RisCura - South African Private Equity Performance Report

Performance Report

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We are pleased to release the September 2015 edition of the RisCura-SAVCA South African Private Equity Performance Report.

This report tracks the performance of a representative basket of South African private equity funds and is published quarterly.

The purpose of the report is to provide stakeholders in South African private equity with insight into industry returns, and to establish and maintain an authoritative benchmark for the measurement of private equity performance in this market. Since its inception in September 2010, this report has become is a vital component in the marketing of the private equity industry.

We would like to thank SAVCA members for making their performance data available, and for their commitment to this project.

Rory Ord
Executive

Erika van der Merwe
Chief Executive Officer: SAVCA

If 2015 has taught us anything, it is that global markets are more connected than ever. Lower growth in the Chinese economy has resulted in decreased demand for the raw materials produced across emerging markets. This has led investors to move decisively out of emerging markets to safe havens, even where this means certain negative returns. South Africa has not been spared this rout, and from a currency perspective, has in fact been one of the worst affected markets globally. In addition to the global emerging market sell-off, low growth, political manoeuvring and fiscal stresses have compounded these difficulties. While the private equity industry generally does not invest directly in it, the mining industry remains one of South Africa's large employers and has been very hard hit by lower commodity prices. The country and its neighbours have also been suffering very low rainfall, and the region as a whole is facing the spectre of food price inflation through 2017 as the impact of the drought and the weak exchange rate work through into prices. Besides these structural weaknesses, the overall economy is faced with tightening monetary and fiscal policy and lowest consumer and business confidence recorded in over a decade.

The major constraints to economic growth in South Africa remain uncertainty of electricity supply, lack of reforms and a very low savings rate in comparison to GDP. The unexpected downgrade of Brazil's credit rating has led to speculation that South Africa's rating would follow suite, however Standard & Poor's provided South Africa with some relief indicating it would give South Africa 18-24 months to address the above mentioned problems. Notwithstanding the risk of recession, the SARB will continue with the tightening of monetary policy begun in 2015, with most economists expecting three rate rises of 25bps through 2016.

Against this negative backdrop, corporate earnings have remained fairly strong outside of the resources sector, and many listed company earnings reports managed to surprise analysts on the upside. The advantage that South Africa has relative to some other emerging and frontier markets is a fairly well diversified and sophisticated economy, with stable middle class employment. This means that while the economy is growing very slowly, spending from this group has been relatively consistent, supporting corporate earnings and tax collections.

It is useful to divide corporate South Africa into three main groups for a broad understanding of financial performance. First, resources and agriculture are subject to specific pressures and must viewed separately. The spillover from these sectors could result in higher unemployment and difficulties for those businesses whose customers are middle and lower level employees of these sectors. This further presents a worsening political stability risk as discontent from the unemployed increases alongside food prices.

Secondly, there are those businesses that have Rand cost bases, but which have significant revenues in offshore markets denominated in hard currency. This group includes several JSE listed companies, but many are unlisted. These companies will have a windfall period of high margins over the next few years before these gains are eroded by the higher inflation that is a certain product of a weak Rand and higher food prices.

Lastly, the largest group of local companies are those whose market is local and slow growing, with some foreign currency inputs. These companies will try to maintain margins by containing costs and passing on higher input costs to customers, but will inevitably have margins squeezed as employee costs and imported inputs raise cost bases.

The performance of private equity portfolio companies will be largely determined by which of these groups they form a part, and how well managers, with help from their private equity partners, react to these circumstances. The South African private equity market in the third quarter of 2015 had a number of realisations on investments however capital drawdowns still exceeded distributions. The trend of realisations has now slowed in comparison to previous quarters and reflects the uncertainty in the market.

After 5 years of strong performance, South Africa's listed market showed a negative return in 2015, and has begun 2015 in similar form. All in all, the JSE All Share Index is now roughly where it was 2 years ago. Investors in South African private equity have certainly benefitted from their more diversified exposure over this period.

Private equity is a long term asset class which differs in nature from most other assets, including listed equity. Typically, private equity fund investments show low correlation to quoted equity markets and are relatively illiquid, particularly in the early years. Private equity will normally show a drop in net asset value before showing any significant gains. This is often the effect of management fees and start-up costs on the relatively small capital base of a new fund.

Private equity funds in South Africa typically follow a commitment and draw down model, which means that investors commit a certain total of capital at the start of a fund, but are only requested to transfer cash to the private equity manager as investments are identified or costs are incurred. These funds typically return capital during the course of the fund's life as investments are realised.

South African private equity offers institutional investors the opportunity to invest in an asset class which has historically outperformed listed equity over the long term. It does, however, have a different nature from quoted equity and it is crucial that an institutional investor considers the appropriateness of private equity to its particular objectives.

Methods of measuring performance

The most widely accepted method for calculating returns of private equity funds is the annualised internal rate of return (IRR) achieved over a period of time. As a sense check to the IRR measure, we also use the Times Money performance measure. This report measures performance in two ways: by ‘since inception’ and ‘end-to-end’ (over three, five and ten years).

IRR Since inception

This is the most widely used IRR measure of private equity performance. It measures the return of PE funds based on all cash flows in and out of the fund, as well as the remaining net asset value of the fund. This therefore most closely reflects the return an investor would achieve if they invested at the start of the fund. This is the most likely scenario in South Africa where investors in private equity funds are locked in for the life of the fund, and must catch up initial fees when joining a fund after the initial investors.

End-to-end IRR

End-to-end IRRs allow the computation of the return of groups of private equity funds which do not necessarily have the same inception date. This calculation also allows a better comparison of private equity returns to those of other asset classes over similar periods.

While this method has advantages, it must be noted that it allows the returns of funds at different life cycle stages to be combined. Where the period selected contains more new funds than older funds, the return will likely include a higher balance of fees than a time period with more older funds.

The longer term IRRs are considered to be the most indicative of private equity performance across different stages of the economic cycle, and are considered to be the headline measures. Shorter term returns should be viewed with caution as private equity is a long term investment. However, shorter period returns may be indicative of the general performance of private equity over this short period.

Times Money

Times Money is the ratio of total capital invested to total capital returned and remaining value. This is a useful cross-check of IRR measures, and is easily understandable. While IRR calculations are heavily dependent on the length of time that capital has been invested, Times Money does not take time into account. A Times Money in excess of 1 means that value has been created for the investor.

Public market equivalent (PME)

This measure seeks to equate the heavily timing dependent returns of private equity funds with the returns of public market indices. The measure is a ratio of the net outflows from PE funds re-invested into the public index to the end of the fund’s life, divided by the inflows into a PE fund invested in the public index until the end of the fund’s life. A ratio of above 1 reflects outperformance of private equity, while a ratio under 1 reflects underperformance.

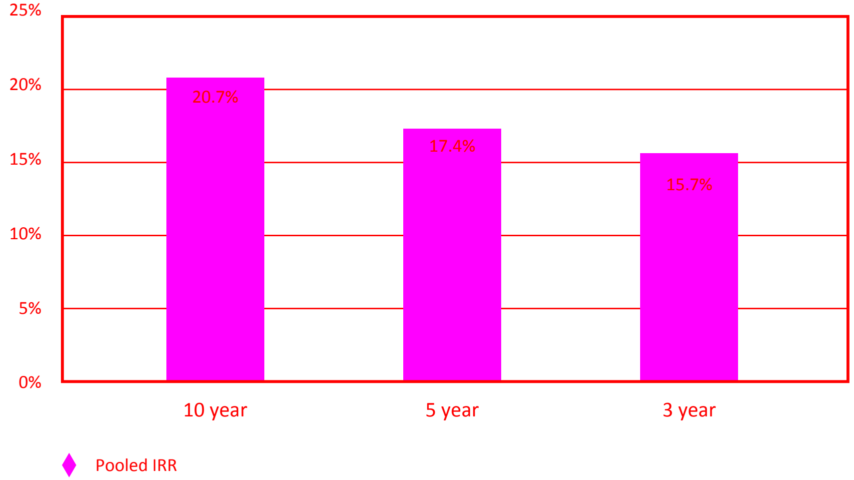
Performance in South African Rands (ZAR)

5a) Returns over different time periods (ZAR)

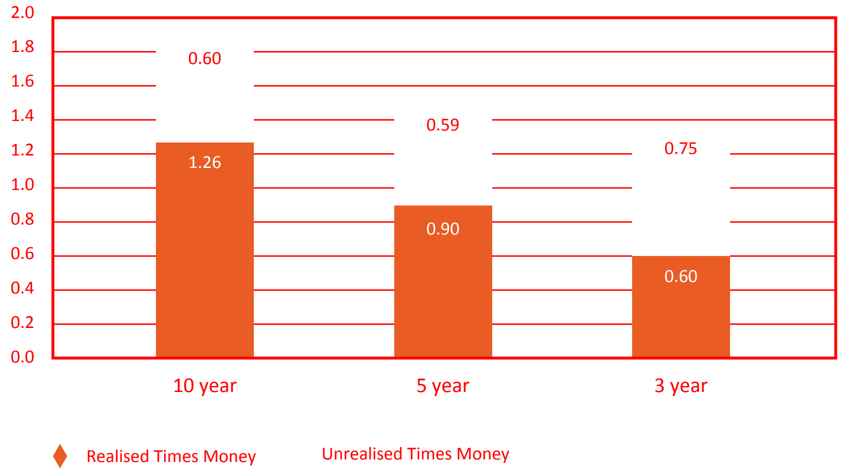
We regard the ten year return as the headline measure of private equity returns. This is because of the long-term nature of private equity investments, and the locked-in nature of typical fund structures.

In the private equity context, one year returns are not a reliable measure of performance and have not been presented.

Pooled IRR by time period (ZAR)



Times Money by time period (ZAR)

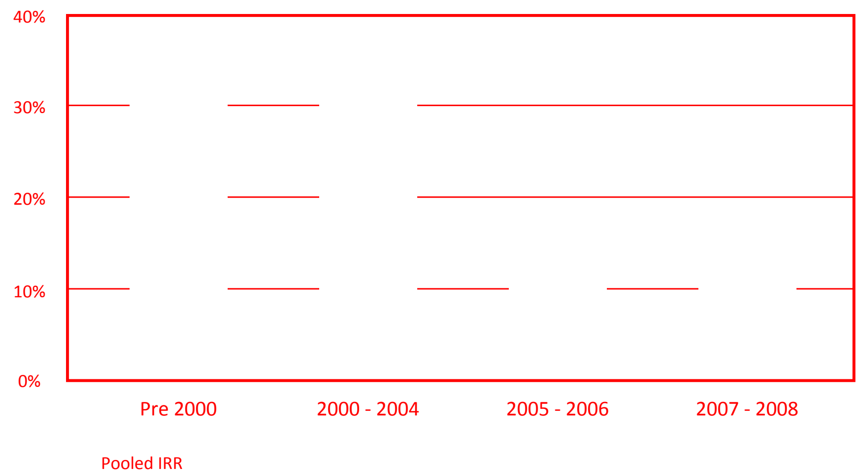


5b) Returns by vintage year (ZAR)

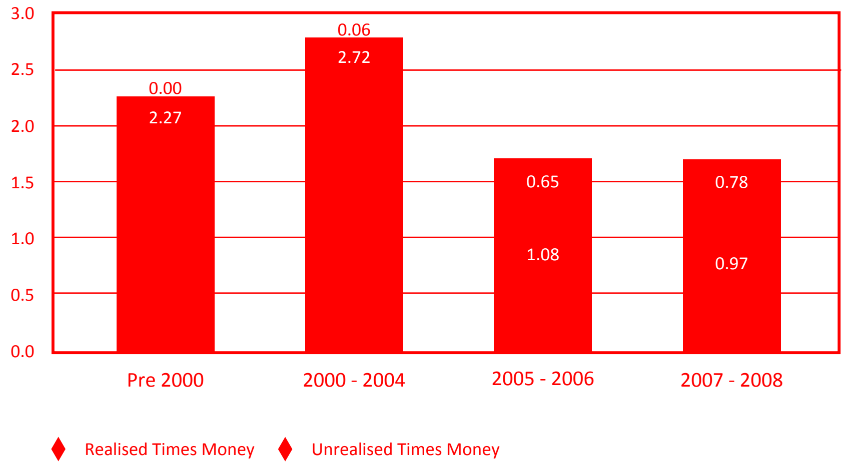
Previous studies have shown fund vintage year to be an important determinant of private equity returns. Our findings are consistent with these studies and show a dramatic difference in returns by vintage grouping.

Funds starting in or after 2005 have been negatively impacted by the downturn in the economy. Part of the reason for the poor current results of the most recent vintage grouping is that these funds are still mid-cycle, where management fees still play a significant part in determining fund returns and the investments made by these funds still need to be enhanced by the private equity fund manager.

Pooled IRR by vintage year (ZAR)



Times Money by vintage year (ZAR)

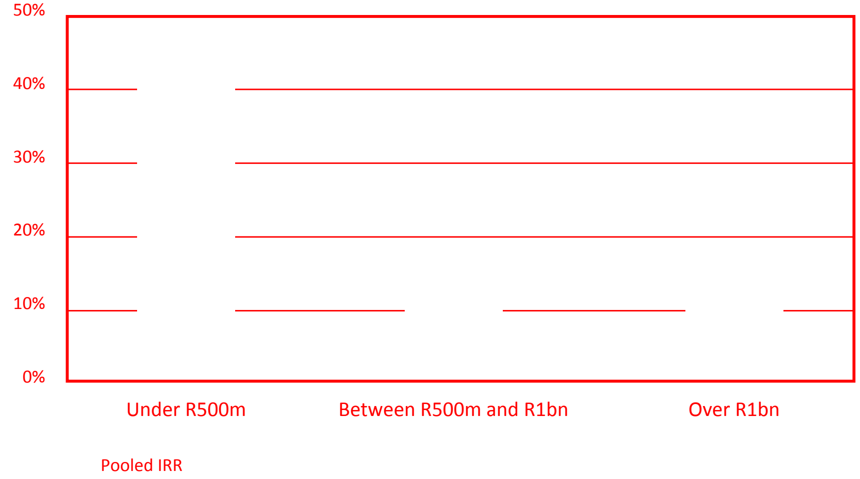


5c) Returns by fund size (ZAR)

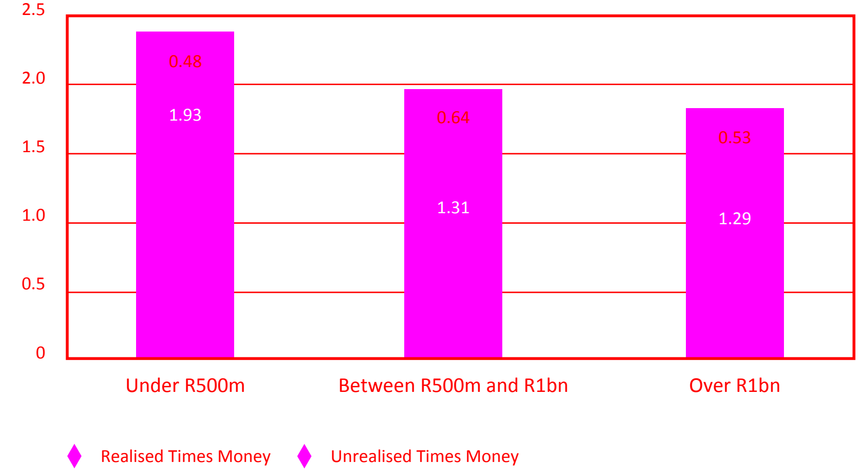
The analysis shows that historically, smaller funds have performed very well. This strong performance may be due to smaller funds investing in the high growth mid-market sized companies that have performed well under generally good economic conditions.

However, it is important to note that the larger funds were more likely to have been in existence more recently, and therefore be part of the poorer vintage year groupings. It is likely that vintage year is a bigger determinant of performance than size.

Pooled IRR by fund size (ZAR)



Times Money by fund size (ZAR)



*Fund Size is reflected as committed capital in South African Rands.

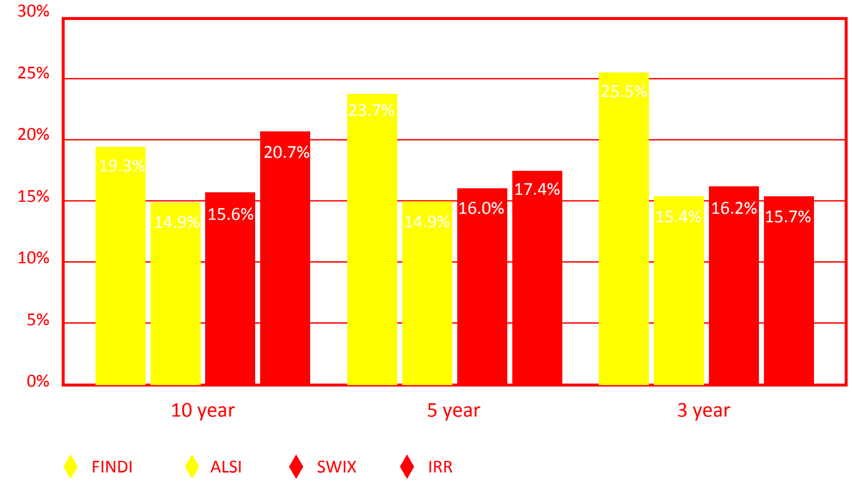
5d) Listed equity comparison (ZAR)

IRR returns have been compared to CAGRs of listed indices on a direct basis, and on the more comparable Public Market Equivalent (PME) basis.

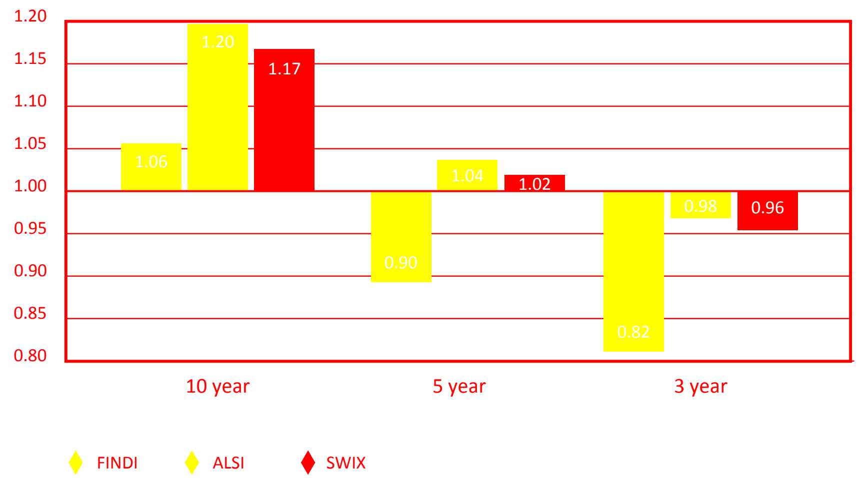
Private equity returns compare favourably to the returns of the FTSE/JSE indices over the longer term.

*Listed index returns are before fees.
**Listed indices used in the computations are total return indices before fees.

Pooled IRR compared to listed indices (ZAR)



Public market equivalent results

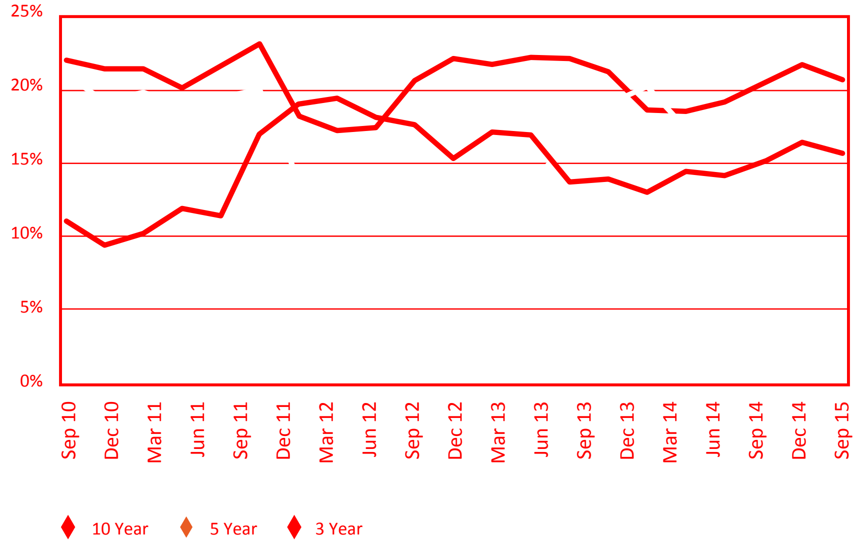


5e) Historical returns over different time periods

The table below presents the three, five and ten year returns reported in each quarterly release of the RisCura-SAVCA South African Private Equity Performance Report. This shows how the performance of each term has changed over time.

We regard the ten year return as the headline measure of private equity returns. This is because of the long-term nature of private equity investments, as well as the typical investment cycle of funds which takes some time to realise returns.

Pooled IRR by time period



Performance in US Dollars (USD)

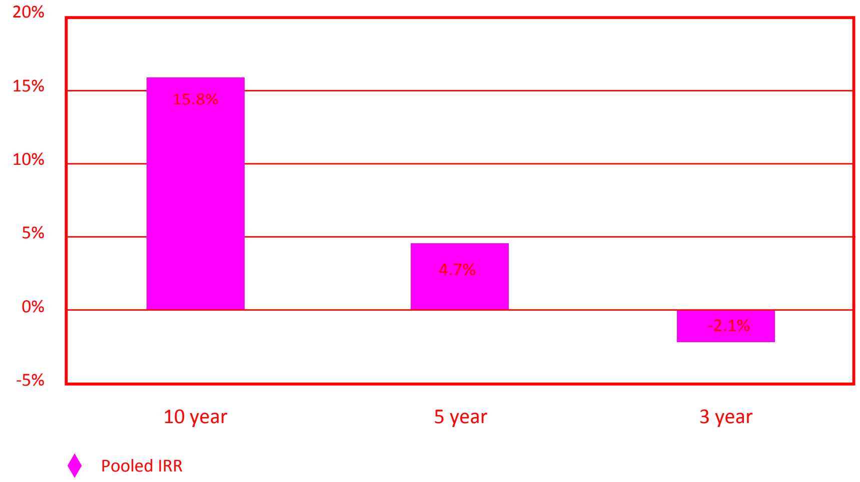
6a) Returns over different time periods (USD)

We regard the ten year return as the headline measure of private equity returns. This is because of the long-term nature of private equity investment, and the locked-in nature of typical fund structures.

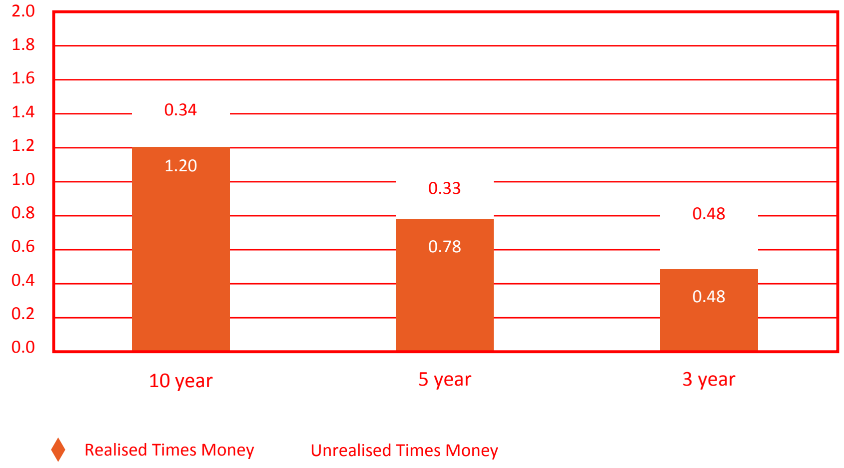
In the private equity context, one year returns are not a reliable measure of performance and have not been presented.

Exchange rate fluctuations have had a large effect on 3 year returns as a result of the steady depreciation of the ZAR over the 3 year period.

Pooled IRR by time period (USD)



Times Money by time period (USD)



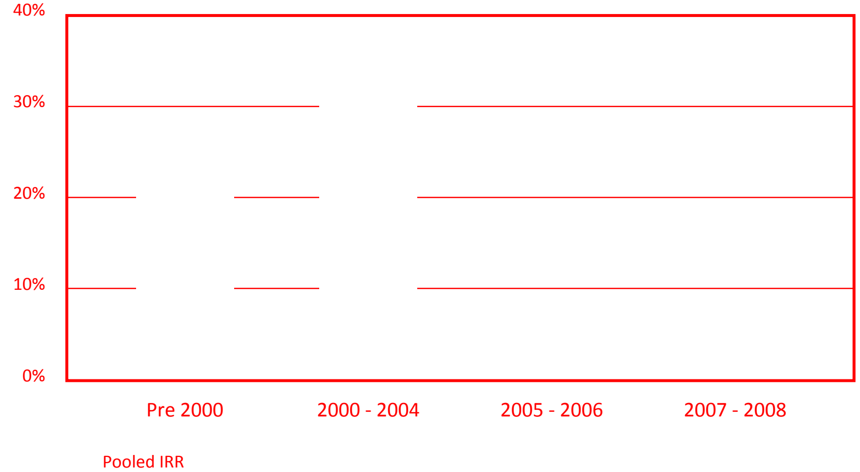
6b) Returns by vintage year (USD)

Previous studies have shown fund vintage year to be an important determinant of private equity returns. Our findings are consistent with these studies, and show a dramatic difference in returns by vintage grouping.

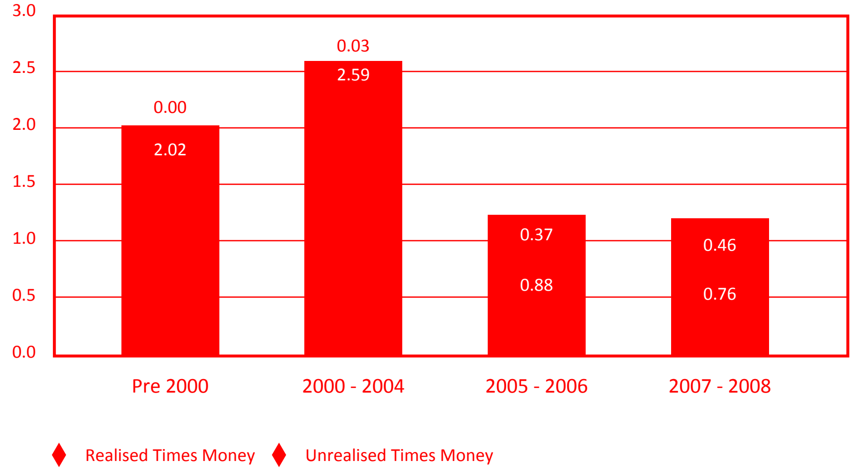
At 36.5%, the 2000 to 2004 vintage year grouping was the best of the vintage groups surveyed. This time period matches a period of strong growth in the South African economy, as well as strong growth on the Johannesburg Stock Exchange.

The more recent vintages have been more negatively affected by the Rand/Dollar exchange rate.

Pooled IRR by vintage year (USD)



Times Money by vintage year (USD)



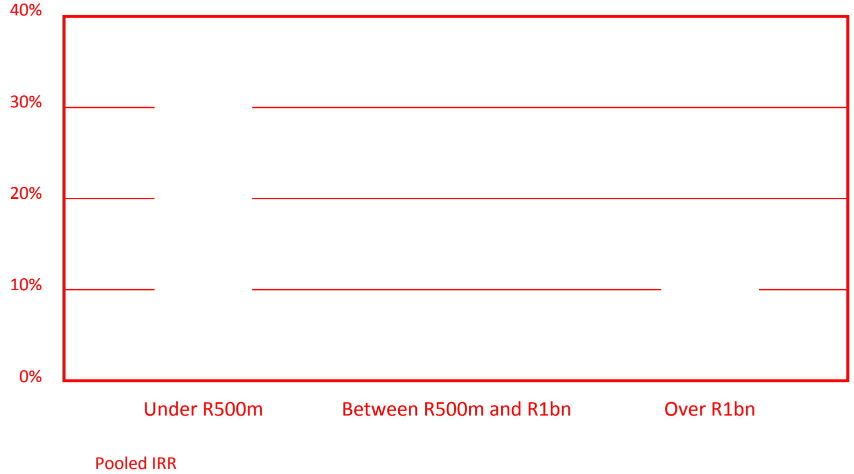
6c) Returns by fund size (USD)

The analysis shows that historically, smaller funds have performed very well. This strong performance may be due to smaller funds investing in the high growth mid-market sized companies that have performed well under generally good economic conditions.

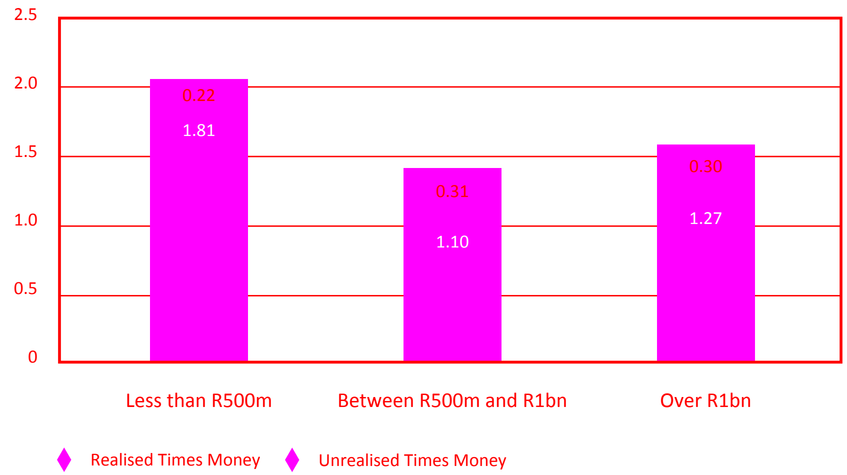
However, it is important to note that the larger funds were more likely to have been in existence more recently, and therefore be part of the poorer vintage year groupings. It is likely that vintage year is a bigger determinant of performance than size.

*Fund Size is reflected as committed capital in South African Rands.

Pooled IRR by fund size (USD)



Times Money by fund size (USD)



Users of this report may find the following information useful:

- Returns of cash flow and portfolio value data from private equity managers are the primary source for information included in this Report.

- The IRR performance calculation solves for the discount rate that makes the Net Present Value of a set of cash flows equal to zero. The calculation is based on cash-on-cash returns over equal periods, modified for the residual value of the fund's equity (NAV). The residual value attributed to each respective group being measured is incorporated as its ending value.

- The database accounts for cash flows on a daily basis wherever possible otherwise a monthly basis, and NAVs on a quarterly basis.

- The End-to-End performance calculation is similar to the since inception IRR, however, it is measuring the return between two points in time. The calculation takes into account the opening NAV, the in-period cash flows and the closing NAV. Returns are then annualised for comparability.

- The pool of funds has been split into subsets where this would enhance the user's understanding of returns. However, this has been balanced with confidentiality considerations, and no such subsets include fewer than four funds.

- Most funds included in this Report have unrealised investments, and therefore rely on the valuation of these investments to determine returns. All participating fund managers are members of SAVCA and apply the International Private Equity and Venture Capital Valuation Guidelines to determine these valuations. RisCura has not verified that these Guidelines have been adhered to.

- Only South African Rand denominated funds have been included in this Report, and therefore none of the returns included are affected by exchange rate movements. Returns in USD have been presented for comparability with other markets.

CAGR is the cumulative annual growth rate.

Committed capital is the value of dedicated investment funds pledged by the investors of a private equity fund and available for investment. This is a proxy for the size of the fund.

Fund Size is determined by the committed capital of a fund.

IRRs are money-weighted returns that should be compared to time-weighted returns with caution. Time-weighted returns are used to measure returns in most asset classes where frequent valuations are available.

PME Public Market Equivalent is a measure that determines whether private equity returns have exceeded or underperformed a public market. A PME score of more than one indicates outperformance of private equity.

Pooled IRR aggregates or "pools" all cash flows and ending NAVs to calculate a money-weighted return.

Realised Times Money is the multiple of cash returned to investors divided by total cash invested.

Total Times Money is the sum of the Realised and Unrealised Times Money.

Unrealised Times Money is the multiple of the carrying value of portfolio investments not yet returned to investors divided by total cash invested.

Vintage Year is defined as the year in which a fund first draws down capital from its investors.

RisCura is a global, independent provider of professional investment services. RisCura services institutional investors, asset managers, hedge funds and private equity firms with over USD200 billion in assets under advice. RisCura is a leading provider of investment consulting, independent valuation, risk and performance analysis services to investors.

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