Catalyst

SA's quarterly Private Equity & Venture Capital magazine

Vol 17 No 1
MARCH QUARTER 2020

Private equity self isolates from COVID-19

VC buyers' market emerges from pandemic

Deals not in complete lockdown

FROM THE EDITOR'S DESK

How will the coronavirus pandemic and resultant global economic collapse affect the private equity industry? The only honest answer is that nobody really knows.

As a healthcare crisis, the most recent precedent, the Spanish influenza, is 100 years old and so offers little use to measure its global sweep and impact. As an economic event, it raises many unknowns about how the sudden demand shock and existential dread will affect business activity and consumer behaviour — especially if the lockdown persists for an extended time.

Yet, a close look at the impact of previous economic shocks, such as the 2008 global financial crisis, can provide some clues as to how PE funds and their limited partners (LPs) will behave in a period of rapid contraction.

Polo Leteka, the co-founder and Executive Director of IDF Capital, tells me that it's all about going into triage mode with her portfolio companies now: to assess the damage, capital requirements to weather the storm, operational issues arising from the lockdown, and a path into the risk-adjusted approach of reopening the South African economy.

There will be opportunities for funds with dry powder, which will establish private equity funds among the major predators, as the coronavirus pandemic peels the weak from the herd. Cash flush, and with mandates that already accommodate a two-year additional period with which to return capital to LPs, means that the industry will be ideally positioned.

But the growing sense of frustration at Government's oftentimes incongruent and seemingly irrational approach to opening up sectors like e-commerce, and allowing an appropriate balance between lives and livelihoods, is palpable among dealmakers that I talk to.

Perhaps most concerning of all was an e-mail that I received from a retired High Court judge who tells me that his suspicions – that state capture forces are using this opportunity to regather and mount a concerted fightback against the president – were confirmed when the decision was taken to rescind the proposal in the draft regulations lifting the ban on the sale of tobacco products.

Connect the dots and it doesn't take a forensic expert to see who stands to benefit from the booming black market.

Saddled with debt to create the fiscal wiggle room to fight the pandemic, South Africa can ill afford to be dragged back to the obsidian days of factional infighting in the ruling party, delaying the long-awaited structural reforms required to ignite growth.

The time for the president to act against those in his cabinet who undermine his mission has arrived. ◆

Michael Avery

Contents

Catalyst

Editor: Michael Avery

Sub-editor: Lee Robinson

Design & Layout: Janine Harms, Gleason Design Studio

Catalyst is published by the proprietor Gleason Publications (Pty) Ltd, reg no: 1996/010505/07
from its offices at 30 Tudor Park, 61 Hillcrest Avenue Blairgowrie, Randburg 2194.

Tel: +27 (0)11 886 6446

Gleason Publications

Funds in the acquisition cycle

For fund managers in the investment cycle, there is a significant opportunity to capitalise on the market instability and lower valuations, for example, by acquiring listed companies that they may look to take private. Fund financing is likely to be attractive as interest rates are low.

While there are certainly operational challenges in relation to obtaining the required regulatory approvals, and to establishing the intermediate vehicles necessary to structure investments, this need not prevent deals being done, subject to conditions precedent. The negotiation, documentation and electronic due diligence of investments can and should continue to the extent possible. We expect substantial movement in pricing and terms, even as deals are being finalised, so fund managers should be alert and quick to respond.

Fund managers should ensure that their fund documents allow them to complete deals that are in-process after the end of their commitment periods and, depending on where they are in the cycle, should consider requesting a six-month (or longer) extension to the commitment period now, in order to alleviate pressure down the line.

They may also want to revisit their investment guidelines in order to hone in on opportunities arising in particular sectors or geographies, or to redirect their focus to sectors that are not as hard hit by the pandemic.

Funds in the value-add cycle

Fund managers need to take proactive steps to assist portfolio companies to survive the COVID-19 onslaught of lockdowns, suspended operations and upended markets. They should be assisting portfolio companies with developing and implementing contingency plans to address workforce considerations, identify and mitigate any potential supply chain disruptions, and ensure business continuity and financial stability.

Boards of portfolio companies should be reviewing *force majeure* terms of material contracts, reviewing insurance policies to assess potential recoveries for business disruption, managing liquidity and complying with *ad-hoc* obligations to notify lenders of possible adverse effects on their financial condition and/or business operations.

Funds nearing the end of their term may seek term extensions to provide portfolio investments with ample time to recover from short-term depreciation in value.

The implications of COVID-19 are changing with each passing week, and fund managers need to be nimble and seize opportunities as they present themselves. Those that are best prepared, and quickest to act decisively to protect the interests of their investors and portfolio companies, will be the ones that emerge strongest from this crisis. ◆

Paige, Denenga and Nyatsumba are Partners in Webber Wentzel's Private Equity Practice

Deals not under complete lockdown

Despite COVID-19 placing most M&A activity into an extended lockdown, some funds are still managing to announce closure on transactions.

Catalyst caught up with Phatisa Deal Principal, Lize Lübbe, to talk about how she sees the current dealmaking environment after Phatisa Food Fund 2 (PFF 2) and a group of co-investors – Norfund, Mbuyu Capital and DEG – announced the acquisition of integrated agricultural solutions provider, Farming and Engineering Services Limited (FES).

"Due to the tough economic climate and uncertainty, the general attractiveness, or at least perceived attractiveness, of opportunities for acquisition might reduce," says Lübbe. "However, there are interesting pockets of opportunity that are emerging during these times, such as investments in essential goods and services (including food security) and new disruptive technologies (including distribution and e-commerce)."

Lübbe also believes that reduced valuations will pose attractive acquisition opportunities – especially of quality companies with quality management – in the right sectors.

The investment in FES is a case in point, where the company's unique position in Malawi's agriculture matches the fund's mandate to seek out high growth firms in the food sector, and this deal will support FES's long term growth strategy, assisting the company to expand its successful business model to neighbouring countries.

FES's roots date back to 1967. It is the single largest investor in Malawi's agricultural equipment industry, and the sole distributor of several well-known and trusted brands including Massey Ferguson, Komatsu, AJ Power and Toyota Forklift. The company provides a wide range of high-tech agricultural solutions, including precision and low-till farming; drone technology for crop analysis and crop protection; irrigation systems, including water management solutions; and contracting services.

AgriLab, an FES initiative, is Malawi's first independent soil- and leaf-testing facility which allows farmers to test, manage and

control their soil, leaf and water quality. This initiative contributes to improved yields and crop quality, increased revenue and reduced input costs.

FES's impact objectives – mechanising African agriculture, ensuring food security, and enhancing farmer profitability – are aligned with the UN Sustainable Development Goals. Located in a region where resources are limited and input costs high, FES has expanded its offering to include a comprehensive range of climate-resilient precision agricultural solutions.

As part of the new owners' expansion strategy, FES is acquiring (subject to normal conditions precedent) the business assets of agricultural equipment supplier BHBW Zambia. On the back of this, AGCO has agreed to award FES the Massey Ferguson and Challenger franchises for Zambia. FES intends to replicate its successful model of equipment dealership with precision contract farming and other agricultural solutions in Zambia.

The consortium bought the FES stake held by Phatisa's inaugural food fund (African Agriculture Fund) while the company's management maintained their shareholding.

Mbuyu Capital is a specialist African private markets investor, managing segregated accounts of co-investments and funds for institutional investors.

Michiel Timmerman, Managing Partner of Mbuyu Capital Partners, reveals that Mbuyu's co-investments are focused on agri-business, non-bank financial services, logistics & distribution, and healthcare, which present attractive opportunities for financial return as well as impact, by creating jobs, improved food security, access to finance and greater health and well-being.

"FES is a leader and innovator in bringing precision-farming and agritech to Africa," says Timmerman. "New product development and expansion in the region can be expected to benefit the company's growth, as well as its customers – including smallholder farmers – by increasing yields, optimising use of inputs and improving climate resilience.'

At this time of economic stress, debt levels are coming under increasing scrutiny and Lübbe acknowledges that while the leverage model is popular, it is not one that enjoys much success in Africa.

"At Phatisa, we do not believe in high gearing ratios in our portfolio, especially considering the developing status of the economies that we invest in, and a focus on growth investments. As a result, we take a very conservative approach to gearing, and fund growth opportunities through a combination of debt and equity," adds Lübbe.

That's not to say that debt stress isn't emerging. Lübbe is observing a significant increase in debt restructuring across the board, and banks are being forced to exercise patience.

Lize Lübbe

"Generally, valuations will be negatively affected, and some industries might bounce back sooner than others. The average holding period for investments may be extended. We also hope to see a bit more activity in the availability of soft funding, especially for companies in essential goods and services, including those involved in food security and healthcare. It is very likely that PE firms will have to assist companies with further equity, especially in industries that are hit the hardest, such as tourism and hospitality. This might lead to further capital calls to the fund investors. We have generally found that the industry as a whole, and in Africa's case in particular, supported by a very constructive approach by DFIs, has come together with support to get through this crisis."

"Lübbe is observing a significant increase in debt restructuring across the board, and banks are being forced to exercise patience."

One thing is certain, and that is that the industry will forever speak in terms that mark this as a seminal turning point: pre COVID-19 and post COVID-19.