

Allan Gray supports significantly amended Shoprite offer

In our previous GrayIssue we set out the reasons why we believe the current surge in private equity transactions is a net positive trend for retirement funds and investors. We did however point out that we were opposed to the proposed buyout of Shoprite. Subsequently, Shoprite announced that Brait had changed the terms of its offer and that Allan Gray had given an undertaking to advise its clients to vote in favour of the revised transaction. We have written this follow-up GrayIssue to set out the reasons for and nature of our support. In particular, we feel it important to correct the impression that we changed our view solely due to the increase in the offer price (from R26 to R28).

Why was Allan Gray opposed to the original offer?

Allan Gray, acting on behalf of its clients, objected to the transaction in the form originally proposed. This objection was primarily driven by the fact that the structure used meant that many shareholders (such as unit trust investors and many retirement funds) were prevented from accepting the option to retain an interest in the unlisted 'New Shoprite' and were instead forced to take the cash offer of R26 in the event that the transaction was implemented.

As a consequence the underwriters of the offer, who included certain existing shareholders in Shoprite, were 'guaranteed' a significantly enhanced shareholding in 'New Shoprite'. This, in Allan Gray's opinion, presented a conflict of interest as such shareholders stood to benefit from the transaction to a greater extent than the average shareholder. It was this that led to our objection rather than the simple fact that the holders of high voting shares were permitted to vote. While we may not be in favour of high voting share structures, we were fully aware of their existence in Shoprite before we invested on behalf of clients and that their holders would be permitted to vote on all matters provided that there was no conflict of interest.

Why is the revised transaction better?

The revised structure allows those who purchased Shoprite shares on or before 24 November 2006 the choice to either remain invested in the business of New Shoprite via a listed entity or receive R28 in cash. The opportunity to remain invested via the listed entity, in our view, removes the conflict of interest referred to above, as the previously conflicted shareholders are no longer 'guaranteed' to acquire the interests of shareholders who would have been forced out. The previously conflicted shareholders are now essentially being treated the same as other shareholders including being diluted in favour of the new shareholders (Shoprite management, Brait and future BEE partners). We are therefore no longer opposed to these shareholders voting at the general meeting.

As has been made clear in the revised public announcement, Allan Gray's support for the transaction is dependent upon the satisfactory listing of the entity that will hold the look-through interest in 'New Shoprite'. Should the listing not occur in a manner that facilitates our clients' interests, our support for the transaction will fall away.

What about the price?

Brait have increased the offer price by R2 per share, or R1bn in total. The price offered was always of secondary importance relative to the structure. We would have still objected to the original deal irrespective of the offer price due to the important principles at stake. Importantly, under the revised structure shareholders are not forced to accept the R28 as they now have an option to take R20.50 per share in cash and reinvest the remainder in 'New Shoprite'. This is a significant change. Shareholders who choose to reinvest, will retain approximately 63% of their current holding in the profits of Shoprite. Shareholders will thus be selling down 37% of their current holding at R28 per share to facilitate the entry of the new shareholders, of which 12% will be set aside for a BEE transaction.

Therefore the correct way to evaluate the offer price is to probably compare (excluding the BEE dilution) the dilution experienced as a result of selling 25% of one's share in Shoprite's future profits, with the benefits to be gained as a result of the restructuring. These include the removal of the high voting shares, the gearing of the balance sheet, and the clear alignment of management's interest with those of shareholders evidenced by them borrowing to invest alongside shareholders.

Commentary by Duncan Artus, Portfolio Manager, Allan Gray Limited