ANYTHING BUT CHARITY

FIXING THE ILLS OF BEE SHARE PURCHASE SCHEMES

By Linda Nobaza

A closer look at BEE share purchase deals shows that companies hold all the cards


Linda Nobaza takes a closer look at BEE share purchase schemes.

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The racial dimension of South Africa's grinding economic inequality is a ticking time bomb. The country's social and political stability and, by extension, its sustainable development hinges on the success of the broad-based black economic empowerment (BBBEE) policy. It cannot be allowed to fail: without economic redress, the clock will continue to tick closer to the detonation point.

I have previously characterised BEE share purchase schemes as corporate fraud (Nobaza 2014). Some clarification and solutions are now needed to rescue the policy from its quagmire. In this article, I propose an amendment to further strengthen the amended BBBEE codes of good practice and a hybrid form of call option agreement. I also counter the misconception that these schemes are equivalent to charity.

TRUE VALUE

People often assume that the size of a BEE share purchase scheme transaction is the same as the net value of black shareholding it represents. In fact, *the* *net value is equivalent to the size of the transaction less the debt*. Some business leaders deliberately take advantage of this confusion, especially at the stage of initial public offerings (IPOs). Companies wrongfully overstate black shareholding and misrepresent the small cash contributions paid by BEE participants as "discounts" (West and West 2009; Nobaza 2014). These deals are structured such that black people, who otherwise could not afford to, can buy a substantial number of shares with a small cash contribution. This is not a discount. BEE share purchase schemes are, in fact, call options, and the BEE participants' cash contribution covers the cost of the call option and transaction costs. They remain in debt for the remainder, a debt that is either financed by the vendor company itself or a financial institution.

Unfortunately, the BBBEE legislation is ambiguous about how companies must calculate the net value of black shareholding, stating only that "a standard valuation method" must be used. This has muddied the ground for accountability. For example, the prospectus of a celebrated BEE transaction accepts that the scheme is "call option", but says that call option methodology was not used to calculate the fair value of the offer to prospective BEE partners. That being the case, the real net value of black shareholding in this scheme is anyone's guess. If this ambiguity is left open, the misinformation will continue.

To fix this confusion and apparent wrongdoing, the BBBEE Codes of Good Practice (South Africa 2013) needs to be more specific. Section 3.13.4, which addresses options and share warrants, could be amended as follows: "the value of the instrument must be determined by using a *financial option* standard valuation method for calculating the net value". This amendment would ensure that suitably qualified practitioners, trained in financial mathematics or quantitative finance, would lead such valuation. Most importantly, it would ensure that the product would be labelled and communicated correctly when sold to BEE participants, and that its fair value reflected the market sentiment.

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FINANCIAL OPTION STRUCTURING

Black people must begin to assess and quantify their risk in order to formulate an optimum strategy to maximise their returns. The dramatic drop of Sasol's share price and the bankruptcy of African Bank offer opportunities to rethink how they enter into BEE share purchase schemes.

BEE participants seem to apply little due diligence when entering these deals, relying instead on advice given by consultants who are paid by the vendor company. This is naïve, because their interests are not the same as those of the vendor company. A vendor company enters into a scheme to optimise its BEE shareholding in order to maximise its profits. The long lock-in periods associated with these schemes serve the interest of a vendor company by guaranteeing a minimum black shareholding over that period.

BEE participants must start to act like business investors, not charity recipients, and also enter into these deals to maximise their returns and minimise their risk. They need to hire their own consultants to conduct an independent valuation and offer advice, and to negotiate a deal structure that will optimise their position without necessarily undermining the objectives of the vendor company.

The contractual position of a BEE partner in a BEE share purchase scheme could be optimised by combining the features of "Barrier" and "Bermudan" call options. "Barrier Options are option contracts whose payoff depends on whether or not the price of the underlying asset crosses a certain level during the option's lifetime. Bermudan Options… offer the holder multiple exercise dates over the option's lifetime" (Trade Forecast 2015). A hybrid Barrier/Bermudan structuring of a BEE share purchase scheme would enable both parties to agree on certain features to yield a win-win deal. BEE participants could exercise their option before expiry, provided that the share price of the underlying asset reached a predetermined level agreed upon by both parties. In this situation, a vendor company would want to set the price threshold high enough to maximise its black shareholding. A BEE partner would want to set it low enough to exercise its option as soon as the option is in the money. The art of negotiation must prevail on both sides in order to reach a mutually beneficial situation. Unfortunately, BEE participants seem happy just to be a part of these deals.

Take, for instance, the Sasol Inzalo transaction. The upward trajectory of the Sasol share price created value for Sasol Inzalo investors until recently, when it was dramatically reduced on the back of falling international crude oil prices. If a Barrier/Bermudan hybrid structure had been used, Sasol Inzalo investors would have exercised their option when the share price hit its all-time high of

R645. They would have paid their debt – which must have been under R350 per share by then – and been left with substantial debt-free shareholding.

Predicting the direction of a share price is like predicting the direction of a drunkard, but this missed opportunity may prove very costly for Sasol Inzalo investors. It is possible that the Sasol share price will continue to fall and wipe out the remaining value of Sasol Inzalo investors. The reverse is also possible but, as the English idiom says, a bird in the hand is worth two in the bush. Or consider African Bank. Its fall wiped out the value of BEE shareholders overnight and left BEE partners poorer, despite the fact that the bank had performed exceptionally well in previous years. These consequences can be avoided in future BEE share purchase schemes if BEE participants become active in structuring the deals, seek independent advice, and hedge their position against downturns.

NO CHARITY

When I criticised BEE share purchase schemes as "the biggest corporate fraud in South Africa", the general response was that the issues I raise can be ignored because these schemes are only charity anyway. In fact, they are anything but.

The idea of charity seems to emanate from two features that are inherent to call options and found in many BEE share purchase schemes:

- in the event that the value of the underlying asset plummets, eroding the value of the BEE partner, and the partner consequently can longer honour debt payments, the partner walks away with no obligation to pay the outstanding debt;
- the BEE partner enjoys legal ownership of the shares during the debt period, despite the fact that, in reality, the partner owns a call option.

These features do not reduce the status of BEE share purchase schemes to charity. In the first place, every call option owner in the market today is protected from the downside of the underlying asset. If its value nosedives, the option owner loses no

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more than the initial cash paid.

Second, where the vendor provides financing, there is no real money changing hands except for the initial cash contribution paid by the BEE partner. The vendor gets a cash injection, perhaps to fund its own expansion, while the BEE partner receives only voting rights. By now the cynicism of vendor financing must be clear to the reader. For the duration of the debt period, dividend flows from the BEE partner's shares are paid to the company to service the debt. The same company decides when and how much dividend to pay out. If the deal goes "underwater" because the dividend flows are not sufficient to service the debt, the company takes its shares back. There is no doubt that the BEE participants are the biggest losers when this occurs.

Thirdly, when a financing institution is involved to purchase the equity, it typically buys an asset-backed bond just like a housing bond. Unlike a housing bond, where the bond issuer (the house buyer) enjoys all the privileges that come with owning the house, the BEE partner only enjoys the shareholder's right to vote. Again, dividend flows are wholly paid to the financing institution to service the debt for the remainder of the debt period. The BEE partner has absolutely no discretion in the use of dividend flows.

Lastly, in recent years, most companies have used BEE share purchase schemes to partly fund their expansion plans. Particularly for companies that still want to comply with BEE policy, this may very well turn out to be an optimal form to finance corporate expansions. However, it increases the risk for BEE partners. The BEE value depends on the appreciation of share value – but astute managers will only use equity finance to fund expansions when they believe that the firm is overvalued by the market.

Thus the idea that these schemes are equivalent to charity is misleading: both parties are exposed to risk that is proportional to each party's respective benefit. In fact, the risk borne by the BEE partner is greater than that of an ordinary call option buyer because of the extraordinarily long interval before a BEE partner can exercise the call option.

In a vendor-financing setup – where it is practically arbitraging the deal – the company is a sure winner. Even the minor detail of expensing the option in its books can be priced-in as zero sum by the market. Clearly, this is a glorified fronting scheme. There is no real money changing hands. Insofar as dividend flows are concerned, the value of the BEE partner depends on decisions made by the vendor. When dividend flows are not enough to pay the debt, the vendor takes back its shares and re-balances its books, while BEE partners lose their initial investment. NA

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