

Bulls & Bears

The Impact on 'Net Value'

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When the terms 'Bulls' or 'Bears' spring to mind, they generally provoke thoughts of 'Net Worth' rather than the concept of 'Net Value'. What many are unaware of is that fluctuations in an organisation's value - or share price - not only impact one's 'Net Worth', but the 'Net Value' calculation under the Ownership element of a B-BBEE Scorecard.

As B-BBEE transitioned from being measured on the 2007 Codes of Good Practice (Old Codes) to the 2013 Amended Codes of Good Practice (Amended Codes) in 2015, the rules of engagement dramatically changed on how Ownership was measured; it became a Priority Element, with the introduction of Sub-minimum requirements and the Discounting Principle.

Calculating Ownership

The Old Codes introduced 'Black' Ownership in Code 100: Statement 100 with a simple assertion, which on the face of it made perfect sense. If a 'Black' Person owns shares in an organisation, then the organisation is 'Black' Empowered or 'Black'-owned. However, upon digging deeper into the implications of the measurement benchmarks put in place, the measurement of 'Black' Ownership takes on a level of complexity that is reserved only for the brave or foolhardy!

Paragraph 3.1.1 states "As a general principle, measuring the Rights of Ownership in any category of 'Black' People in an organisation, only rights held by a natural person are relevant. If the Rights of Ownership of 'Black' People pass through a juristic person, then the rights of Ownership for 'Black' People in that juristic person are measurable. This principle applies across every tier of Ownership in a multi-tiered chain of Ownership until that chain ends with a 'Black' Person holding Rights of Ownership, which are referred to and broken down on the Ownership Scorecard as Voting Rights, Economic Interest and 'Net Value'."

While it is generally understood that Voting Rights measure the right of 'Black' Shareholders to vote at shareholder meetings, and Economic Interest generally measures the right to dividends receivable by 'Black' shareholders out of profits, the least understood measurement of the Rights of Ownership is how 'Net Value' is attributed to 'Black' Shareholders.

What 'Net Value' aims to measure is the "unencumbered" value of equity in the hands of 'Black' Shareholders. It is measured in terms of a number of variables that drive three formulas in the Amended Codes. In addition, a Time Graduation Table places a timeline to achieve this "unencumbered" value over a nine-year period.

From the next day of the:	Time-based Graduation Factor	Effective Target % of 'Net Value' in a 'Black' Shareholder's hands
1st year	10%	2.5%
2nd year	20%	5%
3rd year	40%	10%
5th year	60%	15%
7th year	80%	20%
9th year	100%	25%

The three formulas are:

Deemed Value:

$$A = (B - C) \times D$$

B = Value of equity instruments determined on the date of measurement (i.e. the value of shares held by 'Black' participants)

C = the carrying value of any acquisition debts of the relevant 'Black' participants on the date of measurement

D = the value of the Measured Entity on the date of measurement.

Formula A

$$A = B \times (1 / (25\% \times C)) \times 8$$

B = is the Deemed Value

C = the Time Based Graduation Factor of the Economic Interest compliance target

Formula B

$$A = B / C \times 8$$

B = Percentage Economic Interest in the measured entity of 'Black' Participants

The Amended Codes set requirements for a lower result from Formula A and Formula B, which is the score that must be used for the 'Net Value' calculation. However, all three of these formulas must be taken into account when measuring 'Net Value'.

In May 2015 the Amended Codes introduced a Sub-minimum requirement. It specifies that the measurement of the 'Net Value' score must be equal to or greater than 40% of the 'Net Value' target to avoid discounting of the overall status level on a B-BBEE Scorecard. It is this added dimension of complexity that can have a significant and dire impact on the overall status level of an organisation's B-BBEE score.

Share Price Impact on 'Net Value'

One unexpected curve-ball in the 'Net Value' calculation, which is often overlooked, is the long-term business performance of an organisation. The devaluation of an organisation's share price could have a negative impact on their 'Net Value' calculation.

Recently, with the low (negative) GDP growth, many organisations that in good faith embarked on B-BBEE Ownership deals to secure Ownerships points on their scorecard, have fallen foul of their share price plummeting. The impact is often a two-level drop for example from a Level 3 status to a Level 5 on their BEE Scorecard, which is particularly devastating when a Level 4 or better is a condition of a government supply contract, even though the organisation has met the 25% target for 'Black' Ownership.

Scenario Bullco and Bearco

The scenario hereunder outlines a real chain of events - although the names and values have been changed for confidentiality purposes - and illustrates how the Bulls and Bears do have an impact on an organisation's 'Net Value' calculation. In this scenario, we examine the fortunes of Ms Dlamini and Ms Mtembu. They have a longstanding friendship since meeting at university. They decided to follow their dream of being business owners and established an organisation called Edu Holdings (Eduhold) whose core business is selling educational books and training materials.

Fully aware of the value 'Black' Women have on an Ownership Scorecard, in 2011 they approached Bullco, a small distributor of children's textbooks with a proposal to acquire 25% equity in the organisation. With a goodwill deposit of R100,000.00 they had saved, the Bullco owners agreed to sell 25% to the newly formed Eduhold for R2.25m. A decision was taken that the balance of the purchase price would be paid from future dividends earned.

The terms of the deal between the parties were:

Enterprise Value = EBITDA x PE multiple of 3 (market adjusted multiple based on entities of a similar size)

Vendor loan = R2,15m repayable over 10 years at 7.5% interest per annum

Dividend policy = 50% of Profit after tax (PAT)

Loan repayment = 95% of dividends received for loan repayment, 5% trickle dividend to shareholders.

It took a while for Ms Dlamini and Ms Mtembu to find their feet. However, after a couple of years, Bullco started on a healthy growth trajectory, with profits more than doubling after seven years.

Bullco	At Transaction	Old Codes	Old Codes	Old Codes	Old Codes	New Codes	New Codes	New Codes
		28 Feb '12	28 Feb '13	28 Feb '14	28 Feb '15	28 Feb '16	28 Feb '17	28 Feb '18
EBITDA		3000	2850	3420	4104	4925	5910	7092
PAT		2160	2052	2462	2955	3546	4255	5106
PE ratio		3.0	3.0	3.0	3.0	3.0	3.0	3.0
Enterprise Value	9000	9000	8550	10 260	12 312	14 774	17 729	21 275

Dividend policy		50%	50%	50%	50%	50%	50%	50%
Dividend		1080	1026	1231	1477	1773	2128	2553
Dividend withholding tax		162	154	185	222	266	426	511

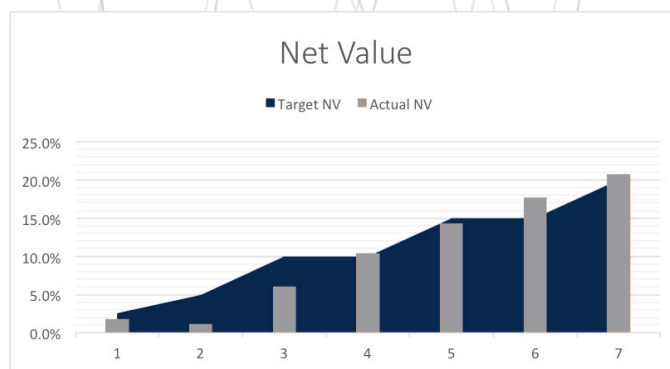
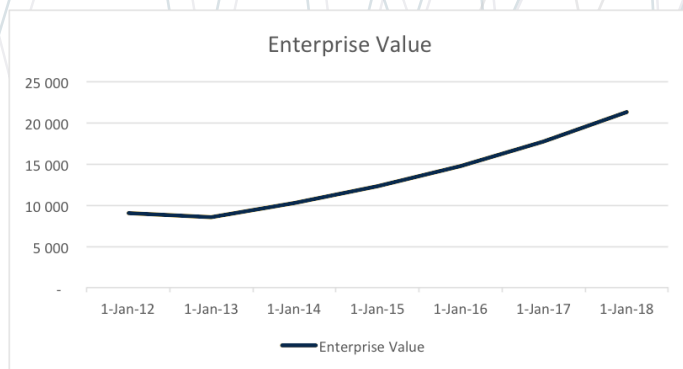
Dividend received		230	218	262	314	377	426	511
Equity sold to EduHold	25%							
Equity value	2250	2250	2138	2565	3078	3694	4432	5319
Discount								
Deposit	100							

Vendor finance	2150	2150	2093	2043	1948	1796	1572	1286
Interest		161	157	153	146	135	118	96
Repayment		218	207	249	298	358	404	485
Loan balance	2150	2093	2043	1948	1796	1572	1286	897

Net dividend		11	11	13	16	19	21	26
Graduation factor		10%	20%	40%	40%	60%	60%	80%

Deemed Net Value $A = (B - C) / D$		1.7%	1.1%	6.0%	10.4%	14.4%	17.7%	20.8%
Formula A $A = B \times (1 / (25\% \times C)) \times 8$		4.9	1.5	4.2	7.0	7.7	8.0	8.0
Formula B $A = B / C \times 8$		7.0	7.0	7.0	7.0	8.0	8.0	8.0
Net Value Score		4.9	1.5	4.2	7.0	7.7	8.0	8.0

Target NV		2.5%	5%	10%	10%	15%	15%	20%
Actual NV		1.7%	1.1%	6%	10.4%	14.4%	17.7%	20.8%



In February 2015, 2017 and 2018, Bullco scored full points for 'Net Value' as the "unencumbered" 'Net Value' in the hands of Eduhold exceeded the graduation target in those years. All in all, the investment was a great success for Eduhold shareholders, Ms Dlamini and Ms Mtembu. Over the seven-year period since becoming a 25% shareholder, they had received R117,000.00 in cash dividends. From the initial R100,000.00 they invested, they owned shares valued at R5.3m and an outstanding loan of R897,000.00 which would be repaid in full over the following two years.

Following the success of the first investment, Eduhold began looking for the next investment opportunity. In 2015, the owners of the much larger Bearco operating in the university book market indicated they were looking for a value-adding partner to acquire 25% equity in their business, the cost of which totalled R10m. For Eduhold, it was an opportunity to enter the big league!

Negotiations for the equity purchase began shortly after the Amended Codes came into effect in May 2015. The parties agreed that a discount of 10%, equal to R1m would be deducted off the sale price of the shares so that the transaction would be compliant with the 'Net Value' sub-minimum requirement from year one. Furthermore, Bearco required a 10% deposit of R1m from Eduhold to secure the deal. The parties agreed to a valuation of 3 x EBITDA and dividend policy of 35% to assist in the repayment of a vendor loan.

The terms of the deal between the parties were:

Enterprise Value = EBITDA x PE multiple of 3 (market adjusted multiple based on entities of a similar size)

Deposit = 10% - a R1m cash deposit to secure the deal

Discount = 10% - a R1m discount from the sale price

Vendor loan = R8m repayable over ten years at 7.5% interest per annum

Dividend policy = 35% of Profit after tax (PAT)

Loan repayment = 95% of dividends received for loan repayment, 5% trickle dividend to shareholders.

By February 2016 Bearco was performing reasonably well; however, dividends were not enough to reduce the loan balance. In February 2017, Bearco lost its contract with Wits University following a reduction in spending. This chain of events, which resulted in the devaluation of Bearco, had a dire impact on the Ownership score, losing 4.2 points on its 'Net Value' score.

In February 2018, the situation worsened as the 'Net Value' calculation revealed that the "unencumbered" value of Bearco shares in the hands of Eduhold had dropped below the graduation table requirements sub-minimum of 40%. Bearco scored 2.6 points on its 'Net Value' score and was consequently penalised by the discounting of their overall scorecard by 1 level.

The investment was a real concern to Ms Dlamini and Ms Mtembu. They had invested R1m of their own money and now owned shares that had lost R313,000.00 in value. The Eduhold loan had ballooned by R428,000.00 since the commencement of the deal in February 2015. Adding insult to injury, the discounting of 1 status level from a Status Level 4 to a Level 5 put Bearco at risk of losing further university business owing to its less favourable B-BBEE score.

Bearco		New Codes	New Codes	New Codes
	1 May '15	28 Feb '16	28 Feb '17	28 Feb '18
EBITDA	10 000	10 300	10 197	9993
PAT	7200	7416	7342	7195
PE ratio	4	4	4	4
Enterprise Value	40 000	41 200	40 788	39 972

Dividend policy	35%	35%	35%	35%
Dividend	2520	2596	2570	2518
Dividend withholding tax	378	389	514	504

Dividend received	536	552	514	504
Equity sold to EduHold	25%			
Equity value	10 000	10 300	10 197	9993
Discount	-1000			
Deposit	-1000			

Vendor finance	8000	8118	8230	8385
Interest	600	609	617	629
Repayment	482	496	463	453
Loan balance	8118	8230	8385	8561

Net dividend	54	55	51	50
Graduation factor	10%	20%	40%	40%

Deemed Net Value $A = (B - C) / D$	5%	5%	4%	4%
Formula A $A = B \times (1 / (25\% \times C)) \times 8$	8.0	8.0	3.6	2.9
Formula B $A = B / C \times 8$	8.0	8.0	8.0	8.0
Net Value Score	8.0	8.0	3.6	2.9
				1 level drop

Target NV	2.5%	5.0%	10%	10%
Actual NV	4.7%	5.0%	4.4%	3.6%

The result of Bearco losing the Wits University contract had significant consequences for Eduhold. As a result, Eduhold was, in terms of its debt warranties, liable for repayment of the vendor loan. In order to raise cash to repay the loan, Ms Dlamini and Ms Mtembu were considering either selling their shares in Bullco or liquidating part of their investment in Bearco, a situation that the Bearco shareholders did not wish to entertain.

What are the golden rules when embarking on a B-BBEE Ownership transaction?

- ① A 'Black' Ownership transaction is no different from any commercial transaction; it must make business sense.
- ② Thorough due diligence on both the Seller and Purchaser should be conducted by each party to establish that the parties are fully apprised with the risks and requirements for the deal to be sustainable.
- ③ Careful and best estimates of future growth prospects must be well understood to inform the funding model for a transaction.
- ④ Get an opinion from a B-BBEE Professional who is versed on the Ownership Scorecard and understands the commercial terms of the transaction and can translate these into a nine-year score forecast.

“Many organisations lose Ownerships points due to their share price plummeting.”

