

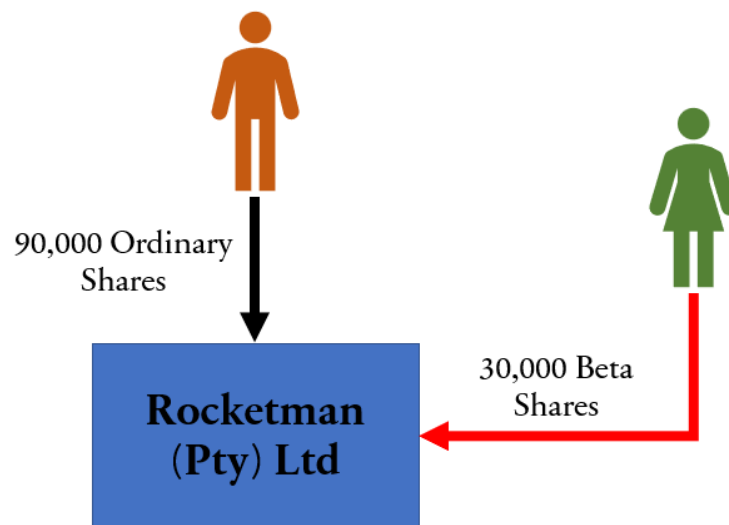
# The Cost of B-BBEE Schemes

Unique to South Africa, the topic of Broad-Based Black Economic Empowerment (“B-BBEE”) is incredibly involved. Based on “righting the wrongs” of the socio-political past, B-BBEE schemes allow previously disadvantaged individuals to actively take part in the economy, often where there are substantial (financial) barriers to entry.

What, however, is the financial cost of implementing a B-BBEE scheme, and how is this measured? To answer these especially important questions, we first need to understand the Valuation and Accounting implications of the said B-BBEE schemes. Because each of these aspects are rather complicated, let us explore these with the use of an example:

Rocketman (Pty) Ltd is a small, manufacturing company operating in South Africa. The sole shareholder of Rocketman is Mr John, and he is eager to improve the BEE (Black Economic Empowerment) Rating of his company. After exploring various ways of doing this, he has identified Mrs Elton as being an ideal black strategic equity partner. Over a coffee in Sandton City, Mr John and Mrs Elton have agreed the following:

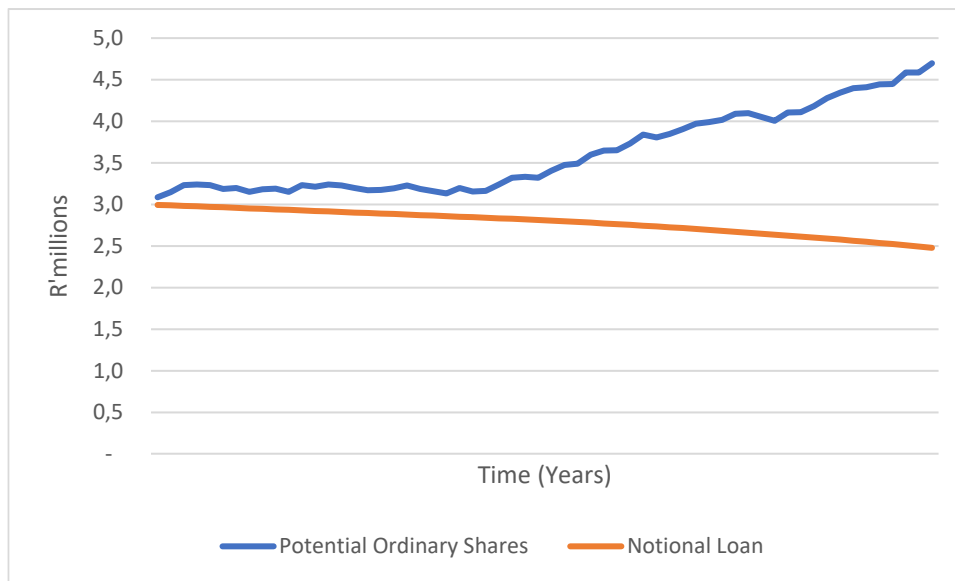
- 90,000 Ordinary Shares have already been issued by Rocketman (all to Mr John) and a further 30,000 Ordinary Shares will be earmarked for Mrs Elton. This will bring the total issued share capital to 120,000 Ordinary Shares, of which Mr John and Mrs Elton will own 75% and 25%, respectively.
- The Ordinary Shares of Rocketman (i.e., the “Equity Value”) were recently valued at R9 million by an independent expert. The Value per Ordinary Share (Share Price) of Rocketman is therefore R100.00.
- Mr John and Mrs Elton agree that, on a pro-rata basis, the Fair Value of the new earmarked 30,000 Ordinary Shares, fully paid-up, should be R3 million.
- As Mrs Elton does not have access to liquid funds of R3 million, she and Mr John agree on a Notional Vendor Funding (“NVF”) arrangement which will last 5 years.
- The Notional Loan (of R3 million) will carry a Notional Interest Rate of 4% per annum.
- During the 5 years of the NVF, Mrs Elton will be entitled to a Trickle Dividend equal to 10% of the Dividends paid on an Ordinary Share.



Before we continue, let us consider some of the items above:

1. The 30,000 Ordinary Shares have been earmarked for Mrs Elton and are therefore Potential Ordinary Shares. Only at the end of the 5 Years will these Potential Ordinary Shares be converted into actual Ordinary Shares. We will run through the mechanics of this shortly.
2. The 5-Year period (in this example) is often referred to as the “BEE Lock-In Period”. During this time, there are restrictions on what Mrs Elton and Mr John can do with the 30,000 Potential Ordinary Shares.
3. The Notional Loan is “in name” only and, unlike a traditional loan from a bank or funder, there has been no physical flow of cash. The 30,000 Potential Ordinary Shares and the Notional Loan are therefore intrinsically linked and cannot be separated. They combine to form a new share class (separate to the Ordinary Shares), which we will call “Beta Shares” in this example.
4. The Ordinary Shares and the Beta Shares are identical in terms of Voting Rights but differ in terms of Dividend Rights. So, although the Beta Shares are entitled to only 10% of Dividends paid on Ordinary Shares during the BEE Lock-in Period, Mrs Elton is still able to vote on 25% of all decisions of Rocketman.
5. The 90% Dividends “given up” by the Beta Shares are used to reduce the Notional Loan during the 5-Year Period. The effect of this is that Rocketman starts building up Cash Reserves against which Ordinary Shares will be issued (in terms of the contractual agreement, upon the conversion of the Beta Shares at the end of the 5-Year Period).
6. The Notional Interest (of 4% per annum) takes into consideration the Time Value of Money. On Day 1, the Notional Loan is R3 million but this will only be reduced over the subsequent 5 Years.
7. The 10% Trickle Dividends provide Mrs Elton with some liquidity during the 5 Years. Of course, it will then take longer for the Notional Loan to be reduced.

## The Benefit of Hindsight



Let us now fast-forward to the End of 5 Years, and the graph above shows what happened to each of the Potential Ordinary Shares and the Notional Loan. There are some interesting things to highlight:

1. Both starting with a value of R3 million on Day 1, respectively, the Potential Ordinary Shares and the Notional Loan then took quite different routes.
2. The 30,000 Potential Ordinary Shares grew to a value of R4.7 million at the End of Year 5, representing an annual growth rate (CAGR) of 9.4%. This excludes the additional benefit of any dividends that may have been paid during the 5 Years. (For the purposes of this example, we have deliberately ignored any Time-Based Graduation Factor considerations.)
3. The Notional Loan grew with Notional Interest but was also reduced by (90% of) Dividends Declared on the Potential Ordinary Shares over the 5 Years. The net effect is that the Notional Loan has a value of R2.5 million at the End of Year 5.
4. It is important to remember that the Potential Ordinary Shares and the Notional Loan are bundled together as a single Financial Instrument, i.e., the Beta Shares. So, at the End of Year 5, the Value of the Beta Shares is R2.2 million (R4.7 million less R2.5 million).
5. It can reasonably be assumed that the value of the original 90,000 Ordinary Shares grew at the same rate as the 30,000 Potential Ordinary Shares, i.e., CAGR of 9.4%. On this basis, the 90,000 Ordinary Shares will have a value of R14.1 million at the End of Year 5.

So, at the End of Year 5, the total Equity Value of Rocketman is therefore R16.3 million, made up of the 90,000 Ordinary Shares (valued at R14.1 million) and the 30,000 Beta Shares (valued at R2.2 million). This seems to be equal to a Share Price of R135.83.

Note, however, that this is a blended share price because there are still TWO share classes in existence, namely Ordinary Shares and Beta Shares. Moreover, because the Beta Shares are about to “disappear” (as they are converted into Ordinary Shares) we should tread carefully.

So how do we go about converting these 30,000 Beta Shares into a certain number of Ordinary Shares?

This is why it is important to distinguish between the Ordinary Shares and the Beta Shares. Specifically:

- The 90,000 Ordinary Shares have a Value of R14.1 million, and hence Share Price of R156.67.
- The 30,000 Beta Shares have a Value of R2.2 million, and hence Share Price of R73.33.

Viewed from a different angle, 30,000 Beta Shares (each valued at R73,33) have the same value as 14,043 Ordinary Shares (each valued at R156.67). As such 30,000 Beta Shares will be converted into 14,043 Ordinary Shares and issued to Mrs Elton.

With the benefit of hindsight, it is now easy to see the impact of the B-BBEE Scheme at the End of 5 Years:

1. There are now a total of 104,043 Ordinary Shares issued by Rocketman, of which Mrs Elton owns 13.5%.
2. With a total Equity Value of R16.3 million, the Share Price of Rocketman is now R156.67. There are no longer any Beta Shares in existence (having all been converted into Ordinary Shares), and so this remains the Ordinary Share Price.

In reality, however, the Value of the Beta Shares would not only be calculated at the End of Year 5 but would have arisen when they were first issued to Mrs Elton (i.e., on Day 1). Accounting rules are also strict in this regard, and shares must be fairly valued on the day they are issued.

So, then, without the benefit of hindsight, how does one go about calculating this Value?

### **Valuation of the Beta Shares**

If we return to our example, there are at once two glaring weaknesses that we need to address:

1. The Value of the Beta Shares (R2.2 million) is a Future Value at the End of Year 5. We will therefore need to consider some Present Valuation technique to determine the Present Value of the Cost on Day 1.
2. With the benefit of hindsight, we followed the exact pathways of the Potential Ordinary Shares and the Notional Loan, respectively. We will therefore need to apply some forecasting technique that simulates a multitude of pathways. To help us with this, consider the following 10 Scenarios on the next page:

Scenario	Value of Potential Ordinary Shares	Notional Loan Balance	Value of Beta Shares
	R'millions	R'millions	R'millions
1	4,7	2,5	2,2
2	3,0	3,2	-
3	2,4	3,3	-
4	6,1	1,8	4,3
5	4,2	2,7	1,5
6	3,5	3,6	-
7	3,8	3,1	0,7
8	4,5	2,7	1,8
9	4,8	3,1	1,7
10	2,7	4,2	-
<b>Average</b>	<b>4,0</b>	<b>3,0</b>	<b>1,2</b>

Scenario 1 is, of course, the “Perfect Hindsight” Scenario and the actual pathway that the Potential Ordinary Shares and the Notional Loan ultimately followed. Using statistical forecasting methods, such as Geometric Brownian Motion, we are able, on Day 1, to simulate possible Scenarios of where the values of the Potential Ordinary Shares and the Notional Loan may land at the End of Year 5. We have, of course, only simulated 10 Scenarios in our Example, while, in reality, we may well consider 100,000 Scenarios using modelling techniques.


You will see that there are certain scenarios (i.e., Scenarios 2, 3 and 10) in which the Notional Loan Balance exceeds the Value of Potential Ordinary Shares. This simply means that, in each of these scenarios, the Beta Shares have no economic value to Mrs Elton. Because the Notional Loan is “in name” only, and its only recourse is to the Value of the Ordinary Potential Shares, there are no further obligations on Mrs Elton to make up the shortfall and thus results in her shares being ‘underwater’.

The Value of the Beta Shares, being the Average Value of the 10 Scenarios at the End of Year 5, is R1.2 million. As highlighted, however, this is a Future Value. If we therefore assume some arbitrary discount rate (say, of 8% per annum), the Present Value of the Beta Shares (i.e., on Day 1) will be R0.9 million.

### What is the B-BBEE Cost?

The B-BBEE Cost will be the difference between this Present Value (R0.9 million) and the Consideration paid for the Beta Shares. If the Consideration is zero, as in our example, then the B-BBEE Cost will be R0.9 million.

Let us consider what practically happened on Day 1. The total Equity Value of Rocketman was initially R9 million, and it went up momentarily by R0.9 million (being the value of the newly issued Beta Shares).



Instantaneously, there was a reduction in value of R0.9 million (reflected by the B-BBEE Cost), and so the total Equity Value of Rocketman remains at R9 million.

From an Accounting perspective, the B-BBEE Cost (of R0.9 million) will be recognised as an Expense in the Income Statement. Whether this Expense is recognised immediately on Day 1, or gradually over the BEE Lock-in Period, depends on the specific circumstances of the B-BBEE Scheme.

### **Bringing it All Together**

Continuing with our Example, based on our best estimates on Day 1, we therefore expect the following to happen (at the End of Year 5):

- The Value of the 30,000 Potential Ordinary Shares will increase (from an initial value of R3 million) to R4 million (in the table above), representing an annual growth rate of 5.9%;
- The Value of the 90,000 Ordinary Shares will increase (at the same annual growth rate of 5.9%) to R12 million, with an Ordinary Share Price of R133.33;
- The Value of the 30,000 Beta Shares will be R1.2 million;
- The total Equity Value of Rocketman will therefore be R13.2 million, comprised of 90,000 Ordinary Shares (valued at R12 million) and 30,000 Beta Shares (valued at R1.2 million);
- After the conversion of 30,000 Beta Shares into 9,002 Ordinary Shares, the Share Price of Rocketman (with a total number of 99,002 Ordinary Shares in issue) will be R133.33;
- Mrs Elton will hold 9,002 (9.1%) of the 99,002 Ordinary Shares; and
- An Expense of R0.9 million, being the B-BBEE Cost, will be recognised in the Income Statement of Rocketman.

It would be quite easy to now conclude and relegate this discussion to the realms of complex valuations. We should therefore step back and understand, commercially, what all this means.

For Mrs Elton, the implementation of this B-BBEE Scheme allows her to vote on 25% of all decisions of Rocketman over the subsequent 5 years. At the end of the 5 years, Mrs Elton is then expected to remain a 9.1% shareholder in Rocketman. Financially, this arrangement is highly beneficial to Mrs Elton, as, at no point, will she incur any capital outlay. Moreover, throughout the 5 years, she will actually receive some liquid income (through the Trickle Dividends).

And, of course, let us not forget the notorious B-BBEE Cost of R0.9 million; the subject of this article and which seems to attract so much negative attention in the media.

## To Implement or Not to Implement

In closing, instead of focussing on the B-BBEE Cost, let us rather consider the cost of **not** implementing the B-BBEE Scheme.

Suppose that, in an alternate scenario, Mr John does **not** implement the B-BBEE Scheme. His 90,000 Ordinary Shares grow to a value of only R10.5 million (Share Price of R116.67) after 5 years.

For a Cost of R0.9 million, as we have seen, Mr John's Ordinary Shares instead grew to a value of R12 million (Share Price of R133.33), being a total upside benefit of R1.5 million. With some clever work in Excel, this turns out to be a fairly decent IRR of around 11%.

If we view the B-BBEE Scheme in this way, should we not rather replace the words "B-BBEE Cost", which has connotations of wastage and value reduction, with "B-BBEE Investment"? There are undoubtedly a handful of accounting rules that will justify an "Expense" over an "Asset", and the intention is certainly not to challenge the IFRS status quo.

Regardless, from an Economics perspective, therefore, instead of us focussing on the "Cost of B-BBEE Schemes" we should rather reframe our point of view to the "Benefit of B-BBEE Schemes".