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1 Types of private equity transactions

What different types of private equity transactions occur in your jurisdiction? What structures are commonly used in private equity investments and acquisitions?

Private equity transactions in South Africa are as varied as they are in other jurisdictions. Generally, they can be classified into three categories, namely venture capital, development capital and buyouts. Typically, partnerships (usually en commandite or limited liability), trusts and companies are the most common legal structures used as vehicles for private equity investments. In addition, captive funds of financial services players, such as insurers, play an important role in the country's private equity industry. Collective investment scheme structures might sometimes be utilised where it is possible to accommodate the relevant regulatory requirements. Certain investors (for example, pension funds) are entitled to specific and often beneficial tax treatment, in which event the transaction is structured so that gains 'flow' through the investor, so that the fund entity is 'tax-transparent'. Private equity transactions are funded by equity or debt or a combination of both. Sources of funding generally include independent private equity firms, banks, government or development funding institutions and institutional investors, including pension funds, endowments and insurance structures. Investors in private equity funds will generally derive a return in the form of dividends, interest, proceeds from the sale of shares, initial public offering or recapitalisation.

The majority of transactions concluded by the private equity industry in South Africa have a significant black economic empowerment (BEE) component and indications are that this will continue to be the case in the future. BEE is a statutory policy designed to facilitate greater economic participation for black, historically disadvantaged individuals through the acquisition of equity ownership or management of an investee company (or both). BEE is an important factor to consider when structuring private equity transactions. In addition, BEE transactions themselves represent a significant class of private equity transactions.

2 Corporate governance rules

What are the implications of corporate governance rules for private equity transactions? Are there any advantages to going private in leveraged buyout or similar transactions? What are the effects of corporate governance rules on companies that, following a private equity transaction, remain or become public companies?

There are a number of legislative and regulatory schemes that govern private equity activities as with other corporate transactions. In addition to the BEE policy framework, private equity transactions must take cognisance of the Companies Act, 2008, as amended (the New Companies Act), which came into force on 1 May 2011 and replaced the Companies Act, 1973 (the Old Companies Act) except for Chapter XIV of the Old Companies Act, which will be repealed by future bankruptcy and insolvency legislation; and, further, the King Report on Governance for South Africa (2009) and the King Code of Governance Principles (King III); the new Takeover Regulations, read with sections 117 to 127 of the New Companies Act (the Takeover Regime); and the JSE Listings Requirements (the Listings Requirements), as well as legislation regulating exchange controls, competition and anti-trust activity. The New Companies Act addresses various aspects including incorporation, registration, organisation and management of various kinds of companies as well as providing for more equitable and efficient amalgamation, mergers and takeovers of companies. Corporate governance is affected by changes introduced by the New Companies Act, in addition to King III: the New Companies Act partially codifies directors' fiduciary duties, which were previously governed by common law, and seeks to promote transparency and higher levels of corporate governance and accountability.

The New Companies Act retains the recent amendments to the Old Companies Act, including the ability of companies to provide financial assistance as part of private equity transactions, particularly common in BEE transactions, if such company's board is satisfied that, subsequent to the transaction, the consolidated assets of the company fairly valued will exceed its consolidated liabilities and that subsequent to providing financial assistance, and for the duration of the transaction, the company will be able to pay its debts as they become due in the ordinary course of business. The terms upon which the financial assistance is to be given must also be sanctioned by a special resolution of the shareholders of the company.

The New Companies Act further allows a company to provide financial assistance in connection with the subscription for any securities to be issued by the company or a related or inter-related company, or for the purchase of any securities of the company or a related or inter-related company if the company's board is satisfied that, subsequent to the transaction, the solvency and liquidity tests will be satisfied and the terms under which the financial assistance is to be provided are fair and reasonable to the company. The allowance of financial assistance under the New Companies Act has thus far been, and will continue to be, subject to compliance with shareholder and board approvals, facilitated BEE transactions, especially where third-party funding was expensive.

The main advantages of going private are that the administrative costs and disclosure burdens that apply to a public company are reduced. While previously there were less onerous corporate governance and financial reporting obligations that apply to a private company, the New Companies Act has reduced the potential advantage for private companies by now requiring that all types of companies' financial statements have to comply with accounting standards (IFRS or GAAP). Furthermore, the New Companies Act provides that all companies: public, private, non-profit and state-owned, whose 'public interest score' is 350 or more, are obliged to have their annual financial statements audited. Those companies with a public interest score of more than 500 are now also obliged to appoint a social and ethics committee to monitor the companies' activities with regard to its social responsibilities.

The public interest score is calculated by adding points determined by the following four factors, which will apply to many large private companies:

- the number of points equal to the average number of the company's employees during a financial year;
- the aggregate amount of its liabilities to third parties at financial year end (one point for every R1 million or portion thereof);
- its turnover during the financial year (one point for every R1 million or portion thereof); and
- in the case of a profit company, the number of its direct or indirect shareholders who are natural persons at financial year end (one point for every individual).

3 Issues facing public company boards

What are the issues facing boards of directors of public companies considering entering into a going-private or private equity transaction? What procedural safeguards (eg, special committees of independent directors), if any, do public companies use when considering transactions? What is the role of a special committee in such a transaction where senior management, members of the board or significant shareholders are participating or have an interest in the transaction?

The main issue facing boards of directors of public companies is ensuring that directors exercise their common law fiduciary duties, now partially codified by the New Companies Act, towards the company. The common law fiduciary duties include the duty to exercise independent judgment, the duty to avoid conflicts of interest and the duty to act in the best interests of the holders of the securities in the company. In particular, the conflict of interest that some directors may have between their personal interest as purchasers of the company and their duty to act in the best interests of the company – avoiding the exploitation of any property, information or opportunity of the company – needs to be properly managed by the board. This conflict of interest is typically dealt with and managed through the establishment of a special committee of the board. The committee would typically be chaired by the independent chairperson of the company and would be mandated to run the private equity transaction on behalf of the company. Those directors who have a direct or indirect interest in the buyout would not be members of the committee but could be called upon by the committee to assist where necessary.

It is important to note that the New Companies Act expanded the meaning of 'director' to include an alternate director, prescribed officer, member of a board committee or a member of the audit committee, irrespective of whether the person is also a board member. The new statutory fiduciary duties imposed by the New Companies Act will thus have to be observed by these persons as well.

The New Companies Act codifies most of the director's fiduciary duties and provides more detailed and in certain respects stricter provisions relating to standards of conduct for directors, the liability of directors and the indemnification of directors from liability for conduct in breach of certain provisions of the New Companies Act. For example, if a director has a personal financial interest in respect of a matter to be discussed at a board meeting, or knows that a related party has a personal financial interest in the matter, the director must disclose the interest and its general nature to the board before the matter is considered at the meeting and, if requested by the other directors, may not take further part in the consideration of the matter. Where the common law and statutory duties are in conflict, the statutory provision will prevail. The common law remains applicable where the New Companies Act does not apply.

4 Disclosure issues

Are there heightened disclosure issues in connection with going-private transactions or other private equity transactions?

Private equity transactions are subject to the general disclosure requirements prescribed by South African law. Although there are no specific disclosure requirements for private equity transactions, if a party involved in the transaction is a listed company then the general disclosure requirements applicable to listed companies, as well as the requirements of the Takeover Regime and the Listings Requirements, will have to be met.

The Listings Requirements require the issuing of cautionary announcements when transactions are contemplated that may affect the price of the shares of the target company or the acquiring company. This is in addition to various other disclosure requirements that are not specific to private equity transactions.

The Takeover Regime, which applies to 'regulated companies' as defined, requires the parties to an 'affected transaction' to comply with a prescribed standard of conduct in respect of matters such as the form and conduct of offers, the announcements, mandatory offers, asset valuations, equal treatment of shareholders and the disclosure of information. A 'regulated company' is defined as all public and state-owned companies, as well as certain private companies that have transferred more than 10 per cent of its securities to persons other than related persons in the 24 months prior to the relevant transaction. It is possible to obtain exemption from compliance with the provisions of the Takeover Regime, although such exemption is not lightly granted. In certain cases, the Takeover Regulation Panel will consider waiving compliance with the Takeover Regime if there is no reasonable potential of the affected transaction prejudicing the interests of any existing holder of a regulated company's securities, if the cost of compliance is disproportionate relative to the value of the affected transaction, or if exemption is otherwise reasonable and justifiable in the circumstances having regard to the principles and purposes of the Takeover Regime.

The Takeover Regime, contained in the New Companies Act, regulates affected transactions and offers and prescribes disclosure requirements concerning certain share transactions. In terms of the New Companies Act, a person must notify a regulated company within three days after he or she:

- acquires a beneficial interest in sufficient securities of a class issued by that company such that, as a result of the acquisition, the person holds a beneficial interest in securities amounting to 5 per cent or any further whole multiple of 5 per cent of the issued securities of that class; or
- disposes of a beneficial interest in sufficient securities of a class issued by a company such that, as a result of the disposition, the person no longer holds a beneficial interest in securities amounting to a particular multiple of 5 per cent of the issued securities of that class.

Upon receipt of the notice, the company is under an obligation to file it with the Takeover Regulation Panel and report the information to the holders of the relevant class of securities unless the notice concerned a disposition of less than 1 per cent of the relevant class of securities.

5 Timing considerations

What are the timing considerations for a going-private or other private equity transaction?

Depending on the nature of the transaction, the general negotiation and implementation of the transaction may take several months, particularly when sophisticated or complex structures are used or if regulatory approvals (such as exchange control or competition) are required.

When delisting is involved, the delisting procedure would itself require 17 calendar days from the time a complete application has been lodged with the JSE Limited (the JSE). This does not include the time required to implement the pre-application steps. In the case of category 1 transactions, the shareholders must approve the transaction in a general meeting. This could add several weeks to the timing of the transaction.

When the offeror makes a firm intention to acquire the securities of the offeree company, the Takeover Regime requires that independent directors of the target company tasked with advising the holders of the relevant securities of its views on the offer, should be independent and should do so within 20 days of the publication of the offer document. On the 45th business day after the day upon which a conditional general offer opened, an announcement shall be made by no later than 16.30 as to whether the offer is unconditional as to acceptances or has lapsed. No announcements revising an offer consideration may be posted on or after the 45th business day after an offer has opened unless the offer is unconditional as to acceptances. The consideration must be settled within six business days after the later of the offer being declared wholly unconditional and acceptance thereof by a holder. Extensions to a general, mandatory or partial offer before the expiry of the 45 day period are only allowed if the right to do so has been reserved in the circular and not subsequently withdrawn. Extensions after the expiry of the 45 day period are allowed with the consent of the independent board. A revised offer must be kept open for at least 15 business days after the date on which the revised offer document is posted. The Takeover Regime requires an offeror to make an announcement thereof within one business day after the offer has become unconditional as to acceptances. The announcement must specify the total number and percentage of securities for which acceptances have been received and which are held by the offeror at that time.

In terms of the Competition Act 1998, the Competition Commission (the Commission) has 20 business days in which to investigate an 'intermediate merger' (which meets the relevant thresholds of assets and turnover set out in the Competition Act) and to approve it without conditions, approve it conditionally or prohibit the transaction entirely. If the Commission has not reached a decision by the end of the initial period of 20 business days, the time frame may be extended for a further 40 business days.

If a transaction is categorised as a 'large merger', the Commission has 40 business days in which to assess the transaction and refer its recommendation to the Competition Tribunal (the Tribunal). The Commission may apply to the Tribunal for an extension of the 40 business day period. This period may be extended further, but only by 15 business days at a time. Upon receiving the recommendation of the Commission, or upon expiry of the applicable time period, the Tribunal will set a date for a hearing in relation to the transaction. There is no specific time frame for the period between the recommendation by the Commission and the date of the hearing of the Tribunal. This will depend on the caseload of the Tribunal at any given time.

In the case of a scheme of arrangement under the New Companies Act, the time frames prescribed by the courts in authorising the scheme will have to be complied with.

Where the approval of the exchange control department of the South African Reserve Bank (SARB) is required, timing considerations will depend on the complexity of the transaction and the specific approval required. Applications for exchange control approval will usually require at least 6 to 8 weeks to be processed. Generally, exchange control approval is required in respect of transactions that require the outflow of capital from South Africa or create obligations on South African resident companies in favour of non-resident entities. Outward investments by South African private equity funds are also subject to exchange control approvals, to the extent that they do not fall within the ambit of recently relaxed exchange control regulations relating to investments into the rest of Africa (see question 18).

6 Purchase agreements

What purchase agreement provisions are specific to private equity transactions?

In South Africa, due diligence, warranties, disclosure issues, insolvency protection and regulatory approvals are important aspects of the negotiation of purchase agreements. There is a close interrelation between due diligence, warranties and disclosure aspects.

Minority protection provisions in an existing shareholders' agreement may render the purchase agreement subject to the approval of the minority shareholders. This is sometimes obviated by the drag-along provisions in shareholders' agreements.

Where there is a distinction between the registered and the beneficial owner of shares in the target company, appropriate contractual provisions must be negotiated to ensure that the registered owner gives effect to the provisions of the share purchase agreement.

Reverse break-up fees are rarely encountered but are occasionally provided for where the acquiring party is subject to certain uncertain future events that may in the contemplation of the parties prevent the transaction from being completed. Sometimes options (whether in conjunction with full transaction agreements or not) are used to achieve this end. There seems to be resistance in the market to the proliferation of reverse break-up fees and it is unclear whether they will become more common in future. Certain financial houses have taken a more flexible approach to break-up fees and reverse break-up fees. It is unclear whether this will become a trend in the South African private equity sphere.

The issues relating to limitations on remedies for breach apply to purchase agreements of a private equity nature and purchase agreements in general. Agreements sometimes provide for claims based on a breach, particularly breach of warranty, to be made within a specific time period and for the amount claimed to be capped. Sometimes claims are disallowed if they do not reach an agreed threshold, individually or in aggregate, or both. Insurance is available in respect of claims of this nature. Private equity funds that are active in the distressed companies sector should be aware that liquidators are usually not prepared to provide warranties in relation to the target company.

Indemnity clauses are usually a matter of bargaining strength. They are often encountered in connection with undisclosed liabilities pre-dating the acquisition date and sometimes also in connection with disclosed liabilities where the quantum of the liability is not known. Tax indemnities in respect of taxation not provided for in the target's financial statements are common. Indemnities are sometimes subject to minimum thresholds and sometimes per claim and aggregate caps and time limits are agreed. In regulated industries (such as financial services), indemnities in connection with regulatory breaches are common.

Covenants to assist in raising finance are rare.

Complex financial conditions are not necessarily encountered in the agreements documenting the private equity transaction itself, but are often found in the finance agreements between the acquiring party and the financing banks. Banks generally require adequate security to be provided and in certain cases cession of receivables is required to bulk up the available security. Provisions dealing with minimum debt-servicing ratios and repayment triggers are commonplace.

Where exchange control approval is required it would usually have to be dealt with as a condition precedent, as agreements entered into in contravention of the exchange control laws are at risk of being void ab initio.

7 Participation of target company management

How can management of the target company participate in a going-private transaction? What are the principal executive compensation issues? Are there timing considerations of when a private equity sponsor should discuss management participation following the completion of a going-private transaction?

In South Africa, the phrase 'going private' is understood to refer either to transactions that involve delisting from the JSE or to transactions in which a company converts from a public company into a private company.

There are generally no legal restrictions in respect of management participation. Management participation may be in the form of its involvement in the new ownership structure through specific employment arrangements, participation in employee share incentive schemes, or a combination of the two.

Private equity transactions in South Africa often involve a 'lock-in' of the existing management of the target company in order to retain management expertise for existing business and for the development of new business, particularly in industries such as the financial services sector where reputation, relationships and proven business expertise are critical for client retention. Management lock-ins are commonly effected through retention bonuses or, where management has been given equity participation, as a staggered transfer of shares, for example in BEE transactions where the option to acquire specified tranches of shares is conditional upon continued employment, sometimes coupled with performance triggers.

The retention of skilled management may also be achieved by concluding non-compete agreements with the relevant members of management.

Traditionally, issues regarding remuneration of management become important in private equity transactions that involve conversion of the target company from a public into a private company since different standards of remuneration are applied to public companies as opposed to private companies. In order to ensure the retention of management following a target company 'going private', innovative packages need to be offered to management, which may include stock options.

The Takeover Regime and the Listings Requirements are also relevant in the context of 'going private' transactions. The Takeover Regime applies to 'affected transactions' – in broad terms, acquisitions by any person of 35 per cent or more of a company's voting securities – and prescribes that the offer document must specify whether and in what manner directors' emoluments will be affected by the acquisition of the offeree (target) company or by any other associated transaction. In addition, disclosure must be made of the existence of any agreement between the offeror or any person acting in concert with it, on the one hand, and any of the directors of the target company, or persons who have been directors during the past 12 months, on the other. The Takeover Regime also provides that the offeree response circular must disclose the material particulars of the service contracts of any director or proposed director of the offeree regulated company.

The Listings Requirements in turn classify transactions into categories 1 and 2, depending on the percentage ratio of the transaction. The percentage ratio is determined with reference to the consideration-to-market-capitalisation ratio, the dilution factor or, in the case of settlement partly in cash and partly by the issue of shares in the acquiring company, a combination of the two. The relevance of these categories is that, for the purposes of category 1 transactions, details pertaining to the contracts of service of the directors, be they current or prospective, of the listed company involved must be sent out in a circular to shareholders.

In BEE transactions, where shares are to be issued to employees who qualify as BEE participants, there may be pressure to issue shares to all employees and not only to the employees qualifying as BEE participants. This is typically achieved by transferring shares to a trust created for the benefit of the employees rather than by issuing shares directly to employees. Financial assistance can be given to the trust for purposes of the acquisition of shares without the issuing company first having to comply with liquidity and solvency requirements.

Question 8 deals with some of the tax considerations pertinent to the matters discussed above.

8 Tax issues

What are the basic tax issues involved in private equity transactions? Give details regarding the tax status of a target, deductibility of interest based on the form of financing and tax issues related to executive compensation. Can share acquisitions be classified as asset acquisitions for tax purposes?

South Africa applies a residence-based income tax system in terms of which South African residents are taxed on their worldwide income and non-residents are subject to income tax on income derived from a South African source. Residents are also subject to capital gains tax (CGT) on capital gains arising from the disposal of their worldwide assets, while non-residents are subject to CGT on capital gains arising from the disposal of immoveable property situated in South Africa or any interest in or right to immoveable property situated in South Africa, as well as in respect of the disposal of assets that are attributable to a permanent establishment (PE) of that non-resident in South Africa.

Funding of acquisitions

Private equity acquisitions are generally funded by substantial debt, usually as a combination of senior debt, mezzanine debt and equity loans. The deductibility of interest expenditure on such loans depends primarily on whether the interest expense was incurred in the production of 'income' as required by the Income Tax Act, 1962 (ITA). Dividend income is exempt from tax and is not income as defined in the ITA. Therefore, if the loan was raised to purchase shares, a deduction of the interest is generally not available.

However, with effect from 1 January 2013, taxpayers may in certain circumstances deduct interest incurred in respect of the acquisition of shares. In terms of a recent amendment to the ITA (section 24O of the ITA) where, during any year of assessment an instrument as defined in the ITA (any interest bearing arrangement or debt) is issued, assumed or used by a company for the purpose of financing the acquisition by that company of an equity share in an operating company (any company that carries on business continuously, and in the course or furtherance of which it provides goods or services for consideration or a controlling group company in relation to such a company) in terms of an acquisition transaction (any transaction in terms of which a company acquires an equity share in an operating company and as a result of which that company, as at the close of the day of that transaction, becomes a controlling group company in relation to the operating company) or in substitution of an instrument issued, assumed or used for such a purpose, any interest incurred by that company in terms of that instrument is deemed to have been:

- incurred in the production of the company's income;
- laid out or expended for the purposes of trade; and
- incurred in respect of income received by or accrued to the company.

The effect of the section is that interest incurred on debt used to acquire at least 70 per cent of the equity shares in an operating company or a controlling group company in relation to an operating company will be deductible. The deduction of the interest will remain for as long as the acquiring company remains a controlling group company in relation to the target (operating) company. It must be noted that the deductions are only available in respect of wholly domestic acquisitions.

The deduction of interest in relation to the direct acquisition of equity interests is subject to anti-avoidance provisions that were introduced into the ITA in 2011. These provisions, which are discussed in more detail below, initially applied to indirect acquisitions of equity acquisitions but have been amended to extend their application to direct acquisitions of equity interests.

Prior to the introduction of the anti-avoidance provisions and section 24O into the ITA, to ensure that interest incurred in respect of the acquisition of shares was tax-deductible, 'debt pushdown' structures were utilised. In such a structure, the acquisition of the shares in the target company by the local holding company would be followed by the transfer of the assets of the target company to a new subsidiary of the holding company, which raised third-party loans for the acquisition of the assets. The interest on the money borrowed by the new subsidiary to acquire the assets was generally tax-deductible. The proceeds of the sale of the assets were then distributed to the holding company, which used the amounts to repay the debt that was raised to purchase the shares. In addition, because the ITA contains specific provisions that provide tax rollover relief for restructuring transactions, the transfer of the assets under the debt pushdown structure usually qualified for tax rollover relief. In general, the provisions provide a rollover or deferral of any tax payable by the target company arising from the disposal of its assets to another company that is part of the same group of companies.

In June 2011, new restrictions were introduced into the ITA to restrict the tax deduction of interest incurred in respect of loans raised to fund the acquisition of assets in terms of a reorganisation transaction. The effect of the amendment (section 23K) was that interest associated with debt used to finance a reorganisation transaction, or debt that refinanced or substituted debt that was used to fund a reorganisation, would no longer be automatically deductible. Instead, the South African Revenue Service (SARS) could, on application by an acquiring company, issue a directive permitting the deduction of the interest. In considering the application for the directive, SARS will take into account the amount of interest incurred by an acquiring company in terms of a debt raised to fund an acquisition or reorganisation transaction, and all amounts of interest incurred, received or accrued in respect of all debt instruments issued, assumed or used directly or indirectly to fund a debt instrument in respect of which interest is incurred by the acquiring company. SARS may only issue a directive if and to the extent that it is, having regard to the criteria prescribed by regulations issued by the minister, satisfied that the issuing of the directive will not lead nor be likely to lead to a significant reduction of the aggregate taxable income of all parties who incur, receive or accrue interest in respect of all periods during which any amounts are outstanding in terms of debt. In determining whether a reduction of taxable income is significant, SARS will have regard to criteria prescribed by regulations issued by the minister. With the introduction of section 24O, the application of section 23K has been extended to transactions involving the direct acquisition of equity interests.

If the acquisition is financed by loans from a non-resident connected person, the deductibility of the interest will also be affected by the transfer pricing and thin capitalisation rules of section 31 of the ITA. In terms of the rules, which were amended with effect from April 2012, where a transaction, operation, scheme, agreement or understanding is entered into between or for the benefit of connected persons, one of which is a South African resident and the other a non-resident on non-arm's length terms and conditions, and it results or will result in a tax benefit for one of the parties to the transaction, SARS is empowered to determine the tax liability of the party deriving the tax benefit (defined to include the avoidance, postponement or reduction of any tax liability) as if the transaction, operation, scheme, agreement or understanding had been entered into on arm's-length terms. In other words, SARS is empowered to disregard the non-arm's length terms in determining the tax liability of the person.

Interest is generally subject to income tax in the hands of a resident recipient, but in terms of section 10(1)(h) of the ITA, interest received by a non-resident is exempt from income tax unless the non-resident at any time during the year carried on business through a PE in South Africa. A withholding tax of 15 per cent will apply with effect from 1 July 2013 in respect of interest payments to non-residents.

Dividends declared by a South African company are as a general rule exempt from income tax. However, with effect from 1 April 2012, they are subject to dividend withholding tax (DWT) at a rate of 15 per cent. As DWT is a tax on the shareholder (unlike the now repealed Secondary Tax on Companies, which was a tax on the company declaring dividends) the rate of DWT can be reduced where a non-resident shareholder is resident in a country with a DTA that provides for a reduced rate of less than 15 per cent in respect of dividends.

Taxation of proceeds on disposal of shares in target company

Shares could be held either as capital assets or as trading stock, depending on the intention of the shareholder as evidenced by the facts. Profits realised on the disposal of shares held as trading stock are subject to income tax, while the gains realised on the disposal of shares held as capital assets are subject to CGT.

In view of the uncertainty as to the intention of a shareholder, the legislature introduced a safe harbour rule under section 9C of the ITA for both listed and unlisted shares in South African resident companies in terms of which profits from the sale of shares that have been held for at least three years will be regarded as being capital in nature and thus only be subject to CGT and not income tax. This does not mean that the proceeds on the disposal of shares held for less than three years will automatically be of a revenue nature – depending on the circumstances, such proceeds may still be regarded as capital in nature.

CGT is imposed on South African resident companies at an effective rate of 18.66 per cent, which is significantly lower than the income tax rate of 28 per cent.

A non-resident will be subject to income tax at a rate of 28 per cent in respect of the profits realised from the disposal of shares held (in a South African company) as trading stock, unless DTA protection applies. A non-resident will be subject to CGT at a rate of 18.66 per cent in respect of profits realised from the sale of shares held as capital assets if the non-resident held at least 20 per cent of shares in a company that held immoveable property, comprising at least 80 per cent of the value of the shares held in the company or if the shares were attributable to a PE of that non-resident in South Africa.

To reduce the risk that a local fund manager may create a PE for non-resident investors of a private equity fund conducted via a limited partnership or trust, the definition of a PE in the ITA (as defined in article 5 of the OECD Model DTA) is restricted by disregarding the activities of the partnership or trust in South Africa in respect of financial instruments in considering whether the foreign investors had a PE in South Africa.

Executive compensation

The tax consequences of executive compensation schemes involving equity instruments are governed by section 8C of the ITA. The application of section 8C may have the effect that management will be required to pay income tax (at the maximum rate of 40 per cent) either when an equity instrument is received by virtue of employment or when any gains are made as a result of the vesting of restricted equity instruments that are acquired by virtue of their employment. Vesting occurs when a restricted equity instrument becomes freely disposable. Equity instruments include options, shares, any financial instrument convertible to a share, or contractual rights or obligations the value of which is determined directly or indirectly with reference to a share. Section 8C may impact on management equity ownership schemes where the management is locked in, even if the management vehicle has participated on a fully funded basis (if, that is, they have paid market value for their shares). When structuring contractual relationships with any equity investments by management, expert tax advice should be obtained in this regard.

Carried interest

Carried interest is typically derived in the form of a disproportionate share of the gains from the disposal of investments by the private equity fund. As indicated above, the ITA contains certain 'safe harbour' rules in respect of the sale of shares in South African resident companies. The effect of these safe harbour rules is that the gain derived from the sale of any shares issued by certain South African resident companies after being held for at least three years will be treated a receipt of a capital nature. This treatment is subject to certain anti-avoidance rules contained in the tax legislation. Therefore, it is important to consider the application of the anti-avoidance provisions before placing reliance on these safe harbour rules.

Venture capital company incentive

In order to encourage equity finance investment by small and medium-sized businesses, a new incentive was introduced in section 12J of the ITA in 2009. In terms of section 12J, taxpayers may deduct expenditure actually incurred in acquiring equity shares issued by a venture capital company (VCC), subject to the conditions and limitations set out in section 12J. Non-company structures do not qualify as VCCs.

To qualify as a VCC, and thus allow investors to claim the deduction, the company in question has to comply with certain requirements. For example, the company must be a resident, its sole object must be the management of investments in qualifying companies, its tax affairs must be in order, it must have complied with all relevant provisions of the laws administered by SARS, and it must be licensed in terms of section 7 of the Financial Advisory and Intermediary Services Act of 2002. The section also sets out criteria regarding the target companies in which the VCC may invest (qualifying companies). In terms of the section, a VCC may invest only in companies that do not carry on impermissible trades as defined in section 12J.

In addition, the VCC must invest at least 80 per cent of the funds in qualifying shares in companies that hold assets with a book value of not more than 20 million rand – or, if such company is a junior mining company, not exceeding 300 million rand – and must not invest more than 20 per cent of invested funds in any one qualifying company.

Approval as a VCC may be withdrawn should the VCC fail to comply with the requirements of section 12J(5) of the ITA, in which event an amount equal to 125 per cent of the expenditure incurred by the investor will be included in the income of the VCC.

Headquarter companies

In recognition of South Africa's economic position in Africa, the legislature amended the ITA to establish South Africa as a holding company gateway into Africa. The objective that is sought to be achieved by the legislation is the removal of what are considered to be significant barriers to South Africa's role as an ideal holding company jurisdiction. In order to remove the identified barriers, the legislature introduced a regional holding company regime (the concept of a headquarter company into the ITA) that will entitle qualifying holding companies to tax relief in South Africa.

In order for a company to qualify for the proposed tax relief, it must satisfy the requirements of the definition of a headquarter company. These are:

- it must be a South African resident company;
- for the duration of the current tax year and all previous tax years, each shareholder (whether alone or together with any other company that forms part of the same group of companies as the shareholder) must have held at least 10 per cent of the equity shares and voting rights in the company;
- at the end of the current tax year and all previous tax years of the company, at least 80 per cent of the cost of its total assets must be attributable to any interest in equity shares in; any debt owed by; any intellectual property that is licensed to any foreign company in which the company (whether alone or together with any other company forming part of the same group of companies as the company) held at least 10 per cent of the equity shares and voting rights; and
- where the gross income of the company for the current tax year exceeds 5 million rand, at least 50 per cent of that gross income must consist of any rental, dividend, interest, royalty or service fee paid or payable by the foreign company referred to above or any proceeds from the disposal of any interest in equity shares in or any intellectual property licensed to the foreign company.

9 Principal accounting considerations

What are some of the principal accounting considerations for private equity transactions?

Accounting considerations generally mirror those of other classes of transactions. In particular, the treatment of goodwill is considered important as it is not allowed as a tax deduction. The intangible assets of the target are accordingly carefully scrutinised.

With effect from reporting periods subsequent to 30 June 2005, SAVCA has formally adopted the International Private Equity and Venture Capital Valuation Guidelines published by the Association Française des Investisseurs en Capital, the British Venture Capital Association and the European Private Equity and Venture Capital Association.

10 Debt financing structures

What types of debt are used to finance going-private or private equity transactions? What issues are raised by existing indebtedness at a potential target of a private equity transaction? Are there any financial assistance, margin loan or other restrictions in your jurisdiction on the use of debt financing or granting of security interests?

The distinction between private equity funds that are captive funds and those that are independent funds is relevant when considering the financing arrangements of private equity transactions. Captive funds arrange finance for private equity transactions through their internal sources of funds and various internal treasury arrangements. No specific financing methods are used by independent funds: the financing structures range from straightforward combinations of equity and debt financing to complex financing structures involving tiered multilateral arrangements. Financing of private equity transactions through borrowed funding generally attracts interest rates commensurate with the perceived risks and, due to their unique risk profile, borrowings for BEE transactions tend to attract particularly high interest rates. Preference share structures are sometimes used to reduce the cost of funding since a lower coupon rate can generally be negotiated due to the dividends received by the funder being tax-free.

Following the scrapping of the capital maintenance rule in favour of solvency and liquidity tests, the provision of funding by the target company itself is now generally possible in terms of the New Companies Act.

Foreign involvement in private equity transactions is subject to exchange control approval. More specifically, cross-border debt will require exchange control approval with respect to repayment terms, interest rates, security and the like. Interest on foreign debt at a rate higher than the base rate applicable to the currency of the debt will only be permitted in exceptional circumstances. Margin loans generally do not play a prominent role in the South African private equity market, although they can play a role in enabling a private equity fund to build a stake in the target prior to making a formal offer.

With regard to security interests, the Takeover Regime and the Listings Requirements may impose disclosure and administrative requirements, as set out more fully in questions 2, 4 and 7.

11 Debt and equity financing provisions

What provisions relating to debt and equity financing are typically found in a going-private transaction? What other documents set out the expected financing?

Going-private transactions usually involve a combination of debt and equity financing. The traditional role of banks as providers of funding has to a certain extent been eroded by the availability of funding through institutional investors. In addition, banks have historically been averse to taking an equity stake in the transactions that they finance. The major local banks have separate private equity arms that are often prepared to depart from the traditional banking stance. The basic funding structure is usually set out in the acquisition agreement, with more detailed provisions in the shareholders' agreement, loan agreements and associated security agreements. In more complex structures, funding guarantees, inter-creditor agreements and derivatives may play an important role. Preference share structures are also often encountered, with the bank or an associate of the bank subscribing for preference shares instead of providing conventional loan funding. Where the funder is in a particularly strong bargaining position, the preference shares can be made convertible into ordinary shares upon a failure by the borrower company to redeem the preference shares. Where the total number of issued ordinary shares is only a fraction of the number of preference shares, the resultant dilution of the existing holders of ordinary shares effectively allows the funder to take control of the borrower company. These structures may in certain cases provide tax advantages. Parastatal funding agencies play a significant role in financing certain classes of private equity transactions, with such funding being linked, as a rule, more to the potential socio-economic benefit of the investments than to commercial returns, which in turn often leads the parastatal to demand participation in the running of the borrower company so as to ensure that the contemplated socio-economic gains are achieved.

12 Fraudulent conveyance and other bankruptcy issues

Do private equity transactions involving leverage raise 'fraudulent conveyance' or other bankruptcy issues? How are these issues typically handled in a going-private transaction?

Although this has never been a contentious issue for the purposes of the South African private equity market, the provisions of the Insolvency Act, 1936 (the Insolvency Act), which allow certain dispositions to be set aside on liquidation of a company (among other matters), apply with equal force to private equity transactions. These include dispositions not for value, voidable preferences, undue preferences and collusive dealings.

A disposition not for value may be declared void if made within the two years prior to the date of liquidation of the debtor company and if the beneficiary of the disposition is unable to prove that, immediately after the disposition, the assets of the company in liquidation exceeded its liabilities. In the case of a disposition not for value made more than two years before liquidation the onus is reversed, and will be voidable only if the liquidator can prove that the liabilities of the company in liquidation exceeded its assets immediately after the disposition.

A voidable preference includes a disposition by a company in liquidation made within the six months prior to the date of liquidation that has the effect of preferring one creditor over another if, immediately after the disposition, the liabilities of the company exceeded its assets – unless the disposition was made in the ordinary course of business and was not intended to prefer one creditor over another.

An undue preference is a disposition by a company intended to prefer one creditor over another at a time when the liabilities of the company exceed its assets.

Collusive dealings relate to transactions between a company and a third party that prejudice the creditors of the company or prefer some of them over others, in the knowledge that the company is insolvent and with the expectation that the creditors of the company will be prejudiced or that some creditors will be preferred over others.

In addition, section 34 of the Insolvency Act provides that if a trader (a term that is very widely defined) sells or disposes of its business or assets and does not publish a notice of such sale or disposal, first in the South African Government Gazette and secondly in two editions of an Afrikaans newspaper and two editions of an English newspaper circulating in the district where the sale took place, by not later than 30 days and not earlier than 60 days prior to the effective date of the transfer, the transfer will be 'void' as against creditors for a period of six months afterwards. In practical terms, this means that if the sale is not advertised as required, and the seller has unpaid debts, the seller's creditors can, for a period of six months after transfer, attach the sold assets/business in the hands of the buyer. In addition, if the seller is liquidated within six months of the transfer, the liquidator has an election to declare the sale void and claim back the assets or business from the purchaser, leaving the purchaser with an unsecured, concurrent claim for repayment of the purchase price. Thus, if the decision is made not to advertise the sale as required, a purchaser should obtain extensive indemnities from the seller, coupled with a deferment of payment of the purchase price or retention of at least a portion of the purchase price in escrow, ideally until expiry of the six-month period.

In addition to the Insolvency Act, the New Companies Act introduced a new form of bankruptcy regulation into South African insolvency law: business rescue. The New Companies Act permits the business rescue practitioner to suspend contractual obligations or entire contracts (although court permission is required to cancel such contractual obligations or entire contracts) simply because they are commercially onerous and there is no need to establish that the obligations or contracts are fraudulent or impeachable.

Fraudulent conveyance issues are often not dealt with separately in the transaction agreements. In practice, they are usually dealt with in the course of the negotiation of warranties that would cover the prospect of the transaction being set aside (including solvency warranties, warranties in respect of the right to transfer title and warranties in respect of the rights of third parties) and the associated indemnities. As is the case in most other jurisdictions, South African private equity funds, particularly independent funds, are generally loath to give warranties. However, if a due diligence investigation reveals specific areas of concern in this regard, tailor-made warranty and indemnity clauses will usually be negotiated. In addition, where real areas of risk have been identified, it is likely that certain retentions in respect of the purchase price will be provided for.

13 Shareholders' agreements and shareholder rights

What are the key provisions in shareholders' agreements entered into in connection with minority investments or investments made by two or more private equity firms? Are there any statutory or other legal protections for minority shareholders?

Shareholders' agreements in the context of private equity transactions often have complex arrangements relating to the control of the target company, especially in BEE transactions where the target company may have a well-entrenched control structure. BEE legislation, however, requires a transfer of management powers and commercial benefit in addition to bare ownership and, in practice, sophisticated control structures are put in place. Measures that dilute the management and control powers of the BEE partner will usually impact negatively on the BEE rating of the target.

Shareholders' agreements almost invariably contain a full suite of minority protections. This involves a combination of drag-and-tag clauses, pre-emption rights, transfer restrictions, reserved matters and warranties.

Dispute resolution sometimes raises difficult questions and mechanisms for the resolution of deadlocks are subject to fierce negotiation. Although arbitration is commonly used to resolve the deadlock, the application of arbitration in the context of commercial decisions that require buy-in of the parties to the dispute has been the subject of criticism, leading to the inclusion of deadlock-breaking provisions involving binding decisions by independent experts knowledgeable in the field relevant to the dispute, as well as more robust remedies such as Russian roulette and Texas shoot-out provisions.

Shareholders' agreements usually provide for referral of corporate opportunities to the company and often contain comprehensive non-compete clauses. Restrictions are frequently placed on the transfer of shares to a competitor of any of the shareholders.

The New Companies Act introduced new rights and remedies for shareholders and other stakeholders where a company contravenes the New Companies Act or acts beyond its powers: The New Companies Act provides that one or more shareholders, directors or prescribed officers of a company, or a trade union representing employees of the company, may apply for a court order restraining the company from doing anything inconsistent with the New Companies Act. The New Companies Act further provides that one or more shareholders, directors or prescribed officers of a company may apply for a court order to restrain the company or the directors from doing anything inconsistent with any limitation, restriction or qualification of the company's purposes, powers or activities contained in its memorandum of incorporation.

Certain actions require a special resolution of the shareholders. These include, for example, share issues to directors or related persons, amending the memorandum of incorporation and the acquisition of its own shares by the company under certain circumstances. A special resolution usually requires at least 75 per cent shareholder approval, and an ordinary majority requires 50 per cent plus one. However, the New Companies Act provides that the memorandum of incorporation may provide for different thresholds, as long as the ordinary majority remains at least at the 50 per cent plus one level, and provided that a special majority should be at least 10 per cent more than the ordinary majority agreed upon. Under the New Companies Act, a special majority may thus be as low as 60 per cent.

14 Acquisitions of controlling stakes

Are there any requirements that may impact the ability of a private equity firm to acquire control of a public or private company?

The Takeover Regime now requires that an acquisition by a person of 35 per cent or more of a regulated company's voting securities will trigger an obligation of the acquirer to make an offer to acquire all the regulated company's remaining voting securities. The Takeover Regime has however abolished the 'creep provisions' that previously triggered a further mandatory offer should subsequent securities acquisitions cross the 40 per cent, 45 per cent, 49.9 per cent or 50 per cent voting securities thresholds. An offeror may obtain an exemption from the obligation to make a mandatory offer by virtue of a 'whitewash resolution' passed by independent securities holders of more than 50 per cent of the general voting rights where an affected transaction includes an issue of securities by the target company. A whitewash resolution is also required in the following instances:

- if an offeror wishes to make a partial offer;
- if a conditional offer is amended; and
- if an offeror wishes to give certain directors and management of the target company the right to re-invest the consideration offered to them.

Squeeze-outs of minority shareholder interests are allowed in circumstances where, within four months after the date of an offer for the acquisition of any class of securities of a regulated company, such offer has been accepted by the holders of at least 90 per cent of that class of securities (other than certain related or connected persons). The offeror is then entitled to buy the remaining interest of that class of securities. Should the remaining interest holders wish to object to such forced sale, they may, within 30 days, apply for a court order declaring that the offeror is not entitled to acquire the applicant's securities, or a court order imposing certain conditions of acquisition that differ from the original offer.

Conversely, should the remaining minority wish to sell its interest, the Takeover Regime provides a compulsory acquisition mechanism whereby, once the holders of at least 90 per cent of the relevant class of securities have agreed to sell their shares, the remaining interest holders have three months within which to demand sale of their interests to the offeror.

If the acquisition is financed by loans from a non-resident connected person, the deductibility of the interest will be restricted under the transfer pricing and thin capitalisation rules of section 31 of the ITA. The transfer pricing and thin capitalisation rules are in the process of amendment. However, in terms of the current rules, SARS applies a safe harbour ratio of shareholders' debt to equity of 3:1.

The New Companies Act also prescribes that, before getting shareholder approval for the transaction, the directors must reasonably believe that certain solvency and liquidity requirements will be met when implementing the proposed transaction.

A dissenting shareholder may apply to the court to review the transaction (see question 13).

Legal advice should be sought to determine the extent of the application of the requirements in the Takeover Regime, Listing Requirements and any deal specific legislation, if applicable.

15 Exit strategies

What are the key limitations on the ability of a private equity firm to sell its stake in a portfolio company or conduct an IPO of a portfolio company? In connection with a sale of a portfolio company, how do private equity firms typically address any post-closing recourse for the benefit of a buyer? Does the answer change if a private equity firm sells a portfolio company to another private equity firm?

Exit strategies commonly encountered in South Africa are similar to those encountered in other jurisdictions and include trade sales, listings on the JSE, management buyouts (currently less popular due to the difficulty of obtaining financing), recapitalisations and sales to other private equity funds or to financial institutions. As in many other jurisdictions, the popularity of listing as an exit strategy has fluctuated in South Africa in recent times but continues to be a viable option, although listing on a foreign stock exchange is complicated by exchange control regulations.

Restrictions on the sale of shares, such as tag-along rights or pre-emptive rights, may limit a private equity firm's ability to sell such shares, although such restrictions are temporary in nature.

Key concerns when considering an IPO are mostly business related, such as whether the market has sufficient liquidity or the availability of underwriters, rather than legal restrictions to listing.

Where approval for an issue and listing of securities is required from the Exchange Control Department of the SARB, JSE approval of an issue and listing of such securities will not be given until such time as copies of the requisite authority from SARB, giving a ruling regarding the use of funds introduced through normal banking channels from abroad or from a non-resident account or from an emigrant's blocked Rand account relating to such issue, is received.

Accordingly, foreign funders of private equity funds in South Africa should bear in mind that the repatriation of both capital and profit will require exchange control approval. This is generally dealt with in advance in the context of initial investment arrangements.

Outward investment by South African private equity funds are also subject to exchange control approval. South African institutional investors as a result of recent relaxations to the exchange control regulations are entitled to a foreign investment allowance with certain additional concessions being given in respect of outward investment into Africa. South African individuals with the appropriate tax clearance are permitted to make outward investments subject to certain thresholds.

While non-residents are not subject to exchange controls, South African subsidiaries and branches of foreign companies are treated as South African residents for exchange control purposes. Exchange control regulations generally apply equally to branches and subsidiaries. Private equity entities must be aware that certain forms of investment by non-residents are controlled by virtue of restrictions imposed on residents and resident entities, for example, the introduction of foreign loans into South Africa requires SARB approval.

A company seeking to list must have reached certain minimum value thresholds. For example, an applicant seeking a listing on the Main Board of the JSE must satisfy the following criteria:

- it must have a subscribed capital, including reserves but excluding minority interests and revaluations of assets and intangible assets that are not supported by a valuation by an independent professional expert acceptable to the JSE and prepared within the last six months, of at least 25 million rand;
- it must have not less than 25 million equity shares in issue;
- it must have a satisfactory audited profit history for the preceding three financial years, the last of which reported an audited profit of at least 8 million rand before taxation and after taking account of the headline earnings adjustment on a pre-tax basis; and
- it must be carrying on as its main activity, either by itself or through one or more of its subsidiaries, an independent business that is supported by its historic revenue earning history and that gives it control (which for the purposes of this section is defined as at least 50 per cent +1 of the voting shares) over the majority of its assets and must have done so for a certain prescribed period (unless it is a company whose main activity is to own securities in other companies).

Listing on alternative boards, such as AltX, a parallel market for small and medium sized high growth companies, should be a viable alternative if the requirements for listing on the Main Board are too stringent. BEE share schemes may also be separately listed.

The Listing Requirements impose further conditions, such as additional corporate governance measures, on companies wishing to go public.

The breach of certain warranties and indemnities made by the seller (which varies significantly on a deal by deal basis but typically includes limitations on payments to third parties or debt incurred and an undertaking that the accounts are accurate and in good order) will, in the case of material breach, allow the buyer to rescind the agreement by notice within a certain time period.

16 Portfolio company IPOs

What governance rights and other rights and restrictions typically included in a shareholders' agreement are permitted to survive an IPO? Are registration rights required for post-IPO sales of stock? What types of lock-up restrictions typically apply in connection with an IPO?

As the circumstances of deals vary greatly, it is difficult to observe trends in this regard. Provided that it does not contravene the applicable law, which includes the Listing Requirements and King III, both of which only become binding on a company upon listing, a variety of rights could be negotiated

An IPO will in all cases involve the allotment and issue of shares on the JSE. This can be done through a prospectus as an offering document, which is required to adhere to all the formalities of the New Companies Act, or alternatively through a pre-listing statement, which has less compliance requirements, but provides the investor with slightly less protection. The JSE does not distinguish between registered and unregistered offerings to the public.

A lock-up period of 180 days usually applies to IPOs.

17 Target companies and industries

What types of companies or industries have typically been the targets of going-private transactions? Has there been any change in focus in recent years? Do industry-specific regulatory schemes limit the potential targets of private equity firms?

Despite a marginal increase in early-stage investments in 2006, the South African private equity market leans towards later-stage investments, and investments in seed, start-up and early-stage entities remain at low levels. This has been a consistent trend across all sectors with private equity firms showing a tendency to replace or expand existing capital reserves. In 2010 and 2011, the majority of private equity activity took place in the mining and natural resources sectors with greater interest being shown in the infrastructure, information technology, services and manufacturing sectors.

During 2012, there was increased interest and investment in the infrastructure, information technology, mining and resources (especially in clean energy and other sources of power), agriculture and health sectors. In respect of the health, energy and infrastructure sectors, investors have shown increased interest, due to the viability of these sectors, and also because the South African government has announced it intends to roll out financial support in respect of these sectors. We anticipate the continuation of the same trend of investments in these sectors during 2013. To the extent that BEE transactions are private equity transactions, BEE transactions have been prevalent over all economic sectors in recent years due to the fact that BEE is a legislative imperative that applies to all the sectors of the South African economy.

The trend in South Africa for private equity investment has not been towards any specific sector, the focus being on the assets and cash flows of the target. A recent development is the establishment of private equity funds focused on business rescue transactions. Business rescue mechanisms featured in relation to private equity transactions in South Africa during 2010, and to a lesser extent during 2011 and 2012, as the New Companies Act makes specific provision for restructuring of companies that are insolvent or may imminently become insolvent. However, business rescue funds can be expected to be more sensitive than other funds due to the lack of credit in the markets.

Although industry-specific regulatory schemes do not limit acquisitions by private equity firms, private equity acquisitions are subject to the general restrictions and requirements imposed by such industry-specific regulatory schemes. A few examples of these are set out below.

The Banks Act, 1990 provides that the acquisition of shares in a bank or the controlling company of a bank, if resulting in the acquirer holding more than 15 per cent of the issued shares in the bank or controlling company, is subject to the consent of the registrar of banks. A similar restriction applies in respect of the acquisition of more than 24 per cent of the issued shares in a bank or controlling company of a bank. An acquisition resulting in the acquirer holding more than 49 per cent and 74 per cent, respectively, requires the approval of the minister of finance.

The Short-Term Insurance Act, 1998 and the Long-Term Insurance Act, 1998 prohibit the acquisition of shares or any other interest in an insurance company that will result in the acquirer (whether alone or with a related party) controlling the insurance company except with the approval of the relevant registrar (being either the registrar of short-term insurance or the registrar of long-term insurance).

For these purposes, a person is deemed to 'control' a company if he or she: holds 25 per cent or more of the issued shares of the company; holds shares that entitle him or her to exercise 25 per cent

Update and trends

Retirement funds, both local and foreign, are major investors in private equity funds both in South Africa and in foreign jurisdictions. Most, but not all, retirement funds domiciled in South Africa are subject to regulation in terms of the Pension Funds Act, 1956 (the PFA). For example the Government Employees Pension Fund (the biggest fund by both asset value and membership) is subject to regulation in terms of the Government Employees Pension Law, 1996.

The investments of retirement funds that are subject to regulation in terms of the PFA are subject to limitations in terms of PFA regulation 28 which was withdrawn and replaced with effect from 31 December 2011. The new regulation 28 defines the term 'private equity fund' as:

a managed pool of capital that:
- *has as its main business the making of equity, equity orientated or equity related investments in unlisted companies to earn income and capital gains;*
- *is not offered to the public as contemplated in the Companies Act, 2008 (Act No. 71 of 2008);*
- *is managed by a person licensed as a discretionary financial services provider as defined in the Code of Conduct for Administrative and Discretionary Financial Services Providers, 2003, or if a foreign private equity fund, managed by a person licensed as a Category 1 Financial services Provider that is authorised to render financial services [in] securities and instruments as defined in the Determination of Fit and Proper Requirements for Financial Services Providers, 2008; and*
- *is subject to conditions as may be prescribed.*

Invitations to invest in a private equity fund will not be 'offered to the public' if the invitations are issued to only 'financial institutions' as defined in the Financial Services Board Act, 1990, such as retirement funds.

In the new regulation 28, the minister of finance has increased from 2.5 per cent to 10 per cent the maximum percentage of a retirement fund's assets by value that may be invested in private equity funds. However:
- no more than 2.5 per cent may be invested in a single private equity fund;
- no more than 5 per cent may be invested in a fund of private equity funds;
- the amounts of a retirement fund's investments in private equity funds (including funds of private equity funds) and hedge funds (including funds of hedge funds) together may not exceed 15 per cent of the value of the retirement fund's assets;
- a retirement fund may not commit capital to a private equity fund which is not constituted in a manner that will shield the retirement fund from losses in an amount greater than the amount of its capital commitment;
- while the 'look through' principle must be applied when assessing a retirement fund's compliance with the asset allocation limitations in regulation 28, the retirement fund's 'exposure' to a private equity fund must be disclosed as an investment in the private equity fund and not in the assets in which the private equity fund has invested;
- a retirement fund's investment in a foreign private equity fund must be disclosed as an investment in a foreign asset for the purpose of measuring compliance with the regulation 28 limit on foreign investments; and
- to fall within the scope of the definition of 'private equity fund', the private equity fund must comply with conditions determined by the registrar of pension funds.

On 15 March 2012, the registrar of pension funds published the Conditions for Investments in Private Equity Funds referred to in the definition of 'private equity fund' in regulation 28. In essence, they say that a retirement fund may only invest or remain invested in a private equity fund which:
- is a member of a private equity fund industry body recognised by the registrar (although it is usually the managers of those funds, rather than the private equity funds themselves, that are members of such an organisation);
- is structured as:
  - an *en commandite* partnership in which retirement funds are only en commandite (limited) partners and so cannot be held liable to creditors of the partnership for more than its capital contribution to the partnership;
  - a *bewind* trust in relation to which retirement fund investors are co-owners in undivided shares of the trust assets and are only beneficiaries, not trustees;
  - a company the assets and liabilities of which are limited to the assets and liabilities arising from its private equity investments; or
  - a foreign private equity fund that takes the form of a limited partnership, an open-ended investment company or a company the assets and liabilities of which are limited to the assets and liabilities arising from its private equity investments;
- if domiciled in South Africa, is managed or advised only by a discretionary financial services provider (that is, a financial services provider that exercises discretion in regard to the choice of 'financial products' in which its client might invest) with a 'Category II' licence as contemplated in the Financial Advisory and Intermediary Services Act, 2002 (FAIS) Codes of Conduct and, if domiciled elsewhere, is managed by a financial services provider with a Category I FAIS license;
- has assets that are verified at intervals not exceeding six months by means of 'scrip counts' by auditors;
- has 'clear policies and procedures for determining the fair value of its assets, which ensures that those determinations are performed in a manner consistent with the Private Equity Valuation Guidelines and are verified at intervals of not more than 12 months by independent third parties;
- submits to the retirement fund, at intervals not exceeding three months, reports on the private equity fund's performance, activities, the value of its investments and any other information required to enable the pension fund to fulfil its reporting requirements; and
- has annual financial statements that are audited and made available to the pension fund within 120 days after the end of the private equity fund's financial year end.

The Conditions also say that the board of a retirement fund must take the following into account before making a decision to invest in a private equity fund:
- the private equity fund's investment strategy and objectives, investment and borrowing powers, restrictions and associated risks (including types and sources of leverage);
- the procedures by which the investment strategy and policy might be changed;
- details about the valuator, auditor, administrator of the private equity fund and any other service providers, requiring a description of the duties of the service providers and investor's rights should a failure arise;
- liquidity risk management of the private equity fund as well as the pension fund as an investor, including redemption rights both in normal and exceptional circumstances, and how fair treatment is guaranteed across investors;
- the ownership of the assets;
- the level of management fees, performance fees and any initial charges or early redemption fees;
- the manager's risk and compliance management standards, including the necessary independence of these functions from portfolio management; and
- the liquidity profile of the private equity fund relative to the liquidity requirements and liability profile of the pension fund.

Finally, the Conditions confirm that 'the responsible person, manager, administrator or adviser of the private equity fund must disclose to the retirement fund:

any possible conflict of interest that may arise or any direct or indirect benefit it may obtain or may have obtained as a consequence of any transaction concluded by the private equity fund or the acquisition or disposal of assets in the execution of the business of the private equity fund.

Recognising that it would be inappropriate to require retirement funds to disinvest in haste from private equity funds that did not comply with the Conditions, in September 2012 the registrar granted an extension of the period, up to 31 December 2012, during which private equity funds had to comply with the Conditions or face disinvestment by retirement funds.

The notice in which the Conditions appear states that private equity funds that comply with the Conditions are now formally

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'approved' custodians of retirement fund assets as contemplated in section 5(2)(e) of the PFA. For these private equity funds, this eliminates a thorny issue that was the subject of difficult legal debates between SAVCA and the registrar of pension funds during 2010-11.

In 2012, National Treasury published for comment the draft Financial Services Laws General Amendment Bill 2012. The draft Bill proposes the amendment of various pieces of legislation including the Pension Funds Act, 1956 (the PFA).

The proposed amendments of the PFA will affect a retirement funds' ability to invest in private equity funds and, conversely, the ability of private equity funds to attract significant investments from pension funds. In particular, it is proposed that a new subsection (5D) be inserted in section 19 of the PFA stating the following:

(a) Subject to this subsection, a fund shall not, without the prior approval of the registrar, directly or indirectly acquire or hold:
(i) an ownership interest exceeding 49 per cent in another entity; or
(ii) shares or any other financial interest in another entity which results in the fund exercising control over that entity.

(b) The approval referred to in paragraph (a) may be given subject to such conditions as the registrar may determine.

(c) For the purposes of paragraph (a)(ii), a fund shall be deemed to exercise control over another entity if the fund:
(i) is directly or indirectly able to exercise or control the exercise of more than 35 per cent of the voting rights associated with the shares of that entity, whether pursuant to a shareholder agreement or otherwise; or
(ii) has the right to appoint or elect, or control the appointment or election of, directors of that entity who control more than 35 per cent of the votes at a meeting of the board of that entity.

If the bill is passed by parliament in its current form, the following would be of particular concern to retirement funds:
- the definition and low thresholds for the deeming provisions in 5D(c) (ie, the exercise of control) coming into operation;
- whether a private equity fund in the form of a partnership or trust will be deemed to be an 'entity' as contemplated in the section ('entity' is not defined);
- how the retirement fund's indirect rights are to be determined in an underlying portfolio company; and
- whether this amendment will apply to existing investments in private equity funds or only to new investments.

If these proposed amendments are enacted and made applicable to existing investments, private equity funds will need to consider whether
- they should assist their retirement fund investors to either apply for exemption from compliance with section 19(5D) or the approval by the registrar of their investments in the private equity funds if those investments will exceed the thresholds provided for in the section; and
- if any of their retirement fund investors are unable to obtain those exemptions or approvals, the private equity funds' founding documents should be amended to minimise the prejudice to those retirement funds that otherwise would be entailed in their premature disinvestment from the private equity funds.

or more of the voting rights in the company; or can determine the appointment of 25 per cent or more of the directors of the company. The two insurance acts provide specifically that the acquisition of shares in an insurance company is subject to the approval of the relevant registrar if it results in the acquirer (whether alone or together with a related party) holding 25 per cent or more of the issued shares of the relevant company.

Acquisition of control of entities that administer the assets of pension funds is also subject to regulatory approval. Due to recent relaxation, a pension fund may now invest up to 10 per cent of the aggregate fair value of its assets into a private equity fund (as defined). The maximum allowance per individual private equity fund is 2.5 per cent of the aggregate fair value of the assets of the pension fund and 5 per cent of the aggregate fair value of the assets of the pension fund per fund of private equity funds. South African pension funds are now required by law to take environmental, social and governance criteria into consideration in determining their investment policy and strategies.

18 Cross-border transactions

What are the issues unique to structuring and financing a cross-border going-private or private equity transaction?

Foreign investment in and disinvestment from South Africa is subject to strict exchange control regulations, particularly those transactions entailing outflows of capital. The Exchange Control Regulations 1961 (the Regulations) govern the movement of capital, be it direct or indirect, across the borders of South Africa. The Regulations require that such movements of capital be approved by the SARB subject to certain concessions in respect of member countries of the Southern African Development Community. The SARB has granted the authority to certain authorised dealers to authorise transactions in certain specified circumstances that would otherwise have required SARB approval.

Foreign funders of private equity funds in South Africa should bear in mind that the repatriation of both capital and profit will require exchange control approval. This is generally dealt with in advance in the context of the initial investment arrangements. Outward investment by South African private equity funds is also subject to exchange control approval.

The exchange control position with regard to the international headquarter company regime has been clarified by the SARB

during 2011: the need for SARB approval on a deal by deal basis from transactions outside the common monetary area of South Africa, Namibia, Lesotho and Swaziland has been eradicated with respect to qualifying headquarter companies and these qualifying fund now only have to acquire upfront approval for foreign investment and thereafter adhere to their reporting obligations as required by the SARB. Further relaxations are expected in the future.

South African institutional investors, such as managers of collective investment schemes, are entitled to a foreign investment allowance (with certain additional concessions in respect of outward investment into Africa). South African individuals with the appropriate tax clearance are permitted to make outward investments subject to certain thresholds.

Cross-border transactions in South Africa normally include complex hedging arrangements to minimise currency risk. Managing exchange rate risks is important for non-resident private equity entities in the current volatile global environment.

19 Club and group deals

What are the special considerations when more than one private equity firm (or one or more private equity firms and a strategic partner) is participating in a club or group deal?

Club or group deals are relatively rare in South Africa (despite the presence of certain private equity firms that focus on putting together such deals). Club or group deals are usually structured as limited liability partnerships and sometimes involve tiers of limited liability partnerships or other funding structures – as is often the case in deals having an offshore funding component. Care must be taken in structuring complex funding structures to ensure that the regulatory frameworks relating to financial services, collective investment schemes and banks are not inadvertently brought into operation. The equity, debt and insurance wrappers used by the hedge fund industry can be regarded as a form of group deal, although in practice there is often no wish on the part of individual investors to regard themselves as part of a group of investors.

Club or group deals in South Africa often involve a lead investor who takes investment decisions or an independent investment manager or both. The presence of an independent investment manager (who would usually be a regulated entity) is often favoured by offshore funders as it gives them an added layer of protection in an unfamiliar jurisdiction.

The formulation of a comprehensive investment mandate has proven important in club or group deals.

20 Issues related to certainty of closing

What are the key issues that arise between a seller and a private equity buyer related to certainty of closing? How are these issues typically resolved?

On the one hand, the seller insists on certainty that a buyer cannot terminate the transaction agreement in the absence of a material adverse change in the seller's business and, in this regard, requires effective remedies against a buyer for wrongful termination. Specifically, the seller will seek to maintain its right to seek specific performance of the transaction, that is, the right to require the buyer to close the transaction.

On the other hand, the private equity buyer would insist on certainty in regard to both the circumstances in which it can terminate the transaction agreement if the assumptions on which it agreed to buy the seller's business have materially changed and the maximum amount of potential recourse that a seller has against it if it terminates. In this regard, the buyer typically insists on the right to terminate the transaction for any reason upon payment of an agreed termination fee. This limits the buyer's exposure and the sellers' remedies in the event that the buyer does not close the transaction for any reason, including failure to obtain financing.

In small private equity transactions where regulatory and other approvals or consents are not required, both parties normally insist on signing and closing to occur simultaneously in order to ensure certainty of closing.

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