Transformation | Ownership

OWNERSHIP

FIND THE RIGHT BALANCE

Levanya Reddy is a Director at MSCT BEE Services, a SANAS Accredited B-BBEE Rating Agency. Following an honours degree and subsequent career in Biotechnology, her shift to the B-BBEE space was born from new opportunities and a desire to put herself at the forefront of a transforming South Africa. As B-BBEE is the catalyst for change, the move was a good fit. She has an in-depth understanding of the Codes; with her experienced team at MSCT, verifications are conducted according to the standards outlined in the R47-03 document.

Ownership in terms of the B-BBEE Scorecard is the most challenging to measure, with harsh consequences for misinterpreting the requirements. Therefore, it is paramount that organisations have a holistic understanding of the measurement criteria, specifically when it comes to 'Ownership Incentive Schemes', which necessitate the application of the Modified Flow-Through Principle or Exclusion Principle, amongst others. The impact of these principles on the Ownership calculation could result in a re-calculation of the applied share percentages without adjusting or amending the actual share distribution. When applying such principles alongside one another, the Ownership calculation becomes complex. Then, when adding other Ownership mechanisms to the pot, like Sale of Assets, Private Equity Funds and Share Options with Preferred Share Options, the Ownership Scorecard becomes all the more daunting.

In this article we aim to unpack some of the applications and highlight critical factors that cover the foundation of the Ownership Scorecard, which are the interpretations that guide transactions and the process of evaluation.

Interpretations

The Codes of Good Practice (Codes) contain a list of definitions that a person must read in conjunction with B-BBEE legislation - refer to 'Schedule 1'. In the case where Schedule 1 is silent on a definition, as per the B-BBEE Act (The Act), one must refer to other legislation, for example, the Companies Act, to apply a definition to a specific scenario. If Schedule 1 defines a word or phrase, that definition must take precedence over any other one. The reason is that the application of any definition must align with The Act. Hence the common phrase "Where the Codes are silent, apply substance and reference to another Act that meets the intent of The Act".

What definitions apply to Ownership?

When interpreting the provisions of the Codes, reasonable interpretation, consistent with the objectives of The Act and an organisation's B-BBEE Strategy, must take precedence. Words importing persons shall, where the context requires or admits, include individuals, organisations, partnerships, trusts, corporations, government bodies, authorities, agencies, unincorporated bodies of persons or associations and any organisation with legal capacity.

Schedule 1 refers to the following definitions relevant to the Ownership Scorecard that all interlink with one another:

> "Companies Act"
means the Companies Act, No. 71 of 2008 as amended or substituted;

> "Associated Entity"
means an Entity with which a Seller has concluded a Qualifying Transaction;

> "B-BBEE Controlled Company"
means a juristic person, having shareholding or similar members interest, in which 'Black' Participants enjoy a right to "Exercisable Voting Rights" that are at least 51% of the total rights measured using the Flow-Through Principle;

> "B-BBEE Owned Company"
means a juristic person, having shareholding or similar members interest, that is a B-BBEE Controlled Company, in which 'Black' Participants enjoy a right to Economic Interest that is at least 51% of the total rights measured using the Flow-Through Principle;

Importantly, there is a core difference between the definitions "B-BBEE Controlled Company" and a "B-BBEE Owned Company", which is:

> "Voting Rights" are associated with a "B-BBEE Controlled Company"; and

> "Economic Interest" is associated with a "B-BBEE Owned Company".

> "Voting Right"
means a voting right attached to an Equity Instrument owned by or held for a participant measured using the Flow-Through Principle or the Control Principle;

> "Exercisable Voting Right"
means a voting right of a Participant that is not subject to any limit;

> "Economic Interest"
means a claim against an Entity representing a return on ownership of the Entity similar in nature to a dividend right, measured using the Flow-Through Principle and, where applicable, the Modified Flow-Through Principle;

The collective term of the above is Rights of Ownership and effectively has an Interest Date which Schedule 1 defines as:

> "Rights of Ownership"
is a collective term for the right to "Economic Interest" and the right to "Exercisable Voting Rights";

> "Current Equity Interest Date"
means the later occurring of the date of commencement of statement 100 and the date upon which the transaction undertaken by an organisation to achieve 'Black' Rights of Ownership became effective and unconditional;

Most Ownership transactions link to finance. There are various funding solutions to an Ownership transaction, and thus organisations should engage with legal and/or auditing third party representation to facilitate the transaction. References to these definitions appearing in Schedule 1 address the financial arrangements and possible restrictions as well as "Third Party Rights", which need consideration:

> "Acquisition Debt" means the debts of:
(a) 'Black' Participants incurred in financing the purchase of their equity instruments in an organisation; and
(b) Juristic persons or trusts found in the chain of ownership between the eventual 'Black' Participants and an organisation for the same purpose as that in (a);

> "Third Party Rights"
means third party legal or commercial rights that restrict, withhold or defer any benefit associated with ownership of any Equity Instrument. Third-party rights include only those rights:
(a) created against a 'Black' Participant to secure, for a lender, repayment of a loan advanced to that Participant for financing the purchase of their equity instrument in an organisation;
(b) held against a juristic person or trust in the chain of ownership between an organisation and the eventual 'Black' Participant for the same purpose mentioned in (a) above.

An Ownership transaction triggers debt referred to as acquisition debt, which may require "Third Party Rights" to facilitate a transaction.

The percentage of 'Black' Ownership held in an organisation is paramount to the scorecard. Schedule 1 defines the criteria that categorise 'Black' Ownership.

> "51% 'Black'-owned"
> means an Entity in which:
> (a) 'Black' People hold at least 51% of the exercisable voting rights as determined under Code series 100;
> (b) 'Black' People hold at least 51% of the economic interest as determined under Code series 100; and all the points for "Net Value" under statement 100 have been earned.

> "51% 'Black' Woman-owned"
> means an Entity in which:
> (a) 'Black' Women hold at least 51% of the exercisable voting rights as determined under Code series 100;
> (b) 'Black' Women hold at least 51% of the economic interest as determined under Code series 100; and all the points for "Net Value" under statement 100 have been earned.

> "30% 'Black' Woman-owned"
> means an Entity in which:
> (a) 'Black' Women hold at least 30% of the exercisable voting rights as determined under Code series 100;
> (b) 'Black' Women hold at least 30% of the economic interest as determined under Code series 100; and all the points for Net Value under statement 100 have been earned.

In summary, by applying the above definitions, a "B-BBEE Owned Company" is a juristic person, having shareholding or similar members interest, that is a "B-BBEE Controlled Company". Therefore, participants enjoy a right to "Exercisable Voting Rights" with at least 51% being in the hands of 'Black' Participants, who enjoy a right to "Economic Interest" in at least 51% of the total rights measured using the Flow-Through Principle. Closing the calculation cycle is the "Net Value" calculation.

> "Net Value"
> means the percentage resulting from the formula in Annexe 100(C) of statement 100.

The "Net Value" application and calculation completes the ownership calculation cycle and is the most critical aspect of the Ownership Scorecard. The reason is that "Net Value" is the outcome of effective true Ownership by 'Black' People in an organisation. To simplify the concept, when one purchases a house financed through a bank, one does not own the house. In effect, the bank owns the house until the "loan" is paid, with the bank having a right to repossess the home if contractual obligations are not met.

A similar concept is applied when purchasing shares in a business. The share effectively carries the "Voting Right" and "Economic Interest". The "Net Value" is a calculation that reveals how many shares each 'Black' Participant effectively owns against the liability or debt associated with the share. One might have purchased 20% shares in a business; however, only settled 50% of the debt outstanding on shares. Therefore, by settling half of the debt, one would own 50% of the shares. This means the "Net Value" is 50% of 20% in this example, equaling to 10%. "Net Value", therefore, puts a value on an asset that is owned outright versus one where one may have a liability. It determines 'true', 'outright' or, in financial terms, 'unencumbered shares'.

How does one determine the value of a business?

As "Net Value" determines the value of an organisation, every share held by a business carries a value. For example, let's consider the historical case of OK Bazaars. Following its demise between 1970 and 1997, it eventually sold for R1, thus illustrating that any operational business has value regardless. Even if an organisation is not operational, the business could hold assets that carry value, including the name of a company or shelf company. Therefore, when entering into an Ownership transaction, one needs to consider the value of a business. Thus, one cannot state that a business has no value, especially when entering into a share transaction. Therefore, one would pose the question: "how much would I want for my business if I were to sell it?" Well, some multiple methodologies and formulae calculate the current value of a business irrespective of its status.

Schedule 1 refers to the following definition for valuation purposes:

> "Standard Valuation"
> means a standard valuation method for an asset, an Economic Interest, or any other instrument or right relevant to measurement under statement 100, using normal valuation methods that represent standard market practice.

Government Gazette #31255 issued on 18th July 2008, known as the Verification Manual of that year, refers to sections 7.11 and 7.12.

When determining the "Standard Valuation" of an Asset, "Economic Interest" or any other instrument or right relevant to the measurement of "Net Value" under statement 100 of the Codes, normal valuation methods must apply. It represents the market practice a B-BBEE Rating Agency must use to inspect a valuation to determine reasonability, which may include taking the following into account:

> Professional competence and objectivity of the evaluator;
> The source data reference;
> Assumptions, which means the fair value of assets that is reasonable relative to the age and depreciation of the assets and the method used;
> Confirmation that all liabilities factor in any replacement assets in the calculation. It includes the results of the evaluator in terms of the B-BBEE Rating Agency's knowledge of the business; and
> Document evidence that supports all steps taken to assess the valuation's reasonability.

Section 9.2.5 confirms that the method to obtain or perform a valuation must be in line with the "Standard Valuation" methodology as set out in the Codes, which includes but is not limited to:

Discounted Cash Flow applies when reasonable forecasts are available. Inspect the valuation for reasonability, which may include evaluating:

> Professional competence and objectivity of the evaluator;
> The source data reference;
> Assumptions, which means the fair value of assets is reasonable relative to their age and depreciation as well as the method used;
> The methodology applied; and
> The outcome of the valuation considering the B-BBEE Rating Agency's knowledge of the business.

"... when adding other Ownership mechanisms to the pot, like Sale of Assets, Private Equity Funds and Share Options with Preferred Share Options, the Ownership Scorecard becomes all the more daunting."

Price-Earnings Multiple applies when a business is profitable and is showing sustainable earnings. Inspect the valuation for reasonability, which may include evaluating the following:

> Professional competence of the evaluator;
> The objectivity of the evaluator;
> Source data reference;
> Assumptions, ensuring that the Price Earnings Multiple is reasonable and relative to equivalent listed businesses or a sector average.
> The methodology applied; and
> The outcome of the valuation considering the B-BBEE Rating Agency's knowledge of the business.

Net Asset Value of the business applies to a business in a capital-intensive sector or one that is making a loss. Inspect the valuation for reasonability, which may include evaluating:

> Professional competence and objectivity of the evaluator;
> Source data reference;
> Assumptions, ensuring that the fair value of assets is reasonable and relative to their age and depreciation;
> The methodology applied;
> Confirmation that all liabilities and replacement assets factor in the calculation; and
> The outcome of the valuation considering the B-BBEE Rating Agency's knowledge of the business.

It is essential to note that the valuation methodology is not limited to the three items mentioned above. It may include a combination of methods or formulae to gauge a business's overall value, which becomes the basis of an agreement between parties. Documentation of the valuation methodology must feature in both the Memorandum of Incorporation (MoI) of a Shareholders Agreement and a Sales of Shares Agreement. Evidence which shows how the value of the business was derived must be available to 'Black' Participants. Such an agreement would encompass any "Third-party Rights" that may directly impact the outcome of effective "Voting Rights" or "Economic Interest", which directly link to the definition "B-BBEE Owned Company". The valuation methodology will consequently determine the "Net Value" of a 'Black' Participant; the calculation is the Deemed Net Value. In short, the formula would consider the value of the shares held by a 'Black' Participant and the debt associated with equity interest held over an organisation's total value.

The Deemed Net Value result is applied to one of two formulae to calculate the "Net Value". The lesser outcome of the two formulae translates into "Net Value" points that a B-BBEE Rating Agency awards on an Ownership Scorecard.

The "Net Value" calculation is complex. To alleviate the risk of misinterpretation, an organisation should ensure that the calculation is accurate according to the requirements of the Ownership Scorecard. The consequence of an inaccurate interpretation may reduce an organisation's overall Status Level and associated Preferential Procurement Recognition. Furthermore, any oversight may constitute Fronting Practice that carries penalties.

The definitions held in 'Schedule 1' that guide Ownership apply in several forms. Each is provided for in the legislation, whether through direct shareholding held by Participants, organisations or trusts that house schemes like an employee and broad-based ones, Share Option Agreements or in the Sale of Assets. Each avenue has its own set of rules – with two vital common denominators being the correct application and interpretation thereof.

www.bbbee@msctbee.co.za