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FINAL IPO ACTIVITY REPORT & SUMMARY ANALYSIS (TELKOM S.A. LIMITED)

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INTRODUCTION

Deloitte Emerging Markets was retained by the United States Agency for International Development to provide technical assistance to the Government of South Africa (GOSA) in support of Government's objective to sell a portion of its shares in the incumbent fixed-line telecommunications company Telkom, SA Ltd. through an initial public offering on the Johannesburg Securities Exchange (JSE) and the New York Stock Exchange (NYSE).

The local South African office of Deloitte Consulting provided initial support for this activity. DPE later requested supplemental expatriate assistance through Deloitte Emerging Markets. In June 2000, Robert O'Brien was appointed as an Investment Banking advisor to provide assistance to the Department of Public Enterprises (DPE). His initial tasks were to help establish an IPO Office within the Department and to prepare a Request for Proposals for the competitive bidding and subsequent appointment of financial advisors and lead managing underwriters for the Telkom IPO. In July 2000, Alan Smith joined the advisory team with the task of providing financial communications advice and support to the DPE. In October 2000, the DPE hired Dr. M.E. Mokeyane to serve as Head of the IPO Office.

Mr. O'Brien departed South Africa in November 2000, having completed his initial tasks. Yet, early in 2001, the DPE asked that Mr. O'Brien be re-enlisted to advise the Head of the IPO office for the duration of the transaction, and this was initially scheduled for completion in the 4th quarter of 2001. Accordingly, Deloitte Emerging Markets re-mobilized Mr. O'Brien and he returned to the country in February of 2001. The IPO transaction was postponed 3 times and eventually concluded in March of 2003. In the final analysis, Robert O'Brien and Alan Smith remained engaged on behalf of the IPO Office until 31 March 2003, the former on a full-time basis and the latter on an intermittent basis. Mr. O'Brien's responsibilities were to follow negotiations between the parties, advise on potential problems and conflicts, propose solutions and alternatives and interpret issues of a technical nature. Mr. Smith's responsibilities were to plan communications strategies, positions and messages; advise on public relations issues and risks; and coordinate advertising, marketing, public relations, and public education programs.

It was during Mr. O'Brien's hiatus away from the Department in late 2000 that the GOSA Selection Committee (encompassing representatives from the Departments of Public Enterprises, Communications and National Treasury) retained Deutsche Bank and JP Morgan to serve in the capacity of "Joint Global Coordinators" (JGCs) for the IPO transaction. A contract was concluded between the parties.

This report summarizes the IPO preparation and closure process from beginning to end and attempts to draw insights and observations that may be useful to the GOSA and DPE on future transactions. Chapter 1 of the report lays out a chronology of events leading up to the IPO transaction to provide a framework for the content that follows. Chapter 2 summarizes the IPO process, including objectives, planning, implementation and results. Chapter 3 examines some of the issues, problems and obstacles encountered. Chapter 4 summarizes the lessons that can be drawn from this experience.

1. CHRONOLOGY OF IPO EVENTS

Dates proposed for IPO listing: 4Q 2001, 1Q 2002, and 4Q 2002

Actual listing date: March 4, 2003

1991	Department of Posts and Telecommunications was unbundled and three separate entities were formed, namely: Department of Posts and Telecommunications (government ministry); Telkom SA Limited (100% government owned); and SA Post Office (100% government owned).
1993	The license requirements for the mobile industry were published and this provided the basis for licensing the two first operators and facilitated rapid growth of the mobile industry.
1995	Launch of the Green Paper/White Paper process to develop a new Telecommunications Act. The Green Paper process was completed by the end of October 1995 and was followed by the White Paper process, which laid the basis for the Telecommunications Act of 1996.
1996	Publication of the Telecommunications Act, 15 March 1996, set out the legislative basis for achieving the government's sector objectives and legally enshrined the institutional framework for policy and regulations.
1997	Government sold 30% of its interest in Telkom SA Limited to strategic equity partner, Thintana Communications, a joint venture between SBC Communications (18%) and Telekom Malaysia (12%). Thintana paid $1.3 billion for management control through a shareholders agreement that granted a 5-year fixed line monopoly through May 7, 2002, but had certain universal service and infrastructure capital obligations. The shareholders agreement called for an additional 10% of government's interest to be allocated to *past, present and future* Telkom SA employees and black economic empowerment groups.
	During the exclusivity period, 1997-2002, the market structures of the telecommunications industry were either monopolistic, in the case of fixed voice business, or competitive in the case of mobile services (Vodacom, MTN and Cell-C), or fully competitive in the case of paging, VANS, radio trunking and satellite sectors (where two government-owned companies, Transnet and Eskom, were dominant players).
1999	Government agreed to set aside 10% of its Telkom shares to be allocated: 2% to Telkom employees, 3% to a BEE group and 5% to the National Empowerment Fund.
June 2000	IPO Office established at DPE.
J/Aug 2000	DPE solicits and receives 10 proposals from investment banks to act as financial advisor and lead managing underwriter of Telkom IPO.
Oct 2000	Dr. M.E. Mokeyane hired as Head, IPO Office.
Nov 2000	Government selected two investment-banking consortiums, JP Morgan (with Standard Bank and WIP Capital/Legae Securities) and Deutsche Bank with African Harvest toserve as the be the joint global coordinators (JGCs).
Jan 2001	Government received an unsolicited offer for its indirect 35% interest in Vodacom from Vodafone plc, 31.5% owner of Vodacom. Vodafone also offered to buy the SEP's indirect 15% interest as well. It was an all cash offer valued at R50-55 billion for 100% of Vodacom equity. The SEP was adamantly opposed to the idea one reason being that market value was significantly higher than the offer price at the time.

Mar 2001	Government received bids for its 3% interest designated for allocation to a BEE group. Ucingo Investments won the bid and paid R565 million for the stake. This strike price of 40 Rand per share implied a 100% equity value of Telkom of R18.8 billion at that time. Ucingo's purchase transaction was 100% debt financed by SA institutions in anticipation that the eventual IPO strike price would be higher and/or the eventual market price would enable Ucingo to repay the loan from resale into the secondary market after the IPO took place -- initially expected in 4Q of 2001.
Mar 2001	Department of Communications gazetted Draft Policy Directives for comments on a second national operator (SNO) thereby creating a source of delay. Many industry stakeholders wanted to open the market for third national operator.
Mar 2001	Third party service providers, such as advertising, public relations and research agencies, were solicited and retained for the IPO office of DPE.
Apr 2001	Department of Communications revised its Draft Policy Directives by including the concept of a third national operator thereby splitting the telecom interests of Eskom and Transnet.
Jun 2001	Department of Communications finalized Policy Directives vis-à-vis a Second and Third National Operators (SNO & TNO). The SNO will be owned 30% by government through Eskom and Transnet, 19% by BEE investors, and 51% by a foreign telecom operator. A third national operator license will be issued in 2005.
Jun 2001	Cabinet approved the concept of a two-tier IPO retail offering including one tier targeted at historically disadvantaged individuals (HDI) and another at all other retail investors.
Jul 2001	Government began negotiations with the Thintana Communications SEP on amending the Shareholders Agreement and Strategic Services Agreement for various changes: (1) to take effect of changes expected after the exclusivity period expires on May 7, 2002, (2) to deal with the concept of new shareholders resulting from the IPO.
Oct 2001	Cabinet approved HDI shares to be held in Khulisa Trust.
Nov 2001	Telkom and ICASA dispute tariffs and tariff regulations.
30 Nov 2001	President enacted the Telecommunications Amendment Act.
Apr 2002	DPE and DoC submitted Cabinet Memo seeking clarity on telecommunications policies and regulations in light of proposed amendments to 1996 Telecoms Act.
Jun 2002	Telkom and ICASA reached an out of court settlement on tariff rate dispute.
Aug 2002	Government and Thintana SEP conclude new Strategic Services and Shareholders' Agreement.
16 Sep 2002	Telkom and Vodacom present their business plans to Government, JGCs and their legal advisors.
23 Sep 2002	New domestic PR firm, Spin Media, retained by DPE for IPO media support within South Africa.
03 Oct 2002	Public Education phase of retail marketing began.
17 Oct 2002	Confidential documents initially filed at the JSE and the US Securities and Exchange Commission (SEC). Several subsequent filings made as comments came from respective jurisdictions.
30 Jan 2003	Preliminary prospectuses filed with JSE and SEC, and distributed to institutional investors.

30 Jan 2003	Offer phase began. A Summary Prospectus is produced and used for SA retail investors.
03 Feb 2003	Institutional investor road shows began in Johannesburg and continued to Pretoria and Cape Town in the first week; London, Edinburgh, Frankfurt, The Hague, Rotterdam, Amsterdam, Zurich, Paris and Milan in the second week; and New York, Boston, San Diego and San Francisco in the third week.
02 Mar 2003	The original price range of R33.50 to R40.90 per share is adjusted downward to R27-30 per share, reflecting institutional buying price indications.
03 Mar 2003	Pricing is set at R28 per share or US$13.98 per American Despository Share (ADS).
04 Mar 2003	First trade on JSE and "when issued" trading on NYSE. The stock closed up at R28.20 at the end of the first day of trading, but a stronger US$ weakened the US$ price to $13.90 per ADS.
07 Mar 2003	Celebration at NYSE and formal listing ceremony. Also, the closing took place in New York and Johannesburg, at which point Government received R3.2 billion and US$41.5 million from institutions and R251.4 million from retail offering.
24 Mar 2003	Second closing as the JGCs exercised their over-allotment option for 14,941,513 shares at R28 and closed out its stock loan agreement on 20,023,738 shares. Government received R413.9 million net proceeds.

2. THE IPO PROCESS

Part of the overall economic strategy of the post 1994 government was to restructure the vast network of state-owned enterprises (SOEs) that it inherited from the pre-1994 regime. The government wanted to divest itself of non-strategic assets and ensure that those SOEs in strategic industries operated efficiently and delivered the services needed for economic growth and development.

The Department of Public Enterprises (DPE) was established to drive the restructuring process and represent Government's interests as a shareholder in SOEs. Telecommunications was deemed a critical strategic industry dominated by an inefficient SOE, Telkom SA. The need to restructure Telkom, and indeed the entire telecommunications sector, was recognized long before the new government came to power in 1994.

In 1997, the Department of Communications, official Government shareholder of Telkom SA Limited, agreed to sell 30% of Telkom to a strategic equity partner, Thintana Communications. The Thintana consortium consisted of SBC Communications at 18% and Telecom Malaysia at 12%. In 1999, a further 10% of Telkom shares were earmarked for past, present and future Telkom employees (2%), Black Economic Empowerment (BEE) groups (3%) and the National Empowerment Fund (5%). The 3% for BEE groups was sold to Ucingo Investments in March 2001 but the allocations for the employees and the National Empowerment Fund have not yet been exercised since the exercise price was set on the 1997 value (set by the strategic equity partner Thintana) and the stock is currently trading below that value.

At what point the Government decided to sell a portion of its remaining shares through an IPO is unclear although the idea had been tabled for some time. Once the decision was made, DPE moved quickly to establish a separate IPO Office, with its own budget and staff, and to retain investment banks JP Morgan and Deutsche Bank as joint global coordinators and lead managing underwriters of the Telkom shares. JP Morgan and Deutsche Bank were selected by Departments of Public Enterprises, Treasury and Communications in November 2000, and formally engaged in September 2001, while an initial listing date was set for the fourth quarter of 2001.

The government's commercial and social objectives for the Telkom IPO were set out in the Rules of Engagement, which was included in the engagement letter and the original request for proposals for the Financial Advisor in 2000. Both commercial and social objectives were defined and included the following:

Commercial objectives

- Achieve an optimal level of net proceeds;
- Achieve maximum participation of SA retail and institutional investors (without prejudicing the optimal level of proceeds);
- Establish a broad base and orderly market for shares;
- Establish a new image for Telkom;
- Raise international awareness of South African market and privatization;
- Develop principals and policies for future privatizations; and
- Establish South African government as credible and professional vendor in international capital markets.

Social objectives

- Raise awareness/interest in capital markets among general public;

- Provide opportunity for people with limited financial resources to participate;
- Maximize participation of Historically Disadvantaged Individuals (HDIs); and
- Ensure skills transfer to local institutions and HDIs.

The JGCs were to be compensated by a percentage of the proceeds (1.9%), plus incentive fees (0.45%) for achieving all of the stated objectives. They were also allocated a fixed budget for expenses to be paid by government. At the time of their appointment in 2000, the JGCs estimated that proceeds from sale of a 20% stake of Telkom shares would be on the order of $2 billion. When the IPO was completed in 2003, actual proceeds were about a quarter of that amount— approximately $500 million. As a result, the fees of the JGCs (excluding incentive fees) were reduced from an original expectation of $38 million to $9.5 million. Whether or not the government will pay an incentive fee remains to be determined and the decision is currently under discussion between the sponsoring departments of government.

Under the JGCs' interpretation of the terms of their engagement, and with the acquiescence of the government, almost all expenses necessary for the planning and implementation of the IPO were shifted to the government. This practice apparently is common in the UK but appeared surprising and unreasonable to the American advisors O'Brien and Smith. This likely came about as a result of the contracting process whereby it was the JGCs who initially tabled their version of an advisory contract to DPE instead of the other way around.

Immediately after being retained, the JGCs instructed government to retain and pay for market research, advertising, public relations, printing, logistics and IT support. After a short while, the list of parties involved in preparation of the IPO totaled 74 organizations as presented in Annex 1. Working groups were set up by the JGCs in five areas: documentation, logistics, retail, marketing, and legal support. The working groups met weekly and proposed actions or questions to the IPO Management Committee, which was headed by the DPE Deputy Director General in charge of the IPO Office. The Management Committee referred actions requiring decisions to the IPO Steering Committee chaired by the Director General of DPE.

Throughout 2001, and much of 2002, the lack of capacity in the IPO Office prevented government from participating in most working groups and made the Management Committee meetings sporadic at best. Indeed, throughout its tenure, the IPO office was staffed by only five individuals: the Deputy Director General, an Assistant Director, a Project Manager and the two expatriate advisors. This "thin" staff complement created animosity and friction between the JGCs and the IPO Office. While the IPO Office was charged with managing the IPO budget and with representing government in the IPO process, it had difficulty keeping up with either task, effectively leaving the JGCs with greater latitude to drive the process, make key decisions and manage service providers and vendors contracted by the government.

An intensive public education campaign got underway in October of 2002, involving road shows and town meetings, public radio spots in multiple languages, television advertising and the distribution of pamphlets and informational brochures throughout South African post offices. As a result of this massive outreach effort, more than 1.6 million South African individuals registered to express their formal interest in purchasing shares. This response rate far surpassed Government and JGC estimates that approximately 350,000 individuals would register.

Throughout most of 2001 and 2002, Telkom SA was only peripherally involved in the preparation process. They wanted to wait and assess the outcome of the legislative and regulatory processes underway before undertaking to develop a post-IPO business plan and underlying assumptions. In August, 2002 GOSA and Thintana concluded new Strategic Services and Shareholders' Agreements, shortly after the regulator, ICASA, had promulgated new regulations. The SOE became more involved during the months preceding the listing, presenting their business plan in September 2002.

On March 4, 2003, 139,257,954 Telkom shares (representing a 25% stake in the company) were listed under the symbol TKG on the JSE Securities Exchange South Africa and as American Depository Shares (ADS), on the New York stock exchange. The shares were offered: at R28.00 per share or US$13.98 per ADS to institutions and to US individuals; at R26.60 per share to the general retail investor in SA (a 5% discount from the institutional price); and at R22.40 per share to HDIs and others in the Khulisa Trust, (a 20% discount from the institutional price). The stock price rose to R29.10 per share on the first trading day and reached a peak of R30.30 per share in secondary trading in subsequent weeks. On March 24, 2003, the JGCs exercised their over-allotment option for 14,941,512 more shares, bringing to 154,199,467 the total number of shares sold by the GOSA, amounting to disposal of a 27.7% stake in the company. Telkom is now ranked number 21 in market capitalization on the JSE and has thereby placed in the JSE Top 40 Index.

The offering prospectus, published on January 24, 2003, indicated an expected IPO price of between R33.50 and R40.90. This price range was reduced to R27.30 on the night before the listing in the light of lacklustre offers received from domestic institutions. Naturally, investors and analysts greeted the lower price positively and, in the end, shares at the strike price were over-subscribed by two to one.

In the final analysis, 27.7% of Telkom shares were sold by the GOSA, generating total proceeds of R4.2 billion. Of the total sold, 92.5% of shares were purchased by institutions, 4.4% (6,127,350 shares) went to individuals in SA under the general retail offer and 3.1% (4,316,997) went to individuals under the Khulisa Trust offer. A total of 168 institutions purchased shares, of which 51.5% were SA institutions. Foreign investors took up 41% of the total share allocation.

With respect to retail participation, 127,000 of the 1.6 million individuals registered actually purchased shares at the subscription stage. This reflects a conversion rate of 8% and compares with an average worldwide conversion of 38% in similar privatization IPOs . The government and outside observers consider the 8% conversion rate very respectable considering the prior lack of share ownership and history of South Africa. (By comparison, the recent IPO of Ikageng attracted only 32,000 retail investors.) Overall, retail participation exceeded government's and JGCs' early estimates that retail SA buyers would subscribe for less than 5% of the total. The retail participation has been cited by the government as an indicator of the success of the IPO, particularly in spreading a culture of equity ownership and bringing more HDIs into the economy. The government speaks of the IPO as an important step in creating an economic democracy and in adjusting the racial imbalance in South Africa's capital markets.

The Khulisa offer at a 20% discount to the IPO institutional price was originally targeted at historically disadvantaged individuals. However, in response to a threatened lawsuit by a white labor union, Solidarity, the government opened the Khulisa offer to all South Africans with priority given to HDIs in the event of an over-subscription. In the end, all applications under the Khulisa offer were allocated. In addition, all applications under the general offer were allocated, but only up to a maximum of R2 million each.

Based on the IPO strike price at the time of the listing in March 2003, Telkom's equity was valued at (or had a market capitalization of) R15.6 billion. This compared to a much higher valuation of R80 to R100 billion estimated in August 2000 by JP Morgan, Deutsche Bank, and the 8 other investment banks competing for the underwriting contract. At the time, analysts estimated that only 40% of Telkom's market value was made up of its 50% stake in Vodacom. Today, most of Telkom's value is derived from its Vodacom stake reflecting the diminished prospects of fixed line telecommunications businesses in line with global trends.

This decline in value caused great hardship to Ucingo Investments, the Black Economic Empowerment firm that had purchased the 3% stake in Telkom at 40 Rand per share in March 2001. Ucingo had secured bank loans to finance 100% of the stock purchase. At the time of the transaction, the participating banks expected to make a windfall in that the interest rate was set at 4% over prime and the terms included 25% participation in any increase to the equity price at the time of the listing. As the prospectus was released, indicating a price range significantly lower than 40 Rand per share, it became evident that Ucingo was an illiquid organization and the banks were inclined to call their loan immediately. This would have forced the BEE into immediate bankruptcy. The eventual listing price was approximately two-thirds of the original strike price exercised by Ucingo and only an intervention by the Department of Finance has caused the banks to delay in calling their loan for an additional one year period. At this point, the BEE dimension of this transaction will succeed only if the share value is to rise above 40 Rand, quite a far stretch from its current level.

Certainly the Company's valuation and the proceeds of the IPO were much lower in March 2003 than was predicted in 2000, yet the size of the proceeds has not generated much criticism. The IPO was rescheduled at the last minute to allow the Finance Minister's budget to precede the listing. The fact that government revenues had grown and the economy appears strong reduced pressure on the government to generate more proceeds from the IPO. This also acted to dampen criticism in the press of the amount of revenue from the IPO.

The JGCs point out that at the time of its listing, the Telkom IPO was the largest global IPO since the start of the year, and was the first Telkom IPO in Europe or Africa to take place since February 2001. In November 2002 China Telecom raised $1.4 billion from its IPO, also much less than the $3 billion it had hoped to raise.

In summary, and stated in dollar terms, at the time of their appointment in 2000, the JGCs estimated that proceeds from sale of a 20% stake of Telkom shares would be on the order of $2 billion. When the IPO was completed in 2003, actual proceeds were about a quarter of that amount. As a result, transaction fees of the JGCs amounted to $9.5 million, down from the $38 million estimated at the outset. Adding to this the cost of government's own legal advisors plus other IPO expenses of $25 million incurred out of the DPE IPO office during 2001, 2002 and 2003, approximately $34.5 million was expended to produce revenues on the order of $525 million. This tally does not include the costs of in-kind support for USAID-funded IPO advisors, and the advisors' incentive fee, on which a determination has not yet been made.

3. ISSUES AND CHALLENGES

The IPO was scheduled and rescheduled four times: 4the quarter 2001, 1st quarter 2002, 4th quarter 2002, and then actually offered on March 4, 2003. The first two postponements were attributed to weak market conditions for telecom stocks (which were indeed in decline) whereas part of the delay was because the Company was unable and unwilling to present its business plan (needed for the prospectus and initial pricing) before September 2002. As Telkom's fiscal year end is March 31, and a full audit would take several months, the IPO could theoretically have taken place in 4th quarter 2002, but the company only made the business plan available in September of that year once regulatory uncertainties had been cleared up. As a result, the government and JGCs agreed to wait until March, 2003. (February 28th was the target date changed to March 4 at the last minute.) In September 2002, nobody had predicted the Iraq War or the depressing effect that would exert on global stock markets. This chapter identifies the main issues and problems that affected the conduct and outcome of the IPO.

Liberalization Simultaneous to Privatization

The delay in the IPO was brought about primarily because the government was attempting to divest shares and simultaneously liberalize the telecommunications market by introducing new competition. While not unexpected, the timing of this initiative, the confusing way the DoC went about tabling proposals, and the time it took for amendments to be passed by Parliament, effectively put the IPO transaction on hold. Neither Company management, nor the JGCs, nor potential investors could reasonably assess the value of the company until its new competitive market situation and the new regulatory environment were made clear. Either the intention of the Department of Communication (DoC) to introduce new legislation was unknown to the DPE and JGCs (most likely the case), or they failed to appreciate the impact this would have on the IPO. It does speak to the lack of communication and cooperation between DPE and DoC in the early days of the IPO as well as the difference in stakeholder interests. As the legislative and regulatory regime unfolded, the communication improved beginning in late 2002 but initial delays had already occurred.

The Institutionalization of a New Regulator

In addition, South Africa's telecommunications regulator, the Independent Communications Authority of South Africa (ICASA), was a fairly new organization and it was not a sufficiently independent body. Government continually meddled in its affairs and regulatory processes. This status affected the speed and effectiveness with which the regulator was able to drive through sector reform. At the same time that the DoC was introducing new competition, Telkom and ICASA entered into a dispute about a rate tariff increase proposed by the Company in advance of a new tariff regime being prepared by ICASA. This dispute carried on for months and was eventually settled out of court. Essentially, Telkom tried to make an end-run and push through new tariffs before they became legally subject to ICASA's review.

The Power of the Strategic Equity Partner incumbent within Telkom

With the IPO pending, the government also began re-negotiating its shareholders agreement with Thintana, the strategic equity consortium. This put Thintana, and especially SBC, in a strong bargaining position and permitted them to drag on the negotiations to increase pressure on the government. Both the tariff dispute and the disproportionate bargaining position of the SEP added to the inability and unwillingness of Telkom to prepare its business plan. One must also bear in mind also the fact that the Company itself had little incentive to conduct the IPO. Proceeds from the IPO would not recapitalize Telkom; the proceeds would go the National Treasury and the outcome would result in Government of

SA still being the majority shareholder while Telkom would gain the added cost of conducting shareholder relations with a new broad constituency. It appeared that Telkom's SEP block was in no hurry to execute the IPO under the prevailing market conditions.

The Shortage of Human Resources within DPE's IPO Unit

The Telkom IPO was a new experience for all parties and individuals concerned. This obviously led to some wasted time and resources, and perhaps some poor decisions while participants were climbing a steep learning curve. One weak link in the institutional chain was the IPO Office within DPE because it lacked the experience, resources, authority and staff to properly carry out its mandate. DPE was absent from the discussion table for much of the planning process and early implementation because it could not possibly attend all meetings of the five working groups. The two advisors were frequently the only "representatives" present at planning meetings, but they had no authority to make decisions for Government. The Director General made most decisions taken at the DPE with regard to the IPO, while the Minister of Public Enterprises did not get actively involved except when a direct political link could be made. The consequences for the IPO were the following:

- Costs to government were greater than necessary due to ineffective fiscal oversight (recognizing however that some cost excesses were deliberately incurred for social/political reasons);
- Skills transfer from the IPO office to other DPE staff was minimal. With the subsequent departure of DPE's Director General, DPE is only slightly more prepared to manage an IPO now than they were in 2000.
- However, the Department is now preparing a comprehensive "How To" manual in order to document the IPO process to serve as a generic guide should the Government choose to implement other such listings in the future.

Multiple Stakeholders with Disparate Interests

To be fair, however, even a well functioning IPO Office, would have had difficulty "driving" the IPO process when so many of the delaying factors were outside of its control. The DPE had little leverage with other government organizations, like DoC, National Treasury, and ICASA. It could not set deadlines or impose its will. It also had little leverage with Telkom, as DoC is the official Government "shareholder" of the company and appoints its board of directors.

Mixed Performance by the Joint Global Coordinators

Weaknesses on the part of the Joint Global Coordinators (JGCs) also cost the government money. The JGCs won the competitive bidding based on several factors, including the facts that they were lead managers of the Government's bond offerings and major equity traders on the JSE Securities Exchange. Yet, the South African staff of JP Morgan, Deutsche Bank and their respective subcontractors had no experience in IPOs of this scope and had to rely on their superiors in London. While the initial plans for the IPO included a possible listing in London, Government, SEP and Telkom wanted to trade next to their peer group on the New York Stock Exchange and so a London listing was abandoned. The South African bankers, backed by their London colleagues, lacked experience in South African equity issues, especially to the retail market, and they also lacked experience in U.S. listings. The JGCs devoted only 3 days to the U.S. road show, missing some potential major accounts which contributed in part to the need to re-price the shares. The results of their marketing efforts were poor initial responses to the offerings from domestic SA institutions and from US institutions and pension funds, though this assessment would be strongly disputed by the JGCs. An alternate perspective is that the concentration of power among a small, oligopolistic financial sector in South Africa gave them substantial bargaining power to withhold demand until the price became extremely attractive.

The rules of engagement for the JGCs had clearly stipulated the government's social as well as commercial objectives. Yet, throughout the IPO process, the position of the JGCs was that the retail offering, especially the marketing to retail investors, was the responsibility of the government. In late September 2002 they even proposed to not underwrite the retail offer. Even though government immediately rejected this approach, it became the de facto reality: no underwriting was actually provided for the retail offering. It is easy to see why the JGCs did not want to support the retail offer: a very small portion of their compensation was going to come from the retail side. The cost of the retail operation would be higher and the JGCs had little retail equity marketing experience or capability. The JGCs paid almost no attention to domestic retail investors, focusing their marketing efforts on European institutions and local institutions, whom they estimated would take 60% of the offering. However, the JGCs could have made better use of Standard Bank whom they had engaged to distribute the registration materials in the offering, but with whom they did not want to share the commissions. In short, the JGCs wanted control of 80% of the economics in the offering with little concomitant effort. In the final analysis Government restrained them to a 70% share, with the balance going to their subcontractors and other participating financial institutions. In the view of the technical advisors, there was an element of "bait and switch" between the offer in the winning bid and the actual delivery of investment banking services. In awarding the JGC position to Deutsche Bank and J.P. Morgan, the GOSA assumed that the inclusion of Standard Bank would enhance their retail distribution capacity. But the JGCs apparently had little interest in meeting expectations at the retail end of the transaction and few salesmen were ultimately deployed to interact with retail buyers. Consequently, the investment by GOSA in the extensive education campaign did not yield an adequate social return with respect to converting the interest of retail buyers into stock sales.

Telkom's Lackluster Financial Performance and Future Prospects

Telkom's own financial weaknesses also contributed to the limp interest shown by investors and the lower price its shares were able to command. The Company's investment case was weak and it was poorly presented. As remarked upon often in the press, the value of Telkom's shares rest largely in its 50% stake in mobile phone carrier Vodacom and not in the stagnant fixed line business. With the fixed line market flat, high debt (estimated at R22 billion) and labor costs, there are not encouraging near-term prospects for growth. Coupled with a weak investment case, Telkom's business plan and presentation lacked energy and it failed to inspire confidence in senior company management (with the exception again of Vodacom). Abroad, the JGCs failed to make the case for South Africa as an investment decision in spite of urgings to do so by National Treasury.

Global Market Conditions

Market conditions certainly impacted negatively on Telkom's valuation. Globally, both Telkom and emerging market stocks became increasingly unattractive between 2000 and 2002. Yet loss of the company's monopoly position combined with weak prospects for fixed line growth contributed to an erosion in Telkom's value. Comparatively, the stock of MATAV, (the Hungarian incumbent telephone service provider), was also trading below its 1997 IPO price on the NYSE and Budapest Stock Exchange.

Labor Conditions & Government Resolve

Outside observers often remarked that the opposition of labor to privatization must have had a negative impact on the Telkom IPO. In our view, this was not a factor. Labor's concerns are likely to have a much greater influence on the restructuring of Eskom and Transnet, especially in a run up to the next election. Government's commitment to the Telkom IPO never wavered, so government resolve was also not a problem.

4. LESSONS LEARNED

The lessons that might be learned from the Telkom IPO, and how these can be applied to other liberalization and restructuring initiatives within South Africa, are relevant to a wide audience. More specific, however, is their relevance to the restructuring committees set up between DPE and other departments of government to drive forward change in specific sectors or SOEs. Accordingly, this paper might be of particular interest to the Transnet, Eskom and Port sector restructuring committees currently driving reform in the transport and energy sectors.

Lesson # 1: The Outcome of the IPO was Successful in Many Respects. In spite of the obstacles and delays and the weak market conditions, South Africa's Telkom IPO should be regarded as a success. Certainly the government can claim that most of its social objectives, barring the BEE dimension, were met. And, as an indicator of the government's commitment to restructuring and privatization, execution of the IPO despite adverse market conditions succeeded in sending a strong message to both domestic and foreign investors.

Lesson # 2: Cost/Benefit Transaction Norms from "International Best Practice" may be less Relevant to the South African Context. An argument can be made that more was spent than needed on third party contractors for the execution of the IPO, but that doesn't appear to be a concern of government. That there is a cost to achieving social goals, both in processes and in outcomes, is keenly understood and embraced by the present government. Indeed, there is a unique South African cost to overcoming the legacy of apartheid. This is an insight that is not immediately apparent to advisors, particularly individuals or institutions of foreign origin. In light of this perspective, the cost of South Africa's Telkom IPO transaction should not be judged as unreasonable.

Lesson # 3: "Get Rich Quick" Schemes Carry Potential Pitfalls. Government's intention in setting aside a 3% stake of Telkom stock for a Black Economic Empowerment firm was certainly to redistribute wealth in favor of a qualified investment firm owned by historically disadvantaged individuals. Unfortunately, the downward evolution in the stock price led in the opposite direction, and though a final outcome has been put on hold, the prospects for share price recovery sufficient to restore Ucingo solvency is not encouraging. There are a number of insights that DPE should gain from this experience and apply to future restructuring efforts. First, transactions that require 100% debt finance carry enormous down-side risk and should be avoided. It might be preferable to distribute the BEE stake among a greater number of bidders, each of whom can bring a certain amount of their own equity into the transaction. (In the U.S., for example, the Securities and Exchange Commission does not permit the use of more than 50% debt to finance a purchase of stock. This might be a relevant principle for South Africa to contemplate.) Second, "empowerment" can be accomplished through other means, such as a scheduled buy-in of incremental stakes over a period of time, subcontracting of services or out-sourcing of functions to a BEE firm or the like. This lesson has been learned more broadly in the South African economy at large and is the reason behind the recent definition of a "balanced scorecard" approach to empowerment. DPE should lend significant attention to this new direction in designing the BEE dimension of future restructuring transactions.

Lesson # 4: Sequencing of Divestiture Stages Must be Carefully Thought Out. In the Telkom reform process, the first wave of divestiture took place when a 30% stake was sold to the Thintana consortium. With that stake, private investors also gained management control of the enterprise. This effectively inserted strong private interest into the heart of the SOE and it should come as no surprise that Telkom became focused on profit maximization and would have reason to resist a speedy IPO. There was little for Telkom to gain from the process given that the company would now have the obligation to expend resources on external shareholder relations added to the fact that government still remains majority equity holder after the IPO. Government and Telkom closely reviewed whether Telkom should issue shares (for recapitalization) simultaneously with Government's secondary offering. Except for dilution, Government felt that a sale of Telkom property was a better option so as to provide a better debt to equity ratio for investors. A capital infusion into the company concurrent with divestiture of Government's stake might be fruitful in future transactions, given a review of the value proposition. This is worth contemplating in an eventual ACSA (Airports Company South Africa) transaction for example.

Lesson # 5: Concurrent Liberalization and Restructuring Renders the Alignment among Stakeholders more Difficult. The IPO process itself was not complicated and could have been completed in a relatively short period of time. Even though numerous parties had to come together to make the offering happen, the differences between participating professional advisors with regard to IPO preparation tasks were few. More serious problems were evident, however, in aligning objectives between various change agents and affected stakeholders involved in the process. This is not unusual in SOE reform given that privatization or restructuring usually results in a changed set of winners and losers. Competing agendas became even more pronounced in the context of concurrent market liberalization. In retrospect, perhaps the IPO should not have been attempted until after the market liberalization measures and regulatory changes were already in place and a bona fide independent regulator had been established. The wrestling match over legislative and regulatory processes between the Department of Communications and ICASA contributed significantly to uncertainty and process delays. The lesson here is that the transaction (IPO) was being carried out in an unstable and changing environment and, as such, was extremely difficult for the prime change agent (DPE) to manage according to a predictable timetable.

Lesson # 6: Transaction Advisors' Contract Terms Must be Clearly Aligned to Government Interests from the Start & Must Include Measurable Benchmarks for Successful Outcomes. In spite of the fact that the IPO Request for Proposals and Terms of Engagement specified clear transaction objectives, (whether for the JGCs or for other vendors), the parties to an agreement often have different ideas of what those objectives mean. This was the case for the Telkom IPO. For example, what qualifies as "optimal revenue" from the IPO? Whose perspective should predominate: that of Treasury, the JGCs, DoC or DPE? At what point can it be said that retail participation has been "maximized"? All such questions were relevant in the IPO. Ideally, the definition and measurement criteria for successful outcomes should be spelled out in the advisory contract. The DTT advisor was not involved during contract negotiations and the opportunity to introduce specific outcome indicators was missed during the first phase of the GOSA-JGC contract. Though the IPO office and the DTT advisors later attempted to introduce benchmarks into the contract at a stage of contract extension, government had very little bargaining power at that point or chose not to use it.

In seeking incentive fees, the JGCs will likely claim that they have achieved all objectives because there were no specific benchmarks specified in their contract.

In future transactions, it is recommended that extra time and care be taken in advance to draw up precise contract performance terms by which advisors' objectives and compensation arrangements are unambiguously aligned with those of government. Specific performance measures should be established reflecting expected outcomes— vis-à-vis both policy and fiscal objectives, particularly where trade-offs exist between the two.

The importance of alignment between external advisors and Government around shared policy goals is particularly relevant to DPE as it moves ahead with transactions in the transport and energy sectors. Particularly given DPE's practice of sourcing transaction advisory contracts through the SOEs affected by change, it is critical that the "master"/"servant" relationship between DPE and advisors be clearly established at the outset. Regardless of who "pays the bill" (eg. National Ports Authority for the Durban Container Terminal concession advisors), contract supervision and decision-making authority must be firmly vested within the Department and advisors should be clear that they are accountable to Government for delivering desired results, not to the participating SOE.

Having identified these lessons, there are still other things that could be done differently "if we had it to do again."

Recommendation # 1: Secure and Situate Adequate Resources with the Primary Change Agent—DPE.

The fact that this was a process new to DPE and to government at large put the transaction sponsors at a disadvantage. This disadvantage could have been reduced if the lead department had had the resources to retain a larger staff and advisory team to prepare it for carrying out the IPO. This would have included advice on what to expect, how to select transaction agents, what advisors can and can't do, what resources the government would need to carry out the transaction and how long it would take. This recommendation remains relevant for upcoming transactions in the ports and energy sectors where DPE's independence and ability to drive reform processes and accompanying transactions would be enhanced if it were able to finance advisory work out of its own direct budget.

Suggestion # 2: Secure and Retain Control by the Transaction Sponsors (Government) rather permitting authority to devolve to Transaction Advisors.

The government effectively selected a financial transaction advisory consortium and then permitted the latter to determine what other advisors and supplemental resources were needed. The JGCs went to the extent of selecting the other advisors and drafting their contracts. Government merely signed and paid the bills. In the process, government lost some track of who was doing what and how much it was costing them. The JGCs had no incentive to economize. While Mssrs. O'Brien and Smith exerted significant effort to assist DPE in controlling IPO expenditures, government effectively shifted many tasks to the JGCs themselves. The government could have benefited from a more ample staff and broader team of short-term advisors (legal, financial and marketing) to help map out resource needs, estimate costs, develop TORs and interview, select and contract advisors and service providers. This is a recommendation that remains relevant to DPE as it proceeds with the ambitious restructuring mandate given it by Government.

ANNEX 1: LIST OF CONTRACTED PARTIES INVOLVED IN IPO PREPARATION

Department of Public Enterprises

Department of Government Communications and Information Systems

Department of National Treasury

Post Office

Manamela Damons Mbanjwa Inc.

African Merchant Bank

Paul, Hastings, Janofsky & Walker LLP – US

Paul, Hastings, Janofsky & Walker LLP – UK

Werkmans

Mukwevho Adekeye Inc.

Qunta Ntsebeza

Nalane Manaka Attorneys

Ernst & Young

SBC

Telkom Malaysia Berhad

Bowman Gilfillan Inc.

Sullivan & Cromwell

Greenberg Traurig, LLP

Jowell Glyn Marais Inc.

Deutsche Securities – South Africa

Deutsche Bank – London

J.P. Morgan – South Africa

J.P. Morgan – London

African Harvest

WIP Capital / Legae Securities

Standard Corporate and Merchant Bank

Standard Bank

Telkom

Skadden, Arps, Slate, Meager & From LLP

UBS Warburg – South Africa

UBS Warburg – London

Mohiala Attorneys at Law

Fres e s rue aus Deringer

White & Case LLP

Deney Reitz

Chuene, Kwinana & Motsatse Inc.

Smithfield Financial

Meropa Communications

Louise Klopper Promotions & Banesa Enterprises

Sakaza Communications

Mirror Public Relations

Inroads Marketing & Pro-Africa Communications

Mazwai Strategic Communications

Saatchi & Saatchi Advertising

Solid Solutions Associates

FCB Jonssons

INCE