CASE STUDY

Business Unusual for South African Private Equity

Survey

The widespread disruption caused by the Coronavirus pandemic has led to ‘business unusual’ for many companies in South Africa as they respond to new challenges in an unpredictable and rapidly changing operating environment.

Private Equity Investors and portfolio companies must take this new reality into account, not only for their day-to-day operations, but in their strategic plans for the foreseeable future.

“Private Equity Investors are stress-testing and reworking various scenarios for financial models and assessing cash flows, net working capital and liquidity forecasts for all their portfolio companies.”

THE SITUATION

FTI Consulting surveyed a number of Private Equity Investors who invest in South Africa to understand how this period of ‘business unusual’ has impacted their business, their current portfolios and how they expect investing in a post COVID-19 world to be different.

Whilst the current focus of Private Equity Investors may be to proactively manage and minimise the impact of COVID-19 and the imposed lockdowns on portfolio companies, we believe, from feedback received, that they will, over the coming months not only consider a new approach to portfolio diversification, but also reconsider the way in which they evaluate new investments, including the types and level of due diligence applied, timing of exits, as well as transaction funding and structures, amongst others.

There is no doubt that the COVID-19 pandemic will prove a game changer for many South African businesses.

Support of portfolio companies and management teams

All the Private Equity Investors we surveyed are engaging with portfolio companies and management teams far more frequently than they ordinarily would, some even on a daily basis. Investors are supporting their management teams by sharing best practice across their portfolio companies, acting as a sounding board and providing leadership support and direction.

Although there is no "one size fits all" approach, Investors are actively providing input and support to their portfolio companies in three main areas:

- **People :** The safety and protection of staff and customers is considered a priority across almost all businesses. This includes offering support for employees working from home, as well as leave and other relevant Human Resources policies, protective equipment and support in applications for UIF and other grant payment provisions.
- **Financial :** Private Equity Investors are stress-testing and reworking various scenarios for financial models and assessing cash flows as well as net working capital and liquidity forecasts for all their portfolio companies. Fixed costs, such as rent, salaries and other fixed overheads are being considered for possible cost savings in the immediate to short term. Most Investors are also assisting portfolio companies by providing an interface with financial institutions, assessing debt covenant positions and in some instances, negotiating delayed interest and capital repayments. Investors are also working with banks to soften collections and negotiating grace periods and concessions.
- **Operational :** Operational issues being considered include closing of businesses due to lockdown restrictions and scenario planning for reopening once restrictions are lifted; application for permits where businesses can continue operating; access to and availability of essential equipment repairs; staff rotation schedules; and implementing work-from-home technical and practical support.

"Importantly, many Private Equity Investors are working with management teams to rethink business operating models to ensure more efficient operations and enable growth and expansion through and after a COVID-19 lockdown environment."

Many businesses and Investors are thinking about what a post-COVID-19 "fit for purpose" business will look like and what changes may need to be considered and made when required.

This includes reviewing budgets and forecasts for the short to medium term and digital transformation.

Acquisitions and bolt-ons

70%

Around 70% of Private Equity Investors surveyed had active acquisition transactions in progress in advanced stages when the first Coronavirus cases were detected in South Africa early in March 2020.

For some early stage transactions, Private Equity Investors anticipate that delays may be caused by difficulties in conducting adequate due diligence processes remotely, without full access to management teams, site visits, financial information and supporting documentation.

A further consideration that could cause delay for these early stage transactions is around the financial reporting and forecasts, where target companies themselves are being forced to relook at and re-evaluate their own business models and profitability as a result of lockdown restrictions and other related impacts on the business. Seller pricing expectations and how deal pricing may be impacted by the lockdown "blip" and future trading conditions is a further consideration.

This may result in some deals not being done at all, where buyer and seller cannot come to agreement on revised or adjusted deal pricing or structure.

To quote one Private Equity Investor, ***"You need a reasonable seller and a reasonable buyer for a deal to be done***."

54%

54% of Investors indicated that bolt-on acquisitions are still very much part of their short to medium term investment strategy. Unless these transactions were already in advanced stage at the start of the lockdown restrictions in March 2020, they may be placed on hold in the short term.

Exits

Whilst no Private Equity Investors surveyed are under pressure to exit any of their investments, half had current exit processes on the go when President Cyril Ramaphosa declared the Coronavirus pandemic a state of disaster in South Africa.

Of these, half have put their exit plans on hold, while the other half are going ahead with the transactions without any significant delays anticipated, other than potential delays in the regulatory approvals due to backlog in the system.

Almost all Private Equity Investors interviewed expect some kind of delay in exit plans for their portfolios. A Private Equity Investor said the following:

"Returns are generated from interim cashflows and exit cashflows. If interim cashflows are slower or lower, holding periods will be extended."

The ultimate objective of Private Equity investments is to generate and create value enhancement and generate returns for shareholders and investors.

Most Investors are likely, through discussion with and support of their Limited Partners, to amend their exit timelines to ensure these objectives will be met.

Another Private Equity Investor said, "Exits will take longer, there will be a longer holding period to realise true value or perceived value in portfolios."

THE IMPACT

Impact of COVID-19 and lockdown restrictions on portfolio companies

INDUSTRY IMPACT OF COVID-19 AND LOCKDOWN RESTRICTIONS ON PORTFOLIO COMPANIES

NEGATIVE

- Non-essential healthcare
- Manufacturing
- Non-food retail
- Transportation and logistics
- Construction materials and allied industries
- Hospitality
- Non-essential services
- Education
- Retail and commercial property

POSITIVE

- ITC (telecoms and technology)
- Food production and packaging
- Pharmaceuticals
- Healthcare
- Engineering service repairs

All Investors noted that the main negative impact on portfolio companies was the demand side slow down or collapse. This, in turn, has resulted in working capital constraints, including a cash crunch and liquidity issues. Some Investors noted that certain of their portfolio companies have been impacted by supply chain disruption and disruption to distribution channels. One respondent explained:

"Some of our portfolio companies may be placed in the Intensive Care Unit, but we are confident that they will come out of ICU in the short term."

On the other hand, industries such as ITC (telecoms and technology); Food production and packaging; Pharmaceuticals; Healthcare; and Engineering service repairs stand to benefit positively from Covid-19-related impacts. Another respondent said:

"Whilst the immediate positive impact is limited, emerging trends post-COVID-19 may well impact certain businesses within the portfolio positively."

Investing in a post COVID-19 pandemic environment

"There is opportunity in the chaos and crisis."

All Private Equity Investors indicated that they will continue doing deals and are considering new opportunities going forward, indicating they had 'dry powder' to deploy in the next 12 to 24 months. Half indicated that they would consider opportunities that they would not have considered in the past, such as distressed companies or temporarily distressed companies. The sense is that there will be many good companies with inappropriate capital structures which will require equity funding and/or some sort of bridge funding. Some Investors see opportunity for supporting distressed businesses through convertible loan structures, where there is option to convert debt to equity over time. Further opportunities noted were the possibility of listed entities becoming open to private buy-outs, in piecemeal transactions over time or as one transaction, and an increase in disposal of 'non-core' business segments by listed companies in financial distress.

Investors specifically noted that they anticipate sellers' pricing expectations to "become more realistic" and that business valuations are likely to decline in the short- to medium-term. One investor noted:

"There is likely to be a downward trend in pricing for businesses which have been negatively impacted and conversely, sellers are likely to have higher price expectations for businesses that have been positively impacted."

Alongside the anticipated downward trend in deal pricing, Investors expect financing and structuring of deals to change going forward too. The expectation is that whilst South Africa has already had low levels of gearing, lower levels of gearing may be considered in future deals, both from the Investor's side, but also from the banks requiring Investors to fund deals with more equity.

When it comes to transaction contracting, some Investors believe more focus will be placed on Material Adverse Clauses and Force Majeure Clauses, as well as more regular use of earn outs in deal structuring.

Most Independent Funds (ie. those who raise capital from third party investors), believe that new fund raising is likely to be delayed or timelines reassessed. However, some Independent Funds are proceeding with their fund raising, as planned. They expect that some Limited Partners may no longer be looking to invest in South Africa going forward and there will definitely be a longer time horizon to raising their funds.

77%

77% of Private Equity Investors indicated that they anticipate a reassessment of investment strategies going forward. This includes consideration of portfolio diversification, investing in sectors previously not considered or mandated, new dimensions to considering investments and new ways of formulating the investment thesis.

23%

The other 23% of Investors believe their investment strategy will remain unchanged.

62%

62% of Private Equity Investors said that future due diligence will include more extreme disruptive scenario testing.

38%

The remaining 38% said that various upside and downside scenarios have always been considered and that they would be more likely to consider adjusting deal valuation or structuring to account for risks caused by extreme “black swan events”.

Almost all Private Equity Investors surveyed indicated that due diligence processes for future investments are likely to include a sharper focus on:

- Potential disruptive scenarios and short-term cash flow head room
- Sustainable earnings
- Disaster recovery plans
- Leadership abilities of the management team
- Business resilience
- Extended technical and commercial DD’s
- Market testing (customers, suppliers, etc)
- Downside risks
- Plausibility of growth forecasts
- ESG

Although Private Equity Investors and their portfolio companies are facing challenges never experienced before, there is a sense of optimism around opportunities that could arise out of this crisis.

It is believed that companies will come out more robust and resilient, using the solutions found through navigating hardship to contribute to positive changes to business models and growth in the future.

There is no doubt that the pandemic will prove a game changer for many South African businesses.

> ***“The majority of Private Equity Investors are, however, confident that the industry will benefit over the longer term not only from new investment opportunities that will arise out of the chaos and disruption it causes, but that the pandemic will catalyse Investors to review their business strategies and the way they evaluate future investments.”***

OUR ROLE

The FTI Consulting Corporate Finance team helps clients maximise value throughout the deal life cycle. From origination to exit, we use knowledge-driven skill and experience, focusing on critical financial, commercial and operational opportunities, to help create and enhance shareholder value.

Our experts help clients navigate their way through the deal cycle. We work with our clients to execute controlled disposal and acquisition transactions, bringing industry and transaction experience and expertise to ensure that clients are able to maximise shareholder value.

The due diligence team has assisted many Private Equity clients in assessing price, funding requirements and other financial matters which need to be considered in the sale and purchase agreement. Our buy-side and sell-side due diligence work includes a comprehensive analysis of the key drivers of business performance, including quality of earnings, cash flows, working capital and net debt. We provide input into deal negotiations providing a valuable cross-link from the financials to the sale and purchase agreement.

FTI Consulting has offices in Cape Town, Stellenbosch and Johannesburg which are home to our Forensic & Litigation Investigations, Economic & Financial Consulting, Business Transformation, Corporate Finance and Strategic Communications teams.

And with offices in 29 major financial centres across the globe, we successfully serve clients wherever and whenever challenges and opportunities arise.

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