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The International Comparative Legal Guide to:

Private Equity 2017

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A practical cross-border insight into private equity

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South Africa

Nicole Paige

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Andrew Westwood

1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

The South African market continues to see a substantial number of private equity ("PE") transactions by local and foreign private equity houses, including leveraged buyouts, follow-on acquisitions, exits and Broad-Based Black Economic Empowerment transactions (see question 11.1 below). Recent years have seen an established trend in exits by way of auction/managed disposal processes and an increasing number of secondary PE transactions (demonstrating that the PE market in South Africa is maturing).

Transactional activity, both on the acquisition and the realisations side, was firm over the past year, across the deal-size spectrum and in a range of industry sectors. The quarterly data tables prepared by the Southern African Venture Capital and Private Equity Association ("SAVCA"), in collaboration with Webber Wentzel, indicate that there were 203 reported acquisitions and 41 exits in Africa during 2016. There were 99 reported deals and 14 exits in Southern Africa over this period. Of the acquisitions, a third were in South Africa, with Nigeria, Kenya and Namibia also featuring prominently.

There has been a shift towards a broader regional perspective with many African PE acquisitions being of companies operating across multiple African jurisdictions. PE investors are also backing the expansion of South African businesses into the rest of Africa.

1.2 What are the most significant factors or developments encouraging or inhibiting private equity transactions in your jurisdiction?

In an African context, South Africa is seen as a jurisdiction with strong and efficient banking and regulatory institutions, an established legal system as well as access to debt and capital markets including the Johannesburg Stock Exchange ("JSE") which is highly regarded.

The South African Rand is relatively volatile, which can be to the advantage or disadvantage of an investment depending on the timing, although this is not necessarily an unusual attribute for investors looking to invest in emerging markets.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction? Have new structures increasingly developed (e.g. minority investments)?

In most leveraged buyout transactions, a 'debt push down structure' would be used in order to facilitate the introduction of acquisition debt on an efficient basis. This involves a two-stage transaction whereby, in the first stage, the purchaser ("Bidco") acquires the shares in the target company using equity funding and a bridge loan. Immediately thereafter, the assets of the target company are acquired by a new company ("Newco"), typically a subsidiary of Bidco, using term debt. The proceeds of the business acquisition are then distributed to Bidco and Bidco applies the proceeds to settle the bridge loan.

In recent years, subscription and buy-back structures have often been used as an alternative to traditional share sale transactions.

We have recently also started seeing a rise in buy-in structures, where PE investors that were traditionally only interested in taking majority stakes in buyout transactions are now increasingly open to exploring minority stakes with strong veto rights. These transactions would often be coupled with a refinancing implemented by the target.

2.2 What are the main drivers for these acquisition structures?

The use of a debt push-down structure allows the funding bank to take direct asset security from Newco, as well as a pledge over Bidco's shares in Newco. It also allows the target company to be liquidated in order to mitigate any historical liabilities, and is efficient from a tax perspective (subject to certain interest deduction limitations).

Subscription and buy-back structures potentially provide a tax efficient exit for disposing shareholders (especially South African tax resident corporate shareholders). However, changes announced in South Africa's 2017 budget are likely to limit the efficiency of this structure in the future.

The main driver for the growth in minority investment/buy-in transactions seems to be a desire by the founders or management of primarily South African businesses to realise value and diversify their investments, whilst retaining control and continuing to drive the growth of the business. Another driver is expansion into the African continent where having a PE partner with capital and a well-developed continental network is seen as an advantage.

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2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

The equity capital structure typically consists of a combination of shareholder loans, preference shares and ordinary share capital. Typically the pure equity (ordinary share) component is relatively small after taking into account third-party acquisition debt and shareholder funding in the form of shareholder loans and preference shares.

Management will generally reinvest alongside the PE investor for a minority stake of between 10% and 40% of the equity investment, often on a subsidised basis. Their investment would usually be held through a management trust or other investment vehicle.

Carried interests are typically dealt with as part of the fund formation and structuring, and do not typically form part of the equity structuring at individual deal level. However, 'ratchet' type structures are often used to drive exit alignment and incentivise management if a particular return hurdle is met by the PE investor at exit.

2.4 What are the main drivers for these equity structures?

The main drivers for the structuring of equity capital are usually: (i) ease of returning funds to shareholders; (ii) tax efficiency, including for the ultimate investors; (iii) subsidisation of management, where applicable; and (iv) correct ranking of instruments, including relative to third-party debt.

2.5 In relation to management equity, what are the typical vesting and compulsory acquisition provisions?

The extent to which management shares may vest over time will usually depend on whether such management shares were subsidised and, if so, to what extent (i.e. if management paid full value for their shares, they would acquire their shares outright and there would be no vesting). Vesting would typically occur over a period of between three and five years.

Shareholder agreements will usually contain compulsory offer provisions which would be triggered if a management member's employment with the company comes to an end. A distinction is sometimes (but not always) drawn between good leavers (e.g. due to death, disability or retirement) and bad leavers (e.g. due to dismissal), but this may affect the value received for the shares rather than whether an offer is triggered. A good leaver will generally receive the fair market value for his/her shares (subject to any vesting provisions) while a bad leaver will be penalised in some way.

Any vesting and/or compulsory offer provisions in relation to management shares should be analysed from a tax perspective.

2.6 If a private equity investor is taking a minority position, are there different structuring considerations?

Where a PE investor is taking a minority position, it is unlikely that a debt push-down structure would be implemented as the PE investor would usually just invest into the existing group structure. Often a refinancing or restructuring would take place at the same time as the investment.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

The governance arrangements in respect of a portfolio company are contained in its constitutional document, namely its memorandum of incorporation, and the shareholders' agreement, which would usually set out, at a minimum: (i) the composition of the board (which is dependent on the shareholding structure); (ii) the conduct of board and shareholder meetings; (iii) specially protected matters (veto rights) in favour of the PE investor or other shareholders; (iv) provisions regarding the future funding requirements of the portfolio company and the further issuance of shares and/or the advancement of shareholder loans; and (v) restrictions of the transferability of shares and shareholder loans, as well as tag-along, drag-along and exit provisions.

The day-to-day management of the portfolio company is the responsibility of the board over which a majority PE investor will usually have control. Where the PE investor only acquired a minority stake and does not control the board, it would expect to have veto rights in respect of certain specially protected matters at shareholder level.

Whilst the shareholders' agreement is a private contract between the shareholders *inter se*, and between the shareholders and the portfolio company, any inconsistency between the shareholders' agreement and the memorandum of incorporation will result in the memorandum of incorporation superseding the shareholders' agreement. The memorandum of incorporation must therefore be aligned with the shareholders' agreement. The memorandum of incorporation is required to be lodged with the Companies and Intellectual Property Commission and is, in principle, a public document.

3.2 Do private equity investors and/or their director nominees typically enjoy significant veto rights over major corporate actions (such as acquisitions and disposals, litigation, indebtedness, changing the nature of the business, business plans and strategy, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

In terms of the Companies Act 71 of 2008, as amended ("Companies Act"), ordinary resolutions can be passed with majority support, and special resolutions with the support of at least 75% of the ordinary voting rights. These thresholds can, however, be altered in the memorandum of incorporation.

A shareholder holding a majority stake would (by default) be able to elect the board of directors, and a shareholder holding 25% or more would be able to block special resolutions.

In addition to corporate actions requiring a special resolution, the memorandum of incorporation and shareholders' agreement may set out additional specially protected matters or veto rights. The extent of these protections would vary depending on the size of the PE investor's stake, but would typically be extensive if the PE investor holds more than 25%.

Generally, veto rights apply at a shareholder level.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

Any veto arrangements contained in the portfolio company's

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memorandum of incorporation and/or shareholders' agreement will be void to the extent that they contravene or are inconsistent with the Companies Act. This does not generally present any practical difficulty, however.

Directors are subject to fiduciary duties in favour of the company, which may potentially conflict with the interests of a particular shareholder. Accordingly, it is best if veto rights are exercised at shareholder level, but a PE investor's veto rights can be structured so as to be effective at either level.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

Whilst shareholders do not generally owe any duties to each other, section 163 of the Companies Act does provide a shareholder with relief from oppressive or unfairly prejudicial conduct on the part of another shareholder. This section allows a court to come to the assistance of a shareholder if the shareholder satisfies the court that an act or omission of the company or another shareholder, or the manner in which it has conducted its affairs, is unfairly prejudicial, unjust or inequitable, or unfairly disregards the interests of the applicant.

In reaching its decision, a court would take account of the underlying motives of the majority in deciding whether particular conduct requires relief, and our courts uphold the general principle that by becoming a shareholder a person undertakes to be bound by the decisions of the prescribed majority of shareholders provided that these are in accordance with the law. Accordingly, mere dissatisfaction with the conduct of the company's affairs or the majority shareholders will not of itself constitute grounds of prejudice, injustice or inequity within the meaning of the section.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

A shareholders' agreement must be consistent with the Companies Act and the relevant portfolio company's memorandum of incorporation, and any provision of a shareholders' agreement that is inconsistent with the Companies Act or the company's memorandum of incorporation is void to the extent of the inconsistency.

It is permissible for the shareholders' agreement relating to a South African portfolio company to be governed by foreign law and for the parties to submit themselves to the jurisdiction of foreign courts, provided that this does not give rise to any conflicts between the shareholders' agreement and the Companies Act or a contravention of the Companies Act.

To the extent that the shareholders' agreement contains any non-compete and/or non-solicitation provisions, they must be reasonable as to, *inter alia*, (i) geographic area and (ii) time period, and should be limited to what is reasonably required in order to protect the legitimate interests of the PE investor and its investment in the portfolio company. The courts tend to scrutinise restraint provisions more closely when applied to individuals, given public concerns regarding employment and the right to a trade.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies under corporate law and also more generally under other applicable laws (see section 10 below)?

Before appointing its nominees as directors to the board of a portfolio company, a PE investor should ensure that such nominee is not ineligible or disqualified (e.g. because he/she is an unrehabilitated insolvent) to be a director as set out in section 69 of the Companies Act.

The common law duties of directors have been partially codified in sections 75 and 76 of the Companies Act. These consist of fiduciary duties and duties of care, skill and diligence. To the extent that such duties have not been codified, the common law continues to apply.

Directors are required to exercise their powers and perform their functions in good faith, for a proper purpose and in the best interests of the company. Furthermore, a director cannot use his position on the board or information obtained by virtue of his position to gain an advantage for anyone other than the company or a wholly owned subsidiary, nor to do harm to the company or any subsidiary (whether wholly owned or not) of the company. Directors are also required to disclose all information they believe to be relevant to the company unless they are subject to a legal or ethical obligation not to disclose it.

A director is required to exercise the care, skill and diligence that may reasonably be expected of a person carrying out the same functions as that director and having the general knowledge, skill and experience of that director.

In terms of section 77 of the Companies Act, a breach of these duties may attract liability for a director in his or her personal capacity.

Furthermore, although directors' duties and liabilities in the Companies Act are owed (in line with the common law) to the company and not to the shareholder appointing the director, where applicable, section 218(2) of the Companies Act effectively extends the remedies available for a breach of any duty contained in the Companies Act to anyone who has suffered loss due to the breach.

Typically, PE investors would require that a portfolio company take out D&O insurance to provide protection to its nominee directors.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

As set out above, directors owe their fiduciary duties to the company and not to the PE investor appointing him/her.

In terms of section 75 of the Companies Act, a director is required to avoid any conflict of interest and accordingly, if he has a material personal financial interest in a matter before the board, he is required to recuse himself from all discussion on that matter. However, a decision by the board will be valid despite any personal financial interest of a director or a person related to the director if it has been ratified by an ordinary resolution of the shareholders.

Due to the risk of nominee directors or the PE investors appointing them being regarded as having a personal financial interest in any decisions of the board, it has become practice for board resolutions in respect of major corporate, commercial and/or financial decisions to be ratified by shareholder resolutions.

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In an effort to limit any potential conflicts of interests, it is recommended that veto rights and the like fall to the shareholders and not be exercised at board level.

A conflict would typically only arise between portfolio companies where they are in competition or transact with one another. The director would need to make the appropriate disclosure to the respective boards and recuse himself where necessary. Where portfolio companies are in competition or in similar sectors, competition law may prevent there being common directorships.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including competition and other regulatory approval requirements, disclosure obligations and financing issues?

PE transactions in South Africa typically take about 12 weeks from signature of the transaction agreements until completion. This is largely due to regulatory approvals, including competition approvals (in South Africa and, if applicable, other Sub-Saharan African jurisdictions) and exchange control approval from the Financial Surveillance Department of the South African Reserve Bank. Additional regulatory approvals may also be required in respect of certain specific industries/sectors (e.g. the mining, banking, insurance, security, media and broadcasting industries).

4.2 Have there been any discernible trends in transaction terms over recent years?

Over the last couple of years, there has been a clear trend towards (i) the "locked-box" purchase price mechanism, and (ii) the use of warranty and indemnity insurance.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

The main features of a public-to-private transaction relate to the application of the takeover provisions contained in sections 117 to 120 of the Companies Act ("Takeover Provisions"), the Takeover Regulations and the JSE Listings Requirements, which impose stricter rules and disclosure requirements (as opposed to those applicable to private acquisitions) and a greater amount of publicity.

The Takeover Provisions and Takeover Regulations are aimed at ensuring transparency and fairness to shareholders in regulated companies in the conduct of specific transactions known as "affected transactions". These transactions, which will require notification to and a clearance certificate from the Takeover Regulation Panel, include: (a) a disposal of all or the greater part of the undertaking of a regulated company; (b) an amalgamation or merger involving at least one regulated company; (c) a scheme of arrangement between a regulated company and its shareholders; (d) the announced intention to acquire a beneficial interest in the remaining voting securities of a regulated company not already held by a person or persons acting in concert; (e) mandatory offers (triggered by an acquisition of more than 35% of the voting securities of a regulated company); and (f) "squeeze-out" transactions (which may be exercised by a shareholder who acquires more than 90% of the voting securities of a regulated company).

For purposes of the Takeover Provisions and the Takeover Regulations, all public companies and certain state owned companies are "regulated companies". A private company will also be a "regulated company" if more than 10% of the issued shares of that company have been transferred, other than by transfer between or among related or inter-related persons, within the period of 24 months immediately before the day of a particular transaction or offer. In addition, a private company may, in its memorandum of incorporation, elect to be a "regulated company".

Public to private transactions in South Africa are invariably implemented by way of a scheme of arrangement proposed by the board of the target to its shareholders, as the scheme of arrangement, if approved, allows the PE investor to acquire 100% of the target (and thus delist it).

The main challenges faced by PE investors would include: (i) obtaining board approval for the transaction (as the board would need to propose the scheme of arrangement); (ii) getting certainty regarding the deal, as the approval of 75% of the shareholders would be required, and there are restrictions on approaching shareholders prior to a firm intention announcement; (iii) financing must be secure at an early stage, as bank guarantee or cash confirmation is required at firm intention stage; and (iv) restrictions on the conditionality of the deal, as the scheme of arrangement may be subject only to objective conditions.

Public-to-private transactions have not been a feature of the South African market in the last few years.

5.2 Are break-up fees available in your jurisdiction in relation to public acquisitions? If not, what other arrangements are available, e.g. to cover aborted deal costs? If so, are such arrangements frequently agreed and what is the general range of such break-up fees?

Yes, break fees are permissible and are commonly agreed. However, the Takeover Regulation Panel requires that break fees be limited to 1% of the offer value and the details thereof must be fully disclosed.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

PE sellers prefer the "locked-box" pricing structure; whilst on the buy-side, completion accounts are generally preferable. It is more common for sellers and buyers to settle on a "locked-box" structure; however, often these have hybrid elements, for example, by including verification/adjustments for deviations in, for example, net working capital, net asset value and/or net debt.

It is also not uncommon to see earn-out structures/agterskot payments where a portion of the purchase price is paid on completion with a second portion only payable on a later date and upon the target meeting certain performance thresholds.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

In South Africa, both the PE seller and the management team are typically expected to provide a full suite of business warranties,

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pro rata to their shareholding percentages in the target company. However, as mentioned below, warranty and indemnity insurance is commonly taken out to cover the negotiated warranty and indemnity package and provide a clean exit to the PE seller.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

Interim period undertakings in relation to: (i) the conduct of the business between the signature date and the completion date; (ii) no leakage (in a "locked-box" compensation structure); and (iii) cooperation and assistance with regulatory filings, are standard.

Indemnities are not typical, but may be agreed where specific risks have been identified as part of the due diligence (in which case the indemnity may be insured).

6.4 Is warranty and indemnity insurance used to "bridge the gap" where only limited warranties are given by the private equity seller and is it common for this to be offered by private equity sellers as part of the sales process? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such warranty and indemnity insurance policies?

Whilst in the South African market it is expected that PE sellers will provide business warranties, it has become the norm (particularly in larger transactions) to obtain a warranty and indemnity insurance policy. In auction/managed disposal processes, this is usually a requirement of the seller, and the preliminary terms for a buyer warranty and indemnity insurance policy would often be provided in the data room as part of the proposed transaction documentation.

A warranty and indemnity insurance policy will typically have a *de minimis* threshold equal to 0.1%, and a floor equal to 1%, of the target's enterprise value. The cap for warranty and/or indemnity claims will be negotiated in line with the transaction agreements (and will typically range between 10% and 30% of the target's enterprise value).

Environmental, anti-corruption, transfer pricing and product recall warranties are uninsurable and excluded from warranty and indemnity insurance policies.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

Warranty claims against the PE seller and management team are usually qualified by information disclosed to the purchaser prior to signature as part of the due diligence and/or in a disclosure schedule attached to the acquisition agreement.

Liability is further limited by providing the warranties on a *pro rata* basis which means that, whilst the PE investor will be liable for the largest proportion of any warranty claim, the management team is also exposed and encouraged to make full disclosure as part of the due diligence and in the disclosure schedule.

Warranty claims would be subject to *de minimis*, floor, cap and time period limitations. Where warranty and indemnity insurance is taken out, these will be aligned to the policy.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

PE sellers will typically insist on warranty and indemnity insurance so as not to be subject to an escrow or deferred consideration mechanism.

PE buyers will look for security to the extent that the seller (for example, an individual, trust or SPV entity) is not considered creditworthy. They may also look for security over shares held by management to the extent that warranties are obtained from management.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain if commitments to, or obtained by, an SPV are not complied with (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

Buyers typically rely on bank term sheets, as well as their track record in securing debt for other transactions, to provide comfort that debt financing will be available. It is, however, common for the deal to be conditional on the debt being raised, although in some circumstances a buyer may be willing to underwrite the full acquisition price.

Comfort regarding the equity component may be provided through an equity commitment letter or similar form of confirmation/ undertaking, particularly where an SPV is used.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break fees are not typical in PE transactions in South Africa. However, cost-sharing arrangements are often agreed, in order to mitigate costs incurred in respect of, for example, competition filings, in the event of a failed transaction.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

An IPO exit may provide an attractive valuation, particularly as private equity multiples would typically be lower than listed multiples. However, the valuation would only be known once the IPO takes place and cannot be locked in advance.

In considering an exit by IPO, PE sellers should ensure that they have alignment with management and other stakeholders and are well aware of the process required to prepare the portfolio company for IPO (particularly a smaller/younger portfolio company which has not previously been listed). The possibility of an IPO and the process to achieve an IPO should be addressed in the shareholders' agreement.

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7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

The PE seller and the management team will ordinarily be subject to a lock-up period of between six and 12 months.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

Dual-track exit processes are not generally pursued in the South African market, and there is no established practice in this regard. There have, however, been instances of this and it may become more common for portfolio companies which are suited to an IPO.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

Debt finance for PE transactions is most commonly sourced in the form of secured term loans from the major South African banks. The finance market is generally receptive to funding these transactions, particularly those undertaken by established sponsors, at healthy levels based on the profitability of the underlying businesses.

Mezzanine financing is not often used in larger transactions, but may be seen in smaller deals involving growth businesses.

Bonds, notes and the like are not commonly used to finance PE transactions, although there is an appetite for bonds issued to portfolio companies to refinance existing bank funding. Whilst secured bonds in the South African market have some elements of the high-yield space off-shore (e.g. more covenant light than investment grade bonds and incurrence rather than maintenance covenants), the local bond investors have been more conservative and have been able to negotiate terms more akin to bank funding than high-yield bond funding.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

As mentioned in the answer to question 2.1 above, debt push-down structures are used to facilitate the security package and a tax efficient structure for acquisition debt.

When structuring the security package as part of a senior debt financing, tax events that may be triggered upon exercise of the security (especially as a result of the original acquisition structure) should also be taken into account.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

The most material tax consideration for investors would be to invest through a vehicle or structure that is tax transparent, i.e. any income (including capital gains, dividend distributions and interest payments) derived should be taxed in the investors' hands (in their tax jurisdictions) in accordance with the underlying nature of such income.

Off-shore structures are common for foreign investors that seek exchange control friendly jurisdictions. Due to the increasing trend of foreign investors investing into South African-managed funds, it is common practice to provide for a "dual fund" structure. The dual fund structure provides a second mirrored partnership that is established outside of South Africa, with the same investment strategy and structure of its South African counterpart – this is the vehicle through which foreign investors will invest.

9.2 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

Management teams that are not exiting (wholly or in part) will seek to roll-over their investment into a new acquisition structure in a tax neutral manner. There are various tax roll-over concessions contained in the South African Income Tax Act, which may assist in achieving this desired outcome for management.

9.3 What are the key tax-efficient arrangements that are typically considered by management teams in private equity portfolio companies (such as growth shares, deferred / vesting arrangements, "entrepreneurs' relief" or "employee shareholder status" in the UK)?

Given the extent of the tax legislation in South Africa governing employees' remuneration and the taxing thereof, it is important to distinguish income for services rendered from participation in the growth of the underlying PE portfolio companies.

As a result of the wide scope of the tax legislation, it is becoming increasingly challenging to structure participation schemes (i.e. participation in the growth of the underlying PE portfolio companies) that are not fully taxed at marginal rates.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

The tax rules (primarily section 8C) that regulate the taxation of employees in respect of share incentive schemes is constantly modernised to cater for the perceived abuse of such incentive schemes. Section 8C seeks to include in (or subtract from) an employees' income the gain (or loss) arising upon the vesting of an equity instrument, where such equity instrument was acquired by that taxpayer by virtue of his/her employment or from any person by arrangement with that person's employer.

With effect from 1 March 2017, an amendment to the section 8C rules will provide that gains and non-exempt dividends vested by employee share trusts are taxed as income in the hands of the beneficiaries. This amendment, together with amendments from 2016, have created the real potential for double taxation in employee share trusts where the trust vests shares or share gains in employees, who will also pay income tax on the share or gain as remuneration.

As noted in the answer to question 9.1 above, the "dual fund" structure has become common practise in South Africa for

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investments that need to be made outside South Africa (i.e. into the rest of Africa). Although the "dual fund" structure is highly effective, the formation process is quite burdensome and is becoming increasingly difficult to manage by South African funds. In order to compete with exchange control friendly jurisdictions, South Africa has introduced the "Headquarter Company" regime that essentially mirrors the benefits of exchange control friendly jurisdictions. Due to the common law transparent nature of the South African fund, the fund will not qualify for the "Headquarter Company" regime and the attendant benefits. As a result, the "dual fund" structure is the only viable alternative. An amendment to the "Headquarter Company" regime that allows for South African funds to qualify would negate the necessity for the "dual fund" structure.

10 Legal and Regulatory Matters

10.1 What are the key laws and regulations affecting private equity investors and transactions in your jurisdiction, including those that impact private equity transactions differently to other types of transaction?

PE investors and transactions are subject to a broad range of South African laws and regulations, including (but not limited to) the Companies Act, the Competition Act 89 of 1998, the Takeover Regulations and the JSE Listing Requirements (in the context of a public-to-private transaction or IPO exit), and various taxation statutes. In addition, fund managers or advisers who render services from South Africa are generally required to register as financial services providers under the Financial Advisory and Intermediary Services ("FAIS") Act.

10.2 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

The prudential investment limits for local pension funds were amended in 2011 to expressly permit pension funds to invest up to 10% of their assets in PE funds (with sub-limits of 2.5% per PE fund and 5% per fund of funds). The relevant regulations stipulate various requirements that a PE fund needs to comply with in order to qualify for investment purposes – these apply equally to local and foreign PE funds. The most significant requirements contained in the conditions are the following:

- fund managers must be members of SAVCA, the local industry body, and licensed under FAIS (foreign investment managers fall within a less onerous licence category);
- the auditors of the PE fund must verify the assets of the PE fund on a biannual basis and the PE fund must produce audited financial statements complying with international financial reporting standards within 120 days of the end of its financial year;
- the PE fund must have clear policies and procedures for determining the fair value of its assets in compliance with the International Private Equity Valuation Guidelines, and any valuations must be verified at least annually by a third party; and
- the pension fund must consider a list of prescribed due diligence matters before investing in a PE fund, including the fee structure of the PE fund and the risk and compliance policies and procedures of the PE fund.

We also understand that the South African regulator is considering the creation of a new category of FAIS licence for PE fund managers, but this has been in the pipeline for several years now without much progress.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)? Do private equity investors engage outside counsel / professionals to conduct all legal / compliance due diligence or is any conducted in-house?

PE investors usually conduct comprehensive legal due diligence on the target prior to an acquisition. The scope and materiality threshold will typically depend on the nature and size of the target's business, and will be determined by the PE investor in consultation with its investment committee and advisers. PE investors will usually engage outside legal counsel to conduct the legal due diligence (including, *inter alia*, corporate, commercial, employment and intellectual property arrangements) which would typically be completed in between three and six weeks (depending on the size and complexity of the target). Compliance due diligence (including anti-corruption/bribery compliance and know-your-client ("KYC") checks) may be done in-house with support from outside counsel.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

Yes, particularly in respect of international PE investors subject to foreign laws (including the US Foreign Corrupt Practices Act and the UK Bribery Act). Locally, the Financial Intelligence Centre Act ("FICA") imposes KYC requirements on 'reporting institutions' to identify clients and report transactions to the Financial Intelligence Centre. Amendments to FICA to bring it in line with international standards, including introducing requirements in relation to 'politically exposed persons' have been adopted by Parliament but not yet signed into law. The Prevention and Combatting of Corrupt Activities Act also allows for international reach in that it criminalises corrupt actions undertaken outside South Africa by any South African citizen, anyone domiciled in South Africa, or any foreigner, if: (i) the act concerned is an offence under that country's law; (ii) the foreigner is present in South Africa; or (iii) the foreigner is not extradited. It also criminalises the act of not reporting attempted or actual corrupt transactions.

Conducting a compliance due diligence (including anti-corruption/bribery compliance and KYC checks) is expected and PE investors are increasingly looking for contractual protection against possible non-compliance by way of anti-corruption/bribery warranties (which are typically excluded from any warranty and indemnity insurance policy).

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

The general principle is that shareholders (including PE investors investing in South African companies) have limited liability and will not be held liable for the liabilities or obligations of underlying portfolio companies. Accordingly, a PE investor could not be held liable unless the PE investor provides direct warranties, indemnities and/or guarantees in respect of the actions or obligations of the portfolio company.

There are instances where a court may be willing to "pierce the corporate veil" in very specific circumstances. In addition, particular

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pieces of legislation, for example environmental legislation and tax legislation, would impose liability on shareholders in certain instances.

It is unlikely that one portfolio company would be liable for the liabilities of another portfolio company unless they, for example, provide cross guarantees for each other's debts.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

The South African Reserve Bank ("SARB") operates a system of exchange controls governing the import and export of capital into and from South Africa. Foreign PE investors would need to comply with the exchange control regime and seek approval for transactions where applicable. Certain powers have been delegated to authorised dealers (the major South African banks), who can grant approval for certain transactions and submit applications to the SARB where required.

Broad-Based Black Economic Empowerment ("BBBEE") is a policy of the South African government intended to empower and promote the participation in the economy of historically disadvantaged South Africans. The policy is given effect to primarily by the Broad-Based Black Economic Empowerment Act ("BBBEE Act") and the Codes of Good Practice on BBBEE which create a system by which entities are measured for BBBEE purposes in accordance with stipulated scorecards. Importantly, no sanction or prohibition on trading arises from a low measurement or failure to comply, however as BBBEE will be a key factor in the government and public entities' decision to do business with an entity and also a factor for other South African businesses doing business with an entity (procurement being one of the measurements on their respective BBBEE scorecards), BBBEE is a business imperative for most companies doing business in South Africa.

Accordingly, it is often necessary for PE investors to introduce BBBEE ownership into portfolio companies to ensure an appropriate BBBEE ownership rating. Proposed amendments to the BBBEE Act would introduce a requirement to report to a newly created BBBEE Commission the details of major BBBEE ownership transactions, and this is something PE investors would need to be aware of and comply with in structuring transactions.

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Andrew has advised on a number of leveraged buyouts and exits by local and international private equity houses, as well as related transactions including follow-on investments, acquisitions by portfolio companies, refinancings, black economic empowerment transactions and exits.

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Webber Wentzel provides specialised legal and tax services to the private equity industry in Africa, including in relation to fund formation, acquisitions and disposals and management arrangements. We have been consistently involved in the highest profile private equity transactions in South Africa.

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