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ID#090417

PUBLISHED ON MARCH 1, 2010

Makalani Growing a South African Mezzanine Fund

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ABSTRACT

South African government policies called Black Economic Empowerment (BEE) provided incentives for the sale of equity interests in companies to black owners. Makalani, a mezzanine fund which provided financing exclusively for BEE transactions, had successfully completed its first two years of operation and considered several different possibilities for growth.

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Acknowledgements

The Eugene Lang M. Center for An earlier version of this case was prepared by Michael Costa, SIPA/MBA'07, Richard de Wet, MBA '08, Jennifer Fitzgerald, JD '08, Andrea Hauge, MBA '08 and Nnena Nkongh, MBA '08 under the supervision of Professors Murray Low and Paul E. Tierney, Jr. Mika Bouvard provided additional research and writing support for this case. Richard De Wet, '09, MBA, assisted with case development and research for the revised case.

> The case was sponsored by the Goldman Sachs Foundation, the Chazen Institute, and the Columbia University Center for International Business Education and Research (CIBER). Special thanks to Professor Terrence Taylor, Gordon Institute of Business Science, Johannesburg.

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Introduction

It was getting late in Johannesburg. The conference call to Germany was taking longer than expected. The directors of DaimlerChrysler were slow to understand why the company's South African subsidiary wished to sell part of its stake in Sandown Motors, its largest single dealer network in South Africa. Mike Broome, CFO of Sandown Motors, explained that new South African government policies called Black Economic Empowerment (BEE) provided incentives for the sale of equity interests to black owners. "If we have 25% black ownership, we'll have a much easier time doing business with the government," explained Broome. "It will also bolster our image locally as a progressive company committed to social responsibility." Sandown had found a suitable buyer, a consortium of black partners called True Class that, even more importantly, had found a source of financing for the deal. Many would-be black acquirers had trouble securing financing for various reasons, including the lack of performance track records. True Class had approached a new mezzanine fund, Makalani, which provided financing exclusively for BEE transactions. Broome looked across the table at Vusi Mahlangu, Makalani's CEO, and gave him a weary shrug. "It will happen," Broome assured him, "but we just need to explain carefully why we're doing this."

The BEE transaction would be arranged by Makalani since often the social and economic conditions of postapartheid South Africa limited the amount of capital blacks had to purchase equity stakes independently. In this way, Makalani would advance its business model of a private-equity fund involved exclusively in third-party mezzanine empowerment financing.² As a vehicle for empowerment financing, Makalani would make sure that the investment would uphold BEE principles and thereby improve the fund's scorecard as a participant in promoting BEE objectives and upholding corporate social responsibility.

For his part, Mahlangu was not worried. Deals like this were hard for outsiders to understand. These transactions, and the BEE policies that catalyzed them, were born of the peculiar circumstances of postapartheid South Africa. Such deals took time, but they were usually successful. Indeed, Makalani's history proved this. Just 18 months after Makalani had been listed on the Johannesburg Stock Exchange, it had already financed 17 BEE transactions.

Mahlangu was feeling pretty good about his decision to leave his high-profile position at Investec, one of South Africa's premier investment banks, to run Makalani, a start-up. As the sun set and the conference call to Germany continued, Mahlangu's thoughts wandered to the future.

The Sandown Motors transaction promised to be the first of several new BEE deals for Makalani in 2007 and beyond. In a relatively short time, Makalani had built a reputation and made important connections. Could this Sandown Motors BEE transaction be the beginning of a new era for the

² Mezzanine financing is a hybrid of debt and equity financing that can be employed, for example, to finance the growth of existing companies or the acquisition of a company by means of a leveraged buyout.



¹ Interview with J-P Fourie, January 2009, Johannesburg.

mezzanine fund? Mahlangu had always weighed the options for the future structure of the fund as South African markets evolved. Should Makalani continue to invest exclusively in mezzanine debt of BEE transactions or expand by venturing into private equity, for example? He was concerned not only with obtaining favorable terms in the Sandown deal but also about whether leading Makalani to invest solely in BEE transactions would be a successful—and more importantly, sustainable—business strategy. Would favorable terms for BEE transactions expire, competition for BEE deals grow fierce, or financial investments in South Africa other than BEE companies present better returns? Mahlangu asked himself if Makalani's investment mandate would limit potential growth and returns of the fund, or even the growth of his very own career. What, Mahlangu wondered, did the future hold for Makalani?

South Africa: Background

South Africa was an emerging market country with abundant natural resources, modern infrastructure, and well-developed financial and legal systems. As of 2008 South Africa's population of 47 million accounted for only 6% of Africa's people but 50% of the continent's buying power. Nelson Mandela, leader of the African National Congress, assumed South Africa's presidency in 1994, after the first election in which the entire population of South Africa—including its majority black population—was eligible to vote. In June 1999 Thabo Mbeki succeeded Mandela as president in a smooth transition, proving that the country's postapartheid government was stable.

The government was committed to free trade, privatization, and the creation of a favorable investment climate. Its economic strategy from 1996 to 2000, called Growth, Employment, and Redistribution, had mixed success. While the strategy improved financial discipline and macroeconomic stability, it failed to deliver structural economic change. Efforts to increase employment and broaden economic participation among previously disadvantaged populations were less successful than anticipated. From 1994 to 2000 real GDP per capita rose at a disappointing average annual rate of 0.86%. While the broader economy grew by 3.1% between 2000 and 2006, overall poverty levels in South Africa did not decline significantly.³

Pervasive inequality between the white and the nonwhite populations carried negative implications for social stability and was a significant issue for the South African government. In 1996 blacks represented nearly 80% of the population (see Exhibit 1), but directed only about 40% of total

³ Average annual per capita real GDP growth is based on information obtained from the Economist Intelligence Unit.



income; by 2001 that percentage had not significantly increased.⁴ Against this backdrop, a new policy, Black Economic Empowerment (BEE), was conceived.

Black Economic Empowerment

In postapartheid South Africa, white South Africans still controlled much of the country's businesses. According to the government's statistics bureau, SSA, whites composed just under 10% of the population, which meant that the country's economy was controlled by a very small minority of the population.

Black Economic Empowerment (BEE) policies were designed to transform South Africa's distribution of wealth to make asset ownership more representative of the country's diverse population. The BEE Act of 2004 sought to increase black participation in the South African economic infrastructure (both directly and indirectly) through:

- Black ownership and control of enterprises and assets
- Higher levels of black senior management at firms
- Human resource development and employment equity for black people
- Indirect empowerment through:
 - o Preferential procurement policies, favoring suppliers who implemented BEE
 - o Enterprise development
 - Corporate social investment

Although BEE was not mandatory for private companies, the government considered a firm's BEE compliance when awarding state contracts, licenses, and concessions. Compliance is rated on a BEE scorecard⁵ (see Exhibit 2).

In 2002 the financial sector developed the Financial Sector Charter (FSC), a voluntary pledge to commit capital and other resources to implement BEE (see Exhibit 3). The FSC established targets and outlined processes for BEE implementation, monitoring, and results reporting. The targets set forth in the charter were to be applied from January 1, 2004, to December 21, 2014, but the concerned parties agreed that the principles outlined in the document were relevant in the longer term as well. In addition to the BEE guidelines outlined above, the FSC introduced the concept of empowerment financing, the provision of finance for or investment in BEE transactions and targeted investments for economic development and job creation. As previously mentioned, BEE transactions involve the transfer of equity interests in firms to blacks. Targeted investments are directed investments or credit extensions in agriculture, housing, infrastructure, and black-owned small and

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⁴ Murray Leibbrandt, Laura Poswell, Pranushka Naidoo, Matthew Welch, and Ingrid Woolard, "Measuring Recent Changes in South African Inequality and Poverty using 1996 and 2001 Census Data," *Working Paper 9629*, Development Policy Research Unit, University of Cape Town, 2007.

⁵ The generic BEE scorecard is used to rate firms in sectors that have not implemented their own specific charters and scorecards.

medium-sized enterprises (SMEs). Financial institutions gain points on the FSC scorecard for their involvement in such transactions. These ratings are audited annually and used to qualify firms for government tenders and other state business, giving rated companies a comparative advantage over their BEE-noncompliant peers. The FSC committed South African financial institutions to provide R123.5 billion for empowerment financing: R50 billion for BEE transactions and R73.5 billion for targeted investments.

BEE transactions could be structured in many different ways. In a typical transaction, an empowerment company (defined as one that is at least 25% black-owned) acquired shares in the target company for cash, often at a discount, and, in some cases, using third-party financing (see Exhibit 4). In such a transaction, the target company received points on the BEE scorecard for transferring equity stakes to black owners, and the financier received points for financing a BEE transaction.

The cost of completing a BEE transaction could be high. According to James Formby of Rand Merchant Bank, "the cost to companies, mainly as share price discounts or financial guarantees, is equivalent to roughly three percent of their stock market value for the first ten percent of ownership that is transferred to new black owners." However, government incentives for BEE compliance were valuable enough for firms to absorb the costs of BEE transactions. Accordingly, the market saw an increased number of these transactions. This, combined with the FSC's allocated R123.5 billion for empowerment financing, suggested long-term vitality in the BEE transaction pipeline.

Origins of Makalani

By 2004 several of these black-owned investment firms, known as BEE partners or empowerment companies, had formed. However, without a fundamental change in the regulatory regime for nonbank institutional investors, there was a structural mismatch between the supply of capital and the demand for it.

Institutional investors' inability to invest directly in unlisted equity and subinvestment grade debt limited the pool of available funds for BEE transactions (see Exhibit 5). Early in 2004 Leon von Moltke, a senior corporate finance executive at Rand Merchant Bank (RMB), one of South Africa's largest investment banks, was exploring alternatives that would reduce its capital base and boost shareholder returns. von Moltke realized that it might be possible to link institutional investors to the BEE transaction market and earn returns on RMB's own capital by establishing an outside fund. If RMB could create an independent fund to act as an intermediary for financial institutions—particularly the institutional investors operating under a restrictive regulatory regime—RMB could

⁷ Roger Southall, "Ten Propositions about Black Economic Empowerment in South Africa," *Review of African Political Economy*, 34, no. 111 (2007).



⁶ The Economist, December 19, 2006.

unlock a large pool of capital and tap into a lucrative deal pipeline (see Exhibit 6). RMB management considered that a mezzanine fund might be the appropriate vehicle for its entry into empowerment financing. At that time, the mezzanine debt market in South Africa was practically nonexistent.

Since no funds of the type that RMB envisioned existed in South Africa, basic questions such as how to structure the fund had no market precedent. What was clear, however, was that to attract institutional investors the fund would need to be publicly listed and have an investment-grade credit rating.

Determining the size of the fund's initial public offering (IPO) involved both pragmatic concerns and market analysis. At that time in South Africa, mezzanine finance was not clearly identifiable or explicitly measured as a distinct subsector of bank lending. RMB believed that the fund could initially invest R5 billion, but raising this sum from the markets would be challenging. Successfully deploying a smaller, initial round of capital would facilitate subsequent raising of capital to the targeted R5 billion level. A second structural consideration was that in order for investing institutions to receive BEE points for their investment, the new fund had to qualify as a black-empowered business and be managed by black executives.

Launch of Makalani

Mahlangu had made quick progress since graduating from Harvard with an MBA in 1998. Several years after joining Investec Bank, he was tapped to start up and run their public finance group. After six successful years at Investec, Mahlangu was looking for a new challenge. In 2004 Mahlangu was discussing this with Sydney Mhlarhi, a long-time friend who was then a director and joint head of the acquisition finance group at Standard Bank. The two men had similar backgrounds and had both developed significant experience and excellent reputations within South Africa's tightly knit corporate finance community. The two also shared a desire to strike out on their own as entrepreneurs. "We were at the point professionally where we needed to take on some new risks and find some new challenges. Vusi and I were like-minded and so it made sense that we should start a business together," Mhlarhi recalled.⁸

Their timing seemed auspicious; BEE and the FSC had set the stage for sweeping changes, which both men saw as an opportunity. Involvement in BEE transactions had already made black entrepreneurs wealthy. By 2004 many major firms were actively looking for black-empowered or black-owned firms to purchase an ownership stake in their organizations in compliance with BEE.

⁹ One of the criticisms of early BEE equity ownership transfer transactions is that they benefited a relatively small number of well-placed and well-connected black individuals rather than the broader population of historically disadvantaged peoples or black South Africans. For example, in 2004, seven empowerment companies accounted for 80% of BEE transactions. *Source*: Interview with Chia-Chao Wu.



⁸ Interview with J-P Fourie, January 2009, Johannesburg.

Firms were willing to finance these transactions themselves or to issue discounted shares for purchase by the black partners. Thus, the black firms could acquire sizeable minority stakes, often at a discount, in some of South Africa's largest and most profitable firms. ¹⁰ It made sense for Mahlangu and Mhlarhi to leave their banking jobs and start up their own empowerment company (see Exhibit 7), but they needed additional equity investors—such as banks, insurance firms, or other financial institutions—with access to significant amounts of capital. Over several months, the two held exploratory talks with several potential partners, but without success. There were significant barriers to entering the market as an empowerment company, especially for two young professionals in their early thirties. "We realized that the potential partners were probably looking for someone who had a few more gray hairs on their head," Mahlangu commented. "Sydney has two or three gray hairs, but I'm not sure that was enough for them!"11

Late in 2004 Mahlangu and Mhlarhi met with von Moltke at RMB. As they pitched their idea to him, he appeared attentive and intrigued. While he was not convinced about the empowerment company opportunity for RMB, he believed Mahlangu and Mhlarhi might be the right team to run the empowerment financing fund RMB wanted to form, and he offered them that opportunity.

Establishing their own empowerment company would give Mahlangu and Mhlarhi entrepreneurial freedom and had the potential to provide large financial gains. However, the two were concerned that they did not yet have the experience, public stature, and political connections that had been critical to the success of the first empowerment companies. 12 RMB's proposal offered them outstanding brand recognition, with possible future investment financing. Still, it seemed risky, since no funds or investment companies were specifically devoted to providing third-party mezzanine empowerment financing. There were also no independent mezzanine funds in South Africa and little mezzanine lending by South African banks. Would there be enough demand for mezzanine debt? Would empowerment financing be a large enough market?

Mahlangu and Mhlarhi considered their options.

Mezzanine Fund

Makalani sought to launch a successful venture in empowerment financing by means of a mezzanine fund. Since mezzanine financing is debt capital (typically, in the form of an unsecured or subordinated note), often combined with rights to an ownership or equity interest in a company (e.g., preferred stock), the mezzanine tranche of debt is often subordinate to debt from senior lenders such as banks; thus, mezzanine debt is frequently referred to as subordinated debt.

¹² First movers in the BEE space were men such as Tokyo Sexwale and Cyril Ramaphosa, prominent politicians turned businessmen.



Small firms are exempt from BEE.
 Interview with J-P Fourie, January 2009, Johannesburg.

This hybrid debt structure on a firm's balance sheet is treated like equity and consequently frees up capital to enable firms to obtain more conventional bank financing. The distinct, seamless blend of debt and equity in mezzanine finance provides flexibility in the risk and return profiles for both issuers and investors, and in the structure of transactions, that cannot be found with straight debt or straight equity finance.

Mezzanine debt is usually not collateralized and includes a repayment schedule. Due to the elevated risk involved in this form of debt financing, and the associated higher rates of return (companies that invest in mezzanine debt often seek returns of 20% or higher¹³), venture capital and alternative lending firms—such as Makalani—that focus solely on mezzanine deals are the most common providers of mezzanine financing.

The position of mezzanine debt in a firm's capital structure is senior only to common shares with respect to a potential claim on a firm's assets (see Exhibit 8). Accordingly, mezzanine debt can be a more expensive source of finance for a firm than senior debt. The higher cost of capital associated with mezzanine debt reflects the more elevated level of risk associated with the financial product.

Mezzanine financing is unsecured and junior to other obligations; in other words, should there be a credit event such as a default, the mezzanine debt holders will be repaid only after all senior obligations have been repaid in full. Thus, investors of mezzanine debt will require a higher rate of return on their investment to compensate for the increased risk that they incur in comparison to an investment in secured or more senior debt. Firms that seek mezzanine financing typically have a proven track record in the industry, an established product, demonstration of profitability (minimally at a break-even level), and a viable business plan (e.g., growth through acquisition or increased market penetration) that mezzanine finance could help realize.

Equity Finance

Other potential alternatives to mezzanine finance for a firm seeking to raise capital could include (though are not limited to) senior debt and private equity or common equity; however, the business implications and financial impact between the three alternatives—mezzanine finance, senior debt, and equity finance—vary. Senior debt, as already mentioned, will be repaid in full, with priority, and lies higher in the capital structure with relatively less risk than either mezzanine or equity finance. Thus (reflecting the risk premium needed to compensate the investor), senior debt is the least costly of the three means of financing, and equity is the most expensive, with mezzanine finance lying between the two. Equity financing, in contrast to debt, results in more dilution of existing equity holders and may obligate owners to relinquish some control as well, thus rendering this option less attractive at times to companies seeking to raise capital.

¹³ Minority Business Development Agency, U.S. Department of Commerce, http://www.mbda.gov



Within the realm of equity finance, private equity entails a firm issuing stocks that are not listed or quoted on a stock exchange. Stocks issued for common or public equity, on the other hand, are quoted on an exchange and, in general, information on the company's operations and financials is available to the public by law. Private equity firms finance investments with the goal of selling a company for profit through an acquisition, a buyout, or an initial public offering, within a short- to medium-term time horizon. Companies that have decided to pursue the private (rather than the common) equity route are not under the intense scrutiny of governmental regulatory bodies, Wall Street analysts, or in particular, shareholders, that companies pursuing the public equity route are. Private equity firms are in a sense liberated to pursue business on their own without the constraints faced by public companies. However, it is important to note that some private equity firms are at times scrutinized intensely by their investors, who can in turn limit the firm's activities and business pursuits.

Driven to act quickly, and motivated by the relatively short-term investment perspective in private equity, companies with private equity often exhibit volatile earnings that would be disruptive and potentially damaging to a company with public shares on the market. This volatility is more or less expected of private equity firms and, when combined with a short time in which to deliver positive results, often leads to investors in private equity demanding higher returns than investors in common equity, as compensation for taking elevated risks.

Common equity is exposed to the vagaries of the stock market exchanges in a way that private equity is not, and a firm's value may be tied to the market valuation of the company more closely. In the case of common equity, the realized performance of young companies will at times take precedence over future potential gains. Alternatively, the valuation of growing businesses under private equity may be driven more by how the company and its private equity investors see the future performance of those businesses and less on the losses and growing pains of earlier years. With more weight placed on the potential future earnings in the case of a private equity investment, an investor may require additional premiums for assuming the risk involved in investing in a volatile business with limited revenues initially and a promise of superior gains much later. Though common equity finance may be available at a discount to private equity, the risks associated with an investment in a company where information is readily accessible and public are less than in a company whose business information and financials are available to only a select few.

Overall, equity finance, either through private or public channels, stands at the lowest level of seniority in the capital structure and is thus associated with the highest cost of capital. Unlike debt, equity does not involve interest payments or a repayment schedule, and companies may at times choose not to issue any dividends (shares of corporate profits paid out to shareholders). In general, investors can lose their total investment without receiving any collateral, recovery claims, or additional payment to minimize any loss in an equity investment.



There are two basic types of equity a firm can issue to raise capital: preferred shares or common shares. Holders of both preferred and common shares own a fraction of the reference company, but their shareholder rights may vary. Common stock shareholders have voting and preemptive rights, giving them more control and participation in the firm's activities, while preferred stockholders may not have such rights. Instead, preferred stockholders may receive dividends (e.g., fixed dividends that, if not paid, accrue until payment can be made) and a higher or more senior claim to company assets in the case of a liquidation. Preferred shares are often known as preferred stock or preference shares. The Sandown Motors deal would the first BEE transaction for Makalani in 2007 as a mezzanine fund, with an investment proposition in preferred shares.

Growth of Makalani

By 2007 Mahlangu, Mhlarhi, and RMB had established the country's first listed vehicle for empowerment financing, Makalani Holdings Ltd. (see Exhibit 9). The company had a slow start in deploying its capital because of the underdeveloped mezzanine market. However, in its first two years as a public company, Makalani demonstrated significant growth in invested assets, yield on those assets, and shareholder distributions, and successfully executed 21 transactions (see Exhibits 10 and 11 and Appendix 1).

This was no time, however, for Mahlangu and the Makalani team to rest on their laurels. Investors and other market participants would soon start looking for indicators of Makalani's future direction. On a broad level, the economic outlook for South Africa was favorable and boded well for Makalani's future growth. Annual GDP growth was projected to remain above 4% over the next few years. Along with foreign investment, domestic investment in South Africa was expected to keep growing, driven in part by increased government spending on infrastructure. The Johannesburg Stock Exchange had performed well over the past several years (see Exhibit 12), and corporate M&A activity was brisk. The private-equity markets had been increasingly active in the recent past, and observers were cautiously optimistic about volume growth in the near future. However, competition was increasing. All of the major banks in South Africa—chief among them Standard Bank, Nedbank, Absa and Investec—were involved in financing BEE transactions, as BEE had become an important driver of domestic M&A activity.

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Additionally, tight spreads relative to benchmark levels in the South African credit markets suggested that more banks and other financial institutions were chasing returns in new business areas, including the mezzanine debt market. Since Makalani's initial listing in May 2005, two other mezzanine funds had been created. In November 2005 Mezzanine Partners raised South Africa's first closed-end mezzanine fund of R300 million. Although the fund was not exclusively focused on BEE deals, a fair

¹⁵ Ernst & Young Mergers & Acquisitions: A Review of Activity for the Year 2006.



¹⁴ Interview with J-P Fourie, January 2009, Johannesburg.

share of its portfolio would be devoted to BEE. Vantage Risk Capital formed the second competitor mezzanine fund in April 2006. Like Mezzanine Partners, Vantage Risk Capital, an R1 billion fund, also invested in BEE deals, but not exclusively. Increasingly, development finance institutions were getting involved in BEE deals. The International Finance Corporation (IFC), the World Bank's private sector arm, had provided R173 million for a BEE deal and had others in its active pipeline. In addition, the Industrial Development Corporation, South Africa's state development finance agency, was preparing to launch a R10 billion fund to finance BEE business opportunities.

Although the empowerment financing market was becoming more competitive, Mahlangu was confident that there were more deals to be made. Since 2002 there had been a steady rise in the annual volume of BEE transactions (see Exhibit 13). The BusinessMap Foundation, which tracks BEE deals in South Africa, estimated that—on the basis of the R278 billion worth of empowerment transactions executed since 1999—only about 6% of the JSE market capitalization had been transferred to black ownership. More than half of the South African business owners polled in a 2007 business outlook survey foresaw a BEE-related change in ownership within their businesses in the next ten years. According to investment officers at the IFC's South Africa office, the market expected to see an increased number of BEE transactions as new sector charters were adopted and existing BEE companies consolidated their holdings.

Sandown Motors BEE Transaction

Mahlangu reflected on the Sandown Motors deal and Makalani's business proposition as he sifted through the large pile of deal documents that his lawyers had prepared for his review. As was typical of a BEE transaction, Sandown would sell an equity stake of 40% to True Class, a consortium of black investors, by issuing new equity at a discount. True Class would qualify as a black-owned and black-controlled enterprise, where black persons own 50.1% of the equity, management is predominantly black, and board control, if not already 40% black, must be so within 10 years. Additionally, when 50%+1 vote vests in the hands of black people and there is full management control, the company is considered a black-controlled enterprise.

This strategic financial transaction would redistribute the ownership of Sandown Motors by decreasing ownership of DaimlerChrysler South Africa and Sandown Managing Director Roy McAllister in order to include True Class, the BEE group. The introduction of black ownership, through the inclusion of True Class, would help qualify Sandown Motors as a black-empowered

¹⁸ International Finance Corporation (IFC) officers Anne C. Hawkins, principal investment officer, financial markets, Africa Department; Reuben Warirah, investment officer, global financial markets department; and Madalitso Ben Makhela, investment analyst, global financial markets department met with Makalani representatives on January 16, 2008.



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¹⁶ The R278 billion figure includes both debt and equity values of the transactions.

¹⁷ Grant Thornton International Business Report 2007, Country Focus: South Africa.

enterprise or empowerment company, where at least 25.1% of the equity is owned by black persons and there is also substantial black management control (e.g., black persons are executive directors of the enterprise). This transformation of Sandown was intended to become a business advantage for all parties involved, in light of postapartheid South Africa's BEE movement and shift in economic competition.

The benefit of the transaction would be that the posttransaction Sandown Motors would be a black-empowered company. The new Sandown entity would not only symbolically reflect political and economic democracy in South Africa, with black participation in the economy, but would also enhance stakeholders' access to government funding and, on occasion, preferential treatment in business deals.

The Sandown transaction included discount pricing (of preferred shares) and special financing (with the engagement of Makalani) that were compatible with the pressure that stakeholders were often under to complete a BEE deal. (The usual process for non-BEE sales of equity stakes did not necessarily involve features such as discount pricing well below the current market price of equity, special financing, and strong government backing.) Ultimately, BEE deal participants sought to accomplish more than the completion of a business transaction. Other goals included advancing a moral imperative; improving corporate reputation and credibility; enlarging economic contacts to gain access to new markets and business opportunities; becoming eligible for preferential treatment by the government; remaining competitive; and growing a business profitably.

Strategic Alternatives

As Mahlangu pondered these factors over lunch at his favorite Johannesburg restaurant, The Grill House, he considered the most appropriate strategic direction for Makalani's growth beyond the Sandown Motors deal. One element of Makalani's growth strategy concerned the financial products it marketed. Although Makalani could invest in senior loans, convertible instruments, and equity, its main focus had been on mezzanine instruments in BEE transactions. Reflecting back, von Moltke remembered that "banks weren't really keen on lending in the mezzanine space. Markets were doing quite well so the banks were just doing traditional senior lending and secured lending." But since Makalani's May 2005 listing, the South African markets had changed; there were more players in the mezzanine space. Although there was no reliable data regarding the size of the South African mezzanine debt market or the market shares of the respective financiers, the financing of BEE transactions was split evenly among equity, senior debt, and mezzanine debt. The financing mix could therefore be used to approximate the size of the mezzanine debt market, given the levels of BEE transactions and general M&A activity in South Africa. Another proxy measure of the trends in and size of the South African mezzanine debt market was the distribution of bank assets, as reported



¹⁹ Interview with J-P Fourie, January 2009, Johannesburg.

to the South African Reserve Bank, in higher risk categories of loans and in redeemable preference shares, which are often used in mezzanine finance packages.

Although incomplete and imprecise, the data indicated a sizable and growing mezzanine debt market in South Africa. One strategy for Makalani would be to stay in this financing space and pursue a larger market share. However, as von Moltke observed, competition in this market would probably continue to grow in the near- to mid-term. The portfolio director for Capital for Development (a UK government-backed fund of funds investing in private equity in emerging markets), which committed R100 million to the Vantage Mezzanine Fund, commented:

The South African government's success in reducing inflation and interest rates has created a large potential for mezzanine financing...Although mezzanine is a relatively young asset class in South Africa, we believe that there are now excellent opportunities for mezzanine investment in South African mid-market companies.²⁰

As well as competing against the other newly established domestic mezzanine funds, Makalani would have to compete with nondomestic investors, who were increasingly aware of the attractive returns offered by South African corporate debt instruments. Despite increased competition, however, ultimately the enhanced profile of South African debt instruments and the profitability of lending in this segment suggested a positive long-term profile for this type of lending.

Alternatively, Makalani could make a push into the private-equity market (see Exhibit 14). Although returns were difficult to measure and compare, one study of private-equity funds in South Africa found that the average aggregate gross internal rate of return (IRR) since inception was 34.8%, a performance premium of 18% per annum relative to listed South African equities. These returns had attracted new BEE firms to private equity (see Exhibit 15). It was also predicted that global firms would move into the South African private-equity space. According to John van Wyk, a South African—based partner of Actis,

South Africa is now very much registered on the radar screens of large private-equity firms. Even the few big firms that have yet to enter the market have declared an interest. David Rubenstein of Carlyle is reported to have called Africa a 'sleeping giant in terms of private equity.'22

²² Chloe Hayward, "Private Equity: Bain and Actis Hunt Big Game in Africa," *Euromoney*, April 2007.



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²⁰ Capital for Development, press release, "CDC Backs South Africa's First Independent Mezzanine Fund," press release, March 30, 1997,

http://www.cdcgroup.com/files/PressRelease/UploadPDF/Media%20release%20-

^{%20}CDC%20commits%20R100m%20to%20Vantage%20Mezzanine%20Fund%20_2_.pdf.

²¹ I. Missankov, R. van Dyk, A. van Biljon, M. Hayes, and W. van der Veen, "Is Private Equity a Suitable Investment for South African Pension Funds?" (paper, the Convention of the Actuarial Society of South Africa, October 2006)

Although the private-equity market opportunity was tempting, Mahlangu worried about whether Makalani could compete with an increasing number of local players as well as more established global firms such as Bain Capital and Actis.

Mahlangu cleared his table, laid out the financial information for the BEE transaction, and picked up the two deal term sheets (see Appendices 2 and 3). He rubbed his forehead as he recalled the lengthy round-table negotiations Makalani had had with True Class and Sandown in order to draft the term sheets. The term sheets they had prepared together were the official contracts for Makalani's first BEE transaction in 2007. The first term sheet (see Appendix 2) was an agreement between Makalani and True Class, with details of the terms of Makalani's financing of True Class's purchase of an interest in Sandown Motors. The second term sheet (see Appendix 3) was the contract between True Class and Sandown Motors, detailing True Class's purchase of shares in Sandown Motors. The proposed transactions illustrated the various risks and associated returns for each party. As he reviewed the term sheets, Mahlangu started to have some reservations about the potential returns on Makalani's investment in this BEE transaction. Was the 13% per annum interest rate for providing mezzanine finance to True Class sufficient to cover not only the costs but also the risks Makalani would be exposed to in this deal? Would he find the returns on the deal more attractive if Makalani ultimately invested directly in Sandown Motors without lending to True Class—which would in turn raise questions about the benefits of investing in BEE deals? Did the senior subordinated debentures provide the best return with respect to the risk taken in the investment? He wrote a reminder to himself in the corner of the page to further investigate Sandown Motors's growth rate and the rate of return on Makalani's investment; was 13% a good return?

Mahlangu carefully considered the detailed income statement (see Appendix 4), balance sheet information (see Appendix 5), and eash flow statement (see Appendix 6) that Sandown Motors had prepared. The BEE component of this deal was still compelling, but Mahlangu wondered whether it would continue to seem so upon closer examination of the historical and future financial performance of Sandown Motors. From a first glance at the financial statements, Mahlangu was pleased by the positive growth of net income levels of Sandown Motors combined with efforts to reduce costs. Sales figures appeared consistent and positive for the core business, and the overall future business seemed promising, with net income projected to more than double over the next year. As Mahlangu rapidly scanned Sandown's balance sheet, he noticed that Sandown had a reasonable ratio of assets to liabilities (with the company's assets considerably greater than its liabilities), combined with a sound debt to capital ratio. He made a mental note to check all the relevant financial ratios once he was back in his office, and then pulled out the cash flow statement. Mahlangu was pleasantly surprised that Sandown also had positive cash flows and was projected to continue a similar trajectory in the near future. He jotted down a reminder to check on Sandown's assumed future growth rate to help give him a better idea on how much of a return he could realistically expect from an investment made in the company.



As Mahlangu concluded his preliminary review of the financials, he felt that the numbers looked good but that he needed to delve further into the true story behind them. He observed that the 13% per annum interest rate might be problematic if the IRR of the investment was not appropriately adjusted for the risk taken. Was this transaction a solid example of mezzanine finance, or were the inherent risks more like that of an equity investment? Were the terms fair for all parties or did they favor some at the expense of others because the investment was a BEE deal? Moreover, the question as to whether the benefits of BEE transactions were truly worth the costs kept recurring in Mahlangu's mind as he considered the implications of this BEE transaction for the future of the Makalani fund itself.

When thinking about potential areas of growth, Mahlangu and his team had to consider Makalani's investment mandate, which was limited to the empowerment financing area. More specifically, its purpose was to make FSC-compliant investments in BEE control transactions and targeted investments. To grow, Makalani could stay within this investment mandate and simply pursue more and larger FSC-compliant investments. Mahlangu and his team believed that BEE deal flow would continue to be strong at least for the short and intermediate term—especially when they were starting the year with a BEE transaction like Sandown Motors. However, by staying within this narrow investment mandate, Makalani could miss out on important opportunities. Expanding Makalani's investment universe into general M&A, real estate development, and other transactions that did not necessarily accumulate FSC scorecard points could prove attractive. Together, these options gave rise to four alternative growth strategies:

Set of Financial Products

Investment	Narrower	Narrower Mezzanine finance for BEE deals	Broader Mezzanine finance + private equity for BEE deals
Mandate	Broader	Mezzanine finance for BEE and non-BEE deals	Mezzanine finance + private equity for BEE and non-BEE deals

In addition to considering the attractiveness of each strategy, Mahlangu and the Makalani team had to think about growth constraints. According to a 2007 survey, the lack of skilled workers was the most significant constraint on business expansion in South Africa. In addition to the shortage of black professionals faced by all South African businesses, investment funds faced specific challenges. In the private-equity sector, a significant component of compensation was based on carried interest or profit sharing in the fund's returns. In Makalani's case, profit sharing was based on the percentage of employee ownership in the management company. Since BEE partners owned 25% and RMB 75% of the Makalani management company, Mahlangu and his team were limited in their ability to compensate additional staff via a long-term incentive scheme.

²³ Grant Thornton International Business Report 2007, Country Focus: South Africa.



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Another critical constraint on Makalani's growth was its relationship with RMB. Since Makalani's founding, RMB had been intimately involved in all aspects of its operations. RMB had contributed a significant portion (R500 million) of Makalani's initial capital and even seeded Makalani's initial four investments. Two RMB professionals currently served on Makalani's board, and the RMB executive committee reviewed all potential investments of over R30 million. Makalani had its offices in RMB's building and received infrastructure and back-office support from RMB. Mahlangu knew that the formal relationship between RMB and Makalani had been an important indicator of confidence to outside investors in its IPO, but he wondered how the relationship should change as Makalani's business grew.

By 2007 Makalani had a track record as a successful public company and as a leader in the mezzanine empowerment finance segment. Its ability to source deals outside of the RMB network had improved, and the company hoped to rely on its reputation to attract new investors. Makalani had gained permission to increase its own leverage (and the commensurate returns to investors) by up to R750 million over the next year. In short, Mahlangu and his team had begun to think that increased entrepreneurial freedom from RMB might be in Makalani's best interest. In the long run, the team could envision the BEE partners owning a majority stake in the management company.

After choosing the best strategic option for growth, the next question to be addressed was size. At R2.1 billion in invested assets, Makalani was currently one of the smaller players in South African capital markets. If it was to move into private-equity or non-BEE deals, it would have to raise more funds. Mahlangu and Mhlarhi believed that growing Makalani to a R7–10 billion fund over three to five years was feasible, taking into account both the portfolio profile and the need to deploy returned capital and newly generated assets. But was this the right target for Makalani for each of the alternative growth strategies identified? Was it the right size if Makalani were to move beyond mezzanine finance or beyond BEE deals? What other structural options might support the company's future growth?

Mahlangu reminded himself to keep the overall future direction of Makalani in mind as he continued the Sandown Motors BEE deal negotiations again the next day. Was 13% per annum a sufficient return to compensate for the risks the fund would be undertaking, and was this BEE deal fair to all parties? He lined up the two term sheets in front of him and highlighted the following sections of the mezzanine financing term sheet to focus on: senior subordinated debt, interest rate, subordination, and use of proceeds. On the "Preference Shares and Warrants" term sheet, which documented the agreement between True Class and Sandown, he highlighted the following areas for further analysis: preference shares and warrants, dividends, ranking and liquidation preference, use of proceeds, negative covenants, and warrants. The additional financial information would provide a context to the term sheets and help Mahlangu make an informed decision with respect to his potential BEE investment. Mahlangu needed to be clear about his rights as an investor and the implications of those of True Class as shareholders of Sandown. He also had to determine if the rates of return on this BEE deal justified Makalani's financing of True Class and to ensure that he had fully evaluated the



associated risks. As Mahlangu collected the Sandown Motors BEE deal documents he wondered, in the Johannesburg twilight, whether this would be a new direction for Makalani.



Exhibit 1
South Africa: Population as of Mid-Year 2007

		% of Total
	Number ('000)	Population
African	38,079	79.6
Coloured	4,245	8.9
Asian/Indian	1,174	2.5
White	4,352	9.1
Total population	47,850	100

Source: Statistics South Africa, Mid-Year Population Estimates, 2007

Exhibit 2
The Generic BEE Scorecard

CORE		
COMPONENT	INDICATORS	SCORE
Direct empowers		
Equity ownership	% share of economic benefits	20%
Management	% black persons in executive	10%
	management and/or executive	
	board and board committees	
Human develop	nent & employment equity	score
Employment equity	Weighted employment equity	10%
	analysis	
Skills development	Skills development expenditure	20%
	as a proportion of total payroll	
Indirect empowe	erment score	
Preferential	Procurement from black-owned	20%
procurement	and -empowered enterprises as a	
	proportion of total procurement	
Enterprise	Investment in black-owned and	10%
development	-empowered enterprises as a	
	proportion of total assets	
Residual	To be determined by sector or	10%
	enterprise	
TOTAL SCORE		100%

Source: Economist Intelligence Unit

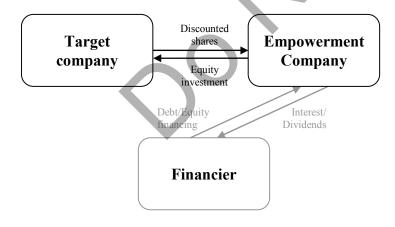
Financial Sector Charter (FSC) Scorecard

The FSC scorecard is divided into the following six main categories, each of which has been allocated the weighting below:

Charter component	Maximum Scorecard Points
Human resources development	20
Employment equity	15
Skills development	5
Procurement and enterprise development	15
Access to financial services	18
Empowerment financing	22
Targeted investments	17
BEE transaction financing	5
Ownership and control	22
Corporate social investment	3
Total	100

Exhibit 4

Typical BEE Transaction



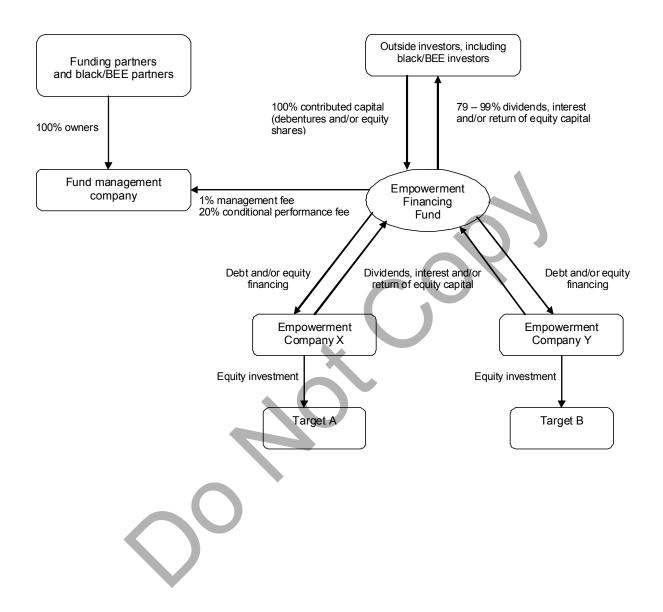
Glossary of BEE Terms

Term	Definition
BEE transactions	1) All transactions for the acquisition, by black people, of direct ownership in an existing or new entity in the financial or any other sector of the economy; and 2) joint ventures with, debt financing of, or other form of credit extension to, and equity investments in BEE companies.
BEE companies	Black companies, black-empowered companies, and black-influenced companies.
Black companies	Companies that are more than 50% owned and controlled by black people.
Black-empowered companies	Companies that are more than 25% owned by black people and where substantial participation in control is vested in black people.
Black-influenced companies	Companies that are more than 25% owned by black people and in which black people participate in the control of the company.
Black people	All Africans, Coloureds, and Indians who are South African citizens.
Empowerment financing	The provision of finance for or investment in: 1) BEE transactions and 2) targeted investments as set forth in the FSC.
Empowerment company	A black company that makes equity investments on its own account in non black companies seeking to comply with BEE. In BEE transactions, the empowerment company is often referred to as the BEE partner.
Targeted investments	Direct investments in or credit extensions for agriculture, housing, infrastructure, and black owned small and medium sized enterprises (SMEs). Investments should promote economic development and jobs creation.

Note: The government's statistics bureau, Statistics South Africa (SSA), uses the following racial categories: African, White, Coloured (people who possess some sub-Saharan African ancestry, but not enough to be considered African under South African law), and Indian/Asian. For purposes of BEE policies, however, Africans, Indians, and Coloureds who are South African citizens are considered "black people."



Empowerment Financing Fund Structure



Empowerment Company Structure

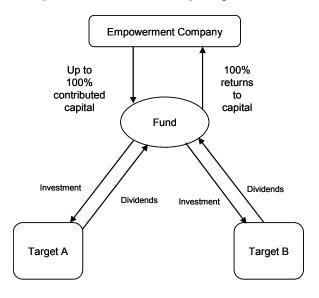
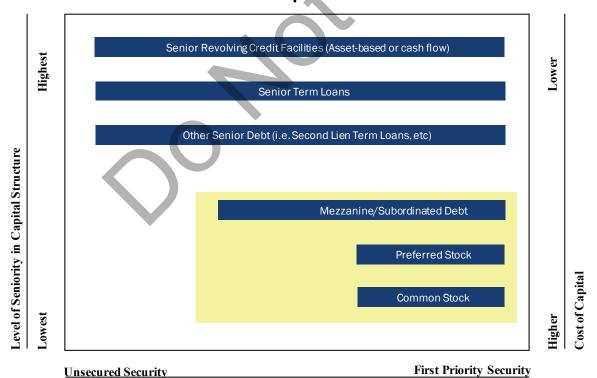
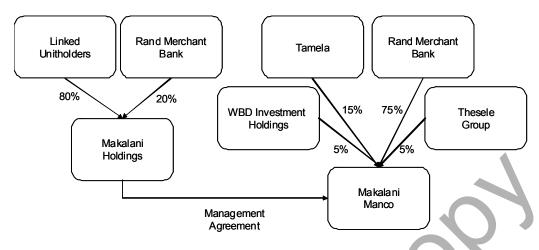


Exhibit 8
Financial Products within the Capital Structure



Source: Fidus Partners

Makalani Structure (Fund and Management Company)



Notes:

- Tamela is a black-owned company established by Vusi Mahlangu and Sydney Mhlarhi.
- WDB Investment Holdings is a broad-based woman-focused empowerment company.
- Thesele Group is a black-owned investment vehicle.
- Together these BEE partners hold a 25% interest in the Makalani Management Company (Manco), which qualifies the company as a black-empowered company.

Exhibit 10
Selected Performance Metrics of Makalani Holdings, Ltd.

	Fiscal Year Ended			
	2005 ^{/1}	2006	2007	
Invested assets	R522 million	R1,782 million	R2,113 million	
as a % of total capital	20.9%	71.3%	93.9% /2	
Number of investments	8	14	21	
Weighted average pre-tax yield on invested				
assets	13.8%	12.9%	15.2%	
Total linked unitholder distributions (R '000)	100.3	175	201.9	
Number of employees	4	5	6	

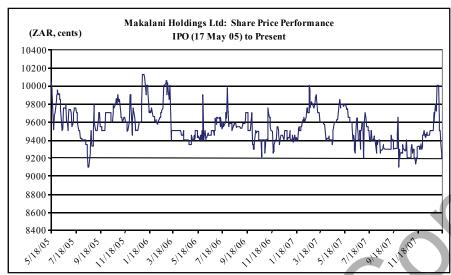
Notes:

Sources: Makalani Holdings Ltd. Annual Reports, Interim Reports, and Prospectus dated April 28, 2005

^{1/}Represents the 8-month period to December 31, 2005

²/ Based on total capital after the repurchase of 2,570,226 units for R250.7 million

Historic Share Price Performance of Makalani: May 17, 2005 to January 17, 2008



Note: ZAR = Zuidafrikaanse Rand (South African Rand)

Source: INET

Exhibit 12

Johannesburg Stock Exchange (JSE) Index, January 2002–2007



Source: Economist Intelligence Unit

BEE Transactions

	2000	2001	2002	2003	2004	2005	2006
Number of transactions	126	101	104	189	243	238	221
Total value (Rbn)	28	25.1	12.4	42.2	49.9	56.2	56
Change from previous year	-	-10.4%	-50.6%	240.3%	18.2%	12.6%	-0.4%

Notes: Rbn stands for Rand [billion]

Total value includes equity and debt

Source: Ernst & Young Mergers & Acquisitions: A review of Activity for the Year

Exhibit 14

Historic and Projected South African Private-Equity Market Activity

Projected South African Private-Equity Market Activity

	2006A	2007E	2008E	2009E	2010E	2011E	2012E
Investment Value (Rbn)	6.0	7.0	7.4	7.9	8.3	8.8	9.4
Total funds under management at year end (Rbn)	56.2	70.0	65.0	75.0	75.0	79.5	84.3

Note: Investment value represents only the equity component of announced South African private-equity deals (including the private-equity component of BEE transactions.

Sources: SAVCA KPMG Private Equity Surveys and author estimates.

Notes: Rbn stands for Rand [billion]

Investment value represents only the equity component of announced South African private-equity deals

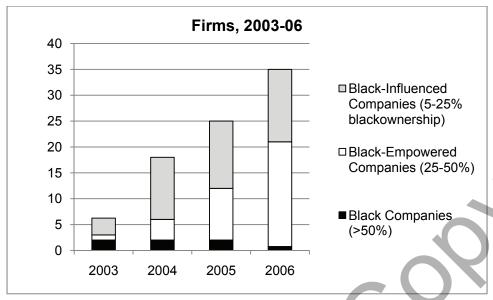
(including the private-equity component of BEE transactions)

Sources: SAVCA KPMG Private Equity Surveys and author estimates



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Exhibit 15
Private-Equity Funds Under Management by BEE



Source: Private Equity and Venture Capital in South Africa, 2007 Industry Review, SAVCA



Appendices

Appendix 1

The Sandown Motors Transaction

The Sandown Motors transaction was a typical and simple BEE control transaction financed by Makalani. The capital structure included multiple components, including senior and junior financing and vendor facilitation.

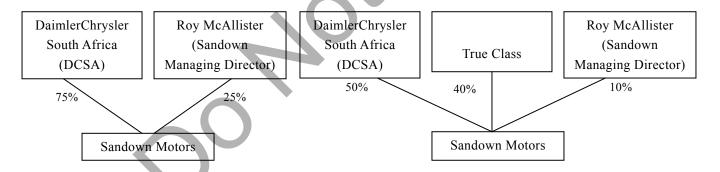
Sandown Motors, the owner and operator of several automobile dealerships under the DaimlerChrysler (Daimler) brand in South Africa, sought, with the support of its local Daimler affiliate, to acquire a BEE minority partner. It reached an agreement with True Class, an empowerment company comprising 172 members, to acquire a 40% equity interest in Sandown Motors.

The consultant responsible for the introduction of the BEE consortium recommended that Makalani facilitate the transaction because of Makalani's market reputation. With Makalani's valuation confirming the valuation by PriceWaterhouseCoopers, negotiations focused on the transaction structure and interest coverage of the preference shares to be issued to Makalani.

The transaction would change the structure of Sandown Motors as follows:

Pre-BEE Transaction Structure

Post-BEE Transaction Structure



The acquisition price for the 40% equity interest in Sandown Motors was R515 million, to be financed by a mix of funds:

Financier	Amount	Terms
Makalani Holdings Ltd.	R315MM*	 R165MM senior preference shares
_		 R150MM junior preference shares
DCSA Trust**	R65MM	No capital or interest payments for first five years
Sellers (DCSA and Roy	R135MM	Subordinated to Makalani loans
McAllister)***		

^{*}True Class borrowed R15MM from Makalani to pay transaction fees.

^{***}Seller participation included partially financing the purchase by True Class.



^{**} DCSA established a trust to facilitate BEE transactions within the South African dealer network.

As of January 2008 the BEE transaction had not yet affected Sandown Motors's bottom line, although Mike Broome thought that it would "ensure a healthy future for the company," with respect to social responsibility, facilitated business opportunities with the government, and preferential procurement.



Mezzanine Financing Term Sheet

Summary of Terms and Conditions

Issuer: True Class Motor Holdings Ltd. (the "Company," and together with all direct and indirect

subsidiaries and any parent holding company, the "Company Parties").

Investors: Makalani Mezzanine Holdings Ltd. and other holders of the Senior Subordinated Debt and

Warrants (as defined below) (collectively, the "Investors").

Senior R315, 000,000 principal amount of Senior Subordinated Debentures of Sandown Motor

Subordinated **Debt**:

Holdings ("Sandown" or "Borrower")

Debt.

Maturity Date: Eight years from the date of closing

Interest Rate: 13.0% per annum, compounded quarterly, payable quarterly in arrears, comprised of

(i) 10.0% per annum payable in cash and (ii) 3.0% per annum payable, at the option of the

Company, in cash or accrued as additional principal of Senior Subordinated Debt.

Interest Payments:

Ouarterly

Collateral: Makalani will hold a lien on the two classes of preferred stock held by True Class Motor

Holdings.

Subordination: The right to certain payments under the Senior Subordinated Debentures is subordinate to the

debt provided under the Senior Secured Credit Facilities provided by Makalani, as to be set

forth in a Subordination Agreement.

Investment Documents:

The transactions described herein would be evidenced by an investment agreement, containing terms of the Senior Subordinated Debt (based on an exhibit to the investment

agreement), a Subordination Agreement to evidence the preference of debt repayment, and other ancillary agreements, documents, opinions, certificates, schedules, and exhibits deemed necessary by the Investors for such transactions (collectively, the "Investment"

Documents").

Use of Proceeds:

The proceeds from the issuance of the Senior Subordinated Debt and the Warrants would be

used solely: (i) for acquisitions of a 40% stake in Sandown Motors as approved by the holders of the Senior Subordinated Debt; and (ii) to pay fees and expenses related to the

issuance of the Senior Subordinated Debt and the Warrants.

Mandatory

Matched to the redemption of the senior subordinated debentures of Sundown Motor

Redemption: Holdings.



Optional **Prepayment:**

The Senior Subordinated Debt may be redeemed at the option of the Parent, in whole or in part, upon not less than 45 days notice, at a prepayment price (the "Prepayment Price") equal to the initial purchase price of the Senior Subordinated Debt being redeemed, multiplied by the Prepayment Price Percentage shown below, in each case plus accrued but unpaid dividends on the Senior Subordinated Debt being redeemed. Notwithstanding the foregoing, in the event that the Company Parties desire to consummate an acquisition of another business but the holders of the Senior Subordinated Debt do not consent to or approve such acquisition, the Parent may elect to redeem the Notes in whole (and not in part) at a Prepayment Price having a Prepayment Price Percentage of 100%.

Date of Prepayment:	Prepayment Price Percentage:
From and after the issuance of the Senior Subordinated Debt through the first anniversary of the date of	105%
issuance of the Senior Subordinated Debt	
After the first anniversary of the date of issuance of the Senior Subordinated Debt through the second anniversary of the date of issuance	104%
After the second anniversary of the date of issuance of the Senior Subordinated Debt though the third anniversary of the date of issuance	103%
After the third anniversary of the date of issuance of the Senior Subordinated Debt though the fourth anniversary of the date of issuance	102%
Thereafter	100%

Conditions Precedent to Closing:

The purchase of the Senior Subordinated Debt would be subject to conditions customary for this type of financing and any additional conditions deemed appropriate by the Investors (currently contemplated to be total leverage, maximum leverage ratio, and minimum adjusted EBITDA, in each case defined as satisfactory to the Investors).

Affirmative Covenants:

The Investment Documents would contain affirmative covenants applicable to the Company Parties customary for this type of financing and any additional covenants deemed appropriate by the Investors, including without limitation: (i) delivery of consolidated and consolidating monthly, quarterly, and annual financial statements; (ii) annual delivery of consolidated and consolidating operating budget and cash flow projections, prepared on a quarterly basis; (iii) delivery of customary information; and (iv) maintenance of corporate existence, franchises, and properties; compliance with laws; payment of taxes; and other obligations, inspection rights, and maintenance of insurance, books, and records.

Negative Covenants:

The Investment Documents would contain negative covenants applicable to the Company Parties customary for this type of financing and any additional covenants deemed appropriate by the Investors, including without limitation: (i) restrictions on consolidation, merger, sale, or disposition of assets, and sale-leaseback transactions, including a prohibition on a change of control or sale of all or substantially all assets of the Company Parties; (ii) restrictions on indebtedness, including guaranties and the layering of indebtedness (subject to the ability of the Company to increase its working capital-secured facility by an amount to be agreed upon); (iii) restrictions on liens (negative pledge);



(iv) prohibition on joint ventures and acquisitions (except as specifically submitted to and approved by the holders of the Senior Subordinated Debt) and limitations on other investments; (v) restrictions on dividends, Prepayments, and distributions with respect to capital stock and Prepayments of subordinated debt; (vi) restrictions on transactions with affiliates; (vii) restrictions on changes in lines of business (including any change in the holding company status of the Parent); (viii) restrictions on amendments to debt documents and equity documents; and (ix) restrictions on other negative pledges, changes in accounting policies, and changes in fiscal year.

Debt Incurrence Test:

The Investment Documents would prohibit the incurrence of any indebtedness by the Parent and its subsidiaries if after such incurrence the ratio of Net Total Debt to LTM EBITDA (Net Total Debt to include all outstanding Senior Subordinated Debt, each term to be defined in a manner acceptable to the Investors) of the Parent and its subsidiaries on a consolidated basis would exceed 3.0x, provided, however, that on the second anniversary of the Closing Date, the maximum ratio of Net Total Debt to LTM EBITDA would decrease to 2.5x. Further, the Investment Documents would prohibit the incurrence of any indebtedness by any individual subsidiary if after such incurrence the ratio of Net Total Debt of the subsidiary to LTM EBITDA of the subsidiary would exceed 4.0x.

Senior Debt to EBITDA:

The ratio of Senior Debt to EBITDA as of the end of any fiscal quarter during the period set forth below shall not be greater than the ratio set forth opposite such period below:

January 31, 2007 through January 30, 2008	3.75:1.00
January 31, 2008 through January 30, 2009	3.25:1.00
January 31, 2009 through January 30, 2010	3.00:1.00
January 31, 2010 through January 30, 2011	2.50:1.00
January 31, 2011 through January 30, 2012	1.95:1.00
January 31, 2012 and thereafter	1.65:1.00

Funded Debt to EBITDA:

The ratio of Funded Debt to EBITDA as of the end of any fiscal quarter during the period set forth below shall not be greater than the ratio set forth opposite such period below:

January 31, 2007 through January 30, 2008	5.40:1.00
January 31, 2008 through January 30, 2009	4.50:1.00
January 31, 2009 through January 30, 2010	3.80:1.00
January 31, 2010 through January 30, 2011	3.25:1.00
January 31, 2011 through January 30, 2012	2.75:1.00
January 31, 2012 and thereafter	2.50:1.00



The Minimum Debt Service Coverage Ratio: Debt Service Coverage Ratio shall be defined as EBITDA less unfinanced capital expenditures, less dividends/distributions, less cash taxes accrued and paid, divided by the current portion of required principal payments on long debt plus interest made during the prior four quarters calculated on a rolling four quarter basis.

The Minimum Debt Service Coverage Ratio as of the end of any fiscal quarter during the period set forth below shall not be less than the ratio set forth opposite such period:

January 31, 2007 through January 30, 2008	1.15:1.00
January 31, 2008 and thereafter	1.10:1.00

Minimum EBITDA to Interest Expense:

The ratio of EBITDA to interest expense, determined on a rolling four quarter basis, for any period shall not be less than the ratio set forth below:

January 31, 2007 through January 30, 2008	2.50:1.00
January 31, 2008 through January 30, 2009	3.70:1.00
January 31, 2009 through January 30, 2010	3.25:1.00
January 31, 2010 through January 30, 2011	3.65:1.00
January 31, 2011 and thereafter	4.50:1.00

Events of Noncompliance:

Upon and during the continuance of any of the following events of noncompliance (each, an "Event of Noncompliance"), at the option of the holders of the Senior Subordinated Debt, the interest rate on the Senior Subordinated Debt would increase by 4.0% per annum and the Senior Subordinated Debt would be subject to mandatory Prepayment at the Prepayment Price upon: (i) the failure to declare or pay interest on the Senior Subordinated Debt in full when and as required to be paid; (ii) the failure to redeem or pay the Prepayment price of the Senior Subordinated Debt in full when and as required; (iii) commencement of bankruptcy, receivership, or similar proceedings; (iv) breach of the Investment Documents; and (v) payment default under the Subordinated Notes (the "Subordinated Notes") proposed to be purchased by the Investors simultaneously with the issuance of the Senior Subordinated Debt.

Warrants:

Warrants (the "Warrants") would be issued to the Investors at the time of issuance of the Senior Subordinated Debt to purchase equity of the Parent representing 6.0% of the equity ownership of the Parent (Sandown Motors), determined at such time on a fully diluted basis (after giving effect to the pro forma exercise of the Warrants, the Warrants issuable in connection with the Subordinated Notes, all existing management and employee equity compensation plans [as well as subsequent changes thereto], and all other outstanding common equity equivalents); provided that if total payments to the Investors in respect of the Senior Subordinated Debt and Warrants (including return of capital and all dividends and return on equity issued in respect of the Warrants) do not exceed 3.0x invested capital, then additional Warrants shall be issued so that the aggregate equity represented by the Warrants is 6.7%. The Warrants would be exercisable at any time, in whole or in part, by the holders thereof at an aggregate exercise price of \$0.01.



The holders of the Warrants would have the right to put all of such Warrants (or membership interests) to the Parent from and after the earliest to occur of: (i) Prepayment by the Parent of all of the Senior Subordinated Debt or any event requiring Prepayment by the Parent of any of the Senior Subordinated Debt, including on the maturity date; and (ii) an Event of Noncompliance. The Prepayment Price would be based on the fair market value of the Parent's entire equity interests, determined at the time of Prepayment without any discounts applied for factors such as minority interest or lack of liquidity.

Equity Rights:

The Investors would have equity rights with respect to the Warrants customary for this type of financing, including without limitation: (i) antidilution protection, (ii) preemptive rights; (iii) cosale rights, and (iv) demand and piggyback registration rights.

Board Observations Rights:

The Investors would be entitled to have two nonvoting representatives attend all board of director or managers' meetings (and all committees thereof subject to certain agreed-upon exceptions) of each of the Company Parties. All Investors would be entitled to receive copies of all materials prepared for such meetings from the Company Parties, and the Company Parties would reimburse the board observers for all reasonable expenses incurred in connection with attending such meetings.

Majority, subject to certain customary 100% voting issues **Voting:**

The Investors may assign and transfer the Senior Subordinated Debt and the Warrants to **Assignment:**

any of their affiliates or any other persons at their discretion.

2.0% of the aggregate principal amount of the Senior Subordinated Debt **Structure Fees:**

Expenses and **Indemnification:** The Company Parties would pay: (i) all reasonable out-of-pocket costs and expenses of the Investors (including the reasonable fees and disbursements of counsel and of the providers of third-party diligence reports) in connection with the preparation, execution, delivery, and administration of the Investment Documents and any amendment or waiver with respect thereto; and (ii) all reasonable out-of-pocket costs and expenses of the Investors and other Note and Warrant holders (including the reasonable fees and disbursements of counsel) in connection with the enforcement of any of the Investment Documents.

The Company Parties would indemnify the Investors and the other Note holders and hold them harmless against all claims, losses, liabilities, and expenses (including reasonable fees and disbursements of counsel) arising from or relating to the proposed issuance of the Senior Subordinated Debt and the Warrants and the other Transactions, except to the extent of such

indemnified party's gross negligence or willful misconduct.

Governing Law: South Africa



Preference Shares and Warrants

Summary of Terms and Conditions

Issuer: Sandown Motors Holdings Ltd. (the "Company," and together with all direct and

indirect subsidiaries and any parent holding company, the "Company Parties").

Investors: True Class Motor Holdings Ltd. and other holders of the Preference Shares and

Warrants (as defined below) (collectively, the "Investors").

Preference Shares and Warrants

Shares of Preference Shares, at a price per share to be determined, for an aggregate principal amount of R315,000,000 (the "Preference Shares"), consisting of R165,000,000 of Senior Preference Shares, and R150,000,000 of Junior Preference Shares and warrants to purchase common equity of the Company as set forth below in

"Warrants" (the "Warrants").

Dividends: 12.0% per annum, compounded quarterly, payable quarterly in arrears, comprised of:

(i) 10.0% per annum payable in cash; and (ii) 2.0% per annum payable, at the option of the Company, in cash or accrued as additional principal of Preference Shares at the

initial purchase per share of the Preference Shares

No dividends on any other capital stock of the Parent would be permitted to be paid in cash prior to the payment in cash of all accrued but unpaid dividends on the Preference Shares and the redemption of all shares of Preference Shares issued as

payment in kind of dividends accrued on the Preference Shares.

Ranking and Liquidation Preference:

In the event of any liquidation, dissolution, or winding up of the Parent, the holders of the Preference Shares would be entitled to a preferential cash payment equal to the aggregate purchase price of the Preference Shares (including all Preference Shares issued as payment in kind of dividends) plus any accrued but unpaid dividends on the Preference Shares. A change of control (to be defined as satisfactory to the Investors) or a sale of all or substantially all of the assets of the Parent and its subsidiaries would be deemed to be a liquidation of the Parent. Payment of such preferential amount to the holders of the Preference Shares would be prior and in preference to any distribution to holders of any other existing or subsequent series or class of capital stock of the Parent.

Investment Documents:

The transactions described herein would be evidenced by an investment agreement, containing terms of the Preference Shares (based on an exhibit to the investment agreement), a warrant agreement to evidence the issuance of the Warrants, and other ancillary agreements, documents, opinions, certificates, schedules, and exhibits deemed necessary by the Investors for such transactions (collectively, the "Investment Documents").



Use of Proceeds:

The proceeds from the issuance of the Preference Shares and the Warrants would be used solely: (i) for general corporate purposes, including working capital and acquisitions approved by the holders of the Preference Shares; and (ii) to pay fees and expenses related to the issuance of the Preference Shares and the Warrants.

Optional Redemption:

Data of Padamption

The Preference Shares may be redeemed at the option of the Parent, in whole or in part, upon not less than 45 days notice, at a redemption price (the "Redemption Price") equal to the initial purchase price of the Preference Shares being redeemed, multiplied by the Redemption Price Percentage shown below, in each case plus accrued but unpaid dividends on the Preference Shares being redeemed.

Notwithstanding the foregoing, in the event that the Company Parties desire to consummate an acquisition of another business but the holders of the Preference Shares do not consent to or approve such acquisition, the Parent may elect to redeem the Notes in whole (and not in part) at a Redemption Price having a Redemption Price Percentage of 100%.

Date of Redemption	Redemption Price Percentage
From and after the issuance of the Preference	103%
Shares through the first anniversary of the date of	
issuance of the Preference Shares	
After the first anniversary of the date of issuance	102%
of the Preference Shares through the second	
anniversary of the date of issuance of the	
Preference Shares	
After the second anniversary of the date of	101%
issuance of the Preference Shares though the third	
anniversary of the date of issuance of the	
Preference Shares	
Thereafter	100%

Conditions
Precedent to
Closing:

The purchase of the Preference Shares would be subject to conditions customary for this type of financing and any additional conditions deemed appropriate by the Investors (currently contemplated to be total leverage, maximum leverage ratio, and minimum adjusted EBITDA, in each case defined as satisfactory to the Investors).

Affirmative Covenants:

The Investment Documents would contain affirmative covenants applicable to the Company Parties customary for this type of financing and any additional covenants deemed appropriate by the Investors, including without limitation: (i) delivery of consolidated and consolidating monthly, quarterly, and annual financial statements; (ii) annual delivery of consolidated and consolidating operating budget and cash flow projections, prepared on a quarterly basis; (iii) delivery of customary information; and (iv) maintenance of corporate existence, franchise, and properties; compliance with laws; payment of taxes and other obligations; inspection rights; and maintenance of insurance, books, and records.



Negative Covenants:

The Investment Documents would contain negative covenants applicable to the Company Parties customary for this type of financing and any additional covenants deemed appropriate by the Investors, including without limitation: (i) restrictions on consolidation, merger, sale, or disposition of assets and sale-leaseback transactions, including a prohibition on a change of control or sale of all or substantially all assets of the Company Parties; (ii) restrictions on indebtedness, including guaranties and the layering of indebtedness (subject to the ability of the Company to increase its working capital-secured facility by an amount to be agreed upon); (iii) restrictions on liens (negative pledge); (iv) prohibition on joint ventures and acquisitions (except as specifically submitted to and approved by the holders of the Preference Shares) and limitations on other investments; (v) restrictions on dividends, redemptions, and distributions with respect to capital stock and redemptions and prepayments of subordinated debt; (vi) restrictions on transactions with affiliates; (vii) restrictions on changes in lines of business (including any change in the holding company status of the Parent); (viii) restrictions on amendments to debt documents and equity documents; and (ix) restrictions on other negative pledges, changes in accounting policies, and changes in fiscal year.

Protective Equity Provisions:

The Investment Documents would contain protective equity provisions customary for this type of financing and any additional protective equity provisions deemed appropriate by the Investor, including without limitation protections that the Parent would not, and would not permit any of its subsidiaries to, without first obtaining the written consent or approval of the holders of at least a majority of the outstanding Preference Shares, do any of the following: (i) amend the Parent's articles or certificate of incorporation or by-laws; (ii) create any series or class of stock ranking having preference or priority *pari passu* with or senior to the Preference Shares as to dividends or any other distributions or payments upon redemption, liquidation (including a change of control or sale of all or substantially all of the assets of the Parent and its subsidiaries), winding up, or dissolution; (iii) redeem or repurchase any capital stock, or pay dividends on any capital stock (other than with respect to the Preference Shares); and (iv) amend or alter any rights, preferences, or privileges of the Preference Shares.

Debt Incurrence Test:

The Investment Documents would prohibit the incurrence of any indebtedness by the Parent and its subsidiaries if after such incurrence the ratio of Net Total Debt to LTM EBITDA (Net Total Debt to include all outstanding Preference Shares, each term to be defined in a manner acceptable to the Investors) of the Parent and its subsidiaries on a consolidated basis would exceed 3.0x, provided, however, that on the second anniversary of the Closing Date, the maximum ratio of Net Total Debt to LTM EBITDA would decrease to 2.5x. Further, the Investment Documents would prohibit the incurrence of any indebtedness by any individual subsidiary if after such incurrence the ratio of Net Total Debt of the subsidiary to LTM EBITDA of the



subsidiary would exceed 4.0x.

Events of Noncompliance:

Upon and during the continuance of any of the following events of noncompliance (each, an "Event of Noncompliance"), at the option of the holders of the Preference Shares, the dividend rate on the Preference Shares would increase by 4.0% per annum and the Preference Shares would be subject to mandatory redemption at the Redemption Price upon: (i) the failure to declare or pay dividends on the Preference Shares in full when and as required to be paid; (ii) the failure to redeem or pay the redemption price of the Preference Shares in full when and as required; (iii) commencement of bankruptcy, receivership, or similar proceedings; (iv) breach of the Investment Documents.

Warrants:

Warrants (the "Warrants") would be issued to the Investors at the time of issuance of the Preference Shares to purchase equity of the Company representing 40.0%²⁴ of the equity ownership of the Company, determined at such time on a fully diluted basis (after giving effect to the pro forma exercise of the Warrants, the Warrants issuable in connection with the Senior and Junior Preference Shares, and all existing management and employee equity compensation plans (as well as subsequent changes thereto), and all other outstanding common equity equivalents). The Warrants would be exercisable at any time, in whole or in part, by the holders thereof at an aggregate exercise price of \$0.01.

The holders of the Warrants would have the right to put all of such Warrants (or membership interests) to the Company from and after the earliest to occur of: (i) redemption by the Company of all of the Preference Shares or any event requiring redemption by the Parent of any of the Preference Shares, including on the maturity date; and (ii) an Event of Noncompliance. The redemption price would be based on the fair market value of the Company's entire equity interests, determined at the time of redemption without any discounts applied for factors such as minority interest or lack of liquidity.

Equity Rights:

The Investors would have equity rights with respect to the Warrants customary for this type of financing, including without limitation: (i) antidilution protection; (ii) preemptive rights; (iii) cosale rights; and (iv) demand and piggyback registration rights.

Board Observations Rights:

The Investors would be entitled to have two nonvoting representatives attend all board of director or managers' meetings (and all committees thereof subject to certain agreed-upon exceptions) of each of the Company Parties. All Investors would be entitled to receive copies of all materials prepared for such meetings from the

²⁴ In this situation, assume the preferred converts into 34% of the common stock and the warrant "coverage" provides an option to purchase an additional 6%.



Company Parties, and the Company Parties would reimburse the board observers for all reasonable expenses incurred in connection with attending such meetings.

Voting: Minority, subject to certain customary 100% voting issues

Assignment: The Investors may assign and transfer the Preference Shares and the Warrants to any

of their affiliates or any other persons at their discretion.

Investors' Fees: 4.0% of the aggregate principal amount of the Preference Shares

Expenses and Indemnification:

The Company Parties would pay: (i) all reasonable out-of-pocket costs and expenses of the Investors (including the reasonable fees and disbursements of counsel and of the providers of third-party diligence reports) in connection with the preparation, execution, delivery, and administration of the Investment Documents and any amendment or waiver with respect thereto; and (ii) all reasonable out-of-pocket costs and expenses of the Investors and other Note and Warrant holders (including the reasonable fees and disbursements of counsel) in connection with the enforcement of any of the Investment Documents.

The Company Parties would indemnify the Investors and the other Note holders and hold them harmless against all claims, losses, liabilities, and expenses (including reasonable fees and disbursements of counsel) arising from or relating to the proposed issuance of the Preference Shares and the Warrants and the other Transactions, except to the extent of such indemnified party's gross negligence or willful misconduct.

Governing Law: South Africa



Income Statement Sandown Motors (Annual Filing 02/27/2008)

(in R thousands)

	2007	2006	2005
Sales and revenues	D0.050.050	DE 004 505	D0 040 007
Automotive sales (includes parts and service)	R6,252,350	R5,801,585	R6,213,227
Financial Services revenues	732,078	681,048	948,591
Total sales and revenues	6,984,428	6,482,633	7,161,818
Ocata and sumanas			
Costs and expenses	4.000-557	5 404 740	F 000 000
Automotive cost of sales (includes parts and service)	4,908,557	5,124,712	5,369,260
Selling, administrative, and other expenses	857,345	775,494	995,814
Depreciation and amortization	134,354	205,015	275,753
Goodwill impairment	97,200		
Interest expense	180,354	169,456	175,545
Financial services provision for credit and insurance losses	27,054	9,761	19,562
Total costs and expenses	6,204,864	6,284,438	6,835,934
Automotive interest income and other nonoperating income/(expense), net	47,021	59,859	50,504
Automotive equity in net income/(loss) of affiliated companies	15,755	17,051	11,543
Gain on sale of assets			44,348
Income/(Loss) before income taxes	842,339	275,104	432,278
Provision for/(Benefit from) income taxes	362,206	118,295	185,879
Income/(Loss) before minority interests	480,133	156,809	246,398
Minority interests in net income/(loss) of subsidiaries	(192,053)	(39,202)	(61,600)
Income/(Loss) from continuing operations	288,080	117,607	184,799
Income/(Loss) from discontinued operations	1,661	648	2,511
Income/(Loss) before cumulative effects of changes in accounting principles	289,740	118,255	187,310
Cumulative effects of changes in accounting principles	, -	, -	(10,166)
			(, -)
Net income/(loss)	(R 289,740)	(R 118,255)	(R 177,144)

Disclaimer: This Financial Statement is for illustrative purposes only. Contents do not reflect actual results of Sandown Motors Holdings Company.



Balance Sheet Sandown Motors (Annual Filing 02/27/2008)

(in R thousands)	<u>31 Dec</u>	
	2007	2006
ASSETS		
Cash and cash equivalents	R 811,509	R 664,608
Marketable securities (see note 1)	120,704	493,856
Loaned securities (see note 2)	236,141	120,888
Finance receivables, net	1,756,329	2,122,393
Other receivables, net	188,830	162,541
Net investment in operating leases	764,865	685,101
Retained interest in sold receivables (see note 3)	15,019	22,770
Inventories	232,783	230,391
Equity in net assets of affiliated companies	65,619	64,170
Net property (see note 4)	833,497	829,265
Deferred income taxes	80,500	113,206
Goodwill and other net intangible assets	47,587	83,053
Assets of discontinued/held-for-sale operations	173,351	188,945
Other assets	185,565	175,444
Total assets	R 5,512,299	R 5,956,631
LIABILITIES AND STOCKHOLDERS' EQUITY		
Payables	R 479,136	R 487,922
Accrued liabilities and deferred revenue	1,718,974	1,841,334
Debt (see note 5)	1,543,214	1,875,334
Deferred income taxes	69,782	63,112
Liabilities of discontinued/held-for-sale operations	116,863	130,042
Total liabilities	3,927,969	4,397,744
Total stockholders' equity	832,440<u>1,584,33</u>	,223,4321 1,558,887
Total liabilities and stockholders' equity	R 5,512,299	R 5,956,631

Disclaimer: This Financial Statement is for illustrative purposes only. Contents do not reflect actual results of Sandown Motors Holdings Company.

Notes:

- 1. Marketable securities include investments in government securities, corporate obligations and equities, and asset-backed securities with a maturity greater than 90 days at the date of purchase.
- 2. Loans of certain securities to other institutions through a process administered by a custodial bank. The purpose of entering into these transactions is to provide additional income, which improves the return on these assets.
- 3. The residual interests represent the outstanding balance and rights to future cash flows arising after all other investors have received their contractual return.
- 4. Includes property and related expenses.
- 5. Debt consists of notes of various maturities and a revolver.
- 6. The residual interests represent the outstanding balance and rights to future cash flows arising after all other investors have received their contractual return.
- 7. Stockholders' equity in 2007 was reduced by R751,890 to reflect the purchase of the minority interests of Roy McAllister (R162,345) and True Class Motor Holdings (R589,545).
- 8. Total stockholders' equity in 2007 reflects both common equity and the newly issued preferred stock.



Annual Filing 02/27/2008

(in R thousands)

Statement of Cash Flows			
	2007	2006	2005
Cash flows from operating activities			
Net Income	289,740	118,255	177,144
Depreciation and amortization	134,354	205,015	275,753
Changes in working capital and other adjustments	95,337	58,401	54,473
Net cash flows from operating activities	519,431	381,671	507,370
		•	
Cash flows from investing activities			
Capital expenditures	(138,506)	(157,504)	(172,868)
Acquisitions of retail and other finance receivables and operating leases	(2,395,150)	(2,522,699)	(2,187,972)
Collections of retail and other finance receivables and operating leases	1,842,669	1,680,831	1,954,409
Net acquisitions of daily rental vehicles			(62,856)
Purchases of securities	(220,832)	(350,554)	(397,665)
Sales and maturities of securities	305,000	380,034	375,655
Proceeds from sales of retail and other finance receivables and operating leases	28,674	207,360	300,545
Proceeds from sale of businesses	50,058	2,268	321,449
Cash paid for acquisitions	(2,700)		(82,256)
Transfer of cash balances upon disposition of discontinued/held-for-sale operations	(3,362)	(162)	(50,828)
Other	(55,500)	13,163	74,885
Net cash (used in)/provided by investing activities	(589,648)	(747,264)	72,498
Cash flows from financing activities			
Cash dividends	(74,255)	(5,267)	(7,954)
Sales of preferred stock	500,000		
Changes in short-term debt	17,250	25,000	(352,877)
Proceeds from issuance of other debt	30,000	105,000	50,000
Principal payments on other debt	(150,000)		(50,000)
Other _	(67,320)	(13,730)	(6,197)
Net cash (used in)/provided by financing activities	255,675	111,004	(367,027)
Effect of exchange rate changes on cash	(39,529)	18,792	(20,088)



Appendix 6 (continued)

Net increase/(decrease) in cash and cash equivalents from continuing operations	145,929	(235,797)	192,752
Cash flows from discontinued operations	4.050	(440)	4.005
Cash flows from operating activities of discontinued operations Cash flows from investing activities of discontinued operations	1,053	(446)	1,985 (1,985)
Cash flows from financing activities of discontinued operations	4		· · · · ·
Net increase/(decrease) in cash and cash equivalents	146,982	(236,243)	192,752
Cash and cash equivalents at January 1			
Cash and cash equivalents of discontinued/held-for-sale operations at January 1	(81)	770	553
Net increase/(decrease) in cash and cash equivalents	146,982	(236,243)	192,752
Less: Cash and cash equivalents of discontinued/held-for-sale operations at December 31		81	(95)
Cash and cash equivalents at December 31	811,509	664,608	900,000

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