Is South African merger control raining on private equity's Dezemba?

By all accounts, investor sentiment is trending positively. In principle, this should provide a shot in the arm for South African private equity (PE), which has been languishing somewhat.

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There are compelling arguments for why a dynamic private equity sector is good for an economy. PE funds compete at two levels – for investors' funds and for opportunities to invest in sectors with upside – and both of these imperatives drive investment innovation. Successful investors need to bring something extra to the table to ensure that portfolio companies grow quickly, to realise a demonstrable return and enhance the fund's reputation in subsequent rounds, to secure funding and be the preferred bidder. As far back as 1890, English economist Alfred Marshall developed the notion of "knowledge spillover", and recent studies of data across the OECD have revealed that when there is private equity intervention in an industry, there is an overall increase in employment, productivity, capex and profitability, as peers react to the competitive innovations introduced by PE and venture capital[1].

In the USA, PE has developed a bad rap for loading investee companies with debt and then driving short-term operational improvements by effectively "looting" their investee companies – at the expense of workers and long-term sustainability.

Although South Africa has had the odd leveraged buyout scandal, for the most part, our approach to PE (particularly, home-grown funds) is decidedly less venal. It has to be: progressive labour laws, aggressive unions and merger control rules make retrenchments difficult, and so returns cannot be based on driving "synergies" as a euphemism for job-cuts. Our economy is not as vast as the US's and cannot absorb the odd failing firm without contaminating whole industries. Just as a rising tide lifts all boats, they go down with the ebb, and PE funds in South Africa surely know that in an emerging market, overall growth is an imperative. PE firms here have become adept at fundamentally improving businesses, not hollowing them out. Amid current challenges, they provide access to capital where many businesses would otherwise struggle to find it. In the South African environment, PE is becoming well versed in matters such as ESG, supplier and enterprise development, and all manner of socio-economic imperatives that go with responsible investing in this country.

The sector also has tremendous potential for transformation. Although still under-indexed, black fund managers are becoming more prevalent, and many young, driven, black professionals and entrepreneurs see PE as an exciting space. But private money demands results, and like any PE, black-owned PE can succeed only where it develops a track record of enough successful investments coupled with successful exits to ensure repeat business from investors.

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Finally, South African PE is also a valuable conduit for foreign investment and local pension funds (many funds have an offshore component and a local fund to cater for both sources).

So, if a strong PE sector contributes so significantly to the economy, should we not be doing all we can to foster and support PE firms as they endeavour to inject capital, innovation and growth into various industries? This brings into focus the policy decisions of a key gatekeeper for investment in South Africa: the competition authorities.

While no-one would deny the importance of merger regulation to avoid substantial anticompetitive outcomes or significant risks to the public interest, it would be regrettable if regulation operates to trammel activity that raises no such concerns. And yet the murmur from boardrooms in South Africa and abroad increasingly suggests that merger control is a major factor in deciding whether to invest or not.

While some big M&A transactions can price in the challenges and take a long-term view, PE is disproportionately hit by overzealous merger regulation, as a successful PE model involves making serial investments in circumstances where frictionless exits in relatively short order are as important as closing the investment in the first place.

In PE, trips to the Competition Commission are a regular headache, not a once-off ordeal. There are a number of factors that PE firms need to manage when devising an investment case:

The Commission's public interest guidelines for mergers emphasise that all mergers should result in increased levels of worker ownership, with the introduction of an employee share ownership plan (ESOP) a typical quid pro quo for approval. However, PE typically seeks to deploy growth capital and stimulate reinvestment in the business. This often eliminates dividend flow, which makes an ESOP ineffective.

The Commission's public interest policy also drives HDP ownership commitments. While this may aid black fund managers at the point of entry, it complicates exit as maintaining the same level limits the pool of potential buyers. The notion that a black fund manager's stake is less liquid could affect the ability to seed the funds.

Perversely, this reduces any incentive to introduce higher BEE ownership at or after the investment, as this will create a bigger issue to be solved for on exit, as a reduction in HDP ownership is considered to be contrary to the public interest.

In practice, many firms are exploring ways to avoid triggering a merger, introducing complex structures or a need to avoid any controlling stake or minority investor protections that could give rise to control. This reduces the amount of capital that can be deployed, and also stunts the prospect of meaningful new strategies to grow and disrupt industries.

The Commission's approach to small mergers could chill PE and venture capital support for startups, as valuations that exceed large merger thresholds, even if the business is fledgling, attract merger scrutiny. While these measures were designed to police big tech "killer acquisitions", the size of many private equity funds means they are also caught.

Many of the most attractive industries for private equity investment (such as healthcare, renewables and other infrastructure and technology) are also focus sectors for the Commission, resulting in investigatory delays.

A lack of understanding of fund structures and management means that larger funds face complicated filing disclosures to identify potential cross-shareholdings, even across separate funds, fueling unfounded information exchange concerns. This erodes the proposition that PE investment is less risky for competition than trade buyers.

There is hope that the competition authorities will begin to consider that its policy should not make PE investment in a difficult economic climate more difficult, as this leaves valuable growth and foreign investment money on the table. By the same token, investors need to be sanguine about the reality of the regulatory environment, which means factoring in merger control law and policy at an early stage of developing a deal strategy.

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[1] Aldatmaz and Brown *Private equity in the global economy: Evidence on industry spillovers*, Journal of Corporate Finance, Feb 2020, 10524)