2013

The Economic Impact of Venture Capital and Private Equity in South Africa

SAVCA
SOUTH AFRICAN VENTURE CAPITAL AND PRIVATE EQUITY ASSOCIATION

DBSA
Development Bank of Southern Africa

Foreword

As a promoter of economic growth, infrastructure and human skills development, it is once again our pleasure to be part of this project. The study examines the economic impact of private equity and venture capital in South Africa and evaluates the measurable effects of these industries on investee businesses.

There are several favourable outcomes from private equity and venture capital investment. Besides providing access to capital, these investors bring dynamism, a depth of operational experience, huge financial acumen, contacts, strategic partners and foresight.

It is important to emphasise that the benefits of private equity and venture capital transactions are not confined to investee companies. They can affect the broader South African economy. As we face several economic challenges, including exceptionally high and persistent unemployment, it is rewarding to note the effect of this type of investment on job creation. To mention just one statistic from the many positive observations contained in this report – companies with private equity and venture capital investors clearly do create employment, and those in our survey indicated they have grown their staff by around 40% in the two-year period covered by this research.

The businesses we examined were also able to showcase the progress they have made in their black economic empowerment ratings with the assistance of private equity investors and venture capitalists. Their measurements on employment equity, skills development, procurement and enterprise development have all been boosted. These are key factors in terms of BBBEE legislation, and they also provide livelihoods for many smaller entrepreneurs along the supply chain.

Additionally with the introduction of private investor funding, some well-considered and carefully directed risk-taking becomes possible. New products and enhanced customer offerings become a reality. Untapped markets open up for investee companies. Revenues can grow, and translate directly into enhanced profitability.

Young investee businesses develop in other ways as well. They improve their governance structures and standards. They become more responsible corporate citizens, with a social conscience.

When experienced investors and entrepreneurial investees combine their goals, vision and innovation, some inspirational stories can emerge.

Aubrey Shabane
Manager: Equity Investments
Development Bank of Southern Africa (DBSA)

Content

> "Private equity practitioners are astute and well-rounded investors. They offer insight on strategy and operational matters"
>
> Finance Director, healthcare firm (growth capital investee)

About the survey

This research, focusing on the economic impact of venture capital and private equity in South Africa, is the second commissioned by the Development Bank of Southern Africa (DBSA) and the South African Venture Capital and Private Equity Association (SAVCA). It aims to extend the work of the survey carried out in 2009 – the first of its type in the region – by questioning investee company managers in order to assess both the perceived and measurable impact private equity backing has had on their businesses.

Like its predecessor, this survey relies on a number of assumptions – most importantly that the contribution of private equity is best measured by analysing the economic performance of the investee companies. It charts the impact of private equity investment on a number of different areas: growth before and after investment; innovation and new product development; job creation; corporate governance structures; and Black Economic Empowerment (BEE).

In 2009, the inaugural economic impact survey highlighted the industry's "significant, positive impact on South African society and the economy that supports it."

Several years and one global financial crisis further on, that assertion remains true. The findings of this latest survey, based on in-depth contact with 60 private equity backed businesses*, provide strong evidence that private equity firms continue to create both employment and value in the domestic and international markets. The statistics also show that private equity investors tend to be forward-thinkers, keen to finance the present and future needs of the companies that they are backing through significant capital expenditure and investment in R&D. Their focus on helping investee companies to install corporate governance structures also represents a major contribution to the growing sophistication, quality and robustness of investee companies.

*A detailed overview of the data collection and the sample can be found on pages 14-15

Some highlights

Preference for private equity

Almost half of those questioned state that private equity is preferable to other forms of equity funding. The most commonly cited reason for this is the strength and equality of the partnership between investee and investor, underlining the importance private equity investors place on the correct alignment of interests.

Dynamism and innovation

Exactly three quarters of the survey's respondents reported that their businesses introduced new products or services following the private equity investment. The new capital is also instrumental in funding the purchase of new technology or machinery.

Major growth driver

Over half (56%) of responding investee companies said private equity financing allowed the business to grow faster. The survey showed that the average proportion of total sales growth over the last two years among a sub-sample of investee companies questioned was 49%. The fastest-growing 20 respondents saw their EBITDA increase by more than 130% over the same period.

In addition to underpinning acquisitive growth strategies, private equity firms use their operational and strategic capabilities to help investee companies to generate significant organic growth following investment. Their deep and wide networks of contacts are singled out as being critical to this.

Job creation

The findings of the survey show that investee companies create employment, with the number of staff employed by respondents both within and outside South Africa growing by around 40% over the two-year period covered.

Lasting strength

Private equity investors play an invaluable role in helping their investee companies build more robust, sophisticated structures. According to the survey, no fewer than 70% of responding companies mentioned corporate governance as a key private equity contribution. The financial acumen private equity investors bring to the table is also rated as a major contribution.

Flexibility and commitment

According to a significant number of those questioned, the willingness of private equity firms to take risks is a major benefit to growth businesses.

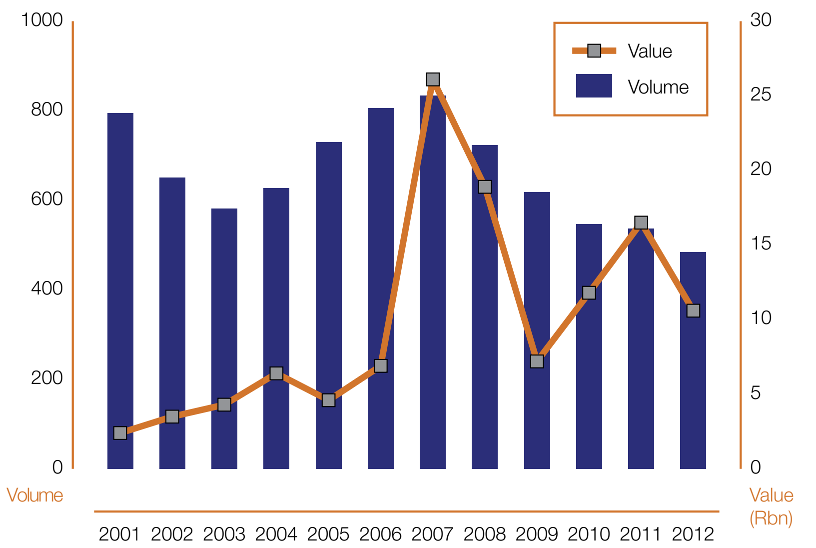
Putting private equity into context

According to the latest figures published in the KPMG/SAVCA Private Equity Survey*, deal flow trends in the South African private equity market over the last decade have followed a similar track to those in Europe and North America, with activity levels rising to a peak in 2007 before falling sharply thereafter.

In volume terms, the downward trend has been relatively steady and consistent, with the number of new and follow-on deals recorded in the market dropping year-on-year from the peak of 834 in 2007 to 484 in 2012. The amount invested has been slightly more erratic with a sharp fall from over R26bn in 2007 to just R7.2bn in 2009. Since then, values have recovered somewhat, though the latest report shows that the value fell back again in 2012.

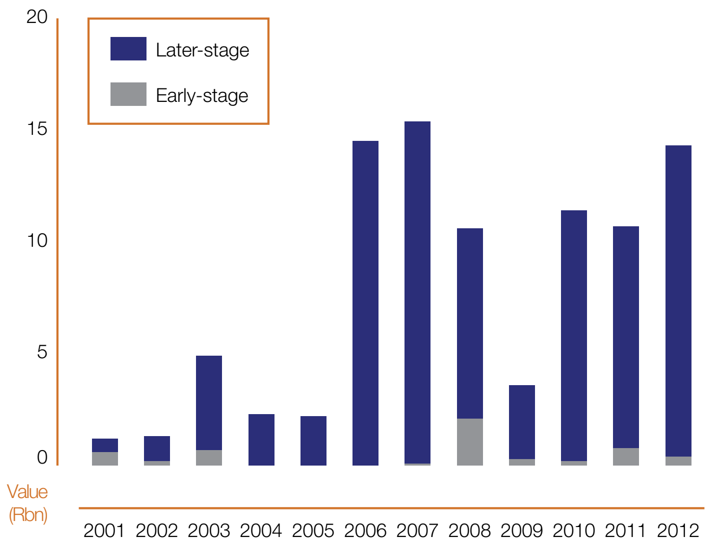
However, despite the downward investment trends since 2007, there are signs of an upturn. Funds under management in private equity rose to their highest levels ever in 2012, reflecting both strong growth in the valuation of unrealised investments and new in-flows of capital into the market. In total, private equity investors in South Africa had just over R126bn under management at the end of 2012, around a quarter of which is available for investment. This is up from R114bn a year earlier and represents a pot of capital amounting to almost R20bn that is exclusively available for investment in South Africa (the balance being held in pan-African vehicles).

South African private equity activity



Source: KPMG/SAVCA 2013

South African third-party funds raised



Source: KPMG/SAVCA 2013

In terms of new fundraising, the total amount of third-party capital raised in 2012 rose by more than a third to reach R14.4bn – just R1bn below the peak fundraising year in 2007. And this strong fundraising has continued into 2013, with a healthy amount estimated to have been raised again during the year.

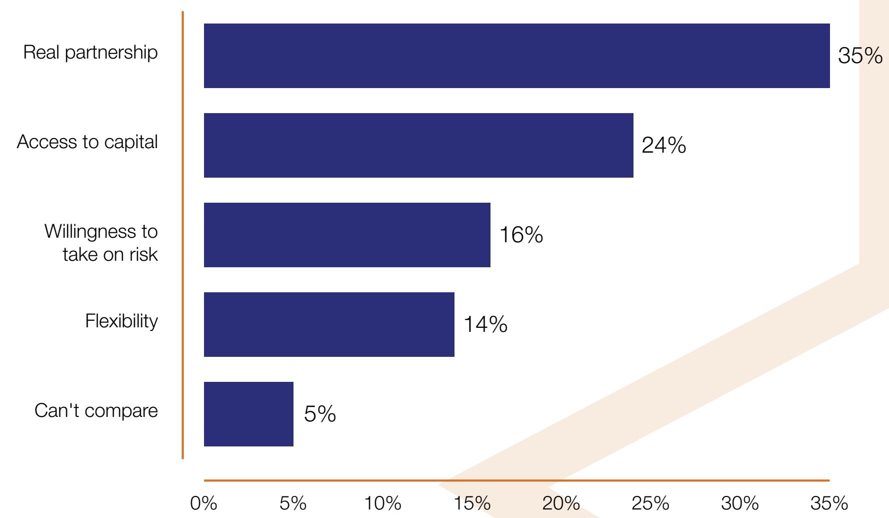
* Published in 2013 and covering activity through to the end of 2012, the latest report is the thirteenth issued by SAVCA and KPMG and is based on almost 100 participants representing more than 100 discrete funds.

Respondents to this year's survey expressed a preference for private equity over other funding routes. In all, nearly half of the overall sample stated that private equity financing is preferable to other equity financing (i.e. public markets). Meanwhile bank lending, which would traditionally be within reach of many more businesses than the public markets, has been significantly affected by global financial markets in recent years. As a result, not only can debt be costly, but according to anecdotal reports from some respondents in this survey, it also takes significant time and effort to raise.

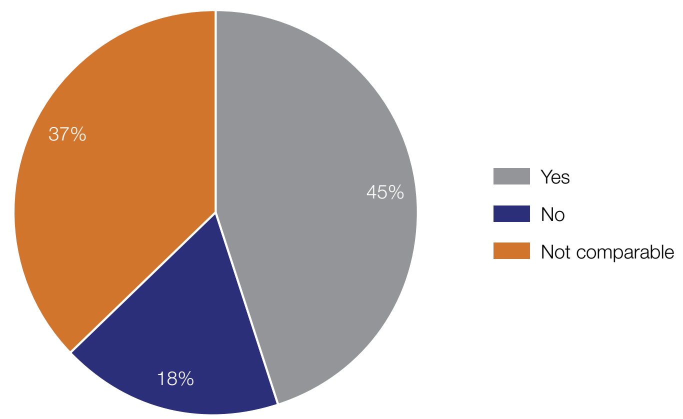
The most commonly cited reason for selecting private equity, mentioned by around a third (35%) of respondents, centred on the equal relationship they enjoyed with private equity firms, underlining the importance private equity investors attach to the alignment of interests. The next most important factor was access to capital, which was mentioned by close to a quarter (24%) of investee companies. Finally, the willingness among private equity investors to take risks, as well as their overall flexibility, was also brought up by a significant number of those surveyed.

> "VCs generally have a network of like-minded investments and this proves useful for networking and forming strategic relationships/partnerships"
>
> CEO, technology business (venture capital investee)

Key reasons for choosing private equity



Is private equity preferable to public equity?

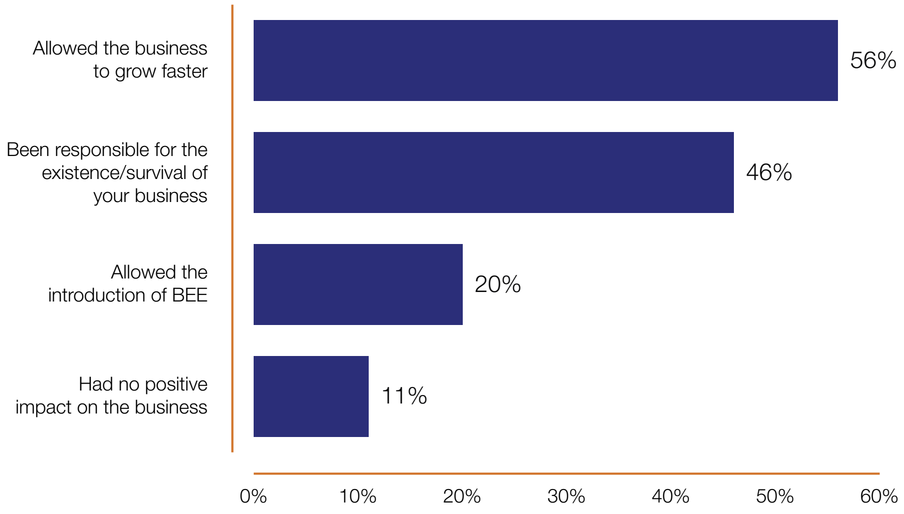


Private equity: key contributions

The results of this year's research clearly show that private equity investment plays an important role in the development of businesses. For over half of the respondents (56%) this was about speeding up the pace of growth; for another sizeable group (46%), private equity capital was instrumental in keeping the business afloat; and for one fifth (20%) of respondents, private equity firms facilitated the introduction of Black Economic Empowerment (BEE) standards.

To counter this, only 11% of respondents in the current sample indicated that raising private equity capital had resulted in no discernible positive impact. This is the same percentage as the first study five years ago, and the fact that this has not risen despite the very different trading environment during the latest research period suggests that the private equity community has been effective in maintaining growth and operational improvement in deteriorating conditions.

Key private equity contributions



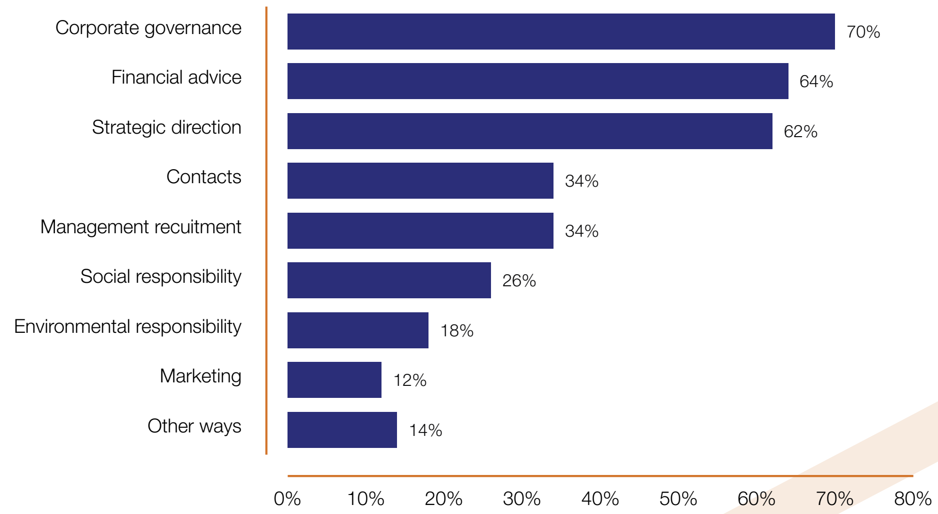
"Private equity investors are more aligned with the focus of the business in order to generate profit growth and long term sustainability as they participate in the profits over the investment period"

CEO, agribusiness firm (growth capital investee)

"When you deal with a private equity firm, you know that you will have a quicker response for capital injection. PE practitioners are astute and well-rounded investors. They offer insight on strategy and operational matters"

Financial Director, healthcare company (growth capital recipient)

Where does private equity bring value to the table?



Looking further into where private equity investors are able to bring value to the table, respondents single out three key areas: corporate governance (mentioned by 70% of those surveyed); financial acumen and advice (64%); and guidance with strategic direction (62%).

Other key areas of contribution included contacts and management recruitment (34% each), and social responsibility (26%). Environmental responsibility and marketing were seen as relatively less important, only mentioned by 18% and 12% of respondents respectively.

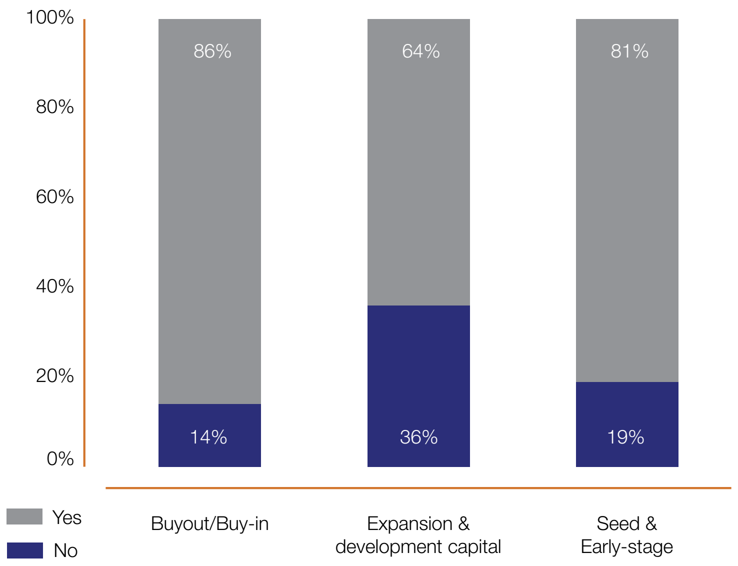
Supporting innovation and expansion

The case for private equity investment is especially compelling in terms of its support for innovation. Overall, no fewer than three quarters of businesses surveyed for this report have introduced new products or services after securing backing from a private equity or venture capital firm in the last two years.

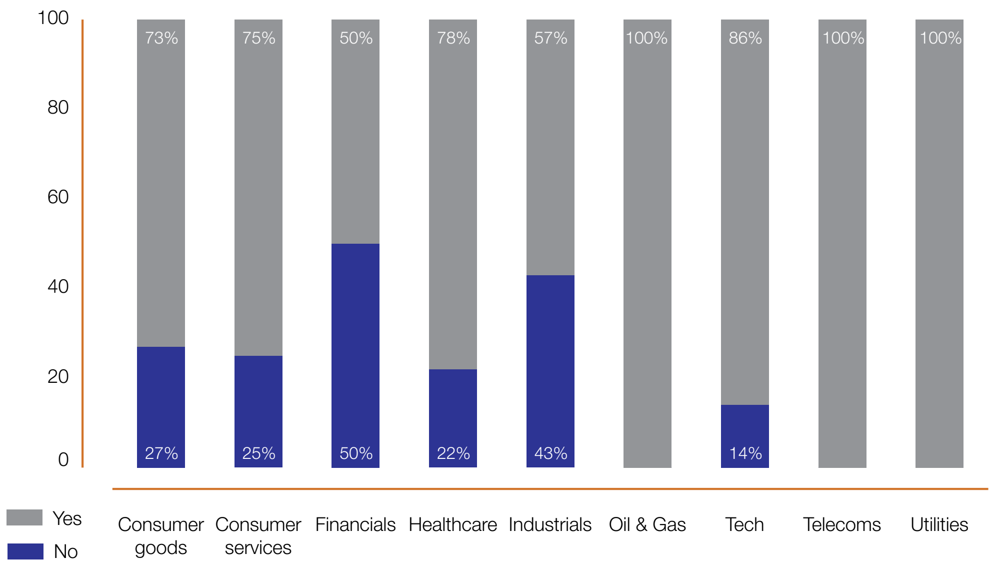
Companies controlled by private equity shareholders (i.e. majority owners) were the most innovative of all respondents, reflecting the power and confidence that controlling shareholders have to support operational improvements and expansion strategies. In all, 86% of these investee companies had brought new products and services to market in the last two years. Recipients of early stage and growth funding are also strong innovators following private equity investment.

As far as sector groupings are concerned, the results of the survey show innovation to be strong among respondents in the consumer goods, consumer services and healthcare sectors, with around 75% of respondents introducing new products and services. Similarly in the industrials sector, over half of the respondents had done the same. Only in the financial sector was there a closer balance between those that had innovated and those that had not. Oil & gas, telecoms and utilities respondents formed a small part of the sample.

Launched new products/services (by finance stage)



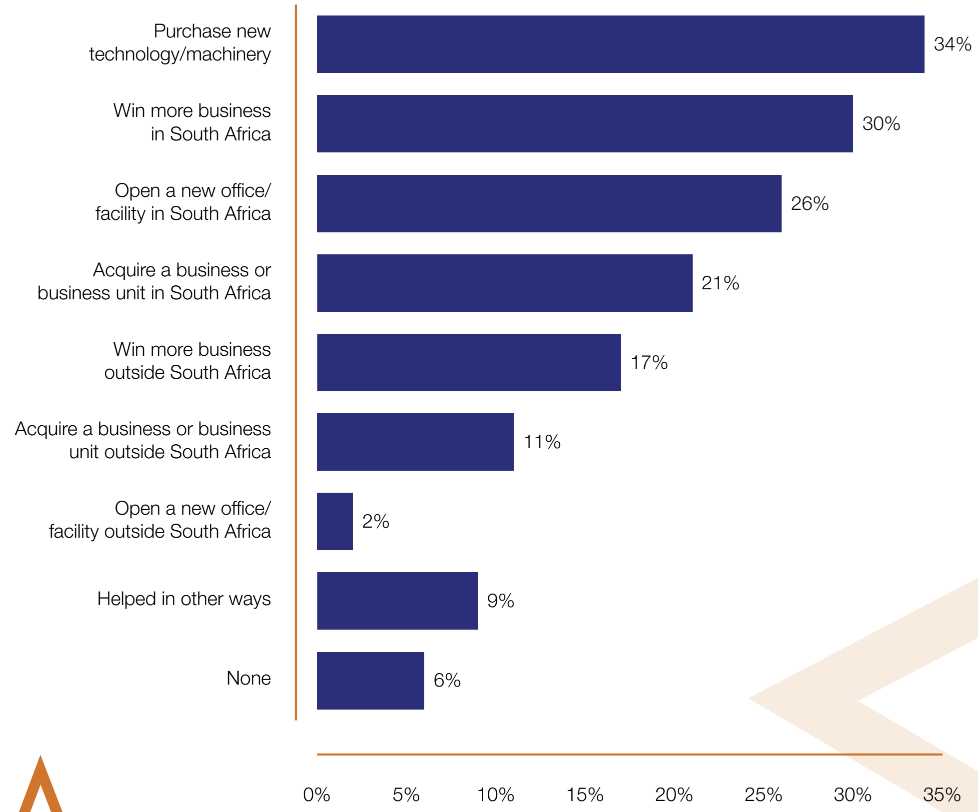
Launched new products/services (by sector)



Other operational areas

The survey results reveal that private equity ownership continues to have a significant impact on helping investee companies achieve business goals across a wide range of other operational areas. For instance, over a third of respondents (34%) cite the ability to acquire new technology or machinery as a significant achievement facilitated by their private equity backers. Similarly, the support in helping to win more business, both within and outside South Africa, is also mentioned by a meaningful number of respondents (30% and 17% respectively). Other positive outcomes include the ability to open new offices and facilities in domestic and foreign markets.

Where does private equity bring value to the table?

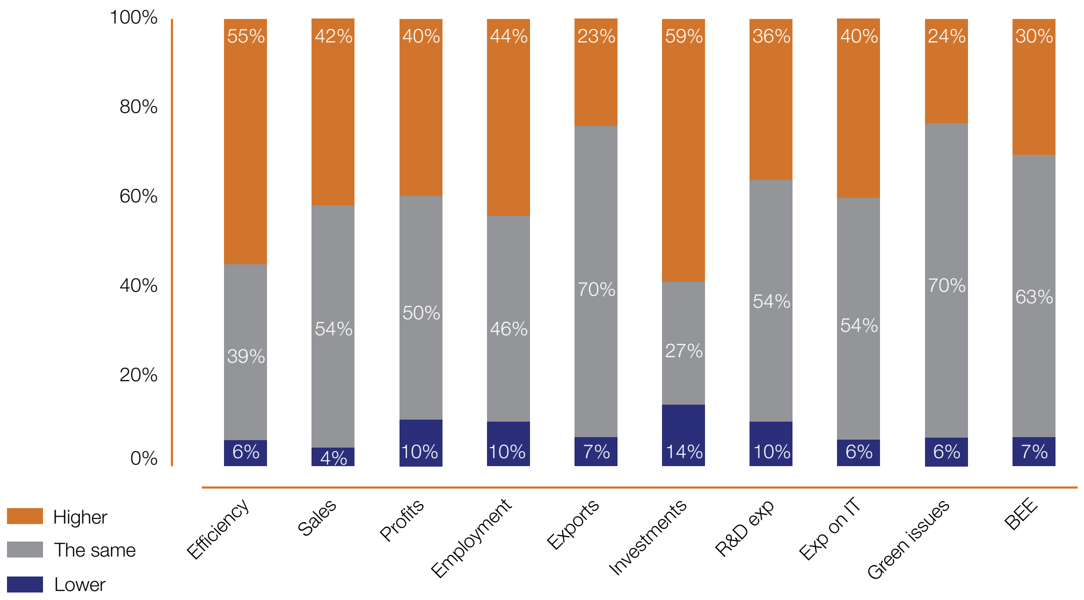


"As a start-up you don't want structured lending whereby the debt needs to be paid off; a venture capital firm gives you the capital, for a share on the risk. VCs generally have a network of like-minded investments and proves useful for networking and forming strategic relationships/partnerships"

CEO, technology company (VC investee)

Financial, social and employment performance

Comparative performance 2010/11 versus 2012/13



Participants in this survey were requested to provide a comparison between their financial performance and employment profiles in 2010/11 and 2012/13. Across all measures, it is striking that very few of these private equity backed businesses reported any drop in overall performance over the two financial-year snapshots. In fact, well over half of those providing responses stated that their companies' efficiency and levels of investment expenditure grew (55% and 59% respectively). Most importantly, the three key measures of sales, profits and employment levels were each boosted in 40% of cases.

Examining those submissions where there was sufficiently detailed financial data, it is clear that the private equity backed businesses showed very robust growth rates over the two periods stated, again suggesting that the structure, rigour and standards put in place by private equity firms translate into material growth for investee companies. Almost 40 of the businesses in the sample supplied revenue data, which revealed an average growth rate of close to 50%. The profit growth rate is more impressive, with 22 businesses reporting an average EBITDA increase of over 130% over the two periods.

Average growth rates of PE-backed firms

	Average	Sample
Total sales	48.8%	38
EBITDA	137.6%	22
SA Employment	40.9%	31
WW Employment	39.9%	31
Exports	60.6%	18
Capital expenditure	37.0%	30
R&D expenditure	43.0%	14

BEE scorecard performance since investment

"I would definitely recommend dealing with private equity firms. We have had a very good experience. Private equity firms helped us strike deals, facilitated bank loans, provided contacts and helped us improve our strategy and corporate governance. They helped us launch the business. It has been a very positive relationship so far"

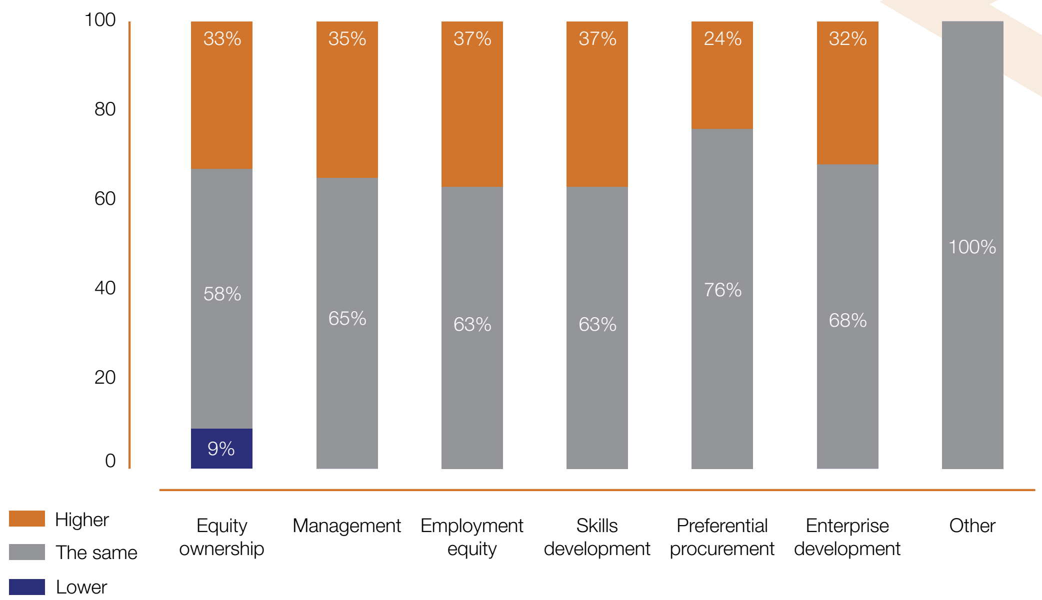
MD, Consumer goods business (expansion/growth capital)

The results of the first economic impact study in 2009 provided valuable data to suggest that private equity capital has an important impact on BEE participation in South African companies: at that time, almost 60% of respondents had no empowerment shareholding prior to raising private equity money, while post investment 72% of respondents had a positive BEE classification.

In all, 56% of respondents in the 2009 survey indicated that BEE performance had improved following investment. Four years on, there is much less scope for improvement, owing to legislative and charter compliance. In this survey, around a third of respondents reported an improved BEE scorecard following private equity.

Looking at the BEE scorecard in more detail shows that only one area – equity ownership – was reported to have deteriorated following PE investment – but only in 9% of cases. In almost all areas, the BEE rating was higher for about a third (ranging from 24% to 37%) of respondents after PE investment.

BEE scorecard performance since investment



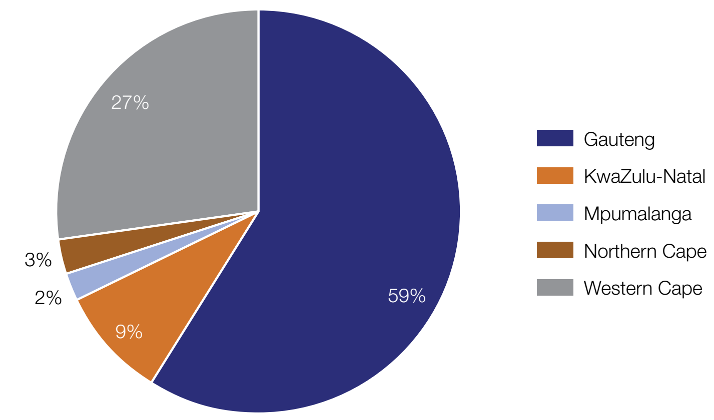
Survey sample: Methodology note

The research for this second Economic Impact (EI) study took place between April and July 2013 and a total of 60 responses were collected from private equity investee companies using a mixture of online questionnaires and more in-depth telephone interviews. At the time of the survey, almost all of the respondents were current investee companies, with only a very small number having seen their backers exit the business.

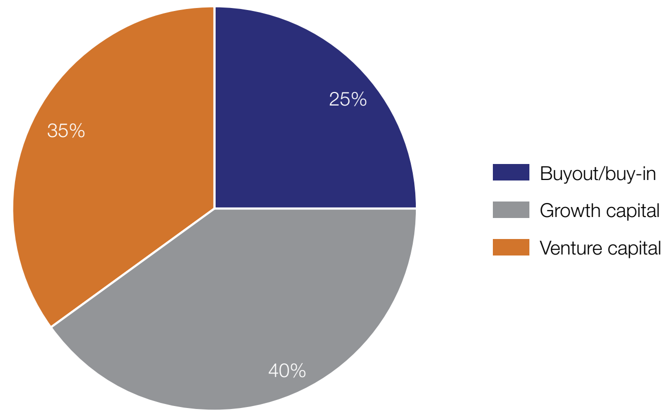
In terms of the location of the respondents, five of nine South African provinces are represented in the current data set, with Gauteng being the home to the largest group of participants; in total almost two-thirds of portfolio companies surveyed are based there. The Western Cape and KwaZulu-Natal provinces were also well represented among the survey's respondents.

Looking at the recipients of private equity investment in terms of the type of investment they have received, there is a bias towards growth capital, though this bias is less pronounced than it is in the market as a whole: according to the latest KPMG/SAVCA figures, two thirds of new deals in 2012 involved development, expansion or replacement capital, while 40% of the respondents in our EI study are classified in the growth capital category. Venture capital investments are comparatively well represented at 35% of the data set (about double that in the KPMG/SAVCA report), while buyouts accounted for 25% (in line with the representation of buyouts in the KPMG/SAVCA report).

Survey sample by region



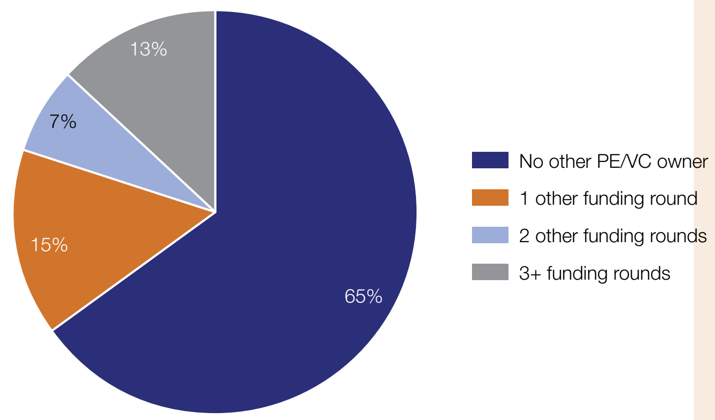
Survey sample by investment type



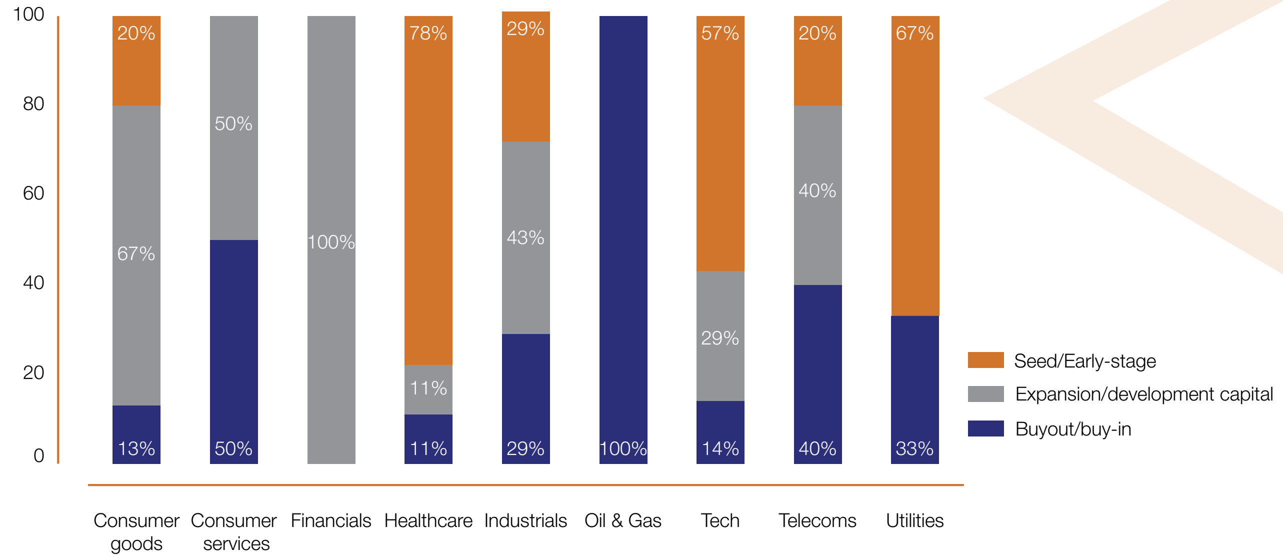
By sector, the survey sample this year was dominated by portfolio companies active in the consumer goods, industrials and healthcare sectors, with these firms making up almost two thirds of all respondents. The three key sectors attract a different profile of private equity investor, with the later-stage buyout and growth capital investors favouring the more mature and established 'old economy' targets in the industrials and consumer areas, while early-stage investors dominate the landscape in the healthcare segment.

Overall, the majority (65%) of the businesses surveyed in this study have raised only one round of funding. Reviewing the underlying deal types, this remains true for growth capital portfolio companies, but is even higher for the earlier-stage businesses in the sample, 71% of which had received a single investment. A smaller percentage of respondents in the buyout sample had only raised one funding round. A quarter of the businesses that had been the subject of buyout investments had received three or more rounds of funding in total.

Survey sample by number of funding rounds



Survey sample by sector



Contact information

Research done in conjunction with i.e.consulting
Incisive Media
Haymarket House, 28-29; Haymarket; London SW1Y 4RX
United Kingdom
T +44-020-7004-7461
E info@ieconsulting.co.uk
www.engage-iec.com

Development Bank of Southern Africa Limited
1258 Lever Road; Headway Hill; Midrand
South Africa
T +27-11-313-3809
www.dbsa.org

South African Venture Capital and Private Equity Association
Suite N 204A; North Wing Office Block, 2nd Floor
204 Oxford Road; Thrupps Illovo Centre
South Africa
T +27-11-268-0041
E info@savca.co.za
www.savca.co.za

Electronic copies of this report are available on the SAVCA website.