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The Succession Fund for South Africa

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Project Background

This project is a funding effort of the Swiss Federal Office for Foreign Economic Affairs through trust funds administered on its behalf by the International Finance Corporation IFC). The purpose of this project is to conduct the second feasibility study for IFC's South Africa Succession Fund.

Innovative Ventures conducted the pilot study in March 1996. We concluded a market need and investment opportunity exists for the IFC strategy of a Succession Fund; a private equity investment fund that finances the purchase of minority stakes in white-owned businesses by black managers and other members of previously disadvantaged groups (PDGs). The appendix contains this report.

Project Organization

The purpose of this second study is to conduct a more detailed look at the market in South Africa:

1. Define the investment opportunity for the Fund and characteristics of market niches for investment.

2. Recommend a dollar capitalization for the Fund based on the market size and availability of transactions. Identify sample investments and their valuations to demonstrate the financial merit of the Succession Fund.

3. Propose off-shore fund structures that provide limited liability and tax neutrality to institutional and bilateral investors in the Succession Fund.

4. Identify domestic private equity investors as possible managers of the Succession Fund.

Innovative Ventures gathered information from knowledgeable sources of the South African investment market including:

- Investment bankers & brokerage firms that raise capital for private placements, domestic and international cross-border investments, mergers and acquisitions;
- Domestic & international investors and fund managers;
- Black entrepreneurs and corporate managers;
- Accounting and legal advisors to South African SMEs and private equity funds; and
- Development finance and industrial development institutions.

Pages 17-18 lists sources of information for this project.

The Investment Opportunity for the Succession Fund

A well-defined market exists for the IFC strategy of a Succession Fund. The objectives of the Fund are to generate investor rates of return and advance black empowerment in South Africa. Innovative Ventures recommends the Succession Fund be capitalized with US$30MM and structured as a ten (10) year fund with a two (2) year extension. Compensate fund managers with a 2% management fee and a 20% carried interest.

Market gaps and financial opportunities exist for the strategy of a Succession Fund due to:

1. Domestic investors' attitude and appetite for risk, their strategic focus for large transactions of R20MM+ which leaves middle market SMEs underserved and underfinanced;

2. The need for white-owned firms to diversify their shareholding and integrate PDGs into the management structure of the corporation. This action is necessary to exploit emerging opportunities as a result of political influences on business in South Africa;

3. New growth opportunities created as South Africa continues its economic transformation.

Market changes since the March 1996 mission

1. Blind pool funds raised over R1.25 billion of equity supplemented with R1.4 billion in debt for leveraged transactions. This success demonstrates the confidence institutions have for South Africa. Investors in these funds include CALPERS, New York State Employees Retirement Fund, Hancock Venture Partners, Donaldson Lufkin & Jenrette (DLJ), and numerous South African institutions. Anglo-American (South Africa) and Mitsubishi (Japan) capitalized a third party managed, US$25MM corporate technology fund.

   This increase in supply has not come at the expense of more competition or higher prices chasing transactions. In fact the South Africa market remains underfinanced and underserved; the two largest private equity investors competed on only two deals the past 12 months in the deal size of R20MM+, the niche targeted for this new capital. Increase in supply of money is stimulating more deal flow and entrepreneurial activity in all segments of the South Africa economy. The Succession Fund will be a beneficiary of this deal flow.

2. Recognition that much asset transfer to PDGs is enrichment not empowerment, and such transfers are seeding resentment in corporate South Africa. Corporate executives, company founders, investors and the infrastructure are actively seeking empowerment alternatives; solutions to integrate PDGs into the management and decision making process of companies, train them so they are net contributors to the prosperity of the organization, and establish the compensation structure to reward accountability and value-added. Such outward thinking is stimulating new black empowerment solutions for investors and their portfolio companies to access. Innovative Ventures integrated these ideas into the black empowerment strategy as presented in this report.

Why Not a Venture Loan Scheme as the Succession Fund

In the first study, Innovative Ventures concluded that a market exists for financing SMEs with capital needs of R1MM-R5MM (US$200,000-US$1MM) structured as venture loan and royalty based investments. This was the original niche as conceived by IFC after it conducted exploratory studies.

While a market certainly exists for venture loan schemes as evidenced by IFC's self-managed Africa Enterprise Fund, it is premature to capitalize a venture loan fund structured as a blind pool for investment in the R1MM-R5MM for the following reasons:

1. SMEs in this niche are too small to leverage investor money into multiples of sales and profits since they serve local and regional markets with undifferentiated products that offer little competitive protection. Moreover these companies lack the depth and breadth of management and operating

structures since their growth prospects do not require nor generate the cash needed to pay the costs of multi-tier management.

Investment in this segment of the market exposes IFC and other investors to too much risk with too little financial return. Equity or venture loan schemes have more potential to produce the financial IRR that IFC demands once SMEs in this market and its infrastructure develop as a result of economic growth in South Africa.

2. Other investment products in the South Africa market generate the equity-like IRR and the other advantages of venture loan and royalty based schemes, but without their corresponding disadvantages. Furthermore, venture loan structures are little used in South Africa (except IFC through AEF), and such hybrid structures require considerable education to achieve SME adoption and the deal flow turnover required of a limited life, blind pool venture loan fund.

   The South African investment market is sophisticated with lenders, investors and financial intermediaries rapidly catching up to their counterparts in North America and Europe. They have tailored financial products and structures to local conditions that shield investment returns from the onerous tax regime imposed in South Africa. Executed as medium term financing (3-5) years at prime + 2%-4% (prime @ 20%), these products yield the cash flow IRR of venture loans.

   Shareholder loans secured with assets are the deal structure of choice since they provide maximum protection and tax shelter to investors. Investors transact deals with layers of shareholder loans as senior debt, junior debt, and convertible debt with preference shares. This convertible debt acts like equity since there is no obligation on the investee company to pay interest or principal.

   The Reserve Bank of South Africa regulates royalty agreements and rates levied. Historically used in the transfer of technology and use of know-how, uncertainty exists if the Bank would approve their use:

   - In investment schemes;
   - With the higher rates required in financing structures to generate investor rates of return; and
   - Allow their off-shore distribution as tax-free returns.

   In the final analysis, financial products and deal structures used in the Succession Fund are dependent on the needs and circumstances of each SME, and the judgment of the manager selected to operate the Fund.

The Market for the Succession Fund in South Africa

The Need

Companies in South Africa suffer from a lack of long-term capital. Only the largest and most creditworthy are able to raise public or private equity to finance expansions or asset transfers like MBOs and MBIs.

Middle market companies can’t access these sources of money, which limits their growth rates to combinations of retained earnings, bank overdrafts, and guarantees on personal assets. Yet, these companies have the turnover, skill in management, and competitive advantage to generate equity rates of return for the Succession Fund.

Middle market companies are the sector of the business economy where black empowerment is most active since strong business reasons exist for integrating PDGs into the ownership and management structure of the white-owned business. Moreover, white executives are taking the initiative to consummate these transactions, rather than marriages being forced upon them. This willingness increases the probability that marriages will survive the inevitable ups and downs of personalities and economic change as the fabric of South Africa business transforms to reflect the 85% PDG population. This is the market segment where the Succession Fund can have the greatest impact on black empowerment.

The middle market consists of companies with investment needs of R5MM-15MM per transaction to effect expansion plans, and consummate small asset transfers like MBOs and MBIs where use-of-funds includes business expansion. IFC achieves several objectives by financing middle market companies.

1. <u>Earn commercial rates of return</u>.

   Investors' historic rate of return in the middle market is 30% compounded IRR, net of fees. Investors universally stated that 25% compounded IRR net of fees is achievable when the objective to earn commercial rate of return is integrated with a mission to promote black empowerment.

2. <u>Catalyze an investment infrastructure that is underserved and underfinanced</u>.

   SMEs in the middle market financing niche have annual turnover of R5MM to R100MM. It is estimated that 5000 companies in this niche seek capital in the range of R5MM-R15MM to affect growth plans.

   There are several reasons for the lack of long-term capital for SMEs.

   a. Large corporates dominate economic growth, and their unbundling of assets created a pipeline of large (R20MM+) buyout deals for private equity investors. Purchased with <u>medium-term cash</u> & tax driven financing, these transactions rewarded investors with superior IRR (35%+). These unbundlings dominate deal flow, and most of the new money raised in local mega-funds is to finance such large leveraged transactions (and privatizations). FirstCorp Investors raised R750MM from American investors and DLJ Pleide recently closed an R1billion fund, R400MM in equity with R600MM of senior debt sourced through NBS Bank and the African Bank. Investors consummate R500MM-R1billion of large leveraged transactions each year.

   b. South African corporates funded R&D and business start-ups with excess cash since restrictions prohibited the investment of capital off-shore. Consequently, investors never developed the risk management skills to fund transactions independent of the security and shelter of corporations. When capital is available to middle market companies, it is short-term and expensive, limited to small amounts, and requires the asset and personal guarantees of the company and entrepreneur.

   c. The history of South Africa shaped the risk attitudes of domestic investors, and this memory affects investment structures, length of investment, terms and conditions. Event risk still dominates the mind of private equity investors, even though conditions that fostered such thinking are much reduced. Event risk is a one-time happening with potentially catastrophic effects on the economy. Examples include a Mandela assassination attempt, a miners' strike that reduces gold production or a drought.

This fear haunts investors' attitude and appetite for risk. Private equity investors limit investment maturity to 3-5 years, and seek the comfort of large MBOs and MBIs. They structure transactions with layer upon layer of senior, junior, cash flow, and subordinated debt with lenders giving co-investors a second, third and fourth charge on assets to secure the investment (or create a false illusion of comfort). Financings include small amounts of preference shares. Security is taken on personal assets when a shortfall exists.

Only the strongest and fewest of companies can support such financial structures. This leaves good quality but abet smaller companies scrambling for growth capital.

Although seed and early stage financing are outside the strategy of the Succession Fund, strong need and demand exist for such a fund in South Africa. Seed and early stage financing does not exist in the country as a formal institution, e.g., as in North America or West Europe. Early stage financing is provided by corporations (for internal projects), wealthy individuals and families (for new ventures). This lack of capital extends from the seed capital segment through and including second stage financing; third stage financing is next to impossible to secure. Reasons cited for this lack of capital are:

- Shortage of entrepreneurial talent to grow new businesses;
- South Africa is a small domestic economy with limited opportunities to create fast growth companies; and
- South Africa is in poor proximity to viable export markets.

Economic growth will overcome these barriers. Professional advancement in corporations for black executives is resulting in white managers leaving for entrepreneurial and greenfield opportunities; talented managers creating an entrepreneurial pool for new ventures reduces the investment risk of early stage funds.

Innovative Ventures recommends that IFC monitor the evolution of early stage SMEs and the infrastructure serving it. Signs that demonstrate the development and timeliness of this niche for an early stage fund include:

- Increase in the number of early stage proposals financed by private equity investors with debt provided by banks in South Africa. Increase in the rejection of quality proposals by investors due to the inability to invest capital without violating their investment diversification guidelines, e.g., not more than 10% of capital invested in the early stage company sector.

  Sources for information include the general partners and senior staff of Capital Partners and the Franchise Fund. Other resources include FirstCorp, SBIC, IDC, Horizon Equity, Umbono Investments and First Africa Holdings. Innovative Ventures suggests that IFC meet with these investors twice a year to discuss the development of the early stage investment niche. The appendix lists names and contact numbers of these funds.

- Growth in services offered to the seed, start-up and early stage company sector from the business community and infrastructure in South Africa.

In the United States for example, accounting, legal and consultant firms established specialized practices to serve the unique needs of growth companies and their suppliers. Universities and specialist firms complement advisors by serving the executive recruiting, information and networking needs of early stage companies.

Company creation in regions like Silicon Valley and Boston's Route 128 resulted from the combined efforts of entrepreneurs and the infrastructure. Just as the West European and Asian early stage company sector developed differently than it did in the U.S., so it will in South Africa; the country's history and economy govern new business formation.

South Africa will adopt similar strategies to stimulate new businesses. IFC should look for the offering of these services and programs as evidence of a growing market of early stage companies and the support networks to assist SMEs.

- Changes in the enabling environments that encourage more SME investing, e.g., pro-small business strategies of municipal or the federal government, tax write-offs or credits granted to investors for investing in growth companies, or liberalization of the Johannesburg Stock Exchange to improve access and liquidity.

Monitoring infrastructure development and the enabling environments is logistically too difficult to implement for a Washington-based IFC project manager. A solution is to assign this task to the IFC resident mission in Johannesburg with quarterly updates to headquarters.

IFC should not adopt a hands-off or a wait-and-see attitude to the development of the early stage company market. It can proactively accelerate its growth by advocating investment tax and SME incentives to government, and supporting the infrastructure through seminars and conferences (possibility with assistance from the World Bank).

3. <u>Create additionality in black empowerment</u>.

The Succession Fund can impact black empowerment in two ways:

a. Provide capital so businesses consummate more transactions with black empowerment;

b. Support the costs of training tomorrow's black business leaders and middle managers.

Businesses lack black senior staff as successors and integral members of the management team. Firms must diversify and broaden their shareholder base to remain viable in the new South Africa through ownership transfer to PDGs or recruit new black managers.

Large corporates attack this need by selling equity stakes in enrichment transactions, and employ black managers to fill positions. Because there are so few trained and qualified black managers in South Africa, new positions created are on the periphery of the decision making process; these employees are excluded from making mainstream contributions. When qualified blacks are found and recruited, many take advantage of the shortage and jump from one company to the next with ever-increasing salary and perks.

Middle market companies are too leanly staffed to hire ‘window dressing’ or afford the cost to bid for talent. Their strategy of black empowerment is to:

- Sell ownership stakes and/or hire when it makes business not political sense, and the new shareholder can make a contribution to the company;
- Integrate individuals into the firm from the acquiring entity as long as they agree to professional development and training as a subordinate;
- Develop black talent in-house leveraged with formal training;
- Promote individuals as they demonstrate technical and managerial skill; and
- Reduce involvement so the new owners assume increased operating responsibilities.

It is this self-initiative and strategy that makes black empowerment permanent, and weaves it into the fabric of the South African business economy.

Some companies like Dyambu sell a stake to a black woman trust. Two women are serving a three year apprenticeship under the founders’ direction for succession to managing directors; the white owners will then retire. As a 10 year old R50MM turnover company Dyambu provides food and accommodation services to mine workers employed by mining companies. They made the decision to ‘blacken’ the company after it lost a tender in January 1996 even though their bid was the best quality/price, and they failed to make the short list for another tender in March 1996.

Dyambu sold a minority stake to this women’s trust in a cashless transaction for a note payable in three years, with an option to purchase 100%. Dyambu pays a management fee to the women’s trust, but fees are insufficient to pay-down the note; they must raise the balance from a third party to finalize the sale. Monies from a Succession Fund investment would consummate the transaction.

Dyambu’s restructuring goes in new directions. And these new paths enable the Succession Fund to impact black empowerment far beyond just ownership transfer.

Compensation changed as a result of ‘blackening;’ favoritism eliminated so all employees from cooks to executives now sharing in the bonus pool with benefits like medical and vacation standardized to reflect length of service rather than position. The company created a training institute where employees learn everything from industry basics to supervision and management.

So ownership transfer is just the tip of black empowerment. It can do much more given the opportunity and support of a Succession Fund in areas of:

- Board of Director Participation
- Executive & Senior Management Roles
- Affirmative Action
- Training & Skills Development
- Mentoring & Leadership Development
- Empowerment of Supplier & Distribution Chain

Innovative Ventures heard dozens of like-stories resulting from empowerment. Afro-Projects, a 15 year old white-founded civil engineering company seeks to sell a minority stake to a small black-owned construction company. These individuals lack the money to affect purchase and the founders are unable to sell a note payable like Dyambu. The owners are in their late 50’s, need cash for estate planning, and willing to groom change of ownership over three-five years. And some firms like Graceland Textiles (a black owned business) need working capital to increase inventory and expand production to meet delivery requirements of large corporations.

Black empowerment must impact more lives, and here the Succession Fund can accelerate it by cycling more people into the infrastructure that groom black Africans for supervisory and general management positions.

One firm Paul Tingley Management Services is taking a progressive approach to developing black talent. Candidates for training are assessed one-on-one to identify areas of development within their current job, and build more competencies as the prerequisite for advancement. Development is delivered as training programs to upgrade the skills of individuals so they perform to expectations. Promotion happens only when competency is demonstrated to a benchmark standard. Examples of competency evaluation and training needs are provided in the appendix.

Innovative Ventures supports a US$5MM training fund that will groom the best and brightest blacks in a general management program. While a formal program is essential to develop the long-term pool of corporate leaders, tapping into the infrastructure for medium-term training solutions reduces the investment risk of black empowerment. Risk is not just of color, but of adding new managers and layers of structure to an investee company with ambitious sales and financial targets. Training monies to support the human resource needs of investee companies helps ensure that anticipated investment returns are realized.

Target Markets for the Succession Fund

Target markets for the Succession Fund are more than just the transfer of ownership from white to black. They include:

1. Businesses that diversify their shareholder base because it is a good business decision, e.g., companies whose labor force, suppliers or customers are predominately black.

2. Businesses (corporate or family ownership) that sell products and services to local, municipal or federal governments. These firms require a racially integrated ownership to win government procurement tenders. Parastatals ‘sweeten’ these agreements with a 10% premium paid to suppliers with a diversified shareholding.

3. Family held businesses of white ownership with no plans to retain family ownership.

4. Black businesses in need of capital to expand their depth and breadth of products and markets in the ‘New South Africa.’ Growth capital helps these firms make the ‘succession’ from one stage of growth to the next.

5. Businesses that require capital to ‘reengineer’ their distribution channels and better serve the population of South Africa. Certainly the financing of ‘master franchises’ fits in this target market.

6. Foreign corporations entering (or reentering) the South Africa market with need for joint venture partners of color. Investment opportunities could be either minority or majority shareholdings.

The first study concluded that privatizations and unbundlings represented one set of deal flow for the Succession Fund. Innovative Ventures now believes that opportunities from this sector will not be a significant source of transactions:

- The dollar size to consummate these transactions is R20MM+. This market is well served by merchant banks and the recently established mega-size blind pool funds. Moreover, financing these transactions will not create the additionality that IFC seeks from the Succession Fund; the Corporation participates in this market through its investment in the South Africa Capital Growth Fund, managed by Capital Partners.

  Targeting deals of R20MM+ takes the Succession Fund out of the niche where inefficiencies exist in South Africa. *The middle market niche is the segment where IFC capital can earn equity rates of returns and attract new investors to an underserved and underfinanced market.*

- Privatizations and unbundlings are frequently promoted as black empowerment, when in fact they are enrichment of a few. When a black empowerment component actually exists, newly hired PDGs operate on the periphery of the management structure since these companies lack a comprehensive training and skill development program. *IFC can make a greater and longer-lasting impact to black empowerment by financing middle market companies since they back up their words with deeds of training and incorporating PDGs into the decision-making operations of the firm.*

The Deal Flow Pipeline

South Africa offers investors a first world infrastructure with third world valuations as evidenced by sample transactions as shown in Table 1.

Table 1

	Turnover-RMM	**NAV***	**Investment-RMM**	**Pricing****	**Black Empowerment *** **
Company A	R36MM	R4.1MM	R5MM	2	1 & 2
Company B	Start-up; 1st year projected, R5MM-10MM	Start-up	R3-4MM	Start-up	1-5
Company C	R12MM	R1MM	R9MM	4-5	1, 2 & 5
Company D	R30MM	R9MM	R10MM	4	2, 4 & 5
Company E	R7MM	R2MM	R5MM	4	4 & 6
Company F	Start-up; 1st year projected, R3.7MM	Start-up	R500,000	Start-up	3 & 4
Company G	R80MM	R28MM	R20MM	4	3, 4 & 6
Company H	R35MM	R14MM	R10MM	4	6
Company I	R48MM	R22MM	R15MM	4	6
Company J	R70MM	R21MM	R18MM	5	1-6
Company K	R30MM	Book	R17MM	5	1, 2 & 6

* Net Asset Value. Net worth in US accounting terms
** Pricing as a multiple of profit before interest, taxes and depreciation

*** Categories of black empowerment

Each transaction incorporated empowerment of PDGs in varying degrees. Table 2 lists categories of black empowerment and their impact on the ownership structure of the company.

Table 2

	Category	**Equity Ownership**
1.	Board of Director Participation	Yes
2.	Executive & Senior Management Roles	Yes
3.	Affirmative Action	No
4.	Training & Skills Development	Can Lead to Ownership
5.	Mentoring & Leadership Development	Can Lead to Ownership
6.	Empowerment of Supplier & Distribution Chain	No

For example, the investment in Company A resulted in blacks appointed to the SME's board of directors and hired to fill executive and senior management positions. Company D resulted in the recruitment of PDGs for executive and senior management positions accompanied by training and mentoring to further develop their management skills (see Dyambu example to review how one company implements skill development and mentoring). Company K resulted in ownership as directors of the firm and executives hired to manage day-to-day operations. And this company engaged black suppliers to furnish goods and services, although these contracts did not result in equity ownership by suppliers in their customer's business.

These transactions illustrate middle market companies' commitment to black empowerment for business rather than political reasons. Firms in this evaluation represent a cross-section of firms serving the food, construction, media, and service industries. Three investor groups provided this information with the agreement that names of companies remain anonymous.

Notice the consistency in valuations from one industry to the next, and across three different strategies of structuring and pricing transactions.

ESOPs in South Africa

Public offerings and sale to a third party dominate the liquidation strategies of middle market investments. ESOPs are not a viable exit, nor a co-venture strategy at inception of investment; the reasons are economic and historical.

Workers seek to maximize their earnings and disposable income as ways to improve their standard of living. An ESOP rewards workers with shares and gains postponed to the future. But PDGs had little economic future, and workers still can't make the link of hard work to prosperity and a better life; they see that inequities continue even though the government changed. They feel continued inequities as black unemployment soars yet a select few earn wealth through enrichment schemes. Memories and emotions haunt the current generation to eliminate possibilities for ESOPs except in the occasional one-off transaction.

Capitalization of the Succession Fund

Innovative Ventures recommends that IFC capitalize the Succession Fund at US$30MM. The middle market consists of 5000 companies seeking capital in the R5MM-R15MM. This size of market is large enough for a manager to generate the volume of deal flow necessary for selecting companies to demanding investment criteria. The sample transactions listed earlier illustrate the quality of profit opportunities available in this market.

A 2% management fee generates US$600,000/year in revenues, enough money to staff the fund with two (2) full time investment managers dedicated to this niche with one general partner to oversee operations. This fee is sufficient incentive especially if the capital is an add-on to other monies managed; the manager does not have to create a new organization nor spend money to build the infrastructure to generate and consummate deals. The 20% carried interest is adequate compensation to attract the ‘best of the best’ fund manager from the South African investment community.

One concern of IFC is the temptation of a fund manager to move up-market, pursue larger transactions and abandon the middle market. IFC can minimize this re-occurrence in the Succession Fund:

1. Cap the capitalization of the Fund to US$30MM. Write into the investment agreement that it will be allowed for investments to build up through more than one round of financing, but in any event no more than 10% of the Fund’s capital (US$3MM or R15MM) can be invested in a single company, its affiliates and subsidiaries. This amount is the upper end of the financing need of middle market SMEs, and confines the fund manager to the targeted investment niche.

2. Take lead responsibility to raise co-investment from donors, other bi-laterals, trusts and foundations. Explain IFC objectives to co-investors, and request they invest up to a target maximum.

3. Insist that the manager devote staff to the middle market (if it manages other funds). This solution ensures the middle market receives the attention that IFC demands. Set the carried interest compensation on capital gains (net of fees and a hurdle rate) earned from middle market transactions.

4. Negotiate a reduced fee or carried interest as investment covenants if the manager abandons the middle market. While an option, Innovative Ventures does not recommend this strategy. It creates suspicion, sends a message of mistrust, and positions IFC and the fund manager as potential adversaries. Investing is a people business and this action sets the investment relationship off on a bad footing that is bound to deteriorate.

Legal Structures for the Succession Fund

IFC is an investor in the South Africa Capital Growth Fund (SACGF), managed by Capital Partners and the South Africa Franchise Equity Fund, managed by Ned Bank. The Corporation is familiar with on and off-shore legal structures that provide limited liability and tax neutrality. The investment in SACGF is a complex structure involving four layers of legal entities; the United States, the Cayman Islands, the Dutch Antilles and South Africa.

Opportunities exist to simplify the legal structure in the Succession Fund since it’s anticipated that a double tax agreement (DTA) between South Africa and the United States will be ratified and implemented into law around the year 2000. Innovative Ventures recommends that IFC organize the Fund as an off-shore partnership domiciled in the United States (Delaware for U.S. investors, other locations to suit the investment and political needs of other investors). Just two layers of legal jurisdiction are needed to effect transactions and move money with the benefit of reducing transaction costs, legal costs and administrative overhead. We make this recommendation with certain assumptions:

1. The Succession Fund is in operation by the end of 1997;

2. The investment period is the first three years of fund life (1998-2000); and

3. Investment divestiture begins year 4 through year 10 of the Fund (2001-2007).

Some general comments to the tax situation in South Africa:

1. Interest and dividends are tax free irrespective if a DTA is in effect between South Africa and the USA. DTA is critical for tax neutrality of capital gains.

2. Interest is tax deductible for companies and tax neutral for off-shore recipients.

3. A DTA may change where tax is paid. Taxes will be no more than they are today, but the jurisdiction to where they are paid may change.

4. Capital gains legislation is ill-defined in South Africa. The Reserve Bank looks to intent of the investor as to whether it made an investment for ordinary income or capital gains. If an investor makes an investment, and one year later a third party makes an offer to purchase its equity, appreciation is likely declared capital gains by the Bank, and tax-free. If the investor sought a buyer one year after investment, the Reserve Bank might rule capital appreciation as revenue and subject to tax.

Fund Managers for the Succession Fund

Various institutions and funds in South Africa are involved in economic empowerment. These investors vary widely in their nature and methods of achieving empowerment, and can be divided into categories of local development agencies, country specific development agencies, merchant banks, dedicated funds, specific commercial bank operations, retirement funds, black business and black trade union investment companies. Table 3 presents funds with investment philosophies, market focus, and/or empowerment objectives similar to the Succession Fund.

Table 3

Fund	Investors	Size of Fund	Products	PDG Strategy	Deal Size	Expected Return
Msele Ned Ventures Fund	Proparco, CDC, NED Corp., DEG	R60MM	Expansion financing; buy-outs; possibly start-ups	Focus on PDG held businesses; Also diversify shareholder base in traditional SMEs	R400K - R10MM	25% - 30%
Horizon Equity	Ango-American Indus. Corp.; Mitsubishi Corp.	US$25MM	Strategy reflects corporate investor backing	No explicit empowerment investment objective or target	R3MM - R15MM	35%+
FirstCorp Capital	CALPERS, Hancock Venture Capital, New York State Employees Retirement Fund, others	R750MM	MBOs, MBIs, Replacement Capital, Unbundling, Privatizations	No explicit empowerment objective	R20MM+	35%+
Fed Life (Capital Partners)	Fed Life (South Africa) & Capital Partners	Evergreen Fund (deal by deal)	MBOs, MBIs, Replacement Capital, & Expansions	No explicit empowerment objective	<R20MM	30%+
Umbono (listed, closed-end fund)	Calvert New Africa Fund	R50MM	Buy-outs; expansions; early-stage; start-ups	Diversify shareholder base	R5MM - R30MM	25% - 30%
Capital Enterprise Fund	CDC (London) & Investec (South Africa)	R60MM	Expansions, MBOs, MBIs	Empowerment, financial	NA	35%+
IDC	100% SA government	R200MM	Equity financing for start-ups and expansions; strictly manufacturing	Requires PDG equity stake and mgt. role	up to R5MM	25%
First South Africa Holding Ltd.	First South Corp. Ltd. (NASDAQ listed)	R60MM	MBOs, MBIs, Expansion Financing	Empowerment, Financial	R20MM-R80MM	35%+
SBDC “Equity Partner”	SBDC; SA government	Revolving	Start-up & early stage financing; primarily equity	Target PDG entrepreneurs; offers training, mentoring & financial TA	R50K - R3MM	20%+

Criteria for Selecting a Fund Manager

The biggest risk to IFC in the Succession Fund is its choice of fund manager. South Africa is loaded with peril for the investor lacking the right mix of skills. Suggested criteria for selecting a manager of the Succession Fund include:

1. Proven performance to generate equity rates of return from minority investments of R5MM-R15MM in middle market companies. This financial performance implies skill in the entire investment process from fund strategy through deal origination to profitable exit of transactions.

2. Talent to retain executives, key members of the management team or other selling shareholders in leveraged transactions.

   A few key executives dominate decision-making in middle market companies. The success of the Succession Fund is dependent on these executives to groom a new crop of owners during the three-five year management transition. And this challenge in South Africa is more difficult since PDG managers need greater amounts of training, skill development, and mentoring.

   The fund manager asked to operate the Succession Fund must have a superb track record in retaining selling management through earn-outs, employment contracts and contingency payments as bonuses based on future performance of the company. These skills and solutions are more important now than in the past as reforms continue in South Africa; the Reserve Bank is expected to lift restrictions and let citizens move wealth off-shore in 1997. Controls on foreign exchange will no longer be a motivating factor for selling managers to stay active in the business.

3. Commitment to help management teams translate opportunity into reality. SMEs in South Africa have two needs to grow in the new competitive environment of South Africa:

   - Receive guidance in strategic planning, executive staffing and compensation with investors exerting fiduciary judgment as a member of the investee’s board of directors on issues like purchase/sale of assets, mergers/acquisitions, and new rights offering.

   - Mentor executives in the calculated, but risk-taking operating style needed in entrepreneurial ventures to increase sales and profits exponentially. Assist these new entrepreneurs to develop the second tier group of corporate managers and implement entrepreneurial plans in a corporate setting.

   Innovative Ventures’ expects the Fund to consummate 10-15 transactions over the life of the fund with two investment officers dividing portfolio responsibilities equally. Each will oversee 5-8 companies which leave ample time to be proactive in the investee’s Board of Directors. The fee schedule and carried interest for the fund managers are adequate to pay the costs and efforts of hands-on assistance.

Recommendations on Fund Managers for the Succession Fund

Most of the funds listed in Table 3 have either a different strategic focus or are in the early stage of their life cycle. Consequently they are not recommended as candidates to manage the Succession Fund. Of the funds listed, two stand-out as most qualified in meeting the selection criteria.

1. Capital Partners. Known to the IFC, this group is experienced in the South Africa market, possesses an established network to generate deal flow, and demonstrated its ability to generate superior returns in the transaction size of R5MM-15MM through its Fed Life Fund. The principals of Capital Partners expressed a strong commitment to black empowerment and believe that financial and social objectives are not mutually exclusive.

   However, potential for conflict of interest exists between the Fed Life Fund and the Succession Fund. Fed Life supports 100% of the financing to consummate transactions in the market niche targeted by the Succession Fund, and have made it clear they intend to continue investment. The issue before IFC, Fed Life, and Capital Partners is to negotiate a procedure that decides which investor to put into a transaction. The second issue concerns follow-on financing for deals consummated with Fed Life money. Some investors prohibit managers from investing capital into past deals with the concern of 'good' money chasing bad deals to support predecessor funds.

These issues are not insurmountable. One solution is to create a co-investment agreement between investors in the Succession Fund and Fed Life with each group investing 50% or a pre-agreed share of investment.

A 'look back' clause in the investment agreement prevents Succession Fund monies from being invested in past Fed Life deals. A separate and independent investment committee can rule on merit if Capital Partners recommends a follow-on investment from the Fed Life portfolio.

With two funds under management, Capital Partners demonstrate a manager can invest in smaller and larger transactions; to execute this strategy the general partners organized internal operations and assigned staff to each niche so investment officers developed expertise and knowledge.

2. FirstCorp Investors. This is the private equity fund of the merchant bank First National Bank. It raised R750MM from leading American investors. While Innovative Ventures was unable to evaluate their investment track record, we presume FirstCorp has an excellent track record given their 'blue chip' list of investors.

   FirstCorp is investing bank money as private equity into transactions under R20MM. Bank principals are considering the raising of blind pool fund focused on the Succession Fund market niche.

   Innovative Ventures interviewed the senior manager responsible for these smaller transactions. A concern with FirstCorp as the Succession Fund choice is the Bank's uncertain commitment to black empowerment as an investment objective. The Bank has not made the decision to focus on investments where black empowerment is an integral component of a transaction.

If these two funds decline to manage the Succession Fund, consider Horizon Equity or First South Africa Holding as alternatives.

Recommendations & Closing Comments

The Succession Fund is a sound investment approach to increase investment into SMEs in South Africa without introducing market distortions. It is a right-timed strategy for South Africa; investment, financial, and social opportunities exist for the Fund. Innovative Ventures recommends that IFC proceed on the activities necessary to capitalize this fund.

Innovative Ventures thanks IFC and the Swiss Federal Office for Foreign Economic Affairs for including us in this project. We welcome reader comments to this report.

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17. Melanie Bernard, Managing Director, Paul Tingley Management Services, Tel. # 463.5990

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