BEE share-purchase deals:
South Africa's biggest corporate fraud

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Vendor companies have been misrepresenting BEE share-purchase schemes to clients.

Black economic empowerment (BEE) share-purchase schemes are the biggest untold corporate fraud in 20 years of democracy in South Africa.

Vendor companies deliberately misrepresent these schemes as discounts to unsuspecting potential BEE participants, who lack the financial aptitude to understand the prospectus. Worse, BEE shareholding is deliberately overstated. This is fraud, because a company's BEE shareholding meets a legal requirement, promotes the vendor company and provides opportunities for new business, in particular state and parastatal business.

The innovation behind the structuring of these deals is commendable. The innovation allows black people to purchase substantial numbers of shares that they could not otherwise afford. Equally, the misrepresentation of how much these deals really translate to black ownership must be condemned.

A typical BEE share-purchase scheme would allow participants to buy shares of a vendor company with a small cash contribution. The remainder will be debt financed, either by the vendor company or a financial institution. Dividend flows of the shareholding are used to pay the debt. Over time, the debt increases with interest and decreases with dividend flows. At the end of the lock-in period, which is usually 10 years, if the share price is higher than the debt, the BEE partner sells sufficient shares to pay the remainder of the debt – or else walks away.

Thus, a BEE share-purchase scheme is a European call option of a special kind. A European call option is a financial contract that gives the buyer the right – not an obligation – to buy an agreed amount of a particular commodity or stock from the seller of the option at a future date (expiry date) for a predetermined price (strike price).

The small cash contribution paid by BEE participants is the cost of the option, not a discount. The lock-in period represents the expiry date of the option and the debt amount is the strike price. The difference between a BEE share-purchase scheme and a typical European call option is that the strike price of the former is not constant – it rises with interest rates and falls with dividend flows.

In essence, before the option is exercised, BEE partners own nothing but an option to buy the underlying stock at a future date. What seems to be a consolation prize for BEE partners is the voting right and board representation.

It can be argued that this is a deliberate move by vendor companies to cloud the fact that BEE partners actually have no ownership. Inversely, this could be enough of a carrot for those who will be appointed as board members and executives representing the BEE vehicle to keep quiet.

Graeme West and Lydia West make an interesting observation in their paper, "The pricing of Black Economic Empowerment share purchase schemes" (*Treasury Management International*, 2009):

> When the vendor company wishes to trumpet the successful creation of a BEE structure, it announces that such-and-such a percentage of the company is now held by black partners. On the other hand, if it is being pressured about a grant which some parties – such as the financial press – view as too generous, then it will brazenly retort that the partner owns precisely nothing until such time as the debt has been paid down.

To put this into perspective, consider a R5 billion BEE transaction in a company that has a market capitalisation of R100 billion. To say this transaction constitutes BEE shareholding of 5 percent is obviously not true. As we have said, these transactions are call options. The writer of the option (the seller) is obviously the owner of the underlying asset. In most BEE share-purchase schemes, the vendor company and financial institutions are the funders of the transaction, in effect making them the owners of the underlying assets until the option is exercised. At best, the shareholding of a BEE partner is equivalent to the sum total of the small cash contributions of individual BEE participants, assuming that there are no transaction costs.

Reading the prospectus of these schemes provides for great amusement. The prospectus of one of the celebrated BEE transactions accepts that the scheme is a call option, but says a call-option methodology was not used to calculate the fair value of the offer to prospective BEE partners. In other words, the fair value of the offer in the prospectus is unreliable and doesn't reflect market value because the market uses call-option methodologies, such as the Black-Scholes formula, to price call options. More amusing is the fact that two of the three co-funders of this particular BEE transaction are also co-debt arrangers. You need not be a rocket scientist to figure out that the inaccuracy in the calculation of the fair value of the option will almost always prejudice BEE partners.

The recent listing of BEE shares on the JSE has put this scandal into overdrive. For instance, information on one of these reads as follows: "Due to the fact that the trading platform is not a licensed exchange as contemplated in the [Financial Markets] Act, the anti-insider trading and prohibited practices provisions and the prohibitions against publication of false and misleading statements provided for in sections 78 to 81 of the… Act do not apply to the trading platform." Thus, those who buy these BEE shares are in effect exposed to all aforementioned risks with no recourse.

Moreover, it is an exotic option – the strike-price (debt) follows a path over the life of the option – that is traded, not the underlying asset. Any investment professional would tell you about the complex mathematical methodology used to price exotic options. Go to any of the four big banks' online trading platforms – prospective traders are warned about the risk of trading options. Prospective traders are advised to consult professionals or study through online derivatives courses.

This is not the case with listed BEE share schemes. Black people are left to trade among themselves with no knowledge of the fair value of the product they sell or buy, let alone the ability to comprehend the risk involved. This kind of trading can only be described as pure speculation.

Without the knowledge of the amount of debt, the dividend forecast of the underlying asset, the implied volatility or the volatility of the underlying asset, an interest rate forecast and the price of the underlying asset, it is impossible to know or calculate the fair value of the listed BEE share scheme. This information is unavailable.

BEE share-purchase schemes are a big corporate fraud that has hit democratic South Africa. These schemes are worse than "BEE fronting". BEE share-purchase schemes are always oversubscribed, possibly because of misrepresentation of their fair value. The BEE shareholding is always overstated. As a result, the vendor company derives material benefit in the form of meeting a legal requirement and accessing business opportunities with the state.

A market-wide review of these deals by the relevant state institutions is required. A proper adjustment of black ownership derived from these deals is required. Subsequently, some form of penalty must be imposed on the transgressors.