

## BETTER BEE FUNDING STRUCTURES CAN BE FOUND

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Black economic empowerment (BEE) ownership poses a major political risk for South Africa. Most empowerment transactions have been done on the traditional special purpose vehicle (SPV) structures, or hybrids thereof. These structures require a funder to inject cash into a specially created company where the ordinary shares are owned by the empowerment shareholders. In return, the funders acquire preference shares in the SPV that are equivalent to the total debt required for the empowerment deal at a rate of about 12 percent.

The interest on the preference share can be rolled up into the capital of the debt, attracting further interest on interest. On paper the BEE shareholders own their shares, but in reality these shares are subject to a significant debt burden. The underlying investment company needs to pay a dividend to settle the interest and if possible the capital portions of the preference share loan. The average dividend yield on the JSE is currently 4 percent. This means that 4 percent of the profits after tax are distributed to shareholders. If the interest rate on the preference share is 12 percent and the dividend yield is only 4 percent, then the difference is capitalised to the loan.

On a R100m transaction this would mean that in the first year alone, the capital increases by over R8 million. Since the dividend yield is too low to cover the full or even part of the interest, the empowerment shareholders are heavily reliant on the capital appreciation in the share price. Consequently, the underlying share price would need to grow at over 1700 percent (cumulative) over a 10-year period for the shareholders to retain their 25,1percent shareholding (based on a 10 fixed term loan, 4 percent dividend yield and a 15 percent interest rate). Over the past 10 years the JSE All Share Index has grown at 357 percent in a bull market. This clearly demonstrates that at best many black shareholders will be left with only one third of their original stakes, or between 5 percent and 7 percent.

In 1998 and 1999 when the equity markets crashed due to the Asian economic crisis, many empowerment deals had to be restructured. Think back to Johnnic and Foodcorp transactions that needed to be restructured and refinanced as the appreciation in the share price was not sufficient for the empowerment shareholders to retain any material stake. In an environment of increasing interest rates and a global liquidity crunch, we are heading for some turbulent times ahead. Empowerment deals done in the last three years when prime interest rates were as low as 10 percent, will particularly come under pressure.

If interest rates remain at the current levels and the JSE continues to grow at record highs, then only approximately 10 percent of shares will vest in black hands, a far cry from the government's desired 25,1 percent.

It's clearly time that policy makers in the corridors of government became aware of the long term implications of what is currently happening. There was much debate on empowerment ownership

structures following the 1998/1999 empowerment collapse. Given the current economic outlook, this clearly is a debate that needs to re-emerge.

The worsening economic climate will not leave empowerment unscathed, and turning a blind eye to this will only be foolhardy. We need to confront the reality that the vast majority of current transaction will result in empowerment shareholders having very little to show for "lending their blackness" to companies.

The end result will be that government policy objectives of a substantial transfer of ownership of productive assets to black people will not be realised. That is the real political risk facing South Africa. At best, this risk could result in increased empowerment regulation, at worst trigger a major social unrest.

The most likely scenario though is some middle ground, with many companies doing top up deals and having to go back to shareholders for approval. For companies taking this route, however, it is advisable to do this once and ensure that the deals are done on a sustainable manner with a realistic chance of a significant transfer of ownership to empowerment groups. According to Ernst & Young's mergers and acquisitions survey, a total of 1 738 empowerment deals have been concluded in the listed company environment during the past 13 years. If we assume that 80 percent of transactions are done by the banks, and then we can assume that 1 390 of these transactions would have been done on the typical special purpose vehicle structures. What this means is that as a country, we are facing a significant challenge to ensure that an empowerment groups do not remain disillusioned about broad-based empowerment.

Furthermore the strategy on broad-based BEE states that a further objective is to have schemes such as employee share participation and co-operatives taking part in empowerment ownership. In a typical SPV structure, the empowerment shareholders are required to contribute anything between 2,5 percent and 10 percent of the value of the equity (including the 10 percent discount provided by the sellers) prior to the funders lending on the preference share structure. Broad-based schemes therefore, are typically excluded from these transactions as they do not have access to cash to inject into the transaction unless facilitated by the sellers or shareholders.

Many empowerment groups enter into transactions without good, or even independent advice, putting them at the mercy of funders, who also play the role advisors - to both sellers and buyers. This player-referee scenario is clearly untenable; empowerment groups need to have access to independent advisors who are looking after their interests. It's important that empowerment groups understand that funders are largely looking after their own interests, and make money through the provision of funding rather than doling out advice.

Empowerment players to need to explore the various structures that could yield better results, such as the leveraged finance models often used by the private equity industry or face the wrath of the government and impoverished citizens.


The private sector has the means to avert this looming political risk. Banks and corporates could review the funding rates, increasing the dividend yield and provide enhanced vendor support to transactions at a greater discount than the current 10 percent average. For their part, politicians, in this case the department of trade and industry (dti), could mitigate the risk by reviewing the various elements of the codes, especially on the ownership score to ensure that transactions really do result in a substantial transfer of ownership to black people.

Such a review does not have to involve dramatic changes. Dti would have to clarify the spirit and intended outcome behind the codes, especially around broad-based schemes and the transfer of productive assets to blacks. This will give funders and the private sector the clarification they have long sought.

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