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2016

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Understanding the Information Considered in Private Equity Buying Decisions in South Africa

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A research report submitted to the Faculty of Engineering and the Built Environment, University of the Witwatersrand, in fulfilment of the requirements for the degree of Masters in Engineering.

May 2016

Declaration

I declare that this research report is my own unaided work. It has been submitted for the Degree of Master of Science in Engineering in the University of Witwatersrand, Johannesburg. It has not been submitted for any degree or examination in any other University.

Signature

Date

Abstract

The South African Private Equity Industry collects billions of Rands from investors locally and abroad and utilises this cash to purchase controlling shares in companies operating within Africa. Within 5 to 10 years of purchase, these companies are purposefully altered, upgraded and moulded prior to resale. Each Private Equity firm has different growth targets, but the generally expected result should be a multiplication of the funds invested over that time. The mechanism by which these firms accomplish such a result was of strategic importance for business people whom wish to decode the route to success and apply the same actions in their organisations, or those they wish to evaluate for purchase.

This research aims to bridge a particular aspect of this process by acknowledging that the choice of company to purchase was critical to the overall ability to grow and dispose of the company in the allotted timeframe. In the run up to purchasing a company, Private Equity will contract external firms to delve into a potential Target Firm. These Service Firms will report into the Private Equity client on particular aspects of operations, finance and legality that would affect future running and risk profiles. These reports would inform the buying decision, potential pricing structures and legalities of ownership transfer right up to the point of sale.

The evaluation stages are graphically modelled as three distinct but sequential Phases at the end of an extensive literature review. This Conceptual Model is tested against the results of a series of semi-structured interviews held with industry experts. The opinions of local Private Equity and Service Firm respondents are sorted, refined and presented as a more detailed Modified Model at the end of the report. It was found that through substantial refinement of disconnected data, the available literature largely agreed with expert opinion in practice.

The research concludes that the proposed evaluation Models constitute a useful starting platform from which to conduct future research into specific aspects of Private Equity activity.

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1. INTRODUCTION

1.1. Background

One of the fundamental tenets of modern capitalism is private rather than government investment in an asset with the hope that it increases in value prior to its inevitable sale. Much time has been devoted to frameworks which attempt to predict the possible increase in asset value given certain actions, or the probability of certain events. Companies have been started, prospered or closed around the success or failure of such models, and investors have made and lost vast sums of money in the process (Armstrong Economics, 2016).

An entire industry has come about which takes such models beyond rudimentary share trading, and into the realm of majority ownership of companies. Practitioners in this industry take money from investors, purchase companies they believe they can accurately predict the growth and success of, and turn those companies into profit-engines over a long term strategy (Barber & Goold, 2007). Investor capital is gathered and used to purchase these companies, or portions thereof, and through direct action coupled with equity injections, practitioners in this industry attempt to generate significant returns from the acquired company anywhere from 5 to 10 years from initial investment (The Financial Globe-Trotter, 2015).

Value is created through leveraging the knowledge of the new owners in that industry segment to create efficiency gains in the operations. Infrastructural upgrades are installed; employees are changed or coached to be better; and at some point in the future, the company will be sold again at a value that pays back multiples of what was invested to that point (Barber & Goold, 2007).

This industry's name is synonymous with the asset class: *Private Equity (PE)*.

In order to reach company buying decisions, PE firms make use of third party partners, referred to here as Service Firms, whom all contribute to the body of knowledge that fuel the decision making process. Audit Firms, Lawyers, Corporate Banks, Management Consultants and even Credit Agencies all form part of the Service Firms consulted in the process, and each varies in their approach and the information that can be provided.

It is the aim of this research report to create an understanding of the evaluation phase leading up to a buying decision, and thus what information is sought to inform the PE buying decisions through such Service Firms. It also seeks to create graphical models that define the information flows over an evaluation of a target firm, both from literature and from direct expert opinion.

1.2. History

PE can trace its roots back to the 1950's in North America. However, in South Africa its' activities have been recognized since the mid 1980's following a period of rapid divestment of foreign capital. Potential deals were unlocked for local investors, usually banks, in companies requiring urgent direct investment (SAVCA, 2015a).

Private Equity is the name given to an asset class which is not publically listed or traded. Private Equity *Companies* are those which invest directly into private firms. They also perform buyouts of

public firms with an intention to de-list them from a stock exchange and focus on improvements while out of the public eye. The equity which these firms use to perform such buyouts would usually be sourced from large institutional investors. This includes Pension Funds, Insurance Funds or periodically through other large PE Firms funded by groups of accredited investors (Investopedia, 2015).

Critically, the money is not made freely available to PE firms and much effort goes into raising the cash through funding drives and marketing activities (SAVCA & EBS Advisory Research, 2015). However, once the money is pooled into Funds, the investors have limited influence over what the PE firm does with it. The next step is for PE management to purchase controlling shares in a Target Firm with a view to reengineering it and increasing inherent value prior to divesting and realizing the improved investment as cash (Barber & Goold, 2007).

Usually the companies that are traded are in industry segments that the management of the PE firm have strong ties to. This is motivated by their apparent understanding of what factors influence success in a particular industry and can shorten the timeframe between acquisition of the firm, improvement, and subsequent disposal to realise the value in the investment (Barber & Goold, 2007).

Each industry has its own specific approach. This usually culminates in an industry best-practice which the PE firm attempts to install in the acquired firm in order to rapidly create shareholder value. There is seemingly no shortage of information about which best-practice works in acquired firms. However, little information exists on the nature of the PE decision to buy the company in question (SAVCA & EBS Advisory Research, 2015). That is, the information available to the public is not clear on the evaluation stage of why one company is chosen over others. Almost all information is linked to post-acquisition performance, which in turn is used in marketing activities the PE firms employ to increase faith in their activities for subsequent fund raising (Barber & Goold, 2007).

1.3. Purpose of the Study

PE operates in an environment that demands information from a multitude of sources before any decision can be reached. Thus, the aim of a PE firm is to create a rich picture of the potential target company before buying it on as many operational, legal and financial levels as possible, without spending too much time and money in the process.

However, there is little understanding of how such firms go about evaluating the companies they wish to acquire. This pre-acquisition stage is of strategic importance and the purpose of this study is to decode the deal structure in a PE environment with a view to understanding the information required to reach a buying decision.

Furthermore, the intent is to define the mechanisms through which the information is gathered, culminating in a series of models which explores the complexity of such an evaluation. The end result is to create a sufficiently detailed picture of the way PE works, thereby opening this field of research.

1.4. Research Motivation

The PE industry is a complex one to begin to analyse. In part this is because there seems to be no strict deal design; no clear comparable between industry norms applied within it; and because the very nature of the people involved is complex and secretive. As such, when looking at the clear evidence for success from a financial point of view, there appears to be much to learn from seeking a common thread between motivations, information and processes related to PE deals (KPMG and SAVCA, 2015).

The South African Venture Capital Association (SAVCA) survey of firms purchased by PE Funds found the following (SAVCA, 2013):

- Three quarters of respondents reported that their businesses introduced new products or services following Private Equity investment.
- The capital provided was instrumental in funding the purchase of new technology or machinery.
- 56% of responding investee companies showed an average proportion of total sales growth over the prior two years of 49%.
- The fastest-growing 20 respondents saw their Earnings before Interest, Tax, Depreciation and Amortisation (EBITDA) increase by more than 130% over the same period.
- The number of staff employed by respondents within South Africa grew by approximately 40% over the two-year period covered.

The SAVCA (2014) official survey of the 2013 calendar year reflected a growth in assets under management of 17% in to R162.2 billion at end December of that year. Figure 1 shows 12 years of growth in assets under management. Annualized growth rates indicate that in the last 14 years the industry's assets under management have grown by 11.8%.

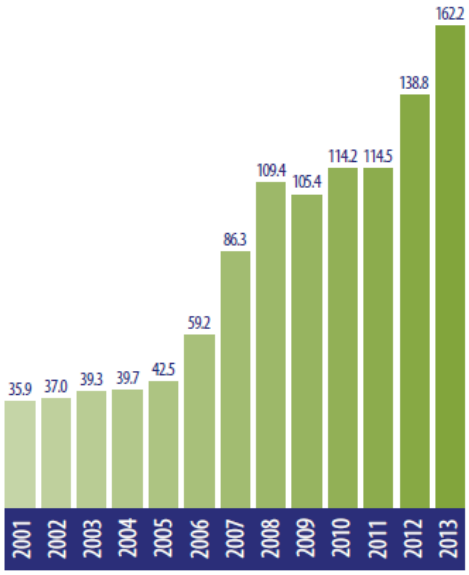


Figure 1: Growth in assets under management since 2001 (KPMG and SAVCA, 2014]

The latest figures reflect that in 2014 the total assets under management increased to R171.1 billion. Now, in the 15 years of research conducted by this source, the compound annual growth rate of funds under management has been 11.3%. The funds returned to investors (that is, divested Funds equating to the profits made) increased by 44.7% from R9.8 billion during 2013, to R14.2 billion in 2014 (KPMG and SAVCA, 2015).

This growth is partially fuelled by PE firms' reputations for dramatically increasing the value of their investments. This ability to achieve high returns could come from a combination of (Barber & Goold, 2007):

- Performance-linked incentives for PE portfolio managers and for operating managers of the acquired firms, pushing effort levels higher on persons employed to manage these facilities;
- The aggressive use of debt instruments and geared finances, in turn providing financing and tax advantages;
- A focus on cash flow, as well as both gross margin and EBITDA improvement, and;
- Freedom from restrictive public company regulations by taking the firm away from the public eye.

The mix of approach differs with each PE Company and the operational managers who run it.

A PE firm will typically control the majority of an acquisitions' ownership. This requires a large capital outlay, in turn prohibiting the casual investor from entering this investment realm. Thus, larger firms with access to bigger cash reserves dominate the industry worldwide (Davis et al., 2014). As such, the size of the PE market has driven research into the nature of the investment models employed by such institutions post the acquisition phase.

The research conducted in writing this report has uncovered mostly the nature of financing structures, exit strategies and exit timing. Most of this information is outside the scope of the report, and despite months of searching, little to no published research can be found which details directly the nature of company evaluation from a PE perspective. That is not to say such research does not exist, but rather that it appears not to be readily available, and those sources which are accessible only allude to partial pieces of information. Hence, the motivation is clearly to decode this information and begin a body of knowledge that clears the path for future research into more specific aspects of PE deal motivations.

1.5. Problem Statement

The buying process entered into when targeting a company is a complex series of events (as detailed later in the Literature Review). It involves multiple parties and Service Firms which, once contracted to do so, operate in parallel to the PE company in order to more fully inform the buying decision. The steps taken between possibly buying a firm and actually making a binding offer are fundamentally important to the actual offer being ratified by the PE firm and money exchanging hands.

The evaluation process precedes the acquisition of a company, and the process itself is a mixture of subjective and objective information. The purpose of this evaluation stage is to determine if the target company is a good fit and a worthy purchase relative to the strategic thinking in the PE firm

doing the buying. To accomplish this, a rich picture of the operation itself needs to be built. This encompasses:

a. The financial status, sometimes through a full audit (Gillman, 2002).
b. The legal matters pertaining to ownership and other unfinished or unclear scenarios around which the business could be built, through contractual evaluations, as discussed by Mckenna, Long & Aldridge (MLA) (2013).
c. The operational capability and capacity evaluation (Davis et al., 2014).
d. The fundamental valuation of an offer price that PE could make, as well as deal structure (SAVCA & EBS Advisory, 2015).

This research aims at providing introductory high level models around the evaluation stages, probes the motivations, and expands upon the critical thinking, applied by PE investors.

1.6. Central Research Question

This research attempts to create a fresh understanding of Private Equity motivations and methods in the evaluation of companies for purchase. To open the field of research and build on concepts needed to understand general buy-sell scenarios around PE deals, the central research question has become:

What information supports buying decisions in the South African Private Equity Industry?

1.7. Research Objectives

The objectives of the research are:

1. To determine a series of steps as driven by Private Equity for an evaluation process prior to reaching the decision to buy a company;
2. To determine what information is sought by PE companies in order to continue the evaluation with a view to purchasing a company;
3. To group evaluation information with their original sources, and seek deal information flow;
4. To develop an graphical model for an evaluation from the literature, and;
5. To develop a modified graphical model as suggested by interview recipients and expert opinion.

1.8. Development of a Research Method

This research is aimed at expanding on an industry practice that is affected by multiple disciplines and sources of information. The information that is fed into the PE buying decision comes from well-established business services provided by each of the associated firms doing the work (vis-à-vis, Auditing, Legal, Banking and Management Consulting). However, there is no body of research that seeks to link these pieces of information together to create the rich picture understanding required by PE to reach a buying decision at a company-wide level. This remains the strategic function that a PE company holds as closely guarded business secret. Therefore, for this field to be opened to further analysis and interrogation the starting point was chosen to be a high level approach to what information can be found or generated on the evaluation stages of a potential PE deal.

The research is fundamentally qualitative owing to the need to explore concepts not necessarily clear from quantitative sources. There are very few of either types of research that pertain to "the PE approach" in question (Seidman, 2013). The methodological approach is thus a collection of strategies and techniques based on:

1. Analysing the available literature with a view to creating a PE-deal evaluation timeline and model of information flow.
2. Semi-structured interviews held with a PE firm as well as members of Service Firms that support PE through analysis of potential acquisitions.
3. Visual sense-making of initial concepts brought to the interview process.
4. Narrative description of each interviewee's expert opinions and subsequent modifications to the proposed PE evaluation model.

This report therefore takes the view that an extensive Literature Review can provide an initial layer of understanding to a PE evaluation process. It then seeks to formulate a generic graphical representation/model of the process, role players and information at distinct stages or phases.

The initial framework is subsequently tested against the views and practices provided by companies linked to PE deals (Service Firms). The semi-structured interview was the preferred method for seeking modifications to the initial model as it asks the same questions in the same order with a view to determining pattern recognition and congruency between respondents (Richards & Morse, 2013).

All activities were conducted under the University of the Witwatersrand's Ethics Clearance number MIAEC 045/15.

1.9. Limitations and Assumptions

The research was conducted with the following assumptions:

a) That the literature consulted has been exhaustive enough to develop the initial model.
b) The literature is an accurate enough reflection of actual industry practice.
c) That interviewees are experts in their fields, sufficiently voiced in PE deals.
d) The interviewees were honest in their replies and not masking trade secrets or proprietary information pertinent to the subject being advanced.

Additionally, the research is limited because:

a) The number of respondents is less than favourable. The intent was to have more than one respondent from each field, but the poor response from approached parties has prevented the research from seeking a wider base in the interview process.
b) The PE industry has a secretive nature. Access to PE firms has been hampered by the subject matter in question, where even the voluntary PE association in South Africa refused access to themselves or their members.
c) Simple time limitations in the allotted research bracket meant that conclusions had to be drawn from limited information.

1.10. Outline of Chapters

The report reflects the following structure:

Chapter 1 Introductions to the material and topic are found here.

Chapter 2 An extensive Literature Review has been done to expand on the deliverables from Service Firms, Private Equity motivations and overall valuation techniques. This culminates in the Conceptual Model as proposed by literature, and some deeper understanding of the evaluation information provided in a graphical format.

Chapter 3 The Research Methodology is expanded upon in this section, whereby the actual approach is given for the qualitative research and the subsequent results.

Chapter 4 The Interview Findings are presented here in a narrative of the discussions, paraphrased in line with accepted methods.

Chapter 5 Showcases the graphical development of the Modified Model as proposed by the author including the narrative results, presenting additional information as supplied through the interview process.

Chapter 6 A Discussion of the findings and models is presented in the context of the Literature Review. This chapter focuses on drawing important lessons from the data as a whole.

Chapter 7 Conclusions are drawn and suggestions for further research bring the report to a close.

References An exhaustive list of reference sources is provided.

Appendix A A few of the interviewees required consent to be given for them to talk to the researcher. This appendix houses those as signed on the day of the interviews.

Appendix B A Participant Information Sheet was prepared to further explain the motivations for this research to potential interviewees. This was used to introduce the subject matter and author's motivations to potential respondents.

Appendix C The Questionnaire, unanswered as it is, is provided here. There are two effective sections, one aimed at PE Firm answers and one aimed at Service Firms.

Appendix D The interview answers are housed against each respondent's name, position and firm (as applicable) in this appendix.

2. LITERATURE REVIEW

Yin (2014) describes the use of a Literature Review as a way to show mastery of the topic at hand, as well as to support the development of the research question. He goes further to suggest that the approach should be to provide relevance to the key citations in other existing research, highlighting the information pertinent to the question one is attempting to answer. Noting again the limited research available, the research will have to secure context from globally available sources in order to contextualise the results in a South African frame work.

Therefore, literature will be reviewed within the PE field and through publically available information distributed by organizations like the South African Venture Capital and Private Equity Association (SAVCA). Such institutions partner with Service Companies used by PE firms, as well as PE firms themselves with a view to self-governance and research. Since PE deals and strategy happens largely out of the public-traded arena of a stock exchange, the reporting of results and industry performance is only possible through such organizations. This will lead to the formulation of a conceptual model that will form the theoretical foundation for this research.

2.1. The General PE Model in South Africa

According to The Financial Globe-Trotter (2015) Private Equity is an umbrella term for different types of investments in private firms or in publicly listed companies that will become private as a result of the investment. Currently there are approximately 80 registered PE firms operating in South Africa. An indicative selection of five PE firms which operate within the country are summarised below in Table 1. The table also shows the nature of investment the firm would usually commit to, as well as the Funds it has access to at this moment (SAVCA, 2014).

Table 1: Five examples of South African Private Equity Firms (SAVCA, 2014)

Private Equity Firm	No. of Funds	Combined Fund Value [millions]	Min. Investment [millions]	Max. Investment [millions]
Actis	4	$2306	$50	$200 to $250
Business Partners Limited	8	R 7 995	R 0.15	R 25
Ethos	3	R 13 370	R 750	R 3 000
Old Mutual Investment Group	7	R 25 700	R 75	R 2 000
Rockwood Private Equity	1	R 4 200	R 250	R 1 000

There are tiers to PE investors. Traditional PE takes the form of a company, but anyone who uses their own money, or raises cash through other means to buy a company will also fall into this model. Therefore, learning from the institutional investment model could aid the framework applied by the more casual investor.

South African Private Equity is a long-term asset class that differs in nature from most other assets, including listed equity. This class tends to follow a different trend to listed companies which operate in the same industry segment. This is particularly because the class does not allow an investor to convert their investment to cash unless the PE Fund disposes of the assets previously purchased. (SAVCA & EBS Advisory, 2015). It is inherently an illiquid asset class that demands a long term approach.

South African PE offers institutional investors the opportunity to invest in an asset class that has historically outperformed listed equity over the long-term. However, it has a different timeframe and nature relative to exchange-based stocks. It usually forms part of a diversified portfolio rather than a fully developed single basis for comprehensive investment (RisCura Fundamentals, 2014).

Notably, Fulmer (2012) talks about trends in PE Fund performance mirroring that of target company performance in the early months or even years of investment: downward in value. In this timeframe management is busy being coached in new strategies and challenged in their roles to provide substantial growth in relatively short time frames. That is, acquired firms, and therefore the value of Funds themselves, will normally show a drop in Net Asset Value (NAV) before showing any significant gains. In Figure 2 Fulmer (2012) goes on to further provide a typical J-Curve for this timeframe.

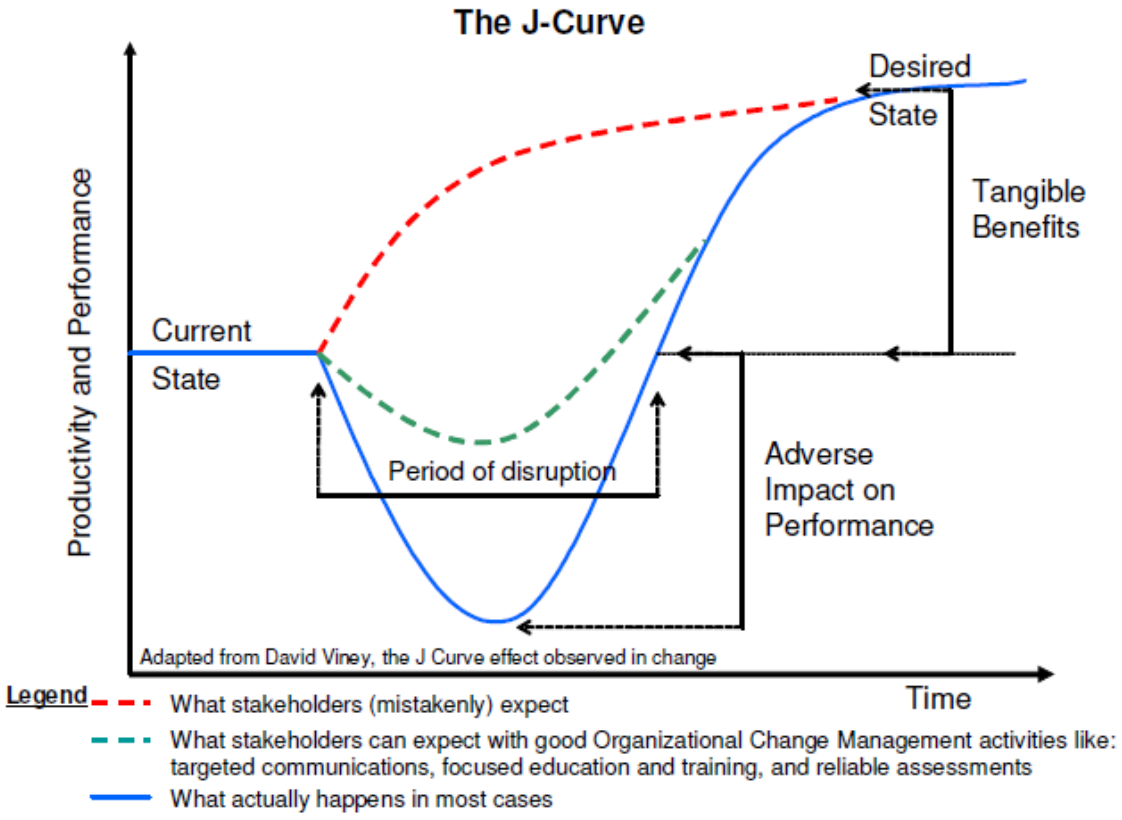


Figure 2: Typical J-Curve model in the early days of PE ownership (Fulmer, 2012)

This comes partially from the effect of management fees and start-up costs on the relatively small capital base (RisCura Fundamentals, 2014). Likewise, the Fund will inject cash into the firm for the purposes of capital expenditure or working capital. This money goes to funding the uncertainty in revenue, staff changes, infrastructure upgrades and supplier payments. The amounts are usually carried as loans within the acquired firm so as to maintain an accurate tally of what direct investments were made and for what reason they were used. By treating this funding as a loan, the gearing of the company initially rises faster than the growth the company is pursuing. According to The Financial Globe-Trotter (2015), the drop in the curve implies that the company was not necessarily doing worse under new ownership, but rather that it drew down monies in order to prepare for growth by design.

South African Funds typically follow this type of "commitment and draw down" model. This implies that investors commit a certain portion of the total capital available at the start of a period, but are only requested to transfer cash to the Private Equity manager as investments are identified, or expenses are incurred. Only once the acquired firm is disposed of, will the Fund see a return on investment.

The modified J-Curve provided by Wiitala (2015) in Figure 3 overlays the impact of cash input and output in the early years of PE ownership. This captures the cash drawdown challenges facing a Fund which has chosen to purchase a company with a view to long term growth.

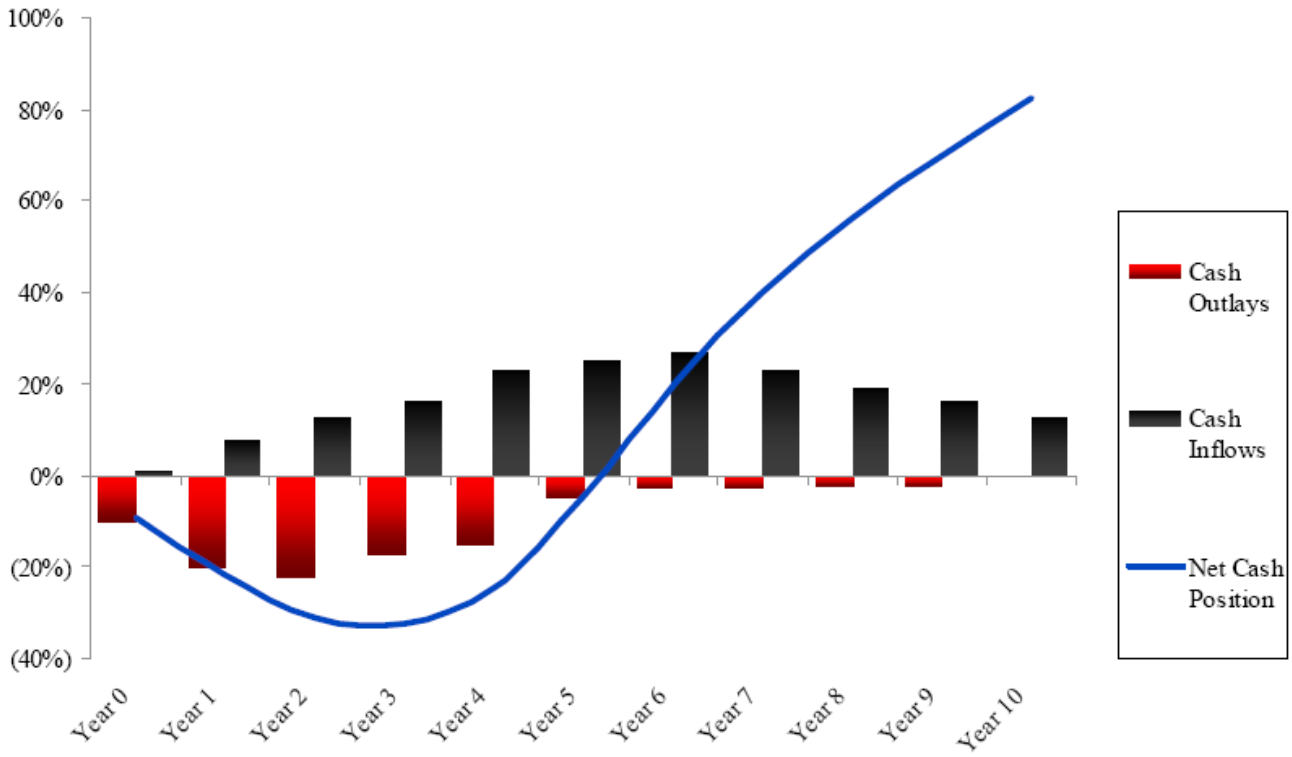


Figure 3: Modified J-Curve showing cash flows over time (Wiitala, 2015)

The importance of this curve is the implication that early years of investment go along with increased spending in the acquisition and the PE management structures, and hence the draw down from the Fund will be substantial. In the early stages of the investment, the Fund will experience losses. Eventually the cash return profile of the acquisition should, with the intervention of the PE firm, intersect the x-axis within the allotted investment time and move to a state where surplus cash is being generated. Thus the investment model of the PE Fund is realised in the latter half of the investment cycle (Wiitala, 2015).

2.2. Private Equity Fund Structure

PE Firms create and manage Funds, which are structured to exist for the amount of time it takes to turn an acceptable profit from the equity invested. The Fund can be thought of as a pot of money fed by investors to a fixed point, typically closed within 3 years of Fund raising activities starting. This limited amount of capital is thereafter managed by Private Equity employees up to full realisation of

the investments on total exit of all companies purchased. Figure 4, reproduced in part by Altor (2016), shows the connection between the investors, fund and acquired portfolio companies.

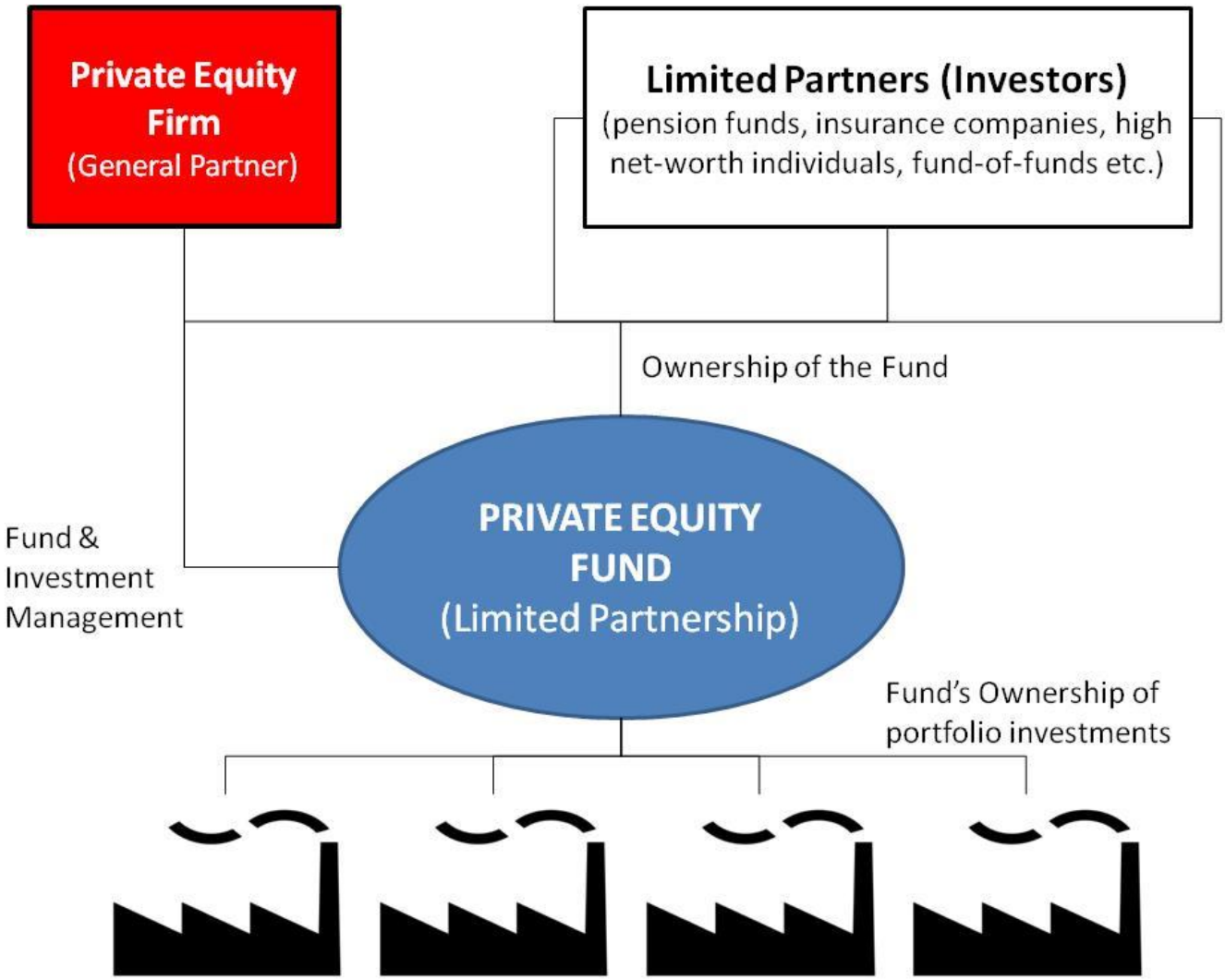


Figure 4: Fund and investment structure (Altor, 2016)

The investor is regarded as a Limited Partner (LP) and has limited to no ability to affect change on the daily management decisions made with his money. The PE staff are referred to as General Partners (GP) (Baldwin, 2015). It is noted that the GP's are responsible for raising the cash needed to build the Fund to begin with and will naturally spend time liaising with current or potential LP's with a view to increasing their investment commitments prior to closing the Fund to future investors (Boyte, 2014).

The Funds in South Africa are organised to be limited liability partnerships or trusts and have a finite life (usually 10 years or less). This means that a Fund would normally go through an overlapped lifecycle as detailed in Table 2 (Boyte, 2014).

Table 2: Private Equity Fund Lifecycle (Boyte, 2014)

Year	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Activity											
Organisation	1 year										
Fund Raising	3 years										
Deal Sourcing & Investing		4 years									
Portfolio Management			6 years								
Exiting Investment				8 years							

Typically, the GP's are given the right to manage the equity of the Fund and to pick the investments they will include in portfolios. The portfolios themselves are run within the timeframes suggested by Table 2, where acquisitions are done up to 4 years into the Fund's existence. Thereafter the trend is to work within the firm to bed down process change, infrastructural upgrades and overall firm strategy (Baldwin, 2015).

It is entirely plausible to exit certain investments only halfway into the lifetime of a Fund. This can occur for many reasons, some of which even due to mistakes made and realisation that the acquired firm is not a suitable fit for the Fund. However, it is more common to exit on realisation that no more growth can be reliably expected from the acquired firm, meaning it is more feasible to sell the firm and employ the raised capital in other areas of the Fund (Boyte, 2014).

2.2.1. Investment and Pay-out Structure

The structure of a Fund begins with a Limited Partnership Agreement (LPA). When a Fund sets out to raise money, institutional and individual high-net-worth investors (the LP's) become signatories to this agreement. The document usually sets out the classification of risk for LP's and GP's as well as the "Duration of the Fund", the aforementioned 10 years being typical (Boyte, 2014).

LP's are liable for providing the full amount of money they have committed to the Fund, and GP's are fully liable to the market interactions. That is, if the Fund were to perform badly and lose the capital provided by LP's, then the GP's are responsible for the debt and operating obligations (Boyte, 2014) (Baldwin, 2015).

One of the more important features of an LPA is to understand the costs of doing business with the Fund. Over and above the decision rights given to GP's, the inherent risk they take in performing their jobs requires a management fee and a "carry". The common management fee is 2% of the value of the Fund per annum. This goes towards paying for the PE's operating expenses like salaries and costs to employ Service Firms (Baldwin, 2015).

The "carry" is a substantially different source of Funds and can only be accessed on successful exit from acquisition firms. It is a performance fee accepted at 20% of the excess gross profits for the Fund. Investors accept both these fees as the cost of doing business in this fashion, where the Fund's ability to help manage and mitigate corporate governance and management issues that would otherwise negatively affect the acquisitions is largely removed (Harris, 2013).

Notably, PE Firms will endeavour to build multiple Funds up to the point where their investments are at varying levels of maturity. This ensures sustainability for the PE firm as there will be a steady source of fees to collect (The Financial Globe-Trotter, 2015).

2.3. Processes Leading to Purchase

Private Equity deals are not always originated by the PE firms themselves, and often there is motivation in a private or public company to secure a PE investor. Such companies may actually seek PE involvement with a view to securing financing for a variety of applications; from increasing their working capital base in times of business expansion; developing new technologies and products to grow and remain competitive; making acquisitions of other businesses; to buying out certain shareholders and to restructure the ownership and management of the business (KPMG & SAVCA, 2014).

From a Private Equity point of view, the purpose of investing in a target company is to reengineer its activities and structures with a view to re-sale to other institutional investors, or to re-list through an Initial Public Offering (IPO) on the relevant stock exchange (Barber & Goold, 2007). PE firms believe they have the ability and expertise to take underperforming companies and turn them into stronger ones by eliminating inefficiencies in their operations, in turn increasing earnings. Quite often PE firms will see that this potential exists in the industry and, more importantly, the target firm itself long before anyone else does. It is, therefore, important to understand the combination of motivations within the PE firm's structures which culminate in the purchase of a target company, leading to the later release of capital intended for operational improvement or debt Funding (SAVCA & EBS Advisory, 2015).

Conversely, the shareholders of the target firm may wish to sell to a PE buyer due to the lack of revenues, cash flow and debt financing available to that company at that time. As such the willing-Seller (Target) offers the willing-Buyer (PE firm) a significant portion of their company in the hope that the value of their remaining shares grow beyond what they could have attained without the Funding and expertise brought by the new PE shareholding (Barber & Goold, 2007). The sale process is intrinsically based on these opposing viewpoints in which the Seller shares with the Buyer a set of information about the Seller's firm. The process of gathering the information and analysing it fundamentally influences the outcome of the buying decision.

When a PE firm chooses to pursue the purchase of a potentially strategic company for one of its Funds, it follows a particular process. This process is driven by a combination of inputs from multiple sources in order to generate a rich picture understanding prior to any binding offer being made. The process of purchase has been defined in general terms by MLA (2013):

1. Tentative selection of target firm (PE)
2. Indication of Interest - Non-Binding Letter of Intent (PE sends to Target)
3. Confidentiality Agreement and Access to Information Terms (PE signs with Target in Letter of Intent)
4. Due Diligence, Operational and Legal Audits (Audit, Legal and Management Consulting Service Firms on behalf of PE)
5. Corporate valuation (Bank as Financial Advisor to PE)
6. Binding Offer (PE submits the offer and deal structure to Target)

The process, after signatories commit to the Confidentiality Agreement, is usually conducted through a Data Room. This can be a physical space in an office, or shared electronic storage set up between the PE firm and the target company. It is entirely managed by the target company so that the flow of information is controlled on an as-requested basis. MLA (2013) requires that the Letter of Intent define the access rights the PE firm is granted during this process. Ultimately, there is little space to hide anything from being analysed if it is requested. This complexity of such an evaluation is precisely what is being researched in this report.

2.3.1. Due Diligence

A Due Diligence (DD) is fundamentally a financial evaluation combined with that of tax clearance; legal investigations into matters pertaining to company rights and intellectual property; and operational inquiries linked to capacity and capability within the firm. In theory anyone can conduct a DD on their own firm, or that of a firm they wish to make an offer for. It is not linked only to PE models, but is rather a tool used my many facets within industrial relations (Gillman, 2002).

A DD is driven by the need to assess all the benefits and liabilities of the proposed investment by evaluating all imaginable aspects of the past, present and future prospects of the business. It seeks to understand the business and its environment and to use that information to come to an accurate valuation and to build the most reliable and predictable financial model to theorise about the potential earnings the company can expect. This sort of model is then tested under varying eventualities in order to predict a range of performances from best to worst. Such numbers are thereafter used by PE to understand the economic strategy that could be employed in certain instances, given certain outcomes of such a model. This inherently leads to a risk-based approach to pricing the firm in the final contract of sale (Poerink, 2011).

In addition to investigations done by members external to the PE firm itself, the PE employees and Fund managers would look very closely at:

1. Comparable and precedent transactions – looking at historical sales of other firms in the same industry (Poerink, 2011).
1. Financial operating models – as mentioned, the actual performance of the firm relative to current trading numbers (Davis et al., 2014).
2. Compatibility relative to the Fund and the PE's ability to manage it (Davis et al., 2014).
3. The macro-environment and whether or not the target firm is operating in a market deemed strategically important. This includes mature and growth potential (Davis et al., 2014).
4. The marketing activities possible to generate interest and revenue streams from hitherto untapped segments of the customer base (Barber & Goold, 2007).
5. The management of the target firm with a view to avoiding friction in a fast-changing environment (Barber & Goold, 2007).
6. The information systems which manage the firm's accounting software, stock, production and procurement activities so as to ensure the transparency and ease of conducting day-to-day business tasks (MLA, 2013).
7. Legality surrounding the existence of prior contractual obligations, ownership of assets and tax implications where changing ownership can transfer prior liabilities to the new owners (Gillman, 2002).

PE firms require the richest picture of the target firm as possible, and so their version of a DD goes well beyond the financial matters. The combined results of all their Service Firms' findings, as well as their own internal analysis is essentially an all-encompassing DD. Post this process there no clearer picture of the firm's status quo can be painted without actually running it for a period of time.

The complete collection of this information is thus closely linked to the valuation of the firm because it asks the question: do we buy the company? The answer to this question can only be evaluated in terms of what price is being asked. It is therefore imperative that a comprehensive DD lies at the centre of the valuation model: a combination of subjective and objective information which colours the target firm with a BUY or DON'T BUY suggestion, as well as a suggestive price (Gillman, 2002).

2.3.1.1. The Auditor's Role

Typically an Audit Firm will be engaged and sent into a particular target firm with a view to delivering on a financial DD. MLA (2013) and Gillman (2002) propose that a good financial investigation should provide the following:

1. Focus on the balance sheet and invoice statements, making sure all numbers are realistic (effectively a full audit).
2. Understand what is the revenue stream of the company, i.e. what is it the company actually regards as product or service it sells, and how is this converted to cash.
3. Detail clear lines for where the company sees expenses and how it gets financing.
4. Provide an inventory valuation based on direct observation.
5. Look at accounts receivable and understand the collections challenges.
6. Review financial statements for hidden policies and treatments of company financial matters, especially in footnotes.
7. Provide an asset valuation where certain risks related to the assets are identified.
8. Provide a liability evaluation linked to the assets on hand, culminating in a Net Asset Valuation (NAV, to be discussed later).
9. Build a financial summary showing a Discounted Cash Flow (DCF, to be discussed later), taking the company's earnings and working them into a forecast in light of risk factors determined in their prior evaluations.

2.3.1.2. The Lawyer's Role

MLA (2013) talks at great length about the role of a legal team in a DD scenario. The lawyer's, apart from drafting agreements related to the non-disclosure of information and sale, are required to consume the information generated by others with a view to uncovering legality that may prove difficult for new owners.

Literature from MLA (2013) and Bowman Gilfillan (BG) (2014) would suggest that common legal issues investigated include:

1. An organisational registration and legal structure, typically focused on Certificates of Incorporation. It is imperative that the company actually exists as it is portrayed in the sale.
2. Examine minutes of Board Meetings, specifically with a view to ensuring the validity of the potential sale as agreed by the members.

3. Determine the juristic areas in which the company can operate, including export and import regulation in relation to the market and products.
4. Tax clearance in relation to VAT, if registered, and any company tax owing to SARS.
5. Determine where any debt is held, and under what clauses these debts have been provided.
6. Assess the number and type of shareholders, specifically relating to rights and obligations. This is more complex in the listed space where stock classification comes into play (e.g. preferential versus ordinary shares).
7. Location and state of property ownership or leases. This will impact any restrictions there may be on operating conditions, space allocation, annual rental increases, terminations and so on.
8. Insurances are also often overlooked and need to be fully understood relative to the assets, services and market in which the company requires adequate cover.
9. Intellectual property needs to remain the property of the company post the acquisition and any threat to this requires knowledge before a deal is made.
10. Prior litigation and any potential threats to cash flow and management time should be laid out in advance.
11. Employee benefits and contractual agreements with employees should be looked at. Clauses exist which, in the instance of changing ownership, could transfer liabilities to the new owners unknowingly. Notably, unpaid provident funds, medical aids and PAYE could be transferred.
12. Contractual obligations, either with suppliers or customers, need to be understood. Continued performance on both fronts constitute mandatory efforts post-acquisition so as not to threaten supply or revenue.

2.3.1.3. The Management Consultant's Role

Harding and MacArthur (2010) believe that management consultants adopt a more holistic position in the evaluation of potential deals. They will provide assistance to the PE firm on the level of "deal thesis evaluation"; the reasons for purchase staying front of mind. That is, they will assist PE to determine if the potential acquisition will provide the expected benefits to their other business (if merging) or conduct DD on the strategic aspects of the business which need to be shored up, maintained or dropped in order to ensure future success can be reached.

Between Harding and MacArthur (2010), Elton and Weddigen (2006) and Bain & Company (B&C) (2015), the role of a management consultant is more behind the scenes in the early phases of deal generation. This literature on direct practice suggests they will perform the following functions:

1. Conducting interviews with clients, suppliers and staff to understand the interplay at levels a set of financial forecasts cannot provide.
2. They will even interview competitors with a view to 3rd party understanding of the target and its capabilities or perceptions in the marketplace.
3. Go into operational evaluations around production or service procedures and capabilities, focused on finding out if the firm is in complete possession of the ability to produce or source the goods and services they trade on.
4. Evaluate for weaknesses in cultural fit between the Fund and/or businesses being merged, critically linked to the ability to manage the firm post-acquisition.

5. Provide a bottom-up view of the target with strategic benefits and broader deal logic in mind (hence, “deal thesis evaluation” mentioned above).

2.3.2. The Role of the Bank

The determination of a price for the target firm is done on two levels: the PE firm does an analysis to make a non-binding offer up front; and the Bank (financial advisor to the transaction) does the fundamental analysis taking the inputs from the Auditors, Lawyers and Management Consultants. Effectively, the Bank acts as the project management of the other service firms (Gillman, 2002). The Bank then sits side-by-side with the PE firm in possession of semi-equal information pertaining to potential purchase (MLA, 2013).

The decision to buy is not reached without the Bank. The Bank provides a view on the amount of debt it is willing to provide the PE firm to use to conduct the deal. The capital raised in the Fund goes together with the debt offered by the Bank in order to conduct the purchase, and hence the Bank takes a guiding role in the process. It is simply easier to have the same Bank fund the balance of the purchase price as they too understand the company being purchased. This leverage means that PE firms usually only supply a percentage of the funds, allowing them to conduct multiple purchases from their limited resources. The Bank is thus a critical partner for the PE industry and extends their reach through debt instruments offered at elevated interest rates (Barber & Goold, 2007).

It is worthwhile noting that the acquired firm is responsible for funding the interest and charges that arise out of any debt used to purchase itself, not the PE firm itself. Therefore, the purchase price is linked to what the cash flows of the acquired firm can sustain prior to purchase. This is the free cash that the PE purchaser will look for in effect to pay off the debt it raises through the Bank to fund the purchase price. Furthermore, it would be remiss not to discuss some high level detail on the methods of valuation typically employed: Net Asset Value (NAV); the Residual Income Method (RIM); and the most common being a comprehensive Discounted Cash Flow (DCF) model (Gillman, 2002).

2.3.2.1. Net Asset Value

The NAV model is usually only used for an initial negotiation as it is purely based on accounting book values, which are not related to actual market value in the firm. As a rough estimate based on audited financial statements, it is reasonable to use this in discussions about pricing decisions in the early days of evaluation. This model is not relied on in practice as a simple misstatement of asset value, or asset impairment (fair value) issues would significantly alter the valuation of the firm if not disclosed in time or accounted for properly (Correia, et al., 2011).

2.3.2.2. Residual Income Method

The RIM uses current modified financial statement information to ascertain the net book value of equity in the firm, plus earnings in excess of the cost of capital. In other words, the method attempts to calculate assets less liabilities, and then add back expected earnings. The terms of the calculation include items only determined post a financial DD (Gillman, 2002). It is a method only applicable in certain instances, like in the valuation of a mine where its mineral resources decline over time by a definitive amount annually and its lifetime is finite by design (Correia, et al., 2011).

2.3.2.3. Discounted Cash Flow Model

The prominent valuation technique is a DCF which requires the free cash flows to the firm into perpetuity, discounted to present value by the weighted average cost of capital (WACC) of the firm. As the WACC is of no consequence to the PE firm as yet, the preferred discount rate is the internal rate of return (IRR) set by the PE Funding model. This is case-specific and would differ in each PE firm subject to their prevailing strategies and expectations over time (i.e. the IRR is the expected increase in Fund value that the PE Firm has promised its investors). It is this model which is given the most attention by the Financial Advisors and is mandated in line with International Financial Reporting Standards (IFRS), and the model which ultimately gives the most trusted value to the purchase price (IFRS 13, 2011).

2.3.3. Typical Results of the Evaluation Stages

In each of the above instances, the suggested purchase price (i.e. the result of the calculations used) is also only a suggestion to the PE firm. It is their decision which will be imparted to a binding offer. From the start of negotiations, the non-binding offer letter makes mention of the value the firm is being offered by the PE Fund. This usually comes from a pre-accessible state in which the PE managers have had to evaluate based almost entirely on a price-earnings ratio (P/E ratio), or the market-to-book ratio, or even the NAV. This is seldom close to the final number offered. Only one of these valuation methods will provide an accurate, albeit assumed, price for the firm (Barber & Goold, 2007).

2.4. Conceptual Model Proposed by Literature

This section proposes an initial graphical model around the steps, or phases, of a generic timeframe leading up to Private Equity purchase of a targeted firm, as outlined in section 2. That is, the model in Figure 5 attempts to provide a left-to-right timeline of events in a multi-layered approach in which the fundamental influence of each service firm is brought into the PE decision space. The time it takes to conduct all actions has been assumed at 1 year, coinciding with *Deal Sourcing & Investing* stage introduced in Table 2 earlier in the report.

Figure 5 is broken down into three distinct sections which will be referred to hereafter as Phases:

2.4.1. Phase 1: Pre-Feasibility

The influences of the PE Firm, their investment methodologies and general motivations to get into a sale agreement fundamentally influence this phase. It is here that potential targets are motivated as good fits for the Fund. This can be thought of as a funnel in which all potential acquisitions are scrutinized at face-value through publically available information, culminating in the selection of one to pursue further. The PE firm will approach the intended target firm and introduce their interest at the end of Phase 1, culminating in letter of intent and non-disclosure documentation which allows them additional access. Of course, the target has to want to sell their shares, either in part or wholly, to the PE firm that has approached them.

2.4.2. Phase 2: Full Evaluation

All the Service Firms are contracted as necessary in this phase. Here the target firm is required to set up the Data Room and respond to requests for information and access to customers, staff, and suppliers alike. This is the real evaluation, spearheaded by the PE firm in combination with the Banking partner.

An Auditor will be selected to perform a financial Due Diligence, feeding into the Lawyer whom will consider the legalities that may arise around their findings. Simultaneously the Management Consultant, should there be one, will ensure that the goals of the PE firm are being reinforced by the possible synergies that exist in the target firm.

The Bank will oversee the resultant information being fed into a fundamental valuation, and present this information to the PE firm at regular intervals where necessary. All through this process there is PE involvement. It is not left to the 3rd party Service Firms to come up with an answer in isolation as this would divorce the PE strategic thinking from being involved at intermediate stages for early decision making.

2.4.3. Phase 3: Contractual Sale

Should the comprehensive DD, along with prevailing feeling in the PE firm result in a favourable buying decision, the Lawyers are further contracted to draw up a Sale Agreement and the final pricing is written down for the target firm's shareholders to consider. This Phase enters the negotiation table which is beyond the scope of this research report. It is mentioned only to provide clear pathway to further research, and to provide a closing point for the scope presented here.

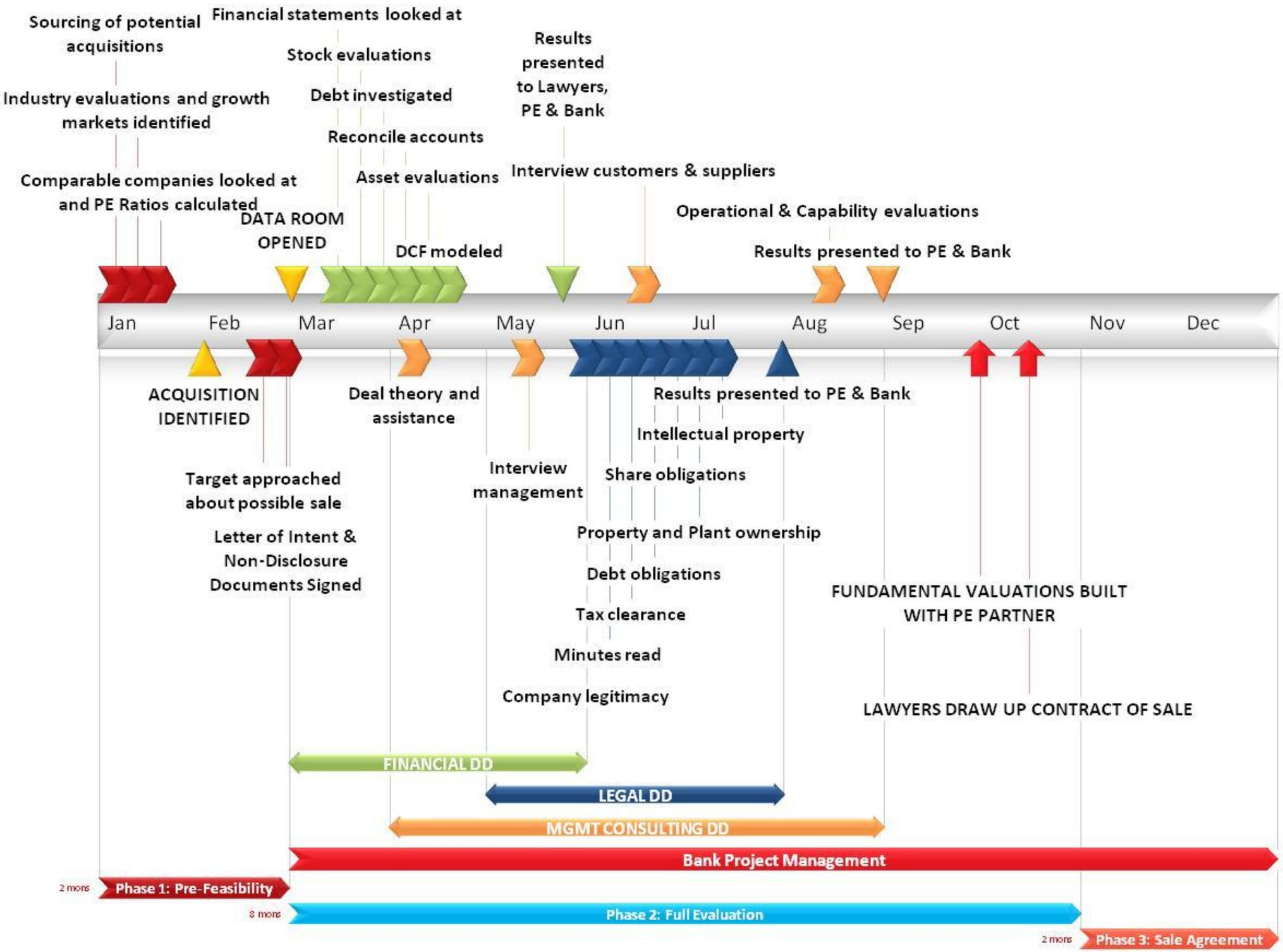


Figure 5: Private Equity Acquisition Evaluation Conceptual Framework (Own source)

3. RESEARCH METHODS

3.1. Qualitative Reasoning

Much effort has been spent by others defining the differences between quantitative and qualitative research, with later receiving criticism for its inability to remove subjective bias from results (Brown, 2012). The propensity to deride qualitative forms of research is most often exhibited in the hard sciences like Physics, Engineering and Health Sciences where the nature of bias is actively routed out and methods of statistical relevance have been developed to secure validated results (Seidman, 2013).

However, when research is required to build an *initial concept* before it becomes a *field of research*; where the data is limited and comparable resources not available; the act of breaking new ground requires that the methodology be qualitative. The limited data sets couple together to prevent seeking statistical relevance and the value of the research is more in the burgeoning concepts created from a general perspective than from a quantitatively driven data pool. In this case, once additional research is conducted on evaluation stages of PE deals, it may be possible to go into specific cases, individual stages or industry methods employed by competing PE firms to such a degree that quantitative results could be drawn (Brown, 2012).

3.2. Methodological Design

The nature the research presented in this report has been driven by the limited information available. The qualitative research approach was therefore identified very early as the only one that would yield results of a meaningful nature. In the build up to conducting exploratory activities it emerged that there are various qualitative methods applicable to this mode of enquiry. The methods are typically driven by the field of research in question, and not chosen arbitrarily in an attempt to qualify the data available.

The various methods, or approaches to gathering information, were simplified into the following list (Trochim, 2015):

1. Ethnography
2. Phenomenology
3. Grounded Theory
4. Field Research

Ethnography is extensively used in the field of anthropology where different races, cultures and backgrounds play the key role in research. Phenomenology, on the other hand, is more suited to the philosophical research field and seeks to provide reasoning for observed phenomena in sociological circles. Grounded Theory was developed specifically to deal with research relating to theorising based on phenomena of interest, “grounded” in data. All of these can be conducted through pure literary evaluation, or out in the field where direct observations can be made and additional data may be gathered, hence Field Research (Trochim, 2015).

Additionally, in Ethnology one seeks detailed descriptions and "storying" with a view to pattern recognition and process generation, and Grounded Theory looks to develop concepts, categorise data and often diagrams the results (Richards & Morse, 2013). This research has been approached along mixed aspects of all of these methodological means simply because the idea is to formulate a conceptual understanding of the PE approach to evaluations, largely through interacting with people whom bring their own professional views on the topic. That is, the ethnological and phenomenological aspects of their views cannot be removed from the research and instead should be embraced for the "expert" experience they represent. Furthermore, the methodologies have been retrofitted to fit the context of the research question at the core of the report, and selected with a view to securing a richer picture of the PE landscape through visualisation and contextualisation of qualitative results.

In order to lay the groundwork of the research, a thorough literature review would be conducted in order to contextualise the information available and lend understanding of the holes in current publically available knowledge (Chapter 2). Additional data would thereafter be gathered through direct field research through interviewing individuals whom have a professional link to actual evaluations on both the PE and Service Firm side. This entails the researcher going into the field to observe and collect field data through notes that are based on observations and interviews (structured and unstructured). Such data is consistent with Grounded Theory which typically begins a line of thought with "what's going on here?" (Richards & Morse, 2013).

Thereafter the approach to meaningful interpretation of the information gathered, both in literature and in the field, will be summarized in narrative and graphical forms. That is, the literature will provide a conceptual model of the evaluation process as viewed by 3rd parties, whereas the data from the field will initially be dealt with through paraphrased narrative. The data gathered from the field interviews will be added to the literature-based model and modify it as necessary, expanding upon it and providing a more in depth understanding of the interplay between PE and Service partners, as well as Target firms. Of key importance will be to formulate a series of visual models which capture the complexity of the exchanges between parties.

3.3. Interview Methodology

On reflection on the research question (i.e. *What information supports buying decisions in the South African Private Equity Industry?*"), the ideal result would be a list of items that multiple PE firms would agree is an exhaustive list of topics to evaluate about a proposed acquisition company. In reality, in the absence of a comprehensive, unrestricted and thorough investigation on a statistically significant set of PE firms, this is not a result that can be inferred from the data. There is not enough time, access rights nor willing parties on the side of the PE firms available. As such, the research at such a fledgling stage of enquiry into this topic asks only that a limited number of involved parties provide information from their lived experiences.

A semi-structured interview would suffice in this instance as it provides a research gathering tool that provides a basic mode of inquiry, building structure to other's experiences and probing them for value and meaning. The purpose of interviews is not to test hypotheses, but rather to develop the understanding of the lived experiences of others; in this case the approach adopted in evaluating companies on behalf of PE, or as PE themselves (Seidman, 2013).

3.3.1. Interview Participants

Interviews will be done with industry experts whom act as agents on behalf of PE firms during the evaluations stage (Audit Firm, Legal Firm, and Bank). The information regarding the actual practice of evaluation between the Letter of Intent and the Binding Offer will be crucial to understanding the depth to which information is sought, and made available by the target companies, and exactly how useful it is meant to be relative to evaluating a company for acquisition.

In addition, members of PE firms who have access to information regarding buying decisions no longer considered privileged information (i.e. can exist in the public realm without derogating from the value of their business, or incurring undue risk) will also be approached. These interviews will be based on the topics emerging from the *Conceptual Model Proposed by Literature* to determine what information the PE firm typically considers important during the evaluation phase. The intention will be to draw out the most pertinent information which could lead the firm to a final buying decision.

3.3.2. Ethical Considerations

In writing the proposal for this research report, it was determined that access to information would be a key risk to the process of gathering data. This stems precisely from the nature of the information in question. That is, the PE industry trades on the basis of their ability to pick and choose the best firms for them to develop and sell. This research touches directly on their methodologies.

The University of Witwatersrand Guidelines for Human Research Ethics Clearance Application (non-medical) were consulted for high level influence on the interview approach and access to information. Additionally, the research involved direct contact with people, resulting in ethical considerations around the nature of the interview process and the possible abuse of any power position that may result (Seidman, 2013). This pointed to the requirement to provide the following documents in an attempt to smooth the process and ensure all parties felt comfortable with the purpose of the research:

1. Letter of Consent (Appendix A houses the blank and signed versions, as necessary)
2. Participant Information Sheet (Appendix B)

It was understood that the information that could exchange hands in the interviews may be construed as potentially threatening to the firm whose employee was sharing it. After all, the research question was pursuing an understanding of their strategic thinking, the same thinking that allows them to secure billions of Rands in funding to conduct their activities. The respondents were brought into the study was by way of contextualising the reasons for the research from the perspective of the writer (Seidman, 2013).

The Letter of Consent specifically called for the respondent to be comfortable with sharing their information and provided them with anonymity if they requested it. It also provided for access rights they could invoke if they wished to peruse the data gathered, or the way in which their information was presented. If they indeed wished to revoke their participation then they were more than welcome to do so.

The Participant Information Sheet is a more subtle document aimed at opening the door to the actual questionnaire. The researcher has had significant exposure to Private Equity deal-making post acquisition and this experience was thought to endear the research to the respondents. That is, the aim was to demonstrate to the potential respondents that the researcher posed no threat to the company they represent, but rather had a deep-seated and well developed interested in the material in question. This was designed with the express intent to create common ground on which any questionnaire/interview-type discussion could be based.

3.3.3. Interview Questions

Seidman (2012) regards interviews as having a very wide range of applicability to qualitative research. An interview can take the form of tightly structured surveys with standardised, normally closed-type questions. The answers to which are usually constrained to limited options, applicable to wide ranges of respondents and easily transferrable to quantitative results. These are reserved for studies where a very clear and hardwired question is desirable; non-leading and carefully selected wording is needed in order to pry an honest result from respondents.

On the other end of the spectrum is an interview where the phenomenological value is more in-depth in relation to the structure of the questions. In practice this results in an open-ended set of questions informed more by the respondents' life-history and lived-experience. Primarily this results in an interview where the respondent reconstructs their experience within the topic under study. Seidman (2012) regards this approach highly in relation to the experiences of contemporary people whose experience may be the only window into a particular field. This is also consistent with Richards and Morse (2013) whom hold that when just enough is known about a particular subject to formulate questions about a topic in advance of the interview itself, then open-end/semi-structured interviews are most feasible.

With this in mind, two sets of semi-structured question sets were built; one set aimed at PE directly, and one aimed at the Service Firms. The larger set was aimed at PE respondents, whereas the second section was designed to be a diluted version of the same questions. There was some intent to get the respondents to answer directly the questions posed, but more emphasis was placed on getting them to provide deeper context in light of the topic suggested by the questions. Considering just how little was known about the actual efforts put in by PE on evaluations, this semi-structured approach would yield results on a far deeper level than a fully structured question-and-answer session.

PE respondents were approached with 14 questions. These were selected, and in some cases overlapped partially in order to create connections between the topics touched on. What was important in the question structure was to connect the following gaps in understanding:

1. Industry segments that the PE firms operate in and find valuable.
2. Actual processes followed in the run up to the end of Phase 1 (*Pre-Feasibility* as proposed in the *Conceptual Model*) tentative selection of a potential acquisition target.
3. Which Service Firms are used and what sort of outputs are taken from them into the PE valuation strategic approach.
4. As much detail as possible on Phase 2 (*Full Evaluation* as proposed in the *Conceptual Model*).

5. What pricing methods (or valuation techniques) are being used most commonly, or favoured by the firm in question leading into Phase 3 (*Sale Agreement* as proposed in the *Conceptual Model*).
6. What sort of value the PE firm places on soft-topic results (subjective, for example the nature of current management) versus actual quantitatively determined matters (objective, for example the current profit margins) throughout their decision making process.

Acknowledging that each PE firm may have a different approach to such an evaluation, the questions focused on creating a rich picture of that specific firm's strategy and market focus. Where the discussions went into industry practice in general, the researcher pursued these points with vigour in order to expose potentially congruent information.

When considering the Service Firms and their questions, the PE questions were taken and broken down into 5 pointed matters to clarify with the respondents. These were simply designed to probe the following:

1. The nature of the services offered the PE customer.
2. The width and breadth of the information gathered by the Service Firm in line with Phase 2 (*Full Evaluation*) as provided by them alone.

There was no attempt made to complicate the responses of the Service Firms whom took part. The question style and length was approached with a preconceived notion that their input was a purely independent result not linked in any way to the activities of the other Service Firms. The research initially underplayed the role of the Service Firm in the evaluation phases, and subsequently found that much more information was gleaned from their actions and involvement than was originally understood.

As much as semi-structured seemed the best approach, a certain amount of structure was needed in the information presented to respondents. In the context of the interview process, a high level depiction of the researcher's current impressions of the interplay between parties was presented. This was built out of a prior literature review conducted during the motivational process of the topic at hand. The graphic was presented to the interview respondents and discussed with a view to verification and modification. Notably, the questions were never amended post any interview in order to keep the approach and information presented consistent in all subsequent discussions with respondents. This was important since having differently worded questionnaires for a small sample of people would inherently build inconsistent results (Seidman, 2012).

The questionnaire is presented in Appendix C, where both PE and Service questions are on the same sheet. This was presented in exactly this form to potential respondents in email form, with the Letter of Consent and the Participant Information Sheet. All parties were approached telephonically by consulting with the SAVCA membership list (provided in the *SAVCA 2014 Members Directory,* referenced in the back of this report) and background research on the appropriate contact in the company. This took the form of website searches and probing phone calls to these companies. All subsequent interviews were held in public places to reinforce the non-threatening nature of the research.

3.3.4. Presentation and Development of Interview Data

During the process of the selection of an appropriate qualitative methodology, formulating the questionnaire out of prior literature and the then-current understanding of the subject matter, the research unearthed aspects of inquiry in unexpected ways. This type of open-ended development of concepts, and the sometimes disconnected development of detail and understanding, has strong roots in a continuum of Grounded Theory known as Situational Analysis (Richards & Morse, 2013).

Richards and Morse (2013) talk about Situational Analysis as a recent development brought on by analysis that "focuses on a situation made up of context, people, and their relations, actions and interactions." The results of such inquiry require interview, observation, text and graphics. Thus, a strong element of understanding complex scenarios like PE evaluations from multi-party perspectives requires a situation-centred framework. In this way, the "situation" becomes the unit of analysis, and understanding its elements and their relationships is the primary goal. In such a way, the development of valuable data from interview results and literature has been approached from two angles:

1. Narrative of interviews
2. Graphical presentation of interactions between involved parties

In the opening section of this chapter, concern was raised about subjective bias influencing results in qualitative research. Hennink *et al*. (2011) talks to this issue and addresses the problem by embracing it through Reflexivity. That is, we need to acknowledge that the interpretive approach of an interview through a narrative is, in effect, a combination of the interviewer *and* respondent coming together with each of their subjective views. These include views on the topic, situation and physical setting. We can then begin to understand *which* aspects of a narrative result are biased by the interviewer.

Reflexivity is the process of conscious self-reflection on the part of the researcher to make explicit their potential influence on the research process. The narrative, therefore, is a direct result of this and should be appreciated as a result of the researcher's experiences as much as that of the respondent. Reflexivity thus assumes that the researcher, and subsequently the reader, is explicitly aware of their own values and ideologies in the context of the presentation of results. Reading research with this in mind can provide an excellent high level understanding of the intrinsically complicated situation and in turn provide options for additional research (Hennink, *et al.*, 2011).

3.3.4.1. Interview Data in Narrative Form

Research labelled *narrative* is also closely related to phenomenology as well as case study research in the family of qualitative research designs (Miles, *et al.*, 2014; Yin, 2014). This type of research is distinguished by the recreation of lived-experiences and heuristics people have developed in order to perceive their experiences via storytelling. This principle has been borrowed to develop a recreation of the experiences the interviewees have had. Thus, the value of the resultant paraphrased version of the interviews is to both expand upon and infer details related to being involved in Private Equity buying decisions and evaluations (Miles, *et al.*, 2014; Yin, 2014).

Hence, the narrative builds a story to illuminate the meaning of his or her work or life experiences in ways that help the reader understand the complexities of, for example, the depth of investigation a company has to pursue in order to fully elevate potential issues that could arise post-acquisition (Seidman, 2013). Ultimately the narrative will aide in providing a chronology of a generic investigation, or Due Diligence, from the perspective of both Service Firms and Private Equity employees. The outcome of narrative research is a researcher-generated definition of elements of the persons' and situations' stories (the raw data), thereafter identifying themes, uncovering important sequences, and retelling the "story" in way that provides insight (the meaning)(Miles, *et al.*, 2014).

The value of narrative could best be highlighted by the comparison with a kaleidoscope as made by Dye, *et al.* (2000) where the researchers were faced with similar challenges in choosing and interpreting qualitative research methods. Narrative provides a way to reduce complex "clouds" of data appearing like multi-coloured bits of glass mixed together into categories. Figure 6 provides a visualisation of the process of gathering disorganised data and working towards a final model that makes sense.

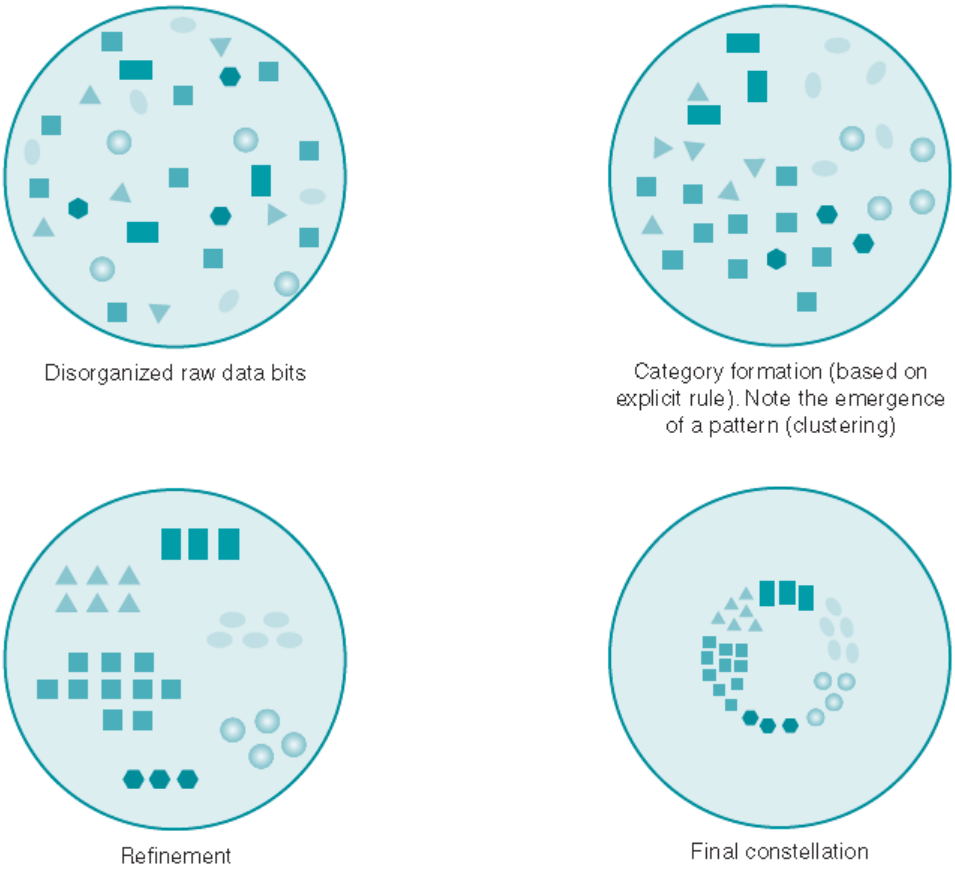


Figure 6: The Kaleidoscope of Data (Dye, et al., 2000)

Out of the emergent pattern, the research would seek to refine the common themes and aspects of commonality. Value, or meaning, would not be achieved through reductionist means but rather through trying to consolidate the information presented into a "constellation" of concurrent and intertwined themes (Dye, *et al.*, 2000).

The narrative, coupled together with the Literature Review and subsequent Conceptual Model will be the basis of the final interpretation of the situation at hand. That is, the research will be developed into a Modified Model and present the best understanding of how a chronological, relationship-based and deliberate evaluation is conducted of a Target Firm in a Private Equity setting. This will be the "final constellation" as suggested in Figure 6.

3.3.4.2. Validity and Repeatability of Results

Miles *et al.*, (2014) talks to the repeatability and validity of research results by the purposeful use of triangulation. This method requires that the researcher chooses three different sources of information to corroborate findings. This is challenging in so far as the trustworthiness of those sources are also called in question. Ideally a maximum number of alternative sources should be evaluated in order to develop full congruency between results. Yin (2014) is more focused on case study methodology, but he makes some clear points about clear records of the methodologies used in reaching any type of result.

This research has been conducted acknowledging the exploratory nature of the topic at all points. There are limited resources available to interview and even less online content relevant to the questions posed in the interview itself. Therefore, the approach has to be one that aims to achieve as much triangulation between the following:

1. Literature from multiple sources, including international and South African (two sources)
2. Interview Respondents from Service Firms and Private Equity Firms (two sources)
3. Researcher experience intertwined with the narrative (loosely, one source)

Triangulation is sought by comparing the views of multiple parties to the similar shared experiences.

As many PE firms would be approached as possible. The aim was to seek at least 5 to 8 once-off interview sessions with different PE firms, however this was not possible. It was only possible to meet with one PE respondent, albeit a high-level employee with keen understanding and long experience in the field. It was initially believed that a large number of respondents would be found in the selection of Private Equity Firms registered with SAVCA. As such, the majority of questions were aimed at getting such firms to really explore their approach within the realm of the research proposed. As time went by, the risk factors were more clearly understood when the PE Firms started refusing to take part in the research. And so, the approach was amended to absorb the data that was available.

Furthermore, at least 2 to 3 consultation sessions would be sought within companies servicing the PE industry with a view to understanding how their scope of the evaluation is conducted in reality, and what kind of output is generated. The Bank, an Auditor, Lawyer and even an Industry Expert (ex-Service Firm employee) were far more willing to have the discussions than PE firms. Their responses constitute the most comprehensive data sets.

All mechanisms for data collection have been included in this report for the use of any future researcher if their desire is to repeat or expand upon the topics presented herein.

4. DATA AND ANALYSIS

This chapter details the paraphrased narrative version of each of the interviews conducted during the 2015 and early 2016 researching period. Description of the approach to analysis of the results is provided, and the resultant Modified Model is presented at the end of the section.

4.1. Respondent Profiles

The respondents who participated in the research were each well versed in their respective fields and offered an almost unbridled view on the topic in question. To lend weight to their views, a short introduction to each respondent is given below, where pseudonyms are used for all. The order of their introduction is mirrored in the order the interviews are presented later.

4.1.1. Private Equity – Warwick Capital

Thomas Voigt is currently an Advisor to Warwick Capital (WC), prior to which he was a partner from 2007 to 2014. Prior to joining WC, Thomas was the founder and Managing Partner of Axis Venture Associates, a South Africa-based venture capital advisory consultancy. The firm provides advisory services to government, technology funds, and corporate spinouts. Prior to founding Axis, Thomas was a Principal & Deal Executive at Brait Technology Fund in South Africa where he was responsible for sourcing, evaluating, and sponsoring investments.

Before he joined Brait Technology Fund, Thomas was a Finance Executive with Sun International Limited, the largest operator of hotels and casinos in Africa, where he was responsible for financial analysis on more than $400 million of investment. He joined Sun International from Rightsizing Technologies, a Sun Microsystems reseller where he was a Business Development Executive. Thomas started his career as an accountant with KPMG in Johannesburg.

Thomas received a Bachelor of Commerce Degree from the University of the Witwatersrand in South Africa and a Bachelor of Accounting from University of South Africa.

4.1.2. Bank – European Bank

Justin Scott is currently the Vice President of Corporate Finance at European Bank South Africa (EB). He has been with the Bank for 6 years, rising from the ranks of Associate. Prior to joining European Bank he held the position of Analyst at Merrill Lynch for 2 years.

He has worked on multiple large Private Equity deals in the past years, being closely linked to the whole process. Owning to non-disclosure agreements he was unable to detail much beyond the high level of his experience and exposure.

He holds a Bachelor of Economics Degree in Actuarial Science from the University of the Witwatersrand in South Africa.

4.1.3. Auditor – African Auditor Inc.

Ajit Ram is currently the Head of Financial Services Group at African Auditor Inc. South Africa (AA). His expertise is mainly in the financial services industry, with areas of practice including advisory, valuations, due diligence investigations and IFRS. He is responsible for the firm's major insurance, asset management and treasury clients.

With over 12 years experience, he joined AA's VSP in 2003 as a Senior Audit Manager and in 2006 was promoted to a Partner in the financial services division. He gained extensive experience in corporate and retail banking, treasuries, stock-broking, securitisation, insurance (long and short term), retirement funds and medical schemes. He also has experience in corporate advisory and corporate finance. Prior to joining the firm, he worked for Deloitte & Touche.

Ajit holds a Bachelor Degree in Accounting as well as a Accounting Diploma, is a registered Chartered Accountant and holds a Level 2 in Chartered Financial Analysis. He is also a registered auditor on the JSE.

4.1.4. Lawyer – Arkaitz Lenard Konstantin Inc.

Martin Levy works as a Senior Associated for Arkaitz Lenard Konstantin Inc. South Africa (ALK). He is an Attorney of the High Court of South Africa, having practised as such for 5 years. Simultaneously, he holds Right of Appearance in the highest courts in South Africa including the Supreme Court of Appeal and the Constitutional Court. He has special interest in Commercial Litigation and Criminal Law, and consults directly on Due Diligence matters on behalf of both buyers and sellers. He has been with the firm since completing his undergraduate degree in 2008.

He holds a Bachelors of Commerce Degree in Law, majoring in Economics, as well as a Bachelors of Law from the University of Johannesburg. He is currently reading for his Masters in Banking Law and is shortly to be admitted as a Notary Public.

4.1.5. Industry Expert – Private Business Owner

Michael Clyde is currently the Commercial Finance Director at Local Metal Works, a family owned business where he is re-scoping the strategy of the firm. Prior to this he has worked for OIM Group out of Cape Town as a Consultant on performance and CAPEX matters for listed and manufacturing entities. He spent time as a Transactor for an Italian-based credit agency, SACE. While at SACE he was directly contracted to Private Equity firms to secure the credit worthiness of African deals with specific financing structures coming from outside of South Africa.

He has key ties with the Private Equity Industry and access to investors on multiple levels Through these connections he has maintained a keen knowledge of the industry and some of the behind-the-scenes activities.

He holds a Bachelors of Commerce Degree in Economics and Econometrics as well as a Bachelors of Commerce Degree in Finance, both from the University of Johannesburg. He also holds a Masters of Industrial Engineering from the University of the Witwatersrand and has a Level 2 accreditation as a Chartered Management Accountant.

4.2. Interview Data

The interview notes can be viewed in Appendix D – Interview Transcripts. Notes were taken during the interviews and transcribed into the questionnaire sheets directly. Later reading of these notes provided the context for the results.

4.2.1. Interview Analysis

The process of organising, analysing and refining the interview data as described by Dye, *et al.* (2000) was used to develop the narratives into a kaleidoscope of understanding. The interviews each presented a set of expert opinions to the same questions posed. As such, the information gathered was processed in the following way (Dye, *et al.*, 2000):

i. Each interview was independently considered as a disorganised raw data stream. Answers were noted as given by the respondents against each question answered. At times these notes were far more detailed than the initial questions may have inferred, and the notes were expanded as necessary. This was in line with the expectations of a semi-structured interview style where tangential information is possible through linking concepts and uncovering hidden topics.

ii. The transcribed interviews were then converted to narrative style. The narratives are presented under the title of the type of Firm represented by them (e.g. Private Equity's View, Bank's View and so on). The information in each narrative was then categorised into Phases as presented first by the Conceptual Model from Chapter 2:

   a. Phase 1: Pre-Feasibility considerations were extracted from the answers and provided in chronological order to the analysis done by each respondent in the evaluation of a Target.
   b. Phase 2: Full Evaluation aspects were grouped together to provide a written account of how a particular respondent may approach their in-depth analysis of a Target. Where possible, simple lists were created to begin grouping the PE or Service Firm specific considerations.
   c. Phase 3: Sale Agreement and Beyond is a timeframe that is largely out of the scope of this research, but has bearing on the evaluation phases in so far as this is the point at which the evaluation comes to an end and all loose ends are brought together. The results of the interviews, and hence the involvement of each respondent, was brought to a close in this portion of the analysis.

iii. Further to the categorisation of the information into Phases, the dissection of the data streams was refined as the conceptualisation of the whole process developed. That is, despite the design of questions, the order in which they were asked and the fastidious notes taken, many responses would spill over into multiple Phases. These responses would reference motivations, end goals and concerns all in one statement. Thus, the information extracted from interview notes was dissected to be able to follow a chronological sequence of events. Without this refinement, there would be no way to see the end-to-end process under evaluation, and hence contextualise the data.

iv. The end result of all narratives is the Modified Model which is presented over three figures. This is the "final constellation" of the kaleidoscope of information as presented within categories of Service Firm and PE Firms respectively. The information is presented side-by-side as it is difficult to capture the complexity of the interactions without a graphical model

of events. These figures could be considered as process flow-like and provide a generic example of the items of concern in the run up to purchasing a complete company.

The approach yielded a comprehensive “storying” of each respondent’s involvement within the evaluation process. This refined data subsequently provides the context of the Modified Model’s three concurrent time lines where the events under consideration are layered in a fashion that allows further understanding and discussion.

4.3. The Narratives

4.3.1. Private Equity's View

4.3.1.1. Phase 1: Pre-Feasibility

Warwick Capital, or WC, focuses its actions outside of South Africa and prefers to work exclusively in other African markets. It is their view that they can operate in a more flexible way and with less competition. Companies that they pursue are all in the Technology Industry, but unfortunately were not discussed owing to NDA's in place with Thomas.

WC has adopted the approach in the *Pre-Feasibility Phase* of looking at market economics before identifying a target acquisition. They look exclusively at markets where there is obvious growth to be had, i.e. growth markets. Their model looks for the ability to grow revenue between 100% and 200% year-on-year. Failing that, they are content to accept as low as 40% to 50% revenue growth annually if the company can tap into the growth trend evident from market activities.

Additionally, WC looks to enter markets where they could potentially redress the supply-demand equilibrium. Thomas describes this as a situation where you may want to enter a market with the intent to purchase your competitors later on, folding them into one larger organisation. He defines this approach as a way of taking a saturated market where the pricing for your products or services may not offer great profits, and then through systematically taking out the competition you could improve profitability in the original firm. Hence, even in a mature market with little opportunity for organic growth, you could take the view that this approach is a way to build a profitable entity in the long run. In a growth market this could be doubly favourable because you can create close to monopoly-like conditions and really take advantage of profitability.

Whichever the approach, the firm would look to benchmark the competition and major participants in the industry segment and attempt to build a model of possible returns on capital invested. So, this means they would go to some length to evaluate if they were to enter a market through acquisition, what sort of money would need to be invested (either through additional acquisitions, or capital injections towards efforts to grow the acquired firm) before they could sell it again. This will create an image of worthiness before too much money has been spent on Service Firms and proper DD activities.

Once a firm has been tentatively selected, the typical aspects researched then go into:

1. The bargaining power of customers – are they able to dictate the pricing structure of your goods and services? If so, this could be a bit risky.
2. The dominance of suppliers – what portion of your company supply is sourced through external value-adding suppliers and how does this affect your ability to influence costs? If you are a small customer to your suppliers and rely on them for their goodwill, then this needs to be addressed in order to put the company in a position where it can control more of its destiny.
3. Are there substitute products in the industry? This could indicate the true competition coming from alternative technological developments and needs to be adjusted in your understanding of what you plan to do with the company. Likewise, this could present

opportunities for differing sources of supply to diversify the acquired firm if you can source these goods for your own product range.

4. The nature of competition – Even if you are not after redressing the supply-demand equilibrium, you always need to understand the nature of your competitors. Are there many small guys? Are there few large guys? This will drive the operational strategies you may adopt or strengthen.
5. Is the market like a lobster boat problem? Traditional lobster fishing villages found it difficult to survive in the long term precisely because they viewed their key strategy as one to beat out the competition for an ever dwindling revenue stream (think decreasing lobster populations due to over-fishing). Looking at your market as a zero sum game is challenging and you thus need to understand the customer base very well. If your potential offerings appeal to a limited customer base, and that base is not growing but competition is, then you may want to think twice about entering that industry.

4.3.1.2. Phase 2: Full Evaluation

When WC approaches a potential target, they usually understand that they want it already. Their Pre-Feasibility analysis is actually quite in depth and they only go this far when they want to understand what price to pay. The DD model proposed by the questionnaire, where the interactions between the Service Firms, the PE firm and the Target is consistent with industry practice in so far as it details the generic flow of information. WC, however, approaches things a little differently because *they do not use a Bank, nor do they use a Management Consultant*.

This is significant for their firm because they do not use any form of debt to finance their buying decisions or later working capital funding models. Nor do they need any operational evaluations from consultants and prefer to perform this function themselves. On the other hand, they do make extensive use of Lawyers and Auditors.

Lawyers are incredibly important for evaluating companies, especially in African climates. The legal landscape in Africa can be a very difficult one to tread. The hidden links to ethical issues can sometimes cause problems when funding comes from international sources who may not want to be linked to any questionable operations in Africa. Additionally, the Lawyers need to check:

1. Ownership needs to be evaluated as real and truthful in terms of what was presented to WC. That is, the shareholders need to be the legitimate people able to sell the company.
2. Asset ownership and rights of use are looked into as well as they cannot have the revenue stream linked to assets not owned by the company or legally leased in proper ways.
3. Contractual evaluations have to be done, including those on supplier and customer sides. WC needs to know where it has to perform in order to maintain successful contracts.

The Auditors are used for the DD only. Their mode of inquiry is pretty standard and WC expects their output to be as informative as any normal DD would be. WC doesn't really go beyond the traditional DD performance unless a case-specific issue comes up.

Thomas was pressed to share information pertaining to generic valuation techniques as applied by WC, including possibly sharing some internal documentation. He declined to share this information as he saw it as privileged information. However, he went on to share significant

details about the high level approach regarding fundamental evaluations and coming up with a price.

When WC looks to put a non-binding offer price on the table at the start of Phase 2, they look to:

1. DCF's built from information in the public space (if a listed entity)
2. Buyer expectations
3. Industry comparables, that is, what prices have been paid for firms operating in the same space
4. Fundamental evaluations
5. The return on capital ahead of the cost of capital. This refers to the return the PE firm can expect after all fees and costs have been taken into account through the lifetime of the acquisition in the fund (the firm's desired IRR).

When they take the step to offer a final price they rely completely on their own internal ability to perform a fundamental evaluation. This usually takes the form of a DCF, adjusted for the variables looked at by their Service partners and their own people.

4.3.1.3. Phase 3: Sale Agreement and Beyond

Interestingly, the balance of subjective and objective information going into the decision to buy a firm is reasonably close. Thomas and WC like to look at the DD results, the actual values of contracts and associated objective data, but mix in a heavy dose of "feeling" and soft issues. Of course if they uncover legal issues they will walk away early on. Yet, they have also developed their own heuristic which looks at the overall feel of the business and the management members they would work with post-acquisition. If the WC team feel is not there, or if they sense dishonesty, they will walk away from the deal. It is imperative that they be able to confidently work with the current management otherwise they feel the long term growth prospects are limited.

Lastly, even though WC may own a firm after all this effort, Thomas believes they can never afford to stop looking at the fundamentals of the company. This came from asking if there was a logical point at which an offer would be made. He admitted that this is different on all deals, but that the role of PE is to never stop evaluating the company. They may part ways with their Service Firms post the deal being signed, but the act of evaluation is ever present. This is because they are now trying to find the appropriate time to exit the market, realise the investment and return the highest possible return on capital.

WC gets the signs to sell from both the good and bad aspects of a business, and hence they need to remember that their goal is to sell the firm at an incredibly high profitable point within a defined period of time. Industries and people change, and therefore so the information-flow never stops. It is their role to be on top of the numbers and the soft issues in order to see the icebergs and the potential opportunities. This post-acquisition state is iterative and continuous.

4.3.2. Bank's View

4.3.2.1. Phase 1: Pre-Feasibility

European Bank, or EB, take a very active role in PE deals and will act as the Financial Advisor to the PE client as well as the project manager of the entirety of Phase 2. They will coordinate the entire transaction and collate the information provided by the Service Firms, including daily oversight on deliverables.

Justin went on to explain that the Bank will get work in one of three ways:

1. Tendering directly for PE work.
2. EB will often actually pitch potential deals to selected PE companies.
3. Auctions of companies up for sale or resale.

Tendering is a simple matter of utilising relationships, promises of superior service and better interest rates and so on. PE firms will often have their preferred supplier in one or other Bank, and so a lot of work comes directly as a result of prior work done. In such cases, a PE firm would contact EB and contract them directly to advise on a deal.

In an attempt to generate additional work for itself, EB will actually take the role of investigator and go as far as researching markets, identifying potential acquisitions and drawing up a rationale for the transaction. This rationale is then taken and presented to a PE firm and EB attempts to sell the concept of an acquisition to them. Such a document would highlight the following:

1. Indicative valuations based on conceptual models and historical purchase prices of similar companies.
2. Trading comparable information as it pertains to competitors operating in the listed space. This would include a look at Price-Earnings ratios and EBITDA comparisons, adjusted for the size of the organisation.

Other PE Firms or financial houses whom want to sell out will host auctions when shareholders don't want to talk to individual people but rather attract a host of other interested parties, driving the price up by drumming up desire. EB enters the auction space not to bid, but rather to petition PE firms to buy the company. Sometimes the seller will contract EB outright in order to find a bidder. Auction processes differ somewhat in the overall approach of PE purchase. At a high level they proceed in the following phased approach:

Phase 0: Marketing by the sellers where EB goes out to all potential parties and drums up interest in the company. EB will screen the potential buyers and proceed accordingly.

Phase 1: An Information Memorandum is circulated in which a summary of the company's trading numbers and operational details are submitted to interested buyers. Those whom wish to proceed with more detailed analysis will present non-binding offers at the end of this Phase.

Phase 2: A full DD is hosted and the process is followed by anywhere from 3 to 5 PE firms

Phase 3: Binding offers are presented along with Sale and Purchase Agreements (SPA) and negotiations would proceed on a detailed level between the buyers.

Phase 4: Acquisition happens and EB maintains contact to secure future business.

> *The full auction process remains outside of the scope of this research, but is included at a high level in order to introduce the concepts. It is subsequently not taken into the Modified Model as presented in Chapter 6.*

It is worth noting that EB is in the business of making money, so their approach is amended to suit the situation (tender, pitching deals or auction) and ultimately foster an environment in which the next purchaser will utilise EB. This could be on a funding or an advisory level then and in future. It is therefore natural that EB has the interests of both buyer and seller in mind and that their information is as detailed as they can make it. Their future business depends highly on whether or not the deals they are linked to ultimately work out favourably.

In most cases (i.e. excluding the auction workflow) EB takes the role of financial advisor and will help the PE firm build up an investment case for their own internal approval committees and structures. These Pre-Feasibility documents usually set out the views of the process, including the DD requirements and the degree to which information should be accessible. If there is sufficient information in the public space, then this can manifest in a non-binding offer price. Should the internal rigors of the PE firm find the motivations to be satisfactory, then the next step will be to draft the Letter of Intent and proceed into the Phase 2 Full Evaluation. Only at this point would the PE firm mandate other Service Firms to work within the scope of the evaluation in mind.

4.3.2.2. Phase 2: Full Evaluation

Moving into this phase, EB will adopt their traditional project oversight role, collating information and guiding the process in a manner suitable to achieve an outcome in a reasonable time. Justin believes the key role EB has to play is in that of bringing all the Service Firms' information to a case specific result. This means that the output the Bank delivers on is not really a generic result, but rather that the risks and future of the specific firm is case specific and the operational aspects of the business will define the scope of the project as a whole.

Thus, the cost of the evaluation will drive the timeframe more than anything as the PE Firm will be the ones to guide the Bank and other Service Firms based on their budget. Hence, the trade off the PE Firm needs to accept is the cost of evaluation versus the size and risk of acquisition in the face of limited information.

The outputs of the other Service Firms, including that of Legal, will be fed into the Bank's fundamental evaluation model, which is usually a DCF or industry specific method (see Section 2.3.2 for options). Once again, a host of information gets modelled, including the trading comparables of firms in the listed space and whether or not these are over or under valued. Comparisons are always drawn in order to draw a rational outcome from the myriad information supplied by the balance of

the evaluation. Precedent transactions are always a good yardstick to consider so that the PE Firm can see what other people have been willing to pay for the same industry presence.

EB delivers a final document which includes an analysis of:

1. Financial forecasts
2. Benchmarking
3. Scenarios of if the company's margins were to shift or some other impact were to happen in the market
4. The strategic rationale for the transaction

In the same document the Bank offers their opinion of what the final binding offer should be, and in what structure it should be made up of. In many cases offers are made up of initial figures followed by earn outs (i.e. payment for the shares triggered only if the company trades at a rate forecast and agree by parties). These are naturally more risky, but can be worked into the SPA as necessary and negotiated.

4.3.2.3. Phase 3: Sale Agreement and Beyond

In parallel to the evaluation being done, the Bank begins to draft the necessary SPA in conjunction with the Lawyers. This document is descriptive of the terms the Target Company has to meet post the agreement being signed and contains the conditions that underpin the binding offer. A draft offer is presented to the Legal Service Firm for heavy comment post their evaluations. Subsequently the PE customer will amend the document as necessary and consider supplying it to the Target. It is at this point that negotiation takes over and the resultant offer, and associated conditions, becomes a matter of discussion more than pure valuation.

Typical transactions in the listed space take the form of Scheme of Arrangements where the PE Firm proposes to the Board of a Target Company that they take such a Scheme to the shareholders at large. The Scheme is effectively a price mixed with JSE rules and regulations in which transparency is key. The Scheme is put in front of all shareholders and the decision to sell needs to be reached by a 75% vote in favour. If this quorum is reached, then all shareholders sell and the firm is wholly purchased by the PE buyer. EB once again takes the oversight role and ensures all parties adhere to the rules set out by the JSE.

Once the SPA and associated documentation is signed, EB will provide the debt financing the PE Firm requires in order to satisfy the purchase price.

4.3.3. Auditor's View

4.3.3.1. Phase 1: Pre-Feasibility

In practice AA, as with most audit firms, only provides two services to the PE industry:

1. Independent DD services
2. Opinions on valuations done by others

Their DD efforts constitute 80% of the work received from PE. Their role is therefore not linked to pre-feasibility in any way.

4.3.3.2. Phase 2: Full Evaluation

Ajit and his FSG team are only ever contracted in the evaluation as they happen post the signing of NDA's and the Letter of Intent. Their role is strictly limited to developing a DD in line with the requirements of the PE firm and the Bank.

Notably, the possible outputs of their activities are linked to a menu of items that the PE customer can select. The key driver deciding DD depth is cost: the cost the PE firm is willing to pay as well as the depth of investigation required, or suggested, by the Target Company or industry type. Since PE firms have high IRR expectations, the smaller firms are focused on purchase costs relative to the Fund size they administer. Thus they will be more inclined to spend less on a DD to reduce the overheads of the deal itself. Larger PE firms look more to the overall lifetime of their possible acquisition and more readily take the view that detailed DD's are appealing. However, considering the internal skills that the PE Firm itself has, they often times define a split between what the Auditors need to research versus what they will do for themselves.

PE work is secured through either a tender process or being the preferred supplier and getting the work naturally. Either way, in the run up to being awarded the DD work, a PE customer will supply AA with sufficient information to allow them to quote on the scope of work, as well as an NDA to sign. Once AA's quote is accepted, the next step is to for AA to drive a Mandate Letter in which the following is agreed:

1. The scope of the DD
2. The responsibilities of AA and the Customer, including that of the Bank and overall deliverables
3. The fee schedule
4. Clauses on liability

Thereafter, AA proceeds into the DD, which centres round delving deep into the activities and financials of the Target. There is always a checklist for data provided and a Data Room is set up by the client in advance as mandated by the process and Letter of Intent. Although there is an electronic Data Room these days, there is more often than not a physical space also dedicated to the DD process. This can take the form of an office on the premises with a process for key sign in and out of both data and people. The Target firm usually requires one of their people involved to ensure the process is transparent.

The DD scope, notwithstanding the options to limit this, would typically cover:

1. The Annual Financial Statements (AFS) and the validity of the numbers. This takes the form of a full audit in order to validate from a 3rd party perspective what was done by another auditing firm.
2. Internal reporting standards and procedures to understand the internal flow of information.
3. Process evaluations to ensure stability and reasonable transparency.
4. Interviews with management and service providers to understand how the company operates and in what way they see any flaws or requirements for improvement.
5. An HR evaluation where payroll, compliance and regulatory matters are investigated.

Once a full DD has been completed, AA presents their findings in a report. The most objective results are found here, in the detailed descriptions of the risks and mitigating factors uncovered. The most notable outcomes highlighted would include:

1. Areas where there was unavailable information, presenting possible issues or hidden material matters
2. Legal issues around current liabilities and whether or not the PE customer should be happy with the size of liabilities raised.
3. Deal breakers, such as falsified invoicing used to inflate revenue numbers or stock on the books but not held in reality.

They also provided a stand-alone valuation of the firm, usually a DCF based on the numbers provided by the management of the Target. AA keeps this valuation separate from those provided by the Bank or others, and attempts to provide an independent view to the PE customer.

4.3.3.3. Phase 3: Sale Agreement and Beyond

Ajit went on to explain that their fees for the process are not linked to the purchase price or the success or failure of the deal. As such, they are potentially the only Service Firm in the process whom are not influenced by the value of the deal. This, he says, is not true of the Bank whom charge their fees in line with the final value of the transaction.

Their findings are often times presented to the internal structures of the PE Firm, but beyond that they are not involved in the Sale Agreement or any post-acquisition activities.

4.3.4. Lawyer's View

4.3.4.1. Phase 1: Pre-Feasibility

The Lawyers are in no way involved in the initial decision making processes of the Pre-Feasibility Phase. There is simply not scope for them here as they cannot charge fees nor offer any value at such a non-committal stage.

4.3.4.2. Phase 2: Full Evaluation

Phase 2 is rich in scope for a Legal team to get involved. They are often times backed up by the Auditors and Management Consultants and will mostly take their views from the information dug up by the DD work they do. However, they do conduct a fair amount of their own investigation. Critically, the Lawyers occupy a space in the process which is only slightly structured. If they uncover a particular point of interest they will investigate it more fully, but their approach is more guided by the risks found. Therefore, if there is no need to look at a particular facet, then they do not go into it.

Martin, through ALK, provide the following type of advisory services to PE evaluations:

1. Tax matters are clarified as they pertain to:
    a. Unpaid VAT, Companies Tax, Dividends Tax, PAYE and UIF. These would each be very costly and unexpected issues should they come to light post acquisition, and need to be evaluated for the valuation of the company to proceed.
2. Matters of Going Concern, i.e. existence of the company in operation:
    a. The company needs to continue has a going concern the day after it is bought, including issues of an operational nature.
    b. If the purchase is of a business unit and not a whole business, then there is VAT to consider if the entity is registered for VAT.
3. Looking at inherent risks:
    a. What happens to licences of trade when the company changes hands? A key example would be what happens when a bottle store is sold with a liquor licence. The Liquor Board needs to grant the appropriate approval or else this licence will fall away, effectively rendering the business unable to trade immediately. If the underlying value of the Target is the *ability* to trade in a particular market, then legislative effects can be catastrophic if not considered.
    b. The company's indebtedness to creditors and the associated supply contracts which may have a hold on the status of accounts in the instance of ownership transfer. Some suppliers will either automatically cancel accounts, or demand full payment of the account on the transfer of ownership. This could be a major threat, or merely s short term cash flow implication. Either one needs to be understood.
    c. Are there any ongoing legal cases running against the directors or the firm itself? If one of these cases were to culminate in a claim against the company post the acquisition, the PE buyer needs to adjust his valuation to take this into account. None of these would appear on the Financial Statements as potential liabilities and one way of getting around the uncertain nature of them would be to write some indemnities into the SPA.

4. Drafting of agreements:
    a. Non-Disclosure agreements used in the selection of Service Firms and handling the Target during the evaluations stages. This is relevant to ensure no information leaks to the public in which case there are opportunities for insider trading. This is a huge threat in the listed space where knowledge if an impending PE deal would alter the share price of a Target, leading to criminal cases and JSE investigations.
    b. Shareholder Agreements and associated post-acquisition legal documents which spell out the manner in which shareholders may deal with each other or the sale of their shares to 3rd parties. It could be potentially damaging to the PE owner of a portion of the company if one of the other shareholders were able to sell their shares to a conflicting party outside of the existing directorship. Hence, such a document would allow for first right of refusal for the PE partner.
    c. SPA's and indemnities associated with the initial transaction at the end of Phase 2.

Martin explained that the role of the Lawyer is to interpret the situation from both the buyer's and seller's perspective. Of course, ALK may be brought in to act on behalf of either party, but when contracted to the PE customer, their role is to foresee challenges that other typical qualitative valuations would probably not consider. As such, one of the very first things he would look at would be the background of the seller's directorship and shareholders.

ALK would contact the Companies and Intellectual Properties Commission (CIPC) in order to get information on the people involved at the Target Firm. They determine if the people the PE customer is dealing with are actually directors of the Target, and thus if they have the necessary authorisations to deal with the sale. ALK also look for the minutes of the Board Meetings in which the decision to sell was reached. Additionally they look for the signed Special Resolution, in which 75% of shareholder agreed to the sale. Imagine if they firm were being sold by an illegitimate party? The costs and reputational damage in such an instance would be almost immeasurable.

Furthermore, as a measure of the indemnities the SPA may need, Martin would look into the assets held by the Target's sellers/directors. This would create an understanding of the value the PE buyers could potentially sue for in the instance there were damages post-acquisition accrued to the Target as a result of some negligent activity or unfinished legal case.

However the evaluation works out, the Lawyer's role is really to mitigate the exposure of the PE Firm to litigation. This drives the depth of legal investigation more than the pure cost of paying for a Lawyer. However, having said that, there is usually a time factor which is considered. Often times Martin is brought deal which requires immediate attention and rapid answers. In these cases, the normal processes are done away with and the investigation is done in hours. Where he would normally present a written report and attend a presentation on the findings, sometimes his output is as simple as a phone call discussion.

4.3.4.3. Phase 3: Sale Agreement and Beyond

The context of each transaction drives the need to have legal counsel to a greater or lesser extent. As a minimum, the Lawyers are brought in to draft the SPA, and at the extreme other end of the spectrum they are contracted to pour over every detail they can find. In such cases the PE firm has instructed the Lawyers to drive the commercial viability of the deal and to find every issue they can

in order to reduce the final offer price. The whole process is iterative with feedback from the Lawyer at logical intervals, and further instruction provided by the PE customer at each of those points.

At the end of Phase 2 the normal expectation is that the Lawyers have drafted an SPA based on their findings and those of the other Service Firms. Between the Bank and the PE Firm, this is amended as necessary and presented to the Target. The Lawyers will be involved all the way through this process to advise on any changes proposed by the negotiation process, culminating in the finalised transaction and post-acquisition documentation like the Shareholders Agreement and Memorandum of Incorporation. The out is adjusted to the needs of the deal in question, and the inherent risks that can be suggested by the industry type.

4.3.5. Industry Expert's View

Michael was offered the chance to answer the questions presented to the PE Firm as he has had close involvement with them at multiple levels. As mentioned in the start of this chapter, he can offer some corroborating views on the processes followed by the PE industry. His answers are interpreted as through the eyes of a PE employee, but may not be as detailed as those offered by Thomas. Irrespective, there is value in his account of the activities.

4.3.5.1. Phase 1: Pre-Feasibility

All potential deals are framed within the context of the industry type that the PE Firm in question wishes to operate in. The PE Firms have their own internal structures, including a Board of Directors, and hence will provide their organisation with a mandate of their own. This mandate will talk to the market segments that they are allowed to operate in, taking into account their inherent strengths and contacts in that segment.

The next step in selecting a potential Target Firm is to understand where the growth can be achieved in the market segment. Key to the selection would be a thorough investigation of the companies operating in the market and to figure out which one has the most opportunity to have value unlocked.

Finally, a tentative price can be put into the Letter of Intent if the PE Firm can access publically available information on listed firms. Here one can look at Price/Earnings Multiples and even do a short DCF of there is sufficient information.

4.3.5.2. Phase 2: Full Evaluation

Michael believes that the model in the questionnaire depicting the flow of information between all involved parties is accurate. He added some detail in the approach which was not clear. That is, the PE Firm will preferably set up a meeting with their intended Target in order to determine if there is indeed an interest on their side to sell some or all of their shares. This is a crucial step since if there is no intention to sell, then there is little point to pursuing any further evaluation. It is at this point, or at a subsequent meeting, that the PE Firm requests that Target to sign a NDA if they are going any further.

The evaluation Phase is simply there to gather as much information as possible on the Target Firm, either through the PE Firm's employees' activities or through those of contracted Service Firms. He agrees that these firms include Lawyers, Auditors and Banks. However, Management Consultants are not used on all deals as the expertise on operational matters is usually within the PE Firm itself. Consultants are used when additional clarity is required and when the Target is too large to analyse with the limited resources of the PE staff alone. This is especially true of Targets which have national or international footprints.

The high level DD items investigated include:

1. Financial valuation information, attainable from financial statements and management forecasts. This is especially true when it comes to evaluating the Income Statement for true revenue versus fictitious invoicing, as well as the Balance Sheet for asset ownership.

2. Operational capacity and process evaluations usually through feasibility studies that compare current capacity versus what needs to be invested to get the company to operate at the levels the PE Firm believes it should.
3. Management interviews and cultural best-fit understandings. It is fundamental to have the right management as having the wrong people will prevent the company from scaling upwards.
4. Evaluation of the current order book and the profits attainable from the work on hand.

At the end of the process the PE firm will attempt to clarify the value it is willing to pay the Target for their shares. The valuation technique of choice is the DCF, coupled with looking at comparable companies trading in the same market segment. This provides a sense-check of the evaluation and an indication of whether the firm is undervalued (as hoped) compared to its competitors. Of course, there are also the soft factors like whether there are external market forces at play that the PE firm wishes to take advantage of outside of the evaluation Phase. These factors could be enough to sway the buying decision even in the face of typical deal breakers.

4.3.5.3. Phase 3: Sale Agreement and Beyond

The information gathered in Phase 2 is ratified with the PE Firm's Investment Committee (IC) internally and a decision to buy is made, or sometimes to re-pitch a deeper DD. The PE Firm's perception of risk will ultimately guide the decision making process.

This perception is often times based on the gross profit attainable in the Target firm. That is, the lower the margins possible, the greater the desire to understand all the factors in the company that drive its performance. Hence, the more risky the purchase and the more detailed the evaluation Phase usually is. However, the trade-off is the cost of going after all this information and paying Service Firms to do it. Conversely, the higher the GP, the lower the risk and hence the more relaxed the PE Firm is over unknowns. Simply put, the ability to absorb issues through cash flow can make or break the whole situation.

5. RESULTS: MODIFIED MODEL

In this chapter the original Conceptual Model, is adjusted and expanded to include the views of the interview respondents. The level of insight offered by each respondent has opened up the detail level of each Phase to the point where they have to be represented separate from each other. The resultant Figures 7 through 9 on subsequent pages are the culmination of the interpretation of each interview mixed in with the findings from the Literature Review provided in the first half of this research. The time scale is held at 1 year, however each Phase now occupies its own space in the continuum of the Modified Model. Although the timescale was arbitrarily defined, the Phases are sequential and should be considered as *The Evaluation* itself. Hence, they are to be conceptualised as the entirety of a generic approach to considering a Target company for acquisition

Each Phase of the Modified Model is presented after a brief synopsis of the information that was extracted from the narratives and held as important for the model to reflect. This information has subsequently been added to that which was provided by literature, and so the synopses only refer to the new information presented through interview findings. Note carefully that the Phases of the Model should be viewed from the perspective of a Private Equity company, or any potential buyer, looking top-down on the considerations of its approach to buying the Target.

5.1. Phase 1: Pre-Feasibility

Initially it was thought that PE Firms would find their own potential Target's through a process of investigation and market analysis. After speaking to the Bank, it now appears as though there are three potential ways in which transactions may begin: Auctions; Banks brining potential Targets to PE Companies; and then PE Firms finding their own acquisitions.

The complexity of Phase 1 presented in Figure 7 begins with this split in approach, but treats the Auction process as exempt from this research. This is because the Auction process is an entirely different series of events and independent of the processes under review here. The end point still appears to be the Letter of Intent, but now the model acknowledges these alternative approaches as well as the level of initial discussion that takes place with the Target Firm in the run up to putting a non-binding offer on the negotiation table.

It was also determined that the role of the Bank was originally underplayed in the initial stages of the Conceptual Model, thinking that they were instead contracted in like the remaining Service Firms whom come on board from Phase 2. This led the results in a direction that required this process to be shown separate from the main thrust of evaluation activities. Hence, Figure 7 of the Modified Model goes into the Bank-owned aspects of the generic situation more than the Conceptual Model. As stated in that narrative (4.1.2), the aspects related to Auction processes were not considered as these steps would propose a stand-alone model all on its own.

The only other insight offered from the respondents in Phase 1 was given by the PE respondent. The items not listed in the Conceptual Model which they look at in the pre-feasibility stages include analysis of the supplier-customer dominance factors, as well as the nature of competition. The PE respondent also mentioned that their company will do some quick valuations based on public data here. This is important to note as this suggests that the dependence on Service Firms may only be from the perspective of sense-checking the PE decision to buy a firm of particular interest.

Phase 1 Process

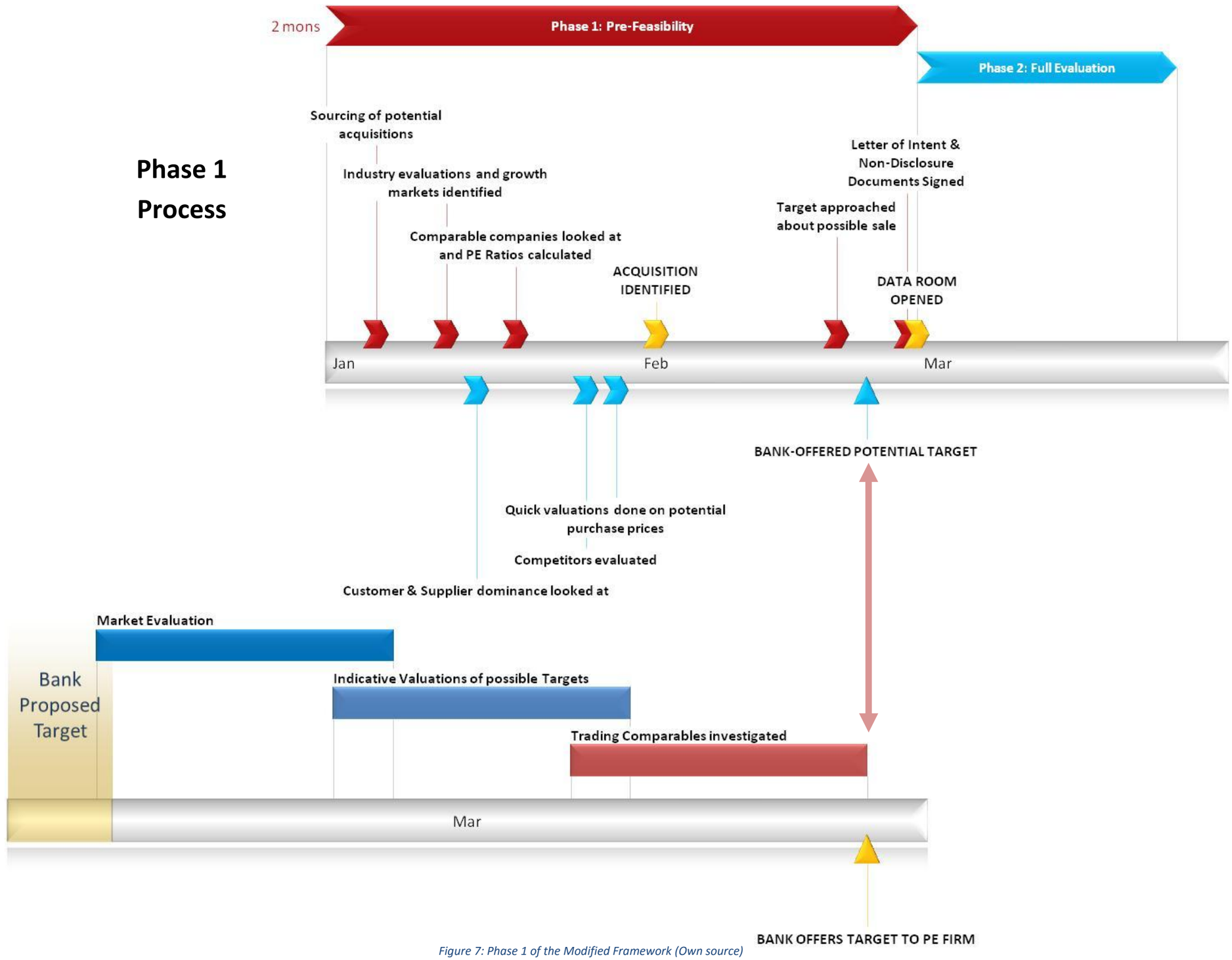


Figure 7: Phase 1 of the Modified Framework (Own source)

5.2. Phase 2: Full Evaluation

Phase 2 is inherently the most complex of all three. There is a wealth of information absorbed and analysed by all of the Service Firms, spearheaded by the Banking partner in the project management role. This has been confirmed by all of the respondents as typical practice. However, a far more expanded understanding of what data is sought during such an evaluation has been proposed by the respondents. The interviews have provided more practical points than the literature suggested.

In order to incorporate the points gleaned from the interviews, the model had to be further split into Financial DD and Legal DD aspects in Figure 8. These two were removed from the main process to operate independently until such time as their respective reports were to be presented to the PE customer. The intention is not to show that these companies operate completely independent from PE or Bank influence on a daily basis, but rather that their own modes of enquiry are split by their functions as Service Firms. There is, however, significant cross-pollination between firms which has not been captured in these Phased models.

Over and above the data provided by Literature, the following additional aspects are considered by the Industry during the evaluation:

Financial DD:

1. A Mandate Latter is signed with the Auditor which creates the framework within which the Service Firm can operate. This defines the role of the Auditor and is important in so far as aspects of the evaluation may be taken over by others (specifically the PE customer itself).
2. The data requiring access in the Data Room is listed and provided in a checklist. This is often driven by the industry segment and the requirement the PE customer has in order to adequately investigate risks.
3. Internal reporting (that is those between management, operations and overall employee deliverables) is modelled and looked at for flaws and gaps in communication. If there are risks defined here then this could indicate the need to change routines or improve systems in the firm post acquisition. All would add cost and time to the required optimisations.
4. Processes are evaluated in so far as they pertain to reporting. This is crucial for the buyer to understand as the nature of financial reporting is critical in order to be in touch with the overall health of the firm. This ability to adequately model the financial health using Target internal resources is a cornerstone of post-acquisition success.
5. The report style that comes from the Financial DD shows the uncovered risks and the inherent possible deal breakers. Additionally, the Auditor does its own fundamental evaluation of the offer price. This is a crucial addition to the data here as the potential for sense-checking the Bank and the PE employee desires for a successful deal. The price suggested by a Firm which has no vested interest in the amount of money offered will ultimately highlight if the transaction is in fact viable. If this number varies wildly from the numbers driven by the Bank or other PE employees, then this could indicate that forces other than the viability of the acquisition are at play.

Legal DD:

1. The Lawyers will do CIPC checks on directors in order to determine if they hold the due authority to broker the sale of the Target's shares. If not, the falsification of the potential transaction could cause immeasurable damage to the PE Firm's cash flow, reputation and its ability to secure future investors. It cannot go into a serious deal with a company that cannot be sold.
2. Going Concern matters are equally as deal-making or breaking. If it were determined that the sale of a division of a company to a 3rd party would render the division unable to function, then the risks and costs of this need to be fully detailed. An example of this would be if a PE Firm wanted to purchase an operational arm of a larger company, but not have to buy the entire company to get hold of it. In this instance, the operating arm, or division, would not have its own operating accounts department, procurement office or even place of business separate from its original parent company. Thus, buying it without considering all the appropriate steps to maintain it as an ongoing and viable business would require knowledge of what infrastructure needs to be installed to keep the business alive.
3. VAT Clearance is one of many Tax Clearance matters than should be understood. It would be hard on cash flow if post acquisition it was found that the company owed on its VAT obligations to SARS. If this was the case, the deal structure may opt to include the VAT costs or allow for the matter to be deferred to the old shareholders for them to finalise when SARS eventually provides settlement figures.
4. Licences of trade are one of the items that could be overlooked or fall broadly into Going Concern issues. As mentioned in the narrative with the Lawyer, the result of not being able to inherit the right to trade in a particular market (think Liquor Licence) would be disastrous for new owners of a company.
5. Assets of shareholders and directors become the source of funds to be recovered should the new owners carefully word their Sale Agreement to allow for their ability to sue for such value. These instances only really come up when there is a claim for damages out of a transaction where some deliberately hidden cost hits the new owners. The PE company would thereafter like to know that if they pursue these damages from the original shareholders and directors, that there would be some asset base to go after.
6. Ongoing litigation is a category of the hidden costs mentioned in the prior point. The Lawyers are tasked with limiting the unconsidered risks by uncovering all possible issues that could cost the PE Firm money. Thus, highlighting the items prior to a fundamental valuation will allow an adjustment for risk figures.

The Conceptual Framework was correct on many levels however the detailed level of the offerings of each Service Firm could not be captured through Literature alone. This Phase is represented in Figure 8 and provides a larger cross section of considerations and interdependencies than the Conceptual Model had captured. Even though the aspects added are limited in number, each one of them is highly detailed work in practice, and confirmed to some degree by the Industry Expert.

It should be noted that the degree of investigation suggested anywhere in the Modified Model is still only at a high level in order to capture the concepts needed to understand the whole approach. Consequently, there is significant scope for future research to delve into the detailed levels of investigation at each stage of the process.

Phase 2 Process

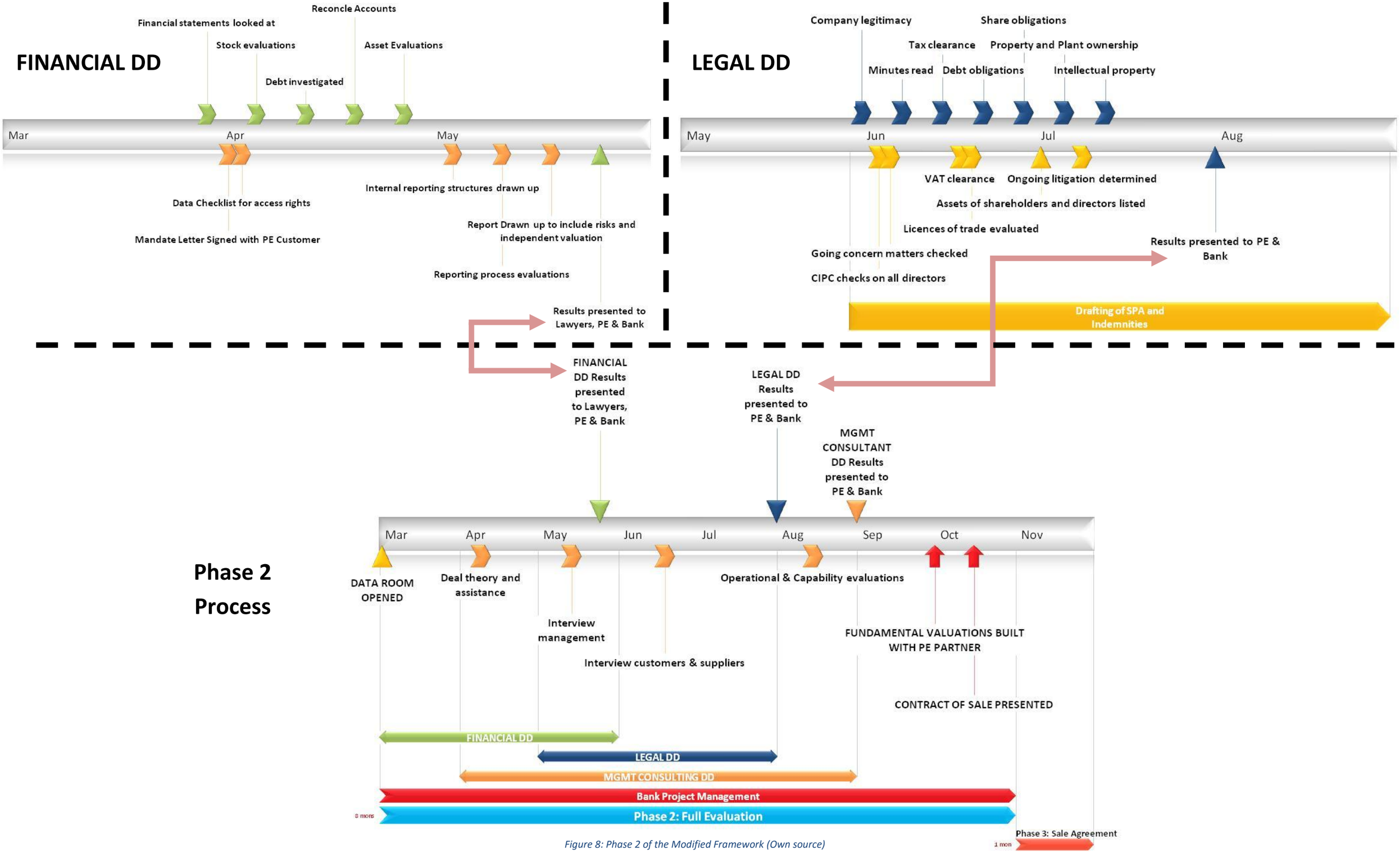


Figure 8: Phase 2 of the Modified Framework (Own source)

5.3. Phase 3: Contractual Sale

Phase 3 was originally presented as a relatively empty section of the evaluation in so far as this was the point in the model that final sale was reached. The Conceptual Framework was correct in suggesting that the sale was concluded here, but was devoid of detail on how this may be accomplished in reality. That is, there is far more negotiation that occurs here and it is worthwhile to note that despite the degree to which fundamental evaluations may provide quantitative pricing for the shares being bought, it is *through* negotiation that this number may be amended. This negotiation caters for the desire of the PE Buyer and Target Seller to have the deal concluded, and may result in a deal structure which is different from that suggested by the Service Firms and draft SPA. Figure 9 is the resultant interpretation of the situation.

The Lawyers are the ones to develop the overall documentation, which includes the SPA, the Shareholders Agreement and the Memorandum of Incorporations. These documents, are not drawn up at a specific point, but are rather considered from a relatively early on in the evaluation. The inherent risks, both operational, contractual and in litigation or matters of future concern are captured in these documents. The reality of the situation around any potential transaction is that these risks could prevent the deal from going ahead, or be used to drive the price down as much as possible. Either way, as per the narrative from the Lawyers, no SPA will be without special indemnities to hidden costs, and clauses referring future performance based on current numbers. This is by nature an iterative process and input is taken from PE and the Bank to ensure the structure of the SPA provides for safe exits and cost mitigation as far as possible.

The variety of contractual structure is as limitless as the imagination of the people involved, and the end result is driven by discussion as much as by objective results from the evaluation. The role of negotiation at this stage (and more than likely earlier stages too) is that the entire process can be turned in on itself if the desire of the buyer or seller is to see the transaction done despite any traditional deal breakers being found.

At the end of the evaluation and negotiation period, the sale of the company is hopefully agreed upon and the transaction can go ahead. Only at this point will the funding be accessed from the PE Fund or from the Bank debt instruments. The combination of monies will be pooled into the sale price and cash will eventually exchange hands. The new owners of the firm will be the PE Company.

However, even at this stage there is a focus on the evaluation of the company going forward. As per WC, there now becomes a focus on making sure the company grows as desired, and that the appropriate exit strategy is followed when the firm has attained its best possible value during the lifetime of the Fund which purchased it.

Phase 3 Process

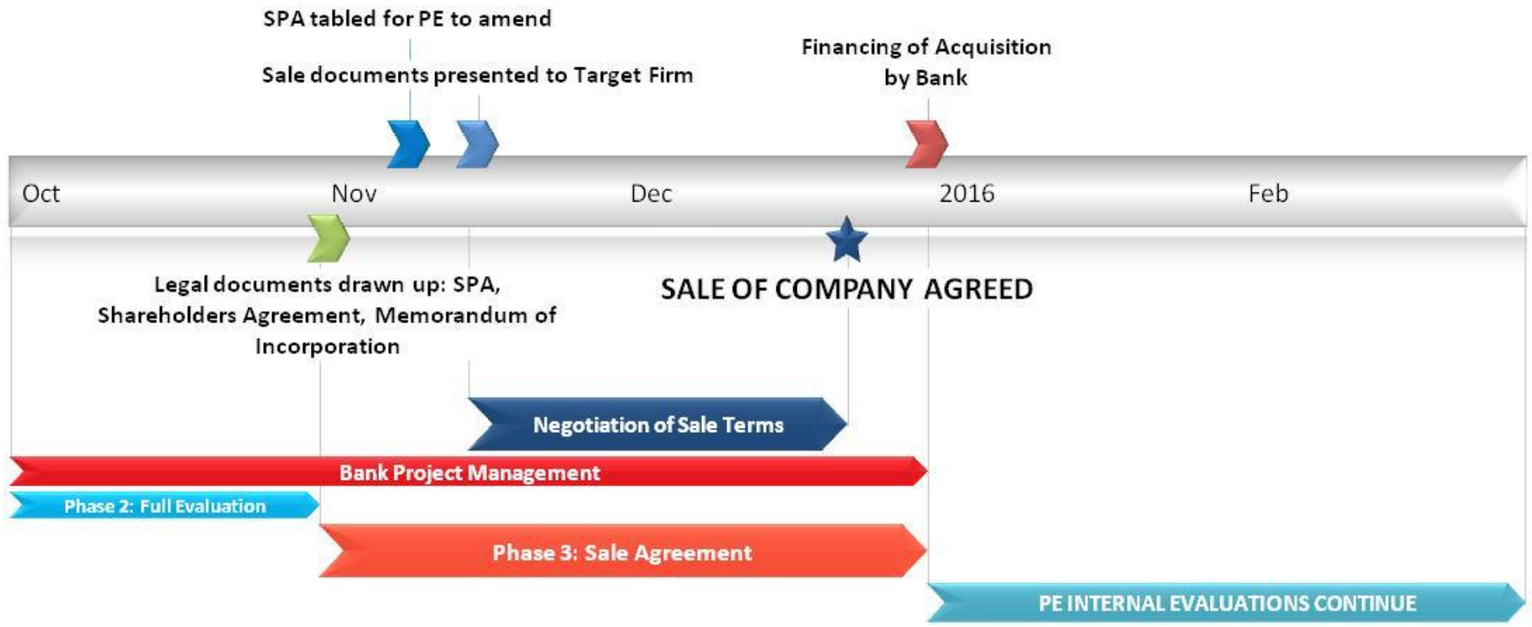


Figure 9: Phase 3 of the Modified Framework (Own source)

6. DISCUSSION

6.1. Conceptual Framework versus Modified Framework

The literature consulted for this research served to provide a grounding understanding of how and why the PE Industry operates in the way it does. The industry and practitioners in it are motivated by the business model that PE adopts, which seeks to convert invested funds into larger-than-average profits than traditional investment options. The existence of Funds, with their limited lifetimes, presents a driving force behind every decision taken to buy or sell companies. In principle, this up-to 10 year timeframe provides a limited amount of time to accomplish the lofty goals that PE sets for itself.

Therefore, for a PE Firm to essentially commit their Fund value to a decade of effort means that the moves it makes to buy companies and subsequently improve them through capital injections must in some way be deeply thought through. The risk factors inherent to the firms the company purchases need to be understood as comprehensively as possible in advance so that potential mistakes are avoided. As pointed out by literature, the J-Curve is a known reality in this field, and almost a given that newly purchased firms will initially perform badly. The timeframe between the trough, or lowest point here, and the desired cash-positive state of the firm is critical for PE to understand, and control. In an instance the “wrong” firm is purchased, the result could be a toxic investment comparable with a poor gamble, long underperformance and possibly even never reaching the intended highs required of it. Wrong moves, investments or decisions all prove costly in a field where the loss of a day, month or year can never be recovered relative to the planned close of a Fund.

This motivated the research to seek literary sources around the evaluation of companies PE finds interesting. An assumption was made that assumed the literature would be adequate to the task. The activities in this space must present an important learning opportunity to all business people to learn, and hence the thought was that existing literature would offer an extensive understanding of the processes followed. Although it was initially stated that literature was sparse, the resultant understanding provided by it was quite thorough. The challenge was more in combining different sources into one cohesive thought process showcasing the end-to-end series of activities taken during an evaluation of a Target Firm. Therefore, initial assumption that literature was adequate to this task was proven correct, albeit with substantial effort to link the common threads.

The resultant Conceptual Model presented in Figure 5 captures the aspects of inquiry that Auditors, Lawyers, PE and Banking Partners employ during an evaluation of a Target. This framework provides a multi-layered understanding of the work that goes into the evaluation of a potential Target. An approach was adopted to refine the data through the arbitrary use of the term “Phases”. The Phases were conceptualised as three distinct sections of an evaluation process, namely:

1. Pre-Feasibility
2. Full Evaluation
3. Sale Agreement

Phasing the approach between three sequential stages was the only way to conceptualise the approach undertaken by multiple parties in a complex undertaking. That is, Phase 1 is seen as Pre-feasibility precisely because there is no commitment made by any party at that stage. This Phase is more than likely undergone multiple times before a PE Firm even considers talking to a Target's management. The PE Firm seemingly iterate through this Phase until they believe they have found a worthwhile entity to purchase. As intimated by the interviews, the approach is to consider almost all options before a Target is approached. Phase 2 is used as a way to ratify the price offering and will seldom even get that far unless they have internally committed to buying this company. However, the reality of the situation is that PE Firms operate in a multitude of environments where the assumption is that each business harbours its own inherent risk profile. Therefore, PE requires a certain level of confidence in the Target Firm as a choice before they spend money on Service Firms to ratify purchase options available. This implies that Phase 1 is a miniature Phase 2; a build up to the commitment to spend monies fully evaluating the Target. For PE to enter Phase 2 seems plausible only if the Firm is confident that it will eventually put a binding offer on the table.

Furthermore, in the conceptual Phase 2 the Service Firms are finally contracted and the real work begins. The degree to which these investigations go is insightful in so far as it proposes aspects of evaluation that may not appear to the casual investor as potential pitfalls. Literature has provided an extensive list of items for consideration, each of which only mentioned from a very high level. The real value of this Phase is quite possibly the journey towards understanding how a Target Company operates. Understanding the financial, legal, operational and growth aspects of the firm cannot be achieved in any other way, short of working in the firm in all departments for years on end. The items considered here could provide a route for businessmen to consider their own operations across such broad issues without stumbling across them in a haphazard fashion as may typically occur in the running of a company on a daily basis.

In terms of the conceptual Phase 3 aspects of sale agreements and the subsequent exchange of shares, the literature could not offer as much detail as in prior Phases. The result is a gray area which just ends in the sale of the firm. This was a less than acceptable result and the gap in understanding was not provided with additional literary searches.

The Modified Model/s as presented in Figure 7, Figure 8 and Figure 9 are a little more difficult to read in conjunction with each other when compared with the Conceptual Model in Figure 5. However, they each capture the stages of action conducted on the level of all Service Firms in more detail than before. The resultant breaking up of the Phases into three distinct figures was directly driven by the versions of each Phase presented by the interview process. That is, the experts consulted in this research each had a specific perspective on the evaluation elements as viewed from their role in it. This was best captured in separate portions of the overall approach modelled.

Through the interviews conducted (semi-structured and with few respondents) this early research was expanded substantially. Of key importance was the practical considerations provided by the respondents. Their responses served to largely confirm the information that the literature suggested was important, but went one step deeper and talked to the heuristic aspects of deal evaluation. That is, the Bank provided more insight into the nature of potential Targets brought to the table, while the PE respondent went far more into the rationale employed when considering companies to look at in industry specific ways. The Auditor was able to talk to the financial aspects of his inquiry and

offered a slightly jaded view of the Bank's involvement and motivations. This could be construed as up-selling his results in the context of others', but could also offer an interesting view on the motivations of Service Firms in general to see certain deals succeed or fail for reasons other than objective. The Lawyer subsequently offered truly deal-breaking information to the considered aspects and broadened the knowledgebase of the later aspects of the process.

Through these interviews it is now understood that there is a lot more subjective information considered through the process, such as cultural fit between management in a Target and the PE operating partners whom have to work with them. There is seemingly so much data that can be brought out of an evaluation, that it may be inferred that there exists a point beyond which no further data is necessary to motivate buying or walking away from a Target. The information presented through visualising the literature and interview results is such that the generic model of an evaluation may not be applicable to all PE Firms in operation today. It is just that complex and expensive to do.

It is possible that the Modified Model suggests a theoretical approach which could be too complex and costly for all possible deals. Multiple respondents had indicated that the degree to which the evaluation is taken is directly linked to the funding available to the PE buyer. The inference was made that smaller firms or individuals whom buy companies do not go into as much detail in their evaluations. Thus, the firms like Actis or Ethos (mentioned as some of the largest firms in the country in section 2.1) may be some of the firms of such capacity that they can afford to delve into such a multitude of considerations. Considering that the deals these two firms enter into can exceed hundreds of millions, even billions, of Rands it is plausible to assume that they do go the extra mile to ensure they avoid or understand J-Curve effects. Irrespective of the firm or the investor, the results provide a notional approach to such an evaluation.

In summary, literature was sought from numerous sources, both local and international, and was selected for its relevance. If it was able to offer even small sections of understanding the topic of Private Equity deals, it was considered. Respondents to the interview questions were sought in specific company segments for Service Firms. Any willing PE Firm would be included in the research when it was determined that the industry was so close-lipped about this process. Hence, the research only has one respondent directly employed by PE. The interview questions were suitable to draw out tangential information as intended, and the respondents added vast quantities of information to the literary results. The resulting models, Conceptual and Modified, show very clearly the roles of each party consulted in the process. The usefulness of the information as presented by the research as a whole could easily be employed to consider issues of risk in any business without necessarily being part of a PE deal or any such sale or purchase has been demonstrated. This means the results have relevance to a very wide audience and that the lessons of company evaluation could be applied in situations where even optimisation is the only goal.

6.2. Objectives Revisited

The research conducted has uncovered a vast quantum of information pertaining to the South African Private Equity industry. In order for the research to reach a point where it has built up sufficient information to reach defining conclusions, the following objectives were undertaken:

1. To determine a series of steps as driven by Private Equity for an evaluation process prior to reaching the decision to buy a company;
2. To determine what information is sought by PE companies in order to continue the evaluation with a view to purchasing a company;
3. To group evaluation information with their original sources, and seek deal information flow;
4. To develop an graphical model for an evaluation from the literature, and;
5. To develop a modified graphical model as suggested by interview recipients and expert opinion.

An extensive literature review the research culminated in Figure 5 which presented a conceptual framework for the evaluation phases. To initially meet Objectives 1 through 3, the steps of an evaluation process were listed under each Service Firm attached to PE deals. That is, respectively; the PE Firms themselves; Auditors used for financial DD's; Lawyers brought in for litigation and related viability of the entity in going concern matters; Management Consultants for their role as sense-checkers to PE; and the Bank which takes a leading role in the management of the other Service Firms through the process. The literature was able to define the majority of this at a high level, while the interviews served to provide additional context for almost all Service Firms. The one missed firm was the Management Consulting team. This was simply an unreachable information source as none are able to breach their NDA's in order to even have a loose conversation on the topic.

Through utilizing carefully selected qualitative research methodologies suggested by Richards and Morse (2013), corroborated by Seidman's (2013) approach to interview style and structure, and subsequently analysed by methods suggested by Dye, *et al.* (2000), the data has been refined into a simplified model of the evaluation process. Therefore, Objectives 3 and 4 were answered through the reflexive approach of collating the data sets into the kaleidoscope of appropriately linked information. Objective 5 was thus met automatically by the dissemination of this information into the Modified Model (presented in Figure 7, Figure 8, Figure 9).

It was not expected that the literature would yield as much as it did. Notably, the subsequent interviews served to confirm the majority of initial findings more than discredit them or amend them totally. These resultant modifications to the Conceptual Model served to expand on the individual processes followed by the Service Firms. This outcome is satisfying given the limited nature of information sources on all levels. The research objectives were therefore met on all levels.

6.3. Reliability and Validity

The results of this research were adapted from a number of dissimilar sources, namely:

1. Literature reviews
2. Interview respondents
3. Researcher experience

These three sources represent an approach at triangulation of the results through corroborating the findings of each through evaluating congruency of the information (Miles, *et al.*, 2014). Literature and interview data was found to agree on all aspects mentioned, and the underpinning of the researcher's background was employed to ensure that the lived experiences correspond with the findings.

To be clear, the best result would have been to determine even more sources of information in the form of additional interview respondents. The limited number of respondents is a serious risk to the overall validity of the research in any qualitative data set. However, it is important to acknowledge a couple points which strengthen the results achieved here, even in their fledgling state:

1. The fact that few respondents were willing to enter the study was directly attributed to the subject matter itself. The PE industry is fiercely competitive and a lot of money is at stake. The research was viewed outright as a threat to their proprietary means of working. This encouraged the research to continue in so far as any resultant window into the operations of PE deals would be more than is currently available to the public to understand.
2. Subject matter associated with *linking* the activities of Service Firms and PE firms is not available. Sources of information talking about each Service role independently exist, but none attempt to bring all sources of evaluation activity together in one model. This means that this research is one of the only available that attempts to build a holistic framework of a PE evaluation.

There is no doubt that the research has provided a worthwhile level of understanding in evaluation stages of firms undertaken in the PE field. In fact, the trustworthiness of the respondents was not even in question come the end of the refinement of results; the data is congruent with each other, and not any interview respondent, nor any piece of literature disagreed with each other. Even though trustworthiness was in doubt at the outset of this process, the interview results are not in question in terms of their validity or that of their source's trustworthiness at the end.

However, even after saying that, it would still have benefitted the research to achieve more respondents than were found. This limitation, other than the secretive nature of the PE industry, was also driven by simple time limitations put on the gathering of data. A lot of effort had to be put into gaining an audience with the few respondents that were achieved. This could imply that there may be a better way to go after data in this field. Future research would have to spend time honing the methodologies and approach to this. If it is possible, at least 5 to 8 PE respondents should be sought, and at least 2 from each Service Firm. This was the original goal of this research effort, but simply not achieved. Far more congruence with industry practice may be achieved this way, and quite possibly some insights not even touched on in the Models presented here.

7. CONCLUSIONS AND RECOMMENDATIONS

In Chapter 1 we presented the following central research question:

What information supports buying decisions in the South African Private Equity Industry?

The research has concluded with a series of graphical models, starting with a Conceptual and ending with the Modified frameworks. Collectively these establish a baseline understanding of how a PE deal may be approached during evaluation phases. It is therefore held that the question has been answered on multiple levels, with information presented on a wide variety of considerations that may be made during the process up to signing an SPA.

However, it is important to note that the research method adopted was purely qualitative with no ability to draw parallels at more detailed quantitative levels. It may not be necessary to approach further research quantitatively on this specific aspect of enquiry precisely because the usefulness of the results is not in question if considered as an entry level exploration of the field. Yet many suggestions can be made to build upon the body of knowledge in general. Some gaps can be seen in the overall understanding of the industry, and are definitely the opportunities for further research if the following were looked at:

1. The defined role of the Service Firms on each level. If it were possible, a valuable development of the model would be to build the detailed steps of how each Service Firm performs the investigations mentioned. By implication, if the Model mentions something to look at, further research could be done to expand this one level into multiple steps. These steps would need to show more clearly how the Service Firm goes into that particular item. For example, one route to investigation here may be through modelling the DD style of each of the largest auditing firms in the country, namely KPMG, Deloite, PWC and Ernst&Young.
2. The mention of possible bias by the parties whom are influenced by the binding offer price should be investigated. The implication of a statement made by the Auditor in relation to the Bank's motivations seeded this possible avenue of enquiry. There could be sufficient cause to investigate the degrees to which Service Firms and even PE employees are remunerated in order to understand the reason for certain deals to be done. This research would need to reference actual Private Equity transactions in the listed space where information of prices paid and contract structure would be publically available.
3. The differing approaches between PE Firms through consultation with multiple firms instead of only one. There are many industries that PE Firms operate in, and the change from one to another may fundamentally alter the nature of an evaluation. This cannot be determined from this research alone, and should be investigated in order to build more specific frameworks for differing cases. Likewise, there could be scope for models employed by firms without the affordability to conduct the depth of evaluation as proposed by the Modified Model.
4. The expanded view of the actual fundamental analyses performed, with mathematical modelling of DCF's. There is substantial opportunity to look at the possible mathematical models used in fundamental evaluations and seek to understand the *modus operandi* of the risk-based pricing approach. That is, there are subjective issues which are interpreted in financial modelling that alter the non-binding offer all the way until the binding offer at the

end of the evaluation. It would be of great interest to take the Modified Model and overlay the way the price changes as additional information comes to light. This may serve a singular exhaustive case study of a listed entity taken private through the transaction.

5. There may be a chance that the PE approach in South Africa differs substantially from the practices of firms that operate in other African countries. This is motivated in part because of the only PE respondent to this research. That firm focuses north of the South African border, and it is plausible to perceive their activities as differing from those of locally based acquisitions. It would be interesting to see if these geographical differences present substantial changes to an evaluation of a Target through juxtaposition of multiple PE firm methods.

This particular research report has provided a high level understanding of a small portion of a large industry. It also appears to be the first of its kind in the South African context. Thus, the penultimate implication of having a series of evaluation Models to refer to from this research is that the PE Industry can be approached with a level of understanding hitherto not available from any singular literary source. The research is by no means exhaustive, and therefore is not an ideal result. However, it is a healthy starting point for a novice to begin to understand the complex and lucrative Private Equity industry. With an ever-changing business world full of opportunity for individuals and institutions to take advantage of, this research hopes to provide a small but insightful view on the strengths and methods employed by a group of people whom have achieved extraordinary results in short time frames.

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Appendix A – Letters of Consent

The first document is the blank Letter of Consent. Thereafter the individuals whom have requested to sign a copy have done so.

Letter of Consent – Research conducted by Warren Olivey

St. No. 0406311K

I, _____, agree to participate in the MSc research entitled ***Understanding the Information considered in Private Equity Buying Decisions in South Africa***, to be undertaken by ***Warren Olivey*** whom is under the supervision of Bernadette Sunjka, Postgraduate Coordinator and Senior Lecturer, and certify that I have received a copy of this letter of consent.

I acknowledge that the research has been explained to me and I understand what it entails, as follows:

1. I agree to allow access to my company through this interview for the purpose of this research.
2. There will be one interview, which is expected to take no more than 1.5 hours, but can be as long as I like should I wish it.
3. The interview will be audio taped, and transcribed for analysis by the researcher.
4. The approach of my company to Private Equity evaluations will be mapped.
5. I will provide a brief tour of my manufacturing facilities at my discretion, and that the researcher will record her own observations.
6. I have the right to withdraw my assistance from this project at any time without penalty, even after signing the letter of consent.
7. I have the right to refuse to answer one or more of the questions without penalty and may continue to be a part of the study.
8. I may request a report summary, which will come as a result of this study.
9. I am entirely free to discuss issues and will not be in any way coerced into providing information that is confidential or of a sensitive nature.
10. Pseudonyms will be used to conceal my identity, and that of my company, my employees, my suppliers and my customers. The information disclosed in the interviews will be confidential.
11. Audio-tapes and transcripts will be kept securely stored during the research and after the research has been completed.
12. This project was approved by the Faculty of Engineering and the Built Environment of the University of the Witwatersrand and the School of Mechanical, Industrial and Aeronautical Research Ethics Committee (non-medical) of the University.
13. If I have any questions or concerns about my rights or treatment as a participant, I may contact the Postgraduate Coordinator of the School of Mechanical, Industrial and Aeronautical Engineering, Bernadette Sunjka, at the contacts on the bottom of this page.

Signed: _____

Date: _____

Questions concerning the study can be directed to: BERNADETTE SUNJKA
Please quote ethics clearance number, MIAEC 045/15, and the SUBJECT of the report.
Tel: +27 11 717 7367 **Email:** bernadette.sunjka@wits.ac.za

Appendix B – Participant Information Sheet

April 2015

Re: Participation in Research Relating to Private Equity Buying Decisions and Approach

Thank you for taking the time to read this introductory brief on the research at hand.

I am a part-time MSc student in the School of Mechanical, Industrial and Aeronautical Engineering at the University of the Witwatersrand, under the supervision of Ms Bernadette Sunjka. My MSc title is: ***Understanding the Information considered in Private Equity Buying Decisions in South Africa.***

My working history has lead me down the path of wanting to understand Private Equity buying decisions. Back in 2012 I was approached to work in the South African arm of a newly formed Group of companies, the result of a Scottish Private Equity investment in RSA and Australia. The most fascinating aspect of this experience was to learn that the internal workings of the PE firm who were building this Group were not in favour of doing it. That is, the result of the evaluation of the core firms was not to buy either, yet the CEO of the Private Equity firm made an executive decision to buy in. The firm committed £75 million to building the possibility of future success, a lot of which I was responsible to motivate and spend. I strategically left the firm before the investment was fully realised.

My belief is that there is a unique approach to the purchasing decisions made by Private Equity firms, and that in the South African context there is more skill and subtlety than we as South Africans believe. As such, I wish to understand the context in which buying decisions are made, particularly at the evaluation stages between the Letter of Intent and the Binding Offer.

As such, I would like to formally invite you to participate in this study. Your knowledge and experience would contribute significantly to my research.

The study will be conducted between May and November 2014. Involvement in the study would be limited to a single face-to-face interview with you, at your convenience and at your place of business. During the interview I would like to understand how your firm approaches the evaluation of potential targets, with key focus on the subjective versus objective information sought.

Participation in the study is voluntary, and you may withdraw at any time. Anonymity of both the firm and the individuals involved in the interviews will be upheld throughout the process. I would also like to record the interview such that I can later transcribe it. Your consent will be sought, and if you do not wish the interview to be recorded this will be respected.

The results of the study will form part of my MSc Research Report, and may also be reported in academic papers and at conferences. A summary of the results of the research will be made available to you on request.

I look forward to hearing from you and the possibility of including your expert views on this subject matter.

Yours faithfully



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Johannesburg, South Africa
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Supervisor: Bernadette Sunjka
Tel: +27 11 717 7367 **Email:** bernadette.sunjka@wits.ac.za

Appendix C – Questionnaire

Date: _____ *Conducted by W. Olivey, Student Number 0406311K*

Firm: _____

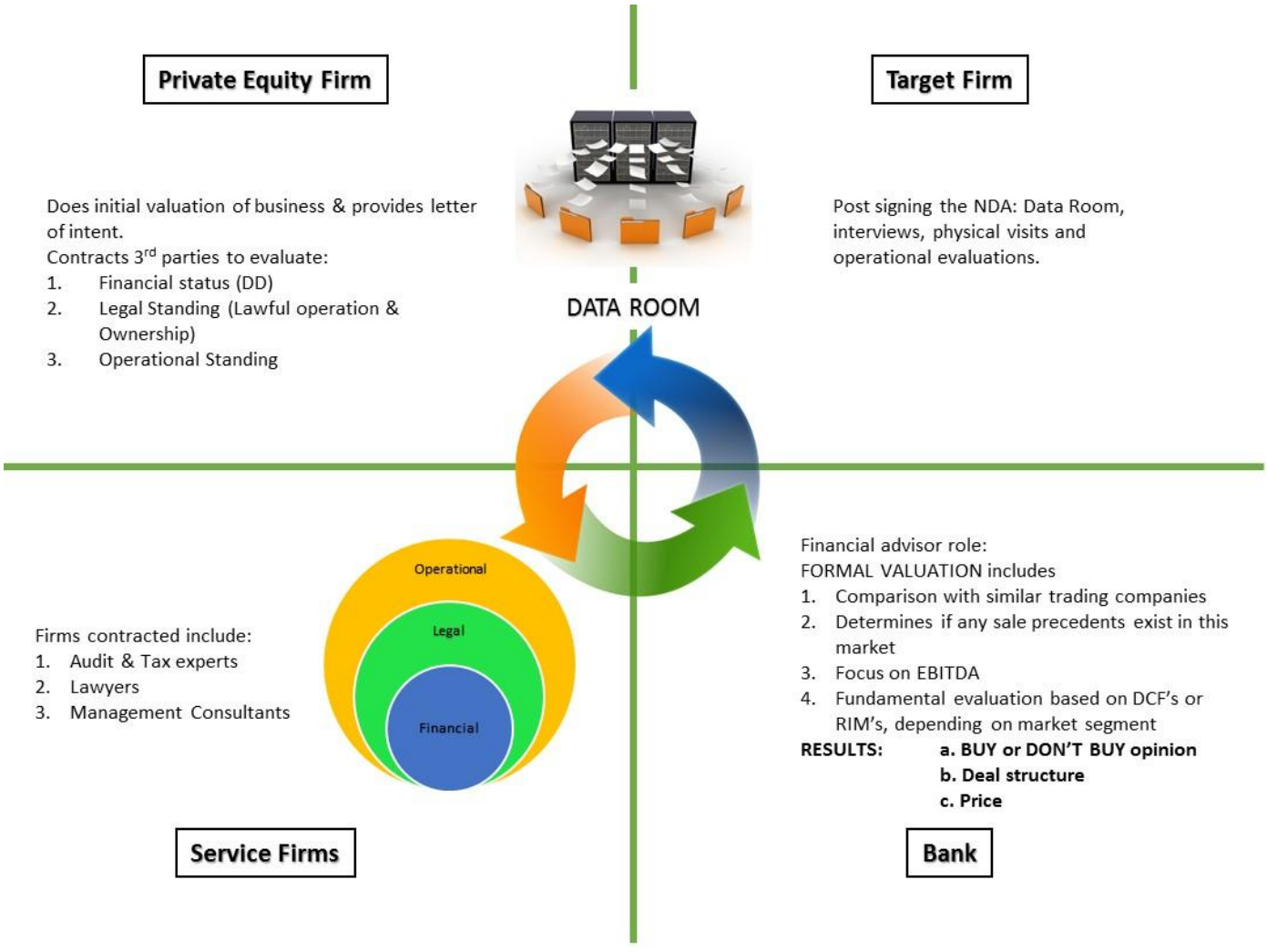
Questionnaire: ***Understanding the Information considered in Private Equity Buying Decisions in South Africa***

Preamble

Predetermined topics have been set down in the form of open-ended questions. It is the researcher's view that rigid question-answer sessions will not be conducive to in-depth discussions. Each Private Equity (PE) firm will have a specific strategy and market focus, so the tools, focus and information they value would more than likely vary considerably. This prevents structured interviews from gathering sufficient information tangential, but relevant, to the topic at hand. As such, the questions are there to prompt additional discussions regarding the approach and criteria a South African PE firm would find useful in their evaluations of target companies.

Questions for Private Equity Firms

1. What target industry/s does the PE firm operate in?
2. How does the firm determine what firm is desirable before any evaluation is even considered?
3. What is the process followed between initial selection and letter of intent? May we draw the model?
   For example:



4. What service provider companies does the PE firm make use of in the evaluation phase?
    a. Legal?
    b. Audit?
    c. Banking?
    d. Management Consulting?
5. What information is sought through the on-site/data room investigations?
    a. How much is existing management included in the evaluations?
    b. What sort of information is sought from an operational standpoint?
6. What topics does the firm consider imperative to cover during a Due Diligence process?
7. What initial valuation method is used to ascribe a value to a target firm for the non-binding off in a letter of intent?
8. Is there a generic model for the formal evaluation done by the PE firm?
    a. Is there some standard form documentation that can be shared with the researcher to this effect?
9. What fundamental valuation methods are used in determining the potential price of the target firm?
10. Does the firm conduct its own fundamental calculation of an offer price?
    a. Is the Banking partner's fundamental valuation weighted more heavily than the firm's own?
11. What sort of Legal topics need to be covered in order to proceed with purchase?
12. Which does the firm consider more valuable:
    a. Purely factual information (e.g. existing financial statements, actual machine capacities, NPV of current contracts)?
    b. Purely subjective information (e.g. desirable market segment, knowledge of the customer base, agreeability of existing management to change)?
13. Are there obvious hold-points in the evaluation process which prevent the PE firm from continuing the evaluation?
14. At what point does the PE firm consider that enough information has been collected to make a buying decision?
    a. What is this information?

<u>Questions for Service Providers of Private Equity Firms</u>

1. What service do you provide the PE firms that approach you?
2. How much of the process is a generic output relative to the Private Equity industry's usual requirements?
3. How much of the process is guided by the PE firm's questions?
4. Can you go into the process between contracting to the PE firm and concluding on a result or providing a report?
5. What sort of result can the PE firm expect from your specific evaluation?

Thank you in advance for your input into this research. Its result will be made available to you if you wish.

Appendix D – Interview Transcripts

The answers to each question presented to the respondents are written in blue immediately after the question. The interviews are presented in the following order:

1. Private Equity
2. Bank
3. Auditor
4. Lawyer
5. Industry Expert

PRIVATE EQUITY

Date: *10 November 2015* *Conducted by W. Olivey, Student Number 0406311K*

Firm: Warwick Capital

Interviewee: Thomas Voigt

Background: Advisor to Warwick Capital, prior to which he was a partner from 2007 to 2014

Principal & Deal Executive at Brait Technology Fund

Founder and Managing Partner of Axis Venture Associates (AVA)

Questionnaire: ***Understanding the Information considered in Private Equity Buying Decisions in South Africa***

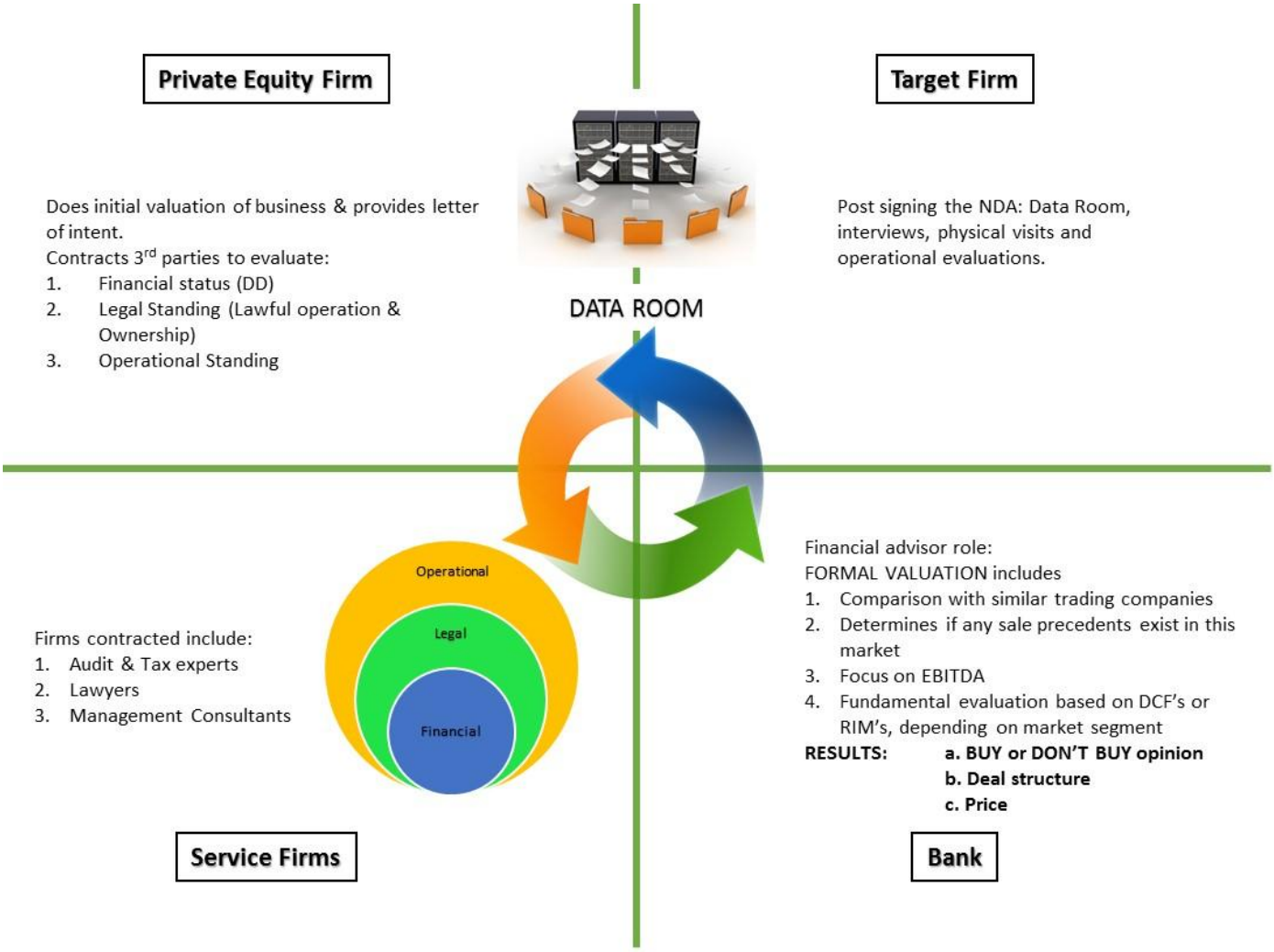
Preamble

Predetermined topics have been set down in the form of open-ended questions. It is the researcher's view that rigid question-answer sessions will not be conducive to in-depth discussions. Each Private Equity (PE) firm will have a specific strategy and market focus, so the tools, focus and information they value would more than likely vary considerably. This prevents structured interviews from gathering sufficient information tangential, but relevant, to the topic at hand. As such, the questions are there to prompt additional discussions regarding the approach and criteria a South African PE firm would find useful in their evaluations of target companies.

Questions for Private Equity Firms

1. What target industry/s does the PE firm operate in?
    a. Technology industry
    b. Growth industries, industry economics first (100 and 200% year on year, 40 to 50% year on year, even if not profitable but showing the trends of growth within 5-8 years)
    c. What is the supply demand equilibrium
    d. Trend in major participants in industry
    e. Return on capital in this industry
2. How does the firm determine what firm is desirable before any evaluation is even considered?
    a. Need to be sure of the market you want to operate in before one goes and does any kind of push into the company structure you wish to own/run
    b. Bargaining power of customers
    c. Dominance of suppliers
    d. Substitute products
    e. Inter-industry rivalry
    f. Competitive? Lots of small guys? Few big companies
    g. Lobster Boat problem, research whom did this and the industry economics problem as per Thomas's starting point

3. What is the process followed between initial selection and letter of intent? May we draw the model?
   For example:



   a. The model is consistent with the approach used by all PE firms, but our firm is different in that it does not leverage anything and focuses on only equity form the funds.
   b. We also do not use the banking partners in Africa as their work there is limited and we don't need the debt, as mentioned.

4. What service provider companies does the PE firm make use of in the evaluation phase?
    a. Legal?
        i. Imperative to understand the legal landscape the firm is operating in, as well as the resultant ethical links.
    b. Audit?
        i. Yes, for the DD only.
    c. Banking?
        i. Not needed as we do not use debt instruments to raise funding.
    d. Management Consulting?
        i. Not used. We don't need them nor want to pay their fees.
5. What information is sought through the on-site/data room investigations?
    a. How much is existing management included in the evaluations?
        i. Plenty – from an ownership point of view and philosophy of the future. Need a shared vision
    b. What sort of information is sought from an operational standpoint?
        i. Sustainability is key, ownership of PPE
6. What topics does the firm consider imperative to cover during a Due Diligence process?
    a. NB to understand the entrepreneurial vision
7. What initial valuation method is used to ascribe a value to a target firm for the non-binding off in a letter of intent?
    a. DCF's
    b. Buyers expectations
    c. Industry comparables
    d. Fundamental valuations
    e. Return on capital ahead of the cost of capital
8. Is there a generic model for the formal evaluation done by the PE firm?
        i. Yes. Sorry, I cannot share this with you.
    b. Is there some standard form documentation that can be shared with the researcher to this effect?
        i. No.
9. What fundamental valuation methods are used in determining the potential price of the target firm?
    a. DCF's are heavily relied on.
10. Does the firm conduct its own fundamental calculation of an offer price?
        i. Yes. Since no bank is used, we do our own calculations and offer validations internally.
    b. Is the Banking partner's fundamental valuation weighted more heavily than the firm's own?
        i. Not really using the investment bankers in the industries they play. Important in buy-outs where there are debt tools. But here there is no debt in this game.
11. What sort of Legal topics need to be covered in order to proceed with purchase?
    a. Ownership checks. Assets are looked into, as well as the validity of actual ownership and their ability to sell the company.
    b. Contractual evaluations, including supplier and customer sides.

12. Which does the firm consider more valuable:
    a. Purely factual information (e.g. existing financial statements, actual machine capacities, NPV of current contracts)?
        i. BOTH
    b. Purely subjective information (e.g. desirable market segment, knowledge of the customer base, agreeability of existing management to change)?
        i. BOTH
        ii. Got to have the fundamentals and the feelings. Have walked away from people they don't like even if the numbers say yes.
13. Are there obvious hold-points in the evaluation process which prevent the PE firm from continuing the evaluation?
    a. Dishonesty
    b. Legal issues
    c. BUSBY article backed by Ethos. Look at the reputational fallout here. NO GO AREA
14. At what point does the PE firm consider that enough information has been collected to make a buying decision?
        i. It never stops. There is no end the flow of information even after the acquisition.
        ii. Industries change and so do people
    b. What is this information?
        i. Everything mentioned previously. You cannot forget that the goal is to sell the firm at an incredibly high profitable point within a defined period of time.
        ii. Need to get the sell signals both from the good and bad aspects of the business, and the landscape is always changing.
        iii. Need to be on top of the numbers and the soft issues in order to see the icebergs and the potential opportunities.

Thank you in advance for your input into this research. Its result will be made available to you if you wish.

BANK

Date: *15/7/2015* *Conducted by W. Olivey, Student Number 0406311K*

Firm: European Bank

Interviewee: Justin Scott

Background: Vice President, Corporate Finance

Questionnaire: ***Understanding the Information considered in Private Equity Buying Decisions in South Africa***

Preamble

Predetermined topics have been set down in the form of open-ended questions. It is the researcher's view that rigid question-answer sessions will not be conducive to in-depth discussions. Each Private Equity (PE) firm will have a specific strategy and market focus, so the tools, focus and information they value would more than likely vary considerably. This prevents structured interviews from gathering sufficient information tangential, but relevant, to the topic at hand. As such, the questions are there to prompt additional discussions regarding the approach and criteria a South African PE firm would find useful in their evaluations of target companies.

Questions for Service Providers of Private Equity Firms

1. What service do you provide the PE firms that approach you?
    a. Financial advisor, project management of all other service firms
    b. Coordinate the entire transaction, taking input from all the other service firms and take input from all of them
        i. Tax, legal, accounting, IT
            1. Oversight and project coordination
            2. Accounting: if there are big tax liabilities on the balance sheet, picked up in DD, considered in the purchase price (tax settlements affecting earnings etc.)
            3. Legal: disputes ongoing between creditors/claims and the probability of this dispute coming of age/deferring to the new owners, hence pricing the risk into the potential purchase price
            4. IT: unlicensed systems, no rights to those systems, down the line costs
    c. Transaction structuring
        i. Is it a Listed Firm (scheme of arrangement, general offer)?
            1. Offer circulars
                a. Scheme of arrangement: PE proposes to board of target-company to propose a scheme to the shareholders. EB works to adhere to JSE rules, makes sure works clearly and goes to shareholders as a vote. If 75% agree, then all sell.

b. Offer or Hostile Takeover popularised in the 80's in the USA: go straight to the shareholders (doubt one has ever happened in RSA)

ii. Private Firm:

1. Sales and Purchase Agreements: a SPA document. Lawyers draft this but EB has input to this. Particularly around key financial terms and risks in the terms. Warranties, indemnities come from the lawyers wording, but the EB guys have a say in some sense.

d. When does EB get involved:

i. EB pitches an idea to a PE firm for a company they should buy.

1. Transaction rational
2. Indicative valuation (based on info available, trading comparables operating in the listed space, maybe an EBITDA number in public – for example, buy a retailer but look at listed companies and a ratio on EDBITDA there, adjusted for the possible acquisition)
3. Will work with the PE form to build an investment case, and the end result will be an expression of interest to the target company (Letter of Intent)
    a. Sets out the views of the process (DD requirements, access to information)
    b. If there is sufficient info in public, possibly an offer.
    c. If a favourable reply, go into DD and the PE firm would mandate other service firms to work with (IT, Audit etc)
4. In parallel to this one negotiates an SPA.
    a. Balance of offer versus risk (what are the terms which the company has to meet post the agreement, conditions around the binding offer and so on)
5. A binding offer is provided (drafted) by EB and the PE will comment (lawyers will also be heavily involved) and the PE firm will adjust as necessary.

ii. PE firm identifies and opportunity, and EB is contacted and follows the same route

iii. Auction process, and this is held by PE firms or other financial houses, whom want to sell out. The shareholders don't want to enter into discussion with single people, but want to effectively go on auction to a host of people.

1. EB will try and find a suitable bidder
2. Or a bidder will try find EB

iv. Phase 0: Marketing by the sellers (EB goes out to all potential parties and tries to drum up interest in this company, screen and proceed)

v. Phase 1: Information Memorandum, Non-binding offers from all

vi. Phase 2: DD and process (3 to 5 PE's)

vii. Phase 3: Binding offer/s, and marked up SPAs (negotiations proceed on detail level)

viii. Acquisition and life carries, and EB maintains contact to future business

2. How much of the process is a generic output relative to the Private Equity industry's usual requirements?
    a. DD is a fixed requirement, IC is a fixed thing
    b. Advisors will give input specific to this DD
    c. Not a generic output, excepting the end result which is the advice on the purchase price and the risks. But the risks and future of the specific target firm is case specific.
    d. Operation aspects define the scope, and the analysis of future performance/numbers is bespoke.
3. How much of the process is guided by the PE firm's questions?
    a. Answered.
4. Can you go into the process between contracting to the PE firm and concluding on a result or providing a report?
    a. Done already.
5. What sort of result can the PE firm expect from your specific evaluation?
    a. Fundamental Valuation (usually DCF, DDM, Warranted Equity Valuation but industry specific)
        i. Trading comparable analysis (Listed Environment - what are others in this industry trading on, overvalued etc.)
        ii. Transaction comparable analysis (precedent transaction for similar, and what have people paid – focused on premiums to share prices if listed, and if private then multiples of whatever the key driver is – EBITDA, book value, embedded value etc)
        iii. FINAL DOCUMENT = analysis of forecasts, benchmarking, scenarios if the company's margins shift, strategic rationale for the transaction, Point i and ii above
        iv. END OUTPUT in same document will be what the offer should be and in what structure if should take.
            1. Earn outs, portions paid over performance in future, over and above other points mentioned in question 1.

Thank you in advance for your input into this research. Its result will be made available to you if you wish.

AUDITOR

Date: *7 August* *Conducted by W. Olivey, Student Number 0406311K*

Firm: African Auditor Inc.

Interviewee: Ajit Ram

Background: Director and Head of Department for Financial Services Group

Questionnaire: ***Understanding the Information considered in Private Equity Buying Decisions in South Africa***

Preamble

Predetermined topics have been set down in the form of open-ended questions. It is the researcher's view that rigid question-answer sessions will not be conducive to in-depth discussions. Each Private Equity (PE) firm will have a specific strategy and market focus, so the tools, focus and information they value would more than likely vary considerably. This prevents structured interviews from gathering sufficient information tangential, but relevant, to the topic at hand. As such, the questions are there to prompt additional discussions regarding the approach and criteria a South African PE firm would find useful in their evaluations of target companies.

Questions for Service Providers of Private Equity Firms

1. What service do you provide the PE firms that approach you?
    a. Independent DD services (80% of the time)
        i. Tax
        ii. Financial and legal DD's
    b. Independent valuations (80% of the time)
    c. Valuation reviews, of someone else's (80% of the time)
    d. Model validations and determine if someone else's work makes sense – output is an opinion on the model (20% of the time)
2. How much of the process is a generic output relative to the Private Equity industry's usual requirements?
    a. So there is a menu, and each product has layers determined by size of deal
        i. True cost defines the choice of PE firm makes, as well as the depth of the investigation required
        ii. The high IRR PE firms have determined the depth
            1. Smaller firms are focused on purchase costs
            2. Larger firms define by deals and contracts over time
            3. Otherwise the PE guys have their own skills and define the split between service firm and their own in-house skill sets
3. How much of the process is guided by the PE firm's questions?
    a. The menu is defined, so the whole IRR in the PE firm drives the point home.
4. Can you go into the process between contracting to the PE firm and concluding on a result or providing a report?
    a. Limited info to get the firm interested in quoting, then NDA, then full quote

b. NDA is always at the beginning, with Mandate Letter (AA drives the mandate)
    1. Scope
    2. Responsibilities
    3. Fees
    4. Clauses on liability
    ii. Starting point is signed AFS
    iii. Looking at internal reporting
    iv. DD is a deep dive, not only on the basis of publically available information
    v. Process evaluation
    vi. Interviews with management and service providers
    vii. Looking at Hr and payroll, compliance with regulations
c. Checklist for data in advance, and Data Room is set up by client in advance.
    i. Also a physical data room at times, sign ins and presence of target person
d. The report will include
    i. Unavailable info – highlighting issues or hidden material matters
    ii. Legal matters – comfort or discomfort with the size of liability raised
    iii. Highlighting deal breakers

5. What sort of result can the PE firm expect from your specific evaluation?
    a. Objectivity in the DD reports only
    b. Subjectivity in the valuation as it works on the future numbers, unseen but assumed
        i. DCF based on management's reports (Target's numbers only)
        ii. Follows the IPEV Valuations Standards
        iii. AA makes their valuation separate from the other service providers to give the PE firm the best results
    c. Report, presentation
        i. To the IC, looking at assumptions and methodology

PE's approach to the Audit firm is through:

1. Tender
2. Preferred service providers in the PE firm
3. Always seemingly about cost

The value is not letting the PE firm burn his fingers. It is about making sure the PE firm feels comfortable. The AA type service provider DOES NOT have a stake in the purchase price, therefore their independence is almost guaranteed. UNLIKE THE BANKS.

Thank you in advance for your input into this research. Its result will be made available to you if you wish.

LAWYER

Date: *14 January 2016* *Conducted by W. Olivey, Student Number 0406311K*

Firm: ALK Law

Martin Levy, Senior Associate

BCom LLB, Reading for Masters in Banking Law

Questionnaire: ***Understanding the Information considered in Private Equity Buying Decisions in South Africa***

Preamble

Predetermined topics have been set down in the form of open-ended questions. It is the researcher's view that rigid question-answer sessions will not be conducive to in-depth discussions. Each Private Equity (PE) firm will have a specific strategy and market focus, so the tools, focus and information they value would more than likely vary considerably. This prevents structured interviews from gathering sufficient information tangential, but relevant, to the topic at hand. As such, the questions are there to prompt additional discussions regarding the approach and criteria a South African PE firm would find useful in their evaluations of target companies.

Questions for Service Providers of Private Equity Firms

1. What service do you provide the PE firms that approach you?
    a. Advisory services first and foremost
        i. Tax matters with the Auditors as backup
            1. Unpaid VAT
            2. Unpaid companies Tax
            3. Unpaid dividends tax
            4. Unpaid PAYE
            5. Unpaid UIF
        ii. Matters of Going Concern
            1. If a business UNIT changes ownership there is VAT to consider if it is registered as a VAT vendor
            2. Company needs to continue on the day after it is bought, including all issues of an operational nature
        iii. Looking at inherent risks from:
            1. Labour law, what are the legislative effects on transfer of ownership, such as do licences of trade (e.g. liquor) have an effect?
                a. Authorisations from Boards to take over the appropriate licence (Liquor Board)
                b. The real asset can be the ability to trade in a certain market, and these need to be transferable to the new owners
            2. The company's indebtedness to creditors
            3. Ongoing matters related to cases that do not show on the AFS

        a. Would look at indemnities to counteract these risks, such as if they are sued then the prior owners can still be liable.
      4. Has the seller got any goods/assets registered under a notarial bond?
  b. Drafting of agreements:
    i. Non-disclosure agreements
    ii. Shareholders Agreements,
    iii. Indemnities
  c. Some of the first checks done are:
    i. Look at the seller and do a CIPC Office (Companies and Intellectual Properties Commission)
      1. Who am I dealing with, very often taken for granted!
      2. Is he a director of the company
      3. Does he have authorisation to deal with the sale
      4. Do a bond search, related to prior indebtedness
      5. Who has properties and what value do the sellers have to their names in case the buyer needs to go after them in the instances of damages related to the deal
    ii. The company need to have resolutions and appropriate board level documentation in place for the sale to be valid, allowable, desired by the sellers themselves
      1. Get the minutes of the meeting wherein this was decided
2. How much of the process is a generic output relative to the Private Equity industry's usual requirements?
  a. Nothing.
  b. The lawyer requests the information that the PE firm has and looks at the case-by-case situation and meets with the PE people to advise up front.
    i. Lawyers will feed off of the findings of others, such as the Mgmt Consultants and Auditors in order to see the context from a legal perspective.
  c. The output is adjusted to the needs of the deal in question, and the inherent risks that can be suggested by the industry type.
  d. The drafting of the agreement or other legal documents is a function of the context the deal finds itself in, and is usually modelled each time.
  e. The function the lawyer has is to mitigate the customer's exposure to litigation, and so this fuels the outcome.
  f. The other main function is to drive impetus to the commercial viability of the buyer's deal, and ultimately go looking for issues to reduce the price.
3. How much of the process is guided by the PE firm's questions?
  a. As above. It is an iterative approach and the feedback will amend the approach at all stages.
4. Can you go into the process between contracting to the PE firm and concluding on a result or providing a report?
  a. Contacted by the PE firm and brought in to sign a mandate, discuss payment terms.

   b. Thereafter the time is defined by the complexity of the deal, and sometimes the PE firm will only provide hours in which to come up with answers. The urgency is a huge factor.

5. What sort of result can the PE firm expect from your specific evaluation?
   a. Outputs can be written reports, presentations, meetings to provide results.
   b. Sometimes it's a simple discussion.

Thank you in advance for your input into this research. Its result will be made available to you if you wish.

INDUSTRY EXPERT

Date: *30/11/2015* *Conducted by W. Olivey, Student Number 0406311K*

Firm: N/A

Interviewee: Michael Clyde, BCom Hons (Econometrics), MSc (Ind)Eng, Lev2 CIMA

Background: Transactor for SACE, Export Credit Agent, Italy – Contracting to Private Equity to secure credit worthiness of deals

Management Consultant, OIM, Cape Town

Questionnaire: ***Understanding the Information considered in Private Equity Buying Decisions in South Africa***

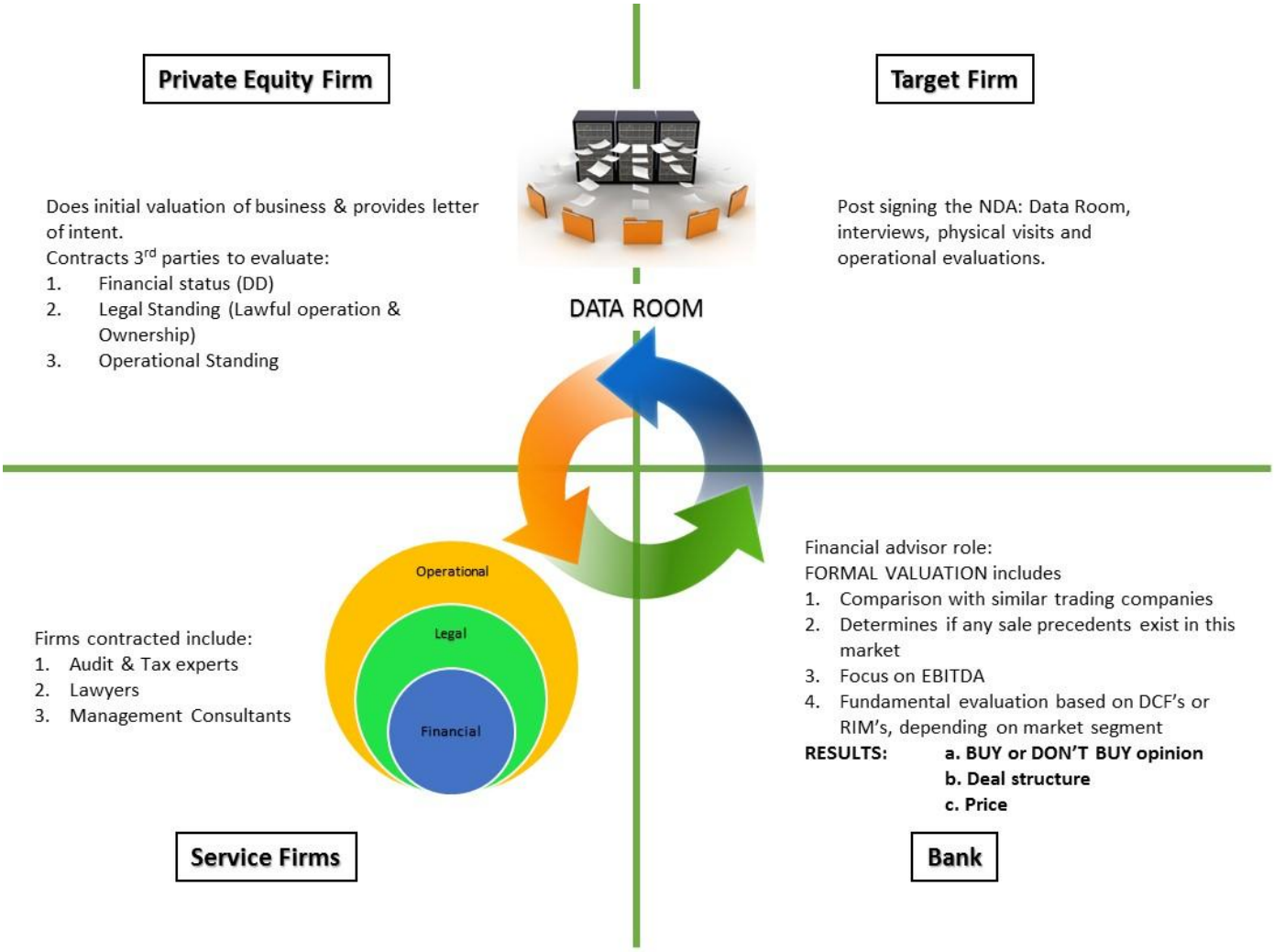
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Questions About Private Equity Firms

1. What target industry/s does the PE firm operate in?
    a. This depends entirely on their mandate, as strategically determined by their Board.
2. How does the firm determine what firm is desirable before any evaluation is even considered?
    a. Industry Segment
    b. Market forces
        i. Growth market?
        ii. Whom are the Value Players? The bigger players, and whom if any of them you want to buy.
            1. Find the one which is undervalued and has the most opportunity to have value unlocked

3. What is the process followed between initial selection and letter of intent? May we draw the model?
   For example:



a. The model is consistent with the overall approach.
b. Set up meeting with the target and understand that there is an interest
c. Sign an NDA with the target
d. Gather as much information as possible, through their own activities or those of service firms
e. Ratify this data with something like an Investment Committee internally and make a decision to buy or re-pitch a deeper DD

4. What service provider companies does the PE firm make use of in the evaluation phase?
    a. Legal?
        i. Yes, definitely.
    b. Audit?
        i. Yes, for a full in depth DD.
    c. Banking?
        i. Yes, as additional value analysis and as the funding partner for debt instruments required to further fund the acquisition price.
    d. Management Consulting?
        i. Yes, but not on all deals. These companies are not always needed as the expertise on operational matters is usually within the PE firm itself. Used when additional clarity is required and the target firm is too large to analyse with PE staff alone.
5. What information is sought through the on-site/data room investigations?
        i. Financial valuation information
        ii. Operational capacity
        iii. Management interviews
        iv. Process evaluations
            1. Feasibility studies into the capacity versus what needs to be invested to get the company to operate at the levels it needs/wants
            2. Capex to brand bigger and better?
    b. How much is existing management included in the evaluations?
        i. It is fundamental to have the right management
        ii. Some management do not have the ability to scale the company
    c. What sort of information is sought from an operational standpoint?
        i. Capacity of operations to do more of the same (UTILIZATION)
        ii. How much are the existing assets able to deliver on current work
        iii. Actual value of order book
6. What topics does the firm consider imperative to cover during a Due Diligence process?
    a. Income statement
        i. Is your revenue truly your revenue? Show the invoices and products sold
    b. Balance Sheet
        i. Asset register and who owns the machines or tooling needed to do the work you do
7. What initial valuation method is used to ascribe a value to a target firm for the non-binding offer in a letter of intent?
    a. PE Multiples
    b. Even a quick DCF is possible if information is in the public space
8. What fundamental valuation methods are used in determining the potential price of the target firm?
    a. DCF
    b. Comparatives in the same industry
    c. Indirect factors like market forces and the direction of the current
9. At what point does the PE firm consider that enough information has been collected to make a buying decision?

a. Determined by the IC and the perception of risk
    i. So, if you buy something with low margins then the desire to understand everything is high
    ii. If in a high GP situation, this pressure disappears
    iii. The timeline, the costs and the overall approach is driven by clarity of information and the desire to know enough to be able to unlock additional value

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