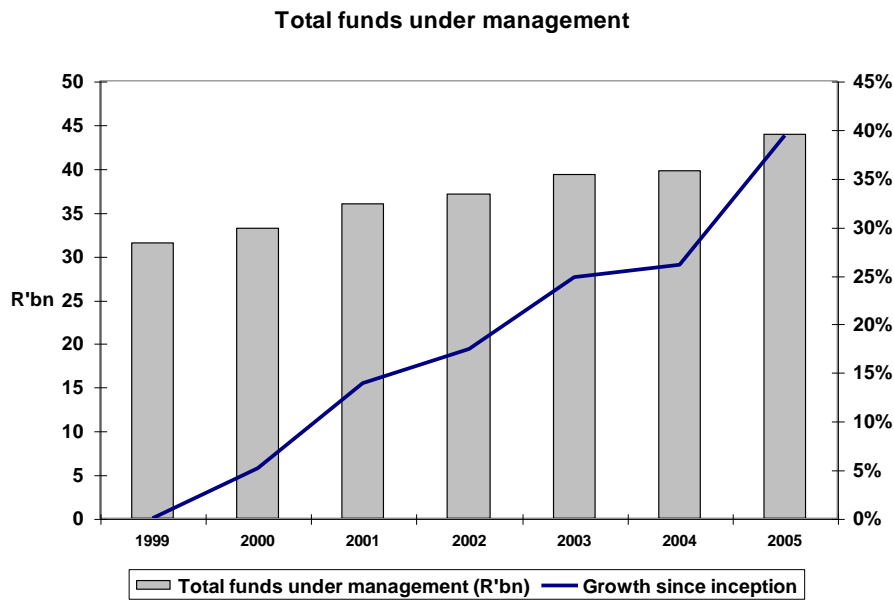
**Table 1**

Rank	Amount Invested	Compound Average Growth
1	USA	Pakistan
2	United Kingdom	Denmark
3	Japan	India
4	France	Malaysia
5	Germany	Sweden
6	Spain	Japan
7	Australia	Australia
8	China	Spain
9	Netherlands	South Africa
10	Sweden	France
11	Italy	Singapore
12	Korea	United Kingdom
13	India	Korea
14	Singapore	Israel
15	South Africa	Germany
16	Israel	Norway
17	Canada	China
18	Malaysia	Netherlands
19	Denmark	Italy
20	Pakistan	Switzerland

(Source: PWC, 2005)

Figure 2 illustrates the growth in funds managed by South African private equity fund managers since inception (1999).

**Figure 2**

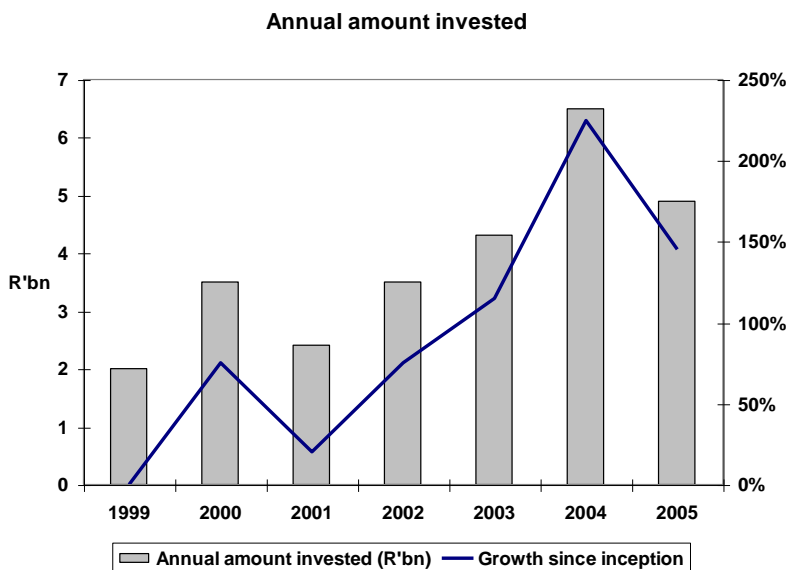


(Data source: KPMG and SAVCA 2000 and 2005)

On 31 December 2005, total funds under management amounted to R43.9 billion (KPMG and SAVCA, 2005:13), an increase of almost 40% since

1999. The annual amount invested in private equity funds increased with approximately 145% from 1999 to 2005 as can be seen from figure 3.

**Figure 3**



(Data source: KPMG and SAVCA, 2000 and 2005)

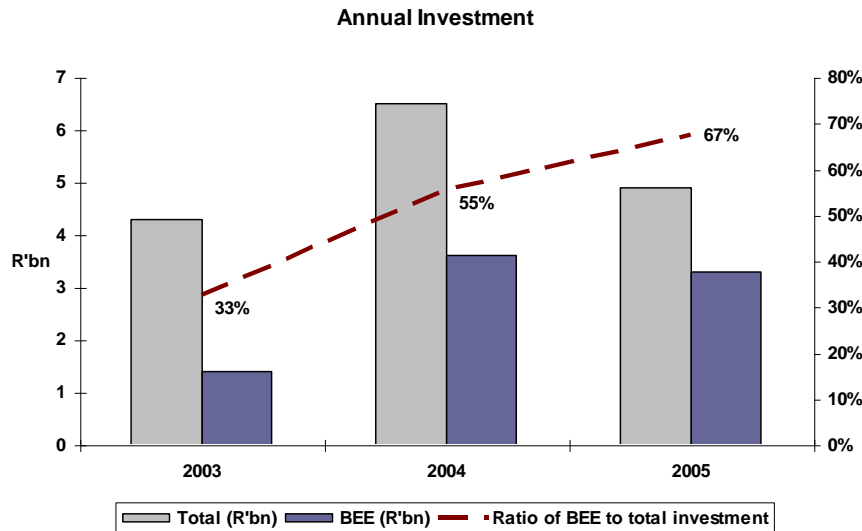
Compared with the steady growth in funds under management (Figure 2), Figure 3 shows more variance in growth of the annual amount invested in private equity funds. The steep increase from 1999 to 2000 was mainly due to the growth in the value of large buy-out transactions (KPMG and SAVCA, 2000: 13). Due to tough market conditions and the uncertainty in the markets, especially after September 11<sup>th</sup> a decrease was experienced in 2001 (KPMG and SAVCA, 2001: 17). Steady growth was experienced

during 2002 and 2003 as market perceptions started to recover. During 2004, an increase of approximately 60.5% was experienced in the annual amount invested in private equity funds, representing the largest annual increase since the formalisation of the industry in 1999. During 2005 a decrease of around 24% was experienced which may be ascribed to the cyclical nature of private equity investments, and/or a lack of quality investment opportunities (Fourie, 2006). The cyclical nature refers to the average length of time a

typical investment is held, which is between 3 to 4 years in South Africa (Schindehutte, 2000: 71). Since inception of the private equity industry however, an increase of approximately 145% was experienced in annual amount invested.

R3,3 billion of the annual investments made during 2005 was towards black-influenced, -empowered and -owned companies (KPMG and SAVCA, 2005: 41). This is an increase of more than 135% relative to 2003. Figure 4 shows BEE-investments made since 2003 as a percentage of total annual investments.

**Figure 4**



(Data source: KPMG and SAVCA 2005)

Figure 4 indicates that almost a third (33%) of the total private equity investments made during 2003 was BEE-related. This number increased to 55% during 2004, followed by a further increase to 67% in 2005, indicating that more than two thirds of all private equity investments made during that year were BEE-related.

Drawing from these results, it appears that the major driving force behind the steep increase in private equity investments experienced since 2003 was the increase in BEE-related investments. This view that BEE has a major influence on the private equity industry especially during the last three years is also supported by Bent, Williams and Gilbert (2004: 43). From their research on the syndication of private equity investments in South Africa (which refers to the situation where two or more firms participate in an investment opportunity), BEE proved to be an important reason for syndication, therefore contributing to the increase in private equity investments. But what is the driving force behind the increase in BEE specific related private equity investments?

### 3. BEE related Private Equity Investments

One would expect that an increase in an investment in any specific asset class is directly correlated to the expected performance of that asset class. By definition private equity firms invest in private companies. Therefore there is no public information available to help set the valuation of the companies in

which the private equity firms have invested. This makes it very difficult to determine a fair value for the firm invested in, implying that the private equity fund's reported expected returns are very subjective. This view is supported by the Center for Private Equity and Entrepreneurship (2003: 3) as well as KPMG and SAVCA (2004: 34). Therefore further research (which is beyond the scope of this paper) has to be conducted in order to determine the extent to which expected returns influence the increase in BEE related private equity investments.

The FSC scorecard was released late 2003 and is used to measure a participating financial institutions' BEE progress. As mentioned earlier, equity ownership, enterprise development and empowerment financing are core components of the FSC scorecard. The scorecard results, based *inter alia* on the progress and encouragement of these components, will be used in decision making regarding future governmental support and private sector contracts awarded to the specific institution. According to the definition of private equity, the uses of private equity include the financing of equity ownership (buyout capital), enterprise development (venture and development capital) and empowerment deals (buyout capital). Therefore it appears that the private equity industry provides a convenient vehicle for enterprises and investors to become BEE compliant, resulting in higher FSC scores enabling them to participate in the accompanying benefits. Due to this reason, an increase was (and still is) experienced in private equity investments with fund managers who are

themselves black empowered, investments in empowerment deals through a private equity fund manager and companies approaching private equity firms in need of appropriate BEE partners (SAVCA, 2005: 41 – 45; “Private Equity”, 2005:7). It therefore emerges that earning empowerment scorecard credits must be one of the main drivers behind the increase in BEE related private equity deals, resulting in the substantial growth experienced in the industry. Furthermore, as the investments are primarily made to earn BEE credentials, it is at the same time accelerating the BEE process due to the increased amount of funds exclusively available for supporting government’s BEE strategy.

Up to now we have shown that the growth in the private equity industry is mainly due to investors becoming more comfortable with private equity as an additional asset class and more recently due to the increase in BEE related private equity investments. Furthermore, we have noted that the increase in BEE private equity investments has an accelerating effect on the BEE process, indicating the existence of an interrelationship between BEE and the private equity industry. Next we will examine the implications of this interrelationship.

#### **4. Managerial Implications of the Interrelationship**

It might seem obvious that the interrelationship in the form of a simultaneous growth in the private equity industry and acceleration in the BEE process could only be beneficial to companies, investors and the government. However, managerial decisions such as increasing a portfolio’s exposure towards BEE private equity investments or approaching a private equity fund manager in need of an appropriate BEE partner should not be isolated from certain facts. The first is that to date there is no clear policy as to the extent to which the empowerment credentials of a company invested in by a private equity fund manager transfers back to the investee company (i.e. the original “investor”) (“Private Equity”, 2005: 7). Secondly, private equity normally has a short duration of its investment time span (“Private Equity”, 2005: 7). Typically after approximately 3 to 4 years (Schindehutte, 2000: 71) the fund manager will be looking at an exit. If a fund manager cannot find another BEE partner to take up its stake, the target company will lose its BEE credentials (“Private Equity”, 2005: 7). Therefore a BEE partnership via a private equity deal might be seen as a short term solution rather than a strategic move towards BEE compliance. Thirdly, the huge number of Private equity firms starting up to take advantage of the growth experienced might be an early sign of a bubble, i.e. a rapid expansion followed by a contraction developing in the private equity industry (“Private Equity”, 2005: 7). This implies that although the private equity industry is looking very healthy at the moment, caution should be taken when increasing

your investment exposure towards this asset class, as the safeness of such an investment will depend on the maturity of the industry.

Even though the above matters might pose a risk in future to investors wanting to invest in BEE private equity deals and companies looking for BEE partners via the private equity industry, the reality is that the industry is currently experiencing substantial growth, making it an attractive asset class to invest in and a comfortable method of finding an appropriate BEE partner. What makes this strategy even more attractive is that it can currently be done under the umbrella of becoming BEE compliant.

#### **Conclusion**

BEE forms an integral part of the South African government’s objective of transforming the economy into one that meets the needs of all the economic citizens in a sustainable manner. A major objective of BEE is to increase the number of black people who have ownership and control of new and existing enterprises, the number of new black owned enterprises, black empowered enterprises and black influenced enterprises. Partnerships are formed between the government and the private sector in order to implement this strategy successfully by 2014. This partnership includes the development of scorecards to determine a firm’s progress and support in terms of government’s BEE objectives. The score will be used by government to determine the level of future governmental support and by the private sector in managerial decision making regarding future contracts awarded to the specific firm. Equity ownership and enterprise development are two core components of the scorecard.

The South African private equity industry was formalised with the constituting of SAVCA in 1999. Private equity provides equity capital to investors or companies that are typically not quoted on a public stock exchange. The uses of private equity include the financing of equity ownership, enterprise development and empowerment deals, all of which are directly correlated with some of the core components of the BEE scorecard. The industry has shown substantial growth in terms of funds under management (approximately 40%) and annual amount invested (approximately 145%) since 1999.

This article has shown that this significant increase, especially during the last three years, is mainly due to the increase in BEE related private equity investments, which in turn is largely driven by the firm’s need to earn BEE credentials in order to improve its score. The increase in BEE related private equity investments at the same time accelerates the BEE process, indicating the existence of an interrelationship between BEE and the private equity industry. Although it is noted that there are a number of inconclusive aspects regarding the benefits of investing in BEE private equity deals in order to become BEE compliant, the industry is currently

providing a creative way of supporting the transformation process through this strategy.

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