Introduction to Private Equity

Straight advice from an independent perspective.

February 2013
We will be looking at...

1. What is Private Equity?
2. Private Equity Strategies
3. Risk and Return
4. Why Do Pension Funds Invest in PE?
### What is Private Equity? A comparison

<table>
<thead>
<tr>
<th>PRIVATE EQUITY</th>
<th>LISTED EQUITY</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Low liquidity</td>
<td>• Strong liquidity</td>
</tr>
<tr>
<td>• Long investment horizon</td>
<td>• Short or long term</td>
</tr>
<tr>
<td>• High active involvement</td>
<td>• Little active involvement</td>
</tr>
<tr>
<td>• Low market efficiency</td>
<td>• Higher market efficiency</td>
</tr>
<tr>
<td>• No published information</td>
<td>• Published information</td>
</tr>
<tr>
<td>• Low regulatory oversight</td>
<td>• Highly regulated</td>
</tr>
</tbody>
</table>
Stages of Funding

Seed
- VENTURE CAPITAL
  - Seed, start-up

Early
- EXPANSION
  - Bridged financing, phased financing

Expansion
- BUYOUT
  - Buyout, MBOs

Certainty of cash flows

Private Equity

Debt

Nandos

Consol Glass

Business Maturity

Angel Investor

Venture Capital
Why Do Companies Seek PE Funding?

THE SAME REASONS LISTED COMPANIES SEEK FUNDING

- Increase Working Capital Base
- Business Expansion & Development
- Develop New Products in Order to Grow/Remain Competitive
- Buy Out Shareholders to Restructure Ownership & Management
- Finance Acquisitions of Other Businesses

Non Monetary Benefit

PE vs. Debt Financing

- Not every business suits debt funding
- Balance of debt and equity needed
- Experienced professionals
- Political / corporate Connections
- GP’s have experience in sector / stage of business
Structure and roles of LPs and GPs

Advisory Committee
- General partner
- Bank (limited partner)
- Individual (limited partner)
- Pension Fund (limited partner)
- PE FoF (limited partner)

Advisor
- PE FUND

Investment Committee
- Investment A (Company)
- Investment B (Company)
- Investment C (Company)

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Commitments vs. Drawdowns

Investment Period

Realisation Period

Cashflow

Time

Dec-08  Mar-10  Jun-11  Sep-12  Dec-13  Mar-15  Jun-16  Sep-17

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Understanding the J-curve

Cash flow J-curve

Returns J-Curve

- Return
- Fee % of Drawn capital

Drawdowns
Distributions
Cumulative cash flow

Fee % of draw downs
**Where Does a Company’s Value Come From?**

<table>
<thead>
<tr>
<th>Financial Performance</th>
<th>Company Valuation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>EBITDA</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>EBITDA Multiple</td>
</tr>
<tr>
<td>Gross profit</td>
<td>Enterprise value</td>
</tr>
<tr>
<td>Overheads</td>
<td></td>
</tr>
<tr>
<td>Operating profit (EBITDA)</td>
<td></td>
</tr>
</tbody>
</table>

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>100</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(60)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>40</td>
</tr>
<tr>
<td>Overheads</td>
<td>(25)</td>
</tr>
<tr>
<td>Operating profit (EBITDA)</td>
<td>15</td>
</tr>
<tr>
<td>EBITDA</td>
<td>15</td>
</tr>
<tr>
<td>EBITDA Multiple</td>
<td>X 6</td>
</tr>
<tr>
<td>Enterprise value</td>
<td>90</td>
</tr>
</tbody>
</table>
Where Does the Value Go?

Low debt (leverage):
- Debt: 10
- Equity: 80
- Enterprise Value: 90

Higher debt (leverage):
- Debt: 50
- Equity: 40
- Enterprise Value: 90

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<table>
<thead>
<tr>
<th></th>
<th>Return</th>
<th>Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>Return limited to interest rate</td>
<td>Low risk</td>
</tr>
<tr>
<td></td>
<td></td>
<td>All equity must be eroded before any loss for debt</td>
</tr>
<tr>
<td>Equity</td>
<td>Unlimited upside</td>
<td>More risky than debt</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Takes the first losses of value</td>
</tr>
<tr>
<td></td>
<td></td>
<td>The more debt there is, the more risky</td>
</tr>
<tr>
<td></td>
<td></td>
<td>the equity</td>
</tr>
</tbody>
</table>

- As long as returns on debt taken on exceed the interest rate on the debt, equity returns are enhanced
- But there are limits – ratio of Debt : EBITDA is common (2-3 times is normal)
**Fee Structure**

<table>
<thead>
<tr>
<th>Single Fund</th>
<th>Fund of Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>2% advisory fee</td>
<td>1% advisory fee</td>
</tr>
<tr>
<td>A participation in the gains and surpluses up to 20%</td>
<td>A participation in the gains and surpluses up to 10%</td>
</tr>
</tbody>
</table>

**Advisory fee** – an annual payment is made by the fund to the Advisor to cover the costs of the private equity firm's investment operations (the fee is typically 1% to 2.5% of the aggregate committed capital of the fund)

**Gains and surpluses** – a participation in the gains and surpluses of the fund (typically up to 20%) is paid to the General Partner or Trustee as a performance return. The remaining 80% of the gains and surpluses is paid to the investors pro rata to their capital

**Hurdle rate or preferred return** – a minimum rate of return (normally 8% to 12%) earned by investors on their committed capital must be achieved before the General Partner or Trustee can receive its participation in the gains and surpluses
SA Private Equity has largely outperformed the major listed indices. FINDI tests resources bias of JSE. SWIX tests market cap vs. tradability bias - less than 10 years old.

Source: RisCura Fundamentals SA Private Equity Performance Report
Vintage Year Performance

Older vintages have performed better
Newer vintages are largely unrealised
All vintages show positive returns

Source: RisCura Fundamentals SA Private Equity Performance Report
What Are the Risks of Private Equity?

- Lightly Regulated
- Conflicts of Interest
- Liquidity
- Valuation
- Concentration
Ways to Invest in Private Equity

INSTITUTIONAL INVESTOR

1 company

PE FUND
8-10 companies

PORTFOLIO OF FUNDS

PE FUND
80-120 companies
Building a Private Equity Portfolio

**Risk & Complexity**

- **Portfolio of Funds**
  - Diversified portfolio of interests
  - Lowest level of due diligence required
  - Additional layer of fees
- **Direct (PE Fund)**
  - Interests in funds with direct control over portfolio co.
  - Lower level of due diligence
  - Manager Selection
  - Access through relationships
- **Co-Investment**
  - Investing directly into a private company
  - Greater Skill set required
  - Knowledge of local market
  - Specific industry expertise and networks

**Exposure**
Asset Allocation Decision

IS PE THE RIGHT ASSET CLASS FOR YOU?

- Historic performance
- Risks may impact returns
- Micro/macroeconomic
- Regulation
- Diversification benefits
- Developmental impact
Why Do Pension Funds Invest in PE?

“Long-term savings vehicles, such as pension funds, are uniquely positioned to manage the long investment term and limited liquidity of private equity investment to capture what appears to be a significant performance premium and diversification benefits.”

- “Is Private Equity a suitable investment for South African Pension Funds?”
  released at the Convention of the Actuarial Society of South African in October 2006

PORTFOLIO OPTIMISATION

- Performance premium to listed equity
- Low correlation to listed equity (although becoming more correlated)
- Exposure to small and medium sized companies

DEVELOPMENTAL VEHICLE

- Facilitation ownership by company staff
- Provides finance and expertise to unlisted companies
- Improves governance
Many Other Benefits to Private Equity

**ECONOMIC BENEFITS**

- **Efficient Markets Concept**
- Bridges the Gap Between Medium-sized Companies & the Listed Market
- Alignment of Incentives & Risk: PE Fund Managers Rewarded After Investors Realise Return
- ‘Corporatise’ Management & Enhance Corporate Governance
- Benefits of Active Management Maximise Value & Correct Performance
- A Source of Growth for Listed Markets
### What is Happening in Developed Markets?

**LARGE US PENSION FUNDS’ ALLOCATIONS TO PE**

<table>
<thead>
<tr>
<th>Investor name</th>
<th>2005 Allocation</th>
<th>2009 Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>($)</td>
<td>(%) of AUM$^3$</td>
</tr>
<tr>
<td>California Public Employees’ Retirement System</td>
<td>9.8</td>
<td>5.1</td>
</tr>
<tr>
<td>California State Teachers’ Retirement System</td>
<td>6.9</td>
<td>5.4</td>
</tr>
<tr>
<td>CPP Investment Board</td>
<td>2.9</td>
<td>3.6</td>
</tr>
<tr>
<td>Michigan Department of Treasury</td>
<td>5.9</td>
<td>11.0</td>
</tr>
<tr>
<td>New York State Common Retirement Fund</td>
<td>9.4</td>
<td>6.3</td>
</tr>
<tr>
<td>Oregon State Treasury</td>
<td>5.1</td>
<td>7.6</td>
</tr>
<tr>
<td>University of Texas Investment Management Company</td>
<td>1.2</td>
<td>8.4</td>
</tr>
<tr>
<td>Washington State Investment Board</td>
<td>6.9</td>
<td>5.4</td>
</tr>
<tr>
<td>Wellcome Trust</td>
<td>2.7</td>
<td>11.5</td>
</tr>
</tbody>
</table>
How to Manage Risk as an Investor into PE

1st Asset Allocation Decision
- Should an allocation be made to PE?
- Historic performance
- Risk
- Regulation
- Diversification
- Geography
  - Local
  - Regional
  - Global

2nd Manager Selection Decision
- Has the manager run a previous successful fund?
- Manager reputation
- Manager network
- Risk management processes

3rd Fund Selection
- What is the fund going to invest in?
- Legal & tax structuring
- Fee structure – alignment of interests
- Quality of advisors
- Reporting requirements
- Mandate fit
- Who are the other investors?
- Essentially a due diligence process

4th Ongoing Monitoring
- Performance analysis
- Independent valuation
- Regular interaction with managers
Thank you
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- We work in partnership with our clients to deliver the transparency and accountability that increasingly is demanded by investors.
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- Email fundamentals@riscura.com
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