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CORPORATE & COMMERCIAL ALERT

IN THIS ISSUE

PRIVATE COMPANIES AND THE PARADOX OF THE PRIVATE EQUITY MODEL IN SOUTH AFRICAN COMPANY LAW

Private companies in South Africa, in terms of s8(2) of the Companies Act, No 71 of 2008 (Companies Act), are (i) prohibited from offering their securities to the public and (ii) required to restrict the transferability of their securities in their memorandum of incorporation (MOI) (although the Companies Act does not prescribe the manner in which this must be done). These two elements distinguish a “private company” from a “public company”.

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Private equity funds, on the other hand, manage the capital of investors including institutional market players that invest funds on behalf of members of the public. Instead of trading on public forums such as stock exchanges, private equity funds acquire ownership and control in private companies where they see untapped potential, with the intention to exit within two to six years after the acquisition, once they have made the required return on their private investment.

Herein lies the paradox: Investors (ie the public) who directly or indirectly invest in private equity funds, are afforded the opportunity to “acquire” securities in private companies, contrary to the first of the distinguishing elements of South African private companies, namely that they are prohibited from offering their securities to the public. The private equity fund investing in private companies, further typically insists on relaxed restrictions on the transferability of the private company’s securities in order to facilitate its exit, contrary to the second of the distinguishing elements of South African private companies.

The target exit

Private equity funds seek investments in private companies with the intention of making significant returns within two to six years after acquiring equity. Thus, they are typically interested in undervalued private companies with a potential for growth, or private companies that are not performing to their full potential because they are not managed dynamically, with the aim of supporting such private companies to target growth and increase profits. The private equity fund exit is structured in a number of ways in terms of the MOI and/or shareholders’ agreement of the private company including standard private company exit deals between the private equity fund and existing shareholders of the private company, or between the private equity fund and third parties, or an Initial Public Offering (IPO) converting the private company into a public company and listing the company on a recognised stock exchange.



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CONTINUED

Existing shareholders benefit from the private equity fund introducing more sophisticated management, compliance and company structures as well as reaping the advantage of a capital injection and increased growth and profits.



What do private equity players need in a private company?

Control: To create value in the company for their growth-and-exit strategy, private equity funds need control. That said, private equity funds do not necessarily want to acquire a controlling interest in the private company, have multiple board representatives or be responsible for the company's day-to-day management. Private equity funds therefore need control through extensive minority protection and related mechanisms in a private company's MOI and shareholders' agreement. Such minority protections enable them to influence the company's strategy and material business decisions as well as financial reporting, corporate governance and general industry compliance to ensure it is done properly so that the company will not be exposed to any regulatory issues, fines or penalties which will damage the private equity fund's investment.

Forced sale provisions need to be negotiated in favour of the private equity fund in order to buy out or facilitate on-selling the equity of existing shareholders where their behaviour could have detrimental consequences to their investment and they are not yet ready to exit.

Exit: Given that an essential element of the private equity model is the fund's planned exit, it needs the right to exit when ready and on favourable terms to maximise its return.

A carve out from traditional private company pre-emptive rights and other provisions restricting the transferability of securities in a private company is essential

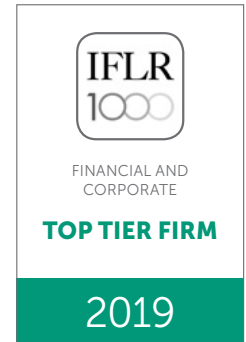
to facilitate such exit. An agreement with the private company's existing shareholders that the private equity fund will only be required to give limited warranties on exit if they were not involved in the company's day-to-day management will also benefit the private equity fund. Although often minority shareholders in private companies, private equity funds benefit from the ability to drag the existing shareholders through a 100% acquisition of the company if necessary to achieve their exit-and-return goal.

Conclusion

The private equity model which plays a very important role in the economy, by adding value and providing direction to promising private companies, therefore creates an interesting paradox in terms of s8(2) of the Companies Act.

The existing shareholders of these private companies (often start-up or family businesses with big potential if managed properly and steered towards profit-making) further enter into a trade-off not necessarily contemplated by the legislature when promulgating s8(2) the Companies Act: They relinquish control of the company and, in return, they benefit from the private equity fund introducing more sophisticated management, compliance and company structures (given that the private equity fund operates in a more regulated market, managing the capital of investors including institutional market players) as well as reaping the advantage of a capital injection and increased growth and profits.

Elnalene Cornelius and Tessa Brewis



2018 1ST BY M&A DEAL FLOW FOR THE 10TH YEAR IN A ROW.

DealMakers

<p>2018 1st by M&A Deal Flow. 1st by M&A Deal Value. 2nd by General Corporate Finance Deal Flow. 1st by BEE M&A Deal Value. 2nd by BEE M&A Deal Flow. Lead legal advisers on the Private Equity Deal of the Year.</p>	<p>2017 2nd by M&A Deal Value. 1st by General Corporate Finance Deal Flow for the 6th time in 7 years. 1st by General Corporate Finance Deal Value. 2nd by M&A Deal Flow and Deal Value (Africa, excluding South Africa). 2nd by BEE Deal Flow and Deal Value.</p>	<p>2016 1st by M&A Deal Flow. 1st by General Corporate Finance Deal Flow. 2nd by M&A Deal Value. 3rd by General Corporate Finance Deal Value.</p> <p>2015 1st by M&A Deal Flow. 1st by General Corporate Finance Deal Flow.</p>	<p>2014 1st by M&A Deal Flow. 1st by M&A Deal Value. 1st by General Corporate Finance Deal Flow.</p> <p>2013 1st by M&A Deal Flow. 1st by M&A Deal Value. 1st by Unlisted Deals - Deal Flow.</p>
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