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&

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**Private Equity and Capitalisation of SMMEs in South  
Africa: Quo Vadis?**

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## Foreword

This study on microinsurance in South Africa was completed thanks to the generous funding of the Dutch Government as part of the Dutch Partnership Program with the International Labour Organization (ILO). This paper forms part of a multi-country project that seeks to understand the risks that low-income entrepreneurs face, their coping strategies, and the potential role that insurance can play in managing those risks.

Low-income entrepreneurs are particularly vulnerable to risks. Lacking adequate financial and other assets, the poor are exposed to the smallest economic shocks. Their vulnerability is exacerbated by the fact that low-income persons tend to live and work in riskier environments than wealthier people, with a greater likelihood of illnesses, accidents and thefts. Furthermore, low-income entrepreneurs do not usually have access to effective risk management strategies.

The paper reviews the regulation of the South African insurance industry. It provides an account of some interesting developments in the industry, that are likely to become increasingly significant in other countries if the microinsurance industry continues to grow. The paper argues that for the most part microinsurance in South Africa consists of funeral insurance, although the author provides an account of the emergence of a range of microinsurance products that are targeted at household enterprises, including hire-purchase insurance.

The author surveys SME operators in South Africa, to assess the risks that they face, and then explores the possibility of insuring those risks. He concludes that there is an important, albeit limited, role for microinsurance (especially life insurance) and provides suggestions as to what MFIs could do to provide microinsurance. For many of the risks that are difficult to insure, the author suggests a range of possible non-financial services that could help SME operators reduce their risk, such as the provision of various business development services.

Many of the lessons learned in this study have been incorporated into a training manual developed by the Social Finance Programme (SFP) with the InFocus Programme on Boosting Employment through Small Enterprise Development (IFP/SEED), which will be used to train the managers of microfinance institutions in introducing and managing microinsurance products.

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## Acronyms

DCM	Development Capital Market
FNB	First National Bank
JSE	JSE Securities Exchange
MSE	Micro and small enterprises
NGO	Non-governmental organisation
ROI	Return on investment
SME	Small and medium enterprises
SMME	Small, medium and microenterprises
VCM	Venture Capital Market

# 1. Introduction

## 1.1 Access to finance for South African SMMEs

A cursory analysis of survey and research results of small, medium and micro enterprises (SMMEs<sup>1</sup>) in South Africa quickly reveals common reactions from SMME owners interviewed. When asked what they perceive as constraints in their businesses and especially in establishing or expanding their businesses, they answer that access to funds is a major constraint. This is reflected in perception questions answered by SMME owners in many surveys (BEES, 1995; Graham & Quattara, 1996; Rwingema & Karungu, 1999). However, the constraint presented by a lack of access to finance cannot necessarily be regarded as a first order problem. Many other constraints on running or establishing a business may be couched in financial terms.

Rodgerson (2000) indicated this in his study of clothing manufacturing SMMEs in which finance was not seen as a major constraint, and many other constraints were identified. Furthermore, one should also differentiate between the problem encountered with access to different sources and types of finance. As we will show later, internationally most SMMEs use their own funds as start up capital. This is also the case in South Africa. Another common constraint is the high failure rate of start-up SMMEs internationally and in South Africa. Financiers are generally unwilling to enter one of the most unknown and risky segments of the market, and will rather invest their capital in traditional markets. The question is - in what way could equity play a role to assist in setting up SMMEs and indeed in decreasing the risk to the owner?

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<sup>1</sup> SMMEs refer to Small, Medium and Micro enterprises. SMEs refer to Small and Medium enterprises.

## 1.2 The terms of reference

For the most part, donors and other development agencies have in the last few years focused on credit as the missing element in the finance of small, medium and micro enterprises (SMMEs). This focus exists in a context where most SMMEs are under-capitalised and over-leveraged. In the rush to establish microcredit institutions, the role of equity finance in establishing and sustaining business and employment growth has been neglected. Thus, it is postulated that many SMMEs suffer from the so-called equity gap in capitalising their businesses. Little has been done to identify the *causes*, *consequences* and *remedies* for the equity gap in microfinance.

As set out in the terms of reference, the study should explore these three issues by focusing on four key topics:

- (a) What are the causes of the equity gap?
- (b) What types of SMEs are mostly affected by the equity gap and what types of equity finance exist?
- (c) Do these equity finance mechanisms work?
- (d) How can the situation be remedied, what kinds of policy interventions could be implemented?

## 1.3 Our approach

For the purposes of this study we have regrouped the questions raised in the terms of reference and we added some elements. We start the study with an overview of the SMME market and the current financial support to SMMEs. Following this is a review of the typical capitalisation mechanisms of start-ups and SMME expansions. We draw this information from several recent South African surveys. We then turn to the issues raised in the terms of reference. To summarise, the report contains sections on:

- The South African context: the number of SMMEs and the financing of SMMEs;
- The typical capitalisation of SMMEs in South Africa during the start-up phase;
- Is there an equity gap for South African SMMEs?
- If yes, what are the causes of the equity gap and what types of SMMEs are mostly affected?
- The equity market in South Africa and the types of equity that exist;
- Do the equity instruments work? and
- How can the situation be remedied, what kinds of policy interventions could be implemented?

## 1.4 Definitions

### 1.4.1 Private equity

Private equity entails the provision of equity to enterprises that are generally not listed on a public stock exchange. Private equity can be used to develop new products and technologies, to expand working capital, to make new acquisitions or to strengthen a businesses' balance sheet. It can also resolve ownership and management issues, a succession in a family owned business or facilitate the buy-out or buy-in of a business by experienced managers. We classify private equity into broadly three sub-classes, namely venture capital, development capital and buy-out funding (KPMG, 2001). Table 1 below lists the definitions of various types of private equity to be used in the report.

<b>Table 1: Private equity investment, stages and definitions</b>		
Venture capital	Seed capital	Funding for research, evaluation and development of a concept or business before the business starts trading or operating
	Start-up and early stage	Funding for new companies being set up for the development of those that have been in business for a short time (one to three years)
Development capital	Expansion and development	Funding for the growth and expansion of a company, which is breaking even or trading profitably.
Buy-out	Management buy-out (MBO) or buy-in (MBI)	Funding to enable a management team, either existing or new, and their backers to acquire a business from the existing owners, whether a family, conglomerate or other. Unlike venture and development capital, the proceeds of a buy-out normally go to the previous owners of the entity. Buy-outs are often leveraged.
	Replacement capital	Funding for the purchase of existing shares in a company from other shareholders, whether by individuals, other venture-backers or the public through the stock market. Management is not necessarily involved.

## 1.4.2 SMME definitions in SA context

Providing and agreeing upon the exact definition of different enterprise sizes is a complex task. Definitions differ from country to country and between institutions in countries. We chose the detailed approach followed by South African Small Business Act of 1996. This uses the number of employees (the most common mode of definition) per enterprise size category combined with the annual turnover categories, the gross assets excluding fixed property and differentiates these according to sub-sectors. The information on assets is important for this report as this gives us an indication of capitalisation needs. Gross assets exclude any fixed property as SMMEs will reflect a wide range of access forms to physical facilities, most being rented. Inclusion of rented property as part of assets would be an incorrect reflection of assets. South Africa also has a wide range of definitions of ownership and use rights, this is not an issue in this approach, as property is excluded in these definitions.<sup>2</sup>

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<sup>2</sup> Property is only excluded for the purpose of the definitions reflected in the table and not in the rest of the document where it can play a role as an important asset in most businesses.

<b>Table 2: SMME definition by industry (selected) in South Africa</b>				
Sector or sub sector	Size/Class	Employees (less than)	Annual turnover limit in R million	Gross assets (excl. fixed property in R million)
Agriculture	Medium	100	4	4
	Small	50	2	2
	Very small	10	0.4	0.4
	Micro	5	0.15	0.1
Manufacturing	Medium	100	40	15
	Small	50	10	3.7
	Very small	10	4	1.5
	Micro	5	0.15	0.1
Construction	Medium	100	20	4
	Small	50	5	1
	Very small	10	2	0.4
	Micro	5	0.15	0.1
Retail and motor industry	Medium	100	30	5
	Small	50	15	2.5
	Very small	10	3	0.5
	Micro	5	0.15	0.1
Catering, accommodation and other trade	Medium	100	10	2
	Small	50	5	1
	Very small	10	1	0.2
	Micro	5	0.15	0.1
Transport, storage and communication	Medium	100	20	5
	Small	50	10	2.5
	Very small	10	2	0.5
	Micro	5	0.15	0.1
Finance and business services	Medium	100	20	4
	Small	50	10	2
	Very small	10	2	0.4
	Micro	5	0.15	0.1

Source: Adapted from The Small Business Act of 1996.

## 2. Context, number and financing of SMMEs in South Africa

South Africa has never executed a baseline survey of SMMEs, such as the classical USAID-funded Growth and Equity through Microenterprise Investments and Institutions (GEMINI) type surveys, executed in many countries of the world.<sup>3</sup> Thus, we have to rely on estimates and aggregations of sample surveys, to obtain a profile of SMMEs. The number of SMMEs in the country is therefore often underestimated for two reasons. Firstly, we tend to

<sup>3</sup> The GEMINI project (1989-1995) carried out more than 100 applied research, design, and implementation activities in 60 countries, including 5 long-term projects.

ignore small-scale farmers as entrepreneurs and defining small-scale farmers is also difficult. It is estimated that there are approximately 2.1 million small farmers in South Africa (ESKOM, 1998). Secondly, the official unemployment figure is about 30 percent, although an unofficial unemployment figure of about 40 percent is sometimes quoted. There is no reasonably accurate indication of the number of people who are self-employed. In the next table we provide an estimation of the number of SMMEs in South Africa.

<b>Table 3: Estimated number of SMMEs in South Africa in 1998 and 1999</b>			
	<b>1998</b>	<b>1999</b>	<b>Percentage change</b>
Formal private	349,720	357,780	2.3
Public service	83,430	88,100	5.5
<b>TOTAL FORMAL</b>	<b>433,150</b>	<b>445,880</b>	<b>2.9</b>
Informal micro enterprises	1,762,720	1,823,320	3.4
<b>TOTAL INFORMAL</b>	<b>1,762,720</b>	<b>1,823,320</b>	<b>3.4</b>
<b>GRAND TOTAL</b>	<b>2,195,870</b>	<b>2,269,200</b>	<b>3.3</b>

Source: Standard Bank 2000

The estimate reflected in Table 3 is very conservative. A further observation is that the growth in the number of SMMEs in South Africa is linked to two aspects. Firstly, the increase in unemployment will increase the number of survivalist<sup>4</sup> SMMEs and, secondly, overall economic growth should stimulate the growth of SMMEs, which are non-survivalist in nature. The latter aspect could be reflected by the growth in formal private SMMEs, while the growth in survivalist SMMEs could be reflected by the growth in the total informal SMME growth in the Table 3.

SMMEs in South Africa are faced with many difficulties inherent in operating in South Africa. Among these is the dual nature of the economy, where SMMEs often have to compete with established multi-national giants in the same sector. Although this is true for most settings, in South Africa most sectors are extremely concentrated around a few large firms. SMMEs

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<sup>4</sup> Survivalist refers to that category of SMMEs whose owners started SMMEs as they could not keep or acquire employment in the wage economy. The number of survivalist enterprises therefore fluctuates depending on the ability of the economy to provide wage and salary employment. Most survivalist SMMEs are disbanded or closed when the owner finds employment.

therefore face two obstacles during formation, first the normal range of obstacles in terms of registration and capitalisation and secondly entering highly competitive markets. Below are additional constraints facing SMMEs, most are structural in nature:

- ❑ The South African economy has been undergoing significant structural changes towards a more service-orientated economy. Consequently, South Africa is experiencing a labour surplus, as the existing labour pool is predominately oriented towards primary production. The labour surplus is exacerbated by the previous substandard apartheid policies with respect to education and training (Strauss, 2001).
- ❑ Large enterprises as they restructure, have focused on the recruitment skilled rather than unskilled workers, exacerbating the unemployment levels of low skill workers.
- ❑ Years of restrictions and control of access to entrepreneurial opportunities (during Apartheid) created a mindset focused on wage and salaried work rather than the establishment of small businesses and entrepreneurs.
- ❑ The lack of education and exposure to management experience further impacts upon the management skills of entrepreneurs.
- ❑ Financiers are used to working with larger borrowers and thus lack the capacity to lend to smaller clients such as SMMEs.
- ❑ The legislative framework in South Africa needs an overhaul to ensure that adequate finance flow to SMMEs. For example, the interest rate ceiling imposed by the Usury Act could restrict access to finance for entrepreneurs.

### **3. Typical capitalisation of start-up SMMEs in South Africa**

Most SMMEs in South Africa are started with own savings and loan capital. This is reflected in the range of tables in this section. This is not a unique South African phenomenon and is also reflected in international experience. We begin this section by reflecting on some unique features of the South African microfinance industry, the level of commercialisation, and the vast emphasis on consumer finance. In Table 4 we reflect the current size of the microfinance industry, estimated in terms of current advances (as at end of 2000). We define

microfinance transactions as financial services to poor people that are under R10 000 (US\$ 833)<sup>5</sup> per transaction.

<b>Retail institutions</b>	<b>Current Advances R million</b>	<b>Savings R million</b>	<b>Number of outlets</b>	<b>Number of loan accounts</b>	<b>Number of savings accounts</b>
Public sector	205	1,774	2,434	63,028	2,650,000
Private sector	14,259	4,703	9,427	4,497,766	4,711,114
Informal sector	400	1,760	1,150,000		14,750,000
<b>Total in Rand</b>	<b>14,864</b>	<b>8,237</b>	<b>1,161,861</b>	<b>4,560,794</b>	<b>22,111,114</b>
<b>Total in USD</b>	<b>1,239</b>	<b>686</b>			

Source: Coetzee and Grant, 2001  
1 USD = R12.00

The private sector financed portion of the sector is approximately 95 percent of the total sector. The component that goes for enterprise finance<sup>6</sup> is very difficult to calculate. If we calculate it based on the intentions or objectives of financiers, enterprise finance contributes approximately 2.3 percent of the total current advances. However, several studies indicated that there are leakages from consumer finance to enterprise finance.<sup>7</sup> These leakages to enterprise finance range from 2 to 24 percent over a selection of studies (MFRC, 2001). We used different estimates in Table 5 to calculate the portion of the total current advances that focuses on enterprise finance.

<b>Mostly for</b>	<b>Loans R million</b>	<b>Number of Outlets</b>	<b>Loan accounts</b>	<b>Average size in Rand</b>	<b>Estimated market penetration</b>
Enterprise finance	343	119	163,069	2,103	7%
Leakage at 4 %	565	373	175,909	3,212	15%
Leakage at 10 %	1,412	933	439,773		27%
Leakage at 20 %	2,824	1,866	879,545		

Leakage refers to a flow of funds from consumer finance sources to enterprise finance uses  
Source: Coetzee and Graham, 2001.

<sup>5</sup> US\$1: ZAR 12 – this rate obtained for much of 2001 but fluctuated greatly between 10 and 15 from Jan 2001 to Jan 2002

<sup>6</sup> Note that we define enterprise finance as any finance that is used in running or establishing or expanding a business. Consumer finance refers to the use of finance for household consumption. Consumer finance excludes using the finance for asset accumulation.

<sup>7</sup> MFRC, 2001; Kgowedi, 2000.

It is clear from the table that it can be as high as 27 percent, however, the essence of the argument is that SMMEs are largely self-financed and the next three tables reflect that it is largely from own savings. We studied a range of survey results that looked at urban and rural SMMEs and we could not find any indication that private equity sources (except own equity) play any significant role in the capitalisation of SMMEs.

The research studies all reflect an emphasis on savings. In the rural areas (see table 6) retrenchment packages also played a big role in 1997, specifically in the Northern Province. Further, the multiple livelihood strategy of rural households is clearly reflected in the use of other business income to finance new business ventures, and also reflected in the small proportion of farming income of total household income.

<b>Table 6: Selected results from farm household and small business surveys in two provinces (1997)</b>				
Item (in %)	Small Farmers surveys		Small business surveys	
	NP (n=150)	KZ (n=152)	NP (n=270)	KN (n=225)
Agricultural income as % of gross household income	3.4	2.8	1.0	8.5
Percentage of households who used loan finance to finance:				
• Durables/assets	4.0	9.9	14.0	16.0
• Farm inputs/other inputs	7.3	9.0	7.0	11.0
Savings at (in % of respondent households):	29.0 (60.7)	29.7 (45)	92.0	77.0
• Formal institution (average distance km) <sup>a</sup>	80.7 (0.0)	29.6 (19)	64.0	76.0
• Informal institution (average distance km) <sup>b</sup>				
Sources of finance for establishment of business by individuals:				
• Personal savings			93	73
• Retrenchment package			30	12
• Pension			17	1
• Loan from family or friends			10	5
• Loan from development corporation			6	6
• Income from other business			4	13
a. The institutions with highest use.				
b. Information not available for small business surveys				
Source: Graham and Quattara, 1996.				

The supply side analysis (reflected in table 4 and 5) and the demand side analysis (reflected in table 6, 7 and 8) indicate clearly that the capitalisation of SMMEs through loan finance is not as important as the use of savings. Further, the role of co-investors in starting SMMEs cannot be observed in any of the studies we looked at, except for a 0.2 percent contribution in KwaZulu Natal, as reflected in Table 8.

**Table 7: Source of start-up capital in clothing manufacturing SMMEs**

Source	No	Percentage
Loans from family	8	30
Loans from friends	2	7
Own savings	15	56
Partnerships	2	7

Source: Rodgerson, 2000.

Table 8 also indicates (through mere observation)<sup>8</sup>, that a difference exist between retail and services SMME capitalisation, and that of manufacturing SMMEs. In the case of manufacturing SMMEs, loans play a bigger role than with other SMMEs. This may be a reflection of the higher capital needs in setting up a manufacturing enterprise, and that the conventional sources of own capital cannot accommodate these higher requirements for start-up capital. It also reflects the situation where assets that are financed can also serve as collateral.

**Table 8: Main source of start-up capital, by sub-sector (in % of survey sample)**

Source	Retail (non-food)	Retail (food)	Manufacturing	Services	Total
No capital required	2.4	1.6	3.7	4.3	3.1
Own savings	60.6	57.6	47.8	57.7	56.3
Loans from relatives/friends	22.4	19.2	26.1	22.1	22.2
Money from ROSCA	7.9	7.1	9.0	6.7	7.6
Loan from money lender	1.8	1.1	3.0	1.2	1.7
Trade credit	0.6				0.2
Loan from bank	1.8	8.8	7.5	3.7	5.4
Government support		0.5	1.5	1.2	0.8
NGO or donor support	0.6	0.5	0.7	1.2	0.8
Co-investors				0.6	0.2
Inheritance	1.8	3.3		0.6	1.6
Insurance pay-out			0.7	0.6	0.3
	100.0	100.0	100.0	100.0	100.0

Source: Guide to the preliminary results of the ERU/BEES survey in KwaZulu-Natal, 1996

<sup>8</sup> Note that this is based on averages with out any tests for significance or confidence.

The bottom-line is that private equity plays an insignificant role in the capitalisation of micro and small businesses in South Africa. We note that there is a need to differentiate between micro and small, and medium sized enterprises as will be reflected in the next section.

## **4. The equity market in South Africa**

### **4.1 Introduction**

Venture capital is one of the oldest forms of enterprise financing around. Private investors, family and friends have for centuries been the first port of call for budding entrepreneurs. There are some outstanding examples of flourishing venture capital cultures around the world. Much of the economic activity in Silicon Valley (US), in Australia, the UK and Taiwan, Ireland and Israel was financed by venture capital and is driven by advances in technology, high entrepreneurial culture, high skill levels, access to markets and the right economic and legislative environments.

In South Africa there is increasing scope for both hi-tech and low-tech venture capital investment. In keeping with South Africa's dual economy and progressive re-integration into the global economy there is a burgeoning need (and indeed an increasing supply) of venture capital financing for high technology enterprises. Many of the companies listed on the Venture Capital Board of the Johannesburg Stock Exchange (commonly known as JSE) fall into this category. Also many unlisted companies were formed over the last few years to address the demand for venture capital in this part of the market.

At the other end of the spectrum lie the low-tech, small business sector – and the acknowledgement by both the government and the private sector that the small, medium and micro enterprise sector is where most jobs are likely to be generated in future. This is

increasingly paving the way for venture capital investment in sectors as diverse as light manufacturing and tourism to aquaculture, agri-tech and financial services. However, this area justifies closer scrutiny, as the expectation is that micro and small enterprises would not necessarily be in a position to attract venture capital. This is attended to in the next section.

## 4.2 Sourcing equity finance in South Africa

### 4.2.1 Introduction

We started with the member list of the venture capital association of South Africa and expanded it through the use of various sources.<sup>9</sup> We contacted all the institutions on the list. Through these telephonic interviews it was clear that limited sources of equity exist in South Africa for the financing of micro and small businesses. Although South Africa has quite a developed venture capital market with more than 71 organisations active (in 2000) in the private equity/venture capital market, very few of these institutions concentrate on the micro and small enterprise (MSE) finance segment. Further, only 58 of these institutions existed in 2001, with a small percentage active in the lower investment category where you would find the MSE capitalisation requirements.

<b>Table 9: Minimum investment required by number of venture capital firms in SA</b>			
<b>Investment range</b>	<b>Number of firms</b>	<b>Percentage</b>	<b>Cumulative Percentage</b>
R500 – R10 000	3	5.2	100.0
R10 001 – R100 000	1	1.7	94.8
R100 001 – R250 000	7	12.1	93.1
R250 001 – R500 000	6	10.3	81.0
R500 001 – R5 000 000	23	39.6	70.7
R5 000 001 – R10 000 000	11	19.0	31.1
R10 000 001 and more	7	12.1	12.1
Total	58	100.0	

<sup>9</sup> The list was obtained from the Venture Capital Association. We used our own information to expand it.

It is clear from the table that more than 80 percent of funds expect a minimum investment of more than R250 000 and 70 percent expects a minimum investment of R500 000 or more. On closer investigation (see next table) it is clear that medium and perhaps some small enterprises could well succeed in sourcing equity finance from these limited sources, but microentrepreneurs have at the most three formal sources of equity finance in South Africa. It must also be noted that these three sources of equity have limited capacity - one still in process of being established, one is only active in the Western Cape and the other targets rehabilitated prisoners.

Table 10 is an extract of a comprehensive information source representing private equity providers in South Africa. It is drawn from the membership list of the association. The list and the relevant information was validated, checked and expanded by contacting all the institutions by telephone. In table 10 it can be seen that the SA government indirectly supports four of the nine funds listed.

<b>Table 10: Detail on venture capital funds that require R200 000 and lower minimum investments</b>								
Organisation	Fund Name or type	Min Invest. In R	Max Invest. In Rand	Start-ups	Min eq taken	Max equity	Excluded industries	Preferred industries
Nations Trust	Start-up equity	500	35,000	Yes			Agriculture, Alcohol	Enterprise
NICRO	Start-up equity	750	6,000	Yes			Agriculture, Alcohol	Enterprise
SME Investments Fund	Equity	10,000	300,000	No	20%	49%	Unknown	Unknown
Business Partners	South fund	150,000	15,000,000	Yes	10%	49%	Agriculture, mining, on lending	None
Business Partners	East fund	150,000	15,000,000	Yes	10%	49%	Agriculture, mining, on lending	None
Business Partners	Central fund	150,000	15,000,000	Yes	10%	49%	Agriculture, mining, on lending	None
Business Partners	West fund	150,000	15,000,000	Yes	10%	49%	Agriculture, mining, on lending	None
Catalyst Innovation Incubator		200,000	2,000,000	Yes	20%	49%	All except life sciences and engineering	Life sciences and engineering
Viking Investments and Asset Management	Priv Eq, Ven Cap	200,000	2,000,000	Yes	20%	80%	Agriculture	IT

### 4.2.3 The Johannesburg Stock Exchange (JSE)

Another possible source of finance for medium sized enterprises is through the JSE, which created a Development Capital Market (DCM) in 1984 and a Venture Capital Market (VCM) in 1989. The aim of the DCM was to provide growing companies with an opportunity to raise capital by listing on the stock market. This endeavour has not been successful in providing seed and start-up capital to enterprises, especially not SMEs. This situation will be further aggravated with a proposed merger of the two instruments (the DCM and the VCM), as the minimum investment will then amount to R2 million per business. This is clearly outside the reach of most SMEs.

#### 4.2.4 The financial institutions

Leading equity funds include those established by merchant banks and investment companies (who generally requires upward of 30% return on investment (ROI)). For instance, the World Bank Group's International Finance Corporation (requires 20% ROI in USD terms), and the Industrial Development Corporation and Business Partners (previously the Small Business Development Corporation) that both require 15% ROI.

A recent study (KPMG, 2001) of the South African private equity industry calculated the size of the industry to be R33.1 billion (US\$ 2,76 billion) with a growth rates at times as fast as R1.6 billion (US\$ 133 million) in a single year. The majority of this funding is for later stage expansion (61%) and buy-outs/replacement capital (33%), with only about 6.1% available for start-ups and early stage investing. There are about 14 funds in South Africa with a specific Black economic empowerment ("BEE") focus, representing some R9 billion. However this figure overstates the volume of finance available to SMME empowerment projects, which are estimated realistically at only between around R500 million and R700 million. It is further estimated that the shortfall of the equity requirement for early stage investing (i.e. not currently available from the Private equity/Venture capital industry) could amount to about R1.4 billion (EU, 2001).

The South African venture capital industry is tiny in comparison with that of the United States, but larger than those of many European countries including Sweden and the Netherlands. In terms of size relative to GDP, South Africa's private equity industry is more significant than most of Europe's, but still some way off Israel's (SA 4.2 % vs. Israel at 12.1 % of GDP).

In the USA the retirement funding industry has proved to be the single largest contributor to the private equity market. In the UK, as in South Africa, institutional investors have generally been reluctant to invest into private equity. This is mainly due to the risk, the

long time horizons before investments realise high returns and the fact that returns are hard to measure.

Yet in South Africa, the banks are the largest investors in the private equity market. Their investment is through the private equity funds, in buy-outs and expansions (75%), Seed Capital (10%) and Start-up and “Early Stage” funding (15%). Not surprisingly, these same financiers (i.e. banks) that are not interested in investing in SMEs through loans do not make equity investments in SMEs.

#### **4.2.5 Social investment funds in South Africa<sup>10</sup>**

This section deals with the funds created by firms as part of their social responsibility programs. Support is provided to firms whose products and services are deemed socially desirable but who ordinarily would struggle to find investors. This is a small market in South Africa in terms of support through the provision of equity. One of the best known funds are the Land Reform Credit Facility which, however, provides wholesale loan funds to commercial financiers to on-lend to land reform beneficiaries who participate in share equity or similar transactions. The SME Investment Fund (referred to in Table 10) is a joint venture between an NGO and First National Bank (FNB) with the aim of providing equity to SMMEs who are business linkages (i.e. suppliers) partners with larger firms.

#### **4.2.6 Informal equity finance**

This is one of the most common sources of equity finance. This finance normally comes from friends, neighbors or family members who have knowledge of the SME and wish to have a stake in it. It is a common source of equity finance because there is often a relationship of trust between the contracting parties and because the investor tends to have knowledge of SME they

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<sup>10</sup> Information to complete this section is still outstanding.

are investing in. Both these factors reduce transaction costs. We did not find any direct reference to this type of equity finance in the literature that we studied. However, table 6, 7 and 8 indicate a large presence of family and friends in providing loan finance to assist with the establishment of SMEs. Although it is entirely possible that many of these transactions could have been in the form of private equity rather than loan finance, we could not verify it. The possibility is based on the work of Rodgerson (2000) who provided case studies of SMMEs in the clothing sector in Johannesburg where family members did support these entrepreneurs with private equity in some cases.

## 5. Is there an equity gap for South African SMMEs?

### 5.1 Answering the question

It is clear from the previous sections that the majority of SMMEs are self-financed in South Africa. As shown in the previous section an equity gap does exist and it is especially the Micro and Small enterprises that find it difficult to obtain equity investments. Standard investments by equity funds in South Africa range from R500 000 (US\$ 41,600) upwards. This means essentially that these institutions invest mainly in medium sized and larger enterprises, as the investment requirements of small and microenterprises are much smaller. In Table 11 the average minimum and maximum investments in the private equity markets (15 and 40 percent respectively) were applied to the average asset value of the range of definitions for SMMEs to calculate an indicative minimum and maximum investment for the different sizes of enterprises.

<b>Table 11: Indicative sizes of minimum and maximum equity investments for the official definitions of enterprise sizes</b>		
<b>Enterprise size</b>	<b>Average minimum investment in Rm</b>	<b>Average maximum investment in Rm</b>
Medium	0.836	2.229
Small	0.315	0.840
Very small	0.084	0.223
Micro	0.015	0.040

It is clear from the table that the majority of existing equity providers will not be interested in Micro and very small enterprises, and will only be interested in the larger small enterprises where the average maximum investment of R840 000 (US\$70 000) is higher than the minimum investment of R500 000 (US\$41 700), favoured by the equity financiers in South Africa.

## 5.2 The causes of the equity gap

Colin Mayer (1992) provides a comprehensive discussion of the different methods of sourcing finance to invest in the expansion or establishment of non-financial institutions. He based his work on the trends over several years to 1985 in the countries as indicated in Table 12.

Table 12: Average gross funding of non-financial enterprises in selected countries								
	Canada	Finland	France	Germany	Italy	Japan	UK	USA
Retentions	54.2	42.1	44.1	55.2	38.5	33.7	72.0	66.9
Capital transfers	0.0	0.1	1.4	6.7	5.7	0.0	2.9	0.0
Loans	12.8	27.2	41.5	21.1	38.6	40.7	21.4	23.1
Trade Credit	8.6	17.2	4.7	2.2	0.0	18.3	2.8	8.4
Short term securities	1.4	2.5	0.0	0.0	0.1	na	2.3	1.4
Bonds	6.1	1.8	2.3	0.7	2.4	3.1	0.8	9.7
Shares	11.9	5.6	10.6	2.1	10.8	3.5	4.9	0.8
Other	4.1	6.9	0.0	11.9	1.6	0.7	2.2	-6.1
Stat adjust	0.8	-3.5	-4.7	0.0	2.3	na	9.4	-4.1

Source: Mayer, C. (1992). Financial systems, Corporate Finance, and economic development.

It is clear that the equity market (in this case the private and public) plays a small role in most countries' new investments. In general Mayer (1992) made the following observations:

- ❑ Retention of earnings is the dominant source of investment in all countries. In the next section we will try and argue why, however, this is a worldwide phenomena and in all sizes enterprises.
- ❑ Banks are the dominant source of external finance for the larger enterprises.
- ❑ Small and medium sized firms are more reliant on external sources than larger firms.

How do we explain the choices of firms in accessing finance to do investments? Five theories (not all of which are mutually exclusive) are discussed to explain these financing patterns. We summarise the work of Mayer (1992):

- Irrelevance - the argument is that there is no relationship between the choice of financial sources for investment and the firm's existing capital structure, i.e. the Modigliani Miller proposition, in the presence of perfect and complete capital markets, and in the absence of taxation, the cost of capital are independent of the firm's capital structure. We know that the strong assumptions on which this theory rests do not hold in real life.
- Transaction costs: the level of transaction costs in a specific market will influence the choice of financial instruments. The immediate implication is that retentions will be preferred above external finance. However, in the UK and the US where efficient financial systems exist they still have the lowest external financing. It may be then due to low demand for external finance, but then the equity markets in UK and US are also the most developed and trade the highest volumes!
- Taxation:- Most countries in study favoured debt finance above equity, however, we could find no correlations between those instruments favoured in tax legislation and those favoured and applied in specific countries.
- Information theories claim that the existence of asymmetric information in financial markets would influence the decision making pattern of the institutions. Indeed this is confirmed through casual observation that information theories are consistent with the findings by Mayer (1992). The question then is, why would countries like Japan and Italy favour bank loans above retentions, it seems that there are aspects of relationships between institutions and firms that information theories fail to capture.

Control theories: Based on the previous argument (asymmetric information) principal-agent problems arise where we find a lack of information, but principal agent problems can also arise due to the lack of enforcement of contracts or due to a lack of monitoring. In the absence of complete contracts, the allocation of control over deployment of assets matter. Here the control theory relies on the managerial ability of creditors, the nature of assets, cost of co-

ordinating creditors. It seems that control theories may be a relevant reason for the observed capital structure in these countries. In no country do security markets contribute a large proportion of corporate sector financing – why not? Neither transaction costs arguments, nor taxation rules explain this phenomenon. One interpretation for the important role of bank finance is the banks role in decreasing information costs (Levine, 1992). This is quite true, but not an adequate explanation since other institutions can also play this information role and banks differ markedly between countries. It therefore seems as if control theories are the nearest to explain differences in capital structures of firms where control refers to the control of firms through the application of property rights (ownership), or the control of creditors, especially where the foreign capital component is relatively high.

How do we relate this to SMMEs? Firstly, Mayer observed that smaller firms made more use of bank finance than retentions or private equity, which is consistent with our general findings. Secondly, many SMMEs are sole ownership firms, which means that the use of private equity will imply a weakening of ownership, thus losing control and the ability to make unchallenged decisions in the firm. Often SMMEs are so integrated with household consumption and income patterns that it is virtually impossible to separate household and business, indeed a separation crucial to the mobilisation of equity stakes in businesses. This raises a further point, the ability of institutions to provide information on which investment decisions can be made and the general availability of information on SMMEs. A lack of adequate information in any market is a serious constraint for the efficient functioning of the market.

Factors that negatively influence the ability to accumulate assets are a lack of schooling, gender and age, people retrenched from their salary or wage employment and lack of business experience (Heino & Pagan, 2001). All these factors correlate strongly with the use or lack of outside capital to start a business. But this is also the catch, as access to outside capital is negatively influenced by many of the mentioned variables (i.e. lack of business experience). When we look at sectoral differences, it is clear that the obstacles to entry in the trading sector

are less than for the manufacturing sector. This is a logical differentiation due to the limited demand for funds to obtain entry into trading activities vs. manufacturing activities. In the final analysis Heino and Pagan (2001) remark that 67 percent of microenterprises use personal savings when establishing their businesses. The findings of the Mexican study are very similar with several South African studies.

Most venture capital funds will require the presence of the following basic elements in an investment opportunity:

- ❑ Appropriate entry or acquisition price for the particular fund;
- ❑ The potential of the business to meet the required ROI;
- ❑ Proven committed management;
- ❑ Sustainable market position; and
- ❑ Downside risk limited or hedged.

Other constraints are the lack of management skills, the lack of an “entrepreneurial spirit”, higher levels of risk and transactions costs, inability of SMMEs to engage profitable in high return sectors (IT, services, etc) (Abedian, 2000).

## **6. Remedies?**

The South African financial market is highly developed and is slowly turning its focus inwards to clients hitherto ignored. An example is the reaction of commercial banks that are now prime players in the microfinance market, however, mostly indirectly through investments in specialised microfinance institutions. Several motivations moved the banks in this direction. Firstly, international competition for the prime upmarket corporate clients forced the commercial banks to re-appraise the mass retail market. Secondly, the presence of a new regulator, the Microfinance Regulatory Council in the microfinance sector brought more

credibility and stability to a market that suffered from exploitation of clients and bad press. Thirdly, the initial experiments based on social responsibility motivations led to losses in this market, a perception change is now evident due to the high profit margins of consumer finance institutions.

Thus the banks are turning their attention more and more to this sector. This is however a slow process and therefore we need to evaluate the situation and look for more opportunities to improve the capitalisation of SMMEs in South Africa. At the same time we have to look for areas where constraints can be alleviated. The following are of importance:

- The DCM and VCM sections of the JSE are not the appropriate instruments to apply in the financing of SMEs. Thus either the instrument must be changed or we should create a new instrument. In addition, the control of the JSE and markets where the JSE have instruments is quite strict, and correctly so. The JSE is the biggest stock market in Africa and any perceived increase of risk by role-players may taint the reputation of the JSE. The question should be asked whether another instrument, for example, an instrument run on the lines of the DCM and the VCM, but not necessarily part of the JSE could be the answer.
- The experience of the banks' involvement in the microfinance industry should also serve as a lesson. They only entered this market after certain structural changes took place and they witnessed the profitability of microlenders. What structural changes are needed in the private equity market? We need some success stories of institutions willing to experiment and show results, on which the banks could then capitalise. Unless the banks and the bigger institutional investors are pulled into this market, the private equity market in SA for SME capitalisation will not emerge.
- The lesson is to build on current experience. A few firms in South Africa are very successful in linking SMMEs and larger firms into viable contracts as part of a black empowerment drive. Some firms (like ECI) have succeeded in facilitating contracts worth millions of dollars over the last two years. Part of their approach is to do due diligence investigations and assist with technical and capacity building support. This means that information already exists on firms that would be good investments. This is an example of how

the information problem for possible investors can be solved or at least decreased. This is exactly the assumption underlying the SME Investment fund, a recent joint venture between an NGO institution and a commercial bank (FNB). Thus the commercial banks are already indicating quite strongly that they are interested!

□ Lastly, healthy clients make healthy financial institutions. The average SMME in South Africa is a struggling entity due to some inherent problems (as highlighted earlier). The role of support institutions should be to alleviate the capacity constraints in SMMEs. Equity investors therefore need to be able to identify the promising ventures and need to be able to assess the risk and the potential. This is an area where the current experience of linkage firms can be mobilised (the point we make above). However, we want to emphasise the non-financial business development support services to SMEs as an important ingredient of a healthy SME sector.

What external support would improve the situation? Here we suggest the following. We have to solve the information gap, and ensure that smaller investments are possible without the effect of increased transaction costs of small investments impacting negatively on the volume in the market.

□ This means that we should focus on those areas where more information is available first. Some of these areas include the firms working with SMMEs and facilitating transactions and market opportunities. Another approach here could be to identify the most viable sectors first and in this way target the most promising investments first.

□ Secondly, we should identify how information constraints can be alleviated over the longer term.

□ Third, we should identify opportunities and support the formation of funds that are willing and looking to make smaller minimum investments. Larger funds with higher minimum investments can then invest in the smaller funds. It will also help to identify and mix the capital in the smaller fund with those of social investors (like a public private sector partnership approach).

## 7. Summary and conclusions

Funding of start-up or expansion of SMMEs in South Africa is largely from entrepreneur's own sources, or in a limited way from family investments and / or loans. Although South Africa has quite a developed venture capital market with more than 71 organisations active (2000) in the private equity/venture capital market, very few of these institutions concentrate on the micro and small enterprise finance segment. Further in 2001 only 58 such institutions exist, with a small percentage active in the lower investment category where you would find the SMME capitalisation requirements. In terms of minimum investment 3 in the R500 to R10000 range; 1 in the R10001 to the R 100 000 range; 7 in the R100 001 to the R250000 range; 6 in the R250001 to he R500000 range; 23 in the R500 0001 to the R5 million range, and the rest above R5 million.

Venture capital financiers normally set the following requirements before investing:

- ❑ Appropriate entry or acquisition price for the particular fund;
- ❑ A proven market exists for the products or services of the business to be financed;
- ❑ The potential of the business to meet the required ROI;
- ❑ Proven committed management;
- ❑ Sustainable market position; and
- ❑ Downside risk limited or hedged.

The inherent risk in SMMEs in South Africa is quite high as illustrated by the high failure rate noted by Abedian (2001). A recent overview of the SMME market indicates a lack of an entrepreneurial culture in South Africa and a severe shortage of management skills. This is in line with the phenomena that the highest unemployment rate in South Africa is in the area of unskilled workers. South Africa as a country has been experiencing a structural shift in the economy to a more service orientated structure. This structural shift has created unemployment,

especially unemployment of less skilled workers. The lack of skills in the South African economy is partly a result of the legacy of Apartheid education.

A possible source of venture finance for medium sized enterprises is through the JSE, which created the DCM in 1984 and the VCM in 1989. The aim of the DCM was to provide growing companies with an opportunity to raise capital by listing on the stock market. This endeavour has not been successful in providing seed and start-up capital to enterprises, especially not small enterprises. This situation for SMMEs will be further aggravated with a proposed merger of the two instruments (the DCM and the VCM), as the minimum investment will then amount to R2 million per business. This is clearly outside the reach of micro and small businesses.

Recently South Africa has witnessed an expansion funds and plans to develop potential funds to provide equity for SMME. These funds (or potential funds) could solve the constraints mentioned above by firstly concentrating on expansions rather than start-ups and secondly by working with institutions that specialise in business linkages.

Immediate actions to assist in improving the use of private equity should include:

- ❑ Focus on those areas where more information is available first. Some of these areas include the firms working with SMMES and facilitating transactions and market opportunities.
- ❑ Identify how information constraints can be alleviated over the longer term.
- ❑ Identify opportunities and support the formation of funds that are willing to make smaller minimum investments.

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