

AN FTI CONSULTING REPORT - PUBLISHED OCTOBER 2019

Experiences & perspectives of the partnership between private equity investors & owner managed businesses



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Foreword

Owner Managed Businesses form an integral part of South Africa's economic landscape. The country's history is closely linked to many of these businesses, which, forged from an entrepreneurial spirit, have gone on to grow into global conglomerates, competing with the best in their sectors from around the world.

There is also a plethora of mid-tier Owner Managed Businesses which remain an important part of the growth engine of our economy. Some of these businesses have remained in the same family for generation after generation. Others are relatively young and have only grown exponentially in recent years.

Over the past few decades South Africa's thriving Private Equity sector has enabled many Owner Managed Businesses to unlock the value in their businesses through well structured, win-win transactions. In this survey of the Experiences and Perspectives of the Partnership between Private Equity Investors and Owner Managed Businesses, FTI Consulting explores some of the key dynamics and insights from the perspective of both sides of the deal.

Our findings show that today's business and regulatory landscape presents a number of challenges for South African Owner Managed Businesses. Owner Managers recognise that Private Equity Investors can help them access much-needed capital for future growth, assist with succession planning, accelerate growth through providing improved access to new markets and clients as well as meet regulatory requirements, for example compliance with the Broad-Based Black Economic Empowerment codes.

Yet, they face a number of challenges when evaluating potential deals. They worry about how to pass on 'know-how' to new shareholders, for example, and how to determine and assess a fair value for their business, they are required to implement better governance practices and effect structural changes to their decision-making processes.

The change for the Owner Manager from being in control and not being answerable to anyone to often being a minority shareholder and answerable to others is not easy.

On the other hand, Private Equity Investors understand that concluding a deal with an Owner Managed Business is different from a large corporate or listed entity. Relationships, work ethic and a cultural fit are essential

factors of the long-term success of these partnerships. Private Equity Investors also recognise that they can bring immense value to these types of businesses not only through corporatisation, improvements in governance and access to funding, but also through 'softer' issues and knowledge transfer in the day-to-day management of the business.

Insights gathered from the respondents demonstrate that because Owner Managers have often invested years of time, effort, emotion and finances into building their business, mutual trust and alignment with the new investor is key during the process of choosing a prospective investor.

It is also evident from the responses received from both Private Equity Investors and Owner Managers that Transaction Advisors play an important role from the early stages of Deal Origination, through the due diligence and valuation and ultimately to

to conclusion and closing. Most Owner Managers, who were interviewed, reported that they used a Transaction Advisor to assist them during the disposal process.

We hope you find FTI's report a useful insight into the experiences and perspectives of both the Private Equity Investors and the Owner Managers in concluding deals, what needs to be considered and challenges to overcome to ensure a successful partnership.

John Geel

Senior Managing Director and Head of Corporate Finance
FTI Consulting





Perspectives of Private Equity Investors

Deal origination

The primary source of deal origination for Private Equity Investors tends to be through personal professional networks, with these deals more likely to progress to conclusion than those sourced from corporate finance advisors and legal firms.



78% of respondents indicated that their main source of deal flow originates through established **Personal Professional Networks**.



22% of respondents said that their main source of deal flow comes from **Corporate Finance Advisors**.

Some respondents indicated that some of their deal flow comes from their own research of potential targets which meet their specific investment criteria, however this was not the primary source of deal origination.

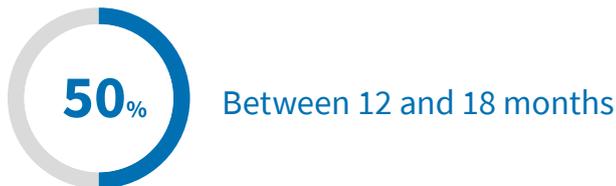
When asked to elaborate, respondents shared that personal professional networks include co-investor requests or referrals, other Private Equity Investors for second round Private Equity deals, networks of previous management teams, industry experts and relationships within the larger business community.

Some respondents suggested that investment opportunities brought to them directly through their personal and professional networks were more likely to be progressed to conclusion as they were generally a better “fit” for their typical investment criteria than those sourced from corporate finance advisors and legal firms.



Time taken to conclude the deal

Closing a deal with Owner Managers typically takes longer than large corporates or listed entities, making building a relationship and establishing trust with Owner Managers essential for progressing the deal.



50% of respondents said that deals with Owner Managed Businesses took **between 12 and 18 months** from origination to deal closure and implementation.



33% of respondents noted that deals with Owner Managed Businesses took **less than 12 months** from origination to deal closure and implementation.



The balance of respondents indicated that deals with Owner Managed Businesses took **longer than 18 months** from origination to deal closure and implementation.

The size of the deal was not highlighted as a factor that would increase or decrease the time of deal execution, however most respondents noted that more complex deals would take longer to close.

Closing a deal with Owner Managers typically takes a longer time, compared to deals done with large corporate business or listed entities, as Owner Managed Businesses are not always “investment ready” or prepared for the deal process.

In most cases, the Owner Manager has an emotional connection to the business and needs to feel a connection and partnership with the Private Equity Investor before bringing them into the shareholding and management structure.

“Building a relationship and establishing trust with the owner manager takes time and is an essential part of progressing the deal.”

Key attributes of potential targets

Private Equity Investors look first and foremost for strong, positive cash flows when considering an investment opportunity, but a strong management team, opportunity for growth, positive historical financial performance and favourable industry trends are also key considerations.

The Top Five attributes that Private Equity Investors look for in Owner Managed Businesses when considering an investment opportunity are:



“Owner managers tend to ‘sweat the small stuff’ in deal negotiations.”

Other attributes noted, not in the Top Five, included the ability for bolt-on M&A opportunities, internalisation, digitisation (as both an opportunity and a risk), strong brand and intellectual property.

Culture fit and relationship “alchemy” are additional points that are considered critical for a deal to progress to completion.

A small group of respondents had a different view from the majority in that they indicated that a strong management team is not essential. They would, or could, work with the existing management team for a while and if they didn’t show the skill or experience required, they would replace them in time.

“The business has to have a reason for being – it must answer the question ‘why do customers keep coming back?’”



Exit plans

Nearly 40% of Owner Managers exit the business with the Private Equity Investor and planning for this is an important consideration before the conclusion of the deal.

These respondents emphasised that alignment on exit was an important factor for consideration before conclusion of any deal between the Private Equity Investor and the Owner Manager and management team.

“We’re not out of the starting blocks without a strong management team.”

Although a large group of Private Equity Investors typically exit their investment in the company together with the original Owner Managers and the management team, there is understanding that this will not always be the case.

For example, where the new investor is a Private Equity Investor and offers the original Owner Manager/s and management team an opportunity to reinvest alongside them in the follow-on transaction, or where the new

“The business must be a price maker, not a price taker.”

investor requires the management team to remain. A few respondents noted that even where the management team exit together with the Private Equity Investor, the management team’s involvement in the business does not necessarily end – they could continue in senior leadership positions and are integral to the new investor to ensure continuity and integration post-acquisition.

“Even if we like the horse (the business), we need to like and trust the jockeys (the management team).”



Opportunities for value-add

Private Equity Investors identify most areas in which they can add value during the Due Diligence phase of the deal process.

The Private Equity respondents were **equally split** in indicating that they identify all areas in which they can add value to the business before conclusion of the deal, i.e. **during the Due Diligence phase**.

The balance of respondents indicated that some areas in which they, as the Private Equity Investor can add value are only identified post-deal closure, i.e. once they are shareholders of the business.

Private Equity Investors identify corporate governance, formalised reporting structures, executing a clear post-acquisition strategy, financial management and robust succession planning as key ways they can add value to the Owner Managed Businesses they invest in.



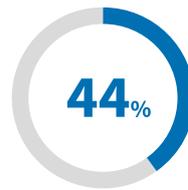
Introduce Corporate Governance

100% of respondents indicated that one of the most notable areas in which they add value is through the **introduction of corporate governance and formalised reporting structures – corporatising and professionalising the business**.



Implement Post-Acquisition Strategy

67% of respondents indicated that they've provided value add to the business through **implementation and execution of a clear post-acquisition strategy** for the business, including expansion of product or service offering, expansion into new markets and territories, acquisitions (i.e. sourcing and introducing deal opportunities to the business), disposals of non-core operations and access to new customers through their existing portfolio company networks.



Introduce Improved Financial Management

44% of respondents indicated that **financial management** was a key area in which they added value to the business. This includes cash flow and working capital management, access to capital and lines of credit, formalised budgeting processes, assessment and monitoring of margins (specifically with a view to ensure margin enhancement) and cost management and optimisation.



Consider Succession Planning

33% of respondents believe a key area in which they add value to the business is through **robust succession planning**, from early on in the partnership with the Owner Manager and the management team. It is clear that for traditional Private Equity Investors, alignment on the plan for exit is essential for a successful partnership.

This succession planning involves the selection of a strong management team and working closely with them to optimise their skills and contribution to the growth of the business for long term sustainability of the business. It also includes assistance with recruitment of new management team members or recruitment of other key non-equity management positions in the business.

“A key area of value-add is robust succession planning.”

Other areas in which Private Equity Investors add value to the Owner Managed Businesses in which they invest are:

- Operational experience from other businesses
- Access to industry experts
- Better-informed decision-making processes
- Setting and measurement of Key Performance Indicators (KPIs) for management, employees and financial performance
- B-BBEE credentials, policies and processes are becoming increasingly important. In some instances, it was determined as the catalyst for a transaction
- Design and implementation of incentive schemes for equity and non-equity management team members
- ESG (Environmental, social and governance) policy implementation

“Transforming a rough stone into a polished diamond.”

Most respondents indicated that their input to the business in these ways contributed positively to overall improved business performance and quicker, informed strategic decision-making.

“A critical value add is the introduction of proper governance and processes as part of a ‘corporatisation’ program. This, however, needs to be balanced and cannot be over the top so as to stifle the existing entrepreneurs.”

“Governance means that everyone knows what is going on at all times and there is a free flow of information. There is connected decision-making.”



Investment challenges

One of the biggest challenges faced by Private Equity Investors when investing in Owner Managed Businesses relates to developing a relationship and trusted partnership with the Owner Managers and the management team during the transition from an Owner Managed Business to a corporatised business.

For many years, Owner Managers would have largely made autonomous decisions without much structure or process. As new investors get involved with the business as shareholders and directors, these investors will look for open communication and consultative decision-making and management processes.

“The need to create a ‘corporate’ culture, without losing the entrepreneurial spirit.”

For the Owner Manager, this is often a significant shift in mind-set and takes time. This is also often an emotional process of change, due to partial loss of control of the business which they would have invested in financially and emotionally over a long period of time.

“To fully understand the business, the industry and what is in the owner’s head.”

“The most challenging aspect is the journey with the Owner Manager due to the loss of control, together with its associated emotions.”

“The ability of the Owner Manager to let Managers transition to being shareholders and part of the decision-making process can also be as much of a challenge as having a new outside Private Equity Investor.”

There are many ways in which the partnership between Private Equity Investors and Owner Managers can be developed to unlock value.

Ways in which these challenges have been overcome include the following:

- “Having a continuous open dialogue”
- “Common understanding of the investment goal and what the end picture looks like”
- “Establishing a shared vision – alignment of all shareholders is critical”
- “Establishing trust”
- “Patience”
- “Tenacity”
- “Setting clear expectations from early on, to ensure there are no surprises”
- “The Three P’s – Patience, Persistence and gentle Persuasion”
- “Delicate handling of conversations and relationships. Honest, open and frank conversations.”

“The ‘old way of doing things may be sub-optimal and the Owner Manager needs to understand the willingness for a ‘mindset change’ – this concept must be fully understood, appreciated and agreed to by all the shareholders.”

“The transition of the Owner Manager to being accountable to another shareholder is often challenging and the transition to a shared philosophy and chemistry takes time and patience.”

Dealbreakers

Dealbreakers are often related to the ‘softer’ issues such as a lack of alignment on organisational culture, work ethic and lack of trust between the partners.

Non-negotiable dealbreakers include:

- The clear, agreed path to exit
- The Management Team, not just the leader, must have “skin in the game”
- Lack of ethics and integrity of the Owner Manager and the management team
- Dishonesty during the Due Diligence process
- The wrong culture and relationship fit
- Not finding consensus on valuation
- An unclear growth plan
- The need to have the requisite key terms in shareholders agreements

“Alignment of interests is fundamental to our transactions.”

“Chemistry and relationship are essential. We will walk away from a potential opportunity if there is no partnership feel.”

“No matter how good the business is, a bad management team can turn a good deal into no deal.”



Valuation and Deal pricing

Private Equity Investors use a variety of valuation methodologies on a case-by-case basis to determine the value of Owner Managed Businesses.



56% of respondents use appropriate **earnings multiples** as their primary valuation methodology.



33% of respondents use a **discounted cash flow** as their primary valuation methodology.

Almost all respondents use a secondary methodology to support and corroborate the valuation range determined by the primary methodology.

Most respondents indicated that their selected methodology would be determined on a case-by-case basis, depending on the nature and industry of the business, as well as availability and quality of the financial information available.

Earnings multiples most frequently used include EBITDA, EBIT and NOPAT.

Key value drivers were assessed through:

- Extensive financial and commercial due diligence, including discussions with management, key customers and key suppliers
- Consideration of market and commercial parameters
- Assessment of working capital requirements and cycles and capital expenditure
- Assessment of cash generation and cash distributions
- Consideration of margin enhancement
- Consideration of expected future growth
- Assessment of operational scale

- Identification of potential synergies
- Engagement with industry experts to access their knowledge and understanding of the industry

It is clear from our discussions around the assessment of key value drivers, that there is no “one size fits all” approach.

The value drivers that are identified during the due diligence phase are included in the valuation metrics, where possible.

Private Equity Investors assess and quantify risks and mitigate these risks through deal structuring and appropriate legal, insurance and management agreements.



53% of respondents would capture non-quantifiable risks in the valuation **through risk adjusted returns.**

Most respondents indicated that risks would be assessed and quantified or captured in the valuation, where possible. Where the risk is not quantifiable, it would be assessed as ‘manageable’ or not. Where the risk is considered to be ‘manageable’, the risk is noted and addressed in the ‘First 100 day plan’, or similar, with mitigating factors being put in place to reduce the threat of the risk over time. Mitigating factors also included appropriate deal structuring and appropriate inclusion in the transaction legal agreements, including appropriate warranties from vendors, insurance products and adequate, robust succession planning.



Perspectives of Owner Managers

Triggers for the disposal process and potential buyers

Owner Managers report that access to capital, lack of succession options, regulatory requirements and the need to accelerate growth were key reasons for entering partnerships with Private Equity Investors.

Owner Managers report that they embarked on a partnership with Private Equity Investors as co-shareholders in their businesses for a number of reasons, including:

1. Requirement for funding for growth – access to capital
2. Retiring shareholder with no succession within the family
3. Regulatory requirements, for example B-BBEE codes and the ability to introduce B-BBEE shareholders
4. Ability to accelerate growth through providing access to new clients, markets and additional services

Most Owner Managers approached Private Equity Investors over strategic, trade players with the potential opportunity to invest in their business

At the point of commencement of a disposal process, an Owner Manager has the opportunity to approach strategic, trade players or Private Equity Investors. Of the Owner Managers we interviewed, most had approached only Private Equity Investors with the potential opportunity to invest in their business.



Challenges faced by owner managers during and after the disposal process

Owner Managers highlight that ensuring a fair valuation, passing on ‘know-how’ to new shareholders and changes to the decision making process as key challenges.

Bringing in a new shareholder to a business is challenging, especially when the Owner Manager has invested years of time, effort, emotion and finances into building the business.

Some of the most common challenges faced by Owner Managers, when bringing a Private Equity Investor into their shareholding structure (both pre-deal closure and post-closing) include:

1. Ensuring the valuation of the business, and ultimate deal value, is fair (there is often a mismatch between the Owner Manager’s expectation of value and ‘the offer’)
2. Ensuring the investor has a thorough understanding of the business
3. A change in the decision-making process, to ensure that key decisions are made collaboratively, rather than autonomously
4. The time required to prepare for Due Diligence, while still running the daily operations of the business
5. The significant time taken to adequately deal with questions from the investor and their service providers, during Due Diligence phase and to ‘educate’ them about the business and industry
6. The protracted length of time taken from initial discussions with the investor, to closing the deal
7. Fully understanding unfamiliar terminology, commonly understood to seasoned investors (e.g. EBITDA, NOPAT, etc.)
8. Extended approval processes of the investor



Value-add of partnering with private equity investors

Owner Managers report that Private Equity Investors can add value to their businesses in a number of key areas.

Private Equity Investors can add value to Owner Managed businesses in a number of ways.

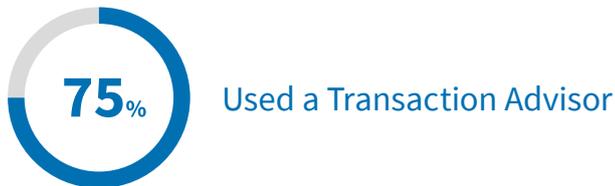
Some key areas found most valuable by Owner Managers who have partnered with Private Equity Investors include:

1. Peace of mind that the investors have sound financial understanding of the business and that they are able to contribute to an improved finance function of the business
2. There is access to capital, if required
3. There is opportunity for knowledge sharing from best practices experienced in other businesses in which the investor is involved
4. A clear exit strategy for down the line to create wealth for all parties
5. Opportunity to access new networks
6. Ability to grow the business through access to new services and new clients
7. Contribution to improved B-BBEE ratings
8. Introduction of governance structures



Choosing transaction advisors

Most Owner Managers used a Transaction Advisor to assist with the disposal process.



75% of Owner Managers interviewed, used a Transaction Advisor to assist them with the disposal process.

Most of these Owner Managers were not familiar with the transaction process and appreciated the assistance of the Transaction Advisor for “hand holding”, understanding what and when various steps were required throughout the process, assistance with valuation and negotiations, assistance with Due Diligence management, insight into the landscape of potential buyers and the relationships held within those networks.

Determining a fair valuation

Owner Managers use Transaction Advisors to help them determine a fair value for their business.

Deal value expectations are often based on a “sense” of what the exiting Owner Manager would like for their business.

Those Owner Managers with more informed deal value expectations base these on previous, related acquisition transactions, widely recognised valuation methodologies, available information for comparable transactions and other benchmark market information.

Where a Transaction Advisor is used to determine the valuation range of the business, some guidance is required to ensure that the Owner Manager fully understands the valuation methodologies, assumptions and terminology used.

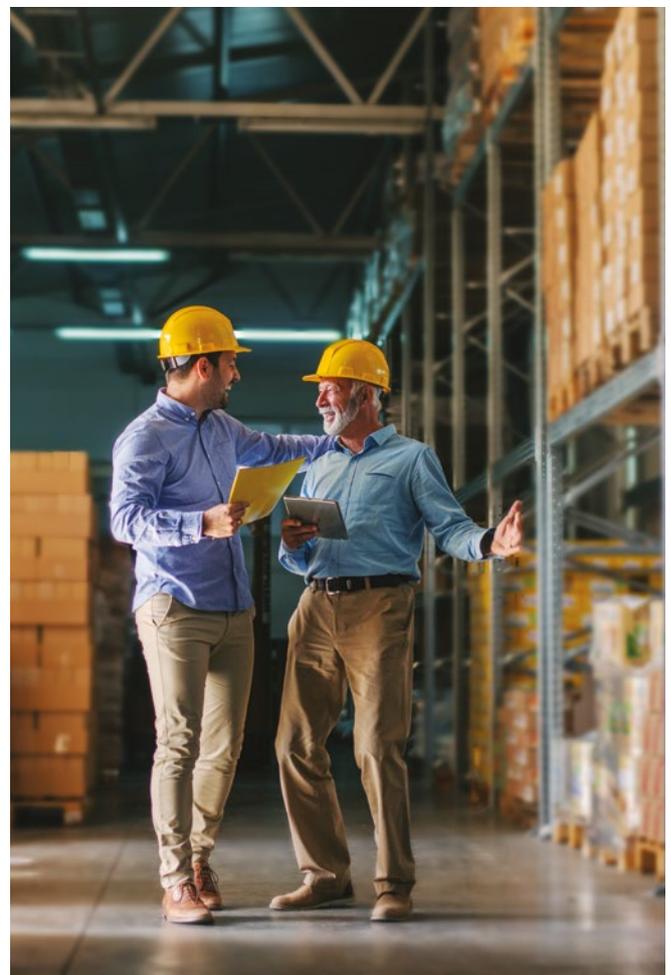
“We could not have concluded the deal without a transaction advisor.”



Over 70% of respondents indicated that the ultimate deal value compared fairly well to the value expectations.

Exit plans and re-investment opportunities

Owner Managers often plan to exit with the Private Equity Investor, but may re-invest in a follow-on transaction. More than half the respondents do plan to exit with the Private Equity Investor, however they anticipate that the management team may reinvest into a follow-on transaction, if there is opportunity to do so.



Research Methodology

FTI Consulting conducted one on one interviews with selected South African based Private Equity Investors as well as Owner Managed Businesses, who have done deals with Private Equity Investors, using a pre-determined set of questions. The questions used for the Private Equity Investors were different from the Owner Managers, to obtain perspectives from both sides of the deal.

All responses were aggregated and are reported on a consolidated basis in this report. All individual responses are kept strictly confidential. Where quotes are included, these are directly from respondents, however these individual respondents remain confidential.

Glossary

B-BBEE	Broad-Based Black Economic Empowerment
DCF	Discounted Cash Flow
EBIT	Earnings Before Interest and Tax
EBITDA	Earnings Before Interest, Tax, Depreciation and Amortisation
ESG	Environmental, Social and Governance
IRR	Internal Rate of Return
KPIs	Key Performance Indicators
LBO	Leveraged Buy-Out
M&A	Mergers and Acquisitions
NOPAT	Net Operating Profit After Tax



Respondents

FTI Consulting would like to thank all Private Equity Investors and Owner Managers that took part in the survey. Thank you to those Private Equity Investors who have granted us permission to include their names in the survey:



Adinah Capital Partners



Agile Capital



Awande Investment Management



Bopa Moruo Private Equity



Capitalworks Equity Partners



Calibrate Group



Ethos Mid Market Fund



Medu Capital



PAPE Fund Managers



RMB Corvest



RMB Ventures



Rockwood Private Equity



Sanari Capital



Trinitas Private Equity



Wiphold

FTI Consulting Team

FTI Consulting Corporate Finance team helps clients maximise value throughout the deal life cycle, providing expert-driven industry focussed insights helping clients to identify, create and capture value. 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. FTI Consulting Corporate Finance team survey contributors:

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