Private Equity in Africa – Key risks and risk management strategies

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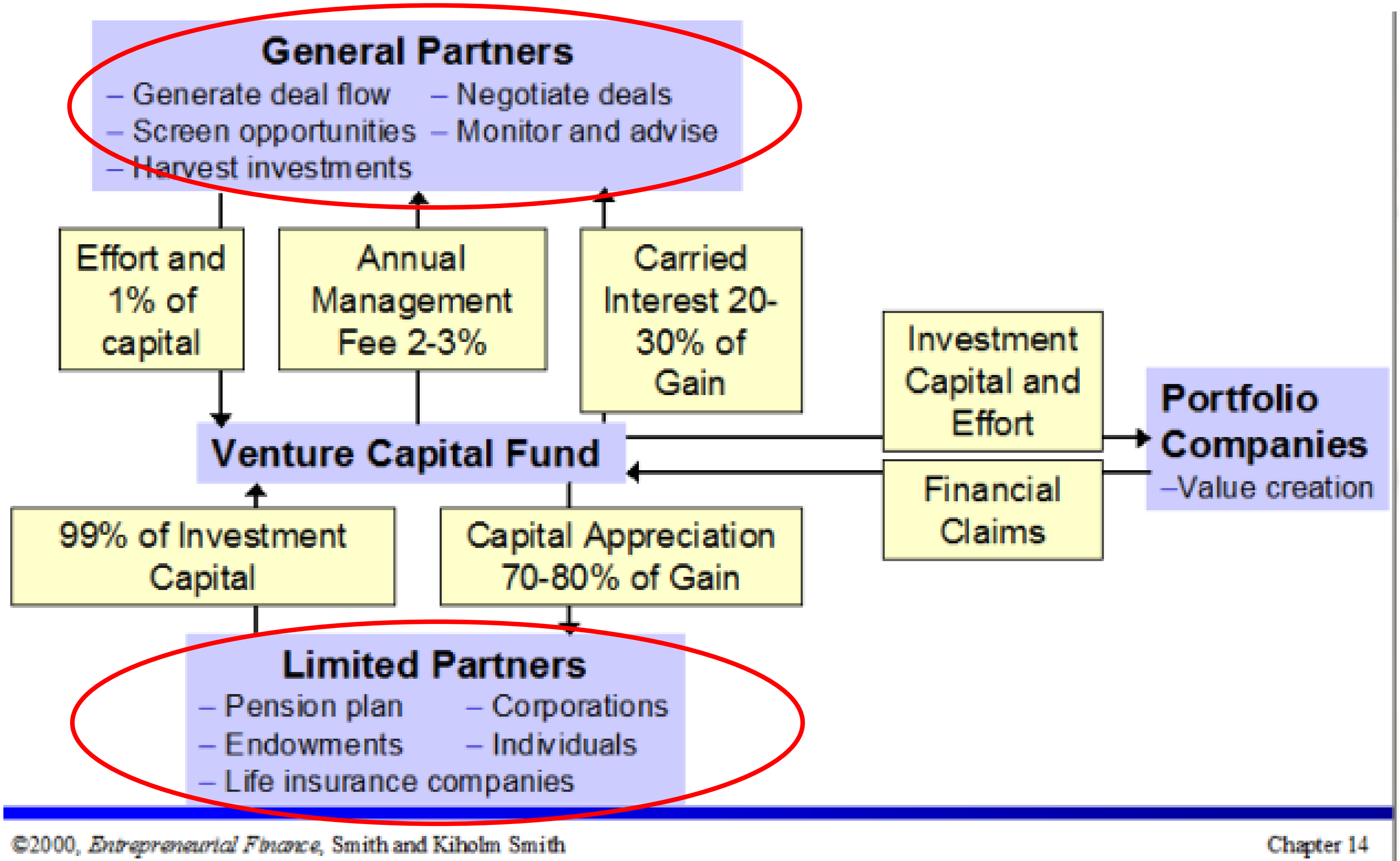
September 2011

Where is risk management required?



Where is risk management required? (cont.)

LIMITED PARTNERS

- Two major decisions that have potential risk:

  (1) Asset allocation decision: Is PE for you?

  (2) Manager selection decision: Finding the right PE manager for you?

GENERAL PARTNERS

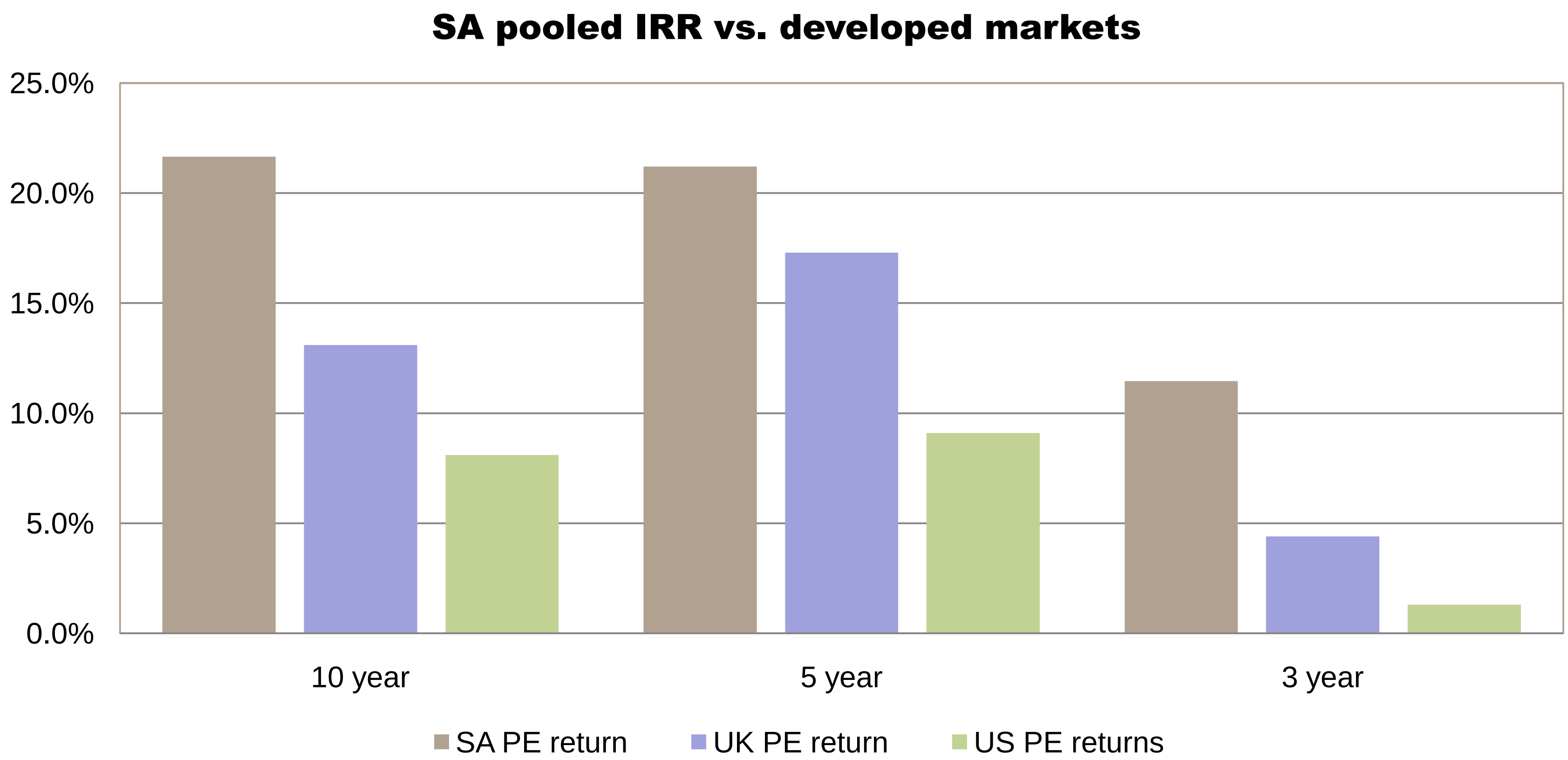
- How much do you know about a potential PE manager?
- Aligning of LP and GP interests

Limited Partner risk management

(1) ASSET ALLOCATION DECISION

- Is PE the right asset class for you?
- An informed decision can be made by understanding the following:
    - Historic performance of the asset class in Africa/ rest of the world?
    - Risks that may impact returns…micro/macroeconomic
    - Regulation – e.g. Statutory limits that define investment
    - Diversification benefits

Historic performance of Private Equity



*Source: RisCura Fundamentals

#Source:British Private Equity and Venture Capital Association Private Equity and Venture Capital Performance Measurement Survey 2009.

‡Source: Cambridge Associates LLC U.S. Private Equity Index September 2010

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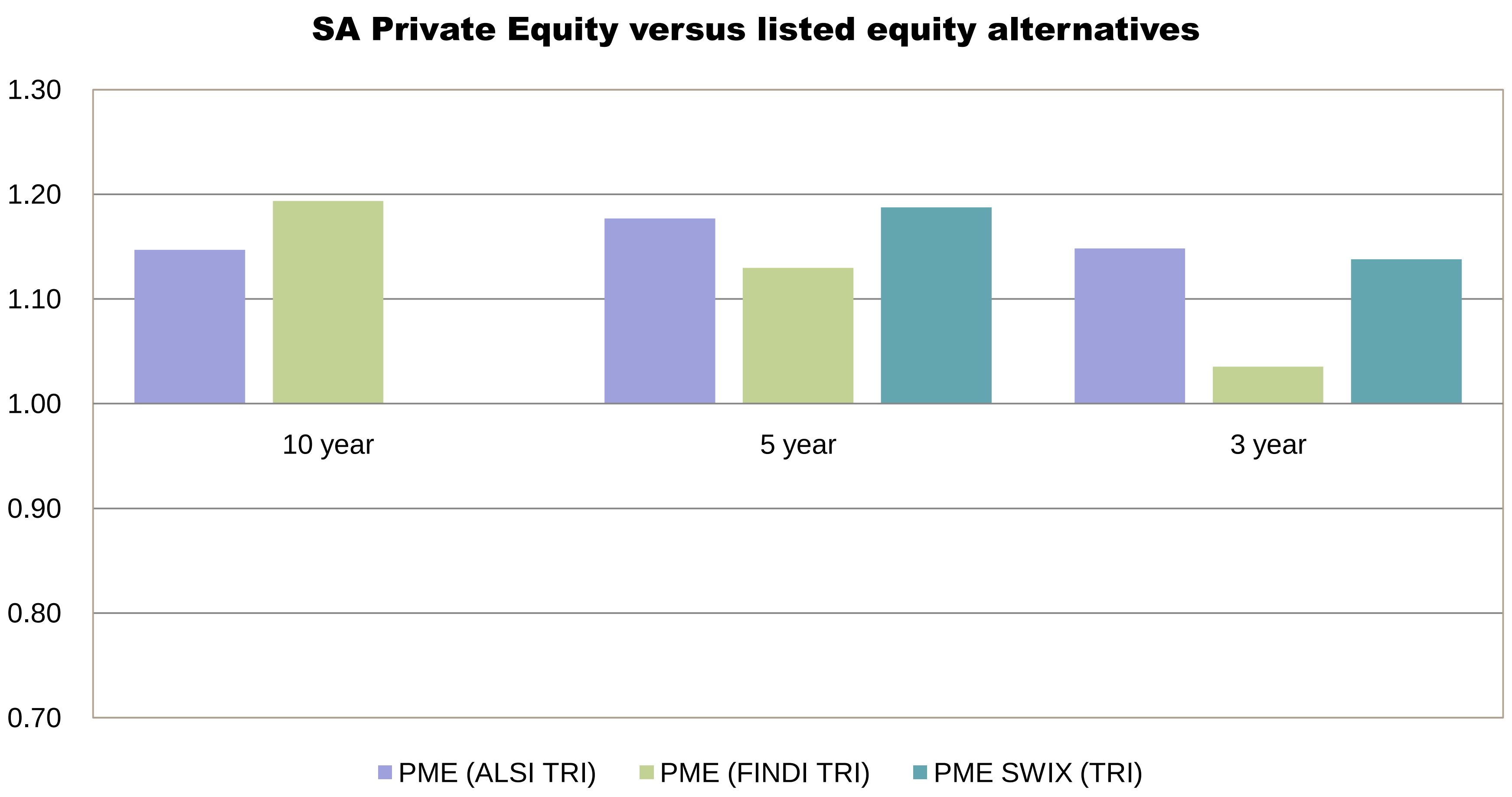
Historic performance of Private Equity (cont.)



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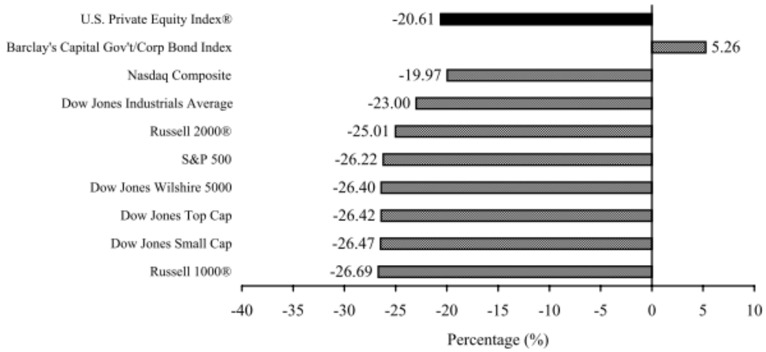
Historic performance of Private Equity (cont.)

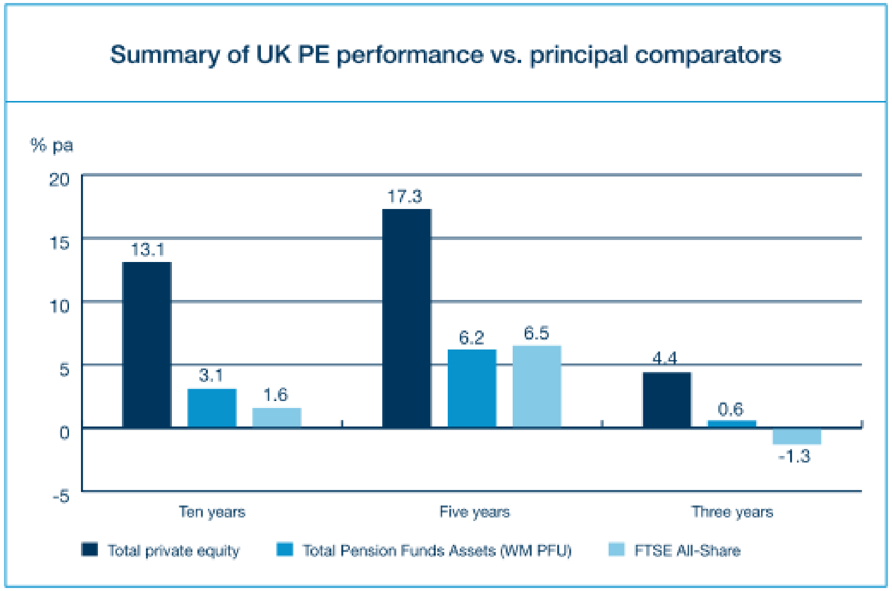
CAMBRIDGE ASSOCIATES LLC U.S. PRIVATE EQUITY INDEX®

As of June 30, 2009

Period	End-to-End Pooled Mean Net to Limited Partners (%)*
One Quarter	4.32
Year to Date	1.14
One Year	(20.61)
Three Year	0.91
Five Year	9.92
Ten Year	7.65
Fifteen Year	11.09
Twenty Year	11.37

U.S. Private Equity Index® Compared to Other Market Indices for the One Year Ended June 30, 2009





*Source: Cambridge Associates LLC US Private Equity Index and Benchmark Series, June 30 2009
#Source:British Private Equity and Venture Capital Association Private Equity and Venture Capital Performance Measurement Survey 2009.

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Risk factors that may impact returns

- Remember private equity is essentially providing capital to unlisted companies.
- Therefore, any micro/macro economic factors that impact the provision of capital to unlisted companies or their operating performance will impact returns to investors. For example:

  - Availability of credit;
  - Achieving a fair entry price i.e. performance of equity markets
  - Competitive environment;
  - Ease of exit.

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Regulations that define investment limits

- Example: Regulation 28 in South Africa

Asset Class	Previous Limit	New Limit
Cash	100% 20% with a single bank	100% 25% with a single bank
Bonds	100% 100% in govt guaranteed	100% 100% in govt guaranteed 75% in banks / 50% in corp
Equity	75%	75%
Commodities (Listed instruments on an exchange)	Kruger Rands permitted	10% 10% gold and all other commodities 5%
Foreign Allocation	15%	Linked to Exchange Control 25% international 5% Africa
Private Equity	n/a	10% overall 5% to a Fund of Funds 2.5% to a Single Fund
Hedge Funds	n/a	10% overall 5% to a Fund of Funds 2.5% to a Single Fund

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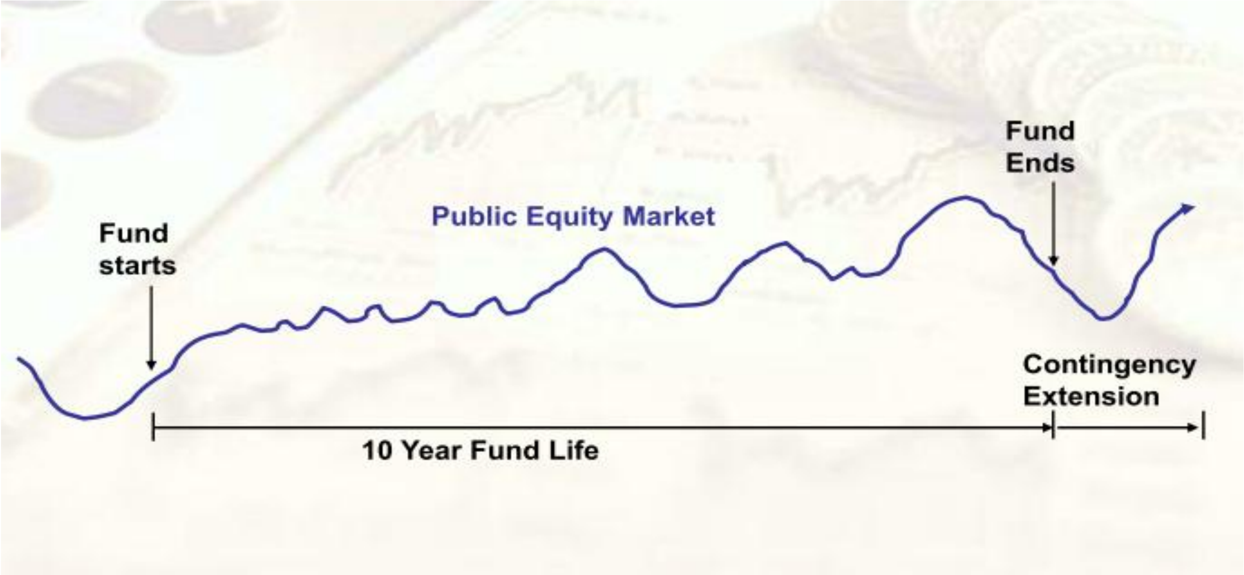
Diversification

- As Private Equity is a long term, illiquid asset class, its return profile is somewhat uncorrelated to listed equity, fixed income, etc.
- However, not like listed equity…PE Funds don't hold fully diversified portfolios
- Not diversified, or liquid…concentrated and illiquid…



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Limited Partner risk management (cont.)

(2) MANAGER SELECTION DECISION

- How much do you know about your potential manager?
- Getting a sense of managers track record is critical, do your due diligence…
- Some necessary questions to be answered…
  - Has the manager run a previous **successful** fund?
  - Manager reputation…ask around
  - Manager network…critical in PE, about finding that ‘great’ deal
  - Risk management processes…does the manager know what he is exposed to? commodity prices, exchange rates, etc

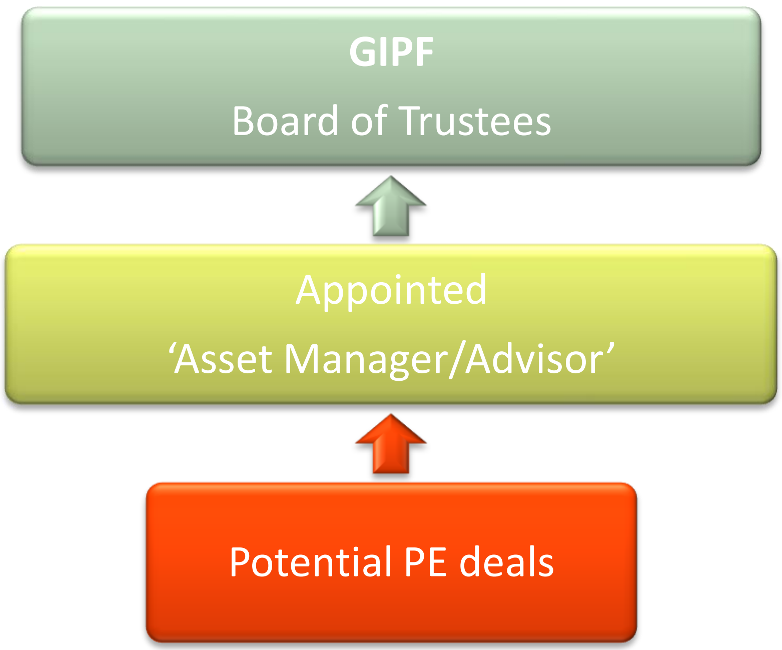
Limited Partner risk management (cont.)

(3) CHOOSING THE RIGHT PE FUND

- What is this particular fund going to invest in?
  - Sector bias, type of instruments…impacts return profile.
- Legal and tax structuring
  - Pension funds are tax exempt…fund needs to be structured accordingly
- Fee structure – alignment of interests
  - 2/20 – incentivise managers to take time and find good deals
- Quality of advisors
  - Due diligence in-house/outsourced, team experience…
- Reporting requirements
- Who are the other investors?

Example: How it can all go wrong…

- The Private Equity model has been developed over time and to date has a proven track record in both developed and developing markets.
- However, where LP's decide to deviate from this tried and tested model demonstrate how the previously identified risk factors can erode performance.



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How it can all go wrong (cont.)

- In response to Government legislation promoting local investment…
- Trustees appointed an ‘Asset manager/Advisor’ who sourced many deals for review along with recommendations.
- Trustees empowered themselves to select and finance those deals they considered economically viable…
- Deals included concerns such as financial institutions, fast food retail, abattoirs, …….etc

- Result: More than $100 million dollars of lost funds…misappropriated and irrecoverable….
- Why?

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Why it all went wrong? (cont.)

- **Trustees lack experience in PE space:**
  - Private Equity is a specialist asset class, with PE managers having experience in managing and deploying investment capital into portfolio companies. None of the board members understood the asset class nor had any relevant experience.
- **Political agendas override business sense:**
  - Trustees ignore the recommendations of the appointed business advisor and instead choose deals themselves. Much speculation as to significant conflicts of interest present in the chosen deals.
- **LP's playing in the space of GP's**
  - Trustees executing deals with limited knowledge as to the type of capital that should be provided, understanding of management competence, strategy/plan to realise growth path of company, etc.

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A closer look at some of the bad choices…

- **City Savings and Investment Bank**: Financier that provided loan funding to politically connected individuals. The security for these loans was very limited, with no credit checks being performed, collateral requested or market related interest rates being levied.
- ***Result:*** *Millions of dollars of non-performing loan financed by GIPF had to written off as bad, so reducing the value of civil servants pension funds.*

- ***Abattoirs, Windhoek Hotel, Namibian Chicken, etc.***

- It should be noted that not all deals were bad from the outset.
- Poor governance, lack of plan and execution ability caused even the good deals to falter and eventually fail.

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And now…

- GIPF has re-written its policy on Private Equity to be more closely aligned with developed and emerging market practices.

4.1.1 Investment philosophy

Investing in unlisted securities requires a specialized range of skills in order to optimize investment returns. In terms of clause 7.4 of the Investment Policy for Listed Investments of the GIPF, "The Fund wishes to make sound, profit-driven investments in areas of social and development need. Such investments will be made via professional investment managers and the framework within which investments will be made is contained in the GIPF's Unlisted Investment Policy."

- RisCura was appointed as investment consultant to the GIPF, has taken the fund from a bottom to a top quartile performer

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What are the risks of investing in PE?

RISK	MITIGANTS

PE is a non-regulated sector	• Largely self-regulated by contracts with investors
	• Investors perform Due Diligence of fund managers prior to making an allocation
	• Investors require significant reporting and governance structures
	• Advisory board (composed of investor base and GP/Trustee)
	    • Manage conflicts of interest
	    • Adherence to management obligations
	    • Reporting and valuation obligations

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What are the risks of investing in PE? (cont.)

RISK	MITIGANTS
Non-regulated product	• GPs/Trustees believe that product regulation is impractical due to unique characteristics of each PE fund raised • It is important that investors carefully evaluate each PE product
Liquidity	• Institutional allocation to PE is generally small in the portfolio, and liquidity to meet capital calls is manageable. • Pension funds can afford to invest in assets with a longer term liquidity profile • Can be mitigated by investing across vintage years

What are the risks of investing in PE? (cont.)

RISK	MITIGANTS
Concentration	• A PE fund will typically invest in less than 10 companies over its life • Investors can mitigate this risk by spreading their PE allocation amongst several PE funds, or investing in a FoF
Valuation	• Funds apply International PE valuation Guidelines • Value portfolio quarterly • Quality and frequency has improved
Conflicts of interest	• May be conflict of interest where management team has interest in portfolio company

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What are the risks of investing in PE? (cont.)

RISK	MITIGANTS
Pipeline	• Manager must have good sources and network to establish a deal pipeline
Ability to exit	• Proven track record of ability to exit through different methods. Eg. IPO, trade sale, sale to another financial investor.

Common misconceptions around PE

	MYTH	REALITY
Transparency	Private equity firms are not as transparent as businesses reporting in a stock exchange listed environment	Contractual agreements between private equity fund managers and their investors require rigorous reporting and governance structures, including periodic reports and valuations of fund and portfolio investment performance. Investor access to investment performance data far exceeds that of an investor in a listed security, albeit this information is not within the public domain.
Leverage	PE funds over-leverage companies and jeopardize its value: • Creditors are not sure that they will recover their funds; • Employees fear for their jobs; and • Shareholder value may decrease	While leverage reached extremely high levels internationally during 2007/8 (c.8-9 times EBITDA), South Africa never experienced these heights. Rather, due to prudent measures introduced by local banks and regulators, leverage in South Africa has remained between c.2-3 times EBITDA
Structuring	Private equity firms structure their funds and transactions to circumvent local taxation requirements to the benefit of private equity fund manager	Most investors in private equity funds are tax exempt institutions such as pension funds. As they are exempt and other non exempt investors get taxed in accordance with their own tax jurisdiction, any taxes paid by the intermediate structure are not creditable

Terms of investment into a PE fund

- **Term of the fund** – fixed-life with a typical term of 10 years;
- **Advisory fee** – typically 1% to 2% of the aggregate committed capital of the fund;
- **Hurdle rate or preferred return** – normally 8% to 12% on their committed capital must be achieved before the General Partner or Trustee can receive its participation in the gains and surpluses;
- **Gains and surpluses** – a participation in the gains and surpluses of the fund (typically up to 20%) is paid to the General Partner or Trustee as a performance return. The remaining 80% of the gains and surpluses is paid to the investors pro rata to their capital commitments;
- **Return of proceeds** – the proceeds of fund investments are returned to the investors as and when the investments are realised and are generally not retained or reinvested by the fund;

General partner risk management and controls

- **Advisory Board**: Resolve conflicts of interest and to grant permission to the General Partner or Trustee to oversee all prudential limits. The Advisory Board also often reviews valuations of investments.
- **Reporting and Valuations**: Quarterly reports and valuations of the fund's performance and its investments are carried out by the GP/Trustee or appointee and provided to investors. The fund is audited annually. Valuation methodologies set forth in the International Private Equity and Venture Capital Valuation Guidelines are applied.
- **Proper licences in place**: private equity funds must apply for a license and representatives are required to comply with the Fit and Proper requirements.
- **Co-investment commitment**: The individuals that make up the GP/Trustee are required to invest their own capital into the fund.

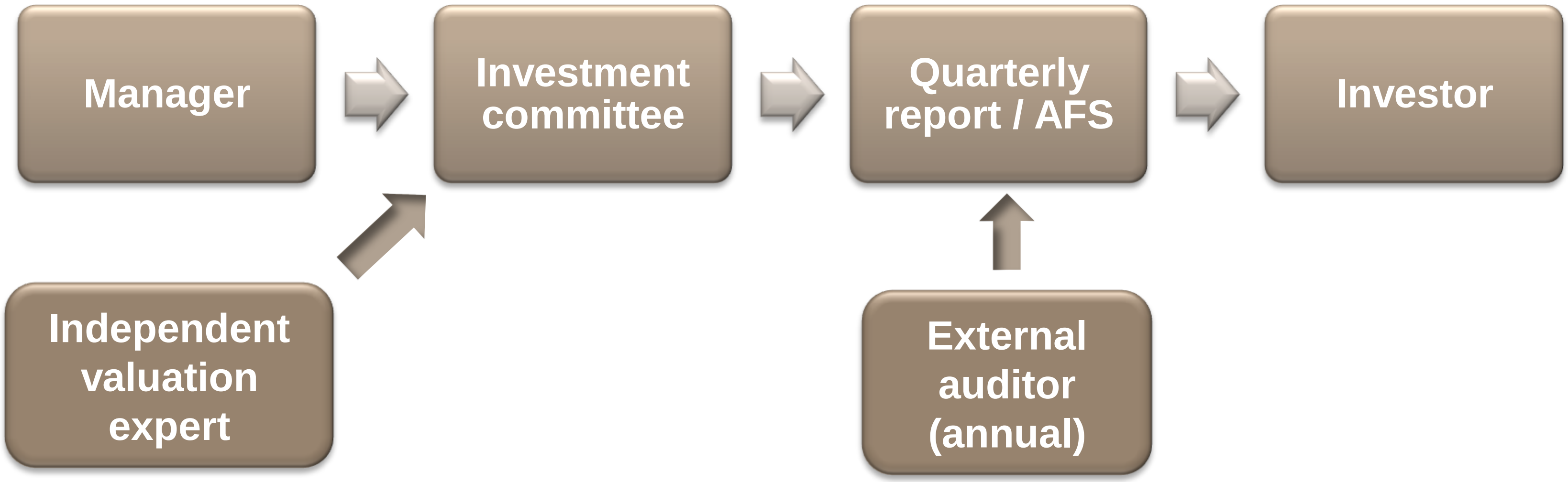
Valuation of PE investments

- Funds invest in unlisted companies – no quoted price
- Investment valuations are determined using financial models
- Most South African PE apply the International Private Equity and Venture Capital Valuation Guidelines
- Still concept of fair value / realisation value
- Time consuming process
- Valuers must consider many factors – quantitative and qualitative
- Private Equity vs. Venture Capital

Valuation of PE investments (cont.)

BEST PRACTICE VALUATION PROCESS

- Quarterly valuations by fund managers
- Internal fund processes
- Annual independent fund audits
- Independent valuation experts



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In summary

- Pick PE managers who are experienced, understand the markets they are looking at, and have good networks
- Spend time up front doing homework on the manager, and making sure that interests are aligned
- Ensure that necessary reporting will be available for you and your advisors

Thank you

Disclaimer

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